Technical Efficiency Evaluation of Kenyan Sample Banking Sector

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Abstract

The Kenyan financial institutions structure has changed for the last two decades. The commercial banks have undergone incredible development. The study attempts to investigate technical efficiency of Kenyan commercial banks during 2004-2013 by using a Data Envelopment Analysis (DEA). The results suggests that the degree of technical efficiency was found to be lower which indicates that the inefficiency is due to producing at an inefficient scale level rather than producing below the production frontier.

Keywords: Banking; Technical; Efficiency and Evaluation


Introduction

The Kenyan financial institutions structure has changed for the last two decades. In addition, global trend towards liberalization in banking has led to blurring segregation of lines separating activities of the different groups of financial institutions and the removal of artificial barrier competition. At the same time, deposit taking, credit granting, investment, insurance and financial advisory services are being bundled into one financial corporation of financial supermarkets. As the financial integration of financial markets within and across borders as well as the mergers among banks, reflect an attempt to increase financial industry efficiency.

Efficiency Measurement in Banking

Efficiency is the maximum output that can be produced from any given total of inputs. It refers to the efficiency of a firm, which allocates resources to produce maximum quantity of output. The allocation efficiency of resource, Sparks, Guthrie and Shepherd [1]. This pinpointed two categories i.e. internal efficiency which referred to effective management within the firm itself like how the ways the management inspires the staff, control costs and keep the operation lean. However, when a company is increased in size, profit flows also show an increase. Hence, the management becomes less effective. Such shortcomings are known as inefficiency in management. Early research in banking industry was mainly concerned with estimating the average productivity using some sort of indices and with comparison by Farrell [2]. Researchers tended to substitute efficiency by market share. They assumed that banks with medium market shares are expected to earn higher profits because of the lower unit costs [3,4]. In other words, banks with lower cost structures could maximize profits by either maintaining the current level of prices and size or reducing the price levels and expanding a positive relationship between firms’ profits and market structures being attributed to the gains made by firms that are more efficient.

Statement of the Problem

An attempt to study the efficiency in respect of return on assets of sample Kenya banks is important for benchmarking and strategic planning in the financial services sector. In Kenya, the dominance of the public sector has declined due to the use of technology and introduction of professional management by private and foreign sector banks that gained remarkable position in the Banking Industry. Private sector banks play an important role in the development of the Kenyan Economy. Many firms in the service industry, including the banks, face the problem of not producing better results in terms of return on assets efficiency. In particular, the last decade witnessed continuous changes in regulation, technology upgradation and competition in the global financial services industry and the Kenyan Commercial Banks are no exception to this. The efficiency of banks in general and technical efficiency in respect of return on assets in particular, has become an important issue in Kenya. It is therefore crucial to benchmark the efficiency of banks operating in Kenya, based on efficiency and hence this study on investigation of the efficiency (return on assets) of Kenyan Large, Medium and Small Bank groups (Table 1).

Objectives of the Study

The main objective of this study was to analyze the Total Assets of Kenyan Sample Banks

Hypothesis of the Study

The following null hypothesis was framed and tested in this study

NH01: There is no significant difference in the efficiency of Total Assets among the Kenyan Sample Banks.

Methodology of the Study

(A) Sample Selection

For the purpose of the study, the sample selection was made systematically. In Kenya, there are 41 banks, including public and private sector, as on 31 December 2013. It was found that the required data for analysis were available only for 35 banks. Finally, only six banks were selected by adopting the following criteria.

1. Sample banks were classified as medium, medium and small size for this study as used by Kenya Central Bank. The Kenya Central Bank used weighted composite index, covering assets, Total Assets, capital, and number of deposit accounts and loan accounts to classify the banks.

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Received May 26, 2016; Accepted June 03, 2016; Published June 06, 2016


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2. Fifty percent of the total banks for which the required data were available, were selected as sample (i.e 50% of 35=18 banks). In these 18 banks, only six banks were selected from medium size.

3. According to the top index value, 6 banks from medium size (i.e top 3 and lowest 3. The details of sample banks are given in Table 2.

(B) Sources of Data

The present study was mainly based upon Secondary Data. The required secondary data were collected from Annual Report published by Central Bank of Kenya, various reputed journals and respective bank websites. The other relevant information for this study was collected from Books, News Papers, Magazines, Articles and various websites.

(C) Feedback

The experts in the field of banking, including officials of the banking, were contacted by the Researcher. Their views and valuable information helped the Researcher to validate the findings. Consultations with the experts helped the Researcher to fine tune the research study. Some of the suggestions offered were based on the interaction with the experts.

(D) Period of Study

The study period covered a period of ten years from January 2004 to December 2013.

(E) Tools Used

For the purpose of the analysis, the following tools were used.

i) Descriptive Statistics

a) Mean

The arithmetic mean is the sum of the entire list divided by the number of items in the list. It is often simply to as the average. The following formula was used to calculate the mean.

\[
\text{Mean } \bar{x} = \frac{\sum x_i}{n}
\]
Where, 
\[ \bar{x} = \text{represents the mean,} \]
\[ \sum = \text{Symbol of Summation} \]
\[ x_i = \text{Value of the } i^{\text{th}} \text{ item}, \quad i = 1, 2, 3, \ldots, n \quad \text{and} \]
\[ n = \text{total number of items} \]

b) Standard Deviation

Standard Deviation is the square root of the mean of the squared deviation from the arithmetic mean. It measures the absolute dispersion. Greater the standard deviation, greater will be the magnitude of the deviation of the values from their mean. A small standard deviation means a high degree of uniformity of the observation as well as homogeneity of a series. The standard deviation of a random variable X is defined as below (Table 2).

\[ \sqrt{\text{Var}(X)} = \sqrt{\text{E}(X^2) - (E(X))^2} \]

Where,
\[ E(X) = \text{is the expected variable of } X, \quad \text{and} \]
\[ \text{Var}(X) = \text{is the variance of } X. \]

ii) Correlation

Correlation Analysis refers to the techniques used in measuring the relationship between the variables. Correlation Co-efficient indicates the direction and degree of correlation. Correlation may be positive or negative, depending upon the direction of changes of the variables. If both the variables are varying in the same direction it is called positive correlation and if the variables are varying in the opposite direction, it is called negative correlation. Coefficient of Correlation always lies between +1 and -1. +1 is perfect positive correlation, -1 is perfect negative, depending upon the direction of changes of the variables. If the variables are varying in the same direction, correlation is positive and if the variables are varying in the opposite direction, it is called negative correlation. Coefficient of Correlation always lies between +1 and -1. +1 is perfect positive correlation, -1 is perfect negative correlation and 0 is no relationship between variables.

\[ \rho_{X,Y} = \frac{\text{cov}(X,Y)}{\sigma_X \sigma_Y} = \text{E}[(X-\lambda_X)(Y-\lambda_Y)]/\sigma_X \sigma_Y \]

Where,
\[ \rho_{X,Y} = \text{random variables of } x \text{ and } y \]
\[ \lambda_X = \text{expected value of } x \]
\[ \lambda_Y = \text{expected value of } y \]
\[ \sigma_X = \text{standard deviation of } x \text{, and} \]
\[ \sigma_Y = \text{standard deviation of } y \]

iii) Data Envelopment Analysis (DEA)

This is a non-parametric method for the measurement of the efficiency relative to various Decision Making Units (DMUs). DMUs are the homogeneous units and in the present study, DMUs are the sample commercial banks. Technical Efficiency Score is the total weighted sum of outputs divided by total weighted sum of inputs. In this model, the efficiency was measured by the ratio of weighted outputs to weighted inputs. The efficiency of bank was measured in terms of how efficiently a bank utilized its inputs by using the following formula (Charnes et al., 1978). Their model assumed Constant Returns to Scale (CRS) to measure the relative efficiency of each DMU which is between 0 and 1 and can determine whether a DMU is constant, increasing or decreasing returns to scale. Following Emrouznejad and Anouze the linear programming formulation is as follows:

Efficiency = \frac{\text{weighted sum of Outputs}}{\text{weighted sum of Inputs}}

CCR Model

Charnes et al. [5] coined the term Data Envelopment Analysis (DEA). They extended Farrell [2] piecewise-linear convex hull approach to frontier estimation by expanding multiple inputs and single output to multiple inputs and and multiple outputs and utilized linear combination to convert it to single virtual input and output. Their model assumed Constant Returns to Scale (CRS) to measure the relative efficiency of each DMU which is between 0 and 1 and can determine whether a DMU is constant, increasing or decreasing returns to scale. Following Emrouznejad and Anouze the linear programming formulation is as follows.

\[ \text{Minimum } \lambda \]

Subject to:
\[ \lambda \leq 0 \text{ for all } x \]
\[ \lambda \geq 0 \text{ for all } y \]

The value of \( \lambda \) obtained will be the efficiency score of the \( i^{\text{th}} \) DMU.

BCC Model

Banker et al. (1984) widened the CCR model to account for Variable Returns to Scale (VRS). The CRS linear programming problem can be easily modified to account for VRS by adding the following constraints to the above model [6-9].

\[ \sum \lambda_i = 1 \]

This approach forms a convex hull of intersecting planes which envelope the data points more tightly than the CRS conical hull and thus provides technical efficiency scores which are greater than or equal to those using CRS model. For the purpose of calculating data for this study, Data Envelopment Analysis Online Software (D.E.A.O.S) was used by [10,11].

<table>
<thead>
<tr>
<th>Bank groups</th>
<th>Categories of Banks</th>
<th>SR. No.</th>
<th>Names of the Banks</th>
<th>Market Index Value as on 31 December 2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Medium size Banks</td>
<td>Top size Banks</td>
<td>1</td>
<td>Commercial Bank of Africa Ltd</td>
<td>4.40%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2</td>
<td>Bank of India Ltd</td>
<td>4.35%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>3</td>
<td>Bank of Baroda Ltd</td>
<td>4.23%</td>
</tr>
<tr>
<td>Lower size Banks</td>
<td>National Industrial Development Bank of Kenya Ltd</td>
<td>4</td>
<td>4.21%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>I&amp;M Bank Ltd</td>
<td>5</td>
<td>4.19%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Diamond Trust Bank (K) Ltd</td>
<td>6</td>
<td>4.16%</td>
<td></td>
</tr>
</tbody>
</table>

Note: Market Index Value was calculated by the Central Bank of Kenya as on 31st December 2013

Table 2: Details of Sample Banks (Selected based on Market Value as on 31st December 2013).
Limitations of the study

The present study suffers from the following major limitations.

- The study investigated the relative efficiency and inefficiency of Kenyan Commercial Banks and not their absolute efficiency.
- The three sample categories of banks (medium, medium, and small) were selected from public and private banks.
- The study was based on only secondary data.

Analysis Efficiency of Kenyan Sample Selected Banks

8.1 Descriptive Statistics of Total Assets for Medium (Top and Lower) size Kenyan Commercial Banks

8.2 Technical Efficiency of Kenyan Commercial Banks (Top and Lower in the MEDIUM group) in respect of TOTAL ASSETS

Descriptive Statistics of TOTAL ASSETS for Medium Size (Top and Lower) Kenyan Commercial Banks

The results of descriptive statistics, for medium size Kenyan sample banks (top and lower size), during the study period from 2004 to 2013, are given in Table 3. The efficiency of sample banks was measured in terms of Total Assets as an indicator. The mean values (for total assets) of three top sample banks (Bank of India, Bank of Baroda (K) Ltd and Commercial Bank of Africa Ltd) in the medium size group, were Ksh. 15845.50, Ksh. 25159.70 and Ksh. 60677.50 respectively, during the study period. Besides, one top sample bank, namely, Commercial Bank of Africa Ltd earned a maximum total assets value of Ksh. 124882.00 with a dispersion value of Ksh 

<table>
<thead>
<tr>
<th>Sr. No.</th>
<th>Name of the Banks</th>
<th>Min</th>
<th>Max</th>
<th>Mean</th>
<th>Std Deviation</th>
<th>P-value</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Bank of India</td>
<td>6138.00</td>
<td>30721.00</td>
<td>15845.50</td>
<td>8423.64</td>
<td>0.000</td>
</tr>
<tr>
<td>2</td>
<td>Bank of Baroda (K) Ltd</td>
<td>8355.00</td>
<td>52022.00</td>
<td>25159.70</td>
<td>0.802</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>Commercial Bank of Africa Ltd</td>
<td>20176.00</td>
<td>124882.00</td>
<td>60677.50</td>
<td>0.000</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>National Industrial Development Bank of Kenya Ltd</td>
<td>16636.00</td>
<td>112917.00</td>
<td>52159.40</td>
<td>33547.44</td>
<td>0.000</td>
</tr>
<tr>
<td>5</td>
<td>I&amp;M Bank Ltd</td>
<td>14912.00</td>
<td>110316.00</td>
<td>50667.80</td>
<td>0.000</td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>Diamond Trust Bank (K) Ltd</td>
<td>11037.00</td>
<td>11436.00</td>
<td>51259.40</td>
<td>34704.93</td>
<td></td>
</tr>
</tbody>
</table>

Note: Raw data in Kenyan Shillings (Ksh.) were used for the statistical calculation

Table 3: Results of Descriptive Statistics of Total Assets of (Top and Lower in the Medium group) Kenyan Commercial Sample Banks from 2004 to 2013.
The Commercial Bank of Africa Ltd and Diamond Trust Bank (K) Ltd maintained efficiency, in respect of its total assets satisfactorily, under CCR, BCC and Technical Efficiency models, indicating their growth. Other sample banks, namely, Bank of India, Bank of Baroda (K) Ltd, Commercial bank of Africa Ltd, National Development Bank of Kenya Ltd and I & M Bank Ltd experienced fluctuating efficiency scores all through the study period. Hence it is suggested that sample banks like Bank of India, Bank of Baroda (K) Ltd, Commercial bank of Africa Ltd, National Development Bank of Kenya Ltd and I & M Bank Ltd have to adopt the latest technology and innovations in their products and create awareness among the public to attract more customers and to earn high profits.

Table 4: Results of Technical Efficiency Total Assets (using CCR, BCC and T.E Models) for Kenyan Commercial Banks (three Top and three Lower banks in the Medium group) during the study period 2004-2013.

<table>
<thead>
<tr>
<th>Sr. No.</th>
<th>I. Medium – (top) banks in the medium group</th>
<th>CCR</th>
<th>BCC</th>
<th>T.E</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Bank of India</td>
<td>0.290</td>
<td>0.542</td>
<td>0.411</td>
</tr>
<tr>
<td>2.</td>
<td>Bank of Baroda (K) Ltd</td>
<td>0.663</td>
<td>0.705</td>
<td>0.584</td>
</tr>
<tr>
<td>3.</td>
<td>Commercial Bank of Africa Ltd</td>
<td>1.000</td>
<td>1.000</td>
<td>1.00</td>
</tr>
<tr>
<td></td>
<td>Average Score (among three top banks)</td>
<td>0.651</td>
<td>0.749</td>
<td>0.665</td>
</tr>
<tr>
<td>II. Medium – (lower) banks</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4.</td>
<td>National Industrial Development Bank of Kenya Ltd</td>
<td>0.936</td>
<td>0.958</td>
<td>0.947</td>
</tr>
<tr>
<td>5.</td>
<td>I&amp;M Bank Ltd</td>
<td>0.921</td>
<td>0.983</td>
<td>0.952</td>
</tr>
<tr>
<td>6.</td>
<td>Diamond Trust Bank (K) Ltd</td>
<td>1.000</td>
<td>1.000</td>
<td>1.00</td>
</tr>
<tr>
<td></td>
<td>Average Score (among three lower banks)</td>
<td>0.952</td>
<td>0.980</td>
<td>0.966</td>
</tr>
<tr>
<td></td>
<td>Average Score (overall among six sample banks)</td>
<td>0.802</td>
<td>0.865</td>
<td>0.816</td>
</tr>
</tbody>
</table>

Note: I) CCR: Charnes, Coopers and Rodhes Model, BCC: Bankers, Charnes and Rodhes, T.E: Technical Efficiency Models. II) Scale value of 1.000 indicates efficiency. III) Scale value of 0.500 to 0.999 indicates near or moderately efficiency. IV) Scale value of less than 0.499 indicates inefficiency of banks.

References

Conclusion
The Commercial Bank of Africa Ltd and Diamond Trust Bank (K) Ltd maintained efficiency, in respect of its total assets satisfactorily, under CCR, BCC and Technical Efficiency models, indicating their growth. Other sample banks, namely, Bank of India, Bank of Baroda (K) Ltd, Commercial bank of Africa Ltd, National Development Bank of Kenya Ltd and I & M Bank Ltd experienced fluctuating efficiency scores all through the study period. Hence it is suggested that sample banks like Bank of India, Bank of Baroda (K) Ltd, Commercial bank of Africa Ltd, National Development Bank of Kenya Ltd and I & M Bank Ltd have to adopt the latest technology and innovations in their products and create awareness among the public to attract more customers and to earn high profits.


