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   REVIEW OF LITERATURE

   NEED/IMPORTANCE OF THE STUDY

   STATEMENT OF THE PROBLEM

   OBJECTIVES

   HYPOTHESES

   RESEARCH METHODOLOGY

   RESULTS & DISCUSSION

   FINDINGS

   RECOMMENDATIONS/SUGGESTIONS

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   ACKNOWLEDGMENTS

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   APPENDIX/ANNEXURE

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CONTRIBUTIONS TO BOOKS

- Sharma T., Kwatra, G. (2008) Effectiveness of Social Advertising: A Study of Selected Campaigns, Corporate Social Responsibility, Edited by David Crowther & Nicholas Capaldi, Ashgate Research Companion to Corporate Social Responsibility, Chapter 15, pp 287-303.

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- Schemenner, R.W., Huber, J.C. and Cook, R.L. (1987), "Geographic Differences and the Location of New Manufacturing Facilities," Journal of Urban Economics, Vol. 21, No. 1, pp. 83-104.

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BANK -SPECIFIC DETERMINANTS OF PROFITABILITY OF QUOTED COMMERCIAL BANKS IN KENYA

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ABSTRACT
The aim of this study is to examine the impact of bank-specific determinants of Kenyan commercial banks profitability. This study used a panel dataset of audited financial statement of nine banks between the years of 2007 and 2011.Ordinary Least Square (OLS) regression technique was used to investigate the impact of Capital Adequacy, Assets Quality, Management Efficiency, Earning Quality and Liquidity on major profitability indicator namely., return on asset (ROA). The study utilized explanatory research design. Document analysis was employed to collect secondary data. The estimation results show that most bank-specific determinants of profitability, with the exception of liquidity, insignificantly affected commercial banks profitability in Kenya. The results of the study are of value to bank regulators, academics and policy makers.

KEYWORDS
Capital Adequacy, Profitability, Assets Quality, Bank-specific and Financial Performance.

1.0 INTRODUCTION
Banks and other financial institutions are a unique set of business firms whose assets and liabilities, regulatory restrictions, economic functions and operating make them an important subject of research, particularly in the conditions of the emerging financial transformation in the world. During the last decades the banking sector in Kenya has experienced major transformation in its environment due to improvement in the requirement of financial services and high tech facilities, resulting in significant impacts on its profitability. Both internal and external factors have been affecting the profitability of banks over time. Hence, identification and analysis of the determinants of bank profitability have attracted for many years the interest of academic researchers as well as bank management, supervisors and financial service participants. The study of bank performance becomes even more important in view of the ongoing financial and economic crises, which have had a fundamental impact on the banking industry in many countries around the globe. The problem of banking and financial system soundness has become more important in all countries over the recent years. The financial sector, and especially the banking system, is vulnerable to systemic crises which has led to the creation of costly safety nets, as depositor insurance schemes with well-known moral hazard problem (Athanasoglou *et al*, 2006).

According to Short (1979) and Bourke (1989) the determinants of commercial bank Profitability can be divided into two main categories namely the internal determinants which are management controllable and the external determinants which are beyond the control of the management of the institutions. Empirical studies pertaining to the relationship between bank-specific factors and profitability provides mixed finding. Earlier studies by Flamini *et al.,* (2009) Kosmidou, 2008; Sufian and Chong, 2008) establishes a positive and significant relationship between internal factors and profitability. Besides, the earlier works by Dietrich and Wanzenried (2011), and Funacova and Poghosyam (2011) report a negative but insignificant relationship internal factors and profitability.

The present study aims at examining the key determinants of bank profitability in Kenya. The study of determinants of bank profitability in Kenya could be justified due to the limited stock of knowledge on determinants of bank profitability in Kenya. Though determinants of bank profitability are thoroughly examined in developed and emerging countries, studies related to determinants of bank profitability in Kenya are scarce. Previous studies on Kenya banks have emphasized on other aspects of bank performance. For instance, Olweny and Sipho (2011) study the relationship between banking sectoral factors and profitability of commercial banks in Kenya. Another study by Flamini et al (2009) on bank profitability has considered Kenyan banks as part of a larger sample pooled across a number of Sub-Sahara countries. According to Flamini *et al.,* (2009), bank profitability is high in Sub-Saharan Africa (SSA) compared to other regions .Given the conflicting results cited above, the present study examines whether bank-specific affects the profitability of commercial banks in Kenya.

2.0 REVIEW OF LITERATURE
REVIEW OF RELATED LITERATURE ON DETERMINANTS OF BANK PROFITABILITY
Commercial banks profitability could be affected by a number of determining factors. In most literatures bank profitability usually expressed as a function of internal and external determinants. Bourke (1989) also indicated that the determinants of commercial bank profitability can be divided into two main categories namely the internal determinants which are management controllable and the external determinants which are beyond the control of management. The internal determinants of commercial banks profitability are those management controllable factors which account for the inter-firm differences in profitability, given the external environment. Vong and Chan (2008) define internal determinants of bank profitability as factors that are influenced by a bank's management decisions. As stated by Rasiah (2010) internal determinants can be broadly classified into two sub-categories namely financial statement variables and non-financial statements variables. The financial statement variables are determining factors which are directly driven from items in a balance sheet and profit & loss accounts of the bank. On the other hand, the nonfinancial statement variables are those factors which do not directly displayed on the financial statements accounts.

The external determinants of commercial bank profitability are those factors which are external to the commercial banks and hence outside the control of management. As defined by Athanasoglou *et al.,* (2005) the external determinants are variables that are not related to bank management but reflect the economic and legal environment that affects the operation and performance of financial institutions. Unlike the internal determinants, external determinants are indirect factors, which may be uncontrollable, but nevertheless influence the bank's profitability. Although the commercial banks cannot control these indirect factors but can build flexibility into their operating plans to react to changes in these factors (Rasiah, 2010). The following sections discussed about external determinants of commercial bank profitability such as industry-specific determinants and macroeconomic variables.

Uhomoibhi, (2008), investigated the determinants of bank profitability in Nigeria. This study sought to econometrically identify significant macroeconomic determinants of bank profitability. Using a panel data set comprising 1255 observations of 154 banks over the 1980-2006 period and macroeconomic indices over the same period, regression results reveal that real interest rates, inflation, monetary policy, and exchange rate regime are significant macroeconomic determinants of bank profitability in Nigeria. Banking sector development, stock market development, and financial structure are insignificant; and the relationship between corporate tax policy and bank profitability in Nigeria is inconclusive.

Kosmidou (2008) examined the factors that affect the performance of Greece Banks for the period 1990-2002 using unbalanced time series data of 23 banks. A number of internal and external factors were considered in the study and were regressed against the banks' ROAA. The study finds that ROA was positively correlated with high capital and lower cost to income ratio as well as with size and the growth of GDP. Moreover it was found that inflation had significant negative effect on performance.

Naceur and Goaied, (2010), investigated the determinants of commercial bank interest margin and profitability in Tunisia. This study investigated the impact of banks' characteristics, financial structure and macroeconomic indicators on banks' net interest margins and profitability in the Tunisian banking industry for the 1980-2000 period. Individual bank characteristics explain a substantial part of the within-country variation in bank interest margins and net profitability. High net interest margin and profitability tend to be associated with banks that hold a relatively high amount of capital, and with large overheads. Size is found to impact negatively on profitability which implies that Tunisian banks are operating above their optimum level.

Haron (2004) examined the impact of different factors on the profitability of Islamic Banks. The study considered total income to total assets, net profit before tax to total assets, net profit before tax to capital and reserves, net profit after tax to capital and reserves as dependent variables in the analysis. Further, the study took into account a number of internal and external factors such as total financing to total deposits, total capital and reserves to total assets, total deposit in current accounts to total assets, total deposit in investment accounts to total assets, total funds in profit sharing principles to total assets, total funds in mark-up principles to total assets, income from financing activities to total financing, bank's share of income to total savings and investment deposits, total expenditure to total assets, staff expense to total assets, provision for loan loss to total assets, other expenses to total assets, money growth supply (M2), inflation, dummy variable (1 if a bank operates in a monopolistic market) market share, consumer price index, size as explanatory variables. The study showed positive relationship between profitability, and liquidity, capital structure, and money supply while an inverse relation between profitability and asset structure and market share. Moreover, the study found mixed result with regard to the impact of size on bank profitability.

Khrawish et. al (2011) examined the determinants of Islamic bank profitability in Jordan . This study examined and analysed the factors that might have an effect on the Jordanian Islamic bank profitability during the period from 2005 through 2009 by using Multiple Linear Regression Model. The analysis revealed that there are significant and positive relationship between Return on Assets (ROA) and Provision for Credit Facilities + Interest in Suspense)/Credit Facilities(PRFCFI/CF) , Total Equity/ total Assets (TE/TA) and total income / Total Asset (TI/TA) of the Islamic Banking , and there are significant and negative relationship between ROA and the Bank size (Log TA), Total liabilities/ Total Assets (TL/ TA) Annual Growth Rate for Gross domestic product(GDPGR), Inflation Rate (INF) and Exchange Rate (ERS) of the Islamic Banking . Also this study found that there are significant and positive relationship between Return on equity (ROE) and Log TA, TL/ TA, TI/TA and ERS of the Islamic Banking, and there are significant and negative relationship between ROE and PRFCFI/CF, TL/ TA, GDPGR and INF of the Islamic Banking.

Sufian and Habibullah (2009) examined the determinants of commercial bank profitability in Bangladesh using the data of 37 banks over the period 1997-2004. The result of the study indicates that loans intensity, credit risk and cost are the bank specific factors that have positive and significant impact on the profitability of Bangladeshi commercial banks. However, the finding of the study is inconclusive with regard to the impact of size on profitability. While size is found to have positive and significant impact on ROA and NIM, its impact on ROAE is negative and significant. As far as the external factors are concerned, the study indicates that such factors have no significant impact on the profitability of commercial banks in Bangladesh.

Athanasoglou , *et al*, (2008), investigated the determinants of bank profitability in South Eastern European Region using an unbalanced panel dataset of South Eastern European (SEE) credit institutions over the period 1998-2002.They found a positive relationship between banking reform and profitability .

Flamini et al. (2009) took a sample of 389 banks in 41 SSA countries to examine the determinants of bank profitability and explore the relationship between profits and equity in the region. To do that they considered a number of bank specific and macroeconomic variables including credit risk, activity mix, capital, bank size, market power, GDP growth and inflation as factors to influence bank profitability in the region. They found that higher returns on assets were associated with large bank size, activity diversification, and private ownership, and that banks returns were also affected by macroeconomic variables.

Badola and Verma (2006) investigated the major determinants of profitability of public sector banks in India using data over the time period 1991-02 to 2003-04. They considered net profit as dependent variable and spread (S), non-interest income, Credit/deposit ratio, Non-performing assets as a percentage to Net advances, Provision and contingencies, operating expense, business per employee as independent variables in their analysis. The study found high degree of association between profitability and the independent variables.

Park and Weber (2006) carried out a study to examine the major determinants of profitability of Korean banks over the period 1992-2002 testing the market structure hypothesis against the efficient structure hypothesis. In estimating the technical inefficiency they used three inputs (labor, capital and deposits) and three outputs (commercial loans, consumer loans, and securities). The proxies that they used for operating efficiency included operating expense per employee (log) and operating expense per branch that of asset inefficiencies are total asset per employee (log) and asset per branch. They alternatively used ROA and ROE as measures of bank profitability in their analysis. Their study reveals that market share has a significant positive impact on bank profitability, favoring the market structure /performance hypothesis. However, when they controlled bank efficiency, they found market share to have insignificant impact on profits, providing evidence in support of the efficient structure hypothesis. Contrary to the market structure hypothesis they found concentration to have a negative impact on bank profitability over the entire period. They also found that banks with a greater net interest margin, lower operating cost per employee or branch, less technical inefficiency, a higher equity capital ratio, a smaller non-performing loan share are found to be more profitable.

Pasiouras and Kosmidou (2007) examined the factors that influence the profitability of commercial domestic and foreign banks in the 15 European Union countries using bank data over the period 1995-2001. In their analysis they measured bank profitability by ROAA and considered a number of internal and external factors. In their study they found that capital strength and efficiency management as the most determinant factors of profitability of both domestic and foreign banks; while equity to asset ratio is positively related with profitability, cost to income ratio is negatively associated. Moreover, their study indicates that liquidity is statistically significant and positively related to the profitability of domestic commercial banks, but liquidity is statistically significant and negatively related to foreign banks. Their study also finds negative association between bank size and profitability of both domestic and foreign banks. Though inflation growth and GDP growth rates are statistically significant and are positively related to the profitability of domestic banks, they are negatively related to foreign banks. Moreover, their study indicates that while concentration is statistically significant and negatively related to domestic bank profitability; it is statistically significant and positively related to foreign bank profitability.

More recent study by Dietrich and Wanzenried (2011) carried out a study to identify the factors that influence the profitability of commercial banks in Swaziland for the period 1999 to 2006 by taking data from 453 banks. They used ROAE and ROAA alternatively as dependent variables and considered eleven bank-specific and five industry-specific and macroeconomic factors as explanatory variables in their analysis. The study found a positive and significant relationship between bank profitability and equity to total assets as well as GDP growth rate, whereas bank size and cost to income ratio were found to be negatively and significantly associated with bank profitability. Moreover the study revealed that private banks were more profitable than state-owned banks.

A study carried out by Sufian and Chong (2008) examined the key factors that influence the profitability of banks in Philippines during the period 1990-2005. Their study indicates that all the bank specific variables are the major determinants of bank profitability in the country. The result of their finding reveals that bank size, credit risk, inflation, and expense preference behavior have negative impact on bank profitability in Philippines whereas diversification and capitalization have positive impact. However, economic growth, money supply, and stock market capitalization are found to have no significant impact on the profitability of banks in Philippines.

Kosmidou et al (2006) examined the factors that affect the profitability of UK domestic commercial banks from the period 1995-2002. Their finding indicates that capital strength is the most significant factor that positively affects UK owned commercial banks' profitability. Moreover, factors such as efficiency management in expense and bank size are also factors that have influence on the profitability of domestic UK commercial banks. More specifically, their study shows that cost to income ratio and bank size have a significant and positive impact on both measures of UK's bank profitability. Their study also indicates that liquidity has a positive effect on ROA but a negative effect on NIM, and loan loss reserve to total loans has positive and significant on NIM but has no significant impact on ROAA. Moreover, all the external factors considered in the study are found to individually have significant impact on UK's bank profitability: they found economic growth, concentration, and inflation to have positive and significant impact on bank performance.

Naceur and Goaied (2001) that examined the factors that affect the performances of Tunisian banks for the period 1980 to 1995 have found a positive association between bank profitability and equity to asset ratio. A review of the literature raises serious questions about the extent to which bank-specific factors are affecting bank profitability with some studies showing positive relationship while other studies show negative results.

3.0 IMPORTANCE OF THE STUDY

The results of this study have a great importance for the management of Kenyan commercial banks through identifying significant determining factors of profitability. In addition, the study has a great significance for regulators, policy makers, managers and the government which regulate the sector and ensures the safety of the public resource and sustainable economic development. The result of this study contributes to the existing literature by providing evidence on the relation between bank-specific determinants and their financial performance. This study was selected since the banking sector in Kenya is one of the vital economic sectors, however there are few studies on the Kenyan commercial banks performance. The current study, therefore, seeks to fill this gap of bank-specific determinants of Kenyan commercial banks using panel data from the banking industry in Kenya.

4.0 STATEMENT OF THE PROBLEM

Commercial banks always play an important role in the economic development of every country. During the last decade, the banking sector of Kenya has experienced major transformation in terms of investment and geographic distribution due to the financial sector reform and liberalization of 1995. These reforms have brought about many structural changes in the sector and have also encouraged foreign banks to enter and expand their operations in the country. Kenya's financial sector is largely bank-based as the capital market is still considered narrow and shallow (Ngugi *et al*, 2006). Over the last few years the Banking sector in Kenya has continued to register growth in assets, deposits, profitability and products offering. The growth has been mainly underpinned by an industry wide branch network expansion strategy both, automation of a large number of services and a move towards emphasis on the complex customer needs rather than traditional 'off-the-shelf' banking products. Banks dominate the financial sector in Kenya and as such the process of financial intermediation in the country depends heavily on commercial banks. In fact Ngugi *et al*, (2006) describes the banking sector in Kenya as the bond that holds the country's economy together hence any failure in the sector has an immense implication on the economic growth of the country. This is due to the fact that any bankruptcy that could happen in the sector has a ripple effect that can lead to bank runs, crises and bring overall financial crisis and economic doom. By dwelling on bank- specific, determinants this study will be conducted to shade light on the financial performance of banks in Kenya, and measures that should be taken to enhance their performance. Further, the current banking failures in the developed countries and the bailouts thereof motivated this study to evaluate the financial performance of banks in Kenya.

5.0 OBJECTIVES

GENERAL OBJECTIVE

The primary objective of the study is to examine the impact of bank-specific determinants of commercial banks profitability in Kenya.

SPECIFIC OBJECTIVES

1. To examine the relationship between capital adequacy and profitability of commercial banks in Kenya.
2. To investigate the relationship between asset quality and profitability of commercial banks in Kenya
3. To investigate the association between management efficiency and profitability of commercial banks in Kenya
4. To examine relationship between earning quality and profitability of commercial banks in Kenya
5. To determine the relationship between liquidity and profitability of commercial banks in Kenya

6.0 HYPOTHESES

H1: There is a significant relationship between capital adequacy and profitability of commercial banks in Kenya.
H2: There is a significant relationship between asset quality ratios and profitability of commercial banks in Kenya
H3: There is a significant relationship between management efficiency and profitability of commercial banks in Kenya
H4: There is a significant relationship between earning and profitability of commercial banks in Kenya
H5: There is a significant relationship between liquidity and profitability of commercial banks in Kenya

7.0 RESEARCH METHODOLOGY

7.1 RESEARCH DESIGN

The study utilized explanatory research design as it sought to identify and evaluate the causal relationships among the key study variables. A panel data study design was also used. The advantage of panel data analysis is that more reliable estimates of the parameters in the model can be obtained between the different variables under consideration (Gujarati, 2004).

7.2 SAMPLING DESIGN

The sample size for the study comprised a total of nine commercial banks which were listed on the Nairobi Stock Exchange (NSE) in the period 2007-2011. Purposive sampling was used to get the sample in order to include a representation critical to providing answers to the research hypotheses. The unit of analysis in this study was all the nine listed commercial banks operating in Kenya. All the 43licensed commercial banks in the country were the target population of this study.

7.3 DATA SOURCE AND COLLECTION METHODS

The data for this study was collected from secondary sources. The secondary sources of data were the audited financial statements of the sample commercial banks over a period of five years (2007-2011). Data for the study were extracted from the annual reports of the nine listed banks. The website of each of the banks was visited to collect necessary data for the study. In all, 45 observations were obtained after editing the annual reports of the nine banks and were used for the study.

7.4 DETERMINANTS OF BANK PROFITABILITY AND VARIABLE SELECTION

VARIABLE SPECIFICATION: INDEPENDENT VARIABLE

Independent variables of the study on which data were collected include the following:

CAPITAL ADEQUACY

The bank's capital is one of the bank specific factors that influence the level of bank profitability. According to Athanasoglou et al. (2005) capital is the amount of own fund available to support the bank's business and acts as a buffer in case of adverse situation. Capital adequacy reflects the capital strength of a bank. The Capital adequacy of a bank is measured as the equity to asset ratio (Demerguç-Kunt and Huizingha (1999), Sudin (2004), Uhomoibhi (2008) and Hamid (2003). Since this ratio is a measure of capital strength, commercial banks with high equity to asset ratio are relatively assumed to be safe in the event of loss or liquidity. This is because the large size of equity is expected to reduce the capital risk and a lower capital ratio may trigger safety and public confidence concerns for the respective bank. Therefore, taking into account the risk-return hypothesis, equity to asset ratio and bank performance would obviously be negatively associated. Conversely, banks with higher equity to asset ratio will have lower risk and this would enhance their credit worthiness. Hence, they will have lower cost of funding. Further, banks with high equity to asset ratio will have lower needs to solicit external funding because, banks with high equity to asset ratio will have more profitability. Sangmi and Nazir, (2010) assert that the Capital adequacy ratio is directly proportional to the resilience of the bank to crisis situations and has a direct effect on the profitability of banks by determining its expansion to risky but profitable ventures. It is expected a significant positive relationship between Capital adequacy and Return on Asset.

ASSET QUALITY

The asset quality of a bank is measured by the ratio of non-performing loans to total loans (Demerguç-Kunt and Huizingha (1999), Sudin (2004). The asset quality is measured to ascertain the component of non-performing assets as a percentage of the total assets. This shows what types of advances the bank has made to generate interest income (Sangmi and Nazir, 2010. It is argued by Dang, (2011) that the quality of loan portfolio determines the profitability of banks and has a direct bearing on bank profitability. Since, the highest risk facing a bank is the losses derived from delinquent loans low nonperforming loans to total loans shows good health of the portfolio a bank. Hence the lower the ratio the better the bank is performing.

MANAGEMENT EFFICIENCY

The Management Efficiency of a bank is measured by the ratio of operating profit to income ratio (Rahman et al. in Ilhomovich, 2009; Sangmi and Nazir, 2010). The higher the operating profits to total income the more the efficient management is in terms of operational efficiency and income generation. The operating profit to income ratio is considered as an explanatory variable since it shows how a bank's management is operationally efficient in managing the affairs of the bank which will eventually have an impact on the bank's profitability. This ratio measures the efficiency and effectiveness of management as they are tasked with making crucial decisions depending on its risk perception. Management Efficiency is represented by different financial ratio such as the expense to asset ratio, total asset growth, loan growth rate and earnings growth. Sangmi and Nazir (2010) argue that the performance of management is often expressed qualitatively through subjective evaluation of management systems, organizational discipline, control systems and quality of staff. Thus, the operating profit to income ratio, which is a proxy for management efficiency, is predicted to have a positive relationship with profitability.

EARNING QUALITY

The earning quality of a bank is measured by the ratio of net profit to average assets. This ratio measures the efficiency in utilization of assets and how much a bank can earn profit from its operation for every shilling spent in the form of assets. The quality of earnings is a very important criterion that determines the ability of a bank to earn consistently. It basically determines the profitability of bank and explains its sustainability and growth in earnings in future (Athanasoglou et al., 2005). Thus, net profit to average assets ratio, which is a proxy for earning quality, is predicted to have a positive relationship with profitability.

LIQUIDITY

The liquidity of a bank is measured by the ratio of total loans to customer deposits. It shows the capacity of a bank to meet payments as and when its depositors and other suppliers of funds require. Liquidity refers to the ability of the bank to fulfill its obligations, mainly of depositors. A lower liquidity ratio implies that the bank will face difficulty in meeting payments in the right time hence the bank will struggle to get funds or else it will have to incur an extremely high rate of interest which will mount the cost of funding and eventually affects the profitability of the bank unfavorably. Conversely, an extremely higher ratio of this would mean that the bank has kept excess liquid assets inactive and hence losing interest income. According to Dang (2011) adequate level of liquidity is positively related with bank profitability. The most common financial ratios that reflect the liquidity position of a bank according to the above author are customer deposit to total asset and total loan to customer deposits. Other scholars use different financial ratio to measure liquidity. Some researchers, Hamid (2003) and Sudin (2004) used the cash to deposit ratio as a proxy for liquidity.

VARIABLE SPECIFICATION: DEPENDENT VARIABLE

The dependent variable was the banks profitability. Return of Asset (ROA) was used as a proxy to measure profitability of the banks and Return on Equity (ROE) which were the dependent variables. It shows how well the shareholders funds are managed and used to generate return.. Return on Asset (ROA) measures the overall efficiency of management and gives an idea as to how efficient management is at using its assets to generate earnings (Al-Manaseer et al., 2012). ROA is defined as profit after tax divided by total asset. According to Rivard and Thomas (1997), bank profitability is best measured by ROA because It is not distorted by high equity multipliers and reflects a better measure of a bank's ability to generate returns on its assets. Further, ROA takes account of the disparity in the absolute magnitude of the profits that may be related to size (Guru et al, 1999).

7.5 MODEL SPECIFICATION

On the basis of previous studies, the following model was developed to empirically investigate the key bank specific factors that influence the profitability of commercial banks in Kenya:

$$Y_{it} = \beta_0 + \Sigma\beta_K X_{it} + \varepsilon_{it} \qquad (1)$$

Where:

- Y_{it} represents the dependent variable (ROA) of bank *i* for time period *t.*
- β_0 is the intercept
- β_K represents the coefficients of the X_{it} variables
- X_{it} represents the explanatory variables (BGD, BSIZE, BCAP and BCR) of bank *i* for time period *t.*
- ε_{it} is the error term

Therefore, the panel data models relating to the impact of board gender diversity on the firm's financial performance was stated as:

$$ROA_{it} = \beta_0 + \beta_1(BCAP_{it}) + \beta_2(BAQ_{it}) + \beta_3(BME_{it}) + \beta_4(BEQ_{it}) + \beta_5(BLQ_{it}) + \varepsilon_{it} \qquad (2)$$

Where:

i denote banks ranging from 1 to 9 (cross-sectional dimension).

t denote years ranging from 2007 to 2011 (time-series dimension).

DEPENDENT VARIABLES

ROA_{it} Return on Asset for *i*th bank and time period *t*

INDEPENDENT VARIABLES

$BCAP_{it}$ Capital adequacy for *i*th bank and time period *t*

BAQ_{it} Asset Quality for *i*th bank and time period *t*

BME_{it} Management Efficiency for *i*th bank and time period *t*

BEQ_{it} Earning Quality for *i*th bank and time period

BLQ_{it} Liquidity for *i*th bank and time period

The study model is tested on time series cross-sectional bank level data in the context of Kenyan over the 2007-2011 period. The empirical specificationfocuses on the reported determinants of Kenyan commercial banks performance which is assumed to be a function of a set of bank characteristics.

7.6.1 MODEL RELIABILITY AND DATA PROPERTIES

The following diagnostic tests were carried out to ensure that the data suits the basic assumptions of linear regression models:

Mulitícollinearity: Multicollinearity exists when independents variables correlate with each other. Multicollinearity was investigated using Variance Inflation Factor (VIF) and correlation coefficient (Scores of 10 and 0.8 respectively show the existence of multicollinearity. As shown in Table 3, there is no serious problem of multicollinearity in the study.

Normality: Descriptive statistics ware used to check for normality by examining the distribution of data,. Kurtosis and Skewness of the distribution of the data were examined and most of the variables were close to normal distribution.

7.7 DATA ANALYSIS AND PRESENTATION

Correlation and Ordinary Least Square (OLS) regression analysis were employed to analyze data collected. The correlation analysis was used to identify the relationship between the independent, dependent and control variables using Pearson correlation analysis. The correlation analysis shows only the degree of association between variables and does not permit the researcher to make causal inferences regarding the relationship between variables (Marczyk et al., 2005). Therefore, Ordinary Least Square (OLS) regression analysis was also used to test the hypothesis and to explain the relationship between bank-specific determinants and profitability of commercial banks in Kenya. SPSS 17 software was used for analysis and the results were presented through tables.

8.0 RESULTS AND DISCUSSIONS

DESCRIPTIVE STATISTICS OF FINANCIAL PERFORMANCE OF COMMERCIAL BANKS

Table 1 presents the descriptive statistics of the bank specific factors that determine the financial performance of commercial banks in Kenya. As indicated in the Table, the average capital ratio of listed Commercial Banks in Kenya was 0.2214(22.14%) According to the CBK, each bank in Kenya has to maintain above 8 % of their risk weighted assets as Capital.

TABLE 1: DESCRIPTIVE STATISTICS FOR ALL STUDY VARIABLES

	N	Minimum	Maximum	Mean	Std. Deviation
CAPITAL ADEQUACY	45	.14	.59	.2214	.09833
ASSET QUALITY	45	.00	.22	.0309	.03499
MANAGEMENT EFFICIENCY	45	0.64	0.82	0.742	.1765
EARNING QUALITY	45	.01	.07	.0427	.01414
LIQUIDITY	45	.23	.97	.7311	.16443
RETURN ON ASSET	45	.01	.07	.0411	.01369
Valid N (listwise)	45				

Source: SPSS correlation result based on the data obtained from sample commercial banks.

It is clear from this table that Kenyan banks are maintaining higher CAR than the prescribed level which could imply that banks prefer less risky investment resulting in lower profit. The average asset quality of the commercial banking sector in the stated period was 0.0309 (2.09%) which shows the existence of low exposure to credit risk and the relationship is expected to be positive with profit. The average management efficiency, of the commercial banking sector was 74.3% on average. It shows that in Kenya more than 70% of commercial banks income is derived from their intermediation) function. The Table also indicates that the average total loans to total deposit (Liquidity) were 73.11%. This indicates that commercial banks in Kenya use 73.11% of customer deposit for on lending which implies that banks are keeping more than the statutory liquidity requirement. Customer deposit is one of the cheapest sources of fund due to the high margin between deposit and lending rate that banks utilize to generate income. Further, the results show that commercial banks in Kenya target domestic resources, mainly customer deposit, for their banking business. As can be observed from the Table 1, the average ROA, for the sector as a whole was 4.11%,. When Compared to other countries bank performances as expressed by the above ratios, the Kenyan banks' performance is above average. According to Flamini et al. (2009.) the average ROA in Sub-Saharan Africa,(SSA) was about 2%. Thus, the average ROA of listed Kenyan banks is above average of the SSA.

CORRELATION ANALYSIS OF BANK PROFITABILITY AND ITS BANK-SPECIFIC DETERMINANTS

This section presents the relationship between the identified bank specific factors and its relationship with bank performance as expressed by ROA. The Pearson's correlation matrix in Table 2 shows the relationship between the return on asset, capital adequacy, asset quality, management efficiency, earning quality and liquidity

TABLE 2: CORRELATION ANALYSIS OF RETURN ON ASSET (ROA) AND BANK DETERMINANTS

		CAPITAL ADEQUACY	ASSET QUALITY	MANAGEMENT EFFICIENCY	EARNING QUALITY	LIQUIDITY	RETURN ON ASSET
CAPITAL ADEQUACY	Pearson Correlation	1	.130	-.099	.274(*)	-.488(**)	.252(*)
	Sig. (1-tailed)	.	.197	.259	.034	.000	.047
	N	45	45	45	45	45	45
ASSET QUALITY	Pearson Correlation	.130	1	.229	-.171	-.235	-.077
	Sig. (1-tailed)	.197	.	.065	.131	.060	.308
	N	45	45	45	45	45	45
MANAGEMENT EFFICIENCY	Pearson Correlation	.099	.229	1	.632(**)	.038	.630(**)
	Sig. (1-tailed)	.259	.065	.	.000	.403	.000
	N	45	45	45	45	45	45
EARNING QUALITY	Pearson Correlation	.274(*)	-.171	-.632(**)	1	.065	.887(**)
	Sig. (1-tailed)	.034	.131	.000	.	.335	.000
	N	45	45	45	45	45	45
LIQUIDITY	Pearson Correlation	-.488(**)	-.235	.038	.065	1	.053
	Sig. (1-tailed)	.000	.060	.403	.335	.	.366
	N	45	45	45	45	45	45
RETURN ON ASSET	Pearson Correlation	.252(*)	-.077	-.630(**)	.887(**)	.053	1
	Sig. (1-tailed)	.047	.308	.000	.000	.366	.
	N	45	45	45	45	45	45

* Correlation is significant at the 0.05 level (1-tailed).

** Correlation is significant at the 0.01 level (1-tailed).

Source: SPSS correlation result based on the data obtained from sample commercial banks.

Table 2 presents the Pearson correlations between return on assets and bank-specific determinants. . The analysis show the capital ratio is positively related to ROA at 1 percent significance level but the relationship is weak. This relationship may indicate that banks face no volatility in earnings due to leverage.

Bouwman, (2009) argues that higher capital ratios encourage banks to invest in safer assets, such as lower-risk loans or securities, which may affect bank performance Asset quality is negatively related to bank profitability which implies that the banks have poor asset quality or high nonperforming loans to total asset related to poor bank performance. The negative correlation coefficient between poor asset quality and return on equity is very strong. This is may be due to the fact that loan constitutes the largest share of assets that generate income for the investment. Management efficiency and earning quality are positively related to profitability and these relationships are strong. On other Liquidity is also positively related to ROA, but the relationship is very weak. This may be due to the fact that liquidity management is more related with fulfilling depositors' obligation (safeguarding depositors) than investment as explained in the agency theory.

REGRESSION RESULTS AND DISCUSSION

To assess the impact of bank's specific factors on their profitability, the dependent variable return on assets was regressed on the independent variable (capital adequacy, asset quality, management efficiency, earning quality and liquidity). The analysis in Table 3 indicates that the overall effect of the explanatory variables on the bank's profitability is statistically significant (overall p-value=0.000). The first objective of this study was to examine the relationship between capital adequacy and profitability of commercial banks in Kenya. It was hypothesized that there is a significant relationship between capital adequacy and profitability of commercial banks in Kenya. The relevant results are presented in Table 3 below.

TABLE 3: SUMMARY OF REGRESSION RESULTS

MODEL SUMMARY (b)

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.897(a)	.804	.779	.00644

a Predictors: (Constant), LIQUIDITY, MANAGEMENT EFFICIENCY, ASSET QUALITY, CAPITAL ADEQUACY, EARNING QUALITY
b Dependent Variable: RETURN ON ASSET

ANOVA (b)

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	.007	5	.001	32.017	.000(a)
	Residual	.002	39	.000		
	Total	.008	44			

a Predictors: (Constant), LIQUIDITY, MANAGEMENT EFFICIENCY, ASSET QUALITY, CAPITAL ADEQUACY, EARNING QUALITY
b Dependent Variable: RETURN ON ASSET

COEFFICIENTS (a)

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.	Collinearity Statistics	
		B	Std. Error	Beta			Tolerance	VIF
1	(Constant)	.011	.009		1.199	.238		
	CAPITAL ADEQUACY	.004	.012	.025	.286	.776	.644	1.553
	ASSET QUALITY	.039	.029	.100	1.330	.191	.886	1.129
	MANAGEMENT EFFICIENCY	.003	.002	.144	1.516	.137	.556	1.798
	EARNING QUALITY	.778	.096	.803	8.060	.000	.506	1.977
	LIQUIDITY	.003	.007	.042	.480	.634	.670	1.491

a Dependent Variable: RETURN ON ASSET

Source: SPSS regression results based on the data obtained from sample banks

As shown in Table 3, the capital adequacy does not affect the profitability of listed commercial banks in Kenya(β=-0.004, -value= .286). The relationship between capital adequacy and the return on asset (ROE**)** is insignificant although it has a positive coefficient. The above results thus leads to the rejection of Hypothesis one that there is a significant relationship between capital adequacy and profitability of commercial banks in Kenya. This hypothesis can be rejected with 95% confidence level. The empirical finding is inconsistent with those of Pasiouras and Kosmidou (2007), Demirguc-Kunt and Huizinga (1999), Berger (1995), Staikouras and Wood (2003), Goddard et al. (2004), and Kosmidou (2008). These studies indicate that well-capitalized banks face lower risks of going bankrupt,by building their creditworthiness, thus reducing their cost of funding which will ultimately enhance their profit margin. Therefore by strengthening the capital structure of Kenyan commercial banks is crucial since it provides the banks an additional buffer and cushion to endure financial crises and offers better safety for depositors during unstable macroeconomic conditions. Well-capitalized banks are considered less risky and are better able to raise uninsured funds in order to compensate the drop in deposits (Van den Heuvel, 2002).

The second objective of this study was to investigate the relationship between asset quality and profitability of commercial banks in Kenya. It was hypothesized that there is a significant relationship between asset quality ratios and profitability of commercial banks in Kenya. Table 3 above show that The relationship between asset quality and profitability (ROA**)** is insignificant (β=-0.039, -value= .191) and it has a negative coefficient implying a very weak relationship. Thus, hypothesis is rejected since there no significant relationship.

The third objective of this study was to evaluate the association between management efficiency and profitability of commercial banks in Kenya. . It was hypothesized that there is a significant relationship between management efficiency and profitability of commercial banks in Kenya. The above results show that the relationship between management efficiency and profitability is insignificant (β=0.003, -value= .137) although it has a positive coefficient. Based on these findings, the third hypothesis is rejected since there no significant relationship between management efficiency and profitability of listed commercial banks in Kenya. Though the relationship between management efficiency and profitability is statistically insignificant, its sign provides important implication for bank managers. According to Pasiouras and Kosmidou (2007), and Kosmidou (2008) operationally efficient commercial banks reported higher profits compared to commercial banks that have poor expense management. A reduction in costs increases the profits of the commercial banks.

Objective four sought to examine relationship between earning quality and profitability of commercial banks in Kenya. Table 3 shows that there is positive significant association between earning quality and profitability (β=0.778, -value= .000). A positive and significant correlation between earning quality and profitability indicates that commercial banks in Kenya over the period 2000-2009 were focusing on making sound lending decisions which reaffirms that banks with more earning tended to engage in higher loan risk lending for higher profits. Thus, the fourth hypothesis is accepted since there is significant relationship. Between earning quality and profitability,

The fifth objective sought to determine the relationship between liquidity and profitability of listed commercial banks in Kenya. The results indicates that there is no significant association between liquidity and profitability (β=0.003, -value= .634). However, the positive correlation between liquidity and bank profitability prima facie reveals that the more liquid a bank is the less profitable it will be. It's important to note that a bank should be liquid enough to meet its depositors' demand of withdrawing money at any time they want to withdraw or risk facing difficulty in meeting payments in the right time due to its low liquidity. A lower liquidity ratio means that the bank will not effortlessly get funds or else at an extremely high rate of interest which will mount the cost of funding and eventually impact on the profitability of the bank unfavorably. Based on the findings, quoted commercial banks in Kenya may increase their interest rates to attract deposits, which boosts their liquidity, but at the same time lowers their interest margins. This could also be linked to the effect of monetary policy, where an increase in reserve requirements puts pressures on bank interest margins, and vice versa..

9.0 RECOMMENDATIONS

On the basis of the results, the following recommendations were forwarded. The study suggests that the managers of Kenyan commercial banks should formulate policies aimed at enhancing the profitability of the banks through improving the banks' capital, implementing risk management practices, devising mechanisms to better control bank operational costs, and utilizing bank liquid assets more productively to generate higher returns. Thus, a lot needs to be done to improve and optimize the bank performance in Kenya.

10.0 CONCLUSIONS

The study was carried out to explore the key bank-specific that influence the profitability of quoted commercial banks in Kenya using panel data of banks over the period 2007-2011. Using the camel model, five internal factors were regressed against return on assets (ROA) of the banks. Capital adequacy, asset quality, management efficiency, and liquidity are among the bank-specific factors that have positive but insignificant impact on the profitability of quoted commercial banks in Kenya. The earning quality was found to have positive and statistically significant impact on profitability. Although majority of bank-specific factors are statistically insignificant, their signs provide relevant policy implications, and thus, should not be undermined and policy makers and the bank regulators should focus on formulating policies aimed at making the banking sector more competitive, sound and transparent.

11.0 SCOPE FOR FURTHER RESEARCH
Based on the outcomes of this study, the following issues are suggested for further research.
- First, increasing the study population and the sample size to the whole financial sector.
- Second, by taking evidence from other industries and increasing the number of observations through the use of large sample size and long years data.
- The relationship bank-specific and bank's financial performance can also be further explained if future researchers conduct study including more internal variables.

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13.0 APPENDICES

APPENDIX 1: LISTED BANKS IN KENYA

	LISTED BANKS IN KENYA
1.	Barclays Bank Ltd
2.	CFC Stanbic Bank Ltd
3.	Diamond Trust Bank Ltd
4.	Equity Bank Ltd
5.	Kenya Commercial Bank Ltd (KCB)
6.	National Bank Of Kenya Ltd (NBK)
7.	NIC Bank Ltd
8.	Standard Chartered Ltd
9.	Cooperative Bank of Kenya Ltd

Source: Central Bank of Kenya Annual Report (2012)

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