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Effects of Central Bank of Rwanda Regulations on the Financial Performance of Commercial Banks in Rwanda

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Abstract

The study was about the effects of central bank of Rwanda regulations on the financial performance of commercial banks in Rwanda, a case study of Bank of Kigali (BK) PLC. The data was collected from audited financial statement of the bank under study, 13 head of departments in Bank of Kigali as were as central bank of Rwanda regulations. The techniques used in data collection include documentary and interview, to analyse the findings descriptive statistical and inferential statistics were used. The findings shows that that the majority of respondents with 61.5% mentioned that Capital adequacy regulation help BK to protect shareholders equity against risks, 38.5% of the total interviewee confirmed that Capital adequacy helps BK to allocate existing resources effectively. The results demonstrated that 38.9% of the total interviewed confirmed that BNR's Credit risk management requirement help Bank of Kigali PLC to reduce NPLs. They furthermore said that to avoid much negative effect of credit risk Bank of Kigali always prepare provision of these NPLS at 100%. On the issues of the effects of liquidity Management regulations on the financial performance of Bank of Kigali PLC results demonstrate that 38.8% of respondents said that central bank's liquidity management requirement help BK to always meet it short term obligations. Results also shows that 15.4% of the total respondents confirmed that central bank's Liquidity management requirement help BK to keep up its Brand. The analysis shows that there is a significance relationship between the central bank of Rwanda regulations and the financial performance of commercial banks in Rwanda.

Keywords: Central bank regulations • Financial performance • Commercial banks

Introduction

Since the early 1970s, bankers have developed a host of new financial instruments and practices. These innovations have altered the nature of banking, and this in turn has complicated the task of banking regulation. The national regulations have become largely ineffective in monitoring the safety and soundness of global banks. It is the resulting market changes and the growth of knowledge about the risks facing the international financial system that have motivated governments to hold multilateral discussions regarding banking regulation [1]. The Basel Committee on Bank Supervision (BCBS), International Monetary Fund and World Bank now promote an extensive list of "best practices" to be adopted by each and every country for the regulation and supervision of their banks. There is a strong sense that if only policymakers in countries worldwide would implement particular regulatory and supervisory practices, then bank "safety and soundness" would improve, thereby promoting growth and stability [2].

Olweny (2013) conducted a study on capital adequacy requirement and banks' profitability: empirical evidence from Nigeria. The purpose of the study was to assess the effect of capital adequacy requirement of both domestic and foreign banks in Nigeria and their profitability. The findings revealed that, capital adequacy relates positively to profitability of banks in Nigeria because it is a confidence booster to the depositors, public and regulatory authority in Nigeria. He concluded by suggesting capital adequacy as the most important factor in determining profitability for banks in Nigeria. In this issue of strong relationship between capital adequacy and bank's profitability, it was supported by the following other authors [3].

The Central Bank of Kenya (CBK) issued a new set of CBK regulatory requirement that came into force on 1st January, 2013. Banks, financial institutions and mortgage finance companies need to adhere to these prudential guidelines. The CBK regulatory requirement deals with a wide range of issues including licensing requirements, corporate governance, capital adequacy requirements, Liquidity Management, stress testing, foreign exchange exposure limits, prohibited business, anti-money laundering, consumer protection, enforcement of banking laws and regulations, agent banking and representative offices (Thumbi, 2014).

Kamau, et al. (2014), used the simultaneous equations approach to model the regulatory effects of minimum capital requirements on bank risk behavior and capital levels in Kenya. The study established that the Kenya's banking sector has an oligopolistic market structure, Examined safety and soundness protection via minimum capital requirements by looking at the passage of regulations advocating a mandatory subordinated debt policy especially for large banks. They found out that over the period of time in which the Gramm-Leach-Bliley Act was passed, a portfolio of banks with relatively high amounts of subordinated debt experienced positive and significant wealth effects [4].

Basel Committee is a global body responsible in setting standards for the prudential regulations for the banking institutions. It ensures effective and efficiency in both regulation and supervision practices for worldwide banks in order to achieve its main objective which is to enhance financial stability in banks. And Rwanda is a member of this Committee. The Central Bank of Rwanda in the year 2000 made a major effort to studying banks' performance in Rwanda and agreed that 'inefficient supervisory action and inadequacy of regulatory framework' were among factors that could have contributed to banking distress in Rwanda [5].

The central bank of Rwanda also established various regulations such as Regulation N° 06/2017 of 19/05/2017 on capital requirements for banks; Regulation N°12/2017 of 23/11/2017 on credit classification and provisioning and Regulation N°07/2017 of 19/05/2016 on liquidity requirements for banks as well as others with the main purpose of ensuring well-functioning and banks' performance. Therefore, it is from that background researcher intended to carry

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out this study and assess the effect of central bank of Rwanda regulations on the financial performance of commercial banks, particularly of Bank of Kigali PLC [6].

Objectives

The general objective of the study is to investigate the effect of central bank of Rwanda (BNR) regulations on the financial performance of commercial banks in Rwanda on the following specific objectives:

- To examine the effect of capital adequacy regulations on the financial performance of Bank of Kigali PLC
- To determine the effect of liquidity Management regulations on the financial performance of Bank of Kigali PLC
- To find out the effect of credit risk management regulations on the financial performance of Bank of Kigali PLC.

Literature Review

Liquidity management can have different impact on financial performance according to different researchers. Vossen (2010) did his study on Bank liquidity management requirements in New York. He reported that, liquidity risk exposes banks to financial difficulties which lead to depositor runs, fleeing of investors and tougher financing. Establishment of bank regulations helps banking institutions in New York to avoid this situation. He summarized his findings by stating that, Banks in New York attempts to contain liquidity risk by ensuring balance between cash inflow and cash outflow as well as holding liquidity cushions for strategic purpose.

Molefe and Muzindutsi (2015) did a study on effect of capital and liquidity management on profitability of major South African Banks. The study covered five leading banks in South Africa for a period between 2004 to 2014. The study showed capital adequacy is the most effective tool for soundness of financial institutions in South Africa. There was weak relationship between liquidity and profitability for those five leading banks in South Africa. They conclude that, South Africa banks should revise the liquidity management guideline to determine optimal liquidity level in order to improve financial performance [7].

Alshatti (2015) conducted a study on effect of credit risk management requirement on Jordanian commercial banks performance. The study covered a period between (2005-2013) for sample of thirteen Jordanian commercial banks. He found that, non-performing loan ratio which is a credit risk management indicator has positive effect on banks profitability. Also results revealed that, capital adequacy ratio, credit facilities and leverage ratio has no effect on Jordanian commercial banks. He concluded that, Banks should conduct serious information evaluation before approving loans to the customers in order to have effective and sound credit risk management system [8,9].

Wang (2013) studied on credit risk management requirement in Rural Commercial Banks in China. The study found that, Rural Commercial Banks (RCBs) in China need to gather enough information concerning the potential costumer in order to prevent credit risk exposure to the bank. The gathered enough information will assist in assessing if any possibility of the loan borrower to default that loan and make wise decision. He concluded by stating that, for RCBs to maintain good credit risk management, it should much concentrate on business operating environment which may has unique risk before adopting any credit risk management strategy [10].

Bridges (2014) did a study on capital adequacy regulation on banks' lending, a case study of Bank of England. They found that, any change in capital adequacy results to change in both capital and lending that is, increase in capital requirement causes an increase in banks capital ratios and reduction on loan growth. The study also found that, after change in capital requirement loan growth mostly returns to normal within 3 years. He concluded that, banks response to change in capital adequacy differs depending business cycle, bank size and direction of the change in capital requirement [11,12].

Alkadamani (2015) investigated on capital adequacy, Bank behavior and crisis: Evidence from emergent economies. His study analyzed data from 46 commercial banks between 2004 and 2014 from four Middle East countries. The study reported that, there is existence of strong relationship on the effect of regulations on level of capital. He concluded that, banks which are closer to the minimum regulatory capital adequacy improves there capital adequacy by capital increase while reducing risk taking activities. Bank should keep enough capital adequacies because during economic crisis banks tend to increase their risk taking activities.

Olalekan (2013) conducted a study on capital adequacy and banks' profitability: empirical evidence from Nigeria. The purpose of the study was to assess the effect of capital adequacy of both domestic and foreign banks in Nigeria and their profitability. The findings revealed that, capital adequacy relates positively to profitability of banks in Nigeria because it is a confidence booster to the depositors, public and regulatory authority in Nigeria. He concluded by suggesting capital adequacy as the most important factor in determining profit ability for banks in Nigeria. In this issue of strong relationship between capital adequacy and bank's profitability, it was supported by the following other authors. Sangmi and Nazir (2010) researched on financial performance of commercial banks in India and reported that, suggested that, capital adequacy ratio (CAR) has direct effect on the bank's profitability in India because they have managed their capital adequacy ratio well by keeping it above the minimum standard of 10% as it is fixed by RBI (Reserve Bank of India).

Methodology

This study adopted a descriptive survey. Descriptive survey research design is a scientific method which involved observing and describing the behavior of a subject without influencing it in any way. It employed both quantitative and qualitative approaches.

Researcher adopted the regression model as the analytical model for the study. The model was formulated as follows:

$$Y = \beta_{0+}\ \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + e$$

Where;

Y= Financial performance was measured by using the ROA, ROE and Net profit margin

X_1 = Capital Requirement which was measured by using the capital adequacy ratio which is the ratio of total risk weighted assets to total capital

X_2 = Liquidity requirement which was measured by using the liquidity ratio, which is the ration of liquidity investments to total loans and advances

X_3 = Credit risk Management requirement which was measured by using the None Performing loans(NPLS) which is ratio of none performing loans to total loans, $\beta 0$ = Constant, $\beta 1$ - $\beta 3$ = Regression coefficients, e=Error term

Results and Discussion

Descriptive and inferential statistics were used to discuss the findings of the study. The data was collected on the annual report of BK.

Financial performance of BK

The second specific objective of this study was to analyze the performance of Bank of Kigali PLC by using profitability ratios, and the results are presented below.

Profitability of BK

The results show that from 2015 to 2019, the ratio of Return on Assets are 3.65%; 3.25%; 3.21%; 3.12% and 3.66% respectively. This means that, in 2015 for 100 RWF of invested they got 3.65 RWF; in 2016 for 100 RWF of invested they got 3.25 RWF; in 2017 for 100 RWF of invested they got 3.21 RWF and in 2018 for 100 RWF of invested they got 3.12 RWF and in 2019 for 100 RWF invested; the BK ltd got 3.66 RWF. The above results show that

BK PLC is profitable during the covered period. Because the standard ratio of Return on Assets is 1% and looking on the result above Bank of Kigali PLC has more than three time every year. And the most important factor that can lead BK to this smartness in use of asset is the respect of central bank regulation such as liquidity requirement, credit risk management requirement and capital adequacy requirement.

From 2015 to 2019 the Return on Equity are as following: 20, 64; 19.13%; 19.02%; 14.06% and 16.90% respectively. This means that in 2016 the 100 RWF invested in BK, generated 19.13RWF, in 2017 and 2018 investors got 19.02RWF; 14.06 Rwf and 16.90 of benefit respectively. Normally the above ratios demonstrate that within this period BK PLC's stockholders were in period of happiness during since the average of income generated by their equity shows that for each 100 Rwf they invest they gain at least 17.95 Rwf and of cause this has a direct link with the respect of capital adequacy; liquidity management and credit risk management's central bank regulation because they are all there to ensure the effective utilization of bank's resources including equity.

Compliance with central bank regulations

Looking at the results it is clear that from 2015- 2019 the Liquid Assets to total Assets is: 38.4%; 32.8%; 28%; 30.1% and 27.7% respectively. This shows that in almost all the years under study the liquidity assets covered 30% and more of the total assets, and the central bank requirements asked banks to do not go under 20%. Therefore, referring to the ration of Liquid Assets to total Assets has been respected. The Liquid Assets to Total Deposits are: 30%, 35.3%, 42.1%; 59.0% and 68.0% respectively from 2015-2019. Therefore, this shows that the ratios of assets to total deposit vary positively in this period on the bank under study. Even in the last year the ratio tripled because the standard ratio according central bank of Rwanda's requirement. Therefore, this is good because it enable the bank to meet depositors request when they immaturely need to withdraw their money.

The Liquid Assets to Total Liabilities was: 46.7%; 39.5%; 34.7%; 38.6% and 34.5% respectively from 2015 to 2019. This shows that in each year researcher assessed liquidity assets of the bank are able to meet bank's obligations (liabilities) at the level of more than 30%. Even in 2015 it cover the bank's liabilities at 46.7%. Therefore this is good because if they are able to cover their total liabilities at this level, they would cover almost all current liabilities. Liquidity investments to total loans and advances are: 68.7%; 54, 3%; 44.4%; 46.4% and 40.9% respectively from 2015-2019. Therefore, this shows that in first year of the study the ratio tripled the minimum regulatory requirement and in the other four year which remained more than double the minimum regulatory requirement of 20 percent. Briefly the results presented above shows that Bank of Kigali PLC always tried it best to respect the liquidity risk regulation of the central bank of Rwanda and there is no doubt this is contribute a lot to the performance of this bank. Normally, liquidity risk is the current and future risk arising from a bank's inability to meet its financial obligations when they come due. A bank might lose liquidity if it experiences sudden unexpected cash outflows by way of large deposit withdrawals, large credit disbursements, unexpected market movements or crystallization of contingent obligations. The other cause may be because of some other event causing counterparties to avoid trading with or lending to the bank. A bank is also exposed to liquidity risk if markets on which it depends are subject to loss of liquidity. Therefore, the respect of central bank regulation against this risk is the only way to fight against these risk identified above.

Looking at the results above it is clear that Bank of Kigali PLC's management has not been able to control and mitigate credit risk since the ratio of NPLs to total loans demonstrate that are high above the NBR medium term objective of 5 percent because they were: 6.04%; 5.56%; 6.98%; 5.78% and 6.73% respectively from 2015 to 2019. However central bank of Rwanda took various measures to strengthen prudential and regulatory framework and put in place banks internal credit policies. In line with this, NBR strengthened its supervisory role for banks and required banks to write-off bad loans that were overdue for long. And in addition, NBR introduced credit reference bureau in July 2010 in a move to reduce the information asymmetry that existed between creditors and borrowers in Rwanda. To further reduce the incidences of NPLs, NBR enacted the regulation in 2011 on credit classification and provisioning. The purpose of the regulation was to ensure that banks promptly identify their non-performing credit facilities and undertake adequate correction efforts. Therefore, the bank understudy has to reinforce it credit recovery policies as well as trying it best to respect central Bank regulation to effectively avoid any kind of none performing loans risk that may arise.

The findings demonstrate that core capital to risk weighted assets was 22.1% in 2015; 19.0% 18.9%; 30.4% and 26.6% respectively from 2015to 2019. Normally this is good for Bank of Kigali ltd because this result ensure that it's most freely and immediately available resources to meet claims against deposit takers is enough because BNR regulation requires banks to hold a minimum total of 10% of core capital to risks weighted assets. And in most of the years under study bank of Kigali had more than 2 times of this. Also total qualifying capital to risk weighted assets is 22.5%; 19.6%; 19.5%; 30.4% and 26.4% from 2015to 2019.

This means that capitalization enables Bank of Kigali PLC to mitigate the proportion of nonperforming loans because BNR's regulation requires banks to hold a minimum total of 12.5% of total qualifying capital to risk weighted assets and the bank under study exceed this percentage in each year of the covered period. Normally, banks must maintain adequate capital in their vaults if they want to survive. However, what constitutes "adequate" is subjective. This is generally measured in the form of a "capital adequacy ratio" and central banking of Rwanda prescribed the level of capital that needs to be maintained. And capital adequacy ratio is important from the point of view of solvency of the banks and their protection from untoward events which arise as a result of liquidity risk as well as the credit risk that banks are exposed to in the normal course of their business.

The solvency of banks is not a matter that can be left alone to the banking industry. This is because banks have the savings of the entire economy in their accounts. Hence, if the banking system were to go bankrupt, the entire economy would collapse within no time. Also, if the savings of the common people are lost, the government will have to step in and pay the deposit insurance.

The effect of central bank of Rwanda (BNR) regulations on the financial performance BK PLC

The findings demonstrate that the majority of respondents with 61.5% mentioned that CA regulation help BK to protect shareholders equity against risks. Normally every shareholder invest his/her money with the main purpose of receiving a return, however any kind of investment is exposed on the risk environment. Therefore, to ensure the effectiveness in use of shareholders' equity and security of customers deposit security against any kind of risks that may raise, bank's management have to pay much attention in further discussion interviewed mentioned that banking industry all over the world is exposed on risks and that any kind of financial crisis raised from banking sector and of cause this affect each angle of economy that why regulators like central banks and Basel committee settled requirement like capital adequacy and central banks are there to follow up the implementation of these regulations in every registered bank. On the other side these help our bank to keep eyes on what can cause risks because automatically affects shareholders equities and the more we respect all central bank's regulation including capital adequacy regulation is the more we avoid these risks, and of cause this lead bank of Kigali to a considerable return on equity and return on assets. Interviewed furthermore said that the bank under study also settled internal rule and procedures that helps bank and staff to stay in line with BNR,s capital adequacy requirement and always calculate the ratio to ensure that the bank remain in the norms. Therefore for the interview, all these lead bank to the performance.

Also 38.5% of the total interviewee confirmed that Capital adequacy helps BK to allocate existing resources effectively. The effectiveness in allocation of shareholders equity is one of the many factors that boost the greater income generated by you investment. And if is not performed effectively it automatically lead to the fail. But for the interviewed staffs, the respect of central bank's capital adequacy regulation helped this bank to stay in line with proper allocation of resources as well as effective management of customers'

money which on the other side help bank of Kigali to avoid any kind of risks that may arise against. Therefore, these allow bank to record enough return on equity and on assets every year. Respondents furthermore testify that working in line with what central bank's capital adequacy require financial institutions on capital adequacy helped bank of Kigali as bank and as group to always work safely and lead the owners to a considerable profit which allowed the bank to extend business. And referring to what respondent testified, the calculation of both Return on equity and return on assets, what they said is true because both ROA and ROE of this bank shows positive results.

The results demonstrate that 38.9% of the total interviewed confirmed that BNR's Credit risk management requirement help BK to reduce NPLs. In further discussion with respondents researcher realized that the main reason behind this requirement is to ensure the performance of granted loans. And for them this effectively lead Bank of Kigali PLC to a considerable ROA because Loans portfolio cover a large part of banks assets and the more are protected against risks is the more return are generated because due to this bank got chance to recovery both granted amount and interests they generated. Here, researcher more ask them why the figures shows that in the period of this study bank exceeded the minimum required level of none performing loans ratio and if this has not affected negatively, the performance of this bank, and they all mentioned that Bank of Kigali PLC as well as other commercial bank exceeded this ratio and that this was not the willing of this bank because it tried it best to recover granted loans however some are not. But for them there is no big gap because they are always near the minimum required ration. They furthermore said that to avoid much negative effect of this bank of Kigali always prepare provision of these NPLS at 100% rate. And of cause finally bank recovers this amount.

Results also shows that BNR's Credit risks mgt requirement help BK to effectively manage bank's assets as confirmed by 27.8% of respondents. And in further discussion interviewed mentioned that banks has to keep easy on loans portfolio since it cover a large part of bank's asset. They also said that this is the leading products in banks. Therefore, for them whatever helps Bank of Kigali PLC to avoid any kind of risk that can lead to none performance of this product has a very huge contribution of the overall bank's performance.

It is also observed that equally 16.7% of the total respondents confirmed that BNR's Credit risk risks mgt requirement lead BK to a considerable ROE and ROA and that these requirements help bank to maintain enough provision on NPLs. And in further discussion respondents mentioned that Bank of Kigali PLC always consider specific provisions for "Substandard" assets which is not less than 20% of the outstanding balance of the credit facility as it indicated by central bank regulation. They also confirmed that specific provisions for "Doubtful" assets are maintained at not less than 50% of the outstanding balance of the credit facility and specific provisions of "Loss" assets are maintained at 100% of the outstanding balance of the credit facility. Therefore, all these allow researcher too confirm that the BNR's Credit risk risks management requirement has positive effect on the performance of the bank under study.

Results demonstrate that 38.8% of respondents said that central bank's liquidity management requirement help BK to always meet it short term obligations. And in further discussion with respondents what researcher realized is that according to respondents the most important short-term obligation that bank needs to meet is the immature withdraw of customers. Respondents furthermore said that this requirement help Bank of Kigali PLC to put it liquidity asset to productive use, but not let it go near to zero because even if it want to use them to generate income it is not good to go in a liquidity crisis because banking institutions must plan for potential unanticipated withdrawals of deposits in addition to its lending program's liquidity needs. Also referring to BNR's regulation the minimum liquidity ratio of 20% is imposed to ensure that banks are all the time capable of meeting the average cash withdraws at short notice, and Bank of Kigali exceeded this as it is proved by the calculated liquidity ratios.

Results also show that 15.4% of the total respondents confirmed that central bank's Liquidity management requirement help BK to keep up its Brand. In further discussion with respondents they mentioned that everyone knows that whenever he/she come to withdraw his/her money in Bank of Kigali at any Branch he/she wants he/she find it. And this build trust between bank and clients so that they depose their money without any worriers of losing their money whenever they want, and of cause this help bank to used customers' deposit to grant loans to others as intermediate which bring enough interest to both bank and customers. They more said that here what bank always keep in mind is that it doesn't exceed 80% of these deposit.

Also 23.1% of the total respondents said that BNR's liquidity management help requirement help Bank of Kigali to retain customers, and 30.8% said that liquidity management requirement helped BK to build customer loyalty. Normally, building trust in bank's clients that they never lose their money whenever they need them help the bank to find out that there is no needs to go anywhere else since he received whatever he need and encourage friends and relatives to join this bank as well and always say positive things about the bank to other people and never change this Bank which is good in competition because to recruit new customer cost a lot than maintaining the existing one. Therefore, all these allow researcher to confirm that BNR's liquidity regulation affect Bank of Kigali PLC's performance effectively.

Relationship between central bank of Rwanda regulations and financial performance of Bank of Kigali PLC

The findings show that R which is the multiple correlation coefficients that shows quality of the prediction of the dependent variable by the independent variable is 0.908. This is a good indication since it points to a strong correlation. The R-Square which is the coefficient of determination shows that the five independent variables in the model explain 77.9% of performance of BK. Subsequently from the Adjusted R Squared it is evident that after adjusting the model for inefficiencies the independent variables can explain 77.6% of performance of BK. From the data in the above table the established regression equation was

$$Y = 0.218 + 0.239X1 + 0.392\ X2 + 0.284X3$$

From the above regression equation it was revealed that holding capital requirement, Liquidity requirement and credit risk management requirement to a constant zero, financial performance of Bank of Kigali PLC would be 0.218, a unit increase in respect of capital adequacy requirement would lead to increase in performance of Bank of Kigali PLC by a factor of 0.239, a unit increase in Liquidity requirements would lead to increase in performance of Bank of Kigali PLC by a factor of 0.392 and also unit increase in Credit risk management requirement would lead to increase in performance of Bank of Kigali PLC by a factor of 0.284. The study also found that all the p-values were less than 0.05 and indication that all the variables were statistically significant in influencing financial performance of Bank of Kigali PLC.

Conclusion

From the findings of the study, it was concluded that Bank of Kigali had implemented and complied with Central Bank regulations requirements except credit risk management requirement where they exceed the maximum requirement on NPL ratio but they are not far for the required ratio. And it is observed that the respect of these regulations had more improved financial performance of this bank under study. From the findings, it was revealed that Bank of Kigali observed monitoring compliance to capital requirement including providing direction to its staffs. From the regression analysis there was a significant positive relationship between central bank of Rwanda regulations and financial performance of Bank of Kigali PLC it is clear that the implementation of regulations imposed by BNR results in positive financial performance. Therefore, this allow researcher to conclude that there is a significant relationship between central bank of Rwanda regulations and financial performance of Bank of Kigali PLC. Basing on the study findings, the study recommends that; Banks should effectively implement and comply with prudential regulations imposed by the regulator due to the nature of the riskiness of the banking sector and its impact on the economic growth of the Country. The banks Board of Directors as well as the overall management of the bank are required to ensure the implementation of regulations imposed by the BNR. The National Bank of Rwanda is recommended to monitor

and supervise Commercial Banks to ensure financial reporting, legal and regulatory requirements are met by the banks and transparent periodic reporting to stakeholders on Corporate Governance, Risk Management and Internal Controls is undertaken.

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