ISSN 2348-3156 (Print)
International Journal of Social Science and Humanities Research ISSN 2348-3164 (online)
Vol. 11, Issue 1, pp: (89-95), Month: January - March 2023, Available at: www.researchpublish.com

EFFECTS OF OPERATIONAL COSTS ON FINANCIAL PERFORMANCE OF TIER 1 COMMERCIAL BANKS IN KENYA

Geoffrey Nyamari Angima[1], Dr. Moses Odhiambo Aluoch[2]

[1,2]Department of Accounting and Finance, School of Business, Economics and Tourism, Kenyatta University, Kenya

DOI: https://doi.org/10.5281/zenodo.7571990

Published Date: 26-January-2023

Abstract: **Banks raises the interest rate on loan repayment so as to earn revenue that is enough to cater for the deposit costs, other expenses such as non-repayment of loans. The banks also cannot raise these interest rates too high as this can create poor relationship with its clients. The balance between the two poses a challenge within the banking sector. Therefore, this study sought to investigate the effects of operational costs on financial performance of tier 1 commercial banks in Kenya. A descriptive research design was employed. The 8 tier 1 commercial banks in Kenya formed the unit of analysis. The study data was obtained from the secondary source including the audited financial statements of these banks. The analysis of the data was descriptively done using mean and standard deviations. In addition, the application of inferential statistics was done to determine the association between the variables. The study found that operational cost had a positive significant effect on the financial performance of tier 1 Commercial Banks in Kenya. The study concluded that that there were effective policies at the bank to govern the operating cost and administrative cost of the Banks. The Non-interest income, like trading income and fees, makes up a higher portion of the profits of larger banks. The study recommended that all the Tier 1commercial banks in Kenya should have effective strategic plans and operating procedures, according to the management of the banks, as this will save operating expenses.**

Keywords: **Operational Costs, Financial Performance.**

1. INTRODUCTION

Interest rate is amongst crucial elements affecting the financial performance of a bank and it is one of the economic tools that the Central Bank of Kenya (CBK) uses in controlling inflation and boosting the development of the economy which is subject to variations and it's affected by a number of factors that eventually affect the banking institutions performance (Corb, 2015). According to Mang'eli (2017) the fluctuating market interests affects significantly the commercial banks' financial performance. Therefore, there is need for a better accurate measure of the way the market interest rate fluctuates affecting financial institutions that largely rely on sensitive variations open market rates on assets owned by the banks and their liabilities.

The commercial banks' financial performance is very important on operational tasks in future and therefore there is a great desire in understanding their various determining interest rates aspects and their contributions towards performance (Omowunmi, 2014). According to Petersen and Rajan (2017) the banking industry is seen as a very crucial financing source for many firms. When the financial performance increases also organizational functions and activities increases. The country's economy as a whole is also affected together with the firms activities since the banks are the main financial sources that creates better development of job opportunities in being innovative and other prosperities.

Berend (2016) argue that commercial banks cannot earn income from lending devoid of certain limitations since they are subjected to a certain amount of money they can lend in consideration to remaining profitable within the competitive banking procedures. A careful lending practices and prudential regulations in addition is a limiting factor on the activities of the bank in maintaining the banking system resilience. Kallberg and Udell (2018) observe that for a bank to arrive at a financial lending decision it is dependent and in guidance of a number of factors related to the present situations including interest rate, economic fluctuations and the ability of the borrower in repaying the loan amongst others.

Ahmed, Rehan, Chhapra and Supro (2018) demonstrates how interest rates and deposits made at other banks could have a detrimental impact on a bank's profitability in Pakistan, whereas advances, loans and investment could pose a positive effect on the banks profitability. Because of the stiff competition, it is to a larger extent a requirement of a bank to provide a competitive deposit rate to enable them have an efficient and effective management of liquidity. Khan and Sattar (2014) argue if there is an increase in interest margin of a bank it could be of a benefit. However, it could impact negatively on a lender or a borrower. However, a rising interest rate may have an impact on the investment because this will lead to an increase in capital cost. Contrary to this, the decreasing rate of interest will also lead to a decreasing rate of deposits thus suppress savings.

Obamuyi (2019) observe that Nigerian financial framework in subject to mass governmental interventions, poor quality of assets and low capital. The Federal Government of Nigeria (FGN) through the Central Bank of Nigeria (CBN) for many years has done a number of reforms in enhancing the Nigerian deposit money banks (DMBs) profitability and sustainability. First, the reforms on financial sector between the years 2013 to 2019 consisting of liberalization aspects and measurements in enhancing the prudential regulations and tackling bank distress. Due to the importance of the DMBs role it plays in developing the any economy, there is a continuous monitoring and reforming towards performance improvement.

The Kenyan banking and any other financial institution as a whole is very important in the economy of the Country. The realization of the Kenya's Vision 2030 can only be achieved through recognizing the importance of the banking industry in Kenya (Kamau, 2019). Muasya (2020) observe that the performance of the banking industry during this period of increasing regulations and controls has not been good. A number of actors within the lower tiers have quit from the business arena due to the challenges in performance and just a few numbers have been subjected to receivership. Therefore, having a better performing banking industry has a benefit to the economy through promotion of capital accumulation as a credit source.

Bank characteristics are mainly distinctive elements forming the foundation of bank and include such factors like the size of the bank, structural ownership, composition of the board and bank’s age (Altunbas, Gambacorta & Marques-Ibanez, 2016). According to Ani, Ugwunta, Ezeudu and Ugwuanyi (2018) the size of the bank is seen as the value of the market of the investments by banks and it reflects the asset base, the number of branches and volume of sales. The base of asset is the fundamental assets that represent the banking institutions value, its not static and its appreciation or depreciation is caused by the market forces. Net asset ratio is amongst most important indicators of the company’s asset base and characterizes all the assets less all the liabilities is reported as the firm’s stockholders’ equity.

Operating costs include expenses relating to the bank’s way of operation and also the resource costs utilized by a bank to keep on existing. The operation cost is removed from the revenue so as to have real operating income and it’s found in the income statement of the bank (Kiaritha, Gekara & Mung’atu, 2014). According to Chaddad and Cook (2016) banks ought to maintain a tracking record of its operating costs together with the associated costs with non-operating activities like expenses incurred on loan interest. Since profitability is a determinant of the bank’s earned revenue and the expenditure from operations, additional profits can be achieved by having more revenue and by lowering cost of operation.

Financial performance refer to the extent where a bank, a company or an organization’s goals are reached thorough evaluation of a company's financial strategies and practices, as well as being used to track the control of financial risks (Kenneth & Thygerson, 2015). Moosa and Bhatti (2018) observe that in management, financial performance is a good element that organizations cannot afford to ignore because of its centrality in the continual existence of any organization since the good bank’s financial health is an assurance to its depositors, stakeholders, employees and the economy at large.

Financial Performance is a way of result measurement of the policies of a firm and monetary operations aspects and it’s utilized when evaluating a company's overall financial health over a specific time period and could also be utilized in comparing related organizations within the same sector (Vogiazas & Nikolaidou, 2016). According to Ngumo (2018) the profitability is mostly a measure used in determining the performance of a certain financial institution and its used in the evaluation hoe best investments are well done by the organization’s management on its total capital compared to hostile situations like loan loss or any other loss that may result due to unpredictable change on interest rate. Therefore, for the banking sector to be profitable it ought to be in position where it can absorb adverse shocks and make the financial systems stable.

The Central Bank of Kenya Act (Cap. 91) and the Banking Act govern commercial banks in Kenya (Cap 488). These Acts are primarily meant to make it easier to create and maintain a sound monetary policy. Currently there are forty-three (43) commercial banks. In Kenya, commercial banks are one of the primary sources of funding for both business endeavors and other undertakings (Daniel & Wandela, 2013). They transfer deposits in the form of loans and advances from surplus to deficit sectors. By giving borrowers access to capital in the form of loans, commercial banks significantly contribute to developing economies.

The banking industry has been struggling as a result of rising inflation, interest rates, and currency volatility. When compared to March 2016, when it was 3.97 percent, and April 2017, when it was 12.05 percent, it was 18.93 percent in December 2017. Large price increases for food and fuel were primarily to blame. The Euro sovereign debt crisis, which increased demand for US dollars and widened the current account deficit, was blamed for the depreciation of the Kenya Shilling in relation to the majority of world currencies traded during the year (Central Bank of Kenya, 2018).

2. STATEMENT OF THE PROBLEM

The Kenyan commercial banks constantly place the banking lending interest rates on loans that are acquired by businesses and private individuals. The main purpose of interest rates on loans is to encourage those who have money to lend it to other people or enterprises (Mwangi, 2014). Simiyu and Ngile (2017) observe that through increasing the rate of lending and lowering the deposit rate, Commercial banks can increase their marginal profits. Since the income from income interest is insufficient to cover deposit costs, general expenses, and revenue loss from the portfolio of non-performing loans, banks are unable to offer lending rates that are very low. On the other hand, these banks cannot put a higher loan rate since it can be difficult to maintain their relationship with the borrowers. Therefore, determining an appropriate lending rate mainly is a main problem in the banking sector.

The lending rate in Kenya has not achieved its stability due to fluctuations using the Central bank as a resource monetary policy committee's speed on this rate. The average yearly lending interest rate in 2016 was 15.05 percent. 2017 saw an average lending interest rate of 15.05% with a 20.04% annual lending interest rate, while 2018 saw a similar average lending interest rate, the average lending interest rate 20.34% ,20.30%,19.73% and 18.15 in the months of for March, June, September and December respectively. According to data from the Central Bank of Kenya, 2016-2019, the lending interest rate decreased by 8.5% in 2019. The banks made a profit before taxes of Ksh. 74.3 billion in the month of December 2015; by Ksh. 89.5 billion in the month of December 2016 (20.5% increase); and by Ksh. 107.9 billion in the month of December 2017 (107.9% increase); and at the end of the year 2018 at Ksh.125.8 billion and finally in the year 2019 a Ksh. 139.8 billion Profit before taxes was achieved.

There was growth in the banks' asset at 9.1% by the year 2019 which was a slight decline from 10.1% in the previous year. The capital level of the industry had a decline in the same year due to the accumulation of losses from the same sector attached with the increasing provisions in line with what is required by the international financial reporting standards. Therefore, the main capital ratio in relation to all the risk weighted assets had reduced 15.2% from 17.2% by the end of the year 2019. The analysis of the share of the market indicated that both the large and the smaller peer groups had declined by 3% and 0.9% respectively as per the 2018 market share while the medium peer group had faced a 4.1% growth rate.

3. LITERATURE REVIEW

Theoretical Literature Review

The trade-off theory proposed by DeAngelo and Masulis (1980) considers that each source of finance has its own cost and return, which are based on the company's potential for profit as well as its business and insolvency risks. The cost of financial difficulty and the gain of the tax shield are consequently balanced because businesses with higher tax advantages will issue more debt to finance corporate operations. According to DeAngelo and Masulis (1980), trade-off theory-based decisions made about corporate financing have an impact on the features of a corporation. The company's cash flows would be impacted by excessive leverage because a sizable portion of it would be used to pay off current debt and interest costs. The company's performance may suffer as a result of its inability to generate the residual cash flows required to invest in current business opportunities.

Gaud, Jani, Hoesli, and Bender (2005) focus on the size of a firm, arguing that large enterprises are heavily indebted because of their size, stability, and less unpredictable cash flows. Additionally, they have a higher chance of profiting from scale advantages that develop once securities are issued on the market. However, during recessionary times when businesses find it difficult to generate adequate cash flow to pay down debt, excessive leverage can be very costly to the organization (Mostafa & Boregowda, 2014). Additionally, because the company's cash flow is restricted, it may not be able to expand its operations, which would result in a stagnant performance. Because they lack collateral for high level debts, smaller businesses might not be able to take on more debt. The trade-off theory is pertinent to this study because it explains that companies below the objective are more likely to use debt financing more frequently, while companies above the target are more likely to use debt financing less frequently. Furthermore, it claims that businesses are more inclined to issue loans when their marginal tax rates are high. because interest payments are tax deductible.

Empirical Literature Review

A study by Kiaritha, Gekara and Mung'atu (2014) focused on how operating costs had an effect on the SACCO's financial performance. Adoption of descriptive research design was done. The SACCOs formed the target population which were sampled through stratified method and the respondents selected using simple random sampling techniques. It was observed that the SACCO's policies were very effective in the management of the operating costs. Particularly, the outcome from the study was that employees were in correspondence that the major costs incurred were from the salaries, rent and interest rates placed on deposits made by the members to their SACCO.

Kinyugo (2014) researched on cost efficiency effect on the financial performance of listed firms in Nairobi securities exchange. The study population constituted of all banks that were listed at NSE and a census of these banks was done. The study relied on secondary data. The results were that the management of the assets demonstrated the way management efficiency utilized the assets of the firm in generating sales within a particular timeframe. The outcome also was that return on asset had related positively on efficiency.

Muriithi (2017) conducted research on the connection between operational expenses and the financial performance of occupational pension schemes in Kenya. The study focused on secondary data based on 164 pension schemes from the year 2007 to the year 2009. A sample of 329 pension schemes was obtained through stratified technique. It was observed that the investment management costs as well as administrative cost exhibited a negative correlation with financial performance.

Sinta, Kembaren and Fadli (2021) study examined the relationship between operational cost and the financial performance of Pt. Gotong Royong Jaya. Quantitative data was used as the research methodology. Although the information used was secondary. Simple linear regression analysis was employed in this study's data analysis to create a thorough picture of the impact of variable operating costs on financial performance. A simple linear regression model is used to determine whether the independent variable has a substantial impact on the dependent variable. The study found that operating costs have a big impact on PT. Gotong Royong Jaya's financial performance.

4. RESEARCH METHODOLOGY

A descriptive research design was employed. The 8 tier 1 commercial banks in Kenya formed the unit of analysis. The study data was obtained from the secondary source including the audited financial statements of these banks. The analysis of the data was descriptively done using mean and standard deviations. In addition, the application of inferential statistics was done to determine the association between the variables.

5. FINDINGS

The descriptive statistics results of operational costs are presented in Table 1.

Table 1: Operational Costs

	Minimum	Maximum	Mean	Standard deviation
Operational costs (Maintenance costs)	0.023	2.384	15.481	3.592
Operational costs (Administrative costs)	0.087	5.673	12.413	4.684

The results as presented in Table 4.1 show that the operational costs (maintenance costs) and the operational costs (administrative costs) had a mean of 15.481 and 12.413 respectively with a respective standard deviation of 3.592 and 4.684. The minimum value for operational costs (maintenance costs) and the operational costs (administrative costs) was at 0.023 and 0.087 respectively. The maximum value for operational costs (maintenance costs) and the operational costs (administrative costs) was at 2.384 and 5.673 respectively. This shows that the banks have made money after covering their operating and maintenance expenses. With the help of these monthly fees, banks may be able to partially offset the costs of ongoing operations and specific account features.

Results of Inferential Statistics

Correlation analysis

Table 2: Correlation Analysis

		Operational cost	Financial performance
Operational cost	Pearson Correlation	1	
	Sig. (2-tailed)		
Financial performance	Pearson Correlation	.815**	1
	Sig. (2-tailed)	.001	

The Pearson r value of operational cost on financial performance was at 0.815 with a significance value of 0.001 which is less than 0.05. This shows that operational costs had a very strong correlation with financial performance.

Results of Regression Analysis

Table 3: Model Summary

Model	**R**	**R Square**	**Adjusted R Square**	**Std. Error of the Estimate**
1	.709	.812	.804	0.418

The results in Table 3 show that there was a variation of 80.4% of financial performance of tier 1 commercial banks due to the influence of operational costs as indicated by the value of adjusted R^2 . Therefore, the remaining 19.6% represents other variables.

Table 4: Analysis of Variance

Model		**Sum of Squares**	**Mean Square**	**F**	**Sig.**
1	Regression	208.017	52.004	71.117	.001
	Residual	5.85	.731		
	Total	213.107			

The statistical value of F and that of mean square was 71.117 and 52.004 respectively. The level of significance was less than the assumed error term of 0.05. This means that all the conditions are satisfied to conclude that the model was significant.

Table 5: Coefficients

Model		**Unstandardized Coefficients**		**Standardized Coefficients**		
		B	**Std. Error**	**Beta**	**t**	**Sig.**
	(Constant)	.634	.254		2.496	.000
	Operational costs	.763	.127	3.418	6.008	.001

The results as presented in Table 5 show that the financial performance of tier 1 Commercial Banks in Kenya would be at 0.634 without the influence of operational costs. The financial performance of Kenya's Tier 1 Commercial Banks would improve by 0.763 factors if operational costs were raised by one unit as indicated by regression coefficient of was 0.763.

Financial performance = 0.634 + 0.763 (Operational costs)

The results in Table 5 also show that the t- value of operational costs was positive at 6.008 with a significance value of 0.001. So, the financial performance of Kenya's Tier 1 Commercial Banks was positively and significantly impacted by operational costs.

6. CONCLUSIONS

The study concluded that that effective policies were in place at the bank to control the administrative and operating costs of the banks. This is because the banks incurred significant costs from rent, salaries, and interest on member deposits. Operating costs are crucial for any corporate organization due to the demand to maximize returns on various organizational components and the impact such a choice has on a firm's capacity to deal with its competitive and dynamic environment. The Tier 1 banks in Kenya would have much profit if they are able to exercise efficient cost management practices.

7. RECOMMENDATIONS

The study recommended that all the Tier 1 banks in Kenya should have effective strategic plans and operating procedures, according to the management of the banks, as this will save operating expenses. The banks should factor analysis of cost efficiency as significant contributor towards improving their profits and management of risks. The study also recommended that there should be a proper consideration of operational costs resulting from the management of pension schemes that should be appropriately monitored and controlled by trustees and authorities.

REFERENCES

[1] Ahmed, A., Rehan, R., Chhapra, I. U., & Supro, S. (2018). Interest rate and financial performance of banks in Pakistan. *International Journal of Applied Economics, Finance and Accounting*, *2*(1), 1 – 7

[2] Altunbas, Y., Gambacorta, L., & Marques-Ibanez, D. (2016). Do bank characteristics influence the effect of monetary policy on bank risk?. *Economics Letters*, *117*(1), 220-222

[3] Ani, W. U., Ugwunta, D. O., Ezeudu, I. J., & Ugwuanyi, G. O. (2018). An empirical assessment of the determinants of bank profitability in Nigeria: Bank characteristics panel evidence. *Journal of Accounting and Taxation*, 4(3), 38-43

[4] Berend I. (2016). Case Studies of Modern European Economy: Enterprenour, invention and Institutions. New York: Routledge

[5] Chaddad, F., & Cook, M. (2016). The Economics of Organization Structure Changes: A US Perspective on Demutualization. *Annals of Public and Cooperative Economics*, 75(4), 575 – 594

[6] Corb, H. (2015). *Interest rate swaps and other derivatives*. New York: Columbia Business School

[7] DeAngelo, H., & Masulis, R. (1980). Optimal Capital Structure under Corporate and Personal Taxation. *Journal of Financial Economics*, 8(1), 3 – 29

[8] Gaud, P., Jani, E., Hoesli, M., & Bender, A. (2005). The capital structure of Swiss companies: an empirical analysis using dynamic panel data. *European financial management*, *11*(1), 51-69.

[9] Kallberg, J. G., & Udell, G. F. (2018). The value of private sector business credit information sharing: The US case. *Journal of Banking & Finance*, 27(3), 449 – 469

[10] Kamau, A. W. (2019). *Efficiency in the banking sector: An empirical investigation of commercial banks in Kenya* (Master' project, University of Nairobi)

[11] Khan, W. A., & Sattar, A. (2014). Impact of Interest Rate Changes on the Profitability of four major commercial banks of Pakistan. *International Journal of Accounting and Financial Reporting*, 4(1), 142-148

[12] Kiaritha, H., Gekara, M., & Mung'atu, J. (2014). Effect of operating costs on the financial performance of SACCOs in the banking sector in Kenya. *Prime Journal of Business administration and management*, *4*(2), 1359-1363

[13] Kiaritha, H., Gekara, M., & Mung'atu, J. (2014). Effect of operating costs on the financial performance of SACCOs in the banking sector in Kenya. *Prime Journal of Business administration and management*, *4*(2), 1359-1363

[14] Kinyugo, J. M. (2014). *The effect of cost effeciency on financial performance of companies listed on Nairobi securities exchange* (Doctoral dissertation, University of Nairobi).

[15] Mang'eli M. (2017). *Relationship between Interest Rate Spread and Financial Performance of the Commercial Banks in Kenya* (Unpublished MBA project, University of Nairobi)

ISSN 2348-3156 (Print)
International Journal of Social Science and Humanities Research ISSN 2348-3164 (online)
Vol. 11, Issue 1, pp: (89-95), Month: January - March 2023, Available at: www.researchpublish.com

[16] Moosa, I. A., & Bhatti, R. H. (2018). *The Theory and Empirics of Exchange Rates.* World Scientific Inc: Portland

[17] Mostafa, H. T., Boregowda, S. (2014), A brief review of capital structure theories. *Research Journal of Recent Sciences*, 3(10), 113-118

[18] Muasya, B. W. (2020). *The impact of non-performing loans on the performance of the banking sector in Kenya* (Master's project, University of Nairobi)

[19] Muriithi, J. (2017). *Analysis of the Effect of Operating Costs on Financial Performance of Occupational Pension Schemes in Kenya.* Unpublished PhD thesis, Nairobi: University of Nairobi

[20] Mwangi, S. (2014). *The Effect of Lending Interest Rates on Financial Performance of Deposit Taking Micro Finance Institutions in Kenya* (MBA Project, University of Nairobi)

[21] Ngumo, L. W. (2018). *The effect of interest rates on the financial performance of firms offering mortgages in Kenya* (Doctoral dissertation).

[22] Obamuyi, E. O. (2019). An economic study of fixed capital and investment behaviour in Nigeria manufacturing industries. *Nigeria Journal of Economics and Social Studies*, 26(2), 271-272

[23] Omowunmi O. F., (2014). Determinants of Commercial Banks' Lending Behavior in Nigeria. *International Journal of Financial Research*, 2(2), 45 – 51

[24] Petersen, M. A., & Rajan, R. G. (2017). The benefits of lending relationships: Evidence from small business data. *The journal of finance*, 49(1), 30 – 37

[25] Simiyu, C.N., & Ngile, L., (2017). Effect of Macroeconomic Variables on Profitability of Commercial Banks Listed in The Nairobi Securities Exchange. International Journal of Economics, Commerce and Management, 3(4), 7 – 16

[26] Sinta, I., Kembaren, E. T., & Fadli, F. (2021). Conjucture effect of operational cost for increasing financial performance Pt. Gotong Royong Jaya. *International Journal of Economic, Business, Accounting, Agriculture Management and Sharia Administration (IJEBAS)*, 1(1), 54 - 61

[27] Vogiazas, S. & Nikolaidou, E. (2016). Investigating the Determinants of Nonperforming Loans in the Romanian Banking System: An Empirical Study with Reference to the Greek Crisis. *Economics Research International*, 5(1), 6 – 13