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IMPACT OF INTEREST RATE CAPPING ON THE FINANCIAL PERFORMANCE OF COMMERCIAL BANKS IN KENYA

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Abstract: **The goal of this study was to investigate the short-term implications of the capping of interest rate on the financial performance of commercial banks' in Kenya. This study was guided by three main objectives, which are: to examine the impact of deposit interest rate capping on financial performance of commercial banks, to investigate the impact of interest rate capping on loans on financial performance, and lastly, to determine the effect of the interest rate spread on financial performance. Literature review of these specific objectives and theories that are related have been explained in-depth in chapter two. Data for one year before and after interest rate capping came to force was used which was obtained from CBK Banking Survey 2016, and 2017, CBK Statistical Bulletin 2016 and 2017. Descriptive analysis, correlation analysis and regression analysis were used to perform the data analysis. The model used is $ROA = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \varepsilon$.The mean of Deposit Rate Capping before interest rate capping came to effect stood at .9403 while for Interest Rate spread stood at .9758.The mean of Loan Rate Capping before interest rate capping came to effect stood at 1.1288 while for ROA stood at 0.0131.The mean of Deposit Rate Capping after interest rate capping came to effect stood at 0.9403 while for Interest Rate spread stood at .9796.The mean of Loan Rate Capping after interest rate capping came to effect stood at 1.1102 while for ROA stood at .2391.A correlation analysis was done to establish the relationship between the variables and the study found out that there was a positive relationship between Deposit Rate capping and financial performance at pre capping era at r=0.266, was a positive relationship between Interest rate spread and financial performance at pre capping era at r=0.240 and finally a positive relationship between Loan rate capping and financial performance at pre capping era at r= 0.023.The study recommends that policy makers should reevaluate the effect of the interest rate capping law and consider the long term effect that it could have on credit risk. The study recommends that a proper balance between capping on loans and deposits needs to be maintained so that banks realize a good return on their assets. Banks also need to diversify their investment portfolio so as to take realize a good return on assets so that they do not perform poorly due to interest cap legislation. This means that the regulator needs to continue in the enforcement of this law as this does not affect the banks negatively. This study looked into the aspects of deposits, loans and return on assets of commercial banks, hence limited since it dos not look at other sectors of the economy.**

Keywords: **Deposit performance, Loan performance, Overall performance and Return on Assets.**

1. INTRODUCTION

The introduction of interest rate capping by the regulator to commercial banks have brought a lot of challenges to the banks (Olaka, 2017). This has led to banks downsizing, reduction in their lending due to profiling of their clients depending on their risk profile. There has also been a lot of politics which could have worsened the situation (Olaka, 2017).The policy perspective of interest rate capping came to effect in September 2016 was to act as a control mechanism on the percentage of interest that banks charge their clients on borrowings in order to lower the cost of credit and reduce the cost of doing business. The goal of the government was to put on check the rate at which borrowers get their financing with the aim to reduce cost of doing business, increase access to credit by individuals and corporate so as to facilitate growth and hence enhance economic growth(Olaka, 2017).

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Various analyses have however shown that the objective of the government has not been met because of the various stringent requirements that banks have put in place which has made access to credit more difficult. They have for instance increased processing costs for these loans hence defeating the intention of this law (Olaka,2017).Capping of the interest rate has been defined to mean fluctuation of interest rate to fluctuate, but not to the extent that it surpasses or go below a dastated interest cap(World Bank,2014). The interest rate can thus fluctuate up and down, but can never go higher than the 14% capped rate. For the case of Kenya, Banking Amendment Act 2016, Section 33B (1) provides financial institutions have been provided with the authority of setting up maximum interest rates of no more than 4% the base rate which has been established by the CBK.

The interest rate capping significantly affects the bank budgetary execution (Muriuki, Muthuva and Egondi, 2017). There have been thinks about world over to research the impact of the financing costs on bank execution. For example, in an assessment researching short-term impacts of the financing costs on bank net premium edges, utilizing total English (2002) discovered that in numerous nations there is no proof that adjustments in the levels of short-term and long-term rates or the outcomes have a negative effect on the premiums.

Statement of the Problem

Before September 2016, the interest rates applied by the various banks were not capped. The unregulated interest rates were relatively high and led to exploitation of the consumers and reduced access to credit. To address this concern, Jude Njomo introduced a private bill, Banking Amendment Bill 2016. The bill was debated and its provisions came into force on September 2016. It is noteworthy to point out that whereas the interest capping introduced by the Act was meant to protect the borrowers from exploitation by commercial banks, it remained unclear how the move would affect the performance of both listed and unlisted commercial banks in Kenya.

When the Banking Amendment Act 2016 "the Act" came into force in September 2016, the expectation was that households and businesses would flock banks to access cheap credit. However, banks have put in place tighter credit controls by profiling clients in terms of their riskiness, realigned their portfolio away from risky segments, and are carefully analyzing their deposits and lines of credit so as to properly match the asset profile in the new dispensation (Olaka, 2017).The Act does not address the structural and policy influences on the cost of credit, such regulation potentially has adverse implications (Olaka, 2017).

The president assented to the bill with the expectation that it would improve access to credit by businesses and individuals leading to much credit lent which was thought to help improve the performance of businesses as well as banks and hence the economy (Olaka, 2017). However, there have been a lot of changes which seemed to have gone to the contrary and hence necessitating the researcher to carry out this study to specifically look at the extent it has affected the selected banks. Baum, Mustafa, & Neslihan, (2009) in their investigation of effect on interest rate capping on financial performance, concluded that when there is interest rate volatility, there is negative impact on the financial performance which can be explained by the failure of regulators to take into consideration the short-term and long-term effects of the policy changes.

Several studies have been done on the impact of the interest rate capping on the commercial banks financial performance.Okwany (2017) examine the impact of capping of interest rate on operating performance indicators of commercial banks in Kenya;Nduati (2013) examine the impact of premium spread on Kenya business banks budgetary execution;Nyakio (2013) research on the effect of interest capping by the CBK on the share income of 11 listed commercial banks;Meja (2017) did a study on the effect of interest rate capping on financial performance of commercial banks;Kavwele, Ariemba and Evusa (2018), did a study on the effect of interest rate capping on the profits of banks and the economy as a whole. However, the finding on some of these studies have mixed findings on the impact of the interest rate capping on the financial performance of commercial banks. For instance, Irungu (2017), on his study found out that interest rate cap affected negatively tourism and hospitality industries and further led to reduced profits while Ogare and NO(2013), on their study concluded that interest rate cap has positive relationship with innovations that financial institutions put in place.Furthermore,the related studies on the interest rate capping were also designed to focus on each factor of bank financial performance to the exclusion of the other factors while some only focused on listed commercial banks. It is against that background that this study intends to evaluate the effect of interest rate capping on the financial performance of commercial banks in Kenya.

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Objectives

i. To examine the impact of Deposit Rate Capping on financial performance return of commercial banks in Kenya.

ii. To examine the impact of Loan Rate Capping on financial performance of commercial banks in Kenya.

iii. To establish the impact of Interest rate spread on financial performance of commercial banks in Kenya.

2. THEORETICAL REVIEW

The Classical Theory of Interest

Keynes (1936) proposed this theory and associates interest as a payment for capital savings which in other words; similar any items value, price allocated for saving is determined through the knowledge on demand and supply of the savings. Defining it with more realistic terms, interest is the gift given after successive usage of income which is similar to the marginal results produced by physical income. Physical income or capital is bought using monetary funds, which is the money in an economy. The interest rate is the annual returns instead of the income used to invest various assets using physical capital. Keynes acknowledged that apart from the classical theory, interest rates can easily be understood through the savings investment theory which holds that the interest rate can be known when the demand and supply of capital intersect (Caplan, 2000).

The demand for funds in a business comes for the business people who use it only for productive reasons. Therefore, the routine for demand investment shows the demand for funds which means that the supply of money comes from people's savings. Moreover, the savings plan shows the income supply. In addition to this, it is possible to say that the two main factors that determine the interest rate are investment and savings (Fredman, 1991).

Based on the classical theory of interest, highly liquid banks are supposed to give loans charging low interests with an aim of increasing borrowers while putting low interests on bank saving thereby reducing the rate of saving. Rochon & Vernengo, (2001) opined that financial performances of high liquid banks should be much improved in comparison to low liquid banks. The classical theory assumes full employment and as Keynes noted, equality between investment and savings is because of changes in capital level but not because of interest rates changes. Irrespective of this, the classical theory of interest has been criticized to be often limited by the assumption of full employment which is unreasonable and unrealistic for any capital economy. Moreover, this theory ignores the impact of the income level changes and also wrongly assumes independence of savings (Andersen & Piterbarg, 2010).

Loanable Funds Theory

A Swedish economist known as Knut Wicksell proposed this theory which suggests that the rate of interest is determined after knowing the demand and supply of loanable capital. What this means is that the assumption is that the rate of interest can only be known via the credit demand and the supply of loanable income. The theory therefore, aims to improve the concept of the classical theory. Additionally, the theory states that money plays a disturbing role when saving and investing hence causing an imbalance of capital. Moreover, this means that the theory has an economical approach to the interest theory an aspect that is different from the classical theory (Wensheng,Wung & Shu, 2002).

When the equilibrium level that has supply and demand of loanable funds equal, it favors the investors and individuals who save income. Fluctuations on interest rates come from the differences in loan demand, credit capital for loans or the supply of loans. According to Ngugi (2013), interest is defined as the price that levels the demand for lending funds and their supply.

Keynes acknowledged that the loanable funds theory is unrealistic in particular due to the failure of providing full employment meaning that the theory suffers from some defects of the classical theory. The theory is also based on the assumption that national income is always intact. However, the national income changes due to investment meaning that it cannot be constant (Baum et al 2009)

Loanable funds can be defined as "the sums of money supplied and demanded at any time in the money market." Nonetheless, the demand of loanable income is known through two factors which include the demand involved in investment and the demand for accumulated capital. However, this theory has certain implications to the bank borrowers and savers since at equilibrium they have to be compensated. The rate of interest should be equal to all parties Emmanuelle (2003).The major limitation of this theory according to critics is that it fails to resemble a real-world finance system and hence built more on a unrealistic and imagination platform.

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The Expectations Theory of Interest

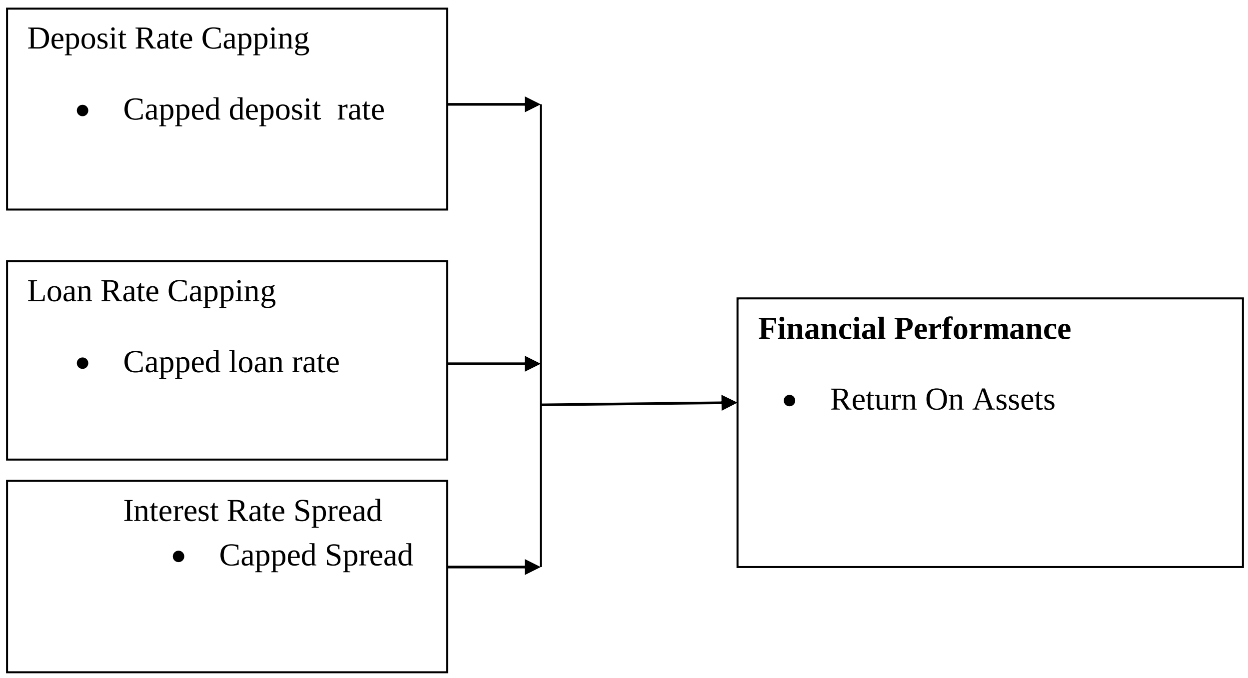
The expectations theory of interest proposed by Lutz (1940) explains the relationship between the maturity and yield for capital and money market investments. What this means in other words is that it provides an explanation of the connection between long-term and short-term interest rates. This theory states, “the expected return from holding a long term money or capital market investment (from now investments1) until maturity is equal to the expected return from rolling over a series of short term investment with a total maturity equivalent to that of the long term investment.” This implies outcomes from long-term investment become the average of the expected short rates (Kim &Orphanides, 2007). The underlying assumption of this particular theory is the rational expectations hypothesis. This infers: there is a stable monetary condition; investors comprehend this condition and can make expectations about future loan fees; most certainly not deliberately wrong and are shaped utilizing all open data accessible around then. This implies members do not efficiently over or under-evaluate the current present and future rates of interest (Cook & Hahn, 1990).

This theory has a direct implication in the present study in relation to the interest rates. Through this theory, investors make useful decisions by forecasting the interest rates future. Despite this, people should know that the theory is not always reliable. The major limitation of the theory is that at times it can overestimate future short-term rates which would mislead investors via inaccurate predictions (Bekaert et al, 2001).

Conceptual framework

The following is a schematic diagram showing the relationship between variables.

Independent variables **Dependent variables**



3. RESEARCH METHODOLOGY

A case study research design will be used in this study. The choice of this design is appropriate since it allows an in-depth understanding of the behavior pattern of the concerned unit. It is also forms a framework that guides the collection and analysis of data. This study used all the 42 commercial banks in Kenya as its population. The research employed use of data collection sheet and hardware and software tools. The hardware that was used include a computer which was used to run the software components necessary to give the research results. Software that was used includes statistical software such as SPSS and Microsoft Excel. The researcher used secondary data which extracted from the CBK website specifically the Statistical Bulletin 2017. The data included data on total deposits, total assets, non-performing loans, total loans and net income.

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4. CORRELATIONS ANALYSIS

Correlations Analysis -Pre–Capping

A correlation analysis was done to establish the relationship between the variables and the study found out that there was a positive relationship between Deposit Rate capping and financial performance at pre capping era at r=0.266, was a positive relationship between Interest rate spread and financial performance at pre capping era at r=0.240 and finally a positive relationship between Loan rate capping and financial performance at pre capping era at r= 0.023.The rest of the results have been summarized in the table below.

Table 4.1: Correlation Analysis: before interest rate cap

		Deposit Rate Capping	Interest Rate Capping	Loan Rate Capping	ROA
DepositRate capping	Pearson Correlation	1	-.354*	.573**	-.176
	Sig. (2-tailed)		.021	.000	.266
	N	42	42	42	42
Interest rate capping	Pearson Correlation	-.354*	1	-.466**	.185
	Sig. (2-tailed)	.021		.002	.240
	N	42	42	42	42
Loan rate capping	Pearson Correlation	.573**	-.466**	1	-.350*
	Sig. (2-tailed)	.000	.002		.023
	N	42	42	42	42
ROA	Pearson Correlation	-.176	.185	-.350*	1
	Sig. (2-tailed)	.266	.240	.023	
	N	42	42	42	42

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

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

Correlations Analysis -Post–Capping

A correlation analysis was done to establish the relationship between the variables at Post–Capping and the study found out that there was a positive relationship between Deposit Rate capping and financial performance at post capping era at r=0.074, was a positive relationship between Interest rate spread and financial performance at post capping era at r=0.670 and finally a positive relationship between Loan rate capping and financial performance at post capping era at r= 0.294. A research conducted by Hurn and Farl (2007), established that interest capping affect bank profitability either directly or indirectly. This study found out that bank profitability had not increased since the law came into effect since banks were not likely to advance unsecured loans to individuals and organization hence leading to reduction in profits. This finding contradict the argument by Gao (2012) that interest rate charges greatly affects the lending systems in banks leading to low interest income. The rest of the results have been summarized in the table below.

Table 4.2: Correlation Analysis: post interest rate cap

		Deposit	Interest	Loan	ROA
Deposit	Pearson Correlation	1	-.370*	.632**	-.278
	Sig. (2-tailed)		.016	.000	.074
	N	42	42	42	42
Interest	Pearson Correlation	-.370*	1	-.517**	-.068

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	Sig. (2-tailed)	.016		.000	.670
	N	42	42	42	42
Loan	Pearson Correlation	.632**	-.517**	1	-.166
	Sig. (2-tailed)	.000	.000		.294
	N	42	42	42	42
ROA	Pearson Correlation	-.278	-.068	-.166	1
	Sig. (2-tailed)	.074	.670	.294	
	N	42	42	42	42

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

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

Regression Results

Model Coefficients

The variables coefficients demonstrates a deteriorating contribution of interest capping in post capping era as compared to pre capping.

Table 4.3: Significance of Independent Variable in relation to pre-capping

Model		Unstandardized Coefficients		Standardized Coefficients		
		B	Std. Error	Beta	T	Sig.
1	(Constant)	1.087	.241		4.506	.000
	Deposit rate capping	.848	.141	.555	3.182	.003
	Loan rate capping	.762	.234	.071	.265	.004
	Interest Spread	.728	.218	.295	1.321	.002

Table 4.4: Significance of Independent Variable in relation to Post-capping

Model		Unstandardized Coefficients		Standardized Coefficients		
		B	Std. Error	Beta	T	Sig.
1	(Constant)	1.169	.522		2.240	.000
	Deposit rate capping	.285	.163	.282	1.754	.002
	Loan rate capping	-.559	.157	-.576	-3.558	.001
	Interest spread	-.224	.220	-.167	-1.018	.000

The results in Tables above indicate that deposit rate capping has a significant and a positive effect on Return on asset of Kenyan commercial banks during pre-capping period and there is significant positive effect of deposit rate capping on Return on asset during Post-capping period. The interest rate cap law set a minimum rate of 70% of the Central Bank Rate as the minimum rate payable on deposits placed with banks which led to improved liquidity in the bank as more depositors were attracted to the interest rates which were on average higher than before (CBK,2017)

Further, the results indicate that interest rate spread has a significant and a positive effect on Return on asset of Kenyan commercial banks during pre-capping period and also a positive effect during post capping period. As a result of interest rate spread, banks have declined offering unsecured loans to individuals and corporate .The decrease in supply of credit has affected the supply of money because it is one of the tools that the Central Bank uses in regulation of the total money supply in an economy. Therefore, overall spending and consumption on the economy has been affected. The investors have limited amount to invest meaning very few job opportunities will be offered, the purchasing power of the consumers declined and finally most firms have not been able to sell their products as usual. According to Actech (2012) it was found out that loan loss provisions in UK banks continued to increase as borrowers were unable to pay loans due to increased bank charges. This has also been the case in Kenya since there is increasing non-performing loans leading to increased loan loss provisions which has been brought about by interest rate cap law.

Finally, the results indicate Loan Rate Capping has a significant and a positive effect on return on assets of Kenyan commercial banks during pre-capping period and also a positive effect during post capping period. The regression output shows that a unit increase in the interest rate cap will result into increase in the in the return on assets generated by the Kenyan Commercial Banks.

5. CONCLUSION

The study concluded that that interest rate capping has a significant and positive effect on return on assets of Kenyan commercial banks during both the periods before and the period after the interest rate capping. The interest rate cap law set a minimum rate of 70% of the Central Bank Rate as the minimum rate payable on deposits placed with banks which led to improved liquidity in the bank as more depositors were attracted to the interest rates which were on average higher than before the interest rate capping hence the positive relationship between interest rate cap on deposits and return on assets. The findings from the study also shows that interest rate capping on loans has a significant and positive relationship with return on assets of Kenyan commercial banks during the period before interest rate cap as well as the period after the rate cap. Even though the banks declined to offer unsecured loans to individuals and hence leading to the decrease in supply of credit they were still able to register positive results though there was instability in the supply of money because it is one of the tools that the Central Bank uses in regulation of the total money supply in an economy.Finally,the study concluded that interest rate spread has a significant and a positive effect on return on assets of Kenyan commercial banks during the period before and after interest rate cap. The analysis above shows that there was a positive and statistically significant correlation between bank return on assets and interest rates cap at 1% level of significance.

6. RECOMMENDATIONS

The study recommends that policy makers should reevaluate the effect of the interest rate capping law and consider the long term effect that it could have on credit risk.

The study also recommends that government should develop long-term solutions to address the money supply side constraint. The government and banking institutions should mobilize more long-term capital from the market through pooling funds and long-term savings and deepening capital markets by incorporating the informal into the financial system sector and introducing tax incentives to encourage saving culture in Kenya.

The study further recommends that the banks should explore more adoptive ways of reducing their operational cost like adoption of modern technology in advertisement and offering other essential services

The study finally recommends that a proper balance between capping on loans and deposits needs to be maintained so that banks realize a good return on their assets. Banks also need to diversify their investment portfolio so as to take realize a good return on assets so that they do not perform poorly due to interest cap legislation.

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