

Abstract

Purpose

The study seeks to evaluate the effect of capital adequacy and competition on the liquidity creation of Kenyan commercial banks.

Design/methodology/approach

Unbalanced panel data from 36 Kenyan commercial banks with licenses from 2001 to 2020 is used in the study. The generalized method of moments (GMM), a two-step system, is employed in the investigation. To increase the robustness and prevent erroneous findings, serial correlation tests and instrumental validity analyses are used. The methodology developed by Berger and Bouwman (2009) is used to estimate the commercial banks' levels of liquidity creation.

Findings

The study supports the financial fragility-crowding out hypothesis by finding a significant negative effect of capital adequacy on the liquidity creation of commercial banks. The research also identifies a significant inverse relationship between competition and liquidity creation, depicting competition's value-destroying effect.

Practical implications

A trade-off exists between capital adequacy and liquidity creation, which must be carefully evaluated as changes in capital requirements are considered. The value-destroying effect of competition on liquidity creation presents a case for policy geared toward consolidating banks' operations through possible mergers and acquisitions.

Originality/value

To the best of the authors' knowledge, this is the first study to empirically offer evidence concurrently on the effect of competition and capital adequacy on the liquidity creation of commercial banks in a developing economy such as Kenya. Additionally, the authors employ a novel measure of competition at the firm level.