

**EFFECTS OF LIQUIDITY MANAGEMENT GUIDELINES ON FINANCIAL PERFORMANCE OF  
COMMERCIAL BANKS IN KENYA.**

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**ABSTRACT**

*The purpose of the study was to investigate the effect of liquidity management guidelines on financial performance of commercial banks in Kenya. This study used descriptive survey research design. The researcher targeted all 42 commercial banks in and purposively selected three senior management staff from every bank to arrive at a sample size of 130 respondents that participated in the study. The study collected both primary and secondary data. Structured questionnaires were used to collect primary data. Data collected was quantitative in nature and it was analyzed by factor analysis and descriptive analysis. The descriptive statistical tools such as SPSS version 26 was used to describe the data and determine the extent to which the growth strategies are used and the level of growth achieved. The findings were presented using tables and charts. The findings indicated that central banks prudential guidelines on liquidity management affects the overall banks performance on total deposits.*

**Key Words:** *Liquidity Management, Central Bank of Kenya Guidelines*

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## **INTRODUCTION**

Central bank is widely regarded as a vital part of the public safety net supporting the stability of the banking system and financial markets. A central bank that is financially independent and has a sizeable portfolio of securities can provide large amounts of liquidity to institutions on very short notice. Indeed, central bank lending has been a prominent part of regulatory assistance to troubled financial institutions for a long time. The Central Bank of Kenya (CBK), like most other central banks around the world, is entrusted with the responsibility of formulating and implementing monetary policy directed at achieving and maintaining low inflation as one of its two principal objectives; the other being to maintain a sound market-based financial system.

The CBK has issued a new set of Prudential Guidelines and Risk Management Guidelines which came into force on 1st January, 2013 (the “Prudential Guidelines”). Banks, financial institutions and mortgage finance companies need to adhere to these Prudential Guidelines. This study delimited itself to guidelines on Liquidity Management. The study sought to assess the effect of liquidity management guideline on the financial performance of banks in Kenya. The guideline on liquidity management was issued under Section 33(4) of the Banking Act, which empowers the Central Bank of Kenya to issue guidelines to be adhered to by institutions in order to maintain a stable and efficient banking and financial system.

The banking sector is always deemed to be one of the most vital sectors for the economy to be able to function. Its importance as the “lifeblood” of economic activity, in collecting deposits and providing credit to the state and people, households and businesses is undisputable. In all economic systems, banks have the leading role in planning and implementing financial policy. The difference lies with prioritizing goals and their way of achievement. Based on the neo-liberal model, achieving greater profits by using all means is an end in itself, while in the socialistic systems bank operations also aim at improving economy in general and at satisfying social needs.

Bank performance can be influenced by both internal and external factors. The internal factors are the individual banks characteristics influenced by decisions made by the individual bank management and governing board. External factors are issues that are beyond control of individual banks, inflation, interest rates and political instabilities of a country. (Ongore and Kusa, 2013). In commercial banks, good performance results in increased profitability and shareholder’s worthiness. A profitable bank increases its shareholder’s worthiness thus maximization of wealth is achieved (Njeule, 2013). Commercial banks play a major role in the economy of resources allocation in Kenya, they channel funds from depositors to investors. This can only be done if the banks are profitable. Good financial performance rewards shareholders for their investment thus encourage additional funding resulting in economic growth. Poor performance by the banks can result in banking failure than can have a negative impact on the economy of a country (Ongore and Kusa, 2013).

In the past two decades, research on the performance of commercial banks have indicated that commercial banks in the sub-Saharan Africa have been more profitable than the rest of the world. This is largely attributed to the risky ventures that banks undertake. There is also a huge gap between supply and demand for banking services as there are few banks in East Africa thus less competition and high interest rates resulting in high profits. In Kenya, the financial performance of commercial banks has improved in the last decade as indicated by the placement of only two banks under statutory management by the Central Bank of Kenya compared to 37 banks that failed between 1986 to 1998 (Nzoka, 2015).

### **Statement of the Problem**

Recently Kenya has experienced banking problems requiring major reforms of the banking systems. For example, Chase bank Ltd a mid-sized lender was temporarily closed by the regulator in April after an unexplained loss of billions of shillings. KCB Group was appointed its receiver and the central bank promised

to return it normal operation by the end of the first quarter of 2017. The temporary closure of Chase, which followed the closure of Imperial Bank, another mid-sized lender, and Dubai Bank Kenya, a smaller lender, dented confidence in the industry, which has also seen a jump in bad debts. The problems were largely due to domestic causes, such as weak banking supervision and inadequate capital. A key part of bank regulation is to make sure that firms operating in the industry are prudently managed (Berg, 2010) Thus, prompting the need for this study that sought to examine the effects of Central bank prudential guidelines on bank financial performance. To the best of the researcher's knowledge there was limited studies that focused on Central Bank of Kenya prudential guidelines on liquidity management and financial performance. It was against this background that his study investigated the effect of Central Bank of Kenya prudential guidelines on liquidity management and financial performance of commercial banks in Kenya.

### **Objective of the Study**

The objective of the study was to find out the effects of liquidity management guidelines on financial performance of commercial banks in Kenya.

## **LITERATURE REVIEW**

### **Theory of Liquidity and Regulation of Financial Intermediation**

The Theory of Liquidity and Regulation of Financial Intermediation was formulated by Farhi, Golosov and Tsyvinski (2009). The theory postulates that there are two informational frictions: agents receive unobservable shocks and can participate in markets by engaging in trades unobservable to intermediaries. Without regulations, intermediaries provide no risk sharing because of an externality arising from arbitrage opportunities. With regulations, intermediaries provide risk sharing because of an externality arising from arbitrage opportunities.

Farhi *et al.*, (2009) identified a simple regulation a liquidity requirement that corrects such an externality by the interest rate on the markets. They showed that whether markets under provide or over provide liquidity and whether liquidity cap or liquidity or should be used depends on the nature of the shocks that agent's experience. Moreover, they proved that the optimal liquidity adequacy requirement implements a constrained client allocation subject to unobservable types and trades. They provide closed form solutions for the optimal liquidity requirement and welfare gains of imposing such requirements for two important special cases. In contrast with the existing literature, the necessity of regulation does not depend on exogenous incompleteness of markets for aggregate shock. It is difficult for an individual financial intermediary to preclude an agent to enter in additional risk sharing contracts with other intermediaries. Possibility of hidden trades can significantly worsen and even eliminate risk sharing.

Allen and Gale (2004) then conclude that, in the absence of aggregate shocks and incompleteness of the markets for aggregate risk, there is no regulation that can improve upon the market equilibrium. In contrast to the literature, Farhi et al, (2009) proposed that imposing a liquidity requirement on the minimal (liquidity cap) or the maximal (liquidity cap) amount of liquidity holdings of the short asset for an intermediary. They identify a reason for the market failure and externality in which intermediaries do not internalize how liquidity they provide aspects other intermediaries via the possibility of trades on private markets. Importantly, this externality exists even when there are no aggregate shocks. This contrasts with the conclusions of Holmstrom and Tirole (1998) and Allen and Gale (2004) that the government has a role in regulating liquidity only if there are aggregate shocks. They also provide a closed form solution for the optimal regulation in two cases: for a setup with logarithmic utility and for the environment studied by Diamond and Dybvig (1983). Their model suggests practical implications for regulation of financial intermediation. Various types of intermediaries or different regions in a country, depending on the primary nature of the shocks that the agents whom they serve experience, should have different forms of liquidity regulations.

## Empirical Review

### Liquidity Management Prudential Guidelines and Financial Performance

Liquidity refers to the ability of an institution to fund increase in assets and meet obligations as they fall due without incurring unacceptable losses or risking damage to the banks reputation. (Guthua, 2013). The theory was put forward by John M. Keynes (1939). The theory asserts that institution hold funds to meet obligations as they fall due without incurring unacceptable losses. Liquidity preference refers to the amount of money the public is willing to hold given the prevailing interest rate. Liquidity refers to the ability of an institution to fund increase in assets and meet obligations as they fall due without incurring unacceptable losses or risking damage to the banks reputation (Guthua, 2013). Liquidity risk emerges when market players are unable to convert their stocks into cash when required. This may be due to infrastructure inefficiencies and general market tightness (The Kenya Financial Sector Stability Report, 2014). Keynes argued that there are three reasons for holding liquid assets; for transactions purposes, precaution against a contingency and for speculative purposes.

Commercial banks face various risks that may affect their performance; liquidity risk is the risk that a bank will encounter difficulty in meeting obligations from its financial liabilities. The aim of managing liquidity is to ensure, that banks have sufficient liquidity to meet its liabilities.

when due, banks are required to maintain a portfolio of short-term liquid assets, largely made up of short-term liquid investment securities, loans and advances to banks and other inter-bank facilities, to ensure that sufficient liquidity is maintained thus increase its performance (Njeule, 2013). The theory therefore is applied in the study to determine the effects of liquidity management on financial performance of commercial banks in Kenya.

Banks maintain a portfolio of short-term liquid assets, largely made up of short-term liquid investment securities, loans and advances to banks and other inter-bank facilities, to ensure that sufficient liquidity is maintained. The level of liquidity of a bank is measured by the ratio of total loans to customer deposits or customer deposits to assets ratio (Mwongeli, 2013). This study measured liquidity by using customer deposits to assets ratio since it's the most used ratio by banks.

Mugo (2020) assessed whether prudential measures like liquidity regulation influence banks' performance in Kenya. Additionally, the study's purpose was to look at how liquidity regulation influences banks' performance in Kenya. Analysis included both descriptive and panel regression analysis, as well as the use of STATA software. Liquidity regulation was noted to influence bank financial performance significantly. The moderator had insignificant impact on prudential regulations and bank performance, and its interaction with liquidity had no significant impact on Return on equity (ROE). The study, conducted in Kenya, did not consider the impact of foreign exchange regulation. Mwenda (2018) assessed whether liquidity regulations influence microfinance institutions' financial performance in Kenya. The study used descriptive study approach. Data analysis was done by employing descriptive and also inferential statistics. It discovered significant positive correlation between liquidity regulation and financial performance. Although this research was conducted in Kenya, it concentrated on Kenyan microfinance banks, whereas the present research focused on commercial banks. Mohammed, Mutegi and Muriuki (2017) assessed liquidity management, as a measure of CBK prudential guidelines, and performance of commercial banks in Kenya. In addition, the researcher examined liquidity management (CBK/PG/05) on commercial banks' performance in Kenya. Furthermore, this research used a descriptive study approach. Findings indicated that commercial banks' performance is significantly affected by liquidity regulation. However, this study used secondary data, Primary was employed in the current research and cross tabulation as well as descriptive analysis was deployed for data analysis. Munywoki (2017) examined effect of liquidity regulation by CBKs on NSE-listed commercial banks' financial performance. Descriptive statistics as well as panel data regression analysis were adopted for data analysis from 2012 to 2016. Liquidity regulation

had significant positive association with listed banks performance as per the results obtained. The researcher focused on NSE-registered commercial banks whereas this research was carried out in samples commercial banks in Kenya hence contextual gap was addressed. In Nigeria, Aremu and Ajibike (2015) investigated whether liquidity influences bank performance. Moreover, the study assessed whether bank liquidity influences its performance. Additionally, the investigation focused on the Generalized method of moment techniques, which were tested on a panel of thirteen banks from 2004 to 2012. The outcomes of the study revealed an inverse and also significant link between net loans and bank performance. Hence, the study concluded that bank's liquidity is important in ascertaining its success hence they advised that banks need to increase their liquidity levels to guarantee improved performance. However, this study was performed in Nigeria but current research was performed in Kenya thus, addressing contextual gap. Bonner (2014) studied whether liquidity guidelines influences bank behavior in Netherlands. This research was carried out from 2008 to 2012. This study revealed that capital regulation was related to decreasing liquidity buffers. Due to the fact that liquidity and capital are costly for banks, this seems to be a potential cause for this impact. The other possible explanation was that through pressure of attaining capital adequacy, regulators and banks abandoned 20 liquidity risks. Lastly, reducing liquidity buffers may moderately be caused by rational choices of banks. Even though liquidity risk is not addressed by capital alone, it increases banks' chances to finance themselves in the market. Nevertheless, financial crisis revealed that, independent of particular reasons, liquidity buffers of banks were very low. In addition, high levels of capital were not an alternative for buffers and prudent liquidity risk management. The study was based in Netherlands but the ongoing research study was on banks in Kenya hence creating contextual gap deposits to assets ratio (Mwongeli, 2013). This study measured liquidity by using customer deposits to assets ratio since it's the most used ratio by banks.

## **METHODOLOGY**

This study adopted a descriptive survey research design. In this study, the researcher targeted all the 43 commercial banks in Kenya. The study population comprised of the senior most managers. In this study the researcher randomly selected a sample 13 banks from a population of 42 licensed commercial banks in Kenya. This sample included banks from all the 3 tiers. Further, 10 questionnaires were being administered in the banks selected. This yielded 130 questionnaires for analysis. The questionnaire items comprised of both closed ended and open- ended questions. A pilot study was conducted prior to the main study to ensure that the tools developed for use in the research were suitable in their content and length and that the respondents are interpreting the questions in the manner intended. To enhance the content validity of the questionnaires, appropriate and adequate items relevant to the research questions were included. The researcher used the most common internal consistency measure known as Cronbach's alpha ( $\alpha$ ). The data was then coded to enable the responses to be grouped into various categories. Qualitative data were analyzed through content analysis. The descriptive statistical tools such i.e. SPSS helped the researcher to describe the data and determine the extent used. The findings were presented using tables and charts. Data analysis used SPSS percentages, tabulations, means and standard deviation.

## FINDINGS

### Liquidity Management Guidelines and Financial Performance of Commercial Banks in Kenya

**Table 1: Overall Banks Performance over the last 5 years on Total Deposits**

			Overall Banks Performance over the last 5 years on Total Deposits				
			Very Poor	Poor	Average	Good	Very Good
Extent to which central bank prudential regulation guidelines affect your banks financial performance on Liquidity management regulation	Large Extent	Count	2	24	30	4	25
		% within Extent to which central bank prudential regulation guidelines affect your banks financial performance on Liquidity management regulation	2.4%	28.2%	35.3%	4.7%	29.4%
	Moderate Extent	Count	0	0	0	0	19
		% within Extent to which central bank prudential regulation guidelines affect your banks financial performance on Liquidity management regulation	0.0%	0.0%	0.0%	0.0%	100.0%
	No Extent	Count	2	8	6	2	8
		% within Extent to which central bank prudential regulation guidelines affect your banks financial performance on Liquidity management regulation	7.7%	30.8%	23.1%	7.7%	30.8%

The goal of this objective was to find if CBK prudential regulations on liquidity management affect the banks financial performances. To do this, the analysis involved correlating the independent variable and sought to access the effect of this on the dependent variable. I.e., the banks financial performance over the last five years on total deposits. 29.4% of those bank employees who said that the central bank prudential regulations on liquidity management affect their banks financial performance to a large extent also noted that the overall bank performance over the last 5 years on total deposit was very good. A further 4.7% of these noted that the banks overall performance was good. 19 respondents representing 100% of the respondents who thought that the central bank prudential regulations on liquidity management affected their banks financial performance to a moderate extent said their banks total performance on total deposit was very good. This shows some level of confidence in which the respondents believed the central banks prudential guidelines on liquidity management affects the overall banks performance on total deposits.

**Table 2: Overall bank performance over the last five years**

			<b>Overall Banks Performance over the last 5 years on Profitability</b>				
			<b>Very Poor</b>	<b>Poor</b>	<b>Average</b>	<b>Good</b>	<b>Very Good</b>
Extent to which central bank prudential regulation guidelines affect your banks financial performance on Liquidity management regulation	Large Extent	Count	37	10	20	0	18
		% within Extent to which central bank prudential regulation guidelines affect your banks financial performance on Liquidity management regulation	43.5%	11.8%	23.5%	0.0%	21.2%
		% of Total	28.5%	7.7%	15.4%	0.0%	13.8%
	Moderate Extent	Count	0	0	0	10	9
		% within Extent to which central bank prudential regulation guidelines affect your banks financial performance on Liquidity management regulation	0.0%	0.0%	0.0%	52.6%	47.4%
		% of Total	0.0%	0.0%	0.0%	7.7%	6.9%
	No Extent	Count	11	2	4	1	8
		% within Extent to which central bank prudential regulation guidelines affect your banks financial performance on Liquidity management regulation	42.3%	7.7%	15.4%	3.8%	30.8%

43.5% of those bank employees who claimed that the central bank prudential regulations on liquidity management affect their banks financial performance to a large extent did not concur that this led to the bank’s profitability over the last 5 years. This shows that the bank’s profitability may not necessarily depend purely on the liquidity management guidelines. 30.8% of those respondents who believed that the liquidity management guideline has no effects moreover believed that their respective banks were profits over the last 5 years were very good.

**Table 3: Organization performance on ability to retain essential customers**

			Organization's performance on Ability to retain essential employees					
			Very Poor	Poor	Average	Good	Very Good	
Extent to which central bank prudential regulation guidelines affect your banks financial performance on Liquidity management regulation	Large Extent	Count	22	7	15	8	33	
		% within Extent to which central bank prudential regulation guidelines affect your banks financial performance on Liquidity management regulation	25.9%	8.2%	17.6%	9.4%	38.8%	
	Moderate Extent	Count	2	8	0	0	9	
		% within Extent to which central bank prudential regulation guidelines affect your banks financial performance on Liquidity management regulation	10.5%	42.1%	0.0%	0.0%	47.4%	
	No Extent	Count	11	3	3	2	7	
		% within Extent to which central bank prudential regulation guidelines affect your banks financial performance on Liquidity management regulation	42.3%	11.5%	11.5%	7.7%	26.9%	
			% of Total	16.9%	5.4%	11.5%	6.2%	25.4%
			% of Total	1.5%	6.2%	0.0%	0.0%	6.9%
			% of Total	8.5%	2.3%	2.3%	1.5%	5.4%

38.8% of the respondents who believed that their banks' is ability to retain essential employees as very good attributed this to the central bank prudential regulations on liquidity management. A further 47.4% believed that the central bank prudential regulations on liquidity management affected their bank's ability to retain the essential employees in a moderate manner. This shows that's the banks' ability adherence to central bank prudential regulations on liquidity management may have an effect its ability to retain essential employees.

### CONCLUSION AND RECOMMENDATIONS

The study found out if CBKs prudential regulations on liquidity management affected the banks financial performances, the study involved correlating the independent variable and sought to access the effect of this on the dependent variable. I.e., the banks financial performance over the last five years on total deposits. 29.4% of those bank employees who said that the central bank prudential regulations on liquidity management affect their banks financial performance to a large extent also noted that the overall bank performance over the last 5 years on total deposit was very good. A further 4.7% of these noted that the banks overall performance was good. 19 respondents representing 100% of the respondents who thought that the central bank prudential regulations on liquidity management affected their banks financial performance to a moderate extent said their banks total performance on total deposit was very good. This shows some level of confidence in which the respondents believed the central banks prudential guidelines on liquidity management affects the overall banks performance on total deposits.



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The study recommended a study to be done in future to compare the authors results with other similar studies that employed different method of analysis. Liquidity problems arise as a direct consequence of low capital input, which force inadequately financed banks to rely on deposits for working capital. Significant withdrawal of deposits ends up crippling banks, a scenario observed through banks that have become insolvent in this period. The regulator should seek to provide more holistic and integrated regulations to avoid stifling the industry like during this period where bank performance continued to decline.

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