

Capital and Liquidity Regulatory Compliance and Financial Performance: Evidence from Commercial Banks in Kenya

Stephene O. Magadi

Faculty of Commerce, School of Business and Economics, Kabarak University, Private Bag -20157 Kabarak- Kenya

Abstract: *This study examined the effect of capital and liquidity regulatory compliance on the financial performance of commercial banks in Kenya. The study was motivated by the need to establish whether adherence to prudential capital and liquidity requirements contributes to improved financial performance in the Kenyan banking sector. The study adopted a sequential explanatory mixed-methods design, with quantitative data collected through structured questionnaires and qualitative insights obtained through interviews. The study targeted chief credit officers and chief risk officers of commercial banks in Kenya, with 42 observations used for the analysis. Descriptive statistics were used to assess the extent of compliance, while Pearson correlation and simple linear regression were employed to establish the relationship and effect of capital and liquidity regulatory compliance on financial performance. The descriptive findings indicated a generally high level of compliance, with an overall mean of 3.64. In particular, management's adherence to set liquidity limits recorded the highest mean ($M = 3.83$, $SD = 0.49$). Inferential findings showed a strong, positive, and statistically significant relationship between capital and liquidity regulatory compliance and financial performance ($r = .792$, $p = .000$). Regression analysis further showed that capital and liquidity regulatory compliance explained 62.7% of the variation in financial performance ($R^2 = .627$). The regression coefficient was positive and statistically significant ($\beta = .792$, $t = 8.179$, $p = .000$), while the overall regression model was statistically significant ($F = 67.143$, $p = .000$). The study rejected the null hypothesis and concluded that capital and liquidity regulatory compliance has a significant positive effect on the financial performance of commercial banks in Kenya. The study recommends that the Central Bank of Kenya strengthen supervisory oversight of capital and liquidity requirements, while commercial banks should enhance liquidity monitoring, stress testing, contingency planning, and compliance mechanisms to support sustained financial performance.*

Keywords: Capital Adequacy, Liquidity Regulation, Regulatory Compliance, Financial Performance, Commercial Banks, Kenya

1. Introduction

The banking sector is a critical component of modern financial systems because commercial banks mobilize savings, allocate credit, and facilitate payments, support investment, and economic activity. The stability and efficiency of banks therefore have implications that extend beyond individual institutions to the wider financial system and economy. A central concern in banking regulation is ensuring that banks maintain sufficient financial buffers to absorb unexpected losses while remaining able to meet their obligations as they fall due. Consequently, contemporary prudential regulation places considerable emphasis on capital adequacy and liquidity as mechanisms to strengthen bank resilience and reduce the likelihood that individual bank distress will develop into systemic instability. The Basel III framework has consequently reinforced the importance of high-quality capital, capital buffers and liquidity requirements as key components of prudential banking regulation [17]-[19]. Capital regulatory compliance is particularly important because adequate capital provides banks with a buffer against unexpected losses and supports their capacity to continue operating during periods of financial stress. However, complying with higher capital requirements can also affect banks' financial performance. On the one hand, stronger capitalization can enhance financial resilience, reduce vulnerability to shocks, and strengthen stakeholder confidence. On the other hand, maintaining capital above regulatory thresholds may constrain the funds available for lending and other income-generating activities, creating a potential trade-off between financial stability and profitability. Recent empirical evidence demonstrates that this relationship is not uniform across banking systems. For

instance, [19] show that capital requirements are important for the performance of African commercial banks, while [17] demonstrate that Basel III capital regulations affect bank efficiency in selected African countries. Similarly, evidence from Sub-Saharan Africa indicates that regulatory capital requirements significantly influence bank stability, reinforcing the importance of capital regulation in strengthening banking-sector resilience.

Liquidity regulatory compliance constitutes the second important dimension of prudential regulation. Banks are inherently exposed to liquidity risk because they transform relatively liquid liabilities, particularly deposits, into comparatively illiquid assets such as loans. Maintaining adequate liquidity enables banks to meet deposit withdrawals, settle obligations and respond to unexpected funding pressures. Nevertheless, excessive liquidity can impose an opportunity cost because funds held in highly liquid, relatively low-yielding assets may generate lower returns than funds deployed in loans and other productive investments. Recent evidence suggests that liquidity regulation can enhance resilience while also constraining bank operations. [22], for example, find that liquidity regulation reduces banks' liquidity risks but that mandated liquidity buffers can crowd out bank lending. Similarly, [20] find that banks subject to liquidity regulation can reduce lending and liquidity creation, although such regulation also reduces their exposure to fire-sale externalities. These findings demonstrate that compliance with liquidity requirements may have both stabilizing and performance-related consequences.

The interaction between regulatory compliance and financial performance is therefore theoretically and empirically

important. Financial performance reflects the extent to which banks efficiently utilize their resources to generate returns, with return on assets (ROA) and return on equity (ROE) commonly used as indicators of bank profitability [2]-[6]. Evidence from European banks indicates that liquidity is positively associated with bank performance, while the effects of capital and regulatory requirements may vary by institutional and bank-specific characteristics [2]. Further, [6] demonstrate that the effect of banking regulation on profitability and efficiency differs by bank size, with regulation producing more favorable outcomes for large and medium-sized banks than for smaller institutions. Such evidence suggests that regulatory compliance should not necessarily be understood as having a uniform effect on financial performance; rather, its implications may depend on the extent to which banks can absorb the associated costs and adjust their business models.

In Kenya, the importance of capital and liquidity compliance is particularly evident given the prudential oversight exercised by the Central Bank of Kenya (CBK). The Kenyan banking sector is subject to prescribed minimum capital adequacy and liquidity requirements designed to safeguard depositors, strengthen institutional resilience and maintain financial stability. Recent CBK evidence indicates that the banking sector remained above the prescribed capital thresholds in 2024: the total capital-to-total-risk-weighted-assets ratio increased from 18.6% in 2023 to 19.6% in 2024, above the regulatory minimum of 14.5%. The core capital-to-total-risk-weighted-assets ratio also increased from 15.4% to 17.3%, while the core capital-to-total-deposits ratio increased from 16.0% to 17.2%. The average liquidity ratio similarly increased from 51.0% in 2023 to 56.0% in 2024, substantially exceeding the statutory minimum of 20%. During the same period, banking-sector profit before tax increased from Sh. 219.3 billion to Sh. 260.3 billion.

Despite this apparently favourable regulatory position, the relationship between compliance and financial performance among Kenyan commercial banks remains insufficiently established. Existing Kenyan studies have largely examined capital adequacy, liquidity management, or liquidity creation as separate bank characteristics rather than conceptualizing them jointly as dimensions of regulatory compliance. [7], for example, examined 36 Kenyan commercial banks and found that capital adequacy had a significant negative effect on liquidity creation. A related study by [8] also examined capital adequacy and income diversification in relation to liquidity creation. While these studies provide important evidence on the consequences of bank capitalization, they do not directly establish whether the extent to which banks comply with regulatory capital and liquidity requirements translates into improved financial performance.

This gap is important because regulatory compliance and financial performance represent related but conceptually distinct phenomena. A bank may comply with minimum prudential requirements without necessarily achieving superior profitability, while a bank maintaining substantially higher buffers may experience different performance outcomes from one operating close to the regulatory threshold. The Kenyan banking environment therefore provides an important setting for investigating whether

compliance with capital and liquidity requirements supports or constrains financial performance. This study consequently examines capital and liquidity regulatory compliance and financial performance among commercial banks in Kenya, with the aim of generating empirical evidence that can inform bank management, regulators and financial-sector policymakers on the performance implications of prudential compliance. The study is particularly timely given continuing developments in Kenya's capital requirements and the sector's strong capital and liquidity positions alongside changing profitability patterns.

2. Statement of the Problem

Commercial banks are required to maintain adequate capital and liquidity to absorb financial shocks protect depositors and support the stability of the banking system. In Kenya, the Central Bank of Kenya (CBK) requires banks to maintain a minimum capital adequacy ratio of 14.5% and a minimum liquidity ratio of 20%. Despite these requirements, financial performance remains uneven across commercial banks. In 2024, the banking sector recorded a total capital adequacy ratio of 19.6% and a liquidity ratio of 56.0%, both substantially above the regulatory thresholds. During the same period, profit before tax increased by 18.2%, from Sh. 219.2 billion in 2023 to KSh. 260.0 billion in 2024, while return on assets (ROA) increased from 2.9% to 3.4%. However, return on equity (ROE) declined slightly from 22.4% to 22.0%, indicating that improvements in sector-wide profitability were not reflected consistently across all performance measures [5]. This raises an important question about whether maintaining capital and liquidity above regulatory minimums necessarily translates into improved financial performance. The problem is further reflected in the considerable differences in performance among banks and the deterioration of asset quality despite strong regulatory buffers. In 2024, large banks recorded an ROA of 4.1%, compared with 2.3% for medium-sized banks and only 0.2% for small banks. Small banks also experienced a 64.5% decline in profit before tax, from KSh. 3.7 billion in 2023 to KSh. 1.3 billion in 2024. At the same time, the gross non-performing loans (NPLs) to gross loans ratio increased from 15.6% in December 2023 to 17.1% in December 2024, while gross loans declined by 2.7% [5]. The coexistence of high capital and liquidity ratios with rising credit risk and substantial profitability differences suggests that regulatory compliance may not have a uniform effect on financial performance. Although adequate capital and liquidity enhance resilience, maintaining excessive buffers may also create opportunity costs by restricting the funds available for lending and other income-generating activities. Previous empirical studies have examined capital adequacy, liquidity, and bank performance in Kenya, but have given limited attention to capital and liquidity regulatory compliance as joint dimensions of prudential compliance and their effect on financial performance. For example, [7] examined capital adequacy and liquidity creation among Kenyan commercial banks, but focused on liquidity creation rather than the financial-performance implications of compliance with regulatory thresholds. Consequently, empirical evidence remains limited on whether the extent to which commercial banks comply with capital and liquidity requirements enhances or constrains their financial performance. This gap

is particularly significant in Kenya, where banks maintain regulatory buffers substantially above the minimum requirements while simultaneously experiencing rising NPLs and differences in profitability. Therefore, this study seeks to determine the effect of capital and liquidity regulatory compliance on the financial performance of commercial banks in Kenya, thereby providing evidence to inform bank managers and regulators on the performance implications of prudential regulatory compliance.

2.1 Objective of the study

To evaluate the effect of capital and liquidity limits guideline compliance on the financial performance of commercial banks in Kenya

2.2 Research Hypothesis

H0: There is no statistically significant effect of capital and liquidity limits guidelines compliance on the financial performance of commercial banks in Kenya.

2.3 Significance of the study

The study is expected to contribute to understanding the relationship between capital and liquidity regulatory compliance and financial performance among commercial banks in Kenya. This matters because, despite banks maintaining regulatory buffers above minimum requirements, financial performance remains uneven. In 2024, the sector recorded a 19.6% capital adequacy ratio against the 14.5% minimum and an average liquidity ratio of 56.0% against the 20% statutory minimum. At the same time, the gross non-performing loans ratio increased from 15.6% to 17.1%, suggesting that strong regulatory positions do not necessarily eliminate financial risks. The findings are expected to benefit commercial bank managers and policymakers by providing evidence on whether maintaining capital and liquidity above regulatory thresholds supports or constrains financial performance. This may help bank managers balance regulatory requirements with lending and profitability objectives, while helping the Central Bank of Kenya evaluate the performance implications of prudential requirements. Recent Kenyan evidence indicates that capital- and liquidity-related macroprudential regulations can influence bank stability and credit provision, highlighting the importance of balancing regulation and financial intermediation [8]. The study is also expected to contribute to academic literature by addressing the limited empirical attention given to capital and liquidity regulatory compliance jointly as determinants of bank financial performance. The findings may provide a basis for future research on prudential regulation, bank profitability, and financial stability in Kenya and other emerging economies.

3. Literature Review

This section reviewed existing literature relevant to the study on capital and liquidity regulatory compliance and financial performance of commercial banks in Kenya. The review examined theoretical and empirical literature on capital regulatory compliance, liquidity regulatory compliance, and financial performance to establish the current state of

knowledge, identify research gaps, and provide a foundation for the study. Specifically, this section presents the theoretical review, empirical review, conceptual framework, and a summary of the research gaps.

4. Theoretical Review

4.1 Buffer Theory

The Buffer Theory of Capital was developed by Calem and Rob (1996) to explain why banks tended to hold capital above the regulatory minimum. The theory argued that banks deliberately maintained a capital buffer above the prescribed regulatory requirement to reduce the likelihood and costs of regulatory non-compliance. According to the theory, banks faced uncertainty regarding future losses and changes in regulatory requirements; consequently, maintaining excess capital provided a safeguard against falling below the minimum regulatory threshold. Banks with adequate capital buffers were also better positioned to absorb unexpected losses and continue their operations during periods of financial stress. Recent literature continued to support this perspective, particularly in explaining why banks maintained capital above minimum regulatory requirements and how regulatory capital could influence banking activities and performance [15]-[21]. Evidence from emerging economies further showed that achieving required capital and liquidity levels could strengthen bank stability and support financial intermediation [21].

The Buffer Theory was particularly relevant to the present study because capital regulatory compliance represented one of the principal dimensions of the independent variable. The theory suggested that banks did not merely comply with minimum capital requirements but could maintain additional capital to protect themselves against regulatory breaches and unexpected financial shocks. Such buffers could enhance financial stability and stakeholder confidence, although holding excessive capital could also reduce funds available for lending and potentially affect profitability. This trade-off aligns with recent evidence showing that prudential capital regulation can improve bank resilience while also affecting lending and financial performance [21].

Although the original Buffer Theory primarily focused on capital, its logic could also provide a useful theoretical foundation for understanding liquidity regulatory compliance. Banks could maintain liquidity buffers above the regulatory minimum to protect themselves against unexpected deposit withdrawals and funding pressures. Recent evidence showed that liquidity requirements such as the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) influenced bank profitability, although the magnitude and direction of the relationship varied across banks and profitability levels [23]. Thus, the theory provided a suitable foundation for explaining why commercial banks maintained capital and liquidity above regulatory thresholds and how such compliance could influence their financial performance.

4.2 Empirical Review

Capital and liquidity requirements are central components of prudential banking regulation because they provide banks with buffers to absorb unexpected losses, meet obligations as they fall due, and maintain financial stability. Recent empirical evidence, however, indicates that the relationship between regulatory requirements and bank performance is not uniform. While adequate capital and liquidity can strengthen resilience and reduce financial distress, maintaining regulatory buffers may also impose opportunity costs by limiting funds available for lending and other income-generating activities. Consequently, the effect of compliance with capital and liquidity requirements on financial performance remains an empirical question. [2] examined the relationship between capital, liquidity and profitability among the largest banks in the European Union. The study covered banks across 28 countries using data from 2010 to 2018 and employed multiple regression models, with return on average assets, return on average equity, and operating profit to risk-weighted assets as measures of profitability. The findings established a positive and statistically significant association between liquidity levels and bank performance, while the study found limited evidence that Basel III capital requirements directly improved profitability. The authors concluded that although the Basel III framework is important for banking stability, its effect on profitability remains limited. This finding suggests that regulatory compliance may enhance financial resilience without necessarily producing an equivalent improvement in profitability.

[14] investigated the relationship between Basel III regulation, bank capital and portfolio allocation. Using evidence from bank holding companies affected by Basel III capital regulations, the study found that increases in risk-based capital requirements encouraged banks to substitute away from higher-risk-weighted loans toward lower-risk-weighted reserves and Treasury securities. The findings suggest that capital regulation influences banks' asset allocation decisions and can therefore affect how banks generate income. The study is relevant to the present research because compliance with capital requirements may influence financial performance indirectly through changes in banks' investment and lending decisions. [3] examined whether capital requirements make banks safer using a quasi-natural experiment. The study found that although regulatory measures of bank solvency improved following increases in capital requirements, some non-regulatory measures indicated deterioration in bank solvency. The decline was associated with reductions in banks' market value of equity and was consistent with lower bank profitability. The findings demonstrate that increasing regulatory capital does not necessarily produce uniform improvements in all dimensions of bank performance. This evidence is important because it highlights a possible trade-off between regulatory compliance and profitability, reinforcing the need to empirically assess the performance implications of capital requirements.

[11], investigated the effectiveness of Basel III capital requirements on bank profitability and efficiency using data from major commercial banks in Australia and the United Kingdom covering 2000–2019. The study employed Fully Modified Ordinary Least Squares and Dynamic Ordinary

Least Squares estimation techniques. The findings showed that stricter capital ratios increased operating earnings but did not necessarily improve bank profitability or efficiency. The study further identified an optimal capital structure at which banks could achieve better performance, with the optimal capital ratios broadly corresponding to the minimum common equity requirements under Basel III. These findings suggest that compliance with capital requirements can strengthen banks' financial positions, but excessive capital beyond an optimal level may not necessarily translate into improved profitability. [6] examined bank profitability and efficiency under the Basel III framework. The study showed that the relationship between regulatory requirements, profitability, and efficiency varied by bank size. The findings indicate that the effects of prudential regulation are heterogeneous across banking institutions and that differences in institutional size may influence banks' capacity to absorb the costs of maintaining regulatory buffers. The study is relevant to the present research because commercial banks in Kenya operate under different institutional and financial capacities, which may influence the relationship between compliance and financial performance.

The liquidity component of prudential regulation has also received empirical attention. [23] examined the effect of Basel III liquidity regulations on bank profitability using the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR). Using simultaneous quantile regression with fixed effects, the study found that both LCR and NSFR had statistically significant but quantitatively small effects on bank profitability. The effects also varied across profitability levels and bank size, with smaller banks more vulnerable to short-term liquidity risks and larger banks more exposed to medium- and long-term liquidity risks. The findings suggest that compliance with liquidity requirements can influence profitability, while the magnitude of the effect depends on bank characteristics. [16] examined liquidity risk, macroprudential regulation, and bank performance among Vietnamese commercial banks. The study specifically sought to establish how liquidity risk and macroprudential policies influenced bank performance. The findings provide evidence that liquidity risk and the regulatory environment are important considerations in understanding banking performance. The study is relevant to the current research because it demonstrates that liquidity regulation should be considered alongside bank performance rather than treated exclusively as a financial stability requirement. A cross-country study by [3] examined the relationship between bank regulation, supervision, and liquidity creation using data from 721 banks in 65 countries. The findings established that stronger supervisory policies increased liquidity creation, whereas tighter regulatory regimes, including capital regulations, reduced liquidity creation. The findings demonstrate that regulatory compliance may produce both stabilizing and constraining effects on banking activities. In particular, although stronger regulation can reduce excessive risk, it may also limit banks' capacity to transform deposits into loans and thereby influence their income-generating capacity. [21] examined the effects of Basel III liquidity and capital regulations on bank lending and financial stability using data from 688 commercial banks in 10 developing economies over the period 2014–2021. The study examined liquidity requirements, including the LCR and NSFR,

together with capital adequacy using fixed-effects panel estimation. The findings provide evidence on how prudential capital and liquidity requirements affect bank lending and financial stability in developing-country banking systems. The study is particularly relevant to the current research because it shifts the evidence away from developed economies and provides insights from banking systems with institutional and economic conditions more comparable to Kenya. [17], who examined Basel III capital regulations and bank efficiency in selected African countries, provide evidence from African banking systems. The study recognized that effective regulation is important for maintaining the stability and efficiency of commercial banks following the global financial crisis. The findings demonstrate the importance of examining the implementation of Basel III capital requirements within African banking systems, where regulatory compliance may interact with institutional characteristics and bank efficiency. This provides a useful regional foundation for investigating the performance implications of capital and liquidity regulatory compliance in Kenya.

Kenyan evidence further supports examining prudential compliance and financial performance. [24], investigated the effect of capital adequacy on the financial performance of commercial banks in Kenya using data from 39 commercial banks. The study adopted an explanatory research design and analyzed bank-level panel data using an unbalanced panel regression model. The findings established that capital adequacy had a positive and statistically significant influence on financial performance ($\beta = 0.033$, $p = .027$). The study also reported that although most banks met the required cash ratio, some continued to face liquidity challenges. The study recommended that banks maintain the required capital adequacy levels and strengthen liquidity measures. These findings provide direct Kenyan evidence that stronger compliance with prudential capital requirements can be associated with improved financial performance. Financial soundness has also been linked to performance among Kenyan commercial banks. In a study covering the period 2009–2020, [25] examined the effect of financial soundness on the financial performance of commercial banks in Kenya using a dynamic panel model based on the CAMEL framework. Financial performance was measured using net interest margin, earnings per share, return on assets and return on equity. The generalized method of moments results established that financial soundness had a statistically significant effect on NIM, ROA and ROE. The study therefore demonstrates that prudential indicators forming part of banks' financial soundness are significantly associated with financial performance in Kenya.

Further Kenyan evidence is provided by [1], who examined liquidity capacity and financial performance among commercial banks in Kenya. The study focused specifically on the relationship between banks' liquidity capacity and financial performance. Its findings further support the importance of liquidity management in explaining variations in commercial-bank performance in Kenya. The study is relevant to the present research because liquidity compliance represents an important regulatory mechanism through which banks maintain adequate capacity to meet their obligations while continuing their financial intermediation activities.

[12] similarly investigated liquidity management and financial performance among commercial banks in Kenya. The study provides recent Kenyan evidence on the importance of liquidity management in determining bank financial outcomes and reinforces the relevance of liquidity-related practices in understanding variations in commercial-bank performance. More recent Kenyan evidence by [24] examined the effect of capital adequacy on the operational efficiency of commercial banks. Using Stochastic Frontier Analysis to estimate efficiency scores and a panel Generalized Method of Moments model to examine their determinants, the study focused on the relationship between capital adequacy and operational efficiency. The study is relevant because operational efficiency represents an important dimension of bank performance and demonstrates that capital adequacy can have implications beyond conventional profitability measures.

Similarly, [18] examined bank-specific and macroeconomic determinants of commercial-bank profitability in Kenya using panel data for banks listed on the Nairobi Securities Exchange. The study found that bank assets, bank capital and debt ratio positively affected bank profitability, while bank concentration had a negative effect. The positive effect of bank capital provides further evidence that capital-related characteristics are important determinants of financial performance in the Kenyan banking sector. Overall, the recent empirical literature demonstrates that capital and liquidity requirements have important implications for bank performance, although the direction and magnitude of the effects vary across countries and banking systems. Evidence from Europe and other developed markets suggests that capital and liquidity requirements may strengthen resilience while imposing opportunity costs on profitability [2] - [11] - [23]. Evidence from developing and African economies similarly demonstrates that prudential requirements influence lending, liquidity creation and efficiency [17]-[21]. Kenyan studies generally report positive relationships between capital adequacy, liquidity-related practices and financial performance ([1]-[18]-[25]).

5. Conceptual Framework

The conceptual framework illustrates the relationship between the independent and dependent variables in the study. It demonstrates how capital and liquidity regulatory compliance influences the financial performance of commercial banks in Kenya. The framework provides the basis for examining the effects of capital regulatory compliance and liquidity regulatory compliance on the financial performance of commercial banks in Kenya.

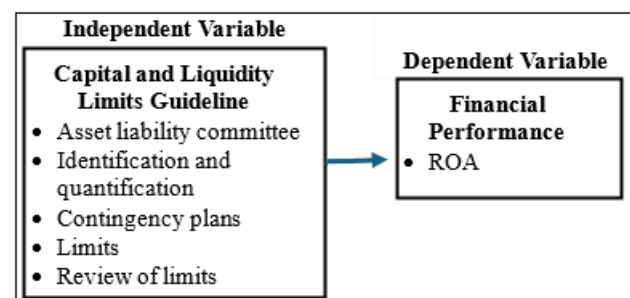


Figure 1: Conceptual Framework

6. Methodology

This study adopted a quantitative research approach guided by a positivist research philosophy and employed a descriptive and ex post facto research design. The study examined the effect of capital and liquidity regulatory compliance on the financial performance of commercial banks in Kenya. The study targeted the 42 commercial banks licensed to operate in Kenya, with the chief financial officer and chief risk officer, or their equivalent, serving as the units of observation. A census approach was adopted, including all 42 licensed commercial banks. Primary data were collected using a structured questionnaire containing closed-ended items measured on a five-point Likert scale, while secondary data on financial performance were obtained from published financial reports and statements of the commercial banks. The financial performance of the banks was measured using return on assets (ROA). Using primary and secondary data enabled the study to obtain information on capital and liquidity regulatory compliance and objectively assess its relationship with financial performance. The research instrument was pilot-tested using five commercial banks, representing approximately 10% of the study population. The pilot study assessed the clarity, suitability, and consistency of the questionnaire before the main data collection exercise. Content validity was established by aligning the questionnaire items with the study objective and having the research supervisors review it, while feedback from the pilot study was used to refine the instrument. Reliability was assessed using Cronbach's Alpha coefficient, with a coefficient of 0.70 or higher considered acceptable. For the secondary data, reliability was enhanced through audited financial statements and published reports from commercial banks. Data collection was undertaken after obtaining the necessary institutional authorization and research permit. The researcher administered the questionnaires to the targeted respondents using the drop-off and pick-up-later method. Before participating, respondents were informed about the purpose of the study, and their participation was kept confidential. The collected data were subsequently edited, coded, and analyzed using descriptive and inferential statistics. Descriptive statistics summarized the characteristics of capital and liquidity regulatory compliance and financial performance using measures such as frequencies, percentages, means, and standard deviations. Inferential analysis involved Pearson correlation and simple linear regression to determine the direction, strength, and effect of capital and liquidity regulatory compliance on the financial performance of commercial banks.

The simple linear regression model was specified as follows:

$$ROA = \beta_0 + \beta_1 CLRC + \varepsilon \dots\dots\dots (i)$$

Where ROA represents the financial performance of commercial banks; CLRC represents capital and liquidity regulatory compliance; β_0 is the regression constant; β_1 is the regression coefficient representing the effect of capital and liquidity regulatory compliance on financial performance; and ε is the error term. The hypothesis was tested using the significance of the regression coefficient at the 5% level. A normality test was also conducted to establish whether the data satisfied the normality assumption required for inferential analysis. The correlation and regression results

were used to determine whether capital and liquidity regulatory compliance had a statistically significant effect on the financial performance of commercial banks in Kenya.

7. Findings

This section presented the findings of the study on capital and liquidity regulatory compliance and financial performance of commercial banks in Kenya. The findings were presented based on the study objectives and research hypotheses. Descriptive statistics were first presented to establish the characteristics and trends of the study variables, followed by correlation and regression analyses to determine the relationships and effects of capital and liquidity regulatory compliance on financial performance. The findings provided empirical evidence on the extent to which regulatory compliance influenced the financial performance of commercial banks in Kenya.

1) Response Rate

The data for this study were collected using structured questionnaires distributed to the respondents. The response rate is presented in Table 1

Table 1: Response Rate

Unit of Observation	Issued Questionnaires	Returned Questionnaires	Response Rate
Chief risk or Finance officers	42	39	92.86%

A total of 42 questionnaires were distributed to the respondents who comprised the chief financial officers and the chief risk officers or their equivalent. Of the 42 questionnaires distributed, 39 were returned, completely and appropriately filled. This translated to a response rate of 92.86% as presented in Table 1. Mugenda and Mugenda (2003) recommend that a 50% response rate is adequate, 60% is good, and any other response rate above 70% is very good. Based on this recommendation, the 92.86% response rate achieved in this study was considered very good. This implied that the collected data could enable the researcher to draw satisfactory conclusions regarding CBK's risk management guidelines compliance.

2) Descriptive Statistics

This section presented descriptive statistics for the study variables, namely capital regulatory compliance, liquidity regulatory compliance, and the financial performance of commercial banks in Kenya. The analysis provided an overview of the distribution, central tendency, and variability of the variables using measures such as the mean, standard deviation, minimum and maximum values. The descriptive results provided an initial understanding of the level and variation of regulatory compliance and financial performance before the inferential analyses were undertaken.

3) Liquidity and Capital Limits Guidelines Compliance

The study examined the extent to which commercial banks complied with the liquidity and capital limits guidelines prescribed by the CBK. Responses were obtained from chief credit officers and chief risk officers using a five-point Likert scale, where 1 = No Extent, 2 = Small Extent, 3 = Moderate

Extent, 4 = Large Extent and 5 = Very Large Extent. Table 2 presents the results.

Table 2: Liquidity and Capital Limits Guidelines Compliance

Statements	NE F (%)	SE F (%)	ME F (%)	LE F (%)	VLE F (%)	Mean	SD
Management sets limits appropriate to the financial condition of the institution	0 (0.0)	0 (0.0)	13 (31.0)	26 (61.9)	3 (7.1)	3.76	0.58
Limits are periodically reviewed when risk tolerances change	0 (0.0)	2 (4.8)	8 (19.0)	32 (76.2)	0 (0.0)	3.71	0.55
Management ensures adherence to set liquidity limits	0 (0.0)	0 (0.0)	9 (21.4)	31 (73.8)	2 (4.8)	3.83	0.49
There is a contingency plan for handling liquidity crisis	1 (2.4)	2 (4.8)	13 (31.0)	24 (57.1)	2 (4.8)	3.57	0.77
Management accurately quantifies primary sources of liquidity risk in a timely manner	1 (2.4)	6 (14.3)	10 (23.8)	21 (50.0)	4 (9.5)	3.5	0.94
Management ensures adherence to set capital limits	0 (0.0)	1 (2.4)	18 (42.9)	22 (52.4)	1 (2.4)	3.55	0.59
Assessment of cash flows identifies potential future funding shortfalls	0 (0.0)	4 (9.5)	10 (23.8)	24 (57.1)	4 (9.5)	3.67	0.79
Management ensures adherence to capital limits	0 (0.0)	3 (7.1)	13 (31.0)	22 (52.4)	4 (9.5)	3.64	0.76
Asset-liability committee effectively monitors liquidity risk	1 (2.4)	2 (4.8)	17 (40.5)	17 (40.5)	5 (11.9)	3.55	0.86
Overall Mean and SD						3.64	0.48

The findings in Table 2 indicate that commercial banks demonstrated a relatively high level of compliance with liquidity and capital limits guidelines, as reflected by the overall mean of 3.64 and standard deviation of 0.72. The relatively high overall mean suggests that respondents generally rated the banks' compliance to a moderate to large extent, with a tendency towards a large extent. Among the individual indicators, management ensuring adherence to set liquidity limits recorded the highest mean score of 3.83 (SD = 0.49). This was followed by management setting limits appropriate to the institution's financial condition, with a mean of 3.76 (SD = 0.58), and periodic review of limits when risk tolerances change, with a mean of 3.71 (SD = 0.55). These findings suggest that liquidity limit setting, adherence, and periodic review were relatively well established among commercial banks. The assessment of cash flows to identify potential future funding shortfalls also recorded a relatively high mean of 3.67 (SD = 0.79), while management's adherence to capital limits recorded a mean of 3.64 (SD = 0.76). The existence of contingency plans for handling liquidity crises recorded a mean of 3.57 (SD = 0.77), while management's adherence to set capital limits recorded a mean of 3.55 (SD = 0.59). The lowest mean score was recorded for management accurately quantifying primary sources of liquidity risk in a timely manner, with a mean of 3.50 (SD = 0.94). Similarly, the asset-liability committee's effectiveness in monitoring liquidity risk recorded a mean of 3.55 (SD = 0.86). Although these scores still indicate compliance to a large extent, the relatively higher standard deviations suggest greater variation in respondents' assessments of these practices across the commercial banks. Overall, the findings demonstrate that liquidity and capital limits regulatory compliance was relatively strong among commercial banks in Kenya, with respondents generally indicating compliance to a large extent. The overall mean of 3.64 provides an appropriate descriptive measure of the independent variable for subsequent correlation and regression analysis.

4) Correlation Analysis

Pearson correlation analysis was conducted to determine the direction, strength, and statistical significance of the relationship between capital and liquidity regulatory compliance and financial performance of commercial banks in Kenya. The analysis was based on 42 observations, with

statistical significance assessed at the 5% level. Table 3 presents the results.

Table 3: Correlation between Capital and Liquidity Regulatory Compliance and Financial Performance

Variables	Capital and Liquidity Regulatory Compliance	Financial Performance
Capital and Liquidity Regulatory Compliance	1	.792**
Financial Performance	.792**	1
Sig. (2-tailed)	—	< .001
N	42	42

Note: Correlation is significant at the 0.01 level (2-tailed).

The results in Table 3 indicate a strong, positive, and statistically significant relationship between capital and liquidity regulatory compliance and the financial performance of commercial banks in Kenya ($r = .792$, $p < .001$). The positive correlation coefficient indicates that higher compliance with capital and liquidity regulatory requirements is associated with higher financial performance. The magnitude of the correlation coefficient suggests a strong relationship between the two variables. Because the p-value is less than .001 and below the 0.05 significance level, the relationship is statistically significant. The finding therefore provides evidence of a significant positive association between capital and liquidity regulatory compliance and the financial performance of commercial banks in Kenya. This result suggests that adherence to prescribed capital and liquidity requirements is closely associated with improved financial performance among commercial banks.

5) Model Summary

The model summary was used to determine the extent to which capital and liquidity regulatory compliance explained variations in the financial performance of commercial banks in Kenya. Table 4 presents the results.

Table 4: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	0.792	0.627	0.618	0.35

Predictor: Capital and Liquidity Regulatory Compliance
Dependent Variable: Financial Performance

The results in Table 4 indicate a strong positive relationship between capital and liquidity regulatory compliance and financial performance, as demonstrated by an R value of 0.792. The coefficient of determination ($R^2 = 0.627$) indicates that capital and liquidity regulatory compliance explain 62.7% of the variation in the financial performance of commercial banks in Kenya. The remaining 37.3% of the variation in financial performance is explained by other factors that were not included in the model. The adjusted R^2 of 0.618 indicates that after accounting for the sample size, the predictor included in the model- capital and liquidity regulatory compliance explains approximately 61.8% of the variation in financial performance. The relatively small difference between the R^2 and adjusted R^2 values (0.009) suggests that the model provides a relatively stable estimate of the explanatory power of capital and liquidity regulatory compliance. The standard error of the estimate of 0.350 indicates the average extent to which the observed financial performance values deviate from the values predicted by the regression model. The relatively small standard error suggests that the predicted financial performance values are reasonably close to the observed values. Overall, the model demonstrates substantial explanatory power, indicating that capital and liquidity regulatory compliance is an important predictor of financial performance among commercial banks in Kenya.

6) Analysis of Variance (ANOVA)

The analysis of variance (ANOVA) was conducted to determine whether the regression model significantly explained variations in the financial performance of commercial banks in Kenya. Table 5 presents the results.

Table 5: ANOVA for Capital and Liquidity Regulatory Compliance and Financial Performance

Model	Sum of Squares	df	Mean Square	F	Sig.
Regression	8.225	1	8.225	67.143	< .001
Residual	4.9	40	0.123		
Total	13.125	41			

Predictor: Capital and Liquidity Regulatory Compliance
Dependent Variable: Financial Performance

The results in Table 5 indicate that the regression model was statistically significant, with an F-statistic of 67.143 and a significance level of $p < .001$. Since the p-value is less than the 0.05 significance level, the regression model significantly explains variations in the financial performance of commercial banks in Kenya. The significant F-statistic provides further evidence that capital and liquidity regulatory compliance has a statistically significant effect on financial performance. This finding is consistent with the correlation analysis, which established a strong positive relationship between capital and liquidity regulatory compliance and financial performance ($r = .792$, $p < .001$). The ANOVA results therefore demonstrate that the regression model containing capital and liquidity regulatory compliance provides a statistically significant explanation of financial performance. The model accounts for 62.7% of the variation in financial performance, while the remaining 37.3% is attributable to factors outside the model.

7) Regression Coefficient

Regression analysis was conducted to determine the effect of capital and liquidity regulatory compliance on the financial

performance of commercial banks in Kenya. Table 6 presents the results.

Table 6: Regression Coefficients

Model	Unstandardized Coefficients B	Std. Error	Standardized Coefficients Beta	t	Sig.
(Constant)	1.012	0.123	—	8.228	0
Capital and Liquidity Regulatory Compliance	0.548	0.067	0.792	8.179	0

Dependent Variable: Financial Performance

The results in Table 6 indicate that capital and liquidity regulatory compliance had a positive and statistically significant effect on the financial performance of commercial banks in Kenya ($\beta = .792$, $t = 8.179$, $p = .000$). The positive beta coefficient indicates that an increase in capital and liquidity regulatory compliance is associated with an increase in financial performance. The unstandardized coefficient ($B = 0.548$) indicates that a unit increase in capital and liquidity regulatory compliance results in a 0.548-unit increase in financial performance. Since the significance value of 0.000 is less than the 0.05 significance level, the effect was statistically significant. The finding is consistent with the correlation analysis, which established a strong positive relationship between capital and liquidity regulatory compliance and financial performance ($r = .792$, $p = .000$). It is also consistent with the model summary, which indicated that capital and liquidity regulatory compliance explained 62.7% of the variation in financial performance ($R^2 = .627$). The ANOVA results further confirmed that the overall regression model was statistically significant ($F = 67.143$, $p = .000$).

Hypothesis Test Results

The study tested the hypothesis that capital and liquidity regulatory compliance had a statistically significant effect on the financial performance of commercial banks in Kenya. The hypothesis was tested using the regression coefficient at the 5% significance level. Table 7 presents the results.

Table 7: Hypothesis Testing

Hypothesis	β	t-value	Sig.	Decision
H_0 : Capital and liquidity regulatory compliance has no statistically significant effect on financial performance	0.792	8.179	0	Reject H_0

The results in Table 7 indicate that capital and liquidity regulatory compliance had a positive and statistically significant effect on the financial performance of commercial banks in Kenya ($\beta = .792$, $t = 8.179$, $p = .000$). The positive beta coefficient indicates that higher levels of capital and liquidity regulatory compliance are associated with improved financial performance. Since the significance value of 0.000 is less than the established significance level of 0.05, the null hypothesis was rejected. The study therefore established that capital and liquidity regulatory compliance has a statistically significant positive effect on the financial performance of commercial banks in Kenya. This finding is further supported by the model results, which showed that capital and liquidity

regulatory compliance explained 62.7% of the variation in financial performance ($R^2 = .627$).

8. Summary of Findings

The study sought to evaluate the effect of compliance with capital and liquidity limits guidelines on the financial performance of commercial banks in Kenya. The findings were summarized based on both descriptive and inferential analyses. The descriptive findings established that commercial banks generally complied with the capital and liquidity limits guidelines to a relatively high extent. The overall mean score of 3.64 indicated that respondents perceived banks as implementing capital and liquidity compliance practices to a large extent. The highest-rated practice was management ensuring adherence to set liquidity limits ($M = 3.83$, $SD = 0.49$), followed by management setting limits appropriate to the financial condition of the institution ($M = 3.76$, $SD = 0.58$) and periodic review of limits when risk tolerances change ($M = 3.71$, $SD = 0.55$). The lowest mean was recorded for management accurately quantifying primary sources of liquidity risk in a timely manner ($M = 3.50$, $SD = 0.94$). The original frequency results similarly showed that most respondents reported high compliance in setting, reviewing, and adhering to liquidity and capital limits. The inferential findings established a strong positive and statistically significant relationship between capital and liquidity regulatory compliance and financial performance. Pearson correlation analysis produced a correlation coefficient of $r = .792$, $p = .000$, indicating that higher levels of capital and liquidity regulatory compliance were associated with higher levels of financial performance. The regression analysis further established that capital and liquidity regulatory compliance significantly predicted financial performance. The model summary indicated an $R = .792$ and $R^2 = .627$, showing that capital and liquidity regulatory compliance explained 62.7% of the variation in financial performance, while the remaining 37.3% was attributable to other factors outside the model. The ANOVA results showed that the regression model was statistically significant ($F = 67.143$, $p = .000$). The regression coefficient results further demonstrated a positive and statistically significant effect of capital and liquidity regulatory compliance on financial performance ($\beta = .792$, $t = 8.179$, $p = .000$). The unstandardized coefficient ($B = .548$) indicated that a unit increase in capital and liquidity regulatory compliance resulted in a 0.548-unit increase in financial performance. Consequently, the null hypothesis stating that compliance with capital and liquidity limits guidelines has no statistically significant effect on financial performance was rejected.

9. Conclusions

The study concludes that compliance with capital and liquidity limits guidelines has a significant positive effect on the financial performance of commercial banks in Kenya. The descriptive findings show that commercial banks established mechanisms to comply with capital and liquidity requirements, including setting appropriate limits, reviewing limits when risk tolerances changed, adhering to liquidity limits, maintaining contingency plans, and assessing potential funding shortfalls. The inferential findings provide strong empirical support for this conclusion. The strong positive

correlation ($r = .792$) demonstrates that capital and liquidity regulatory compliance is closely associated with financial performance. The regression results further show that the variable significantly predicts financial performance, while the R^2 of .627 demonstrates substantial explanatory power. Thus, banks with stronger capital and liquidity regulatory compliance tend to report better financial performance. The study therefore concludes that regulatory compliance should not be viewed solely as a statutory obligation but also as an important component of sound financial management. Effective adherence to capital and liquidity requirements enables commercial banks to maintain appropriate financial buffers, manage liquidity risks and strengthen their capacity to sustain financial performance.

10. Recommendations

10.1 Policy Recommendations

The Central Bank of Kenya (CBK) should continue strengthening supervision of capital and liquidity regulatory compliance among commercial banks. Particular attention should be given to areas that recorded comparatively lower descriptive scores, especially the timely identification and quantification of primary sources of liquidity risk and effective monitoring of liquidity risk by asset-liability committees. The CBK should also encourage commercial banks to strengthen their internal systems for liquidity forecasting, stress testing, contingency planning and periodic review of capital and liquidity limits. Such measures would enable banks to identify emerging funding pressures early and take corrective action while maintaining compliance with prudential requirements.

10.2 Theoretical Recommendations

The findings provide empirical support for the Buffer Theory of Capital, which underpinned the study. The theory argues that banks maintain capital buffers above regulatory minimums to reduce the likelihood and costs of regulatory non-compliance and to provide protection against unexpected losses. The strong positive relationship between capital and liquidity, regulatory compliance, and financial performance supports the proposition that maintaining adequate regulatory buffers can contribute to stronger institutional outcomes. The findings therefore reinforce the relevance of Buffer Theory in explaining how prudential compliance can contribute to bank resilience and performance. Future theoretical work should, however, extend the theory by examining whether the relationship between regulatory buffers and financial performance is linear or whether excessive capital and liquidity buffers eventually generate opportunity costs that may constrain profitability.

10.3 Recommendations for Further Studies

Further studies should investigate the other factors that account for the 37.3% of variation in financial performance not explained by capital and liquidity regulatory compliance. Future research could incorporate variables such as credit risk management, bank size, asset quality, operational efficiency, corporate governance, interest-rate risk, and technological innovation. Future studies should also consider using

longitudinal or panel-data designs involving several years of bank-level observations. Such designs would provide deeper insight into how changes in capital and liquidity regulatory compliance influence financial performance over time. Finally, comparative studies could examine whether the effect of capital and liquidity regulatory compliance differs according to bank size, ownership structure, or business model. This would help establish whether the observed relationship is consistent across different categories of commercial banks in Kenya.

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Author Profile

Dr. Stephene Oloo Magadi is an academic and researcher in business and management studies, with experience in teaching, research, postgraduate supervision, and academic administration. He is affiliated with Kabarak University, where he contributes to postgraduate education and academic development. His academic interests encompass finance, banking, accounting, strategic management, operations management, and related areas of business research. He has experience in postgraduate teaching and supervision, research, curriculum development, and facilitation of academic workshops and professional training. His scholarly work focuses on contemporary issues affecting organizational performance, financial management, regulatory compliance, and institutional effectiveness. Dr. Magadi is also actively involved in academic and community engagement activities. His academic profile reflects a commitment to research, postgraduate mentorship, curriculum development, and applying business knowledge to address contemporary organizational and societal challenges.