



## Prudential Regulations and Financial Performance of Selected Microfinance Banks in Nairobi City County, Kenya.

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### ABSTRACT

*Prudential regulations are aimed to protect depositors and general stability of financial systems, hence enhancing microfinance banks' effectiveness and sustainability. However, due to their strict nature, MFBs' have continued to suffer from poor financial performance. This study sought to investigate prudential regulations and financial performance of selected microfinance banks in Nairobi City County, Kenya. The study used descriptive research design. The target population for the study was 14 licensed microfinance banks. The study used purposive sampling technique with sample size of 124 respondents. Data collection was done using questionnaires and analysis was done by use of Statistical Package for Social Sciences (SPSS) version 24. Presentation of findings was done in form of tables, charts and graphs. From the study, it was found that capital adequacy has a substantial effect on MFBs' financial performance and deduced that, it influences MFB's lending strategies, ability to allocate funds, outreach, customer behavior and lowers unfair market segments. Majority of the respondents were in disagreement that their MFBs had enough capital to handle loan defaults. The study also found that liquidity management, operational requirements and financial reporting requirements all affected financial performance of MFBs. Therefore, the study concludes that Kenyan microfinance banks' financial performance was significantly affected by capital adequacy requirements, liquidity management, operational requirements and financial reporting requirements. The study recommends that microfinance banks should carefully manage their liquidity, set minimum capital requirements depending on their risk appetite, and look at methods to improve their operational effectiveness in order to promote their financial performance.*

**Keywords:** Microfinance banks, performance, Prudential guidelines

### 1.0 INTRODUCTION

#### 1.1 Background Information

Many developing nations rely heavily on microfinance banks for their economic growth and stability (Hartungi, 2017). However, MFBs have several difficulties, one of which being majority of nation's inadequate or strict regulatory framework. Curll, Demirg-kunt, and Morduch (2020) state that although many countries lack an appropriate prudential guideline, these guidelines are essential to improving the microbanks' financial performance.

Globally, several countries have passed laws and regulations pertaining to microfinance banks in an attempt to safeguard depositors (Cull, Demirg- Kunt, & Morduch, 2020) nonetheless, other nations have chosen various frameworks for regulating microfinance banks. Microfinance institutions have three options for regulation; self-regulation, special law regulation, or banking law regulation (Haq, Hoque, & Pathan, 2018; Staschen, 2019). The evolution of microfinance prudential guidelines varies throughout countries as well. Within the European Union, member law governing microfinance banks range from those pertaining to microfinance to those that specifically addresses microlending within law governing the banking or non-profit sectors. Certain regulations concerning microfinance and nonbanking institutions are found in the legislative frameworks of Romania and France, for instance. The European microfinance network (2016) states that whereas Spain lacks a dedicated microfinance statute, Italy has laws pertaining to the establishment of non-bank microfinance banks.

In the East Africa region, Central banks are responsible for licensing and supervising deposit-taking microfinance firms. Microfinance institutions in Rwanda are subject to regulation and oversight by the National Bank of Rwanda. Microfinance institutions encompass limited corporations that engage in microfinance operations as well as SACCOs (Savings and Credit Co-operations) (Republic of Rwanda, 2014). Microfinance institutions in Burundi are subject to regulation and oversight by the Bank of the Republic of Burundi (BRB, 2012).

In Kenya, microfinance activities were unregulated until the Microfinance Act of 2006 and the microfinance deposit taking institutions regulations of 2008, despite the fact that Kenya has one of the most active microfinance sectors in sub-Saharan Africa with a variety of institutional forms and good infrastructure to serve the poor. Prudential rules for microfinance banks were published by the Kenyan Central bank and came into being on January 1<sup>st</sup>, 2013. These rules were designed to safeguard consumer deposits, control systemic risks, and ultimately improve the financial results of the banking industry (Mabeya et al., 2016). However, low liquidity is the primary factor in certain recent issues in the financial industry, inadequate capital, operational

deficiencies and poor financial reporting issues. For instance, the Kenyan Central bank placed Dubai Bank Kenya under receivership in 2015 because of what it described as substantial capital and liquidity issues. Due to what the regulator described as liquidity issues; the Chase bank was likewise placed under statutory protection on April 1, 2016, for a year (Kipruto et al., 2017). Effects of Prudential rules on the monetary performance of microlending organizations have been subject to several research studies in Kenya. However, the results are uneven and reveal informational gaps. According to certain research (Guthua, 2013; Sentero, 2013 and Majakusi, 2016), there is a favorable effect on financial performance. Nyanga (2015), however, also discovered a negative association between a bank's financial health and its level of capital.

### ***1.2 Statement of the problem***

Underwhelming financial performance is as a result of Kenya's strict prudential guidelines and general regulatory environment for microfinance banks. Microfinance practitioners have criticized the regulatory framework, which includes the 2006 microfinance Act and the microfinance regulations of 2008, for being too strict despite being intended to support the effectiveness and sustainability of microfinance banks (FSD, 2012). Banks that offer microcredit are created with the intention of enhancing and promoting direct participation of groups and people in well-established enterprises and improving their social economic condition by offering sustainable financial and social assistance. However, the microfinance industry has continued to suffer from poor performance since the first institution was granted a license by CBK in 2009 (Mung'aho, Ondiek, & Odhiambo, 2016). Studies conducted in Kenya on prudential guidelines and financial performance of microfinance, has not been thoroughly addressed thus the study sought to close this informational gap.

### ***1.3 Objectives of the Study***

The general objective of this study was to establish the effect of prudential regulations on financial performance of microfinance banks in Kenya while specific objectives were to determine the effect of capital adequacy requirements on financial performance of microfinance banks in Kenya, to determine the effect of liquidity management on financial performance of microfinance banks in Kenya, to evaluate the effect of operational requirements on the financial performance of microfinance banks in Kenya and to examine the effect of financial reporting requirements on financial performance of microfinance banks in Kenya.

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## **2.0. LITERATURE REVIEW**

### ***2.1 Theoretical Literature Review***

Public interest theory of regulation was developed by Pigou in 1938 and was adopted as the study's anchor theory. According to this theory, government must enact laws since everyone, has self-interest at their core (Hantke-Domas, 2013). The theory has been used to explain what government actually do as well as what they should be doing (Shleifer, 2015). It has also been used to justify a large portion of financial performance of microfinance banks and regulation during the last century. According to research by Mabeya et al. (2016) and Otieno et.al. (2013), the public interest theory of regulation is essential in explaining why government are necessary for regulation. This theory influences the general objective of the study on prudential regulations and financial performance of microfinance banks.

Buffer theory of capital adequacy is also relevant to the study. According to this theory, a bank nearing the minimum necessary capital adequacy ratio could be driven to obtain financing, mitigate risk and avoid the regulatory implications of capital violation. This theory is anchored on the breach of the both the capital adequacy ratio and the capital's trustworthiness and dependability of long-term planning. Another theory relevant to the study is the shiftability theory of liquidity. This theory was introduced by Moulton in 1918. According to this theory, banks can protect themselves from large-scale deposit withdrawals by using their reserves of credit instruments as a kind of liquidity that can be quickly sold on the secondary market. Treasury bills, commercial paper, and prime banker's acceptances are among the liquidity reserves. The instruments' short term to maturity and capital certainty makes them viable. Therefore, microfinance banks can reduce their exposure to liquidity risk, which has an impact on their financial performance, by keeping liquid assets with a ready market (Sheefeni, 2016).

### ***2.2 Empirical Literature***

#### ***2.2.1 Capital Adequacy requirements and Financial Performance***

Capital adequacy is the quantity of internal funds that a bank has on hand to sustain operations and serve as a safety net in the event of a bad event. MFBS need capital to provide liquidity since deposits are essentially depositors money that may be withdrawn whenever necessary (Dang, 2017). Higher capital levels compared to asset values guarantee that the microfinance have enough cash on hand to cover losses in the case of asset loss, or that there is enough amount of capital needed to absorb possible losses while maintaining financial sustainability (Adhikary, 2016). According to Kahiga (2014), Microfinance bank with enough capitalization may alert the market to the possibility of above-average performance.

#### ***2.2.2 Liquidity Management and Financial Performance***

The capacity of institution to fulfil demand for funds is referred to as liquidity management. When a microfinance bank is not able to satisfy its financial needs or its payments on time and efficiently, liquidity risk develops (Idama et al., 2021). Microfinance banks with insufficient cash may be more

vulnerable to unforeseen events in the future, timely refinancing delays, difficulties fulfilling growth strategies, and elevated portfolio risk (Brom, 2019). Every microfinance bank must create a daily fund plan to help with the matching of their daily cash withdrawals and inflows from loan repayment and savings deposits in order to minimize liquidity risk (Idama et al., 2021). Typically, the loan to assets ratio, which shows what proportion of total assets were utilized to make the loan, is used to assess MFB's liquidity position (Adhikary, 2016)

### 2.3 Study Gaps

The effect of Prudential guidelines on financial performance of microfinance banks have been subject to several research studies in Kenya. However, the results are uneven and reveal informational gaps. According to certain research (Guthua, 2013; Sentero, 2013 and Majakusi, 2016), there is a favorable effect on financial performance. Nyanga (2015), however, also discovered a negative association between a bank's financial health and its level of capital.

### 2.4 Conceptual Framework

The study sought to establish the effect of prudential guidelines on financial performance of microfinance banks in Kenya. The independent variables for this study included; capital adequacy requirements, liquidity management, operational requirements and financial reporting requirements while the dependent variable was financial performance of MFBs. Figure 1 below shows the relationship between dependent and independent variables.

#### Independent Variable

#### Dependent Variable

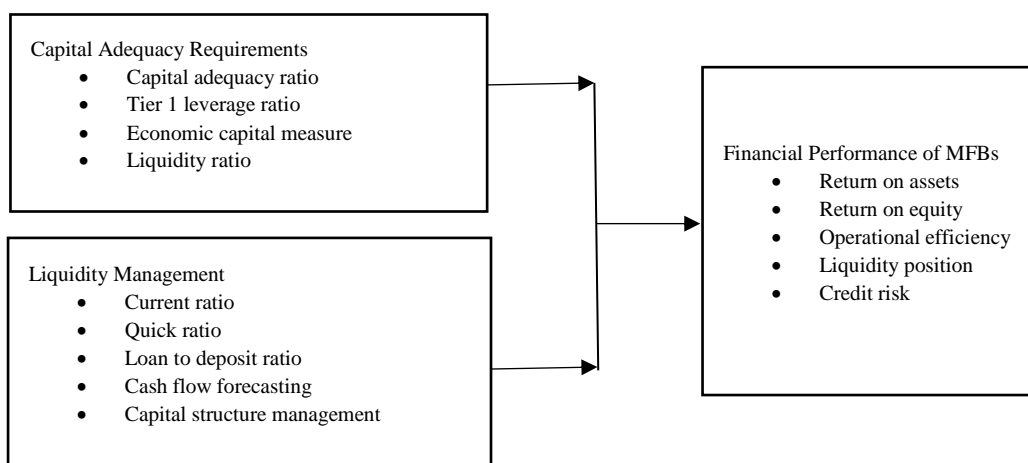


Figure 2.1: Conceptual Framework

## 3.0 METHODOLOGY

According to Bryman & Bell (2015), research design is the overall strategy you select to bring together the many elements of the study in a logical and cogent way, ensuring that the study topic is properly covered. This study used descriptive research design to investigate the effect of prudential guidelines on financial performance of microfinance banks in Kenya. Descriptive research design is cost effective since the components required for this design are found in the respondent's natural surroundings and are neither targeted nor specified (Creswell, 2015). The target population for this study comprised of 14 microfinance banks licensed by Central bank of Kenya as at May 19, 2022, and operated within Nairobi City County.

According to Marshal and Rossman (2019), sample is a subject within the population, use to draw conclusion about the entire group. Employees from finance, risk and compliance departments of the 14 licensed microfinance banks served as the study's unit of observation. The three departments were used since they were the most affected by the regulations. The study used census sampling technique which provided each participant from each stratum with equal chances of participation.

The researcher collected both primary and secondary data. The primary data was obtained by administering questionnaires to the respondents while the secondary data was collected from published sources such as the internet, library and research done by other scholars. Upon receipt of an introduction letter from the Management University of Africa and the research permit from National Commission for Science, Technology & Innovation (NACOSTI), the researcher distributed questionnaires to the respondents via email.

According to Zikmund (2014), data analysis is "the use of logic to comprehend the data acquired with the goal of detecting recurring trends and reviewing the pertinent information presented in the research." Coding, editing, entering data, and overseeing the entire data processing technique are all part of this process. Data gathered from the questionnaire was coded, tabulated, and analyzed using SPSS version 24 (Statistical Package for Social Sciences). Descriptive statistics (Percentages, Standard deviation and mean) were used to enumerate the features of the variables in the research and the inferential statistics (correlation and the model for linear regression) were employed to investigate how the dependent and independent variables were related. Data presentation was done through use of tables, charts and graphs.

By use of the empirical model, the multiple regression analysis was used in determining the relation amongst the variables used in the study.

The model for multiple linear regression was as follows;

$$Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \varepsilon$$

Where;

Y= MFBs financial performance of MFBs

X<sub>1</sub>= Capital sufficiency requirements

X<sub>2</sub> = Liquidity management

X<sub>3</sub> =Operational requirements

X<sub>4</sub> = requirements on financial reporting

$\varepsilon$  = Error term

$\alpha$ = continuous term

$\beta_1, \beta_2, \beta_3, \beta_4$  = The estimated regression coefficients for the independent factor X<sub>1</sub>, X<sub>2</sub>, X<sub>3</sub> and X<sub>4</sub>

## 4.0 FINDINGS AND DISCUSSION

### 4.1 Presentation of Research Findings

#### 4.1.1 Response Rate

The study targeted a sample size of 124 respondents, out of which 109 fully filled and returned the questionnaires making a response rate of 88% while 15 respondents (12%) failed to return or fully fill the questionnaires. According to Mugenda & Mugenda (2013), a response rate of 50% is deemed suitable, a response rate of 60% is good, and a response rate of 70% and more is deemed extraordinary. Therefore, the response rate of this study was deemed to be outstanding.

#### 4.1.2 Pilot Study Results

Taking into account each variable's Cronbach's alpha value, the researcher first performed pilot study to verify the feasibility and dependability of research instruments. The findings shows that capital adequacy requirement has a 0.889 Cronbach's Alpha Coefficient ( $\alpha$ ); liquidity management had a Cronbach's coefficient ( $\alpha$ ) of 0.915; operational requirements scored 0.954 while financial reporting requirements and financial performance had the Cronbach's Alpha Coefficient ( $\alpha$ ) of 0.942 and 0.968 respectively. Since the reliability results exceeds 0.7 lower level of acceptance. The study variables were appropriately measured by the internal consistency reliability metrics, which were deemed high and reliable for analysis and population generalization.

### 4.2 Demographic Information

findings revealed that 55% of the respondents were female and 45% male. This shows that gender distribution of the respondents was reasonably balanced. findings also revealed that majority of the respondents (40%) had university degree, 35% certificate/diploma education, 22% were post graduate, and 3% had PHD. This shows that participants had education required to respond to the questions with ease and good understanding of issues pertaining subject at hand. Moreover, Results show that 47% of the participants, who were the majority, had between six and eleven years of job experience, 33% had between 0 and 5 years of job experience, 15% between twelve to sixteen years, whereas 5% had worked there for seventeen years and above. These results are an indication that participants were long-term employees of the firm, hence they were more equipped to answer the questions with ease and convey accurate information about the study

### 4.3 Correlation Analysis

The findings of a matrix of correlation between the dependent factor (Financial performance of microfinance banks in Kenya) and the independent variables (capital adequacy, operational requirements, liquidity management and financial reporting requirements) are shown in table 1 below. The analysis divided the averages of each element's liquidity management, operational requirements, financial reporting requirements and capital adequacy requirements into independent variables. Pearson's correlation was then performed using 95% confidence interval and a 2-tailed confidence level of 5%.

**Table 1: Correlation Analysis**

		Y	X <sub>1</sub>	X <sub>2</sub>	X <sub>3</sub>	X <sub>4</sub>
<b>Financial performance of MFBs</b>	Pearson correlation	1				
	Sig. (2-tailed)					
	N	109				
<b>Capital adequacy</b>	Pearson correlation	0.769	1			
	Sig.(2-tailed)	0.032	0.00			
	N	109	109			
<b>Liquidity management</b>	Pearson correlation	0.911	0.531	1		
	Sig.(2-tailed)	0.018	0.026	0.00		
	N	109	109	109		
<b>Operational requirements</b>	Pearson correlation	0.725	0.432	0.327	1	
	Sig.(2-tailed)	0.028	0.012	0.017	0.00	
	N	109	109	109	109	
<b>Financial reporting requirements</b>	Pearson correlation	0.743	0.533	0.520	0.413	1.00
	Sig. (2-tailed)	0.041	0.009	0.002	0.014	0.00
	N	109	109	109	109	109

Table 2 above indicates that, the coefficient of 0.769 (Sig = 0.032) shows a strong link between capital adequacy (X<sub>1</sub>) and the financial performance of microfinance banks in Kenya, exists a significance positive correlation between the Kenyan microfinance banks' financial performance and liquidity management (X<sub>2</sub>) as indicated by a 0.911 coefficient (Sig= 0.018), the financial performance of Kenyan microfinance banks and operational requirements (X<sub>3</sub>) show a positive association, with a coefficient of 0.725 (Sig= 0.028), and a positive correlation between the financial performance of microfinance banks in Kenya and requirements of financial reporting (X<sub>4</sub>) as indicated by the 0.743 coefficient (Sig= 0.041). The findings demonstrate that every prudential guideline factor had an effect on Kenya's financial performance of microfinance banks. This is consistent with Mairura and Okatch's (2015) observation that the financial health of microfinance banks is affected by Prudential regulatory rules.

#### 4.4 Regression results

The study model's predictive power was determined using Adjusted R<sup>2</sup>, a coefficient of determination, and it was found to be 0.687 as shown in the table 3 below. Meaning, the variations in the capital adequacy, operating requirements, liquidity management, and requirements on financial reporting represent 68.7% of the variations in the Kenyan microfinance banks' financial performance.

**Table 2: Summary of a Regression Model**

Model	R	R Square	Adjusted R square	Std. error of the estimate
1	0.814	0.708	0.687	0.143

#### 4.5 ANOVA Results

**Table 4: ANOVA Results**

Model		Sum of squares	Df	Mean Square	F	Sig.
1	Regression	2.964	4	0.741	32.217	0.000
	Residual	1.291	56	0.023		
	<b>Total</b>	<b>4.255</b>	<b>60</b>	<b>0.764</b>		

The model F-value of 32.217 show that capital adequacy requirement, liquidity management, operational requirement and financial reporting requirements statistically and significantly affect financial performance which means, the regression model is good fit of the data and that all the variables significantly influence financial performance of Kenyan microfinance banks. The level of significance is 0.000 which is less than 0.05 hence the regression model significantly predicts the dependent variable.

#### 4.6 Regression coefficients.

**Table 3: Regression coefficients.**

	Unstandardized Coefficients		Standardized Coefficients	T	Sig.
	B	Std. Error	Beta		
(Constant)	0.713	0.293		3.095	0.003
Capital Adequacy	0.723	0.128	0.823	5.647	0.000
Liquidity management	0.876	0.350	0.386	2.834	0.006
Operational requirements	0.721	0.222	0.426	3.270	0.002
Financial reporting requirements	0.730	0.278	0.368	2.494	0.016

Source: Researcher (2023)

The study's established model was as follows;

$$Y = 0.713 + 0.723X_1 + 0.876X_2 + 0.721X_3 + 0.730X_4$$

According to the regression equation above, the effect of Kenya's microfinance banks' financial performance was 0.713 when all other factors (requirements on capital liquidity, liquidity management, operational needs and financial reporting needs) were held constant. A change in capital adequacy ( $X_1$ ) would increase MFBs financial performance by 0.723, holding other parameters constant; A change in liquidity management ( $X_2$ ) would result in an improvement in MFBs by 0.876, holding other parameters constant; A change in operational requirements ( $X_3$ ) would increase microfinance banks' financial performance by 0.721, keeping other variables the same and a change in financial reporting requirements ( $X_4$ ) would increase performance of MFBs by 0.730 all other factors held constant.

## 5.0 CONCLUSION AND RECOMMENDATIONS

### 5.1 Conclusion

The study concludes that capital adequacy has a substantial influence on the financial performance of microfinance banks. However, although there are signs of effort to maintain and improve capital adequacy, the report found that microfinance banks still encounter difficulties getting enough capital. On liquidity management, the study came to a conclusion that there is a positive relationship with financial performance of microfinance banks in Kenya. Moreover, the study concludes that financial performance of microfinance banks is significantly impacted by operational requirements. According to the study, Microfinance institutions perform less when prohibited from making loans to a single borrower that exceeds 5% of their core capital and the need that big exposure loans be kept to no more than 30% of an institution's basic capital. Lastly, the study came to the additional conclusion that financial reporting rules have a big effect on how well-off microfinance banks are. The research found that financial reporting is expensive and has an adverse impact on financial health of microfinance banks. Additionally, it was discovered that the daily financial reporting process has a detrimental effect on financial success as well as that the computer technology (IT) framework necessary for accounting reporting imposes needless expenditures on microfinance institutions.

### 5.2 Recommendations

The research suggests that, there must be measures in place to ensure that the minimum capital adequacy requirements for national microfinance banks are set at a level that all institutions can satisfy without experiencing financial hardship, more expenditures be made in creating more MFB networks in regard to liquidity management, such as inexpensive routes for the transfer of liquidity across institutions, which are linked to successful financial performance, highly marketable asset may also aid in boosting liquidity, as the theory claims, There should be plans in place to improve the microfinance industry's operational effectiveness through the use of cutting-edge technology and creative operational approaches that improve MFBs financial performance, and strong information technology infrastructure should be planned for by microfinance banks to support their financial reporting capabilities.

Since the study concentrated on the effect of prudential guidelines on financial performance of Kenyan microfinance banks, Further research can be done concentrating on other financial organizations, such as commercial banks. This will make it easier to see any noteworthy trends or variations for purposes of comparison and identifying generalization.

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