FINANCIAL STABILITY OF LISTED COMMERCIAL BANKS IN KENYA

1PHILEMON AZANGU NGAIRA, 2DR. JULIUS MIROGA

1Master Student, Jomo Kenyatta University of Agriculture and Technology, Kenya
2Senior Lecturer, Department of Economics, Finance and Accounting College of Human Resource Development
Jomo Kenyatta University of Agriculture and Technology, Kenya

Abstract: A steady bank system is an important cornerstone which helps modern economies maintain stability and healthy development. In order to achieve this goal, Kenya's banking industry has experienced a long-term reformed process. A dysfunctional financial industry puts pressures on businesses and households thereby adversely affecting the real economy as capital may be prevented from flowing to worthy investments and may lead to credit crunches. In order to ensure that the financial industry remains sound to perform its financial intermediation role effectively, it is important that individual financial institutions in the industry implement relevant strategies that would ensure their financial stability. The purpose of this study was to establish the determinants of financial stability of commercial banks. The specific objective was to assess the influence of operating costs on the financial stability of the listed commercial banks in Kenya. The study was based on the theory of systemic risk and design of prudential bank regulation. A descriptive survey research design was adopted for the study. The study population comprised of 356 bank staff from eleven listed commercial banks in Kenya. A representative sample of 78 respondents was drawn from the population. The data for the study was collected by use of questionnaires. Cronbach’s Alpha of coefficient test was used to determine the reliability while test-retest and data triangulation technique was used to determine the validity of the instruments. The SPSS was used to analyze questionnaires. The empirical analysis of the study was conducted using both descriptive statistics and Ordinary Least Square regression analysis. It was concluded that Operation Costs have a significant negative influence on financial stability of commercial banks. It was suggested that further studies should consider inflation and GDP which affect commercial banks earning.

Keywords: Operational Costs, Financial Stability, commercial banks.

1. INTRODUCTION

Stability of the financial system in an economy is an important catalyst for economic growth due to its function in facilitating exchange of value (Swamy, 2014). Through their functions, they facilitate the flow of funds from surplus households to deficit households in a more efficient manner thereby promoting economic growth and development (Ratnovski, 2013). Commercial banks need to proactively study the operating environment and develop relevant strategies that would reduce the severity of their exposure to situations that are likely to affect their financial stability. According to Huang and Ratnovski (2011), an adequate regulatory mechanism beyond the traditional reserve requirements needs to be enforced to address and mitigate the systemic component of funding liquidity risk among commercial banks. The reserve ratios made by each bank may not be adequate for the liquidity exposure they face as they are subjectively determined. Allam (2013) argues that some commercial banks set their liquidity levels through mimicking behavior in liquidity choices which may also arise from learning motives.

According to Azam and Siddiqui (2012), commercial banks have to learn, adopt and re-orient themselves to the changing environment if they are to be competitive and perform their intermediation function effectively. Like other organizations, the banking industry is faced with turbulence arising from increased globalization, internationalization, advancements in information, communication and technology and trade liberalization. Commercial banks therefore, ought to proactively engage themselves in strategies that will enable them to respond to the environmental challenges in
order to gain competitive advantage (Khrawish, 2011). Financial stability describes the condition where the financial intermediation process functions smoothly thereby building confidence among users (Merga, 2013). It refers to the smooth operation of the system of financial intermediation processes between households, firms and the government through a range of financial institutions supported by a myriad of financial infrastructure (Khan, 2011).

Financial stability may be hampered by both internal processes and strong shocks leading to the emergence of weak spots. Such shocks may arise from the external environment, domestic macroeconomic developments, main debtors and creditors of financial institutions, economic policies or changes in the institutional environment (Azam & Siddiqoui, 2012). Any interaction between weak spots and shocks can result in the collapse of major financial institutions and disruption of the functions of the financial system as regards financial intermediation processes. In the extreme case, it may even lead to a financial crisis with adverse implications for the economy (Vento & Ganga, 2010).

The Financial stability of commercial banks can be affected by internal and external factors. These factors can be classified into bank specific (internal) and macroeconomic variables. The internal factors are individual bank characteristics which affect the bank's performance. These factors are basically influenced by the internal decisions of management and board (Almazari, 2014). The external factors are sector wide or country wide factors which are beyond the control of the company and affect the profitability of banks (Azam & Siddiqoui, 2012).

Bank stability is mostly measured in a negative way by considering individual or systemic distress broadly defined as periods where the banking system is not capable of fulfilling its intermediation function for the economy effectively anymore. Koch and MacDonald (2014) define banking distress as systemic if non-performing assets reach at least 10% of total assets at the peak of the crisis; the fiscal cost of the rescue operations. Many central banks through their financial stability reports (FSRs) attempt to assess the risks to financial stability by focusing on a small number of key indicators (Gadanecz & Jayaram, 2008).

Fluctuations in the global financial system are a constant concern and due to this many countries are prioritizing financial stability over financial growth, as growth maybe unsustainable over long periods of time (Schneider, 2008). To achieve financial stability, many countries are strengthening financial regulation. Without sound and effective regulation, financial systems can become unstable, triggering crises that can devastate the real economy as evidenced by the recent global financial crisis that began in 2007 (Spratt 2013). Finances are meant to facilitate productive economic activity; the aim of regulation is to maintain financial stability and to promote economic growth.

Statement of the Problem

A safe and sound banking system ensures that there is optimal allocation of capital resources. Regulators therefore aim to prevent costly banking system crises and their associated adverse feedback effects on the real economy (Jahn & Kick, 2012). A dysfunctional financial industry puts pressures on businesses and households thereby adversely affecting the real economy as capital may be prevented from flowing to worthy investments and may lead to credit crunches. A number of studies have been conducted on financial stability and financial sector responses across the world (Ahiawodzi et al, 2012; Njiwakale, 2013; Muguchu, 2013; Othieno, 2010; Odongo, 2014). Some scholars argue that interest rate, operation costs and bank size have significant effect on banks stability while others ascertain no significant relationships among the variables (Othieno, 2010; Odongo, 2014). These mixed results trigger further research. Banks management practices such as restructuring, reduction in physical bank branches and employee lay-offs are indicators of instability (CBK, 2016). Mergers, acquisition and change in shareholding in the banks such as the Spire Bank are in the rise. Secondly, many financial institutions including commercial banks and microfinance institutions are closing down in the Kenya for instance, Chase Bank and Imperial Commercial Bank (CBK, 2016). Profits for commercial banks shrank by 5 per cent to Sh134billion in 2015 in a disruptive year that saw two lenders placed under receivership. The National Bank of Kenya has been going through a rough patch, with its profit after tax having dropped to Sh138.1 million in the period to September 2017 compared to Sh521 million reported over a similar period in 2016 (CBK, 2017). According to KBA (2017) members cut 1,933 jobs between August 2016 and the end of June 2017. Banks had 28,009 staff as at August 2016, but the firing spree saw the sector’s workforce fall to 26,076 employees by June 2017. The country’s biggest bank by asset, Kenya Commercial Bank, announced it would lay off some staff. Sources put the number at more than 500, including 28 workers in its Rwanda branches. In June of the 2017, Barclays Bank of Kenya announced that it would lay off 130 employees through a voluntary exit scheme. First Community Bank, which does not even charge interest, also announced it would axe 106 staff. In early 2017, Equity Bank, Kenya’s largest by customer base, let go of more than 400 workers. Standard Chartered Bank followed closely, sending home more than 300 workers while Sidian Bank let go of 108. The NIC Bank
sacked 32. So far, at least 10 banks have shed part of their workforce. This study seeks to understand the factors that affect the institutions’ stability. These therefore trigger further research with an aim of understanding instability in the banking sector. Lastly, there is also little research done on banking stability in Lurambi Sub-county. This study therefore bridges this gap.

Specific Objective and Hypothesis
The main objective of this study was to establish the determinants of financial stability of listed commercial banks in Kenya.

H01: There is no significant statistical influence of operational cost on financial stability of the listed commercial Banks in Kenya.

2. CONCEPTUAL FRAMEWORK

Figure 1: Conceptual Framework showing relationship between operation cost and financial stability.

Operational Cost
The level of operating expenses is normally looked at as a way of measuring the efficiency of a firm’s management (Onuonga, 2014). Memmel and Raupach (2010) in their study of several European countries conclude that operating costs have a negative effect on profit measures despite their positive effect on net interest margins. Efficiency in cost management is normally measured as a ratio (operating costs to assets). This is due to the fact that only operating expenses can be directly associated to the outcome of bank management (Athanasoglou et al. 2008). This has resulted in a negative relationship due to the fact that improved management of bank expenses lead to improved efficiency and thus improved profitability ratios. Commercial banks that are interested in achieving high profitability need to develop ways of ensuring that their costs of operations are maintained at an acceptable level. Firms that are able to minimize their costs of operations are considered to be more efficient and it is also expected that they post higher profits margins than their counterparts that have higher costs of operations (Ongore & Kusa, 2013).

Hoffmann (2011) suggested that high cost of operations lead to lower profit margins since it means that the organization is spending more in order to get output. It is important to note that due to competition and market regulations, a bank that is faced by high cost of operations cannot pass the whole burden to the customers through increasing the bank fees and charges and therefore this means that the bank has to shoulder it (Andrés & Arce, 2012). Increased costs affect the left side of the profit and loss statement and this means that the profits realized will be lower than in a case where the costs of operations are lower (Kusa, 2013). The operating costs of a bank are normally expressed as a percentage of the profits and they are normally expected to influence the financial performance of the bank in a negative manner (Swarnapali, 2014).

Onuonga (2014) conducted a study on the analysis of financial stability of Kenya’s top six commercial banks. This study aimed at investigating the impact of the internal determinants of financial stability of Kenya’s top six commercial banks over the period 2008-2013. This study used generalized least squares method to estimate the impact of bank assets, capital, loans, deposits and assets quality on banks financial stability. This paper used return on assets (ROA) as a measure of profitability. The findings revealed that bank size, capital strength, ownership, operations expenses, diversification do significantly influence financial stability of the top six commercial banks.

Financial Stability
The turmoil on the financial markets during 2007-2008, invalidated a number of paradigms, due to the fact that many large credit institutions with international activities, although they were assigned by rating agencies with lower levels of risk categories faced bankruptcy or last minute intervention of the state so that they can continue their activity (Hodachnik, 2009). Thus arose some controversy about the effectiveness of financial ratings as surveillance tools and on
the level of trust that was given to this instrument for monitoring and evaluation of the stability of commercial banks in order to avoid an excessive level risk due to asymmetry information. Taking into account the fact that banks must have an appropriate tool to assess their strengths and their vulnerabilities in order to consolidate their capacity to trigger a systemic risk (Lavrushin & Mamonova, 2011).

Stability of the banks is provided by high profitability of their activities, and also sufficient liquidity which indicates that banks has a balanced structure of assets and liabilities (Klaas & Vagizova, 2014). Financial stability of the banks in medium term can be reduced because of insufficient quality of capital, assets and liabilities, associated with aggression of their credit policy that increases credit risk, and as a result, probability of losses. Poor quality of credit portfolio indicating that unqualified management approaches of a credit portfolio are used with insufficient capitalization of some of banks. But the size of capital defines ability of bank to maintain stability during the crisis periods, dependence on interbank credit market and significant share of demand liabilities in structure of bank liabilities (Salim, 2014).

The considerable share or active growth of such mobile, difficult to predict resources is dangerous, because recall of these funds or their spending can lead to bank insolvency and as a result to loss of bank stability (Klaas & Vagizova, 2014). Financial stability of banks is maintained by sufficient capitalization which is characterized by the security level of risk assets and act as the guarantor of bank reliability and liquidity, and also high profitability demonstrates effectiveness of credit organizations resources use (Hodachnik, 2009). Batorshina (2013) posited that problem areas of lack of financial stability by commercial banks are the poor quality of assets and liabilities due to a considerable share of the overdue credits and demand liabilities, dependence on interbank credits that on the one hand characterizes unstable position of bank, but on the other hand shows trust in bank from other banks, the aggressive credit policy, and also poor quality of credit portfolio.

According to Gomez (2015) some banks in financial instability are characterized by sufficient level of liquidity and qualitative resource base. The raised funds take vital share in structure of bank resources and they provide the needs of the enterprises, the organizations and the population, including credit resources requirements. Relative instability banks were connected with undercapitalization, a considerable share of the interbank credits in structure of liabilities and overdue credits, poor quality of credit portfolio, and in some cases with aggressive credit policy and insufficiently stable resource base (Gomez, 2015).

### 3. FINDINGS AND DISCUSSIONS

**Descriptive Statistics: Operational Cost**

Operational costs are one of the crucial factors of financial stability that affects financial stability. To measure operational costs, a set of ten statements were formulated. The respondents were asked to indicate the extent of agreement with each of the operational cost statements from strongly disagree to strongly agree. The pertinent results are presented in Table 1.

<table>
<thead>
<tr>
<th>Operational Cost</th>
<th>SD</th>
<th>D</th>
<th>U</th>
<th>A</th>
<th>SA</th>
<th>Mean</th>
<th>STDEV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Uniqueness of products/services offered to the customers increase the operational costs in your bank</td>
<td>2.9%</td>
<td>5.8%</td>
<td>10.1%</td>
<td>58%</td>
<td>23.2%</td>
<td>3.9275</td>
<td>.91264</td>
</tr>
<tr>
<td>The company adopt business process re-engineering to manage the operational costs</td>
<td>5.8%</td>
<td>14.5%</td>
<td>24.6%</td>
<td>40.6%</td>
<td>14.5%</td>
<td>3.4348</td>
<td>1.09112</td>
</tr>
<tr>
<td>The company adopt consolidation of business functions as a strategy for managing the operational cost</td>
<td>2.9%</td>
<td>10.1%</td>
<td>7.2%</td>
<td>68.1%</td>
<td>11.6%</td>
<td>3.7536</td>
<td>.89780</td>
</tr>
<tr>
<td>The company adopted mergers and acquisitions as an operational cost management strategy</td>
<td>1.4%</td>
<td>13%</td>
<td>7.2%</td>
<td>53.6%</td>
<td>24.6%</td>
<td>3.8696</td>
<td>.98389</td>
</tr>
<tr>
<td>The company adopt restructuring cost management strategy to reduce the bank’s operational costs</td>
<td>4.3%</td>
<td>5.8%</td>
<td>4.3%</td>
<td>73.9%</td>
<td>11.6%</td>
<td>3.8261</td>
<td>0.87374</td>
</tr>
</tbody>
</table>
The objective of the study was to assess the influence of operational costs on financial stability of listed commercial banks in Kenya. The objective sought to test the research hypothesis of the study which posits: H0: There are no significant statistical effect of operational cost on financial stability of the listed commercial Banks in Kenya. This was accomplished by use of Pearson correlation (r) and linear simple regression (R^2) with aid of SPSS version 22

**Correlation between Operational Costs and the financial stability**

The Pearson correlation analysis was used to investigate the relationship between Operational Costs and the financial stability of listed commercial banks in Kenya. In investigating the influence of Operational Costs on the financial stability of listed commercial banks in Kenya, the study established a coefficient of correlation (r) as -0.582** , P<0.01 at 99.0% confidence level. This shows that there exist a moderate and significant negative relationship between Operational Costs and the financial stability of listed commercial banks in Kenya. This imply that the financial stability of commercial banks
increase with decrease in Operational Costs and an increase in Operational Costs leads to a decrease in their financial stability. The results are as shown in Table 2 below:

### Table 2: Correlation between Operational Costs and the financial stability

<table>
<thead>
<tr>
<th>Operational Costs</th>
<th>Pearson Correlation</th>
<th>N</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1</td>
<td>69</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Financial Stability</th>
<th>Pearson Correlation</th>
<th>N</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>-0.582**</td>
<td>69</td>
</tr>
</tbody>
</table>

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

### Regression Results of Operational Costs and Financial Stability

A simple linear regression was carried to assess the influence of operational costs on financial stability of listed commercial banks in Kenya and thereby test the second research hypothesis of the study which posits: \( H_01 \): There is no significant statistical effect of operational cost on financial stability of the listed commercial Banks in Kenya. This entails composite variable of Operational Costs index which was mean obtained from ten metrics that was used to measure Operational Costs in this study. Similarly, the composite value of financial stability was obtained by getting mean of ten metrics that was used to measure financial stability. The coefficient of determination, \( R^2 \) was relied on to overcome the problem of determining causality as it indicates the amount of variability in one variable that is explained by the others. The detailed results of simple linear regression analysis involving Operational Costs and financial stability of commercial banks in Kenya is as shown in Table 3 which is composite table comprising of Model summary, ANOVA and regression coefficients.

### Table 3: Simple Regression Analysis Results

#### Model Summary

<table>
<thead>
<tr>
<th>Model</th>
<th>( R )</th>
<th>( R^2 )</th>
<th>Adjusted ( R^2 )</th>
<th>Std. Error of Estimate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>.582a</td>
<td>.339</td>
<td>.329</td>
<td>.31294</td>
</tr>
</tbody>
</table>

\( a. \) Predictors: (Constant), Operational Costs

\( b. \) Dependent Variable: FinStab

#### ANOVA

<table>
<thead>
<tr>
<th>Model</th>
<th>Sum of Squares</th>
<th>df</th>
<th>Mean Square</th>
<th>F</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regression</td>
<td>3.358</td>
<td>1</td>
<td>3.358</td>
<td>34.294</td>
<td>.000b</td>
</tr>
<tr>
<td>1</td>
<td>Residual</td>
<td>65</td>
<td>.098</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>9.920</td>
<td>67</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

\( a. \) Dependent Variable: FinStab

\( b. \) Predictors: (Constant), Operational Costs

#### Coefficients

<table>
<thead>
<tr>
<th>Model</th>
<th>Unstandardized Coefficients</th>
<th>Standardized Coefficients</th>
<th>T</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>B</td>
<td>Std. Error</td>
<td>Beta</td>
<td></td>
</tr>
<tr>
<td>(Constant)</td>
<td>.4.659</td>
<td>.168</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Operational Costs</td>
<td>-.494</td>
<td>.084</td>
<td>-.582</td>
<td>-5.856</td>
</tr>
</tbody>
</table>

\( a. \) Dependent Variable: FinStab

The proportion of variance in commercial banks financial stability in Kenya explained by the independent variable (Operational Costs) is 33.9% or \( R^2=0.339 \). The adjusted \( R^2 \) value obtained, which is a corrected \( R^2 \) value to provide a useful estimate of the true study population. In order to assess the model significance, simply whether the model fits well the given data, the study resorted to F ration. The F-ratio from the findings indicates the ratio of the

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improvement in the model relative to the inaccuracy that still exists in the model. From the findings, the F ratio is greater than 1, as indicated by a value of 34.294, which means that improvement due to fitting the model is much greater than the model inaccuracies (F(1,69)= 34.294, P=0.000). The F value is large which is very unlikely to have happened by chance (p<.05), thus implying that the final model significantly improves the ability to predict financial stability of commercial banks. This also implies that Operational Costs is useful predictor of financial stability of commercial banks in Kenya.

The study has an option of either using Unstandardized Coefficients or Standardized Coefficients depending on the type of data. The study used unstandardized coefficient column because we want to compare Operational Costs level effect across same measures (Likert Scale 1 through 5) with financial stability. However, if the measure were different, then standardized coefficients which are based on standard deviation would be appropriate. From the findings presented in Table 4.0, Operational Costs carried negative significant predictive power while the constant carried positive and significant value. This implies that if Operational Costs is held at zero or it is absent, the financial stability will be significantly at 0.4.659, p<0.01. The B coefficient of Operational Costs was -0.494. This values is significant (B=-.494, p=.000) implying that a unit change in Operational Costs level would result to significant change in financial stability by 0.494 in the opposite direction. Therefore, the linear regression results indicated that there was a statistically significant negative relationship between Operational Costs and financial stability of commercial banks in Kenya.

The study developed analytical model shown below for predicting financial stability from Operational Costs is stated in the form of:

Financial Stability=4.659-0.494Operational Costs

The null research hypothesis posited H$_{0}$: There is no significant effect of operational cost on financial stability of the listed commercial Banks in Kenya was rejected using both r and R$^2$. From the results, operational cost had significant negative effect on financial stability with P<0.01 and it significantly accounted 33.9% variance in financial stability of the listed commercial Banks in Kenya. Therefore, the null hypothesis is rejected as operational cost has significant effect on financial stability of the listed commercial Banks in Kenya.

These findings compare favourably with Memmel and Raupach (2010) in their study of several European countries conclude that operating costs have a negative effect on profit measures which affects financial stability of banks. Andrés and Arce (2012) found out that increased costs affect the left side of the profit and loss statement and this means that the profits realized will be lower than in a case where the costs of operations are lower. Further, Swarnapali (2014) revealed that operating costs of a bank are normally expressed as a percentage of the profits and they are normally expected to influence the financial performance of the bank in a negative manner. Also, Onuonga (2014) conducted a study on the analysis of financial stability of Kenya’s top six commercial banks indicated that bank size do significantly influence financial stability of the top six commercial banks.

4. CONCLUSION AND RECOMMENDATION

It was found that there is significant negative influence of operational cost on financial stability of listed commercial banks in Kenya. Thus the second research hypothesis was rejected. An increase in operational costs would make commercial banks less stable financially as it would make commercial banks to realize more profits. It was noted that listed commercial banks have adopted restructuring cost management strategy to reduce the bank’s operational costs.

Operating costs negatively influenced financial stability of listed commercial banks in Kenya. It was recommended that commercials banks need to reduce their operational costs so as to increase their profit margins. This can be achieved by adoption of appropriate information technology to automate various processes and restructuring cost management strategy to reduce the bank’s operational costs.

REFERENCES


