

THE RELATIONSHIP BETWEEN INTEREST RATE AND PERFORMANCE OF COMMERCIAL BANKS IN KENYA

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Abstract

The purpose of this study was to determine the relationship between interest rate and performance of commercial banks in Kenya. Commercial Banks have on average been posting a continuous decline in their performance over the last decade. The central bank of Kenya is tasked with responsibilities to ensuring, among them price stability, economic growth, full employment, smoothing the business cycle, preventing financial crises and it uses commercial banks as transmission mechanism through monetary policy formulation and implementation. The objective was to establish the relationship between interest rate and performance of commercial banks. The study targeted all commercial banks in Kenya from which simple random sampling was used to obtain a sample. Sampling frame being the central bank's list of licensed commercial banks in Kenya before the year 2011. Primary data were obtained by administering questionnaire on a drop and pick basis while secondary data were obtained from central bank of Kenya annual reports and specific commercial banks audited financial statements. Data collected were analysed using simple regression model. Data presentation was by use of graphs and tables. Correlation research design was also adopted to explain the

relationship between interest rate and performance of commercial banks in Kenya. Taking into account the interest rate variable at zero the performance of commercial banks was 10.365, a unit increase in central bank rate will lead to a 0.025 increase in performance commercial bank.

Keywords: Interest rate, Performance, Banking, Commercial banks

INTRODUCTION

Monetary policy encompasses any policy designed to influence the level of economic activity by influencing the supply and demand or the cost of money. A sound monetary-policy framework needs to meet two objectives: maintaining price stability and promoting the utilization of the economy's resources at the highest attain-able level (Svensson, 2011)]. The former is an integral part of the mandate of every central bank, while the latter is one of the stated objectives outlined in the mandate of central banks such as the Federal Reserve and an implicit consideration in the conduct of monetary policy of others. In normal times monetary policy consists in the central bank signalling its desired overnight interbank rate that banks use to meet reserve requirements and settle transactions by engaging in open market operations and clearly communicating its stance on monetary policy. This is what is usually called the central bank's main policy rate.

The effectiveness of monetary policy, however, is not without limits. During the recent financial crisis, it became evident that under certain circumstances a central bank may find itself unable to meet its mandate using conventional monetary policy instruments. Under such circumstances, it is forced to resort to unconventional monetary policy measures. When the zero lower on the policy rate becomes binding and the transmission mechanism of monetary policy is seriously impaired; a central bank has to part ways with the convenience and safety of conventional monetary policy.

Commercial banks play a very imperative role in countries' economy first is mobilising savings for capital formation, providing long-term finance for the improvement of economic activities and aiding implementation of monetary policy to achieve the desired level of development among others. Performance of these commercial banks determines their continual operation existence. Its existence is felt by wider range stakeholders such as shareholder, debt holders, customers and even the government through the taxes it collects from them. High performance therefore is the main driver of commercial banks activities. Consequently, banks engage in a variety of products and services in order for them to diversify and earn profit, the

commonest being advancement of loans to borrowers seeking financial accommodation, (Kimani, 2013)

Federal Reserve Bank of United State uses three instruments of monetary policy, Open Market Operation where it engages in the buying and selling of government securities therefore altering the level of money supply therefore attaining the desired level of prices and thus making it the most frequently used tool of monetary policy the discount rate and the cash reserve ratio to promote employment, stable prices and moderate the long-term interest rate thereby supporting the long-term economic growth. United State has enhanced its development through the immense support of Federal Open Market Committee. In developing countries across the world, long-term bank loans represent more than 70% of its total long-term debt, (Mudida, 2015).

The introduction of monetary policy in most developing countries has been gradual. Kenya introduced open market operation in 1990 while other countries like South Africa introduced earlier in 1989 and closely followed by others. In the past decade significant change in the conduct of monetary policy has been felt around the world. Many developing countries, including Kenya have adopted monetary policy with an objective of enhancing sustainable economic growth, achieving full employment and ensuring that inflation rate is predictably low and stable. A rise in the overall price level erodes savings and discourages investments. In recent years many central banks through the monetary policy organ have adopted inflation targeting where they set the desired inflation targets and attempts to steer actual inflation towards the target rate. A popularly use tools is the interest rate among others, (Adeusi, Kolapo, & Aluko, 2014).

Monetary policy in Kenya

Monetary policy committee (MPC) is an organ of central bank responsible for formulating monetary policy. It was formed vide Gazette Notice 3771 on 30th April 2008 replacing the hitherto monetary policy advisory committee (MPAC). The membership of MPC is constituted by the CBK Governor who chairs the committee, the deputy Governor, two members appointed by the Governor and four other external members who have exemplary knowledge in matters relating to finance, banking and fiscal monetary policy. MPC is required by the law to submit report on the findings to the Cabinet secretary for the National Treasury. Although monetary policy framework has remained the same over decades, CBK has been routinely altering its operations and procedures in order to enhance effectiveness and efficiency in delivering its objectives in dynamic financial and economic environment, (CBK Act, 2005). During early years, CBK relied upon support of banking institutions through their regular meetings with the chief

executives of banks to explain the monetary policy that should be exerted in banks to enhance economic development, (Price Water Coopers, 2011)

One of the responsibilities of monetary policy committee is to determine the rate at which banks lend to borrowers in order to attain a stable economy. Interest rate is the price that one pays in excess of the funds advanced to. Poor performance of commercial banks puts them pressure to retain high interest rate in order to minimize losses associated with poor performance of loans and cater for unforeseen defaults and in so doing it affects their clients leading to slow uptake of loans. Commercial banks engage in transforming short-term liabilities into long-term assets. The mismatch in maturity of these assets and liabilities exposes banks to re-pricing risk and it is seen as one of the causes of interest rate fluctuation. Suitable interest rate by the monetary policy committee helps the commercial banks reduce on the exposure to this risk. The ceiling and floor lending rate was established in order to remove punitive cost of doing business by entrepreneurs. This rate was then reduced to a ceiling of no more than 4% above Central Bank Rate (CBR) of 10%. The nation's growth and development, an objective of monetary policy, is enhanced through small investments of small investors, however, this effect bringing unfavourable result both to institution and the nation (Ngari, 2013).

Central bank of Kenya requires that commercial banks maintain a cash reserve ratio of all customer deposits liabilities. Cash reserve ratio has been linked to attempt to control money circulation and provide revenue to Treasury. This is done to facilitate commercial banks liquidity management and is checked on a daily basis, if reserve money cannot easily be increased the cash reserve ratio restrict commercial bank balance sheet growth, however banks may hold voluntarily excess reserve. This cash reserve ratio does not earn commercial banks any interest and hence reducing on profit margin of the sector. When CBK wants to raise the amount of money in circulation it reduces on the cash reserve ratio and banks be supplied with additional money which was in excess and when there is excess money in circulation the cash reserve ratio is revised upwards and commercial banks are required to remit certain fraction of their cash holding. The main aim of introducing cash reserve ratio is to keep inflation by regulating the amount of money in circulation, (Clews, 2005).

Central bank of Kenya through the monetary policy organ uses open market operation (OMO) where it sells and purchases government security through the central bank to alter money supply of bank and check on the capacity to expand credit to its customers. Central bank sells these government securities at a high and attractive rate to entice commercial bank subscribe to them, the treasury bills are sold at 8.662% as of January 2017. When the central bank sells security it reduces the amount of money in circulation and thus the interest rate reduces and hence ensuring price stability but the commercial banks are left with liquidity

challenge where they have little money to lend to clients, and when central banks buys securities, banks are left with better lending position and encourages high inflation rate, (Central Bank of Kenya, 2016) Central bank as a lender of last resort can employ discount window operation (DWO). The CBK lends to the commercial bank on an overnight basis at penal rate currently at 16% as of January 2017 which is above commercial banks' lending rate. This penal rate is meant to control the commercial banks from regularly seeking finances from the CBK and to them it is made lender of last resort by raising the lending rate and utilizes other finances first and opts for DWO funds when they cannot get from anywhere else. However, this facility is not readily always available to commercial banks but is regulated (Central Bank of Kenya 2009).

Statement of the problem

Cheng (2006) study on the impact on monetary policy intervention in Kenya showed that there was significant relationship between the monetary policy and price stability, employment and economic development. The Central Bank of Kenya (CBK), just like other monetary controlling institutions in the world is entrusted with the task of formulating and implementing monetary policies geared towards maintaining the set monetary targets in order to achieve economic growth and development. In additional CBK should ensure that there is regulation to maintain a sound based financial system. Between 2012 and 2016 inflation has fluctuated despite frequent intervention by the central bank monetary Committee. Most prices of goods have sky rocketed in the same period making the cost of living unbearable to most Kenyan, unemployment on the other hand, in which the CBK's monetary policy attempts to address has been continually increasing gradually and constantly.

The central bank is tasked with the responsibility to ensuring that inflation is kept at reasonable levels and setting of lending rate to ensure that loans become affordable in order to aid in economic development. Whereas CBK has to some extent managed to intervene, mostly the intervention is too late when the damage is already caused or the time lags between response and effect have been big hence attempts only to restore the initial state and fails to enhance economic development. CBK uses commercial banks as the main transmission mechanism of the formulated monetary policies towards attainment of the set targets. A study by (Nairobi Securities Exchange, 2013) raised question 'why are some commercial banks more successful than others' which is relevant to the study. The continual operation of commercial banks is solely determined by the current and or future performance. This study therefore seeks to inform on the policies formulation through the examination of monetary policy and performance of commercial banks in Kenya

Objective to the study and Hypothesis

To establish the relationship between interest rate and performance of commercial banks in Kenya.

H₀: There is no significant relationship between interest rate and performance of commercial banks in Kenya.

Significance of the study

Banks plays an imperative role in nation's economic development as a medium through which surplus unit and deficit unit interacts to form equilibrium and provision of finances to investors seeking financial accommodation. Their existence is solely determined by their performance. However, level of intervention by the regulator explains their survival. Low level of interventions by the regulator encourages competition in the sector and in the long run does not guarantee survival. Therefore, there is a specific level of regulation that should be exerted on these institutions. The findings of this study would benefit the central bank in attainment of monetary policy objective as it would provide an insight to the effects of varying monetary policies on the performance of commercial banks. The central bank through the monetary policy organ partners with banks to ensure price stability and economic growth through provision of affordable credit.

The findings of the study would be important to commercial banks, as they would be able to establish the effect of monetary policy on their performance and hence appreciate their role in attainment of desired economic growth and price stability in Kenya. This study is also of great importance to various stakeholders in banking sector among them, banks' clients who wants to know why they are paying the price they are paying and fluctuations in interest rate and shareholder on investment decision. Further, the findings of this study would also be helpful to upcoming researchers and scholars, as it would form a reference for further research on other factors which affect the performance of all the commercial banks other than the Monetary Policy.

Scope of the study

The study investigated interest rate and its relationship and the performance of commercial banks and analysed each and every tool of interest rate policy to determine how it affects the performance of commercial banks in Kenya. The study sampled the commercial banks in Kenya for a period of five years from the year 2012 to 2016 based on the continuous decline in the Return on Asset (ROA) and Return on Equity (ROE) as well as increase in inflation and fall on performance of commercial banks. The study utilised both Primary and Secondary data from the commercial banks.

THEORETICAL REVIEW

This section review existing theories relating to performance of commercial banks.

Loanable fund theory

Interest rate with which banks lend depends on demand and supply of loan-able fund, and savings and investments are responsible for determination of the long run interest rate while short-run interest rate is determined by the prevailing financial conditions in a country. Interest rate is determined by the availability of loan-able funds, the availability of such loan-able funds is determined by deposits made by customers, and demand for loan-able fund determined by availability of investments opportunities offered by the environment. The nominal interest rate is determined by the interaction between supply of and demand for loan-able funds. However, holding all other factors constant, an increase in demand for loan-able fund push interest rate upwards and reverse is true. The demand for loan-able fund is determined by demands for final goods and services. An increase in supply of loan-able fund reduces interest rate. If both demand and supply of loan-able fund change, change in the interest rate depends on the magnitude and net change. Supply of and demand for loan-able fund is not the sole determinant of interest rate but also other factors such as productivity of capital and savings affects interest rate. (Bibow 2000)

Central bank system has ability to alter supply of loan-able fund available in the economy through the use of monetary policy instruments. The expansionary monetary policy leads to the reduction of interest rate which is in itself designed to stimulate the growth in the economy through the safeguarding of small scale borrowers from exploitation while the contraction of monetary policy results to the rise in interest rate, (Albertazzi & Gambacorta, 2006).

Classical theory of interest rate

The classical theory of interest rate is the most adapted theory in determining the equilibrium interest rate by comparing supply of saving and demand of borrowing. Equilibrium is reached when supply of saving and demand of borrowing for investment equals each other by drawing a simple demand-supply curve and the intersection is taken as the equilibrium interest rate and the desired level of money supply and demand. Investment represents demand for investable resources and savings represent supply of these resources. If supply of funds is greater than investment, interest rate drops up to a point where the two are equal and vice versa and if savings is less than investment it causes disequilibrium and the interest rate shifts to ensure equality in both, (Albertazzi & Gambacorta, 2006).

It is also explained by the loan-able fund theory supply of credit represent activities of depositors and any party supplying directly or indirectly credit to finance market and activities of investors which include parties selling financial assets to raise capital for their business to determine interest rate equilibrium, Classical theory of interest rate therefore is indeterminate because the position of savings depends on the level of real income. As income rises amount of savings also rises. Therefore rate of interest cannot be known unless level of income is known, and the level of income cannot be known unless rate of interest is known and hence the classical theory of interest offers no solution to how interest rate in the economy is determined, (Satija, 2009).

Liquidity preference theory

According to Keynes (1936), liquidity refers to the ease at which assets are converted into liquid cash cheaply and quickly. People prefer liquidity depending on individuals varying reasons and can either be transactional, precautionary or speculative motive. Transactional motive according to Keynes refers to the amount of money that individual holds to cater for daily usage of funds. The precautionary motive is the amount of money held to cater for unplanned activities such as illness while speculative is where individuals hold money to take advantage of investment opportunities that may arise in security market. The speculative demand for money is affected by the prevailing interest rate in the market, commercial banks may get exposed to low level of liquidity and reduces their performance level by constraining on the funds that will be lend out and earn profits and may lead to a state of bank run a situation where depositors panic and withdraw their deposits. Banks depends mostly on the individuals' deposit, which they consider it to be the cheapest source of loan-able funds. Liquidity preference theory is centred on the interest rate that the bank offers out of client's savings as it would lead to attracting deposit from them. If investment yields them higher returns, then they will choose to deposit and forego liquidity, (Biefang & Howells, 2002).

However, excess liquidity may lead to increase in profit in a condition of strong demand for loan-able funds by investors. It may lead to a fall in profit in a condition of weak demand especially when the rate at which deposits earn to a customer is such that profits earned from the loan-able funds is utilized to pay depositors and hence condenses the ability of banks to make profits. However, Keynes only explains interest in the short-run and did not give clue on how long-run interest rate is determined, Keynesian theory of interest rate is indeterminate like the classical and the loan-able fund theory as one cannot know with certainty how much money will be needed for speculative demand unless the transaction and precautionary demand for money is known due to interdependence (Njoki, 2014).

Financial Intermediation theory

According to Adrian and Shin (2009), financial intermediaries exist because they can bridge information gap and transaction cost between borrowers and lenders. Banks as financial intermediaries therefore assist the efficient functioning of the market by bringing the lenders and borrowers together. Adrian and Shin concluded that rational investors are risk averse and cannot predict timing of future consumption needs, therefore preferring to hold their wealth in a more liquid form which can be accessed on demand basis and hence providing funds to commercial banks to lend to investors at a fee. Without the financial intermediation by commercial banks leads to locking out of investors and slowing down the nation's development and similarly forcing depositors to dive into illiquid long-term inconvenient investment yielding high pay-off while those who must consume early receives low pay due to premature liquidation of long term investment. Commercial banks can perfect the market by sharing risk among individuals who need to consume at a different and unpredictable random times. The optimal contract in Adrian and Shin is a demand deposit contract where the depositors are given their deposit on demand basis.

Commercial banks as financial intermediaries are able to overcome this market failure and resolve the information asymmetry problem. Information asymmetry arise as a result of borrowers generally knowing more about their investments opportunities and without information asymmetry financial intermediaries would not receive deposit as they would prefer investing in this investment opportunities, than the lenders/depositors do. Therefore, information asymmetry is the bedrock of financial intermediation. This information asymmetry occurs either "ex ante" or "ex post". An ex ante information asymmetry is as a result of lenders cannot differentiate between borrowers with different credit risk before providing loans and leads to an adverse selections problem.

A problem in which interest rate will be raised to accommodate a most risky pool of investors a situation which also reduce the economic growth of a nation by charging high interest rate which discourages potential borrowers from seeking funding. To overcome the problem of adverse selection, lenders put the borrowers under thorough scrutiny to determine their credit worthiness and may not fully meet financial need of an investor and or in the extreme may reject finding at all. Adrian and Shin (2009).

Mbotu (2010) claimed that the interest rate affects directly the quality of loan and commercial banks should be more concern about interest rate in order to improve on the loan quality. The information asymmetry occurs "ex post" when borrowers can observe actual returns after perfect completion a situation which lead to moral hazard where the commercial banks engage in activities that reduces the likelihood of the loan being defaulted. In summary financial

intermediaries play an important role in economic development absorbing surplus from the surplus unit in the economy and advancing it to the deficit units which will carry out development activities. In addition, it helps the surplus unit collect funds from them and professionally scrutinize those requiring financing from the deficit unit in the economy in order to enhance economic development as well as risk taking and providing assurance to the depositors as well as availing liquidity on demand when needed by depositors

Interest rate and Performance

Monetary policy involves the relationship between acts by the central bank and economic development and price stability. Central bank employs a variety of measures to attain the desired level of economy and inflation rate. A handful of literature related to monetary policy exist; Irungu (2013) in his study on the effects of interest rate on the financial performance of commercial banks said that interest rate impacts commercial banks positively and negatively, high interest rate benefits commercial banks and on the other hand discourages borrowing leading to shrinking investment in the economy. Kimani (2013) concluded that low interest rate increases the demand for loans.

Otuori (2013) studied the influence of exchange rate on the financial performance of commercial banks in Kenya and found out that there is a direct and positive relationship between interest rate and performance of commercial banks. As interest rate rises, profitability of commercial banks rise since there is a greater spread between central bank rate and the rate at which bank charges its customer and the spread between long term rate and short term widens since short term rate hikes faster than long term leaving a commercial bank better off and additionally banks response to interest rate hike faster than what they pay on deposits boosting their net interest margin instantly Gavin (2010). Mohanty (2003) concluded that, central banks changes short term interest rate in response to any deviation in target rate of inflation and exchange rate movement to restore equilibrium and it refers to the price paid for the use of funds.

RESEARCH METHODOLOGY

Research Design

The study adopted correlation research design to study relationship between variables. According to Kothari (2004) the major purpose of correlation research is to reveal the relationship between variables as it exists at present and the degree to which they are related, correlation research is concerned with how one or more variables affects the other.

Target Population

According to Kothari (2004) population refers to an entire group of individuals or objects having common observable characteristics. The target population for the study were the 42 heads of departments of all the commercial banks in Kenya licensed by the central bank of Kenya before the year 2011. In Kenya there are a total of forty-two commercial banks, which constituted the population for the study and from which the sample were drawn.

Sampling

According to (Kothari, 2004) defined sample as a smaller unit of the population that has the same composition and characteristics as the universe. According to (Cooper & Schindler, 2001) sampling frame is the list of elements that contain complete and correct members of the population from which the sample is drawn. To obtain the sample for the study, the researcher used the non-probability sampling method; convenience sampling was used while data collection was done based on availability and access.

The sampling frame for the proposed study was the list of commercial banks maintained in the central bank of Kenya and or Kenya National Bureau of Statistics (KNBS). To obtain the sample for the study, the researcher used the non-probability sampling method; convenience sampling will be used where data collection will be done based on availability and access. Yamane, (1967) formulae was adopted to determine the sample size which was;

$$n = \frac{N}{1 + Ne^2}$$

n = optimum sample size

N = number of commercial banks

e = probability error

In the study, N = 42, e = 5 % (at 95% confidence level). The sample size was 38 banks.

Data Collection

The study used data both primary and secondary sources; the primary data were obtained by administering questionnaire randomly to commercial banks head of department staffs on a leave and pick basis. According to (Kothari, 2004) secondary data is available in various publications of the central bank of Kenya depository and individual banks' annual financial statements. The data contained in the central banks of Kenya relates to the performance of commercial banks and the regulations of the independent variables in different years from the year 2012 to 2016.

Validity of Research Instrument

According to (Kothari, 2004), validity is the extent to which differences found with a measuring instrument reflect true differences among those being tested. Validity therefore refers to the extent to which an instrument can measure what it ought to measure and it implies the extent to which an instrument asks the right questions in terms of accuracy and the degree to which the research instrument is emanates from the research objective. Content validity were determined through discussion of research instrument with the supervisor and lecturers of Masinde Muliro University of Science and Technology, school of business and economics and they helped in checking of the appropriateness of the research instruments if it measures what it ought to measure.

Reliability of Research Instrument

According to (Cooper and Schindler, 2003), reliability refers to the consistency of the research instrument in order to ensure that the data collected has internal consistency to enable data analysis. Reliability testing was conducted using the Kuder Richardson coefficient of reliability which was 78% rated as good.

Data analysis and Presentation

The researcher edited the data collected. Errors and omission were checked for completeness and correctness (Kothari, 2004). The data were then analysed with the aid of Statistical Package for Social Sciences (SPSS) version 16 to help the researcher describe the data. Regression tool of analysis was used to infer 5% significance level. The findings were then presented using graphs and table to enable comparison.

Model Specification

The variables of the study comprised of the banks' performance as the dependent variable and interest rate as the independent variables. Study adopted simple regression analysis to study the relationship between the performance of commercial banks and causal variable. Simple regression model.

$$Y = \beta_0 + \beta_1 X_1 + \varepsilon$$

Regression model two

Where; Y = banks performance; β_0 = the constant; $\beta_1, \beta_2, \beta_3, \beta_4$ = beta coefficients; X_1 = Interest rate; ε = error term

The bank performance was taken to mean the overall performance of the commercial banks as defined in the dependent variables as return on asset. The percentage change in Y was taken

to mean the percentage change in the performance of commercial banks in Kenya. The errors term refers to the deviation that may arise during the measurements of these variables either by the banking institutions and/or the researcher, the error term helped in stabilizing the model. The β_0 terms represent the performance of commercial banks that is not dependent on the variable under the study.

RESULTS AND DISCUSSIONS

Central bank rate

The study aimed at establishing the relationship between interest rate and performance of commercial banks in Kenya. It therefore obtained data regarding the trend of interest rate and performance of commercial banks. The descriptive statistics was conducted and revealed that the bank performance had a mean of 4.424 with a standard deviation of 0.344 while central bank rate had a mean of 10.62 with a standard deviation of 2.67.

Model summary

Table 1 Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.059 ^a	.004	-.329	.39609

a. Predictors: (Constant), Central bank rate

The coefficient of multiple determination, R^2 value of 0.004 indicates that only 0.4% of the variation in performance of commercial banks in Kenya can be explained by variation in central bank rate. The other portion of 99.6% of the variation is explained by other forces as shown in table 1.

Analysis of Variance (ANOVA)

Table 2 ANOVA

Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	.002	1	.002	.011	.025 ^a
	Residual	.471	18	.157		
	Total	.472	19			

a. Predictors: (Constant), Central bank rate b. Dependent Variable: Performance

An important statistical test conducted was in analysis of variance was the *F*-test. The correlation coefficient was 0.059 which showed that there was a weak and positive relationship between the central bank rate and performance of commercial banks in Kenya.

The *F*-statistics was 0.011 and significant at 5% level, $p = 0.025$ implying that the model was fit to explain the relationship between central bank rate and performance of commercial banks in Kenya. The hypothesis testing was conducted to test the relationship between the independent variables and dependent variable. Where the *p*-value was less than the critical value of 0.05, the null hypothesis was rejected. The null hypothesis indicated that there is no significant relationship between the central bank rate and performance of commercial bank in Kenya. The *p*-value was 0.025 which was less than the significance value of 0.05 which implied that the null hypothesis is rejected. And therefore there is a significant relationship between central bank rate and performance of commercial banks in Kenya.

Regression coefficients

Table 3 Coefficients

Model		Unstandardized Coefficients		Standardized Coefficients		
		B	Std. Error	Beta	T	Sig.
1	(Constant)	4.344	.800		5.431	.012
	Central bank rate	.008	.073	.059	.103	.025

a. Dependent Variable: Performance

With 95% level of confidence, holding central bank rate constant, the performance of commercial banks would be 4.344 and a unit increase in central bank rate would lead to 0.008 increase in performance of commercial banks as shown in table 4.3. The regression equation would therefore become Performance (Y) = 4.344 + 0.008X₁ which implies that holding all the factors constant, the performance of commercial banks would be 4.344 as depicted by the constant in the regression equation. A unit increase in central bank rate would lead to 0.008 units increase in performance of commercial banks. This was in support to Otuori (2013) conclusion that there is a positive direct relationship between interest rate and performance. Otuori argued that as interest rate rises the performance of commercial bank also rise since the lending rate is raised leading to higher interest rate spread between lending rate and central

banks rate as banks are responding to interest rate hike faster than response to what they pay on deposits boosting their net interest margin

CONCLUSION AND RECOMMENDATIONS

The study concluded that central bank rate had a very weak positive relationship with performance of commercial banks in Kenya. As interest rate rises the performance of commercial bank also rise since the lending rate is also raised leading to higher spread between lending rate and central banks rate as banks are responding to interest rate hike faster than response to what they pay on deposits boosting their net interest margin. These findings supported (Otuori, 2013) conclusion that there is a positive direct relationship between interest rate and performance. The study showed that central bank rate was a significant determinant of performance of commercial banks in Kenya which implies that a unit increase in central bank rate led to increase in the performance of commercial banks. Central bank rate was positively correlated to the performance of commercial banks in Kenya with beta of 0.025 and p-value of 0.010.

To improve the performance of commercial banks, central bank of Kenya should consider raising the central banks rate since it was found to be the only variable from monetary policy that is improving commercial banks profitability. Cash reserve ratio has been negating the performance of commercial banks in Kenya, central bank of Kenya should select a low and suitable rate the commercial banks are required to maintain in the cash tills.

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