THE EFFECT OF MONETARY POLICY ON FINANCIAL PERFORMANCE OF COMMERCIAL BANKS IN KENYA

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DECLARATION

I declare that this project is my original work and has not been submitted to any other university for award of a degree.

Signed

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This project was submitted for examination with my authority as the university supervisor

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DEDICATION

This research project is dedicated to my parents, Mr Fredrick Waweru and The Late Mrs. Lucy Gathoni Waweru for their enormous support and encouragement through out the procss

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ABSTRACT

The purpose of this study was to establish the effect of monetary policy on financial performance of commercial banks in Kenya. This study adopted a descriptive survey of commercial banks in Kenya. The main reason for selecting descriptive research design was because it provides a knowledge base when little is known about a phenomenon or such things as clarification of a situation, classification of information, or description of subject characteristics that will aid in the refinement of the research problem, formulation of the hypothesis, or design of data collection and analysis procedures. Secondary data was collected from financial reports of commercial banks in Kenya from 2008 to 2012 Regression analysis was conducted in order to establish the effect of monetary policy on financial performance of commercial banks in Kenya Monetary policy was measured using three variables which were the independent variables of the study. These variables included the deposits made by the commercial banks to the Central Bank of Kenya, the base interest rate that is usually provided by the Central Bank of Kenya and the amount of money the commercial banks have invested in government securities. The dependent variable of the study was the profitability of the commercial banks in Kenya and this was measured using the return on assets as a percentage. The findings from the study confirmed that monetary policy explained 54% of the variance in the profitability of the commercial banks in Kenya. This was a clear indication the variance that remained unexplained by the monetary policy variables was 46% and this could only be explained by other variables that were outside the scope of this study. These findings are in line with that of Fatade (2004) who in studying the effect of monetary policy on performance of banks in Nigeria established that various monetary policy measures instituted in the country over the years have directly and indirectly affected performance of the banking sector in a number of ways while includes Banks profitability, Deposit/Savings mobilization Loans & Advances and so on. He further confirmed that the effectiveness of bank's performances depends on the instruments used in macroeconomic policies and the prevailing economic conditions and the deregulation of the sector has led to a number of improvements. . He further confirmed that the effectiveness of bank's performances depends on the instruments used in macroeconomic policies and the prevailing economic conditions and the deregulation of the sector has led to a number of improvements. In the year 2009, monetary policy still explained a significant variance on the profitability of commercial banks in Kenya but with a reduced percentage than what it was in 2008. In 2009 the variance explained was 49.2% which was less than half of the total variance on the profitability of the commercial banks. The same trend was replicated in the subsequent years 2009, 2010 and 2011 The findings further indicate that monetary policy variables such as the amount of investments in government securities; amount of funds commercial banks deposit with CBK and the average base rate of the CBK have a significant impact on the profitability of commercial banks in Kenya.

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LIST OF ABBREVIATIONS

CBK: Central Bank of Kenya

SPSS: Statistical packages for social sciences

ROA: Return on Assets

CHAPTER ONE: INTRODUCTION

1.1 Background of the Study

Most countries around the globe do make frequent significant changes in the design and conduct of their monetary policy in order to address the prevailing economic conditions. These adjustments in monetary policy are adopted by both developed and developing countries in order to respond to the changes in economic changes in various countries or regions. Monetary policy is a very essential element in achieving desired objectives such as promoting economic growth, achieving full employment level, reduction in the level of inflation, maintenance of healthy balance of payment, sustenance of growth in the economy, increase in industrialization and economic stability. Recent research has confirmed that monetary policy has other important objectives such as smoothing of the business cycle, reducing chances of economic crises; stabilization of interest rates and real exchange rate stabilization (Mishra and Pradhan, 2008).

Monetary policy changes largely affect the way banks operate. Ahumada and Rodrigo (2004) argue that the nature of banking activities and the position banks hold as intermediaries makes these financial institutions the most appropriate channels for adoption of the monetary policy of any country. They further assert that there are two important channels of monetary policy transmission that largely depend on the functioning of the banking sector. The first is the conventional interest rate channel and the other is the credit channel. The former channel operates when the central bank's adjustments to the nominal interest rate have an impact on the real interest rate and thus

on the pattern of investment and consumption. This channel will only work, however, if banks transmit the changes in the monetary policy rate to their customers. The credit channel, in turn, assumes some capital market imperfections, such as asymmetric information, that induce a contraction of the quantity of credit when the central bank imposes a restrictive monetary policy (Ahumada and Rodrigo, 2004).

The banking industry is one of the sectors that play an important role in the allocation of capital resources and risk sharing of future flows in any given economy or country. An efficient and effective banking industry in any economy is likely to facilitate increased growth and welfare, and it will smooth business cycles. There are several functions that are performed by banks thus making them more appropriate channels of monetary policy implementation. For instance banks provide money changing and payment processing services; transformation of assets in terms of their maturity, quality, and denomination and more recently management and control of risks. These functions give banks a central position within the process of saving and investment allocation. However, these functions make banks vulnerable to different sources of shocks, and they have a negative effect on the economy because of banks' central role. Consequently, there is a case for strong regulations in a banking environment. Because of the type of functions banks perform there is need to have in place proper monetary policy involving issues such as barriers to entry, market concentration, the borrower-lender relationship, deposit insurance, and the taxation of financial intermediation in order to improve the performance of the financial market (Ahumada and Rodrigo, 2004).

1.1.1 Monetary Policy

Ajayi and Atanda (2012) define monetary policy as the regulations instituted by any government in order to control the amount of money circulating within an economy. These regulations are usually developed by the central bank of a country. Therefore, Central Banks around the globe employ certain monetary policy instruments like bank rate, open market operation changing reserve requirements and other selective credit control instruments. Central bank also determines certain targets on monetary variables. Ajayi and Atanda (2012) however argue that when the Central bank of any country institutes actions and regulations restrict the activities and operations of profit making financial institutions such as commercial banks, finance companies and non-financial institutions such as co-operatives, thrift institutions and pension funds, there is a tendency of these institutions shifting to alternative ways of making their profits and enhance their performance to the detriment of economic growth and development.

According to Kashyap and Stein (2000), the monetary policy actions and regulations adopted by any Central bank do not affect economic activities directly but instead through their effects on financial markets. The most primary initial impact of monetary policy instruments is observed on the demand for and supply of reserves held by depository institutions and consequently on availability of credit. The monetary policy adopted must have an effect on rate of growth of the money supply, the level of interest rate, security prices, credit availability and liquidity creation from commercial banks. The likely outcome of these factors is monetary imbalances or shocks on the economy through influencing the level of investment, consumption, imports, exports, government

spending, total output, income and price level in the economy (Mishra and Pradhan, 2008). Amidu and Wolfe (2008) also confirm that monetary policy has an effect on changes on loan supply of less liquid banks, deposit base and induce banks ability to perform their expected roles within the financial system.

1.1.2 Concept of Financial Performance

There are different definitions of organizational performance that have been coined by different researchers and authors. According to Maria, Florica and Catalina (2002), the performance of an organization is equated to a state of competitiveness of that organization which is reached through attaining a given levele of efficiency and productivity which ensures a sustainable market presence. Carton (2004) also defines financial performance of an organization as the measure of the change of the financial state of an organization or the financial outcomes that results from management decisions and the execution of those decisions by members of the organization. He further argues that the outcomes are not universal in nature but largely depend on the organizational context hence selection of the measures that represent performance of a particular organization is done based upon the circumstances of the organization being rated.

Measuring the performance of an organization is a representation of quantification of results of various activities undertaken within that organization over a period of time. For performance measurement to be undertaken there is need to know the link between objectives, performance measurements and organization results and the relevance of the performance metrics. In most contemporary organizations, organizational performance is

done or undertaken using three types of methods. The first method is through the use of a balanced score card which was introduced by two Harvard University experts Kaplan and Norton in early 1990s. The main aim of the balanced score card is to give an organization the chance to translate its corporate strategy into action (Maria, Florica and Catalina, 2002). The other modern method of measuring performance of an organization involves the use of the Deming model which stresses on the identification of variations in the production process and fixing them. The last method is through the use of the BALDRIGE model which suggests that the standards used to measure the performance of an organization must be derived from business strategy and they must have the ability to relevant information (Maria, Florica and Catalina, 2002).

According to Carton (2004) there are more than twenty measures that can be used to measure the financial performance of an organization. Organizations can adopt any of these measures depending on the suitability and context. These financial performance measures are however grouped into five major categories: The first category contains profitability measures such as return on equity, return on assets, return on capital, return on sales and operating margin; The second category of measures includes growth measures calculated on sales, total assets and total employees; The third group of financial performance measures includes Leverage, Liquidity, and Cash Flow Measures such as Debt to equity ratio, operating cash flow to equity ratio and growth rate of operating cash flow; there are also market based measures such as cost of equity capital and price to book ratio; The last category of measures are referred to as Economic Value Measures such as residual income and Residual income return on investment.

1.1.3 Monetary Policy and Financial performance

Monetary policy forms part of the macroeconomic environment that is very critical in enhancing the financial performance of organizations. The financial development of any economy largely depends on the short run stabilization of the monetary policy of any economy. Financial performance therefore plays a very significant role in implementation of monetary policy. There is a very high degree of interdependence between monetary policy implementation and the financial performance of commercial banks in an economy. The main reason behind this interdependence results from the fact that commercial banks are the main agents of monetary policy implementation within any economy. The performance of monetary policy will therefore depend entirely on the level of financial performance within the banking industry (Krause & Rioja, 2006).

According to Caruana (2005) monetary policy stability is very essential for financial stability in an economy and this also leads to stable asset prices. He further asserts that stability in monetary policy simply implies that there is a stable and low rate of inflation in an economy. The monetary stability enables organizations to achieve high levels of financial performance because of the stable prices. However, Caruana (2005) further argues that having stability in monetary policy is not a guarantee that there will be no financial stress in the economy. He indicates that the there are incidents when some developments in the financial sector may lead to financial stress and subsequent poor financial performance.

1.1.4 Banking Industry in Kenya

According to Equity Bank (2013) Kenya's banking sector involves 44 registered and licensed commercial banks providing banking and financial services to customers. Kenya's banking industry is one of the fastest growing industries both in the region and in Africa as a continent. Most Kenyan banks have fully owned subsidiaries spread out in various countries within the region. For instance between the year 2002to 2012, the banking sector in Kenya registered very significant growth patterns that saw most of the banks increase their deposits, profit before taxation net advances to customers and the number of accounts (Ndungu, 2013).

The banking industry in Kenya s regulated by the Central Bank of Kenya which is given the legal authority of formulating and implementing monetary and fiscal policies. The Central bank of Kenya is the lender of last resort in Kenya and is the banker to all the commercial banks operating in the country. The main duty of The Central Bank of Kenya is to ensure proper functioning of the Kenyan financial system, the liquidy in the county and the solvency of the Kenya shilling (CBK, 2013). However, the banking industry in Kenya faces a number of challenges stemming from unstable macroeconomic environment such as frequently changing interest rates and mandatory deposits. This is likely to affect their financial performance.

1.2 Research Problem

The type of monetary policy that any given country adopts is a major determinant on the financial operations of most financial institutions operating in that economy. Monetary

policy has the potential to trigger or inhibit investment activities through provision of affordable and denying access to credit respectively. Commercial banks are usually considered around the globe as the most appropriate channels of implementing monetary policy by most Central Banks in many countries. This leaves the commercial banks in a vulnerable situation that is likely to affect their financial performance due to changes occurring in the macroeconomic environment.

Kenya has experienced unstable macro environment in the last few years which led to changes in monetary policy. These changes in monetary policy forced most of the commercial banks to shift the effects to their customers. Shifting these changes to customers may have an impact on the financial performance of the banks. Studies on monetary policy and bank performance indicate different results on the existing relationship. For instance Ajayi & Atanda (2012) carried out a study on monetary policy and bank performance in Nigeria. The findings confirmed that bank rate, inflation rate and exchange rate are total credit enhancing, while liquidity ratio and cash reserves ratio exert negative effect on banks total credit. Another finding indicated that although only cash reserve ratio and exchange rate found to be significant. Fatade (2004) carried out an investigation on the impact of monetary policy on banks' performance in Nigeria. The study established that various monetary policy measures instituted in the country over the years have directly and indirectly affected performance of the banking sector in a number of ways while includes Banks profitability, Deposit/Savings mobilization Loans & Advances and so on. The effectiveness of bank's performances depends on the instruments used in macroeconomic policies and the prevailing economic conditions. Ongore and Kusa (2013) also carried out a study on the determinants of financial

performance of commercial banks in Kenya. The study established that the performance of commercial banks is mainly driven by board decisions. Ngendo (2012) conducted a study on the relationship between non interest income and financial performance of commercial banks in Kenya. The study revealed that noninterest income has partial significant positive impact on financial performance.

Despite the studies mentioned above, no study has been conducted to establish the effect of monetary policy on the performance of commercial banks in Kenya. Kenya varies her monetary frequently and there is need to find out the effect of these variations on the performance of commercial banks. This is therefore a research gap the study sought to address by answering two main questions: What is the main monetary policy instruments used in Kenya? And how does the monetary policy affect the performance of commercial banks in Kenya.

1.3 Research objective

The study sought to achieve the following objective

> To determine the effect of monetary policy on financial performance of commercial banks in Kenya

1.4 Value of the Study

The findings from this study will assist in providing more literature to support existing theoretical propositions on the effect of monetary policy on performance of commercial

banks. It will also be a significant source of literature on monetary policy and performance of banks for future researchers or those in the academic field.

The government of Kenya will be able to understand the effect of monetary policy on the performance of commercial banks. The government will also get o understand how this affects the economic growth and development of the country. The findings will therefore assist the government to come up with appropriate monetary policy that can enhance not only the performance of banks but the economy at large.

The commercial banks in Kenya will be able to understand how changes and variations in monetary policy by the existing government is likely to affect or impact on their financial performance. This will enable them to take necessary approaches to react to variations in monetary policy.

CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

This chapter contains the review of various studies that are relevant to monetary policy and organizational performance. It presents a review of the relevant theories that explain monetary policy and organizational performance; literature on empirical studies conducted on monetary policy and organizational performance; monetary policy as well as organizational performance.

2.2 Theoretical Literature

2.2.1 Slack Resources Theory

The Slack Resources theory was first published by March and Simon (1958). This theory equates an organization to a living organism that struggles to survive amid turbulence from the environment within which it operates. According to Bourgeois (1981), slack is a cushion of actual or potential resources which allow an organization to adapt successfully to internal pressures for adjustment or to external pressures for change in policy, as well as to initiate changes in strategy with respect to the external environment. The theory suggests that slack performs four main functions in an organization. The first function of slack is acts as an inducement to members. The second function of slack is to act as a resource for conflict resolution. The third is function of slack is to act as an insulation to protect the organization from environmental turbulence. Finally, slack can be a facilitator of strategic behavior, which allows the firm to experiment with new

strategies such as introducing new products and entering new markets (Tan and Peng, 2003).

However some critics of the slack resources theory argue that slack resources are an additional cost to an organization hence an excessive level of slack cannot be tenable by any organization. According to Shaffman et al, (1988) organizational slack can be split into absorbed and unabsorbed slack. The latter refers to resources that are currently not committed to any activity hence can easily be redeployed to another activity depending on the environmental requirements. This gives the management greater discretion on how to commit the resources and it can impact on the performance of an organization. The absorbed slack refers to excess costs in the organization and these are usually very difficult to redeploy (Tan and Peng, 2003).

2.2.2 Structural Contingency Theory

There is also the structural contingency theory by Pfeffer (1982). This theory has come to be known as the Contingency Theory of Organizational Structure. The theory states that Proponents of the theory such as (Hamilton and Shergill, 1992; Chandler, 1962) argue that an organization in fit enjoys higher performance, which generates surplus resources and leads to expansion, such as growth in size, geographic extension, innovation or diversification. However, this may increase the level of the contingency variables, such as size, leading to a misfit with the existing structure. The misfit lowers performance, eventually leading to a performance crisis and adaptive structural change into fit. It is therefore clear that the change from fit to misfit depends on the performance of the

organization. Critics of structural contingency theory sometimes argue that it is not sensible for organizations to move into fit with their contingencies, because while the organization is changing its structure to fit the contingencies, the contingencies themselves change, so that the organizational structural change does not produce fit. Nevertheless, by moving towards the fit, the organization is decreasing misfit, and thereby increasing its performance relative to what it would be if it were to make no structural change (Donaldson, 2001).

2.2.3 The Agency Theory

The agency theory is gaining a lot of popularity in explaining the financial performance of organizations. The theory seeks to explain the relationship that exists between the management of an organization and the owners of the organization who are usually the people holding stocks for the organization. The theory posits that there is an agency conflict. The management of an organization is usually considered as an agent who has been contracted by the stockholders to work towards enhancing the stockholder value through good financial performance. The management is therefore expected to act in the best interests of the owners and enhance the financial performance of the organization.

However, the theory suggests that the managers who are agents may be involved in activities that are aimed at serving personal interest at the expense of the owners of the organization. The theory suggests that when this happens, the financial performance of the organization may easily suffer. Stockholders therefore can employ a number of strategies to ensure the management acts in the interest on the organization. The theory

suggests that management can be rewarded financially in order to motivate them to work for the interests of the company. The owners can also issue threats such as hostile takeover to force management to perform the required duties.

2.3 Empirical Literature

Several empirical studies have been conducted on monetary policy and commercial banks. Ahumada and Rodrigo (2004) carried out an investigation on banking industry and monetary policy in Chile. It was established that banks play a very significant role in the implementation of monetary policy. Monetary policy largely affects that market interest rates thus forcing banks to change their investment decisions. When banks change their investment decisions their financial performance is also likely to change or be affected due to the changes in monetary policy. The study concluded that regulatory distortions have an important effect on the efficiency and profitability of the banking industry. Whether we measure the spread from intermediation or the interest rates charged for traditional banking activities, the microeconomic structure has an effect on these variables.

Seppo and Mittra (2002) conducted a study on the performance of monetary policy and the internal Central Bank forecasting. The study featured the European Central Bank. The purpose of the study was to examine the impact of interest rates heterogeneity in forecasts of the European Central Bank. The findings from the study confirm that learnability restrictions for interest rates rules derived under the assumption of homogenous forecasting continue to be important when homogeneity is present.

Another study was also carried out by Brissimis and Delis (2009) bank heterogeneity and monetary policy transmission in Europe. The main aim of the study was to examine the role of bank liquidity, capitalization and market power as internal factors influencing banks' reaction in terms of lending and risk-taking to monetary policy impulses as well as the ultimate impact of a monetary policy change on bank performance is also considered. The findings confirm that the average value reported for the coefficient of the monetary policy variable in the lending equations is negative and statistically significant regardless of which smoothing variable is used. The study found that monetary policy changes cause a very different response of bank lending on the basis of their capital structures, with more capitalized banks responding less to monetary policy changes. The same and even more pronounced in terms of variance are the results obtained when the distributional characteristic is the market power variable. In particular, high capitalization and market power tend to buffer the negative impact on bank lending of a shift in policy rates.

In a study by Fatade (2004) on the impact of monetary policy on banks' performance in Nigeria, a number of observations are made. The main purpose of the study was to establish whether the various monetary policy measures instituted in the country over the years had directly and indirectly affected the performance or the bank sector in Nigeria. The results from the study indicate that various monetary policy measures instituted in the country over the years have directly and indirectly affected performance of the banking sector in a number of ways while includes Banks profitability, Deposit/Savings mobilization Loans & Advances and so on. It is also clear from the findings that the effectiveness of bank's performances depends on the instruments used in macroeconomic

policies and the prevailing economic conditions and the deregulation of the sector has led to a number of improvements.

Yener, Leonardo and David (2010) also carried out a study on the role of monetary policy on bank risk taking. The main purpose of the study was to r investigate the relationship between short-term interest rates and bank risk. The study made use of a unique database that includes quarterly balance sheet information for listed banks operating in the European Union and the United States for duration of 10 years. The study findings confirm that unusually low interest rates over an extended period of time contributed to an increase in banks' risk.

Cheruiyot (2012) carried out a study on the effectiveness of monetary policy in countering inflation in Kenya. The study used time series empirical data on the variables to describe and examine the effectiveness of monetary policy tools in countering inflation in Kenya by establishing correlation coefficients between the inflation and the monetary policy tools. The findings from the study revealed that inflation and the supply of money in the economy have a positive correlation. This implies that as the amount of money in circulation in the economy increases the level of inflation also increases. This largely happens because an increase in money supply leads to people spending the excess of their money supply over money demand. It was also established that exchange rate changes has an important role in reducing or minimizing the risk of fluctuations in exchange rates, which will have an impact on the economy.

A study carried out by Ongore and Kusa (2013) on the determinants of financial performance of commercial banks in Kenya give contrary findings to the other studies

mentioned above. Whereas other researchers have indicated that macroeconomic stability is very significant in the development of the financial sector, Ongore and Kusa argue that macroeconomic factors have no significant role in the financial performance of commercial banks in Kenya. Their study also established that the determinants of the financial performance of commercial banks in Kenya are not uniform but rather specific to individual banks.

According to Friedman (1968) monetary policy is one of the economic policies that are initiated by any government for the purpose of achieving high employment, stability of interest rates and rapid economic growth and development. The type of monetary policy in place has a number of effects on the above mentioned variables. For instance stability in prices in the long run is a precondition for maximum sustainable output growth and employment as well as moderate long-term interest rates. Stable prices have the potential of serve as clearer signals and guides to the efficient allocation of resources and thus contribute to higher standards of living. The other reason why stable prices are significant is because they foster saving and capital formation, because when the risk of erosion of asset values resulting from inflation and the need to guard against such losses are minimized, households are encouraged to save more and businesses are encouraged to invest more.

Changes in short-term interest rates will influence long-term interest rates, such as those on Treasury notes, corporate bonds, fixed-rate mortgages, and auto and other consumer loans. Long-term rates are affected not only by changes in current short-term rates but also by expectations about short-term rates over the rest of the life of the long-term

contract. Generally, economic news or statements by officials will have a greater impact on short-term interest rates than on longer rates because they typically have a bearing on the course of the economy and monetary policy over a shorter period; however, the impact on long rates can also be considerable because the news has clear implications for the expected course of short-term rates over a long period (Federal Reserve System, 2013).

Changes in long-term interest rates also affect stock prices, which can have a pronounced effect on household wealth. Investors try to keep their investment returns on stocks in line with the return on bonds, after allowing for the greater riskiness of stocks. For example, if long-term interest rates decline, then, all else being equal, returns on stocks will exceed returns on bonds and encourage investors to purchase stocks and bid up stock prices to the point at which expected risk-adjusted returns on stocks are once again aligned with returns on bonds. Moreover, lower interest rates may convince investors that the economy will be stronger and profits higher in the near future, which should further lift equity prices (Federal Reserve System, 2013).

According to Kaplan (2001) accountability is very significant in ensuring that organizations achieve the level of performance that is stipulated in their strategic objectives. Kaplan further indicates that most organizations traditionally measured performance using financial performance. Measurement of organizational performance is now taking a different dimension since companies have recently recognized that financial measurements by themselves are inadequate for measuring and managing their performance. The main reason why financial performance is considered inadequate is

because financial reports measure past performance but communicate little about long-term value creation. This is the motivation behind Kaplan and Norton (1996) Balanced Scorecard aimed at assisting in measuring performance for private sector organizations. The balanced score card retained financial measurements but complemented these with measures from three other perspectives: that of the customer, the internal process, and learning and growth.

Yacuzzi (2005) also concurs with Kaplan and Norton (1996) that performance measures have traditionally been financial. However, with time, these measures are being considered insufficient to accurately measure the performance of an organization. One of the strongest concerns is that financial reporting often does no support investment in new technologies and markets, and this investment is required for enterprise advancement. Corporate balances measure historical issues, but they do not indicate potential yield of future technological and commercial opportunities. The reason why financial measures became popular in measuring organizational performance is because when they were developed, corporate markets and products were much simpler than today's. Yacuzzi (2005) further asserts that financial measures are slightly bias because they tend to focus on the short term achievements of an organization at the expense of long term gains. In order to be useful, a performance measurement system has to be in line with corporate policies and must be applied consistently to realize strategy. It has also to be multidimensional, in order to capture the many aspects of an enterprise, its products and services. Approaches such as the balanced scorecard and the multiple dimensions of

quality were introduced to deal with the complexity of measuring efficiency and effectiveness (Enrique, 2005).

The financial performance measurement of any given firm is basically a measure of how well a firm uses its assets from its core operations and generates revenues over a given period of time. Whatever measure an organization uses is compared to some given industrial average standard of similar firms in the same industry. Financial performance can be measured using variables such as profitability, liquidity, solvency, financial efficiency and the capacity of the firm to repay its liabilities. Profitability is the measures of the profit generated by a firm through the use of its productive assets; liquidity measures the ability of a firm to meet its obligations when they fall due; solvency measures a firm ability to pay all its financial obligations if all of its assets are sold. Therefore, a firm financial performance can be measured using net income or net operating income, its assets performance or even its cash flows (Brealey, Myers and Marcus, 2009).

Adrian and Shin (2008) liquidity, monetary policy, and financial cycles in the United States of America. The main aim of the study was to establish the relationship between the balance sheet of financial institutions and the tightening of the monetary policy. The findings from the study reveal that commercial banks and other financial intermediaries increase their leverage during asset price booms and reduce it during busts. This pro-cyclical behavior is likely to exacerbate financial market fluctuations as institutions overturn the normal supply and demand responses by buying assets when the price rises

and selling them when the price falls. The study therefore concluded that the short term rate target by policy makers may be a key price variable in any economy.

Another study was also carried out by Spiegel (2008) financial globalization and monetary policy discipline. The study was a survey done by the reserve bank of San Francisco. The main objective of the study was to establish the relationship between financial remoteness and financial openness. The study confirmed that there is a negative relationship between median in action and financial globalization in the base specification, but this relationship is sensitive to the inclusion of conditioning variables or country fixed effects, precluding any strong inferences.

2.4 Summary

The main purpose of any monetary policy is to ensure stability in prices, interest rates and enhancing economic growth and development. The monetary policy in place within any given economy largely determines the availability of credit to customers as well as the ability of households to save and make investments. Monetary policy also affects the operations of financial institutions more especially when there is volatility of interest rates. Commercial banks are the main channels of monetary policy implementation and are likely to be affected by frequent changes or variations in monetary policy.

From the studies reviewed, it is evident that very few of them have tried to establish the effect of monetary policy on performance of commercial banks. One of such studies by Fatade (2004) on the effect of monetary policy on performance of banks in Nigeria indicates that banks' profitability is actually affected by the type of monetary policy in

place. The studies are few and there is need to carry out more studies in order to ascertain the authenticity of the findings.

CHAPTER THREE: RESEARCH METHODOLOGY

3.1 Introduction

This chapter discusses the methodology the researcher will employ in investing the effect of monetary policy on financial performance of commercial banks in Kenya. Among the elements discussed in this section are the target population, the sample size and the sampling technique that will be used, the data collection techniques and tools as well as the techniques that will be used to analyze the data that will be collected.

3.2 Research Design

According to Rajendra (2008) a research design is the linkage and organization of conditions for collection and analysis of data in a manner that aims at combining relevance to the research purpose with economy in the procedure. Vaus (2005) also asserts that that research design focuses on the structure of an enquiry, which leads to the minimization of the chance of drawing the wrong casual inferences from the data. This study will adopt a descriptive survey of commercial banks in Kenya. The main reason for selecting descriptive research design is because it provides a knowledge base when little is known about a phenomenon or such things as clarification of a situation, classification of information, or description of subject characteristics that will aid in the refinement of the research problem, formulation of the hypothesis, or design of data collection and analysis procedures (Powers & Knapp, 2006). It also allows one to establish a relationship between variables.

3.3 Population and Sampling

The target population for this study will include all the commercial banks that are registered and currently operating in Kenya. According to the Central Bank of Kenya, there are currently 44 commercial banks that are operating in the country (CBK, 2013). This implies that the target population for this study will therefore be all the 44 commercial banks registered and operating in Kenya. The study will collect data for all the 44 commercial banks since this is a small population. This implies that a census will be more applicable in this study.

3.4 Data Collection tools

The data to be utilized in this study will be secondary data. The data will be collected from a number of sources such as the audited financial statements of the sample commercial banks; the Central Bank of Kenya and the Kenya National bureau of statistics. A data collection schedule will be prepared to assist in gathering this information. The data to be collected will be for a duration of five years from 2008-2012. This duration was considered appropriate since a number of monetary policy changes were made hence it will be prudent to find out how they affected the performance of commercial banks.

3.5 Data Analysis

The data collected will be sorted and organized before capturing the same in Statistical packages for social sciences (SPSS) for analysis. A regression analysis will be conducted

to assist the researcher establish the effect of monetary policy on the performance of commercial banks in Kenya. In order to make the regression analysis possible, the study will adopt the following analytical model: $P_f = a + b_1x_1 + b_2x_2 + b_3x_3 + e$

Where P_f is the financial performance of commercial banks in Kenya. The financial performance will be measured using Return on Assets (ROA). X1 is the interest rate changes made by the Central Bank of Kenya and they will be measured using the average base rate for each year. X2 is the minimum reserve maintained by each bank with the Central Bank of Kenya (CBK). The minimum reserve is usually adjusted according to the level of inflation. A yearly average of the reserve will be used. X3 is the amount of funds commercial banks have invested in government securities such as Treasury bills and Bonds. It will be measured using the average annual assets in form of Treasury bills and Bonds.

CHAPTER FOUR

DATA ANALYSIS AND INTERPRETATIONS

4.1 Introduction

The purpose of this study was to establish the effect of monetary policy on financial performance of commercial banks in Kenya. The study made use of secondary data that was obtained from financial reports of 31 commercial banks in Kenya out of the sample size of 43 commercial banks. This is a confirmation that a response rate of 72.09% was achieved in this study and it was considered appropriate in enabling the researcher to generalize the research findings on the banking industry in Kenya. The findings are presented next.

4.2 Regressions for 2008

Table 4.1: Model summary for 2008

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
	.735[a]	.540	.521	.185

From the regression results for the year 2008, it is evident that the R value of 0.540. This implies that the three independent variables of monetary policy i.e. amount of investments in government securities; amount of funds commercial banks deposit with CBK and the average base rate of the CBK explain 54% of the variance in the profitability of the profitability of commercial banks in Kenya. This is an indication that in 2008, the monetary policy explained 54% of the variance in the profitability of commercial banks in Kenya.

Table 4.2: Anova for 2008

Model	Sum of Squares	df	Mean Square	F	Sig.
Regression	4.651	8	.452	2.214	.012
Residual	7.462	35	.225		
Total	11.113	43			

It is also evident that the significance value of 0.012. This is an indication that the model in Table 4.1 above is relatively significant in explaining the variance on the profitability of commercial banks in Kenya.

Table 4.3: Model coefficients for 2008

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	.874	.298		3.056	.003
Deposits with CBK	.124	.221	.643	3.382	.001
Average CBK base rate	.863	.246	.767	3.509	.001
Investments in securities	.295	.193	.341	1.499	.156

It is evident from the table of model coefficients above that all the three independent variable of monetary policy have positive coefficients. Deposits with CBK have a positive coefficient of 0.124; Average CBK base rate a positive coefficient of 0.863 and

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investments in government securities a positive coefficient of 0.295. This confirms that three variables directly affect the profitability of commercial banks in Kenya.

4.3 Regressions for 2009

Table 4.4: Model summary for 2009

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
	.711[a]	.492	.411	.162

In the year 2009 the findings from the regression results indicate that the three independent variables in this study account for 49.2% of the variance in the profitability of commercial banks in Kenya. It was also clear that there was a huge variance of 51.8% that was not explained by the monetary policy. This confirms that the profitability of the commercial banks does not solely rely on monetary policy but also on other factors other than the monetary policy which accounted for 51.8% of the variance.

Table 4.5: Anova for 2009

Model	Sum of Squares	df	Mean Square	F	Sig.
Regression	3.785	6	.354	2.107	.043
Residual	6.324	29	.211		
Total	10.109	35			

The study results in the table 4.5 above also reveal that the model significance stands at 0.043. This is a confirmation that the model is still relatively significant since the three monetary policy variables explain 49.2% of the variance on profitability of commercial banks in Kenya.

Table 4.6: Model coefficients for 2009

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	.698	.251		2.305	.013
Deposits with CBK	.097	.221	.531	3.147	.148
Average CBK base rate	.769	.246	.664	3.233	.007
Investments in securities	.186	.159	.197	1.248	.149

The model coefficients for year 2009 confirm that the three monetary policy variables have positive coefficients as was in the case in the year 2008. Table 4.6 reveals that Deposits with CBK have a positive coefficient of **.097**; Average CBK base rate a positive coefficient of **.769** and investments in government securities a positive coefficient of **.186**. It is therefore a clear indication that in the year 2009, monetary policy had a direct relationship with profitability of commercial banks in Kenya.

4.4 Regressions for 2010

Table 4.7: Model summary for 2010

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
	.649[a]	.423	.354	.201

The results from the multivariate regression analysis for the year 2010 indicate that the same trend observed in the year 2008 and 2009 still continued in the banking industry in Kenya. It is clear from the model summary for the year 2010 that the monetary policy variables explain 42.3% of the variance on profitability of commercial banks. This left a variance of 57.7% that was not accounted for by the monetary policy. This is an indication that however much monetary policy influenced the profitability of commercial banks in the year 2010; there were other more significant factors that also affected the profitability of the banks.

Table 4.8: Anova for 2010

Model	Sum of Squares	df	Mean Square	F	Sig.
Regression	3.417	4	.301	1.847	.094
Residual	5.633	24	.196		
Total	8.040	29			

It is also evident from the results that as the variance explained by the three independent variables continued to reduce in 2009 and into 2010, the significance of the model summary also keeps deteriorating. In the year 2010 the significance of the model is 0.094

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and indication that the variance explained by the three monetary policy variables was growing less significant.

Table 4.9: Model coefficients for 2010

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	.579	.229		2.305	.102
Deposits with CBK	.068	.201	.412	3.147	.178
Average CBK base rate	.638	.218	.594	3.233	.009
Investments in securities	.173	.116	.186	1.248	.185

It is also clear from the table 4.9 above that the value of the model coefficients kept on reducing from the year 2008 through to 2010. As illustrated in the table above, the coefficients for year 2010 were slightly lower in value than those of the preceding years. For instance the coefficient for deposits with CBK was 0.068; the coefficient for average CBK base rate was 0.638 and the coefficient for investment in securities was 0.173. The study reveals that the average CBK rate continued to reflect higher coefficient values than the other two an indication that the central bank base rate is very significant in determining the profitability of commercial banks in Kenya.

4.5 Regressions for 2011, 2012 and for the Five years

Table 4.10: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
2011	.697	.489	.421	.239
2012	.668	.446	.385	.248
Overall 5 years	.682	.477	.393	.277

The regression results for 2011, 2012 and overall for the five years indicate that the variance of profitability of commercial banks explained by the monetary policy variables is slightly below 50%. For instance the results tabulated above confirm that in 2011 the three independent variables of monetary policy explain 48.9% of the variance on profitability; in 2012 they explain 44.6% and the overall regression for the five years shows that the three variables explain 47.4% if the variance on profitability of commercial banks in Kenya. This is a revelation that although the monetary policy variables i.e Deposits with CBK, Average CBK base rate and Investments in securities have a significant impact on the profitability of the commercial banks. However there are other factors that account for more than half or the variance.

Table 4.11: Model coefficients for the five year regression

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	.634	.243		2.305	.013
Deposits with CBK	.071	.203	.429	2.834	.148
Average CBK base rate	.731	.221	.559	3.123	.008
Investments in securities	.156	.126	.178	1.147	.121

The model coefficients for the average figures from the year 2008 to 2012 indicate that the same trend that was witnessed in the earlier years is still evident. The three independent variables have positive coefficients confirming that they positively influence the profitability of commercial banks n Kenya. Using the overall regression coefficients it is possible to obtain an empirical equation to explain the relationship between monetary policy and profitability of commercial banks in Kenya: $P_{f} = 0.634 + 0.071x1 + 0.731x2 + 0.156x3 + 0.243$

4.6 Summary and Discussion of Findings

The purpose of this study was to establish the effect of monetary policy on the financial performance of commercial banks in Kenya. Monetary policy was measured using three variables which were the independent variables of the study. These variables included the

deposits made by the commercial banks to the Central Bank of Kenya, the base interest rate that is usually provided by the Central Bank of Kenya and the amount of money the commercial banks have invested in government securities. The dependent variable of the study was the profitability of the commercial banks in Kenya and this was measured using the return on assets as a percentage.

The findings from the study confirmed that monetary policy explained 54% of the variance in the profitability of the commercial banks in Kenya. This was a clear indication the variance that remained unexplained by the monetary policy variables was 46% and this could only be explained by other variables that were outside the scope of this study. These findings are in line with that of Fatade (2004) who in studying the effect of monetary policy on performance of banks in Nigeria established that various monetary policy measures instituted in the country over the years have directly and indirectly affected performance of the banking sector in a number of ways while includes Banks profitability, Deposit/Savings mobilization Loans & Advances and so on. He further confirmed that the effectiveness of bank's performances depends on the instruments used in macroeconomic policies and the prevailing economic conditions and the deregulation of the sector has led to a number of improvements.

In the year 2009, monetary policy still explained a significant variance on the profitability of commercial banks in Kenya but with a reduced percentage than what it was in 2008. In 2009 the variance explained was 49.2% which was less than half of the total variance on the profitability of the commercial banks. The same trend was replicated in the subsequent years 2009, 2010 and 2011. However, it was evident that in all the four years

from 2008 to 2012 monetary policy explains a significant portion of the variance on the financial performance of the commercial banks in Kenya. In all the five years under this study, the Central Bank of Kenya base interest rate had high positive coefficients and this was an indication that it explained a greater portion of the variance than the other two variables. These findings agree with the position held by Ahumada and Rodrigo (2004) who established that monetary policy largely affects that market interest rates thus forcing banks to change their investment decisions. They further indicated that when banks change their investment decisions their financial performance is also likely to change or be affected due to the changes in monetary policy. Their study concluded that regulatory distortions have an important effect on the efficiency and profitability of the banking industry.

The overall regression results for the five years from 2008 to 2012 established that monetary policy explained a variance of 47.7% of the financial performance of commercial banks in Kenya. Though this portion was slightly lower than half of the total variance, it was an indication that monetary policy has a significant impact on the financial performance of commercial banks and it should be treated with the seriousness it deserves. It was also evident that interest rate measured by the CBK base rate was the variable with the highest positive coefficient ant it explains much of the variance since it affects the operations of the commercial banks as well as their investment and lending decisions. Brissimis and Delis (2009) had also arrived at similar findings and indicated that monetary policy can make commercial banks change the cause of their lending activities.

CHAPTER FIVE

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Summary of Findings

The study established that the three variables of monetary policy, that is, amount of investments in government securities; amount of funds commercial banks deposit with CBK and the average base rate of the CBK have some significant effect on the profitability of commercial banks in Kenya. The regression results for the individual years for the duration of the study from 2008 to 2012 confirm that the variance explained by the three variables decreases slightly each year but the average is slightly below 50%. It was evident that the variance explained is less than the unexplained variance on profitability of commercial banks and this implies that other than the monetary policy, there are other factors that affect the profitability of commercial banks in Kenya. However these factors are beyond the scope of this study.

It was further clear from the study that the three coefficients of monetary policy have positive model coefficients that kept decreasing slightly with the decrease in the variance they explain. The positive coefficients were an indication that monetary policy has a direct relationship with the profitability of the commercial banks in Kenya. It was also evident that one of the three variables had a higher positive coefficient consistently throughout the duration of the study. The average base rate of the CBK is the variable with the highest positive coefficient throughout the duration of study and it implies that it is a very important determinant of the profitability of commercial banks in Kenya.

Central Bank base interest rate was the variable with the highest positive coefficient in the five years hence its ability to explain higher variance.

5.2 Conclusions of the Study

Monetary policy is an important determinant of the financial performance of commercial banks in Kenya. The percentage of variance of the financial performance of commercial banks that is explained by monetary policy is statistically significant as it was established from the findings. The results from regression results for the individual years from 2008 to 2012 confirmed that although the variance of financial performance of commercial banks explained by monetary policy revealed a downward trend, the reduction was not significant enough as the variance that was explained in each of the years.

All the three independent variables registered positive coefficients all through the five years both on individual yearly regressions as well as the average regressions for the five year duration. However, the Central Bank of Kenya base interest rate was found to have the highest positive coefficient in the individual yearly regressions and the average regression results. Therefore interest is the variable that explains much of the variance than the other two variables since it has an effect on the investment and lending decision that are made by commercial banks in Kenya.

The study has revealed that monetary policy variables such as the amount of investments in government securities; amount of funds commercial banks deposit with CBK and the average base rate of the CBK have a significant impact on the profitability of commercial banks in Kenya. The three variables account for approximately 47.7% of the variance in

profitability of commercial banks. However, there is still a higher unexplained variance of more than 50% that is explained by other variables beyond the scope of this study.

5.3 Recommendations of the Study

The study has revealed that the average base rate of CBK has a more significant effect on the profitability of commercial banks in Kenya. It will be important for CBK to efficiently regulate the interest rates to ensure that it provides favorable conditions for the commercial banks.

The study has also revealed that the monetary policy generally has a significant effect on the profitability of commercial banks in Kenya. It will be important if the government will enact sound monetary policies in order to enhance growth in the banking industry. The government will also need to benchmark for best practices in monetary policy development from those economies that are more advanced in order to develop better monetary policies that can improve the performance of the banking industry.

The study has revealed that the investment and lending decisions made by the commercial banks in Kenya largely depend on the prevailing Central Bank of Kenya base interest rate. It will be important for the central bank of Kenya to do wider consultations with all stakeholders before adjusting the base interest rate. This will assist in reducing the effects that are brought by adjustments of the base interest rates.

The study revealed that frequent fluctuations in the base interest rates also led to frequent changes in the amount of money commercial banks channel into investments involving government securities. This has other effects on the lending decisions that are made by

the banks as well as other investments decisions. The Central Bank of Kenya should be careful not to attract so much investment from the commercial banks as this will affect the lending decisions made by the banks.

5.4 Limitations of the Study

The study had a few challenges in accessing complete and comprehensive data for all the commercial banks operating in Kenya. This explains the reason why the study managed to achieve a response rate of about 71% for the data collection exercise.

The results of this study are limited to the commercial banks in Kenya. Therefore the findings can only be directly applicable to the commercial banks that are operating in Kenya. At the same time the, the findings are also relevant to the duration that is specified in this study and not any other duration.

Time and financial resource limitations could not allow the researcher to cast the net wider than the commercial banks. If it were possible all the financial institutions would have been part of this study but this could take a lot more time and finances to achieve and the researcher did not have the capacity to do this.

The findings of this study are based on secondary data that was compiled by other people other than the researcher. It may be subject to some level of errors that the researcher may not be able to determine.

5.5 Suggestions for Further Research

This study focused on the effect of monetary policy on financial performance of commercial banks in Kenya. It will be prudent to carry out another study of comparative nature with other countries to establish the similarities or to assist authenticate the findings of this study.

It will be significant to carry out a study to establish the variables that explain the more than 50% variance on the profitability of the commercial banks in Kenya. This is important because the study has managed to establish that the monetary policy variables only account for 47.7% of the variance.

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