Key Issues in the Future Development of Kenyan Banking

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1. Introduction

Since assuming office in December 2002 the new Government of Kenya (GOK) has sought to initiate reform in a wide range of areas. The GOK was soon aware of the very serious difficulties in the country's financial sector and quickly outlined a number of proposals for reform some of which were incorporated in the Economic Recovery Strategy (ERS[1]) published in June 2003. Other initiatives were announced in the Minister of Finance's first budget speech in March of that same year.

There are certain symptoms of the problems in the financial sector that concern the government and undermine the prospects of achieving its main objectives for the economy (e.g. job creation) Those referred to in the ERS include:

- An excessive ratio of non-performing loans in some major banks
- Ineffective competition in the banking and NBFI sectors
- Persistence of wide interest rate spreads and so a high cost of credit
- Insufficient quantities of credit (and poor quality credit assessments)
- Insufficient depth of access to banking services for the Kenyan public
- Absence of vibrant institutions for long term finance
- Weak legal arrangements creating long delays in contract enforcement and dispute resolution

In the months following the publication of the ERS, the Government implemented various policy actions to address these and other problems. However, the solutions offered have mainly been specific to particular aspects of the problem with only a limited recognition of the interdependent nature of most of the issues listed above. The authorities still need to develop *a comprehensive and integrated banking strategy for the medium term.* Such a strategy also requires a clear articulation of the benefits for the Kenyan economy that can be generated by a larger, and sounder banking sector.

This present paper looks selectively at some of the issues listed above and outlines the main features of a possible strategy to address them.[2] A short paper cannot hope to

[1] *Economic Recovery Strategy for Wealth and Employment Creation: 2003-2007*, Government of Kenya, Nairobi, June 2003

[2] This overview paper is based on a report prepared in October 2003 by a joint Kenyan – UK team for the Government of Kenya and with financing from the UK-Department for Foreign International Development (DFID). The Report is entitled *A Banking Sector for the Future – A New Vision*. .Joseph Kimura and Alan Roe were the joint team leaders. However, the views expressed here are personal to the author and are not necessarily shared by all other members of that team. This report itself is hereafter referred to as the *Joint Report*

cover all outstanding issues but it can present the key elements and provide some analysis of how they are connected.

Section 2 below looks at some of the underlying causes of today's problems in the sector. Section 3 outlines the structure of a proposed strategy to resolve these problems. Sections 5 through 8 elaborate on five selected aspects of the strategy: spreads, non-performing loans, long term finance, regulation and extending access to a greater number of people.

The analysis is based mostly on the joint Report referred to in footnote 2. The recommendations there include certain components that were worked out in some detail and others that were included mainly to initiate a debate. The recommendations in this present paper are offered in that same spirit.

2. The Legacies from the 1990s

Many of the problems seen in the financial sector today trace back to the mal-administration of the economy in general and the financial sector in particular during much of the 1990s. Empirically the decline in the sector and its contribution to economic development is clear from a few key macro developments such as:

- A decline in financial depth (M2/GDP) – now 6 percentage points lower than at its peak.
- A slight rise in the ratio of cash money to broad money (now around 15% as against 12% in the mid 1990s) signifying a decline of public confidence in banks
- A substantial fall in both aggregate savings and investment rates

The Joint Report lists various events that together contributed to the difficulties in the sector. These included:

- The liberalization of financial markets in June 1991
- The serious financial abuses that preceded the multi-party elections held in late December (e.g. the Goldenberg events)
- The extreme monetary expansion and inflation episode associated with that period – inflation rose to more than 50% by end 1993
- The extremely high levels of interest rates (led by Treasury securities) that arose because of the mopping up (of liquidity) operation needed in 1993-94. This led to rates on Treasury Bills of over 70% by mid- 1993
- The sustained availability of large volumes of Treasury securities (Treasury .Bills and Bonds) even after the mopping-up operation and through 2002 – around KES 8 billion monthly falling to KES 4.5 billion only in mid-2003
- Liberalization in trade, foreign exchange and other areas that increasingly forced Kenyan businesses to (a) face greater competition domestically and internationally with far less protection and (b) deal with a variety of new risks.
- Greater difficulties for the real economy because of generally low growth rates (only 1.0 % in the period 1998-2002) and greater risks due to the instability of growth, major external shocks, and the substantial retreat of the international donors.

These developments confronted mainstream banks with THREE major new circumstances that together has conditioned their behavior ever since:

1. A significantly riskier client base – associated with the weaknesses of the economy generally and the enhanced risks that individual borrowers faced in the new era of more open and global competition. This risk environment was compounded by the generally higher interest rates that prevailed after 1992.
2. A variety of new or increased regulatory and tax burdens. This included periodic increases in the liquidity requirement but more significantly the tightening-up of the Banking Act in 1995. Prudential regulations were tightened at that time to enforce greater duties and responsibilities on directors, executives and auditors. The rules for the definition and recognition of bad and doubtful debts (NPLs) were also greatly improved. These measures have undoubtedly resulted in far greater quality in bank supervision but they have also imposed high costs on banks such as NBK and KCB that had the highest burdens of NPLs Some of this new regulation and enforcement was definitely necessary to enhance the soundness and the stability of the banking system. But some placed an *avoidable* cost on banking.
3. Government debt management policies have provided a plentiful availability of high yielding and risk-free assets that the banks can hold in their portfolios. This defines the floor to the interest rate that a bank would set on a new (and riskier) loan made from a marginal unit of available funds.

In brief, points 1 and 2 have increased the difficulties of banking in Kenya. Point 3, until mid-2003, offered banks an easy solution to these problems – just invest a larger part of the balance-sheet in risk-free TBills and TBonds!

Parastatal Debt

A further important legacy of the 1990s relates to the debts of various parastatal organisations. These now constitute an important part of the problems that confront the stabilisation of problem banks. Whereas banking analysts concentrate on the non–performing loans and other assets of the mainstream banks, there is a parallel and even larger mountain of such problematic debt embedded in the country's 113-191 parastatals[3]. Both coherent fiscal management and coherent banking sector strategies are severely compromised by the uncertainties about how these various debts might be addressed.

As already noted, the recognised part of the government's domestic debt in the form of Treasury securities (Treasury bills and bonds) grew rapidly in the early 1990s as mopping-up operations sought to reduce excess liquidity in the economy. At the same time, the Central Government was running large fiscal deficits that injected further liquidity that also needed to be mopped up through open market operations. The central government deficit (including grants) reached nearly 10% of GDP in 1992 and averaged 7.8% of GDP throughout 1990 -1993.

[3] the true "messiness" of this debt is symbolized by the fact that there is not even a definitive official list of parastatal organizations. The MOF, Government Investments Division "List of State Corporations and their respective parent Ministry" indicates around 113 parastatals, but this number excludes individual tea factories and also may exclude those public enterprises where the government holding is less than 50 percent. A list of parastatals obtained from CBK shows 191 public enterprises – strategic and non-strategic- some of which have been partly divested. A standardised list of ALL parastatals is urgently needed for CBK reporting and preparations for restructuring/privatisation that will also show the Government's share holding, even where this is below 50 percent of the total.

However, after the package of stabilisation measures introduced in 1993-94, the fiscal deficit reduced sharply to less than 2 percent of GDP, and thereafter Kenya has maintained a relatively low *central* government fiscal deficit of 1-2% of GDP despite the fiscal legacy of high domestic interest payments. *On the face of it this quite modest deficit should not have imposed any undue costs on the banking system.*

Unfortunately, the good performance on the surface masks a variety of aspects of public administration that led to a significant build up in the *overall* deficit[4] and the level of public debt. This has became a burden on banks in various ways. Public sector financial administration generally deteriorated throughout the 1990s, particularly with regard to budget execution and the control and accountability of public resources.[5] The tight budget combined with weak expenditure management, governance issues, and underlying fiscal pressures led to a domestic debt-overhang and substantial claims accumulated for things such as pending bills/expenditure arrears, off-budget claims, and contingent liabilities that are not well-captured in the formally approved central government deficit.

The burden of this overhang of "messy" debt shows up as a consistent additional pressure on the annual expenditure budget. It is also an ongoing problem for organisations, including banks, that suffer arrears of payment. It is an administrative nightmare for over-stretched officials who have to deliberate on the rights and wrongs of myriad unpaid claims often going back many years: the *KES 10 billion of NBK's claim on the government is a prime example.*

From the viewpoint of this present paper, the key point to stress is that the resolution of problem banks is seriously compromised and often delayed by the significant deposits and loans that most of them have with parastatals. Non-performance of these parastatal loans is one of the most important causes of the overall high level of NPLs in Kenya. But these NPLs cannot easily be resolved given the poor financial condition of the parastatals and the need, as a consequence to go to the budget (and the political process) to find the funds. Equally, deposits from major parastatals prop up the asset base and liquidity of some problem banks. Hence any resolution involving the write down of assets and the imposition of losses on non-insured depositors would again pass a burden to the budget.

[4] The public sector deficit in its broadest sense covers not only the Central Government, but also the non financial - public sector (extra budgetary funds, pension funds, parastatals, public enterprises), plus the Central Bank of Kenya. So it explicitly includes the deficits of the 5 state-owned banks as well as 113-191 parastatals

[5] The financial management system has been analysed in a number of reports: (i) GOK *1997 Public Expenditure Review,* (October 1997); (ii) GOK *Public Expenditure Review 2003* (July 2003); (iii) Ministry of Finance, *Quarterly Budget Review,* (various) "Stock of pending bills", and "Guaranteed Loans for Parastatals"; (iv) World Bank, *Report of a Country Financial Accountability Assessment* (November 2001); (v) World Bank/IMF in collaboration with EU, UK/DFID and GOK, Public Expenditure Management: *Country Assessment Action Plan:* Kenya (May 2003)

3. The Elements of an Integrated Strategy

Based on this analysis of the situation, the Joint Report argues that any future strategy for the financial sector needs to embrace and integrate **three** aspects of overall GOK policy namely:

1 Sustaining sound Macroeconomic Policies

- public deficits (broadly defined to include the resolution of unpaid bills, expenditure arrears and other components of messy debts)
- monetary and debt management

2 The resolution of Generic Problems

- High Spreads
- High NPLs,
- Poor Access,
- System Instability

3. The resolution of Specific Problems in particular state-owned banks

By implication, the actions and responsibilities for the strategy reside in many parts of GOK. Financial sector reform is not a CBK responsibility alone.

We cannot expect a coherent approach unless we re-think some of the present compartmentalisation of responsibilities.

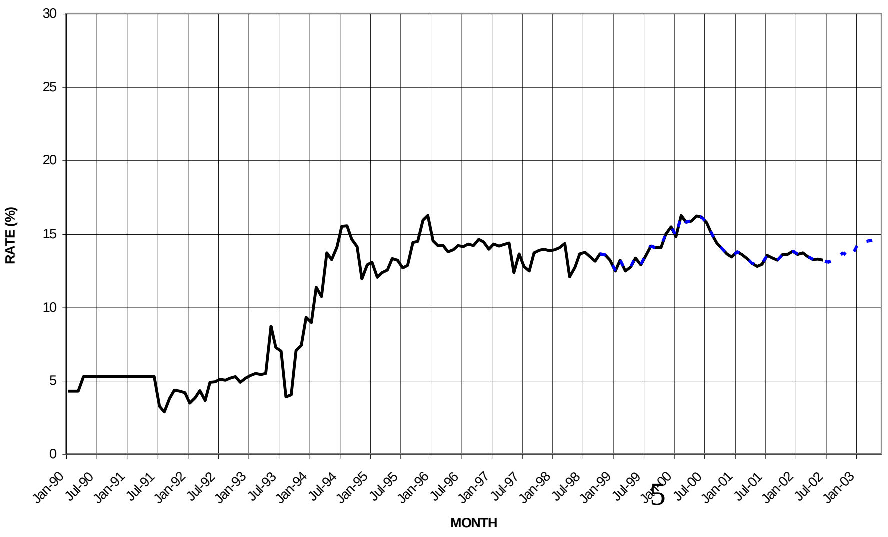
At the same time, any strategy for the sector must deal promptly and conclusively with both the inherited ***stock problems*** and especially:

- The unsustainable balance-sheet positions of a few large state banks
- The wholly unsatisfactory balance-sheets of major DFIs
- The large stock of messy debt in parts of the parastatal sector

and then also with the ***ongoing issues*** such as the sound regulation and governance of the whole of the financial system. This must involve the systematisation of regulation and supervision for parts of the sector that are today inadequately regulated and supervised and especially:

- SACCOs
- Micro Finance Institutions (MFIs)
- The DFIs
- The POSB

Figure 4: The Spread - Real lending vesus Real deposit Rates

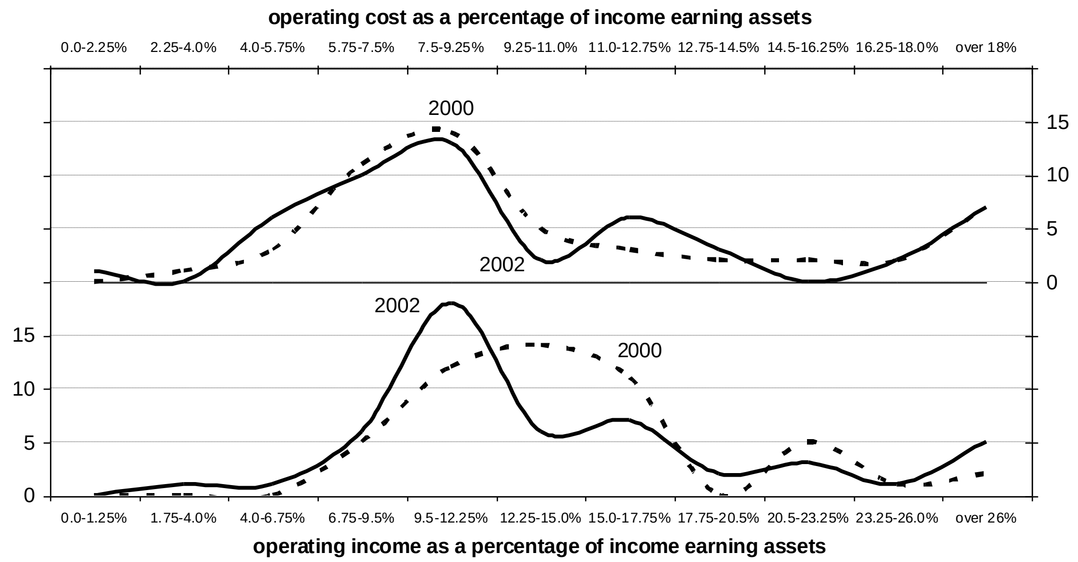


4. The Problem of High Spreads

This problem almost certainly traces back to the changing circumstances of the early 1990s as described earlier. As Figure 4 from the Joint Report makes clear the big hike in spreads from an earlier norm level of around 5% to a new level of 14-15% occurred after the liberalization of rates and the other key events of the early 1990s that changed radically the environment in which banks needed to operate.

But it is of crucial significance in designing a policy response to the high spreads to take full account of the different ways in which different categories of banks now set their charges. Based on cost data for each of Kenya's 49 banks, the Joint Report showed (a) very wide variations in *operating costs* between banks (b) variation across banks but at a significantly lower level in terms of their *operating income* (spread plus fee income relative to income earning assets. These contrasts as well as the tendencies between 2000 and 2002 are summarized in the Joint Report (see Figure 2).

Figure 2: Number of banks by Operating Cost Ratio (top panel) and Spread plus Fee Income (bottom panel)



The Joint Report suggests that the variations such as those shown in Figure 2 arise because certain main segments of Kenyan banking have significantly different ***cost*** structures. Differences occur in particular as between ((i) state-linked banks with large branch networks versus (ii) foreign banks with large branch networks versus (iii) foreign banks with limited branch networks and versus (iv) local niche banks with small branch networks. But significantly *those banks able to operate at lower cost did not seem to be systematically using their cost advantages to compete business away from higher cost competitors*. Hence low costs often imply high spreads rather than a rising market share achieved by the competitive pricing of services by more efficient banks.

Possible explanations for such non-competitive behavior include (a) the need of some banks such as the smaller niche banks to build capital in response to rising minimum capital requirements but without seeking funds from new shareholders and (b) the confining of banking activity of each class of banks to specific known segments of the market as an explicit device of risk management.

The policy implications from such an assessment are extremely important and can run counter to some of the ideas that are commonly expressed. They include for example the following conclusions:

- the authorities are correct to insist on much greater transparency in the tariffs charged for banking services including spreads. But it would be a mistake to try to control spreads directly given the diversity of bank behavior that is evident and the variety of reasons why some banks need to extract high spreads – those reasons can be good ones.
- Kenya may be a case, contrary to emerging global experience, where a forced consolidation of banking would be a *bad* idea, The smaller niche banks (both local and foreign) seem to be more cost-efficient. This their absorption in larger banking groups could worsen rather than improve the overall cost efficiency of the sector.
- There is no obvious correlation between ownership-type (e.g. foreign versus Kenya) and efficiency levels
- The authorities may have a point in lowering minimum capital requirements at least for some banks (although this has been a controversial policy change) if higher capital requirements have indeed forced smaller banks to maintain high spreads in order to build capital.

The point here is not to insist on any of these policy reforms but to suggest the need for a far more nuanced approach to the problem of spreads than has been seen so far. Above all that approach has to understand the incentives to which different classes of banks are responding. The need for this becomes much clearer once the problem is decomposed onto a bank-by-bank basis.

5. The Problem of Non-Performing Loans

The Joint Report confirmed that the NPL problem is one that is concentrated on only a limited sub-set of banks. Fortunately it is not a problem that threatens the banking sector at large. Since the problem banks all have significant state-involvement, their problems too can be resolved given appropriate policy decisions.

In Kenya, total gross lending by all the mainstream banks and non-bank financial institutions amounts to almost KES 300 billion but KES 126billion or 42% is non-performing. Although this is an alarmingly high figure, it need not represent a systemic threat to the Kenyan banking system. This is because the amount in question is very heavily concentrated on the state-linked banks and non-bank financial institutions. Specifically 73% of all NPLs in Kenya are concentrated in just *eight such institutions*[6]. This means of course that 27% or KES 34 billion of NPL are found in the other 38 banks and deposit-taking institutions and this is not a trivial figure. But in all but two[7] of these other cases, there is a very ample coverage of capital and provisions for the NPLs. On average these other deposit taking institutions have capital and reserves equal to three times the non-performing loans that have not yet had provisions made against them. This contrasts very favourably with the state-linked banks and non-bank-financial institutions, which only have capital and reserves equal to 40% of un-provided non-performing loans.

[6] These eight are not named in the paper because the data used to identify them is confidential
[7] These two are very small banks together - accounting for just 2% of total banking system assets

The evolving nature of the problem in the seven main problem institutions is summarised in Figures 2 and 3 below. They show that these institutions ***collectively*** have unsustainable balance-sheets. Specifically, their interest –bearing liabilities exceed their assets with the gap if anything widening in the past few years. At the same time, the level of unprovided NPLs relative to Capital and Reserves has also risen. The good news is that the ***collective*** performance of these seven banks shows some improvement in that in 2003 bad loan recoveries ensured that the bad-loan charges against profit reduced substantially relative to the operating profits of the banks taken together (Figure 3).

Figure 2: Balance sheet structure at state-linked banks and NBFIs

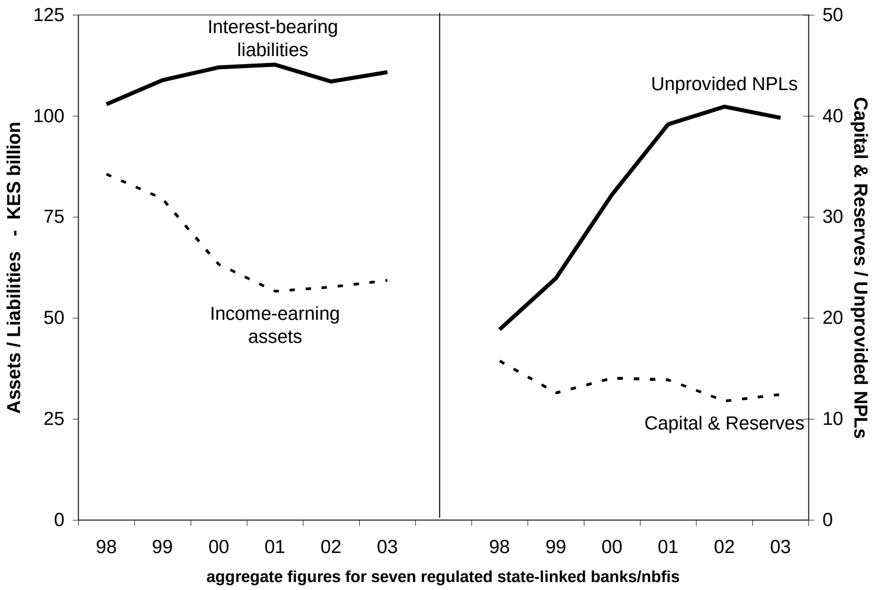
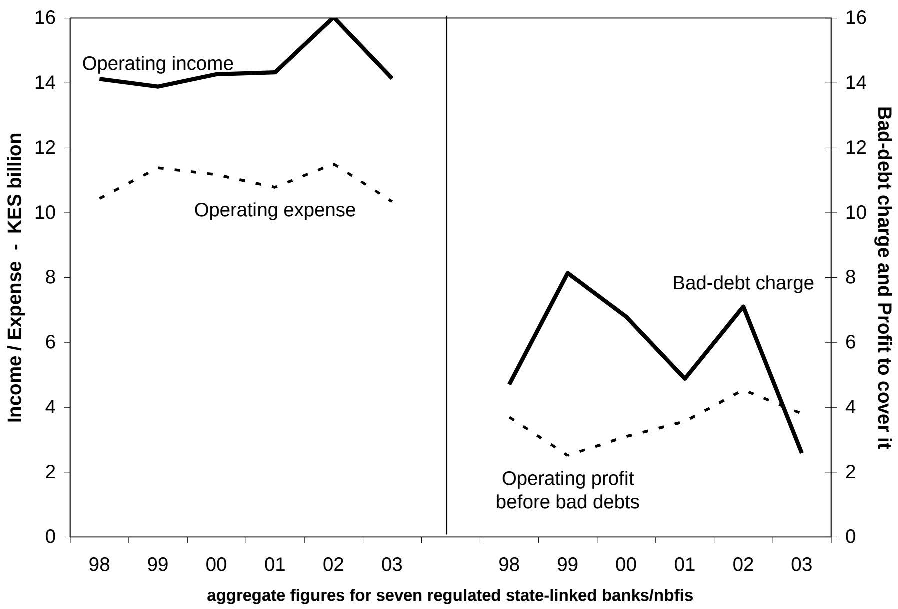


Figure 3: Profitability trends at state-linked banks and NBFIs



Given this broad diagnosis of the problem, it is evident that *the resolution of the NPL problem must involve a case-by-case approach* with each of the problem banks being the subject of its own resolution programme. Some banks such as KCB that take much of the credit for the improving situation shown in Figure 3 have already demonstrated that improved management in banks can deliver at least a part of the solution to their earlier distress. In other cases, only large budgetary injections as the basis for fundamental financial and organisational restructuring will resolve the problems.

Case-by-case solutions for individual banks were discussed in detail in the Joint Report[8] but specific conclusions are not given here for reasons of confidentiality. However, the following broad principles of strategy are important and need to be incorporated explicitly in any approach that the authorities may adopt.

i. *Solvency.* Any resolution programme must restore the balance sheet solvency of any banks that are technically insolvent and are to remain in business. This will normally create the minimum required liquidity of each bank.

ii. *Operational Viability*. The programme must also create banks that are operationally viable. If they are not operationally viable then NPL problems and capital deficits will quickly recur – experience from other countries offers plentiful examples of this. *If there are serious doubts that the injection of new capital to restore solvency will achieve operational sustainability, then it may be better to liquidate the bank or arrange its merger with a healthier bank.*

iii. *Due Diligence in Using Budget Funds.* The restoration of solvency will in many cases involve the injection of substantial public funds. It is important therefore that the resolution of the financial aspects of the NPL problem be accompanied by credible restructuring plans that prevent a recurrence of the same problems - GOK must avoid paying to solve the same problem twice. This inevitably also means addressing the underlying causes of past problems, and especially the links between parastatals and state-linked financial institutions. It also means not delaying resolution of problems that will only get bigger with time. The costs of delaying actions in some of the worse case banks already costs the government some KES 200mn per month. (i.e. the interest accruing on on-performing loans that are still presented as a claim on government)

iv. *Corporate governance*. Issues of governance are as critically important as operational restructuring. If a bank seems likely to be poorly managed or to be damaged by poor direction from its Board or from politicians, then the future will see a repeat of current solvency and liquidity problems. From a budgetary efficiency perspective, let alone from an economic efficiency perspective, *liquidation or merger will almost certainly be a better solution than a government-funded injection of capital to the existing bank in cases where good governance is in doubt.* There is a myth that it is fiscally efficient to put a small

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[8] For each bank one or more of the following seven options was assessed (and compared where there was more than one option that was appropriate). Immediate liquidation; closing solvency gaps before deciding about restructuring or liquidation; partial restructuring to eliminate insolvency before bringing in a strategic investor; full restructuring to restore solvency and liquidity prior to privatization; the same but with the bank retained in the public sector; immediate sale to a strategic investor; and allowing the bank itself to self-correct problems.

amount of budget money in to capitalise a state-linked bank that then gears up on this to direct a much larger amount of funds to favoured sectors of the economy. The fallacy of this is well illustrated by past failures. In one case *the GOK, in effect, is paying 26% compound interest per year on directed loans that it could be funding at below 10% a year given the current cost of funds in the market.* The compounded cost of this is now running at over KES 2billion a year – many times more than was originally lent under GOK direction.

v. *Shareholder structure.* Given that governments everywhere are not good at denying themselves the urge to exert maximum control over state-linked institutions, the shareholder structure resulting from any restructuring should force government to share control of board appointments. This would help to avoid future moral responsibility for standing behind an institution despite not being its sole owner. The clearest example of where this should happen is KCB. Because the bank was privatised through market placement, the other shareholders of the bank are very diffuse and unlikely to fully subscribe for their share of the bank's planned KES 2 billion rights issue. The GOK's past tendency to control KCB board appointments despite only having a 35% equity stake has therefore put it in the invidious position of possibly having to underwrite the whole issue even though neither government nor the management of the bank want to see an increase the degree of public ownership. It would be much better for GOK if the rights issue were underwritten by a suitable single large strategic investor so that in the future GOK can share responsibility for the bank, proportionate to its shareholding.

vi. *Spreading the Budgetary Cost.* As much of the resolution as possible should done off-budget. This is because the problems of these banks have built up over many years before the current government came to power and are of a magnitude that should be amortised over a similar number of years (probably 5-10 years). It would be wholly unrealistic to try to cover the whole of the costs in one year's budget.

vii. *Strategic Positioning*. Resolution proposals should be realistically costed and compared objectively against the alternative cost of liquidation. But, an important consideration in balancing these two will be the economic importance of maintaining competition in the lower mass middle market in which the state-linked banks operate. The Joint Report emphasised the need to close gaps in the Kenyan banking market where they exist. The restructuring decisions that the government must shortly make about the state-linked financial institutions provide a good opportunity to contribute to that objective.

6. The Problem of Long-Term Finance

A significant part of long-term finance for the economy can be expected to be intermediated through mainstream banks – an expectation that will be greatly enhanced if the immediate problems in some of these banks are addressed. In addition, Kenya has traditionally placed considerable importance on specialised Development Finance Institutions (DFIs) for this purpose. DFIs were typically formed by statute to supplement the activities of banks and other NBFIs. This was done in recognition of the shortages of medium and long-term credit to the priority sectors. They were also designed to encourage a flow of concessionary formal credit specifically to the rural areas.

The assessment at this stage is that the DFIs have largely failed to provide a reliable basis for the provision of *sustainable* long-term finance to industry and agriculture. Their roles and modes of organisation need to be fundamentally re-appraised as a part of any overall strategy for the sector.

The DFIs were successful and sound institutions in their early years and through the 1980s. But in the past decade huge operating losses and NPLS have been an increasing burden and the lending capacities of the institutions have consequently been eroded. Today they mainly await further replenishment from budget funds to carry out their designated. Government and donors need to decide whether and on what terms to provide such further support.

Their main structural weaknesses can be summarised as

- generally low capital adequacy ratios
- generally poor asset quality and weak loan appraisal capabilities,
- poor contract enforcement
- weak regulation and supervision
- some dependence on political patronage/ corruption.
- significant exchange rate and interest rate risks in some cases

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The Joint Report was unable to gain enough access to good quality data to assess the true performance and capabilities of the individual DFIs[9]. A further DFID-funded study is now underway to try to fill the gaps in information. However, the key elements of any reform strategy for the DFIs should probably embrace the following.

- Detach all DFIs from direct sectoral Ministry control. Instead they should be treated less as quasi budgetary institutions and more as proper financial institutions. This would require proper much improved accountability as well as *sustainable* arrangements for resource mobilisation and the use of funds.
- Create explicit professional regulation and supervision of all the DFIs with an appropriate degree of independence for the regulator
- Develop a CAUTIOUS overall strategy for re-capitalization but insist on the same pre-conditions for this that will apply to the restructuring of the state banks in difficulty (as defined above). In particular the authorities should pay strict attention to:

  –Solvency
  –Operational viability
  –Sound Governance

7. Financial Sector Regulation

The situation today can be characterised as follows:

[9] The exception to this was those DFIS that have been formally re-established as banks and are now regulated by the Central Bank. The information that they present to their various stakeholders is of good quality.

- The regulation of *mainstream commercial banks* is done to a good international standard
  –The CBK has a good grasp of problems in PRIVATE banks (resulting in less chance of abuse than was seen in the early 1990s)
  –The CBK has a good information base relating to problems in state banks but insufficient power to resolve these on its own

- An incomplete or in other ways inadequate regulation and supervision of most other types of banking institutions – albeit with good ideas for improvement already in the pipeline. This applies to:
  –SACCOs
  –Micro Finance Institutions (MFIs)
  – the DFIs
  – the POSB

The Joint Report presented the following general conclusions in this area:

A. In the Longer Term perspective, there is merit in moving bank regulation outside the Central Bank, because
  –the autonomy to conduct Monetary Policy is itself difficult to achieve
  –that autonomy is severely compromised if the Central Bank is also responsible for the stability of the banking system

B. But in the MEDIUM-TERM – the Regulatory System needs to build on the high professional standards and expertise already found in CBK – while capacity is built elsewhere

C. So as new agencies are established, policy should seek to create a Common Culture of Sound Regulation – superintended by the existing trained regulators who are found mainly in the CBK.

The Joint Report also emphasised the important reason for seeking to achieve better regulation of quasi banks (such as the SACCOs and the MFIs). Without such regulation a variety of dangers confront the development of the sector including:

  • A potentially important source of financial innovation (e.g. SACCOs) is seriously compromised by stakeholder doubts about the safety of funds
  • There is a lack of basic principles that apply across all banking markets and so the arbitraging of bad practice may be encouraged
  • A risk exists of contagion to/from the mainstream banking sector
  • Without effective regulation any work to strengthen the legislative platform for quasi banks will be wasted.

So for discussion purposes, a possible new structure for financial regulation and supervision in Kenya in the medium term (prior to integrated supervision in a new unified regulator) might look something like the following:

- CBK at the apex of the system (and professional standards) and regulating
  •Commercial banks
  •Mortgage finance companies, building societies and remaining NBFIs

•Deposit-taking MFIs

- CBK providing technical support to new autonomous agencies supervising
  •Larger SACCOs
  •Development Finance Companies

- A new Autonomous Agency to regulate SACCOs

- A new Autonomous Agency to regulate DFIs

- Common professional and minimum prudential standards for all THREE agencies.

8. The Problem of Access to Financial Services

Although 1.55 million bank accounts in Kenya's 43 mainstream banks may seem to be indicative of a reasonable spread of banking services in a country of 32 million people, the reality is different. Although bank branches are well spread around Kenya's major provinces, recent studies have shown that large segments of the population have no access to financial services since the bulk of credit goes to large enterprises in urban areas.[10] Vast areas of the country still have no commercial banking outlet.

Previous government efforts to extend the access of mainstream banking have had a mixed record. These efforts have included the creation in the early post-colonial years of banks such as the Co-operative Bank, NBK and later KCB[11] that were mandated to spread banking to new functional and geographical areas. Similar efforts in the future based around mainstream banks seem likely to fail since it is the commercial viability of branches that determine whether they open and then survive. The record of state-owned banks that have been required to open remote branches evidence such failure. As these banks have struggled to restore their solvency – invariably a struggle that has required their rationalization and privatization – they have had no choice but to close the less viable branches[12].

Hence any new strategy should recognize that improved access in future must rely more explicitly on the fostering of alternative to mainstream banks including the SACCOs, the Post Office Savings Bank, and some Micro-Finance Institutions. These organizations can operate at a lower cost than mainstream banks, achieve a more systematic link between savings and credit, and have proven their abilities to win large numbers of customer. By 2003, there were 1.3 million accounts in the POSB; an

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[10] See the data from Central Bank of Kenya, Statistical Abstract for the province by province distribution of bank branches. A very useful study on access is KIPPRA, *Legal and Other Constraints on Access to Financial Services in Kenya*, Kippra, Nairobi, 2001.

[11] Soon after independence in 1963, two Kenyan banks were set up to counter the excessive power of the foreign banks. The Cooperative Bank was set up in 1965 to look after interests in farming and the cooperative movement. The National Bank of Kenya was set up in 1968 to look after other the banking needs of national interests including the rising number of parastatal organizations. The Kenya Commercial Bank emerged from the 1971 split of the former National and Grindlays Bank and operated with a large government equity stake.

[12] KIPPRA, *Legal and Other Constraints on Access to Financial Services in Kenya,* Kippra Special Report, Nairobi, 2001

estimated 1.11 million members in urban SACCOs and 0.60 million members (0.39 million borrowers) in rural SACCOs. Assuming no overlap of membership or duplicate accounts, this adds up to 3 million persons with access: twice the numbers served as depositors by mainstream banks.

The general challenge for future strategy as regards access to is to find ways to make these quasi banking institutions a more robust and reliable part of the financial sector and a genuine competitor in some market segments with mainstream banks. At the same time the role of the mainstream banks that have traditionally served smaller savers and borrowers needs to be kept in view when the restructuring of some of them is under consideration. The restoration of the operational viability of the NBK for example is important here given the earlier conclusions about the segmented nature of banking competition.

Other significant actions that could pay dividends in terms of improving access include the following:

- Putting the situation of KPOSB on a sounder basis. This builds on the recent improvement in its financial situation (good but not yet good enough). The financial situation of that bank will be put on a sounder basis if it could be subject to intensified regulation by the CBK
- Strengthening the MFI and SACCO movements by being more explicit about the rights of some of them to accept deposits and the corresponding prudential obligations that go with these new rights. This has to be backed by serious and high quality regulation to avoid the financial scandals that could set these institutions back more than a decade.
- In the slightly longer term the strategy will move to exploring ways to link MFIs more directly to local and even international capital market funding so as to increase their capacities to lend
- Enhancing the general level of competitiveness in the banking sector (in various ways as discussed in the Joint Report). This will increasingly force banks to recognise the business to be won in new and unconventional areas. Experience in other countries shows that banks can and do make profitable business in the mass markets and small business sectors. But they need lower costs to achieve this and competition must be enhanced to force this into the system.

10. Conclusions

Kenya has traditionally had a large and effective financial sector by African standards. The performance as well as the size of that sector was undermined seriously by the financial improprieties of the 1990s but a recovery away from that situation is already evident in many dimensions. Unfortunately the efforts to date have been partial in nature and have not articulated a coherent integrated approach for the medium term.

Fortunately, in the 18 months since the new government came to power, there has been a great deal of analysis of the component problems both by experts inside the industry and the GOK/CBK as well as by external organisations such as the IMF and the World Bank. Most of the building blocks of a coherent strategy for the medium term are now shaped up to a degree. However, there are still difficult political judgements to be made and so high-level political leadership is required to move the commitment to a coherent integrated strategy into a higher gear. Delay is costly. Most obviously, the budgetary costs of some of the unavoidable restructuring of major banks grows with every month of delay. But, in addition the economic costs and risks of putting up with second rate arrangements in, for example, the area of regulation and supervision of quasi-banks are potentially very large.

So this Forum is very timely. It provides an excellent opportunity to begin to gain stakeholders agreement about the priority components of the integrated strategy. The particular ideas presented in this paper provide the outline of one possible package.

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