THE EFFECT OF FOREIGN OWNERSHIP ON THE PROFITABILITY OF COMMERCIAL BANKS LISTED AT THE NAIROBI SECURITIES EXCHANGE

BY

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DECLARATION

This research project is my original work and has not been submitted for examination in any other University.

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

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DEDICATION

This work is dedicated to my family

ABSTRACT

Studies all over the world have over the years indicated that foreign banks outperform domestic banks. Several other studied have tackled the question of why this is so and a number of theories have been developed to explain the same. The debate on what are the determinants of bank profitability is however still alive. The banking industry in Kenya has grown over the years since the Central Bank of Kenya put up measures to regulate the banks in order to streamline the activities and more so to prevent the collapse of the banking industry as had been before. This study analysed profitability of foreign and domestic banks listed on the NSE. The study sought to: determine whether there are any differences between the profitability of foreign and local banks listed at the NSE; examine the determinants of profitability of foreign and local banks listed at the NSE.

This was a correlational study. The population was listed banks at the NSE and therefore the sample was restricted to the nine commercial banks listed. Three of them were foreign banks while the rest were domestic banks. Secondary data was collected from the 2011 Banking Survey handbook. The CAMEL model was adopted to test the determinants of bank profitability. Data was analysed using descriptive analysis, One-Way ANOVA, correlation analysis, and regression analysis. The SPSS aided in the analysis. The results were presented in tables.

The study found that there were no statistically significant differences between the performance of foreign and domestic listed banks. The regression result also showed that foreign ownership did not affect bank profitability. The study also revealed that none of the variables had a significant influence on ROA or ROE ($p > 0.05$). The study concludes

that listed foreign banks in Kenya do not outperform the domestic listed banks. The study also found out that the CAMEL model is not a good predictor of the determinants of profitability of listed commercial banks in Kenya. The study recommends that there is need for the Central Bank of Kenya to rethink its use of the CAMEL model to gauge performance of banks. The study also recommends that commercial banks should reduce the capital adequacy ratio as it was way beyond the 8% recommended by the CBK.

TABLE OF CONTENTS

LIST OF TABLES

ABBREVIATIONS

CAMEL   Capital adequacy, Asset quality, Management efficiency, Earnings performance and Liquidity

CBK   Central Bank of Kenya

IMF   International Monetary Fund

NSE   Nairobi Securities Exchange

OECD   Organisation for Economic Cooperation and Development

ROA   Return on Assets

SPSS   Statistical Package for the Social Sciences

UAE   United Arabs Emirates

USA   United States of America

CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

The Banking sector acts as the life blood of modern trade and commerce because the sector is to the major source of finance. This increasing phenomenon of globalization has made the concept of efficiency more important both for the non-financial and financial institutions and banks are the part of them. Banks largely depend on competitive marketing strategy that determines their success and growth. The modalities of the banking business have changed a lot in the new millennium compared to the way they used to be in the years bygone. Bank efficiency is a multi-dimensional concept. The efficiency of financial service firms and the approach being followed by them is largely mused in the information condensed in their financial statements (Hussain and Bhatti, 2010).

The presence of foreign banks in a domestic financial landscape has positive as well as negative implications, particularly for a developing economy. On one side of the argument, foreign banks' presence contributes positively in the development of a strong and stable domestic banking industry. The comparatively more efficient foreign banks which adopt cutting-edge technology in their banking services create competitive pressure on the domestic banks, resulting in positive spill-over effects on the banking industry in general (Berger, DeYoung, Genay and Udell, 2001).

Commercial banks are the foundation of the payment system in many economies by playing an intermediary role between savers and borrowers. They further enhance the financial system by ensuring that financial institutions are stable and are able to effectively facilitate financial transactions. In Kenya, commercial banks play an important role in mobilizing financial resources for investment by extending credit to various businesses and investors. Lending represents the heart of the banking industry and loans are the dominant assets as they generate the largest share of operating income.

The ratio of a bank's profits to its total assets reflects the overall profitability outcome of the bank. Foreign banks entry is usually expected to have a positive effect on the competition in the banking market and therefore it is expected to have a negative effect on banks' profitability. Several authors have found that foreign banks entry reduces the profits of the domestic banking sector (Claessens et al., 2001).

1.1.1 Profitability in Commercial Banks

The stability of the banking sector as a whole is conditional upon the overall stability of the economic environment in applying the basic principles of a market economy and the principles of managing a modern democratic society. A stable macro-economic environment contributes to the effective growth of savings, sound investment decisions and consequently also to economic growth. Appropriate macroeconomic policy should support the correct functioning of the banking sector mainly in the areas of financial stabilisation, transparent fiscal policy and monetary policy support. An important role in ensuring banks' stability at the macro- and micro-level is played by the central bank,

2

which through monetary policy and the application of suitable monetary instrument parameters can positively influence the banking sector's stability (Kithinji, 2010).

Commercial banks appear very profitable in Sub-Saharan Africa. Average returns on assets were about 2 percent over the last 10 years, significantly higher than bank returns in other parts of the world. This picture holds true whether returns on assets are assessed by country, by country income group, or by individual banks. An alternative measure of profitability, net interest margins, provides a similar picture (Flamini, McDonald and Schumacher, 2009).

To identify the relevant factors influencing commercial bank profitability, the CAMEL framework is normally used by researchers. CAMEL is a widely used framework for evaluating bank performance. The Central Bank of Kenya also uses the same to evaluate the performance of commercial banks in Kenya (Olweny & Shipho, 2011). CAMEL stands for Capital adequacy, Asset quality, Management efficiency, Earnings performance and Liquidity. The system was developed by the US Federal Deposit Insurance Corporation (FDIC) for early identification of problems in banks operations (Uzhegova, 2010). Though some alternative bank performance evaluation models have been proposed, the CAMEL framework is the most widely used model and it is recommended by Basel Committee on Bank Supervision and IMF (Baral, 2005). Ownership structure is chosen because the ownership structure of banks in Kenya has somewhat changed over last decade. More foreign banks have expanded their operations in the country thus changing the structure of the banking industry.

1.1.2 Foreign Ownership and Profitability

Ownership refers to the person or institution with control of a firm. In this study, foreign or local ownership will be defined by how the Central Bank of Kenya (CBK) defines banks by ownership. The CBK website has banks categorized as being either foreign or locally owned. A bank is defined as a foreign bank when the control of the bank is by the foreign investors (CBK, 2012). A most comprehensive empirical survey about foreign banks entry was carried out by Claessens et al. (2001) who investigated the relationship between foreign banks entry and the performance of the domestic banking sector in 80 countries. They used panel estimations with 7,900 bank observations for 1988-1995. The main result of the study was that foreign banks tend to have higher profits than domestic banks in the developing countries, while in developed countries foreign banks are less profitable than domestic banks. Their results also indicated that higher foreign bank presence is related with lower profitability, costs and margins of domestic banks.

Claessens, Demirguc-Kunt, and Huizinga (1998) examine the effects of foreign bank entry on the domestic banking sector. They show that in developing countries foreign banks tend to have greater profits, higher interest margins, and higher tax payments compared to domestic banks. But the opposite is true in developed countries. Another interesting conclusion is that both profitability and overhead expenses of domestic banks fall with foreign bank entry.

Demirguc-Kunt and Huizinga (1999) present similar results. They show that foreign banks have generally higher profits and margins compared to domestic banks in developing countries, while the opposite is true in industrial countries. Demirguc-Kunt, Levine, and Min (1998) show that foreign bank participation lowers the possibility that a country will experience a banking crisis. They indicate that the presence of foreign banks lowers overhead costs and profits of domestic banks. Foreign banks also increase overall economic growth by raising the efficiency of domestic banks.

The entrance of foreign banks may improve the quality and availability of financial services in the host market by increasing competition, enabling a better application of modern banking skills and technologies, encourage the development of the bank supervision and legal framework, and enhance a country's access to international capital markets. Claessens et al. (2001) argue that while foreign banks have lower overhead expenses, profitability and interest margins than domestic banks in developed countries, the opposite is true in developing ones. Besides, they found that the increased presence of foreign banks is associated with reductions of profitability, non-interest income and overall expenses of domestic banks and competitive pressure from foreign banks lead to positive efficiency effects at domestic banks. Lensink and Hermes (2004) also claim that the entrance of foreign banks motivates domestic banks to enhance their efficiency and increase the diversity and quality of financial services in order to retain their market share. In addition, foreign banks entry is associated with falling costs, profits and interest margins of domestic banks.

1.1.3 Commercial Banks in Kenya

According to the Central Bank of Kenya, there are 43 licensed commercial banks in Kenya. Three of the banks are public financial institutions with majority shareholding being the Government and state corporations. The rest are private financial institutions. Of the private banks, 27 are local commercial banks while 13 are foreign commercial banks. Of these banks, 9 are listed at the NSE (see list in appendix 1)

Commercial banks in Kenya play a major role in Kenya. They contribute to economic growth of the country by making funds available for investors to borrow as well as financial deepening in the country. Commercial banks therefore have a key role in the financial sector and to the whole economy. In this study, the listed banks are used because of the availability of information on their performance through their annual reports which are available freely to the public.

Bank financial performance in the recent past has significantly improved since 2000. Data from the Central Bank of Kenya shows a significant growth in the industry in all areas including financial performance. While this is the case, some banks, especially the foreign banks, have been performing better than others. The factors leading to this needs an investigation as has been the focus of many studies in other countries such as China, Nigeria, Singapore, UAE, UK, USA, among others.

1.2   Research Problem

It is important to analyze foreign bank performance, what determines it and how it differs from domestic bank performance. The different structure and characteristics of foreign and domestic banks on one hand, and the different influence of external factors on these banks on the other could lead to performance differences between the two categories. Empirical analysis of foreign and domestic bank performance will illustrate if the two groups of banks perform differently and the reasons behind the difference. This may help clarify the necessary conditions for successful entry of multinational banks to foreign markets, and on the other hand, could assist in developing a regulatory framework for foreign bank entry and expansion (Elyor, 2009).

The banking industry in Kenya has grown over the years since the Central Bank of Kenya put up measures to regulate the banks in order to streamline the activities and more so to prevent the collapse of the banking industry as had been before. Banks expand internationally by establishing subsidiaries and branches or taking over establishing foreign banks. This internationalization of banking systems has been encouraged by the liberalization of international financial markets (Muthungu, 2003).

A number of studies have been carried out on the impact of ownership structure on firm performance. For instance, Omindi (2011) studied the effect of government ownership on financial performance of firms listed at the NSE and found that government shareholding or control did not significantly affect firm performance. Ongore (2011) on the other hand found that the effect of foreign ownership had a positive and significant relationship with

7

firm performance. Studies of the relative performance of foreign versus domestic focusing on developing countries include Muthungu (2003) who carried out an evaluation of financial performance of commercial banks in Kenya. The study concluded that foreign banks outperformed local banks. Reasons for this have also been an interesting area of research for various scholars. For instance, Guru et al, (2002) and Sufian and Habibullah (2009) found out that liquidity, credit risk, capitalization, size and costs are some of the determinants of profitability. As it can be observed, over a period of 9 years, only one study has focused on a comparison of domestic and foreign owned banks in regard to their profitability in Kenya. In this period there has been entry of more foreign banks like First Community bank, Gulf Africa Bank and also Eco Bank. There is therefore need to undertake a study on the performance of banking industry in Kenya. This study seeks to bridge this gap in literature by performing a differential analysis of the profitability of both domestic and foreign owned Commercial banks listed by the Nairobi Securities Exchange. The study sought to answer the following questions: Are there any differences in the profitability of domestic and foreign owned banks listed at the NSE? And what are the determinants of profitability of foreign and local banks listed at the NSE?

1.3   Research Objective

The objectives of the study were:

i.   To determine whether there are any differences between the profitability of foreign and local banks listed at the NSE.

ii.   To examine the determinants of profitability of foreign and local banks listed at the NSE.

1.4   Value of the Study

The results of our study are also very important for managers of the banks as the performance of the bank can be compared to the overall banks performance. This would be a good indicator for them to understand their banks' performance against the industry. Further analysis of financial ratios could also provide a signal and be able to predict future progress of their banks' situation that enhancing the financial institution efficiency and stability of the Kenyan financial structure.

This study will also guide policy makers in the banking sector especially the Central Bank of Kenya and the Treasury in coming up with policies which will spur growth and profitability in this sector.

Researchers and academicians in the field of finance and banking will find this study a useful guide for carrying out further studies in the area.

CHAPTER TWO

LITERATURE REVIEW

2.1   Introduction

This chapter presents the literature review on the profitability of commercial banks. First it reviews the theories and models of bank profitability. Then it summarizes the information from other researchers who have carried out their research in the same field of study.

2.2   Theoretical Literature

Studies on the performance of banks started in the late 1980s/early 1990s with the application of two industrial organizations models: the Market Power (MP) and Efficiency Structure (ES) theories (Athanasoglou et al, 2006). The balanced portfolio theory has also added greater insight in to the study of bank profitability (Nzongang and Atemnkeng, 2006). An additional theory, the limited global advantage theory, is also reviewed as it is more focused on why foreign banks outperform local banks. These theories are explained below.

2.2.1 The Market Power (MP) Theory

Applied in banking the MP hypothesis posits that the performance of bank is influenced by the market structure of the industry. There are two distinct approaches within the MP theory; the Structure-Conduct-Performance (SCP) and the Relative Market Power hypothesis (RMP). According to the SCP approach, the level of concentration in the banking market gives rise to potential market power by banks, which may raise their

10

profitability. Banks in more concentrated markets are most likely to make 'abnormal profits' by their ability to lower deposits rates and to charge higher loan rates as a results of collusive (explicit or tacit) or monopolistic reasons, than firms operating in less concentrated markets, irrespective of their efficiency (Tregenna, 2009). Unlike the SCP, the RMP hypothesis posits that bank profitability is influenced by market share. It assumes that only large banks with differentiated products can influence prices and increase profits. They are able to exercise market power and earn non-competitive profits.

2.2.2 Efficient Structure (ES) Theory

The ES hypothesis, on the other hand posits that banks earn high profits because they are more efficient than others. There are also two distinct approaches within the ES; the X-efficiency and Scale–efficiency hypothesis. According to the X-efficiency approach, more efficient firms are more profitable because of their lower costs. Such firms tend to gain larger market shares, which may manifest in higher levels on market concentration, but without any causal relationship from concentration to profitability (Athanasoglou et al, 2006). The scale approach emphasizes economies of scale rather than differences in management or production technology. Larger firms can obtain lower unit cost and higher profits through economies of scale. This enables large firms to acquire market shares, which may manifest in higher concentration and then profitability.

2.2.3 Balanced Portfolio Theory

The portfolio theory approach is the most relevant and plays an important role in bank performance studies (Nzongang and Atemnkeng, 2006). According to the Portfolio

balance model of asset diversification, the optimum holding of each asset in a wealth holders portfolio is a function of policy decisions determined by a number of factors such as the vector of rates of return on all assets held in the portfolio, a vector of risks associated with the ownership of each financial assets and the size of the portfolio. It implies portfolio diversification and the desired portfolio composition of commercial banks are results of decisions taken by the bank management. Further, the ability to obtain maximum profits depends on the feasible set of assets and liabilities determined by the management and the unit costs incurred by the bank for producing each component of assets (Nzongang and Atemnkeng, 2006).

2.2.4 The Limited Global Advantage Hypothesis

This theory was first advanced by Berger, et al. (2000). The limited global advantage hypothesis argues that banks from some nations are able to overcome the diseconomies of cross-border operations due to various unspecified advantages (Sturm & Williams, 2007). From a review by Berger, et al. (2000), they concluded that efficiently managed foreign-owned institutions are able to operate more efficiently than the domestic institutions because of better operational, technological and cost control skills of foreign-owned, global banks.

As argued by Miller and Parkhe (2002), foreign firms face a number of potential competitive disadvantages in the host nation due to information asymmetries, cultural and language differences and other factors. In order to operate successfully across borders the foreign bank must possess compensating advantages. Under the limited global advantage

approach these advantages are unspecified but related to nationality. Miklaszewska &
Mikolajczyk (2009) tested this theory in Poland and found no evidence to support the
limited global advantage hypothesis.

The above theoretical analysis shows that MP theory assumes bank profitability is a
function of external market factors, while the ES and Portfolio theory largely assume that
bank performance is influence by internal efficiencies and managerial decisions. Several
models of the banking firm have been developed to deal with specific aspects of bank
behaviour but none is acceptable as descriptive of all bank behaviour. Some of these
approaches are: univariant analysis, multiple discriminant analysis, multiple regression
analysis, canonical correlations analysis and neural network method. Olugbenga and
Olankunle (1998) noted that a major limitation of the univariant analysis approach is that
it does not recognize the possibility of joint significance of financial ratios, while the
canonical correlations method precludes the explicit calculation of marginal value of
independent variables on the dependent variable. Nor can the significance of individual
explanatory factors be ascertained. They noted that multiple regression approaches
correct for these limitations and they produce comparable results to the discriminant
analysis method.

2.3   Foreign Ownership and Firm Performance

The effect of foreign ownership on firm performance has been an issue of interest to
academics and policy makers. According to Gorg and Greenaway (2004), the main
challenging question in the international business strategy is the outcome gained from

foreign ownership of firms. It is mainly accepted that foreign ownership plays a crucial role in firm performance, particularly in developing and transitional economies. Researchers (Aydin, Sayim and Yalama, 2007) have concluded that, on average, multi-national enterprises have performed better than the domestically owned firms. It is therefore, not surprising that the last two decades have witnessed increased levels of Foreign Direct Investments in the developing economies.

Two main reasons have been put forward to explain the phenomenon of high performance associated with foreign ownership of firms. The first reason is that foreign owners are more likely to have the ability to monitor managers, and give them performance-based incentives, leading the managers to manage more seriously, and avoid behaviours and activities that undermine the wealth creation motivations of the firm owners. The second reason is the transfer of new technology and globally-tested management practices to the firm, which help to enhance efficiency by reducing operating expenses and generating savings for the firm.

Ali (2005) studied the differences in profitability between domestic banks' and foreign banks' in London and the determinants of performance. He also analyzed and compared the profitability of domestic and foreign banks operating in the Lebanese Market between fiscal year 1993 and fiscal year 2003. He found that foreign banks were more profitable than all domestic banks regardless of their ownership structure and although they operate in the same market, but domestic banks' and foreign banks' profitability determinants are

different. Finally, they found that foreign banks are less affected by the macroeconomic factors of the host country than domestic banks.

Azam and siddiqui (2012) analyzed and compared the profitability of domestic (Public & Private) and foreign banks operating in the Pakistan Banking market between 2004 and 2010 on quarterly basis. The study found that foreign banks were more profitable than all domestic banks regardless of their ownership structure by applying regression analysis. This may suggest that it is better for a multinational bank to establish a subsidiary/branch rather than acquiring an "existing player" in the host country. They also found that domestic and foreign banks have different profitability determinants, i.e. factors that are important in shaping domestic banks' profitability are not necessary important for the foreign banks and vice versa. Empirical results showed that foreign banks were less affected by the macroeconomic factors of the host country than domestic banks and they had a higher profitability margin in Pakistan.

Janek (2004) estimated empirically the short-term effects of foreign banks entry on bank performance in the Central and Eastern European (CEE) Countries. A sample of 219 banks from ten CEE countries (Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovenia, and Slovakia) was used in the analysis. The research results showed that foreign banks entry affects negatively domestic banks' revenues from interest-earning assets, noninterest income, and profitability. Foreign banks entry can also raise the overhead costs of the local banks in short term. The general conclusion was that foreign banks entry is likely to increase competition in the host country.

Dorothea and Oleksandr (2007) found that banks profitability was generally associated with foreign presence by analyzing the 160 Ukraine banks during 2003-2005. They found that there is a positive relationship between domestic banks profitability and share of foreign banks assets in Ukraine. After splitting banks by size and profitability level this effect was particularly strong for large, small and most profitable Ukrainian Banks, whereas it was marginally important for the least profitable banks.

Wahid and Rehman (2009) worked on the efficiency of foreign banks in Pakistan Banking Industry. They conducted a study to explore the myth that foreign controlled banks were supposed to be more profitable and efficient than local controlled ones. Two out of three financial indicators, understudy, pointed out that the overall performance of the foreign commercial banks, operating in Pakistan, and were 24.44% better than the local controlled banks. At the end of year 2007, foreign investors were controlling 58.22% of the outstanding shares in the commercial banks, in Pakistan. Despite the fact that 40% of the foreign controlled commercial banks were running into deficit, the bank and the capital efficiency of the foreign controlled banks running into profit was better than locally controlled commercial banks. They concluded that the bank efficiency of the foreign controlled commercial banks in Pakistan was much better than local controlled commercial banks.

Chantapong (2003) studied the performance of domestic and foreign banks in Thailand in terms of profitability and other characteristics after the East Asian financial crisis. The study was based on a micro bank-level panel data on financial statements by pooling

cross-bank time-series data with the major balance sheet and income statement ratios for domestic and foreign banks in Thailand for 1995-2000. The estimation results of this study indicated that foreign bank profitability was higher than the average profitability of the domestic banks. All banks gradually improved their profitability during the post-crisis period after the shock. As for the commitment to domestic economy, both domestic and foreign banks reduced their credit exposure during the hard times. Importantly, the study found that in the post-crisis period, the gap between foreign and domestic profitability became closer. This showed some positive results of the financial restructuring program.

Sabi (1996) compared the performance of foreign and domestic banks in the process of transition into a market-oriented economy in Hungary. This study shows that foreign banks are more profitable than domestic banks and were not exposed to a greater liquidity or credit risk. Foreign banks provided less money for consumer loans and were reluctant to give long-term loans, only 8.4% of foreign banks' loans are long-term. It is also mentioned that the entry of foreign banks did not help to improve the performance of domestic banks.

Liao and Chen (2009) using both bank- and country-level data on banking sectors from 70 countries over 1992 to 2006, empirically identified cross-country determinants of bank profitability in domestic versus foreign banks with respect to bank characteristics, macroeconomics environment, the quality of institution, country risk, banking regulation, and supervision across countries. More specifically, the paper further investigated the joint influences of differences in macroeconomic condition, and institution between host

17

and home country on foreign banks. The empirical results revealed that foreign banks showed better performance than domestic banks. Banks operating in more comparative market showed less profitable while the cross-country difference in regulation and supervision also affect foreign bank's margins. Specifically, their finding indicated that foreign banks profitability was partially and negatively related to inflation rate, development level, and regulatory quality in home country. While GDP growth rate, country risk, regulatory quality and government effectiveness in host country also significantly and negatively affect foreign bank profitability.

Claessens, et al. (2001) carried out a study on the efficiency and competition effects of foreign bank presence. Using a large data set containing individual bank accounting information of domestic banks in 80 countries for the period 1988-1995, they showed that increased presence of foreign banks was associated with reductions of profitability, non-interest income and overall expenses of domestic banks. Apparently, the competitive pressure of foreign banks leads to positive efficiency effects at domestic banks. Moreover, they found that these efficiency effects occur as soon as foreign banks enter the market; they do not seem to depend on the market share of foreign banks. Their conclusion was that foreign bank presence enhanced efficiency and improved the functioning of domestic banks.

Horen and Claessens (2009) examined the relative performance of foreign banks, as measured in terms of profitability, in a large group of countries over the period 1999-2006 in a regression framework. They systematically analysed which factors have an

important impact on the advantage or disadvantage of being foreign. The large number of countries in their database enabled them to exploit the variation in host country and home country characteristics and the distance between the two. The use of bank characteristics allowed them to control for and study key bank characteristics that can play a role in performance. In addition, the panel structure of their data allowed them to disentangle possible differences in short and long-term effects of foreign ownership. They found that the location of the parent bank, the competitiveness in the host country, the geographical and cultural distance between host and home countries, and the bank's size and time it has been present in the country, as well as its funding structure, are important factors explaining the relative performance of foreign banks.

Denizer (2000) analysed the effects foreign bank presence has on domestic banks in Turkey. His empirical results showed that net interest rate margins, returns on assets and overhead expenses of domestic banks decreased after foreign banks have entered the market. These findings support the idea that foreign banks put competitive pressure on the domestic banks in Turkey, despite the fact that these foreign banks had a market share of only between 3.5 and 5 per cent during the period 1970-1997.

Lensink and Hermes (2003) focused on the short-term effects of foreign bank presence on domestic bank performance, using data of 990 banks for the period 1990- 1996. This paper investigated the short-term effects of foreign bank entry on the behaviour of the domestic banking sector. They argued that these effects were dependent on the level of economic development of the host country and showed that at lower levels of economic

development foreign bank entry was generally associated with higher costs and margins for domestic banks. At higher levels of economic development the effects appeared to be less clear: foreign bank entry was either associated with a fall of costs, profits and margins of domestic banks, or was not associated with changes in these domestic bank variables.

Barajas, Salazar and Steiner (2000) carried out a similar analysis focussing on the Colombian banking system and using individual bank accounting data for the 1985-1998 periods. Their study showed that foreign bank presence generally increased competition in the domestic banking system as evidenced by reduced intermediation spreads. Yet, foreign bank presence was also associated with a deterioration of reported loan quality among domestic banks. Moreover, administrative costs of domestic banks rose, possibly due to the fact that these banks have to upgrade their activities because of increased competitive pressure. Thus, in general foreign bank presence seems to be associated with an increase of costs for the domestic banking system of Colombia.

Bakar and Tahir (2009) evaluated the performance of the multiple linear regression technique and artificial neural network techniques with a goal to find a powerful tool in predicting bank performance. Data of thirteen banks in Malaysia for the period 2001-2006 was used in the study. ROA was used as a measure of bank performance and seven variables including liquidity, credit risk, cost to income ratio, size, concentration ratio, were used as independent variables. They note that neural network method outperforms the multiple linear regression method but it lacks explanation on the parameters used and

they concluded that multiple linear regressions, not withstanding its limitations (i.e. violations of its assumptions), can be used as a simple tool to study the linear relationship between the dependent variable and independent variables. The method provides significant explanatory variables to bank performance and explains the effect of the contributing factors in a simple, understood manner. This study adopted this approach together with the correction analysis to determine the effects of banking sectoral factors on bank profitability in Kenya.

2.4 Research Gap

The empirical review above has shown a comparison of profitability of foreign and domestic commercial banks and the determinants of these differences. However these studies were done in different environments and hence the results may not be generalized to developing countries such as Kenya. Other than Mathungu (2003) who studied the performance of the banking sector, other scholars such as Omindi (2011) and and Ongore (2011) did not focus on the banking industry as much as they studied performance determinants of firms. Further, the CBK uses the CAMEL model to evaluate bank performance in Kenya. This is a model that has been extensively used by various scholars in the banking industries in other countries and is even recommended by the Basel Committee on Banking Supervision as a model of performance evaluation by central banks. This model has not been tested on its fit as a model to explain bank performance in Kenya. There is therefore a gap in literature as regards the comparison of profitability of foreign and domestic commercial banks listed on Nairobi Securities Exchange and the determinants of these differences. This study therefore seeks to fill this gap.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This chapter describes the methods that were used in the collection of data pertinent in answering the research questions. It is divided into research design, population and sample design, data collection, and data analysis methods.

3.2 Research Design

This was a correlational study. According to Mugenda and Mugenda (2003), a study design can be named based on the classification by method of analysis. In this manner, a study could be designed as descriptive, causal-comparative, or correlational study. The method of analysis that most captured the objectives of this study was correlation and the study design was therefore appropriately named a correlation design. In this manner, the study was able to establish the relationship between the variables in the study. This was therefore the appropriate research design in this study.

3.3 Population and Sample

The population of this study was all the 9 listed commercial banks in Kenya. According to the Nairobi Securities Exchange website, there are nine banks currently listed at the NSE (Appendix 1). Of the 9 commercial banks, 3 are foreign banks (Barclays, Diamond Trust Bank, and Standard Chartered Bank) while the rest are local banks (CFC Stanbic, KCB, NBK, NIC bank, Equity bank, and Co-operative Bank). All these banks formed the sample size for the study.

3.4   Data Collection

Data was collected using secondary sources. The financial data from 2001-2011 was used

in the study. A panel data for the test variables was selected for the period under study.

These data was sought from various sources including the respective bank websites, the

Capital Markets Authority, the bank premises, and the Banking Survey 2010 booklet by

Think Business.

3.5   Data Analysis

The following model was used to test the effect of foreign ownership on bank

profitability:

Model 1: ROE

$ROE/ROA = \alpha + \beta_1 FOR + \epsilon$

Where *FOR* is the foreign ownership measured as a dummy variable of 1 for foreign

banks otherwise 0.

To test the determinants of bank profitability, the following regression model were used:

Model 2: ROE

$ROE = \alpha + \beta_1 CAR + \beta_2 CR + \beta_3 NIM + \beta_4 CIR + \beta_5 LR + \beta_6 ADV + \epsilon$

Model 3: ROA

$$ROA = \alpha + \beta_1 CAR + \beta_2 CR + \beta_3 NIM + \beta_4 CIR + \beta_5 LR + \beta_6 ADV + \epsilon$$

Where:

ROA is Return on Assets and ROE is Return on Equity as dependent variables define bank's specific characteristics. And the Independent variables are:

Symbol	Variable	Proxies
CAR	Capital Adequacy Ratio	Total Capital to Total assets
CR	Credit Risk	Ratio of total debt to total assets
NIM	Net Interest Margin	Net interest income to total gross Income
CIR	Cost Income Ratio	Total Costs to Net income
LR	Liquidity Ratio	Cash to total assets
ADV	Advances and Deposit Growth	Total advances to total deposits
ROA	Return on Assets	Net income to Total Assets
ROE	Return on Equity	Net income to Total Equity.

The data collected was analysed using descriptive statistics, One-Way ANOVA, correlation analysis, and regression analysis. The descriptive statistics were the minimum, maximum, mean, and standard deviation. One-Way ANOVA was used to analyse the differences between profitability ratios of Foreign and Domestic banks. Correlation analysis was used to test any serial correlations between the independent variables in the study. Regression analysis was used to test the determinants of bank

profitability. The strength of the models was tested using significance of F statistic at 5% level as well as using R^2. Pearson correlation coefficients were interpreted for the effect (positive or negative) and the significance (at 5% level) of the variables in the model. The analyses will be aided by SPSS 20. Results are shown in tables.

CHAPTER FOUR

DATA ANALYSIS, FINDINGS AND INTERPRETATION

4.1   Introduction

This chapter is organised as follows. Section 4.2 presents the results of descriptive analysis on the variables used in the study. Section 4.3 presented the results on the differences in performance of foreign and domestic listed banks in Kenya.

Section 4.4 shows the correlation analysis results on all the independent variables of the study. Section 4.5 presents the results on the determinants of bank performance using the regression analysis. Then in section 4.6, a discussion of results is presented.

4.2   Descriptive Results

Table 4.1 shows the descriptive results of data analysis. The descriptive statistics explores and presents an overview of the variables used in the analysis. The result shows the range of mean, standard deviation, maximum and minimum for the all variables.

The results indicate that the capital adequacy ratio ranged from 9% to 22%. The mean CAR was 13% with a standard deviation of 3.7%. The CAR is therefore above the 8% recommended by the Central Bank of Kenya through the Basel III requirements. The credit risk ranged from 78% to 90% with a mean of 87% and a standard deviation of 3.4%.

Table 4.1: Descriptive Analysis for the Dependent and Independent Variables

	Minimum	Maximum	Mean	Std. Deviation	Kurtosis	
	Statistic	Statistic	Statistic	Statistic	Statistic	Std. Error
Capital Adequacy Ratio	.09	.22	.1302	.03739	4.017	1.400
Credit Risk	.78	.90	.8667	.03455	4.920	1.400
Net Interest Margin	.44	.54	.4904	.03600	-1.600	1.400
Cost Income Ratio	.60	1.00	.7898	.14824	-1.694	1.400
Liquidity Ratio	.05	.09	.0767	.01160	2.673	1.400
Advances and Deposit Growth	.52	1.00	.7723	.13787	.781	1.400
Return on Assets	.07	.15	.1081	.02813	-1.248	1.400
Return on Equity	.52	1.03	.8227	.19170	-1.330	1.400

Source: Research Findings

The net interest margin ranged from 44% to 54% with a mean of 49% and a standard deviation of 3.6%. The results also show that the cost income ratio ranged from 60% to 100%. The mean CIR was 79% with a standard deviation of 15%. The study found that liquidity ratio ranged from 5% to 9%. The mean LR was 7% with a standard deviation of 1%. Advances and deposit growth was found to range from 52% to 100% with the mean ADV being 77% with a standard deviation of 14%. Further, the study found that the ROA ranged from 7% to 15% with a mean ROA of 11% and a standard deviation of 3%. The study also found that the ROE ranged from 52% to 103% with a mean of 82% and a standard deviation of 19%.

4.3 Differences in Performance between Foreign and Domestic Banks

Table 4.2 shows the performance of foreign banks versus domestic banks listed on the NSE regarding the various ratios.

Table 4.2:   Performance of foreign versus domestic listed banks in Kenya

Ratios	Foreign Banks	Domestic Banks
Capital Adequacy Ratios	0.110	0.140
Credit Risk	0.876	0.862
Net Interest Margin	0.504	0.483
Cost Income Ratio	0.753	0.808
Liquidity Risk	0.074	0.078
Advances and Deposit Ratio	0.699	0.809
Return on Assets	0.106	0.109
Return on Equity	0.836	0.816

Source: Research Findings

The CAR for foreign banks was 11% while that of local banks was 14%. The CR for foreign banks was 87.6% while that of the domestic banks was 86.2%. The NIR for foreign banks was 50.4% while that for domestic banks was 48.3%. The CIR for foreign banks was 75.3% while that for domestic banks was 80.8%. The LR for foreign banks was 7.4% while that for domestic banks was 7.8%. The ADV for foreign banks was 69.9% while that for domestic banks was 80.9%. On profitability, the ROA for foreign banks was 10.6% while that for domestic banks was 10.9%. Further, ROE for foreign banks was 83.6% while that for domestic banks was 81.6%.

As the results in Table 4.2 show, that foreign banks outperform local banks regarding net interest margin, cost income ratio, and ROE while domestic banks performed better on capital adequacy ratios, credit risk, liquidity ratio, advances and deposit growth, and ROA. In areas where foreign banks outperform local banks, the outperformance is very marginal. Thus from the results, foreign banks do not absolutely outperform domestic banks in Kenya. Whether these differences are significant is tested and presented in Table 4.3.

The study used one-way ANOVA to determine whether there were statistical differences in the performance of foreign and domestic listed commercial banks in Kenya. The results are presented in Table 4.3.

Table 4.3: **Differences in performance of foreign and domestic banks**

		Sum of Squares	df	Mean Square	F	Sig.
CAR	Between Groups	.002	1	.002	1.350	.283
	Within Groups	.009	7	.001		
	Total	.011	8			
CR	Between Groups	.000	1	.000	.309	.595
	Within Groups	.009	7	.001		
	Total	.010	8			
NIM	Between Groups	.001	1	.001	.656	.445
	Within Groups	.009	7	.001		
	Total	.010	8			
CIR	Between Groups	.006	1	.006	.255	.629
	Within Groups	.170	7	.024		
	Total	.176	8			
LR	Between Groups	.000	1	.000	.235	.643
	Within Groups	.001	7	.000		
	Total	.001	8			
ADV	Between Groups	.024	1	.024	1.324	.288
	Within Groups	.128	7	.018		
	Total	.152	8			
ROA	Between Groups	.000	1	.000	.020	.890
	Within Groups	.006	7	.001		
	Total	.006	8			
ROE	Between Groups	.001	1	.001	.018	.897
	Within Groups	.293	7	.042		
	Total	.294	8			

Source: Research Findings

The study found that there were no statistically significant differences between the performance of foreign and domestic listed banks. The one-way ANOVA results in Table 4.3 show that none of the differences in the variables' F statistic was significant at 5% level of confidence (Sig > 0.05). This means that there are no differences between the performance of foreign listed banks and domestic listed banks in Kenya.

Table 4.4 shows the regression analysis results on the effect of foreign ownership on bank profitability using two models: ROA and ROE. Significance is shown in parentheses.

Table 4.4:   Effect of foreign ownership on bank profitability

Independent variables:	Return on Assets	Return on Equity
Constant	0.109	0.816
Foreign bank dummy	-0.003 (0.890)	0.019 (0.897)
R	0.054	0.051
R square	0.003	0.003
F statistic	0.020 (0.890)	0.018 (0.897)

Source: Research Findings

The results in Table 4.4 reveal that foreign ownership had a negative effect on ROA (beta = -0.003) but the effect was not significant at 5% level of confidence ($p > 0.05$). Foreign ownership explained only 0.3% of the variance in bank profitability and the model was not fit enough to explain the variances since the F statistics was not significant.

The results in Table 4.4 further reveal that foreign bank ownership had a positive effect on ROE (beta = 0.019). This relationship was not significant at 5% level. The model explained 0.3% of the variance in bank profitability and the model itself was not fit to explain the relationship as the F statistic was insignificant.

The results of the two models therefore show that foreign ownership does not have a significant effect on bank profitability. In other words, foreign bank ownership does not affect the profitability of listed banks in Kenya.

30

4.4   Correlation Analysis Results

Table 4.5 presents the correlation results for all the independent variables in the study. This is done in order to check for any multicollinearity among the variables in the study. This is important to ascertain before regression analysis is performed on the data.

Table 4.5:   Correlations between independent variables in the study

		CAR	CR	NIM	CIR	LR	ADV	FOR
CAR	Pearson Correlation	1	-.928**	-.023	-.275	.563	.269	-.402
	Sig. (2-tailed)		.000	.954	.473	.114	.484	.283
CR	Pearson Correlation		1	-.051	.298	-.601	-.311	.206
	Sig. (2-tailed)			.896	.437	.087	.415	.595
NIM	Pearson Correlation			1	-.805**	.262	.158	.293
	Sig. (2-tailed)				.009	.496	.685	.445
CIR	Pearson Correlation				1	-.473	.089	-.187
	Sig. (2-tailed)					.199	.819	.629
LR	Pearson Correlation					1	.258	-.180
	Sig. (2-tailed)						.503	.643
ADV	Pearson Correlation						1	-.399
	Sig. (2-tailed)							.288
FOR	Pearson Correlation							1
	Sig. (2-tailed)							
**. Correlation is significant at the 0.01 level (2-tailed).								

Source: Research Findings

The correlation results show that there is a very high and significant correlation between capital adequacy ratio and credit risk (-0928). This means that the two variables are serially correlated and their inclusion in the regression analysis might therefore bring some problems by overestimating the relationships. The rest of the variables were not highly correlated. Since it is the prerogative of the researcher to decide which variables to include and which variables not to after carefully examining the circumstances of the study, the researcher decided to ignore the serial correlation present in the data and included all the variables in a regression analysis.

31

4.5   The Determinants of Bank Profitability

Table 4.6 presents the results on the determinants of bank profitability. The results are presented using two profitability models: ROA and ROE.

Table 4.6:   Determinants of bank profitability in Kenya

Independent variables:	Return on Assets	Return on Equity
Constant	-0.146	-7.270
Capital Adequacy Ratio	0.490 (0.312)	4.901 (0.215)
Credit Risk	0.349 (0.461)	9.494 (0.082)
Net Interest Margin	-0.101 (0.778)	-0.834 (0.757)
Cost Income Ratio	-0.163 (0.188)	-1.215 (0.190)
Liquidity Ratio	0.236 (0.721)	2.833 (0.577)
Advances and Deposit Growth	0.062 (0.319)	0.488 (0.302)
R	0.972	0.966
R square	0.944	0.932
F statistic	5.621 (0.159)	4.586 (0.190)

Source: Research Findings

Table 4.6 shows that ROA was positively influenced by capital adequacy ratio, credit risk, liquidity ratio and advances and deposit growth while it was negatively influenced by net interest margin and cost income ratio. However, none of these variables had a significant influence on ROA ($p > 0.05$). The model explained 94.4% of the variance in bank profitability. The model was not fit to explain the variance as the F statistic was insignificant.

The results in Table 4.6 also show that ROE was positively influenced by capital adequacy ratio, credit risk, liquidity ratio, and advances and deposit growth. ROE was negatively influenced by net interest margin and cost income ratio. None of these effects was significant at 5% level. The model explained 93.2% of the variance in profitability.

The F statistic shows that the model was not fit enough to explain the relationship as the p value was more than 0.05.

The results therefore show that none of the variables determined bank profitability. The CAMEL model was not fit enough to explain the determinants of profitability of listed commercial banks in Kenya.

4.6   Interpretation of Findings

The study results from Table 4.2 show that there are no statistically significant differences between performance of foreign banks and local banks listed on the Nairobi Securities Exchange. This is inconstant with the findings of other studies such as Demirguc-Kunt and Huizinga (1999), Claessens, Demirguc-Kunt, and Huizinga (1998) and Claessens et al. (2001) who found that foreign banks in developing countries tend to perform better than local banks. The results are also inconstant with that of Muthungu (2003) who found that foreign banks outperformed local banks in Kenya. This may be attributed to the fact that there are more domestic listed banks than foreign listed banks in Kenya (three foreign banks and six local banks) and this was the sample used in this analysis.

The study results from Table 4.4 show that foreign ownership did not affect bank profitability. This is inconsistent with the findings of Ongore (2011) who had found that foreign ownership positively and significantly influenced firm performance. The major reason for these differences would be that the former study did not solely focus on commercial banks and hence the results may not be generalized to commercial banks.

The study results from Table 4.6 found that none of the determinants tested in this study significantly influenced bank profitability. This is inconsistent with the findings of the study by Guru et al (2002) and Sufian and Habibullah (2009) who revealed that liquidity and credit risk were some of the determinants of profitability.

CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1   Introduction

This chapter presents the summary of the study in section 5.2, conclusion in section 5.3, recommendations in section 5.4, limitations of the study in section 5.5, and suggestions for further research in section 5.6.

5.2   Summary

This study analysed profitability of foreign and domestic banks listed on the NSE. The study sought to: determine whether there are any differences between the profitability of foreign and local banks listed at the NSE; examine the determinants of profitability of foreign and local banks listed at the NSE.

The study reviewed four theories that explain why foreign banks outperform domestic banks. These theories are the market power theory, the efficiency structure theory, the balanced portfolio theory, and the limited global advantage theory. The empirical review focused specifically on the studies that tested the effect of foreign ownership on firm performance. The conclusion from these studies was that local banks are outperformed by foreign banks in a number of ratios but the determinants of their performance were varied.

This study was designed as a correlational study because it sought to examine relationships between variables. The population was listed banks at the NSE and therefore the sample was restricted to the nine commercial banks listed. Three of them

were foreign banks while the rest were domestic banks. Secondary data was collected from the 2011 Banking Survey handbook. The CAMEL model was adopted to test the determinants of bank profitability. Data was analysed using descriptive analysis, One-Way ANOVA, correlation analysis, and regression analysis. The SPSS aided in the analysis. The results were presented in tables.

The descriptive results have shown the range in various ratios, the mean values and the standard deviations. The mean CAR was 13% which was above the 8% recommended by the CBK. The mean CR was 86.7%, NIR was 49%, CIR was 78.9%, LR was 7.6%, ADV was 77.2%, ROA was 10.8%, while ROE was 82.3%.

The results also showed that foreign banks outperformed local banks in cost interest ratio, net interest margin, and ROE while domestic banks performed better on capital adequacy ratios, credit risk, liquidity ratio, advances and deposit growth, and ROA. The study found that there were no statistically significant differences between the performance of foreign and domestic listed banks. The regression result also showed that foreign ownership did not affect bank profitability.

The study also revealed that none of the variables had a significant influence on ROA ($p > 0.05$). The model explained 94.4% of the variance in bank profitability but it was not fit to explain the variance as the F statistic was insignificant. The results also showed that ROE was not significantly affected by any of the variables in the model. The model

explained 93.2% of the variance in profitability but the F statistic shows that the model was not fit enough to explain the relationship as the p value was more than 0.05.

5.3   Conclusion

The study concludes that listed foreign banks in Kenya do not outperform the domestic listed banks. These results can be attributed to the fact that many of the listed banks are domestic banks and therefore the results may be biased towards the domestic banks. The entry of foreign banks may also have improved the performance of the banking sector hence the indifference in performance of domestic and foreign banks in Kenya.

The study also concludes that the CAMEL model is not a good predictor of the determinants of profitability of listed commercial banks in Kenya. Further, none of the variables in the model determine bank profitability in Kenya. Thus, the variables used in the model do not affect bank profitability in Kenya.

5.3   Recommendations for Policy

The study recommends that there is need for the Central Bank of Kenya to rethink its use of the CAMEL model to gauge performance of banks, especially the listed banks in Kenya as the study found it to be a poor predictor of bank profitability.

The study recommends that commercial banks, especially the domestic listed banks, should reduce the capital adequacy ratio as it was way beyond the 8% recommended by the CBK. The banks are holding too much capital relative to the total assets.

5.5   Limitations of the Study

This study was limited to the listed commercial banks in Kenya and therefore the sample was restricted to only nine banks. The results should therefore be interpreted with care as only the listed banks were selected in the study.

The study used the CAMEL model to evaluate the determinants of bank profitability. Whereas this model is favoured by researchers, it fails to capture other factors which may influence bank performance and therefore the use of the model in this study limited the number of factors which could be studied.

Lastly, this study has compared data for ten years without adjusting the data obtained from financial statements. Comparison over time becomes difficult when unit of measurement changes in value due to general inflation in the economy.

5.6   Suggestions for Further Research

There is need for future studies to be done in this area but a number of modifications are necessary. First, the sample should be increased to focus on all the banks. Secondly, the use of other models other than the CAMEL model might give better results as far as the determinants of bank profitability in Kenya are concerned. Thirdly, financial information should be adjusted for general inflation changes before a comparison is made over a long period of time.

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APPENDICES

Appendix 1: Listed Banks at the NSE

1. Barclays Bank Ltd
2. CFC Stanbic Holdings Ltd
3. Diamond Trust Bank Kenya Ltd
4. Kenya Commercial Bank Ltd
5. National Bank of Kenya Ltd
6. NIC Bank Ltd
7. Standard Chartered Bank Ltd
8. Equity Bank Ltd
9. The Co-operative Bank of Kenya Ltd

Source: Nairobi Securities Exchange website (2012).