Liquidity Risk Premium and Loan Performance of Non-Listed Commercial Banks in Kenya

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ABSTRACT

Loans performances are widely associated with the liquidity risk premium which is usually charged by the banks. Liquidity risk premium which is charged on loans can lead to success or financial crises of non-listed commercial banks in Kenya. Due to the nature of their business, non-listed commercial banks usually expose themselves to liquidity risks. Loans performance usually determines the conditions to which it improves the economic status and stability in the banking sector. When Non-Performing loans exist, resources are being locked up in unprofitable sector; hence hindering the economic growth, impairing the economic efficiency and hence causing collapsing of banks. In this study researcher carried out the investigation on the effect of liquidity risk premium towards the loan performance of non-listed commercial banks in Kenya. The guiding objectives includes: to establish the influence of liquidity risk premium on loan performance. Literature review was undertaken to strengthen the knowledge on liquidity risk premium variable and the eliciting gaps which are to be filled. The study adopted descriptive research design of All 31 non-listed commercial bank in Kenya were targeted and sampled through census sampling method. Data was derived from secondary data from banks supervisory reports and audited financial reports of all 31 non-listed commercial banks in Kenya. Data analysis was analyzed using the Statistical Package for Social Science programme. Both descriptive and inferential statistics were used. Results from data collected showed that there was a significant relationship between the loan interest factors of liquidity risk premiums on loan performance in non-listed commercial banks in Kenya. Adjustments on cash and cash balance with CBK and amount of loan issued were strong predictors of liquidity risk premium affecting the loan performance. However, regulatory requirements such as statutory reserve requirements or regulated minimum deposit rates lowly contributed to loan performance. The study thus concluded that liquidity risk premium significantly affected loan performance in non-listed commercial banks in Kenya. The study recommends that the non-listed commercial banks should strengthen cash management systems that reduce liquidity imbalance and ensure sufficient reserves in the institution and with central bank of Kenya. They should also apply rigorous policies on loan advances so as loans are awarded to those with ability to repay and mitigate moral hazards such as insider lending and information asymmetry. Arising from this study recommendations were made for further research. A study which will focus on challenges of interest rate capping by the CBK in both listed and non-listed commercial banks in Kenya. Further, a comparative study should be undertaken to establish the effect of the difference between liquidity risk premiums of microfinance institutions on loan performance of commercial bank in Kenya.
Key Words: *Liquidity Risk Premium, Loans Performance, Non-Listed Commercial Banks in Kenya*

1. INTRODUCTION

Liquidity premium is a premium demanded by investors when any given security cannot be easily converted into cash for its fair market value. When the liquidity risk premium is high, the asset is said to be illiquid, and investors demand additional compensation for the added risk of investing their assets over a longer period of time since valuations can fluctuate with market effects. Shen, Chen, Kao, &Yeh (2010) assert that, when a market-based financial systems risk on liquidity are being positively related to the net interest margin this is an indication that, the banks have got high level illiquid loan/assets and receives high interest on income.

Liquidity risk premium has an adverse effect on loan performance, if the assets used as collateral for loans advanced cannot easily converted to cash quickly or traded at fair market price, and the bank has no liquid cash the institution is faced by liquidity risk. Hence, the institution reduces issuing out loans and incorporates high liquidity premium to cover the risk. High liquidity risk premium usually causes rise of interest rate which acts as disincentive to loan repayment (Kariuki & Ngahu, 2016). Generally, the liquidity risk measures they are calculated from statement of financial positions. From past, the best practices of liquidity risks measures were focusing on the use of the liquidity ratios. Blake & Poorman, (2005) noted that, it was not only enough to measure the liquidity only by use of the liquidity ratios and this was not solution.

Beyond liquidity ratios, all banks needs to develop the new view of the liquidity measurement. Currently, there are so many methods which are being provided in assessing banks liquidity risk besides the traditional methods of liquidity ratios. Aim of this entire study was to come up and to carry an alternative liquidity risk method of measuring which are besides on the liquidity ratio. It used the financing gap measures which are being provided by Cornett &Saunders, (2006) in order to assess the banks liquidity risk. Saunders and Cornett, (2006) noted that, banks can also tend to use sources such as liquidity, peer groups ratios comparisons, liquidity index, financing requirements, and planning on liquidity in order to measure their particular liquidity risks exposure.

Banks usually apply statements of financial position liquidity analysis, maturity mismatch approach and cash capital position approach in order to assess their liquidity risk. Their qualitative means of assessing liquidity risks are always as at least as the important as the quantitative measurement which is being based on the models. Also they provide qualitative liquidity risk measures besides the quantitative measures (Matz & Neu, 2007). Thadden, (2008) used US Treasury-swap spread as the means of global credit risk factor and the bid-ask spreads on the side of liquidity. In the corporate bond markets, Driessen &Bongaerts, de Jong, (2011) analyzed the trading-based liquidity measures and the default probability estimates as for particular single assets, and Dick-Nielsen, Feldh ̈utter, & Lando (2009) used information on the CDS spreads and the ratings in order to extract the rating-dependent liquidity components before crisis and during crisis. Therefore, the problem of using the proxies for the liquidity and sovereign credit is that in most of the markets they are not reliable or not in place.

Loan performance in non-listed commercial bank is measured by the loan default rate of the borrowers. Failing of Dubai Bank in 2015 and Chase Bank in 2016 in Kenya attributed to the holding of numerous non-performing loans by the banks. Non-performing loans are those loans whose payments on interest and principal have been defaulted by more than three months (Central Bank of Kenya, 2015) Loan performances of the banks are the determinant of the

liquidity and finance stability of the banks. Gitahi, (2013) asserts that loan portfolios are among the largest assets held by banks and are equally one of the largest sources of their income.

In 2014**,** percentage of non-performing loans to the total number of loans issued in Kenya was 5.5%, up from 5.0% in 2013, (World Bank Group, 2015). This percentage was arrived by dividing by the entire non-performing assets/loans by the total asset/loan portfolio. According to CBK (2014) report, the ratio of total non-performing loans was 5.6%. Similarly, total non-performing loan held by commercial banks in Kenya increased from Ksh. 81.8 billion in the year 2013 to Ksh. 108.3 billion in the year 2014 (CBK, 2014). Loan performances are the main reasons for wounding up banks in Kenya (Waweru & Kalani, 2009). This is because when level of non-performing loans increases in a particular bank, other asset provisions made cannot be adequate to protect it against the risk of defaulting on its payments (Kwambai & Wandera, 2013)

The non-performing Assets (NPAs) are defined in the situations where borrower is unable to make interest payments and principal repayment. At this point the loan is being classified as non-performing by financial institution, and when it will become bad debt, it usually depends on country regulations. Banks usually set aside loan loss provision in order to cover any loan default and writes off loans bad debt in their statement of comprehensive income. In countries, where banks accumulate too much NPLs usually sell them at a discount - to asset management companies (AMCs), which attempts to recover part of the money owed, (Lexicon, 2013). Fofack (2005) further defined the non-performing assets/loans as the total loans, in which for a long time have not generated income, which is the principal and the interest on these loans, they are unpaid for the past ninety days. The Non- performing assets/loans are also be described as those loans which are for the past ninety days are in arrears (Guy, 2011). However in this study, non-performing assets/loans are being described as those loans in which, ninety or more day's delinquent in paying interest and principal (Nenninger & Bexley, 2012). The term "bad loans" as being described by the Fofack (2005) is being used interchangeably together with the non-performing assets/loans and together with the impaired loans. In effect, all these loans are being considered as the bad debts or the toxic assets in the books of accounts in a particular bank (Bexley & Nenninger, 2012). These kinds of descriptions are being interchangeably used in the study. Non- accrued loans are those loans whose interest have being already discontinued since the borrower has a financial constraints. Unsecured loans are usually placed in non-accrual status whenever the principal and interests are not paid for the past 90 days; these are not always the requirements. Asset/loan is being considered as a restructured in a situation where a particular bank has given out the concession to its debtors and it has changed its terms and conditions of loan in order to mitigate the bank from being charged-off as long as that particular debtor can be able to fulfill new terms and condations, (Boudriga *et al* .2009).

2. STATEMENT OF THE PROBLEM

Performance of Non-listed commercial banks loans has been dwindling overtime. CBK (2014) report noted, ratio of total non-performing loans was 5.6% in the year 2014 and the total value of non-performing loans which was held by the commercial banks in Kenya also increased from Ksh. 81.8 billion in the year 2013 to Ksh. 108.3 billion in the year 2014 (Central Bank of Kenya, 2014). Loan performance is the main reason which has cause demising of wounding up of banks in Kenya (Waweru & Kalani, 2009). Since when level of non-performing loans tends to increase in a bank, provisions in assets made are usually not adequate to protect them against the risk of defaulting on their payments (Kwambai & Wandera, 2013).

Due to credit crunch of the year 2007, it made banks to know the of the liquidity risk management in the entire world. Liquidity risk in most cases usually it cause most of the to go under receivership or liquidation, Davis (2008) in his research noted that, most of the banks can protect themselves against liquidity risk premium. On the side of the asset, it's done by the bank holding a certain percentage of the assets which are liquid. Cash is being used in order to meet the need of banks liquidity needs, and the government treasury bills and bonds are used readily as the means of collateral. In the banks side of liability, banks are supposed to ensure they have got enough diversified (portfolio) funding sources which will help the banks to reduce the impact of liquidity risk. Chung-Hua Shen (2009) asserts that, most of the banks sells liquid assets which was used as collate of an asset in order to recover the noon-performing loans hence it obtains liquid funds. When a bank is holding the liquid assets mostly it helps in reducing its own liquidity risk premium. However, sometimes the banks might face a challenge while selling the asset which was used as collateral because of the credit freezing of that asset. Due to this kind of reason, the liquid assets it's being divided into the less risky liquid assets and the highly risky liquid assets. Most of times Banks usually sells the liquid assets which are usually less risky in order have enough cash balance in order to run their operations and issue loans to their customers.

3. OBJECTIVES OF THE STUDY

To establish effect of liquidity risk premium on loan performance of non-registered Commercial Banks in Kenya

4. THEORETICAL FRAMEWORK

In this part, stakeholder theory is discussed and reviewed in context of the loan performance of Non- listed Commercial Banks in Kenya.

4.1 Stakeholder Theory

Stakeholder theory was developed by brainchild of Freeman (1984). The theory argued that, institutions usually have stakeholders whom they pay attention to. Philips (2003) asserted that, firms which seek to serve the interests of the wide range of stakeholders and usually increases the value over given time. Yet, its being averred that there are many and various ways of interpreting basic ideas of stakeholder's theory development which has been difficult. (Scherer & Patzer, 2011) and Freeman, Harrison, Wicks, Parmar and de Colle, (2010) group supported the argument that, the existences of a positive relationship between stakeholder-oriented managements and the performance of the firms. According to Choi and Wang (2009) firms' performances are more often than not measured in the terms of the financial returns. In other words, financial performance is the most used measure of the value created by a firm. However, loan performance depicts financial performance of non-listed Commercial banks to a great extent given that these financial institutions rely on the interest accruing from loans advanced by them to borrowers. In the context of non-listed Commercial banks, stakeholder theory was employed to illustrate how those firms advance the interests of the stakeholder through enhancement of loan performance.

4.2 Empirical Review

This section reviews empirical study that was carried out in respect to liquidity risk premium in all non- listed banks in globally, regionally and Kenya.

Huang, & Wang, (2013) carried out empirical analysis of liquidity risk premium in China. They carried out analysis on liquidity risk which was based on issued amount, the priced returns and the age of the bond amongst the others. They also noted an increase in amount of money which was issued which translated to a high liquidity. Ivaschenko & De Nicolo, (2009) carried out the examination on global liquidity risk premiums and the opportunity growths. Their study noted 3 key results. They revealed there was an increase in the market liquidity all over the world which started in the early 1990s which resulted to the advanced international financial integration, although the markets has been increasingly being exposed to the global liquidity shocks. Secondly, liquidity indicators were the vital determinants of the bonds spreads in the advanced economy and EMBI spreads arising in the any emerging economy. Lastly, the improvement in the market liquidity has a great real effect since the liquidity indicators have a great significant effects and positive effects on the proxy measures in the growth of the opportunities in the various countries across the world.

Viral and Lasse, (2005) also carried out an investigation on link between asset pricing and liquidity risk. They come up with a model which indicated that the securities required of the returns usually depends on the anticipated liquidity and also its covariance of its particular own return, its being liquidity with its own market returns and its own liquidity. The model still illustrated understanding on various channels where the liquidity risk usually affects the asset pricing. In their study, still it was noted there is possibility of the liquidity might tend to disappear from the market and hence it fails to be available when it's being needed, which is the biggest cause of risk among the investors. It is also believed that, amongst the financial liquidity users, greatest challenges are the variability and the uncertainty of the financial liquidity (Ngugi & Kariuki, 2016).

On a study on factors which affecting the institutional transformations with specific interest in commercial banks in Kenya, it was observed that, its requirement to have the deposit reserve funds which usually reduces the available funds which are used in lending out to the borrower and also it usually reduces the firms' insolvency (Ndulu, 2010). This has concurred with the earlier study which was carried out by the Christen, Lyman and Rosenberg (2003) where they noted that, reserve funds are employed in case financial institutions tend to become insolvent Ndulu,(2010) still added that, in countries like Kenya, foretasted reserve fund is being transferred to and is being held by Central Bank of Kenya. This action intends to bind the increase on the cost of capital and liquidity constraints to Non-listed Commercial Bank.

Higher bids in a banking sector usually reveals higher risks in the liquidity premium, if frictions exist between the interbank markets and the banks are being the risk averse. However, high spread usually indicates high liquidity risk. Therefore, this type of measure in a funding liquidity risk can be the only proxy. It usually happens when the bidding behaviors are being influenced by other various factors. Ewerhart *et al,* (2000) considered a model with frictionless interbank markets where the values for collaterals were used for OMOs and the secondary market used to differ. This tends to induces banks in order to submit bids which are usually being higher than the marginal rate during the OMO. It was also indicated that, at the year-ends, banks are used in engaging window-dressing, in order to establish the favorable end of year balances in their statements of financial position Bindseil *et al*, (2003). These were trends to be always holding during the other reporting times. These seasonality effects are usually unrelated to liquidity risk since they are driven by the bank managers' desire in order to signal specific balance sheet to market rather than by using reaction on the funding pressures (Drehmann & Nikolaou, 2009)

5. CONCEPTUAL FRAMEWORK

From literature review, this study has come up with the following conceptual framework model in order to understand issues regarding liquidity risk premium and the loan performance. Independent variable was studied on the term of Liquidity risk premium was studied in Amount of loan issued, Cash balance with CBK The dependent variable loan performance will be studied in terms of; loan contracts incomes and provision for non-performing loan.
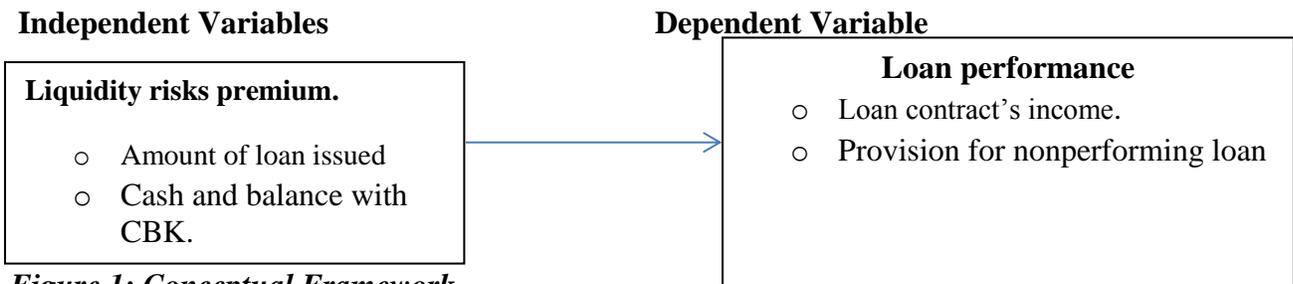
Independent Variables   **Dependent Variable**

Liquidity risks premium. o Amount of loan issued o Cash and balance with CBK.	→	**Loan performance** o Loan contract's income. o Provision for nonperforming loan

Figure 1: Conceptual Framework

6. RESEARCH METHODOLOGY

Based on the purpose of a research, research design is usually the blueprint of conducting a research study. It usually guides the study relied on in the course of the research. Specifically, study will adopt descriptive research design. Descriptive design primarily aims at providing precise and valid representation of the factors that are relevant and related to the research questions or objectives (Kothari, 2008). This design was appropriate in determining the correlation that exists between, interest rates spread and performance of loan of non-listed banks in Kenya. Secondary research was conducted using data Collection template. Secondary data was collected from supervision reports of CBK, non-listed commercial banks financial statements, macro-economic indicators, audited financial statements and the Kenya National Bureau of Statistics (KNBS) published reports in order to meet objectives of study. Secondary research helped in obtaining information on how interest rates spread affects loan performance of non-listed commercial banks.

Zikmund, Babin, Carr and Griffin, Zikmund (2010) described population (universe) as a complete group of people, sales territories, stores, or college students which share common set of characteristics. Beck and Polit (2003) defined the term population as the aggregate or totality of those conforming to a set of specifications. CBK (2016) identified the total number of non-listed commercial banks licensed to operate in Kenya as thirty one in number. In this study, there is only one type of population, target population. Target population was all non-listed commercial banks in Kenya. Population was small and hence leading to the use of census study. All Thirty one (31) non-listed commercial banks acted as units of analysis and observation which was used by the study in the analysis. A list containing all sampling units is known as sampling frame (Kothari, 2004). The study will establish effects of interest rate spread on the loan performance of all non-listed commercial banks in Kenya. Census sampling was used in order to collection information from all non-listed commercial banks in Kenya. Census study occurred since the entire population was very small and thus reasonable to include the entire population. The researcher studied all thirty one non-listed commercial banks in Kenya since a conclusive and whole representative analysis was arrived at in the end.

The study obtained secondary data by the use of data Collection template from CBK supervision reports including published non-listed commercial banks financial statements, banks audited

financial statements and Kenya National Bureau of Statistics (KNBS) reports and review of related written literature from different authors. Secondary data collections methods helped in guarantying the authenticity of all data collected at the end. Since secondary data was available, primary data was not required and hence questionnaire surveys were not be used: even if they are being valuable methods in collecting wide range of information's and also data from a large numbers of the respondents and are straightforward for them to and easy to carry analysis (Saunders *et al,* 2009). The data collection template was built from; the study objectives in chapter one and Chapter two literature review, objectives and the literature review covered questions on variables such as; Default risk premium, Liquidity risks premium and competition risks. They were used by researcher. The researcher ensured that the data collection template was aligned with the literature review in order to strengthen results in this study. Data collections sources were justified by fact that, the data on loan performance of all non-listed banks was in place in CBK's end of year supervisions reports and in in KNBS by making estimations and statistics. Data was collected starting from the year 2012 to 2016.

Before collection of secondary data from central bank of Kenya supervision reports including the published non-listed commercial banks financial statements, KNBS (Kenya National Bureau of Statistics) reports and review of related written literature by different authors, the researcher sought permission from the School of Business of Kenyatta University. In addition, the consent of the management head CBK & KNBS section from where secondary data was be drawn. The Data Collection Template was be administered on CBK & KNBS through the management of each non-listed commercial banks. The filling of data collection template was carried out by researcher. The collected data was edited and coded ready for analysis. First, descriptive analysis in form of the frequencies, standard deviation, means and percentages were carried out. Descriptive data's analysis enabled presentation of respondents views regarding the study constructs while inferential analysis related the independent variables (default risk premium, liquidity risk premium, and competition risk premium) to the dependent variable (loan performance). This was followed by the inferential analysis in the form of Pearson's correlations. The inferential analyses specifically multiple regression showed the extent to which interest rates spread affects loan performance. Statistical tables were used in presenting the findings.

7. DATA ANALYSIS RESULTS

The inferential statistics involved the use of correlation and multiple linear regression analysis. Before running the regressions, descriptive statistics and correlation analysis were considered. Correlation analysis shows that there is a relationship between the different variables considered in the study. The correlation matrix presented simple bivariate correlations not taking into account other variables that may influence the results.

7.1 Correlation Analysis Results

This study aimed in establishing relationship that existed between liquidity risk premium and the loan performance of non-listed in Kenya. Karl Pearson Correlation analysis was used to achieve this end 95% (.05 sig) confidence level as shown in table below. The correlation analysis enabled the testing of study's hypothesis that liquidity risk premium had significant effects on loan performance of non-listed in Kenya.

Table 1: Correlation Analysis

Factors	2012	2013	2014	2015	2016
Liquidity risks premium	-0.799	-0.122	-0.223	0.146	-0.372

Table 1 shows a consistent strengthening relationship, which is negative for liquidity risk premiums. This shows that, the liquidity risk mitigation relationship is negatively linear with loan performance. This depicts that as banks strategize on enhancing liquidity management, the liquidity risk premium charged highly affect loan uptake, repayment and performance. Kariuki and Ngahu (2016) findings concur as they established that high liquidity risk premium which usually causes disincentive to loan repayment and performance.

Table 2: Correlation Results Test of Significance

Factors	LP	DRP	LRP	CRP
Loan Performance (LP)	1			
Liquidity Risk Premium (LRP)	.401**	358**	1	

   a. Dependent Variable: Loan Performance

Findings from table 2, the Hypothesis test results in regard to liquidity risk premium having no relationship with loan performance were undertaken. Results showed positive liner relationship with a fairly statistical significant correlation to loan performance (r = 0.401,) showing that liquidity risk premium had 40.1% positive relationship with loan performance. As such, the study rejects the null hypothesis and accepts the alternative. In all, the study finds out there is significant linear relationship existed between the liquidity risk premium and the loan performance in non-listed commercial banks in Kenya.

7.2 Regression Analysis Results

The study sought to establish the relationship between the liquidity risk premium and loan performance for all non-listed commercial banks in Kenya. Multiple regression analysis was applied using mean score for each variable to determine the effect of independent variables (liquidity risk) and on dependent variable (loan performance). This was performed using the secondary data and the results interpreted according to the R values, R^2 values, the beta values and F ratio at the 95% level of significance. Explanation and interpretation of the findings regarding the expected relationships between liquidity risk premium factors and loan performance are as indicated in table 3 to 5.

Table 3: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.586[a]	.355	.314	1.03351

a. Predictors: (Constant), liquidity risk.

The model summary in Table 3 shows the R value was 0.586 indicating that there was a positive relationship between liquidity risk premium and loan performance in non-listed commercial banks in place in Kenya. R squared (R^2) value of 0.355 showed that 35.5 percent of loan performance in the banks is explained by loan liquidity risk premium factor considered in the study. The remaining 64.5 percent is explained by other factors which were not put into consideration in this study.

Table 4: ANOVA

Model	Sum of Squares	df	Mean Square	F	Sig.
Regression	37.170	3	14.493	9.699	.000[b]
Residual	67.300	63	1.068		
Total	104.471	67			

a. Dependent Variable: Loan Performance

b. [Predictor: Constant), liquidity risk premiums.

The results of ANOVA revealed that the entire model was significant with the F ratio = 9.699 at p value 0.000 < 0.05. This is an indication that the model can be relied upon.

Table 5: Coefficients of Liquidity Risk Premium

Model	Unstandardized Coefficients		Standardized Coefficients		
	B	Std. Error	Beta	t	Sig.
(Constant)	.663	1.215		.546	1.00
Liquidity Risk Premium	.445	.096	.474	4.620	.011

b. Dependent Variable: Loan Performance

The results in table 5 show a beta coefficients of the resulting model indicate that liquidity risk had positive effect on loan performance with slopes of β1= 0.445. This implies that holding all the other variables constant, loan performance in all non-listed commercial banks in Kenya increase by 0.445 units when liquidity risk premium went up by one unit. The study found out

that there was positive and statistically significant relationship between the liquidity risks in the commercial banks which are non-listed commercial banks in Kenya. Further, the liquidity risk premium factor was found to have positive and statistically significant relationship on loan performance at P value 0.011< 0.05 (liquidity risk premium). Njeri, Ombui and Kagiri (2014) noted that small liquidity risk premium (spread) assists the banking institutions in remaining competitive and hence it's usually being encouraged. Thus a high increase in the liquidity risk premium affects the loan uptake and liquidity positions of the banks.

8. SUMMARY OF FINDINGS

The study aimed at establishing the effect of liquidity risk premium on loan performance in non-listed commercial banks in Kenya. Specifically, the study sought to establish the influence of liquidity risks on loan performance. Secondary data collected provided the basis for analysis. The loan performance was observed to be affected by liquidity risk premium. When based on provisions for non-performing loans and loan contractual income was found to affect loan performance. In the case of liquidity risk premium, the study established a significant relationship to loan performance. Descriptive statistics showed a strong influence of amount of loan issued based on the banks' liquidity cushion on loan performance. When the banks have to maintain a certain liquidity level based on CBK limits and/or institutional financial management and cash flow policies, affecting loan performance. As inferential statistics have shown, an increase in liquidity risk premium affects loan performance in the non-listed commercial banks in Kenya. There was a low influence of reserve funds in CBK, thus lowly affecting loan performance of non-listed commercial banks in Kenya.

9. CONCLUSION

Liquidity risk premium is a cost on loans borrowed by non-listed banks customers and on the other hand, loan contracts income to the banks is a crucial determinant of profitability, sustainability and growth of the non-listed commercial banks. This study however, aimed in establishing the effects of the liquidity risk premium on loan performance in Kenya non-listed commercial banks. Results from data collected indicated that there was a linier significant relationship between liquidity risk premium and loan performance in non-listed commercial banks provisions for non-performing loans, amount of loan issued was strong predictors of liquidity risk premium affecting loan performance. However regulatory requirements such as statutory reserve requirements or regulated minimum deposit rates lowly contributed to loan performance. The study thus concludes that loan liquidity risk premium significantly affected the loan performance in Kenya non-listed commercial banks.

10. Recommendations

The study, based on the findings and conclusions recommends that, non-listed commercial banks should engage experts in economics to enable prediction of changes in the economy and CBK policies thus management of liquidity risk premium that do not affect borrower behavior and lead to increase in default rates. The banks should work out on income source diversification to cushion against over reliance on loan interest income, thus reducing impact on liquidity risk premium and encourage borrowing. The banks should also strengthen cash management systems that reduce liquidity imbalance and ensure sufficient reserves in the institution and with central bank of Kenya. Commercial banks should apply various rigorous policies on the loan advances in order to ensure loans are being awarded to all those with ability to repay and in order mitigate the moral hazards such as insider lending and information asymmetry. The study further

recommends that other factors that influence the liquidity risk premium of commercial banks be used in order to ensure that non-listed commercial banks set optimal liquidity risk premium and thus improve their performance

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