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Relationship between Financial Services, Central Bank Regulations and Agency Banking Performance in Kenya

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Abstract

The global business environment is undergoing significant changes marked by intense competition, and the banking industry is no exception. In response to these dynamics, commercial banks are increasingly embracing innovation, with agency banking emerging as a notable addition. This study explores the determinants of financial performance in agency banking in Kenya. The theoretical framework guiding this investigation incorporates agency theory and competitive advantage theory. The study identifies key influencers of agency banking performance, such as financial service accessibility, transaction costs, market share, and compliance with Central Bank regulations. Financial service accessibility is crucial in fostering financial inclusion, especially in rural areas, and has positively impacted deposit levels. Transaction costs have significantly decreased, enhancing the viability of small-scale transactions and serving the previously unbanked. Market share is explored as a determinant of profitability, with a larger market share providing institutions more control over services and pricing. The study also emphasizes the role of Central Bank regulations in ensuring the safety of financial transactions conducted through agency banking. This study aims to contribute to the understanding of the determinants of financial performance in agency banking in Kenya, offering insights that can inform strategic decision-making in the dynamic landscape of modern banking.

Keywords: Financial services accessibility, Transaction costs, Market share, CBK Regulations, Agency Banking Performance

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1. Introduction

The business environment is drastically changing globally, and it is characterized by high competition among players. The banking industry has not been left out. This has greatly contributed to commercial banks becoming more innovative. The innovation includes ATMs, credit and debit cards, mobile banking, and now agency banking. Agency

banking was first developed in Brazil in 1999 so as to reach those with low incomes and people living in remote areas, as they were believed to be marginalized. They refer to agency banking as a partnership with non-banks, typically retail commercial outlets (Kumar et al., 2006). By 2010, some 170000 agents in Brazil had covered all 5550 municipalities, and nearly 12 million accounts had been opened by the agents over the years. This offered valuable

lessons for countries where banks can contract an agent (McKay, 2011).

Agency banking refers to the services offered by third parties through retail outlets contracted by a financial institution to offer financial services to clients. The owner of the retail outlet conducts the transaction as allowed by the branch teller, allowing the client to deposit cash, withdraw funds, transfer fund bills, and inquire about the balance (Ivatury & Lyman, 2006). Agents are usually equipped with mobile phones, barcode scanners to scan bills for bill payment, PIN pads or biometrics for customer identification, and sometimes personal computers. This makes agency banking more similar to any other remote channel.

In Kenya, agency banking was made legal by the amendment of the Banking Act of 2010 and is governed by prudential guidelines on agent banking issued by CBK, which became operational in May 2010. Later in February 2011, the CBK came up with regulations allowing banks to offer services through agents. As of December 2016, the CBK had authorized 18 commercial banks and 5 microfinance institutions to offer services through third parties. Since 2010, a total of 55901 agents have been contracted, facilitating over 104,193,211 transactions (CBK, 2016). Agents in Kenya include: equity agent of Equity Bank; cop kwa jirani of Cooperative Bank; and KCB mtaani of KCB Bank. Equity Bank has the largest number of customers currently. Agency banking is now on the rise and has become the most preferred delivery channel, outdoing other former channels like ATMs and over-the-counter branch transactions. It involves three parties: the customer, the agent, and the bank. Both the agent and the customer should authenticate themselves well before initiating any transaction; they should have a unique personal card plus a secret PIN. The bank should come up with a unique secret key for its clients for proper identification before each transaction (Arakji & Lang, 2008). Before agents are authorized to offer selected products, they go through application, vetting, and approval. Agents should also be equipped with the necessary skills and equipment. Some activities involved include cash withdrawals, bill payments, cash deposits, collecting bank correspondence, and mail and transfer of balance inquiries. However, some activities are prohibited in Kenya, and when the agency continues to perform those activities, their contract may be terminated. These activities include carrying out agency banking business when the agent is no longer a going concern, charging customers any fees, offering own banking services apart from those of the sponsoring bank, offering anti-money laundering services, and offering advances and loans.

Financial performance is a conclusion drawn from the financial analysis of a firm. Financial analysis is the selection, evaluation, and interpretation of financial data, along with other pertinent information, which is useful in

investment and financial decision-making. Financial analysis may be used to evaluate issues such as employee performance, the efficiency of operations, credit policies, potential investments, and the creditworthiness of borrowers, among other things (Drake, 2008). Financial performance measures how well a firm utilizes its assets to generate revenue over a given period of time and can be used to compare similar firms across the same industry or to compare industries or sectors in aggregation (Hales, 2005). Financial performance is shown through the level of profitability, liquidity, and solvency as determined by the market share of the firm, CBK regulations, the availability and accessibility of agents, and the transaction cost. In addition, financial performance has used methods such as financial ratio analysis, benchmarking, measuring performance against budget, or a combination of these (Barnet et al., 2006).

Initially, access to banks was not an easy thing for a common man, as banking mostly targeted working-class people with more disposable income. To access more customers, commercial banks started to allow other commercial outlets to act in their capacity. The government, through the CBK, embarked on a knowledge exchange for agency banking models that could work in Kenya. In pursuance of Vision 2030, the financial services sector was identified as key in mobilizing funds to implement the Vision 2030 flagship projects, hence the adoption of the Financial Act (2010) to facilitate the use of third parties to provide services.

Several studies have been conducted on various aspects of the banking sector. For instance, Emoru (2012) looked at factors influencing the growth of agency banking in the banking industry. In a case study of equity bank Mombasa, he found that a decrease in market share and an increase in competition had a higher influence on the growth of agency banking. Aduda, (2013) also studied the effects of agency banking on financial inclusion in Kenya. They established that customers with large transactions are unlikely to transact with bank agents because of security risks. Even after this research, it is not clear whether the adoption of agency banking has led to improved financial performance. Again, most of the studies were done abroad, and according to Aosa (1992), it's important to take into account the differences abroad and locally instead of importing results from other countries in order to understand the problem better. This study intends to be guided by the findings of previous research undertaken abroad in an effort to find out the determinants of financial performance in agency banking in Kenya.

2. Theoretical Review

A theory is a statement that explains a phenomenon. The theoretical framework will guide the researcher in determining what kinds of variables are to be measured and what statistical relationships to look for in the context of the

problems under study. There are several theories that discuss agency banking and its relationship to financial performance. This study will focus on agency theory and competitive advantage.

2.1. Agency Theory

This theory explains the relationship between principals and agents. This theory was first developed by scholars [Stephen Ross in 1972](#) and [Barly Mentic in 1973](#). Ross, in his paper, studied agency in terms of compensation contracting, while Mentic, in his paper on fiduciary rationality and public policy, developed the institutional theory of agency, which is now a common insight that institutes form around agency in response to the essential imperfection of agency relationships. Financial institutions have greatly benefited from the rapid growth of agency outlets, which have helped reduce costs on expansion and staffing, but it is important that the bank has a clear strategic rationale for each agent it sets up to drive decision-making, ensure appropriate agent setup and channel support, and permit subsequent performance evaluation against the original strategic intent ([Siedek, 2008](#)).

Banking agents help in reducing the congestion of customers at financial institutions' branches, which are more often crowded, hence providing a complementary option. Financial institutions have attached great benefits to their agents as they help in accessing more clients, especially in developing markets where there is a large population and in rural areas where access to the institution's branches may be limited by some constraints. Building branches in rural areas is often prohibitively expensive for financial institutions since transaction numbers and volumes do not cover the cost of setting up a fully-fledged branch. In such remote environments, banking agents assist in lowering setup and running costs, playing a vital role in offering low-income people access to a range of financial services just as high-income earners do. Also, low-income clients often feel more comfortable banking at their local store than walking into a marble branch ([Siedek, 2008](#)). Financial institutions in agent businesses generate more profits and higher revenues than those that use only branch networks. Banks can benefit from lower running costs as agent banking requires less paper work, fewer staff, and fewer physical branches ([Cheng et al., 2006](#)).

Agent Banking has proved to be successful as it has gained a competitive advantage for financial institutions that have adopted it; it is able to offer a variety of products just as the branches do; a wider market has also been achieved; and resources are now more utilized than initially. It is very important for strategists to understand the financial industry in order to identify competitive success factors that are more important than others. Due to changes in driving forces and competitive conditions, the key success factors are not similar in every industry. [CBK, \(2016\)](#) states that there are many technological and operational challenges in employing a successful agent banking strategy. Technology should be

embraced in order to create a good rapport between banks and their customers through existing local retail outlets. For agent banking to be more effective, it requires a generally good infrastructure in terms of road networks, communication, and information technology. Considerations should be made for areas that are hard to reach due to poor fixed infrastructure and a poor transport system. Key issues to note are technology, competitive rates, product innovation, brand image, size of the company, location, and convenience.

2.2. Porter's Competitive Advantage Theory

A competitive advantage is an attribute that allows a firm to outperform its competitors. It needs a financial institution to adopt a competitive strategy; this means developing a wide formula on how the business is going to compete advantageously, the kind of goals and objectives the business has, and what policies would be needed to carry out these goals ([Porter, 1980](#)). Porter defined competitive strategy as a combination of the goals for which the firm is working and the policies it is using to get there.

Competitive strategy is concerned with what the company does and how it actually positions itself commercially and conducts the competitive burden through unique ways of competing. This can be through offering clients better and greater value products, high quality interests, lower prices, and many other ways. It aims at achieving an advantage and establishing a profitable and sustainable position in the changing environment through its own configuration of resources and competence, with the aim of fulfilling stakeholders' expectations. In the banking industry, one way of gaining a competitive advantage is through the use of agency banking. This will enable a financial institution to access more customers and, hence, make more returns, outperforming its competitors. This will contribute to brand loyalty; customers will prefer one's products and services over another. [Barney, \(1991\)](#) also puts more emphasis on the fact that competitive advantage is the basis for superior performance.

It's critical to understand the components of competitive advantage for the finance managers who take on the responsibility of ensuring the long-term survival and success of the firm. Analysing the advantage enables the firm to fully maximize its potential and sustainability. This theory is relevant as superior financial performance achieved through competitive advantage will ensure market leadership. The competitive advantage is gained as finances are easily accessible to clients and the institution is operating at a low transaction cost compared to other institutions. In addition, the studies provide an understanding that business strategies like agency banking will have a profound effect on generating competitive advantage.

3. Agency Banking Performance influencers

This section describes the various principles that

influence the agency banking performance in Kenya. Some of the aspects discussed are financial services, market share and CBK Regulations.

3.1. Financial Service Accessibility

Financial inclusion has been low, and this is because of the long-distance customers, especially in rural areas. They have to walk over long distances to access financial services or use large amounts of transport, making banking more expensive. Expansion of banks is usually hindered by the high startup cost of opening a branch, and in many areas, due to the low economic status of the people living in these areas, banks have opted to use agents to increase the provision of their services. These agents influence deposits as they are also influenced by the level of deposits in a certain area. This is because banks expand their facilities and service provision by considering factors such as competition, deposit levels, the number of customers, the income of their clients, and the level of infrastructure. By creating greater access to financial services, agency banking has in turn increased the level of deposits for banks. This safer and cheaper financial service has led to banks recording more deposits than before. Equity banks attribute two-thirds of their income to agency banking as a result of deposits and the remainder to withdrawals (Bankelele, 2015). Most customers are more comfortable using agents compared to banking halls. Access to financial services is essential for sustainable economic growth and development. Financial inclusion encourages low-income earners and marginalized sectors of society to actively participate in the economy, which leads to increasing employment and decreasing poverty levels (Bold, 2011).

Agency banking has increased convenience in banking for customers, especially those residing in rural areas. Agents are more flexible since they don't have fixed operating hours, as it depends on an individual operating the agent, unlike banks, which are governed by a rigid set of rules on opening and closing hours. Some agents open as early as 6 a.m. and close as late as 7 p.m., depending on the location and convenience of customers. Through agency banking, customers can deposit and withdraw conveniently because of the short distance since a lot of travel costs have been cut. In addition, agency banking is deemed more accessible for illiterates as there is more and more close interaction with the agent operator and the very poor, who might not be comfortable in branches. Customers are now able to conserve the time they had to travel to a bank branch and the time they had to queue to be served (Mwangi & Wanyoike, 2012). When demand for these services is at its peak, like during school opening times, month-ends, or festive seasons, waiting in long lines may lead to customer dissatisfaction. Customers in today's Kenyan market will opt to go to competitors; this will reduce revenues for the former, therefore taking away the business (Jaldesa, 2015). This has been cabbed by the use of agents, making customers more loyal to their specific banks. The availability

of credit by households, particularly among low-income individuals, has been a subject of significant concern for a considerable period of time. In order to tackle this concern effectively, digital credit has emerged as a highly useful tool, providing a solution to a great extent (Kamau, 2021). Additionally, agency banking plays a crucial role in enhancing the accessibility of financial services, further contributing to the overall improvement of the situation.

3.2. Transaction Costs

Transaction costs related to financial services have reduced considerably since agency banking is targeted towards financial inclusion. The people targeted are often customers with low balances but with frequent transactions. Banking agents provide a lower-cost channel for cash transactions, as reflected by the low transaction charges. Transaction charges are usually lower on deposit than on withdrawal, leading to additional revenue deposits. In fact, in most cases, customers are given the opportunity to deposit freely. as banks aim to recover more of their costs on deposits than withdrawals. This increases the volume of deposits into the bank, making money available for loans and other investment opportunities. Agent banking systems are most cost-effective for transactional accounts with low balances and frequent transactions (Veniard, 2010).

The minimum deposit amounts for opening bank accounts had previously led to low-income customers shying away from banking. The amount of money expended to serve a poor customer with a small balance and conduct small transactions is too great to make the accounts viable (Veniard, 2010). However, through agency banking, the delivery of services has moved from the traditional way towards more efficient and customer-friendly services.

Customers' banking through agents will benefit from lower transaction costs as services are now closer to home and there is no need to travel all the way to a bank. Agents will operate for longer hours, resulting in minimal queues as compared to branches. There have always been hindrances for the poor who may need to access financial services, e.g., low levels of literacy, gender, and age, low and irregular income and geographical location, and institutional restrictions like minimum account balances. Some major barriers financial service providers experience when expanding appropriate services to poor people are the cost of providing those services and finding the regulatory space to innovate (Afande & Mbugua, 2015). These poor people usually do small transactions, but transaction costs do not vary in direct proportion to a transaction's size. This has helped serve the poor with small-value services. Access to financial services, insurance, deposits, and savings accounts is crucial to allowing poor people to invest in their homes and small and microbusinesses. Initially, there was a high cost of transaction when delivering small-scale financial services across large geographic areas due to networking constraints such as a lack of roads, poor communication means, a lack of proper and effective identification systems,

and a lack of information asymmetry amongst both providers and consumers. All these have now been surpassed by the use of agents. On the other hand, with the adoption of agency banking, Systems are easily installed on mobile phones to allow the agents to conduct transactions, and data is sent automatically to the central processing center, where the information is captured and data reconciled, reducing costs for the bank. Agency banking systems have been found to be far cheaper to operate than branches for two reasons. First, agent banking minimizes fixed costs by leveraging existing retail outlets and reducing the need for financial service providers to invest in their own infrastructure (Veniard, 2010).

3.3. Market Share

Market share is the portion of the market through total sales that is controlled by a particular company over a stipulated period of time. It's calculated by looking at the ratio of the company's sales over the period to the total sales of the industry over the same period. Market share is highly linked with profits made by the company, and thus many firms seek to increase their sales as compared to their competitors as they access a large number of customers. Increased market share warrants a company to achieve a greater degree in its operations and improve profitability. Companies try to grow the size of the total market by appealing to larger demographics, lowering prices, or through advertising. Additionally, market share is seen as a determinant of profit, as it is assumed that through their great efficiency, firms will penetrate a larger market and thus increase their profitability. A greater market share gives a financial institution more power in determining the services it offers to customers and the cost of those services too. (Heggstad & Mingo, 1976) found that the greater the market share, the greater is an institution's control over its prices and the services it offers.

The financial performance of non-deposit taking SACCOs is influenced by the levels of loanable funds and the skills possessed by the board of directors (Wanyonyi et al., 2019). The performance of Agency banking may be improved by gaining access to markets through loanable funds. Smirlock (1985) also had no doubt that market share influences profitability and that market growth creates many opportunities for financial institutions and thus generates more profits. His findings were evident: market growth had a significant direct relationship with levels of profit.

3.4. Central Bank of Kenya Regulations

Policymakers around the world undertake to encourage the provision of financial and non-financial services to the rural poor who are either unbanked at all or underbanked without risking the safety and soundness of the banking system. They put in place regulations that enable the spread of low-cost banking through third parties, agents, while at the same time protecting consumers against fraud (CGAP 2010). It becomes a challenge, though, when regulating and

controlling these agents, who play a vital role in receiving and dispensing cash on behalf of the financial provider (CGAP, 2010). Only licensed deposit-taking financial institutions have the right to conduct agency banking. On the other hand, all customers of financial institutions undertaking agency banking activities must have unique identifications (World Bank, 2010). Identifications include IDs, PINS, passwords, secret codes, and secret messages while performing any transaction requiring identification.

According to the central bank, all financial institutions and their agents must comply with the Anti-Money Laundering Act (2008) as well as the international standards set by the Financial Action Task Force (World Bank, 2010). efficient, and through due diligence, procedures should be put in place to mitigate risks. Agents should follow the policies and procedures as speculated by the institutions they operate under. These procedures specify the duties and responsibilities of the institution with regard to agent management (CBK, 2016). The central bank also requires that the institution supervise and monitor the activities of their agents for accurate statistics on the number and volume of transactions carried out by each agent. Supervision may include periodic physical visits by the institution's staff. Other requirements by the central bank include the publication of agents and their locations; the public should also be made aware of the existence of the agents. The CBK has the power to get information from agents when it is required, carry out impromptu visits, and even direct the termination of agents as it deems fit. The agents have good reputations, no prior criminal records, and no history of financial trouble or insolvency. Utilizing government spending as a fiscal policy tool positively impacts the performance of commercial banks, as suggested by Orod (2022). Additionally, the regulatory framework provided by CBK has the potential to improve the effectiveness of agency banking operations.

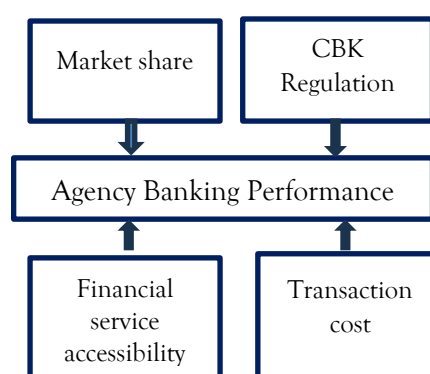


Fig 1: Agency Banking Performance influencers

3.5. Agency Banking Performance

The findings of the investigation conducted by Kustina et al. (2019) revealed that the implementation of branchless banking application did not yield a statistically significant impact on the quantity of third-party funds within the

banking industry of Indonesia. Conversely, the magnitude of third-party funds facilitated through the branchless banking application had a noteworthy influence on the profitability of banking enterprises in the Indonesian context. The study conducted by [Margaret and Ruth \(2019\)](#) divulged the outcomes which indicated an augmentation in the monthly business turnover for agents subsequent to enrolling in agency banking. Furthermore, the study advocates that other aspiring entrepreneurs should contemplate becoming bank agents, while the current agents should amplify their financial resources in order to obtain the maximum benefits from agency banking.

The investigation concludes that the implementation of mobile technology yields a favourable impact on the loan processes and procedures of DT SACCOs ([Millan et al., 2023](#)). The performance of agency banking is enhanced through the adoption of novel technology. In the dynamic financial landscape of Kenya, agency banking has emerged as a pivotal force, catalyzing profound changes in the accessibility and delivery of financial services. As a response to the challenges of reaching unbanked and underserved populations, the model has demonstrated commendable performance, redefining the traditional contours of banking. Central to the success of agency banking is its expansive reach, unfurling financial inclusion to corners of the country previously untouched by conventional banking infrastructure. This feat is accomplished through an ever-expanding network of agents—small businesses and individuals who act as intermediaries, bridging the gap between financial institutions and communities. In remote and rural areas, these agents provide a crucial link, enabling locals to deposit, withdraw, and transfer funds without the necessity of a physical bank branch.

The growth of the agent network is not merely quantitative; it reflects a qualitative transformation in the range of services offered. Beyond basic transactions, agency banking agents have become conduits for an array of financial services, including bill payments, mobile money transactions, and even the disbursement of loans. This diversification contributes not only to the convenience of users but also to the agents' roles as community-centric financial hubs. Technological integration has been a linchpin in the success of agency banking. The seamlessness with which mobile banking platforms and digital payment systems have been integrated into the model has amplified the efficiency and accessibility of financial transactions. This technological synergy not only meets the demands of the digital age but also enhances the resilience and adaptability of the financial ecosystem.

4. Summary and Conclusion

In the rapidly evolving global business environment marked by intense competition, the banking industry,

including Kenya, has witnessed significant changes, prompting commercial banks to embrace innovation for staying competitive. Among the innovations is agency banking, a model first developed in Brazil in 1999 to reach individuals with low incomes and those in remote areas. Agency banking involves partnerships with non-banks, typically retail commercial outlets, acting as intermediaries to provide financial services. In Kenya, agency banking became legal in 2010, governed by prudential guidelines issued by the [Central Bank of Kenya \(CBK\)](#). By December 2016, 18 commercial banks and 5 microfinance institutions had been authorized, contracting over 55,901 agents and facilitating more than 104 million transactions. Notable agents in Kenya include Equity Bank, Cooperative Bank, and KCB Bank. The model involves three parties: the customer, the agent, and the bank, with authentication processes required for transactions.

Financial performance in the context of agency banking is assessed through various factors, including profitability, liquidity, and solvency. Financial analysis techniques such as ratio analysis, benchmarking, and performance measurement against budgets are employed. The study recognizes the transformative impact of agency banking, emphasizing the importance of understanding its determinants of financial performance. The literature review delves into theories relevant to agency banking, with a focus on agency theory and competitive advantage. Agency theory explores the relationship between principals and agents, emphasizing the need for a clear strategic rationale for each agent. Competitive advantage, as outlined by Porter, highlights the importance of positioning and unique strategies for outperforming competitors.

Influencing factors on agency banking performance include financial service accessibility, transaction costs, market share, and adherence to CBK regulations. The model has increased financial inclusion, reduced transaction costs, and positively impacted market share. Regulatory frameworks ensure compliance with anti-money laundering laws and customer identification, fostering a secure operating environment. The performance findings of the investigation by [Kustina et al. \(2019\)](#) in Indonesia and [Margaret and Ruth \(2019\)](#) in Kenya underscore the positive impact of agency banking on profitability and business turnover for agents.

In summary, agency banking in Kenya has emerged as a dynamic and transformative force, expanding financial inclusion, reducing transaction costs, and redefining traditional banking paradigms. The success is attributed to technological integration, regulatory support, and the collaborative efforts of banks and agents. Ongoing research and analysis are essential for understanding the evolving landscape and ensuring sustainable financial performance in the agency banking sector.

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