A RESEARCH PROPOSAL SUBMITTED IN PARTIAL
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An arbitrage trading strategy whereby an investor capitalizes on the interest rate differential
between two countries by using a forward contract to cover (eliminate exposure to) exchange
rate risk. The study sought to establish the existence or otherwise of foreign exchange rate
arbitrage (borrowers’ arbitrage) opportunities between Kenya Shilling denominated loans and
US dollar denominated loans. The specific objectives of the study were: to establish the
existence of individual currency arbitrage on USD, GBP and EUR in the commercial banks in
Kenya and to establish the significance of the arbitrage in selected banks in Kenya. The study used secondary data that were obtained from the Central Bank of Kenya and selected
Commercial Banks in Kenya. The banks were selected inform of their profit performance where
the researcher went for the best performing banks. Data was then analyzed using descriptive
statistics where mean and mode were used to give the central tendency of the forex prices on
whether it is uniformly distributed or not uniformly distributed. Inferential statistic was also used
where paired t-test was used to give significance of the performance. This helped the researcher
obtain reaction level of the financial market. The study found out that arbitrage existence with some currencies at different banks depending
on the time of the year though the gains made by the financial institutions or individuals were not
significant in most of the opportunities that existed. The study also found out that it is not
possible to earn positive returns by borrowing domestic assets for lending, in a similar asset,
abroad (or vice versa) while covering the exchange rate risk through a forward contract of equal
maturity. Domestic and foreign interest-bearing assets can be considered similar if they are of
equal maturity and share the same characteristics, such as liquidity and political and default risk.
Further, it indicates that it appears that profitable CIP arbitrage when measured, e.g., from the
viewpoint of a domestic arbitrageur precludes profitable BA opportunities for a domestic fund
raiser while the converse may not be true. If a positive return can be gained in domestic currency
by borrowing domestic funds to lend abroad, it will also be relatively dearer to borrow funds
abroad (when measured in domestic currency), but the converse may not be the case. The paper
then recommends banks and similar financial institutions to be vigilant of traders and
arbitrageurs seeking to exploit arbitrage opportunities in the foreign currency denominated assets
or liabilities. In turn, very short-term arbitrage opportunities invite traders to exploit them and
hence will be quickly eliminated. Traders and other borrowers are encouraged to exploit these
opportunities whenever there are opportunities.