Effect of Interest Rate Capping Policy on Financial Performance of Commercial Banks in Kenya; Case of Equity Bank Kenya Limited in Nairobi County

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Abstract: Empirical research has over the years shown that there is a strong evidence and a theoretical relationship between interest rates and the way firms perform financially. This study sought to determine the impact of interest rate capping policy on financial performance of commercial banks in Kenya and the main case study was Equity Bank Kenya Limited. The main study used three variables to model the relationship between interest rate capping and financial performance of equity bank. The three specific objectives namely: the effect of capping of interest rate on credit uptake and the performance of the bank, the effect of interest rate capping on bank’s financial exposure of Equity Bank and the effect on loaning practices on financial performance of Equity Bank were selected. Literature review on the three specific objectives was identified and discussed in detail in chapter two. Descriptive research design was also applied in the study. The target population in the study were 78 employees who comprised of operations managers, credit managers and branch managers of Equity Bank. The mode used for data collection was Questionnaires which were well administered. Finally the data collected was analyzed on SPSS and the report generated was used to explain the findings. The study recommended the following; Equity bank, other banks and policy makers should ensure that lending rates are well stated and follow a well-defined structure in order to improve and have a more progressive effect on the bank’s financial performance. Exposure to risk brought about by non-performing loans and loan defaulters can also be avoided or mitigated by having in place good loaning practises and policy and also strict and close scrutiny to remove those likely to default. Finally the government’s role is greatly needed in terms of policies, regulations and laws to control interest rates capping by Commercial Banks thus spurring economic growth and stability.

Keywords: Interest rate cap, credit uptake, financial exposure, loaning practices.

1. Introduction

There is a strong theoretical suggestion that interest rates greatly affect the financial performance of firms. Interest rate can be viewed as the sum of money paid for borrowing money (Makinde, 2016). Makinde (2016) further states that it is the opportunity cost and the cost incurred theoretically for tying up funds in other places which could have been used to generate more money elsewhere. A text book definition is that Interest rates is the return realized or is paid to the lender for funds borrowed or tied up in a project or security.

Interest rates are usually realized or received from loans, and other securities such as mortgages, treasury bills, and other short term and long term investments. Interest rate vary different basis as some banks will charge a high interest if there is a possibility that a loan provided might be defaulted. Other type of loans get high interest rate profiles due to the fact that they are hard to manage and the no form of substantial security is provided this includes things like credit cards or even overdraft accounts. (Mohamed, 2006).

Therefore caps attached to interest rates provide some form of control in the financial sector to prevent banks from charging very high and unreasonable Interest rates. This is a policy or regulation provided by most governments through central banks to control the workings of the banking sector since they play a very important role in an economy. In the recent years, the use of caps has reduced due to the fact that most financial sectors are being liberalized in their operations (Mbua, 2017). In order to evaluate the relevance of an interest rate cap as a policy instrument, or whether other substitute approaches would serve the overall purpose which is to control the banking sector loaning practice, it is very important to understand the process in which interest rates are determined and they become justifiable (Miller, 2013). Miller, (2013) established very important or key factors that are usually considered when coming up with interest rates and these include, 1) Profit, 2) Non-Performing Loans (NPL’s), 3) Overheads and 4) Cost of Funds.

There are several reasons why governments use controls and capping policies, the important reason being economic and politically based. Economically capping of interest rates may support areas in different sectors that are facing difficulties and failure and require financial resources to build themselves up. There are so many reasons why markets fail, things such as information asymmetries where market information is not received by all participants at the same time and the right time, secondly, the risk associated with very high interest rates this being a limitation to finance providers. Therefore according to Miller (2013), the use of caps becomes justifiable to protect both the demand side and to some extend the supply side of financial resources.

Despite capping being a useful tool to the government and also to the users of funds, it has its own disadvantages. One of the disadvantages is that capping of interest rates causes market distortion because banks will start considering only clients who are not likely to default and this in turn leads to ineffectiveness in the financial intermediation process. As intermediaries, banks provide the role of linking the suppliers of funds with those in dire need of the funds that is the demand side (Ongore, 2013). According to Ramsey (2013), since banks are in the middle of this whole process,
the disadvantage brought by capping renders some of the people in much need of the funds not eligible due to the high risk associated with them. It also limits access to the funds. Financial institutions however can still navigate through and remain relevant and still maintain profitability by engaging in sound activities themselves and also cut cost by adopting technologies that are improving greatly the banking services.

2. Statement of the Problem

Robinson (2010) established in his study that bank earnings are laid low with unforeseen changes in loaning interest rates. Matu (2006) argued that poor performance of economic banks led to enhanced pressure on banks to take care of high loaning rates in the markets and an attempt to reduce losses related to dangerous or non-performing loans. On the opposite hand, low credit uptake was directly attributed to the high loaning rates. A hunt study done out by Mang’eli (2012) points out that rate cap have an effect on the performance of economic banks, Kirimi (2015) states that for the banking sector, loaning interest rates play the crucial role because it has power to have an effect on total demand of cash and afterwards, the investment opportunities. Whereas Gardener et al (2005) affirms that loaning rate by business banks confirm the profitableness of economic banks among alternative issues.

High loaning interest rates have remained an economic science downside that has been tough to eliminate and therefore obstructive economic development. So as to uphold the economic growth of the country, the banking sector must perform its task properly (Beck and Hesse, 2006). Therefore as banks increase the cost of loans charged on the borrowers, regulations on interest rates have high reaching effects on performance of businesses since they confirm the rate unfold in banks and additionally facilitate and mitigate ethical hazards concomitant performance of business banks, credit risk management technique remotely affects the worth of a bank’s rate unfold as interest rates are benchmarked against the associated NPLs and NPLs is as a result of high price of loans.

What is emerging is that variety of studies are conducted on interest rates, however, it's apparent from the results of those studies that researchers didn't specialize in the link between interest rates capping and money performance of business banks. Mbua (2017), appearance into result of interest rates capping by the financial organization of Republic of Kenya on the banks listed on the national capital securities exchange, Okwany (2017) appearance into impact of rate of interest capping on operational performance indicators of business banks in Kenya: a case study of KCB bank (Kenya) restricted, Irungu (2013) studied the result of rate of interest unfold on money performance of business banks in Republic of Kenya, Maina (2015) delved into determinants of rate of interest unfold among industrial banks of Republic of Kenya, Kathomi (2017) looked into rate of interest regulation and property of microfinance establishments in national capital county, Kenya.

These studies don't expressly specify the result of rate capping law on money performance of economic banks and therefore disposition rate may have sturdy or weak relationship to banks money performance. Conjointly, different studies were conducted in Republic of Kenya once there have been no developments within the banking sector’s legal and regulative framework to control disposition interest rates. Furthermore majority of those studies were conducted in developed countries whereas Republic of Kenya may be a developing country.

From the summary of those factors, there's no clear indication of the impact of rate capping on monetary performance in Kenyan setting. It's imperative that the gap be crammed therefore that the study set to answer the subsequent question. What's the impact of interest rates capping on the monetary performance of the industrial banks in an African country?

Objectives of the study

The general objective of the study was to investigate the effect of interest rate capping policy on financial performance of commercial banks in Kenya; case of Equity Bank.

Specific Objectives

This study was based on the following specific objectives:

1) To investigate the effect of credit uptake on financial performance of commercial banks in Kenya.
2) Find out the effect of financial exposure on commercial banks in Kenya.
3) To establish the effect of loaning practices on financial performance of commercial banks in Kenya.

3. Theoretical Framework

Interest Rate Parity Theory

Interest rate is that rate of interest charged for the number of cash borrowed. Banks or disposal establishments sometimes have general pointers for the speed they will charge. Cash borrowed by the bank on short-run basis (such as bill of exchange facility) or long basis (debentures, mortgages, or bank loans) has completely different rate of interest. The rate of interest parity condition was developed by economist (1933), as what's known as rate of interest parity these days, to link the rate of exchange, rate of interest and inflation, the idea conjointly has 2 forms: coated rate of interest parity (CIRP) and uncovered rate of interest parity (UCIRP). CIRP describes the link of the commodities exchange and futures market exchange rates with interest rates on bonds in 2 economies (Ngugi, 2001). UCIRP describes the link of the spot and expected rate of exchange with nominal interest rates on bonds in 2 economies (Radha, 2011). This is often the conventional style of the coated rate of interest parity that states that the domestic rate of interest should be beyond the foreign rate of interest by associate quantity adequate the forward premium (discount) on domestic currency. Consistent with CIRP, if the rate of exchange of, say, the shilling against the USD is mounted, the interests of the 2 countries ought to be equal. Thus, a little country with a pegged rate of exchange regime cannot do financial policy severally (Salloum and economist, 2012).

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manipulating interest rates, central banks exert influence over each inflation and exchange rates, and dynamical interest rates impact inflation and currency values (Devereux & Lane, 2001). Higher interest rates supply lenders in associate degree economy a better come back relative to different countries. Therefore, higher interest rates attract foreign capital and cause the rate to rise. The impact of upper interest rates is lessened, however, if inflation within the country is far more than in others, or if further factors serve to drive the currency down. The other relationship exists for decreasing interest rates—that is, lower interest rates tend to decrease exchange rates (Van port, 2010).

Karfakis & Kim (1995) mistreatment Australian rate knowledge found that sudden accounting deficit is related to rate depreciation, and an increase in interest rates. Interest Purity theory helped to elucidate the factors behind the rate fluctuation and adjustment by the financial organisation of African country.

Conceptual Framework

![Conceptual Framework](image)

**Effect of Capping Of Interest Rate on Credit Uptake**

A capped rate is Associate in Nursing rate that’s allowed to fluctuate, however that cannot surpass a declared interest cap (Maimbo, Henriquez, & World Bank cluster, 2014). Wild (2012) outlined rate cap because the limit on however upward the rate will increase on Associate in Nursing adjustable rate of mortgage or loan. Capped rates offer the recipient with a hybrid of a hard and fast and variable rate loan (Cumes, 2014). The fastened part arises from the cap whereas the variable half is thanks to the actual fact that the speed might increase or decrease whereas taking into thought different factors concerned in evaluation a loan facility like risk rating that is Associate in Nursing indicator of a borrower’s chance of default (Tan & Floros, 2012).

Countries have to take into account rigorously that methodology of regulation works best within the context of the establishments of the country, instead of merely repeating a technique from the developed world. Parker and Kirkpatrick (2005) disburs a study in GB to look at various strategies of regulation costs and profits of privatized utilities in low financial gain countries with a read to characteristic their strengths and weaknesses. The results of the study were that the employment of a value cap was abundant reduced in low financial gain economies. This was thanks to its info needs, would like for restrictive experience and, additional generally, the institutional endowment found in several low financial gain countries.

McClain and Meier (2013) did a study in America to examine costs and benefits of cap and trade, along with some examination of the actual mechanics by which the system is expected to operate. They found out that the caps reduced profits of financial institutions which affected the whole economy in terms of developments. In addition the capping law hindered trade between America and other countries because the benefits were few compared to the costs.

Research Methodology

A research style could be a set up showing however the matter of investigation are resolved. The study adopted a descriptive survey style. Kombo and Tromp, (2009) outline a descriptive survey style as an outline of the state of affairs because it exists whose purpose isn’t solely restricted to reality finding. This involves the employment of questionnaires to gather, analyze and interpret the info. (Kothari, 2004), ascertained that this technique is the best suited to gathering descriptive information; wherever the investigator desires to describes the characteristics of people’s feelings, attitudes or preferences regarding one or additional variables through direct question. Since this study had the prime goal of finding out the result of rate cap on money performance of business banks: a case of Equity Bank.

The target population for this analysis study consisted of prime management officers at Equity Bank branches in capital of Kenya County. The sampling frame in this study comprised of all operations managers, credit managers and branch managers from all Equity bank branches in Nairobi County. The study by employed a census sampled all the seventy eight operations managers, credit managers and branch managers from all Equity bank branches in capital of Kenya County (Equity Bank Catalogue). This was thought-about since the target population isn’t therefore massive and every one the targeted respondents can be contacted simply. The analysis utilised each primary as well as secondary knowledge. The questionnaires was distributed via drop and decide and email, conjointly on-line survey was used and this aimed toward minimizing the matter of low response rate. During this case a census are going to be accustomed to minimize the error and every one the targeted respondents can be contacted simply. The analysis utilised each primary as well as secondary knowledge. The questionnaires was distributed via drop and decide and email, conjointly on-line survey was used and this aimed toward minimizing the matter of low response rate. During this case a census are going to be accustomed to minimize the error and every one the targeted respondents can be contacted simply.

The following formula is used to calculate the Pearson r correlation.

\[ r = \frac{N \sum xy - \sum x \sum y}{\sqrt{N \sum x^2 - (\sum x)^2}(N \sum y^2 - (\sum y)^2)} \]

Where:

- \( r \) = Pearson r correlation coefficient

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Increase in number of person seeking for loans

Requirements for loan approval have changed since the law came into effect, respondents were found to agree that more customers are turning to informal lending since the law came into effect, as indicated by a mean of 4.12 and a standard deviation of 0.857. On whether the bank thoroughly vetted the loan applicants the respondents strongly agreed as indicated by a mean of 4.82 and a standard deviation of 0.393. Finally, the respondents strongly agreed that there was intense selection to weed out high risk borrowers this was indicated by a mean of 4.82 and a standard deviation of 0.393.

According to literature Informal financing and trade credit relieves the tension of cash flow chain but cannot solve the financing constraints (Su & Sun, 2011). Respondent were neutral on there were any improvement on banks liquidity since this measure could only be explained by a banks operatives finally the respondents strongly agreed that there was intense selection to weed out high risk borrowers.

\[
N = \text{number of value in each data set} \\
\sum xy = \text{sum of the products of paired scores} \\
\sum x = \text{sum of } x \text{ scores} \\
\sum y = \text{sum of } y \text{ scores} \\
\sum x^2 = \text{sum of squared } x \text{ scores} \\
\sum y^2 = \text{sum of squared } y \text{ scores}
\]

In this study Likert scale was treated as interval scale so that analysis can be done using computer program SPSS. The questionnaire were coded for strongly disagree =1, disagree=2, neutral=3, agree=4, strongly agree=5.

**Regression equation**

The regression equation is:

\[
Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \epsilon
\]

Where Y is the dependent variable (performance), \( \beta_0 \) is the regression constant, \( \beta_1, \beta_2 \) are the coefficients of independent variables, \( X_1 \) is credit uptake, \( X_2 \) is financial exposure, \( X_3 \) is loaning practice and \( \epsilon \) is the error term.

4. Result and Discussion of Findings

<table>
<thead>
<tr>
<th></th>
<th>Mean</th>
<th>Std. Deviation</th>
<th>N</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of borrowers has changed since introduction of interest rate capping policy</td>
<td>4.12</td>
<td>1.054</td>
<td>73</td>
</tr>
<tr>
<td>The number of approved loans have increased since the law came into effect</td>
<td>3.65</td>
<td>.493</td>
<td>73</td>
</tr>
<tr>
<td>There are new borrowers</td>
<td>3.12</td>
<td>.781</td>
<td>73</td>
</tr>
<tr>
<td>Requirements for loan approval have changed</td>
<td>4.00</td>
<td>.707</td>
<td>73</td>
</tr>
<tr>
<td>Increase in number of person seeking for loans</td>
<td>2.76</td>
<td>.970</td>
<td>73</td>
</tr>
<tr>
<td>More customers are turning to informal lending since the law came into effect</td>
<td>4.41</td>
<td>.618</td>
<td>73</td>
</tr>
<tr>
<td>Improvement in the bank liquidity</td>
<td>2.82</td>
<td>.951</td>
<td>73</td>
</tr>
<tr>
<td>The bank has slowed down on lending since the law came into effect</td>
<td>4.12</td>
<td>.857</td>
<td>73</td>
</tr>
<tr>
<td>Through vetting of loan applicants</td>
<td>4.82</td>
<td>.393</td>
<td>73</td>
</tr>
<tr>
<td>Intense selection to weed out high risk borrowers</td>
<td>4.82</td>
<td>.393</td>
<td>73</td>
</tr>
</tbody>
</table>

Summary of findings

From the table 4.2 showed that majority of the respondents strongly agreed that number of borrowers has changed since introduction of interest rate capping policy as indicated by the mean and standard deviation 4.12 and 1.054 respectively. The respondents agreed that the number of approved loans have increased since the law come into effect as indicated by the mean of 3.65 and a standard deviation of 0.493.

Also, the respondents were uncertain about having new borrowers, this was indicated by a mean of 3.12 and standard deviation of 0.781. On whether requirements for loan approval have change the respondents agreed as indicated by a mean of 4.00 and a standard deviation of 0.707. The respondents were neutral on there was an increase in number of people seeking for loans as indicated by a mean of 2.76 and a standard deviation of 0.970. The respondents were found to agree that more customers are turning to informal lending since the law came into effect, this was indicated by mean of 4.41 and a standard deviation of 0.618.

5. Conclusion

**The effect of credit uptake on financial performance of commercial banks in Kenya**

A simple linear regression model was performed with financial performance as the dependent variable and credit uptake as the independent variable. This is aimed to establish a linear relationship between them. According to the findings credit uptake was found to positively explain a less than fifty percent of the variation that occurred in financial performance of commercial banks in Kenya. This implied that despite the fact that there was a relationship the explanatory power of the variable was not that strong. Countries need to consider carefully which method of regulation works best in the context of the institutions of the country, rather than simply copying a method from the developed world.

6. Recommendations of the Study

From the findings of the study, Commercial Bank executives and policy makers should focus on improving their optimal lending interest rates and their in order to improve and have a more positive effects on the bank’s financial performance. Exposure that banks face from risky customers can also be reduced by improving on the loaning practises of the bank and closer scrutiny to weed out those likely to default. Finally the support and influence of the government is greatly needed to control interest rates capping by Commercial Banks thus inventing policies that augment the ventures in the country thus spurring economic growth and stability.

References


