Trend Impact Analysis of Interest Rate Cap on Profitability of Commercial Banks in Kenya

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ABSTRACT

For many years, the cost of borrowing and lending money in Kenya was left to the forces of supply and demand. The coming into force of the Banking (Amendment) Act, 2016 marked the end of operation of these forces. This caused ripples within the banking sector with bankers arguing that it as a wrong move, leading to its subsequent lifting in late 2019. This study, therefore, sought to determine the trend impact analysis of Interest rate cap on profitability of commercial banks in Kenya. This study adopted a longitudinal research design where secondary data was collected with the help of a data extraction form from all the 42 commercial banks licensed and operating in Kenya for the years 2014-2021. The researcher used Microsoft-excel 2021 and STATA to process the data collected. Data was analyzed using trend impact analysis regression analysis and results presented using tables and figures. The findings revealed that profitability overall mean for all the banks for all the years combined were 0.43 with a standard deviation of 0.25. The beta coefficients for profitability, was found to be 0.678 and the p-values of the t-statistics for the coefficients estimated was found to be 0.000,. The study concludes that profitability was impacted by interest rate cap and that the overall impact was a negative trend on interest rate cap of commercial banks in Kenya. The study recommends that; there is need for central banks to review their policy so that commercial banks can enjoy free market and hence make profit.

Keywords: Trend, Trend Impact Analysis, Profitability, Interest Rate, Interest Rate Cap

INTRODUCTION

For the past few decades, the debate on interest rate has attracted the attention of many researchers in different areas of studies (Otieno, 2015). A study by Maigua and Mouni (2016) identified interest rate as the major factor that affects financial institution's performance. Through resources allocation in the economy, it plays a big role in the financial system of a country, (Otieno, 2015). According to the Central Bank of Kenya annual report (2015) the banking sector in Kenya continued to remain stable and resilient despite the slow growth in the global economy. This, it determined to be caused by the high interest rates the banks charged on their loans at the expense of its borrowers (*ibid*). This prompted the amendment of the banking Act that introduced regulations on the financial institutions, the interest rate cap. Financial institutions are regulated for the sole purpose of preserving their stability and protecting clients or borrowers (Kathomi, Kimani & Kariuki, 2017) thus interest rate caps on loans are, without doubt, an important policy adopted by both developing and developed countries (Miyauchi, 2017).

According to Federal Reserve Bank of San Francisco (2007), Japan introduced, in 1954, two types of laws that restricted interest rates on consumer loan. In 2006, the Japanese Diet enacted legislation revising the Money Lending Business (MLB) Law. In 2009, Bangladesh introduced interest rate cap for some categories of loans which were later lifted in 2011 and 2012 (Miyauchi, 2017). The findings revealed that when interest rate caps were introduced, it increased, significantly, the aggregate outstanding amounts, although its removal was noted to have minor negative impacts. In the United States, legislation to limit interest rate exists today at the legislative level in almost all states. In 2017, the kingdom of Cambodia instituted a legislation that set limit on interest that banks and financial institutions can charge at 18 percent.

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Regionally, many countries in Africa, have introduced caps on interest rate with the sole reason of protecting consumers from high interest rates charged by financial institutions. Tunisia and Morocco introduced cap on interest rates in 2008 and since then it has been implemented in Egypt (Adair & Berguiga, 2015). Governments of some countries, according to Adair & Berguiga, (2015) capped their interest on loans as a response to political and cultural pressure from its citizens. The main idea behind capping interest rate on loans is to limit the tendency of financial institutions to increase interest yields.

In the Kenyan context, for many years, the cost of borrowing and lending money was left to the forces of supply and demand. This view is supported by Onsarigo, Selvan, Ramkumar, and Karpagam (2013) who opined that in a liberal economy the market forces should dictate the interest rates that are charged. Even with this argument, commercial banks have at one time or another set their interest rates high citing several reasons. This view is supported by a study by Wanjare and Motari, (2016) who argued that market interest rate, depends, largely, on supply and demand for loans, competition in the loan market, economic factors, such as inflation rate, investors' expectation and monetary policy.

However, the coming into force of the Banking Amendment Act in 2016 marked the end of operation of demand and supply forces in the market. The government capped the lending rate to commercial banks at 4 percentage points above Central Bank Rate (CBR) (The Banking Amendment Act, 2016). The financial sector became polarized with those against Interest rate cap urging for its removal while those for called on the government to maintain the cap on the lending rate. Those against the capping argue that a number of other strategies can be adopted to reduce interest rates such as applying soft pressure and the governments building a regulatory environment and support structures that encourage the supply of financial services at lower cost (Miller, 2013). Furthermore, they advanced reasons that interest rate cap limit access to credit reduce transparency, decrease product diversity and competition and undercuts the demand for formal credit thus affecting firms' productivity

Furthermore, the Banking (Amendment) Act that capped interest rates was to catapult Kenya to greater heights in the journey towards achieving its Vision 2030, the 2030 Global Sustainable Development Goals (SDGs) and the Africa Agenda 2063 (Otieno, 2016). Miller, (2013) argued that interest rate ceilings are justified on the basis that financial institutions were making excessive profits by charging exorbitant interest rates to clients.

Objective of the study

The purpose of this study was to determine the trend impact analysis of interest rate cap on profitability of commercial banks in Kenya.

LITERATURE REVIEW

According to Kavwele, Ariemba and Evusa (2018), interest charged on loans is the main source of income to commercial banks. Their study was carried out among commercial banks in Kenya and they picked a sample of thirty two banks. Their data was within 8 quarter periods (four quarter periods before capping and Four quarter periods after capping). Their findings were consistent with those by Ng'ang'a and Atheru (2020). Their study was finding the relationship between interest rate capping and performance of small and medium restaurants in Nairobi west. Their study population was all the 312 employees. A census study was adopted in their research. Primary data was collected using semi-structured questionnaires while secondary data was obtained from the audited financial statements of the enterprises. Descriptive and multiple regression analysis of their data pointed out that since interest is the main source of income, the central bank usually regulates interest valuation to ensure that commercial banks offer wider range of products under a capped interest structure.

Another study by Thuo (2019) on interest rates concluded that financial products should always be competitive to the borrower as well as profitable to the lenders. Olaka (2017) pointed out the controversies surrounding interest rates capping with the preserved effects on the economy, concluding that by capping interest rates, the rates are allowed to fluctuate but within a given limit. Osiemo (2019) argued that interest rates cap strategies differ across countries with some being rigid while others are flexible. Osiemo (2019) defined a flexible interest cap to mean one that is pegged to a base that is set sets rates. A classic example if the interest rate cap

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introduced in Kenya in 2016. On the other hand, a fixed system of interest cap means that any government is at liberty to give a specified interest rate that should be accepted by the commercial bank (Osiemo, 2019).

Kavwele, *et al*., (2018) carried out a research on interest capping among a sample of thirty two commercial banks in Kenya. Multiple linear regression and sample T-test analyses used in their analysis revealed that the maximum rates set stands at 4% which is above the CRB value with a depositing interest rates standing at 70% which is minimum the CBR rate.

Research to understand the specific determinants of profitability in the banking sector concluded that interest rates is a major factor even though it is a micro-economic factor (Ng'ang'a, 2019). Were (2018) in a study on the influence of interest rate capping on performance of new motor vehicle Firm, Isuzu found out that interest rates and the firm profitability are positively correlated. However, the study targeted only the top-level management of the firm where data was collected through interview method and analysed using content analysis. The study justified that with an increase in the lending rates, profitability increases as noted by Ng'ang'a (2017).

A study by Sofilda, Hamzah and Ginting (2020) established a positive and significant relationship between Interest rate cap and bank's profitability, and any decrease in the interest cap was found to cause a decrease in the profitability of the commercial bank. Results by Ng'ang'a (2019) were consistent with the findings by Kavwele *et al*. (2018) in the sense that accounting profits decreases with regulations while were noted to increase without. Kibobo (2017) understands why interest rates caps caused a decrease in profits and opined that, capping imposed restriction that customers needed to adhere to in order access loans - which was discouraging to them.

Adair and Berguiga (2015) carried out a study on interest rate and performance of micro-finance institutions (MFIs) in the Middle East and the North Africa (MENA) regions. Their data was collected from 66 microfinance institutions in 9 countries in MENA region. Multivariate analysis was used to analyze the relationship between interest rate and social performance. Their study deduced that capping of interest rates caused traditional customers of the bank to resort to other options which were more informal and efficient in loan provision and thus affecting the formal banking system. The ultimate result would be reduction of the banking sector profits (*ibid*).

Findings by Osiemo (2019) in a study examining the negative effects of interest rates capping, pointed that interest rate cap impacts lending to SME's. The negative impact was attributed to the fact that investors are willing to invest their money in alternative investments with more returns (Osiemo, 2019). As a result of diverted investments, the annual profits of the financial institution decline with new regulations as noted in 2016.

Taiwo and Adesola (2013) in a study on fluctuations of interest rate and financial outcomes in Nigeria, established that, in the banking sector, interest rates are an important aspect of monetary policy and plays a crucial role in determining the banking institution's profitability. The findings concluded that an increased interest rate increased the lending abilities of the bank compared to depositing resulting in an increase in profitability The study concluded that interest rates affect the banking industry both directly and indirectly. Thuo (2019) established a direct effect that with lower interest rates, customers are motivated to borrow more and the bank benefits directly from the interest earnings. Conversely, high interest rates charged by commercial banks discourage borrowers thus reduced earnings to the bank

In a research on the impact of interest rate on financial performance of commercial banks in Kenya, Ng'ang'a (2019) carried out a descriptive coupled with content analysis of data from all the 42 commercial banks in Kenya. The study used return on assets to measure financial performance and provided a clear picture of how the management of the banking sector uses its assets to make profits. Findings by Kavwele *et al*. (2018) concluded that since interest rates forms the major source of revenue to the commercial banks, ceiling the rates will impact their financial performance.

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METHODOLOGY

This study used a longitudinal research design to analyze the impact of interest rate capping on commercial banks in Kenya, from 2014 to 2021, covering periods before, during, and after the cap. The target population included all 42 licensed commercial banks in Kenya, and a census was conducted to avoid sampling errors, ensuring comprehensive data on profitability. Secondary data such as profits of commercial banks was extracted from the annual financial statements of these banks, with the data collection process involving both online and physical visits to bank branches. Instrument validity and reliability were ensured through expert reviews and inter-rater reliability testing. Data analysis involved trend impact analysis and regression models, using SPSS and STATA to assess the relationship between the interest rate cap and keprofitability. Ethical considerations included obtaining necessary permits, avoiding data manipulation, and properly acknowledging scholarly sources.

STUDY FINDINGS

Descriptive Analysis

This section gives the descriptive analysis of study based on the study variable.

Interest Rate Cap and Profitability

The first objective was to evaluate the trend impact analysis of interest rate cap on profitability of commercial banks in Kenya. The indicators of profitability were the profits that each commercial bank earned for the particular financial year.

Table 4.1 Trend impact analysis of interest rate cap and profitability

Year	N	Mean	Std.	Min	Max
2014	38	0.43	0.20	0.02	1.10
2015	38	0.44	0.21	0.05	1.13
2016	38	0.42	0.17	0.06	0.74
2017	38	0.40	0.17	0.08	0.75
2018	38	0.38	0.15	0.06	0.67
2019	38	0.38	0.13	0.14	0.70
2020	38	0.42	0.14	0.08	0.67
2021	38	0.54	0.83	0.02	5.11
Average	**38**	**0.43**	**0.25**	**0.06**	**1.36**

Source: Research Data (2024)

Table 4.1 shows that the overall mean for all the firms for all the years combined were 0.43. The overall standard deviation of was found to be 0.25. The table reveals that profitability of commercial banks decreased on average by 43% during the time interest rate cap was in place and increased after the interest cape was removed.

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Trend Impact Analysis of Interest Rate Cap on Profitability

This trend is as shown in Figure 4.1.

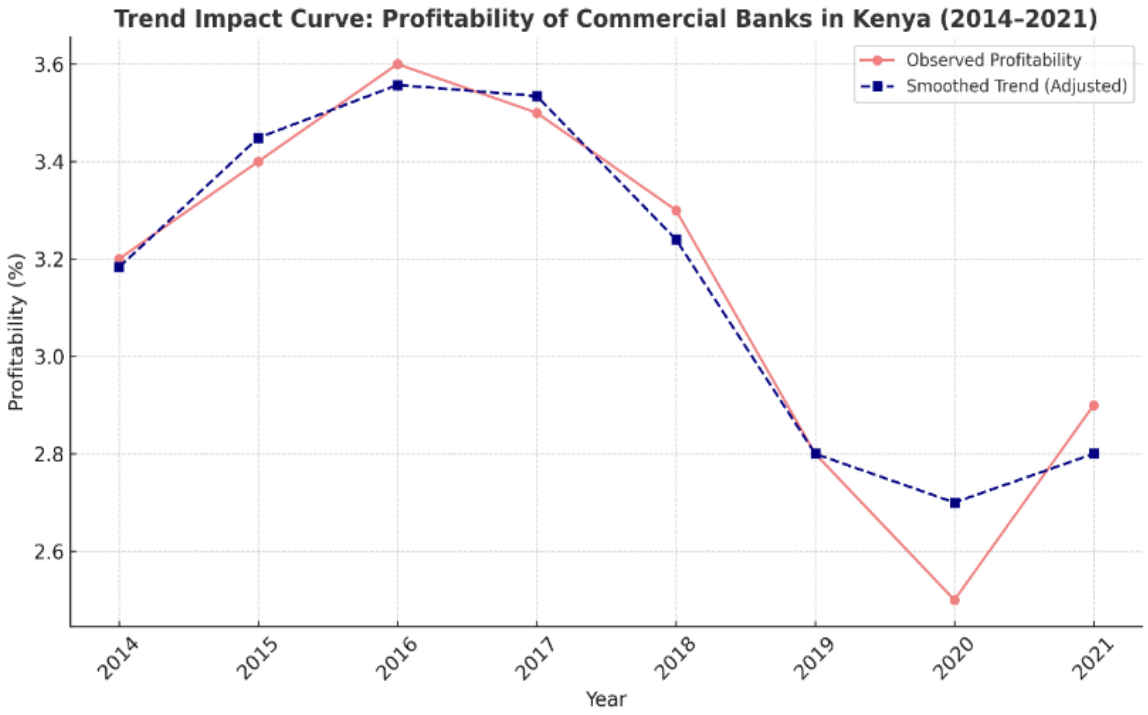

Figure 4.1 Trend of Interest Rate Cap on Profitabbility

Source: Research Data (2024)

The trend impact curve reveals a generally declining profitability among commercial banks in Kenya from 2014 to 2021. Initially, banks maintained relatively strong profitability levels between 2014 and 2016, consistent with findings by Ngugi & Kabiru (2015) that attributed this to favorable economic growth and credit expansion. The observed drop from 2017 coincides with the enforcement of the interest rate cap in Kenya, and the general elections, as highlighted by the Central Bank of Kenya (CBK, 2018), which constrained lending margins. The further decline in 2019–2020 reflects the adverse impact of the Covid-19 pandemic, which, according to the Kenya Bankers Association (2021), significantly reduced lending activity and increased non-performing loans. The smoothed trend line helps isolate and visualize the underlying structural decline in profitability, beyond short-term shocks, aligning with studies like Were & Wambua (2021) that suggest the industry's profitability faces pressure from regulatory changes and global economic disruptions.

These findings align with recent empirical research. Sofilda, Hamzah, and Ginting (2020) reported that interest rate caps constrained banks' profit generation by limiting credit growth, while Kibobo (2017) noted that capping reduced customer access to credit, indirectly lowering profitability. More recent evidence by CBK (2023) shows that after lifting the cap, banks expanded credit to SMEs and households, which, combined with digital lending channels, improved earnings and asset quality. The trend impact analysis shows how policy shocks temporarily suppressed bank profitability, but market liberalization helped recover and enhance performance, supporting global evidence on the benefits of risk-based pricing (World Bank, 2023)

Test of Hypothesis

The current study predicted a positive significant relationship between interest rate cap and profitability of commercial banks in Kenya. Fixed effects regression model was used to assess if the relationship was statistically significant and as a result the following null hypothesis was tested:

H_{01}: There is no statistically significant trend impact analysis of interest rate cap on profitability of commercial banks in Kenya.

From the analysis of findings, the p-value of the t-statistic for the estimated coefficient of profitability is 0.000 which is less than 0.05. The null hypothesis was rejected at 0.05 level of significance and a conclusion drawn that Interest rate cap has a negative significant influence on profitability of commercial banks in Kenya to the extent of -0.310 units. This means that one unit increase in interest rate cap will decrease profitability of commercial banks in Kenya by 0.310 units.

The simple regression model of the study which was

$$y_1 = \beta_0 + \beta_1 x + \acute{\varepsilon}$$

Becomes;

Y_{it}= -0.124 + -0.310P_{it} + $\acute{\varepsilon}_{it}$

Where

Y = Interest Rate Cap

P = Profitability

$_{it}$ = Commercial Bank at a time $_{t}$

$\acute{\varepsilon}_{it}$ = Error term

CONCLUSION

The findings of the study indicate that the introduction of the interest rate cap in 2016 had a significant negative effect on the profitability of commercial banks in Kenya. The overall trend showed a decline in profitability post-implementation of the cap. While the intention of the policy was to make credit more affordable for consumers, it inadvertently squeezed the profit margins of commercial banks. Banks found themselves unable to charge rates that would adequately cover the cost of lending, especially with the rising operational costs and the higher risks associated with certain loan portfolios. As a result, profitability was significantly impacted, with many banks struggling to maintain their previous levels of financial performance.

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