

PRUDENTIAL REGULATIONS AND FINANCIAL PERFORMANCE OF LICENCED MICROFINANCE BANKS IN KENYA

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Abstract: Microfinance enhances the financial capacity of the economically disadvantaged, often ignored by commercial banks and other lending institutions, by offering services such as credits, insurances, and savings, thereby encouraging self-employment. Due to various variables businesses encounter, guidelines, decrees, and rules are necessary to regulate their operations, ensuring a fair structure for all companies within a sector. This regulatory framework is essential for the financial industry, especially microfinance banks, to operate within set boundaries. This study examines the impact of prudential regulations on the financial performance of Kenyan microfinance banks. It specifically focuses on the effects of capital regulation on financial performance. Theoretical framework reviewed was stakeholder theory. The study's target population consisted of the fourteen (14) licensed microfinance banks in Kenya, employing a census of all these microfinance banks and an explanatory research design. The study utilized secondary data, which was sourced from the financial statements of selected microfinance banks in Kenya. This information encompassed data collected over a seven-year period, from 2015 to 2022. Findings revealed that capital regulation significantly ($p = 0.013$) and negatively ($\beta = -3.3184$) impacts financial performance. The study recommends that microfinance banks recognize the importance of capital management and ensure regulatory compliance.

Keywords: Capital Regulation, Microfinance Bank, Financial Performance.

1. INTRODUCTION

In numerous emerging economies, notably in Sub-Saharan Africa (SSA), microfinance has been seen as a progressive instrument to combat poverty by offering long-term help to the underprivileged. On the basis of its organizational framework, purpose, as well as approach/methodology, it provides financial support for customers and interested parties who have no access to traditional institutions or other official finance services companies. Like their counterparts in other countries, microfinance banks in SSA offer low-income customers loans, money transfers, savings, insurance, and other financial services. Microfinance institutions are growing more quickly in SSA, putting them to rank among the most productive institutions worldwide in terms of the volume of deposits and borrowers. Additionally, in SSA, microfinance institutions are now employed as development instruments to assist individuals in escaping poverty (Remer & Kattilakoski, 2021).

According to Ongore and Kusa (2013), strong financing performances of bank results in a stable and lucrative banking industry. Bank robberies, crises, and big financial crises are caused by poor performance (Molefe & Muzindutsi, 2015). Therefore, the main goals of bank rules are maintaining a healthy and successful banking industry. Regulations are a set of instructions that every person or company must follow, failing which there will be severe repercussions, whereas

recommendations are actions that have been suggested as the ideal for producing high returns and enhancing future corporate performance.

1.1 Prudential Regulations

The CBK has established specific thresholds for various prudential regulations, which include capital adequacy where financial institutions are obligated to preserve a minimum core capital of Ksh 250 million. Additionally, the total capital must be at least 14.5% of the total risk-weighted assets (Mwenga, 2014; Nuriye & Gatauwa, 2024). Financial institutions must maintain a liquidity ratio of at least 20%. This ratio is essential for guaranteeing that banks can fulfill their immediate commitments without suffering substantial losses (CBK, 2013; Mwenga, 2014). Furthermore, The CBK has established rules that impose a restriction on the maximum exposure a bank may have to any one borrower or a group of related borrowers. This restriction is set at 25% of the bank's core capital. This is to mitigate the risks associated with high credit concentration and ensure diversification of credit risk (CBK, 2013; Business Results Group, 2023).

A Study by Barth, Gerard, and Levine (2018) According to Till Angels Regulate, due to the various variables that businesses experience, guidelines, decrees, and rules are required to regulate everything they do. This will support the spread of what seems to be a fair arrangement for all companies operating in a certain industry. The finance industry, especially banking-microfinance banks, must be under regulation so that they can carry out operation according to the set guidelines.

Detection, assessment, supervision, and control of credit risk from the potential of delayed payments in reimbursements are only a few of the things that credit risk regulation comprises. (Coyle, et al., 2017). Banks lend loans on the premise that lenders will pay off their debt, although credit is granted to loan borrowers might lead to defaults. Revenue will vary because microfinance institutions don't predict what percentage of their debtors will fail, increasing the risk of profit swings for the banks (Onyiriuba, 2019).

It is impossible to overstate how essential credit risks regulation is in microfinance performance. Credit risks must be properly managed and controlled to increase client trust credit risk regulation employs bank risk, improved risk level of interest, and evaluating the impact of credit risks regulations on banks profitability to limit credits risk exposure to a minimum. (Kargi, 2016).

1.2 Financial Performance

Tomuleasa and Cocris (2019) state that the three primary indicators of Return on assets, Returns on Investments (ROI), and Nets Interests' Margins (NIM) are used in assessing bank' performances. The objective of the measure dictates the preferred metrics that are used to assess financial performance. According to Ross, Westerfield, and Jaffe (2016) and Ceylan, Emre, and Asl (2018), profitability is the most widely used measure of bank success. The two key indicators of profitability of banks are believed to be ROA and ROE. In this study, financial performances evaluation is in light of ROA and ROE.

1.3 Microfinance Banks in Kenya

Kenya was ranked first in Africa and sixth worldwide in terms of microfinance activities (Ayele, 2018). Only roughly 56 of Kenya's nearly 250 microfinance institutions are licensed by Association of Microfinance Institutions, an advocacy group. As of December 2016, Kenya had 13 deposits taking microfinance institutions. Kenya Women Finance Trust (KWFT), Small and Medium Enterprises Program (SMEP), Rafiki MFB, Sumac MFI Bank Ltd, Faulu Kenya, Century MFI, and Uwezo MFB are just a few of the prominent companies in the sector (Njenje & Bengi, 2016).

Kenya's microfinance business caters to households that are receiving little money as their income and Micro and Small Enterprise (MSEs) participating in an economic activity that is not related to farming. MFBs have make known some important advances in goods and services that are used by MSEs over time (Gibson, 2018). The overall resources of the microfinance sector have grown steadily over the last three years, with banks dominating the sector (Agola, 2017).

2. STATEMENT OF THE PROBLEM

The financial success of Kenya's microfinance banks has been appalling despite the importance and improvements in their development (Central Bank of Kenya, 2019). As per the supervisory report from the CBK, the financial losses experienced by 13 microfinance banks surged by an alarming 561% in 2020 compared to the previous year, escalating from Ksh 339 million in 2019 to Ksh 2.2 billion in 2020. In 2015, microfinance banks achieved a return on equity of 5%,

marking the only year in the analyzed period where they generated notable profits. However, subsequent years saw a decline in shareholder returns, with negative figures recorded: -3.2% in 2016, -5.5% in 2017, -13.8% in 2018, -3% in 2019, and a staggering -28% in 2020. Furthermore, the Return on Assets (ROA) for microfinance banks was reported at -0.9% in 2017, deteriorating further to -5.5% in 2018. Although there was a slight recovery in 2019 with a ROA of -0.4%, the situation worsened again, with ROA figures of -3.8% in 2020 and -0.96% in 2021 (CBK, 2022). This data underscores the significant challenges faced by microfinance banks in Kenya during this period, particularly in terms of profitability and asset management.

Mersland and Strom (2019) found that knowing how regulations and supervisions affects the performances of microfinance banks is important in their investigation on efficiency and governance in microfinance institutions. This current investigation assessed the effects of capital, credits as well as liquidity regulations on Kenyan microfinance banks unlike the survey by Mersland and Strom who investigated the Performance and governance in MFIs.

3. OBJECTIVE OF THE STUDY

3.1 General Objective

The general objective of this study is to examine the effect of prudential regulations on financial performance of microfinance banks in Kenya.

3.2 Specific Objectives

- i. To determine the effect of capital regulation on financial performance of microfinance banks in Kenya.

4. RESEARCH HYPOTHESES

H₀: Capital regulation has no significant effect on financial performance of microfinance banks in Kenya.

5. THEORETICAL REVIEW

5.1 Stakeholder Theory

The stakeholders' theory was postulated by Freeman in 1984. The theory asserts that corporations have a responsibility not just to their shareholders but also to a broader range of stakeholders who have the ability to influence or be influenced by the organization's activities (Freeman, 1984). The stakeholders include many groups including as workers, consumers, suppliers, the community, and regulators. The thesis posits that firms need to provide value for all stakeholders, rather than only focusing on maximizing profits for shareholders. This broad perspective is rooted in the belief that long-term success and sustainability are best achieved when the interests of all stakeholders are considered and balanced.

The stakeholder theory serves a pivotal role in highlighting the accountability of organizations towards all parties impacted by their operations. This includes not only microfinance institutions but also regulatory bodies, clients, investors, employees, and the wider community. By integrating stakeholder theory into the research, the analysis will encompass a thorough examination of the diverse effects that prudential regulations have on the financial performance of microfinance banks. This approach will take into account the interests, viewpoints, and results for different stakeholders, which is essential for grasping the extensive ramifications of regulatory actions within the microfinance industry.

6. EMPIRICAL REVIEW

6.1 Capital Regulation and Financial Performance

Wanjiru (2016) looked at how regulation affects the financial performances of Kenya micro-financial banks. The study's targeted demographic was thirteen Kenyan micro financial banks. The research looked at regulatory theory, capture theory, and economic theory of regulation. From 2011 to 2015, secondary data was garnered from the microfinance organizations' finance records in Kenya. Returns on asset and returns on equity were both influenced by capital sufficiency, with return on asset being positively impacted, based on the study. Stakeholder theory, capital buffer theory, and liquidity shiftability theory were all discussed in this research.

David and Muendo (2018) studied the effects of laws from CBK on results of the microfinance institutions financially. The study's intended audience was thirteen microfinance institutions that Central Bank of Kenya was in charge of as of December 31, 2016. All 82 personnel in the risks, legal compliances, and financial divisions of the entire Kenyan microfinance' banks were taken as variables for the population census sample. Primary and secondary data was both

utilized for the inquiry. According to the report, capital adequacy has a big impact on how well microfinance firms operate financially. This study employed the use of secondary and primary data even though it was primarily concerned with Kenyan microfinance banks while secondary data was used for the present investigation which was taken from microfinance banks' financial statements. Secondary data notably is considered as a more objective form of data as compared to primary data.

7. CONCEPTUAL FRAMEWORK

The study dependent variable was financial performances and the independent variable was capital regulation.

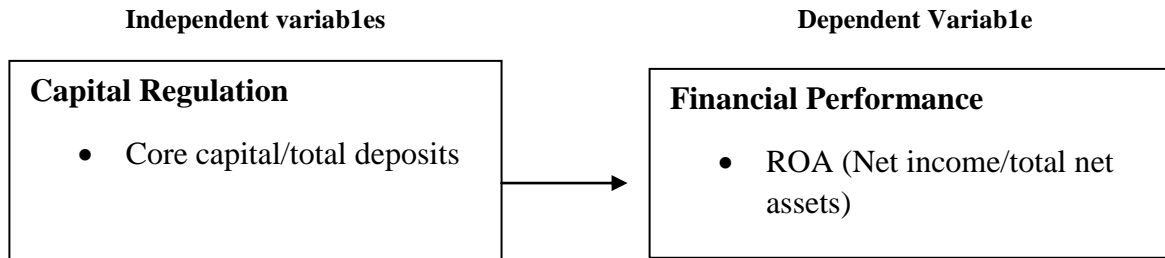


Figure 1: Conceptual Framework

Source: Researcher (2024)

8. RESEARCH METHODOLOGY

The study, which is quantitative in nature used explanatory survey design. All fourteen (14) licensed microfinance establishment in Kenya controlled by CBK were included in the research population (CBK, 2019). A census approach was used because the study's sample consisted of the 14 licensed microfinance institutions.

In the analysis, a correlation and multiple regression model was used. The result of financial performance was expressed as a function of prudential regulations (capital, credit and liquidity regulation).

$$FP_{it} = \beta_0 + \beta_1 CR_{it} + \epsilon$$

Where:

CR_{it} = Capital regulation

β_0 = Constant

β_0 - β_3 = Beta Coefficients

ϵ = Error term

9. DESCRIPTIVE ANALYSIS

The study results shows statistical measures such as means, standard deviations, as well as minimum and maximum values, which are documented and explained. The specific findings of this analysis are presented in Table 1.

Table 1: Descriptive Results

Variable	Obs	Mean	Std. Dev.	Min	Max
Financial Performance	104	-.0794224	.128985	-.5838218	.0466136
Capital Regulation	104	.0029088	.0089651	-.0100599	.0576592

Source: Study Data (2024)

The study results in Table 1 uncovered that a mean of -0.0794224 value associated with financial performance and a standard deviation of 0.128985. The lowest and highest values recorded for financial performance are -0.5838218 and 0.0466136. The mean value of -0.0794224 denotes that, on average, microfinance banks in Kenya have a negative financial performance. This indicates that, as a group, these banks are facing challenges in generating profits and achieving positive financial outcomes. It suggests that their expenses may be exceeding their revenues, resulting in financial losses. The deviation of 0.128985 standards indicates the extent of variability or dispersion in the financial performance values across the observed microfinance banks. A relatively moderate standard deviation suggests that there

is a certain level of consistency in the financial performance among the surveyed banks. These statistics indicate that, on average, microfinance banks in Kenya have a negative financial performance, with some variations observed among the banks. This implies that within the time frame of the survey, the microfinance banks have witnessed losses.

The findings show that capital regulation has a mean value of 0.0029088, with a standard of 0.0089651 deviations. The mean value of 0.0029088 suggests that, on average, microfinance banks in Kenya maintain a balanced approach to capital regulation. This indicates that these banks have implemented measures to ensure they have an appropriate level of capital in relation to their risk exposure, allowing them to absorb potential losses and maintain financial stability. The standard of 0.0089651 deviations signifies the extent of variability or dispersion in the capital regulation values across the observed microfinance banks. A relatively low standard deviation suggests that most banks exhibit similar levels of capital regulation, indicating a certain level of consistency in their capital management practices. The smallest and upper limit values for capital regulation are -0.0100599 and 0.0576592. These figures suggest that microfinance banks in Kenya generally comply with capital regulations, as the mean value is close to zero, indicating a balanced capital position. The outcome contradicts the threshold set by the CBK of 14.5% indicating that microfinance banks in Kenya operate far below the capital regulation of CBK. This implies that microfinance banks in Kenya are vulnerable to the economic and financial risk hence affecting their financial performance.

10. DIAGNOSTIC TEST RESULTS

Table 2: Regression Results

ROA	Coef.	Std. Err.	z	P>z	[95% Conf. Interval]
Capital Regulation	-3.318468	1.312408	-2.53	0.013	-5.928334 - .7086015
_cons	-.0101813	.0241542	-0.42	0.674	-.0582145 .0378519
R-Square	0.1276				
F(3,13)	2.90				
Prob > F	0.0754				

Source: Study Data (2024)

$$Y = \beta_0 + \beta_1 X_{1t} + \epsilon$$

The results indicated the suitability of the regression model which was interpreted as follows;

$$Y = -0.0101 - 3.3184X_1$$

Results from the regression displayed an intercept value of -0.0101813. This term stands for the predictable performance financially when all the independent factors (regulations) are zero. The coefficient is not significant ($p > 0.05$), indicating that there is insufficient verification to suggest a significant linkage concerning the intercept and performance financially. The value of R-squared of 0.1276 detailed capital regulation explain approximately 12.76% of the discrepancy in the explained factor (performance financially). The F-statistic of 2.90 with a corresponding p-value of 0.0754 unveiled that the overall model is marginally significant at the 0.05 level.

The coefficient for capital regulation is -3.318468. This indicates that an increase in capital regulation is related with a decrease in financially performed Kenyan microfinance banks. The negative sign suggests that stricter capital regulation requirements may have a detrimental effect on the banks that financially performed. The significant at the 0.05 level ($p < 0.05$) entails that capital regulation effect on performance financially is unlikely to have occurred by chance.

11. HYPOTHESIS TESTING AND DISCUSSION OF FINDINGS

11.1 Capital regulation has no significant effect on financial performance of microfinance banks in Kenya

Based on the specific objective of determining capital regulation effect on the Kenyans' MFBs financially performance, the initial stated hypothesis put forth that capital regulation has an insignificant effect on performance financially. However, on the precise outcome related to this objective, the hypothesis of null was abandoned, demonstrating capital regulation extensively affects the performance financially of microfinance of Kenyan banks. This outcome can be attributed to microfinance banks maintenance of an appropriate level of capital to meet regulatory requirements and mitigate potential risks.

12. CONCLUSION

The survey primarily examined how prudential regulation affects the MFBs that performed financially in Kenya. Precisely, the survey focused on assessing the regulation of capital effect on the banks performance financially. In relation to the specific objective of investigating the influence of capital regulation on the banks that financially performed, regulation of capital has a significant and negative impact on the microfinance financially performed banks in Kenya. The survey's conclusion highlighted that capital regulation plays a crucial role in shaping the banks performance financially in Kenya. By maintaining appropriate levels of capital, these banks can enhance their ability to absorb losses, mitigate risks, and safeguard depositors' funds.

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