EFFECT OF ECONOMIC ENVIRONMENT ON FINANCIAL PERFORMANCE OF COMMERCIAL BANKS IN KENYA.

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A RESEARCH PROJECT SUBMITTED IN PARTIAL FULFILLMENT OF THE REQUIREMENTS FOR THE AWARD OF A DEGREE IN MASTER OF BUSINESS ADMINISTRATION KENYATTA UNIVERSITY.

MAY, 2012
DECLARATION

declare that this research project is my original work and has not been presented for a degree in any other university.

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To my mum and dad Mr and Mrs Muthike for always being there and shaping my life during the formative years. To my husband Mutua for giving me a reason to pursue life with courage and determination. My sisters and brothers with love and my friends Florence Mukiria and Teresa Duba for their understanding, encouragement and support.
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MBA 2009 class for a lifetime experience

God bless you all.
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The banking industry has increasingly gained popularity in Kenya and beyond due to various changes in the market and economic environment. There has been quantitative and qualitative shift in trade and business opportunities across nations of the world. Furthermore, with the advent of liberalization, structural reform, and innovations in information technology, there is a significant increase in the international mobility of people, capital, knowledge, technology and materials. At the same time, the volatility in socio-economic performance of economies has increased. The increasing competition in the national and international banking markets, the change over towards monetary unions and the new technological innovations herald major changes in banking environment, and challenge all banks to make timely preparations in order to enter into new competitive financial environment. The general objective of the study was to investigate the effects of economic environment on financial performance of commercial banks in Kenya. The research aimed at answering questions on the effects of inflation; exchange rate volatility; fluctuations of interest rate and balance of payment crisis to financial performance of commercial banks. The study was modeled on a Descriptive research design. The target population comprised all the 44 commercial banks in Kenya. The sample size comprised 22 branch managers and 22 finance managers from the various commercial banks. Data was gathered through semi-structured questionnaire and a few open ended questions and secondary data from the various commercial banks records such as financial statements, and CBK publications. Descriptive statistics was adopted as a method of analysing data and data presented in frequencies, pie charts, bar charts and percentages for comparisons, explanations and clarity in line with the study objectives. The findings of this study have revealed that economic environment affects the financial performance of commercial bank. More so inflation rate, exchange rate volatility, interest rate fluctuations and balance of payment deficits. The conclusions drawn from the research were that economic environment affects commercial banks credit growth and quality, liquidity, profitability and return on assets and this consequently affects totality of commercial banks financial performance. The findings and recommendations of this study is of great use to the Managing directors of commercial banks to cushion themselves against unfavourable economic environment and to the regulator (CBK) to deal with imbalances and risks in the economic environment.
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DEFINITION OF OPERATIONAL TERMS

Bank
An organization whose principle operations are concerned with the accumulation of the temporarily idle money of the general public for the purpose of advancing to other for expenditure. Its an institution for the keeping, lending and exchanging etc. of money

Inflation rate
Percentage increase in price levels;

Exchange rate
Also known as the foreign-exchange rate, forex rate
Is the rate at which one currency will be exchanged for another. It is also regarded as the value of one country’s currency in terms of another currency.

Interest rate
The price of money

Balance of payment
Is a sudden devaluation of a currency caused by chronic balance-of-payments deficits which usually ends in a speculative attack in the foreign exchange market. It occurs when the value of a currency changes quickly undermining its ability to serve as a medium of exchange or a store of value
CHAPTER ONE
INTRODUCTION

1. Background of the Study

The financial system is a nerve center of economic development. It provides the important service of financial inter-mediation that largely entails enabling surplus spending units to save and deficit spending units to raise fund for investment and consumption. Kenya's financial system has previously experienced risks emanating from poor corporate governance; weak risk-management frameworks; competition and globalization, including cross border trade risks; rapid technological innovations, mainly product development, delivery channels and methodologies; and from socio-economic shocks (CBK, 2010).

Developments in the global macroeconomic environment impact on Kenya's overall economy and financial sector performance through the trade balance, net capital inflows and foreign exchange market. Despite enhanced activity in Emerging economies, inflation pressures are emerging and there are signs of overheating, partly driven by strong capital inflows. This calls for comprehensive and swift actions to overcome sovereign and financial troubles in the Euro Area. More generally, policies should be implemented to redress fiscal imbalances and reform financial systems in advanced economies in order to achieve robust recovery and check overheating pressures in key emerging economies in order to facilitate external rebalancing.

Further factors are the deficiencies in the legal and institutional framework that limit the range of assets available to banks as acceptable collateral. There has also been periodic uncertainty in the policy environment relating to the control and regulation of interest rates and related bank fees. The current government in 2007 published its strategy for financial sector development in its document entitled Vision 2030 (CBK, 2010).

The Kenyan economy enjoyed a remarkable improvement in its performance between 2002 and 2007, achieving high rates of GDP growth that culminated at 6.9% growth in 2007. This successful period followed two decades of erratic performance and stagnation of the economy. The projected growth of 2008 had been even more impressive at 7.8%. This figure was not achieved, however, due mainly to the violence that followed the presidential elections of
December 2007. Despite this setback, the economy is now slowly regaining macroeconomic stability, though with much reduced GDP growth (only 3% in 2008) and continuing political uncertainty in the context of the uneasy coalition government. Growth in the period since 2002 has been achieved largely through increased domestic demand. Growth in exports, however, has continued to be slow as a result of lack of diversification, low value exports and supply-side constraints related to the investment climate. High food, energy and transport costs have also contributed to higher rates of inflation since 2005: inflation reached 27% in 2008. (FSD Kenya, 2010)

Advanced economies recorded a 3% expansion in 2010 after a 3.4% contraction in 2009. US, German and Japan recorded economic expansion averaging 3% while Ireland, Greece and Spain recorded a contraction, although better than the 2009 level. The recovery has strengthened corporate balance sheets and stabilized some indicators of household leverage.

Despite notable growth of advanced economies, governments and households remain heavily indebted, and the health of financial institutions has not recovered in tandem with overall economy. Financial turbulence re-emerged in the periphery of the Euro Area in the last quarter of 2010 arising from concerns about banking sector losses and fiscal sustainability. These were triggered by the situation in Ireland, which led to widening spreads in these countries, in some cases reaching highs not seen since the launch of the European Economic and Monetary Union.

According to a report by CBK, 2010, funding pressures have also reappeared, but there are limited financial market spillovers to other countries due to the intervening policy actions that managed to keep the financial turmoil and its real effects contained in the periphery of the Euro Area, resulting in only a modest drag on the global recovery. Central banks also play a role in providing liquidity in the region. The policy measures are aimed to prevent a disorderly Greek default, to restore debt sustainability in Greece, and to prevent the spread of the crisis to other Eurozone countries and the global economy.

Despite strong recovery at global scale and robust growth of domestic economy, downside risks remained elevated, particularly in developed economies which might weigh heavily on the global growth projections, with negative spillovers felt in the domestic economy. The specific vulnerabilities include the fiscal problems in the euro area leading to renewed stress, slowdown
in recovery in advanced economies, overheating in emerging & developing economies, and stubbornly high unemployment in developed economies. In addition, the political instability impacting negatively on inflation, escalated drought in Sub Saharan Africa and higher commodities prices, are a cause of further vulnerability. The combined effect of these weaknesses, indicates vulnerability generated from rising oil prices (CBK, 2010).

1.1 The Kenya Banking Industry

Over the last few years, the Banking sector in Kenya has continued to grow in assets, deposits, profitability and products offering. The growth has been mainly underpinned by; an industry wide branch network expansion strategy both in Kenya and in the East African community region automation of a large number of services and a move towards emphasis on the complex customer needs rather than traditional ‘off-the-shelf’ banking products. Players in this sector have experienced increased competition over the last few years resulting from increased innovations among the players and new entrants into the market.

In recent years, retail banking has increasingly gained popularity in Kenya due to various changes in the market. Retail banking has been defined as the provision of cluster products and services by banks to consumers and small businesses through branches, the Internet and other channels (Ashcraft, 2005). This is as opposed to corporate banking, which consists of different banking services to large companies, governments or other big institutions. There are various forms of banking namely corporate, commercial, retail banking and investment banking therefore banks can offer more than one form of banking.

Banking industry in Kenya is divided into three categories: banks, micro-finance institutions, foreign exchange bureaus and non-bank financial institutions. There are forty-six bank and non-bank financial institutions, fifteen micro-finance institutions and forty-eight foreign exchange bureaus. Thirty-five of the banks, most of which are small to medium sized, are locally owned. A few large banks most of which are foreign-owned, though some are partially locally owned, dominate the industry. Six of the major banks are listed on the Nairobi Stock Exchange (PWC report, 2007).
The commercial banks and non-banking financial institutions in Kenya offer corporate and retail banking services but a small number, mainly comprising the larger banks, offer other services including investment banking (PWC report, 2007). As at 31st December 2010, the banking sector comprised of the Central Bank of Kenya, as the regulatory authority, 44 banking institutions (43 commercial banks and 1 mortgage finance company), 2 representative offices of foreign banks, 5 Deposit-Taking Microfinance Institutions (DTMs) and 126 Forex Bureaus. 31 of the banking institutions are locally owned while 13 are foreign owned. The locally owned financial institutions comprise of 3 banks with public shareholding, 27 privately owned commercial banks, 1 mortgage finance company (MFC) while 5 DTMs and 126 forex bureaus are privately owned. The foreign owned financial institutions comprise of 9 locally incorporated foreign banks and 4 branches of foreign incorporated banks.

Retail banks exist to service the financial needs of business and society. The deregulation of financial services markets in the 1980s, and in particular the growing focus of both consumers and producers on quality, has created a process of structural change in the banking industry. Retail banking is a commodity service and the effects of these changes are therefore experienced by most of the population (Llewellyn, 1992).

In the last four years there has been increased competition from new entrants into the banking industry, forcing banks to cut costs and improve efficiency through automation and price rationalization (Paulson and McAndrews, 1998). While the banks have been forced to cut costs and improve efficiency, there is increasing internal and political pressure on banks to expand their products and services to the un-banked and under-banked (Bitner, et al 2000).

Due to the competitiveness of the banking industry many banks which were doing corporate banking changed to partially or completely to retail banking. This is evident from a lot of advertisements made by banks using various forms and also by use of sales people, who have tried to convince many individuals to open accounts (Banking supervision Annual Report, 2005).
Banks which have actually incorporated retail banking in Kenya are Equity bank, CFC, Standard chartered, Barclays, National bank of Kenya, Kenya Commercial Bank, Consolidated bank, NIC bank, Co-operative bank of Kenya (Banking supervision Annual Report, 2005).

The year 2010 witnessed the continued growth of the Kenyan banking sector on various key fronts; increase in the number of service providers, advancements in technology which facilitated service-delivery channels, geographical expansion by service providers both within Kenya and regionally and greater product differentiation resulting in niche market growth, among others. These improvements mark an important stage along the path towards a more efficient, stable and accessible banking system with increased improvements in financial performance of all commercial banks.

1.3 Statement of the Problem

The economic environment has been changing internationally for the last two decades. There has been quantitative and qualitative shift in trade and business opportunities across nations of the world. In recent years, competitive markets and business environments have been volatile, turbulent, uncertain, complex, and heterogeneous. The environment has been characterized by inflation of 19.72%, runaway loss of value of Kenya shilling against the US Dollar characterized by devaluation of 31% within 6 months from Kshs 84 to 107 to the USD, Increase in the central bank interest rate (CBR) from 11% to 18% prompting commercial banks interest rates to rise from an average of 13% to 30% (Daily Nation, December 29, 2011). Furthermore, with the advent of liberalization, structural reform, and innovations in information technology, there is a significant increase in the international mobility of people, capital, knowledge, technology and materials.

At the same time, the volatility in socio-economic performance of economies has increased. This volatility has been exacerbated by the recent economic crisis. With it, many developing economies are more dramatically impacted on than many developed economies. These fluctuations have had mixed impacts on performance of all sectors of the economy the banking sector inclusive worldwide. This implies that concrete policy agenda has to be called for by the international organizations and governments to manage the crisis so as to limit the extent of socio-economic damage the harsh changes in the economic environment will have. In many
developing countries, social, economic and financial implications of the crisis carry long-run implications for economic growth.

The economic fluctuations in Kenya have been of high magnitude and affected all sectors of economy. High fuel prices and prolonged slump of the shillings pushing inflation steadily upwards to 19.72% in November 2011, a weak economic outlook for Japan and UK, Kenya’s main export markets leading to a tighter supply. At the same time, Kenya Revenue Authority increased duty for imported vehicles while shipping costs driven by oil prices increases and the Japanese tsunami that reduced supply of second hand cars to Kenya led to higher costs (Daily Nation, January 10, 2012). As such commercial banks were highly affected by the changing economic environment. Locally, there are no studies that are focusing on the effects of economic environment on financial performance of commercial banks; instead, researchers like Ngaruiya (2007) investigated factors affecting organizational change in Kenya banking industry. This study therefore will assess the effects of economic environment on financial performance of commercial banks in Kenya.

1.4 Objective of the Study

1.4.1 General Objective

The main objective of the study is to investigate the effect of economic environment on the financial performance of commercial banks in Kenya.

1.4.2 Specific Objectives

The study will be guided by the following specific objectives:

1. To determine the effect of inflation on financial performance of commercial banks in Kenya

2. To assess the effect of exchange rate volatility on financial performance of Commercial banks in Kenya

3. To determine the effect of interest rate fluctuations on financial performance of commercial banks in Kenya.
4. To find out how the balance of payment situation affect the financial performance of commercial banks in Kenya

1.5 Research Questions
The study will be guided by the following research questions:

1. What are the effects of inflation to the financial performance of Commercial bank in Kenya?

2. What are the effects of exchange rate volatility on financial performance of commercial banks in Kenya?

3. To what extent do changes in the interest rates affect the financial performance of Commercial banks in Kenya?

4. How does balance of payment affect the financial performance of Commercial banks in Kenya?

1.6 Significance of the Study
In a nutshell this study would assist the strategy managers in the banking industry as it will provide information on changing economic environment and its influence on financial performance of business entities more so to banks. Therefore the bank management will be able to formulate effective plans and align the business with the changing economic environment and put on strategies that will curb business losses and focus on other income earning parameters in commercial banks to address financial shortfalls when the economic environment is not favorable. The data from this study will be helpful in monitoring the economic environment towards the millennium development goal.

It will help the policy makers to pursue policies that would improve the economic environment and access to finance for a majority of the population, thus, raising the level of monetization in the economy for economic development and effective implementation of monetary policy.

This study will help the regulators to be better prepared to contain and deal with any imbalances and risks in the economic environment before they become a threat to overall commercial banks instability. Create a well-functioning, sound and stable financial system, based on prudent risk
management and business continuity strategies and market-disciplining mechanisms that achieve resilience and prevent financial crises.

The study will be of importance as it contributes to generation of knowledge and information for decision making that would improve strategies of dealing with changing economic environment and adopt the strategies to the economic environment and their effect on financial performance of commercial banks. Research information will also provide data to assist researchers, development practitioners, planners and programme implementers to monitor and evaluate economic environment and thereby mitigate factors that will hinder or lower financial performance of commercial banks.

Stakeholders would benefit from this research as it would be an important blueprint for the other players in the banking and financial industry (BFI).

1.7 Assumptions of the Study

This study is based on assumptions that the general market environment of a firm or bank expects to operate in over the life of a financial plan; the prevailing economic conditions always have an impact on trade and general business activities that exist within it and there are policy measures that can successfully be taken by business people to cushion their ventures against adverse economic conditions.

1.8 Scope of the Study

This study examines the effect of economic environment on financial performance of Commercial banks in Kenya. It focuses on four main independent variables; that is inflation rate, exchange rate volatility, interest rate and balance of payment situation and their effect on financial performance of commercial banks. The study adopts descriptive research design with target population being branch and finance managers in the 44 commercial banks. Data is presented in tables, pie charts, bar graphs, frequencies and percentages.
CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter draws on literature in the area of commercial banking and the effects that economic environment has on its financial performance. Secondary material such as books, journals, and articles which carry previous research work on the study topic are analyzed. The material is of importance to this study as it forms a basis for observations which will be made during the study in line with the study aims and objectives.

Generally, the financial performance of banks and other financial institutions has been measured using a combination of financial ratios analysis, benchmarking, measuring performance against budget or a mix of these methodologies (Avkiran, 1995). The financial statements of corporations in Kenya that are published commonly contain a variety of financial ratios designed to give an indication of the corporation's financial performance. Simply stated, much of the current bank performance literature describes the objective of financial organizations as that of earning acceptable returns and minimizing the risks taken to earn this return (Coleman, 1986). There is a generally accepted relationship between risk and return, that is, the higher the risk the higher the expected return. Therefore, traditional measures of bank performance have measured both risks and returns.

The increasing competition in the national and international banking markets, the change over towards monetary unions and the new technological innovations herald major changes in banking environment, and challenge all banks to make timely preparations in order to enter into new competitive financial environment. Spathis, and Doumpos, (2002) investigated the effectiveness of Greek banks based on their assets size. They used in their study a multi criteria methodology to classify Greek banks according to the return and operation factors, and to show the differences of the banks' profitability and efficiency between small and large banks.

Chien Ho, and Song Zhu, (2004) showed in their study that most previous studies concerning company performance evaluation focus merely on operational efficiency and operational...
effectiveness which might directly influence the survival of a company. By using an innovative two-stage data envelopment analysis model in their study, the empirical result of this study is that a company with better efficiency does not always mean that it has better effectiveness. A paper in the title of efficiency, customer service and financing performance among Australian financial institutions (Elizabeth and Elliott, 2004) showed that all financial performance measures as interest margin, return on assets, and capital adequacy are positively correlated with customer service quality scores.

Generally, the concept of efficiency can be regarded as the relationship between outputs of a system and the corresponding inputs used in their production. Within the financial efficiency literature, efficiency is treated as a relative measure which reflects the deviations from maximum attainable output for a given level of input (English and Warn, 1992). However, there have been numerous studies analyzed the efficiency of financial institutions. Among these, (Rangan and Grabowski, 1988) use data envelopment analysis to analyze technical efficiency in US banking into pure technical and scale efficiency. (Aly and Rangan 1990) extend this analysis to contain analysis of allocative efficiency, and (Field, 1990), (Dark, 1992), (Chu-Meiliu, 2001), (Tser-Yieth Chen, and Tasi Yeh, 1998), and (Leigh and Howcroft, 2002) have conducted some studies into banking efficiency.

Many research works have been too much focus on asset and liability management in the banking sector ignoring the effect of economic environment on financial performance of financial institutions some of these studies are: (Richard and Moloney, 2003), (Ruth, 2001), and (Ian Candidy, 2000).

Much of what scholars have written about the determinants of industry, firm and business financial performance is in the form of measures of individual relationships in models linking various hypothesized causal variables to various performance measures. The causal variables usually describe some combination of elements of environment, firm strategy and organizational characteristics. This work is found in several disciplines including economics, management, business policy, finance, accounting, management science, international business, sociology and marketing. In the last decades various studies have been conducted that investigated the determinants of financial performance of commercial banks around the world. Commercial banks, mutual savings banks, savings and loan associations, and credit unions comprise a group
of financial services institutions, collectively called depository intermediaries (Auerbach, 1985). The product/service offerings these institutions have in common bind them into an industry grouping that is subject to similar influences. Major regulatory influences on these institutions have been the Depository Institution Deregulatory and Monetary Control Act of 1980, and the Garn-St. Germain Act of 1982. These Acts have eased entry, location, and activity restrictions within the general financial services industry (Bush, 1987). According to banking experts (Auerbach, 1985; Gup and Whitehead, 1989), these Acts are responsible for allowing increased competition from nonbank suppliers of financial services (e.g., Sears, Merrill Lynch, General Electric, and Kmart) as well as from contractual intermediaries (e.g., insurance companies). It has been suggested that in service industries of this type, where competition can move very quickly and new players can enter easily, there is a constant need to think strategically about what is going on (Schmenner, 1995). This appears to be precisely what banks, in particular, have begun to do in recent years. In response to increasing complexity and change in the financial services industry, banks have turned to strategic planning.

The relatively new trend toward strategic planning in banks is viewed as a move designed not only to help them negotiate their environment more effectively, but to improve their financial performance as well (Bettinger, 1986; Bird, 1991; Prasad, 1984).

Studies that have focused on strategic planning-performance relationships in banks have given mixed results. The inconsistencies in these results might be attributed to spurious research findings, resulting from the researchers focusing on the wrong performance measures and not considering the length of time banks have been involved in formal strategic planning (Hofer and Schendel, 1978; Fulmer and Rue, 1974), and extraordinary environmental pressures and other factors that are unique to banks (Bird, 1991; Hector, 1991a; Kallman and Shapiro, 1978).

The intensity with which managers engage in strategic planning depends on managerial (e.g., strategic planning expertise and beliefs about planning-performance relationships), environmental (e.g., complexity and change), and organizational (e.g., size and structural complexity) factors. The effects of these factors on strategic planning intensity have been suggested by several studies (Kallman and Shapiro, 1978). A number of factors affect the financial performance of banks, factors such as strategic planning expertise and beliefs about planning-performance relationships (managerial factors), environmental complexity and change
Many other studies suggest that environmental conditions have an influence on organizational actions, including the extent to which organizations engage in the strategy-making process. This line of research also suggests that environmental complexity and change represent such conditions, and that these two conditions may be the strongest determinants of strategic planning intensity.

2.2 Economic environment
The Economic Environment is a totality of economic factors, such as, income, inflation, interest rates, exchange rate, balance of payment, productivity and wealth that influence the buying behavior of consumers and institutions. These factors are those so called "uncontrollable", unlike the "controllable" factors of price, promotion, place and product. They include market tastes, economic, socio cultural, legal, technological, competitive and political factors to name but a few. (Spathis and Doumpos 2002). Failure to account for these factors can lead to dire consequences. The environmental factors affect the banking sector in a variety of ways and this study will focus on how it influences the financial performance of commercial banks in a case study of Equity bank of Kenya. It concentrates on the following environmental factors; Inflation, interest rate fluctuations, exchange rate volatility and the balance of payment situation.

Global Economic Conditions
In an ever-changing global economy Johnson and Scholes (2003) notes that organizations must find ways for operating by developing new competences as the old advantages and competences gained are quickly eroded owing to environmental changes.

According to a report from Central Bank of Kenya (2010), macroeconomic environment was sound in 2010 as evidenced by global economic recovery from a contraction of 1.0 percent in 2009 to a real growth rate of 4.6 percent in 2010. The growth was supported by austerity measures put in place by governments to counter the effects of the recession coupled with stimulus policies which particularly strengthened out-turn, especially in Japan. There was also a general increase in private consumption, which fell sharply during the international financial
crisis. Growth in emerging and developing economies remained robust and buoyant while many advanced economies recovered and experienced positive growth in 2010.

The global economy is projected to continue on a recovery path though at a slower real GDP growth of 4.2 percent in 2011. Activity in the advanced economies is projected to expand by 2.5 percent during 2011–12, which is still sluggish considering the depth of the 2009 recession and a significant dent in high unemployment rates. In both 2011 and 2012, growth in emerging and developing economies is expected to remain buoyant at 6.5 percent, a modest slow down from the 7.0 percent growth registered last year. The Global Financial conditions generally remained stable in 2011 as expected, though the growth was strained by normalization of the financial sector which was still open to shocks arising from risky markets since interest rates remained low (Central bank of Kenya, 2010).

The Regional Economy

Organizations are operating where globalization has become key and in a post modern setting that features a constantly changing environment.

Most developing countries, particularly in Sub-Saharan Africa (SSA), continued with growth momentum with real GDP growth of 5.0 percent recorded in 2010 compared to 2.8 percent in 2009. The positive growth was attributable to sound macroeconomic management and increased commodity demand from emerging economies. Many countries also supported output by injecting fiscal stimulus and lowering interest rates.

The East Africa Community (EAC) comprising of East Africa’s five member countries recorded the highest growth rate of 5.4 percent in 2010 compared to 4.8 percent in 2009. All the countries except Burundi recorded growth of above 5 percent in 2010. Uganda recorded a decelerated growth of 5.8 per cent in 2010 compared to 7.2 percent in 2009. The performance of the region was influenced by the linkages of member countries and the global economy hence impacting on the recovery in 2010. The growth is also attributed to political stability, favorable weather conditions and increased demand for commodity exports in European markets (Central bank of Kenya, 2010).
The strong economic performance in Sub-Saharan Africa is expected to continue, with a real GDP projected to grow at 5.5 percent in 2011. This is due to an anticipated increase in domestic demand, an expansion in public infrastructure investments, growth of the service sector, agriculture output and prices. Increased trade with Asia through commodity markets is also expected to contribute to the growth in the region in 2011. In the East Africa Community, real GDP is projected to grow at 6.2 per cent in 2011 with the support of stable macroeconomic environment and the operationalization of the East African Common Market in July 2010, which is expected to boost trade and movement of goods, services and labour across the region. However this expectation may be curtailed by the high inflation level in the EAC in 2011 when Kenya’s hit an all time high of 17%(Central bank of Kenya, 2010).

The Domestic Economy

Towards the end of 2009, Kenya’s economy started to recover more strongly and this positive momentum was sustained into the year 2010. The resilience of the Kenya economy was evident in 2010 when real GDP expanded by 5.6 percent after suppressed growths of 1.5 and 2.6 percent in 2008 and 2009 respectively. These developments were attributable to favorable weather conditions, increased credit to the private sector, low inflationary pressure, improved weather conditions and relatively stable domestic environment. The pro-active government policies also led to encouraging developments in the economy. These factors encouraged a steady growth leading to a turnaround in the agriculture, electricity and water sectors and a rebound in most of the other sectors. As a consequence, manufacturing, construction and the service industries were favoured by reliable supply of electricity and resilient domestic demand therefore compounding the growth(Central bank of Kenya 2010).

In addition, the country benefited from improved prices of the main exports and increased remittances from abroad resulting from the global economic recovery. Despite the campaigns associated with the 2010 constitutional referendum, business and consumers confidence remained largely intact thereby boosting economic growth.

An overview of the major contributors showed a rebound in agriculture production as a result of good weather, which led to decline in prices of various commodities and improved export prices while Wholesale and Retail Trade were primarily boosted by improved business and consumer
confidence. Tourism improved significantly from Ksh 62.5 billion in 2009 to Ksh 73.7 billion in 2010 (Central bank of Kenya 2010).

This translated to a growth of 17.9 percent which surpassed the 2007 bestyear benchmark. Activities in the manufacturing sector were supported by improved power supply and lower costs of inputs while the financial sector recorded its highest growth for the last decade growing at 8.8 per cent in 2010 compared to 4.6 percent in 2009. The growth was due to increased borrowing riding on financial innovation that enhanced access to financial services. The Nairobi Stock Exchange also recorded recovery which was primarily due to increase in foreign investment, which indicates the improved confidence in the Kenyan market as a whole. The economic performance for the year 2011 faced some headwinds, as initial economic performance indicators for the first quarter pointed to suppressed economic activities. The beginning of 2011 was characterized by high oil prices, low rains, high inflation rates, instability in the foreign exchange market and political uncertainty surrounding the succession politics and implementation of the new constitution. These factors combined are likely reduce the growth momentum and as a result, the domestic economy is projected to grow by between 3.5 and 4.5 percent in 2011 (Central bank of Kenya, 2010).

2.3 Empirical Review

2.3.1 Inflation Rate

Inflation is the percentage increase in price levels. When most prices grow, there is inflation, provided the other prices don't drop too heavily. If inflation is not compensated by nominal increases of income, people become poorer. High and variable inflation makes economic price forecasting more difficult and decision-making processes may be negatively affected. (Bullard, James, and Keating, John, 1995).

Uncompensated inflation reduces incomes, thus consumption and savings, both in aggregate and with particular reference to certain social groups. Through a Keynesian multiplier, income and consumption will cumulatively fall further. If inflation is mainly demand-pulled, it vanishes the increases in nominal effective demand and it frustrates consumption expectations. By contrast, if inflation is mainly due to efforts of increasing margins and profits, it is possible a rise in consumption in high-income groups. Investment should be discouraged by uncertainty about
future engendered by inflation and its wide fluctuation. Still, to the extent that benefits of inflation are mainly reaped by domestic firms, the real interest rate for investment fall inversely with mounting inflation. Thus, a low or moderate inflation may help investments, at least to the extent they are actually influenced by real interest rates and until a central bank intervention. (Bullard, James, and Keating, John, 1995).

In fact, central banks can try to control inflation through a sharp increase in real interest rates, more than proportionally reflected in nominal interest rates. This move usually provokes a fall in investment and a revaluation of currency. The first effect brakes domestic demand, the second the foreign one (Huybens, Elisabeth, and Smith, Bruce, 1999). In summary, higher inflation leads to higher nominal interest rates. In a first phase, the later may not keep pace with inflation, thus real interest rates may fall. But afterward, if the central bank does not accommodate inflation, the real interest rates are kept much higher than before. Still, too many elements are intertwined, so that these relationships should be treated with great caution.

In absence of central bank reaction, it is for example common that inflation tends to provoke currency devaluation, opening a vicious circle. This is certainly the case with hyperinflation. In fact, in this case, central banks often choose to fix a certain exchange rate target as a nominal anchor in the battle against inflation: with fixed exchange rates, inflation makes imports cheaper in comparison to domestic products, so that domestic firms face more intense competition, which should brake inflation (Huybens, Elisabeth, and Smith, Bruce, 1999). Until the fall in inflation does not takes place, domestic goods become more expensive in an international comparison, typically with a fall in exports and a rise of imports, heavily deteriorating the trade balance. At the same time if indexed, local wages and incomes will improve their international purchasing power, due to fixed nominal exchange rates.

Bullard and Keating (1995) noted that financial markets of fixed-interest bonds, an increase of inflation will reduce the burden of debt and interest payments. In the case of large public debt, inflation is an important relief for the State (also through larger tax revenues and lower personnel costs), menacing to engender a political tolerance toward inflation.

Bullard and Keating, 1995) notes that there is a substantial body of evidence indicating that sustained high rates of inflation can have adverse consequences either for an economy's long-run
rate of real growth or for its long-run level of real activity. Huybens et al., (1998) describes mechanisms whereby even predictable increases in the rate of inflation interfere with the ability of the financial sector to allocate resources effectively.

More specifically, recent theories emphasize the importance of informational asymmetries in credit markets and demonstrate how increases in the rate of inflation adversely affect credit market frictions with negative repercussions for financial sector (both banks and equity market) performance and therefore long-run real activity (Huybens and Smith 1998, 1999).

An increase in the rate of inflation drives down the real rate of return not just on money, but on assets in general. The implied reduction in real returns exacerbates credit market frictions. For example, lower real rates of return reduce agents' incentives to lend, and increase their incentives to borrow. Consequently, lower real returns can reduce the availability of credit and draw additional, lower quality borrowers into the pool of credit seekers. The diminished availability of funds and the erosion in the quality of the borrower pool increases the severity of credit market frictions. Since these market frictions lead to the rationing of credit, credit rationing becomes more severe as inflation rises. As a result, the financial sector makes fewer loans, resource allocation is less efficient, and intermediary activity diminishes with adverse implications for capital investment. The reduction in capital formation negatively influences both long-run economic performance and equity market activity, where claims to capital ownership are traded (Huybens and Smith 1999 and Boyd and Smith 1996).

Literature on credit market frictions, finance, and growth delivers empirically testable implications regarding the consequences of higher long-run or permanent rates of inflation as follow: Higher rates of inflation are associated with greater inflation and stock return variability; Higher inflation implies less long-run financial activity. Afanasieff and Nakane, 2002) notes that economies with high inflation, intermediaries will lend less and allocate capital less effectively, and equity markets will be smaller and less liquid; Several inflation thresholds may characterize the relationship between inflation and financial sector conditions. Most prominently, once inflation exceeds a critical level, incremental increases in the (long-run) rate of inflation may have no additional impact on financial sector activity and
finally, Higher long-run inflation implies lower long-run levels of real activity and/or slower long-run growth rates (Huybens and Smith 1999 and Boyd and Smith 1996).

2.3.2 Interest Rate Fluctuations
Interest rate reflects the price of money and has an effect on other variables in money and capital markets. The interest rates indirectly affect the valuation of the stock prices and also its volatility directly creates a shift between the money market and capital market instruments thus affecting the banking sector who are key players in the stock market. (Guru et al., 2002).

Studies on the determinants of bank’s interest margin and profitability have focused on a particular country (Berger, 1995; Guru et al., 2002; Barajas et al., 2001; Ben and Goaied, 2001) and on a panel of countries (Abreu and Mendes, 2002; Demerguc-Kunt and Huizingha, 1999). The empirical evidence in the US is due to Berger (1995), Neeley and Wheelock (1997) and Angbazo (1997). Berger (1995) examines the relationship between the return on equity and the capital asset ratio for a sample of US banks for the 1983-1992 time period. Using the Granger causality model, he shows that the return of equity and capital to asset ratio tend to be positively related. Neeley and Wheelock (1997) explore the profitability of a sample of insured commercial banks in the US for the 1980-1995 period. They find that bank performance is positively related to the annual percentage changes in the state’s per capita income.

Anghazo (1997) investigates the determinants of bank net interest margins for a sample of US banks for 1989-2003 period. The results for the pooled sample documents that default risk, the opportunity cost of non-interest bearing reserves, leverage and management efficiency are all positively associated with bank interest spread.

The main Studies on the determinants of bank’s performance in emerging countries were carried out in Colombia (Barajas et al.,1999), Brasil (Afanasieff et al., 2002), Malaysia (Guru et al., 2002) and Tunisia (Ben and Goaied, 2001). Barajas et al. (1999) document significant effects of financial liberalization on bank’s interest margins for the Colombian case. Although the overall spread has not declined after financial reform, the relevance of the different factors behind the bank spreads were affected by such measures. Another change linked with the liberalization process was the increase of the coefficient of loan quality after the liberalization. Afanasieff et al.
make use of panel data techniques to uncover the main determinants of the bank interest spreads in Brazil.

A two-step approach due to Ho and Saunders (1981) is used to measure the relative impact of the micro and macro factors. The results suggest that macroeconomic variables are the most relevant elements to explain bank interest spread in Brazil. Ben and Goaied (2001) investigate the determinants of the Tunisian bank's performances during the period 1980-1995. They indicate that the best performing banks are those who have struggled to improve labour and capital productivity, those who have maintained a high level of deposit accounts relative to their assets and finally, those who have been able to reinforce their equity.

Guru et al. (2002) attempt to identify the determinants of successful deposit banks in order to provide practical guides for improved profitability performance of these institutions. The study is based on a sample of seventeen Malaysian commercial banks over the 1986-1995 period. The profitability determinants were divided in two main categories, namely the internal determinants (liquidity, capital adequacy and expenses management) and the external determinants (ownership, firm size and external economic conditions). The findings of this study revealed that efficient expenses management was one of the most significant in explaining high bank profitability. Among the macro indicators, high interest ratio was associated with low bank profitability and inflation was found to have a positive effect on bank performance.

Interest rate volatility influences the valuation of the stocks by affecting the basic values of the firm, such as net interest margin, sales and etc. An increase in interest rates negatively affects the value of assets by increasing the required rate of return. Furthermore, an increase in interest rates discourage borrowers from getting loans from banks and hence reduce the investment of commercial banks in loans. Conversely, a decline in interest rates leads to an increase in the present value of the future dividends (Hashemzadeh and Taylor, 1988). Banks face the interest rate risk as follows;

Repricing risk: As financial intermediaries, banks encounter interest rate risk in several ways. The primary and most often discussed form of interest rate risk arises from timing differences in the maturity (for fixed-rate) and repricing (for floating-rate) of bank assets, liabilities, and OBS positions (Hashemzadeh and Taylor, 1988). While such repricing mismatches are fundamental to
the business of banking, they can expose a bank’s income and underlying economic value to unanticipated fluctuations as interest rates vary. For instance, a bank that funded a long-term fixed-rate loan with a short-term deposit could face a decline in both the future income arising from the position and its underlying value if interest rates increase. These declines arise because the cash flows on the loan are fixed over its lifetime, while the interest paid on the funding is variable, and increases after the short-term deposit matures (Hashemzadeh and Taylor, 1988).

Yield curve risk: Repricing mismatches can also expose a bank to changes in the slope and shape of the yield curve. Yield curve risk arises when unanticipated shifts of the yield curve have adverse effects on a bank’s income or underlying economic value. For instance, the underlying economic value of a long position in 10-year government bonds hedged by a short position in 5-year government notes could decline sharply if the yield curve steepens, even if the position is hedged against parallel movements in the yield curve (Afanasieff T., P.Lhacer and Nakane, 2002).

Basis risk: Another important source of interest rate risk, commonly referred to as basis risk, arises from imperfect correlation in the adjustment of the rates earned and paid on different instruments with otherwise similar repricing characteristics. When interest rates change, these differences can give rise to unexpected changes in the cash flows and earnings spread between assets, liabilities and OBS instruments of similar maturities or repricing frequencies. For example, a strategy of funding a one-year loan that reprices monthly based on the one-month US Treasury bill rate, with a one-year deposit that reprices monthly based on one-month LIBOR, exposes the institution to the risk that the spread between the two index rates may change unexpectedly (Adler & Dumas, 1984).

To evaluate the potential impact of interest rate risk on a commercial bank’s operations, the study will consider the effect on both its earnings (the earnings or accounting perspective) and underlying economic value (the economic or capital perspective). In the following paragraphs, the effects of interest rate risk are analyzed in the context of both earnings and economic perspectives (Demerguc-Kunt and Huizinga, 1999).
next one or two years. Fluctuations in interest rates generally affect reported earnings through changes in Commercial banks’ net interest income. Net interest income will vary with the movement of interest rates because of differences in the timing of accrual changes (repricing risk), changing rate and yield curve relationships (basis and yield curve risks), and options positions (Demerguc-Kunt and Huizinga, 1999).

An addition cause as identified by Demerguc-Kunt and Huizinga (1999) is changes in the general level of market interest rates also may cause changes in the volume and mix of Commercial banks’ balance sheet products. Declines in the market values of certain instruments may diminish near-term earnings when accounting rules require a Commercial bank to charge such declines directly to current income. Commercial banks should regularly conduct the income sensitivity analysis in the base case and in the shock scenarios, including changes in the level of interest rates and the slope of the yield curve to forecast how interest rate changes affect their earnings. The Commercial bank should be able to measure how changes in interest rates affect their Generally Accepted Accounting Principles earnings and capital due to accounting principles.

The economic perspective provides a measure of the underlying value of the Commercial banks’ current position and seeks to evaluate the sensitivity of that value to changes in interest rates. This perspective focuses on how the economic value of all Commercial banks assets, liabilities, and off-balance sheet contracts change with movements in interest rates. The economic value of these instruments equals the present value of their future cash flows (Huybens, Elisabeth, and Smith, Bruce, 1998).

According to Huybens, Elisabeth, and Smith Bruce, (1998), the traditional effects on an increase of interest rates are, among others, the following: a fall in stock exchange and in the value of other assets (as private and Treasury bonds or houses and real estate); a fall in profitability of firms; a fall in private investment; a fall in consumption credit; an inflow of foreign capital for buying bonds; an upward pressure on exchange rate; a larger public expenditure to pay for a previously accumulated public debt, whose burden might lead to reduction in other chapters in public expenditure; a narrower disposable income for households having a large debt taken at variable rates; a larger disposable income for households that have lent to others at variable rates (e.g. they own government bonds with variable rates); a redistribution of income from debtors to lenders (in the part of debt that has variable rates). If the rate is kept higher for a longer period of
time, also newly agreed fixed rate instruments will adjust up. Still, the general environment in which the rise takes place is crucial, since such effects can be completely absorbed by other (more powerful) forces. A booming economy might absorb a small increase in the interest rates possibly well. Similarly, a non-linear relationship could be worth considering between the size of rate increase and the differentiated effects on real and financial markets. In fact, a small change in the official discount rate might arguably have no real effect at all, while triggering substantial echoes on financial markets.

By contrast, a large and abrupt increase in general interest rates can have devastating effects on crucial real variables, exerting a depressing pressure on GDP and the economy at large. In particular, if prices in the real estate (including housing) market and Treasury bonds are falling, their value as collateral for loans would be reduced. The credit crunch would squeeze private investment. If the business environment is such that the State begins to delay due payments to firms and has difficulties in re-financing its debt (with some risk of default, even if just in long term perspective) banks might be compelled to reduce credit for current business transactions across the supply chain (Afanasiieff, Lhacer and Nakane 2002).

A chain of bankruptcies would close down plants, select the surviving firms, and reduce employment. At the local scale, entire neighborhoods and towns would economically collapse, with empty buildings and dismissed industrial estate, looking for a future urban regeneration.

2.3.3 Exchange Rate Volatility
In finance, an exchange rate (also known as the foreign-exchange rate, forex rate or FX rate) between two currencies is the rate at which one currency will be exchanged for another. It is also regarded as the value of one country’s currency in terms of another currency (Luehrman, 1991).

The exchange rate expresses the national currency’s quotation in respect to foreign ones. In a slightly different perspective, the exchange rate is a price. If the exchange rate can freely move, the exchange rate may turn out to be the fastest moving price in the economy, bringing together all the foreign goods with it (Luehrman, 1991).

Luehrman, 1991 states that volatility in the foreign exchange rate is the one of the other major sources of macroeconomic uncertainty that affects the firms. After the financial liberalization and deregulation after 1970s and the adoption of the floating exchange rate regime, many countries
are exposed to the foreign exchange rate volatility. Foreign exchange rate volatility influences the value of the firm since the future cash flows of the firm will change with the fluctuations in the foreign exchange rates. Depreciation of a currency of a country affects the competitiveness of the firms engaged in international competition by leading an increase in the demand for its export goods.

Adler and Dumas (1984) reported that although firms whose operations are widely domestic may be influenced by the fluctuations in the foreign exchange rates as their input and output prices may be affected by the currency movements. At the same time, if the country is import denominated, the weak currency may have a negative impact on the country due to the increase in the cost of imported goods.

Luehrman, (1991) states that market based exchange rate will change whenever the values of either of the two component currencies change. A currency will tend to become more valuable whenever demand for it is greater than the available supply. It will become less valuable whenever demand is less than available supply (this does not mean people no longer want money, it just means they prefer holding their wealth in some other form, possibly another currency.

Increased demand for a currency can be due to either an increased transaction demand for money or an increased speculative demand for money. The transaction demand is highly correlated to a country's level of business activity, gross domestic product (GDP), and employment levels. The more people that are unemployed, the less the public as a whole will spend on goods and services. Central bank typically has little difficulty adjusting the available money supply to accommodate changes in the demand for money due to business transactions (DeYoung and Roland 2001).

According to DeYoung and Roland (2001), speculative demand is much harder for central banks to accommodate, which they influence by adjusting interest rates. A speculator may buy a currency if the return (that is the interest rate) is high enough. In general, the higher a country's interest rates, the greater will be the demand for that currency. Speculation can undermine real economic growth, in particular since large currency speculators may deliberately create downward pressure on a currency by shorting in order to force that central bank to sell their
currency to keep it stable. When that happens, the speculator can buy the currency back from the bank at a lower price, close out their position, and thereby take a profit.

Caballero and Corbo (1989), show that higher volatility of the real exchange rate hurt exports in a large group of developing countries. McKenzie (1999), concludes that empirical results on exchange rate volatility have so far been inconclusive. Recent and stronger evidence of a negative impact of exchange rate volatility on trade flows can be found in Arize et al. (2000) and Dell’Ariccia (1999).

2.3.4 Balance Of Payment Situation
Balance of payments (BOP) accounts are an accounting record of all monetary transactions between a country and the rest of the world. These transactions include payments for the country’s exports and imports of goods, services, financial capital, and financial transfers.

The balance of payments account records a country’s international economic performance, with the two most important accounts being the current account and capital account. Whereas the current account records all transactions of goods and services and unrequited transfers in a country, the capital account records all exchanges and money capital for various kinds of real or financial assets. The latter account is important as it relates domestic transactions to international transactions. (http://en.wikipedia.org/wiki/Balance_of_payments)

When there is disequilibrium in a country’s balance of payments, authorities often battle with how to correct it. Whether authorities can actually do something to remedy such a situation – for example, through policy actions, or whether there are self-correcting mechanisms in place – is often a point of debate. Throughout the years different adjustment mechanisms to such disequilibrria in a country’s balance of payments have been identified (see e.g. Du Plessis et al., 1998). Three of these mechanisms are the monetary approach, the elasticities approach, and the absorption approach.

Throughout the years different adjustment mechanisms to balance of payments disequilibria have been developed, namely the monetary approach, the elasticities approach, and the absorption approach (Du Plessis et al., 1998). This approach flows from the classical price-specie-flow mechanism, and is based on the notion that money plays an important role in causing a
disturbance in the balance of payments account as well as serving as an adjustment mechanism to correct the disturbance (Salvatore, 1998).

The Monetary approach to balance of payment regards money as a stock, and argues that money stock can be changed through international reserve flows. It states that a fixed exchange rate system could work without having to resort to devaluation, provided a country has a sound monetary policy; thus, devaluation will only occur as a result of a failure of monetary policy. This argument stems from the fact that disequilibrium in the balance of payments is a temporary situation that will be corrected if the “money market is in equilibrium” (Du Plessis et al., 1998).

Although the monetary approach has been commended for explaining the balance of payments well, it has prompted criticism from other scholars as an approach that ignores other parts of international trade in determining the balance of payments. The Monetary approach to balance of payment has been blamed for disregarding the fiscal and real factors that influence changes in the balance of payments, whilst concentrating only on monetary factors. Contrary to these views, it can be stated that the monetary approach does not ignore these factors. Valinezhad contends that “the Monetary approach to balance of payment only asserts that the effect on the balance of payments of a higher rate of economic growth should be analysed with the tools of monetary theory” (Valinezhad, 1992).

The Monetary approach to balance of payment, which regards the balance of payments as a “monetary phenomenon”, expresses the relationship between a country’s balance of payments and its money supply (Chacholiades, 1990). Furthermore, it argues that there is disequilibrium in the money market if there are surpluses and deficits in the balance of payments. Deficits are caused by money supply exceeding money demand, while surpluses are caused by money demand exceeding money supply (Howard & Mamingi, 2002). The Monetary approach to balance of payment therefore, largely emphasises the monetary implications of balance of payments disequilibria. In terms of prices, the Monetary approach to balance of payment regards the general price level as the determinant of the real value of nominal assets, money and international debt. Relative prices seem to play a secondary role as they are considered to have only a transitory effect on the balance of payments.
A currency crisis, which is also called a balance-of-payments crisis, is a sudden devaluation of a currency caused by chronic balance-of-payments deficits which usually ends in a speculative attack in the foreign exchange market. It occurs when the value of a currency changes quickly, undermining its ability to serve as a medium of exchange or a store of value. Currency crises usually affect fixed exchange rate regimes, rather than floating regimes (DeYoung and Roland 2001).

A currency crisis is a type of financial crisis, and is often associated with a real economic crisis. Currency crises can be especially destructive to small open economies or bigger, but not sufficiently stable ones. Governments often take on the role of fending off such attacks by satisfying the excess demand for a given currency using the country's own currency reserves or its foreign reserves. (usually in the USD, Euro or Pound sterling). Due to the speculative nature of the foreign exchange market due to the balance of payment crisis, commercial banks make decisions on the exchange rate by which to buy and sell currencies, these decisions call for intense care as they will determine the financial return for banks and thus it has a direct impact on the financial performance of commercial banks (Luehrman, 1991).

There are conflicting views as to the primary cause of BOP imbalances, with much attention on the US which currently has by far the biggest deficit. The conventional view is that current account factors are the primary cause- these include the exchange rate, and the government's fiscal.
2.4 Conceptual Framework

INDEPENDENT VARIABLES

- Inflation Rate
- Exchange rate volatility
- Interest rate fluctuation
- Balance of payment crisis

DEPENDENT VARIABLE

- Financial performance of commercial banks

Source: Researcher 2012
CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction
This chapter presents the study design and methodology to be used in gathering information and data; the research design, target population, sampling design, data collection and data analysis technique that has been adopted to analyze data in order to generate the findings of the study.

3.2 Research Design
The proposed study is modeled on a descriptive research design. This is aimed at providing an in-depth understanding of the effects of economic environment on financial performance of commercial banks in Kenya. According to Gilbert (2005) a research design is the framework or plan for a study, used as a guide to collect and analyze data.

3.3 Target Population
The population of study comprised 44 branch managers and 44 finance managers driven from the 44 commercial banks in Kenya. According to Ngechu (2004) a study population is a well defined or specified set of people, group of things, households, firms, services, elements or events which are being investigated. Thus the population should fit a certain specification, which the researcher was studying and the population should be homogenous.

3.4 Sample Size
The study has adopted probability sampling approach through stratified random sampling in order to achieve the desired representation. Out of the total population, 22 branch managers and 22 Finance managers were sampled which is 50% of the target population. This approach is appropriate as it gives every subject in the population of interest an equal chance of being selected. Mugenda and Mugenda (1999) notes that if there is no estimate available of the proportion in the target population, assumed to have characteristics of interest, 50% should be used as sample size.

Ngechu (2004) underscores the importance of selecting a representative sample through making a sampling frame. A sampling frame is a systematic list of subjects, elements, traits, firms or
objects to be studied. Sampling ensured that some elements of a population are selected as riding representative of the population.

Table 3.1 Target population and sample size

<table>
<thead>
<tr>
<th>Population category</th>
<th>Target population</th>
<th>Sample size</th>
</tr>
</thead>
<tbody>
<tr>
<td>Branch Managers</td>
<td>44</td>
<td>22</td>
</tr>
<tr>
<td>Finance Managers</td>
<td>44</td>
<td>22</td>
</tr>
<tr>
<td>Total</td>
<td>88</td>
<td>44</td>
</tr>
</tbody>
</table>

Source: Researcher (2012)

3.5 Data Collection

This study used both secondary and primary data. The primary data was collected using semi-structured questionnaire having mostly close ended questions and a few open ended questions. According to Chava (1996) in a close ended question, respondents are offered a set of answers and asked to choose the one that mostly represent their views. The close ended questions enabled the researcher to collect quantitative data for statistical analysis. Secondary data was collected using relevant information from the company's records such as financial statements, CBK publications and Renaissance Capital survey on Kenya banks 2012. Both electronic mail and hand delivery was used to deliver the questionnaire and follow up the respective respondents via telephone or e-mail.

3.6 Data Analysis Technique

The researcher perused completed questionnaires and document analysis recording sheets. Data was analyzed using descriptive statistics to enable the researcher to meaningfully describe distribution of scores or measures using measures of central tendency. Quantitative analysis was used to derive information collected from questionnaires to establish patterns, trends, relations from the information gathered. Where appropriate, SPSS was used to analyze and interpret the collected data. Data has been presented in frequencies, pie charts, bar charts and percentages for comparisons, explanations and clarity.
CHAPTER FOUR
DATA ANALYSIS

4.1 Introduction
This chapter presents the report of data analysis, interpretation and summary of findings. As indicated in chapter three, data is presented in frequency tables, pie charts, bar charts and percentages. From the sample size that was selected, a total of 34 questionnaires were completed, 4 were eliminated as they were scantly completed. The remaining 30 questionnaires were used for further processing of the data to come up with the research findings.

4.2 Data Analysis
The completed questionnaires were gathered during data collection and coded. The data was entered in a Microsoft excel document analysis recording sheet and verified for analysis. Frequency distributions, percentages and descriptive statistics (mean and standard deviation) were generated to facilitate comparisons and cross-tabulations of various items. The following tables, graphs, pie charts and discussions highlight the outputs generated from the analysis.

4.3 Biographical Information Analysis
The researcher undertook to obtain the background information on the respondents who participated in this study. This is useful to the readers to know the particulars of the participants in order to have an objective assessment of the findings. The underlying information concerning the respondents who furnished the details that formed the research findings was obtained in terms of gender, age, level of education and no. of years worked in the institution. The analysis is as follows;

4.3.1 Gender Analysis
The researcher requested the respondents to indicate their age brackets. The feedback is as expressed on the pie chart below.
Figure 4.1: Gender distribution

Source: Research data

From figure 4.1, it can be observed that most of the respondents in the study are male which constitute 57% of the respondents. Female respondents constitute 43%. This means that male takes risk to achieve an end due to their masculinity orientation.

4.3.2 Age Analysis

Source: research data

The respondents were asked to state their age and their responses were recorded and analyzed as expressed on the bar graph above:
The data obtained indicate that majority of the respondents were aged between the age of 31-40 years constituting 47%. 37% of the respondents were aged between 19-30 years and only 17% were aged between 41-50 years. There were no respondents aged over 50 years. This shows that majority of respondents were young mature professionals who are energetic, able to make informed decisions and are up to the banking tasks which are involving.

4.3.3 Analysis Of Respondent's Level Of Education

The researcher requested the respondent to indicate their level of education. The results are as per the table below:

Table 4.1: Respondent's level of education

<table>
<thead>
<tr>
<th>Respondents level of education</th>
<th>Frequency</th>
<th>Percentage</th>
<th>Cumulative percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Secondary</td>
<td>0</td>
<td>0</td>
<td>0%</td>
</tr>
<tr>
<td>College diploma</td>
<td>2</td>
<td>7</td>
<td>7%</td>
</tr>
<tr>
<td>University degree</td>
<td>15</td>
<td>50</td>
<td>57%</td>
</tr>
<tr>
<td>Masters degree</td>
<td>12</td>
<td>40</td>
<td>97%</td>
</tr>
<tr>
<td>Others (please state)</td>
<td>1</td>
<td>3</td>
<td>100%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>30</strong></td>
<td><strong>100</strong></td>
<td></td>
</tr>
</tbody>
</table>

Source: Research data

The data obtained indicates that 50% of the respondents had university degrees, 40% had masters degree and 7% had college diploma. Only 3% stated their level of education as others which were CPA(K). From the data, none of the respondents was a secondary school graduate. This shows that the respondents are knowledgeable and would understand the topic under study and thus they would respond to the questionnaire appropriately to elicit the necessary information.
4.3.4 Analysis Of Respondent's Length Of Service In The Commercial Banks

The researcher requested the respondents to indicate the no. of years they have worked in the various commercial banks. The responses were as per the table below:

Table 4.2: Respondent's length of service

<table>
<thead>
<tr>
<th>Length of service</th>
<th>Frequency</th>
<th>Percent</th>
<th>Cumulative percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>1-5 Years</td>
<td>23</td>
<td>77</td>
<td>77</td>
</tr>
<tr>
<td>6-10 years</td>
<td>5</td>
<td>17</td>
<td>94</td>
</tr>
<tr>
<td>11-15 years</td>
<td>1</td>
<td>3</td>
<td>97</td>
</tr>
<tr>
<td>16-20 years</td>
<td>1</td>
<td>3</td>
<td>100</td>
</tr>
<tr>
<td>21-25 years</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>26-30 years</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Over 30 years</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>30</strong></td>
<td><strong>100</strong></td>
<td><strong>0</strong></td>
</tr>
</tbody>
</table>
Majority of the respondents have worked for the various commercial banks between 1-5 years constituting 77% of the total respondents. 17% of the respondents have worked for 6-10 years and 3% for 11-15 years and 16-20 years consecutively. None of the respondents had worked for 21 years and above. This means that the respondents are knowledgeable about the effects of economic environment on financial performance of commercial banks.


The researcher started off by examining whether financial performance of commercial banks is affected by economic environment. All the respondents indicated that there is a positive influence which constituted 100 percent of the respondents. 73 percent strongly agreed that the general economic environment has an effect on financial performance of commercial banks. This indicates that the economic environment has a great influence on how commercial banks perform financially.
Further the researcher examined whether inflation rate has no direct effect on financial performance of commercial banks. A significant large proportion of respondents (70%) strongly disagreed, 20 percent of the respondents agreed. However, 3% strongly agreed and 7% agreed. Therefore this indicates that inflation rate has an influence on financial performance of commercial banks.

In order to find out if fluctuations of interest rates affect financial performance of commercial banks, a huge 83 percent strongly agreed with 17 percent agreeing. There were no respondents who were neutral, disagreed nor strongly disagreed. This indicates that Commercial banks performance is affected by fluctuations of interest rates.

Moreover, the researcher examined whether commercial banks financial performance is affected by volatility of exchange rate. There was significance spread of the percentages with 53 percent strongly agreeing, 30 percent agreeing and 17 percent were neutral. This shows that volatility of exchange rate affects financial performance of commercial banks.

To find out if financial performance of commercial banks is not affected by the national balance of payment, 57 percent of the respondents disagreed, 17 percent strongly disagreed, 13 percent were neutral and 10% and 3% agreed and strongly disagreed respectively. This therefore indicates that national balance of payment has an effect on financial performance of commercial banks.

A mean of 10.8 strongly agreed that inflation rate has no direct effect on financial performance of commercial banks, fluctuation in interest rates have implications while volatility of exchange rates affects commercial banks performance which is halfway below a standard deviation of 20.5. An addition mean of 6.5 strongly disagreed on the discussed issues above against a norm of 9.42.
4.5 Analysis Of The Four Independent Variables And Their Effect On Financial Performance Of Commercial Banks

4.5.1 Inflation rate

The researcher examined the effect of inflation rate on financial performance of commercial banks. On average, 37 percent indicated that increased rate of inflation leading to less lending is of very great extent, while 40 percent indicated that its of great extent. Only 3 percent indicated that its of moderate extent while 20% were of the opinion that increased rate of lending does not lead to less lending.

The respondents were significantly different on increased inflation rate not reducing equity market activities. On average 17 percent indicated that it affects to a very great extent, 27 percent to great extent, 10 percent to moderate extent while the remaining 23% being small extent and not at all.

On examining to what extent inflation interfered with the ability of financial sectors to allocate resources, 20 percent indicated that it interferes to very great extent, 43 % to great extent, 13 percent to moderate extent, 7% to small extent while 17 percent felt it does not interfere at all.

The researcher further sought to know whether increased inflation does not drive down rate of return on money and assets. A small percent of 27 percent indicated that it affects to very great extent, 7% to great extent and 10% to moderate extent. A significant number 23% to small extent while 33% indicated not at all.

The researcher also sought to find out whether inflation reduced debts and interest payment on fixed- interest bonds. A small proportion of 10 percent felt it does to very great extent, while 47 percent felt it does to great extent, 20 percent indicated to moderate extent, 7 percent to small extent whereas 17 percent felt it doesn't at all.

In terms of inflation reducing income and pulling down consumption and savings, a majority 53% felt it does to very great extent, 23 percent to great extent. 10 percent felt it would affect to small extent and 13% not at all. None of the respondents indicated it would be moderate extent.

In order to find out to what extent inflation provokes currency devaluation, a whooping 57 percent felt that it does to very great extent, 30 percent to great extent and none of them felt it
would affect to moderate extent, only 7% felt it would affect to small extent and the rest 7 percent it would affect at all.

A significant proportion 67% felt higher inflation lead to higher nominal interests on loans to very great extent, while 23 felt it affects to great percent. Less than a quarter of the total percentage felt it would affect to moderate extent, others to small extent and others not at all.

A mean of 10.8 strongly agreed that increased inflation would lead to less lending, reduces equity market, interferes with the ability of the financial sector to allocate resources, does not drive down rate of return on Money and assets and tends to provoke currency devaluation which is below the norm of 16.4.

4.5.2 Fluctuations In Interest Rate
The researcher sort find out to what extent fluctuations of interest rate affects financial performance of commercial banks. A mean of 12.2 indicated to very great extent that fluctuations of interest rates affect the borrowing powers of customers and decline in interest rates leads to decline in present value of future dividends and high interest rates leads to increased cost of funding on deposits to the bank which is above the norm of 8.7. However a mean of 4.1 felt that it does not affect at all which is way below the standard of 7.41.

A significant proportion of 67 percent felt that increased interest rate discouraged borrowers from getting loans thus reduced bank investments on loans to very great extent while 10 percent felt it would affect to great extent. However 20 percent of the respondents felt it wouldn't affect at all.

To find if declined interest led to decreased value of future dividends, the respondents were of differing opinions with scores spread within the scale as follows 23 percent to very great extent, 30% to great and moderate extent, 10% and 7% to small extent and not at all respectively. 57 percent felt that increased interest rate led to fall in stock exchange, treasury bonds and real estates to great extent while 23 percent felt it would affect to very great extent. Only 3 percent felt it would not affect at all. 47 percent felt that higher interest rates led to increased non
performing loans to very great extent, 43 percent to great extent and only 10 percent felt it would affect at all. 33 percent of the respondents felt that declined interest rate reduced disposable income for families and savings to commercial banks to very great extent and the same percentage felt it does not at all. An equal number of 13% felt it would affect to moderate extent and to small extent. 50 percent of the respondents indicated high interest rate resulted to increased cost of funding on banks deposits to very great extent, 27 percent indicating to great extent and a low of 10% felt it would not affect at all.

4.5.3 Volatility Of Exchange Rate

The researcher also sought to find out if volatility of exchange rate influenced Central bank to increase interest rate to contain the value of currency and 40 percent felt it does to great extent while 37 felt it does to very great extent. Only 10 percent felt it does not at all. In terms of increased demand of currency being caused by increased speculative demand of money, 43 percent felt it affects to great extent, 23 percent to very great extent and 10 percent felt it does not affect at all. 37 percent indicated that depreciation of country's currency does not affect the competitiveness of a bank at all, whereas 20 percent indicated it affects to very small extent. A similar proportion of 17 percent felt it does to very great extent and to great extent. To the question as to whether stable exchange rates are precondition for stable trade policies, 40 percent of the respondents felt it affects to very great extent, 27 percent to great extent while same proportion of 13% felt it affects to small extent and it does not affect at all.

On volatility of exchange rate, a mean of 9.5 felt that central bank increased the interest rate to check the value of currency and that increased demand for a currency is due to increased speculative demand for money to great extent which is above the norm of 6.4. Another 8.75 indicated it does to very great extent which is above a standard deviation of 5.72. Moreover, a mean of 5.5 indicated that the above mentioned parameters does not affect volatility of exchange rate at all against a standard deviation of 6.56

4.5.4 Balance Of Payment Situation

The researcher sought to find out to what extent BOP affects financial performance of commercial banks, a mean of 11.83 indicated that changes of balance of payment led to a dip in
business confidence and investment, that BOP deficits are good for the economy and excess money supply plays a significant role in disequilibrium of BOP in Kenya to great extent. This is above a standard deviation of 8.33. Additionally, a mean of 6.83 indicated that the above mentioned statements affects BOP to very great extent which is above the norm of 4.44. Consecutively, a mean of 3.3 felt that BOP does not affect financial performance of commercial banks against a norm of 3.92.

The researcher examined whether balance of payment changes led to a dip in business confidence and investment. 53 percent of the respondents felt that it affects to great extent while 23 percent felt it affects to very great extent; whereas a similar no 10% felt it affects to moderate extent and a further 10 percent it does not affect at all. A significant high proportion of 40 percent indicated that balance of payment deficits is good for the economy to a small extent, 7% felt it will not affect at all. 17 percent felt it would affect to moderate extent and the same number to very great extent. 20 percent felt it would affect to great extent. In terms of whether changes in exchange rate had an effect on balance of payment, 50 percent felt it affects to great extent; 27 percent to very great extent; 10 percent to both moderate and small extent while 3% felt it would not affect at all. A significant proportion of 43% reported that sudden devaluation of currency caused by chronic balance of payment deficits affects foreign exchange market to a great extent, 33 percent to great extent. Less than quarter percent of the respondents indicated it does not affect at all. In order to establish whether changes in balance of payment had little effect to financial performance of commercial banks, 30 percent of the respondents felt it affects to great extent, while 20 percent felt felt it affects to moderate extent, 23 percent to small extent and 20 percent felt it does not affect at all. However a minority group of 7 percent felt it affects to very great extent. In establishing whether excess money supply plays a significant role in the disequilibrium of balance of payment in Kenya, 40 percent indicated that it affects to great extent, 30 percent to very great extent. However 13 percent felt it affects moderately while another 13 percent felt it would not affect at all.
CHAPTER FIVE
SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Summary
This research has unfolded the extent to which inflation rate, interest rates, exchange rates and balance of payment deficits affect the financial performance of commercial banks. This study found out that all the four independent variables converge to one dependent variable: financial performance of commercial banks.

A whooping 100% of the respondents felt that the economic environment affects the financial performance of commercial bank with a large proportion of 73 percent strongly agreeing that the general environment affects financial performance of commercial banks.

The researcher established that increased inflation led to reduced borrowing thus reducing the profitability of commercial banks in Kenya. The credit growth has fallen as CBK rate of interest rose to 18 percent to curb the inflation rate. Borrowing has become too expensive on the demand side and too risky on the supply side. This sharp increase in the cost of debt is a deterrent to demand for small corporates and SME’S, retail customers and property developers. Thus commercial banks financial sustainability is affected negatively. Commercial banks are also unable to allocate resources effectively when the inflation is high. Equity market activities tends to reduce when inflation is high. Treasury bills and bond rates are affected by increased inflation rate making the yields on treasury bills to fall. When inflation is high, the return on money and assets goes down and reduces banks deposits as the income goes down. It became clear that inflation provokes currency devaluation.

Most of the respondents felt that increased interest rates reduces borrowing with 67 percent indicating that it reduces the banks investments. The interest rate hikes makes the retail and SME’S customers to have little bargaining power on loans. They must accept the higher lending rates or stop borrowing. This affects the total loan book of commercial banks. Declined interest rate leads to decline in the value of a company's future dividends which reduces the shareholders future income. Higher interest rates leads to increased non performing loans as the borrowers are either laid off due to inflation and companies wants to cut on costs or their
business venture go down as peoples buying power declines. The increased lending rates erodes disposable income and erodes the ability to make the monthly payments if they are hiked instead of being held constant by extending the duration of loans. The study further revealed that loan default due to increased lending rates and inflation increases which in-turn forces the commercial banks to make provisions on NPL's (a loan that is no longer generating income) which reduces their profitability. In worse case scenario, commercial banks are forced to write off bad debts from their books.

It became clear that high interest rates leads to a decline in stock exchange rates, treasury bonds and real estates with 57 % indicating that it does to great extent. Investors pummel banking stocks due to high interest rates. Developers complete their projects but are unable to find suitable buyers or tenants given the high-interest-rate environment. This, in turn, encumbers their ability to service their debts.

In addition, interest rate led to reduced income for families whereas they don't have money to deposit to the banks and thus the banks deposits goes on the declining edge and further increased interest rates causes the cost of funding on deposits to go up especially for the fixed term deposits.

The researcher established that Central bank of Kenya increases the interest rate to check the value of currency. This has made CBK to increase interest rates from a low of 8% to a record high of 18 percent when the Kenyan currency was devalued to a low of 107 against the US dollar. The respondents felt that increased demand for a certain currency is due to speculations of demand that leads to volatility of exchange rates. Depreciation of a country's currency affects banks competitiveness for those that are operating internationally.

The study has revealed that balance of payment deficits leads to a dip in business confidence and investment and the deficits are bad to the economy. Changes in the exchange rate has a big impact on balance of payment. Devaluation of currency caused by balance of payment deficits ends in speculative attack in foreign exchange market. Excess money supply plays a significant role in disequilibrium of balance of payments in Kenya. Balance of payment deficits leads to
local currency devaluation, leading to high costs of imports that eventually causes inflation of prices of commodities thus reducing deposits to commercial banks vis a vis its liquidity.

From a perusal of financial statements of various commercial banks from the newspaper for the year ended 2011, most banks profits went up as the effect of inflation, exchange rate and interest rate was only felt at the end of the last quarter. Most banks confessed that growth in the last quarter was slow due to weakening of shilling, rising inflation and increased interest rates that reduced borrowing. Consecutively, most banks reviewed their interest rates and made a lot of income from interest income. Another thing that worked for commercial banks like Equity, KCB and Co-operative bank was the introduction of agency banking where they have made banking services accessible which was a plus for them in terms of deposit growth. Additionally, liquidity of most commercial banks was on a decline edge with Equity moving from 40% in 2010 to 37%, Co-operative bank 39.4% to 27.2%, Stanchart 55% to 34%.

5.2 Conclusions
This study has established that economic environment greatly influences the financial performance of Commercial banks. It is evident the four variables affect financial performance of commercial banks in Kenya.

High and variable inflation weakens the shillings hence affecting financial performance of commercial banks. When inflation passes certain thresholds, there is a corresponding collapse in the financial system performance with adverse effects on resource allocation and economic activity. This study indicates that the relationship between inflation and commercial banks performance is non linear; bank lending activity, bank liability issues, stock market size and liquidity display strong negative correlations with inflation.

Interest rate fluctuations directly affects the return on equity and the capital asset ratio of commercial banks if all other factors are held constant; the higher the interest rate, the lower the return on equity and capital asset ratio and vice versa.

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Exchange rate volatility influences the financial value of the commercial banks. i.e the stronger the shillings against other major currencies like euros, usd and pounds, the more the financial value of banks. A weakening local currency triggers instability in the financial sector through negative impact on trade balance, higher external debt service and foreign reserves. It also leads to flight by foreign investors from domestic financial markets and heighten inflationary pressures due to excess supply of local currency amid constrained supply of hard currency.

As balance of payment deficit adversely affects financial performance of commercial banks, balance of payment surplus favors them. Stability of capital flows is important in balancing the capital account. Disproportionately large inflow of short term capital is a source of instability to the balance of payment and domestic prices. Speculative capital flows triggered by interest rate differentials are detrimental to commercial banks stability.

5.3 Recommendations

Commercial banks should refocus their financing to agricultural sector to improve the sector as it will help to drive down food inflation which has been one of the main drivers of inflation.

Commercial banks should reposition themselves in terms of offering good customer service in order to retain the existing ones and attract new ones and enhance transaction income to caution themselves against tough economic times.

Given the prevailing tough economic environment and a highly unsustainable interest rate regime, commercial banks should endeavor to tap the unbaked population estimated to be 50% as their key target market to weather the effects of unfavorable economic environment by reaping from non-interest income.

Central bank of Kenya should create a well-functioning, sound and stable financial system, based on prudent risk management and business continuity strategies and market-disciplining mechanisms that achieve resilience and prevent financial crises when economic environment is turbulent.

Commercial banks should pursue policies that would improve access to finance for a majority of the population, thus, raising the level of monetization in the economy for economic development and effective implementation of monetary policy.
CBK should contain and deal with any imbalances and risks in the economy before they become a threat to the overall financial system stability.

Commercial banks should form a system that effectively and efficiently allocates its resources among its economic agents, while managing and mitigating risks, mobilizing savings and facilitating wealth creation for wider economic sustainability.

Commercial banks should endeavor to have a growth correlation between customer numbers and deposit base.

To the future scholars, they can research on the impact of global macroeconomic environment to Kenya's financial sector stability.


Daily Nation newspaper(2011); Inflation rate drops for first time this year 29th December.

Daily Nation Newspaper(2012); Car buyers to wait longer for lower prices despite strong shilling,10th January.


Financial sector development, 2010. Summary report


http://www.equitybank.co.ke/about.php?subcat=112


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APPENDIX I

QUESTIONNAIRE

Questionnaire for research on effects of economic environment on financial performance of commercial banks in Kenya.

Please respond to the questions below to the best of your knowledge.

SECTION ONE: BIOGRAPHICAL INFORMATION

1) Please indicate your Gender.
   ( ) Male   ( ) Female

2) What is your age bracket?
   19 – 30 Years   31 – 40 Years
   41 – 50 Years   Over 50 years

3) What is your highest level of education?
   Secondary   ( ) Masters degree   ( )
   College diploma   ( ) Others (please state) .....................
   University degree   ( )

4) How many years have you worked in this institution?
   1-5 years   ( )   16-20 years   ( )   26-30 years   ( )
   6-10 years   ( )   21-25 years   ( )   Over 30 years   ( )
   11-15years   ( )

SECTION TWO: GENERAL ISSUES

1) Is the financial performance of Commercial banks affected by economic environment factors?
   YES ( )   NO ( )

2) To what extent do you agree with the following statement: The general economic environment has an effect on the financial performance of commercial banks.
3) What is your level of agreement with the following statements that relate to the effect of economic environment to your company? Use a scale of 1 – 5 where 5= strongly agree and 4 = Agree 3=Neutral 2= Disagree 1= strongly disagree

<table>
<thead>
<tr>
<th>Statement</th>
<th>5</th>
<th>4</th>
<th>3</th>
<th>2</th>
<th>1</th>
</tr>
</thead>
<tbody>
<tr>
<td>The inflation rate has no direct effect on the financial performance of commercial bank</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fluctuations in the interest rates have financial implications to commercial banks performance</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Commercial banks financial performance is affected by the volatility of the exchange rate</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>The financial performance of commercial banks is not affected by the national balance of payment situation</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**SECTION THREE: MAIN ISSUES**

1. To what extent is your bank's financial performance affected by the following economic Factors? Use a scale of 1 – 5 where 5 = very great extent, 4 = great extent, 3 = moderate extent 2 = small extent and 1 = not at all.

<table>
<thead>
<tr>
<th>Factor</th>
<th>5</th>
<th>4</th>
<th>3</th>
<th>2</th>
<th>1</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Inflation Rate</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. An increase in the rate of inflation leads to less lending</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. Increased inflation does not reduce equity market activities</td>
<td></td>
<td></td>
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</tr>
<tr>
<td>3. High rate of inflation interferes with the ability of the</td>
<td></td>
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<td></td>
<td></td>
</tr>
</tbody>
</table>
financial sector to allocate resources effectively

4. An increase in inflation does not drive down rate of return on money and assets.

5. For fixed-interest bonds, an increase of inflation reduces the burden of debt and interest payments.

6. Inflation reduces income pulling down consumption and savings further.

7. Inflation tends to provoke currency devaluation.

8. Higher inflation leads to higher nominal interest rates on loans.

9. What are the implications of high and variable inflation rate on the shilling and how does it affect financial performance of commercial banks?

<table>
<thead>
<tr>
<th>Fluctuations in Interest Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Increase in interest rates discourage borrowers from getting loans from the bank and hence reduce the investment of your bank in loans.</td>
</tr>
<tr>
<td>2. Decline in interest rates leads to an decrease in the present value of the future dividends.</td>
</tr>
<tr>
<td>3. Increased interest rates lead to a fall in stock exchange, treasury bonds and real estates.</td>
</tr>
<tr>
<td>4. Higher interest rates leads to increased non performing loans to this bank.</td>
</tr>
<tr>
<td>5. Decline in interest rates reduces disposable income for</td>
</tr>
</tbody>
</table>
families vis a vis savings to the commercial banks.

6. High interest rates results to increased cost of funding on deposits to this bank.

7. How does interest rate fluctuations affect the return on equity and the capital asset ratio of Commercial banks?

Volatility of Exchange Rate

<table>
<thead>
<tr>
<th>Statement</th>
<th>5</th>
<th>4</th>
<th>3</th>
<th>2</th>
<th>1</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. The Central bank increasing the interest rate to check the value of the currency</td>
<td></td>
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</tr>
<tr>
<td>2. Increased demand for a currency is due to increased speculative demand for money.</td>
<td></td>
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<tr>
<td>3. Depreciation of a currency of a country does not affect the competitiveness of the bank</td>
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<td></td>
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<td></td>
</tr>
<tr>
<td>4. Stable exchange rates are precondition for stable trade policies</td>
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<tr>
<td>5. How does exchange rate volatility influence the financial value of commercial banks?</td>
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<td></td>
<td></td>
</tr>
</tbody>
</table>
### Balance of Payment Situation

<table>
<thead>
<tr>
<th></th>
<th></th>
<th>5</th>
<th>4</th>
<th>3</th>
<th>2</th>
<th>1</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Changes in balance of payment leads to a dip in business confidence and investment.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>Balance of payment deficits are always good for the economy.</td>
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</tr>
<tr>
<td>3</td>
<td>Changes in the exchange rate can have a big effect on the balance of payments although these effects are subject to uncertain time lags</td>
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<td></td>
</tr>
<tr>
<td>4</td>
<td>A sudden devaluation of a currency caused by chronic balance-of-payments deficits ends in a speculative attack in the foreign exchange market</td>
<td></td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>Changes in balance of payment have little effect to financial performance of commercial banks.</td>
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</tr>
<tr>
<td>6</td>
<td>Excess money supply plays a significant role in the disequilibrium of balance of payments in Kenya.</td>
<td></td>
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<td></td>
</tr>
</tbody>
</table>

7. What implications does balance of payment pressures have on financial performance of commercial banks?
## APPENDIX II
### WORK PLAN

<table>
<thead>
<tr>
<th>Time in weeks</th>
<th>1 &amp; 2</th>
<th>3 &amp; 4</th>
<th>5 &amp; 6</th>
<th>7 &amp; 8</th>
</tr>
</thead>
<tbody>
<tr>
<td>Preparation of instruments and Pilot Testing them</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Data Collection</td>
<td></td>
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</tr>
<tr>
<td>Data Collection</td>
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<td></td>
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<tr>
<td>Data Processing</td>
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<tr>
<td>Data analysis</td>
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<tr>
<td>Draft preparation and presentation</td>
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<tr>
<td>Final report writing/presentation preparation</td>
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<tr>
<td>Presentation of the project</td>
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</tbody>
</table>
## APPENDIX III

### BUDGET

<table>
<thead>
<tr>
<th>Item Description</th>
<th>Cost (Kshs)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Proposal</strong></td>
<td></td>
</tr>
<tr>
<td>Stationary (pens, papers etc)</td>
<td>1000/-</td>
</tr>
<tr>
<td>Printing and binding</td>
<td>3000/-</td>
</tr>
<tr>
<td>Internet expense (downloading journals)</td>
<td>2000/-</td>
</tr>
<tr>
<td>Travelling</td>
<td>2000/-</td>
</tr>
<tr>
<td>Contingencies/Miscellaneous</td>
<td>4000/-</td>
</tr>
<tr>
<td><strong>Formal Project</strong></td>
<td></td>
</tr>
<tr>
<td>Stationary (papers and pens)</td>
<td>1000/-</td>
</tr>
<tr>
<td>5 research assistants @ 300 per day</td>
<td>3000/-</td>
</tr>
<tr>
<td>Telephone bill (airtime)</td>
<td>2000/-</td>
</tr>
<tr>
<td>Travelling</td>
<td>3000/-</td>
</tr>
<tr>
<td>Printing and binding of final document</td>
<td>12000/-</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>33,000/-</strong></td>
</tr>
</tbody>
</table>
### APPENDIX IV

#### DATA ANALYSIS TABLE

<table>
<thead>
<tr>
<th>General Issues</th>
<th>STRONGLY AGREE</th>
<th>AGREE</th>
<th>NEUTRAL</th>
<th>DISAGREE</th>
<th>STRONGLY DISAGREE</th>
</tr>
</thead>
<tbody>
<tr>
<td>The inflation rate has no direct effect on the financial performance of commercial bank</td>
<td>1 3%</td>
<td>2 7%</td>
<td>0 0%</td>
<td>6 20%</td>
<td>21 70%</td>
</tr>
<tr>
<td>Fluctuations in the interest rates have financial implications to commercial banks performance</td>
<td>25 83%</td>
<td>5 17%</td>
<td>0 0%</td>
<td>0 0%</td>
<td>0 0%</td>
</tr>
<tr>
<td>Commercial banks financial performance is affected by the volatility of the exchange rate</td>
<td>16 53%</td>
<td>9 30%</td>
<td>5 17%</td>
<td>0 0%</td>
<td>0 0%</td>
</tr>
<tr>
<td>The financial performance of commercial banks is not affected by the national balance of payment situation.</td>
<td>1 3%</td>
<td>3 10%</td>
<td>4 13%</td>
<td>17 57%</td>
<td>5 17%</td>
</tr>
<tr>
<td><strong>Mean</strong></td>
<td><strong>10.8 36%</strong></td>
<td><strong>4.75 16%</strong></td>
<td><strong>2.25 8%</strong></td>
<td><strong>5.75 19%</strong></td>
<td><strong>6.5 22%</strong></td>
</tr>
<tr>
<td><strong>standard deviation</strong></td>
<td><strong>20.5</strong></td>
<td><strong>5.35</strong></td>
<td><strong>4.55</strong></td>
<td><strong>13.88</strong></td>
<td><strong>9.42</strong></td>
</tr>
</tbody>
</table>

### SECTION 3

#### MAIN ISSUES

<table>
<thead>
<tr>
<th>Inflation Rate</th>
<th>VERY GREAT EXTENT</th>
<th>GREAT EXTENT</th>
<th>MODERATE EXTENT</th>
<th>SMALL EXTENT</th>
<th>NOT AT ALL</th>
</tr>
</thead>
<tbody>
<tr>
<td>An increase in the rate of inflation leads to less lending</td>
<td>11 57%</td>
<td>12 40%</td>
<td>1 3%</td>
<td>0 0%</td>
<td>6 20%</td>
</tr>
<tr>
<td>Increased inflation does not reduce equity market activities</td>
<td>5 17%</td>
<td>8 27%</td>
<td>3 10%</td>
<td>7 23%</td>
<td>7 23%</td>
</tr>
<tr>
<td>High rate of inflation interferes with the ability of the financial sector to allocate resources effectively</td>
<td>6 20%</td>
<td>13 43%</td>
<td>4 13%</td>
<td>2 7%</td>
<td>5 17%</td>
</tr>
<tr>
<td>An increase in inflation does not drive down rate of return on money and assets.</td>
<td>8 27%</td>
<td>2 0%</td>
<td>3 10%</td>
<td>7 23%</td>
<td>10 33%</td>
</tr>
<tr>
<td>For Fixed-interest bonds, an increase of inflation reduces the burden of debt and interest payments.</td>
<td>3 10%</td>
<td>14 47%</td>
<td>6 20%</td>
<td>2 7%</td>
<td>5 17%</td>
</tr>
<tr>
<td>Inflation reduces income pulling down consumption and savings further.</td>
<td>16 53%</td>
<td>7 23%</td>
<td>0 0%</td>
<td>3 10%</td>
<td>4 13%</td>
</tr>
<tr>
<td>Inflation tends to provoke currency devaluation.</td>
<td>17 57%</td>
<td>9 30%</td>
<td>0 0%</td>
<td>3 10%</td>
<td>7 23%</td>
</tr>
<tr>
<td>Higher inflation leads to higher nominal interest rates on loans</td>
<td>20 67%</td>
<td>7 23%</td>
<td>1 3%</td>
<td>1 3%</td>
<td>1 3%</td>
</tr>
<tr>
<td><strong>Mean</strong></td>
<td><strong>10.8 36%</strong></td>
<td><strong>9 29%</strong></td>
<td><strong>2.25 8%</strong></td>
<td><strong>3 10%</strong></td>
<td><strong>5 17%</strong></td>
</tr>
<tr>
<td><strong>standard deviation</strong></td>
<td><strong>16.4</strong></td>
<td><strong>10.3</strong></td>
<td><strong>5.57</strong></td>
<td><strong>6.24</strong></td>
<td><strong>7.07</strong></td>
</tr>
</tbody>
</table>

#### Fluctuations Of Interest rate

| Increase in interest rates discourage borrowers from getting loans from the bank and hence reduce the investment of your bank in loans. | 20 67% | 3 10% | 1 3% | 0 0% | 6 20% |
| Decline in interest rates leads to an decrease in the present value of the future dividends | 7 23% | 9 30% | 9 30% | 3 10% | 2 7% |
| Increased interest rates leads to a fall in stock exchange, treasury bonds and real estates | 7 23% | 17 57% | 2 7% | 3 10% | 1 3% |
| Higher interest rates leads to increased non performing loans to this bank | 14 47% | 13 43% | 2 0% | 0 0% | 3 10% |
| Decline in interest rates reduces disposable income for families vis a vis savings to the commercial banks. | 10 33% | 2 7% | 4 13% | 4 13% | 10 33% |
| High interest rates results to increased cost of funding on deposits to this bank. | 15 50% | 8 27% | 4 13% | 0 0% | 3 10% |
| **Mean**                                                                      | **12.2 41%**     | **8.6667**  | **29%**         | **3.333**    | **11%**    |
| **Standard deviation**                                                        | **8.7**          | **12.86**   | **6.36**        | **4.16**     | **7.41**   |

57
<table>
<thead>
<tr>
<th>Volatility Of Exchange Rate</th>
<th>F</th>
<th>%</th>
<th>F</th>
<th>%</th>
<th>F</th>
<th>%</th>
<th>F</th>
<th>%</th>
<th>F</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>The Central bank increasing the interest rate to check the value of the currency</td>
<td>11</td>
<td>37%</td>
<td>12</td>
<td>40%</td>
<td>2</td>
<td>7%</td>
<td>2</td>
<td>7%</td>
<td>3</td>
<td>10%</td>
</tr>
<tr>
<td>Increased demand for a currency is due to increased speculative demand for money.</td>
<td>7</td>
<td>23%</td>
<td>13</td>
<td>43%</td>
<td>3</td>
<td>10%</td>
<td>4</td>
<td>13%</td>
<td>3</td>
<td>10%</td>
</tr>
<tr>
<td>Depreciation of a currency of a country does not affect the competitiveness of the bank</td>
<td>5</td>
<td>17%</td>
<td>5</td>
<td>17%</td>
<td>3</td>
<td>10%</td>
<td>6</td>
<td>20%</td>
<td>11</td>
<td>37%</td>
</tr>
<tr>
<td>Stable exchange rates are precondition for stable trade policies</td>
<td>12</td>
<td>40%</td>
<td>8</td>
<td>27%</td>
<td>3</td>
<td>10%</td>
<td>2</td>
<td>7%</td>
<td>5</td>
<td>17%</td>
</tr>
<tr>
<td>Mean</td>
<td>8.75</td>
<td>29%</td>
<td>9.5</td>
<td>32%</td>
<td>2.75</td>
<td>9%</td>
<td>3.5</td>
<td>12%</td>
<td>5.5</td>
<td>18%</td>
</tr>
<tr>
<td>Standard deviation</td>
<td>5.72</td>
<td>6.4</td>
<td>0.87</td>
<td>3.3</td>
<td>6.56</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Balance Of Payment Situation</th>
<th>F</th>
<th>%</th>
<th>F</th>
<th>%</th>
<th>F</th>
<th>%</th>
<th>F</th>
<th>%</th>
<th>F</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Changes in balance of payment leads to a dip in business confidence and investment.</td>
<td>7</td>
<td>23%</td>
<td>16</td>
<td>53%</td>
<td>3</td>
<td>10%</td>
<td>1</td>
<td>3%</td>
<td>3</td>
<td>10%</td>
</tr>
<tr>
<td>Balance of payment deficits are always good for the economy.</td>
<td>5</td>
<td>17%</td>
<td>6</td>
<td>20%</td>
<td>5</td>
<td>17%</td>
<td>12</td>
<td>40%</td>
<td>2</td>
<td>7%</td>
</tr>
<tr>
<td>Changes in the exchange rate can have a big effect on the balance of payments although these effects are subject to uncertain time lags</td>
<td>8</td>
<td>27%</td>
<td>15</td>
<td>50%</td>
<td>3</td>
<td>10%</td>
<td>3</td>
<td>10%</td>
<td>1</td>
<td>3%</td>
</tr>
<tr>
<td>A sudden devaluation of a currency caused by chronic balance-of-payments deficits ends in a speculative attack in the foreign exchange market</td>
<td>10</td>
<td>33%</td>
<td>13</td>
<td>43%</td>
<td>2</td>
<td>7%</td>
<td>1</td>
<td>3%</td>
<td>4</td>
<td>13%</td>
</tr>
<tr>
<td>Changes in balance of payment have little effect to financial performance of commercial banks.</td>
<td>2</td>
<td>7%</td>
<td>9</td>
<td>30%</td>
<td>6</td>
<td>20%</td>
<td>7</td>
<td>23%</td>
<td>6</td>
<td>20%</td>
</tr>
<tr>
<td>Excess money supply plays a significant role in the inequilibrium of balance of payments in Kenya.</td>
<td>9</td>
<td>30%</td>
<td>12</td>
<td>40%</td>
<td>1</td>
<td>3%</td>
<td>4</td>
<td>13%</td>
<td>4</td>
<td>13%</td>
</tr>
<tr>
<td>Mean</td>
<td>6.83</td>
<td>23%</td>
<td>11.833</td>
<td>39%</td>
<td>3.333</td>
<td>11%</td>
<td>4.667</td>
<td>16%</td>
<td>3.333</td>
<td>11%</td>
</tr>
<tr>
<td>Standard deviation</td>
<td>4.44</td>
<td>8.33</td>
<td>4.16</td>
<td>9.45</td>
<td>3.92</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
TO WHOM IT MAY CONCERN:


This is to confirm that the above named is a Master of Business Administration MBA (Strategic Management) option Student in the School of Business, Kenyatta University.

She is through with course work and has successfully defended her Masters Degree proposal (Effects of Economic Environment on Financial Performance of Commercial Banks in Kenya) and has done all the corrections that were pointed out by the examiners during the defense. She is now embarking on data collection.

Any assistance accorded her will be much appreciated by this office.

Thank you.

E.N. NYACHOTI
FOR: DOCTORAL AND MBA PROGRAMME COORDINATOR

ENN/nt