

Moderating Effect of Political Risk on the Relationship between Bank Characteristics and Lending Rates among Commercial Banks in Kenya

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Abstract

Low lending rates would encourage increased uptake of loan facilities hence fostering investments that in turn would be expected to spur economic growth. Increase in investments is expected to yield good returns hence resulting in multiplier effects. After the 1990s when financial liberalization had taken root, commercial banks in Kenya stood related in terms of not only other aspects of their trading but also with lending rates. The benefits expected of Financial Liberalization and deepening of the financial sector is narrowing of lending rates. Political risk is the risk faced by commercial banks that include political decisions events conditions or pronouncements which significantly affect their commercial banks profitability. In this context, the effect on profitability would have an effect on lending rates in return. The Political risk index is computed based on twelve items entailing social and political constructs within a country. The study sought to establish the moderating effect of political risk on the relationship between bank characteristics and lending rates among commercial banks in Kenya. The research philosophy for this research was positivism. Explanatory non-experimental research design was employed. The target population was thirty nine (39) commercial banks from whom secondary data was collected by way of census since these are the banks from which complete information could be obtained for meaningful analysis for the study period 2006-2015. Descriptive Statistics including Mean, Standard deviation, inferential statistics (Panel regression analysis and Correlation analysis) were carried out. Data analysis was run on the Stata 13 package and findings presented in figures, tables, graphs and charts while deriving conclusions and recommendations from the findings of the study. Political risk was found to have insignificant moderating effect on the relationship between bank characteristics and lending rates among commercial banks in Kenya.

Keywords: Political Risk, Bank, Characteristics, Lending Rates

Introduction

Background of the Study

From 1992, Kenya has been conducting democratic elections. Since then, the country has suffered bouts of elections violence, tensions that most of the times affect the economic growth of the country. A good example of the high political risk occurred during the 2007/2008 where economic growth also got drastically affected. The Central Bank of Kenya in most cases play down the impact of political risk on economic growth terming it a cyclical event that will be outlasted by longer term fundamentals of the economy. During the campaign period and installation of a new government business with government likely slow down.

Political risk is the risk faced by commercial banks that include political decisions events conditions or pronouncements which significantly affect their commercial banks profitability (Sottilotta, 2013).

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In this context, the effect on profitability would have an effect on lending rates in return. Kenya's political risk index will be obtained from world banks ratings to political risk of countries. The Political risk index is computed based on twelve items entailing social and political constructs within a country (Datta *et al.*, 2015). The twelve items include: the stability of the government, socioeconomic volatility, investment profile, conflict, corruption, military involvement in politics, tensions in religions, ethnic animosity among others. A composite indicator of political risk was applied (measured on a scale of 0-100) and high values signified low political risk while low values signified high political risk (Click & Weiner, 2010 and Goerzen *et al.*, 2010). According to Datta *et al.*, (2015), the variable can be reverse coded by subtracting the index value from 100. Hence, the higher the reverse code, the higher the political risk.

McLeay *et al.*, (2014) analyzes the effect of political risk on lending rates and finds that the effect of political risk is insignificant since the central bank lends to commercial banks in case of urgent needs to cushion customers and as such, through window dressing and kitting, the commercial banks can maintain the customers' needs. The study recommends political risk to be analyzed as a moderating variable by future studies. Kuttner (2012) finds that political risk, although insignificant in the determination of lending rates, it cannot be overlooked as it could have a stronger influence on other relationships leading to lending rates. The study recommends that this variable be investigated as a moderator or control variable. This study will therefore analyze political risk as a moderating variable in the determination of its effect on lending rates among commercial banks in Kenya.

The increase in lending over the years is an indicator that the rise in lending rates does not bar uptake of loans which could in turn show possibility of economic growth prospects being high (Mbotu, 2010). However, the steady rise in the level of NPLs is reflective of the high lending rates in Kenya. This is because a rise in lending rates increases the repayment and this eats into the return on investment leading to repayment defaults (Messai & Jouini, 2013). The period after financial liberalization is characterized by increased costs with monetary policy achieved through increasing reserve and cash ratios (Sambiri *et al.*, 2014). This therefore means that the importance of lending rates determinants cannot be over emphasized hence this study.

Banks would charge higher lending rates to borrowers perceived to be risky in anticipation of defaults. As such, lending rates accounts for loan loss necessities in the decomposition (Hamid, 2011). Lending rates also would account for overheads, reserve requirements and taxes. All the above contribute to high lending rates. Among the most cited studies in Kenya on lending rates is Ndungu and Ngugi (1999). The study theoretically derived factors likely to influence lending rates including customer deposits, amount of loans, the Treasury bill rate and the inter-bank rate. The banking sector efficiency is measured by lending rates which have generally been found to be higher in the African countries like Kenya (Chirwa & Mlachila, 2004; Gelos, 2006; Crowley, 2007).

Bank characteristics refer to the internal factors that commercial banks consider while setting up lending rates (Uzeru (2012). Lending rates are arrived at by considering bank characteristics including credit risk, bank size, operating costs, among others. Credit risk is a fraction of total loan represented by non-performing loans (NPLR). In financial sector credit risk is used to measure the quality of loans where high non-performing loans ratio implies that there is high cost of bad loans. Since all economic agents are risk averse, commercial banks facing credit risk in most cases pass the risk to borrowers by increasing the lending rates (Maina, 2015).

Bank size is the measure of how much in value the bank holds in terms of all its assets. Bank size is usually determined by a log of banks totals assets. From theoretical perspective big banks are expected to charge lower lending rates compared to smaller banks this is because of the ability of these banks to utilize the economies of scale in their operation efficiency. Large banks also have high potential of investing in modern technology to enhance their efficiency (Were & Wambua, 2014). Operating costs are the day to day running expenses and are to be operationalized as operating costs as ratio of net income. Some of the costs commercial banks incur are credit appraisal costs, application and screening costs and the cost involved in monitoring the projects for which the loans was applied for (Beck, 2010). When the costs associated with loan application increase this is likely to impacts on the cost of loans through increase in lending rates. Operating expenses in usually adopted in financial sector as an indicator of operational inefficiency. In a case where, there is high costs incurred by financial intermediaries this will impacts positively on lending rates while negatively impacting of interest rates charged on deposits. On the other liquidity risk is inability of the commercial banks in this case to meet its current financial obligations.

Liquidity risk is often derived by computing the ratio of bank’s liquid assets to total assets. Liquidity risk varies from one bank to another and depends on the amount of liquidity owned by the banks. Commercial banks with high liquidity faces lower liquidity risks and vice versa hence they are likely to charge lower lending rates than banks with less liquidity. Banks with lower liquidity also charge lower liquidity premiums on loans. Commercial banks facing high liquidity risk are forced to engage in interbank lending to cushion themselves hence cascading the costs to the borrowers as a results they charge higher lending rates (Ahokossi, 2013).

Literature Review

Georgievska, Kabashi, Manova-Trajkovska, Mitreska & Vaskov (2010) finds that bank size, market share, deposit lending rates and non-performing loans are positively related to lending rates and lending rate spreads. However, the study assumes direct relationships and fails to account for macroeconomic variables (GDP and inflation) and the effect of political risk which banks consider as a critical factor. According to Krnic’ (2014) bank size, return on assets, return on equity and capital adequacy was found to have no significant effect on lending rates. Ngigi (2014) study found that operational costs have a negative relationship with lending rates whereas credit risk had a positive relationship with lending rates. Study assumes direct relationship. Kananu and Ireri (2015) study found a strong positive relationship between operational costs and lending rates. However, the study assumes direct relationship which may not be true since there are other factors that may affect the relationship including, but not limited to the political risk of a country in whose territory the banks operate.

Research Methodology

The philosophy of the research that was employed by the study was positivism. In this study, explanatory non-experimental design was adopted that sought to determine the effect of the independent variables on lending rates, the dependent variable and no manipulation of the independent variables is anticipated. This design was appropriate since the purpose is to describe and explain characteristics of certain groups (Were & Wambua, 2014). The target population for this study comprised of forty three (43) commercial banks. According to the CBK (2015), there were 43 commercial banks as at 31st December 2015 in the banking sector in Kenya. However, only thirty nine (39) Commercial banks were studied due to the fact that four (4) of the banks are under statutory management have restricted the availability of credible data. The study used document review guide in collecting quantitative data from the thirty nine (39) commercial banks for analysis to support or refute stated hypotheses and confirm evidence to be obtained from quantitative data analysis.

According to Kraemer *et al.*, (2001) and Baron and Kenny (1986), this test is appropriate while testing for moderation and it’s done by regressing the dependent variable on the independent variables; that is, regressing lending rates on the bank characteristics (BCs and the moderating variables. To determine the moderation effect of political risk on the relationship between BCs and lending rates among commercial banks in Kenya, the study applied equation 3.3 as follows:

$$CBLR_{it} = \beta_0 + \beta_1 CIBC_{it} + \beta_2 PR_{it} + \beta_3 (CIBC * PR)_{it} + \epsilon_{it} \dots \dots \dots \text{Eqn 3.3}$$

Where:

CIBCs is the composite index of bank characteristics, which was computed by calculating the geometric mean of all the bank characteristics.

CBLR_{it} is the Commercial banks lending rates over time.

PR is the political risk index

Analysis, Findings and Discussions

Descriptive Results

Trend Analysis of Lending Rates

The trend analysis for lending rates revealed that lending rates were volatile during the period of this study. The analysis indicates that lending rates were highest in 2006 and lowest in 2008. The results further showed that lending rates have been increasing steadily from 2006 to 2015.

The banks rates on lending and deposit dropped slowly but surely reflecting better liquidity conditions in line with the monetary policy. Average lending rates decreased from 26.0 percent in 2006 to below 21 percent in 2015.

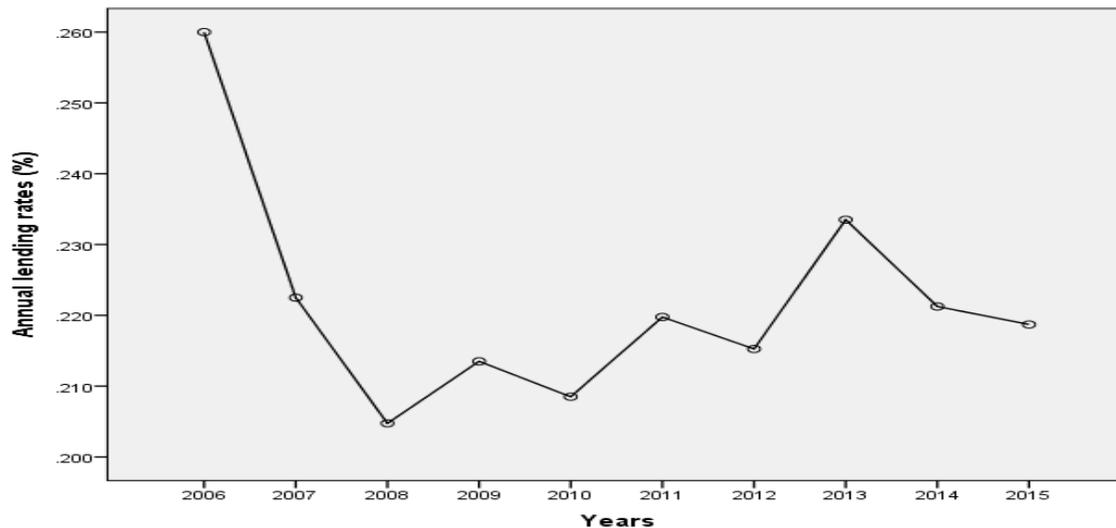


Figure 1: Trend Analysis of Lending Rates

Under the Kenya Vision 2030 initiative, there are policies to action and target the financial sector to increase savings rates from 17 per cent to at least 30 per cent of GDP. To achieve this, it would require increasing banks deposits to about 80% from the current 44% and to lower borrowing costs (GoK, 2007). To achieve financial services enshrined in the Kenyan vision 2030 initiative, lending rates must be kept significantly low. Grenade (2007) posits that CBs are the central players in the financial sector and as such, greater consideration is given to them. Maina (2010) further indicates that in the year 2012, the CBK has continuously pursued reforms in the financial sector aimed towards increasing financial access, the level of efficiency and the sector stability while carrying out offsite and onsite surveillance to ensure compliance to laws and regulations.

The banking sector in Kenya has had numerous challenges. Kithinji and Waweru (2007) highlighted that banking sector challenges can be dated back to 1986 which has led to collapse of major players in the banking sector. They further noted that about 37 failed banks had failed as at 1998 as a result of crisis experienced from 1986 to 1998. Kithinji and Waweru attribute the disasters to non-performing assets arising from the high lending rates that have existed in Kenya for a while. Ongore and Kusa (2013) indicate that Commercial Banks in Kenya exist as firms and as any firm, profit maximization is the key objective. They pool deposits from customers and make investments with care to maintain enough liquidity in case of calls from depositors. Some of these funds are loaned out to borrowers at a price (Interest) whereas depositors, depending on the form of account held, are compensated by way of interest on their deposits. In this way, commercial banks in Kenya act as intermediaries between borrowers and depositors (Griffith-Jones & Gottschalk, 2016).

Trend Analysis of Bank Size

The study computed bank size by computing Log of Total Bank Assets (Log) of the commercial banks. The trend analysis results showed that bank size has been increasing from 2006 to 2015. The increase in the bank size could be attributed to increase in the number of deposits accounts as result of increased customers therefore increasing commercial banks profitability hence investments into assets.

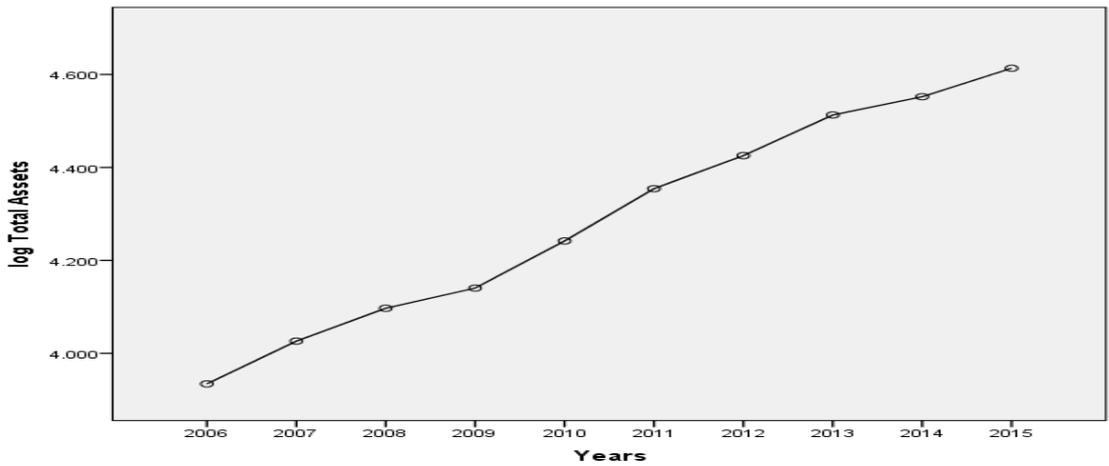


Figure 2: Trend Analysis of Bank Size

Bank size is the measure of how much in value the bank holds in terms of all its assets. According to Were and Wambua (2014), bank size is usually determined by a log of banks totals assets. From a theoretical perspective, big banks are expected to charge lower lending rates compared to smaller banks this is because of the ability of these banks to utilize the economies of scale in their operational efficiency. Large banks also have high potential of investing in modern technology to enhance their efficiency.

Trend Analysis of Credit Risk

Credit risk was computed by dividing value of Non-performing Loans by Total Loans (Kshs). The results indicate that on average credit risk of commercial banks has been decreasing. This is an indication of the awareness by commercial banks in managing loans through strict policy and credit appraisal mechanisms which results to reduction in non-performing loans. Credit risk however was lowest in 2014 which was below 0.1

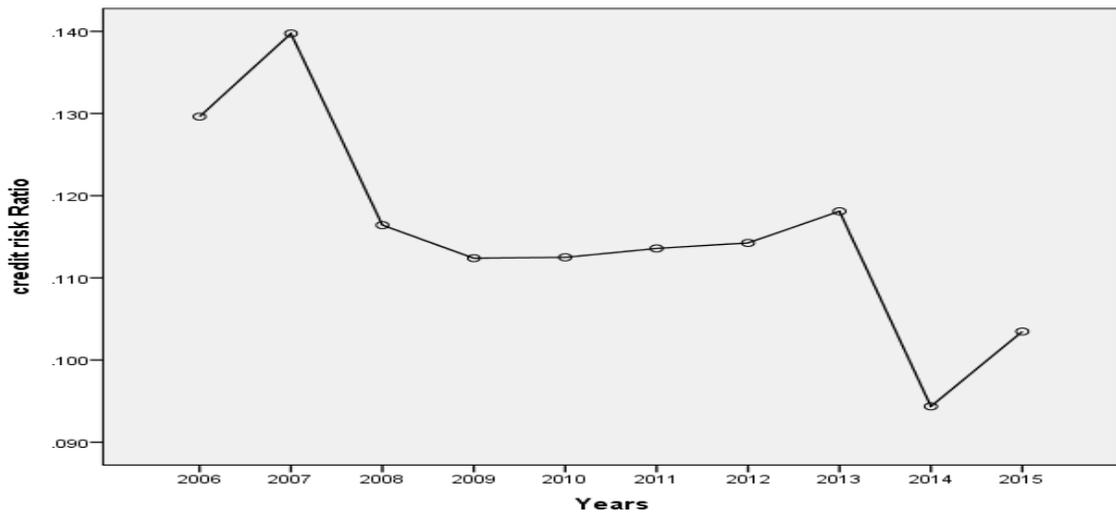


Figure 3: Trend Analysis of Credit Risk

Maina (2015) asserts that lending rates are arrived at by considering bank characteristics including credit risk, bank size, operating costs, among others. Credit risk is a fraction of total loan represented by non-performing loans ratio (NPLR). In the financial sector, credit risk is used to measure the quality of loans where high non-performing loans ratio implies that there is high cost of bad loans. Since all economic agents are risk averse, commercial banks facing credit risk in most cases pass the risk to borrowers by increasing the lending rates.

Trend Analysis of Liquidity Risk

The study also sought to find the trend in the average liquidity risk for commercial banks in Kenya. The result showed that liquidity risk has significantly reduced from what it was in the year 2006. The findings further showed that liquidity risk was low in 2008 and 2010 but has remained stable from 2011 to 2015. This could be attributed to increase in the totals of loans of majority of banks in Kenya. Ahokposi (2013) concurs that liquidity risk is inability of the commercial banks in this case to meet their current financial obligations. Liquidity risk is often derived by computing the ratio of bank’s liquid assets to total assets. Liquidity risk varies from one bank to another and depends on the amount of liquidity owned by the banks. Commercial banks with high liquidity face lower liquidity risks and vice versa hence they are likely to charge lower lending rates than banks with less liquidity. Banks with lower liquidity also charge lower liquidity premiums on loans. Commercial banks facing high liquidity risk are forced to engage in interbank lending to cushion themselves hence cascading the costs to the borrowers and as a result, they charge higher lending rates.

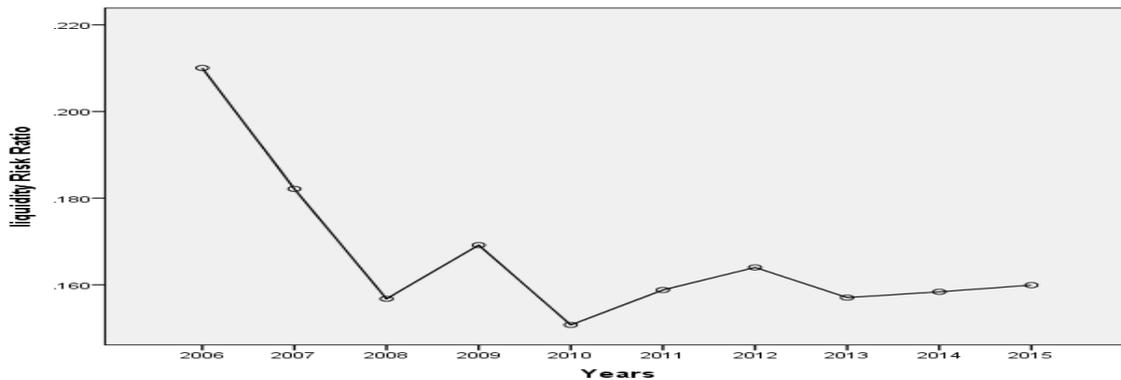


Figure 4: Trend Analysis of Liquidity Risk

Trend Analysis of Operating Cost

The study measured operating costs using operating expenses ratio which was computed by dividing profit before tax by operating expenses. The findings indicated that commercial banks in Kenya saw increase in average operating costs from 2006 to 2011. The increase in the operating costs could have been as a result of banks expansion through increase in the number of branches. However, the trend analysis showed that operating costs tremendously began reducing in 2011 reaching the lowest in 2013. A slight increase in operating costs was experienced in 2014 followed by a reduction in 2015. The findings implied that commercial banks in Kenya decreased their operating costs within the period an indication of a more efficient banking system.

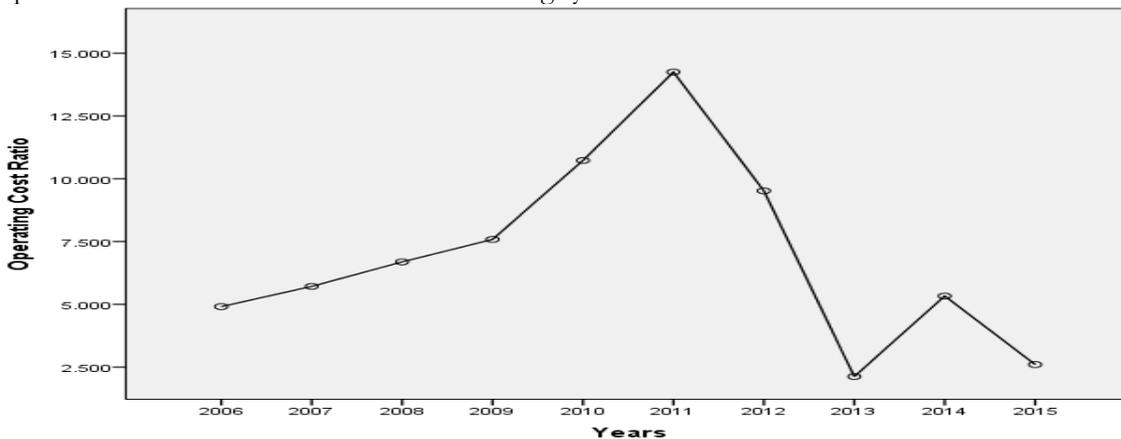


Figure 5: Trend Analysis of Operating Cost

Some of the costs incurred by the commercial banks include credit appraisal costs, application and screening costs and the cost involved in monitoring the projects for which the loans were applied for (Beck, 2010).

When the costs associated with loan application increase this is likely to impact on the cost of loans through increase in lending rates. Operating expenses ratio is usually adopted in the financial sector as an indicator of operational inefficiency. In a case where there are high costs incurred by financial intermediaries, it will impact negatively on lending rates on interest rates offered on deposits.

Trend Analysis of Political risk

Political risk is also a major determinant of economic activities in any country which is likely to influence the movement of lending rates. This is a risk incurred by investors and the business community in a region stemming from political events. The study sought to test if the risk influences the relationship between macro-economic variables and commercial banks’ lending rates. The trend analysis showed that political risk was highest in 2010 which coincided with the referendum to adopt the current constitution. This was a period full of political activities with politicians campaigning for and against the constitution.

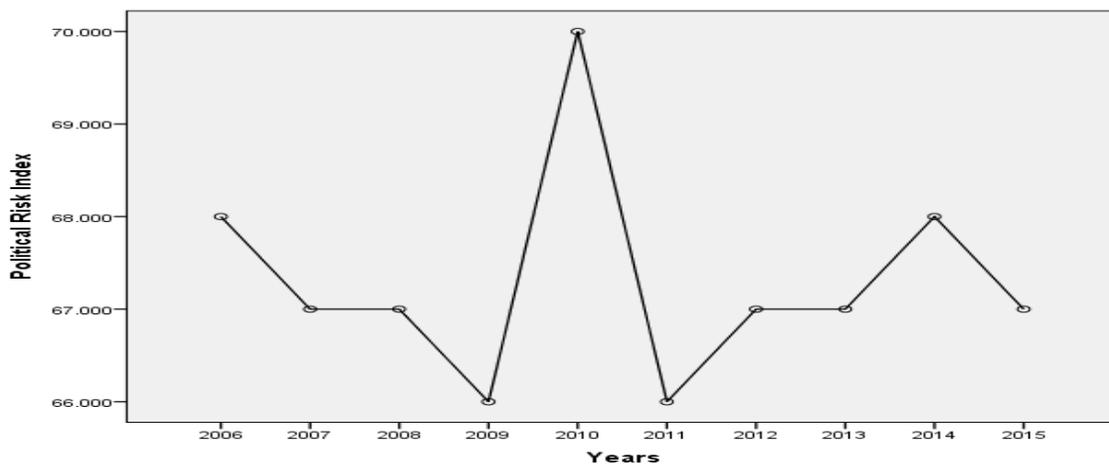


Figure 6: Trend Analysis of Political risk

According to Mcleay *et al.*, (2014) who analyzed the effect of political risk on lending rates and found that the effect of political risk is insignificant since the central bank lends to commercial banks in case of urgent needs to cushion customers and as such, through window dressing and kitting, the commercial banks can maintain the customers’ needs. The study recommended political risk to be analyzed as a moderating variable by future studies. Similarly, Kuttner (2012) found that political risk, although insignificant in the determination of lending rates, it cannot be overlooked as it could have a stronger influence on other relationships leading to lending rates. The study recommended that this variable be investigated as a moderator or control variable. This study therefore analyzed political risk as a moderating variable in the determination of its effect on lending rates among commercial banks in Kenya.

Test for Moderating Effect of Political Risk

The study tested the moderating effect of annual political risk on the relationship between bank characteristics, macro-economic factors and lending rates. According to Kraemer *et al.*, (2001) and Baron and Kenny (1986), this test is appropriate while testing for moderation and it’s done by regressing the dependent variable on the independent variables; that is, regressing lending rates on the bank characteristics (BCs) and the moderating variables.

Table 1: Regression Results

Lending Rates	Coef.	Std. Err.	z	P> z
CIBCs	-0.00032	0.000604	-0.53	0.599
Annual PR	-0.00204	0.002214	-0.92	0.356
CIBS*PR	6.23E-06	8.98E-06	0.69	0.488
_cons	0.337311	0.148959	2.26	0.024

R-sq: within = 0.1809
Wald chi2(3) = 69.35
Prob > chi2 = 0.0000

The conceptual model captioned equation 3.3 was solved to become;

$$CBLR_{it} = 0.337311 + (-0.00032)(CIBCs_{it}) + (-0.00204)(PR_{it}) + 6.23E-06(CIBS*PR) + \varepsilon_{it}$$

The study computed CIBCs which was the composite index of bank characteristics while CIMECs was the composite index for macroeconomic variables and PR is the annual political risk. Composite Indices were constructed based on the Geometric mean of the individual indicators of a similar category. CIBCs*PR was the composite index of bank characteristics multiplied the moderating variable annual political risk. The findings in table 4.14 indicated that CIBCs*PR had a positive effects on the relationship between bank characteristics and commercial banks' lending rates. The composite variable for bank characteristics (CIBCs*PR) had coefficient of 6.23E-06 and p-value of 0.488 implying it was statistically insignificant at 5% significance level. The finding implied that political risk also did not significantly moderate the relationship between commercial banks characteristics and lending rates. Hence the null hypothesis that annual political risk does not have a significant moderating effect on the relationship between bank characteristics and lending rates among commercial banks in Kenya was not rejected.

Conclusions

The study concluded that annual political risk does not significantly influence the relationship between bank characteristics on lending rates among commercial banks in Kenya. The study also concluded that if these findings are looked into by commercial banks in Kenya, then there could be no reason as to why lending rates cannot be pushed down as opposed to the mechanical legislation recently enacted on lending rates. Because there are instances in which the commercial banks have used an excuse of having political pressures to increase lending rates.

Recommendations

Based on the findings, the study recommended that commercial banks and other financial institutions in Kenya should refrain from increasing the lending rates during times of high political risks since political risk has an insignificant moderation effect on the relationship between bank characteristics and Lending rates. The study further recommends that commercial banks should focus on streamlining their internal bank characteristics in order to reduce the cost of lending.

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