

## **THE EFFECT OF CAPITAL ADEQUACY DIMENSIONS ON FINANCIAL PERFORMANCE OF LISTED COMMERCIAL BANKS IN KENYA**

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## **ABSTRACT**

This study investigates the effect of capital adequacy dimensions on the financial performance of listed commercial banks in Kenya. Capital adequacy is a critical factor in ensuring the resilience, stability, and regulatory compliance of banks, enabling them to absorb potential losses and protect stakeholders. The study focuses on how various components of capital adequacy primarily Tier 1 and Tier 2 capital impact financial outcomes measured by performance indicators such as Return on Assets (ROA) and Return on Equity (ROE). Using a descriptive research design, the study analyzed secondary financial data from 12 banks listed on the Nairobi Securities Exchange over a five-year period. Statistical tools, including regression analysis, were employed to examine the relationship between capital adequacy and financial performance. Findings reveal that capital adequacy significantly influences financial performance, with an R-square value of 0.266 indicating that 26.6% of variations in financial performance can be explained by capital adequacy levels. The study observed

considerable differences in capital adequacy ratios among banks, with Stanbic Holdings Plc exhibiting the highest capital adequacy and corresponding superior financial performance, while Diamond Trust Bank recorded the lowest figures. Regression results showed a positive and statistically significant coefficient ( $\beta = 0.148$ ,  $p = 0.019$ ), confirming that higher capital adequacy is associated with improved financial performance. The study concludes that maintaining robust capital adequacy levels enhances a bank's ability to manage risks, meet regulatory requirements, and achieve sustainable profitability. It recommends that listed commercial banks in Kenya strengthen their regulatory capital buffers and implement effective risk management strategies to optimize financial outcomes and safeguard stakeholders' interests.

**Keywords:** Capital Adequacy Dimensions, Financial Performance, Listed Commercial Banks in Kenya

## **INTRODUCTION**

### **Background of the study**

Capital adequacy in accounting is critical for ensuring the resilience and stability of financial institutions and for protecting stakeholders from financial risks. Maintaining adequate capital levels is essential for compliance with regulatory requirements, supporting growth and expansion, and instilling confidence in the institution's financial health. Financial institutions are typically required to disclose information about their capital adequacy in their financial

statements and regulatory filings. This transparency enables regulators, investors, and other stakeholders to assess the institution's financial strength and stability. Capital adequacy is closely linked to risk management practices. Institutions assess their capital needs based on the risks they face, including credit risk, market risk, operational risk, and liquidity risk. Effective risk management helps ensure that capital levels are sufficient to cover potential losses under various scenarios (Flamin 2019).

Capital adequacy considers various components of capital, including: tier 1 Capital: Core capital that consists mainly of common equity and retained earnings. It is the highest quality capital and provides the most loss-absorbing capacity. Tier 2 Capital: Supplementary capital that includes items such as subordinated debt and certain reserves. It provides additional loss-absorbing capacity but is considered less reliable than Tier 1 capital. Then, total is the sum of tier 1 and tier 2 capital, representing the overall capital base available to cover potential losses. Capital adequacy is often evaluated using capital ratios, such as the capital adequacy ratio (CAR) or the Tier 1 capital ratio. These ratios compare a company's capital (both equity and certain types of debt) to its risk-weighted assets. Higher capital ratios indicate stronger capital adequacy and a greater ability to absorb losses without jeopardizing financial stability (Yakubu & Egopija 2021).

Capital adequacy in accounting refers to the sufficiency of a company's capital (both equity and debt) to support its operations and financial obligations while meeting regulatory requirements and maintaining financial stability. It's particularly important for financial institutions such as banks, insurance companies, and investment firms, as they rely heavily on capital to absorb potential losses and safeguard against financial risks. Financial regulators impose minimum capital requirements on institutions to ensure their ability to withstand financial shocks and protect depositors, policyholders, and investors. These requirements may vary depending on the type of institution, its size, complexity, and the risks it faces. For example, banks are often subject to Basel III standards, which set forth guidelines for capital adequacy and risk management among assets (Alfadhli & Alali 2021).

Capital adequacy in banks is crucial for maintaining financial stability, protecting depositors, and supporting sustainable economic growth. Banks must adhere to regulatory capital requirements, implement robust risk management practices, and maintain sufficient capital buffers to withstand financial shocks and crises. Banks are required to disclose information about their capital adequacy in their financial statements and regulatory filings. This transparency enables regulators, investors, and other stakeholders to assess the bank's financial strength, risk profile, and compliance with regulatory requirements. Banks assess their capital adequacy based on the risks they face, including credit risk, market risk, operational risk, and liquidity risk. Effective risk management practices are essential for determining appropriate capital levels and ensuring that the bank's capital adequately covers potential losses under various scenarios. Capital adequacy in banks refers to the ability of a bank to absorb potential losses and meet its financial obligations while maintaining a safe and stable financial position. It is a crucial aspect of banking regulation and risk management, aimed at safeguarding

depositors' funds, promoting financial stability, and protecting the broader economy (Nzioki 2019).

### **Statement of the Problem**

Capital adequacy significantly influences the amount of dividend payments made to investors, as it affects a firm's ability to distribute profits while maintaining financial stability. Recent financial performance indicators raise concerns regarding this relationship. For example, the Return on Equity (ROE) dropped to a low of 19.8% in February 2017, while the Return on Assets (ROA) declined to 2.3%. By December 2017, ROA had only marginally increased to 2.6% from 3.2% in December 2016, and ROE remained relatively low at 20.6%, down from 24.4% in the previous year (Financial Sector Regulators Forum, September 2017). While previous studies have examined various factors influencing dividend policy, they have largely overlooked capital adequacy. Ahmed and Fatima (2013) analyzed sector-specific determinants of dividend policy in Pakistan, identifying profitability and firm size as key drivers. Similarly, Wasike and Ambrose (2015) focused on profitability and cash flow as determinants within the Kenyan banking sector. Chumari (2014) explored the association between dividend payouts and factors like profitability, liquidity, and overall performance. However, none of these studies explicitly investigated the impact of capital adequacy on dividend policy. This study aims to address this gap by examining how capital adequacy affects dividend payments, thereby providing a more comprehensive understanding of the determinants of dividend policy.

### **Objectives of the study**

#### **General objective**

The general objective of the study was to establish the effect of capital adequacy dimensions on financial performance of listed commercial banks in Kenya.

#### **Research Hypotheses**

The researcher was guided by the following research hypotheses:

**H0<sub>1</sub>:** Capital adequacy has no statistically significant effect on financial performance

## **LITERATURE REVIEW**

### **Clientele Effect**

The Clientele Effect theory in dividend policy suggests that companies tend to attract a specific group of investors based on their dividend payout policies. This theory posits that investors have varying preferences for dividend income versus capital gains, and they tend to invest in companies that align with their income preferences. The theory acknowledges that different investors have distinct preferences for receiving income from investments. Some investors, such as retirees or income-oriented investors prefer regular dividend payments to supplement their income. In contrast, other investors, such as growth-oriented investors or tax-sensitive investors, may prioritize capital appreciation and prefer companies that reinvest earnings for growth rather than paying dividends (Norton 2008).

The relevance of the Clientele Effect theory to finance lies in its implications for corporate decision-making, investor behavior, and stock market dynamics. Understanding the Clientele Effect can influence a company's dividend policy decisions. Companies may adjust their dividend payout ratios to attract or retain specific types of investors. For example, if a company's shareholder base consists primarily of income-oriented investors, management may opt to maintain stable or increasing dividend payments to satisfy investor expectations and retain shareholder loyalty (Gitman and Hennessey 2004).

## **Empirical Review**

### **Capital adequacy and performance**

Nzioki (2011) investigated capital adequacy as an essential way in maintaining financial stability, supporting growth, and enhancing shareholder value. The study investigated asset ratio and capital adequacy on performance using descriptive design. Secondary data was used get information from 2009 to 2011 of 9 banks. Component analysis showed those asset ratio and capital adequacies are critical factors that influence a bank's performance, risk profile, and financial stability. Banks need to manage these ratios prudently to optimize their capital structure, support growth initiatives, and maintain resilience in the face of economic uncertainties. Descriptive statistic means also showed that a higher asset ratio and capital adequacy ratio generally indicate lower financial risk and higher financial stability. Banks with strong capital positions are more resilient to economic downturns and credit losses, which can enhance investor confidence and support stock valuation. However, excessively high capital adequacy ratios, may also indicate that the bank is not effectively deploying its capital to generate returns. Banks need to strike a balance between maintaining adequate capital levels to meet regulatory requirements and maximizing profitability by deploying capital efficiently. Musyoka (2017) analyzed the capital adequacy on performance of commercial banks in Kenya. The study investigate liquidity management, bank size and asset quality on financial performance using 42 banks listed from 2016 to 2017. Correlation results showed that Capital adequacy is typically assessed using ratios such as banks need to manage their capital prudently, strike a balance between risk and return, and ensure compliance with regulatory capital requirements to achieve sustainable financial performance which compare a bank's capital to its risk-weighted assets. A bank with adequate capital is better positioned to withstand financial shocks, absorb losses from loan defaults, and continue operating without requiring external assistance or intervention. Effective liquidity management is essential for banks to maintain financial stability, meet short-term obligations, optimize funding costs, and support growth initiatives. By managing liquidity prudently, banks can enhance their performance, minimize risk, and ensure their long-term viability in the face of changing market conditions.

Barus, Muturi, Kibati, and Koima (2017) conducted a study to explore capital adequacy and financial performance of SACCOS. The study analyzed total asset requirements and capital ration on performance. The sample of 83 SACCOS were employed where structured questionnaires distributed. The descriptive statistics indicated that analyzing total asset requirements and capital ratios in relation to performance involves assessing how a bank's asset composition and capital structure impact its profitability, risk management, and overall

financial health. Banks with strong capital positions are perceived as safer investments, attracting investors and supporting stock valuation. Conversely, banks with weak capital positions may face challenges in raising capital, attracting investors, and maintaining shareholder confidence. Total asset requirements and capital ratios influence risk management practices within banks. They would analyze the relationship between capitalization levels, asset quality, provisioning for loan losses, and risk-adjusted returns.

Kioko (2016) conducted an analysis on the impact of capital adequacy on the performance of firms. The study investigated capital requirements and performance using 35 respondents which was used factor analysis to calculate the dimensions. Findings showed on the analysis which provided insights into how total asset requirements and capital ratios affect bank performance, risk management, and financial stability, helping policymakers, investors, and bank management make informed decisions. Macroeconomic conditions, regulatory changes, and market dynamics, to isolate the impact of asset requirements and capital ratios on performance.

The study conducted by Kioko (2016) explored the influence of the capital adequacy with base II Framework on the performance of banks through an examination of credit risk and capital adequacy requirement using 159 respondents. Questionnaires were distributed through the commercial banks. Inferential analysis indicated that analyzing adequate capital levels, banks can absorb unexpected losses without endangering their solvency or ability to meet obligations to depositors and creditors. Maintaining adequate capital levels enhances investor confidence and market perception of a bank's financial health and stability. Banks with strong capital positions are perceived as safer investments, attracting investors and supporting stock valuation.

## **RESEARCH METHODOLOGY**

### **Research Design**

The study utilized descriptive design which revealed the impact of predictor variables to dependent variable. The population under study consisted of 12 banks listed. The utilization of secondary data was chosen due to its effectiveness, a method frequently employed in prior studies. For example, Ndirangu (2014) utilized secondary data to explore dividend policy and bank financial performance. Financial statements were selected as the data source due to their reliability, as they undergo auditing processes before publication. Maranga, W. O., Otieno, S., Mogwambo, V. (2025) defines research design as to the overall strategy and framework that guides the collection, measurement, and analysis of data in a research study. It outlines how the researcher plans to answer the research questions or test hypotheses, specifying the methods and procedures to be used. A good research design ensures that the study is systematic, valid, reliable, and objective, helping to achieve the research objectives effectively. Common types include experimental, descriptive, correlational, and exploratory designs. The target population is the complete set of individuals, units, or elements that the researcher intends to study and about which generalizations would be made. It defines the entire group that meets the criteria

relevant to the research objectives. For example, if a study investigates agricultural practices in Kisii County, the target population might be all smallholder farmers within that county..

**RESULTS AND FINDINGS**

**Capital adequacy**

The research assessed the capital adequacy on financial performance. Descriptive analysis was conducted, and the study's results were presented in Section 4.1.

The study findings indicated that ABSA Bank Kenya Plc Ord 0.50 had mean 0.4764 and standard deviation 0.55131. BK Group Plc Ord 0.80 had mean 0.1456 and standard deviation 0.15668. Diamond trust bank had mean 0.0640 and standard deviation 0.04603. Equity Group Holdings Plc Ord 0.50 had mean 0.3398 and standard deviation 0.68341. HF Group Plc Ord 5.00 had mean 0.5823 and standard deviation 0.129874. I&M Holdings Plc Ord 1.00 had a mean of 0.1084 and standard deviation 0.03210. KCB Group Plc Ord 1.00 had mean 0.4720 and standard deviation 0.48493. NCBA Group Plc Ord 5.00 had mean 0.1070 and standard deviation 0.01294. Stanbic Holdings Plc ord.5.00 had mean 12.2176 and standard deviation 16.69963. standard chartered bank had mean 9.2778 and standard deviation 20.31645. The Co-operative Bank of Kenya Ltd Ord 1.00 had mean 0.0654 and standard deviation 0.07752.

*Table 4.1 Capital adequacy*

	N	Min	Max	Mean	Std Dev
ABS Bank	5	.01	1.23	.4764	.55131
BK Group	5	.01	.36	.1456	.15668
Diamond trust bank	5	.02	.12	.0640	.04603
Equity group holding	5	.01	1.56	.3398	.68341
HF group	5	.02	.29056	.5823	.12987
I& M bank	5	.05	.13	.1084	.03210
KCB holding	5	.03	1.00	.4720	.48493
NCBA Group	5	.08	.12	.1070	.01294
Stanbic Group	5	.00	33.46	12.2176	16.69963
Standard chartered bank	5	.01	45.62	9.2778	20.31645
Cooperative bank	5	.02	.18	.0654	.07752
Average mean				2.16875	

*Source: Field data 2023*

Consequently, the study observed that Stanbic Holdings Plc ord.5.00 had the highest mean, while Diamond Trust Bank Kenya Ltd Ord 4.00 had the lowest mean. Therefore, Stanbic Holdings Plc ord.5.00 exhibited the highest capital adequacy, resulting in higher financial

performance, whereas Diamond Trust Bank Kenya Ltd Ord 4.00 demonstrated the lowest capital adequacy, leading to the lowest financial performance. Additionally, the study found that the capital adequacy of Standard Chartered Bank Kenya Ltd Ord 5.00 and Stanbic Holdings Plc ord.5.00 exceeded the average mean, while others such as ABSA Bank Kenya Plc Ord 0.50 and BK Group Plc Ord 0.80 had capital adequacy below the average mean. According to Nzioki (2011), banks with a substantial capital base enhance depositor confidence.

## Regression Analysis

### Capital adequacy and financial performance

The study used simple regression analysis to examine the effect of capital adequacy on the financial performance of listed commercial banks in Kenya. The results of this analysis were outlined in tables.

*Table 4.2 (a) Model Summary*

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.516 <sup>a</sup>	.266	.083	2.60873

*Source: filed data 2023*

- a. Predictors: (Constant), Capital adequacy
- b. Dependent Variable: financial performance

The study revealed that R was equal to .516, indicating a positive correlation between capital adequacy and the financial performance of listed commercial banks in Kenya. Additionally, the R square value for the study stood at .266, signifying that capital adequacy explained 26.6% of the variation in financial performance among commercial banks in Kenya.

Kombo (2014) noted that adequate capital enables banks to expand their lending activities and support economic growth. Banks use capital to underwrite loans, finance investments, and meet liquidity needs. Higher capital levels allow banks to extend credit to businesses and individuals, fostering entrepreneurship, investment, and consumption. Maintaining optimal levels of capital ensures that a company or a bank can finance its daily operations, such as paying suppliers, employees, and other expenses. Efficient capital adequacy enhances operational efficiency and profitability, positively impacting financial performance.

*Table 4.3 (b) ANOVA*

Model		Sum of Squares	df	Mean Square	F	Sig.
	Regression	40.068	1	40.068	5.888	.019 <sup>b</sup>
1	Residual	360.691	53	6.805		
	Total	400.758	54			

*Source : Filed data 2023*

- a. Dependent Variable: financial performance

b .Predictors: (Constant), Capital adequacy

The F-test result for the study yielded a value of 5.888, with a corresponding p-value of .019, which is less than the significance level of 0.05. This indicates that the overall regression model was deemed suitable for the study. Furthermore, the analysis demonstrated that capital adequacy significantly influenced the financial performance.

*Table 4.3 (c) Coefficient*

Model	Unstandardized		Standardized	t	Sig.	
	Coefficients		Coefficients			
	B	Std. Error	Beta			
1	(Constant)	.149	.584		2.552	.014
	Capital adequacy	.148	.614	.316	2.426	.019

*Source: filed data 2023*

a. Dependent Variable: Financial performance

Thus, capital adequacy was responsible for a 14.9% alteration in the financial performance, all else being equal. Conversely, 85.1% of the changes in financial performance were attributable to other variables. The study highlighted that capital adequacy had a positive and significant impact on the financial performance, indicated by the coefficient B=.148, t=2.426, P=.019

Additionally, the research revealed that a change in capital adequacy resulted in a 14.8% increase in the financial performance. As noted by Kioko (2016), maintaining adequate levels of capital was essential for meeting regulatory requirements and facilitating effective credit risk management, thus fostering growth within the institution. Higher capital levels enable banks to absorb losses from defaulted loans, market fluctuations, or operational failures, minimizing the probability of systemic risk (Maranga, W. O., Otieno, S., Mogwambo, V. 2025).

$$SY = \beta_0 + \beta_1 X_1 + \epsilon$$

$$Y = .149 + .148 X_1$$

### Hypotheses testing

The study examined hypotheses derived from the findings presented.

#### **H01: Capital adequacy has no statistically significant effect on financial performance**

The analysis suggests that capital adequacy does not have a statistically significant impact on the financial performance. However, it's important to note that the capital adequacy showed a positive and significant effect on financial performance  $p < 0.05$ . Therefore, the null hypothesis, which states that capital adequacy has no effect on financial performance, is rejected.

### CONCLUSIONS AND RECOMMENDATIONS

The research findings indicated a strong and positive association between capital adequacy dimensions and the financial performance. Consequently, changes in the level of capital adequacy significantly impacted the financial performance. Furthermore, the study concluded that capital adequacy had a positive and statistically significant effect on the financial

performance. Therefore, fluctuations in capital adequacy led to a substantial increase in the financial performance.

The study recommended that listed commercial banks should enhance their capital adequacy by bolstering levels of regulatory capital. It also suggested that maintaining a favorable capital adequacy ratio could be achieved by mitigating risks associated with weighted assets. By doing so, banks would be better equipped to meet their liabilities and effectively address credit and operational risks as they arise. This proactive approach would particularly benefit banks with capital adequacy levels below the average, potentially leading to improved financial performance. Furthermore, the study advised manager of banks to raise their capital adequacy ratios directly to enhance their financial performance.

The recommendation was made for further research to investigate the impact of different dimensions of dividend policy on the financial performance of non-listed commercial banks in the Nairobi Stock Exchange, Kenya.

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