

Effect of Financing Decisions on Liquidity of Listed Commercial Banks in Kenya

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Abstract: *Corporate financing decisions are a concern of major significant interest in the corporate circle since maintaining high liquidity position helps the firm to meet due obligations and ensure smooth operational business flow while leveraging their debt structure choice. The purpose of this study was to assess the effect of equity financing decisions on the liquidity of listed commercial banks in Kenya. This study adopted a Causal-Comparative descriptive design. Data was collected from secondary sources mainly Nairobi Securities Exchange (NSE). The data collected was coded, classified and analyzed using statistical package for social sciences (SPSS). The findings of the study showed a weak positive relationship between equity financing and liquidity of listed commercial banks in Kenya this meant that equity financing though riskier of all the financing options, had small effects on liquidity as equity was not readily convertible to cash on demand and was also subject to the vagaries of the financial market. The study recommends that there was need for the banks to seek more equity funding probably as a first option to mitigate the financing risks. Lastly, banks should build cash reserves through alternative investments to enable them to internally source finance through their assets in unexpensive way.*

Keywords: *Equity Finance, Financing, Liquidity, Commercial banks.*

1. Introduction

From the perspective of the industrialized countries the need to trade-off between liquidity and profitability to maximize shareholders wealth has been highly debated[5]. 60% of UK listed companies claim to follow a financing hierarchy, consistent with pecking order theory with key determinants for use of debt financing including interest tax shield, financial distress, agency costs and also, at least implicitly, information asymmetry. Capital composition and liquidity management in the banking sector in the developed world has also been stressed as a result of 'one of the worst financial crises in the history of the Western world from 2007 to 2009 [4]. From the emerging market perspective, a Pakistani study show that liquidity risk affects bank profitability significantly, with liquidity gap and non-performing as the two factors exacerbating the liquidity risk with a negative relationship between liquidity and profitability [2]. In most Central America countries, studies have found that banks' liquidity holdings are comfortably above legal or prudential requirements. They observe that demand for precautionary liquidity buffers is associated with measures of bank size, profitability, capitalization, and financial development [9].

In Sub-Saharan Africa, studies found in South Africa that large dividend payments reduce firms' free cash flows thereby reducing funds available for investment projects[8]. This forces corporate managers to seek additional finance from the capital markets. In Nigeria, research found a significant negative relationship between firm's working capital composition and their debt structure choice thereby recommending that corporate financing decision should be considered side by side with their working capital composition [1]. In Kenya, the banking system has been cited as playing a major role in facilitating development and is therefore extremely important engine of economic growth [13]. Commercial banks operations in Kenya are controlled by CBK which defines the environment in which these banks should operate. It also sets the various capital requirements

that any commercial bank should operate by setting up minimum capital requirements. However, globalization of the financial markets though instrumental in developing the financial system and improving transparency, market discipline and financial infrastructure [8], brings about additional risks into the system. Therefore the study will attempt to establish how a bank balances their financing decisions to maximize profit while controlling the liquidity risks of the firms in Kenya.

2. Statement of the Problem

The interplay between the various financing decisions has been a concern of significant interest in the corporate circle since maintaining a high liquidity position helps the firm to meet due obligations and ensure smooth operational business flow while on the other hand reinvesting liquid resources in long-term investments helps maximize returns [1]. However, besides strict legal framework regulating banking financing and liquidity position decisions, it is evident that banking crises are often caused by liquidity problems. For instance, corporate debt is dependent on whether or not retained earnings are sufficient to finance long-term investment projects. That is, when a firm would rather plough its internal funds to finance long-term investment projects, its desires for debt will invariably be lessened [1]. Banks make different financing decisions and it is not clear which type of financing leads to better liquidity. The present study attempted to investigate the effect of financing decisions on liquidity positions of listed commercial banks.

3. Objective of the study

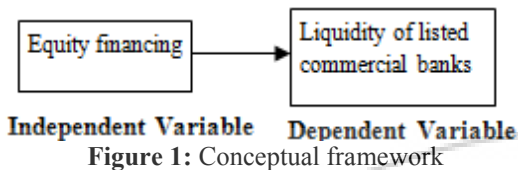
The study's objective was to examine the effect of equity financing on liquidity of listed commercial banks in Kenya.

4. Research Hypothesis

H₀₁: There is no influence of equity financing on listed commercial banks in Kenya

5. Conceptual Framework

The conceptual framework portrayed a scheme containing an independent variable and a dependent variable. This served in helping the researcher achieve the research objectives.



The conceptual framework indicates that there exists a hypothetical relationship between the independent variable (Equity financing) and dependent variable (Liquidity position of listed commercial banks in Kenya).

6. Literature Review

The review consists of a theoretical review which is of specific literature previously conducted and the existing theories that give strength to the study on what other previous writers have contributed to the area under study.

6.1 Theoretical Literature

This section discusses theories pertaining to the financing decisions of firms under study and their effect on their liquidity position.

The Market timing theory

The market timing theory of capital structure argues that firms time their equity issues in the sense that they issue new stock when the stock price is perceived to be overvalued, and buy back own shares when there is undervaluation. Consequently, fluctuations in stock prices affect firms capital structures. There are two versions of equity market timing that lead to similar capital structure dynamics. The first assumes economic agents to be rational. Companies are assumed to issue equity directly after a positive information release which reduces the asymmetry problem between the firms'. Studies have found that the probability of raising external finance is unrelated to the internal funds deficit, and that firms that could have obtained bank loans often choose to issue equity instead [12]. This also contrasts with the static pecking order model.

The decrease in information asymmetry coincides with an increase in the stock price. In response, firms create their own timing opportunities. The second theory assumes the economic agents to be irrational [3]. Due to irrational behaviour there is a time-varying mispricing of the stock of the company. Managers issue equity when they believe its cost is irrationally low and repurchase equity when they believe its cost is irrationally high. It is important to know that the second version of market timing does not require that the market actually be inefficient. It does not ask managers to successfully predict stock returns. The assumption is simply that managers believe that they can time the market. In a previous study, managers admitted trying to time the equity market, and most of those that have considered issuing

common stock report that "the amount by which our stock is undervalued or over-valued" was an important consideration [11]. This study supports the assumption in the market timing theory mentioned above which is that managers believe they can time the market, but does not immediately distinguish between the mispricing and the dynamic asymmetric information version of market timing. Evidence has shown that equity market timing has a persistent effect on the capital structure of a firm. Market timing measure is defined as a weighted average of external capital needs over the past few years, where the weights used are market to book values of the firm. They find that leverage changes are strongly and positively related to their market timing measure, so they conclude that the capital structure of a firm is the cumulative outcome of past attempts to time the equity market [3].

6.2 Empirical Literature Review

Many papers outline the conditions under which debt and/or equity are optimal contracts between investors and a firm (or its managers). There are also many papers that analyze the costs and benefits of having financing provided by banks rather than other agents or markets. However, there are relatively few theoretical papers that explicitly analyze the terms of the contracts that should optimally be signed between a firm and a bank. Research shows that a standard debt contract is optimal in his model, the focus of his paper is on the feasibility and efficiency of delegated monitoring, and his static model cannot address the dynamic issues pursued in the current study[10]. The recent papers which do address the contractual form between banks and firms examine issues somewhat different from the current paper. Studies have examined the quality-signaling effect of having an informed bank choose particular equity positions in its borrowers [6]. This signaling leads to efficient re-negotiations during financial distress by the firm with previously uninformed third parties (such as suppliers or employees), and it is thus somewhat unrelated to the issues of hold-up in this paper. Berlin, et al. do point out, however, that "the relationship between the debt-equity structure of the bank's claim and its power to influence firm behavior is an important topic for research."

Further research examine the effect that equity participation has on project choice [7]. In their model, the bank will, by virtue of holding equity, share in some of the non-contractible perquisites which the firm can withhold from other investors, and the firm's project choice is then influenced by the bank's strategy. Their model is set in a costly state verification framework, and banks will be either lenders or owners, but not both at the same time (the central feature of the current paper) [7]. The issues addressed in this research are more related to deposit insurance and general equilibrium considerations.

7. Research Methodology

The research methodology presents the structural outline upon which data collection and analysis is based. It presents the research design, study location, targeted population, the sample selection procedures, the instruments of data collection, pre-testing for validity and reliability, how data will be collected and analyzed. The study used a Causal-

Comparative descriptive adopting a census strategy in evaluating the effect of financing decisions on liquidity position of listed commercial banks in Kenya. A quantitative approach was applied. The target population for this study was 11 listed commercial banks in Kenya.

A census approach was used in this study to allow all listed Commercial banks to be included in the study since the number is small and reachable. All financial records about the eleven listed banks were used. Secondary Data collection Schedule was used to gather information from bank documents.

7.1 Data processing and analysis

Data was coded and classified before being organized as per aims of study. The inferential statistics (correlations and regression) was used for analysis. Pearson correlation coefficient was used to test hypotheses. The data was analyzed and tabulated using Statistical Package for Social Sciences (SPSS) Version 21. The analyzed data was then presented using tables accompanied by appropriate explanations.

7.2 Research Findings

The data collected by the time of conducting the analysis was from the 11 of the banks, representing a 100% response rate.

The effect of equity financing on liquidity of listed commercial banks in Kenya

The correlation between equity financing and liquidity of listed commercial banks in Kenya was calculated using Pearson's Correlation whose results are as follows:

Table 4.2: Correlation between equity financing on liquidity of listed commercial banks

		Equity Financing
Liquidity of listed Banks	Pearson Correlation	.177*
	Sig. (2-tailed)	.069
	N	11

*. Correlation is significant at the 0.05 level (2-tailed).

The correlation between equity financing and liquidity of listed commercial banks in Kenya was 0.177. This means there is a weak positive relationship existed between equity financing and liquidity of listed commercial banks in Kenya. This meant that equity financing though the less riskier of all the financing options, had small effects on liquidity as equity was not readily convertible to cash on demand and was also subject to the vagaries of the financial market. Consequently, this leads to the rejection of the null hypothesis, which was H_{01} : There is no influence of equity financing on listed commercial banks in Kenya.

8. Summary

The study objective was meant to examine the effect of equity financing on liquidity of listed commercial banks in Kenya. The correlation analysis results indicated that a significant relationship indeed existed between the two variables ($r = 0.177$). However, the Pearson's product moment coefficient of correlation $r = 0.177$ is low and suggests that the relationship between the variables was positive but weak.

9. Conclusion

Equity financing significantly affected the liquidity prospects of the banks although not much since it gave them more leverage in equal measure. Therefore the researcher concluded that equity financing influences the liquidity of listed commercial banks in Kenya.

10. Recommendation

The researcher recommended that there was need for the banks to build cash reserves through alternative investments in order to enable them to internally source finance through their assets in a less expensive way. Further the researcher recommended that research should be conducted on other factors like bank's lending policies among others affecting liquidity position of listed commercial banks.

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