

Impact of Asset Quality Compliance on Financial Performance of Nairobi Securities Exchange Listed Commercial Banks

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ABSTRACT

Asset quality compliance is relatively important; however, the banking sector has undergone major financial shocks due to compliance signals. With losses experienced among commercial banks, for instance, return on assets (ROA) dropped consistently from 29% to 24% in 2019 to 21% in 2020, hence the wrong signals. The decline in the number of assets and low deposits further magnified the challenge; this led to the closure of a number of banks, such as Chase Bank and Charterhouse Bank. Furthermore, a national bank was acquired by Kenya Commercial Bank due to inefficient assets. The purpose of the study was to establish the influence of asset quality compliance requirements on the financial performance of commercial banks listed on the Nairobi Securities Exchange and hence determine the null hypothesis that asset quality compliance requirements have no significant effect on the financial performance of commercial banks listed on the Nairobi Securities Exchange. A mixed research design was applied to a population of 12 commercial banks listed at Nairobi Securities Exchange Kenya. This is comprised of causal research designs and longitudinal designs. The study employed a mixed research design and collected secondary data for a period of 5 years. The study found that asset quality requirements had a significance level of $P < 0.05$, thus $P = 0.0268$, implying significance. The study concluded that assets have a significant impact on banks financial performance. The study recommends that commercial bank stakeholders should invest in assets since they lead to financial performance. The study may benefit a number of people, including bank management, the government, and future scholars.

Keywords: Asset Quality Compliance Requirement, Commercial Banks, Financial Performance

I. INTRODUCTION

Compliance requirements entail following certain prudential guidelines for banks, such as asset quality requirements that impact the financial performance of listed banks and banks in general. Faris (2020) conducted a study on the influence of asset quality on the performance of Islamic banks in Arab and Jordanian banks. The study found a negative, insignificant effect of liquidity on performance.

Banks are highly profit-oriented, but some compliance factors put them at a crossroads. This makes employees find refuge in other activities to make them operational, which complicates performance initiatives (Murthy, 2004). Osaka (2019) adds that the central bank in Nigeria came up with some regulations so as to cleanse the exchange market and impart market discipline. The study aimed at examining the influence of regulation on profitability. The current study focuses on compliance initiatives in the Central Bank of Kenya, of which CAMEL gains weight.

Kariuki and Wafula (2016) opine that asset base counts a lot on banks' ability to perform well and better. Many banks are geared towards wealth maximization by assembling assets. The assets may incorporate both physical and non-physical assets. A bank deposit, which is based on customers, is also an important asset. Banks are also affected by compliance issues, mostly generated by the risks involved (Kariuki & Wafula, 2016).

A study by Gudmundsson et al. (2019) affirmed that the assets of a financial institution have a direct impact on its growth, and hence balancing the current and non-current assets would be of help and concern. This implied that asset value played a significant role in the performance of commercial banks in Kenya.

Compliance issues are geared towards the CAMEL approach: the capital element, asset element, management element, and liquidity element. In the global context, Costa Rica aligns the performance of a bank with its asset strength (Lafuente, 2019). In the Nigerian banking sector, the capital element and bank size were the litmus test for banks performance (Mathenge, 2007). Kenya has a total of 12 commercial banks that have attracted listing under the Nairobi Securities Exchange, forming the scope of this study (Central Bank of Kenya [CBK], 2021).

1.1 Statement of the Problem

Commercial banks have undergone major financial drawbacks due to compliance signals (Central Bank of Kenya, 2020). With losses experienced among commercial banks, for instance, ROA dropped consistently from 29% to 24% in 2019 to 21% in 2020, hence the wrong signals (CBK, 2020). The decline in the number of assets and low deposits further magnified the challenge; this led to the closure of a number of banks, such as Chase Bank and Charterhouse Bank. Additionally, Kenya Commercial Bank acquired a national bank due to inefficient assets (Nairobi Securities Exchange, 2021). Previous studies in the banking arena, for instance, by Apatachioae (2015), focused more on performance than compliance, which provides a need for a study on the asset quality compliance requirements of banks. When Sangmi and Nazir (2010) took into account the central bank's list of distress factors, they discovered that asset quality significantly and positively impacted performance. Furthermore, Muriithi and Waweru (2017) found asset quality to have a negative effect on the performance of banks. Given that the above studies factored in asset quality as a distress factor, this study therefore established the impact of asset quality compliance on the financial performance of Nairobi Securities Exchange-listed commercial banks.

1.2 Objectives of the Study

To establish the impact of asset quality compliance on financial performance of Nairobi Securities Exchange listed commercial banks.

1.3 Research Hypothesis

H₀₁: Asset quality compliance requirement has no significant effect on financial performance of Nairobi Securities Exchange listed commercial banks.

II. LITERATURE REVIEW

2.1 Theoretical Framework

2.1.1 The Shiftability Theory

This was proposed by Moulton (1918), who pointed out that the shift of deposits to firm assets has signals that would impact affirmation in one way or another. A shifting paradigm is a situation where there are huge deposit withdrawals from the bank. Customers have a right to withdraw their funds as banks offer savings for their money. However, massive withdrawals lead to imbalances, and therefore a shift element comes in. The theory offers credit instruments as an optional shift. Credit instruments gain their roots through Treasury bills, the famous commercial paper, and prime bankers' acceptance. They are readily convertible to cash and can help balance the massive withdrawals.

Banks are advised to invest in securities that can help them with several issues, including balancing out withdrawals. Banks that capitalise on liquid assets propel faster in any business environment. Credit instruments are an example of something to borrow (Sheefeni, 2016). Therefore, banks need markets to convert the credit instruments, calling upon banks to be members of readily available markets such as the Nairobi Securities Exchange. The theory also advocates for liquidity as an existing variable (Ibe, 2019). Through the use of other capital approaches, like commercial paper, performance is attained in banks. The theory addresses asset quality compliance requirements. It is evident that the shift through deposit withdrawals reduces the current assets that could make banks operate easily. This lowers the quality of assets, hence challenging the financial performance of commercial banks.

2.2 Conceptual Framework

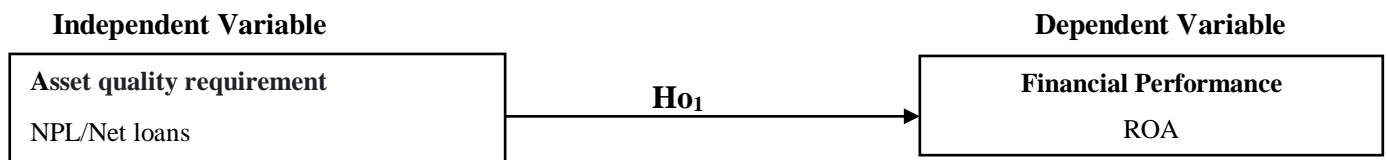


Figure 1

Conceptual Framework

Source: Self Conceptualization (2023)

Asset quality requirements are based on the ratio of non-performing loans to net loans. Quality is basically instituted through the investment in assets. Liquid assets are critical to bank functionality. Credit instruments form part of assets and gain their roots through Treasury bills, the famous commercial paper, and prime bankers' acceptances. They are readily convertible to cash and can help balance the massive withdrawals (Ongore & Kusa, 2019). To assess the financial performance of banks, a return on assets approach was used, where net income to net assets was computed.

2.3 Empirical Literature Review

Muriithi and Waweru (2017) delved into the role of liquidity risk in affecting the performance of Kenyan commercial banks. Their findings indicated that liquidity had a negative impact on the banks' performance. The research gap identified here is that the past study primarily concentrated on Return on Equity (ROE), while the current study shifts its focus to analyzing Return on Assets (ROA), offering a different perspective on bank performance assessment. This variation in focus provides an opportunity to gain a more comprehensive understanding of how liquidity influences bank performance, considering both ROE and ROA in the analysis. The change in the performance metric from ROE to ROA represents a shift towards assessing the profitability of banks based on their core operations, which could yield valuable insights into the impact of liquidity.

A study by Nzioki (2011) explored the impact of capital adequacy on the financial performance of commercial banks quoted at the Nairobi Stock Exchange. The findings of the study revealed that effective management of capital had a positive and significant influence on the performance of commercial banks. The research gap here is that the current study intends to employ a time series model with panel data, while Nzioki's study used a mixed research design, incorporating panel data and causal analysis. This shift in research methodology presents an opportunity to gain a deeper understanding of the long-term effects of capital adequacy on bank performance. The incorporation of causal analysis in the current study indicates a more comprehensive exploration of the cause-and-effect relationships between capital adequacy and financial performance, enhancing the overall research approach.

Apatachioae (2015) focused on the performance of banking risks and their regulation. The research findings indicated that compliance requirements positively and significantly influenced bank performance. The research gap identified is that while the past study employed a time series model with panel data, the current study plans to use a mixed research design. This alteration in research methodology offers the opportunity to gather insights from a broader spectrum of data sources and analytical techniques. By incorporating a mixed research design, the current study can combine the strengths of both time series modeling and panel data analysis to provide a more comprehensive view of the relationship between compliance requirements and bank performance.

The research by Tsuma and Gichinga (2016) investigated the factors influencing the financial performance of commercial banks in Kenya, with a specific focus on the National Bank of Kenya's Coast Region. The findings from this study identified that factors such as capital adequacy, liquidity, credit risk, interest rates, and inflation rates had a significant effect on bank performance. The research gap lies in the fact that the previous study intended to employ a time series model with panel data, whereas the current study aims to use a mixed research design. This shift in research design presents an opportunity to gain a more comprehensive understanding of how these factors interact and affect bank performance over time. The inclusion of causal analysis within the current study's research design enhances the ability to explore the cause-and-effect relationships among these variables, providing a more nuanced view of their impact on bank performance.

Njoroge (2021) investigated the relationship between agency banking and financial deepening in Kenya. The study found that the size of the bank had a positive and significant influence on performance. The research gap



identified here is that while the previous study focused on the moderating influence of the age of the bank, it did not address asset quality, which the current study intends to explore. This shift in focus allows the current study to delve deeper into the factors that influence bank performance by considering the quality of assets. Exploring the role of asset quality alongside bank size provides a more holistic perspective on bank performance drivers and their interactions, offering valuable insights for the banking industry.

A study by Kariuki and Wafula (2016) focused on the influence of adequate capital on the performance of SACCOs (Savings and Credit Cooperative Societies) in Kenya. The study used panel data and a descriptive study. The research gap identified is that the study failed to address asset quality, and the current study focuses on banks, not SACCOs. This shift in research focus allows the current study to explore the impact of adequate capital on bank performance, considering the quality of assets as a crucial factor. Analyzing the role of asset quality in conjunction with capital adequacy offers a more comprehensive view of the factors influencing bank performance, which is distinct from the focus on SACCOs in the previous study.

III. METHODOLOGY

A mixed research design was applied. This comprised a causal research and longitudinal designs applied. These causal design articulated cause-and-effect relationship among variables (Cooper & Schindler, 2006). All the listed 12 commercial banks were adopted; hence the census method due to the small number obtaining published data for the 2017–2021 financial years (CBK, 2021).

Data was collected by looking at the financial statements of the respective banks. The researcher personally sought information, including statements of financial position, from banks. This came after proposal approval and the attainment of a letter of authorization from MMUST and the NACOSTI research permit.

The study adopted descriptive methods and inferential statistics (simple linear, multiple, hierarchical regression, and Pearson correlation analysis) (Cooper & Schindler, 2006). STATA software application version 15 aided data analysis. The significance confidence level was placed at 95%.

Econometric equation

$$Y = \alpha + \beta_1 AQ_{1t} + \varepsilon$$

Where:

Y = bank Performance, α = Value that is Constant, β_1 = retained as the slope, AQ_1 = Asset quality requirement, ε = error term

Mugenda and Mugenda (2013) assert the value of the confidentiality of data, which was guaranteed; hence, data was solemnly used for academic purposes. Plagiarism was avoided through a plagiarism checker and citations to acknowledge previous authors. Information cited about authors was acknowledged and differentiated from personal views. Adherence to the principle of voluntary was highly upheld throughout the research.

V. RESULTS & DISCUSSIONS

Table 2

Normality Test

| Variable | Mean | STD | Skewn | Kurt | JBera | P>chi ² |
|-------------------|-------|--------|-------|--------|-------|--------------------|
| Asset Quality | .8307 | .29153 | .4858 | 1.461 | 46.67 | 0.1500 |
| Financial perform | 8.78 | 1.2130 | 1.357 | 2.7931 | 57.14 | 0.1700 |

AQR-Asset Quality Ratio, ROA-Return on Asset

Jarquebera applicability was vital as data values were positive hence data was normal.

Table 3

Correlation Analysis

| VARIABLES | Financial Performance | Asset quality |
|-----------------------|-----------------------|---------------|
| Financial Performance | 1.0000 | |
| Asset quality | 0.0586** | 1.0000 |
| | 0.0268 | |



Findings showed a significant association between return on asset and asset quality requirement ($P = 0.0268$) ($P < 0.05$). Asset quality requirements had a significant association with financial performance. This finding agrees with Gudmundsson et al.'s (2019) finding that total assets to total deposits were favourable, hence asset quality requirements positively and significantly impacted performance. Furthermore, Mureithi (2019) found that microfinance bank assets have a positive impact on bank performance. The study disagrees with Onang'o (2017), who found asset requirements to be insignificant to bank performance. The above contradictions were based on the fact that the scholars did research on all commercial banks and not listed ones.

Table 4

Hausman Test

| Financial Performance | Coff. | Std. | Er t | P> t | [95% Conf. Interv] |
|-----------------------|-----------|----------------------|-------|-------|--------------------|
| Asset quality | -.0740653 | .0472178 | -1.57 | 0.124 | -.1692266 .021096 |
| _cons | .448414 | .1402611 | 3.20 | 0.003 | .1657363 .7310917 |
| F test == 28.91 | | Prob> F = 0.0 | | | |

The p value benchmark is 0.05 where Prob>chi2 0.0000 was lesser hence adopted the fixed model

Table 5

Influence of Asset Quality and ROA

| . xtreg ROA ASSETQUALITY, fe | | | | | |
|-------------------------------------|---------------------|------------------|--------|-------|-----------------------|
| Fixed-influences (withn) regression | No of observation = | | 60 | | |
| Group var: CODE | Number of groups = | | 12 | | |
| R-square: | Observ per group: | | | | |
| withn = 0.0039 | minimum = | | 5 | | |
| between = 0.0626 | average = | | 5.0 | | |
| overall = 0.0034 | maximum = | | 5 | | |
| F (1,47) = | 0.18 | | | | |
| Corrln (u_i, Xc) = -0.0911 | Prob> F = | | 0.6700 | | |
| ROA | Coeff. | Std. Error | t | P> t | [95% Conf. Intervals] |
| Asset quality | .0174628 | .0407251 | 0.43 | 0.670 | -.0644655 .0993911 |
| _cons | .7156483 | .0338184 | 21.16 | 0.000 | .6476145 .7836821 |
| F test =0: F (11, 47) = 24.41 | | Prob> F = 0.0000 | | | |

The asset quality value of 0.39% (=0.0039), $F(1, 47) = 0.18$, with a consistent p-value of 0.000, implies a positive impact of asset quality compliance on commercial bank performance. The asset quality requirement regression coefficient was 0.0174628, which stated the unit increase in asset quality requirement across time and listed commercial banks. Asset quality had a statistically significant p value of 0.000.

$$ROA = 0.0174628 + 0.174628AQ$$

The null hypothesis was rejected; hence an addition to the asset quality requirement led to a consistent input on commercial banks financial performance. This finding disagrees with Onang'o (2017), who found asset requirements to be insignificant to bank performance. It further agrees that Gudmundsson et al. (2019) found that total assets to total deposits were favourable; hence asset quality requirements positively and significantly impact financial performance. The above contradictions were based on the fact that the scholars did research on all commercial banks and not listed ones.

V. CONCLUSION & RECOMMENDATIONS

5.1 Conclusions

Given that the quality of assets was found to be vital, hence having a positive impact on listed commercial banks financial growth, it is concluded that the quality of assets, especially bank deposits, is of value for financial institutions.

5.2 Recommendations

This study recommends that commercial banks should hold highly liquid assets to manage liquidity state of banks.

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