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Government
Policies and the
Development of
Banking in Kenya

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Government Policies and the Development of Banking in Kenya¹

Martin Brownbridge

1. Introduction

The growth of the Kenyan economy since independence has been accompanied by an expansion and diversification of the financial system. In terms of the numbers and range of financial institutions (FIs) and the depth of financial intermediation, financial development has proceeded further in Kenya than in most other countries in Sub-Saharan Africa (SSA). By the early 1990s the financial sector included commercial banks, non bank financial institutions (NBFIs), development finance institutions (DFIs), insurance companies and a stock exchange. The commercial banks and NBFIs, which are the focus of this paper, include government owned, foreign owned and locally owned private sector FIs. Government intervention in the financial system has been extensive, although the degree and nature of influence and control it has exerted has varied considerably both between and within the different sectors.

This paper examines the development since independence of the banking system (the commercial banks and the NBFIs) and in particular how it was shaped by government policies. The aim is to explore a number of related themes: whether financial repression retarded the development of the banking system, did the government attempt to influence credit allocation and did this undermine the quality of FIs' asset portfolios?, how effective was prudential regulation? have financial sector reforms achieved their objectives of promoting a more competitive, efficient and prudentially sound banking system? The organisation of the paper is as follows. Section 2 presents an outline of the main elements of government policy and intervention in the financial system. Sections 3, 4 and 5 review the experience and performance of the government owned commercial banks, the foreign owned commercial banks, and the local private sector commercial banks and NBFIs respectively. The emergence of the locally owned private sector financial institutions (FIs) has been characterised by several episodes of bank failure since the mid 1980s, the causes of which are discussed in section 6. Section 7 examines the links between financial fragility and the system of prudential regulation and supervision: this section also assesses the impact of the reforms to the regulatory system undertaken since the mid 1980s. Section 8 outlines the main elements of the financial liberalisation introduced since the early 1980s and discusses their impact on the banking system. Section 9 concludes.²

The rest of this introduction provides a very brief overview of the financial system in Kenya and its development since independence. The financial system at independence in 1963 consisted of nine foreign owned commercial banks, of which the largest were Barclays, Standard Chartered and National and Grindlays, together with several NBFIs and DFIs. In the decade following independence the government established the Central Bank of Kenya (CBK), three parastatal commercial banks and a number of DFIs.

During the 1970s the NBFIs sector began to expand rapidly, stimulated by differences in

¹ The author is indebted to Charles Harvey, IDS, for invaluable comments, but accepts sole responsibility for all errors.

² A list of abbreviations and a set of tables detailing monetary aggregates, interest rates, and the main assets and liabilities of the commercial banks and NBFIs follows the conclusion.

the regulatory treatment of banks and NBFIs which created market opportunities for the latter. Some of the NBFIs were established as affiliates of the existing commercial banks, others by local business people and politicians. The NBFIs (also known as finance houses) have engaged in various forms of financial activity including hire purchase, lease hiring, mortgage financing and merchant banking. They have not been allowed to offer checking accounts, and therefore mobilise most of their funds from interest bearing deposits.

The growth of the locally owned FIs accelerated during the 1980s and began to include commercial banks, some of which were set up by the owners of existing NBFIs. During the mid 1980s the financial system suffered its first major episode of financial fragility with several locally owned FIs closed down after encountering severe liquidity problems as result of mismanagement and fraud. This crisis led to a series of revisions to the banking laws, the strengthening of bank supervision, the creation of the Deposit Protection Fund (DPF) and the formation in 1989 of a government owned bank, the Consolidated Bank, which was given the task of restructuring a number of failed private sector FIs.

During the 1980s and early 1990s the government introduced a number of policy reforms aimed at gradually liberalising financial markets. These reforms, together with those aimed at strengthening the institutional framework of the financial system, were supported by a Financial Sector Adjustment Credit (FSAC) from the World Bank.

Financial markets in Kenya were afflicted by severe turbulence in the early 1990s. Rapid inflationary increases in the money supply accompanied widespread fragility and fraud in the banking sector. A major source of monetary growth in this period was irregular borrowing by politically connected FIs (widely known as political banks) from the CBK. Under pressure from the IMF, the World Bank and donors, the CBK put around 16 FIs into liquidation in 1993/94, while others, including one of the government owned commercial banks, were recapitalised by their shareholders.

As of June 1994, the banking system consisted of 33 commercial banks and 50 NBFIs; approximately 25 of the NBFIs were affiliated to, or shared common ownership with, commercial banks. Of the 33 commercial banks, 12 were foreign owned, five were in the public sector and the rest were owned by the local private sector. The deposits of the commercial banks amounted to the equivalent of 30% of GDP in 1993 while those of the NBFIs amounted to 14% of GDP. Commercial banking has been dominated by four large banks, two foreign and two government owned, which together accounted for 70% of commercial bank deposits, but market concentration has been much lower in the NBFI sector.

2. Government Intervention in the Financial System

Government intervention in the financial system in Kenya since independence has had two major objectives: First, to control monetary aggregates for macroeconomic stabilisation and second, to direct the development of the financial system, and in particular the nature of its asset allocations, in accord with political and economic priorities. A third objective, that of the prudential regulation and supervision, did not initially receive much attention, but has been the focus of increasing emphasis since the mid 1980s.³

Prior to the financial sector reforms of the late 1980s, monetary control was

³ Issues pertaining to prudential regulation and supervision are not discussed in this section because they are dealt with in section 7.

implemented through liquid asset ratios and (less frequently) cash reserve ratios imposed on the commercial banks and NBFIs, and through credit ceilings imposed on the commercial banks based on the historic market share of each institution. The CBK also stipulated minimum deposit and maximum lending rates of interest for both commercial banks and NBFIs (Killick and Mwege, 1990). Real interest rates for both deposits and loans were negative during the 1970s, but after nominal rates were raised in 1982, real loan and time deposit rates remained higher than inflation, or nearly so, through most of the remainder of the decade. The monetary policy reforms introduced during the 1990s (discussed in section 8) have entailed liberalising interest rates and replacing direct controls on lending with open market operations.

Until the mid 1980s, statutory interest rates were set at higher levels for the NBFIs than for the commercial banks which gave the former an advantage both in attracting deposits and in extending credit on profitable terms. This, together with other differences in the regulations governing the two types of FIs, gave an incentive for the rapid expansion of the NBFIs in the 1970s and 1980s.⁴ Since the mid 1980s, the CBK has gradually reduced many of the differences in the regulatory treatment of the banks and NBFIs, and is currently encouraging the latter to either convert into banks or, where applicable, to merge with the banks with which they are affiliated.

Government efforts to direct the development of the financial system and the nature of its lending and investment activities mainly took the form of establishing parastatal FIs to operate alongside the private sector FIs. The government set up two commercial banks, several NBFIs and nine DFIs during the 1960s and 1970s. With the exception of the nationalisation of Grindlays, the established commercial banks were neither nationalised nor interfered with in pursuit of government objectives, as in many other African countries: Within the constraints of controlled interest rates and credit ceilings (which applied equally to all banks), the established private commercial banks were left to make lending decisions on commercial criteria.

The financial system which existed at independence was dominated by foreign owned commercial banks concentrating on trade related finance and a handful of other FIs which mainly served the white settler community. As a consequence a financing gap was perceived to exist, consisting of the credit requirements of African entrepreneurs and of the long term financing needs of the business sector. One of the primary objectives for establishing the parastatal FIs was to fill these perceived financing gaps: The emergence of Kenyan owned private sector FIs was not regarded as a realistic alternative in the 1960s (Kariuki, 1993, p67). The DFIs were set up to provide finance to particular segments of the market (farmers, small scale businesses, etc) but the financial performance of most has been very poor largely because many of their clients have not been profitable (Maynard, 1992).

The commercial banks and NBFIs, in both public and private sectors, were largely free of formal government controls over the sectoral allocation of their lending, with the exception of a stipulation that they extend credit to agriculture amounting to at least 17% of their deposit liabilities. There were no penalties imposed on FIs which failed to meet this criteria and

⁴ The NBFIs were not subject to credit ceilings and faced lower capital requirements than the commercial banks. Several of the NBFIs were established as subsidiaries of existing commercial banks (including government owned banks) partly in order to circumvent the more restrictive interest rate controls and other regulations imposed on the commercial banks (Grosh, 1987, pp3-5).

compliance was low (Kariuki, 1993, p291).⁵ The parastatal banks were however subject to informal political pressures to extend credit to particular clients in both the private and public sectors (Grosh, 1987, pp17-19). In addition informal influence over public and private sector FIs was exerted by government and politicians through the placement of parastatal deposits in particular FIs.

Although government intervention in the financial system has been wide ranging, Kenya has managed to avoid some of the most damaging features of "financial repression" that characterised several other countries in SSA, and this is reflected in the expansion of the financial system in terms of both the volume of its liabilities and assets and diversity of institutions over the three decades following independence. Whereas in 1966 broad money amounted to the 22.9% of GDP, broad money plus the deposits of other banking institutions (virtually all of which were established after 1966) amounted to 45.4% of GDP in 1990 (see table 1).⁶ Despite nominal interest rate controls, real interest rates were not sufficiently unattractive (largely because inflation rates were generally moderate) to prevent the Kenyan public from increasing its holdings of real financial assets and thus providing the resources for the growth of intermediation.

Public sector deficits have been large, but access to foreign capital together with the size of the domestic financial system has ensured that private borrowers have not been entirely crowded out of domestic credit markets. Credit to the private sector from the banking system averaged 76% of net domestic credit during the 1970s and 59% during the 1980s.⁷ Finally because direct government controls over the operations of the FIs were relatively light, most of the major private sector FIs have not had the quality of their loan portfolios or their profitability jeopardised through being forced to extend loans to uncreditworthy borrowers or hold unremunerative assets. However, with the exception of the KCB, government influence has contributed to the poor financial performance of many of the parastatal FIs, and in particular the DFIs.

3. Government Owned Commercial Banks

The government established parastatal commercial banks in Kenya after independence because of the perception that the existing foreign owned banks were failing to serve the credit needs of African businesses. The Co-operative Bank was incorporated in 1965 and the National Bank of Kenya (NBK) in 1968. This was followed in 1970 by the nationalisation of the commercial banking operations of National and Grindlays's Bank, which was renamed the Kenya Commercial Bank (KCB). Both the KCB and NBK have issued equity on the NSE to the

⁵ Interviews with officials of several banks in 1995 confirmed that most had not been meeting the agricultural lending requirement.

⁶ Data from IFS: Broad money (money plus quasi money) consists of the currency and deposit liabilities of the banking system (the CBK and the commercial banks). The "other banking institutions" are the NBFIs.

⁷ Data from IFS. There was a downward trend in the private sector's share of net domestic credit (NDC) since the early 1970s, but this was partly because an increasing share of private credit demand has been transferred to the NBFIs which are excluded from the NDC aggregate.

public in recent years.⁸ In 1990 two more government owned commercial banks were established. The Consolidated Bank was formed to take over and restructure the operations of nine private sector FIs which had failed during the 1980s and the Post Office Savings Bank, which had previously been confined to deposit mobilisation, set up a commercial banking affiliate, Post Bank Credit. Post Bank Credit was closed down in 1993 after a large overdraft made to a politically connected borrower was not serviced; it appears to have been used as a conduit to channel funds from the NSSF into campaigning for the 1992 elections.

In terms of deposits, the KCB is (with Barclays) one of the two largest banks in Kenya, holding 22% of total commercial bank deposits at the end of 1993. It also has 55% of the branches of all the commercial banks. The NBK is the fourth largest bank with 9.7% of commercial bank deposits. Both banks extend predominantly short to medium term credit for working capital but have NBFIs which provide longer term loans.

The NBK was established with the main objective of facilitating the financing of African businesses and the transfer of productive assets (such as farmland) to Africans. The KCB has had more explicitly commercial objectives, although developmental criteria have influenced some of its lending policies and the expansion of its branch network into rural areas. It was managed under a management contract by Grindlays until the mid 1980s, and has generally been allowed a greater degree of independence from government control than the NBK.

The KCB and NBK have mobilised a substantial share of their deposits from the public sector and have also extended a significant share of their loan portfolio to the public sector. Public sector deposits have accounted for between 30% and 50% of their combined deposit base since they were established (Kariuki, 1992, pp298-9) and around 50% of the NBK's loan portfolio has consisted of lending to the public sector and co-operatives. The NBK has placed greater emphasis on lending to agriculture and agro-based industries than other banks; these sectors accounted for 38% of its loan portfolio in 1987.⁹

At the request of the government, both the KCB and NBK have extended credit to parastatals or co-operatives for strategic reasons, in circumstances where lending would not have been justified on a purely commercial basis. The government has also ordered parastatal deposits to be transferred to these banks, and then on lent to particular borrowers. Government guarantees have often been provided when credit has been extended on government instructions to public sector borrowers which do not meet commercial criteria. Nevertheless a number of bad debts have been incurred from lending made at the direction of government, a problem which has been especially serious for the NBK.

During the mid 1980s the KCB embarked on a major expansion programme with the aim of extending banking services into rural areas which had not previously been served by banks. This initially adversely affected the KCB's profits, as many of the rural branches incurred losses, but in recent years the rural network has become more profitable, in part because rural deposits have been channelled into high yielding investments, such as TBs, in the urban areas.

The KCB recorded very strong profits over the last two decades and appears to have been well managed, having inherited both bank management and a solid commercial banking

⁸ The KCB issued equity amounting to 30% of its capital in 1988 and 1990 and the NBK sold 20% of its shares to the public in 1994.

⁹ NBK Annual Report and Accounts, 1987.

culture from Grindlays. It avoided incurring significant bad debts, in part because most of its lending was properly secured. Like the two major foreign owned banks, the KCB's profitability was boosted by the low cost of its funds, with almost half of its deposits consisting of demand deposits.

The NBK was much less profitable. Its finances were undermined by non performing loans, particularly to parastatals, and the agriculture and real estate sectors. In 1979 it recorded a large loss after having to make provisions for 11% of its loan portfolio and required an injection of equity from the government to maintain capital adequacy. In 1984, its NBFI subsidiary, KENYAC, incurred a substantial loss after failing to recover a large loan secured against real estate made in the late 1970s. Furthermore the Auditor-General's report to the NBK's 1985/86 accounts noted that the NBK and KENYAC had deposits amounting to KSh 105 million - a sum equivalent to 40% of the NBK's capital and reserves - in companies (presumably FIs) which were in liquidation or had closed down (see section 6 for details of the banking crisis of the mid 1980s).

The underlying cause of the NBK's financial fragility, which was its lack of independence from political influence over lending decisions, was not addressed during the 1980s. As a consequence its problems intensified in the early 1990s. The NBK was forced to make provisions for doubtful debts amounting to 15% of its loan portfolio in 1992 and to write off almost 10% of its loan portfolio during the 1992 and 1993 financial years.¹⁰ It suffered a run on its deposits in 1993 after adverse reports in the media and the closure of another public sector bank, Post Bank Credit. As a result a restructuring plan was adopted under which the government injected Ksh 0.5 billion in equity and provided Ksh 1.5 billion in loan guarantee repayments; a combined sum which amounted to 16% of the NBK's total assets. In addition the NSSF converted deposits held with the bank into NBK shares. The NBK's top management was replaced, improvements were made to loan appraisal procedures, a loan recovery programme was initiated and internal controls were strengthened. The NBK has also made efforts to enhance customer services with the introduction of credit cards and facilities to sell TBs to the public.

To summarise this section, the experience of the two main government owned banks over the last 20 years differed significantly. Although both banks were expected to pursue developmental objectives, especially lending to the public sector, the KCB was able to conduct most of its operations along commercial lines. It generated strong profits and avoided accumulating substantial volumes of bad debts. The KCB remained financially sound because it inherited the management and culture of an established private sector bank, and because government pressure to extend credit to non creditworthy borrowers was relatively limited. The KCB extended its branch network in rural areas in response to government policy but this appears to have only temporarily reduced its profits. As such its performance has not been dissimilar to that of the established foreign owned banks. Given that the government and politicians exerted considerable influence over the lending and investment decisions of other public sector FIs, the question arises as to why the KCB was able to remain relatively independent of government control. It is possible that the NBK and the various DFIs in Kenya provided government and politicians with sufficient opportunities to access credit for developmental needs and political patronage without also having to resort to the resources of the KCB, hence the latter was left alone to pursue largely commercial objectives.

¹⁰ NBK Annual Report and Accounts 1993.

Conversely, government and political pressure on the NBK to extend credit to borrowers who would not have qualified for loans on commercial criteria alone was much greater. The NBK lent heavily to the public sector and politically connected borrowers whose loan repayment record was poor, with adverse consequences for its profitability and the quality of its asset portfolio. Although the financial problems of the NBK had already become apparent by the late 1970s, efforts to restructure the bank were insufficient to prevent much larger losses due to non performing loans from recurring. The underlying cause of the financial distress in the NBK, political pressure to extend loans on non commercial grounds, was not rectified. Major restructuring of the NBK's management was delayed until 1993 by which time the accumulated losses were substantial. Whether the restructuring exercise will enable the NBK to operate along commercial lines and avoid the politically connected lending which had previously undermined its balance sheet remains to be seen. Arguably it will only be able to attain sufficient independence from political interference if the government sells all of its equity in the bank to the private sector.

4. Foreign Owned Banks

The foreign owned banks in Kenya include subsidiaries of Barclays, Standard Chartered Bank (SCB), ABN Amro, Citibank, and several banks from Asia, the Middle East and other African countries. Barclays and SCB are two of the three largest banks in Kenya, together accounting for 38% of total commercial bank deposits in 1993 while the remaining foreign owned banks are relatively small, jointly accounting for less than 5% of deposits. Most of the foreign banks have at least one NBF1 subsidiary. Both Barclays and SCB are engaged in retail and corporate banking and trade financing while most of the smaller foreign owned banks operating in niche markets.

Barclays and SCB have avoided accumulating significant non performing loans by adopting conservative lending policies with strict lending controls largely modelled on those of their parent banks. Their lending has been concentrated mainly on prime (ie the most creditworthy) corporate customers; MNCs and the larger local companies. The existence of a strong private sector in Kenya, which includes a large MNC presence, combined with limited competition in loan markets has enabled them to avoid having to lend to less creditworthy customers. They have extended very little credit to parastatals, to co-operatives or to politicians. Their lending has been predominantly used for financing working capital, is short or medium term, and fully secured with realisable collateral. Forms of collateral which might prove difficult to realise or trade, such as agricultural land, have been avoided. As noted in section 2, the major private sector banks have been free of government pressure to extend finance to sectors to which they were reluctant to lend, with the exception of the minimum requirement for agricultural lending.

Barclays and SCB have both instituted strong internal controls to minimise potentially risky lending. The discretion of branch managers to extend loans is limited, with lending officers required to obtain extensive information from prospective borrowers, and both banks have procedures to protect officers from political or other pressures to influence lending decisions. Lending is concentrated in a handful of the larger (mainly urban) branches which have good credit officers. Credit risk management is an important element of both staff training and internal organisation. Asset allocations are governed by internal regulations which ensure appropriate portfolio mix and diversification.

Both banks experienced growth in real assets since independence (although they have

lost market share particularly to the government owned banks). Barclays undertook a major branch expansion programme in the rural areas in the mid 1980s with the aim of mobilising rural deposits. The rural branch network of Barclays (along with that of the KCB) appears to have been profitable because it has enabled the bank to mobilise low cost rural deposits and channel these into remunerative loans and investments, primarily in the urban areas. SCB however announced the closure of around a third of its branch network in 1995 as part of a shift in the emphasis of its operations in Kenya away from retail banking (major aspects of which are regarded as unprofitable) to concentrate on trade and corporate finance.

Both banks made profits in most years in Kenya since independence and Barclays in particular generated very large profits over the last six years. The profitability of Barclays and SCB has been a result of a combination of factors. Their cost of funds has been low because their reputation and branch networks allowed them to mobilise a high proportion of total deposits from current accounts and to pay relatively low interest rates on savings accounts. Moreover profitability was not undermined by non performing loans. Barclays and SCB have had several important advantages of over other banks in Kenya which allowed them to mobilise deposits cheaply and to lend predominantly to prime corporate customers. These include their reputation for deposit security and their countrywide branch network (rivalled only by the KCB), while their international network provided them with important advantages in securing business from the MNCs.

The controls on interest rates and bank charges imposed by the CBK until 1991 may have had some adverse effects on bank profitability but, given the substantial share of demand deposits in their total deposits, average lending margins were sufficiently wide to ensure that low risk lending was remunerative for the banks. In the last few years since interest rates and other controls were liberalised, the largest banks appear to have been operating an unofficial cartel in order to maintain interest rate spreads and to levy high, and in some cases, exorbitant bank charges.

5. Local Banks and NBFIs

Since the late 1970s locally owned (henceforth local) private sector banks and NBFIs have proliferated in Kenya. By June 1994 there were around 17 locally owned private sector commercial banks and 35 NBFIs in operation; these FIs accounted for almost 25% of commercial bank deposits and approximately 50% of NBFi deposits. Although the distinctions are not absolute, the local FIs can be divided into three categories according to ownership; political banks (which have included prominent politicians among their shareholders), independent (of politicians) Asian owned FIs and independent African owned FIs. In recent years the most rapid growth has occurred among the Asian owned FIs, including some with political connections. The local financial sector has experienced several episodes of financial fragility with a number of these FIs having failed since the mid 1980s, an issue which is explored in the following section. In this section we examine the motivations for the growth of the local FIs and some of the pertinent characteristics of the sector.

The growth of the local FIs has been motivated by a number of factors.

First, there has been a widespread perception that the large banks, including the government owned banks, were failing to provide adequate credit facilities to local businesses, especially small scale enterprises. Many local businesses could not fulfil the creditworthiness criteria demanded by the large banks while in addition the processing of credit applications often entailed considerable delays (sometimes of several months) before loans were disbursed.

Hence a market opportunity was perceived to exist for local FIs to supply loans to businesses excluded by the established banks.

Second, various aspects of the system of financial sector controls and regulations in operation during the 1970s and 1980s segmented the financial markets and created opportunities for the NBFIs to undertake certain types of business, such as hire purchase and lease hire, for which they were either protected from competition from commercial banks or were provided with a competitive advantage (such as the freedom to charge higher interest rates). Although the regulatory segmentation of financial markets prompted the foreign and government owned commercial banks to set up their own NBFIs subsidiaries, it appears that sufficient opportunities remained for local finance houses to attract customers.¹¹

Third, a class of local businessmen, both African and Asian, emerged which had accumulated capital from various forms of commercial activity including, in the case of some of the Asian entrepreneurs, money lending. The Asians in particular had the capital, some of the expertise required (which could also be obtained by hiring staff trained by the established banks) and a potential market among business people in their own communities, to make investment in finance houses and banks a viable proposition. The market among businesses from their own communities provided the owners of some of the local FIs with lending opportunities for which they may have had a comparative advantage over the established banks arising from their more intimate knowledge of borrowers and their ability to bring community pressure to bear on loan defaulters.

Fourth, many of the local banks and NBFIs were established by politicians or by businessmen with close links to politicians. These political connections were used to obtain public sector deposits, thus overcoming one of the major impediments to the viability of newly established FIs, the difficulty and cost of mobilising funds.

Fifth, there has been a perception that banking offers higher rates of return than many other business opportunities in Kenya. This perception has probably been correct over the last few years when banks have made large profits from investing in TBs while profitability in the real sector has suffered due to recession.

Finally, the regulatory barriers to entry, especially for NBFIs, were not onerous. Minimum capital requirements were low; between 1968 and 1980 the minimum capital required to start a locally incorporated NBFIs was equivalent to less than \$100,000. Although the minimum capital requirement for a NBFIs was raised a number of times during the 1980s it remained under \$500,000 and by the early 1990s exchange rate devaluation had reduced it to the equivalent of less than \$250,000. Until 1992 the statutory minimum capital required to open a locally incorporated bank amounted to less than \$1 million (see table 4 below). FIs also faced only very limited entry barriers related to the suitability or expertise of their owners and managers.

Until the late 1980s the local FIs were concentrated mainly in the NBFIs sector. With the erosion of the regulatory differences between banks and NBFIs, most of the new entrants in recent years have been banks, in many cases started by people who had already established NBFIs. Several of the local NBFIs converted to commercial banks in 1994/95 in order to be able to accept current accounts and to conduct foreign exchange transactions.

Because of the perception that they are less secure than the larger foreign and

¹¹ It was also much easier, in terms of capital requirements, liquidity and personnel, to operate a NBFIs than a commercial bank.

government owned banks, the local FIs face much higher deposit costs. They have to pay higher interest rates than the larger banks to attract savings and term deposits and the deposit base of the local banks includes a lower proportion of current accounts than those of the larger banks.¹² The chairman of one of the local banks estimated that his average cost of deposits was around ten percentage points higher than those of Barclays and SCB. Competition for deposits among the local FIs is strong, and several have run advertising campaigns in the local media to attract deposits. Local FIs have been susceptible to bank runs whenever bank failures have occurred over the last decade and as a consequence have to maintain high levels of excess liquidity.

The local FIs mainly lend to small and medium scale businesses. Some of the Asian owned FIs tend to concentrate their lending on Asian businesses, and in some cases on businesses owned by members of the same Asian communities as the owners of the FI. The local NBFIs have mainly been engaged in financing asset purchases, in particular through hire purchase, lease hiring and mortgages. With the exception of the mortgage finance companies, most of these NBFIs have provided short or medium term loans. The local banks have concentrated mainly on the provision of overdrafts and short term loans together with letters of credit. Many of the Asian owned banks derive a large share of their business from trade financing; their access to this market being facilitated by the prominent role in the import/export trade of Asian owned businesses.

Because their costs of funds are higher than those of the larger banks, the local FIs have to charge higher lending rates, with the consequence that their loan portfolios are affected by adverse selection problems. The most creditworthy borrowers in Kenya have generally obtained loans from the established foreign or government owned banks or their NBFIs subsidiaries, which are able to extend credit to prime borrowers at the lowest lending rates. The local FIs are able to attract borrowers despite their higher lending rates for two reasons. First, they are prepared to offer credit to customers who have been refused credit (or would have been refused had they applied) by the established banks because they cannot satisfy the strict creditworthiness criteria demanded by the latter. Second, they provide prospective borrowers with a more personal and flexible service than that provided by the established banks and as a such are able to give much quicker decisions on loan applications.

One implication of the tendency of the local FIs to lend to those customers rejected by the established banks is that their borrowers are less creditworthy and more likely to default. It is likely that some of the Asian owned FIs are able to use community links to reduce default probabilities, but some of the African owned FIs are clearly in a more vulnerable position from the adverse selection of their borrowers. Aside from those FIs which have collapsed or been taken over by the CBK due to mismanagement or fraud, several of the currently operational local FIs have encountered difficulties with non performing loans over the last ten years. Bad debts have arisen for a number of reasons including poor lending procedures, the depreciation of assets used as collateral (such as vehicles bought under hire purchase agreements) and the difficulties of realising security in the courts. Some of the local FIs had to be recapitalised by their owners in the late 1980s or early 1990s, partly to offset losses arising from non performing loans and partly to meet the higher capital requirements demanded by the CBK.

The experience of those local FIs which have managed to avoid financial distress suggests that survival for this sector depends upon how closely they can adhere to several basic

¹² The NBFIs are not allowed under the Banking Laws to accept current account deposits.

rules. These include maintaining a diversified loan portfolio and deposit base, only lending against realisable security, only extending long term loans at variable interest rates, avoiding taking deposits from, or lending to, politicians or the public sector, remaining highly liquid, and employing professional management free from undue interference by shareholders in operational decisions.

The growth of the local FI sector since the mid 1970s has brought both benefits and costs for financial markets in Kenya and the wider economy. Some of these FIs have clearly been used for major fraud and/or been mismanaged at the expense of taxpayers and depositors and the credibility of other, better managed, local FIs. Many local FIs however represent genuine (ie non fraudulent) attempts to provide financial services, despite a variety of difficulties related to the adverse selection of their borrowers, the high costs of their deposits due to their lack of a sound reputation with depositors, and in some cases, shortages of skilled and experienced personnel. The local FIs that have survived have introduced an element of much needed competition into urban deposit markets and have provided loans, hire purchase, trade financing, etc to borrowers who would have been denied credit from the established private and public sector banks. They have also provided much more flexible and quicker services for their customers, especially with regard to decisions on loan applications, than the established banks.

6. Bank Failures

Since the mid 1980s the local financial sector has experienced a series of bank failures involving mainly, but not exclusively, the so called political banks. Around one third of the local banks and NBFIs in Kenya have either been closed down or been placed under statutory management by the CBK, usually after running into acute liquidity problems and/or because of repeated violations of banking regulations (see table 5). Many of the failed FIs were technically insolvent when closed down. The extent of the fragility within the financial system has exposed deficiencies in the regulatory and supervisory framework in Kenya, an issue which is examined in the following section. This section analyses the nature and causes of the bank failures in Kenya.

The first cycle of bank failures occurred during 1984-86 with the collapse of the Rural Urban Credit Finance and the Continental and Union Bank groups. These FIs were liquidated after they were unable to repay deposits obtained from financial parastatals. In 1989/90 several small NBFIs and building societies collapsed and were taken over by the CBK; six of these FIs, together with the Union Bank group, were then merged to form the government owned Consolidated Bank group, which was given the task of restructuring their operations and recovering their bad debts.

During the 1990s the scale of bank failure escalated.¹³ Six banks and 11 NBFIs were put into liquidation or placed under the statutory management of the CBK for serious infractions of the banking regulations during 1993/94 following pressure from the IFIs and

¹³ Whereas the FIs which failed during 1984-86 accounted for only around 2% at most of the total deposits of the commercial banks and NBFIs, and those which failed in 1989 for only about 1%, the failures of 1993/94 are likely to have involved a much larger share. Although it is difficult to be precise in the absence of published accounts from many of the failed FIs, it is likely that those which failed in 1993/94 accounted for at least 10% of the total deposits of the banks and NBFIs; three of the liquidated FIs alone accounted for 7% of the gross assets of the commercial banks and the NBFIs in 1992.

donors. These included several relatively large banks such as Pan African Bank, Trade Bank and Post Bank Credit.¹⁴ Several more have faced the threat of closure from the CBK for infractions of banking regulations but have survived after being recapitalised by their owners.¹⁵

Although there are differences, several common features have characterised many of the bank failures in Kenya. These include the involvement of leading politicians, including government ministers, as shareholders and/or directors of many of the failed banks.¹⁶ Political connections were used to secure public sector deposits and in several cases to circumvent the requirements of the banking laws. Some of the failed FIs relied very heavily on deposits from a few particular parastatals, while in the early 1990s, several of the political banks also accumulated large overdrafts from the CBK.¹⁷ Their dependence on political connections to obtain funds in turn influenced lending decisions with adverse implications for the quality of their loan portfolios. The ownership structure of many of the failed FIs was highly concentrated, with one individual or family effectively controlling the institution including its lending policies.

The major causes of the bank failures in Kenya have been the accumulation of bad debts (and attendant liquidity crises) because of fraudulent or imprudent lending, including lending to companies connected to politicians. Adverse selection problems with regard to prospective borrowers, the poor quality of management and inadequate capitalisation have also contributed to the financial fragility afflicting the locally owned FIs.

Insider lending has been a prominent feature of several cases of bank failure in Kenya. Large non performing loans had been extended to the shareholders and directors of failed FIs (or companies owned by them) often to finance real estate development. Some of the most spectacular examples of insider lending include the Continental Group and the International Finance Company; the latter had extended almost 90% of its total loan portfolio to its owner, a government minister.¹⁸ The Pan African Bank (PAB), which in 1992 was the fifth largest bank in Kenya in terms of gross assets, had lent over 50% of its loan portfolio to companies

¹⁴ Post Bank Credit was not a private sector bank but an affiliate of the government owned Post Office Savings Bank.

¹⁵ Transnational Bank, owned by leading KANU politicians, accumulated a large portfolio of non performing loans, including many extended to companies associated with its shareholders (Weekly Review, November 5, 1993, pp40-41). This bank was technically insolvent in 1992, according to a World Bank report, as well as in breach of the CBK's cash reserve, liquidity and capital adequacy requirements. It was recapitalised in late 1993 and is still trading.

¹⁶ With some exceptions, the FIs which collapsed in the 1980s were mainly set up by Kikuyu politicians, while many of those which were placed under liquidation in the 1990s were owned by Asians with high level political connections.

¹⁷ An addendum to the CBK's 1992/93 Annual Report and Accounts reported that the CBK was owed almost Ksh 17.8 billion (around 17% of the total liabilities of the commercial banks) from the overdrawn accounts of three of the commercial banks which it has since placed under liquidation or statutory management. The provision of overdrafts by the CBK to the political banks was a major cause of the loss of monetary control and consequent inflation which occurred during 1992/93. CBK claims on the commercial banks rose from less than Ksh 1 billion in December 1991 to Ksh 21.3 billion in May 1993. This increase was equivalent to two thirds of the 41% expansion of the broad money supply during this period.

¹⁸ Finance, 1-15 February, 1991, pp 12-18.

controlled by its Chairman, an Asian businessman, mainly to finance the construction of a five star hotel. Trade Bank, another bank which had expanded rapidly to become the ninth largest bank in Kenya before being placed under liquidation in 1993, had extended a large share of its non performing loans to companies associated with its shareholders, one of whom was a former minister and powerful KANU politician, and had also invested heavily in real estate development.¹⁹ Both Trade Bank and Pan African Bank had used political connections to mobilise public sector deposits.²⁰

Because of adverse selection the loan portfolios of many of the locally owned FIs have included the least creditworthy borrowers in the credit markets. Some of the failed FIs had neither the financial resources nor the commercial expertise to manage the risks involved in serving this end of the market (World Bank, 1988, pp38-39). Many of the bank failures involved mismanagement of various forms. Loans were extended without proper security, documentation or evaluation of the creditworthiness and viability of borrowers. Rural Urban Credit Finance, the first FI to collapse, had extended thousands of largely unsecured loans to residents of a slum area of Nairobi (which was represented in parliament by Rural Urban's founder and Chairman) to purchase matatus (minibuses), plots of land and houses.²¹ In other cases, FIs ran into difficulties because loan portfolios were insufficiently diversified or because the same collateral had been used to secure more than one loan. Because many of the FIs were undercapitalised (the paid up capital of the Continental Bank amounted to less than 1% of its deposit base²²) their solvency was easily jeopardised by non performing loans.

Liquidity problems, which have been a pervasive feature of the financial fragility among the locally owned FIs, arose as a result of non performing loans, excessive levels of investment in fixed assets, and the mismatching of asset/liability maturities. In some cases liquidity crisis were triggered by the sudden withdrawal of parastatal deposits, allegedly for political motives.²³

Many of the failed FIs expanded too rapidly, obtaining funds from parastatals or by offering attractive packages to depositors which undermined lending evaluation procedures (as in the case of Rural Urban) and/or squeezed interest rate margins. The quality of managers was often low, either because they lacked experience or because they had been recruited from among the less able employees of the larger banks.

Several of the political banks closed down in 1993 were also used to facilitate other forms of large scale frauds, some of which were probably linked to the financing of the 1992 election campaign. Several of these frauds involved the abuse of pre-shipment export finance

¹⁹ The Weekly Review, April 23, 1993, pp 13-18.

²⁰ Economist Intelligence Unit Country Report, No 2 1992, p12.

²¹ The Accountant, Oct/Dec 1992, pp 2-5.

²² Weekly Review, 30 July 1993, p22.

²³ There is a belief among some members of the banking community in Kenya that some of the locally owned FIs which failed in the 1980s (especially those owned by Kikuyu politicians) were deliberately undermined for political reasons through the withdrawal of their parastatal deposits. Although it is not denied that mismanagement did occur, the belief is that these FIs were attempting to conduct genuine banking business rather than commit fraud and that they could have been rescued had the CBK and government taken a more flexible approach (see also "Rebuilding Indigenous Banks", The Accountant, Oct/Dec 1992, pp 2-5.

and export compensation facilities provided to banks by the CBK, the most notorious of which was the Goldenberg scandal; the alleged theft of a huge sum of money through fraudulent claims for export compensation submitted through the Exchange Bank.²⁴

The bank failures in Kenya have imposed substantial costs on the economy, and in particular on taxpayers, who have borne the burden of the CBK's losses and of reimbursing insured deposits. They have also had adverse effects on those local FIs which have been managed in an honest and prudent manner: bank failures damage the credibility of FIs throughout the local FI sector, raising the costs of deposits and forcing FIs to maintain high levels of excess liquidity as a precaution against bank runs.

7. Bank Supervision and Regulation

The bank failures in the 1980s and 1990s exposed the deficiencies in the system of prudential supervision and regulation of the commercial banks and NBFIs. Both the legal framework and the CBK's supervisory capacities had evolved to regulate a banking system confined to subsidiaries of multinational banks. These had well qualified staff and strong internal controls and therefore required only the minimum of supervision (World Bank, 1989). The emergence of the local FIs from the mid 1970s onwards radically changed the nature of the demands placed on bank supervisors. Not only was there a proliferation of new FIs, but many were inadequately capitalised and were incompetently or fraudulently managed. The prudential system proved deficient in three important respects: The banking laws were not strict enough (particularly prior to 1985), the CBK did not have adequate supervisory capacities, and some of the FIs were able to use political connections to flout the banking laws.

The 1968 Banking Act, which replaced the Banking Ordinance enacted during the colonial period, provided the legislative framework for the banking industry. The Act gave the Minister for Finance responsibility for licensing banks and NBFIs and the CBK responsibility for inspecting these FIs. It also imposed prudential requirements on the banks and NBFIs including minimum capital requirements, a liquid asset ratio to be determined by the CBK, and restrictions on excessive loan concentration, lending against inappropriate security and (by banks but not NBFIs) lending for, or investing in, immovable property or speculative activities.

The collapse of Rural Urban Credit Finance in 1984 led to the strengthening of the banking legislation. The authorities regarded the existing legislation to be inadequate, particularly in respect of the licensing procedure, the level of minimum capital requirements and restrictions on insider or connected lending (CBK, 1986).

The 1985 Amendments to the Banking Act attempted to rectify these deficiencies. Licensing applications were henceforth to be routed through the CBK (although the final decision remained with the Minister for Finance). Both minimum capital requirements and minimum capital/deposit ratios were raised, while FIs were also required to transfer a specified share of profits into a statutory reserve fund and hold these reserves in approved securities. The directors of FIs were prohibited from extending unsecured loans to themselves, their relatives or connected companies, and were made liable for losses arising from unsecured lending, while the restrictions on investment in real estate, equity and speculative assets were extended to the

²⁴ The Law Society of Kenya, in its private prosecution of those alleged to be involved in the Goldenberg scandal, claimed that the fraud amounted to 18 KSh billion - a sum which amounts to almost 6% of GDP - (Economic Review, Jan 30-Feb 5, 1995, p11). The Exchange Bank is also under liquidation. The Economic Review (various issues) has comprehensively covered the Goldenberg scandal.

NBFIs. In addition an amendment passed in late 1984 gave the CBK power to remove and appoint managers of FIs which were not being run in a satisfactory manner. These and subsequent amendments in 1987 and 1988 (which included limits on ownership concentration and further increases in minimum capital requirements) were incorporated into a new Banking Act enacted in 1989.

The rapid growth in the number of FIs in the 1980s was not matched by an appropriate expansion in the supervisory capacities of the CBK. The Bank Supervision Department (BSD) of the CBK lacked sufficient numbers of professional staff, and the reporting requirements and systems through which the BSD received financial data from the FIs were inadequate. Until 1993 FIs were not required to submit much of the information necessary for effective off site examination, such as the classification of loans according to performance criteria and details of loans which might be in breach of banking regulations. Supervision was also impeded by political interference. As a consequence the BSD was unable to perform effective offsite surveillance and to conduct regular on site inspections; many of the banks and NBFIs were able to avoid inspection for substantial periods (Kariuki, 1993, pp306-9).²⁵

The failure to prevent the financial fragility which emerged in the mid 1980s could be attributed largely to weaknesses in the banking legislation and in the CBK's supervisory capacities. These weaknesses were at least partly addressed with the revisions to the banking laws noted above and the strengthening of staffing levels at the BSD.²⁶ Nevertheless this did not prevent bank failures on a much larger scale from occurring in the early 1990s. The main reason why the regulatory and supervisory system failed a second time was political interference in the inspection of FIs and the enforcement of banking laws.

Political considerations influenced the granting and renewal of banking and NBFIs licenses even when applicants had not fulfilled the necessary requirements. The Minister for Finance granted FIs exemptions from provisions of the Banking Act such as those restricting loan concentration, insider lending, lending for real estate and ownership concentration.²⁷ The ability of the BSD to examine politically connected FIs was obstructed, as were their efforts to enforce compliance with the banking laws when infractions were discovered: In some cases inspection reports recommending remedial action were prepared but never sent to the inspected FIs.²⁸ Most importantly, the CBK and DPF extended large overdrafts to several of the political banks, allowing them to continue trading despite the fact that they had become illiquid as a consequence of fraud and mismanagement.

Since the first half of 1993 prudential regulation has been tightened as evidenced by the measures initiated by the CBK to put 17 FIs into liquidation for violating various provisions of the Banking Act. In particular, the capital adequacy and liquidity requirements have been more rigorously enforced and strict rules governing FIs' access to CBK overdrafts have been

²⁵ The BSD was able to undertake on site inspections of only 26 FIs during 1990 and 1991 out of a total of over 80 FIs in operation at the time (Kariuki, 1993, pp307-8).

²⁶ The bank failures of the mid 1980s also led to the establishment of the Deposit Protection Fund (DPF) in 1986 to enhance public confidence in the safety of their deposits and therefore reduce the risk of bank runs. The DPF also provided a mechanism for liquidating failed FIs (CBK, 1986).

²⁷ Section 53 of the Banking Act gave the Minister for Finance authority to grant exemptions from provisions of the Act.

²⁸ World Bank reports and interviews with CBK staff.

introduced. Minimum capital requirements have also been raised. The BSD is receiving more detailed and relevant information from FIs and its staffing levels have been further strengthened. Moreover, with the replacement of the CBK Governor and Minister for Finance and liquidation of most of the political banks, the extent of political interference in banking regulation has been reduced. Whether these improvements, which came about largely as a result of pressure from the donors and IFIs, can be maintained depends on the political economy of Kenya.

8. Financial Liberalisation

A variety of reforms to the financial system have been introduced since the early 1980s. Alongside measures intended to strengthen the institutional structure and regulatory framework of the financial system, such as the revision of banking laws and improvements in supervision discussed above, a number of reforms have been introduced to liberalise financial markets and the conduct of monetary policy. The pace of reform accelerated towards the end of the 1980s financed by the World Bank's Financial Sector Adjustment Credit (FSAC). This section outlines the financial liberalisation reforms adopted in Kenya and assesses their impact on banking markets.

The main policy components of financial liberalisation included the increase in controlled interest rates from 1982. This ensured that pre-tax interest rates were positive in real terms, or were close to positive levels, for most of the period since then. The gap between TB and lending rates was narrowed in 1982. Interest rate differentials between commercial banks and NBFIs were reduced in the mid 1980s and the spreads between minimum deposit and maximum lending rates were widened in the second half of the 1980s. Interest rates were deregulated in 1991; the controls over lending related fees and charges having been removed in the previous year.

The credit ceilings imposed on the commercial banks and NBFIs were abolished in 1993 (they had not always been strictly enforced) with the CBK placing greater emphasis on a combination of open market operations, minimum cash reserve and liquid asset ratios and changes in the discount rate to control monetary aggregates.²⁹

The banking system has also been affected by measures introduced during the 1990s to liberalise foreign exchange markets. In 1992 the commercial banks were authorised to deal in foreign exchange and to accept foreign currency deposits from exporters in forex retention accounts. A market determined flexible exchange rate was adopted in 1993.

Liberalisation is intended to bring about a number of beneficial effects in financial markets. These include first, the stimulus to financial savings and deposit mobilisation through the incentive effects of higher real deposit rates. Second, higher lending rates should encourage a more efficient allocation of loanable funds by reducing opportunities for borrowing at low or negative real interest rates. Third, liberalisation should eliminate distortions which arise from a variety of other administrative controls, such as those which segmented financial markets between banks and NBFIs, and promote greater competition in financial markets.

There is little evidence to suggest that the increased real interest rates prevailing since 1982 had a positive impact on savings and deposit mobilisation. Interest bearing deposits held

²⁹ During the 1980s the CBK had promoted the development of regular TB and bond auctions and provided rediscounting facilities for short term securities in order to facilitate the introduction of OMOs.

in the commercial banks and NBFIs rose as a percentage of GDP from 24.2% in 1981 to 31.7% in 1993 but the rate of increase was less than in the 1970s when real deposit rates were lower.³⁰ Mwega, Ngola and Mwangi (1990) tested the impact of changes in real deposit rates on private sector savings and on financial savings defined as currency and deposits held in the banks and NBFIs. Their results did not support the proposition that real deposit rates had a significant positive effect on either private savings or financial savings.

The impact of liberalisation on the efficiency of credit allocation in financial markets in Kenya is more difficult to determine empirically, not least because many of the intended consequences are microeconomic in nature and may not be evident in macroeconomic statistics. Raising real lending rates will not necessarily improve resource allocation in credit markets if distortions remain elsewhere in the economy. In its assessment of the FSAC, the World Bank's Operations Evaluation Department argued that the efficacy of liberalisation and other financial sector reforms in improving credit allocation was limited because the demand for credit from high yielding investment projects was depressed by constraints in the real sector such as poor infrastructure and price controls (World Bank, 1993).

There is some evidence to indicate that liberalisation has stimulated more competition in banking markets. With the removal of interest rate controls, the market for urban deposits appears to have become more competitive. Many of the local banks and NBFIs have been competing aggressively for deposits over the last few years by offering more attractive deposit rates, as well as other services, and through extensive advertising in the media. In addition efforts have been made by many FIs to attract retail customers by improving customer services and by marketing new products such as credit cards.

There is probably less competition in credit markets, where the local banks are at a disadvantage in servicing the loan requirements of large scale prime borrowers because of capital constraints, and where some of the local banks orientate primarily on a particular section of the community. Nevertheless some of the local banks, particularly the Asian owned banks, have begun to challenge the dominance of the established banks in the provision of trade finance.

Despite the evidence of greater competition in some segments of the banking market, the banking system remains effectively oligopolistic, with the large banks operating an informal cartel in setting interest rates and charges. Barclays, SCB and KCB have been insulated from more vigorous competition by their size, their reputations for deposit safety, their extensive local branch networks and their international links. The large profits generated in the last few years are testimony to the very limited nature of competition faced by the large banks.

The efforts to enhance the efficiency of intermediation through financial liberalisation were undermined by the deterioration of public finances in the early 1990s. A large increase in government bank borrowing to fund a fiscal deficit equivalent to around 8% of GDP in 1992/93 contributed to rapid money supply growth and inflation rates of 30% in 1992 and 46% in 1993. In order to absorb liquidity through OMOs, TB rates were raised to as high as 70% in mid 1993. Although interest rates had been deregulated in 1991, the commercial banks were clearly reluctant to raise their lending rates to match those of TBs or the rise in inflation because this would have threatened the solvency of some of their borrowers. Commercial bank

³⁰ Data are from the IFS and refer to savings, time and foreign currency deposits of deposit money banks and time and savings deposits of other banking institutions.

maximum lending rates were on average around nine percentage points below the rate of inflation in 1992 and 16 percentage points lower than inflation in 1993.³¹ Most banks and NBFIs virtually stopped extending new loans and invested their surplus funds in TBs instead, generating large profits as a result.

9. Conclusions

The financial sector policies adopted by the government in Kenya had very varied effects on the development of the banking system. Government intervention took the form of establishing publicly owned commercial banks, imposing direct controls over interest rates and some components of the asset portfolios of FIs and bringing informal pressures to bear on government owned FIs to influence lending decisions. However, the degree of "financial repression" was relatively moderate did not prevent both financial deepening and the emergence of a diverse range of FIs. An important development since the late 1970s has been the entry into financial markets of locally owned private sector FIs, although the four large banks, two foreign and two government owned, have retained their dominant role in the banking system.

Since the early 1980s a variety of financial sector reforms have been implemented. These include the gradual liberalisation of interest rate and other controls, revisions to the banking laws to strengthen prudential regulation, and the creation of a Deposit Protection Fund. In addition there have been a number of different methods adopted to deal with bank distress: Several failed local FIs were taken over and merged to form a government owned bank in 1990, the CBK closed down other failed local FIs, and one of the two large government owned banks, the NBK, was restructured in the early 1990s.

The government owned commercial banks were expected to address non commercial objectives, in particular lending to African businesses, parastatals and co-operatives and the extension of banking services into rural areas. The NBK has been afflicted by substantial non performing loans, extended mainly to the public and/or agricultural sectors, which seriously weakened its financial position. It required an injection of capital from the government in the late 1970s, but the underlying cause of its financial difficulties - political interference in its lending policies - was not addressed. Consequently the quality of its loan portfolio experienced further deterioration and it required a major recapitalisation and restructuring in the early 1990s. In contrast the KCB managed to avoid accumulating significant bad debts and generated strong profits. The bulk of its operations have been conducted along strictly commercial lines with most of its lending being well secured and, as demonstrated by the big foreign banks, well managed commercial banking has generally been a profitable business in Kenya.

The two large foreign banks, Barclays and SCB, have both remained conservative in their lending policies, concentrating on the provision of short term well secured loans to prime corporate customers and avoiding potentially risky sectors such as parastatals. Apart from a minimum requirement for agricultural lending which was not enforced, direct government controls over their lending were light and they were not obliged to fund the government deficit at negative real interest rates.

Barclays and SCB have been profitable throughout the post independence period for

³¹ Interest rate data is from QER. No data on the NBFIs' lending rates are given.

several reasons. They have been well managed, faced only limited competition, and the lack of direct government controls allowed them to concentrate on low risk commercial banking operations. The latter has proved to be highly remunerative in Kenya for two reasons: there was a large pool of creditworthy customers among private sector businesses, and the cost of mobilising funds was low.

One of the most dynamic features of the Kenyan financial sector has been the vigorous growth of local NBFIs, and more recently, commercial banks. The potential for high rates of return combined with the perception that the established banks were not adequately serving important sections of the credit markets, especially local businesses, have stimulated the emergence of this sector. The relationship between government and the development of the local FIs has been complex. Their growth was facilitated by the market opportunities created by the differential regulatory treatment of banks and NBFIs, by the low legislative barriers to entry and in some cases by the lack of enforcement of banking regulations. In addition some of the local FIs have been able to expand rapidly by utilising political connections to mobilise public sector deposits.

Financial fragility has characterised many of the local FIs, mainly because of fraud, especially insider lending, imprudent management, undercapitalisation, and the difficulties involved in having to service the least creditworthy segments of the credit market. While political connections undoubtedly facilitated the establishment and growth of many of the local FIs, they also contributed to their downfall, not least because loans made to politically influential borrowers were often not serviced.

It appears that most of the local banks and NBFIs which have remained independent of political connections have avoided serious financial distress. This suggests that a viable niche exists in financial markets for local FIs if they are professionally managed and operate on sound commercial principles. These FIs have made a positive contribution to financial development by promoting greater competition and by extending credit to borrowers excluded from access to loans from the major commercial banks. The difficulties they face include operating on narrow interest rate spreads because of their high cost of funds and the need to maintain substantial levels of excess liquidity to guard against deposit runs.

Bank regulation and supervision has not been very effective in Kenya. Following the bank failures of the mid 1980s, the banking laws were revised and the supervisory capacities of the CBK strengthened, but these improvements were undermined by political interference which prevented the CBK from inspecting political banks or enforcing compliance with the banking laws. The consequences of this became apparent with the banking crisis of 1993, when it emerged that several of the political banks with severe liquidity and solvency problems had been able to access large overdrafts from the CBK. Since then the CBK has more rigorously enforced the banking laws, liquidated many of the political banks and appears to have gained a greater degree of independence from political pressures.

Since the early 1980s most of the direct controls, other than those relating to prudential regulation, have been phased out in a process of financial liberalisation. The impact of liberalisation on financial markets is difficult to determine with precision. There is evidence of more vigorous competition among FIs for deposits and in providing customer services. However it is not clear that liberalisation stimulated deposit mobilisation by the banking system in aggregate nor that it has necessarily improved the efficiency of credit allocation in the presence of widespread distortions elsewhere in the economy.

To summarise, the banking system in Kenya is in much stronger shape than in most other countries in SSA. There were deficiencies in post independence financial sector policies:

political interference in some of the government owned banks and DFIs undermined their solvency, prudential regulation and supervision was inadequate, and controls over interest rates impeded efficiency. But serious disintermediation was avoided and the bulk of the banking system remained solvent. Financial sector reforms were introduced on a rather piece-meal basis beginning in the early 1980s. The reforms included a strengthening of the legislative framework for prudential regulation, and the removal of interest rate and other controls which has stimulated greater competition in banking markets. The reform effort was impeded by political constraints, principally continued political interference in the government owned banks and the enforcement of banking laws, and by the impact of large fiscal deficits on interest rates and inflation. Nevertheless there is a core of sound and profitable banks providing a relatively diverse range of services, and since 1993 the authorities have adopted a much stricter approach to bank regulation.

Table 1

Dates of Establishment of Government Owned, Foreign Owned and Local Private Sector Banks and NBFIs

Commercial Banks

Year	Foreign Owned	Government Owned	Local Private Sector	Total
before 1971	8	2	1	13
1971-75	2	0	1	3
1976-80	4	0	0	4
1981-85	1	0	4	5
1986-91	0	1	5	6

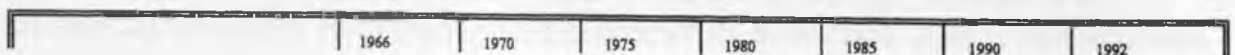
NBFIs

Year	Foreign Owned	Government Owned	Local Private Sector	Total
before 1971	4	0	2	6
1971-75	1	3	1	5
1976-80	3	0	8	11
1981-85	2	0	17	19
1986-91	4	0	12	16

Source: reproduced from Kariuki (1993, p307).

Key Monetary and Banking Statistics: 1966-1992

KSh Billions 1990 Prices



Narrow Money	6.0 (16.2)	13.6 (19.4)	15.9 (17.4)	20.9 (16.0)	19.0 (12.8)	27.5 (14.1)	36.6 (18.4)
Broad Money	8.6 (22.9)	21.4 (30.4)	26.2 (28.6)	40.0 (30.6)	39.7 (26.7)	58.1 (29.7)	76.1 (38.3)
Liquid Liabilities of Banking System			31.0 (33.8)	50.6 (38.8)	58.3 (39.1)	84.8 (43.3)	100.7 (50.6)
Banking System Claims on Public Sector	0 (0)	0.9 (1.2)	8.4 (9.1)	11.8 (9.1)	22.7 (15.2)	31.1 (15.9)	22.6 (11.3)
Banking System Claims on Private Sector	4.8 (12.8)	10.5 (15.1)	20.0 (21.8)	39.5 (30.2)	46.9 (31.5)	64.2 (32.8)	60.0 (30.2)
GDP Deflator	22.1	16.4	26.0	40.3	67.8	100.0	162.5

figures in parenthesis refer to percentages of GDP

Narrow money refers to deposits and cash of monetary system (monetary authorities and deposit money banks). Broad money refers to narrow money plus time and foreign currency deposits of the monetary system. The banking system consists of the monetary system plus other banking institutions.

Credit data for 1966 and 1970 refer to the monetary system only.

Source: IFS

Table 3

Selected Nominal and Real Interest Rates: 1975-93

Percent per annum

	1975	1980	1985	1990	1993
Commercial Banks' Lending Rate	10.0 (-7.9)	11.0 (-2.5)	14.0 (0.8)	19.0 (2.9)	38.6 (-4.9)
Commercial Banks' 3-6 month Time Deposit Rate	5.1 (-12.0)	7.0 (-6.1)	11.3 (-1.6)	14.5 (-1.0)	33.1 (-8.7)
NBFIs' Lending Rate	12.0 (-6.0)	14.0 (0.1)	19.0 (5.2)	19.0 (2.9)	free
NBFIs' Deposit Rate	7.5 (-10.0)	11.0 (-2.5)	14.5 (1.2)	18.0 (2.1)	52.0 (4.3)
Treasury Bill Rediscount Rate	5.7 (-11.5)	5.6 (-7.3)	14.1 (0.9)	15.9 (0.3)	39.3 (-4.5)
Consumer Price Inflation	19.4	13.9	13.1	15.6	45.8

Figures in parenthesis refer to real interest rates (nominal rates adjusted for consumer price inflation): the real rates do not take account of taxation.

The interest rates shown are the maximum stated in the QER.

NBFT's rates are those pertaining to hire purchase companies and merchant banks

1993 rates are those prevailing in December.

Sources; QER for interest rates, IFS for inflation

Table 4**Minimum Capital Requirements for Locally Incorporated Commercial Banks and NBFIs: KSh millions and \$ millions**

Year	Commercial banks		NBFIs	
	KSh m	\$ m	KSh m	\$ m
1956-68	2	0.28-0.28		
1968-80	2	0.28-0.27	0.5	0.07-0.07
1980-82	5	0.67-0.46	1.0	0.13-0.09
1982-85	10	0.92-0.61	5.0	0.46-0.30
1985-92	15	0.91-0.41	7.5	0.46-0.21
1992-	75	2.07-1.37*	37.5	1.04-0.69*

* value as of June 1995

Notes: The minimum capital requirements were denominated in Kenyan shillings. These were constant during each of the periods shown in the table. However the equivalent values in dollars depend upon the exchange rate, which was not constant. Hence two dollar values are shown for each period, one determined by the exchange rate prevailing in the first year of each period and the other determined by the exchange rate in the last year. The capital requirements introduced in 1992 were still in force in 1995.

Minimum capital requirements for NBFIs were first established in 1968.

Sources: Central Bank of Kenya, 1986, CBK Annual Report, 1992/93.

Table 5

Failures of Banks and NBFIs and other FIs in Kenya

1984-86	Rural Urban Credit Finance Continental Bank, Continental Finance Union Bank, Jimba Credit Pioneer Building Society
1993-94	International Finance Company United Bank Trade Bank, Trade Finance, Diners Finance Pan African Bank, Pan African Finance Post Bank Credit Exchange Bank Thabiti Finance Export Bank
1995	Meridien BIAO Kenya

Includes banks and NBFIs closed down or placed under statutory management by the CBK.

Post Bank Credit was a public sector bank and Meridien BIAO was foreign owned; all the others were owned by local private sector.

Where more than one FI is shown on the same line, as with Continental Bank and Continental Finance, they share common ownership.

Sources: CBK and miscellaneous.

Abbreviations

AFC	.....	Agricultural Finance Corporation
CBK	.....	Central Bank of Kenya
CIC	.....	Capital issues Committee
DFCK	.....	Development Finance Corporation of Kenya
DFI	.....	Development Finance Institution
DPF	.....	Deposit Protection Fund
FI	.....	Financial Institution
FSAC	.....	Financial Sector Adjustment Credit
HFCK	.....	Housing Finance Corporation of Kenya
ICDC	.....	Industrial and Development Finance Corporation
KCB	.....	Kenya Commercial Bank
KIE	.....	Kenya Industrial Estates

KSh Kenya Shillings
MNC.....Multinational Corporation
NBFI Non Bank Financial Institution
NBK National Bank of Kenya
NSE Nairobi Stock Exchange
OMO Open Market Operation
QER Quarterly Economic Review
SECAL Sectoral Adjustment Loan
SEFCO Small Enterprise Finance Company
SOE State Owned Enterprise
SSA Sub-Saharan Africa
TB Treasury Bill

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