THE EFFECT OF CAPITAL ADEQUACY ON THE LENDING PERFORMANCE OF COMMERCIAL BANKS IN KENYA

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THE EFFECT OF CAPITAL ADEQUACY ON THE LENDING PERFORMANCE OF COMMERCIAL BANKS IN KENYA

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Abstract: Kenya's banking industry is one of East Africa's best known and has tremendous potential. Commercial banks play a crucial part in improving the transition of credit from surplus to deficit, thus promoting local economic activities. However, in recent times, banks have found that customers' credit efficiency has decreased, late payments, or bad debts has affected the bank’s profits. Bad loans from commercial banks in Kenya continue to erode banks' profitability, hampering the financial performance of the industry. Therefore, this study sought to investigate the effect of capital adequacy on the lending performance of commercial banks in Kenya. To meet the study's objectives, an explanatory research design was adopted. In this study, the demography refers to the complete spectrum of institutions relevant to the examination. The report's primary audience was Kenyan banks. From 2016 to 2021, 39 banks were fully operational and used. Because the population is small, the entire population was studied. A subset of a study population is chosen for sampling. From 2016 to 2021, the study sample included thirty-nine fully operational Kenyan commercial banks. As a result, because it encompassed all business organizations in Kenya, the assessment was essentially a census. The model found a clear relationship between the investigation parameters. Accounting records from the banks and CBK statistical reports were used for this study. Capital adequacy as noted by the regression outcome signify an inverse significantly effect on loan performance of commercial banks in Kenya. The study concluded that capital adequacy provides the commercial banks with the platform for effective loan management options toward optimum performance in Kenya. The study recommended that the size of the board should be determined by the companies listed strength as this is critical due to the fact that each company has unique tax planning goal hence the determination of the size of the board should be strengthen by each firm.

Keywords: Capital Adequacy, Lending.

1. INTRODUCTION

Banks have a significant role in determining the rate of development and economic development of any economy across the world. They facilitate the flow of investment funds from one surplus area of the economy to another. Raises capital to support economic sectors.

Provides financial stability to the economy by supporting the financial needs of companies and consumers by reducing transaction costs (Ngumo, Collins & David, 2017). Commercial banks have always been one of the most important financial institutions in any economy, acting as the link between the business world and the people (Warue, 2013). They provide a wide range of services that assist all members of an economy, the most important of which is lending (Jebet & Wepukhulu, 2020). However, in order to maintain order in the financial sector, these banks are governed by different economies in the pursuit for successful performance. top banks and other regulatory bodies.
Firm considerations significantly affect how well the global banking industry performs. The way these internal factors are managed determines whether these institutions will be successful or not (Ouhibi & Hammami, 2015). These elements define banks’ intermediation functions and shape the development and growth of the financial market. Consequently, good governance of these issues contributes to banks’ profitability and stability. Nyabaga and Matanda, (2020), state that firm-specific characteristics play a significant role in determining the credit performance of banks, which in turn affects banks' earnings and performance. On the other hand, ineffective and inefficient management of these elements puts banks at high risk of intermediation in the lending cycle, resulting in lower credit quality in the banking sector (Kisengo, 2014).

Credit plays a vital role in the global intermediation function of banks. Banks provide liquidity to failing industries. Unfortunately, the majority of credit facilities provided to consumers and other economic segments of the economy go into default, leading to non-performing loans which, if not paid off, could lead to bad debts that affect the bank’s bottom line and the economy as a whole (Koskei, 2020). Because the bank’s features are managed effectively and efficiently, bank credit carries low risk. This outlines the lending channels of the banks and prepares them for any uncertainty that may occur as a result of loan default.

Both enterprises and individuals in Africa have a rising need for loans. This is because financial facilities are made available to enhance production capacity within economic sectors, hence increasing people's quality of life (Kibet et al, 2015). For this reason, African banks should increase capital buffers to reduce credit risk from lending (Arun & Murinde, 2010). In such a situation, the efficiency of the management of African banks has a direct impact on the provisioning of lending facilities within the financial space in Africa, as higher capital ratios of banks influence liquidity, which influences the provisioning of loans to corporates and the general public.

Kenya’s banking system is characterised by bad credit, which has a negative impact on the banks’ financial performance (Makri et al, 2014). This can be explained by liquidity risks, which are the banks’ inability to meet their liabilities due to the exhaustion of assets due to non-performing loans (Alshatti, 2015). A non-performing loan, on the other hand, is a loan that has not been repaid in principal or interest within the contractual term of the loan, which is usually 90 days (Hasanovic & Latic, 2017). Bad debt from Kenyan banks continues to destroy bank profitability, preventing the industry from functioning. According to the CBK report (2020), bad debt stood at 5.99% in 2015 and 8.59% in 2016. This percentage grew to 12.3% in 2017 and 12.7% in 2018, remaining stable through 2019, then increasing to 13.1% in 2020. In 2020, the CBK discovered that the average lending rate for commercial banks fell from 12.477% in 2019 to 11.89% in 2020, while deposit interest rates fell from 7.19% in 2019 to 6.86% in 2020. This ongoing rise in bad debt interest rates continues to impede GDP growth by preventing banks from lending to the rest of the economy (Central Bank of Kenya, 2020).

Capital adequacy measures an institution’s ability to raise capital to cover operating costs. and act as a backup plan in the event of insolvency, reducing the costs of economic suffering by lowering the likelihood of banking insolvency. According to the Capital Adequacy Framework, the banking sector should have minimum capitalization levels. By establishing a regulatory requirement, financial institutions can remain stable and reduce the risk of insolvency (Wafula, 2020). Capital adequacy is also considered an essential element of credit quality for financial institutions (Oduora, Ngokab, & Odongoba, 2017). As a rule of thumb, institutions with higher resource reserves are better placed to position and support businesses and individuals during hard times; reserves enable institutions to go above and beyond and continue to lend during a crisis.

2. STATEMENT OF THE PROBLEM

Kenya’s banking sector is considered one of the fastest-growing in East Africa and has a lot of untapped potential. However, loan performance in the sector has declined over time. Kenya’s banking sector continues to suffer from non-performing loans which continue to reduce the profitability of banks, affecting the financial performance of the sector. According to the CBK report (2020), NPL stood at 5.99% in 2015 and increased to 8.59% in 2016. The rate continued to rise, reaching 12.3% in 2017 and 12.7% in 2018, remaining constant through 2019 before rising to 13.1% in 2020. According to CBK (2020), deposit rates likewise decreased from 7.19% in 2019 to 6.86% in 2020. In contrast, the average lending rate of commercial banks declined from a high of 12.47 percent in 2019 to a low of 11.89 percent in 2020. Following a rise in NPLs in Kenya, as a result of IFRA 9’s implementation in 2018, banks have increased their provisioning for outstanding credit risk. This is due to the fact that credit is a major source of revenue for banks, which typically carries a high degree of risk (Ngungu & Abdul, 2020).
3. LITERATURE REVIEW

Theoretical Literature Review

Calem and Rob (1996) were the pioneers of capital buffer theory. This hypothesis was based on the idea that banks work hard to keep excess capital above the CRB, which they use to cushion themselves against shocks that may result from bad risk in the business environment. In such a situation, rules are intended to provide a counter-cyclical response to capital shortfalls caused by bank lending (Wakaba, 2014). This, in turn, puts banks with limited capital under greater pressure to prepare for bankruptcy, which is borne by insurance companies. Banks with large quantities of capital, on the other hand, are tied down by hazardous investments and the expectation of high profitability through continual capital consumption (Kibet et al., 2015).

Buffer capital theory suggests a link between commercial banks’ capital adequacy ratio and loan performance. According to this theory’s postulation, commercial banks keep buffers to limit the ability to operate below the MCR. What is important is that commercial banks’ capital enables them to plan (Mennawi, 2020). As a result, commercial banks’ capacity to raise deposits does not lead to capital base erosion.

Empirical Literature Review

Oduora, Ngokab, and Odongoba (2017) explored capital sufficiency and credit worthiness in Africa. 163 African banks participated in the survey between 2000 and 2011, while 145 banking institutions across 23 African countries participated between 2007 and 2013. The NPL ratio was used as a measure of financial strength. On the other hand, the data shows that banking institutions play a significant and positive role in financial stability, which means that more equity in small banks will lead to more credit crises in Africa.

Yulianti, Aliamin and Ibrahim (2018) investigate the effects of capital adequacy and bank size on NPLs of Indonesian state banks from 2012 to 2016. Information from Bank Indonesia’s accounting records was gathered via several sources. This experiment was designed to test hypotheses. The study employed a deliberate sample selection technique, and the overall sample size was 81 extracts. In order to investigate the hypothesis, a Multilinear Regression technique was used for panel data evaluation. The data demonstrate that the capital adequacy ratio is having an effect on nonaccrual loans. In line with the data, capital adequacy has positive effects on bad loans.

Wafula (2020) investigated the impact of capital sufficiency on Kenyan commercial banks’ financial stability. The dynamic impact of banking characteristics on the stability of Kenya’s commercial banks has been measured by using an exchange rate. A causal study approach was adopted in the investigation. Between 2011 and 2018, 17 Kenyan commercial banks that were deemed susceptible were investigated. According to a dynamic panel regression analysis using GMM modeling, the financial health of Kenya’s commercial banks is negatively affected by the adequacy of capital. In Kenya, the data indicate that there are direct links between capital adequacy and commercial banks’ financial health.

4. RESEARCH METHODOLOGY

From 2016 to 2021, the study sample included thirty-nine fully operational Kenyan commercial banks. As a result, because it encompassed all business organizations in Kenya, the assessment was essentially a census. The model found a clear relationship between the investigation parameters. Accounting records from the banks and CBK statistical reports were used for this study.

5. FINDINGS

Table 1 displays the descriptive statistics results of capital adequacy.

<table>
<thead>
<tr>
<th>Variable</th>
<th>Obs</th>
<th>Mean</th>
<th>Std. Dev.</th>
<th>Min.</th>
<th>Max.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital Adequacy</td>
<td>273</td>
<td>0.1389</td>
<td>0.0670</td>
<td>-0.2058</td>
<td>0.4854</td>
</tr>
</tbody>
</table>

Capital adequacy of the commercial demonstrated a mean value of 0.1389. The capital adequacy of the banks varied across the banks observations as noted by 0.0670 standard deviation value. The variation indicated that the data used in the survey do not fall outside the range of -0.2058 and 0.4854 as minimum and maximum values.
Results of Inferential Statistics

Correlation analysis

<table>
<thead>
<tr>
<th>Variable</th>
<th>Loan Performance</th>
<th>Capital Adequacy</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loan Performance</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>Capital Adequacy</td>
<td>-0.04004*</td>
<td>1</td>
</tr>
</tbody>
</table>

Results of Regression Analysis

Table 3: Model Summary

Capital adequacy had negative and significant relationship with loan performance of commercial banks in Kenya. The association of the variables is demonstrated by the coefficient of -0.4004*. The significant of the strength is illustrated by the asterisks values in the table.

Table 4: Coefficients

| Financial Performance | Coef. | Robust Std. Err. | z     | P>|z| | [95% Conf. Interval] |
|-----------------------|-------|------------------|-------|------|---------------------|
| Capital Adequacy      | -0.5133 | 0.1579           | -3.25 | 0.001 | -0.8230108 -0.2036746 |
| _cons                 | -0.1978 | 0.1171           | 1.69  | 0.091 | -0.031734 0.4274128  |
| R²                    | 0.1893 |                  |       |      |                     |
| Wald chi² (4)         | 12.87  |                  |       |      |                     |
| Prob> chi²            | 0.0119 |                  |       |      |                     |

Drawing from the outcome obtained in Table 4, the regression equation is expressed as:

\[ LP_t = -0.1978 - 0.5133CA_t + \varepsilon \]

\( LP = \) Loan Performance

\( CA = \) Capital Adequacy

\( BA = \) Bank Size

\( \varepsilon = \) Error term

Capital adequacy suggested a negative but considerable impact on the lending performance of Kenyan commercial banks. The inverse effect of capital adequacy on loan performance is depicted by -0.5133. The significant of capital adequacy is represented by 0.001 < 0.05 implying that an increase in the adequacy of capital of the commercial banks would reduce the loan performance of commercial banks in Kenya.

The study's findings also showed that capital adequacy has an unfavourable and substantial impact on the loan performance of commercial banks in Kenya. Following from the null hypothesis of the survey which states that capital adequacy does not significantly affect the commercial banks’ loan performance in Kenya, the null hypothesis was rejected. The outcome led to the conclusion that capital adequacy significantly affect loan performance of commercial banks in Kenya. The significant of capital adequacy could be attributed to the capital adequacy regulation of the central banks which has helped the banks in holding adequate funds to overcome adverse selection issues that may arise in the course of banking intermediation activities in Kenya.

6. CONCLUSIONS

The effectiveness of capital adequacy was determined on commercial banks’ loan performance in Kenya. Observation from the investigation noted that commercial banks’ loan performance was affected greatly by capital adequacy. The conclusion that emanates from the investigation is that capital adequacy is a major factor determining how commercial banks perform...
their loans. Therefore, capital adequacy provides the commercial banks with the platform for effective loan management options toward optimum performance in Kenya.

7. RECOMMENDATIONS

Capital sufficiency has a beneficial and considerable impact on commercial banks’ loan performance in Kenya. In accordance to this, the investigation suggest that the size of the board should be determined by the companies listed strength as this is critical due to the fact that each company has unique tax planning goal hence the determination of the size of the board should be strengthen by each firm.

REFERENCES


