THE EFFECT OF FOREIGN BANKS ENTRY ON THE FINANCIAL PERFORMANCE OF LOCAL COMMERCIAL BANKS IN KENYA

BY

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DECLARATION

I hereby declare that this research project is my own work and effort and that it has not been presented in any other university for an award.

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Signature: ……... Date: ……

This Research Project has been submitted for examination with my approval as the University supervisor.

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Finally and most importantly, I wish to thank my God for bringing me this far. I pride in his name each day.

DEDICATION

This research project is dedicated to my parents Mr. & Mrs. Dicks and Mr. & Mrs. Odhiambo, my husband Holden and my siblings Peter, Maxi, Mercy, Teddy, Pauline, Josephine, Dickens and my friends for their love, support, patience, encouragement and understanding gave me the will and determination to complete my postgraduate studies.

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LIST OF ABBREVIATIONS

BOC	Bank of China Limited
CBK	Central Bank of Kenya
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
MFCs	Mortgage Finance Companies
NSE	Nairobi Securities Exchange
UK	United Kingdom
US	United States

ABSTRACT

The purpose of the study was to examine the effect of foreign banks entry on the financial performance of local commercial banks in Kenya. The adopted the descriptive design. The population of study consisted of all the 31 licensed local commercial banks that were dully registered with Central Bank of Kenya by December 2012. Secondary data was used in this study which included data on financial performance; determinants of financial performance as well as foreign bank entry were obtained from CBK and the published financial reports of the individual banks. The data collected covered the period between 2003 to 2012. Inferential statistics was adopted to analyze the data whereby regression model was adopted to show the relationship between foreign banks entry and the financial performance of local commercial banks. The study found out that entry of foreign banks have led to transfer of good banking practice and know-how, technology transfers from the foreign banks to the local banks which have improved efficiency in services, introduction or adoption of new products and the creation of improved competitive environments. The study concludes that foreign bank improves the profitability of local banks; the entry of foreign banks had also affected the costs of services in local commercial banks. The study recommends that the government should encourage more local banks to introduce strategic investors. The Kenyan government through the CBK should encourage and help local banks to improve partnerships with their existing foreign banks so that they can adopt new product and services from the foreign banks. There is need for the government to the eliminate barriers to entry of foreign banks into Kenyan market so as to attract more banks in the local market.

CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

In many emerging market economies, the presence of foreign banks has increased, especially during the 1990s. Several papers have investigated the effects of the increased presence of foreign banks on the domestic banking sector (Claessens, Demirguc-Kunt and Huizinga, 2001; Barajas, Salazar and Steiner, 2000; Denizer, 2000; Lensink and Hermes, 2003) and have found that foreign bank presence has effects on the performance of the domestic banking system by increasing competition in the banking sector and improving efficiency of domestic banks.

International banks have been active in the transition countries since the early 1990s, after a significant financial market liberalization and elimination of entry barriers. Growing foreign ownership in the banking sector raises an interesting question about the role played by foreign banks in transition economies. It is argued that liberalization significantly affect the degree of cross-border competition in the integrated banking sector's performance and efficiency (Claessens *et al*., 2001; Gual, 1999; De Brandt and Davis, 2000; Hasan *et al*., 2000; Berger *et al*., 2000). Levine (2001) analyzed the relationship between financial liberalization and banking efficiency, finding that greater presence of foreign banks enhances the efficiency of the domestic banking system by decreasing banks' overhead costs and profits.

In recent studies the main focus has been on how foreign banks entry affects the performance of domestic banks (profitability, costs and incomes, interest margins and loan loss provisions). There is a growing body of empirical studies to suggest that the overall economic success of a country is a positive function of the development of its financial sector, and of its banking system in particular. Recent studies have shown that countries with well-developed financial institutions tend to experience more rapid rates of real GDP per capita growth (Levine, 1997; Levine and Zervos, 1998; Rajan and Zingales, 1998). More importantly, empirical studies have disclosed the existence of a positive correlation between foreign ownership of banks and stability of the banking system (Caprio and Honahan, 2000; Goldberg *et al*., 2000).

1.1.1 Foreign Banks Entry

There continues to be growing interest in Kenya's banking sector by foreign banks. This interest supports Kenya's aspiration under Vision 2030 to be a premier regional financial services hub," said CBK in a statement. The entry of foreign players is believed to promote competition and diversify the current offerings of financial services. CBK has pledged to continue to provide an enabling legal and regulatory environment to spur the growth and stability of the banking sector saying a strong banking sector is expected to play a key role in financing Kenya's growth aspirations.

Table 1.1 Foreign Banks in Kenya

Category	Banks
Foreign owned not locally incorporated	• Bank of Africa (K), • Bank of India, • Citibank N.A. Kenya, • Habib Bank A.G. Zurich
Foreign owned but locally incorporated (partly owned by locals)	• Bank of Baroda (K) • Barclays Bank of Kenya • Diamond Trust Bank Kenya • K-Rep Bank • Standard Chartered Bank (K) • Ecobank Ltd, Gulf Africa Bank (K) • First Community Bank
Foreign owned	• UBA Kenya Bank Limited

For instance, Barclays Bank has been present in Kenya for over 90 years. However, the bank was licensed in its present form in 1953, according to the website of the Central Bank of Kenya. The shares of stock of Barclays Bank of Kenya are listed on the Nairobi Stock Exchange (NSE). The bank is a subsidiary of Barclays Bank Plc., an International financial services conglomerate, whose shares of stock are listed on the London Stock Exchange

Kenya continues to attract growing international interest from renowned international financial institutions as a preferred base for their regional operations. This presents unique opportunities for the Kenyan economy to be part of increasingly global financial markets. With more foreign institutions choosing Kenya as their regional base, the country draws closer to realizing its aspirations of being a regional financial hub as envisaged under the Government's economic blueprint, Vision 2030.

1.1.2 Measurement of Financial Performance

Performance of the banking sector was rated strong as institutions achieved satisfactory financial conditions and improved operations results despite high market competition as each of these institutions scramble for a significant market share. New products have been introduced in the market as a result of rising competition. The system remained well capitalized. Shareholders' funds, deposits and assets increased by 35.2 percent, 27.7 percent and 31.9, respectively (www.centralbank.go.ke). Foreign banks in Kenya control 40.3% of the market share in terms of assets, with Barclays and Stan chart controlling 30%. The first three banks to be formed in Kenya were Barclays, Kenya Commercial Bank and Standard Chartered bank. They are still the largest banks (CBK, 2011).

Financial soundness is a situation where depositor's funds are safe in a stable banking system. The financial soundness of a financial institution may be strong or unsatisfactory varying from one bank to another (DeYoung & Robert, 2001). External factors such as deregulation; lack of information among bank customers; homogeneity of the bank business, connections among banks do cause bank failure. Some useful measures of financial performance which is the alternative term as financial soundness are coined into what is referred to as CAMEL. The acronym "CAMEL" refers to the five components of a bank's condition that are assessed: Capital adequacy, Asset quality, Management, Earnings, and Liquidity. A sixth component, a bank's Sensitivity to market risk, was added in 1997; hence the acronym was changed to CAMELS. (Note that the bulk of the academic literature is based on pre -1997 data and is thus based on CAMEL ratings.) Ratings are assigned for each component in addition to the overall rating of a bank's financial condition (Jose, 1999).

Capital Adequacy ultimately determines how well financial institutions can cope with shocks to their balance sheets. The bank monitors the adequacy of its capital using ratios established by The Bank for International Settlements. Capital adequacy in commercial banks is measured in relation to the relative risk weights assigned to the different category of assets held both on and off the balance sheet items (Cornett, Everen & Tehranian, 2002).

Asset quality is also a common measure of performance in commercial banks. The solvency of financial institutions typically is at risk when their assets become impaired, so it is important to monitor indicators of the quality of their assets in terms of overexposure to specific risks trends in non- performing loans, and the health and profitability of bank borrowers especially the corporate sector. Credit risk is inherent in lending, which is the major banking business. It arises when a borrower defaults on the loan repayment agreement. A financial institution whose borrowers default on their repayments may face cash flow problems, which eventually affect its liquidity position. Ultimately, this negatively impacts on the profitability and capital through extra specific provisions for bad debts (DeYoung & Robert, 2001).

The continued viability of a bank also depends on its ability to earn an adequate return on its assets and capital. Good earnings performance enables a bank to fund its expansion, remain competitive in the market and replenish and /or increase its capital (Jose, 1999). A number of authors have argued that, banks that must survive need: Higher Return on Assets (ROA)., better return on net worth/Equity (ROE), sound capital base i.e. the Capital Adequacy Ratio (CAR), adoption of corporate governance ensuring transparency

to stakeholders that is equity holders, regulators and the public (Cornett, Everen & Tehranian, 2002).

Financial institutions may be driven toward closure by poor management of short-term liquidity. Indicators should cover funding sources and capture large maturity mismatches. An unmatched position potentially enhances profitability but also increases the risk of losses (Cornett, Everen & Tehranian, 2002). Generally, literature shows that Capital Adequacy, Earnings and Liquidity are the key dimensions of measuring financial performance in Commercial Banks.

1.1.3 The Effect of Foreign Banks on Financial Performance of Commercial Banks

There is significant debate surrounding the implications of foreign bank participation for developing countries. Supporters of this process argue that foreign banks can bring much needed capital as well as technical skills, and product innovation to developing countries. Also, they highlight the potential gains in terms of increased competition and improvements in the efficiency of the banking sector. On the other hand, the critics of foreign bank entry argue that foreign banks can destabilize the local banking sector due to a number of reasons. First, foreign banks can "import" shocks from their home countries and/or spread shocks from other developing countries in which they operate. Second, fierce competition with foreign banks can threaten the survival of the local banks. Finally, foreign banks can lead to reduced access to finance for a majority of domestic firms and consumers, if they only concentrate on a top and selected segment of the market (Denizer, 2000).

CBK is mandated to regulate banks in Kenya and to register any new or foreign bank. It also gives guidelines on the new entrants in the Kenyan banking sector. For instance In 2012, the Central Bank of Kenya (CBK) has granted authority to Bank of China Limited (BOC) to open a Representative Office in Kenya, BOC's first office in East Africa. The authority, issued pursuant to Section 43 of the Banking Act (Cap 488) will allow BOC to provide corporate and personal banking, investment banking, treasury and asset financing services. However, under the Banking Act, a representative office of a foreign bank in Kenya is not permitted to engage in banking business as defined in the Act but can only engage in marketing and liaison roles in connection with the activities of its parent bank and affiliates (www.centralbank.go.ke).

1.1.4 Commercial Banks in Kenya

In Kenya, the Banking Sector is composed of the Central Bank of Kenya, as the regulatory authority and the regulated; Commercial Banks, Non-Bank Financial Institutions and Forex Bureaus. As at 31st December 2012 the banking sector comprised 45 institutions, 43 of which were commercial banks and 2 mortgage finance companies. Commercial banks and mortgage finance companies are licensed and regulated under the Banking Act, Cap 488 and Prudential Regulations issued there under. Foreign Exchange Bureaus are licensed and regulated under the Central Bank of Kenya (CBK) Act, Cap 491. Out of the 45 commercial bank institutions, 33 are locally owned and 12 are foreign owned. The locally owned financial institutions comprises 3 banks with significant government shareholding, 28 privately owned commercial banks and 2 mortgage finance companies (MFCs). Of the 42 private banking institutions in the sector, 71% are locally owned and the remaining 29% are foreign owned (CBK report, 2012).

1.2 Research Problem

There is a common perception that foreign banks alleviate financial constraints, improve access to credit, and lower borrowing costs, thereby improving firm performance in host countries. Entering institutions often have access to a larger pool of capital, which potentially increases the supply of loanable funds to domestic firms. The resulting increase in local lending should relax financial constraints on firms' activities, which would then translate into higher real growth, the greater the foreign-bank presence. During local banking crises, this loan-supply" effect should be particularly valuable because foreign-owned lenders, which fund themselves through their parent companies, can continue to extend credit to firms, which otherwise face a credit crunch.

Several papers have investigated the effects of the increased presence of foreign banks on the domestic banking sector (among them, Claessens, Demirguc-Kunt and Huizinga, 2001; Barajas, Salazar and Steiner, 2000; Denizer, 2000; Lensink and Hermes, 2003) and have found that foreign bank presence has effects on the performance of the domestic banking system by increasing competition in the banking sector and improving efficiency of domestic banks. Some studies argue that foreign institutions with superior lending expertise can also exert competitive pressures on local banks, which might cut back their lending activities to an extent that the overall supply of credit falls. Whether foreign entry improves the availability of credit and lowers borrowing costs therefore depends on the competitive reaction of the local banking sector. If foreign banks exacerbate financial constraints on firm performance due to a retrenchment by domestic lenders a larger outside presence should lead to slower industrial growth. At the same time, entrants can suffer from adverse selection if local credit markets are informationally opaque and the

domestic banking sector holds the informational advantage (Dell'Ariccia and Marquez, 2004).

From the above literature, there are mixed reactions on the actual effect that entry of foreign banks has on local banks; moreover, the empirical evidence with respect to the effects of foreign bank presence on domestic bank behavior in Kenya is scarce as there is no known study that has been conducted in the Kenyan context to ascertain this. Hence this study sought to fill this gap by determining the effect of foreign bank presence and domestic bank performance. The question that the study sought to answer is, does foreign banks entry enhance financial performance of Kenyan local banks?

1.3 Objective of the Study

To examine the effect of foreign banks entry on the financial performance of local commercial banks in Kenya.

1.4 Value of the Study

The findings of the survey could be used by management in the banking industry to make appropriate decisions towards how to approach the financial markets as they would be aware of the impact that other entrants bring on the banking environment. They would also understand the benefits and setbacks brought forth by the entrant of foreign banks in the local market.

Future researchers and scholars may use the survey as a source of reference for further research on the same area. It is important to document the research findings for future

reference. Scholars would be keen to understand relationship between foreign banks entry and performance of local banks.

The government could be interested in finding out how the foreign banks that operate in Kenya impact on the local banks. This would help them in making policies to regulate new entrants into the Kenyan market as they would be aware of the possible benefits or threats it may pose to the local banks.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter is concerned with the review of literature related to the study. It covers the theoretical review, empirical review, and the conclusion. The literature touched on the effect that foreign banks entry have on performance of local banks

2.2 Theoretical Review

The Theoretical review seeks to establish some of the contributions that are attributed by other researchers, authors and scholars and are relevant to foreign banks entry and performance and/or behavior of local banks.

2.2.1 Institutional Theory

Institutional theory has its origin from the work of theorists thousands of years ago. Economist and Social theorist Max Weber focused on the ways bureaucracy and institutions were coming to dominate our society with his notion of the iron cage that rampant institutionalization created. However, the integrated perspective came from the work of Scott (1995), where he stated that "the institution provides stability and meaning to a firm's social behavior."

Institutional theory focuses on the deeper and more resilient determinants of economic actors' behavior. It considers the processes by which structures, including schemes; rules, norms, and routines, become established as authoritative guidelines for social behavior

and extends to explain economic interactions between several economic units of analysis. Different components of institutional theory explain how these elements are created, diffused, adopted, and adapted over space and time; and how they fall into decline and disuse. (http://en.wikipedia.org, 2010).

2.2.2 Kane's Theory of Regulatory Dialectic

Kane uses this model to explain most of the evolution that took place in the US during the 1960s and 1970s. The main force is the regulative dialectic between the federal banking regulation and the exogenous market forces such as technological change, changing banking environment and increasing uncertainty about future financial developments. He approaches innovation as an arbitrage instrument trying to take advantage of regulation lags. Innovation takes the form of product substitution in order to circumvent regulation sometimes by just rearranging contracts and by just simply moving along different financial systems (Kane, 1997).

Kane defines regulation's burden as a form of taxation imposed on banks. Banks' main concern during the 1970s was to avoid it. In order to attract customers despite the regulative burden, they used a mixture of means initially covering non-monetary benefits to indirect monetary benefits and at the end mainly monetary advantages. But on the other hand regulators developed their own defences and adopted new approaches resulting in the emergence, in the late 1970's and early 1980's, of a re-regulative action (Kane, 1997). Kane (l988a) explained in details his association and acceptance of the Hegelian concept of thesis (regulation), antithesis (loophole mining), synthesis (re-regulation), using examples from the US banking environment of the period 1960-1985.

A final point is that the final synthesis is going to be a new thesis and the process could go on infinitely. Kane's contribution is essential for the better understanding of the existence of dialectic between financial institutions and exogenous factors.

2.2.3 The Eclectic Theory

There are many theories which try to explain why firms start to internationalize. Although there is a growing body of literature on FDI, there is no comprehensive approach yet that would explain all different types of FDI. In line with the objectives of the analysis, we discuss that the most relevant theories are the ones which explain why banks at a certain stage of development start investing abroad, how it is executed and what implications the development of such activities has for the host market. It explains the reasons why firms decide to start investing abroad, what the preconditions (firm-specific advantages) are, where they invest (where are the location advantages complementing their ownership-specific advantages available), and why they select FDI out of many forms of foreign market entry (maximization of their rents). The important aspect of the OLI theory is that the location and ownership advantages are a necessary but insufficient condition for FDI. They should be complemented by internalization, which helps to take advantage of such conditions.

Dunning (1988) suggests that the three main types of international production, namely, market seeking, resource seeking and efficiency seeking can be explained by the endowment/efficiency paradigm. As for market seeking, the ownership advantage (Oa – asset advantages or Ot – transaction advantages) that can be exploited in the host country to get access to some specific market or resource defines the investment location. The market failure affects the location and internalization by risk distribution, several kinds of

market entry barriers and the oligopolistic market structure. The resource-seeking motivation of FDI considers market size and other characteristics at home and in the host country to get access to production resources. The efficiency seeking argument of FDI looks at economies of scale and scope, risk reduction through product diversification, and taxation.

In Dunning (1994) another FDI motivation is added – strategic asset seeking. Strategic asset seeking is a motivation for sequential FDI. The aim of the strategic asset seeking investment is to acquire resources that are important to enhance the capabilities and 3 advantages of an investor. It is complex integration of strategies that are to seek markets where the corporation's general objectives can be best performed. Yannopoulus (1983) applied an eclectic paradigm to the banking sector, suggesting that multinational banks have location-specific advantages which may include follow-the client, country-specific regulations, and entry restrictions. Ownership advantages can be, for example, easy access to vehicle currency. Internalization advantages can be informational advantages and access to local deposit bases. Ownership advantages are crucial in the eclectic framework, as it is the possession of these advantages that allows the foreign bank to overcome the advantages enjoyed by the domestic banks due to incumbency (Williams 1997).

2.2.4 Internalization Theory

The internalization theory of multinational banking has its origins in the Coase (1937) theory of a firm. The theory of internalization emphasizes the importance of transaction costs in imperfect markets. Market imperfection is a necessary condition for

internalization. Within the internalization framework, the knowledge advantage of a firm becomes a public good within the firm (Williams 1997).

The internationalization process of firms has been intensively studied since the 1960s. Due to the increase in international capital flows, foreign direct investments and international trade at that time, active development of international banking also began. In the transition countries, international banks have operated only since the beginning of the 1990s, after a significant liberalization of the financial market and elimination of entry barriers.

The application of internalization theory to banking presupposes the defensive approach of banks. The bank-customer relationships are unique and market knowledge about clients can be used at low marginal costs in internal markets. Growing foreign ownership in the banking sector raises several interesting questions about the entry process of foreign banks into transition economies. There are no generally accepted theories to explain the internationalization process of banks in the transition economies and its implications. The main reason for this gap in the literature is that foreign bank entry into emerging market has been actual only with the "third wave" of international banks' activities during the second half of 1990s (Herrero and Simón 2003).

2.2.5 Financial Intermediation Theory

Current financial intermediation theory builds on the notion that intermediaries serve to reduce transaction costs and informational asymmetries. Financial systems in many countries have undergone a dramatic transformation in recent years. Financial markets such as the stock and bond markets have grown in size using nearly any metric, such as

the value of companies listed or any other conceivable measure of their importance. At the same time, there has been extensive financial innovation accelerating in the 1970s and 1980s. This includes the introduction of new financial products, such as various mortgage backed securities and other securitized assets, as well as derivative instruments such as swaps and complex options (Berglof and Bolton, 2002).

Banks continue to play a major role as financial intermediaries in many economies (Bonin and Wachtel, 2003). As a result, the costs of financial intermediation services offered by banks remain crucial for the economic development. The observed massive increase of foreign bank participation during the last decade inevitably raises the question to what extent foreign entry has influenced bank interest margins, which is a commonly used measure of financial intermediation costs offered by banks.

Foreign ownership is not considered to be a determinant of interest margins according to the dealership model is that. This is in sharp contrast to a different stream of theoretical literature, which underscores the problem of asymmetric information between entrant (foreign) and incumbent (domestic) banks that might influence the margin. Foreign banks have better screening technologies to identify good borrowers based on *hard* information, while domestic banks possess superior soft information (Dell'Ariccia and Marquez, 2004). Differences in information distribution may result in a cream-skimming caused by foreign entry: in equilibrium foreign banks would focus on providing services to less risky and large borrowers, while domestic banks would concentrate their lending to more opaque and small firms (Sengupta, 2007).

Foreign entry can influence banks in host countries through various direct and indirect channels (Lehner and Schnitzer, 2008). One possible channel is spillover effects from foreign to domestic banks in terms of better screening facilities, technology utilization, and transfer of know-how. These indirect benefits from increased foreign bank participation should result in lower average unit costs associated with the financial intermediation process, reflected in lower equilibrium margins. Another possible channel is the increase in competition due to opening up of the banking market for foreign competitors.

2.3 Motivation for Foreign Banks Presence

Studies have emphasized the importance of economic opportunities in the host countries as a motivation for foreign bank entry. In this regard, there is ample evidence that foreign banks are drawn to larger, more vibrant economies, with greater profit opportunities. Early studies for the US and Japan demonstrated that foreign bank participation was linked to measures of real GNP and GNP per capita (Goldberg and Johnson, 1990; Yamori, 1998) and to more specific measures of banking sector activity such as the size and growth rate of the banking sector and the rate of domestic investment (Goldberg and Saunders, 1980; Goldberg and Saunders, 1981b; Goldberg and Johnson, 1990; Yamori, 1998). Cross-country studies have also shown that foreign bank participation is positively related to the host country's GNP (Claessens et al., 2000) and financial depth (Focarelli and Pozzolo, 2000).

Similarly, research on German banks indicates that these banks are drawn to markets with high levels of GDP and GDP per capita (Buch, 2000; Buch and Lipponer, 2004), while

foreign bank participation in Hong Kong and Korea is linked to growth in the local banking sector (Leung, Young, and Fung, 2008; Lee, 2003). The literature on the drivers of foreign bank participation has focused on four main sets of factors, namely: the desire of banks to follow their home customers abroad, the attractiveness of local profit opportunities in the host countries, the absence or elimination of barriers to foreign bank entry, and the presence of mechanisms to mitigate information costs of doing business in foreign markets.

2.3.1 Following Home Country Customers

Early studies on foreign bank entry have argued that an important motivation for banks to enter new markets is the desire to follow their customers overseas. In other words, they open operations outside of the home country to meet the needs of their clients with international operations. As evidence for this motivation, many of the early studies found a significant relationship between the level of foreign direct investment in the United States and the level of participation by banks from the country of origin in the U.S. banking market (Goldberg and Saunders, 1981a; Hultman and McGee, 1989; Goldberg and Grosse, 1994).

Subsequent studies found strong links between the participation of German banks in other countries and the level of German non-financial FDI in those countries (Buch, 2000; Wezel, 2004). Other studies have linked foreign bank participation to measures of bilateral trade (Goldberg and Saunders, 1980, Focarelli and Pozzolo, 2000) or general measures of trade openness such as the ratio of imports to GDP (Goldberg and Saunders, 1981b, Focarelli and Pozzolo, 2001). A number of studies find significant relationships

for both FDI and trade measures within the same econometric model of foreign bank participation (Goldberg and Johnson, 1990; Brealey and Kaplanis, 1996; Fisher and Molyneux, 1996).

A potential criticism of all of these studies is that FDI and trade are indirect measures, and thus not adequate proxies for the financial services provided by foreign banks to customers from their home countries that operate abroad. However, a similar conclusion is reached by studies using more direct data. For example, there is evidence that Japanese banks were more prevalent in countries where the demand for finance by Japanese manufacturing firms was high (Yamori, 1998). Also, the lending patterns of banks operating in the United States from Canada, France, Germany, Japan, the Netherlands, and the UK indicate that a sizable share of their portfolios went to home country borrowers (Seth et al., 1998). At the same time, banks from four of the six countries in the Seth et al. study allocated the majority of their loans to non-home country borrowers. And cross-country evidence indicates that the marginal effects of trade openness on the level of foreign bank participation are small (Focarelli and Pozzolo, 2001).

For these reasons, some researchers have argued that the follow the- customer hypothesis might be overemphasized in the literature. However, it could be that foreign banks start by serving customers from their country of origin and later branch out to pursue host country clients. Following customers abroad therefore could be an important, even necessary, first step on the way to fuller immersion in a new market. In that vein, Lee (2003) finds that after the Asian financial crisis, foreign bank participation in South Korea was largely determined by local economic growth and financial sector

development, whereas in the pre-crisis period foreign banks were primarily supporting clients from their home country.

2.3.2 Pursuing Opportunities in the Host Country

Along with the desire to serve home clients, studies have emphasized the importance of economic opportunities in the host countries as a motivation for foreign bank entry. In this regard, there is ample evidence that foreign banks are drawn to larger, more vibrant economies, with greater profit opportunities. Early studies for the US and Japan demonstrated that foreign bank participation was linked to measures of real GNP and GNP per capita (Goldberg and Johnson, 1990; Yamori, 1998) and to more specific measures of banking sector activity such as the size and growth rate of the banking sector and the rate of domestic investment (Goldberg and Saunders, 1980; Goldberg and Saunders, 1981b; Goldberg and Johnson, 1990; Yamori, 1998).

Cross-country studies have also shown that foreign bank participation is positively related to the host country's GNP (Claessens et al., 2000) and financial depth (Focarelli and Pozzolo, 2000). Similarly, research on German banks indicates that these banks are drawn to markets with high levels of GDP and GDP per capita (Buch, 2000; Buch and Lipponer, 2004), while foreign bank participation in Hong Kong and Korea is linked to growth in the local banking sector (Leung, Young, and Fung, 2008; Lee, 2003).

2.3.3 Fewer Regulatory Restrictions on Foreign Participation

Another obvious factor that has been shown to affect the level of participation by foreign banks is the existence of restrictions on foreign bank entry and on the activities that banks can pursue, as well as the burdens imposed by regulations and supervision in the host

country. Early studies pointed to the importance of specific pieces of legislation in spurring foreign bank participation such as the 1978 Banking Act in the United States and the Japanese Banking Act of 1982 (Goldberg and Saunders, 1981a; Hultman and McGee, 1989). Subsequent studies demonstrated that foreign bank participation is greater in markets where they face fewer regulatory restrictions on their activities (Goldberg and Grosse, 1994; Focarelli and Pozzolo, 2000; Buch, 2003; Buch and De Long, 2004; Buch and Lipponer, 2004; Galindo et al, 2003; Bertus, Jahera, and Yost, 2008) and lower taxes (Claessens et al., 2000).

Although financial regulation and the restrictions on the entry and activities of foreign are typically taken to be exogenous in the empirical literature, those outcomes are the product of a political process, one that is heavily influenced by external events such as crises. After the Asian financial crisis, for example, governments relaxed entry barriers both in that region (Montgomery, 2003) and more broadly throughout the developing world (Domanski, 2005). Post-crisis policy measures in Argentina, Brazil, and Mexico also led to rapid increases in foreign bank participation (Peek et al., 2000). In Mexico and South Korea foreign banks were brought in specifically to re-capitalize the banking sector post-crisis (Moreno and Villar, 2005). A review of crisis episodes in twelve countries concluded that foreign banks tended not to have substantial presence pre-crisis, but were brought in to act as rehabilitators of weak or failed banks ex-post (Tschoegl, 2005).

2.3.4 Mechanisms that Help Mitigate Information Costs

Another strand of the literature on the determinants of foreign bank participation examines the costliness of acquiring information on borrowers in a destination market.

Data from the top 100 multinational banks link greater foreign bank participation to the existence and quality of the credit reporting agency in the host country (Tsai et al, 2009). Another means of coping with informational asymmetry between lender and borrower is through ex-post enforcement in cases of default. Studies have shown that foreign bank participation levels are higher where there is less corruption and greater adherence to the rule of law (Galindo et al., 2003) and greater judicial efficiency (Focarelli and Pozzolo, 2000).

A final strand of the literature on how information costs affect the level of foreign bank participation emphasizes the roles of cultural similarity and geographic proximity. Cross-country evidence indicates that proximity between home and host country and a common language are associated with higher levels of foreign bank participation and greater likelihood of acquisition by a foreign bank (Buch, 2003; Buch and De Long, 2004). A common legal framework between home and host also coincides with higher levels of foreign bank participation (Galindo et al., 2003; Buch, 2003; Buch and De Long, 2004). A more recent study emphasizes that it is not the absolute physical or cultural distance between home and host but rather a relative comparison with distances for other foreign competitors in the host market that affects location decisions (Claessens and Van Horen, 2008b).

2.4 Empirical Review

2.4.1 International Evidence

Cho (1990) did a study on the foreign banking presence and banking market concentration on banks in Indonesia; he found out that foreign bank presence in Indonesia contributed to increased competition in the banking market.

The most comprehensive study on the efficiency and competition effects of foreign bank presence is provided by Claessens, *et al.* (2001). Using a large data set containing individual bank accounting information of domestic banks in 80 countries for the period 1988-1995, they show that increased presence of foreign banks is associated with reductions of profitability, non-interest income and overall expenses of domestic banks. Apparently, the competitive pressure of foreign banks leads to positive efficiency effects at domestic banks. Moreover, they find that these efficiency effects occur as soon as foreign banks enter the market; they do not seem to depend on the market share of foreign banks. Their conclusion is that foreign bank presence enhances efficiency and improves the functioning of domestic banks.

Denizer (2000) analyses the effects foreign bank presence has on domestic banks in Turkey. His empirical results show that net interest rate margins, returns on assets and overhead expenses of domestic banks decrease after foreign banks have entered the market. These findings support the idea that foreign banks put competitive pressure on the domestic banks in Turkey, despite the fact that these foreign banks had a market share of only between 3.5 and 5 per cent during the period 1970-1997.

Barajas, Salazar and Steiner (2000) carry out a similar analysis focussing on the Colombian banking system and using individual bank accounting data for the 1985-1998 period. Their study shows that foreign bank presence generally increases competition in the domestic banking system as evidenced by reduced intermediation spreads. Yet, foreign bank presence is also associated with a deterioration of reported loan quality among domestic banks. Moreover, administrative costs of domestic banks rise, possibly due to the fact that these banks have to upgrade their activities because of increased competitive pressure. Thus, in general foreign bank presence seems to be associated with an increase of costs for the domestic banking system of Colombia.

Lensink and Hermes (2003) focus on the short-term effects of foreign bank presence on domestic bank performance, using data of 990 banks for the period 1990- 1996. This paper investigates the short-term effects of foreign bank entry on the behaviour of the domestic banking sector. They argue that these effects are dependent on the level of economic development of the host country and show that at lower levels of economic development foreign bank entry is generally associated with higher costs and margins for domestic banks. At higher levels of economic development the effects appear to be less clear: foreign bank entry is either associated with a fall of costs, profits and margins of domestic banks, or is not associated with changes in these domestic bank variables.

Zajc (2002) analysed foreign banks entry effects on domestic banks in the Czech Republic, Estonia, Hungary, Poland, Slovakia and Slovenia for the period 1995–2000. His results are somewhat different from those presented by Claessens *et al* (2001). He found that foreign banks entry is associated with lower non-interest income but increases overhead expenses.

The main expected benefits and drawbacks from the entry of foreign banks are clearly defined by Bonin *et al*. (1998) (Dages *et al*., 2000; Doukas *et al*., 1998). The main expected benefits include: i). Introduction of new banking technology and financial innovations (for foreign banks it is relatively easy to introduce new products and services to the local market); ii). Possible economies of scale and scope (foreign banks can help encourage consolidation of the banking system, they] have knowledge and experience of other financial activities: insurance, brokerage and portfolio management services); iii). Improvement of the competitive environment (foreign banks represent potential competition to local banks); iv). Development of financial markets (foreign banks entry may help deepen the inter-bank market and attract business from customers that would otherwise have gone to foreign banks in other countries); v).Improvement of the financial system's infrastructure (transfer of good banking practice and know-how, accounting, transparency, financial regulation, supervision and supervisory skills); vi). Attracting foreign direct investments (the presence of foreign banks may increase the amount of funding available to domestic projects by facilitating capital inflows, diversifying the capital and funding basis).

The main arguments against foreign banks entry, however, are (Anderson and Chantal 1998, p. 65): i). Fear of foreign control (control over the allocation of credit implies substantial economic power in any economy); ii). Banking as an infant and special industry (this argument is a version of the general infant industry argument, and banks are subject to various special protections due to their central role in economy); iii).Foreign banks may have different objectives (foreign banks may be interested only in promoting exports from the home country or in supporting projects undertaken by home

country firms); iv).Regulatory differences (supervisors of the host country lose regulatory control and if the home country has weak bank supervision, this may lead to unsound banking in the host country).

The literature mentions several arguments why foreign bank presence (Cho, 1990; Stiglitz, 1994; Levine, 1996; Buch, 1997; Berger and Hannan, 1998) may influence domestic bank performance.1 First, the presence of foreign banks may stimulate domestic banks to reduce costs and increase efficiency of existing financial services through competition. In the presence of foreign banks domestic banks are pressured to improve the quality of their services in order to retain their market shares. This may improve the quality of existing financial services of domestic banks. In particular, foreign bank presence may put old-style banking practices under pressure. Moreover, increased competition may lead to lower interest rate margins and profits.

Second, foreign bank presence may lead to positive spill-over effects. To begin with, foreign banks may introduce new financial services. The introduction of these services may stimulate domestic banks to also develop such new services, improving the efficiency of financial intermediation of the domestic financial system. Moreover, foreign banks may also introduce modern and more efficient banking techniques that are new to domestic banks. These modern banking techniques may be copied. Additionally, foreign banks may help to improve management of domestic banks, especially if foreign banks directly participate in the management of a domestic bank, for example in the case of a joint-venture or a take-over. Foreign bank presence may also lead to improvements of bank regulation and supervision, since these banks may demand improved systems of regulation and supervision from the regulatory authorities in the recipient countries. This

may contribute to improving the quality of banking operations of domestic banks. All these spill-over effects may contribute to more efficient domestic banking practices, which may help to reduce costs.

Third, foreign banks may increase the quality of human capital in the domestic banking system in a number of ways. To begin with, if foreign banks import high-skilled bank managers to work in their foreign branches, local employees/bankers may learn from the practices of these foreign bank managers. Moreover, foreign banks may invest in training of local employees. Increasing the quality of available human capital for the domestic banking system may contribute to more efficient domestic banking practices, which may help to reduce costs.

Fourth, foreign bank presence has contributed to a reduced influence of the government on the domestic financial sector. This has reduced the importance of financial repression policies, such as interest rate controls, directed credit policies, etc. Governments in many transition and developing economies have used (and sometimes still use) this kind of policies. Several studies have shown that such policies may reduce the efficiency of banks (Fry, 1995). Thus, by breaking the role of government in domestic financial markets, foreign bank presence may also contribute to improving the efficiency of domestic banks.

Finally, foreign bank presence may also lead to higher costs for domestic banks. Most importantly, domestic banks need to incur costs to keep up with the large, highly reputed, international banks. Thus, for instance, they may need to make costs to implement new services, improve the quality of existing services and operations, and implement new

bank management techniques. Moreover, they may need to make costs first to upgrade their staff. Such costs need to be incurred, at least in the short run. In the longer run, costs of investments focused on implementing new services, improving the quality of existing activities, improving management, and the upgrading of staff should contribute to overall cost reductions of domestic banks.

There is also the experience of the impact of foreign banks' participation in different countries. For example, Dages *et al*. (2000) examined the lending patterns of domestic and foreign banks and found that foreign banks typically have stronger and less volatile lending growth than their domestic counterparts. They also found that diversity of ownership contributes to greater credit stability during times of turmoil and weakness of the financial system.

Weller (2000) showed that the entry of a larger number of multinational banks resulted in a lower credit supply by Polish banks during the early transition phase (1999). The benefits of increased foreign participation in the banking sector are discussed by Gruben *et al*. (1999), and Lardy (2001). Demirguc-Kunt *et al*. (1998) noticed that over the period 1988– 1995, and for a large sample of countries, entry by foreign banks was generally associated with a lower incidence of local banking crises.

An important issue for emerging market economies is whether the entry of foreign banks will contribute to the banking system's stability and being a stable source of credit, especially in periods of crisis. Mathieson and Roldos (2001) have pointed to two related issues: whether the presence of foreign banks makes systematic banking crises more or less likely to occur, and whether there is a tendency for foreign banks to "cut and run"

during a crisis. In general, it has been suggested that foreign banks can provide a more stable source of credit because the branches and subsidiaries of large international banks can draw on their parents (which typically hold more diversified portfolios) for additional funding. Large international banks are likely to have better access to global financial markets and the entry of foreign banks can improve the overall stability of the host country's banking system (stronger prudential supervision, better disclosure, accounting and reporting practice, etc.).

2.4.2 Local Studies

Some of the local studies conducted in this area include Simelane and Bongiwe, (2010) who investigated the effects of foreign bank presence on domestic banks performance in Kenya in 2010. The study used accounting data for 39 commercial banks in Kenya over the period 2002-2009 to investigate the effects of foreign bank presence on domestic bank performance. Secondary data was obtained from annual reports and statistical bulletins from Central Bank of Kenya (CBK) and Banking Survey. The results showed that foreign banks assets and foreign bank loans have a negative impact of domestic performance. The findings suggest that foreign presence is associated with greater efficiency and domestic banks have to give up a portion of their profits so as to maintain their market share.

In 2011, Nyango did a study on foreign entry strategies by Fina Bank in Kenya to enter into East Africa Region. The study adopted a case study research design. Data was collected from a broad number of the bank's senior management about the foreign markets that the bank is operating in different countries of East Africa. The study used

both primary and secondary data whereby the secondary data was obtained from various documents including the annual reports, strategic plan and end term evaluations to supplement primary data. The study established that Fina bank pursues policies and strategies aimed at entrenching its presence in the East African region and in doing this; the Bank benchmarks itself with best practice as per statute, prudential requirements and world class practices.

Muchina, 2011 also did a study on foreign market entry strategies used by Ecobank Kenya Limited to enter the Kenyan market. The study adopted a case study design and nine management staffs were chosen to take part in the study. Both primary and secondary data was used hereby secondary data was collected from the bank's publications, annual financial reports, journals and periodicals.

2.5 Summary of the Literature Review

Overall, the available empirical literature appears to conclude that foreign bank presence has effects on the performance of the domestic banking system through increased competition. It is less clear to what extent this also leads to improved efficiency, however: at least one study, (Cho (1990) reports increasing costs for banks after foreign bank entry. Another study shows (Lensink and Hermes, 2003) that in the short-run costs may go up, depending on the level of economic development of the recipient country. This seems to suggest that there may be a trade-off in terms of benefits and costs for domestic banks from foreign bank presence. This study will however examine the effect of foreign banks entry on the financial performance of local commercial banks in Kenya.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This chapter discusses the methodology that was adopted by the researcher in carrying out the study. The chapter also presents the population studied, the methods used to sample it, the instruments in data collection and procedures that were used in data analysis.

3.2 Research Design

In this study a descriptive survey was used. Descriptive research portrays an accurate profile of persons, events, or situations (Robson, 2002). Surveys allow the collection of large amount of data from a sizable population in a highly economical way. It allows one to collect quantitative data, which can be analyzed quantitatively using descriptive and inferential statistics (Saunders et al., 2007). Therefore, the descriptive survey was deemed the best strategy to fulfill the objectives of this study. Robson (2002) points out that descriptive study portrays an accurate profile of persons, events or situation. Furthermore, Chandran (2004) states descriptive study describes the existing conditions and attitudes through observation and interpretation techniques. These writer claim the descriptive research design is one of the best methods for conducting research in human contexts because of portraying accurate current facts through data collection for testing hypothesis or answering questions to conclude the study (Robinson 2002, Chandran 2004).

3.3 Study Population

"A population is an entire group of individuals, events or objects having common characteristics that conform to a given specification." (Mugenda & Mugenda, 2003: 9). According to Saunders (2003) the population is the full set of cases from which a sample is taken. The population of study consisted of all the 31 licensed local commercial banks that were dully registered with Central Bank of Kenya by December 2012.

According to Cooper & Schindler (2007) a census is feasible when the population is small and necessary when the elements are quite different from each other. When the population is small and variable, any sample we draw may not be representative of the population from which it is drawn. Therefore for the case of this study, it was appropriate for researcher to choose census method because the population was small and the institutions were easily assessable to be reached.

3.5 Data Collection

Data collection is gathering empirical evidence in order to gain new insights about a situation and answer questions that prompt undertaking of the research (Flick, 1998). Secondary data was used in this study. Data on financial performance, determinants of financial performance as well as foreign bank entry were obtained from CBK as well as the published financial reports of the individual banks. The data that was collected covered the period between 2003 to 2012. The study covered this period because the impact of the foreign banks entry was felt during this period with a lot of local banks adopting new financial innovations and technologies transfers from the foreign banks.

3.6 Data Analysis

The whole process which starts immediately after data collection and ends at the point of interpretation and processing data is data analysis (Cooper & Schindler, 2003). Chandran (2004), defines statistics as a discipline that provides the tools of analysis in research and one which refers to facts, information or data and to a system of data collection and analysis. Mugenda (2003) points out it as a process of bringing order, structure and meaning the mass information collected. Therefore, editing, coding, classifying and tabulating are the processing steps used to process the collected data for a better and efficient analysis.

3.6.1 Analytical Model

The regression analysis took the following form:

$$Y = a + B_1 X_1 + B_2 X_2 + B_3 X_3 + B_4 X_4 + B_5 X_5 + B_6 X_6 + \epsilon$$

Where: Y = Financial Performance- as measured by Return on Assets (ROA)

a= Constant to be estimated by the model.

B_i = Measure of sensitivity of variable i to changes in y.

X = X_1- capital adequacy ratio, X_2 - Costs of financial services X_3 – size and growth, X_4 - Efficiency of financial intermediation

X_5 = Assets of Foreign banks/ Total Assets; X_6 = Number of foreign banks/ Total number of banks

Є = Error term

Foreign bank entry was measured using the asset share of foreign banks as a share of total assets in the banking sector; this approach was used by Caessens et al (1998). The alternative way is using the number of foreign banks as a share of total number of banks in the banking sector (Claessens et al; 1998). On the other hand, efficiency was measured by total costs and the output.

The study conducted F- test to establish the significance of the independent variables while ANOVA was conducted to test the appropriateness of the model as whole.

CHAPTER FOUR

DATA ANALYSIS, FINDINGS AND INTERPRETATION

4.1 Introduction

This chapter presents the findings of the study based on the data collected from the field. The study sought to determine the effect of foreign banks entry on the financial performance of local commercial banks in Kenya. The study used the secondary data which included the balance sheets and profit and loss accounts of the commercial banks for a period of ten years, from 2003 to 2012.

4.2 Findings

A multivariate regression model was applied to determine the relative importance of each of the six variables with respect to financial performance of the local commercial banks. The independent variables were; capital adequacy (CA), Costs of financial services (CFS), Size and growth (SnG), Efficiency of financial intermediation (EFI). Foreign bank entry was measured by calculating Assets of Foreign banks/ Total Assets (AFB/TAB) and the number of foreign banks/ Total number of banks (NFB/TnB). The regression model was as follows:

$$Y = a + B_1 CA + B_2 CFS + B_3 SnG + B_4 EFI + AFB/TAB + NFB/TnB + \epsilon$$

Table 4.1: Model Summary for Year 2003

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	0.897(a)	0.805	0.681	4.223

a Predictors: (Constant), capital adequacy, costs of financial services, size and growth, efficiency of financial intermediation

Source: Research Findings, 2013

Adjusted R^2 is called the coefficient of determination and tells us how the financial performance of local banks varied with the capital adequacy, costs of financial services, size and growth, efficiency of financial intermediation as result of foreign banks entry. The value of adjusted R^2 is 0.681. This implies that, there was a variation of 68.1% of financial performance of local banks (dependent variable) with the independent variables (capital adequacy, costs of financial services, size and growth, efficiency of financial intermediation) at a confidence level of 95%.

Table 4.2: Coefficients Results for Year 2003

Model		Un standardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	5.833	3.156		1.839	0.000
	Capital adequacy	2.771	0.061	0.097	0.097	0.038
	Costs of financial services	-0.216	0.018	-0.094	-0.094	0.023
	Size and growth	0.358	0.311	0.090	0.090	0.078
	Efficiency of financial intermediation	0.574	0.418	0.097	0.097	0.037

a Financial performance of local banks

Source: Research Findings, 2013

From the data in the above table 4.2, there is a positive relationship between financial performance of local banks and the predictor factors which are capital adequacy, costs of financial services, size and growth, efficiency of financial intermediation. The following regression equation was established.

$$Y = 5.833 + 2.771\ CA - 0.216\ CFS + 0.358\ SnG + 0.574\ EFI$$

From the above regression model, holding capital adequacy, costs of financial services, size and growth, and efficiency of financial intermediation constant, financial performance of local banks would be 5.833. It was further established that a unit increase in capital adequacy would cause an increase in financial performance of local banks by a factor of 2.771, a unit increase in size and growth would cause an increase in financial performance of local banks by a factor of 0.358, a unit increase in efficiency of financial intermediation would cause an increase in financial performance of local banks by a factor of 0.574. However, a unit increase in costs of financial services would cause a decrease in financial performance of local banks by a factor increase of 2.771.

The study further shows that there is a significant relationship between financial performance of local banks and Capital adequacy ($p= 0.038 <0.005$), costs of financial services ($p= 0.023<0.05$), and efficiency of financial intermediation ($p=0.037<0.005$).

Table 4.3: Model Summary for Year 2004

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	0.798(a)	0.637	0.572	3.441

a Predictors: (Constant), capital adequacy, costs of financial services, size and growth, efficiency of financial intermediation

Source: Research Findings, 2013

Table 4.3 above shows that the value of adjusted R^2 is 0.572. This implies that, the independent variables (capital adequacy, costs of financial services, size and growth, efficiency of financial intermediation) explained of 57.2 % of financial performance of local banks at a confidence level of 95%.

Table 4.4: Coefficient's Results for Year 2004

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	3.441	3.156		1.839	0.000
	Capital adequacy	0.386	0.067	0.095	0.095	0.048
	Costs of financial services	-0.142	0.051	-0.091	-0.091	0.005
	Size and growth	0.215	0.411	0.094	0.094	0.913
	Efficiency of financial intermediation	0.374	0.518	0.093	0.093	0.014

a Financial performance of local banks

Source: Research Findings, 2013

From the summary model, the following regression equation was established

Y = 3.441 + 0.386 **CA** - 0.142 **CFS** + 0.215 **SnG** + 0.374 **EFI**

Holding capital adequacy, costs of financial services, size and growth, and efficiency of financial intermediation constant, financial performance of local banks would be 3.441. A unit increase in capital adequacy would cause an increase in financial performance of local banks by a factor of 0.386, also a unit increase in size and growth would cause an increase in financial performance of local banks by a factor of 0.215 while a unit increase in efficiency of financial intermediation would cause an increase in financial performance of local banks by a factor of 0.374. However, a unit increase in costs of financial services would cause a decrease in financial performance of local banks by a factor of 0.142.

Table 4.5: Model Summary for Year 2005

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	0.856(a)	0.733	0.624	4.605

Predictors: (Constant), capital adequacy, costs of financial services, size and growth, efficiency of financial intermediation

Source: Research Findings, 2013

A correlation value of 0.856 was established which shows a high relationship between dependent and independent variables. This is also shown by a coefficient of determination value of 0.624. The determination coefficient value indicates that the regression line accounts for 62.4% of the total observations. This is to mean, the independent variables (capital adequacy, costs of financial services, size and growth, efficiency of financial intermediation) explained 62.4% of the dependent variable (financial performance of local banks).

Table 4.6: Coefficient's Results for Year 2005

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	3.918	1.715		3.133	0.002
	Capital adequacy	0.579	0.057	0.095	0.093	0.026
	Costs of financial services	-0.200	0.063	-0.091	-0.094	0.035
	Size and growth	0.755	0.610	0.094	0.092	0.189
	Efficiency of financial intermediation	0.332	0.670	0.093	.091	0.031

a Financial performance of local banks

Source: Research Findings, 2013

The following regression equation was established:

Y = 3.918 + 0.579 **CA** - 0.200 **EFI** + 0.955 **SnG** + 0.332 **CFS**

The study established that holding all independent variables constant, financial performance of local banks would be 3.918. Further, a unit increase in capital adequacy would cause an increase in financial performance of local banks by a factor of 0.579, a unit increase in size and growth would cause an increase in financial performance of local banks by a factor of 0.755, while a unit increase in efficiency of financial intermediation would cause an increase in financial performance of local banks by a factor of 0.332. However, a unit increase in costs of financial services would cause a decrease in financial performance of local banks by a factor of 0.200.

The study further established that there was a significant relationship between financial performance of local banks and three of the variables: capital adequacy ($p=0.026<0.05$), costs of financial services ($p=0.035<0.05$), efficiency of financial intermediation ($p= 0.031<0.05$).

Table 4.7 Model Summary- Year 2006

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	0.778(a)	0.605	0.554	.31207

a Predictors: (Constant), capital adequacy, costs of financial services, size and growth, efficiency of financial intermediation

Source: Research Findings, 2013

From the regression model summary above, the value of adjusted R^2 (coefficient of determination) is 0.554. This implies that capital adequacy, costs of financial services, size and growth, efficiency of financial intermediation (independent variables) explained 55.4% of financial performance of local banks (dependent variable); the remaining 44.6% would be explained by other variables not included in the study.

Table 4.8 Coefficients Results- Year 2006

	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	2.821	0.604		4.673	0.000
Capital adequacy	0.157	0.110	0.191	1.424	0.165
Costs of financial services	-0.332	0.067	-0.717	-4.946	0.000
Size and growth	0.084	0.072	0.155	1.162	0.055
Efficiency of financial intermediation	0.034	0.106	0.040	0.322	0.049

a Dependent Variable: Financial performance of local banks

Source: Research Findings, 2013

The study shows that there was a positive association between the financial performance of local banks (dependent variable) and capital adequacy, size and growth, efficiency of financial intermediation (independents variables); however, the study shows a negative association between financial performance of local banks and costs of financial services. From the regression model, the following regression equation was established:

Y = 2.821 + 0.157**CA+** 0.332**CFS** - 0.084 **SnG** + 0.034 **EFI**

The study further established that at there was a significant relationship between financial performance of local banks and the predictors: costs of financial services p=0.000 (<0.005) and Efficiency of financial intermediation (p=0.049 <0.005).

Table 4.9 Model Summary for Year 2007

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	0.854(a)	0.729	0.689	0.257

a Predictors: (Constant), capital adequacy, costs of financial services, size and growth, efficiency of financial intermediation

Source: Research Findings, 2013

The value of adjusted R^2 is 0.689. This implies that the independent variables (capital adequacy, costs of financial services, size and growth, efficiency of financial intermediation) explained 68.9% of financial performance of local banks.

Table 4.10 Coefficients Results for Year 2007

	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	0.124	0.186		0.623	0.005
Capital adequacy	0.582	0.068	0.559	8.478	0.000
Costs of financial services	-0.232	0.043	-0.257	-3.676	0.000
Size and growth	0.114	0.024	0.139	2.115	0.084
Efficiency of financial intermediation	0.037	0.001	0.505	7.097	0.000

a Dependent Variable: Financial performance of local banks

Source: Research Findings, 2013

The regression analysis findings show that there is a positive relationship financial performance of local banks and the predictors; capital adequacy, size and growth, efficiency of financial intermediation but a negative relationship with costs of financial services. The established regression equation was:

Y = 0.124 + 0.582 **CA-** 0.232**CFS+** 0.114 **SnG** + 0.037**EFI**

The study also shows that there is a significant relationship between financial performance of local banks and the three predictors as shown; capital adequacy (p= 000<0.05), costs of financial services p= 000<0.05), and efficiency of financial intermediation (p= 000<0.05).

Table 4.11: Regression Model for Year 2008

R	R Square	Adjusted R Square	Std. Error of the Estimate
0.898a	0.806	0.735	0.546

a Predictors: (Constant), capital adequacy, costs of financial services, size and growth, efficiency of financial intermediation

Source: Research Findings, 2013

A correlation value of 0.898 was established which shows a high relationship between dependent and independent variables. This is also shown by a coefficient of determination value of 0.735. The determination coefficient value indicates that the independent variables (capital adequacy, costs of financial services, size and growth, efficiency of financial intermediation) explained 73.5% of financial performance of local banks.

Table 4.12: Regression Coefficients Year 2008

	Unstandardized Coefficients		**Standardized Coefficients**	**t**	**Sig.**
	B	**Std. Error**	**Beta**		
(Constant)	1.236	1.367		0.871	0.000
Capital adequacy	0.143	0.176	0.109	0.675	0.003
Costs of financial services	0.107	0.182	0.023	0.145	0.046
Size and growth	0.259	0.273	0.246	1.461	0.041
Efficiency of financial intermediation	0.376	0.246	0.256	1.601	0.057

a Dependent Variable: Financial performance of local banks

Source: Research Findings, 2013

The study shows that there is a positive association between financial performance of local banks and the predictors: capital adequacy, costs of financial services, size and growth, efficiency of financial intermediation. The following regression analysis was obtained:

Y = 1.236 + 0.143 **CA**+0.107**CFS**+ 0.259**SnG**+ 0.376**EFI**

The model shows that, holding all variables constant, the value of financial performance of local banks would be 1.236. A unit increase in capital adequacy would lead to a 0.143 increase in financial performance of local banks; a unit increase in size and growth would lead to a 0.259 increase in financial performance of local banks while a unit increase in efficiency of financial intermediation would lead to a 0.376 increase in financial performance of local banks. The study also established that there was a significant relationship between financial performance of local banks and the three variables as

shown; capital adequacy (p= 0.003<0.05), costs of financial services (p= 0.046<0.05), size and growth (p=0.041<0.05).

Table 4.13 Model Summary for Year 2009

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	0.797(a)	0.635	0.596	0.532

a Predictors: (Constant), capital adequacy, costs of financial services, size and growth, efficiency of financial intermediation

Source: Research Findings, 2013

The value of adjusted R^2 is 0.596. This implies that, the independent variables (capital adequacy, costs of financial services, size and growth, efficiency of financial intermediation) explained 59.6% of financial performance of local banks.

Table 4.14 Coefficients Results for Year 2009

Model	**Unstandardized Coefficients**		**Standardized Coefficients**	**t**	**Sig.**
	B	Std. Error	Beta		
(Constant)	2.221	0.402		5.481	0.000
Capital adequacy	0.565	0.094	0.652	5.832	0.001
Costs of financial services	-0.281	0.116	-0.070	-0.694	0.382
Size and growth	0.168	0.054	0.481	5.031	0.045
Efficiency of financial intermediation	0.398	0.080	0.524	4.212	0.000

a Dependent Variable: Financial performance of local banks

Source: Research Findings, 2013

The regression results show that there is a positive relationship between financial performance of local banks and the predictors: capital adequacy (0.565), size and growth (0.168), efficiency of financial intermediation (0.168) but a negative relationship with costs of financial services (-0.281). The following regression equation was established.

Y = 2.221+ 0.565 **CA-** 0.281 **CFS +** 0.168 **SnG+** 0.398**EFI**

The further result shows that there is a significant relationship between financial performance of local banks and three variables as shown; capital adequacy (p=0.000 <0.05), size and growth (p=0.045<0.05), efficiency of financial intermediation (p=0.000<0.05).

Table 4.15 Model Summary for Year 2010

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	0.887(a)	0.787	0.643	4.214

a Predictors: (Constant), capital adequacy, costs of financial services, size and growth, efficiency of financial intermediation

Source: Research Findings, 2013

Table 4.10 above shows the value of adjusted R^2 is 0.643. This implies that, there was a variation of 64.3% of financial performance of local banks with the four predictors (capital adequacy, costs of financial services, size and growth, efficiency of financial intermediation); this means the regression line accounts for 64.3% of the total observations.

Table 4.16: Coefficient's Results for Year 2010

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	3.312	1.715		3.133	0.000
	Capital adequacy	0.242	0.063	0.091	0.094	0.013
	Costs of financial services	0.564	0.057	0.095	0.093	0.000
	Size and growth	0.245	0.061	0.094	0.092	0.187
	Efficiency of financial intermediation	0.382	0.067	0.093	0.091	0.003

a Dependent Variable: Financial performance of local banks

Source: Research Findings, 2013

The study shows that, holding all variables constant, growth of commercial banks would be 3.312. There is a positive relationship financial performance of local banks and all the predictors; capital adequacy, costs of financial services, size and growth, efficiency of financial intermediation. The established regression equation for was

Y = 3.312 + 0.242 CA+ 0.564 CFS + 0.245 SnG + 0.382 EFI

The study findings for year 2010 further shows that there is a significant relationship between financial performance of local banks and three variables as shown; capital adequacy ($p=0.013<0.05$), costs of financial services ($p=0.000<0.05$), efficiency of financial intermediation ($p=0.003<0.05$).

Table 4.17 Model Summary for Year 2011

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	0.843(a)	0.711	0.667	0.276

a Predictors: (Constant), capital adequacy, costs of financial services, size and growth, efficiency of financial intermediation

Source: Research Findings, 2013

From the table above, the value of R^2 is 0.667. This implies that, the independent variable (capital adequacy, costs of financial services, size and growth, efficiency of financial intermediation) explains 66.7% of financial performance in local banks.

Table 4.18 Coefficients Results

	Un standardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	0.238	.186		0.623	0.535
Capital adequacy	0.178	.043	0.257	3.676	0.000
Costs of financial services	-0.487	.068	-0.559	-8.478	0.000
Size and growth	0.074	.024	0.139	2.115	0.063
Efficiency of financial intermediation	0.318	.001	0.505	7.097	0.000

a Dependent Variable: Financial performance of local banks

Source: Research Findings, 2013

The established regression that there was a positive relationship between financial performance of local banks and predictors: capital adequacy (0.178), size and growth

(0.074), efficiency of financial intermediation (0.318) and a negative relationship with costs of financial services (-0.487). The following regression model was established.

Y = 238 + 0.178 **CA**- 0.487**CFS +** 0.074 **SnG +** 0.318**EFI**

The study shows a significant relationship between adoption of financial performance of local banks and three factors as shown by the p values; capital adequacy (p= 0.000<0.05), Costs of financial services (P= 0.000<0.05), efficiency of financial intermediation (p= 0.000<0.05).

Table 4.19 Model Summary for Year 2012

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	0.763(a)	0.600	0.566	0.518

a Predictors: (Constant), capital adequacy, costs of financial services, size and growth, efficiency of financial intermediation

Source: Research Findings, 2013

The adjusted R^2 is called the coefficient of determination and tells us how the dependent variable varied with the independent variables. From the regression model summary above, the value of adjusted R^2 is 0.566. This implies that, there was a variation of 56.6% of financial performance of local banks with capital adequacy, costs of financial services, size and growth, efficiency of financial intermediation.

Table 4.20 Coefficients Results for Year 2012

Model	Un standardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	2.204	0.402		5.481	0.000
Capital adequacy	0.550	0.094	0.652	5.832	0.024
Costs of financial services	0.081	0.116	0.070	0.694	0.491
Size and growth	0.270	0.054	0.481	5.031	0.014
Efficiency of financial intermediation	0.415	0.080	0.524	5.212	0.000

a Dependent Variable: Financial performance of local banks

Source: Research Findings, 2013

The established regression that there was a positive relationship between financial performance of local banks and predictors: capital adequacy (0.550), costs of financial services (0.081), size and growth (0.270), efficiency of financial intermediation (0.415). When all variables are held constant, financial performance in local banks will be at 2.204. The following regression analysis was established:

Y = 2.204 + 0.550**CA+** 0.081**CFS+** 0.270 **SnG+** 0.415**EFI**

The regression model established that there was a significant relationship between financial performance of local banks and capital adequacy ($p=0.000<0.024$); size and growth ($p=0.014<0.05$); and efficiency of financial intermediation ($p=0.000<0.05$).

4.3 Interpretation of Findings

The study established that there was a positive relationship between financial performance of local banks in the year 2003. It was also established that there was a significant relationship between financial performance of local banks and capital adequacy, costs of financial services, and efficiency of financial intermediation. In the following year the study established that a unit increase in capital adequacy, size and growth and efficiency of financial intermediation would increase financial performance of local banks while costs of financial services would cause a decrease in financial performance of local banks.

In 2005, the established that there was a significant relationship between financial performance of local banks and capital adequacy, costs of financial services, efficiency of financial intermediation. Further in the year 2007, the study further found out that there was a positive relationship financial performance of local banks and the predictors; capital adequacy, size and growth, efficiency of financial intermediation but a negative relationship with costs of financial services. Moreover, the study established that there was a significant relationship between financial performance of local banks and the three predictors as shown; capital adequacy, costs of financial services, and efficiency of financial intermediation.

In the year 2009, the result shows that there is a significant relationship between financial performance of local banks and capital adequacy, size and growth, efficiency of financial intermediation. In the following year there was also a significant relationship between financial performance of local banks and capital adequacy, costs of financial services,

efficiency of financial intermediation. Lastly, in the year 2012, the study further established that there was a positive relationship between financial performance of local banks and predictors: capital adequacy, costs of financial services, size and growth, efficiency of financial intermediation. The study also established that there was a significant relationship between financial performance of local banks and capital adequacy; size and growth; and efficiency of financial intermediation.

CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

This chapter presented the summary of key data findings, conclusion drawn from the findings and recommendation made there-to. The conclusions and recommendations drawn were focused on addressing the effect of foreign banks entry on the financial performance of local commercial banks in Kenya.

5.2 Summary

In the year 2003, an adjusted R^2 value of 0.681 was established which shows that (independent variables) capital adequacy, costs of financial services, size and growth, efficiency of financial intermediation explains 68.1% of financial performance of local banks (dependent variable). It was also found out that there is a positive relationship between financial performance of local banks and the predictor factors which are capital adequacy, costs of financial services, size and growth, efficiency of financial intermediation. It was established that there was a significant relationship between financial performance of local banks and Capital adequacy ($p= 0.038 <0.005$), costs of financial services ($p= 0.023<0.05$), and efficiency of financial intermediation ($p=0.037<0.005$).

In the year 2004, the value of adjusted R^2 is 0.572. This implies that the independent variables- capital adequacy, costs of financial services, size and growth, efficiency of financial intermediation explained of 57.2 % of financial performance of local banks at a

confidence level of 95%. It was further established that, a unit increase in capital adequacy, size and growth and efficiency of financial intermediation would increase financial performance of local banks by a factor of 0.386, 0.215 and 0.374 respectively while costs of financial services would cause a decrease in financial performance of local banks by a factor of 0.142.

In the year 2005, the study established a correlation value of 0.856 which implies a high correlation between dependent and independent variables. The study further established a coefficient of determination value of 0.624 which indicates that the regression line accounts for 62.4% of the total observations. The study further established that there was a significant relationship between financial performance of local banks and three of the variables: capital adequacy ($p=0.026<0.05$), costs of financial services ($p=0.035<0.05$), efficiency of financial intermediation ($p= 0.031<0.05$).

In 2007, the study established a value of adjusted R^2 is of 0.689 which This implies that capital adequacy, costs of financial services, size and growth, efficiency of financial intermediation explained 68.9% of financial performance of local banks. The study further found out that there was a positive relationship financial performance of local banks and the predictors; capital adequacy, size and growth, efficiency of financial intermediation but a negative relationship with costs of financial services. Moreover, the study established that there was a significant relationship between financial performance of local banks and the three predictors as shown; capital adequacy ($p= 000<0.05$), costs of financial services $p= 000<0.05$), and efficiency of financial intermediation ($p= 000<0.05$).

In the year 2009, the value of adjusted R^2 was 0.596. This implies that, the independent variables (capital adequacy, costs of financial services, size and growth, efficiency of financial intermediation) explained 59.6% of financial performance of local banks. The study further established that there was a positive relationship financial performance of local banks and all the predictors; capital adequacy, costs of financial services, size and growth, efficiency of financial intermediation. The result further shows that there is a significant relationship between financial performance of local banks and three variables as shown; capital adequacy ($p=0.000 <0.05$), size and growth ($p=0.045<0.05$), efficiency of financial intermediation ($p=0.000<0.05$). In the year 2010, there was also a significant relationship between financial performance of local banks and three variables as shown; capital adequacy ($p=0.013<0.05$), costs of financial services ($p=0.000<0.05$), efficiency of financial intermediation ($p=0.003 <0.05$).

In the year 2012, the value of adjusted R^2 was 0.566. The study further established that there was a positive relationship between financial performance of local banks and predictors: capital adequacy (0.550), costs of financial services (0.081), size and growth (0.270), efficiency of financial intermediation (0.415). When all variables are held constant, financial performance in local banks will be at 2.204. The regression model established that there was a significant relationship between financial performance of local banks and capital adequacy ($p=0.000<0.024$); size and growth ($p=0.014<0.05$); and efficiency of financial intermediation ($p=0.000<0.05$).

5.3 Conclusion

The study concludes that foreign bank improves the profitability of local banks. Therefore, the profitability of Kenyan banks in general increases as more foreign banks penetrate in the Kenyan market. This positive influence can be attributed to technology transfers from foreign investors which have improved efficiency in services, introduction or adoption of new products and the creation of improved competitive environments.

It can also be concluded that foreign bank entry affect the costs of services in local commercial banks. One possible reason for this phenomenon is that, after allowing foreign investors to participate in local banks, costs increase. For example, local Kenyan banks might train staff to enhance their human capital, or might increase software and hardware investment in computer equipment to introduce cutting-edge technologies.

5.4 Recommendations for Policy

The government should encourage more local banks to introduce strategic investors. The Kenyan government through the CBK should encourage and help local banks to improve partnerships with their existing foreign banks so that they can adopt new product and services from the foreign banks. Possible steps might include making periodic reviews of the outcomes of cooperation, providing resources for staff.

The local banks together with the CBK as the regulator must realize that penetration of foreign banks is only an initial step in the improvement of local banks' performance and growth. Hence, there is need for the government to the eliminate barriers to entry of foreign banks into Kenyan market so as to attract more banks in the local market. More foreign banks in the local market will enhance competition and stability in the sector.

5.5 Limitations of the Study

In the pursuit for information, the researcher encountered a number of challenges. One of the challenges was lack of cooperation from some of the banks who were unwilling to give information. This study was dependent on financial statements and records from commercial banks but some banks were unwilling to give such information.

Another limitation was that, this study relied on secondary data from the banks. However, the secondary information did not paint a clear picture on the effect of foreign banks entry on the financial performance of local commercial banks in Kenya. There was need to collect primary data as well so as to get the banks' management opinion on the issue. Hence the study could not clearly a formidable conclusion by relying on secondary data only.

The third challenge was limitation of information given by the banks. Some banks were secretive or rather limited the information they gave out. However, the researcher explained to the banks authorities that the sought information was just for academic purposes and would not be released to third party. Some of this information was crucial for the study to make a formidable conclusion.

5.6 Areas for Further Research

This study concentrated on the foreign banks entry in Kenya. However, entry is dependent on some factors which may vary from legal, political institutions and economic factors. There is therefore need to conduct a further research to establish the factors that influence or affects the entry of foreign banks in Kenya.

This study depended solely on secondary data. This data however could not form a clear picture on the effects on foreign banks entry. The study recommends that future studies could also gather primary data from the staffs and the management so as to get their opinion on the effects on foreign banks entry.

Foreign banks come in with large capital, new bank management techniques with talented human resource, attractive and variety of products and services, and greater efficiency compared to domestic banks. There is need to conduct a study to establish the challenges that local commercial banks experience when competing with foreign banks and the strategies they cope they ensure that they also remain competitive in the market despite their limited capital and resources.

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APPENDICES

Appendix I: List of Commercial Banks

1. African Banking Corporation Ltd.
2. Bank of Africa Kenya Ltd.
3. Bank of Baroda (K) Ltd.
4. Bank of India
5. Barclays Bank of Kenya Ltd.
6. CFC Stanbic Bank Ltd.
7. Charterhouse Bank Ltd
8. Chase Bank (K) Ltd.
9. Citibank N.A Kenya
10. Commercial Bank of Africa Ltd.
11. Consolidated Bank of Kenya Ltd.
12. Co-operative Bank of Kenya Ltd.
13. Credit Bank Ltd.
14. Development Bank of Kenya Ltd.
15. Diamond Trust Bank Kenya Ltd.
16. Dubai Bank Kenya Ltd.
17. Ecobank Kenya Ltd
18. Equatorial Commercial Bank Ltd.
19. Equity Bank Ltd.
20. Family Bank Limited
21. Fidelity Commercial Bank Ltd
22. Fina Bank Ltd
23. First community Bank Limited
24. Giro Commercial Bank Ltd.
25. Guardian Bank Ltd
26. Gulf African Bank Limited
27. Habib Bank A.G Zurich
28. Habib Bank Ltd.
29. Imperial Bank Ltd

30. I & M Bank Ltd
31. Jamii Bora Bank Limited.
32. Kenya Commercial Bank Ltd
33. K-Rep Bank Ltd
34. Middle East Bank (K) Ltd
35. National Bank of Kenya Ltd
36. NIC Bank Ltd
37. Oriental Commercial Bank Ltd
38. Paramount Universal Bank Ltd
39. Prime Bank Ltd
40. Standard Chartered Bank Kenya Ltd
41. Trans-National Bank Ltd
42. UBA Kenya Bank Limited
43. Victoria Commercial Bank Ltd

Source: Central Bank of Kenya (CBK), 2012

Appendix II: Data for Specific Commercial Banks

Banks	Profit / (loss) after tax	Customer deposits
Barclays bank	5,524,802	126,407,913
Equity bank	3,910,283	50,334,525
Stan-Chart	3,250,813	76,898,456
KCB Bank	4,190,690	126,691,066
NIC Bank	1,037,681	35,238,381
Diamond Trust Bank	1,148,980	45,023,186
Housing Finance	136,427	10,063,830
Victoria Bank	116,815	3,581,692
CFC Stanbic	1,732,920	61,528,658
Prime Bank	330,347	15,661,930
Co-operative Bank	2,373,638	65,853,725
CBA	1,319,484	44,802,789
Credit Bank	54,049	2,773,917
Consolidated Bank	96,223	3,278,716
Imperial Bank Ltd	465,687	10,414,043
National Bank	1,240,610	34,277,654
Guardian Bank	29,493	4,585,517
Trans National	132,414	1,890,623
Southern Credit	1,825	4,105,695
I & M Bank	1,113,678	34,420,747
Bank of Baroda	832,011	15,164,904
Fina Bank	97,878	11,470,439
Fidelity Bank	42,190	3,778,298
City Finance Bank	(3,215)	164,364
Giro Bank	80,157	5,127,130
Bank of Africa	218,349	13,820,055
Family Bank	366,740	7,404,069
Development Bank	118,491	2,200,329
Chase Bank	169,185	7,146,814
Paramount Bank	36,725	2,109,482
Bank of India	377,593	10,211,095
Citibank	1,874,901	31,191,803
Equatorial bank	7,435	3,667,533
ABC Bank	147,964	5,339,269
Oriental Bank	48,526	1,314,415
Ecobank	68,920	8,341,460
Habib AG Zurich	157,487	5,372,743
Middle East	17,994	2,021,179
K-Rep	(348,571)	4,501,753
Habib Bank	98,216	3,024,234
Dubai bank	3,239	1,031,794
Gulf Bank	(281,351)	3,248,533
First Community	(224,813)	2,090,646

Appendix III: Financial Statements Of All Commercial Banks

PROFIT AND LOSS ACCOUNT	Totals	AVERAGE
	Shs. 000	Shs. 000
INTEREST INCOME		
1.1 Loans and advances	79,374,772	1,841,963
1.2 Government securities	20,425,007	474,890
1.3 Deposits and placements with banking institutions	5,983,990	138,854
1.4 Other	1,876,717	43,645
1.5 Total Interest income	**107,660,486**	**2,499,352**
INTEREST EXPENSES		
2.1 Customer deposits	27,122,727	630,464
2.2 Deposits and placements from banking institutions	2,813,603	65,409
2.3 Other	1,896,471	44,104
2.4 Total interest Expenses	**31,832,802**	**739,977**
NET INTEREST INCOME	**5,827,684**	**1,759,375**
OTHER OPERATING INCOME		
4.1 Fees and commissions income on loans & advances	10,249,524	238,361
4.1 Other Fees and commissions income	22,224,815	515,456
4.2 Foreign exchange trading income	13,292,019	308,373
4.3 Dividend Income	70,717	1,645
4.4 Other income.	6,020,417	140,010
4.5 Total Non-Interest Income	**51,857,492**	**1,203,844**
TOTAL OPERATING INCOME	**127,685,176**	**2,963,219**
OPERATING EXPENSES		
6.1 Bad and doubtful debts expenses	10,694,391	246,211
6.2 Staff costs	35,432,555	822,777
6.3 Directors' emoluments	1,077,234	24,763
6.4 Operating lease rental	3,598,597	83,322
6.5 Depreciation on property and equipment	4,590,152	106,476
6.6 Ammortisation charges	702,153	16,304
6.7 Other operating expenses	26,781,924	621,472
6.7 Total Operating Expenses	**82,877,007**	**1,921,324**
Profit/(loss) before tax and exceptional items	**44,808,170**	**1,041,894**
Exceptional items	(9,224)	(355)
Profit/(loss) before tax	**44,798,946**	**1,041,540**
Finance Cost	-	-
Share of associate profit	14,992	577
Profit before tax	**44,783,954**	**1,040,963**
Current tax	(13,101,913)	(304,595)
Deferred tax	683,400	15,873
Minority Interest	-	-
Profit / (loss) after tax	**32,365,441**	**752,241**
AUDITED FINANCIAL STATEMENTS		
I BALANCE SHEET	**Totals**	

A. ASSETS	**Shs. 000**	
1. Cash (both Local & foreign)	30,950,249	717,167
2. Balances due from central of Kenya	65,660,835	1,526,223
3. Government securities	181,165,577	4,213,153
4. Foreign Currency Treasury Bills and Bonds	7,493,401	174,265
5. Deposits and balances due from banking institutions	32,916,644	760,341
6. Deposits and balances due from banking institutions abroad	87,851,506	2,041,763
7. Government and other securities held for dealing purposes	33,415,066	775,716
8. Interest receivable and other assets	-	-
9.Tax recoverable	350,096	8,142
10. Loans and advances to customers (net)	669,721,681	15,552,661
11. Investment securities	4,041,054	93,978
12. Balances due from group companies	38,250,926	889,556
13. Investments in associates	2,074,817	48,252
14. Investments in subsidiaries	110,965	2,581
15. Investment properties	1,110,758	25,832
16. Property and equipment	34,258,322	795,813
17. Intangible assets	6,202,131	144,138
18. Prepaid Operating Lease	1,720,473	40,011
19. Deferred tax asset	3,392,197	78,888
20. Retirement benefit asset	2,020,309	46,984
21. Other assets	35,577,957	823,743
19.TOTAL ASSETS	**1,238,284,965**	**28,759,205**
B. LIABILITIES		
19. Customer deposits	912,079,801	21,187,163
20. Deposits and balances due to Local banking institutions	29,055,036	675,699
20. Deposits and balances due to Foreign banking institutions	39,732,170	924,004
21. Balances due to Central Bank of Kenya	106	2
22. Other money market deposits	195,806	4,554
23. Borrowed funds	17,140,071	398,606
24. Balances due to group companies	22,219,513	516,733
25. Interest payable and other liabilities	51,164	1,190
26. Tax payable	2,830,434	65,789
27. Proposed dividends.	117,189	2,725
28. Deferred tax liability	677,010	15,743
29. Retirement benefit liability	169,612	3,944
34. Other liabilities	44,099,125	1,021,029
30. TOTAL LIABILITIES	**1,068,367,036**	**24,817,181**
C. SHAREHOLDERS' EQUITY	-	-
31. Paid up/Assigned capital	53,806,252	1,242,881
32. Share premium	35,202,263	818,657
33. Revaluation reserve	3,827,876	89,020
revaluation reserve available for sale securities	(247,163)	(5,748)

34. Retained earnings	60,568,096	1,407,777
35. Proposed dividends	8,463,365	196,822
42. Capital grants	1,617,351	37,613
36. Translation reserves	40,150	934
37. Statutory loan reserve	4,643,633	107,647
38. Fair value reserve	-	-
39. Shareholders loans/grants	-	-
40. TOTAL SHAREHOLDERS' EQUITY	**167,921,823**	**3,895,603**
Other Balance Sheet Ratios		
Non Earning Assets to Total Assets	12.60	12.59
Government securities to Total Assets	14.63	14.65
Loans to Total assets	54.08	54.08
Net Fixed assets/core capital	28.48	28.53
Net Fixed assets/Total Assets	3.27	3.27
Other Income Ratios		
Income from Govt Securities to Total Net interest income	26.94	26.99
Income from Govt Placement to Total Net interest income	7.89	7.89
Forex Income to Total Non funded income	25.63	25.62
Cash / Total Assets	7.80	7.80
Deposits / Total funding	543.16	73.67
Gross Nonperforming Loans/Loans Outstanding	9.43	9.34
Charge for bad & doubtful debts/gross advances	1.95	1.93
Allowance for Loan Losses/Loans Outstanding	3.89	3.85
Interest Margin (Annualized)	9.34	9.33
Return on Average Equity (After Tax)	25.70	25.75
Return on Average Assets (After Tax)	3.48	3.49
Net Interest income/Average Total assets	8.16	8.16
Non-interest income/ Ave Total Assets	5.58	5.58
Cost of funds	3.96	3.97
Total effective Yields on Loans	15.80	15.79
INTEREST SPREAD	5.38	5.36
Operating income/ave assets	13.75	13.74
Staff & Directors costs / Loan Portfolio	7.27	7.27
Staff & Directors costs/ Assets	3.93	3.93
Operating cost/ Loan Portfolio	16.50	16.47
Operating cost / Assets	8.92	8.91
Total cost to Ave. Total Assets	12.35	12.34

Appendix IV: Data Collection Introduction Letter

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UNIVERSITY OF NAIROBI
SCHOOL OF BUSINESS
MBA PROGRAMME

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P.O. Box 30197
Nairobi, Kenya

DATE 17/07/2013

TO WHOM IT MAY CONCERN

The bearer of this letter NOELINA NADAKI

Registration No. D61/66893/2010

is a bona fide continuing student in the Master of Business Administration (MBA) degree program in this University.

He/she is required to submit as part of his/her coursework assessment a research project report on a management problem. We would like the students to do their projects on real problems affecting firms in Kenya. We would, therefore, appreciate your assistance to enable him/her collect data in your organization.

The results of the report will be used solely for academic purposes and a copy of the same will be availed to the interviewed organizations on request.

Thank you.

UNIVERSITY OF NAIROBI
SCHOOL OF BUSINESS
17 JUL 2013
P.O. BOX 30197 NAIROBI

PATRICK NYABUTO
FOR: MBA CO-ORDINATOR
SCHOOL OF BUSINESS