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ABSTRACT

This study investigated the effect of liquidity management guidelines on financial performance of commercial banks in Kenya. The study used descriptive survey research design. The researcher targeted all 42 commercial banks in and purposively selecting three senior management staff from every bank to arrive at a sample size of 130 respondents that participated in the study. The study collected both primary and secondary data. Structured questionnaires were used to collect primary data. Data collected was quantitative in nature and it was analyzed by factor and descriptive analysis. The descriptive statistical tools such as SPSS version 26 was used to describe the data and determine the extent to which the growth strategies were used and the level of growth achieved. The findings were presented using tables and charts. Tables were used to summarize responses for further analysis and facilitate comparison. The study showed that CBK prudential regulations on capital adequacy affects the banks performance on total deposits.

Key Words: *Capital Adequacy, Central Bank of Kenya Guidelines*

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INTRODUCTION

The CBK has issued a new set of Prudential Guidelines and Risk Management Guidelines which came into force on 1st January, 2013 (the "Prudential Guidelines"). Banks, financial institutions and mortgage finance companies need to adhere to these Prudential Guidelines. The Prudential Guidelines deal with a wide range of issues including licensing requirements, corporate governance, capital adequacy requirements, liquidity management, stress testing, foreign exchange exposure limits, prohibited business, anti-money laundering, consumer protection, enforcement of banking laws and regulations, agent banking, and representative offices (Sonal et al. 2013). A study by Muthoni (2013) focused on CBK/PG/1 CBK/PG/6 CBK/PG/7 CBK/PG/8 (Licensing of New Institutions, Foreign Exchange Exposure Limits, Prohibited Business, and Proceeds of Crime and Money Laundering (Prevention)). Mabeya, Nyakundi and Abuga (2016) studied the effects of prudential guidelines on profitability of Commercial Banks in Kenya, the study focused on risk management guidelines, loan loss prudential guidelines, and consumer protection guidelines. This study delimited itself to CBK guideline on capital adequacy. The study sought to establish the effect of capital adequacy guideline on the financial performance of the banks in Kenya. The capital adequacy guideline is issued under section 33(4) of the Banking Act, which empowers the Central Bank of Kenya to issue guidelines to be adhered to by institutions in order to maintain a stable and efficient banking and financial system. Section 18 of the Banking Act empowers the Central Bank of Kenya to prescribe the minimum ratios that shall be maintained by institutions as between their core capital and total capital on one hand and their risk weighted assets and off-balance sheet items on the other, and for that purpose, may also determine the method of classifying and evaluating assets.

The origin of commercial banking in Kenya relates to commercial connections in East Africa, which existed towards the end of the 19th Century. First, there was National Bank of India in Kenya in 1896 after the establishment of the British in the region. It was followed by Standard Bank of South Africa in 1910. In 1916, the National Bank of South Africa merged with Anglo-Egyptian Bank Ltd to form Barclays Bank (dominion colonial). The Standard Bank of South Africa and Barclays Bank were just branches of British banks based in London. Their establishment in Kenya was in line with the practice of British banks to follow the development of trade in their colonies and concentrate on finance of international trade. National Bank of India operated mainly in India while the Standard Bank of South Africa had its main business in South Africa. Since the banks had links with Europe, South Africa and India, their businesses affected their operations, because they were mainly dealing with customers from their respective areas. Open opportunities for traders and settlers who had come to Kenya and the growing community provided initial sources of deposits in excess. The surplus, which remained unutilized in Kenya, was invested in London. Deposits were also made locally. This situation prevailed mainly because there was a gap between bankers and prospective borrowers. The banking industry in Kenya is regulated by the central bank of Kenyan Act, the companies act among other guidelines issued by the central bank of Kenya (CBK). Banking industry in Kenya was liberalized back in 1995 and exchange controls revoked. Today, the banking system comprises of 46 commercial banks, 15 micro finance institutions and 109 forex bureaus as at the end of December 2014. According to Ngumi (2015), the Kenyan Banking Sector registered improved performance since the introduction of the guidelines in 2006 with the size of assets standing at Ksh. 2.4. trillion, loans & advances amounting to Ksh.1.4 trillion, while the deposit base stood at Ksh. 1.8 trillion and profit before tax of Ksh.28.2 billion as at 31st March 2013. During the same period, the number of bank customer deposit and loan accounts stood at 17.3 million and 2.3 million respectively. Although Kenya's financial access surveys conducted in 2009 and 2014 have shown general improvements in financial access with access to formal finance improving from 19 to 23 percent; to semi-formal improving from 8 to 18 percent; informal declining

from 35 to 27 percent and the excluded falling from 38 to 33 percent, access to finance for rural areas is still low, with 64 percent of the rural population not accessing formal financial services and 21 percent being excluded from any form of financial services. This is a huge drag to development that is driven by financial access. Therefore, access to finance allows the poor to escape poverty by building their assets through savings and credit. The Central Bank of Kenya, remain committed to promoting innovations that will enhance financial access and inclusion for the people of Kenya.

Financial performance is a measure of how well a bank is utilizing its resources to generate income. Bank's financial performance is not only important to bank management and shareholders but alsoto customers and creditors as they make decisions on dealing with the bank (Ndolo, 2017). Commercial banks operate with the objective of making profits. Profits ensure continuity of business taking into account the current competition within the banking industry, this goal can either be enhanced or curtailed by the prudential regulations (Gudmundson *et al,* 2013).

There are various ratios to measure profitability of banks such as return on assets (ROA) and returnon equity (ROE). Return on assets ratio indicates profitability of banks by comparing income to total assets, which is a better measure of performance as it includes even borrowed capital. Returnon Equity indicate what shareholders get in return for their investment by showing how much profits a company has earned compared to the total amount of shareholder's equity. The higher theratio, the better the level of performance as it indicates effectiveness in the use of shareholder's equity while the lower the ratio, the poor the performance and indicate inefficiency in the use of shareholder's equity. The study measured performance using return on assets since it's the most commonly used performance indicator.

Statement of the Problem

Recently Kenya has experienced banking problems requiring major reforms of the banking systems. For example, Chase bank Ltd a mid-sized lender was temporarily closed by the regulator in April after an unexplained loss of billions of shillings. KCB Group was appointed its receiver and the central bank promised to return it normal operation by the end of the first quarter of 2017. The temporary closure of Chase, which followed the closure of Imperial Bank, another mid-sized lender, and Dubai Bank Kenya, a smaller lender, dented confidence in the industry, which has also seen a jump in bad debts. The problems are largely due to domestic causes, such as weak banking supervision and inadequate capital. A key part of bank regulation is to make sure that firms operating in the industry are prudently managed (Berg, 2010) Thus, prompting the need for this study that sought to examine the effects of Central bank prudential guidelines on bank financial performance. To the best of the researcher's knowledge there is limited studies that have focused on central bank of Kenya prudential guidelines on capital adequacy and financial performance. It is against this background that his study investigated the effect of capital adequecy guidelines on financial performance of commercial banks in Kenya.

Objective of the Study

The objective of the study was to investigate the effects of capital adequacy guidelines on financial performance of commercial banks in Kenya.

LITERATURE REVIEW

Public Interest Theory of Bank Regulation

Public Interest theory assumes that the economic markets are very fragile and they have a tendency to operate inefficiently and in favor of individual's concern while ignoring the importance of the society as a whole. Therefore, to direct and monitor the economic markets government's intervention is required. The author said that the government regulates the banks to make them work in the social interest. The banks are able to serve the social interest when resources are allocated efficiently and in social interest.

The Theory was developed by Pigou (1932). The author believed that the regulations are prepared in

the public interest when they are demanded by the public for correcting inefficient practices. Regulations are understood to do good to the whole society rather than any individual's interest. The regulatory body is to serve the interest of the society as a whole rather than making laws in favor of the regulators. Stigler (1972)'s public choice theory is contrasted with Pigou (1932)' public interest theory. Stigler said regulations are prepared when the public demands the efficient allocation of the resources. He said regulations are not socially efficient and used by private players to prohibit the entry of competitors in the market. Now when corporate are disclosing only financial performance of organizations but they are disclosing other non-financial but relevant information such as environmental and social impact of the organizations activities, initiatives of the organizations to improve the undesirable impact of their activities on the society and environment. With reference to the public interest theory it is a rationale decision to introduce the legislation which mandates for the corporate to disclose the impact of their activities on the society and environment and also disclose the initiatives taken by them to protect the society and the environment from the adverse impact of their activities.

The growth of regulation in 1930's was simply a functional response to the changing public needs and interests of an evolving industrial society. Despite its romantic appeal, the public interest theory has been theoretically and practically discredited for its inability to take into account competing conceptions of the public good, its ascription of heroic and unrealistic attributes to regulators, its underestimation of the power of organized interests, and its failure to explain why regulation often fails to deliver public interest outcomes (Baldwin & Cave, 1999). The public interest theory of regulation also holds that firms require regulations in order to guarantee the choice theory of regulation, which rests on the premise that all individuals, including public servants, are driven by self-interest(Hantke-Domas, 2003).

Empirical Review

Capital Adequacy Prudential Guidelines and Financial Performance

The capital structure of banks is highly regulated. This is because capital plays a crucial role in reducing the number of bank failures and losses to the stakeholders. According to Hardy & Bonaccorsi di Patti (2001) and Nwankwo, (1991) capital adequacy is a widely acknowledged key factor in bank performance measurement and evaluation. It is the first of the five CAMEL factors recognized and adopted by the Basel system of bank performance assessment of the Bank for International Settlement (BIS). The used capital adequacy ratio was adopted in the Nigeria banking system in 1990 as stipulated by the bank monitoring and supervising authority which is the Central Bank of Nigeria (CBN).

Beckmann (2007) argue that high capital lead to low profits since banks with a high capital ratio are risk-averse, they ignore potential (risky) investment opportunities and as a result, investors demand a lower return on their capital in exchange for lower risk. The regulation that exists in most countries is capital requirement. Capital adequacy requirements can take a variety of forms. Most countries know their minimum level of required capital. Therefore, many countries require the maintenance of some capital- or solvency- ratio; that is, a minimum ratio between capital and an overall balance sheet magnitude, such as total assets or liability, or some weighted measure of risk assets. The Basel Accord was modified in 2004 introducing more sophisticated ways of computing capital requirements and increasing the focus on risk-management policies and systems in banks. In particular, the new regulation, which will start to be implementation from the end of 2006, encourages banks to develop, with supervisory oversight, their own systems to compute minimum capital requirements (Biggar, & Heimler, 2005).

Acharya (2003) noted that minimum capital requirements are an ex ante mechanism to prevent bank failures and closure policies are an ex post mechanism to manage the cost of bank failures. He

showed that from bank owners' perspective, the optimal level of bank capital decreases in the extent of regulatory forbearance. In contrast, from regulators' perspective, the optimal minimum level of required bank capital is increasing in the extent of regulatory forbearance. Capital requirement regulations represent a mainstay of banking sector policies around the world. Many rules and policies determine the precise amount and nature of capital that banks must hold. In terms of the amount of capital, this is typically characterized in terms of the ratio of capital to total banks assets. In terms of the nature of capital, there are policies concerning the definition of capital beyond cash or government securities, the definition and valuation of bank assets, and whether the regulatory and supervisory authorities verify the sources of capital (Barth, Caprio & Levine, 2013)

Chen, Robinson, and Siems (The Wealth Effects from a Subordinated Debt Policy: Evidence from Passage of the Gramm-Leach-Bliley Act) examined safety and soundness protection via minimum capital requirements by looking at the passage of regulations advocating a mandatory subordinated debt policy especially for large banks. They find that over the period of time in which the Gramm-Leach-Bliley Act was passed, a portfolio of banks with relatively high amounts of subordinated debt experienced positive and significant wealth effects. Portfolios made up of all banks, and those with no subordinated debt, however, experienced statistically insignificant wealth effects. The results suggested that policymakers should indeed consider the use of subordinated debt as a way to enhance market discipline and thus the safety and soundness of commercial banks.Bris and Cantale (2004) suggested that bank capital regulation should allow different banks to hold different capital levels based on characteristics such as separation of ownership and control, which lead to under investment and lower risk taking due to managers' self-interests.

Odunga *et al.,(*2013) examined the effects of liquidity and capital adequacy on the operating efficiency of 40 commercial banks in Kenya for the period 2005-2011. They found that bank's performance is influenced by how a bank moves forward in an effort to streamline its operational strategies. They added that commercial banks with enough liquid assets tend to draw more confidence with customers because of the ability to address short-term financial obligations. It is therefore important for the central bank to ensure full compliance with the minimum liquidity requirement by commercial banks.

Regardless of such regulatory framework, the major intention of holding capital is to build the internal strength of the bank to withstand losses during crisis (Dang, 2011). However, some authors argue that capital also affects performance via creating liquidity, hence banks with strong capital position are able to reduce their financing costs, for example by paying low interest rates on their debt). However, holding high capital level is not without drawbacks: a higher CAR ratio reduces the ROE due to two mechanisms: a high ratio indicates a lower risk and the theory of markets to balance advocating a strong relationship between risk and profitability would lead us to infer a lower profitability (Diamond and Rajan, 2001). Kamau (2009) asserted that adequate capital requirements help to lessen the chance that banks will become insolvent if sudden shocks occur.

METHODOLOGY

This study adopted a descriptive survey research design. The researcher targeted all the 43 commercial banks in Kenya. The study population comprised of the senior most managers. The study focused on the section and particularly on staff who were well versed with the subject of the study. The researcher randomly selected a sample of 13 banks from a population of 42 licensed commercial banks in Kenya. This sample included banks from all the 3 tiers. Further, 10 questionnaires were being administered in the banks selected. This yielded 130 questionnaires for analysis. This study, being descriptive in several characteristics, coupled with the fact that it targets a relatively large population geographically spread in Kenya the researcher sought to develop use questionnaires as the key data collection instrument. The questionnaire items

comprised of both closed ended and open- ended questions.

Before processing the responses, the completed questionnaires were edited for completeness and consistency. The data was then be coded to enable the responses to be grouped into various categories. Qualitative data were analyzed through content analysis. Quantitative data and were analyzed by descriptive analysis. The descriptive statistical tools such i.e. SPSS helped the researcher to describe the data and determine the extent used. The findings were presented using tables. Data analysis used SPSS percentages, tabulations, means and standard deviation. Tables were used to summarize responses for further analysis and facilitate comparison.

RESULTS

Capital Adequacy Guidelines on Financial Performance of Commercial Banks in Kenya.

Table 1: Overall Banks Performance over the last 5 years on total deposits

			Overall Banks Performance over the last 5 years on Total Deposits				
			Very Poor	Poor	Average	Good	Very Good
Extent to which central bank prudential regulation guidelines affect your banks financial performance on capital adequacy guidelines	Large Extent	Count	4	31	24	6	41
		% within Extent to which central bank prudential regulation guidelines affect your banks financial performance on capital adequacy guidelines	3.8%	29.2%	22.6%	5.7%	38.7%
		% of Total	3.1%	23.8%	18.5%	4.6%	31.5%
	Moderate Extent	Count	0	1	12	0	11
		% within Extent to which central bank prudential regulation guidelines affect your banks financial performance on capital adequacy guidelines	0.0%	4.2%	50.0%	0.0%	45.8%
		% of Total	0.0%	0.8%	9.2%	0.0%	8.5%

The goal of this objective was to find if CBK prudential regulations on capital adequacy affect the banks financial performances. This independent variable was correlated against various independent variable to establish if there is relationship between the two. 38.7% of the respondents who said that the banks performance over the last five years was very good attributed this to CBK prudential regulations on capital adequacy. A further 45% of the bank's employees surveyed believed that the banks performance on total deposits depends moderately on to CBK prudential regulations on capital adequacy. Only a minimal 3.8% in this category did not associate this to CBK prudential regulations on capital adequacy. None of the respondents attributed their banks performance on total deposits the last 5 years who did not attribute this to CBK prudential regulations on capital adequacy. Clearly, it's evident that the CBK prudential regulations on capital adequacy affects the banks performance on total deposits.

Table 2: Overall Banks performance over the last 5 years on profitability

			Overall Banks Performance over the last 5 years on Profitability				
			Very Poor	Poor	Average	Good	Very Good
Extent to which central bank prudential regulation guidelines affect your banks financial performance on capital adequacy guidelines	Large Extent	Count	47	12	12	11	24
		% within Extent to which central bank prudential regulation guidelines affect your banks financial performance on capital adequacy guidelines	44.3%	11.3%	11.3%	10.4%	22.6%
		% of Total	36.2%	9.2%	9.2%	8.5%	18.5%
	Moderate Extent	Count	1	0	12	0	11
		% within Extent to which central bank prudential regulation guidelines affect your banks financial performance on capital adequacy guidelines	4.2%	0.0%	50.0%	0.0%	45.8%
		% of Total	0.8%	0.0%	9.2%	0.0%	8.5%

Majority of those banks' employees at 44.3%, who said that their banks profitability over the last 5 years was very poor did note that CBK's prudential regulations on capital adequacy contributed to a large extent to their bank's financial performance. A further 11.3% of these bank employees noted that their banks profitability over the last 5 years was poor did claim that CBK's prudential regulations on capital adequacy contributed to a large extent to their bank's financial performance. Moreover, none (0.00%) of those respondents who felt that their banks performance on profitability was good said that the CBK's prudential regulations on capital adequacy was moderate. We note that CBK's prudential regulations on capital adequacy may not directly and necessarily affect the banks performance on profitability.

Table 3: Organizations performance on ability to retain essential employees

			Organization's performance on Ability to retain essential employees				
			Very Poor	Poor	Average	Good	Very Good
Extent to which central bank prudential regulation guidelines affect your banks financial performance on capital adequacy guidelines	Large Extent	Count	34	18	18	0	36
		% within Extent to which central bank prudential regulation guidelines affect your banks financial performance on capital adequacy guidelines	32.1%	17.0%	17.0%	0.0%	34.0%
		% of Total	26.2%	13.8%	13.8%	0.0%	27.7%
	Moderate Extent	Count	1	0	0	10	13
		% within Extent to which central bank prudential regulation guidelines affect your banks financial performance on capital adequacy guidelines	4.2%	0.0%	0.0%	41.7%	54.2%
		% of Total	0.8%	0.0%	0.0%	7.7%	10.0%

34% of those bank employees who felt that their bank's ability to retain essential employees was very good attributed this to a large extent on CBK's prudential regulations on capital adequacy. However, 32.1% of these employees did not associate this to CBK's prudential regulations on capital adequacy. Moreover, 54.2% of the respondents who felt that their bank's ability to retain essential employees was very good attributed this to a moderate extent on CBK's prudential regulations on capital adequacy. None of this was attributable to low extent in this category. We therefore note that CBK's prudential regulations on capital adequacy may not be a factor in determining the banks' ability to retain essential employees and if true to a moderate extent. A test of hypothesis can be performed in future studies to ascertain if this claim is significant or not given a set of confidence level.

CONCLUSION AND RECOMMENDATIONS

The study found out if CBK prudential regulations on capital adequacy affected the banks financial performances. This independent established if there is a relationship between the two. 38.7% of the respondents who said that the banks performance over the las five years was very good attributed this to CBK prudential regulations on capital adequacy. A further 45% of the bank's employees surveyed believed that the banks performance on total deposits depends moderately on to CBK prudential regulations on capital adequacy. Only a minimal 3.8% in this category did not associate this to CBK prudential regulations on capital adequacy. None of the respondents did not attribute their banks performance on total deposits the last 5 years who did not attribute this to CBK prudential regulations on capital adequacy. Clearly, it's evident that the CBK prudential regulations on capital adequacy affects the banks performance on total deposits.

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bank's financial performance. Moreover, none (0.00%) of those respondents who felt that their banks performance on profitability was good said that the CBK's prudential regulations on capital adequacy was moderate. We noted that CBK's prudential regulations on capital adequacy may not directly and necessarily affect the banks performance on profitability.

The study recommended that the regulator, Central Bank of Kenya should ensure all banks operating in Kenya adopt the prudential regulation as it ensures that banks have adequate capital.

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