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Caroline Waturi Macharia & Dr. John Mungai

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Financial Deepening and Financial Performance of Commercial Banks in Kenya

[1]*Caroline Waturi Macharia & [2]Dr. John Mungai

[1,2]Kenyatta University

***Corresponding author's e-mail: carolinemacharia09@gmail.com**

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Abstract

The collapse of some of the commercial banks in Kenya has raised concerns over the financial performance of the banking industry. Due to this challenge, stakeholders including creditors, depositors, employees and investors have incurred huge financial losses. The study sought to determine the effect of financial deepening on financial performance of commercial banks in Kenya. The specific objectives were; to examine the effect of interest rates, government policies, bank deposits and bank credit on financial performance of commercial banks in Kenya. It employed a descriptive research design. The study population comprised of all the 43 commercial banks in Kenya. The findings indicated that coefficient of bank deposits; bank credit and government regulations had a positive and significant effect on financial performance of commercial banks in Kenya. However, the effect of interest rate on financial performance was statistically insignificant. The study concluded that when combined, all the predictor variables except interest rate positively and significantly influence financial performance of commercial banks in Kenya. In particular, government policies were found to be the most significant predictor of financial performance, followed by bank credit, followed by bank deposits and lastly interest rate. The study recommended that commercial banks management should consider lowering the interest rates they charge on credit. This will enable more people to access loans and will also translate into increased financial returns. The Central Bank of Kenya should streamline banking policies in order to enhance performance of the banks. The banks management should develop effective savings mobilization strategies such as product development and marketing strategies. The management of commercial banks should widen their credit base and advance credit to more customers. This will ensure that they make more profits.

Keywords: *Financial deepening, financial performance, commercial banks in Kenya*

1.0 Introduction

Financial deepening assumes a vital element in deciding on the financial performance of Kenyan banks. It expands its asset base, raises the capital expected to stir speculation through investment funds and credit, and raises the general profitability. The plan and application of powerful mediations and projects in the Kenyan banking sector has prompted steady increase in monetary resources, where in 2013, financial intermediaries contributed 7.2 per cent to the Country's Gross Domestic Product (GDP). Nonetheless, commercial banks financial performance in Kenya, regardless of whether monetary growth or other parameters has been fluctuating for the past one decade with rate as low as 1.5 per cent in 2008 (Ongore, 2013).

Financial deepening involves an expanded proportion of cash supply to total GDP (Onyemachi, 2012). It is therefore, estimated by relating monetary and budgetary totals. The rationale here is that, the more liquidity of cash available in the economy, the more the chances for economic development. Financial Deepening (FD) can thus be characterized to be proportion of cash supply to GDP, is a component of household credit offered by banks as a proportion of gross domestic product, internal loan from the private sector, budgetary investment funds to gross domestic product, inflation and money outside banks to cash supply.

A high level of FD may influence the effectiveness and profitability of banks through competition. This would eventually result to more proficient capital distribution which expands the investment returns. Besides, FD converts the amount saved to business ventures in terms of investment which are facilitated by the banking institutions. Furthermore, FD expands the capital marginal productivity through the intermediation capacity of very much educated financial organizations (Gunu, 2010).

The analysis of commercial banks' financial performance has tremendously attracted interest from various scholars. In regard to assets, foreign banks represent around 35% as from 2011. In a nation where the money market is controlled by banks, any problems in the market significantly impact on their returns. This is because any liquidation that could occur in the market could result to crises in the financial sector and the economy at large (Arestis & Desli, 2011).

1.1 Statement of the Problem

Banking is the focal part of the financial sector in every economy; hence the strength of banking system becomes crucial in ensuring growth as well as favorable economic stability. Banks are the main component of financial services sector in ensuring favorable economic stability and growth (Koch & McDonald, 2013). However, the recent collapse of some of the commercial banks in Kenya is evidence that there is a serious financial performance problem (CBK, 2016). Due to this performance challenge, stakeholders including creditors, depositors, employees and investors have incurred huge financial losses.

The collapse of some of these banks has been linked to capital deficiencies. The affected banks have been breaching their daily Cash Reserve Ratio (CRR) requirement of 5.25 per cent (CBK, 2016). Further, the banks had failed to honor some of their financial obligations. Other causes of the collapse included failure by the banks to meet the statutory banking ratios and under-reporting of insider loans. Mismanagement was also noted as a key determinant of the banks closure. The collapse of the banks is an indication that there is financial performance problem in the banking sector. As a result, the banks are not able to meet their financial obligations. Additionally, failure by the commercial banks to make profit could be attributed to poor financial deepening. Thus, there is need to investigate the role of financial deepening in explaining financial performance of commercial banks in Kenya.

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Several studies have been conducted relating to financial deepening. Bakang (2015) analyzed the influence of financial deepening on the development of commercial institutions in Kenya. The study revealed a conceptual gap because it did not focus financial performance of commercial banks. Akomolafe (2014) investigated the relationship between financial deepening and economic growth Nigeria. The study revealed a conceptual gap since it concentrated on economic growth and not financial performance. Additionally, a contextual gap exists because the study was conducted in Nigeria and not Kenya. Kanyingi (2011) investigated the effect of financial deepening on economic growth in Kenya. However, the study presented a conceptual gap because it focused on economic growth and not financial performance. Most of these studies reviewed above did not focus on the role of financial deepening in influencing financial performance of commercial banks. It is on this premise that this study sought to fill the existing research gap by examining the effect of financial deepening on financial performance of commercial banks in Kenya.

1.2 Research Objectives

i. To determine the effect of interest rates and the financial performance of commercial banks in Kenya.

ii. To examine the effect of government policies on the financial performance of commercial banks.

iii. To assess the effect of bank deposits on the financial performance of commercial banks in Kenya.

iv. To analyze the effect of bank credit on the financial performance of commercial banks in Kenya.

2.0 Theoretical Review

This theory was proposed by Nanna and Dogo (1998) and illustrates that money related area progression prompts monetary advancement and finally to development of the economy which is based on the hypothetical system and is normally utilized to clarify a condition of an atomized monetary framework, that is, a budgetary framework which is to a great extent free from money related constraint (Nanna & Dogo, 1998). Financial deepening comes about because of the selection of suitable real financial approach, in particular in regard to real rates of profits and real stock of financing. Also, shallow budgetary framework is incompletely the outcome mutilations in procedure of fund. Money related intermediation of development takes into account the depth of finance.

Shaw (1973) argues that when there is increase in the size of the financial framework will create open doors for the gainful activities of different establishments, from bill merchants to industrial banks and insurance agencies. In its own particular right, financial deepening adds to development by enhancing the efficiency of speculation. This linkage confirms promote the positive pretended by money related progression on development Friedman (1998).

It is entrenched that an energetic, dynamic, and well-working monetary sector prompts a large group of enhanced financial results, as overviewed first by Levine (1997), at that point by DemirgucKunt and Levine (2008 and 2009), there is a tremendous writing demonstrating the advantages that collect to nations in which budgetary advancement is more prominent. On the hypothetical side, early work by Goldsmith (1969), among others, featured the key part in monetary improvement that could be played by a keeping money framework free of the sorts of controls on loan costs and amounts that were common at the time. As the writing advanced, it started to perceive that the monetary framework when all is said in done not solely banks performed four fundamental capacities basic to financial improvement and

development: assembly of investment funds, assignment of assets to profitable utilizations, encouraging exchanges and hazard administration, and applying corporate control. Through these capacities, a nation giving a situation helpful for more prominent monetary advancement would have higher development rates, with a significant part of the impact coming through more noteworthy profitability instead of a higher general rate of venture. Therefore, the financial deepening in this study advances the financial performance of commercial banks.

2.1 Empirical Review

Onyekachi and Okoye (2013) determined the effect of lending in bank on the development of the Nigerian deposit money banks for the period; 2000 to 2010. The study focused on determining the effects of lending rate and the financial policy on the development and how the lending rate in banks impacts the performance of deposit taking banks. The study employed the application of secondary data econometrics in regression. The findings established that the lending rate and financial policy has relevant and positive effects on the development.

Harash, Al-Tamimi and Al-Timimi (2014) study focused on the relationship between government regulations and the financial performance in SMEs in Iraq. It was established that 99% of the business ventures are the SMEs and that they are beneficial to the country's GDP and also they offer opportunities for employment. The researchers observed that despite the important role of played by the SMEs, their growth are mostly affected by various factors which include; the presence of laws and regulations and also the rules which hinder the growth of the financial sector.

Kanyingi (2011) conducted a study on the impact of financial deepening on the growth of the economy in Kenya. The study collected secondary data on all macroeconomic variables that affects financial deepening from 1997-2010. This included, GDP, economic growth rate, banks domestic credit to private sector, money supply and domestic financial savings. All the variables were found to have positive impact on economic growth. The study concluded that one of the ways of realizing financial deepening is through increased private credit to the economy. The study recommended the need for financial liberalization through deregulation of interest rates, removal of entry barriers and controls on bank credit allocation.

Okun (2012) studied the influence of deposits on banks monetary returns in Kenya. The empirical problem was whether there exists a link between the customer deposits and banks profitability. The results showed there was a significant and positive relationship between deposits Ratio and ROA. In his study he concluded that level of deposits, loans and level of total assets have consistently risen from over the period of study. It implied that measures of capital adequacy, efficiency and operational effectiveness had also improved over years. The study also concluded that loan ratio and deposit ratio had consistently declined since the year 2004 and the decline was because the total assets rose faster than the deposits and loans.

3.0 Research Methodology

The study adopted a descriptive research design. The study population comprised all the 43 commercial banks in Kenya. A census of all the banks was done. Secondary data was collected for a period of 11 years (2007-2017). The data was obtained from audited financial records of the commercial banks. The analysis of data was done using descriptive and inferential statistics.

4.0 Results and Discussion

4.1 Descriptive Statistics

This section provides descriptive results in relation to the study variables: financial performance, deposits, lending rates and bank credit.

Table 1: Descriptive Summary

Variable	Obs	Mean	Std. Dev.	Min	Max
Financial Performance	473	2.216554	8.14974	-32.15	160
Bank deposits	473	40521.31	62226.46	0	440164
Interest Rates	473	16.25981	2.414511	8.31	20.34
Bank Credit	471	30559.01	52782.58	40.57597	4116

From the results presented in Table 1, the mean for financial performance (ROA) over the estimated period was 2.216554 with a standard deviation of 8.14974. Further, the mean of bank deposit over the study period was Kes 40521.31 million with a standard deviation of 62226.46. In addition, the mean of lending rates was 16.25981 with a standard deviation of 2.414511. Finally, the average mean of bank credit was Kes 30559.01 million with a standard deviation of 52782.58. The results indicate that on average, the amount of bank deposits exceed the amount of credit given out by the commercial banks. Further, the average interest rate over the estimated period was 16.26%. The expectation is that bank deposits and bank credit will contribute towards increase in financial performance of the banks. On the other hand, interest rates are expected to lower the financial performance of the banks.

4.2 Correlation Analysis

This section provides results on the correlation between bank deposits, interest rates, bank credit, government policies and financial performance in terms of strength and direction. Table 2 shows the results.

Table 2: Correlation Matrix

		Financial performance	Bank Deposits	Interest Rates	Bank Credit	Government Policies
Financial performance	Pearson Correlation	1.000				
	Sig. (2-tailed)					
Bank Deposits	Pearson Correlation	.267**	1.000			
	Sig. (2-tailed)	0.003				
Interest Rates	Pearson Correlation	-.270**	-.554**	1.000		
	Sig. (2-tailed)	0.001	0.000			
Bank Credit	Pearson Correlation	.324**	.627**	-.661**	1.000	
	Sig. (2-tailed)	0.000	0.000	0.000		
Government Policies	Pearson Correlation	.351**	.293**	-.447**	.482**	1.000
	Sig. (2-tailed)	0.000	0.001	0.000	0.000	

** Correlation is significant at the 0.01 level (2-tailed).

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The findings in Table 2 indicate that bank deposits (r=0.267, P=0.003) had a weak positive and significant correlation with financial performance. This implies that increase in bank deposits is significantly associated with increase in financial performance of commercial banks.

The results also indicate that interest rates (r= -0.270, P=0.001) had a weak negative and significant correlation with financial performance. This implies that increase in interest rate is significantly associated with decrease in financial performance of commercial banks.

The findings further reveal that bank credit (r=0.324, P=0.000) had a weak positive and significant correlation with financial performance. This implies that increase in bank credit is significantly associated with increase in financial performance of commercial banks.

In addition, the findings show that government policies (r=0.351, P=0.000) had a weak positive and significant correlation with financial performance. This implies that improvement in government policies is significantly associated with increase in financial performance of commercial banks.

4.3 Multiple Regression Analysis

The main aim of the study was to examine the effect of financial deepening on financial performance of commercial banks in Kenya. Having established the existence of a significant association between each of the predictor variables (bank deposits, interest rates, bank credit and government policies) and financial performance, it was essential to establish how a combination of the four variables jointly affect financial performance. A multiple linear regression analysis was therefore carried out, where the predictor variables were regressed on the dependent variable. Tables 3, 4 and 5 provide model summary, ANOVA and coefficient results respectively.

Table 3: Model Summary; Financial Deepening and Financial Performance

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.402a	0.161	0.154	7.514

a Predictors: (Constant), Government Policies, Bank Deposits, Lending Rates, Bank Credit

Results in Table 3 indicate that all the four predictor variables in this study jointly explains 16% (R2= .161) of the total variations in financial performance. The R squared was relatively low implying that there are other factors that influence financial performance of commercial banks but were included in this study.

Table 4: ANOVA; Financial Deepening and Financial Performance

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	5064.311	4	1266.078	22.422	.000b
	Residual	26313.25	466	56.466		
	Total	31377.56	470			

The results in Table 4 indicate that the overall model was statistically significant. The results also imply that financial deepening elements are good predictors of financial performance of

commercial banks. This is confirmed by an F statistic of 22.422 and a report P value of 0.000<0.05 at 95% confidence level.

Table 5: Coefficients; Financial Deepening and Financial Performance

	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	-10.966	3.423		-3.203	0.001
Bank Deposits	0.466	0.233	0.106	1.994	0.049
Interest Rates	-0.065	0.246	-0.016	-0.262	0.793
Bank Credit	0.525	0.266	0.125	1.972	0.048
Government Policies	5.151	1.01	0.252	5.101	0.000

a Dependent Variable: ROA

The multiple regression results in Table 5 indicate that bank deposits (β= 0.466, P = .049); bank credit (β= 0.525, P =.048); and government policies (β= 5.151, P = .000) have a positive and significant effect on financial performance of commercial banks in Kenya. However, the effect of interest rate (P>0.000, 0.793) on financial performance is not statistically significant.

Thus, the hypothesized model: $Y_{it}= \beta_0 +\beta_1 X_{1it} + \beta_2 X_{2it} + \beta_3 X_{3it} + \beta_4 X_{4it} + \varepsilon_{it}$, now becomes:

$$Y=-10.966+0.466X2+0.525X3+5.151X4$$

Where;

Y = Financial performance of commercial banks

X_2 = Bank deposits

X_3 =Bank credit

X_4 = Government policies

From regression weights in Table 5, it is evident that all the independent variables except interest rate are significantly influencing the dependent variable in varying degrees. When all of them are combined in one model, the most significant predictor of financial performance is government policies (β= 5.151, P = .000), followed by bank credit (β= 0.525, P = .048), and then bank deposits (β= 0.466, P = .049).

4.4 Discussion of the Findings

The first objective of the study was to determine the effect of interest rates and the financial performance of commercial banks in Kenya. Regression results revealed that interest rates had a negative but insignificant effect on financial performance of commercial banks. The findings agreed with those of Ochanda (2014) who indicated that interest rate hinders the development of businesses. Similarly, Mwangi (2014) found that interest rate inflates the borrowing cost and this translates into reduced profitability.

The second objective of the study was to examine the effect of government policies on the financial performance of commercial banks. Regression results indicated that government policies had a positive and significant effect on financial performance. The findings revealed

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that a unit improvement in government policies would result to 5.151 units increase in financial performance of commercial banks. The findings disagreed with those of Harash, Al-Tamimi and Al-Timimi, (2014) who observed that laws and regulations hindered performance of organizations.

The third objective of the study was to assess the effect of bank deposits on the financial performance of commercial banks in Kenya. Regression results indicated that bank deposits had a positive and significant effect on financial performance. The findings revealed that a unit increase in bank deposits accounts for 0.466 units increase in financial performance.

The findings concurred with those of Ozurumba and Chigbu (2013) who found that deposits are important in the success of the banks. Okun (2012) also concluded that level of deposits, loans and level of total assets have consistently risen from over the period of study. It implied that measures of capital adequacy, efficiency and operational effectiveness had also improved over years.

The fourth objective of the study was to analyze the effect of bank credit on the financial performance of commercial banks in Kenya. Regression results indicated that bank credit had a positive and significant effect on financial performance. The findings revealed that a unit increase in bank credit accounts for 0.525 units increase in financial performance.

The findings were consistent with the work of Bakang (2015) who concluded that credit offered to the privates sector, commercial banks assets, liquid liabilities and the commercial-central bank assets has statistical significance on the impact of GDP. Further, Kanyingi (2011) established that one of the ways of realizing financial deepening is through increased private credit to the economy.

5.0 Conclusion

From the findings of objective one, the study concluded that interest rate has a statistically significant and negative relationship with financial performance of commercial banks. However, when combined with other variables, interest rate did not have a significant predictive ability to influence financial performance of commercial banks.

Based on the findings of objective two, the study concluded that government policies have a statistically significant and positive relationship with financial performance of commercial banks. Furthermore, when combined with other variables, government policies had a significant predictive ability to influence financial performance of commercial banks.

In line with the findings for objective three, the study concluded that bank deposit has a statistically significant and positive relationship with financial performance of commercial banks. Furthermore, when combined with other variables, bank deposit had a significant predictive ability to influence financial performance of commercial banks.

From the findings of objective four, the study concluded that bank credit has a statistically significant and positive relationship with financial performance of commercial banks. Furthermore, when combined with other variables, bank credit had a significant predictive ability to influence financial performance of commercial banks.

From the multiple regression results, the study concluded that when combined, all the predictor variables except interest rate positively and significantly influence financial performance of commercial banks in Kenya. In particular, government policies were found to be the most significant predictor of financial performance, followed by bank credit, then bank deposits and lastly interest rate.

5.0 Recommendations

In view of the foregoing conclusions, the study made several recommendations which are presented as per each research objectives. Based on the findings for objective one, interest rate had a statistically significant and negative relationship with financial performance of commercial banks. The commercial banks management should consider lowering the interest rates they charge on credit. This will enable more people to access loans and will also translate into increased financial returns.

Based on the findings for objective two, government policies had a statistically significant and positive relationship with financial performance of commercial banks. The study recommends that the CBK should streamline banking policies in order to enhance performance of the banks. Commercial banks should also ensure strict adherence with the banking policies. This is because non-compliance could have devastating effect on their financial performance. Failure to comply with the policies could results to penalties, which could adversely the profitability of the banks.

From the findings for objective three, bank deposits had a statistically significant and positive relationship with financial performance of commercial banks. The study recommends that the commercial banks should develop effective savings mobilization strategies such as product development and marketing strategies. This will ensure that the banks have enough savings inform of deposits, which they can re-invest in viable investment projects.

In addition, findings from objective four revealed that bank credit had a statistically significant and positive relationship with financial performance of commercial banks. The study recommends that management of commercial banks should widen their credit base and advance credit to more customers. This will ensure that they make more profits.

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