

## Effects of Lowering Central Bank Rate on Bank's Prime Rate: An Analysis of Kenyan Commercial Banks

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### Abstract

*The study's overall objective analyzed the significant causes that led to rigidity of commercial banks' lending rates despite cost-incentives from the central bank. Towards this, the study adopted a descriptive research design for the purpose of accessing the study's general intent. This involved a set of methods that describe the intended variables using statistical logic. Derived from the study findings, it was evident that despite concerted efforts by the CBK for the commercial banks to lower their lending rates, little gain was made since major determination was dependent on high-level non-performance loans, stiff industry competition, internal policy barriers and lending channels. The authority of the CBK to effectively regulate the channels was in opposition to majority beliefs that banks would only operate with vigor without a strong and visible hand of the regulator. Pegged on these findings the study recommended a collective approach to solving both externally and internally instigated challenges to the industry which is vital to the country's economic growth. Moreover, there needed to be a solid monitoring and evaluation mechanism that would automatically negate non-ratified practices for the sole sake of protecting the vulnerable bank customers.*

**Keywords:** Central bank, commercial bank's prime rate, non –performing loans, industry competition, internal policy and lending channels

### Introduction

Global financial systems or markets have witnessed an impressive expansion in the past decades. Accompanying this expansion is a big evolution in the business practice. The financial sector, in a broad sense, has developed an array of new financial instruments and techniques to adopt the ever-changing global environment. Through their different abilities to promote innovative products, different national financial systems have exerted varying degrees of impact on economic performances. As a result, the rising importance of the financial sector in modern economies and the rapid rate of change experienced have spurred research interest in financial institutions especially in banking (Ho, 2002). Central bank lending is widely regarded as a vital part of the public safety net supporting the stability of the banking system and financial markets more generally. A central bank that is financially independent and has a sizable 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 past (Mwega, 2000).

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. Since its establishment in 1966, the CBK has essentially used a monetary-targeting framework to pursue the inflation objective. The use of this monetary policy strategy has been and continues to be based on the presumption that money matters, that the behavior of monetary aggregates has a major bearing on the performance of the economy, particularly on inflation and general economic growth. Econometric studies done to investigate the link between economic growth and monetary expansion have established and lent credence to the strong link between them in Kenya (Durevall and Ndungu, 1999).

Although the monetary policy framework has essentially remained the same over the past four decades, the CBK has been continuously refining its monetary policy operations and procedures in order to enhance efficiency and effectiveness in delivering its objectives in a changing financial and economic environment. Thus, following the persistent failure of monetary policy to deliver on its inflation objective in the late 1980s and the early 1990s, the CBK effected significant changes to monetary policy implementation procedures, including the introduction of new instruments. The radical changes effected included the shift towards using indirect instruments of monetary control by introducing open market operations (OMO) and by liberalizing interest rates. Consequently, the monetary policy framework has become more specific with respect to the growth objective being pursued and the instruments used to achieve it. Before then, monetary policy in Kenya was sparingly used as a tool of economic management because of the pervasive controls covering almost all economic activities, including the banking sector. Monetary policy, under the regime of direct controls, was more preoccupied with reacting rather driving monetary developments. This was of course not unique to Kenya; control was then the fashionable approach to economic policy management in most developing countries (Mwega, 2000).

The Central Bank of Kenya (CBK) was established under the Central Bank Act (CAP 481), 1966. The Act assigned to the CBK the statutory objectives to assist in the development and maintenance of a sound monetary and credit, and banking system in Kenya, conducive to the orderly and balanced economic development of the country and the external stability of the currency among other functions. With such broadly defined objectives referring only obliquely to price stability, the CBK tended to underpin its monetary policy strategy with controls on interest rates and the volume of credit expansion by banking institutions as its operational targets, and money supply growth as its intermediate target. The operational targets were communicated to banks through guidelines issued from time to time. There were, however, no explicit penalties for non-compliance (Durevall and Ndungu, 1999).

During the early years, the CBK relied mainly on moral suasion. It enlisted the support of banking institutions through regular meetings with the chief executives of banks to explain the thrust of monetary policy initiatives. Being the regulator of commercial banks and non-bank financial institutions, the CBK had some influence in this regard. However, without a clear focus on inflation and appropriate sanctions on the one hand, and lacking both a relevant and supportive fiscal policy on the other, this framework could not ensure that inflation was contained at consistently low levels (Durevall and Ndungu, 1999).

### **Statement of the Problem**

A well-developed financial system promotes economic growth by enabling economic agents to diversify their portfolios and meet their liquidity requirements. In this form of efficiency, financial resources are allocated in a more efficient way and risk management solutions are made available. The existence of these finance elements can push an economy's production possibility frontier outwards and hence a higher growth potential is expected in the long run. Based on the same rationale, if the operation efficiency of the financial system can be raised by compliance of required standards of performance, there will have a positive impact on long-term economic growth (Estrella, 2001). Efficiency in the banking sector is recognized by the Central Bank as a precondition for macroeconomic stability and important for effective monetary policy execution. In addition, a banking sector's ability to allocate credit efficiently is expected to have positive implications for economic growth (Hartmann, 2004).

This study sought to examine the disparity between the CBK's lending rate flexibility and the commercial banks' prime rate adjustment behavior. The analysis was accomplished by determining how factors other than the CBK inducements influenced cost of credit and its availability to the Kenyan entrepreneurs. This would significantly form a basis for addressing holistically the problem of accessing commercial banks' funding with intent of building economic foundations for the country while enhancing the required efficiency in monetary policy administration.

### **Purpose of the Study**

The purpose of the study was to analyze the key factors that made flexibility of central bank lending rates not an adequate instrument in inducing desired adjustments in prime rates adopted by the commercial banks in Kenya.

### **Objectives of the Study**

Objectives of the study were decided as follows:

- i. To establish how non-performing loans impacted on commercial bank's lending rate adjustments,
- ii. To assess how industry competition contributed to commercial banks' rigidity to CBK cost-inducements,
- iii. To find out the significant policy barriers that insulated prime rates from the CBK's expectations, and
- iv. To evaluate how lending channels deterred implementation of recommended prime rates by commercial banks.

### **Research Questions**

The attainment of the study's objectives was guided by the following research questions:

- i. How do non-performing loans impact on commercial banks' adjustments of lending rates?
- ii. How does banking industry's competition contribute to ultimate lending-rate rigidity regardless of the CBK's cost inducements?
- iii. What significant policy barriers insulate prime rates from the CBK's adjustment expectations?
- iv. How do lending channels deter implementation of recommended prime rates by the Kenyan commercial banks?

### **Literature Review**

This chapter gives a range of documented literature related to the study's problem area in order to provide a basis of developing an understanding and establishing appropriate scope in aligning objectives to existing knowledge. The areas considered important for the review include past studies, theoretical framework, loanable fund theory, conceptual framework, operational framework and gaps in literature that the study aims to fill.

Research on the determinants of bank profitability has focused on both the returns on bank assets and equity, and net interest rate margins. It has traditionally explored the impact on bank performance of bank-specific factors, such as risk, market power, and regulatory costs. More recently, research has focused on the impact of macroeconomic factors on bank performance. Using accounting decompositions, as well as panel regressions, Al-Haschimi (2007) studies the determinants of bank net interest rate margins in 10 Sub-Saharan Africa (SSA) countries. He finds that credit risk and operating inefficiencies (which signal market power) explain most of the variation in net interest margins across the region. Macroeconomic risk has only limited effects on net interest margins in the study.

Using bank level data for 80 countries in the 1988–95 period, Demirgüç-Kunt and Huizinga (1998) analyze how bank characteristics and the overall banking environment affect both interest rate margins and bank returns. Results suggest that macroeconomic and regulatory conditions have a pronounced impact on margins and profitability. Lower market concentration ratios lead to lower margins and profits, while the effect of foreign ownership varies between industrialized and developing countries. In particular, foreign banks have higher margins and profits compared to domestic banks in developing countries, while the opposite holds in developed countries. Gelos (2006) studies the determinants of bank interest margins in Latin America using bank and country level data. He finds that spreads are large because of relatively high interest rates, less efficient banks and higher reserve requirements.

### **Theoretical Framework**

Before the 70s, interest rates charged to poor entrepreneurs in development projects, particularly rural ones, were very low. In the 70s and 80s, these low interest rates policies became controversial, especially in response to the emergence of very costly microcredit loans. According to Adams (2004), cheap credit would destroy the incentives to save and distort the way lenders allocate funds. The rationale was that low interest rates on loans to rural people end, paradoxically, by restricting their access to financial services.

Four main approaches and criteria of fairness of interest rates can be identified. The first refers to the deontological approach, the first and oldest one, has a long history. Aristotle already denounced interest as the unnatural fruit of a barren parent. Similarly, heated theological debates on the legality of interest have flourished for centuries. Gonzalez-Vega (1997) argued that any limitation on the interest rate level would have counter-productive effects. Low interest rates or usury laws would make the institutions concentrate their portfolio on fewer clients, the most profitable and powerful ones. Concretely, a usury law putting a low interest rate as maximum would force managers of institutions with limited resources or insufficient margins to issue larger loans in order to decrease their operating costs, and therefore would exclude the poorest segment from their portfolio.

Furthermore, according to Adams (2004), higher and more flexible interest rates would result in a more equitable income distribution.

The second approach, consequentialist in nature, addresses the fairness issue by assessing the worsening of the client's situation. To assess the fairness of interest rates, one should evaluate the client's costs in the absence of the lending institution. In microfinance, this refers to the fact that, even if microcredit interest rates are high, they are much lower than interest rates that the micro-entrepreneurs previously borrowed at. The interest rate is deemed to be fair since all previous and second best opportunities are much more expensive (Aleem, 2000). Accepting the informal lenders' interest rates as point of comparison legitimates a financial system whose practices of exclusion are undeniably unjust by almost all theories of justice. Moreover, the requirements for this criterion of fairness can be very lax.

The third widely used approach to the ethical dimension of credit interest rates focuses on the demand for credit. It uses high repayment rates and repetitive loans as instrumental proxies of fairness. High repayment and constant demand reflect the affordability of the loans and thus their fairness. The emphasis should be put on the access to credit rather than the interest rate level since it is used in productive activities with very high rates of return. Similar arguments are used in the trade debate. Opponents of the inclusion of fairness considerations in trade negotiations often argue that the agreements are voluntary. Consequently, all agreements that developing countries think would make them worse off will be refused (Stiglitz and Charlton, 2006). Nevertheless, in non-competitive markets, the client may well decide to retake a loan even if the price is exorbitant. However, as in the trade case, the distribution of the benefits may well be unequal. The poor may also lack the bargaining power to influence the price or approach another lender.

The fourth and last perspective is a procedural one. Two models of procedural justice can be construed. Under the first model, assuming a well-organized market, fairness only requires that the rules of this market be correctly and impartially applied to all customers. The second model is based on a comparison of interest rate levels between individual borrowers. To develop this approach, a parallel with the fair wage concept may be helpful. While the concept of fair interest rates has not been debated much in recent literature, the notion of a fair wage is much more present in both the ethics and the economics literature (Stiglitz and Charlton, 2006). Similar to fair interest, many interpretations of fair wage have been designed. For Akerlof and Yellen (2000), the fair wage is a perception held by the average worker, presumably on the basis of what has gone on in the past.

### **The Loanable Fund Theory**

The study is based on the loanable fund theory. This is a dynamic and optimizing theory of bank operation that integrates insights of production theory, financial intermediation and portfolio theories. The unified model clarifies the relationship between the risk of asset portfolios and a bank's output of services. Portfolio risk determines the rate of return on loans and banks' borrowed funds and, in turn, the discount rate used to derive the present value of future profits part of which are generated by bank services. Nevertheless, the quantity of service output is affected by risk only to the extent that portfolios of different risk require different amounts of information processing. In addition, the model shows that loanable funds are merely an intermediate input that passes through banks, whereas true bank value added is only the services facilitating the provision of funds. The model further establishes separability between the use of funds and the production functions of value added in a bank's overall optimization problem (Fixler and Zieschang, 1998).

In short, by resolving the fundamental question of how to measure bank output, this model contributes to a large literature on bank production. Moreover, this model can resolve some long-time conceptual debates in the bank production literature, particularly the one regarding the role of deposits. It demonstrates that deposit funds are "materials," inputs in the generation of new loans, but the transaction services associated with deposits are part of bank output. It also provides a theoretical basis for measuring bank output by identifying the value-added components of a bank's gross output.



### Research Methodology

This chapter presents the research methodology adopted by the study. It includes a description on research design, target population, sampling techniques, data collection instruments, study reliability and validity, data collection procedures, and data analysis techniques. The study assumed a descriptive research design. This design helped to describe the characteristics of the population which were of interest to the researcher. Specifically, this enabled the researcher to establish the reasons of disparity between the anticipated prime rate adjustments and the imposed lending protocol. The study's target population constituted all commercial banks' task-specific officers in the lending process. These included credit supervisors and officers, head office credit departments, debt recovery units, and risk and compliance departments. This composition translated to a total number of potential respondents of 176 given that there were a total of 44 registered and active banks in Kenya. The central bank's systems of clustering banks in tiers were used as a basis for developing a sampling frame. Further, the tiers were used as a basis for stratification in order to facilitate a cross-sectional generalization of the findings. Each of the selected departments in the study tiers provided one individual to give information intended for the study. Table 3.1 shows the relative number of respondents targeted from each stratum.

**Figure 1.1: Target Population**

Bank Category	No. of Banks	Population Size
Tier I(Asset base over 15 billion)	14	56
Tier II(Asset base of between 5 – 15 Billion)	17	68
Tier III(Asset base of below 5 Billion)	13	52
<b>Total</b>	<b>44</b>	<b>176</b>

Source: CBK, 2009

The researcher used proportional stratified sampling method to select a sample of 132 informants at 0.75 sampling ratio per tier. This sample size was regarded adequate as it met and exceeded Bell's (1993) one-third criterion of representativeness. Adopting stratified sampling techniques ensured that all the selected respondents equitably represented the all groups that made the banking population heterogeneous in nature. Table 3.2 shows how the sample of 132 respondents was attained.

**Fig. 3.2: Sample Size and Sampling Design**

Bank Category	Population Size	Sampling Ratio	Sample Size
Tier I	56	0.75	42
Tier II	68	0.75	51
Tier III	52	0.75	39
<b>Total</b>	<b>176</b>	<b>0.75</b>	<b>132</b>

Source: CBK, 2009

### 3.5 Data Collection Instruments

The study made use of both the secondary and primary data. Secondary data basically reviewed relevant documentations such as the banks' internal policy guidelines, lending channels, performance charters, agency agreements, strategic plans, press articles and performance appraisals which contained information concerning lending rates. On the other hand, primary data concentrated on respondents' opinions and appraisals concerning the study variables. To assist the researcher gather the primary portion of data, the study adopted a questionnaire instrument which was self-administered. Most importantly, the instrument's structure was designed to accommodate all the critical aspects covering effects of non-performance loans, industry competition, internal policy and lending channels, and how they impacted on prime rate rigidity. The semi-structured format of the instrument allowed inclusion of closed-ended question items, which were essential in limiting response details while facilitating timely analysis. Where the study sought detailed and explained responses, open-ended question items were used.

### 3.6 Reliability and Validity of the Instruments

Prior to large-scale administration of the instruments, it was desirable to conduct a pre-testing session to determine instrument validity and reliability.

This served a role of ensuring that the research instrument was devoid of question items which might have made respondents feel uncomfortable and to detect any tendency for respondents' interest to be lost during completion. The pilot units, equivalent to one-tenth of the proposed sample size, were obtained from comparable members of the population from which the sample for the full study was taken. According to Mugenda and Mugenda (1999) one tenth of the sample size is sufficient for pilot testing. In addition, the data instrument was designed in such a way as to vary question items to be both in positive and negative formats so that respondents were discouraged from bias as a result of particular orientation.

#### **4.0 Data Analysis and Presentation of Findings**

After a two-week administration of research instruments, there were 103 successful completions out of the possible 132 that the study targeted. This represented a study response rate of 78%, on whose basis recommendations were made. In terms of bank tiers, the majority of responses, 45%, were attained from tier I, while tier II and III contributed to the study at proportions of 32% and 23% respectively. Similarly, responses were received from target departments which were the study's strata at different proportions as shown in table 4.1.

**Table 4.1: Response Rates from Study Subgroups**

<b>Study Subgroup</b>	<b>Successful Responses</b>	<b>Response Rates (%)</b>
Credit supervision	34	33
Debt recovery	31	30
Risk and compliance	20	19
Finance	18	18
<b>Total</b>	<b>103</b>	<b>100</b>

**Source: Research Data, 2010**

The credit supervisors' 33% inclusion in the final response tally was the highest compared to submissions from debt recovery's 30%, risk and compliance's 19% and finance's 18%. The fact that every subgroup participated in the study was enough surety and basis for the findings' representativeness and generalization.

#### **Conclusion**

Based on the study findings, it was evident that despite concerted efforts by the CBK for the commercial banks to lower their lending rates, little gain was made since the superior chunk of determination was dependent on high-level non-performance loans, stiff industry competition, internal policy barriers and lending channels. The high non-performance of loans was a culmination of high risk concentration in Kenya, lack of approved credit rating and information sharing agencies, limited risk mitigation strategies, internal policy barriers and instances of the CBK not giving it the consideration it required. In spite of the fact that competition was high and increasing due to high penetration rate, banks were inadvertently keen not to lower their prime rates as a basis of inducing more clients. This implied that other than competition pressures, intra-industry forces played role to sustain higher prime rates. Convincingly, these forces were centered on a weak regulatory framework that did not have strict penalties on over-charges and single-handed desires of making unjustifiable profits at the expense of borrowers and general economy. With policy guidelines, long chains of decision making, especially by multinationals made policy designs more inflexible and inconsistent with local regulatory structures. In the same tone, technological shifts were slow most often than not which made structural adjustments and modernizations a far-fetched reality. Finally, with respect to lending channels, there were minimal hindrances from the bureaucrats but with major intent of reducing administration costs and broadening profit margins. The authority of the CBK to effectively regulate the channels was in opposition to majority beliefs that banks would only operate with vigor without a strong and visible hand of the regulator.

#### **Recommendations**

The study deduces four main recommendations based on the findings. Firstly, there should be an uncompromised effort by all the stakeholders to reduce the propensity of loan non-performance. As a result, a dependable and independent agency with delegated responsibilities on credit rating and information sharing should be formed, backed by legalization and sufficient resource endowment, to frequently feed commercial banks on eminent risk and proposal on avoidance or reduction. Secondly, the CBK's monetary policy role needs to be expanded to capture knowledge dissemination and participatory decision making on appropriate approaches that are agreeable to all in order to reducing risks and costs of borrowing borne by the entrepreneurs.

Thirdly, without causing injury to any independent operation, elimination of internal policy barriers should be addressed by respective institutions but in cases of failure demand shifts should only be caused by prevailing market forces. Finally, the regulator and banks' unions should interface to design most applicable and convenient loan management protocols in the industry that considers shortening of long channels and discourages extra costs on the loan facility.

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