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Interest Rate Capping and Financial Performance of Commercial Banks in Kenya

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Abstract: *Interest rate caps can lead to financial exclusion and consequently affect the banks' performance. In some countries, interest rates regulation is done, especially when ordinary citizens and politicians view it as a remedy for poor economic development. The purpose of this research was to find out the effect of interest rate caps on the banks' performance in Kenya. Therefore, this study sought to test the following hypotheses: there is no significant difference in the mean banks' return on equity (ROE) before and after interest rate caps; there is no significant difference in the mean banks' growth in loan book during the pre and post cap periods. The study adopted a descriptive research design. The population of the study was 43 licensed banks that had been operating in Kenya in the pre and post cap periods. The study used a census sampling method and collected secondary data from the respective subjects' annual financial statements. Data analysis was conducted via the Statistical Package for Social Scientists (SPSS). The study used a paired-sample t-test to examine the research hypotheses. The mean ROE in the pre-cap period was 0.13 and ROE in the post-cap period was 0.07. There was a statistically significant difference in the scores for ROE before interest rate capping (M=0.13, SD=0.087) and ROE after the interest rate capping (M=0.07, SD=0.136) intervention; t (30) =3.174, p=0.003. Also, the study revealed that there was a significant difference in the scores for growth in loans before interest rate capping (M=15.56, SD=9.14) and growth in loans after the interest rate capping (M= -0.77, SD=11.33) intervention; t (30) =6.22, p=0.000. Interest rate capping impacted negatively on the banks' performance in terms of ROE and growth in loans. The government should, therefore, review the policy regarding interest rate regulation to enhance the country's economic growth.*

Key Words: *Interest rate capping, commercial banks, and financial performance*

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I. Introduction

The Kenyan interest rates cap came into effect in September 2016 due to the high cost of credit and predatory lending practices by banks (Safavian & Zia, 2018). Safavian and Zia argued that interest rate caps were meant to promote financial inclusion by availing affordable loans to more people and firms. The regulation of interest rates was intended to prohibit banks from charging interest on loans at more than 4% above the Central Bank Rate (CBK, 2018). Interest rate caps can result in financial exclusion and even make loans more expensive to clients (Maimbo & Henriquez Gallegos, 2014). In some African countries, interest rate caps are put in place, especially when ordinary citizens and politicians view it as a remedy to reduced economic development (Mbengue, 2013). Mbengue points out that placing a ceiling on interest rate may discourage financial institutions from operating in rural areas and make them reduce their transparency on the costing of loans.

Mbengue (2013) argues that an alternative measure like consumer protection should be adopted because it is effective in curbing bad lending practices. Some governments put a ceiling on interest rate upon realizing that financial institutions are making huge profits by overcharging their clients on loan products (Miller, 2013). Karlan and Zinman (2008) found out that in South Africa, a small increase in interest rate made the demand for loans by the unfortunate people fall significantly. Ekka, Wenner, and Campion (2010) found out that interest rate caps made microfinance institutions (MFIs) in Latin America and the Carribean reduce the provision of their services to rural customers. Also, Ekka *et al.* noted that in Nicaragua, the MFIs were regulated on the interest rates they were to charge their clients. The regulation made them exert pressure on the government to be allowed to load new or extra commissions on their financial services, and eventually, their request was granted. Zetzsche and Dewi (2018) argue that capping of interest rates may deny the poor access to finance. Ferrari, Masetti, and Ren (2018) opine that rate capping can result in reduced lending, opaque loan pricing, and reduced loan approval rates. Ferrari et al. found out that more than 76 nations in the world use interest rate caps, but the scope of capping varies from one country to the other.

Research shows that competitive markets are far much effective than artificial rate ceilings in regulating the financial institution from raising the price of a loan (Staten, 2008). Staten argues that a binding

rate ceiling reduces the amount of credit available to consumers. Ramsay (2010) analyzed interest rate ceilings and found out that though rate caps were practiced in France and not in the UK, still there was some financial exclusion in both countries. Ramsay argues that the presence or absence of ceilings does not solve the problem of financial exclusion, but it can be sorted out through alternative measures such as competition, better information, and product term regulation. Under the theory of a free-market economy, the forces of demand and supply are not affected by government intervention hence the prices of goods and services reach their optimum freely because there is no interference from government agencies (Popper, 2012). A study by Priti (2016) on the impact of interest rates regulation and exchange rates on the banks' stocks concluded that changes in the returns of stocks depend on changes in interest and exchange rates. In a free market, the prices of securities in the market are influenced by the forces of demand and supply (Ng'ang'a, 2017).

The study by Ng'ang'a (2017) on the effect of interest rate regulation on the banks' performance found out that interest rate spread significantly impacted on the performance of commercial banks (p=0.028). Ng'ang'a argued that the control of interest rates made the banks decline in their performance. Interest rate capping affected the banking industry in different ways. For instance, in 2017, it was revealed in the Central Bank of Kenya (CBK)'s report that 59% of the banks felt that the regulation of interest rates affected their performance in terms of profitability and growth of loans. As per the CBK findings, small banks' ROE and return on assets (ROA) declined to 19.8% and 2.3% respectively. Also, a further report revealed that the capping of interest rates led to rationing of credit to MSMEs, and this lowered the country's economic growth by 0.4% as of 2017 (CBK, 2018).

There are few comparative studies on the impact of interest rates regulation on the banks' performance. Also, some these studies have only investigated the association between rate capping and the banks' performance. For instance, a study by Ng'ang'a (2017) found out a significant association between interest rate and banks' growth. Amuhinda (2018) examined the effect of interest rate control on the banks' performance and found out that they excluded the micro-entrepreneurs and instead advanced credit to large institutions and government. Olukoye and Juma (2018) studied the effect of interest rate regulation on the performance of Equity bank. They found that the bank had rationed its loans to its clients since the law on capping became implemented. Therefore, little research has been done to contrast the banks' performance during the pre and post cap periods. Due to that, this study sought to bridge the aforementioned gaps by testing these hypotheses:

$H1_0$: There is no significant difference in the mean banks' return on equity (ROE) before and after interest rate caps

$H2_0$: There is no significant difference in the mean banks' growth in loan book before and after the interest rate cap

II. Methods

This research employed a descriptive research design. Through this approach, questions are well answered, and the characteristics of variables are adequately explained (Cooper & Schindler, 2006). The study population comprised of all the 43 licensed banks that had been operating in Kenya before and after the interest rate capping. By using the census approach, all the 43 banks were sampled for data collection. However, 12 banks were excluded because they didn't meet the inclusion criteria – six of them had been under receivership, and the rest's data weren't available on their online platforms. Hence, the actual sample size used was 31 licensed banks. The census method is appropriate when the population to be studied is very small (Sekaran & Bougie, 2016).

The study used annual secondary data from the banks' financial statements for the period 2014-2018. The banks' financial performance data for two years during the pre-cap and two years during the post-cap periods were considered. Therefore, the researcher collected data regarding the banks' ROE and growth in loans for the pre-cap period (2014 and 2015) and for the post-cap period (2017 and 1018). Data was entered and analyzed via SPSS. The research used descriptive statistics (mean and standard deviation) to explain the characteristics of the variables. The paired-sample t-test was used to establish if there was a significant difference in the bank's performance before and after the capping of interest rates.

III. Results And Discussion

The banks' ROE in the pre and post cap periods

From the results (Table 1 and Table 2), it was established that there was a statistically significant difference in the scores for ROE before interest rate capping (M=0.13, SD=0.087) and ROE after interest rate capping (M=0.07, SD=0.136) intervention; t (30) =3.174, p=0.003. Therefore, the null hypothesis that there is no significant difference in the mean banks' ROE in the pre and post cap periods was rejected. Also, it was noted that before the capping, the bank' performance was excellent with a mean ROE of 0.13, but after the regulation, their performance declined to a mean ROE of 0.07. This confirms that interest income contributes a lot to banks' profitability. The outcomes of this research are in line with Ng'ang'a (2017), who found out that interest rate spread had a significant impact on the banks' profitability (p=0.028). This study concurs with

Popper (2012), who argued that under the free market economy, the prices of goods and services reach their optimum freely because there isn't government interference. Also, the results of this research are consistent with the outcome of Okwany (2017), where 62% of the respondents reported that the commercial banks' profits declined after the law on interest rate regulation became effective. However, the findings of this study differ with Amuhinda (2018), who found out that interest rate capping had a significant positive impact on the banks' performance.

The banks' growth in the pre and post cap periods

The results (Table 1 and Table 2) show that there was a significant difference in the scores for growth in loans before interest rate capping (M=15.56, SD=9.14) and growth in loans after the interest rate capping (M= -0.77, SD=11.33) conditions; t (30) =6.22, p=0.000. Consequently, the null hypothesis that there is no significant difference in the mean banks' growth in loan book in the pre and post cap periods was rejected. From the findings, it was noted that before the capping policy, banks had been growing there loan books with an average of 15.56%, but after the capping, the mean growth of banks' loan books reduced to -0.77%. This implies that a quite number of banks might have slowed down their lending to some customers whom they considered to be risky. The results of this study confirm the CBK (2017) report which revealed that 59% of the commercial banks felt that the interest rate capping negatively impacted on their performance in terms of profitability and lending to SMEs and other sectors. The findings of this research are in tandem with the results of Olukoye and Juma (2018), where respondents agreed with a mean 4.12 that interest rate capping made banks to slow down lending to micro and small clients because they perceived them to be risky. Moreover, the results of this study are consistent with Kvwele (2018), who found a significant (p=0.000) association in the mean banks' interest income during the pre and post cap times.

Table 1: Paired Samples Statistics

		Mean	N	Std. Deviation	Std. Error Mean
Pair 1	Return on Equity Before Capping	.12589291	31	.087532764	.015721348
	Return on Equity After Capping	.07053372	31	.135717046	.024375501
Pair 2	Loan Growth Before Capping	15.56815921	31	9.137203392	1.641090175
	Loan Growth After Capping	-.77476025	31	11.333738095	2.035599454

Table 2: Paired Samples Test

		Paired Differences					t	df	Sig. (2-tailed)
		Mean	Std. Deviation	Std. Error Mean	95% Confidence Interval of the Difference				
					Lower	Upper			
Pair 1	Return on Equity Before Capping - Return on Equity After Capping	.0553	.0971	.017	.020	.091	3.174	30	.003
Pair 2	Loan Growth Before Capping - Loan Growth After Capping	16.343	14.628	2.6272	10.977	21.709	6.220	30	.000

IV. Conclusion

The study established that interest rate capping reduced the banks' ROE from an average of 0.13 to 0.70. Also, from the results, it was revealed that the intervention reduced the banks' average growth in loan books from 15.57% to -0.77%. Therefore, the study confirmed that the regulation of interest rate had a significant effect on the banks' performance.

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