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ABSTRACT

This study mainly purposed to determine the influence that interest rate had on the level of performance of the commercial banks of Nairobi County. Questionnaire and data collection sheets were used to collect primary and secondary data respectively. Descriptive statistics were computed, while linear and multiple regression analysis were calculated to determine the association of variables. A total of 100 questionnaires were distributed amongst the pre-identified respondents, 95 were returned dully signed. The results were analyzed through descriptive and inferential statistics was indicative that the independent variable had an effect on the performance of banks under investigation. The results showed that interest rate significantly impacted the levels of performance exhibited by the commercial banks under study. The study settled that interest rates has a significant impact on performance levels exhibited by the commercial banks under study, thus setting effective and favorable interest rates can improve the profits margins of such banks, thereby leading to improved financial performance. The study further reiterated that commercial banks should ensure their interest rates are favorable and attractive to the borrowers. Good interest rates ensure maximum returns and good profitable customer base. A further study can be replicated by use of panel study and time series data in the study model.

Key Words: *Interest Rates, Financial Performance, Banks in Nairobi County*

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INTRODUCTION

Interest rates characterize the prices that commercial banks put on the loans that they extend to the borrowers. Banks ought to contemplate the issues with adverse assortment and moral threat as it is extremely hard to prognosticate the type of a borrower from the onset of the banking association (Hoff & Stiglitz, 1998). Banks initiate hostile section issues through setting of high interest rates, give the willingness with which high risk borrowers accept such rates. The high rates characterized by the banking institutions in Kenya have hampered economic growth and discouraged long term investments into the Kenyan market (Ngumo, 2012).

Commercial banks are commercial establishments which offer deposits services, provide business loans and offer associated financial amenities. They provide for a host of accounts for deposits, including verifying, saving and periodic deposits. They are mainly profit making institutions often held by a group of people. However, some are members of the wild services to individuals, with the primary concern to receive deposits and lend money to businesses (Sanchez, 2009).

The banking system in Republic of Kenya is run through the Banking Act, the businesses Act, the financial organization of Kenya Act and also the numerous sensible pointers set by the financial organization of Kenya (CBK). In 1995 the banking sector in Republic of Kenya was remodeled through its relief and also the lifting of the exchange controls. The CBK, which is run through the cupboard secretary for Finance docket, has the responsibility to articulate and apply financial policy and foster liquidity, economic condition and applicable running of the financial set-up. CBK circulates data on Kenya industrial financial institutions, money establishments, rates and alternative publications and pointers. The sole regulator of economic banks in Kenya (CBK Annual Report, 2016).

Nairobi County was created as a result of the constitutional amendment that was promulgated in the year 2010, formerly known as Nairobi province. Nairobi hosts Kenya’s political, commercial and industrial capital. Nairobi county borders Kiambu, Kajiado and Machakos counties. It has nine sub counties namely; Starehe, Kamukunji, Kasarani, Makadara, Embakasi, Njiru, Dagoretti, Lang’ata and Westlands (Nairobi County, 2018). Nairobi County also hosts Nairobi city the capital city of Kenya. Nairobi County was chosen because it has well established national banks which also serve as headquarters for most banks in Kenya. Hence the information acquired would be of great essence.

Statement of the Problem

Credit rules and measures are created to streamline lending activities and ascertain prudent lending procedures. Recently, issuing of loans has become a matter of concern for commercial banks. It’s difficult for businesses and individuals to fulfill the banks requirements to receive loan, given that the small and budding business operate in new uncharted business locations that are prone to high threats (Bruns, 2009). Additionally, commercial banks find it hard to give loans to customers because of irregular information, which exist in higher levels amongst small businesses than in the big firms. Obtaining valuable information on the small businesses is quite hard given that such information exist only in uncertain quantities (Binks, Ennew& Reed, 2007). Commercial banks heavily depend on the customer’s and organization’s credit history in borrowing to award certain amount of loans, that account movement is seen to be difficult in taking into account approval of loans. Commercial banks consider borrower's personal behavior as an important factor in approving loans sought from the banks. The number of loans procured by the financial institutions is directly affected by the type of credit policies employed by these institutions. This therefore impact the competitiveness of the banks

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and by an extension their performance in the sector (Sangmi, 2010). Generally, few studies have been carried out locally on credit facilities. One such study on credit risk management in Kenyan banks discovered that recovery of loans is still a big issue of the banks despite putting into place strict measures to manage credit risk. The study by Akinlo & Ogo-Temi (2002) indicated that effective loan policies resulted in improved bank performance. The result of the study by Adebisi&Oloyede (2004) is supported by the study (Hosna et al 2009) carried in Sweden . To foster improvement and success, banks tend to reduce interest rate but are not willing to lend and yet people are willing to borrow. Therefore this leaves a gap that this study sought to fill by assessing interest rate and its influence on financial performance of Commercial Banks in Nairobi county.

Objectives of the Study

The objective of this study was to determine the influence of interest rate on the financial performance of selected banks in Nairobi County.

Research Hypothesis

Ho_1: There is no significant relationship between interest rate and financial performance of selected commercial banks in Nairobi County.

LITERATURE REVIEW

Theoretical Review

Transactions Cost Theory

Transactions Cost Theory guided this study. The theory was developed by Schwartz in the year 1974; this theory conjectures that financial institutions can also have an edge over the other creditors in assessing clients' credit worthiness or financial situations. These kinds of supremacies are likely to give these institutions a cost advantage as compared to the other creditors. Some of these benefits exist in terms of information acquisition, consumer control and obtaining of value from current assets (Rajan and Petersen 2007).

The initial supply may be even by the very fact that financial institutions will get data regarding consumers quicker and at lower price as a result of it is obtained during a traditional sequence of business. The frequency and amount of customer orders should give away the customers condition, while a customer utilizing cost reduction for an early payment should alert a supply of the declining credit worthiness of such a customer. Smith (1987) in his model asserts that in the process of a high rate tow-part credit, consumers who fail to value more highly to take advantage of the discount is understood to be a high risk customer. Counting on penalties for later payers, straightforward web terms will turn out an identical sign. The ability of the financial institutions to save values from assets that exist is that the third supply of cost advantages. In the case there is a purchaser default, the financial institutions are known to reclaim the products initially offered, while also further reclaiming the available assets. What differentiates these institutions is that the provision of identical businesses through corporation commercialism means that there already exists a sale network for the seized products, albeit running the risk of selling the seized goods at prices lower than the market value. This cost advantage is exploited through two interesting approaches by the institutions, as exhibited by Petersen androgen (2007). The supplies offer credit that is directly proportional to the value of the collateral provided by the individuals seeking the financial assistance. Another study associated with transaction cost theory was created by mineral (1987), and theorizes that there is a positive link between credit offered and demand viability. The analysis intends to find out how transaction cost theory has affected business performance of commercial banks.

Review of Study Variable

Financial Performance

Financial performance is both long and short term decision and methods that enable the organizational development by guaranteeing return on capital surpassing cost of capital without engaging any unnecessary financial risk (Pandey, 2010).It denotes the extent to which financial objectives have been accomplished. It is the point of assessment of an institution's monetary obligations as effected through their policies and operations. Overall, it is utilized in assessing the financial health of an organization over time. It can as well be useful in comparing firms within a particular industry, industries and sectors in recession.

Interest Rate

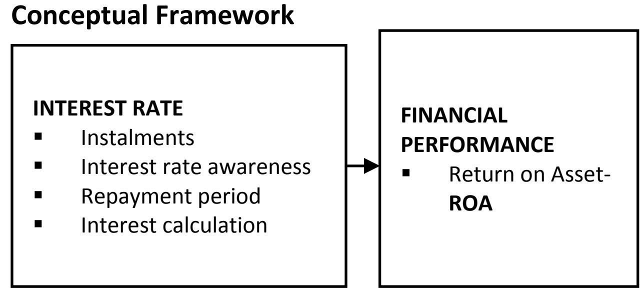
Interest rate is the charge imposed on money borrowed from a lender/financier or stipend imposed on borrowed chattels. It is also referred to as "rent of money". These rates are expressed as a ratio imposed on annual basis, and are essential aspects of the capitalistic society (Sayedi, 2013). Commonly, interest rates are derived from macro-economic factors. These factors include economic growth captured by GDP, fluctuation of interests charged and exchange rates among others. Interest rates are exacerbated by regulations enforced on banks. The impact of macroeconomic dynamics in other sectors of the economy will always have an impact on the banking sector, just the same way the sector will impact the other sectors in the economy (Wainaina, 2013).

Poor financial performance within banks result into instability of the interests imposed on loans. Lack of interest rates stability would ensure that domestic and foreign investors shy away from borrowing, leading to diversion of resources. Indeed, it has been realised that private investment is adversely affected by uncertainties and instability within microeconomics, just as much as it is impacted by the conventional factors such as economic growth, real interest rates and private sector credit (Sayedi, 2013). Even though there is no definite relations between interest rates and profitability, a number of researches point out that the changes in interest rates produce adverse effects on commercial banks financial performance (Gilchris, 2013).

Interest is defined as the fee charged on borrowed money or credit (D'Alberto, 2015). Keynes (1973) defines interest as the prize an institution receives for not hoarding money. Banks remit interest on the money deposited with them on one hand while charging interest on loans and advances given to borrowers on the other hand. The variance between these two interests outlines the interest spread, and serves as an essential portion of the source of profits for MDBs.

Lending rates constitute the levy charged on the money offered as loans to borrowers. Banks need to realize the difficulties that come with poor selection and moral hazard as a result of the problems resulting from the inability to foresee the borrower type at the onset of the banking relations (Hoff &Stiglitz, 1998). Setting lending rates too high would create adverse selection problems given that such rate are acceptable for the high risk borrowers. The commercial banks in Kenya have in the past set very high interest rates, which have in return capped the country's development rate (Ngumo, 2012).

Conceptual Framework



Independent Variable **Dependent Variable**

Figure 1: Conceptual Framework

Source: Author (2019)

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METHODOLOGY

The study adopted the descriptive research design which was preferred since it provides a complete picture of the situation, thereby restricting the level of biasness in the process of data collection and the overall reduction of errors during the interpretation the data collected. The target population was the employees in the 5 banking institutions within Nairobi. These five banks included National bank of Kenya, Equity Bank Limited, Family Bank Limited, Kenya Commercial Bank Limited and Cooperative Bank of Kenya Limited. The researcher utilized questionnaires, yearly reports and financial statements on record. Structured questionnaires were utilized in obtaining the primary data while financial reports and yearly reports were essential in the case of secondary data collection. The quantitative data obtained was analyzed using descriptive statistics, that is, the Statistical Package for Social Sciences (SPSS 24).

FINDINGS

Descriptive Statistics

Descriptive statistics entailed the rundown of reactions in relation to independent variables (credit regulation, collection policy, credit risk control and interest rate) and the dependent variable (Performance of selected commercial banks in Nairobi County). The statistics further indicate the outcomes of the responses to each statement by the respondents using the Likert scale. In this case, the scale has values 1 to 5 catalogued in a descending order, that is; 5=Strongly Agree, 4=Agree, 3= Uncertain, 2=Disagree and 1= Strongly Disagree. The resulting trend it presented in form of a table, showing percentage score.

Interest Rate and Financial Performance of Commercial Banks.

The research evaluated the impact of interest rate on performance of selected commercial banks in the Nairobi County. There were six statements that were presented to the respondents for their reaction, and these include: (i) Borrowers were made aware of the interest rate of their loans per annum; (ii) Borrowers were made aware of installment amount per month; (iii) Banks enlightened borrowers on method of calculating interests.; (iv) Interest rates enabled banks to attract and retain profitable customers (v) Interest rates were the main determinant of financial performance and (vi) generally, a properly defined policy on interest rates was in place. Table 1 below presented the results on the case.

Table 1: Descriptive Statistics; Interest Rate

	Percentage (%)						
Statement	**5**	**4**	**3**	**2**	**1**	**Mean**	**Std. Dev**
1) Borrowers are made aware of the interest rate of their loans per annum.	5.3	58.9	6.3	20.0	9.5	3.31	0.940
2) Borrowers are made aware of installment amount per month	13.7	54.7	4.2	16.8	10.5	3.44	0.927
3) Banks enlightens borrowers on method of calculating interests.	14.7	42.1	5.3	27.4	10.5	3.23	0.892
4) Interest rates enable banks to attract and retain profitable customers	9.5	49.5	6.3	24.2	10.5	3.23	0.824
5) Interest rates are the main determinant of financial performance	5.3	42.1	10.5	32.6	9.5	3.01	0.962
6) There is a well-defined policy document on Interest rates	10.5	51.6	8.4	17.9	11.6	3.32	0.823
Valid N (list wise) 95							
Grand mean = 3.257							

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The table showed that 58.9% of the respondents agreed while 5.3% strongly agreed that the borrowers were made aware of the interest rate of their loans per annum. This implied that most banks in Nairobi County enlighten their borrowers on the interest rates so as they are aware of what they are obliged to. There was a group of respondents who disagreed with the statements, pointing to the idea that some of the banks have not implemented this strategy, and as such, are unaware of its benefits.

A majority of the respondents at 54.7% agreed while about 13.7% strongly agreed that borrowers were made aware of installment amount per month Borrowers were made aware of installment amount per month. This means that commercial banks educates their borrowers adequately on monthly installments before disbursing loans to them to make them fully aware of what they will be liable to. This encourages members to believe and have trust in the bank hence generating high returns.

42.1% of the respondents agreed while 27.4 & disagreed that Banks enlightened borrowers on method of calculating interests. This means that only few commercial banks that enlightens borrowers on method of calculating interests. Also, 49.5% of the respondents agreed while 9.5% strongly agreed that the Interest rates enabled banks to attract and retain profitable customers; implying that a good number of banks in commercial banks in Nairobi County use their interest rates to attract customers hence increasing profitability of the banks.

In the similar fashion, 42.1% of the respondents agreed and 5.3% strongly agreed that that Interest rates were the main determinant of financial performance; indicating that a majority of the banks have their financial boost determined by the interest rates. A majority of the respondents at 51.6% agreed and 10.5% strongly agreed that there exists a properly defined policy document on Interest rates. This means most commercial banks have well stipulated their policy on interest rates on a document and brochure for easy detection and advertisement hence attracting more customers.

Inferential Analysis

Direct influence Interest Rate on Financial Performance of Commercial Bank

This tested how the commercial banks' performances were linearly affected by the interest rates they imposed on their loans. The results were as indicated in the table 2 below.

Table 2: Direct effect of Interest Rate on financial performance of Commercial Banks

Model Summary

					Change Statistics				
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	R Square Change	F Change	df1	df2	Sig. F Change
1	.786[a]	.618	.614	.70648	.618	150.411	1	93	.000

ANOVA[b]

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	75.072	1	75.072	150.411	.000[a]
	Residual	46.417	93	.499		
	Total	121.489	94			

coefficients[a]

Model	Unstandardized Coefficients	Standardized Coefficients	t	Sig.

		B	Std. Error	Beta		
1	(Constant)	.880	.213		4.127	.000
	Interest Rate	.821	.067	.786	12.264	.000

a. Dependent Variable: Bank Performance

In the table, it was shown that R squared was valued at 0.618. This implied a 61.8% disparity in financial performance of the selected banks in regards to their interest rates. The factors not factored in the model accounted for 38.2% disparity. On doing further analysis, it was realized that there existed a positive impact of interest rates on financial performance by the banks. Form the results, it was clear that a unit improvement on the interest rates imposed by these banks resulted in a 0.821 improvement level on their financial performance. The linear regression model applied in this case was:

$Y = 0.880 + 0.821X_1$

Where:

Y = financial performance of selected commercial banks in Nairobi County

X_1 = Interest Rate

Hypothesis Testing

The research **Hypothesis** showed that the link between financial performance of the stated banks and their interest rates was not significant. From the results, it was realized that indeed there was a significant correlation between the interest rates imposed on loans and the commercial performance of the banks (β= 0.374 (0.125), at $p<0.05$. this resulted in the rejection of the third hypothesis. This results indicated that a unit improvement on the operative rates led to 0.374 unit increase in the levels of performance exhibited by the banks. This is consistent with the results from the other researches previously undertaken on the same.

Irungu (2013) assessed relationship between the interest rate spread and the consequent change it resulted on the levels of performance by the Kenyan commercial banks. The study confirmed this relationship to be a positive one. In other words, the spread lead to increase in the interest charged on loans, which in turn had a positive impact on the financial performance. From the study, it was evident that there needs to be a government regulation to cap the interest rates as a means of curtailing exploitation of the borrowers by these banks.

SUMMARY OF FINDINGS

Ho_1; There exists no substantial relationship between interest rate and financial performance of selected commercial banks in Nairobi.

The **hypothesis** pointed to the nonexistence of a relationship between interest rates imposed on loans and financial performance. The study affirmed that a majority of the respondents at 58.9% agreed while 5.3% strongly agreed that their banks embraced interest rate policies. This implies that most banks in Nairobi County enlighten and educate their borrowers on the interest rates so as they are aware of what they are obliged to and their installments.

CONCLUSIONS

It was realized that the level of performance was impacted by the interest rates these banks imposed on the loans they offered. As such, well defined and properly articulated interest rate strategies will offer these banks good profit margins, thereby ensuring improved financial performance.

RECOMMENDATIONS

Commercial banks should ensure their interest rates are favorable and attractive to the borrowers. Good interest rates ensure maximum returns and good profitable customer base.

Areas for Further Research

Firstly, further research can be carried out on the impact of CBK regulations on the fiscal performance of commercial banks in different counties in Kenya.

Secondly, a comparable study can be prepared in form of time series data a panel study and for data comparisons and improved results.

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