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Effect of Capital Requirements and Financial Performance of Commercial Banks in Kenya: A Case Study of KCB Bank Kenya Limited

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ABSTRACT:

This study investigates the relationship between capital requirements and the financial performance of commercial banks in Kenya, with a specific focus on KCB Bank Kenya Limited (KCB). Capital requirements, set by the Central Bank of Kenya (CBK), mandate a minimum level of capital that banks must maintain to mitigate risks and ensure solvency. The research explores how changes in capital requirements have impacted KCB's financial performance metrics, including profitability, liquidity, and capital adequacy. By analysing data over a defined period, the study aims to contribute to the ongoing discussion on the balance between regulatory requirements and bank performance in Kenya's evolving financial landscape.

Keywords: Capital Requirements, Financial Performance, Commercial Banks, Kenya, KCB Bank Kenya Limited, Central Bank of Kenya

Introduction

The Kenyan banking sector plays a crucial role in driving economic growth by facilitating financial intermediation. To ensure the stability and soundness of this sector, the Central Bank of Kenya (CBK) implements various regulations, including capital adequacy requirements. These requirements dictate the minimum amount of capital a bank must hold relative to its risk-weighted assets. Maintaining adequate capital provides a safety net for banks to withstand unexpected losses without jeopardizing their ability to operate, promoting investors confidence and encouraging prudent lending.

However, excessively high capital requirements can have negative consequences. Banks may be forced to restrict lending activities to meet capital requirements, potentially hindering economic growth. Increased capital holdings can lead to lower returns on equity (ROE) if banks struggle to generate sufficient income on their capital base.

KCB Bank Kenya Limited

Established in 1895, KCB Bank Kenya Limited (KCB) is a leading commercial bank in East and Central Africa. KCB offers a wide range of financial products and services for individuals, businesses, and institutions, including savings accounts, loans, mortgages, investment products, trade finance, and cash management. Their financial performance is generally strong, but a key factor is how they manage capital requirements set by the Central Bank of Kenya.

Statement of the problem

Commercial banks are crucial financial institutions and their changes in performance and structure have far-reaching implications on the economy (CBK, 2021). Banks are entrusted with an imperative responsibility to execute the economy by acting as intermediaries between the surplus and deficit units, making their job as mediators of critical significance for the efficient allocation of resources in the modern economy Commercial banks are crucial financial institutions that handle the movements of cash in any economy.

However, the overall performance of KCB Bank Kenya Ltd has not been satisfactory. KCB Bank market share has been decreasing over the years despite being ranked number one in total assets until 2021, when it was overtaken by Equity Bank Kenya Ltd. The market share of KCB Bank Kenya Ltd in 2018 was 14.40%, 13.89% in 2019, 14.05% and 13.81% in 2021. In addition, return on assets was 5.0 % in 2018, 4.9% in 2019 and 3.11% in 2020 (CBK, 2018, 2019, 2020, 2021). Thus, the conduct of the study could be worthy for policy formulation of the bank and other banks in the country.

The banking sector is among the most regulated sectors in any economy. Nonetheless, studies conducted have been contradicting each other. While some concluded that the regulatory reforms have had a positive impact on the performance of commercial banks, others have obtained a negative impact.

Vianney (2013) found out that there was no relationship between regulations and the financial performance of commercial banks. Based on this background, the study seeks to examine the effect of capital requirements on the financial performance of KCB Bank Kenya.

Literature Review

David Stern advanced the capital buffer theory in 1989 (Stern, 1989). The theory holds that banks' purpose in protecting extra capital than recommended. A capital buffer is an obligatory capital that monetary establishments are required to preserve in addition to different minimal capital necessities (Gudmundsson, et al., 2013). Regulations concentrating on introducing enough capital buffers are designed to limit the procyclical nature of lending by merchandising the advent of countercyclical buffers (Rafael &Javier, 2008). The capital buffer is the extra capital a financial institution holds above the minimum capital required. The capital buffer idea holds that extra capital tends to take in negative shocks and, for this reason, reduces the probability of failure (Dagher et al., 2016).

The theory has some weaknesses. For instance, the theory did not establish the precise amount of capital that banks need to hold more than recommended (Bockmeyer, 2021). In addition, Laeven and Levine (2008) note that the management of the banks can become unethical in setting the capital requirements if they are not regulated. The challenges of information asymmetry may arise in some instances. In addition, there is no guarantee that the excess capital held will increase the performance of an organization.

The theory is relevant to the current study. The government has the mandate to regulate the capital held by commercial banks through the capital requirement ratio (Gudmundsson et al., 2013). The concept emphasizes capital as a buffer to soak up shocks to earnings. A minimal quantity of capital is imperative to the viability of the bank. The concept applies to the modern-day as it reviews that a capital buffer is an obligatory capital that economic establishments are required to preserve in addition to different minimal capital requirements. Many studies propose that capital improves a bank's overall performance. This enables commercial banks to be resilient in face of any risks. Further, it enables commercial banks to be confident while doing business, which increases profitability in the long run. Hence, the theory supports variable capital requirements in the current study.

Related studies.

A study conducted by Almazari and Alamri (2017) to examine the effect of capital Adequacy on the profitability of banks in Saudi Arabia indicated that a positive correlation exists between capital adequacy and the return on assets. The study established that capital adequacy refers to the ratio of a bank's capital concerning its weighted risk assets and current liabilities. In addition, Mwai (2017) sought to examine the relationship between capital requirements and the financial performance of commercial banks in Kenya and found that capital requirements have a positive linear relationship with commercial banks' financial performance.

Furthermore, Nguyen and Pham (2020) indicated that capital requirement, interest rate and inflation rates had a positive and significant effect on commercial banks' profitability. Moreover, another study conducted by Gudmundsson, et al (2013), established that the progressive increase in a core capital requirement for commercial banks increases bank profitability. A study by Onyango (2018) established that the ratio of core capital to total assets had a negative and statistically significant effect on return on assets. The study determined that the ratio of core capital to total deposits had a negative but statistically insignificant effect on return on assets.

Furthermore, Emase (2017) indicated that capital requirements, interest rates, and inflation rates had a positive and significant effect on commercial banks' profitability. Moreover, another study conducted by Jackson (2017) on the factor that determines the profitability of the commercial banks in Kenya established that the progressive increase in a core capital requirement for commercial banks increases bank profitability. Moreover, Nyawira, et al (2017) examined the relationship between capital requirements and the financial performance of commercial banks in Kenya and found that capital requirements have a positive linear relationship with the financial performance of commercial banks. This meant that when capital requirements increase, financial performance increases as well.

In contrast, a study conducted by Ayaydin and Karakaya (2014) to examine the relationship between capital and profitability among commercial banks in Turkey found there is a negative relationship between capital and profitability. The results of the study indicated that supplementary capital does not have a significant effect on financial performance among commercial banks. Likewise, Wayiera (2017) conducted a study to look at the determinants of profitability of Commercial Banks. The results of the study showed that bank capitalization has a negative correlation with profitability, while bank size has a positive correlation with profitability.

Regression Analysis

ROA	Coef.	Std. Err.	t	P>t
Capital requirement ratio	0.21495	0.005485	39.19	0.001
Cash reserve ratio	1.36E-13	1.07E-14	12.74	0.006
Voluntary disclosure index	0.002438	0.000059	41.32	0.001

Constant		0.10577	0.004384	24.13	0.002
R squared=	0.6185				
F statistics=	1113.19				
P Value=	0.0009				

Source: Researcher (2022)

Based on the results presented in Table 4.0, the regression model becomes;

Y=0.10577+0.21495X1+1.36E-13X2+0.002438X3

Where;

Y= Financial performance (ROA)

X1= Capital requirements

X2= Reserve requirement

X3= Financial reporting disclosures

The regression results showed that the capital requirement ratio is positively and significantly related to the financial performance (ROA) of KCB bank Kenya (β=0.21495, p=0.001). This means that an increase in capital requirement ratio by one unit leads to an increment of the financial performance (ROA) of KCB bank Kenya by 0.21495 units holding other factors constant. Moreover, the results show that the cash reserve ratio is positively and significantly related to the financial performance (ROA) of KCB bank Kenya (β=1.36E-13, p=0.006). This implied that an increase in cash reserve ratio by one unit would lead to an increase in financial performance (ROA) of KCB bank Kenya by 1.36E-13 units holding other factors constant. Finally, the study results show that the voluntary disclosure index is positively and significantly related to the financial performance (ROA) of KCB bank Kenya (β=0.002438, p=0.001). This implied that an increase of the voluntary disclosure index by one unit would lead to an increase in financial performance (ROA) of KCB bank Kenya by 0.002438 units holding other factors constant.

Findings

The study found that the capital requirement ratio is positively and significantly associated with financial performance (ROA (r=0. 6810, p=0.000). The regression results showed that the capital requirement ratio is positively and significantly related to the financial performance (ROA) of KCB bank Kenya (β=0.21495, p=0.001). The study results agree with the findings of Almazari and Alamri (2017), who indicated a positive correlation between capital adequacy and the return on assets. In addition, Mwai (2017) found that capital requirements have a positive linear relationship with commercial banks' financial performance. Vianney, (2013). established that the progressive increase in a core capital requirement for commercial banks increases bank profitability. According to Mwai (2017), capital requirements have a positive linear relationship with the financial performance of commercial banks. Nyawira (2017) found that capital requirements have a positive linear relationship with the financial performance of commercial banks.

Recommendations

Based on the study's findings, it is recommended that KCB bank Kenya Limited needs to ensure it develops policies and frameworks that will increase the capital requirement. It was revealed that an increase in capital requirement by one unit leads to an increment of the financial performance (ROA) by 0.21495 units holding other factors constant. Increasing the bank's capital requirement can increase investment opportunities, thus significantly spurring financial performance. The capital requirements of the banks should not be decreasing at any point, but it needs to be increasing for the banks to have a higher performance level.

Conclusion

Capital requirement is positively and significantly related to the financial performance (ROA) of KCB bank Kenya. It was shown that an increase in capital requirement by one unit leads to an increment of the financial performance (ROA) of KCB bank Kenya by 0.21495 units holding other factors constant. Increasing a bank's capital requirements can form the foundation for enhancing and improving the overall financial performance. Expanding the bank's capital requirement can increase investment opportunities, thus significantly spurring financial performance.

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