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# Financial Liberalization and Performance of Commercial Banks in Kenya

**Munai Betty Chemutai Chepkwony**
Ph.D. student, Department of Accounting and Finance
Kenyatta University, Kenya
**Paul Sang**
Senior Lecturer, Department of Management science
Kenyatta University, Kenya

***Abstract:***
*Many countries have made attempts to liberalize their financial sectors by removal of government ceilings on interest rates, eliminating or reducing credit controls, allowing free entry into the banking sector, giving autonomy to commercial banks, permitting private ownership of banks, and liberalizing international capital flows in a bid to improve the efficiency of investment and eventually economic growth of a country. It is also the movement of capital, the opening of financial markets to international operators and deregulation in lending and deposit rates to increase interbank competition. The financial liberalization therefore promotes the role of the market and minimizes the role of the state in determining who gets and gives credit and at what price. This study therefore sought to conceptualize the effect of financial liberalization on performance of commercial banks in Kenya. The researcher was guided by the following objectives; reviewing theoretical literature on the construct of financial liberalization on performances of commercial banks, this was done by reviewing past but recent related empirical literature and journals on the constructs of financial liberalization on performances of commercial banks and identifying the emerging theoretical and empirical gaps that form the basis of future research. The study was important in that its findings may enable bank to come up with policies that will enhance their Performances as a result of financial liberalization and serve as a benchmark for policy formulation by the government through the Ministry of Finance and the Central Bank of Kenya on enacting laws and regulations that may enable financial liberalization to stabilize Kenyan banking sector. The study reviewed theoretical models of McKinnon–Shaw hypothesis, Keynesian theory of investment, portfolio and inflation tax model and financial liberalization theory in explaining the effect of financial liberalization on performances of commercial bank. This exposed contextual, empirical and conceptual gap that form the basis for advancing preposition of this independent paper. The researcher in her study therefore, proposes that financial liberalization should be encouraged in order for development and growth in developing countries to be realized but should be done under close monitoring and supervision by a regulating body and in this context, it should be under the watch of the central bank.*

***Keywords:*** *Financial liberalization, average customer deposit, financial growth, level of intermediation commercial banks profitability*

## 1. Background

Financial liberalization has been defined by different authors to like, Kaminsky and Schmukler (2003), they defined it as deregulation of the foreign sector capital account, contrary to the stock market and domestic financial sector which viewed it separately. McKinnon and Shaw (1973) eluded that financial liberalization is involved the establishment of interest rates that are higher and equalizing to the demand for, and the supply of savings. They reiterated that higher interest rates will culminate to increase in savings and financial intermediation whilst improving efficiency of savings. When interest rates increased, financial intermediation also increases and in return enhances economic growth. A number of the third world countries have embraced financial liberalization, this has been done by elimination of interest rates, reducing borrowing, allowing freedom of entry into and out of the banking sector, granting the right of self-government to commercial banks, giving rights of private ownership of banks, and liberalizing international capital flows. Farhani, MhamdiAguir, Smida (2015) reports that, a number of economies have experienced significant transformation s which are regulatory and institutional in nature. These transformations have changes altered the behavior of institutions and capital markets. These changes have been brought about by financial liberalization in the 1980s, which in return has affected most emerging countries. Farhani*et.al*, (2015) mention McKinnon and Shawn on the analysis of the financial repression over time, they found out that excessive government intervention characterizes this phenomenon. Financial liberalization has been endorsed to counter this situation, reason being that efficiency of investment was improved which in return leads to higher economic growth. In summary, financial liberalization has been categorized into three major reforms. Capital movement liberalization, unveiling of financial markets internationally, granting freedoms in lending and deposit to financial entities in order to increase interbank competition. A fully liberalized securities market allows investors to

deposit in foreign currencies, they are given a leeway to hold domestic portfolios without limitations or controls, dividends and interests can be repatriated freely within the initial investments. Wangu (2014), state that, the principal intention of financial liberalization is to enhance the role of the market whilst minimizing the role of the state in ascertaining the beneficiaries and lenders and at what cost. The researcher continues to state that 'financial liberalization is the removal of government ceilings on interest rates and of other controls on financial intermediaries. The ever deterioration of economic and financial conditions capped with unfavorable financial conditions within the financial system in the third world countries have proved inadequate to foster economic growth. the World Bank and International Monetary Fund Aid has led a number of the developing countries especially in Africa and Asia to carryout economic reforms in order to create a sustainable business environment as it strives to develop the private sector based on economic system market mechanisms. These reforms were to transform many of the developing countries in emerging economies. The strength of economic growth is envisaged by the development of the private sector and instantaneous maturity of security markets. Financial liberalization was seen as a response component of the reforms (World Bank 2016).

The Government of Kenya has put various regulations and controls over the years on financial institutions, right from capping of banks' lending rates, capital Base, foreign exchange rates and taxation among others. Financial policies and regulations ensure sound financial practices that protect the interests of stakeholders and enhance good corporate governance and hence economic growth. The need for bank depositors/creditors to be kept abreast of the stability of banking systems occasioned by lending risks related issues and micro economic concerns in order to evade the bank crisis. (Biggar&Heimler, 2015). This led to the rise of the banking regulations in order to address the concerns. Without effective regulations, financial systems can become unstable which in return may trigger crisis by devastating the real economy as envisaged in the recent GFC that commenced in 2007(Spratt2013. According to Suri & Bhattacharya, (2016), Lack of transparency and antitrust activities are key features of the Kenyan financial sector which is further compounded by limited customer information. Kenya liberalized interest rates between January 1988 and July 1991 with the aim of doing reforms in the financial sector, subsequently, the market interest rates shoot up whilst shooting inflation further and in the year 1992-1993, inflation reached its peak, this in return forced the government to intervene by placing controls through restrictive monetary policy. Large capital inflows come as a result of high interest rates which if not moderated will cause inflation. Interest rates increase may lead to a reduction in borrower's net worth, which in return has a negative effect on investment and financial intermediation. This brings a rise on non-performing assets and failure of banks. (Isakson, 2016). The Kenyan government signed into law the banking (amendment) act of 2015 thus amending the existing banking act, this was done by inserting a new section 33b with the sole intention of capping lending rates for all banking institutions. The maximum lending interest rate capped by law was placed at 4% above the base rate set by the Central Bank of Kenya,2016.The rate regulation effect has been felt widely right from low income households ,small business and SME'S in totality thus reducing profitability of the banking sector and hence leading to increased charges on commercial banks products Inadequate financial policies on financial institutions have gross impact on sustainable financial growth in the banking industries and economic growth. Poor articulation of the bill has caused confusion on the implementation of the bill.

Financial Performance is a presumed measure of how well an entity uses its assets right from its primary mode of business in order to generate income/revenue over a given period of time. It's majorly about the policies implemented within an organization and operations thereof in monetary terms, the same can be used to compare similar firms or industries across the same sector (Makinde, 2016). It is also about the overall productivity of an organization as regards the turnover of stocks, the increase or reduction of customers, the profitability and the market share. This forms the core concept of an organization to any other businesses as the major objective is to minimize cost and maximize profits. Iravo*et.al.,* (2013). Performance is the fulfillment on an obligation with regards to meeting the intended objectives, attaining the set targets and the expected goals. Firm's performance in this case is the ability of a firm to achieve the intended goals within a specified period of time. The outcome of which gives the basis under which a firm is evaluated and, in this context, include performance of commercial banks. Kariuki (2013), Makinde (2016) alluded that financial performance is Bravo a yardstick used to review a firm's progress with regard to its strategic plan and goals. Their study confirmed that financial performance is a true measure of comparison between similar firms within the same industry or gauging performance in various sectors of the economy. Financial performance is a satisfactory gauge influencing perception and value of a given entity. It can be measured by a firm's solvency, profitability, and liquidity over a period of time. (Mwangi&Angima, 2016). Performance measurement of an entity therefore can be done through accounting-based measures calculated from firm's financial statements such as Return on Assets (ROA), Return on Equity (ROE), and Gross profit margin (Mwangi&Wanjugu, 2015).

Busch, Bauer and Orlitzky (2015) fronted several financial performance measures and classified them into three; survey-based measures, accounting based measures and finally marketing based measures. The market-based measures reflect the degree of satisfaction of shareholders and they include; stock performance in security exchange, market returns, market value to book value among others (Busch et al., 2015) Accounting based measures use historical information in ascertaining performance and only deals with internal efficiency of the firm. Accounting measures include return on assets (ROA), return on equity (ROE), earnings per share (EPS), assets utilization, assets turnover among others, while survey-based measurement consist of survey respondents who provide subjective estimates for example an opinion on use of firm's assets (Busch et al., 2015).

Commercial banks play a key role in the economy as financial intermediaries they perform the basic functions of accepting deposits, lending money and offering transfer services. They are a vital link in the transmission of government's economic policies with regard to monetary policies to the rest of the economy (Ongore&Kusa, 2013). In the developing countries like Kenya and Africa at large, commercial banks are the dominant channel of financial intermediation. Bank

deposits are the major component of money supply used by the public and changes in money growth are highly correlated with changes in prices of goods and services in the economy. According to Li, Madura and Richie (2013) commercial banks are the key financial intermediaries, they facilitate the flow of funds in the banking industry. Kenya's banking industry is mainly governed by the on-gore Banking Act, the Company's Act, the Central bank of Kenya Act and Kenya capital markets authority regulations. Both the CBK and CMA are the major stakeholders responsible for issuing regulations, as regards suspension, statutory management and the processes of receivership and liquidation of commercial banks in case of insolvency in Kenya. However, several and additional changes have been developed by CBK especially on regulation and suspension (CBK, 2015; CMA, 2012). The Central Bank checks on the capital adequacy, the asset quality, the management quality as well as the earnings and liquidity (CAMEL) rating system in ascertaining the financial soundness of the commercial banks. The CBK (2015) annual supervisory report on the banking sector was overall rated satisfactory in 2015 as compared to a strong rating which was achieved in 2014.

The banking sector plays a key role in an economy with regard to sustaining financial intermediation, financial markets which in return has a substantial impact on the financial health of an entire economy locally, regionally and internationally. Therefore, commercial banks are seen as crucial but necessary forces in the formation of capital, savings, investment and allocation of economic resource to various countries by availing funds for investors (Ongore and Kusa, 2013). Kenyan banking sector has been facing stability challenges time and again (CBK, 2015). The central bank of Kenya warned in 2015 that commercial banks were facing challenges like fraudulent loans, low provisions for bad and doubtful loans, inadequate capital and low cash ratio, all of which have eroded the market confidence in the banking sector. In order to mitigate this, CBK was forced to put all banks operating in Kenya under tight scrutiny in a bid to ensure market confidence. This was as result of the collapse of Imperial Bank, Dubai Bank and Charter House Bank all of which were put under receivership in 2015. Chase Bank is currently facing liquidity troubles and challenges of being put under receivership (CBK, 2016). To tighten the noose CBK intensified its supervision efforts by requiring commercial banks to reclassify some of their loans and increasing provisions for credit losses.

### *1.1. Statement of the Problem*

Despite the fact that many researchers have made attempts to investigate the importance of financial liberalization in developing countries, a good number of the studies have concentrated mainly on financial repression paradigm shift and interest rate determination, specifically issues of relevance of complementarily hypothesis which link interest rate, liberalization, savings and economic development. The study examined the robustness of classic findings on the relationship between financial improvements and the growth of the economy. It was found out that the financial growth relationship estimated with data from the 1960's to the 1980's simply disappeared over the subsequent years. Therefore, the conclusion of the assumption that the underlying relationship widely used is unstable and that given the additional data it might well reappear.

From the empirical analysis, it's evident that a number of the studies found no significant positive correlation between domestic private savings rate and real interest rate; this contradicts the financial liberalization prediction. However, a few studies that found positive relations hip do not warrant much policy significance as the coefficients magnitude is not large enough and the variables used are not appropriate to ascertain financial liberalization. The studies failed to indicate the relationships between financial liberalization and the banking sector performance. Financial liberalization in SSA has significantly aimed at, mobilizing domestic savings, achieving a reasonable level of real positive interest rates and improving efficiency in the usage of financial resources. This region shares many characteristics but the initial financial (as well as economic) conditions varied from country to country before financial liberalization policies were adopted. Actual adoption or implementation of reforms in some of the countries in the study has been far more extensive relative to others. Countries adopting financial liberalization measures hope to remove the distortions (supposedly brought about by financial repression) that afflict their economies.

## 2. Literature Review

Many researchers have come up with several theories and literature amid mixed conclusions and findings on financial liberalization and performances of commercial bank. McKinnon (1973) and Shaw (1973) were among the researchers that criticized financial liberalizations wisdom. Both argued independently that the pursuance of policies like low interest rates, selective credit control, and discriminatory credit practices among other practices, leads to widespread financial repression in the developing countries. They reiterated that, a repressed financial market discourages savings, causes uneven allocation of resources, divisions of financial markets, and causes a reduction in intermediaries between producers and consumers in the banking system thus breaking the chain of commerce. Muhammad and Malarvizhi (2014) examined the linkage among financial liberalization on economic growth and poverty reduction in six sub-Saharan African countries using panel unit root and panel vector error correction tests over the period of 1980-2010. The results showed that poverty reduction was positively related to economic growth and financial liberalization coefficients are positively related to economic growth. Thus, it implies that financial liberalization causes economic growth. The coefficients of financial liberalization were found to be insignificant to poverty reduction suggesting that financial liberalization does not have direct impact on poverty reduction in the six Sub-Saharan African countries, this implies that, good governance policies and strong institution brings bout growth in economy which in return reduces poverty levels. This is as a result of the distributional changes made possible by financial liberalization.

Sulaiman*et al.*, (2012), investigated the effect of financial liberalization on the economic growth in Nigeria using financial deepening (M2/GDP) and degree of openness as financial liberalization indices, the findings showed that there exists a long-run equilibrium relationship among the variables. The study concluded that financial liberalization has a

growth-stimulating effect on Nigeria and recommended that economic stability should either be maintained or pursued before implementing any form of financial liberalization measures and the regulatory and supervisory framework for the financial sector should be strengthened. Owusu and Odhiambo (2013) employed the autoregressive distributive lag-Bounds testing approach to study the impact of financial liberalization on economic growth in Nigeria, between 1969 and 2008. They found long-run relationship between economic growth and financial liberalization represented by an index calculated using principal component analysis. They substantiated the results from Omankhanlen (2012), that financial liberalization policies have a positive and significant effect on economic growth in Nigeria – both in the short run and in the long-run.A study by Boaz and Donatilla (2013) to examine the profit efficiency of commercial banks in Kenya after the financial sector reforms were undertaken in the early 1990s by utilizing the stochastic frontier approach to estimates the annual profit efficiency scores for seventeen (17) commercial banks for the period 1995-2004 found out that there was an average of 65.6% profit efficiency over the study period. However, the mean profit efficiency declined from 67.9% in 1995 to 62.9% in 2000, there after it consistently increased to 68% in 2003. The study concluded that financial liberalization improved profit efficiency of the banks in the long run and non-performing loans negatively affect banks profit efficiency.

Usman Dawood (2014), in his paper titled Factors impacting the profitability of commercial banks in Pakistan, covered the period from 2009 to 2012. He has used Return on equity as dependent variable and liquidity, cost efficiency, deposit to asset, capital adequacy and asset size as explanatory variables. He has not employed credit risk. The results of his analysis showed that cost efficiency and liquidity had a negative and significant relationship with the profitability. Equity to asset and deposits to asset had a positive significant impact on profitability. However, asset size shows an insignificant and positive relationship with the profitability of commercial banks. AragawHailu (2015) in his study on the impact of capital structure on profitability of commercial banks in Ethiopia, where he considers net interest margin, as the dependent variable and total debt to asset, deposit to asset, loan to deposit, spread, asset growth and asset size as independent variables. This author did not include credit risk and equity to asset in his study and found the result that capital structure had a significant impact on the profitability of core business operations of commercial banks. The empirical findings indicated that total debt to asset had a negative and statistically significant impact, whereas loan to deposit, deposit to asset, asset size and spread had positive and statistically significant influence on profitability. However, asset growth was statistically insignificant. Hassan OlanrewajuMakinde (2016) studied the effect of interest rate on commercial bank deposits in Nigeria from 2000 to 2013, using the dependent variable commercial bank deposit and independent variables Gross Domestic Product (GDP) and interest rates. The empirical findings indicated that interest rate has a negative and statistically insignificant correlation with commercial bank. GDP has a positive and statistically insignificant relationship with commercial bank deposits. The author concluded that interest rates did not have any influence on commercial bank deposits.

Yiyou Wang (2015) focused his research on an exploratory study of interest rate liberalization in commercial banks in China employing net interest spread, non-interest income proportion and concentration ratio of state-owned banks as the dependent variables one by one and benchmark interest spread as the independent variable. The result showed that there was a negative significant correlation between non-interest income proportion and benchmark interest spread, while a positive significant relationship was observed between benchmark interest spread and Concentration ratio of state-owned banks. Whereas, benchmark interest spread had a positive insignificant relationship with net interest spread.

## 3. Theoretical Review

The following theories have been reviewed based on the study

### *3.1. The McKinnon–Shaw Hypothesis (1973)*

Many of the theoretical arguments in favour of financial liberalization originate, as already alluded to, in the work of McKinnon (1973) and Shaw (1973). The McKinnon–Shaw (MS) model challenges the policy of financial repression, including the ceilings on interest rates, high reserve requirements, administrative credit allocation, and other government induced distortions, which were so prevalent in developing countries during the 1960s and 1970s. In particular, the MS-model puts focus on the negative effects of ceilings on deposit and loan rates. Thus, McKinnon–Shaw framework argues that in order for an economy to experience economic growth via greater efficiency in capital accumulation and allocation, interest rate and ceilings, credit control and other restrictive financial legislations should be removed. According to Rehman and Gill (2013), the important point of McKinnon's hypothesis is that an increase in the desired rate of capital accumulation (private savings) at any given level of income leads to an increase in the average ratio of M/P to income implying that a rise in return on capital leads to an increase in the need of real cash balancing holding for accumulation purpose. Thus, money is not a competing asset; rather money is conduit through which accumulation takes place in developing countries. This implies that an increase in real return on money can sharply raise investment saving propensities in developing countries. The basic argument is that financial repression in the guise of a ceiling on nominal interest rates will stall financial deepening and thereby improve performances. An interest rate ceiling, leading to low or negative real interest rates, essentially has two negative effects. First, it reduces savings and hence the amount of loan able funds intermediated through the formal financial system and secondly, low real interest rates influence the marginal productivity of capital.

*3.2. Keynesian Theory of Investment*

The theory was propounded by John Maynard Keynes (1936). The theory emphasizes on the central role of investment in the theory of aggregate output and employment. Keynes focused on investment as the driving force of aggregate demand and short run fluctuations in economic activity. Secondly, Keynes rejected the micro foundations of investment that were based exclusively on technological conditions of capital productivity by stressing uncertainty, finance and monetary factors as fundamental determinants of investment. Keynes emphasized on the need for careful financial management to endure the smooth running of economic activity. Keynes introduced the concept of a' liquidity trap' that sets a ceiling to the nominal interest rate. When a trap is binding, the real interest rate exceeds the equilibrium level consistent with full employment, and planned savings exceed planned investments. A decrease in income would therefore reflect a drop in savings to equal investments Keynes argued that individuals save money for three major purposes to bridge the gap between receipts and expenditures as a precaution against unexpected billings and for speculative purposes in case the market value of any alternative assets falls. The latter purpose determines whether individuals save money or consolidate with alternative assets such as government annuities. This involves paying a fixed dividend based on the market interest rate, which reflects both the desire to maximize wealth and opportunity cost of holding money as the expected gains from the annuities and vice versa. Keynesian school argues that the supply of bank credit is not exogenous as treated by the McKinnon-Shaw school. Therefore, the post-Keynesians argue that if banks can create credit without having to increase their deposits, then an increase in financial savings may make no difference to the total credit given to the private sector. Also, the post-Keynesians argue that high interest rates may only result in stagflation (i.e., a combination of high inflation and unemployment). The proponents of this view argue that the financial liberalization model ignores the adverse.

*3.3. Portfolio and Inflation Tax Model*

The model was propounded by Tobin in 1965. The model was derived from the assumption of perfect substitutability of money and productive capital in Tobin's monetary growth model. The model shows that capital/labor ratio and per capita incomes may be raised through financial repression that reduces the attractiveness of holding money vis a vis productive capita. This model stipulates that the return on capital rises relative to the return on money. Such circumstances encourage a shift from money to capital in household portfolios, higher capital to labor ratios and increased productivity. Tobin's approach is expressed in a money and growth model that allocates wealth between money and productive capital for the overall economy (household and private sector). The opportunity cost of holding money is depicted as the foregone return of productive capital. The dynamics of this model are based on an increased return that reflects higher capital/ labor ratios, higher labor productivity and hence higher per capital income.

*3.4. Financial Liberalization Theory*

The theory was propounded by McKinnon and Shaw, Fry (1996). They rejected Keynesian monetarism and challenged Tobin argument. Instead, they introduced a model of an economy with underdeveloped financial markets. McKinnon based his arguments on the fact that developing economies are closed economies with limited access to external finance and self-finance investments. McKinnon claimed that the governments of developing countries intervened in financial markets for specific reasons that revealed investments efficiency, imports licensing policy implicitly directs funding to authorized importers. This can create opportunities for corruption and monopoly privileges, cheapening capital goods and indirectly subsidizing investments costs. As such wealth redistribution can be participating in the funding of land ownership and creating implicit capital controls over foreign investments. They challenged the case for low controlled interest rates and financial repression, advocating financial liberalization and development as major economic growth enhancing policies. Moreover, potential investors must first accumulate monetary assets before investing in physical capital.

*3.5. Empirical Reviews*

Empirically financial liberalization is the form that increases in real interest rates and performances on the rate of economic growth. The Error Correction Model (ECM) was used to capture both the short and long run impact of the variables in the model. The finding shows a low coefficient of the real deposit rate which implies that interest rate liberalization alone is unlikely to expedite economic growth. Overall, the results show a positive impact on the economy of Nigeria. Kasekende and Atingi-Ego (2003) in the case of Uganda examined the impact of financial liberalization on the conduct of banking business and its effect on the real sector. Quarterly data from 1987Q1 to 1995Q3 for the following variables: Gross Domestic Product, Commercial Bank Credit to the Industrial Sector, Premium on Official Exchange Rate, Lending Rate, and Inflation Rate were analyzed using the Vector Autoregressive (VAR) methodology. Their findings shows that financial liberalization has promoted efficiency gains in the banking industry and consequently, the increased growth of credit to the private sector following financial liberalization leads to economic growth. The study provides evidence of a positive impact and supports the McKinnon-Shaw Hypothesis. Financial liberalization is based on the 'neo-structuralist' critique. The critical difference between the McKinnon-Shaw financial liberalization hypothesis and the neo-structuralist view is the role accorded to the informal financial sector. The neo-structuralist school argues that because of the reserve requirements of banks, the diversion of funds away from the informal to the formal sector (due to increased interest rates) may lead to the reduction of the total supply of loans to the private sector. However, the validity of this argument depends largely on the relative size of the informal sector in the economy (Gibson and Tsakalotos 1994; Fry 1997).Nair (2004) examined the impact of financial sector liberalization measures on household sector saving rate in India by constructing a continuous time series financial liberalization index which includes total credit to household sector by bank and other

financial institutions, foreign investment, market capitalization ratio and real effective exchange rate. The study covered the period 1970/1971 to 1999/2000. The financial liberalization index along with other determinants of household savings was estimated using the VAR methodology. It can be deduced from the findings that the financial liberalization index has a negative impact on household saving rate due to the fact that the increased credit availability as a result of financial liberalization lead to increase in consumption rather than savings. Evidence from this study provide argument to nullify the McKinnon-Shaw complementarity hypothesis which asserts that financial liberalization is capable of increasing savings and economic growth and financial repression will do otherwise.

*3.6. Research Methodology*

Extensive literature review was carried out in order to come up with a clear picture on financial liberalization and performance of commercial banks. The researcher reviewed several secondary data from various articles, journals, thesis and dissertations in an attempt to determine the effects of financial liberations on performance of commercial banks.

**4. Contribution and Implications**

The overall objective of this study was to examine the effect of financial liberalization on performance of Commercial Banks in Kenya. In this study the effect of determinants of financial performance of banks was expressed by Average Customer Deposit, Financial Growth, Level of Intermediation and Financial Liberalization. Commercial banks profitability is impacted negatively in an era of financial regulation.

Since financial regulation affects banks performance, the paper recommends that commercial banks look into other areas in a bid to generate more profits i.e., operational re-structuring and managerial efficiency should be adopted to avoid unnecessary operations that can impact organizations profits. Financial regulations have often been formulated through an arbitrary process. This study recommends further research in order to get the optimal interest rate caps as well as other financial control ceilings and floors, given different case scenarios that would be beneficial to the customers as well as financial institutions. This study also found a gap in literature review as well as theoretical review and proposes that more researchers should come out and explore this area in order to come up with solutions for commercial banks in a liberalized economy.

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