EFFECTS OF FINANCIAL DEREGULATION ON PERFORMANCE OF BANKS LISTED AT NAIROBI SECURITY EXCHANGE

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ABSTRACT

The Kenyan banking sector which was heavily regulated, has been moving toward a more open and a less regulated market system. Financial deregulation was expected to allow for positive reduction in the interest rates and for stimulation and mobilization efficiency of the domestic financial resources for financially repressed economy. This study therefore sought to establish the effect of financial deregulation on performance of banks listed at Nairobi Security Exchange (2000 – 2011).The study used a descriptive research design and the population comprised of banks listed at Nairobi Security Exchange. There are 10 banks listed at NSE, therefore the target population of this study was 380 respondents. The sample size was therefore 50% of the target population which was 190 respondents. The study established that, cannibalism relates to competition negatively while there is a positive relationship between customer relationship, interest rates and the banks' performance. This study established that deregulation led to competition which in turn affected performance of banks. This study recommends that banks should increases branches to increase their market segment and enhance products and market segmentation. Banks should discontinue old products after introducing new products that have the same but improved features than old products. The study also established that high interest rates hinder customers from borrowing loans. The study therefore recommends that banks and policy makers should come up with strategies that will lower interest rates to enable many customers borrow thus enhancing economic growth.

Key words: *Bank performance, Regulation, Deregulation, Cannibalism, Interest Rate, Market Strategy, Customer Relations*

Introduction

In recent decades, the banking sector of many industrialized countries has been subjected to various forms of deregulation. Apparently, the policy makers believe that improving the efficiency and performance of financial systems is better implemented through deregulatory measures (Smith, 2004). However the empirical evidence on the impact of such initiatives has been mixed throughout the globe (Ragunathan, 2001; Isik & Hassan, 2003; Huang, 2007). Deregulation on the asset side of the balance sheet focused on the liberalization of the volume and the interest rates of bank lending resulted into improvement of both efficiency and productivity of Norwegian banks (Berg, Forsund, and Jansen, 2003). Similarly, the Turkish banks had the same experience when they introduced deregulation to their financial sector (Zaim, 2002).

However, the impact of liberalization on Indian banks resulted in mixed productivity efficiency depending on the different type of ownership (Bhattacharyya, Lovell and Sahay, 2004).On the contrary, deregulation measures pertaining to the deposit rates competition have not changed efficiency levels in the U.S. banking industry (Bauer, Berger, and Humphrey 2007; Elyasyiani and Mehdian, 2002). In fact, U.S. banks have experienced decline in productivity and growth culminating to the recent financial crises in the USA. In Korea however, it was the privatization of the banking industry rather than its interest rate deregulation on deposits that resulted in increased output and productivity (Gilbert and Wilson, 2006). With regards to geographical deregulation and consolidation in the U.S., Hughes, Lang, Mester, and Moon (2008) reported efficiency to increase with additional operation thus confirming the benefits from geographical expansion.

Despite their stated intentions to investigate the bank performance during the deregulation era in Spain, most studies tended to focus on measuring the level of efficiency and/or productivity growth over time without linking them to the deregulatory process. Although, Grifell and Lovell (2008) attempted to undertake such explanation their study specifically concentrated on analyzing productivity changes. Overall, the above studies have either estimated the efficiency and productivity growth measures from a cost-minimizing framework or have used a non-parametric technique designed to obtain results on technical inefficiency of inputs. However, the recent literature has established the superiority of profit efficiency over the cost efficiency measures for evaluating the overall performance of banks. During financial deregulation processes, countries were encouraged to adopt a mix of economic measures under IMF and World Bank supported Structural Adjustment Programme (SAP) fronted as a comprehensive measures designed to achieve both internal and external balance with minimum cost to the economies of these nations. Several developing countries adopted the programme, these countries included Kenya, Uganda, Tanzania, Rwanda, Sudan Nigeria, Thailand, Korea Republic, Philippines and Cote Devour (Roseline, Esman & Kamau, 2011).

Deregulation of the financial sector in Kenya

Financial liberalization of early 1990s in Kenya opened the banking industry to a number of players leading to stiff competition and weakening of performance of a number of commercial banks and collapse of some. Kenya's commercial banking sector comprises of 3 public, 27 local (private), 11 foreign (private) and 2 Islamic (private). Sequencing of the reforms in Kenya, show some consistency with what is proposed in the literature where financial liberalization preceded trade reforms and opening of capital account. The government of Kenya embarked on a phased tariff reductions and rationalization of the tariff bands in 1990. By 1991, quantitative restrictions affected only 5% of imports compared with 12% in 1987. Simultaneously, foreign exchange controls were gradually relaxed, starting with the introduction of Foreign Exchange Bearer

Certificates (Forex-Cs), which could be used for automatic import licensing in 1991 (Were, et al., 2001). During the same year, currency declaration forms were abolished. In 1992, foreign exchange retention accounts were introduced 100% for non traditional exporters and 50% for traditional exports. Further secondary market for Forex-C's was established. Significant changes were witnessed in 1993 following the resumption of aid after two years of suspension. The government adopted a tight monetary and fiscal policy and also made significant steps in liberalizing the external sector. For example, in March 1993, Forex-Cs were made redeemable at market rate instead of official exchange. However, in the same month, all the retention accounts were revoked and import licensing and exchange controls reinstated.

In May, import licensing was abolished and retention accounts reintroduced, while in October, the official exchange rate was abolished, paving way for freely floating exchange rate. With the trade liberalization having moved a substantial step, capital controls were relaxed for offshore borrowing in February 1994 subjected to quantitative limits. Complete liberalization of offshore borrowing was implemented in May 1994, while some restrictions on inward portfolio investment were lifted in January 1995. By 1995, virtually all the foreign exchange restrictions had been eliminated; foreign exchange bureaus were permitted and the exchange control Act was repealed (Ngugi, 2000).

Statement of the problem

To adequately respond to the challenges that were facing the financial sector, especially the banking sector, a comprehensive reform programme was initiated in early 1990s these reforms permitted financial institutions to conduct offshore business in foreign currencies, freedoms of domestic banks to engage in foreign transactions and foreign banks to enter the domestic market freely. Despite claims of successes of banking sector reforms on different fronts, the efficacy of banks is generally criticized due to low returns on deposits, costly access to banking services and skewed distribution of credit (Shahid, 2001). In addition deregulation led to opening up of the market thereby enhancing competition in the industry. Further, banks responded to competition by being innovative and increasing their products and the new product affects the sales and demand of the existing product (Ragunathan, 2001). The heart of the instability is the excessively liberalized financial markets and capital account regime. The bubbles burst when inflationary expectations and increased perception of risk occasioned by increased debt servicing burden, declining reserves and political factors led the hot money to flee alongside illicit capital flight and speculation on the shilling or simply hoarding of the dollar affected the financial market negatively (CBK 2011).

Research studies have been conducted on financial deregulation, example Ochieng (2004) conducted a study on financial liberalization and performance: study of Kenyan banking industry and established that financial liberalization impacted positively on bank performance. However the interest rate spread widened following the reforms (Ndungu & Ngugi, 2000).
Financial deregulation not only brought benefits but it resulted into significant costs in the form of volatilities, deepening inequalities and poverty (Roseline, Esman &Kamau, 2011), this indicates that the process of financial deregulation was embarked in an environment of high inflationary pressure, distressed financial system coupled with fragile institutional framework. There is therefore a need for a study that will focus on these issues affecting the financial industry. This study therefore sought to investigate the effect of financial deregulation on performance of banks listed at Nairobi Security Exchange (2000 – 2012).

Objectives of the study

To establish the effect of financial deregulation on performance of banks listed at Nairobi Security Exchange. The study also had the following specific objectives;

i. To determine the effects of competition on the performance of banks listed at Nairobi Security Exchange.

ii. To establish the effects of cannibalism on the performance of banks listed at Nairobi Security Exchange.

iii. To find out the effects of customer relationship on the performance of banks listed at Nairobi Security Exchange.

iv. To find out the effects of interest rates changes on the performance of banks listed at Nairobi Security Exchange

Literature Review

Theoretical framework

A theoretical framework is a theoretical review of the study. It is simply a theory, but it can also be more general as basic approach to understanding the issues at hand (Kothari, 2004). Typically, it defines the kind of variables that the study will look at. This study will therefore focus on four theories: evolution theory of cannibalism, Michael Porter's model of customer relationship, institutional theory of competition and loan-able funds theory of interest rate.

Evolution theory of cannibalism

Evolutionary processes are generally seen as occurring on multiple levels of analysis. Campbell's seminal paper suggested that the natural selection model offered a powerful means of explaining the different rates of survival and growth of many social activities (Canals, 2004). Building on evolutionary theory in biology, Campbell identified three basic requirements for the natural selection model to hold; variation, selection, and retention (Clancy & Shulman, 2007). Most banks in the banking industry in Kenya have been inventing new products in the last decade in order to become competitive and relevant in the market, such products include adoption of technology (ATMs, Online banking and mobile banking), business banking, prestige banking and agent banking.

Michael porters model of customer relationship

Competitive advantage grows fundamentally the value a firm is able to create for its buyers that exceeds the firm's cost of creating it. Product or service value is what a customer is willing to pay, superior value stems from offering lower prices than competitors for equivalent benefits or providing unique benefits than the competitor (Hagendorff, Collins, & Keasey, 2007). The theory consists of three main strategies (cost leadership, differentiation and focus) while cost leadership and differentiation strategies address a whole industry, focus strategies address specific or small clusters of customers within an industry. Cost leadership strategy requires a firm (bank) to serve at the lowest cost in the industry. However, the interest rates as well as transactions costs in Kenya have been increasing over the years. Economies of scale, unique technology not available to other firms, and using cost effective channels are some of the ways enabling the use of the strategy (Hasan, Hunter, and Lozano-Vivas, 2009).

Institutional theory of competition

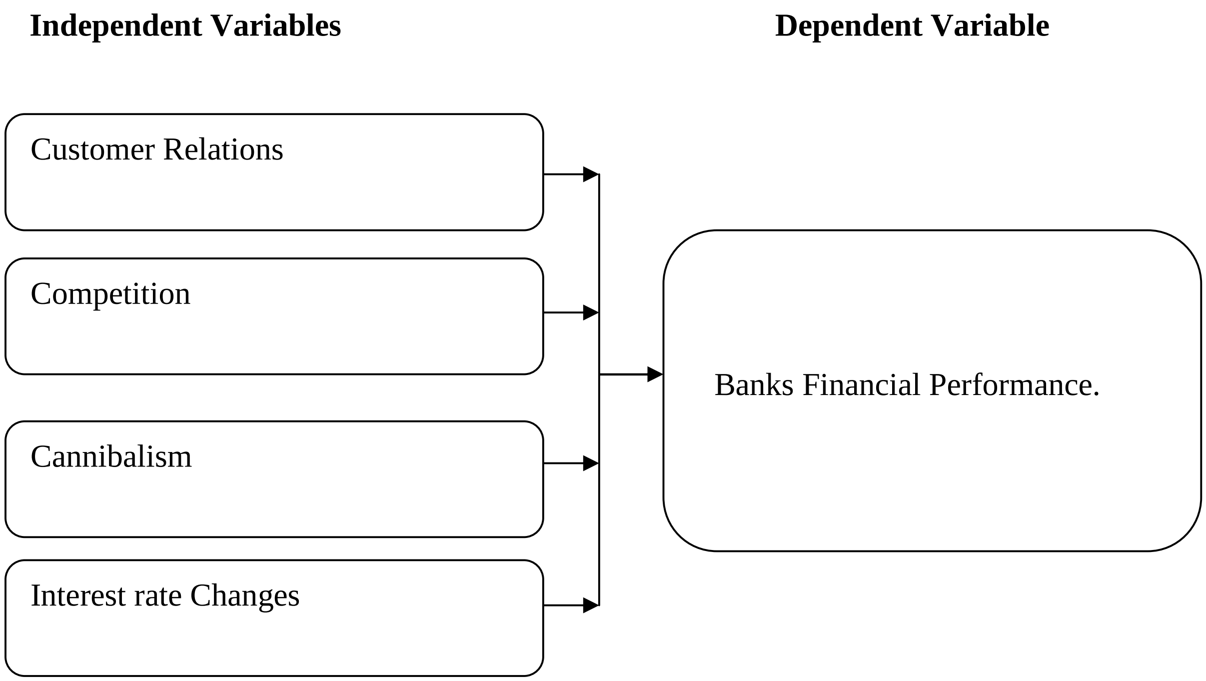
Firms initiate strategic actions to achieve competitive advantage. These actions are shaped, and their outcome influenced by the external environment and internal environment of the firm. Institutional theory suggests that actions of a firm and the outcome of these actions are influenced mostly by knowledge systems, organizational beliefs, and rules that characterize the context of the organization (Berger & Mester, 2004). The firm is embedded in a general environment comprising; Institutions that lay guidelines to shape the behavior of firms and macro-societal factors such as the prevailing culture.

The firm is embedded in an industrial environment that comprises the actors within an industry mostly the suppliers, the customers, the competitors, and channel partners. The nature of the relationship among the industry stakeholders influences the actions that a firm can initiate in pursuit of competitive advantage (Berger & Humphrey, 2004). The firm has an internal environment that comprises its unique sets of skills and resources; collective beliefs about the market, competition, and industry (e.g., shared mental models; and culture).

Loanable funds theory of interest rate

The Theory advocates that both savings and investments are responsible for the determination of the interest rate in the long run (Berg, Forsund & Jansen, 2003). Determination of interest rates in the case of this theory depends essentially on the availability of loan amounts based on certain factors such as the net increase in currency deposits, willingness to enhance cash balances and opportunities for formation of fresh capitals. John Maynard Keynes in an attempt to develop the macro-economic theory in an economy studied minutely the demand and supply interaction of Loanable funds (Bauer, Berger &Humphrey, 2007).

Conceptual Framework



Empirical review

Abbas & Malik (2010) conducted a study on the impact of Financial Liberalization and Deregulation on Banking Sector in Pakistan. Their study analyzed market perception on the performance of Pakistani commercial banks due to financial liberalization and deregulation measures taken by the Central Bank of Pakistan over the last two decades. For this purpose, it used Survey approach, to augment the results of survey based approach, their study employed distribution free approach to measure relative cost inefficiencies of commercial banks. Out of 35 commercial banks, 15 banks had been chosen for analysis purpose. The study found that key banking reforms remain helpful in correcting flaws in the banking sector of Pakistan. In particular, privatization of banks, the deregulation and institutional strengthening measures and switching towards market-based monetary and credit management remain helpful in correcting the prevailing flaws. The cost inefficiency scores of banks also indicated that the efficiency of Pakistani banks have improved during 1990 to 2006. Regarding group-wise efficiency estimates, foreign banks were found to be more efficient, followed by private banks, nationalized commercial banks, and privatized banks.

Huang (2007) evaluated the real effect of bank branching deregulation comparing contiguous counties across US state borders. This paper proposed a new methodology to evaluate the economic effect of state specific policy changes, using bank-branching deregulations in the U.S. as an example. The new method compared economic performance of contiguous counties on opposite sides of state borders, where on one side restrictions on state wide branching were removed relatively earlier, creating a natural regression discontinuity. The study used a total of 285 pairs of contiguous counties along 38 segments of such regulation change borders to estimate treatment effects for 23 separate deregulation events.

Ochieng (2004) conducted a study on financial liberalization and performance: study of Kenyan banking industry. This paper examined the empirical relationship between financial liberalization and bank performance in Kenya. The paper also assessed and identifies the various factors that explain commercial bank performance Time series data covering the period 1973-2002 was analyzed. The nature and characteristics of the data was analyzed and the time series characteristics of the data was assessed using unit root tests to examine the stationary of the variables used in the regression.

Research Methodology

Descriptive research was used to obtain information concerning the current status of the phenomena and to describe what exists with respect to variables or conditions in a situation. The methods used ranged from the survey that described the status quo and correlation study which investigated the relationship between variables. This was the most appropriate research design since it investigated the relationship between the dependent and independent variables. In addition, the study used a qualitative and quantitative research designs.

Target population

The population of this study comprised of the 10 banks listed at Nairobi Security Exchange which include Barclays Bank Ltd, CFC Stanbic Bank Ltd, Diamond Trust Bank Kenya Ltd, Housing Finance Co Ltd, Kenya Commercial Bank, National Bank of Kenya Ltd, NIC Bank Ltd, Standard Chartered Bank Ltd, Equity Bank Ltd and The Co-operative Bank of Kenya Ltd.

Table 3.1: Target Population

Management Level	Target Popul. per bank	No of banks	Total Target Popul.	Percentage
Top level management	5	10	50	13.16
Middle level management	12	10	120	31.58
Low level management	21	10	210	55.26
Total	38	10	380	100.0

Sampling technique and sample size

In determining sample size Gay (1996) and Suskie (1996) indicated that for a population size N ≈ 500, a 50% of the population should be sampled and for population size N ≈ 1,500, 20% should be sampled and a population approximately $N \geq 5{,}000$ the population size is almost irrelevant and a sample size of 400 is adequate. Thus, the larger the population, the smaller the percentage needed to get a representative sample. The sample size of this study was therefore 50% of the population thus 190 respondents.

Data Analysis

Reliability analysis

In order to test the reliability of the instruments, internal consistency techniques were applied using Cronbach's Alpha. The alpha value ranges between 0 and 1 with reliability increasing with the increase in value. According to the pre-test findings, 'competition' scale had a Cronbach's reliability alpha of 0.817, 'cannibalism' scale had an Alpha value of 0.809, 'customer relationship' had an Alpha value of 0.792 and 'interest rates' had a reliability value of 0.712. These findings correlate with Mugenda & Mugenda (2003) argument that coefficient of 0.6-0.7 is a commonly accepted rule of thumb that indicates acceptable reliability and 0.8 or higher indicated good reliability.

Table 4.1: Cronbach's Alpha

Variable	Alpha value
Competition	0.817
Cannibalism	0.809
Customer relationship	0.792
Interest Rates	0.712

Regression analysis

A multiple regression analysis was conducted to establish the relationship between the independent variables (interest rate changes, cannibalism, customers' relations and competition) and dependent variable (financial performance). The four independent variables that were studied, explain 79.4.0% of the effect of financial deregulation on performance of banks listed at Nairobi Security Exchange as represented by the adjusted R^2. This therefore means that other factors not studied in this research contribute 20.6% of effect of financial deregulation on performance of banks listed at Nairobi Security Exchange.

Table 4.2: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	0.872	0. 7604	0.794	0.4238

The significance value is 0.019 which is less that 0.05 thus the model is statistically significance in predicting how interest rate changes, cannibalism, customers' relations and competition contribute to the financial performance of banks listed at Nairobi Security Exchange. The F critical at 5% level of significance was 2.353. Since F calculated is greater than the F critical (value = 2.2141), this shows that the overall model was significant.

Competition and financial deregulation

This study sought to determine the effects of competition on the performance of banks listed at Nairobi Security Exchange. The study established that financial deregulation was affecting the competition in the financial industry to a great extent. Hasan, Hunter & Lozano-Vivas (2009) argues that a number of commentators have blamed the severity of the current UK recession on the excesses of credit expansion in the aftermath of financial deregulation. It was established that capital requirement, market entry, branching and reserve requirement were affecting the financial performance of banks to a great extent. According to Roseline, Esman & Kamau (2011) the banking system has experienced deregulation in terms of interest rates, capital requirement, entry, branching, and investment and reserve requirements. Competition increased as a result of deregulation in the banking industry. The study also found that deregulation in the banking industry increased product lines, barrier to entry were slackened and led to decreased market share, exodus for unsuccessful entrance. These findings agree with Zaim (2002) argument that the effect of removing entry restrictions has frequently been to trigger an inward rush, typically followed by a later exodus of the unsuccessful entrants into the market.

Cannibalism and financial deregulation

According to Ochieng (2004), market cannibalization refers to a situation where a new product eats up the sales and demand for an existing product. This study established that most of the banks had experienced a situation where a new product affects the sales and demand of an existing product. Deregulation affects accounts, loans, M-pesa, M-shwari, agency banking, mobile banking, personal accounts vs. business accounts and prestige accounts vs. current accounts. Ochieng (2004) had earlier indicated that market cannibalization occurs when a new product intrudes on the existing market for the older product, rather than expanding the market base. According to Traylor (2005), deregulation leads to increase in product line which in turn leads to market cannibalism. It was established that product demand and sales, sales volume and market share influence financial performance of banks to a great extent. These findings agree with Ragunathan (2001) argument that the new products appeals to the company's current market, resulting in reduced sales and market share for the existing product.

Customer relationship and financial deregulation

The study established that bank-customer relationship in the banks considered in this study was good. The study also found that deregulation was affecting bank-customer relationship. Deregulation opens up space for the bank to offer products aligned to customers' needs. With deregulation banks can offer more personalized services and come up with more suitable products which meet specific needs of the customers. In addition, deregulation was increasing leniency to customers. These findings agree with Dhar & Hoch (2004) argument that deregulation impinges on bank-customer relationship. The study also found that service delivery quality, customer relation management, customer care and customer bargaining power affects the performance of banks to a great extent. Dhar & Hoch (2004) argues that due to deregulation customers can bargain for the best prices from a larger number of possible suppliers.

Conclusions

The study established that capital requirement, market entry, branching and capital reserve requirement were affecting the financial performance of banks to a great extent. In addition, deregulation in the banking industry increased product lines, barrier to entry were slackened and led to decreased market share, exodus of unsuccessful entrance was opened. In addition, deregulation affect restrictions and control in the banking industry, led to increased marketing of the product and enhanced formulation of products, reduces market share and forces banks to come up with new low quality products and forces banks to open up new branches. The study concludes that increase in cannibalism will lead to reduced bank performance. This study established that most of the banks had experienced a situation where a new product affects the sales and demand of an existing product. The study also established that deregulation leads to market cannibalism. Cannibalism can easily lead to retrenchment which can compromise the morale of other employees.

Improved customer relations will in a great way increase the banks performance. The study also established that deregulation was affecting bank-customer relationship. It opens up space for the bank to offer products aligned to customers' needs. With deregulation banks can offer more personalized services and come up with more suitable products which meet specific needs of the customers. In addition, deregulation was increasing leniency to customers. In addition, it leads to increased customers' base which in turn increases profitability. The study also revealed that changes in interest rates leads to high level of non-performing loans which in turn leads to negative banks financial performance. In addition, when the interest rates are high, the borrowing rate decreases, which increases the rate of loan defaults. However, deregulation allows for increased competition which could have lead to reduced interest rates which in turn could affect the financial performance of banks at the same time positively affecting economic growth.

Recommendations

This study recommends that banks should increases their branches so as to increase their market segment. In addition, banks should ensure that they had a sustainable competitive advantage by offering better products than their competitors. Most banks have been differentiating products over the years which has led to cannibalism and hence a need for better marketing strategies. Financial institutions should use focus strategy that involves concentrating on particular buyer groups, geographical areas or product or market segments. By selecting a particular segment group or group of segments, and attempting to tailor strategies to service the needs of the segment better than the competitors. Events based marketing is an example of focus differentiation strategy (marketing differentiation), which matches customer transactions to tailored marketing and sales pitches. Priority banking is another example of focus differentiation strategy (service differentiation), that financial institutions in Kenya should adopt, this aims at giving better service to more profitable customers of the bank.

This study also recommends that banks should enhance their customer relationship management by creating customer loyalty programs and improving their customer services. In banking industry, a sustainable competitive advantage can be gained with a blend of different strategies, but a powerful focus differentiation strategy in service should not be neglected. Products and price can easily be copied, service is more difficult to imitate than a product because service requires customer input and involvement. Today, building a competitive advantage is based on how well a bank serves its customer CRM is differentiation strategy that banks can use to acquire, grow and retain profitable customer relationship aiming at creating a sustainable competitive advantage.

On cannibalism the study recommends that banks should discontinue old products after introducing new products that have the same but improved features as the new products. The study also established that high interest rates hinder customers from borrowing loans. The study therefore recommends that banks should lower their interest rates so as to enable many customers to borrow.

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