INTERNATIONAL JOURNAL OF RESEARCH AND INNOVATION IN SOCIAL SCIENCE (IJRISS)
ISSN No. 2454-6186 | DOI: 10.47772/IJRISS |Volume VII Issue XII December 2023

Trading in Foreign Exchange and its Influence on Trade Finance Income among Commercial Banks in Kenya

Catherine Khalayi Busaule, MBA[1]; Prof. Emmanuel Awuor[2]

[1]Senior Business Development Manager KCB Group, Kenya.

[2]School of Management and Leadership Management University of Africa, Nairobi.

DOI: https://dx.doi.org/10.47772/IJRISS.2023.7012160

Received: 10 August 2023; Accepted: 21 December 2023; Published: 22 January 2024

ABSTRACT

This study sought to determine the effect of trading in foreign exchange on trade finance income among commercial banks in Kenya. Hence, the unit of analysis for the research were all the registered and fully operational 39 commercial banks in Kenya. The participants for the study were each trade finance manager for the 39 commercial banks. Data was collected using structured questionnaire which were distributed through the emails and followed by telephone calls from the researcher in order to expedite the response process. These resulted in a response rate of 77%, which is considered good enough for such a study. The research adopted a descriptive research design with data being analysed using the statistical package for social sciences (SPSS) and the results represented as percentages, mean, median and variances. The study's inferential analysis, which included correlation analysis and regression analysis, led to the conclusion that there is a significant correlation between trading in foreign exchange and trade finance income. Based on these conclusions, commercial banks are advised to concentrate on trade financing and trade facilitation since foreign exchange will be required at the time that settlement must be carried out. Banks should be aware that fees gained from trading in foreign exchange are in addition to whatever fees they may have earned from other trade finance activities

Keywords: Foreign Exchange Rate Market, Trade Finance Income

BACKGROUND OF THE STUDY

Foreign exchange is necessary in settlement of trade transactions globally given the inherent nature of trade where suppliers and buyers may be located in different jurisdictions operating with different currencies. Any changes in the foreign exchange markets affect banks since they are key players in foreign exchange transactions (Afza & Alam, 2016). The banking sector in any economy is an important player in the provision of finance and foreign exchange services. Thus, banks are a key part of the foreign exchange market and the monetary system in any economy by providing the transmission and exchange of domestic and international currency (Pitia & Lado, 2016).

Review of foreign exchange services offered by banks indicate that the financial institutions in a bid to make profits focus on change in rates (Hossin, 2020). Thus, banks can gain revenue from foreign exchange transactions by taking advantage of volatility in exchange rates. The variations in these rates lead to speculation among investors as they expect that the exchange rate will improve. Focusing on the maturity of the currency denominations of the economy's liabilities and assets, extremely volatile exchange rate can lead to low cash at hand and lead to high impact on balance sheet activities (Babazadeh & Farrokhnejad, 2016).

During the study period, the forex trading variables of spot trading, forwards, swaps, options, firm size, liquidity ratio, and capital adequacy, according to Nyokabi (2018), showed a consistent change. As a result, both high and low rates were seen over the research period. As a result, the study discovered that forex trading features in Kenya were inconsistent for a variety of reasons. As a result, the performance of the banks varied according to the season and the time of year. The study also found that the return on assets (ROA) in the banking sector was not significantly and favorably impacted by features of currency trading.

Manyo, Sabina and Ugochukwu (2016) studied the effect of foreign exchange on the performance of Nigerian Banks. The study used a regression model based on pooled panel data and estimation focused on ordinary least square (OLS) method. According to the findings, income from foreign exchange unfavourably impacted the banks' financial performance. The conclusion made was that the banks sampled did not focus too much on the revenue from foreign exchange to remain relevant and profitable in their operations.

Tight trading spreads are the standard for negotiations between banks in the interbank market, according to Luca (2007), with only a few separating the bid and ask rates for a currency in the volatile world of currency trading, where daily trading volumes surpass $5 trillion. Banks offer exceptionally competitive exchange rates to their big corporate, institutional, and government clients, with low spreads. However, when it comes to retail clientele, it's a very different situation. In the retail market, the spread between the bid and ask price for a currency is normally extremely wide, and it can also differ dramatically from one foreign exchange broker to the next (Luca, 2007).

Burnside et al (2006) define the bid-ask spread as the difference between the price at which a dealer will buy a currency and the price at which the dealer will sell it. In other words, the bid price is the amount a dealer is ready to pay or bid for a currency, whereas the ask price is the amount a dealer desires. Foreign exchange bureaus and local banks such as Kenya Commercial Bank (KCB) and Equity make a living by charging pricing spreads of up to four shillings per dollar above the daily mean exchange rate. The practice, which has picked up steam in recent months, is exacerbating the impact of the shilling's depreciation against major international currencies, with catastrophic ramifications for the economy (Warutere, 2005).

A "price quotation," sometimes known as a "straight currency quote," expresses the cost of a unit of foreign currency in terms of the local currency. The opposite of a direct currency quote is an indirect currency quote, also referred to as a "volume quotation." It indicates the ratio of foreign currency to local currency (Larue, et al 2010). The majority of currencies are quoted in direct quotation form, Chen et al. (2012) contend, such as USD/JPY and USD/CAD, which denote the quantity of Japanese yen and Canadian dollars, respectively, per one US dollar, because the US dollar is the most widely traded currency in foreign exchange markets. The currency to the left of the slash is the base currency, and the currency to the right of the slash is the counter currency or quoted currency.

Commonwealth currencies, such as the British pound and Australian dollar, as well as the euro, are frequently expressed in indirect terms, such as GBP/USD and EUR/USD, which denote the number of US dollars per one British pound and Euro, respectively. According to Offer (2013), Kenyan banks' foreign exchange bureaus have insisted on buying money at the lowest possible price and selling to the highest possible bidder. The revelations of speculation on current volatility come as the Central Bank of Kenya (CBK) recently tried to restrict the operations of foreign exchange bureaus in an effort to control speculation in the foreign currency market. The CBK has proposed measures such as increasing the degree of capitalisation of the organisations and imposing a daily minimum amount below which a foreign exchange bureau cannot function (Ndung'u, Machuki, & Murerwa, 2014). This study sought to determine the effect of trading in foreign exchange on trade finance income among commercial banks in Kenya.

RESEARCH METHODOLOGY

The study adopted a positivist research philosophy in which the researcher was seeking for information using a closed ended structured questionnaire. The research design adopted for the study was descriptive since it was able to present the findings and results of the study using means, standard deviations and modes (Saunders, Lewis & Thornhill, 2019; Kothari, 2014). This approach was ideal for the study since it was appropriate for analysis of the likert scale questionnaire design used (Creswell, 2018). The study used as unit of analysis all the 39 commercial banks registered and fully functional in Kenya as at the time of conducting this study. The banks forming the target population (unit of analysis) were categorized into as: Tier 1; Tier 2 ; and Tier 3

Table 1.0: Target population and Sampling Frame

Category	**Trade finance management employees**	**Percent**
Tier 1 Banks	8	20
Tier 2 Banks	10	26
Tier 3 Banks	21	54
Total	**39**	**100**

Source: CBK Bank supervision annual report (2020)

The research made use of a census sampling frame by taking a trade finance manager from each of the banks as a respondent. Data was analysed quantitatively using statistical package for social sciences (SPSS) and the results presented in form of percentages, means, median and standard deviations. It is also to be noted that the study observed all the ethical protocols required in research, such as: informed consent, voluntary participation, confidentiality, privacy and anonymity (Mugenda and Mugenda, 2019; Cooper and Shindler, 2018)

LITERATURE REVIEW

Spot Foreign Exchange Rate and Trade Finance Income

The exchange rate is crucial to trade financing. For instance, it is impossible to create a balance of commerce when the exchange rate is constantly shifting. Volatile exchange rates make it difficult to do business and shift money around. Foreign investors are less likely to invest in the markets of countries with high foreign currency volatility because they lack faith in those nations. As a result, these nations' economies are growing slowly (Heckman & Singer, 2017). The macroeconomic policies that are intended to stabilize the economy have an impact on the sustained and rapid economic growth of any country. The exchange rate is one of the tools used to manage an economy and keep prices stable. When it comes to spending and choosing investments, this rate is a deciding factor (Kawai, 2017).

Furthermore, the spot market is an important part of the foreign currency market. The spot market is used to facilitate foreign exchange transactions that require immediate currency exchange. The spot exchange rate or spot rate is the current exchange rate at which one currency can be exchanged for another currency instantaneously. When American businesses buy international commodities or acquire a company in another country, or when American investors invest in overseas assets, the spot market is routinely used to obtain the currency they require (Heckman & Singer, 2017).

According to a review by Kawai (1984) on the impact of forward exchange on spot rate volatility under risk and rational expectations, forward trading tends to stabilize spot exchange rates if trade disturbances are the market's main random and stochastic elements, while it exacerbates spot-rate volatility if interest rate differential disturbances are the main random and stochastic components. Singh (2013) looked on the relationship between Kenyan commercial banks' financial health and foreign exchange trading. Finding out how foreign exchange trading impacts the financial performance of Kenyan commercial banks was the goal of the study. Currency swaps, futures, and spots are all associated with the financial success of commercial banks, the paper claims.

Forward Foreign Exchange Rate Market and Trade Finance Income

A forward exchange rate is a price that is fixed now for a currency to be given to a buyer on a specified future date. (Cambridge Dictionary). Manyo et al. (2016) researched on the effect of foreign exchange markets on the performance of Nigerian Banks. The study used annual data from the annual reports of ten (10) Nigerian publicly traded banks. The Kao panel co-integration test revealed that the variables under investigation have a long-term association. The Dynamic Ordinary Least Square (DOLS) analysis found that foreign exchange income had a negative and small impact on Nigerian bank profitability over the period.

Foreign Exchange Option market and Trade Finance Income

International trade involves trading between different countries with different local currencies. This naturally leads to need for purchase or selling of foreign currency. Accordingly, export into the international market leads to receipt of foreign currency as payment is effected in foreign currency, while imports from a foreign country requires purchase of foreign currency in order to settle foreign currency obligations (Pugel, 2007). Apart from forward exchange market, Commercial banks can use Foreign Exchange Options to minimize foreign exchange risk when settling international payments denominated in foreign currencies. Foreign exchange Option is a contract where the buyer has a right but not an obligation to purchase one currency and sell another at an agreed specified rate on a specified future date, at a premium (Dawson & Rodney, 1994). Glaum (2000) observes that Foreign Exchange Options protect the buyer from losses that can arise from adverse FX movements while still leaving an opportunity for buyer to participate in favorable foreign exchange movements.

Kenya lost its nominal anchor to tie local prices down despite liberalizing its foreign exchange market, and so globalization effects are passed straight into the country. The volatility of the exchange rate, as well as the spread between the purchasing and selling rates of the foreign currency, characterize this (Trade Finance Global, 2020). A wide spread implies the presence of arbitrage opportunities, which encourages speculators to purchase more currencies at a lower price and sell them at a higher price. Because the exchange rate is so variable, commercial bank management needs to know exactly how the foreign currency market affects trade finance income.

DISCUSSION OF RESULTS AND FINDINGS

This section summarizes the findings of the study, which were based on many statements that looked at the impact of trading in Foreign Currency on trade finance income. The study used a 5-point Likert scale, with 1= strongly disagree (SD), 2 = disagree (D), 3 = moderate (M), 4 = agree (A), and 5 = strongly agree (S) (SA). The mean and standard deviation of these comments based on this scale are also presented in this section.

ISSN No. 2454-6186 | DOI: 10.47772/IJRISS |Volume VII Issue XII December 2023

Frequency Distribution of Trading in Foreign Exchange

The results reveal that: 74% of the respondents strongly agreed that the bank can identify the foreign exchange gains earned from trade financing activities, 63% of the respondents strongly disagreed that the bank earns foreign exchange income when facilitating trade finance payments on the spot market, 55% of the respondents strongly agreed that spot exchange rate market facilitates foreign exchange trade transactions payments, 44% of the respondents strongly agreed that the bank offers forward exchange contracts to trade finance clients where future obligations to settle trade payments exist, 44% of respondents agreed that forward exchange rate market facilitates foreign exchange trade transactions payments for future trade payments while 37% of respondents strongly agreed that forward exchange rate market facilitates foreign exchange trade transactions payments for future trade payments.

Furthermore, 37% of the respondents agreed that spot exchange rate market facilitates foreign exchange trade transactions payments, and 37% of the respondents strongly disagreed that the bank recognizes premium earned from foreign currency options as trade finance income. The results on table 1.0 show that majority of the respondents strongly agreed with the statements that were provided. These findings show that, majority of commercial banks have different ways of earning foreign exchange income from trading activities.

Table 1.0: Frequency Distribution of Trading in Foreign Exchange

Trading in Foreign Exchange						
	SD	D	M	A	SA	Total
The bank can identify the foreign exchange gains earned from trade financing activities	4%	%	7%	15%	74%	100%
Spot exchange rate market facilitates foreign exchange trade transactions payments	4%	%	4%	37%	55%	100%
The bank earns foreign exchange income when facilitating trade finance payments on the spot market	63%	%	%	26%	11%	100%
The bank earns foreign exchange finance income when receiving trade finance commissions from its correspondent banks	11%	7%	11%	30%	41%	100%
Forward exchange rate market facilitates foreign exchange trade transactions payments for future trade payments	4%	4%	11%	44%	37%	100%
The bank offers forward exchange contracts to trade finance clients where future obligations to settle trade payments exist	4%	15%	11%	26%	44%	100%
The bank offers foreign currency option as a hedging solution to mitigate foreign exchange risk for international trade payments	11%	7%	26%	26%	30%	100%
The bank recognizes premium earned from foreign currency options as trade finance income	37%	22%	19%	15%	7%	100%

Descriptive Statistics of Trading in Foreign Exchange

The study also sought to analyse the views of the respondents on effect of trading in Foreign Exchange on Trade Finance income using a table of means (M) and standard deviation (SD). The results on table 2.0 reveal that the respondents agreed on the following statements: the bank can identify the foreign exchange gains earned from trade financing activities *(M= 4.56, SD= 0.934)*; spot exchange rate market facilitates foreign exchange trade transactions payments *(M= 4.41, SD=0.888)*; and, forward exchange rate market facilitates foreign exchange trade transactions payments for future trade payments *(M= 4.07, SD= 0.997)*.

Table 2.0: Descriptive Statistics of Trading in Foreign Exchange

	N	Mean	Std. Deviation
The bank can identify the foreign exchange gains earned from trade financing activities	27	4.56	.934
Spot exchange rate market facilitates foreign exchange trade transactions payments	27	4.41	.888
The bank earns foreign exchange income when facilitating trade finance payments on the spot market	27	2.22	1.649
The bank earns foreign exchange income when receiving trade finance commissions from its correspondent banks	27	3.81	1.360
Forward exchange rate market facilitates foreign exchange trade transactions payments for future trade payments	27	4.07	.997
The bank offers forward exchange contracts to trade finance clients where future obligations to settle trade payments exist	27	3.93	1.238
The bank offers foreign currency option as a hedging solution to mitigate foreign exchange risk for international trade payments	27	3.56	1.311
The bank recognizes premium earned from foreign currency options as trade finance income	27	2.33	1.330

The study revealed that 74% of the respondents strongly agreed that the bank can identify the Foreign Exchange gains earned from trade financing activities. This meant that Foreign Exchange is necessary in trade transactions. Afza and Alam (2016), confirm that foreign exchange is important in trading especially in settlements of international trade transactions where sellers and buyers are using different currencies. Hossin (2020) notes that financial institutions focus on exchange rates in a bid to make income while Babazadeh and Farrokhnejad (2016) agree that banks can earn income from foreign exchange transactions by taking advantage of the volatility of exchange rates. Therefore, these previous studies confirm that banks earn Foreign Exchange income when dealing with trade and Trade Finance activities since they are major players in Foreign Exchange transactions.

The findings of the study revealed that 55% of the respondents strongly agreed and 37% of the respondents agreed that spot exchange rate market facilitates Foreign Exchange trade transactions payments. These results show that changes in the Foreign Exchange markets affect commercial banks since they are involved in Foreign Exchange transactions. Heckman and Singer (2017) note that, exchange rates that are volatile cause destabilization of trade. This means that countries with volatile currencies encounter difficulties trying to convince foreign investors to invest in their market. Kawai (2017) argues that the exchange rate is an important instrument used for stabilizing prices during trade. However, the study also revealed that 63% of the respondents strongly disagreed that the bank earns foreign exchange trade finance income when facilitating trade finance payments on the spot market.

The findings of the study show that 44% of the respondents agreed and 37% of the respondents strongly agreed that forward exchange rate market facilitates foreign exchange trade transactions payments for future trade payments. Additionally, 44% of the respondents strongly agreed and 26% of the respondents agreed that the bank offers forward exchange contracts to trade finance clients where future obligations to settle trade payments exist. The results of the study are in line with the Bank of Albuquerque (2012) which agrees that, since the foreign exchange market is volatile and exporters and importers face a high risk of fluctuations in foreign exchange rates, companies should protect themselves when trading by securing a forward exchange contract. The forward exchange contract protects companies from adverse market movements by obtaining a predetermined exchange rate for future transactions.

Furthermore, the results of the study revealed that 30% of the respondents strongly agreed and 26% of the respondents agreed that the bank offers Foreign Currency option as a hedging solution to mitigate foreign exchange risk for international trade payments. The Office of the Comptroller (OCC) (2018) confirms that managers of trade finance can use hedging strategies to help them minimize risk. Potential risk may include; price risk, interest risk, foreign exchange rate risk, and country risk. Additionally, importers and exporters can ask a bank to provide a hedging solution against a particular transaction.

CONCLUSION AND RECOMMENDATIONS

Conclusion

The study's objective was to determine the effect of trading in foreign exchange on trade finance income among commercial banks in Kenya. The study's inferential analysis, which included correlation analysis and regression analysis, led to the conclusion that there is a significant correlation between trading in foreign exchange and trade finance income. The results indicate that while trading in foreign exchange where underlying activity is a trade, revenues earned have a positive impact on trade finance income, as evidenced by the finding that a unit increase in foreign exchange from trade finance operations results in a 0.299 increase in trade finance income. The study comes to the conclusion that trade finance income is influenced by trading in foreign exchange.

Recommendations

The research results showed that trade finance income and trading in foreign exchange trading had a very significant positive linear statistical significance. Based on these conclusions, the study advises commercial banks to concentrate on trade financing and trade facilitation since foreign exchange will be required at the time that settlement must be carried out. Banks should be aware that fees gained from trading in foreign exchange are in addition to whatever fees they may have earned from other trade finance activities. Banks should concentrate on increasing their trading in foreign exchange for clients especially undertaking international trade as this will enhance trade finance revenue while a reduction in trading in foreign exchange would decrease trade finance revenue.

Additionally, the study found that most commercial banks can identify the foreign exchange gains earned from trading activities, however, most commercial banks do not recognize foreign exchange gains earned from a trade activity as trade finance income, and especially revenue earned on trading of forex on the spot market. Based on these findings, the study recommends that whilst recognizing trade finance income, banks are urged to consider the ancillary income in form of this FX that follows a trade finance transaction to appreciate the full impact of trade financing on bank revenues. Had the trade finance transaction or the underlying trade not happened, then the related FX income wouldn't have been earned. Perhaps a mirroring of this FX income earned as part of the trade finance income earned in the trade finance departments could be the minimum expectation.

REFERENCES

1. Afza, M., & Alam, K. (2016). Managing foreign exchange risk among Ghanaian firms. *Journal of Risk Finance, 6*(4), 306-318.
2. Babazadeh, M., & Farrokhnejad, F. (2012). Effects of Short-run and Long-run Changes in Foreign Exchange Rates on Banks' Profit. *International Journal of Business and Management*. 2012/08Vol. 7;

Iss. 17. https://ur.booksc.eu/book/80770943/9fb6ab

3. Bank of Albuquerque. (2019). *Foreign Exchange Forward Contracts.* Retrieved from: https://www.bankofalbuquerque.com/resources/articles/commercial-institutional/ foreign-exchange-forward-contracts.
4. Burnside, C., Eichenbaum, M., Kleshchelski, I., & Rebelo, S. (2006). *The returns to currency speculation (No. w12489).* National Bureau of Economic Research.
5. Cooper, D. R & Schindler, P. S. (2014). *Business Research Methods. (12th Edition)*. New York: McGraw Hill/Irwin.
6. Creswell, J. W. (2018). *Research Design: Qualitative, Quantitative, and Mixed Methods Approaches* (4th ed). SAGE Publications Inc.
7. Dawson, Alex J.D. and Rodney, William H. The Use of Exchange-rate Hedging Techniques by UK Property Companies. *Journal of Property Finance,* Vol. 5 No. 4, 1994, pp. 56-67 MCB University Press, 0958-868X.
8. Glaum M. (2000) Foreign-Exchange-Risk Management in German Non-Financial Corporations: An Empirical Analysis. In: Frenkel M., Hommel U., Rudolf M. (eds) *Risk Management*. Springer, Berlin, Heidelberg. https://doi.org/10.1007/978-3-662-04008-9_21
9. Heckman, J. J., & Singer, B. (2017). Abducting Economics. *American Economic Review.* 107(5), pages 298-302, May.
10. Hossin, M. S. (2020). Interest rate deregulation, financial development and economic growth, Evidence from Bangladesh. *Global Business Review, 3*(5), 426-34.
11. Kahuthu, K. M. (2016). *The Effect of Trade Finance on The Performance of Commercial Banks In Kenya*. Unpublished Maters Thesis, University of Nairobi.
12. Kawai, M. (1984). The effect of forward exchange on spot-rate volatility under risk and rational expectations. *Journal of International Economies.* https://www.sciencedirect.com/science/journal/00221996/16/1
13. Kothari, C. R. (2014). *Research Methodology: Methods and Techniques*. New Age International Publishers.
14. Larue, B., Gervais, J. P., & Rancourt, Y. (2010). Exchange rate pass-through, menu costs and threshold cointegration. *Empirical Economics,* 38(1), 171-192
15. Luca, C. (2007). *Trading in the global currency markets*. Penguin.
16. Manyo, T. K., Sabina, N. E., and Ugochukwu, U. S. (2016). The Effect of Foreign Exchange Transaction on the Performance of Nigerian Banks. *Journal of Business Management*. Volume-2 | Issue-11 | November, 2016 | Paper-7.
17. Moffett, M. H., Stonehill, A. I., & Eiteman, D. K. (2019). *Multinational business finance.* 15th ed. Pearson. https://www.pearson.com/us/higher-education/product/Eiteman-Multinational-Business-Finance-14th-Edition/9780133879872.html.
18. Mugenda, O.M., & Mugenda, A.G. (2019). *Research Methods- Qualitative, Quantitative and Mixed Methods Approaches*. Centre for Innovative Leadership and Governance (CLIG).
19. Ndung'u, C. W., Machuki, V. N., & Murerwa, T. (2014). Response Strategies by Commercial Banks to Economic Changes in Kenya. *Journal of Economics and Sustainable Development,* 5(2), 137-153.
20. Nyokabi, N. (2018). *The effect of forex trading on the financial performance of commercial banks in Kenya* (Unpublished master's thesis). University of Nairobi, Nairobi, Kenya.
21. The Office of the Comptroller of the Currency. (2018). *Comptroller's Handbook: Trade Finance and Services*. Retrieved from: www.occ.treas.gov.
22. Offer, M. A. W. (2013). Africa Research Bulletin
23. Pitia, E., & Lado, Z. (2016). Test of relationship between exchange rate and inflation in south Sudan: Granger-causality approach. *Economics, 4(*2), 34-40.
24. Pugel, T. (2007). *International economics* (13th ed.). McGraw-Hill International Edition.
25. Saunders, M. N., Lewis, P. & Thornhill, A. (2019). *Research Methods for Business Students* (8th ed). Pearson Education Limited.
26. Singh, K. S. (2010). *The relationship between foreign exchange trading and financial performance of commercial banks in Kenya*

. (Master's Thesis, University of Nairobi). UON repository.

27. Trade Finance Global (2020). An SME guide for importers and exporters. *Trade Finance explained.* https://www.tradefinanceglobal.com