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Factors Influencing Financial Performance of Commercial Banks in Kitale Town, Kenya

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Abstract

The study aims at establishing the factors influencing financial performance of Commercial Banks in Kitale Town, Kenya. The study was guided by the following sPecifIC objective;to establishing the influence of liquidity management on financial performance of Commercial Banks in Kitale. The study was important because it would assist Central bank of Kenya as the regulator in implementing supervision, to the government in determination and establishment of a stronger regulatory and legal framework for the Banking industry in Kenya. This study adopted descriptive research design. The target population of the study was all the 14 commercial Banks operating in Kitale Town. Census was applied on all 42 employees from each bank which included the finance manager, business development manager and risk manager. This study used primary data specifically a structured questionnaire. The questionnaire comprised of both open and closed ended questions. Data was analyzed quantitatively and presented descriptively and illustrated by use of tables and charts. Descriptive statistics such as percentages, mean, trends and standard deviation was computed to describe the characteristics of the variables of interest while in inferential statistics, corelation, multiple regression analysiswas used to establish the nature and magnitude of the relationships between the variable and to test the hypothesized relationships. Coefficient of determination (R^2) was used to measure the amount of variation in the dependent variable explained by the independent variable. All the analysis was done using SPSS statistical package. The results of data analysis were presented using figures and tables for easy understanding and interpretation. The study findings indicated that liquidity management had a positive and significant effect on financial performance. Results indicated that 95.1% of the variations in financial performancewas jointly accounted for by the variations in liquidity management. The study concludes that management liquidity management were statistically significant in explaining financial performance. The study recommends that commercial banks should invest in other lines of business for example product diversification and investments to supplement their income from core business. This will boost their stability and contribute to profitability.

Keywords: *Liquidity Management, Banks Performance*

1.0 Introduction

Commercial banks play a major role in the economy through their economic role of financial intermediation that performs both a brokerage and a risk transformation function (Hara, 2013). Commercial banks are financial intermediaries that mobilize savings from surplus economic units to deficit economic units. They are also special financial intermediaries that mobilize funds between depositors and borrowers participating in an economy. How well they perform this intermediary function has direct linkage with banks profitability and economic health of a nation. Profitability of banks has relationships with growth and development of an economy (Wainaina, 2013). By its nature banks face number of challenges within internal and the external business environment, the nucleus of banks is known with risks which include credit risk, market risk, interest rate risk, default risk, operational risk, exchange rate risk (Aruwa & Musa, 2014). Basically, banks operate with three basic objectives which are profitability, growth of assets and customer base.

Financial performance is a subjective measure of how well a firm can use assets from its primary mode of business and generate revenues. It is also a general measure of a firm's overall financial health over a given period, and can be used to compare similar firms across the same industry or to compare industries or sectors in aggregation. Profitability of banks is interpreted based on indicators such as ROE (return on equity) and ROA (return on assets). ROE (net profit after tax/equity capital) is the most important indicator, because it shows the bank's shareholders the amount of profit they can expect based on book value of the capital they invested in a bank(Bodla & Richa, 2010). This indicator is most trusted among regulatory bodies, the central banks and rating agencies. In its calculation, it is recommended to use the average number of assets during the year, due to seasonality present in banking business.

There are many different ways to measure financial performance, but all measures should be taken in aggregation. Line items such as revenue from operations, operating income or cash flow from operations can be used, as well as total unit sales. Furthermore, the analyst or investor may wish to look deeper into financial statements and seek out margin growth rates or any declining debt. Other measures of financial performance include liquidity, solvency, profitability, debt repayment capacity and financial efficiency of the firm (Ongore and Kusa, 2013).

1.1.1 Global factors influencing Financial Performanceof Banks

Tregenna (2009) using a sample of USA commercial banks and savings institutions from 1995 to 2005 and a linear regression panel model, found robust evidence that concentration increases profitability in USA banks and then concluded than the high profitability of banks in the USA before the 2007/2008 financial crisis was not earned through efficient processes, but through market power and the profits were not reinvested to strengthen the capital base of the financial institutions. Nzongang and Atemnkeng (2000) examined the effects of concentration to the profitability of Cameroonian commercial banks from 1987 to 1999. Unlike Tregenna (2009), who used the concentration ratio of the 3 largest banks in the USA to model market concentration, Nzongang and Atemnkeng (2000) used the Herfindahl-Hirschman index to measure market concentration in Cameroon. The results indicated that market concentration power is of paramount importance in the determination of bank profitability.

Bakar and Tahir (2009) evaluated the performance of the multiple linear regression technique and artificial neural network techniques with a goal to find a powerful tool in predicting bank performance. Data of thirteen banks in Malaysia for the period 2001-2006 was used in the study. ROA was used as a measure of bank performance and seven variables including liquidity, credit risk, cost to income ratio, size, concentration ratio, were used as independent variables. They note that neural network method outperforms the multiple linear regression method but it lacks explanation on the parameters used and they concluded that multiple linear regressions, notwithstanding its limitations (i.e. violations of its assumptions), can be used as a simple tool to study the linear relationship between the dependent variable and independent variables. The method provides significant explanatory variables to bank performance and explains the effect of the contributing factors in a simple, understood manner. This study adopted this approach together with the correction analysis to determine the effects of various factors on bank performance in Kenya.

1.1.2 Regional factors influencingFinancial Performance of Banks

Ashok (2009) in his study examined how the financial performance of State Bank of India (SBI) group, nationalized banks group, private banks group and foreign banks group in India had been affected by the financial deregulation of the economy. The main objective of the empirical study was to assess the financial performance of scheduled commercial banks through CAMEL analysis. CAMEL stands for capital adequacy, asset quality, management efficiency, earnings performance and liquidity. The objectives of his study were to identify the optimal mix of assets and liabilities for the profitability of banks and to offer suitable suggestions to strengthen the funds position of commercial banks. The study was carried out over a period of 2000-2001 to 2009-2010. He concluded that banking sector should take greatest care on the variables which relate to asset liability management and that all the banking groups must take necessary steps to improve the overall performance of the banking sector.

Heffernan and Fu (2010) looked at how well different types of Chinese banks had performed between 1999 and 2006, and tested for the factors influencing performance. It also evaluates four measures of performance to identify which one, if any, was superior. The independent variables included the standard financial ratios, those which reflected more recent reforms and macroeconomic variables. The results suggested that Economic Value Added (EVA) and the Net Interest Margin (NIM) did better than the more conventional measures of profitability, namely Return On Average Equity (ROAE) and Return On Average Assets (ROAA). Some macroeconomic

variables and financial ratios were significant with the expected signs. Though the type of bank was influential, bank size was not. Neither the percentage of foreign ownership nor bank listings had a discernible effect.

Alkhatib (2012) examined the financial performance of five Palestinian commercial banks listed on Palestine securities exchange (PEX).to assess the financial performance of Palestinian commercial banks. Alkhatib (2012) developed 3 models; each consisted of one dependent variable and 4 identical independent variables. He used ROA as an internal financial performance indicator the Tobin's Q model (price/book) as a market financial performance indicator and finally the economic value added as an economic financial performance indicator. Bank size, credit risk, operational efficiency and asset management were used as independent variables. The study employed the correlation and multiple regression analysis of annual time series data from 2005-2010.the result of the research reveal that, bank size and asset management were positively related with ROA but credit risk and operational efficiency were negatively correlated with ROA under the first model. Under the second model both bank size and asset management were positively correlated whereas credit risk and operational efficiency is negatively correlated with the market performance of banks measured by Tobin's Q. Under the third model that is the model which used economic performance of banks measured by EVA, except operational efficiency, bank size, credit risk and asset management ratio were positively correlated with EVA.

1.1.3 Local factors influencing Financial Performance of Commercial Banks

A major threat to banking sector is prevalence of Non-Performing Assets (NPAs). NPA represents bad loans, the borrowers of which failed to satisfy their repayment obligations. Michael et al (2010), emphasized that NPA in loan portfolio affect operational efficiency which in turn affects profitability, liquidity and solvency position of banks (Ombaba, 2013). Commercial banks are quite important in an economy as intermediaries; they channel funds from depositors to investors continuously. They can do so, if they generate necessary income to cover their operational cost they incur in the due course, that is, for sustainable intermediation function, banks need to be profitable (Ongore and Kusa, 2013).

Ngigi (2015) indicated that financial performance of Kenyan banks has continued to take hit from increased provisioning for bad loans as Central Bank of Kenya (CBK) heightens its scrutiny on their books. Even though CBK had previously encouraged restructuring of loans by banks to keep their risk low; their change of tack in a letter of intent to International Monetary Fund (IMF) on the heightened regulatory scrutiny could cause Kenyan banks to increase their loan loss provision expense, which in turn would lower profitability. The financial performance of commercial banks in the Kenya has improved tremendously over the last ten years, as only two banks have been put under CBK statutory management during this period compared to 37 bank-failures between 1986 and 1998 (Mwega, 2009).

Olweny and Shipho (2011) studied the effects of banking sectoral factors on the profitability of commercial banks in Kenya. The first objective of this study was to determine and evaluate the effects of bank-specific factors; Capital adequacy, Asset quality, liquidity, operational cost efficiency and income diversification on the profitability of commercial banks in Kenya. The second objective was to determine and evaluate the effects of market structure factors; foreign ownership and market concentration, on the profitability of commercial banks in Kenya. This study adopted an explanatory approach by using panel data research design to fulfill the above objectives. Annual financial statements of 38 Kenyan commercial banks from 2002 to 2008 were obtained from the CBK and Banking Survey 2009. The data was analyzed using multiple linear regressions method. The analysis showed that all the bank specific factors had a statistically significant impact on profitability, while none of the market factors had a significant impact.

Moraa (2014) did an analysis of profitability of Kenya's top six commercial banks: internal factor analysis. The study found that bank size, capital strength, ownership, operations expenses, diversification do significantly influence profitability of the top six commercial banks. The result suggests that the Kenyan Government should set policies that encourage commercial banks to raise their assets and capital base as this will enhance the performance of the sector. Ongore (2013) studied the determinants of financial performance of Commercial Banks in Kenya. The study found thatthe financial performance of commercial banks in Kenya is driven mainly by board and management decisions, while macroeconomic factors have insignificant contribution. This study soughtto establish the factors influencing financial performance of Commercial Banks in Kitale Town in Kenya

1.1.4 Commercial Banks in Kenya

The business of commercial banks is accepting deposits from customers and in turn lend out the funds to earn an income. They perform financial intermediation by linking surplus units in the economy with deficit units. Kenyan commercial banks are the main players in financial intermediation (Ongore, 2013). Lending is the principal income generating activity for commercial banks. The loan portfolio is typically the largest asset and

the predominant source of revenue for lending institutions. They grant credit on the premise that the loans will be fully paid however this is not the case as some customers may default thus leading to losses for the banking sector. Credit risk is the major risk that banks face.

Banks have no way of predicting whether a loan will be repaid in full or not. This is exuberated by the fact that loan repayments are dependent on the customers' future income. It's difficult for the bank to accurately determine this especially at the time the loan is granted. NPLs affect the profitability of banks since provisions must be made for them resulting in reduced profits (Ongore, 2013). In the long run, sustained NPLs will eventually affect the survival of the bank. The main reason for the collapse of thirty-seven banks in total in the late 80s and in the 90s was the huge NPLs in their books (Waweru & Kalani, 2009). This is because NPLs affect the cash flow and profitability of commercial banks. A low-quality debt portfolio could pose a great risk to the bank's safety and soundness (Siraj & Pillai, 2012). Banks therefore must exercise credit risk management to ensure that they do not collapse.

The overall profitability of the banking sector in Kenya has improved tremendously over the last 10 years. However, despite the overall good picture a critical analysis indicates that, not all banks are profitable. For example, the small and medium financial institutions which constitute about 57 % of the banking sector posted a combined loss before tax, of Ksh 0.09 billion in 2009 compared to a profit before tax of Ksh 49.01 billion posted by the big financial institutions (CBK, 2013). The huge profitability enjoyed by the large banks vis-a-avis the small and a medium bank indicates that there are some significant factors that influence the profitability of commercial banks. Flamini et al (2009) and other several studies have shown that bank profitability is influenced by bank-specific factors and industry specific factors.

The stock of gross non-performing loans (NPLs) in commercial banks in Kenya increased by 14.1 percent from Ksh. 61.6 billion in December 2012 to Ksh. 70.3 billion in March 2013. The ratio of gross NPLs to gross loans increased from 4.5 percent in December 2012 to 5.0 percent in March 2013. The increase in the NPLs levels was mainly attributable to the spill-over effects of the high interest rates regime in 2011 and 2012. Similarly, the quality of assets, measured as a proportion of net non-performing loans to gross loans declined from 1.5 percent to 2.0 percent over the same period (CBK, 2013). During the period under review, 10 out of 11 sectors registered increase in NPLs by Ksh. 8.7 billion.

As at June 2016; there are 42 licensed commercial banks and 1 mortgage finance company. Out of the 43 institutions, 39 commercial banks and the mortgage finance institution are privately owned while the Kenya Government holds controlling stakes in the remaining 3 commercial banks, 25 of the 39 privately owned banks and the 1 mortgage finance institution are locally owned (i.e their controlling shareholders are domiciled in Kenya) while 14 are foreign owned (CBK, 2016). The study however focused on 14 commercial banks operating in Kitale town.

Understanding the factors that influence the performance of commercial banks is critical not only to the management of these commercial banks but also to other stakeholders and interest groups such as the country's Central Bank, the government as a whole, the banker's association as well as other financial authorities in the country (Ayele, 2012).
Most studies conducted in relation to bank performance focused on sector specific factors which affected the entire banking sector performance. For instance, Chantapong (2005) did a comparative studyof foreign and local banks in Thailand and Goddard *et al*. (2004) did a cross- sectional and dynamic panel analysison the profitability of European banks.Similarly, Ongore and Kusa (2013) studied the effects of various factors in banking sector performance in Kenya. The results of the study showed that board and management decisions influence the performance of commercial banks in Kenya and macro-economic factors have insignificant influence on their performance. This study however omitted the effects of industry specific factors on the performance of commercial banks. therefore the sTuDY Seeks TO establish the influence of liquidity management onfinancial performance of Commercial Banks in Kitale Town

2.0 Influence of Liquidity Management on Banks Performance

According to Bodla and Richa (2010), banks are often evaluated on their liquidity, or their ability to meet cash and collateral obligations without incurring substantial losses. Liquidity management is an important decision that the managers of commercial banks take refers to the liquidity management and specifically to the measurement of their needs related to the process of deposits and loans. The importance of liquidity goes beyond the individual bank as a liquidity shortfall at an individual bank can have systemic repercussions. It is argued that when banks hold high liquidity, they do so at the opportunity cost of some investment, which could generate high returns (Dang, 2011).

Bordeleau and Graham (2010) presented empirical evidence regarding the relationship between liquid asset holdings and profitability for a panel of Canadian and U.S. banks over the period of 1997 to 2009. The results suggested that a nonlinear relationship exists, whereby profitability was improved for banks that hold some liquid assets, however, there was a point beyond which holding further liquid assets diminishes a banks‟ profitability, all else equal. Conceptually, this result is consistent with the idea that funding markets reward a bank, to some extent, for holding liquid assets, thereby reducing its liquidity risk. However, this benefit is can eventually be outweighed by the opportunity cost of holding such comparatively low-yielding liquid assets on the balance sheet. At the same time, estimation results provide some evidence that the relationship between liquid assets and profitability depends on the bank's business model and the risk of funding market difficulties. The researchers recommended that adopting a more traditional i.e., deposit and loan-based business model allows a bank to optimize profits with a lower level of liquid assets.

Odunga *et al. (*2013) examined the effects of liquidity and capital adequacy on the operating efficiency of 40 commercial banks in Kenya for the period 2005-2011. They found that bank's performance is influenced by how a bank moves forward to streamline its operational strategies. They added that commercial banks with enough liquid assets tend to draw more confidence with customers because of the ability to address short-term financial obligations. It is therefore important for the central bank to ensure full compliance with the minimum liquidity requirement by commercial banks

Lartey1 et al, (2013) sought to find out the relationship between the liquidity and the profitability of banks listed on the Ghana Stock Exchange. The study sought to describe the relationship between the liquidity and the profitability of banks listed on the Ghana Stock Exchange using a target population of 9 commercial banks listed on the Ghana Stock Exchange and a sample of 7 banks. Purposive sampling technique was used. In conclusion, both the liquidity and the profitability levels of the listed banks were decreasing within the period 2005-2010. There was a very weak positive relationship between the liquidity and the profitability of the listed banks. These findings support Munther et al. (2013) in the case of Jordanian banks. When banks hold adequate liquid assets, their profitability would improve. Adequate liquidity helps the bank minimize liquidity risk and financial crises. The bank can absorb any possible unforeseen financial position. However, if liquid assets are held excessively, profitability could diminish because they have no or little interest generating capacity. The opportunity cost of holding low return assets would eventually outweigh the benefit of any increase in the bank's liquidity resiliency as perceived by funding markets (Mashhad, 2012)

3.1 Methodology

The study adopted descriptive survey research design. The population for this study constituted of all 14 commercial banks in Kitale Town WhIcH consisted of Finance managers, Business development manager, And Risk managerS to a total of 42 managers, a census was applied. The primary data was collected using questionnaires which comprised of both open and closed ended questions. A likert scale questionnaire was used. A questionnaire was a pre-formulated written set of questions to which the respondents record the answers usually within rather closely delineated alternatives. Pilot study was done as an exercise that ensures that errors are restricted at a very little cost. A Statistical Package for Social Sciences (SPSS) was used to generate the descriptive statistics and to generate inferential results. Descriptive analysis included use of frequencies, trends and percentages Analysis of Variance (ANOVA), regression analysis were used to Regression analysis was used to demonstrate effect of independent variables on dependent variable.

4.0 Discussion

The study aimed at establishing the factors influencing financial performance of commercial banks in Kitale Town in Kenya. The objective of the study was to establish the influence of liquidity management on financial performance of Commercial Banks in Kitale Town. Table 4.1 below indicates the extent of agreement among respondents on the liquidity of commercial banks. The results in particular indicate that liquidity management was one of CBK regulatory requirement to ensure financial performanceas indicated by 79% of the respondents and further that liquidity management affected financial performance of their bankas was indicated by 92.1% of the respondents.The results further indicated that customer deposit to total asset and customer deposit was used as financial ratio to measure their bank liquidity as was indicated by 81.6% of the respondents. it was also established that 68.4% of the respondents agreed that it was important for CBK to ensure full compliance with minimum liquidity requirement and 65.8% of the respondents agreed that the liquidity levels oversight by the firm were adequate in ensuring liquidity levels are kept under control. The mean score for the responses was 3.86 which indicates that majority of the respondents agreed that liquidity management was a key determinant of performance of commercial banks.

The study findings are consistent with Uzhegova (2010) who noted that adequate level of liquidity is positively related with bank profitability. Further, Bordeleau and Graham (2010) presented empirical evidence regarding the relationship between liquid asset holdings and profitability for a panel of Canadian and U.S. banks over the period of 1997 to 2009. The results suggested that a nonlinear relationship exists, whereby profitability was improved for banks that hold some liquid assets, however, there was a point beyond which holding further liquid assets diminishes a banks' profitability, all else equal. Conceptually, this result is consistent with the idea that funding markets reward a bank, to some extent, for holding liquid assets, thereby reducing its liquidity risk. Similarly, Odunga *et al. (*2013) examined the effects of liquidity and capital adequacy on the operating efficiency of 40 commercial banks in Kenya for the period 2005-2011 and found that bank's performance is influenced by how a bank moves forward to streamline its operational strategies. They added that commercial banks with enough liquid assets tend to draw more confidence with customers because of the ability to address short-term financial obligations.

The results revealed that that there exist a positive and significant (r=0.829, p>0.000) correlation between financial performance and liquidity management.The correlation between the variables indicates that if liquidity management is improved and enhanced then this would be associated with improved financial performance as indicated by a positive correlation between the two variables. The study findings are in agreement with those of Lartey1 et al. (2013) who found that there was a very weak positive relationship between the liquidity and the profitability of the listed banks. These findings support Munther et al. (2013) in the case of Jordanian banks. When banks hold adequate liquid assets, their profitability would improve. Similarly, Uzhegova (2010) noted that adequate level of liquidity is positively related with bank profitability.

Table 4.1: Bivariate Correlation

Variable		**Financial performance**	**Liquidity**
Financial performance	Pearson Correlation	1	
	Sig. (2-tailed)		
Liquidity	Pearson Correlation	0.829	1
	Sig. (2-tailed)	0.000	

In order to establish the statistical significance of the independent variables on the dependent variable (financial performance) regression analysis was employed. The results presented in the Table 4.3 below shows the amount of variance in organization performance as explained by the variance in the set of independent variables used in the study (i.e. liquidity management). The R square of 0.951 indicates that 95.1% of the variations in financial performance is jointly accounted for by the variations in liquidity management. From the model summary table below adjusted R^2 was 0.945 this indicates that the combined effect of predictor variable (liquidity management) explains 94.5% of variations in financial performance. The correlation coefficient of 97.5% indicates that the combined effect of the predictor variable had a strong and positive correlation with financial performance. This also meant that a change in the drivers of financial performance (liquidity management) has a strong and a positive effect on performance.

Table 4.12: Regression Model Fitness

model	**R**	**R Square**	**Adjusted R Square**	**Std. Error of Estimate**	**Coefficient**
R	0.975				0.975
R Square					0.951
Adjusted R Square					0.945
Std. Error of the Estimate					0.13375

Prior to estimation of the regression model the goodness of fit was performed and the results are presented in the Table 4.4 below where the results indicated that the overall model was significant, that is, liquidity management are good joint explanatory variable for financial performance(F = 159.033, p-value=0.000). The findings imply that all the independent variable were statistically significant in explaining changes in financial performance. This is demonstrated by a p value of 0.000 which is less that the acceptance critical value of 0.05.

Table 4.13: ANOVA

Indicator	Sum of Squares	df	Mean Square	F	Sig.
Regression	11.38	4	2.845	159.033	0.000
Residual	0.59	33	0.018		
Total	11.971	37			

After it was established that the regression model was significant the following regression estimates as indicated in Table 4.5 below was obtained. In particular, the results revealed that liquidity management and financial performance had a positive and significant relationship (beta=0.228 p value0.000). This implied that a one percentage change in liquidity management effectiveness was associated with 22.8 percentage increase in financial performance.

Table 4.5: Regression Coefficients

Variable	Beta	Std. Error	t	Sig.
Constant	-0.374	0.184	-2.038	0.05
Liquidity Management	0.228	0.059	3.898	0.000

The Y- intercept is -0.374 which is the predicted value of financial performance when all the others variables are 0, implying that without inputs of the independent variable the effectiveness of financial performance would be -0.374.

5.0 Conclusions And Recommendations

The objective of the study was to establish the influence of liquidity management on financial performance of Commercial Banks in Kitale Town, where the results indicated liquidity management was a key determinant of performance of commercial banks. Inferential analysis including correlation and regression analysis indicated that there existed a positive (r=0.829) and significant (p=0.000) correlation between financial performance and liquidity management. Further, the regression results showed that liquidity management had a positive (β=0.228) and significant (p<0.05, p=0.000) influence on financial performance. This implied that a one percentage change in liquidity management effectiveness was associated with 22.8 percentage increase in financial performance.

Based on the above findings the study concluded that financial performance of the commercial banks in Kenya is highly dependent on the level of the institutions' liquidity. There is also a positive association between liquidity management and financial performance of banks. This implies that an improvement in liquidity management leads to a rise in financial performance. This explains that, efforts to stimulate the banks' liquidity would see the financial sector realize increased financial performance. Consequently, this would result to increased efficiency in the sector's operations.

Based on findings the study recommends that banks should improve on their liquidity more so the ability of the banks to promptly repay the depositors. As the findings illustrated, financial performance of commercial banks in Kenya is highly dependent on the level of the institutions' liquidity. To facilitate favorable financial performance of these institutions, strategies to facilitate increased liquidity of banks should be adopted by the institutions for their efficiency in financial operations.

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