The Effects of Capping Interest Rate on Profitability of Kenya Commercial Bank

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Abstract: The main purpose of this study was to investigate the effects of interest rate capping on banks profitability of commercial banks in Kenya with a case study of KCB Bank Kenya Limited, Nairobi. The paper used descriptive research design with time series data for the period September 2016 to December 2017 data gathered from the Kenya Central Bank. The data was subjected to stationarity test and necessary smoothening done. The multiple linear regression Model was used. The regression results showed that interest rate capping was negatively and statistically related to the bank’s profits at 5% level of significance. The paper therefore suggested that 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. Increase awareness and strengthening the Credit Reference Bureau.

Keywords: Capping interest rates, Risk borrowers, financial institutions

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I. Background of the Study

Kenya has got 42 commercial banks regulated by the Central Bank of Kenya. However 6% of the industry is regulated by the top six commercial banks in Kenya known as the tiers that include The Kenya Commercial Bank, Equity Bank of Kenya, National Bank, Cooperative bank, Standard Chattered Bank and Diamond Trust Bank of Kenya. They generate their revenues from the difference rates they charge i.e. the interest rate spread.

The Banking Act Bill 2015 compels commercial banks not to charge interest rates above 4.5% of what the Central Bank Charges meaning therefore that commercial banks will be charging 14.5% interest rates the lowest rates since Kenya liberalized its financial market. The interest rates in Kenya have been so high for decades making it hard for private investors.

The banks have been making billions after net tax; the paper seeks to find out the short term effects after the new banking act law that was implemented in 2016. The country joins a group of 40 developing, transitional countries and European countries including the estranged United Kingdom, Germany, and France that have capped their interest rates and reviewing it on quarterly basis. This move has been opposed by the Kenya Association of Bankers (KBA) stating that banks should be left with the autonomy of interest rate determination. The banks will then have to lend out money to individuals and institutions that have got securities at hand. However, the exponents of the amendment agree with bankers that interest rate ceiling could prevent naive and ignorant borrowers from agreeing to loan terms on which they will eventually default. Ceiling interest rates is a good way of limiting access to credit to some impaired and low-income consumers, because they aid any social harm that they could not be having a hint on. (Ramsey, 2013).

This situation will result into the risk borrowers to rely on the shylocks and other unauthorized money lenders for soft loans which eventually turn out to be very expensive (Helms and Reille, 2004). Therefore albeit good intentions by the government when the controlled interest rates are too low it makes it becomes costly lending small income earners. The investors also shy away from investing on the banks shares listed in the Nairobi stock exchange (Maimbo and Henriquez 2014).

In Zambia the policy was adopted by the Central Bank of Zambia in 2013 and capped interest rates for the commercial banks, microfinances, and all financial institutions to charge no more than 42% interest rates. This was a move to protect the consumers from high rates of borrowing most of the clients were locked of the credit accessibility, economic growth was deteriorating forcing the government to intervene. Despite the good move the ban never lasted long it was lifted in 2015.

Unfortunately, in the recent past many countries are moving away from this norm of controlling interest rates in order to have liberal financial policies or the price mechanism to operate in the financial sectors just like in the market goods and services.
Matu (2006) has attributed high interest rates to the poor performance of the commercial banks, low credit uptake by the lenders and the losses incurred by non-performing loans in a-bide to maintain the running cost of this financial institutions then they had to charge exorbitant rates.

1.2 Purpose of the Study
The major purpose of the paper was to investigate the effect of interest rate capping on financial performance of KCB Bank Kenya Ltd.

1.3 Importance of the Study
From the outcome of the study the banks will be at a better position to negotiate with policy makers on the issue of the interest rates. The study will be important to the government so as to evaluate whether capping interest rates will accelerate economic growth or not. The study is also expected to contribute to the existing body of knowledge.

1.4 Statement of the Problem
Several stakeholders have been affected with the new bank law either positively or adversely. Existing shareholders of bank stocks are some of the stakeholders that were bound to be affected by the new law. The move was lauded by some corporate institutions and the consumers hoped that the credit could be cheaply obtained (Aligomby, 2016). If commercial banks are not closely monitored by the CBK by instituting regulatory policies it may result into financial crisis like the case of Imperial bank and Chase bank in Kenya. Heavy depositors and share-holders have been unable to access their cash worse the two banks are winding up their operation in Kenya. It was highly anticipated by clients that the new law could make them access more credit easily pay less invest and contribute to the economic progress of the country but this has not been the case. The bank cannot issue any loan to risky customers who do not have collateral (Oloo, 2011).

Many studies have been done locally on the effects of bank performance and the interest rates charged. Ngari’ 2013 study found out a positive relationship between bank interest rates and the Rate of Return on Asset. The studies have looked interest rates on a broad perspective and have not captured the issue of the new law of capping interest rate deeply the paper examines whether the regulating the interest rate could increase credit uptake from the banks.

II. Literature Review
The chapter contains the theoretical model underpinning the research and some past studies done by different researchers in relation to the variable in the study.

2.1.1 Keynesian Theory of Interest rate Determination
The concept of liquidity preference refers to the demand for money. It was established by John Maynard Keynes to explain interest rate determination by demand and supply of money. The demand for money according to Keynes depends on the interest forgone by not holding the bonds. The demand for liquidity i.e. money being the most liquid-able asset depends on; the transactions of an individual that is daily buying and selling and this is dependent on an individual income. The precautionary motive this is due to unforeseen emergencies which demands extra costs. Finally, the demand of money for speculative motives people hold liquidity in an anticipation that the bond prices will fall. When the interest rates fall according to keynesian people will demand more money for investment purposes and other daily uses. When the interest rate rise due to central bank adjustments or floating exchange rate, the bonds prices will automatically reduce speculators will buy the bond and the cycle continues.

2.1.2 Effect of Interest Rate Capping On Bank Profitability
The main source of revenue in banks is profits made through interest rate differences on deposits and lending. Capping interest rates will therefore have a direct impact on revenue generation and has to be looked cautiously as the banks will have no option rather to slice down the number of employees if they do not generate enough money to cater for their operating costs.

Interest rate capping is a form of government control in the financial sector. Over the recent years, there has been a decline on the number of countries using this form of control mainly because most countries are aiming at having liberal financial policies. (Hester Peirce and Benjamin Klutsey, 2016)

Profitability and financial performance is measured by return on assets that shows how the management uses company’s assets to generate profits (Rug, 2013). Interest rates affect profits of banks directly (Aren & Duhn, 2016). Farl and Hurn (2007), found out that interest rates can affect bank profitability either directly or indirectly. When the interest rates are low as shown above from the Keynesian Theory more people are motivated to borrow and banks benefit more from increased interest earnings. Equally, high interest rates
discourage consumers from borrowing and this leads to reduced interest income generated and in turn reduced profits of the bank (Teern & Regina, 2011).

Regulation of the interest rates needs thorough investigation of the customer’s credit worthiness before advancing him a loan. Customers will be discouraged to seek loans from the formal sectors due to this long procedures and end up being paid little or no credit at all. A research that was conducted on Kuwait showed that the determinants of bank selection decisions made by the customers were a function of the banks attributes and the difference among the region in respect to these attributes. (Edris, 1997)

III. Research Methodology

3.2 Study area
The study area covered all branches of commercial banks in Nairobi. KCB Bank Group has the highest number of branches across East Africa, with over 250 branches. In Kenya, it has 192 Branches across its 47 counties which can be easily located.

3.3 Data types and sources
Secondary data was used in the study with the data obtained from the central Bank of Kenya

3.4 Research design
A research design is not only a work plan but rather the arrangement of conditions for collection and analysis of data in a manner that aims to combine relevance to the research purpose with economy in procedure while a work plan details what has to be done to complete the project but the work plan will flow from the project's research design. This paper adopted the use of descriptive case research design.

3.4 Specification of the Econometric Model

Y = $\beta_0 + \beta_1 X_1$

Where; Y = Banks profitability
$\beta_0$ = constant
$X_1$ = Interest rates

IV. Data Analysis
The study employed both inferential and descriptive statistics in the analysis. STATA statistical analysis software was used in data analysis.

V. Results and Findings
The chapter presents the findings of the study. The main objective of the study paper was to determine the effect of the capping of interest rates on the profitability of Kenya Commercial bank.

4.2 Estimated Empirical Model
The study used multivariate regression analysis in establishing this relationship. The dependent variable of the study was the gross profits by KCB while the independent variable was the interest rate the results from the regression analysis are as shown below.

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<th>Table 4.2.1: Model Summary</th>
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From the results in Table 4.12 above, it is clear that the interest rates explain 36.0% of the variance in profits made by banks. This indicates that the remaining variance that is unexplained by this independent variable is 64.0% which is explained by other factors.

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<thead>
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<th>Table 4.2.2: Model Coefficients</th>
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Banks always lend with the objective of increasing income from interest income that increases profitability. The study aimed at establishing whether the interest rate capping law increased the bank’s profits. The analysis above shows that there was a negative and statistically significant correlation between bank profitability and interest rates charged by the banks (p=0.005) at 5% level of significance. The regression output shows that a unit increase in the interest rate cap will result into 0.13 decrease in the in the profits generated by the Kenya Commercial Bank. The results collaborates with Scholz, Rochdi and Schaeferes, (2015) The equation derived from the above regression results will therefore take the form of

\[ Y = 4.068 - 0.046X1 + \varepsilon \]

VI. Discussion of the Finding

Regarding the effect of interest rate capping on bank profitability, the study established that interest rate capping had led to a decrease in the profits make by the banks.

When the government regulates the interest rates it can either affect the banks and customers either directly or indirectly. A research conducted by Hurn and Farl (2007), found out that interest rates affect bank profitability either directly or indirectly. The study established that bank profitability had not increased since the law came into effect. Banks are not likely to offer unsecured loans to individuals and organization and this leads to reduction in profits.

As a result of interest rate capping, interest capping, banks have declined offering unsecured loans to individuals and .The decrease in supply of credit having has effect on 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 will be affected. The investors will have limited amount to invest meaning very few job opportunities will be offered, the purchasing power of the consumers will decline and finally most firms will not be selling 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 resulted into establishment of loan loss provisions that rose with the coming into effect of the rate cap law.

5.2 Conclusion and Recommendations

The findings from the study output show that there is evidence to confirm that the coming into effect of the interest rate cap law has had an inverse relationship with the bank profitability. With the banks loosing so much revenue they have resorted into cost cutting measures that can be adopted by banks as they seek to cope with the effects of the interest rate cap to cope with high overheads and operating costs. One of the nasty ways has been laying off staff which has got drastic effects to both the economy and the dependents. Interest rate caps have ensued in a stoppage in credit growth in countries such as Nicaragua and Ecuador. To this extend the paper submits the following recommendations;

The government requires 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.

Consumer awareness to them financial literate

Credit risk should also be reduced in the market by strengthening the Credit Reference Bureau.

The banks should explore more adaptive ways of reducing their operational cost like adoption of modern technology in advertisement and offering other essential services other than lying off staff.

References