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

BY

ISAAC NDACHI WAIRIMU

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DECLARATION

This research project is my original work and has not been presented for a degree in any other university.

Signature... Date................................

WAIRIMU ISAAC NDACHI

D61/84142/2015

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

Signed... Date.............................

Francis N. Kibera, PhD

Professor of Marketing

Department of Business Administration

School of Business,

University of Nairobi.

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DEDICATION

To God Almighty my provider, creator and source of knowledge, which has enabled me to be where I am today.

To my late Mother Margaret who’s loving spirit sustains me still and for being a rock of stability in my life.

To My wife Phiona and Children (David and Maggy) for their love and support. I salute you.

ABSTRACT

The banking industry is usually faced with challenges such as globalization, financial crisis and government regulations. Regulation is defined by Llewellyn (1986) as an organization with particular conditions or approved behavior, enforced by a government or other external agencies or self-imposed by clear or implied agreement within the industry, that curtails the activities a business operation of a financial institution The core purposes of regulation are to ensure a sound and stable financial system, and protect deposits made by the public and lower the levels of risk that bank creditors are exposed to. The measure of actual output against the projected output is known as performance, that is, its objectives and aims. The study Research Objective was to determine how CBK prudential regulation affects the performance of banks in Kenya. The research adopted a descriptive research design. The investigation was a census study utilized primary data. Standardized questions made measurement more particular by effecting uniform definitions upon the participants as well as making sure that similar data was collected from groups then deduced comparatively. The populace of the study was all of Kenya's commercial banks in operation as at 31st December, 2016. According to (Central Bank of Kenya, 2017) there are the forty three (43) Kenyan commercial banks. Among the 43 institutions, 39 commercial banks and the mortgage finance institution are owned privately while the remaining 3 commercial banks have their stakes controlled by the Kenyan Government. The instrument for data collection was the questionnaire. The respondents were the operations and relationship managers. The method used in research administration was the drop and pick method due to the necessity to collect detailed and well thought out responses. The collected data was sorted and arranged for analysis using Statistical Packages for Social Sciences (SPSS). The study found out that several factors helped to influence performance of the banks over the last five years both in a positive and negative manner. Those influencing the performance in a positive way were: restrictions on trading and guarantees, restriction on advances for purchase of land and restrictions on deposit taking while those influencing performance in a negative manner included: limit on advances, credits and guarantees, restrictions on advances, credits and guarantees, restrictions on ownership of share capital of an institution, mortgage finance companies and imposition of charges and payment of interest. The study recommends that some of the factors that the Central bank needs to put into consideration with relation to improving the banks performance would be to change policies or regulation for limit on advances, credits and guarantees, restrictions on advances, credits and guarantees, restrictions on ownership of share capital of an institution, mortgage finance companies and imposition of charges and payment of interest.

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ABBREVIATION AND ACRONYMS

CBK	Central Bank of Kenya
DTMs	Deposit-Taking Microfinance institutions
EACB	East African Currency Board
ROA	Return on Asset
ROE	Return on Equity
ROI	Return on Investment

CHAPTER ONE: INTRODUCTION

1.1 Background of the Study

The banking industry is usually faced with challenges such as globalization, financial crisis and government regulations. Regulation is defined by Llewellyn (1986) as an organization with particular conditions or approved behavior, enforced by a government or other external agencies or self-imposed by clear or implied agreement within the industry, that curtails the activities a business operation of a financial institution (Njeule, 2013). The core purposes of bank regulation are to ensure a sound and stable financial system, and protect deposits made by the public. The objective of prudential regulation is to lower the levels of risk that bank creditors are exposed to. The measure of actual output against the projected output is known as performance, that is, its objectives and aims (Amin, 2012). Performance is an important aspect in every organization including commercial banks. Regulations imposed upon organizations affect their operations thus affecting performance. Prudential regulation limit the extent to which commercial banks can expose their creditors to risk and this influences their performance.

There are various theories that relate to the subject of regulation and its effect on performance. This study will however be based on the Public Interest Theory, Theories of Government Opportunism and the Principal-Agent Theory theories. The Public Interest Theory, which is an economic theory, that holds that the supply of regulation is in response to the public’s demand for ineffective or inequitable market practices correction (Hertog, 2010). The assumption of this theory is that markets are particularly delicate and tend to function ineffectively if not tended to. Regulation is therefore important and in public interest.

Restriction on the discretion of government is necessary so that the sector can provide effective services as described in the Theories of Government Opportunism (Valero, 2015). This theory concludes that regulation occurs because operators desire protection from government opportunism. In the theory of Principal-Agent, the payoff to the principal is dependent on the action taken by the agent. The principal can compensate the agent but cannot contract for action. The compensation can be made based on a signal that is observable in relation to the action.

The study is focuses on commercial banks in Kenya because their performances have also been greatly affected by changes in their operating environment and therefore need to establish the effect of Central bank prudential regulation as a strategic legal framework and respond accordingly for them to be able to survive. Today's global competitive environment is complex, dynamic, and largely unpredictable. To deal with this unprecedented level of change, a lot of thinking has gone into strategy implementation among commercial banks in Kenya. Banks develop strategies that are meant to direct their operations towards the attainment of their vision and mission. Commercial banks still face various challenges in its quest to improve its performance in the industry.

Commercial banks are an important part in any country's economy therefore their performance is of great concern. Kenyan commercial banks today operate in an industry filled with competition from mobile money transfer services like Mpesa and Airtel money. In this digital age, commercial banks need to invest more on technology in order to provide financial services to their customers at all time and places. These challenges offer new risks to commercial banks and necessitate prudential regulation.

These banks have to know the best practices to adopt to cope with these regulations and still obtain optimal performance. To achieve this it is necessary to understand the effect the CBK Prudential regulation has on commercial banks performance. This study therefore seeks to determine the effect of Central Bank Prudential regulation on performance of Kenyan commercial banks.

1.1.1 Central Bank Prudential Regulations

The bank is subjected to a form of government regulations known as Bank regulations in form of requirements, restrictions and guidelines intended at creating transparency between the institutions of banking and the persons and corporations they conduct business with, among other things (Mwongeli, 2016). The government regulator in Kenya is the Central Bank of Kenya (CBK). The Central Bank of Kenya has offered regulations and guidelines in the past and currently which include: past and current regulations Prudential Guidelines, 2013. Prudential regulations refer to bank regulations issued to lower the risk level or protect depositors (Ochieng, 2014).

Central Bank of Kenya Prudential Regulations 2006 for institutions are licensed under the Banking Act and were issued under Section 33(4) of the Banking Act, which bestows the CBK with the power to issue guidelines to be followed by institutions so as to maintain a stable and effective systems of banking and financial (Njeule, 2013). For sound risk management, the CBK identifies board and oversight of senior management, adequate policies, procedures and limits, adequate risk monitoring and adequate internal controls as some important elements. In addition to issuance of prudential regulations, bank supervision is needed.

While the prudential guidelines are issued to lower the risk levels bank creditors are exposed to, bank supervision ensures the guidelines are enforced. Bank supervision entails the enforcement of the regulations and guidelines and also judges the soundness of bank assets, its capital adequacy and management (Njeule, 2013). Effective supervision therefore leads to a healthy banking industry that possesses the power to propel economic growth.

Commercial banks are required to adhere to this legislation to create transparency between banking institutions and the individual and corporations with whom they conduct business. The framework seeks to reduce the level of risk which bank creditors are exposed. Regardless, regulations should be established in an unambiguous way, with clear definitions of what is understood by commercial bank services and of the legal and institutional form of commercial banks in order to avoid regulatory arbitrage (Gallardo et al., 2005).

1.1.2 Organizational Performance

Organizational performance has been defined differently by different people but all agree that it is a multidimensional concept. It involves both financial and non-financial measures. It is defined as the evaluation of the degree to which organizations attain their set vision through fulfillment of set objectives which may be financial and/or non-financial (Bonface, 2014). Organizational performance is therefore the measure of an organization's output against its goals and objectives (Abuya, 2016).

Organizations measure their performance in order to drive improvement, maximize effectiveness of improved efforts, align themselves with business goals and achieve optimal reward and discipline structures among other reasons.

The aspects to be measured must be in line with the organizations' goals and have an implication on them. There are three primary outcomes in corporate organizations have been assessed: financial performance; marketing performance; operational performance (Deegan & Unerman, 2011). The financial perspective of measuring performance is the most commonly used and determines profitability. The main focus is to effectively use the organizations' financial resources to support and advance the goals of the organization.

Financial performance is concerned with return on investment (ROI), return on equity (ROE) and return on asset (ROA). It is however necessary to also measure the non-financial performance. Some of the aspects of non-financial performance are: balance scorecard, economic value added, activity-based costing, quality management and customer value analysis (Abuya, 2016).

1.1.3 Commercial Banks in Kenya

An institution that accepts deposits, makes business loans and offers other related services is what is referred to as a commercial bank (Njeule, 2013). Commercial banks play an important role to the economy as they serve as an intermediation between the households and the economy sector (Wachiuri, 2012). Diverse deposit accounts are allowed by commercial banks, for example, checking, savings and time deposit. Various deposits are allowed by commercial banks. Commercial Banks and Mortgage Finance Institutions are licensed and regulated according to the provisions of the Banking Act.

The banking sector in Kenya has reported massive growth and development in recent years with a few banks experiencing turbulent times.

Currently there are forty-two licensed commercial banks and one mortgage finance company (CBK 2016), all these regulated by the Central Bank of Kenya. Thirty nine of the forty three commercial banks and the mortgage institution are owned privately while the government of Kenya holds stakes in the other three commercial banks.

The Central Bank of Kenya has played a great part in the regulation of banks and has enacted major reforms within the sector. Most banks have automated their functions and a lot of innovation has been witnessed in the recent past with mobile and internet banking taking root with the aim of offering great service to the customers. Banks have increased their presence in the market and are venturing to rural areas which most banks had left in earlier years. This has been triggered by the emergence of innovative products that have accommodated people from all walks of life and everyone can have an account. There is a need for constant innovation to tap the ever-growing market in the banking sector.

1.1.4 Central Bank of Kenya

The 1966 Central Bank of Kenya Act led to the setup of the Central Bank of Kenya after the East African Currency Board (EACB) was dissolved. The bank’s set up resulted directly from the desire of the three East African States to have their own financial independence and policies. The Central Bank of Kenya Act of 1966 spelt out the goals and roles of the bank and gave it limited autonomy. The Act was however altered in April 1997 to enable the bank operations conform to ongoing economic reforms. The CBK is situated in Nairobi (Central Bank of Kenya, 2017).

The core responsibility of the bank as stated in the section four of the CBK Act is: the primary purpose of the bank shall be formulation and implementation of monetary policy aimed at attaining and sustaining stability in prices general level; the Bank shall promote the liquidity, solvency and appropriate operation of a market-based,

Stable financial systems; the bank shall support the government's economic policy as well as its growth and employment objectives.

The other roles of the bank stated in Section 4A of the Act give the Bank the authority to formulate and execute policies on foreign exchange, hold and direct its reserves of foreign exchange, licensing and supervision of dealers who are authorized, formulate and apply as best promote the set-up, regulation and supervision of effective payment, act as banker and adviser to, and as fiscal agent of the Government; and Issue currency notes and coins (Central Bank of Kenya, 2017).

In 2012, CBK came up with a framework for supervisory colleges as part of their consolidated supervision drive. The multilateral working groups of supervisors are referred to as supervisory colleges. The initial supervisory college formed as a pioneer supervisory college by CBK in 2012 was for Kenya Commercial Bank (KCB) group and supervisory colleges for Equity Bank and Diamond Trust Bank were formed thereafter in 2013 (CBK, 2013b). The existing supervisory colleges have shown prove of usefulness to the regulators of the regional banking sector. These colleges have served as experience sharing channels among the regulators.

Regulators have an avenue for harmonization of their practices in administration by implementing the best global practices propagated by global standard-setting organizations like the Basel Committee for Banking Supervision and the Financial Stability Board. As a channel towards a stable and effective banking sector regionally (CBK, 2013b).

1.2 Research Problem

There is a consensus among some scholars that prudential regulations mitigate the effects of economic crisis and lead to the stability of the banking sector and subsequently an improvement in the macroeconomic sector of economy (Scott, 2010). Central bank prudential regulations are meant to guide commercial banks away from risks such as credit risk, strategic risk and liquidity risk. It therefore, acts as a strategic legal framework by providing direction and procedural steps towards protecting the depositors, bringing order into the banking sector as well as placing it in on globally competitive status hence enhancing performance (return on income/assets) (Victoria, 2014).

Commercial banks' performance is important for stability and progress of the economy of the country. The CBK institutes regulations and guidelines to ensure an improved banking sector. CBK did not hurry into regulations of telecom providers developing banking services before the testing of the model hence approach to the mobile banking has particularly become risk-based (Alliance for Financial Inclusion, 2010). The more general suggestion of the Kenyan case is the presence of huge advantages that economies could gain if their central banks strike a balance between safeguarding of financial stability and development of a financial system that seeks to be of service to the actual economy (Mwega, 2014).

Studies on the effect of regulation in the banking sector have been conducted both globally and locally. Globally, Adina (2015) did a paper on the performance, banking risks and their regulations in Romania. The study covered a period of three years and it adopted descriptive survey study. He noted that with regards to risks and profitability, credit institutions need to position themselves constantly.

From the research prudential supervision prevents expression of internal and external risks to the level of a banking institution and prevents their spread thus improving performance. Victoria (2014) on financial innovations and prudential regulation; impact of new rules of Basel 3 in Balti, Moldova. The study relied on primary data and a research questionnaire for data collection.

In Kenya, Mwongeli (2016) studied the impact of regulation on financial performance of Kenyan commercial banks. The study was a descriptive census study. Data collection instrument was a questionnaire. A chi square test of independence was carried out to determine the relationship between the two variables. Eight out of nine ratios analyzed yielded P values that caused the study to accept the null hypothesis that there is no relationship between regulations and financial performance. Ochieng (2014) studied the impact of Central Bank of Kenya careful regulation guidelines and regulations on the financial performance of commercial banks. The study adopted a descriptive research methodology which relied on secondary data. Collected data was analyzed using regression analysis.

Wachiuri (2012) studied the consequence of capital adequacy requirements on credit creation by Kenyan commercial banks. Data collected was secondary and was analyzed using an economic model.

From the studies analyzed above, it can be noted that no study has been carried out on the impact of CBK role on performance of commercial banks. This study aims to fill this gap through answering the research question: what is the effect of CBK prudential regulations as a strategic legal framework on performance of Kenyan commercial banks?

1.3 Research Objective

To determine how Central Bank prudential regulation affects the performance of commercial banks Kenya.

1.4 Value of the Study

This study will provide valuable information to all stakeholders; the information will be useful in different ways. The findings of this research may be used by management and employees of commercial banks to understand the effect of prudential regulation on their performance. This will enable them to adjust themselves better by creating better practices in their operations and risk management so as to achieve optimum performance.

To policy makers and the CBK the findings of the study may be used to understand the effect of the CBK Prudential Regulation on the performance of commercial banks. This understanding will aid in the creation of more informed regulations and guidelines that help foster performance of commercial banks.

To the scholarly field, this study adds to the pool of literature available on effects of banking regulations and more specifically prudential regulation on the performance of commercial banks. This helps scholars and academicians gain a broader understanding of the subject. The findings of this research may be used as a basis for future research or used to identify research gaps to be covered by other researchers in future.

There are various theories on the subject of banking regulation and performance of commercial banks. The findings of this research serve to advance these theories by adding weight or offering them criticism. This will strengthen understanding of the theories to future researchers and increase their credibility for future use.

CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

This chapter contains a review of literature relating to the subject of bank regulations and performance of commercial banks as presented by various researchers. The theoretical foundation consists of public interest theory and market failure, theory of government opportunism and principal-agent theory. These theories will guide the study with regard to prudential regulations and performance and empirical studies relating to this subject. From these empirical studies the research gap that this study seeks to fill will also be brought out.

The literature on the Central bank prudential regulations and organizational performance is also covered in this chapter. It discusses into detail the type of existing regulations, they include, corporate governance regulations, foreign exchange exposure limits, licensing of new institutions, capital adequacy, liquidity management, business prohibition, prevention of proceeds of crime and money laundering, external auditors duties and responsibilities and publishing financial statements.

Lastly, the chapter is also inclusive of the empirical studies and knowledge gap. It covers studies on financial regulations and prudential innovations, impact of regulations on financial performance, relationship between regulation and the financial sector's stability, impact of capital sufficiency requirements on creation of by Kenyan commercial banks.

2.2 Theoretical Foundation

A theoretical review helps a researcher determine their variables clearly in a study, provides a general structure for assessment of data and aids in selecting a research design that is applicable. There are two ideas on regulatory policy that have been formed: positive regulation theories and normative regulation theories. The positive regulation theories assess why regulation takes place (Posner, 1974). These theories include those of market power, “interest group theories that describe the interest of stakeholder’ regulation,” and “theories of government opportunism that explain why government discretion restrictions may be necessary for the banking sector to provide effective customer service.

Positive theories of regulation include the public interest theory and the theories of government opportunism. Normative theories of regulation promote competition where feasible, minimization of information asymmetry costs and provision for economically efficient price structures (Posner, 1974). These theories include the principal-agent theory.

2.2.1 Public Interest Theory and Market Failure

The Public interest theory is an economic theory that was initially developed by Arthur Cecil Pigou in an attempt to explain why regulation occurs. According to the theory, the supply of regulation is in response to the public demand for the market practices that are ineffective or inequitable.

This theory's assumption is that the regulation is beneficial to the whole society and the regulatory body is deemed to represent the society's interest where it functions instead of the regulator's private interests or vested interests of a few individuals within the society (Deegan & Unerman, 2011).The assumption of this theory is that markets are delicate and incapable of regulating themselves.

This theory assumes that markets are fragile and unable to regulate themselves. These so-called "market failures" take place when there is breakdown in price mechanism that regulates supply and demand collapses, necessitating action from the government (Njeule, 2013). Governments are assumed to be a neutral arbiter. The most famous types of market failure are natural monopolies and external costs (externalities). This theory however has had its criticism. Incumbent firms can capture regulation so as to protect the market from competitors' entry according to (Stigler, 1972). The public choice theory is skeptical about government behavior and motives and is normally contrasted with public interest theory and sees regulation as ineffective socially.

In the banking industry, public interest theory holds that governments control banks to enhance their effective operation by neutralizing market failures for the advantage of the broader civil society. In the banking sector the interest of the public would be served if the banking system allocates resources in a manner that is socially effective. This would entail maximizing output and minimizing variance. It also involves the banks performing their other financial functions well (Stigler, 1972).

2.2.2 Theories of Government Opportunism

Deficiencies in a normative, moral or ideological commitment are defined as opportunism; or attitude towards a specific dependent circumstance, time horizons or potential supporters (Perri, 2011). The broadly used definition in political economy and in studies of strategic management is Williamson's (1983, 1993) definition. Theories of Government Opportunism explain why government discretion restrictions may be necessary for the sector's provision of effective customer service (Valero, 2015). This theory concludes that regulation occurs because operators desire protection from 'government opportunism'.

The development of this theory was for assessments of transaction costs of relations between principals and agents. Opportunisms, for Williamson means self-interest with the will to use cunningness or intentionally give incomplete or vague information disclosure, particularly calculated efforts to mislead, misrepresent, conceal, obfuscate or otherwise confuse in individual expectation at the expense of others (Scott, 2010).

In the context of the banking sector, this theory explains that banking regulation occurs so as to protect the bank creditors and society in general from opportunism by the banks. In the event that commercial banks engage in unethical activities aimed at their own gains (opportunism), regulations are necessary to protect creditors from the negative impacts of these activities. The CBK, which is the regulatory body in Kenya, is therefore mandated according to this theory to institute regulations that protect from opportunism for the benefit of the society. Prudential regulations achieve this by protecting from unrealistic risks that banks would otherwise take without these regulations (Valero, 2015).

2.2.3 Principal-Agent Theory

The principal-agent theory arises from the connection between the owner (principal) of an asset and the persons (agents) hired to supervise that asset on behalf of the owner. This theory recognizes decentralization and delegation of tasks. In Principal-Agent Theory the payoff to the principal is dependent on what action the agent takes. The principal can only compensate the agent based on an observable signal related to the action but cannot contract for the action. The principal offers an incentive and the agent decides on the optimal action to take, given the incentives (Laffont & Martimort, 2001).

This theory however has its challenges. Agents may pursue a hidden agenda that is; pursue their own aims other than those of the principal.

This challenge of asymmetrical information favors agents involved in the daily operations and make it hard for principals to supervise the behavior of agents. Problems of moral hazard may also occur further down in the organization (Hertog, 2010). This is when employees engage in work of less than optimal efficiency. These challenges necessitate some form of regulation by the principal.

In the banking sector under study, the CBK is the principal with the commercial banks as the agents. From this theory then, it can be noted that regulation ensures the commercial banks pursue only the objectives for which they exist and not deviate to pursue the interests of a few individuals. Regulation in banking also ensures that they deliver their mandate effectively and efficiently thus regulation directly affects performance. Regulation by the CBK is also necessary in creating a stable banking sector that remains competitive internationally (Laffont & Martimort, 2001).

2.3 CBK Prudential Regulations and Organizational Performance

According to the CBK prudential regulations 2006 for licensed institutions under the Banking Act, banks licensed under the Banking Act have to conform to a wide range of regulatory provisions in their everyday operations (Central Bank of Kenya, 2017). These regulations include the new banks licensing; adequacy of capital; liquidity management; forex exposure limits; business prohibition; prevention of money laundering; external auditor's duties and responsibilities; publishing financial statements; opening of a new business place, closing or changing business location; mergers, amalgamations, asset and liability transfer; and implementation of banking laws and regulations.

CBK regulations on new institutions licensing provide guide that is clear on the requirements and conditions that one must fulfill so as to acquire a license to carry out banking, financial or mortgage business in Kenya. The purpose of the guidelines on corporate governance is for provision of minimum standards needed from directors, chief executive officers and an institution's management for promotion of proper standards of conduct and sane banking services, guarantee and efficiency (Mwega, 2014).

This regulation has no restriction or replacement of management in making decisions on daily operations but requires that policies be formulated on the duties, responsibilities and conduct of directors and management, considering the special needs and circumstances (Mwega, 2012). The separation of the responsibilities of the Board and those of management are also outlined clearly in the regulations to bring about lucidity and responsibility.

Regulations on capital adequacy requires for maintenance of a level of capital for every banking institution: which is sufficient for protection of its depositors and creditors, proportionate to the risk connected with the institution's activities and report, promotes the confidence of the public in the institution. The capital standards in the regulation are the least suitable for institutions that are basically sound, well managed and which have no financial or operational weakness. The risk classification guidelines on assets and provisioning have the purpose of ensuring that all assets are frequently assessed using an objective internal grading system that is in consistence with this guideline; and appropriate provisions and write offs are done in a timely manner to the account of provisions so as to correctly reflect the institution's actual conditions and operating result (Wachiuri, 2012).

Liquidity management regulations: make sure every institution meets the least requirements of liquidity; give guidance of liquidity returns compilation; make sure there is precision and uniformity in the banking sector's liquidity ratio computation; make sure that the liquidity and maturity assessment of assets and liabilities returns to CBK is done in a timely manner. The foreign exchange exposure limits regulations make sure that possible risk of lost due to the fluctuation of foreign exchange rate to the capital base of a bank is within considerable limits (Gale, 2010). The regulation on prohibited business is applicable to every transaction done by an institution and mirrored on the balance sheet or as off balance sheet items. Despite the set limits in this banking acts guideline and provision, institutions are expected to abide by the banking practices that are sound and the written policies, which have been incorporated and approved by the board of directors of institutions (Vianney, 2010).

The application of the guideline of proceeds of crime and money laundering prevention is to all licensed institutions in transaction of business under the Banking Act. It emphasizes methods of identification of prudent customers, keeping of records, identification of any activity that seems suspicious and reporting of any such activity to the necessary authorities for action (Victoria, 2014). The board of directors is mandated with the responsibility to formulate policies on employee training to equip them with the necessary knowledge required for the successful implementation of the guidelines. In the regulations on publication of financial statements, banking institutions are periodically required to publish their financial statements. This is intended at safeguarding the integrity and credibility in these institutions thus maintaining public confidence.

Further, prudential regulations on mergers, amalgamations and assets and liabilities transfer, issue guidance on the procedures and minimum requirements for merging or amalgamating institutions and those of transferring assets or liabilities (Vianney, 2013). The prudential regulations also explain the approach the CBK takes in issuing quick supervisory advice and corrective orders to institutions through the enforcement of banking laws and regulations guidelines. Supervisory imposition actions contained in the CBK regulations 2006 have tried to set forth the banking practices, conditions and violations leading to a specific problem or weakness recognized, ordinarily through on-site assessments (Victoria, 2014).

All these prudential regulations aim at reducing the risk to which banking institutions expose their customers. They also aim at creating a stable banking sector and fostering bank performance. Performance in banking institutions can be measured using various parameters for financial and non-financial performance.

Performance indicators include profitability, economic value addition, quality of management, level of alignment of bank operations to its goals and objectives, size of customer base, customer satisfaction, capital adequacy, asset quality and liquidity management among others (Njeule, 2013).

2.4 Empirical Studies and Research Gap

Vianney (2013) studied the relationship between regulation and the Rwandan commercial banks financial performance. Descriptive research design was employed in the study, the sample size considered was 10 commercial banks. The study found that regulation is not a significant predictor of financial performance of commercial banks in Rwanda.

It is stated in the findings that regulation is a key pillar of financial institutions operation and by extension financial prosperity and stability. The study recommended that the government of Rwanda develop policy that will help banks to operate in a conducive environment and this can create financial stability of financial institutions in the country.

Victoria (2014) conducted a study on financial regulations and prudential innovations; effect of new rules of Basel 3 in Balti, Moldova. The study relied on primary data and a research questionnaire for data collection. The study noted that regulation reduces the banks' participation in activities that are very risky, lowering the chances of extreme consequences due to a crisis and offering the ability to deal with shocks without reliance on the government's support.

Adina (2015) did a paper on the performance, banking risks and their regulations in Romania. The study covered a period of three years and it adopted descriptive survey study. In his study, he notes that credit institutions need to position themselves regularly with regards to risk and profitability.

From the research prudential supervision prevents manifestation of internal and external risks to the level of a banking institution and prevents their spread thus improving performance.

Wachiuri (2012) studied the impact of capital sufficiency requirements on creation of credit by Kenyan commercial banks. The study adopted a descriptive research methodology which relied on secondary data. The study concludes that there is a strong relationship between capital adequacy requirements and credit creation. From the study, after introduction of capital adequacy requirements the credit created experienced a downturn giving a negative trend as banks put in more capital to meet the requirements thus reducing credit creation.

Mureithi (2012) conducted studies on the consequence on financial performance of Deposit-Taking Microfinance institutions (DTMs) in Kenya, by financial regulations. The design of the research used was descriptive survey method and cross sectional method. The target population was 6 DTMs in Kenya. She concluded that the supportive Deposit Taking Microfinance Regulations of 2008 led to the improvement in financial performance of DTMs.

Ochieng (2014) studied the impact of Central Bank of Kenya prudential regulation guidelines and regulations on the financial performance of commercial banks. The study's findings were a positive relationship ($r = 0.628$) between CBK prudential regulations and financial performance. CBK prudential guidelines account for 29.9% of the financial performance of Kenyan commercial banks according to the study.

Mwega (2014) conducted a case study in the Kenyan financial sector to investigate the potential relationship between regulation and the financial sector's stability.

The study focused on the banking sector. The study adopted a descriptive research methodology which relied on secondary data. Collected data was analyzed using regression analysis. The study states that finance aims at propagating economic activity and the main aim of regulations is maintaining financial stability and enhancing economic growth. The study concluded that reforms in the financial sector over the last ten years have strengthened.

Mwongeli (2016) carried out a study on the impact of regulation on Kenyan commercial banks financial performance. In the study finance ratios were carried to measure financial performance between 2010 and 2015. A chi-square test of independence was carried out to determine the relationship between the two variables. Eight out of nine ratios revealed accepted the null hypothesis that there is no relationship between regulations.

From the studies analyzed above, there exists a research gap with regard to Central Bank prudential regulations and performance of Kenyan commercial banks. Most studies have concentrated on the financial performance only without considering non-financial performance. This creates a research gap. This study is therefore important in order to fill this gap by determining the impact of Central Bank prudential regulation as a strategic resource on performance of commercial banks.

CHAPTER THREE: RESEARCH METHODOLOGY

3.1 Introduction

This chapter describes the method to be used in carrying out the research study. It will discuss procedures and techniques used in the collection and processing of data such as the research design as the research design. Populace of the study, instruments of collection of data and techniques and analysis of data.

The research methodology will include research design which explains the research design selected is a descriptive research design. A descriptive design is appropriate since it involves observing and describing the behavior of the variable without influencing it in anyway. The data collection process will use of questionnaire to collect primary data.

The population under study consists of all the 43 commercial banks in Kenya hence a census study is adopted. Collected data will be summarized, coded, classified and tabulated using statistical package for social sciences (SPSS). Data output shall be presented using statistical measures such as such as measures of central tendency and inferential statistics such as multiple regression analysis.

3.2 Research Design

The explanation by Burns and Grove (2003) of research design is a structure that gives direction and systemizes the research with maximum control over aspects that may impede with the finding's validity. Additionally, the structure of a research design incorporates questions that are investigative and also part of formal studies.

This design is suitable since the major interest is exploration of a viable relationship and illustrate how the aspects are in support of the matter being investigated.

The investigation will be a census study and will utilize primary data. A census study involves collecting data from items (banks) under investigation (Cooper & Schindler, 2006). A census study is necessary for this study due to the small number of Kenyan commercial banks (43) and it also provides vast knowledge of the populace of study.

Standardized questions will make measurement more particular by effecting uniform definitions upon the participants as well as making sure that similar data will be collected from groups then deduced comparatively. The use of the study will be in establishment of the impact of the prudential regulations of the Central Bank of Kenya on Kenya's commercial banks performance.

3.3 Population of the Study

Every item being considered in any inquiry field makes up the 'universe' or 'population'. Population here stands for the whole group of individuals or objects from which the study will generalize its findings (Burns & Grove, 2003). Cooper and Schindler (2006) states that the population must be stated so that the right sources from which data are to be collected can be recognized. The population for this study will be Kenyan commercial banks.

The researcher will do a census study due to the small number of respondents in the target population whose responses are important in this study.

Mugenda and Mugenda (1999) explain a target population as one that the researcher wants to generalize the study results. The target population of the study comprised of licensed commercial banks in Kenya.

The populace of the study will be all of Kenya's commercial banks in operation as at 31st December, 2016. According to (Central Bank of Kenya, 2017) there are the forty three (43) Kenyan commercial banks. Among the 43 institutions, 39 commercial banks and the mortgage finance institution are owned privately while the remaining 3 commercial banks have their stakes controlled by the Kenyan Government. Among the 39 privately owned banks 25 of them and the 1 mortgage finance institution privately owned locally while the remaining 14 are owned by the foreign individuals (CBK, 2017).

3.4 Data Collection

In order to comprehensively make valid conclusions, primary data will be collected from study respondents. This is an important approach in a census study as it provides first hand sources of information for the study (Cooper and Schindler, 2006).

The instrument for data collection will be the questionnaire. The questionnaire will be divided into three sections. Section (A) will capture information about general characteristics of the organization and the respondents; Section (B) will capture information on Central Bank prudential regulations on performance.

The respondents will be the operations managers. The method used in research administration will be the drop and pick method due to the necessity to collect detailed and well thought out responses. The method will give respondents sufficient time and privacy to fill in their responses.

3.5 Data Analysis

The primary data obtained from the commercial banks through the use of questionnaires, will be reviewed for consistency and completeness so as to carry out statistical analysis. Mugenda (2003) suggests that to establish a report that is significant, there has to be cleaning, coding and correct analysis of data. The collected data will be sorted and arranged for Statistical Packages for Social Sciences (SPSS).

The assessment of the data obtained will be use of descriptive statistics; frequencies and percentages, means and standard deviations and also inferential statistics. The presentation of data will be in the form of frequency tables, charts and bar graphs. Regression analysis will be performed to determine the relationship between Central Bank prudential regulations and performance.

The model to be used in the study takes the form below:

$Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \varepsilon$

Where; Y= the dependent variable (performance)

α - Is a constant; the concept explaining the level of performance given and it's the Y value when all the predictor values (X_1, $X_{2,}$ $X_{3,}$ X_4) are zero,

β_1, $\beta_{2,}$ $\beta_{3,}$ β_4 – Are constants regression coefficients

Y= performance

X_1 –Capital adequacy

X_2 – Liquidity management regulation

X_3 – Proceeds from crime and money laundering;

X_4 –Regulation on mergers and acquisition

ε - (Extraneous) Error term

CHAPTER FOUR: DATA ANALYSIS, RESULTS AND DISCUSSION

4.1 Introduction

This section provides the output of the analysis on the data collected using the questionnaires provided to the commercial banks employees. The approach adopted is both descriptive analysis and regression analysis to determine the effect of regulatory methods to performance of the commercial banks.

4.2 Demographic Information

The demographic data obtained from individual respondents and their background is examined in this segment. Doing this enabled the researcher comprehend the respondents setting and their ability to provide useful data. The results are presented according to the demographics and the research questions. The general information sought from the respondents included age and length of service in the Commercial banks.

4.2.1 Response Rate

The study targeted a total of 43 respondents from the 43 Commercial banks in Kenya. Structured questionnaires were administered to the respondents who were either finance Managers or administration and accounts Managers. Out of these, 37 respondents successfully filled out the questionnaires and returned them back hence putting the response rate of the study at 86.0%. Mugenda and Mugenda (2009) indicated that a response percentage of more than 70% is to be considered good enough for examination and reporting.

Table 4.1 Response Rate of Questionnaires

Questionnaires Given Out	43
Questionnaires Returned	37
Response Rate (%)	**86.0%**

4.2.2 Age of respondents

The respondents from the Commercial banks were asked to indicate their ages and select appropriately their age brackets. The analysis of age result s are shown in Table 4.2 provides their responses.

Table 4.2 Age of respondent

Age	Frequency	Percentage
Under 30	8	22%
30-40	6	16%
41-50	15	41%
Over 50	8	22%
Grand Total	37	100%

The findings in Table 4.2 indicate that most of the respondents are more than 40 years of age. This is a good indicator that a majority of them are highly likely to have a good understanding of the concepts in the study.

4.2.3 Length of service within the bank of the respondent

The respondents from the Commercial banks were asked to indicate the number of years they have for the commercial and select appropriately. The analysis of number of years of working with the commercial banks is shown in Table 4.3 and their responses.

Table 4.3 Length of within the bank of the respondent

Years	Frequency	Percentage
Less than two years	9	24%
2-5 years	5	14%
6-10 years	12	32%
Over 10 years	11	30%
Grand Total	**37**	**100%**

The findings in Table 4.3 indicate that most of the respondents have more than 6 years of working with their current commercial bank. This is a good indicator that most respondents are likely to have a good understanding of the concepts in the study.

4.3 Central Bank Prudential Regulations

The analysis of the Central Bank Prudential Regulation was also undertaken from the respondents and critical statistics were calculated such as mean and standard deviation. The respondents were asked to what extent do they think the prudential regulation had impact on the banks performance in a scale of 1 to 5 where: 1 = to a large extent; 2 = to a moderate extent; 3 = to a slight extent; 4 = to no extent; 5 = Neutral.

The results show that most of the respondents answered the questions at average scale less than 2, meaning they had a strong believe that the central bank prudential regulations have an impact on the bank performance. The Table below gives the summary statistics on prudential regulations

Table 4.4 Central Bank Prudential Regulations

Central Bank Prudential Regulation	Mean	STD
Limit on Advances, Credits and Guarantees	1.3	2.2
Capital adequacy	1.3	2.1
Liquidity management regulation	1.2	2.3
Restrictions on Advances, Credits and Guarantees.	1.5	3.1
Restrictions on Proceeds from crime and money laundering;	1.5	3.0
Regulation on mergers and acquisition	1.5	3.1
Restrictions on Trading and Investments	1.3	3.6
Restrictions on Ownership of Share Capital of an Institution.	1.5	3.0
Restrictions on Advances for Purchase of Land.	1.3	3.0
Mortgage Finance Companies.	1.4	2.6
Restrictions on Deposit Taking.	1.4	3.0
Imposition of Charges and Payment of Interest	1.4	2.7

4.4 Regression Analysis

Regression analysis was used determine the correlation between CBK regulation and the performance of banks in Kenya. The dependent variable is the performance of Commercial banks while the independent variables are central bank regulations. The regression model on performance and the entire regulation variables were adopted to determine how the factors affect the performance of the commercial banks.

The regression variables with all the 12 variables gave the following results from the 37 respondents:

Table 4.5 Regression Statistics

Regression Statistics	
Multiple R	0.8557
R Square	0.7322
Adjusted R Square	0.5984
Standard Error	0.8627
Observations	37

The multiple R shows a value of 0.8557 which implies that 85.57% of the variation in performance can be attributed to the prudential regulation by CBK on the commercial banks. The adjusted R square reduces to 59.84% which is still significant value of variation to performance explained by CBK regulations.

The above results is confirmed by the ANOVA results table, which validates that the effects of the 12 CBK variables did not occur by chance but are statistically significant at 10% level in determining the performance of the commercial bank. The column SS (sum of squares) shows that SS due to regression is 48.8 while the residual SS is 17.8 thus the CBK regulation variables have an impact on the performance of the commercial banks.

Table 4.6 ANOVA Results Table

ANOVA

	df	*SS*	*MS*	*F*	*Significance F*
Regression	12	48.8421	4.0702	5.4692	0.0002
Residual	24	17.8606	0.7442		
Total	36	66.7027			

The regression model of the 12 variables to the performance gave the results in the Table below, from the model results it was clear that not all variables have affects performance at 10% level however, Capital adequacy, Liquidity management regulation, Restrictions on Proceeds from crime and money laundering as well as Restrictions on Ownership of Share Capital of an Institution to larger extent have an effect on the performance of the commercial banks.

Table 4.7 Regression model of the 12 variables to the performance

Variables	*Coefficients*	*Standard Error*	*P-pvalue*
Intercept	6.5992	1.3706	0.0001
Limit on Advances, Credits and Guarantees	0.1071	0.1459	0.4701
Capital adequacy	-0.2274	0.0639	0.0780
Liquidity management regulation	-0.6835	0.1763	0.0007
Restrictions on Advances, Credits and Guarantees.	-0.0494	0.1897	0.7967
Restrictions on Proceeds from crime and money laundering;	-0.4639	0.2629	0.0903
Regulation on mergers and acquisition	0.0515	0.2428	0.8337
Restrictions on Trading and Investments	-0.1447	0.2704	0.5974
Restrictions on Ownership of Share Capital of an Institution.	-0.1248	0.0899	0.0173
Restrictions on Advances for Purchase of Land.	0.2756	0.2056	0.1926
Mortgage Finance Companies.	-0.0351	0.2073	0.8669
Restrictions on Deposit Taking.	0.1288	0.2345	0.5880
Imposition of Charges and Payment of Interest	-0.1081	0.2215	0.6301

4.5 Discussion of Results

The study targeted a total of 43 respondents from the 43 Commercial banks in Kenya. Out of these, 37 respondents successfully filled out the questionnaires and returned them back hence putting the response rate of the study at 86.0%.

The analysis of age of the respondents indicates that most of the respondents are more than 40 years of age. This is a good indicator that a majority of them are highly likely to have a good understanding of the concepts in the study. A further analysis of the number of years of working with the commercial banks indicates that most of the respondents have more than 6 years of working with their current commercial bank which is a good indicator that a majority of them are highly likely to have a good understanding of the concepts in the study as well.

An analysis of the extent to which the prudential regulation are perceived to have an impact on the banks performance shows that most of the respondents answered the questions at average scale less than 2, meaning they had a strong believe that the central bank prudential regulations have an impact on the bank performance.

Regression analysis on performance and the entire 12 regulation variables were adopted to determine how the factors affect the performance of the commercial banks shows that 85.57% of the variation in performance can be attributed to the prudential regulation by CBK on the commercial banks. From the regression model results it is clear that not all variables have affects performance at 10% level however, Capital adequacy, Liquidity management regulation, Restrictions on Proceeds from crime and money laundering as well as Restrictions on Ownership of Share Capital of an Institution have a significant effect on the performance of the commercial banks.

CHAPTER FIVE: SUMMARY OF FINDINGS, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

This chapter summarizes the research findings, highlights conclusions and pinpoints recommendations made from the study. Suggestions for further research are also presented and limitations encountered in the study.

5.2 Summary of the Findings

The objective of this study was to establish the effects of central bank prudential regulation on performance of commercial banks in Kenya. The study show that most of the respondents answered the questions at average scale less than 2, meaning they had a strong believe that the central bank prudential regulations have an impact on the performance of commercial banks in Kenya. The study results were clear that not all variables had significance effects on performance, however, Capital adequacy, Liquidity management regulation, Restrictions on Proceeds from crime and money laundering as well as Ownership of Share Capital of an Institution to larger extent had an effect on the performance of the commercial banks.

The findings indicate that most of the respondents had more than 6 years of working with their current commercial bank, hence a good indicator that a majority of them were highly likely to have a good understanding of the concepts in the study. Majority of the respondents were over 40 years in age hence a highly likelihood of an informed understanding about the subject under study.

The study regression model of the 12 variables to the performance gave the results that it was clear that not all variables have an effect on performance at 10% level however, Capital adequacy, Liquidity management regulation, Proceeds from crime and money laundering as well as Ownership regulation of an Institution to larger extent have an effect on the performance of the commercial banks. Most regulation variables are implemented by CBK to protect the public from unfair business including high interest from commercial banks, this directly

5.3 Conclusions

Conclusion can be drawn from findings of this study that Performance of Commercial banks is influenced by number variables which include Capital adequacy, Liquidity management regulation, Restrictions on Proceeds from crime and money laundering as well as Restrictions on Ownership of Share Capital of an Institution. From the study, it's clear that most of the central bank prudential regulations hinder the performance of commercial banks as they are aimed at protecting the customer as highlighted on the public interest theory. Regulation on interest rates (interest capping) as implemented by CBK, protects the customer but affects the financial performance of the banks.

From the findings, conclusion can be made that CBK regulation and performance of commercial banks are dependent, hence critical for banks to align strategies to CBK regulation hence control effects on their performance. Conformity and compliance to CBK regulations may affect commercial banks performance positively or negatively.

5.4 Recommendations of the Study

In line with the findings of this study, the researcher recommends that commercial banks in Kenya should align their Strategies to competitively match CBK prudential regulation and in the long run safeguard their financial and non-financial performance. The CBK should adequately probe regulations and their effects on commercial banks before implementing them.

This study also recommends that management in Kenyan commercial banks should closely keenly monitor CBK regulations to allow conformity and compliance hence safeguarding penalties and fines.

5.5 Limitations of the Study

This study had its fine share of limitations. Some of the targeted respondents had a very busy schedule to take time and respond to the questionnaires even after several requests. Securing face to face interviews for further clarifications on some items in the questionnaires was a challenge. The researcher addressed this by using technology to to avail some questionnaires to the respondents.

Considering of the monetary nature of work and sensitivity of financial information handled by Commercial banks, some interviewees were not very ready to give out information for fear that the information may be used negatively against them. The researcher addressed the problem by providing an introduction letter from the university and assured them that the information they would offer would be treated confidentially and it was to be used purely for academic purposes.

5.6 Suggestions for Further Research

This study adds to the pool of literature available on effects of banking regulations and more specifically prudential regulation on the performance of commercial banks. This will help scholars and academicians gain a broader understanding of the subject. The findings of this research may be used as a basis for future research or used to identify research gaps to be covered by other researchers in future.

More variables on regulation should be studied in future to determine the effects on performance of commercial banks. Case studies on specific banks should be carried out to compare effects of regulation on performance of banks.

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Appendix I: Research Questionnaire

This questionnaire is aimed at collecting data regarding the effect of Central Bank Prudential regulations on performance of commercial banks in Kenya. You have been selected to participate in the study and are requested to take a few minutes of your time to kindly answer the questions presented. Kindly give your most accurate response to all the questions as requested. We assure you that your responses will be confidential. Your kind support is deeply appreciated.

SECTION A: BACKGROUND INFORMATION

1. Name of the organization (optional) ………………………………………………...

2. Please indicate here your job title …………………………………………………

3. How many years has the bank been in operation in Kenya?

    Less than two years ( )
    2-5 years ( )
    6-10 years ( )
    Over 10 years ( )

4. Age bracket

    Under 30 years ( )
    30-40 years ( )
    41-50 years ( )
    Over 50 years ( )

5. Length of continuous service within the organization

    Less than two years ( )
    2-5 years ( )
    6-10 years ( )
    Over 10 years ( )

SECTION B: EFFECT OF CENTRAL BANK PRUDENTIAL REGULATIONS ON PERFORMANCE

6. To what extent do the following central bank prudential regulation factors affect performance? (Key: 1 = to a large extent; 2 = to a moderate extent; 3 = to a slight extent; 4 = to no extent; 5 = Neutral)

Statement	1	2	3	4	5
Limit on Advances, Credits and Guarantees					
Capital adequacy					
Liquidity management regulation					
Restrictions on Advances, Credits and Guarantees.					
Restrictions on Proceeds from crime and money laundering;					
Regulation on mergers and acquisition					
Restrictions on Trading and Investments					
Restrictions on Ownership of Share Capital of an Institution.					
Restrictions on Advances for Purchase of Land.					
Mortgage Finance Companies.					
Restrictions on Deposit Taking.					
Imposition of Charges and Payment of Interest					

SECTION C: PERFORMANCE

7. How would you rate the organization performance on the following attributes over the past 5 years to that of other banks? Use a 5 point scale where 1=very poor, 2=poor, 3=average, 4=good and 5=very good.

Statement	1	2	3	4	5
Quality of products or services					
Development of new products or services					
Ability to retain essential employees					
Ability to attract essential employees					
Relationship among employees					
Satisfaction of customers					
Retention of customers					

8. Compared to other banks, how would you rate your banks performance over the last 5 years? Use a 5 point scale where 1=very poor, 2=poor, 3=average, 4=good and 5=very good

Statement	1	2	3	4	5
Profitability					
Market share					
Capital level					
Customer level					
Total deposits					
Internal business process					

Appendix II: List Commercial Banks in Kenya

1. African Banking Corporation Ltd.
2. Bank of Africa Kenya Ltd.
3. Bank of Baroda (K) Ltd.
4. Bank of India
5. Barclays Bank of Kenya Ltd.
6. Charterhouse Bank Ltd.
7. Chase Bank (K) Ltd.
8. Citibank N.A Kenya
9. Commercial Bank of Africa Ltd.
10. Consolidated Bank of Kenya Ltd.
11. Co-operative Bank of Kenya
12. Credit Bank Ltd
13. Development Bank of Kenya Ltd.
14. Diamond Trust Bank Kenya Ltd.
15. DIB Bank Kenya Ltd.
16. Ecobank Kenya Ltd
17. Equity Bank Kenya Ltd.
18. Family Bank Ltd
19. First Community Bank Limited
20. Guaranty Trust Bank Ltd
21. Guardian Bank Ltd
22. Gulf African Bank Limited
23. Habib Bank A.G Zurich
24. I & M Bank Ltd
25. Imperial Bank Limited
26. Jamii Bank Ltd
27. KCB Bank Kenya Ltd.
28. Mayfair Bank Ltd
29. Middle East Bank (K) Ltd
30. M-Oriental Bank Limited.
31. National Bank of Kenya Ltd
32. NIC Bank Ltd
33. Paramount Bank (K) Ltd
34. Prime Bank Ltd
35. SBM Bank Kenya Ltd
36. Sidian Bank Ltd
37. Spire Bank Ltd
38. Stanbic Bank Kenya Ltd
39. Standard Chartered Bank
40. Trans-National Bank Ltd
41. UBA Kenya Bank Limited
42. Victoria Commercial Bank Ltd
43. Housing Finance Ltd

Source: (CBK, 2017)