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Abstract

Regulations and guidelines issued by the Central Bank of Kenya subject banks to certain requirements, restrictions and guidelines. This regulatory structure creates transparency between banking institutions and the individuals and corporations with whom they conduct business, among other things. The special role that banks play in the economic system implies that banks should be regulated and supervised not only to protect investors and consumers but also to ensure systemic stability. More specifically, bank regulations exist for safeguarding the industry against systemic risk, protecting consumers from excessive prices or opportunistic behaviour and finally to achieve some social objectives, including stability. The research gap was based on the observation that there exists conflicting evidence of the effect of regulations on the bank financial performance. For many years, the banks have defied all efforts to lower the prohibitive interest rates and destroyed many businesses while they earned staggering profits, even in the worst of our economic times. After the 2008 global financial crises, many countries moved to limit the self-regulation and market liberalisation of the financial sector to protect consumers. The study was based on the four objectives: to investigate the effect of capital requirement /liquidity on banks profitability; to establish effect of credit and interest rate on the banks profitability; to examine the effect of reserve requirement on the banks performance and lastly to determine the effect of financial reporting on banks profitability. The theories that informed the study included agency theory, economic theory and liquidity theory. The paper used a qualitative research design where journals, books and publications related to the research area were reviewed. The paper used content analysis as its analytical framework. The study found capital requirement may not explain the financial performance due to the fact that the total asset increases more than the equity of the commercial banks and this can lead to the to the low rate of profitability of the commercial banks. It was established that liquidity ratio does not at all explain financial performance of commercial Banks in Kenya. The studies revealed an increase of net loans compared to the short-term borrowing. Higher figures denote lower liquidity. The negative relationship between financial reporting and disclosures and financial performance is most likely to have been resulted from the increase of banks put under receivership. The most important minimum requirement in banking regulation is maintaining minimum capital ratios. There is an association between regulatory reforms and bank performance or profitability.

Keywords: *Regulatory Reforms***,** *Capital Base, Return on Assets, Interest Rates, Capital Flows, Banks' Profitability*

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1.0 Background Information

In the last two decades of the 20th century, countries worldwide have had to face an unprecedented number of commercial bank failures. As a result, attention is turning to the need for more appropriate ways to improve the performance of national financial systems. Indeed, a substantial literature is already emerging on the causes and consequences of financial-mostly banking-crises, and on various reforms that might help prevent future crises. Although the proposed reforms differ in important respects, nearly all include changes in existing financial regulations and supervisory standards. This core of agreement is certainly understandable insofar as the financial crises in countries ranging from the United States and Japan to Korea and Mexico, to Chile and Thailand, to India and Russia, and to Ghana and Hungary have been blamed at least in part on "bad" regulation and supervision (Barth et al. 2006).

The special role that banks play in the economic system implies that banks should be regulated and supervised not only to protect investors and consumers but also to ensure systemic stability. More specifically, bank regulations exist for safeguarding the industry against systemic risk, protecting consumers from excessive prices or opportunistic behaviour and finally to achieve some social objectives, including stability (Llewellyn, 1999). Last but not least regulation is important for the efficiency of the banking industry. In this respect, it is noticeable that whenever regulation is implemented with the aim of restricting or limiting banking activities, the banks' conduct of business and the efficiency with which they operate will be affected. This in turn could induce banks to engage in riskier activities and /or to invest in ways to circumvent regulation. According to some studies, it could even ultimately affect economic growth (Jalilian et al., 2007).

The capital requirement is one of the bank regulations, which sets a framework on how banks and depository institutions performance (Bourke, 1989). In contrast other studies argue that in a world of perfect financial market, capital structure and hence capital regulation is irrelevant (Modigliani and Miller, 1958). However, White and Morrison (2001) posited that the regulator ensures that banks enough of their own capital at stake. Financial performance is the primary goal of all commercial bank. Without financial performance the business will not survive in the long run.

1.1 Statement of the Problem

Regulations and Guidelines issued by the Central Bank of Kenya subject banks to certain requirements, restrictions and guidelines. This regulatory structure creates transparency between banking institutions and the individuals and corporations with whom they conduct business, among other things. The Regulations and Guidelines Pursuant to the Banking Act (Cap 488). Given the interconnectedness of the banking industry and the reliance that the national (and global) economy holds on banks, it is important for regulatory agencies to maintain control over the standardized practices of these institutions. The research gap is based on the observation that there exists conflicting evidence of the effect of regulations on the bank financial performance. If the reforms and strong enough why are banks collapsing? For many years, our banks have defied all efforts to lower the prohibitive interest rates and destroyed many businesses while they earned staggering profits, even in the worst of our economic times. After the 2008 global financial crises, many countries moved to limit the self-regulation and market liberalisation of the financial sector to protect consumers. The move will not negate financial liberalisation but complement the sector's role in enhancing affordable credit access and in serving public interest.

The interest rate capping in the Bill is not absolute, but relative, based on the CBK's benchmark rate. It will also reduce the untenably high spread between the lending and deposit rate usually seen in the larger banks. This spread is largely influenced by monopoly enjoyed by these banks, and has discouraged Kenyans from enhancing their savings. In fact, this capping will increase national savings because the deposit rates will improve significantly, drawing deposits for the banks and providing more funds for investments. It is also important to note that the government's failure to reduce its public sector expenditure leads to budget deficits, which pushes the government to borrow domestically, impacting adversely on the interest rates. Similarly, other factors such as inflation, money supply, reserve ratio and interbank rates, all of which are controlled by the government, influence interest rates.

The financial sector is one of the most heavily regulated sectors in the economy and banking is by far the most heavily regulated industry. Bank regulation typically refers to the rules that govern the behavior of banks, whereas supervision is the oversight that takes place to ensure that banks comply with those rules. The issue of financial regulation – particularly in relation to the banking sector – is often considered a controversial issue. Regulation is costly and can give rise to moral hazard problems. In addition, distortions between regulated and unregulated institutions can occur (Barth et al., 2006). Barth et al. (2004) find that increasing the level of restrictions move together with crises.

Similarly, more restriction comes with lower level of bank development. However, they do not provide a clear-cut explanation on the nature of relationship. While, we expect that regulators are ill-equipped with crises for a number of reasons, the direction of causality requires more work. It is our expectation that causality works both ways. Powerful regulators may not correctly find problems and cures for them. On the other hand, expected crises provide more reasons to control. Barth et al., (2004) do not find a strong association between bank development and performance and official supervisory power, including the quality of regulatory power. This is understandable, because the stability of the rules of the game is more important than behaviors of players. In this vein, they find a positive relationship between supervisory tenure and bank performance, which reflects the effect of regulatory commitment on the industry.

Most of the studies done on the relationship between banks regulation and bank performance of commercial banks have been conducted in the developed countries. Banks in Kenya are required to adhere to regulations set by Central bank of Kenya The management has to present the capital adequacy return reports, liquidity statement reports, Statement of financial of financial position and statement of deposit return as well as return on investment which compares financial assets to the bank's total assets and its core capital. Despite the role played by the Central bank of Kenya, and the studies done on this area, the banking sector continue to face challenges others reporting profits while other are being put under receivership thus there is need to conduct a study on the relationship between bank regulation and commercial bank performance, to fill the existing research gap.

1.2 Research Objectives

i) To investigate the effect of capital requirement /liquidity on banks performance.

ii) To establish effect of credit and interest rate on the banks performance.

iii) To examine the effect of reserve requirement on the banks performance

iv) To determine the effect of financial reporting on banks performance

2.0 Literature review

2.1 Theoretical review

2.1.1 Agency theory

Agency theory deals with two problems in agency relationship (Jensen and Me cling 1976). The first is the agency problem that arises when the goals of the principal and the agent are conflict and when it is difficult for the principal to verify what the agent is doing. The credit relationship can be likened to an agency relationship by which the creditor (the principal)"says" some of his wealth to debtors (agents) who are committed to him capital repayments an interest costs with the conditions established in a contract previously established between the two parties. One can thus infer a divergence of interest between creditor and debtor. The former wants the repayment of capital borrowed and the latter want to maximize the profitability of it. This problem is worse when information asymmetry is exaggerated. In the general finance system and in the bank regulation in particular, information asymmetry problems are bigger than in other sectors. Howels and Bain (2004) stated that the reason for bank regulation originates from the existence of asymmetric information the fact that the customers of banks are less informed and thus more at a disadvantage about the affairs of the banks than the bank itself.

2.1.2 Economic Theory

Regulation consists of rulemaking and enforcement. Economic theory offers two complementary rationales for regulating financial institutions. Altruistic public theories treat rules as governmental instruments for increasing fairness and efficiency across the society as a whole. Agency cost theory recognizes that incentive conflicts and coordination problems arise in multiparty relationship and that regulation introduces opportunities to impose rules that enhance the welfare of one sector of society at the expense of another (Diamond and Dybvig, 1983). Each rationale sets different goals and assigns responsibility for choosing and adjusting rules differently. Altruistic assign regulation to governmental entities that search for market failures and correct them. It is taken for granted that we may rely on a well-intentioned government to use its discretion and choose actions for the common good. (Jensen and Michael, 1994). Agency-cost theories portray regulation as a way to raise the quality of financial services by improving incentives to perform contractual obligations in stressful situations. These private benefits theories count on self-interested parties to spot market failures and correct them by opening more markets. In financial services markets for regulatory service create outside discipline that controls and coordinates industry behavior. Institutions benefit from regulation that: enhances customer confidence; increases the convenience of customer transactions; or creates cartel profit. Agency-cost theories emphasize the need to reconcile conflicts between the interests of institutions, customers, regulators and taxpayers (Edwards, 1997).

2.1.3 Liquidity Theory

Holmstom and Tirole (1998) provided a theory of liquidity in a model in which intermediaries have borrowing frictions. In their Model, a government has an advantage over private markets because it can enforce repayment of borrowed funds while the private markets because it can

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enforce repayment of borrowed funds while the private lenders cannot. They show that availability of government provided liquidity lead to a Pareto improvement where there is aggregate uncertainty. They further argue that the role of the government is thus to correct any Inefficiencies arising from externalities and private information and possibility of hidden trades

2.2 Conflicts in Methodology

In a study to examine the Bank profitability and inflation: the case of China, Yong Tan Department of Economics, Portsmouth Business School sampled a total of 101 banks (five state-owned banks, 12 joint-stock commercial banks and 84 city commercial banks). The period under consideration extends from 2003-2009. The two step generalized methods of moments (GMM) estimators are applied. Empirical results exhibit that there is a positive relationship between bank profitability, cost efficiency, banking sector development, stock market development and inflation in China. The authors report that low profitability can be explained by higher volume of non-traditional activity and higher taxation. Moreover, the authors confirm that there is a competitive environment in the Chinese banking industry. Furthermore, the authors propose policy actions that should be taken to improve bank profitability in China.

In the study of Production efficiency of Chinese banks: a revisit, Zhang and Wang (2014) : Data envelopment analysis is used to investigate the production efficiency of Chinese commercial banks during 2004-2011. First, the technical efficiency (TE) score is constructed to evaluate bank productivity. The TE score is disintegrated into pure technical efficiency (PTE) and scale efficiency (SE) to examine the effects of technical factors and scale economies. Second the Malmquist index is constructed to explore the year-by-year productivity. Lastly, regression analysis examines how bank characteristics and ownership structure affect productivity efficiency.

In the study of Banking supervision and nonperforming loans: a cross-country analysis Boudriga, Taktak and Jellouli (2010) used use two specifications to investigate the bank industry determinants of the aggregate NPLs and the impact of supervisory environment. The baseline model regresses the bank industry variables on NPLs. Lagged GDP growth rate and financial development are used as control variables. The second specification investigates the impact of bank supervision factors by re-estimating the baseline model including each of the four regulatory variables. Panel data combines both time series and cross-section data. First, it has the advantage to increase the number of observations, degrees of freedom and reduce co linearity among explanatory variables especially when the number of years is low. Second, pooling enables to control for exogenous shocks common to all banks (time effects) and reducing the omitted variable bias (unit effects). However, simple pooled regression may not be well designed to capture relationships between the dependent variable and explanatory variables. This is due to the fact that pooled regression assumes homogenous behavior of endogenous variable for all individuals in the sample (same intercept and same slopes).

2.3 Conflicts in Findings

According to Mahmood and Loan (2006) on the effects of financial liberalization on the cost efficiency of Pakistani banks a stochastic frontier approach, the impact of financial liberalization has been the subject of considerable academic research. Studies have shown mixed results regarding the impact of deregulation on the efficiency and performance of the banking sector. The deregulated and competitive environment in the post reform period often poses a challenge to the efficiency of commercial banks. Hüseyin Selimler researched on determinants of the effects of regulations on the performance of banks: evidence from the Turkish banking industry. The results revealed that During the period 1997-2001, the efficiency deteriorated due to the 2001 crisis; after the crisis, an improvement was observed. All models indicate the source of improvements as efficiency instead of technological changes. Rather than external, internal factors seem to be more effective on productivity. Therefore, the importance of regulations for the soundness of banks, management quality and monitoring may be more crucial than what is thought. In general, a new macroeconomic environment, particularly new regulations, have positive effects on productivity. Tighter regulations, monitoring, restrictions, strong supervision, more capital, and new reforms have a positive impact on efficiency. Tan and Floros (2012) report that low profitability can be explained by higher volume of non-traditional activity and higher taxation. Moreover, the authors confirm that there is a competitive environment in the Chinese banking industry. Furthermore, the authors propose policy actions that should be taken to improve bank profitability in China

2.4 Conflicts in Conclusions

Hasan, Wang and Zhou (2009) in the paper: Do better institutions improve bank efficiency? Evidence from a transitional economy found out that the efficiency of financial intermediation is essential for financial stability and sustainable economic growth. Prior studies on banking efficiency are primarily focused don firm-level characteristics, while leaving the impact of institutions on banking efficiency largely unexplored. It raises the concern of the scale inefficiency of Chinese banks with slow profit growth and fast asset growth. Large banks in China may shift their strategy away from asset growth. We also suggest the Chinese government continues to open up the banking sector to foreign ownership and further reduce state ownership of commercial banks.

In their journal on banking supervision and nonperforming loans cross-country Boudriga, Taktak, and Jellouli (2009) found out that there is no support for any relation between official supervision and problem loans. They suffer from the fact that the measures used only relate to statutory powers. Other studies show that all regulatory devices either exert a counterproductive impact on problem loans or do not significantly enhance credit risk exposures for countries with weak institutions, corrupt business environment, and little democracy. These findings are confirmed by the results for the developing countries panel. Moreover, the coefficient estimate on the variable supervisory power indicates a positive association with the level of NPLs. Our results suggest that granting increased power to central bankers is detrimental for financial stability in developing economies.

According to Karemera Jean Marie Vianney (2013), the Capital requirement ratio, Liquidity ratio, as well as management efficiency ratio no evidence explain financial performance of commercial banks in Rwanda. Capital requirement may not explain the financial performance due to the fact that the total asset increase more than the equity of the commercial banks in Rwanda and this can lead to the to the low rate of profitability of the commercial banks. If we look at the equity of all the commercial banks has been increasing but this does not contribute to the increase of return on assets may be because of the increase of total assets in the particular period

2.5 Gaps in Research

The results of empirical literature on the relationship between regulations (central bank of Kenya) and performance are contradictory which justifies further research. Many studies have shown that the importance of regulations for the soundness of banks and for monitoring them may be less crucial than the management quality in contrast to what is believed. To sum up, the empirical findings on some studies explain that huge entrance of banks, removal of interest rate controls, strong banking regulation and supervision and effective liberalization policies reduce net interest margins in sample countries. The policy implications for those countries facing high interest margins could reduce bank interest margins by taking measures such as deregulation of interest rate controls, removal of entry barriers, low financial taxation and strengthening of the regulatory and supervisory environment. These procedures will increase competition, efficiency and stability of banking system, leading to the reduction of net interest margins.

2.6 Empirical Review

The literature on finance and growth has proved that a well-functioning banking system and other financial intermediaries play an important role in the process of economic development Beck et al. (2009) explained that the banking sector of emerging and developing countries keeps a larger share in the financial system of a country and performs an essential role in the development function. Section 43(2) of the Kenya Deposit Insurance Act, 2012 requires CBK to appoint the KDIC as a receiver of a bank, if, among others, an unsafe or unsound condition to transact exists; a bank is likely to fail to meet its financial obligations; a bank has substantially insufficient capital or if there is a violation of any law or regulation. Chase bank sacked top officials on Wednesday after questions were raised over its financial reporting. Imperial Bank and Dubai Bank were closed in quick succession, in what was described as toxic lending practices, according to the CBK boss. National Bank of Kenya has, for instance, reported a Sh1.2 billion net loss, after announcing a Sh3.2 billion profit only three months earlier – on account on stricter reporting guidelines. Beyond the banks, Dr Njoroge has threatened to blacklist audit firms he suspects are colluding with lenders to cook books and conceal financial challenges.

Performance comparison of banks is traditionally conducted based on some key performance indicators, such as Return on Assets, Return on Equity, and other financial ratios. Efficiency studies, on the other hand, are conducted either by parametric or non-parametric frontier-based techniques. Parametric efficiency methods, such as Stochastic Frontier Analysis (SFA), are based on econometric model specifications and assume a predefined production function and error distribution. Shifts from this production function are attributed to error term and inefficiencies. The non-parametric method (DEA), on the other hand, has no assumption about the production function or error distribution. Instead, it defines the sources used for production as inputs and production results as outputs. In the banking efficiency literature, DEA seems to be much more used when compared to SFA (Berger & Humphrey, 1997; Fethi & Pasiouras, 2009; Sharma D., Sharma A., & Barua, 2013). Sherman and Gold (1985) published the first DEA study to evaluate the relative efficiency of bank branches. After that, DEA has increasingly been used to measure the efficiency of banks, bank branches, and other financial institutions.

A number of studies on financial reforms and net interest margins have been conducted in Middle East and North Africa (MENA) countries. A detailed view of the financial reform on net interest margins has been done by Chirwa and Mlachila (2004) on the commercial banking system on Malawi, which sums up the role of financial reforms by using data from 1989 to 1999, finding higher interest margins in the post-liberalization period. Demirgüç-Kunt and Levine (2008) found strong evidence in a recent study on finance and growth literature that efficient and well-functioning financial systems are strongly linked with economic development. They further suggested that consistent macroeconomic policies and strong legal systems are a must for well-functioning financial systems. Banks help or support the economy as a financial intermediary through the process of capital accumulation in a more efficient way, and also by eliminating the asymmetric information between depositors and borrowers (Hawtrey and Liang, 2008; Brock and Suarez, 2000). By providing these financial services to lenders and borrowers, banks have earned revenue, which is mainly based on interest margins.

3.0 Research Methods

This paper used a qualitative research design where journals, books and publications related to the research area were reviewed. The reviewed journals, books and publications were from various perspectives (regions) for comprehensive inferences. The paper used content analysis as its analytical framework.

4.0 Summary

From the studies reviewed, capital requirement may not explain the financial performance due to the fact that the total asset increase more than the equity of the commercial banks and this can lead to the to the low rate of profitability of the commercial banks. If we look at the equity of all the commercial banks has been increasing but this does not contribute to the increase of return on assets may be because of the increase of total assets in the particular period. Liquidity ratio has shown that it does not at all explain financial performance of commercial Banks in Kenya. Furthermore, studies have revealed that s could be attributed to the increase of net loans compared to the short term borrowing. Higher figures denote lower liquidity. This variable measures the risk of not having sufficient reserve of each cash to cope with withdrawal of deposits. Predictions vary regarding the effects of liquidity profitability. The negative relationship between financial reporting and disclosures and financial performance is most likely to have been come from the highest increase of banks put under receivership. Following the lifting of the order by the High Court of Kenya on Friday, 15th July, and the subsequent consent order allowing additional disbursements delivered today 19th July by the court, the Kenya Deposit Insurance Corporation (KDIC) will commence disbursement of funds to Imperial Bank Limited (in receivership) (IBLIR) depositors from Tuesday July 26th.

5.0 Conclusions

Banks usually require a banking license from a national bank regulator before they are permitted to carry on a banking business, whether within the jurisdiction or as an offshore bank. The regulator supervises licensed banks for compliance with the requirements and responds to breaches of the requirements by obtaining undertakings, giving directions, imposing penalties or (ultimately) revoking the bank's license. Regulations and Guidelines issued by the Central Bank of Kenya subject banks to certain requirements, restrictions and guidelines. This regulatory structure creates transparency between banking institutions and the individuals and corporations with whom they conduct business, among other things. The Regulations and Guidelines Pursuant to the Banking Act (Cap 488). The capital requirement sets a framework on how banks must handle their capital in relation to their assets. A central bank imposes requirements on banks in order to promote the objectives of the regulator. Often, these requirements are closely tied to the level of risk exposure for a certain sector of the bank. The most important minimum requirement in banking regulation is maintaining minimum capital ratios. There is an association between regulatory reforms and bank performance or profitability.

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