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KENYA'S FINANCIAL SECTOR: INSTITUTIONAL STRUCTURE, EVOLUTION AND RESOURCE MOBILIZATION MOBILIZATION FOR DEVELOPMENT

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I. KENYA'S FINANCIAL SYSTEM: AN OVERVIEW

1. Kenya's financial system is relatively developed for a country at its income level and also compared with many other Sub-Saharan African countries. The financial system comprises of numerous commercial banks, non-bank financial institutions, a range of insurance companies and a stock exchange. A three-fold growth in the number of commercial banks has taken place in Kenya over the last thirty years. Similarly, there has been a phenomenal growth of non-bank financial intermediaries and the insurance industry has also experienced a rapid expansion, both in terms of numbers and services offered. The country also has thousands of savings and credit associations to which most Kenyan workers belong and which have become important avenues for mobilization of savings. Furthermore, unlike many other Sub-Saharan African countries, the Kenyan economy is highly monetized with the monetary sector contributing for nearly 95 percent of the country's Gross Domestic Product(GDP) and broad money (defined as narrow money plus savings deposits) being nearly 42 percent of GDP in 1993 and when deposits with non-bank financial institutions are included this ratio rises to nearly 58 percent. This ratio is significantly higher than for most Sub-Saharan African countries where the subsistence sector remains important.

2. Although Kenya has a relatively developed financial sector, it is the view of many that the sector should have played a more dynamic role in the country's development process and as a matter of fact development prospects of the country have at times been undermined by critical difficulties and deficiencies of the financial system. The weaknesses of Kenya's financial system became more apparent in the late 1980s and early 1990s and were manifest

in the following characteristics of the financial sector: loss of control of money supply by the Central Bank of Kenya and associated accelerated rates of growth of money supply and inflation; failure and/or distress of several of Kenya's banks and non-bank financial intermediaries; a legal crisis in the sector as reflected in the non-compliance by financial institutions of regulatory requirements of the 1989 Banking Act; the inability of the Central Bank of Kenya to monitor and supervise Kenya's banks and non-banks; and lack of effectiveness and authority of the Central Bank of Kenya to carry out monetary policy and regulate the financial sector.

3. The failure of the Kenyan financial sector to play a more dynamic role in the country's development process, especially during the late 1980s and early 1990s, can be attributed to a number of factors among which were the failure of fiscal policy which resulted in chronic fiscal deficits and accommodation by the Central Bank of Government's loose fiscal policy; excessive control over deposit and lending interest rates (financial repression) with a period of negative interest rates over the 185-1990 period; distortion of the financial system through unequal incentives between commerical banks and non-bank financial intermediaries; erosion in the 1980s of the climate favourable to private sector development, which led to a sluggish private sector growth, reduced profitability and increased problems of non-performing assets for banks and non-bank financial institutions.

4. A number of other factors also contributed to the weakening of Kenya's financial sector. These included the fact that although Kenya had a relatively large number of banks and non-banks, genuine competition with a "level playing field" was still lacking and inhibited by the dominance of four banks in the sector and the

resulting oligopolistic market structure; the use of parastatal deposits and Central Bank of Kenya advances to protect specific banks from the rigors of market discipline; and the close involvement of the Government in the setting of rates for loans and deposits.

5. The failure in the real sector coupled with inappropriate macroeconomic environment resulted by early 1990s in a financial sector which was under severe strain and was more increasingly characterized by: failure of the Central Bank to control money supply and hence accelerated rates of inflation; increased problems of distressed financial institutions and increased involvement by the Central bank in trying to bail out some of these institutions; serious weaknesses in the legal and regulatory framework governing establishment, supervision and regulation of financial institutions; erosion of the authority of the Central bank of Kenya to conduct monetary policy and to make supervisory decisions; and serious credibility problems of the financial sector with the public.

6. As a result of these developments, by the early 1990s the Kenyan economic and financial scene was characterized by : a surge in monetary growth and inflation; increased access of a number of distressed banks to overdrafts and rediscount facilities of the Central Bank of Kenya; monetization of central bank losses arising from transactions in distorted foreign exchange markets; and chronic weaknesses in the legal arrangements to establish, supervise and regulate financial institutions; and severe erosion of the authority of the Central bank of Kenya to conduct monetary policy and supervise banks and non-bank financial institutions. Furthermore, at this stage nearly thirteen commerical banks and

thirty-one non-banks were in serious state of financial distress (either insolvent or on the borderline), including two of the four largest commercial banks.

7. Given these developments, it is not surprising that the real growth in deposits with banks during the period 1987-1992 was slow at around 3.5 percent per annum; and that of non-bank financial institutions even lower at 2.6 percent per annum. The increased state of financial distress of several non-banks severely undermined the confidence of depositors who were trying to shift into "safe" banks. The situation was also characterized by increased financing of public sector deficits by the financial system and with possible crowding out effects on private sector borrowing from the financial sector.

8. It is against this backdrop that Kenya embarked on financial sector reforms designed to: improve the legal and regulatory framework of the financial sector; strengthen the authority and capacity of the Central Bank of Kenya to conduct monetary policy and to make decisions on the supervision of the financial sector; liberalize the process of determination of interest rates and exchange rates and eliminate foreign exchange restrictions; improve the macroeconomic conditions in which Kenya's financial sector operates. The Government of Kenya has in recent years been giving serious attention to the need to reduce budget deficits and tightening of fiscal policy as a **sine qua non** to the success of the financial sector reforms in Kenya. The Minister of Finance of the Republic of Kenya and the Governor of Central Bank of Kenya have been at the center of calls for the Government to bring in check fiscal policy within the framework of the country's economic and financial reforms.

Box 1: Financial Sector Reforms and Mobilization of Resources for Development: The Experience of Kenya

Kenya, unlike many other African countries, has many of the elements needed for the development of vibrant financial and capital markets. These elements include a significantly diversified financial structure, a relatively competent staff of the Central Bank, and a relatively unfettered regulatory framework.

Notwithstanding these positive attributes, Kenya's financial system portrayed the usual weaknesses that characterize African financial systems including: a relatively controlled and fragmented financial system; differences in regulations governing banking and non-bank financial intermediaries which resulted in fragmentation and fragility of the financial system; lack of autonomy of the Central Bank; weak supervisory capacities of the Central Bank to carry out its surveillance role and enforce banking regulations; differentiated interest rate structure between banks and non-banks which produced fragmented credit markets; and inappropriate Government policies which contributed to the poor performance of the financial sector and an accumulation of non-performing loans.

Against this background, the Kenyan Government embarked in the mid-1980s on financial sector reforms designed to promote in the country a more efficient and market-oriented financial system; improve the mobilization, allocation and utilization of financial resources; increase the efficiency of the process of financial intermediation in the country; and develop more flexible instruments of monetary policy. The focus of the reforms were to be on relaxing controls on interest rates; developing and initiating the use of indirect monetary policy instruments; strengthening the framework for supervision of financial institutions; restructuring troubled financial institutions and development finance institutions; and developing capital markets.

The reforms were reinforced in the early 1990s with further changes in the legal and regulatory framework, institutional changes and enhanced with programmes of financial restructuring. Changes in the legal and regulatory framework included amendments to the Central Bank of Kenya Act, the Banking Act, the Capital markets Authority Act, and directives for non-banks to convert into banks. The weak and inadequate legal and regulatory framework was reflected in weak application and enforcement of laws regarding reporting, auditing requirements and contracts; and limited regulatory powers of the Central Bank of Kenya under the Banking Act; and lack of enforcement of banking regulations and supervision.

9. Financial reforms Kenya has embarked on have included the revision of the 1989 and 1991 Banking Acts and strengthening them by the Banking (Amendment) Bill of 1994; and strengthening of the 1967 and 1984 Central Bank of Kenya Acts by the "Finance Bill of 1995" amending the central Bank Act. Similarly, the Capital Markets Authority Act of 1990 was strengthened by the Capital Markets Authority (Amendment) Act of 1994 and the Capital Markets Authority (Amendment) Rules and Regulations of 1994.

10. These measures were designed to strengthen the framework governing the establishment, supervision, and regulation of financial institutions. Full details of the amendments to the various financial Acts are provided in subsequent sections of this paper. Indeed, these measures have resulted in a much improved and liberalized financial sector in Kenya and one that is better posed to play a more dynamic role in the country's development process. Kenya could easily become one of the important financial centers in Eastern and Southern Africa.

II. THE INSTITUTIONAL STRUCTURE AND EVOLUTION OF THE FINANCIAL SYSTEM IN KENYA

11. Kenya's financial sector has expanded significantly since the country attained independence in 1963. The country at independence had only seven commercial banks and by 1972 only one more bank had been established. However, during the 1980s a rapid expansion of the banking sector took place and by 1982 there were 15 banks and by the end of 1993 there 30 banks. The number of banks as of July 1995 was 41. Similarly, there has also been a phenomenal growth of non-bank financial institutions. When the country attained independence, there were only six finance houses and by 1973 the

Box 1: (continued): Financial Sector Reforms and Mobilization of Resources for Development: The Experience of Kenya

The Revised Banking Act of 1991 enhanced significantly the role of the Central Bank of Kenya in the inspection of financial intermediaries; established stringent reporting, auditing and provisioning requirements; stipulated capital adequacy requirements and exposure limits; and also stipulated assessment of penalties against non-compliance with the Banking Act. The Revised Act reduced further the regulatory differences between commercial banks and non-bank financial institutions and subjected building societies to more stringent licensing and operating regulations.

Changes were also made to the Capital Markets Authority Act, through the 1994 Amendment Act, and Rules and Regulations Revisions. The amendments included making the Board of the Capital Markets Authority more broad-based to reflect composition of the various actors in the market; making it more transparent the conditions for participation of foreigners on the Nairobi Stock Exchange (NSE); giving the CMA powers to propose changes to the Act and overall improvements in the performance of the Stock Exchange; and giving the CMA authority to license stockbrokers and traders on the Nairobi Stock Exchange.

Furthermore, a number of policy changes were made with the aim of enhancing the development of capital markets in Kenya and included: removal of the Capital Markets Committee's role in regulating shares; elimination of double taxation of dividends by conversion of the withholding tax into a final tax; elimination of the corporate tax on dividend income of the unit trusts; exemption of withholding tax on the dividends of corporate tax-exempt bodies; abolition of stamp duties on retail share transactions; and deductibility of all costs incurred in the issue of shares, debentures and bonds.

The collapse of a number of banks and non-bank financial institutions in Kenya forced the authorities to critically scrutinize the institutional framework of Kenya's financial system. Accordingly, the Central Bank of Kenya's Bank Supervision Department was strengthened to undertake on-site and off-site inspection of financial institutions and to: undertake, at least once a year on-site inspection of each financial institution; determine capital adequacy and asst quality of institutions; evaluate management competence; examine trends in earnings of institutions, their liquidity and foreign exchange operations; and general soundness of such institutions.

Box 1:(Continued) Financial Sector Reforms and Mobilization of Resources for Development: The Kenyan Experience

The off-site inspection of financial institutions by the Central Bank of Kenya involves requiring financial institutions to submit to the Bank on a monthly basis their balance sheets and profit-and loss returns; submitting every ten days their liquid assets positions; carrying out classification of assets of banks and non-banks in order to determine bad and doubtful debts as well as exposure of such institutions; requiring financial institutions to submit on a monthly basis a list of twenty of their largest borrowers in order to determine concentration of the portfolios of banks; and ranking of banks and non-banks of the basis of their financial strength.

Institutional reforms have also included trying to eliminating fragmentation of financial markets by requiring non-bank financial institutions to convert themselves into commercial banks and/or merge with their parent companies. This has been done in order to bring non-banks under the Revised Banking Act. Furthermore the requirements for entry into the financial sector have been more stringent to ensure that those opening such institutions are people of good standing and have an adequate capital base. Accordingly, the minimum requirements for opening up financial institutions have been raised to Ksh 75.0 million for commercial banks and Ksh 37.5 million for non-bank financial institutions. Furthermore, ownership of commercial banks has been limited to 25 percent per person. The minimum capital requirement for new building societies has also been raised to Ksh 5.0 million and with a minimum of ten shareholders.

These reforms, it is hoped, will lead to a more efficient and dynamic financial system in Kenya. The country is trying to promote "universal banking" rather than "specialized banking." Furthermore, in its continuing efforts to improve the legal, regulatory and institutional framework for the country's financial system their efforts to establish a "Financial Services Board" which will be an overall regulatory body for the financial sector in the country.

number had risen to only eight. However, by the end of 1979 the number had risen to 16 and by 1994 there were over 50 finance houses operating in Kenya. The number of finance houses have, however been reduced as a result of the Government decree in 1994 that finance houses should by the end of 1995 have converted themselves into banks and/or merge with their parent banks.

12. The insurance industry has also evolved rapidly , both in terms of numbers and services. Kenya had less than ten insurance companies at the time of independence. However, since the 1990s the insurance companies have increased to almost 40; with four reinsurance companies and nearly 100 insurance brokers. Furthermore, numerous savings and credit associations have been created in Kenya and most Kenyans belong to one or more of these associations. They have become an important avenue for the mobilization of savings in the country. Kenya also has a capital market which has a market capitalization at present of nearly US$ 2.2 billion and nearly 54 listed companies and a daily turnover of around US$ 225,000.

13. Although Kenya has a relatively developed financial sector, many believe the sector could have played a more dynamic role in the developed of the country. The past weaknesses in the financial sector have been attributed to financial repression and the crowding out effects of Government borrowing from the domestic banking system which characterized the economy in the 1980s and early 1990s. However, with the country currently implementing financial sector reforms, it is the belief of many that the financial sector will play a more dynamic and catalytic role in Kenya's development process. The sector is in the process of modernization, both in terms of the range of financial instruments available to savers and investors as well as in the provision of

banking services. Furthermore, activity on the Nairobi Stock Exchange is becoming more buoyant.

14. Kenya's financial sector at the time of independence was dominated by foreign-owned institutions, both in the banking and non-bank sectors as well as in the insurance industry. However, following the attainment of independence by the country, a number of domestic financial institutions were established by both the Government and private sector. The institutions created by Government included the Central Bank of Kenya (CBK), the Kenya Commercial Bank (KCB), the National Bank of Kenya (NBK) and the Kenya National Assurance Company.

15. The Central Bank of Kenya is the country's central bank and in accordance with the Central Bank of Kenya Act under which it was established its principal objectives are: to regulate the issue of notes and coins; to assist in the development and maintenance of a sound monetary, credit and banking system in Kenya conducive to the orderly and balanced economic development of the country and the external stability of the currency; and to serve as banker and financial adviser to the Government.

16. The Central Bank of Kenya has expanded significantly both in terms of its activities and levels of employment. The total assets of the Bank rose from Ksh 11.9 billion (or 16 percent of GDP) at the end of 1983 to Ksh 97.1 billion (or 30 percent of GDP) at the end of 1993. Furthermore, the Bank was holding at the end of 1993 nearly 27 percent of total financial assets of the banking and non-bank financial institutions and the capital market and of which 54 percent were claims on the Kenya Government, 34 percent foreign assets and 12 percent claims on commercial banks.

Box 1: Structure of Kenya's Financial System (As at end of 1994)

	Number of Institutions	Total Assets (Ksh millions)	%
1. Central Bank	1	38,026	10
2. Commerical Banks	41	162,740	41
3. Non-Banks	45	60,200	15
4. Building Societies	5	n/a	
5. Capital Market	1	136,800*	34
6. Total	93	397,766	100

* Capitalization of the Nairobi Stock Exchange (NSE) estimated at approximately US$ 3.1 billion at the end of 1994.

Source: Various documentation provided by commercial banks and the Central Bank of Kenya

17. An important development in the late 1980s and early 1990s was the sharp increase in credit extended by the Central Bank to Government and commercial banks. Credit to Government rose from Ksh 2.4 billion at the end of 1980 to Ksh 21.4 billion at the end of 1990 and peaked at Ksh 52.6 billion at the end of 1993; before falling to Ksh 0.8 billion at the end of 1994 as a result of the mop up exercise instituted by the Central Bank to reduce excess liquidity. Similarly, while credit by the Central Bank to commercial banks amounted to only Ksh 0.2 billion at the end of 1988, it rose to Ksh 12.7 billion at the end of 1992 and stood at Ksh 10.1 billion at the end of 1994. This rapid expansion of Central Bank credit, particularly to Government, indeed fuelled inflation in Kenya.

18. On the liabilities side, there has been a sharp expansion of reserve money and the Bank's foreign liabilities during the 1990s.

Reserve money rose from Ksh 17.6 billion at the end of 1990 to Ksh 58.5 billion at the end of 1994. Currency in circulation more than doubled during the period rising from Ksh 12.8 billion to Ksh 29.2 billion during the period. Bankers deposits at the Central Bank also rose sharply from Ksh 1.9 billion at the end of 1990 to Ksh 26.2 billion at the end of 1994. Foreign liabilities of the central Bank also rose sharply during the period from Ksh 11.3 billion to Ksh 19.4 billion; reflecting partly increased use of IMF facilities by the country which stood at Ksh 13.2 billion at the end of 1994.

19. Kenya's banking sector has also expanded sharply since independence, and particularly during the late 1970s and early 1980s; although the Kenyan financial sector experienced a shock in the late 1980s with failure of some of the institutions. The forty-one (41) commercial banks currently operating in Kenya had total assets of nearly Ksh 162.7 billion at the end of 1994. The largest among these are Barclays Bank Kenya Limited, Kenya Commercial Bank, Standard Chartered Bank and the National Bank of Kenya.

20. The banks operate a chain of branches, sub-branches and agencies all over the country. At the end of June, 1995 this network included 293 full branches, 47 sub-branches, and 100 agencies (excluding 98 mobile units). This is indeed an extensive banking network, although many Kenyans are of the view that many parts of the country are still poorly served by banks and there are fears that with financial sector reforms some banks may wish to close down some of these branches.

21. Total financial assets of Kenya's commercial banks rose from Ksh 20.2 billion (or 27 percent of GDP) at the end of 1983 to Ksh 120. 0 billion (or 37 percent of GDP) at the end of 1993 and stood at Ksh 162.7 billion at the end of 1994. A noticeable development

during the 1990s has been the sharp rise in credit extended by commercial banks to the Government which more than doubled from Ksh 39.7 billion at the end of 1990 to Ksh 85.4 billion at the end of 1993. This indeed meant significant crowding out of the Government on the private sector. However, notwithstanding these developments, a welcome development took place as credit by banks to the private sector also more than doubled during the same period; rising from Ksh 50.9 billion to Ksh 125.0 billion.

22. On the liabilities side, demand deposits with banks more than doubled rising from Ksh 16.8 billion in 1990 to Ksh 39.3 billion at the end of 1994 and quasi-money more than tripled from Ksh 28.0 billion to Ksh 95.4 billion during the same period. These statistics clearly indicate that there was a sharp increase in money supply during this period with its attendant implications on the rate of inflation.

23. A noticeable feature of the Kenyan banking industry is its high concentration with the big three (Barclays Bank Kenya, Kenya Commercial Bank and Standard Bank Chartered) accounting for nearly 75 percent of market share. The Kenya Commercial Bank is by far the largest commercial bank in Kenya with total assets at end 1994 of nearly Ksh 58.8 billion (or 36 percent of total assets of commercial banks in Kenya) and customer deposits of Ksh 48.4 billion (or 36 percent of total deposits with commercial banks). The next largest commercial bank in Kenya is Barclays Bank Kenya Ltd with total assets of nearly Ksh 42.9 billion (or 26 percent of total commercial banks assets) at end of 1994 and customer deposits of Ksh 33.8 billion (or 25 percent). The other two banks that comprise the big four are Standard Chartered Bank Ltd and National Bank of Kenya. Among the four they account for nearly 87 percent of total commercial bank assets in Kenya and 83 percent of customer

Box 2: Selected Statistics on Kenya's Commercial Banks

	Number of branches	Total Assets (Ksh billions) (As at end 994)	Deposits (Ksh billions) (As at end 1994)
1. Barclays Bank	91	42.9	33.8
2. Kenya Commercial Bank	170	58.8	48.4
3. Standard Chartered Bank	43	24.8	22.0
4. National Bank of Kenya	30	17.6	11.0
5. Others	172	21.1	23.7
6. Total	440*	165.2	138.9

* Includes 47 sub-branches and 100 agencies (excluding mobile units)

deposits.[1]

24. This high level of concentration has its own implications as regards efficiency of market forces in the determination of the exchange rate and interest rates in an environment of financial liberalization and reduced involvement of Government and Monetary authorities in the determination of these key prices. Furthermore,

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[1] The data used here was obtained or derived from: Barclays Bank: **Annual Report and Accounts, 1994**; Kenya Commercial Bank Ltd: **Annual Report and Accounts, 1994**; Standard Chartered Bank Ltd: **Annual Report and Accounts, 1994**; National Bank of Kenya Ltd: **Annual Report, 1994**; and Central Bank of Kenya: **Quarterly Statistical Bulletin, June 1995**.

it also has implications on the efficiency of the "interbank market" in Kenya and its role in providing market signals. These issues are examined in subsequent sections of this Report.

25. There has been a phenomenal growth of the non-bank financial sector in Kenya in the post-independence period. While at independence, the country had only six finance houses, by 1982 these had risen to 28 and to 53 by the beginning of 1994. Furthermore, a number of development finance companies have also been established in the post-independence period and include: the Agricultural Finance Corporation, the Development Finance Company of Kenya, the Housing Finance Company of Kenya, The Industrial and Commercial Development Corporation, and the Industrial Development Bank.

Box 3: Branch Network of Non-Bank Financial Institutions Operating in Kenya (As at end June, 1995)

Institution	Number of full Branches
1. Housing Finance	9
2. Savings and Loan LTD	7
3. Kenya Finance Corporation	6
4. Diamond Trust	6
5. Kenya Commercial Finance Company Ltd	4
6. Thabiti Finance Company Ltd	4
7. Consolidated Finance Company Ltd	3
8. Consolidated Bank Finance	3
9 Others	51
10. Total	93

26. The non-bank financial institutions have significantly

expanded their branch networks and among them has been Housing Finance with 9 full branches; followed by Savings and Loan Ltd (7), Kenya Finance Corporation (6) and Diamond Trust (6). The total number of branches operated by non-banks as at end June, 1995 was nearly 93. The total assets of non-bank financial institutions at the end of 1994 stood at Ksh 60.2 billion, and of which Ksh 20.6 billion were claims on Government (net), Ksh 1.1 billion claims on other public sector (public enterprises and local authorities) and Ksh 39.0 billion claims on the private sector. The non-bank financial institutions were holding at the end of this period nearly Ksh 53.7 billion of customer deposits and a large proportion of which were private sector deposits.

27. The Central Bank of Kenya directed in 1994 that all finance companies should convert into banks and those owned by banks to merge with their parent companies by the end of 1995. As Box 3 indicates, by the end of July 1995, eight(8) of these institutions had converted into banks, four had approval to merge with parent banks, 2 had converted into mortgage and finance companies, 12 had approval to convert into banks but had yet to receive certification and 26 were in the process of converting. Finance houses have played an important role in mobilizing savings in Kenya, as they often offered higher interest rates than commercial banks and were therefore able to attract local deposits. The decision by the Central Bank of Kenya to request all finance houses to convert into banks is based on the need to bring these institutions under closer scrutiny of the Central Bank following the failures of some of these institutions and also under the umbrella of the revised Banking Act. Furthermore, the proliferation of these non-bank financial institutions and their privileged treatment by the Government produced some very weak institutions and resulted in the general weakening of Kenya's financial sector. This situation

became more visible during the latter 1980s and early 1990s and resulted in the collapse of a number of these institutions, and hence the directive by the central Bank of Kenya for all these institutions to convert into banks for closer supervision and monitoring of their operations and to bring them under the requirements of the Banking Act.

Box 4: Status of Non-Bank Financial Institutions on Conversion into Banks (as of July, 1995)

Status of Application	Number of Institutions
1. Those with certificate of specification to convert into banks	8
2. Those with approval to merge with parent banks	4
3. Those which have converted into mortgage and finance companies	2
4. Those with approval, but without certificate of specification	12
5. Those under processing	26
6. Those under liquidation	1
7. Total Number	53

Source: Central Bank of Kenya: **Bank Supervision Department**

28. There has also been a rapid expansion of the insurance industry in Kenya in the post-independence period. Kenya had less than 10 insurance companies at independence and these have grown to nearly 40, with four reinsurance firms and more than 100 insurance brokers. The Government of Kenya established in 1964, the Kenya National Assurance Company; which has emerged to become the market leader in the Kenyan insurance industry, followed by Kenindia

Assurance Company Ltd.

29. Kenya also has a capital market established in 1954. The Nairobi Stock Exchange functioned for a number of years through a voluntary association of stockbroking firms, but has now emerged into a more formalized institution. The Exchange has had as its main objectives: to help mobilize domestic savings and thereby reallocation of financial resources from dormant to active agents; to facilitate transferability of ownership from pioneer proprietors to potential investors at a reasonable price; and to assist companies to invite local participation in their equity thereby helping to meet Government policy of Kenyanization of the economy.[2]

30. The Nairobi Stock Exchange provides vital services for the Kenya capital market through 13 stockbroking firms. The capital market is at present dominated by <u>institutional investors</u>, investing insurance, pension and provident funds. Individual clients, however are allowed to participate. The market capitalization of the Nairobi Stock Exchange has increased significantly in recent years having risen from Ksh 12.7 billion (US$ 452 million) at the end of 1991 to Ksh 136.8 billion (or $3.1 billion) at the end of 1994. Notwithstanding these developments, the Nairobi Stock Exchange manifest a number of institutional and structural weaknesses and among these were: the narrow range of financial instruments traded on the Exchange; the low level of trading that took place; foreign exchange controls and legal restrictions which limited the participation of foreign investors in the market; lack of investment trust units that would have

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[2] For further details see: Kul Bhushan: **KenyaFact Book, 1995/1996**, published by Newspread International, Nairobi, Kenya

enabled the market to become more vigorous; and lack of trading on the market of Government paper (bonds and Treasury Bills).

Box 5: Overview of Kenya's Capital Market

	Number of Companies	Market Capitalization		Trading Values	
		(Ksh Mns)	($ Mns)	(Ksh Mns)	($Mn)
1983	54	3,248	235	-	-
1984	54	3,827	243	-	-
1985	54	4,251	278	-	-
1986	53	5,080	317	-	-
1987	53	7,002	424	-	-
1988	55	8,674	474	-	-
1989	57	10,780	499	-	-
1990	54	10,900	453	235	10
1991	53	12,700	452	302	11
1992	57	23,000	634	384	12
1993	54	72,400	1,062	825	14
1994	56	136,800	3,102	3,076	61

Source: Nairobi Stock Exchange (NSE).

31. However, an increase in activity on the Nairobi Stock Exchange began after 1994 as a result of a number of factors taken which included: the amendment of the Capital Markets Authority Act (CMA) and revision of the rules and regulations governing the Nairobi Stock Exchange; the liberalization of the Kenyan economy currently underway; financial sector reforms which have resulted in a relaxation of foreign exchange restrictions; relaxation of restrictions regarding participation of foreign investors in the capital market; and privatization of some shares of state-owned enterprises (including banks).

32. The Government of Kenya launched in 1990 the Capital Market Authority (CMA) with the aim of creating greater confidence in the

nairobi capital market; ensuring security of investments on the market; regulating new lending procedures and capital market instruments; developing a primary market in private securities and removing impediments for investors on the market; and creating incentives for longer term investments. The Capital Market Authority was created by the Capital Market Authority Act of 1990 , which has subsequently been amended and strengthened by the CMA (Amendment) Act of 1994 and the CMA (Amendment) Rules and Regulations of 1994. The Capital market Authority also operates a fund to compensate investors if a licensed stockbroker or dealer fails to meet his obligations.

III. FINANCIAL AND MONETARY DEPTH IN KENYA

33. The Kenyan financial sector, notwithstanding the weaknesses manifest during the late 1980s and early 1990s, has done exceedingly well in mobilizing domestic savings and in delivering banking services to rural areas. Nonetheless, the sector has gone through ups and downs partly reflecting developments in the real economy and partly as a result of weaknesses in the legal and regulatory framework as well as mismanagement in some of the institutions.

34. Financial and monetary depth is both a reflection of the status of the financial system in a country as well as the state of development of the economy. The deepening of financial systems often occurs through the expansion of the range and use of interest-bearing financial instruments; development and diversification of financial markets; and expansion of the financial infrastructure. Increased use of interest-bearing financial instruments is usually associated with financial

deepening. Financial depth is also supposed to be related to per capita income level, level of transactions in the economy, the degree of development of the infrastructure, rate of return of financial assets; and exchange rate policy.[3]

35. Macro-financial instability, inflation, and financial distress usually combine to cause disintermediation in an economy and in most cases even loss of confidence in the financial system. High inflation often results in a flight of domestic financial assets into foreign financial assets and/or real assets.

36. Poor financial infrastructures have often been a major factor in the shallowness of financial systems in Africa. A strong and diverse financial infrastructure is a catalyst of monetary and financial deepening. For an efficient financial system, the infrastructure has invariably to be characterized by; an appropriate legal, regulatory and prudential framework; financial depth in terms of solvency and liquidity of individual institutions; diversity of the institutional structure; an adequate amount of financial information, including accounting information of uniform and appropriate standards, and its integration into the financial process; and availability of relevant technologies and human skills.[4]

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[3] see Biswa N. Bhattacharyay: Development of Financial Infrastructure: An International Comparison, Saving and Development, XII, Milan, Italy; and Neal R. Craig: Macro-financial Indicators for 117 Developing and Industrial Countries, Policy Research Working Paper 58, World Development Office, World Bank, Washington D.C.

[4] Paul A. Popiel: Financial Systems in Sub-Saharan Africa: A comparative Study, Discussions Papers, Africa Technical Department Series, World Bank, Washington D.C.

37. While many African countries are still characterized by grave deficiencies in their financial infrastructures, Kenya is rather an exception in some of the elements of an infrastructure needed for effective financial intermediation to take place. Kenya has, for example, a relatively diversified financial structure. This is a significant contrast to the situation prevailing in many African countries where the financial system is often dominated by the banking sector and in most cases with heavy concentration in urban areas. Rural regions are usually left financially unserviced or underserviced. This, however, is not the case in Kenya which has a significant range of financial institutions operating in the country and with a wide network of branches.

38. Nonetheless, there are some elements of Kenya's financial infrastructure that have remained weak and only in recent years have the authorities tried to strengthen such areas; This is particularly true of: the legal and regulatory framework for financial and capital markets; problems of solvency and liquidity of financial institutions; deficiencies in financial information; and scarcity of human resources and skills.

39. In order to appreciate developments in Kenya's financial sector it is important to position them within the framework of trends in the Kenyan economy during the last thirty years. Development of the Kenyan economy during this period can be broadly classified into these three phases:

(a) The period 1963-1979:

This period can be sub-divided into two sub-periods: 1963-1975 and 1976-1979. The first period was characterized by a significant expansion of the

economy, bolstered by increased Government activity and favourable commodity prices for the country's exports. The period 1976-1979 were the years of the Coffee Boom which had a significant impact on the Kenyan economy and generated a sharp expansion of the economy;

(c) **The period 1980-1993:**

This period was characterized by the second oil price shock; declining terms of trade of the economy (mainly due to falling commodity prices); a rising debt burden; and financial repression;

(d) **The period after 1993:**

Characterized by liberalization of the Kenyan economy and the financial sector and more vigorous economic reforms.

40. Developments in the real sector of the Kenyan economy during these three phases were accordingly mirrored in the evolution of the financial sector. Kenya has achieved a significant degree of financial depth, as measured by the ratio of various monetary aggregates to Gross Domestic Product. Statistical data indicates that the **country's financial depth**, as measured by the ratio of broad money (M2) to Gross Domestic Product (GDP), progressively improved from 27.2 percent in 1968 to 36 percent in 1979, an average of 31.4 percent for the years 1968-1979, and then declined to 26.7 percent in 1985, an average of 29.5 percent for the period; and then once more rose progressively to 41.9 percent by 1993, representing an average of 31.4 percent for the years 1986-1993.

Similarly, when deposits with non-bank financial intermediaries are taken into account in the measure of money supply, the ratio of broader money (M3) to GDP rises from 27.2 percent in 1968 to 44.2 percent in 1979 (an average of 34.6 percent for the period) and then falls to 40.7 percent in 1979 (an average of 40.8 percent for this period), before once more rising to 57.5 percent by 1993 (an average of 48.5 percent for the latter period).

Box 6: Kenya Indicators of Financial and Monetary Depth

	1968-1979	1980-1985	1986-1993
1. Currency/GDP	5.9	5.4	6.0
2. Demand Depoits/GDP	15.6	12.6	10.5
3. Money (M1)/GDP	21.5	18.0	16.4
4. Quasi-money/GDP	9.9	11.5	17.0
5. Broad Money (M2)/GDP	31.4	29.5	33.4
6. Non-Bank Dep./GDP	5.6*	11.4	15.1
7. Broader money(M3)/GDP	34.6	40.8	48.5

* data refers for the period 1973-1979

Source: Computed from data obtained from Central Bank of Kenya: **Quarterly Economic Review**, Various Issues.

41. **Monetary depth**, as measured by the ratio of narrow money to GDP also shows that Kenya has achieved a higher level of monetary depth than most African countries. This ratio rose from 19.1 percent in 1968 to 23.4 percent in 1979 and then fell to 15.6 percent by 1985, before once more rising to 20.3 percent by 1993. Furthermore, Kenya progressively experienced an increase in the share of quasi-money as a proportion of GDP rising from an average of 9.9 percent during the years 1968 to 1979 and then 11.5 percent for the period 1980-1985 and an average of 17 percent for the years 1986-1993. This increase occurred notwithstanding the fact that

deposits with non-bank financial intermediaries also rose sharply in Kenya, increasing from an average of 5.6 percent of GDP during the years 1973-1979, to an average of 11.4 percent for the years 1980-1986 and then an average of 15.1 percent for the latter period (1986-1993). While the share of savings in GDP has tended to increase, the ratio of currency outside banks to GDP has tended to be stable around 6 to 7 percent. The ratio of demand deposits to GDP on the other hand has oscillated significantly, reflecting partly interest rate policy and financial portfolio management by savers in response to shifts in major economic indicators.

42. These statistics clearly indicate that Kenya has achieved a high level of monetization of its economy relative to most other African countries. Nonetheless, the process of financial intermediation in the country is far from perfect as a number of obstacles still remain as an impediment to the financial sector playing a more dynamic role. The authorities have been trying to address some of these issues as indicated in the chapter of this paper that follows.

IV. FINANCIAL SECTOR REFORMS IN KENYA

43. Kenya embarked on its own structural adjustment programme under **Sessional Paper No. 1 of 1986 on "Economic Management for Renewed Growth."** In line with the objectives of the 1986 Sessional Paper, the Government adopted in 1987 a major stabilization and structural adjustment program which was supported initially by an 18-month Standby Arrangement from the International Monetary Fund (IMF) and a three-year arrangement under the Fund's Structural Adjustment Facility (SAF). The Government further negotiated in early 1989 for financial support under a three-year Enhanced

Structural Adjustment Facility (ESAF).

44. The structural adjustment program was also supported by the World Bank through IDA resources for sectoral lending for the agricultural, industrial and financial sectors and with significant cofinancing from a number of donors.

45. The main focus of the Government's stabilization program was: to reduce the budget deficit to a more sustainable level that could be financed by foreign and non-inflationary domestic resources, and without significant crowding out of the private sector; control monetary expansion and reduce the rate of inflation to rates more in line with Kenya's major trading partners; maintain an appropriate exchange rate policy that supports the Government's import liberalization program and corrects for differentials in domestic and international inflation; limit the use of new non-concessional foreign borrowing to gradually reduce Kenya's debt service ratio; and reduce the current account deficit and build up foreign exchange reserve levels.

46. In the field of money and finance, monetary policy reform from 1986 sought to progressively move from **direct instruments** of monetary management , such as credit ceilings, fixed interest rates, compulsory secondary liquidity requirements, to more **indirect instruments**, such as reserve ratios, variable liquidity ratios and liberalized market-based interest rates. Furthermore, the aim was also to improve the Central Bank of Kenya's control over the growing number of financial intermediaries through changes in legal, regulatory and supervisory powers; improve the process of financial intermediation through enhancing competition; and contain liquidity expansion at a pace consistent with targeted growth rates of GDP and anticipated inflation; and maintain positive real

interest rates.

47. Kenya's financial sector expanded significantly during the 1970s and early 1980s as new financial institutions emerged, both banks and non-bank financial institutions. Many of the non-bank financial institutions in Kenya were established during the 1980s mainly to get around the tighter regulations that governed the commercial banks. On paper, non-bank financial institutions appear to have been constituted as merchant or investment banks, which in principle implied that they would concentrate more on the wholesale end of the banking business and provide long-term finance. However, in reality, non-bank financial institutions in Kenya operated as much at the short-end of the market as commercial banks, taking deposits and making short-term loans. To circumvent Central Bank of Kenya regulations and supervision, commercial banks also began to establish non-bank financial intermediaries. Twelve of the largest non-banks were affiliated with commercial banks.

48. The efficiency and depth of the financial system in Kenya was affected by a number of factors which included: differential regulations for commercial banks and non-bank financial institutions; inadequate regulatory and legal framework for the financial system and weaknesses in prudential supervision; weak monetary control exercised by the Central Bank of Kenya; and the existence of specialized institutions that directed credit to specific sectors.

49. The differences in regulations which applied to commercial banks and non-banks had adverse effects on Kenya's financial system and the availability of financing to the private sector. These differences in regulations that governed operation of commercial banks and non-banks led to the excessive growth in the number of

non-bank financial institutions and building societies during the 1980s. Furthermore, due to low entry barriers and inadequate supervision, most of these institutions were under-capitalized and poorly managed. The application and enforcement of laws regarding reporting, audit requirements and contracts was weak and the regulatory powers of the Central Bank of Kenya under the Banking Act limited. Non-Bank financial intermediaries were not governed by the Banking Act.

50. In this environment, poor financial practices, fraud, and mismanagement led to increasing liquidity and solvency problems for many of the new financial institutions and hence the crisis of 1986. Furthermore, although specialized development finance institutions were established by the Kenyan Government, and with considerable donor support in the 1960s and 1970s, with a view to alleviate perceived failures in the provision of long-term finance, the outcome was less than satisfactory in some cases. Development finance institutions worsened the segmentation of the financial sector as their activities were often characterized by low funding costs, large spreads, and high arrears; a situation which discouraged commercial banks from providing long-term finance. Furthermore, many of these institutions became a significant drain on budgetary resources due to their poor financial performance, unprofitability and serious portfolio problems.

51. A comprehensive financial sector adjustment programme was launched in Kenya in 1989, although prior to this the Government had implemented some policy reforms during the years 1986-1988. The financial sector reform programme included both policy and institutional reforms. The focus on policy reforms was to be on: increasing efficiency of financial intermediation; removal of distortions in the mobilization and allocation of financial

savings; and development of more flexible monetary policy reforms. Institutional reforms, on the other hand, were to focus on restoring public confidence in the financial system; and upgrading the skills required to supervise and regulate financial institutions.

52. According to the program, measures were to be undertaken to progressively relax controls on interest rates; develop and initiate use of indirect monetary policy instruments; strengthen the framework for the regulation and prudential supervision of financial institutions; restructure troubled financial institutions and development finance institutions; and develop capital markets.

53. The financial sector reform programme of Kenya focused both at policy and institutional reforms and in particularly on: reform of legal, regulatory and supervisory framework for financial institutions; reform of the foreign exchange market and exchange rate policy management; improvements in the conduct of monetary policy and interest rate policy; improving the efficiency of financial intermediation in Kenya through increased competition within the financial sector; enhancing the efficiency of capital markets; and improving the institutional framework of Kenya's financial system.

A. Reform of the Legal, Regulatory and Supervisory Framework

54. The reforms of the legal, regulatory and supervisory framework focused primarily on: providing more powers to the Central Bank of Kenya to regulate and supervise financial institutions; to bring non-bank financial intermediaries under greater scrutiny of monetary authorities; to improve accounting, audit and banking standards; and to improve the efficiency of the functioning of capital markets in Kenya. The main types of legislative machinery for financial institutions in Kenya are: Central Bank of Kenya Act, the Banking Act, the Building Societies Act, the Pensions Act, and the Capital Markets Authority Act.

(a) Changes in the Central Bank of Kenya Act

55. In order to strengthen the powers of the Central Bank of Kenya to supervise the country's financial system, the Central Bank of Kenya Act was amended in 1995. The weak and inadequate legal and regulatory framework of the financial system that prevailed prior to the reforms was reflected in weak application and enforcement of laws regarding reporting, audit requirements and contracts; limited regulatory powers of the Central Bank of Kenya under the Banking Act; and lack of enforcement of banking regulations and supervision of financial institutions.

56. Following the collapse of four banking groups in 1985-1986 and a number of non-bank financial intermediaries, the Government of Kenya moved to improve the Central Bank of Kenya's ability to regulate and supervise commercial banks, non-bank financial institutions and building societies, as well as imposing more

stringent licensing requirements for new institutions. It had become obvious that the collapse of the four banking groups in 1985-1986 and the difficulties being experienced then by a number of other financial institutions could be partly attributed to the lack of an adequate regulatory framework and the weak capacity of the Central Bank to supervise and monitor these institutions.

57. Accordingly, steps were taken to strengthen both the legal and technical capacities of the Central Bank of Kenya to carry out its functions. The Revised Banking Act of 1991 enhanced significantly the role of the Central Bank of Kenya, in a number of areas, including inspection of financial institutions; the establishment of reporting, audit and provisioning requirements; stipulation of capital adequacy requirements and exposure limits; and the assessment of penalties against non-compliance. Furthermore, the revised Banking Act reduced further the regulatory differences between commercial banks and non-bank financial institutions and subjected building societies to more stringent licensing and operating regulations.

58. Prior to the revisions in the legal, regulatory and supervisory framework of financial institutions, many people took advantage of the low entry barriers, and less stringent liquidity, capital and reserve requirements applicable to non-bank financial institutions. Furthermore, building societies were not placed under the Central Bank of Kenya's supervisory control until 1987. In this environment, non-bank financial institutions and budding societies mush-roomed. Many of these institutions were severely under-capitalized and often lacked skilled and trained management. Many of the Directors had not been closely scrutinized for integrity and financial credit worthiness. In the words of one official of Kenya's monetary authority: **"many people established banks and non-**

banks during this period with a clear intention to defraud the public by receiving their deposits and then borrowing heavily from the institutions they had established and thereby rendering them insolvent and/or bankrupt."

59. Furthermore, attempts by the Central Bank of Kenya to impose discipline in the financial sector through application of more stringent regulatory mechanisms were often interpreted as an attempt to disadvantage certain sections of the Kenyan society and therefore perceived in political terms rather than financial discipline.

60. However, in recent years Kenya has made significant steps to try and improve the functioning of the financial system. Changes have been made to the legal, regulatory and supervisory framework. The Bank Supervision Department of the Central Bank of Kenya has been strengthened and reinforced. The Department's main functions are to enforce provisions of the Banking Act and to issue prudential guidelines for the proper functioning of the financial sector. The prudential guidelines are based on the **"Basle Committee Accord"** and supplemented by the rules and regulations contained in Kenya's own Banking Act.

61. The Bank Supervision Department of CBK employs two types of mechanisms for supervising commercial banks and non-bank financial institutions. These are **"On-Site Inspection"** and **"Off-Site Supervision."** The **"On-Site Inspection"** involves the Bank Supervision Department sending "Inspection Teams" to branches and offices of financial institutions to: undertake an on-site inspection of the institution, at least once a year; determine capital adequacy of the institution, asset quality; management competence; examine trends in earnings of the institution;

liquidity of the organization; foreign exchange operations; and determine general soundness of the institution. Each financial institution is given 35 returns to fill before the Inspection Team arrives, providing details on key elements of its activities and operations. The Inspection Team at the end of its mission files a Report of its findings which is sent to the management of the institutions for comments and observations within thirty days. Thereafter, the Central Bank takes necessary action depending on the Report.

62. On the other hand, **"Off-Site Supervision"** of financial institutions by the Central Bank of Kenya is done through: requiring financial institutions to submit on a monthly basis their balance sheets and profit-and-loss returns; submitting every ten days their liquid assets position; submitting annually their audited accounts and asset quality; carrying out a classification of assets of banks and non-banks in order to determine bad and doubtful debts as well as exposure of banks to selected borrowers; requiring financial institutions to submit every month a list of their 20 largest borrowers in order to determine their portfolio concentration; and rating of financial institutions into five categories: strong, satisfactory, fair, marginal, and unsatisfactory.

63. The Central Bank officials indicated that prior to the current reforms, although the Bank Supervision Department prepared Inspection Reports, these often were not acted upon by Senior Management of the Central Bank of Kenya and/or ignored by financial institutions. Furthermore, the Central Bank did not have mechanisms for sanctioning financial institutions that did not comply.

64. Amendments to the Banking Act have strengthened rules and

regulations governing operations of commercial banks and non-bank financial intermediaries. The Banking Act Amendment of 1994 made supervision of the Kenya's financial sector by the Central Bank of Kenya more stringent. The changes included: making the requirements for entry into the financial sector more stringent to ensure that those opening financial institutions are people of good repute and standing as well as have adequate capital; requiring financial institutions to respond to queries raised by the Bank Supervision Department of the Central Bank of Kenya within thirty days or face the possibility of the Minister of Finance revoking their licenses, which are renewable annually; requiring financial institutions to indicate to the Central Bank, the extent to which shareholders have had access for credit from the institution and limits were set on such credit; and requiring that external auditors of banks and non-banks be approved by the Central Bank of Kenya and appointed annually.

65. The institutional capacity of the Central Bank of Kenya has also been strengthened with technical assistance from the International Monetary Fund. To improve the effectiveness and coverage of Central Bank of Kenya's supervision of financial institutions, efforts have been made to improve procedures and staffing of the Bank Supervision Department; new reporting formats and revised examination procedures have been developed; installation of computerized off-site surveillance data system; and increasing the frequency of inspections of financial institutions. As a further step to bring non-bank financial institutions under the supervision of the Central Bank, the Government of Kenya decided in 1995 that all non-bank financial intermediaries should convert into commercial banks and/or reintegrate with banks to which they are affiliated. This decision is intended to bring these institutions in line with rules and regulations governing

commercial banks and thereby plug loopholes that have been used by these institutions to evade closer supervision.

66. Although the powers of the Central Bank of Kenya (CBK) to regulate and supervise financial institutions in Kenya were significantly strengthened by amendments of 1991 and 1994 of the Banking Act, nonetheless, the Central Bank is far from being autonomous as to be able to conduct monetary policy independently. The Central Bank has, however, in recent years reduced significantly its accommodation of fiscal budget deficits.

67. Furthermore, although the intention of the Central Bank is to move towards **"indirect instruments"** of monetary management in Kenya, as opposed to **"direct Instruments"**, nonetheless its scope to achieve this objective is limited by the lack of a "secondary market" for Government Treasury Bills and Government Stocks. The Central Bank, therefore, still has to underwrite Government paper.

68. Further improvements in the Central Bank of Kenya Act would therefore have to focus on trying to provide greater autonomy to the Central Bank in order for it to be able to conduct monetary policy with minimum interference from political authorities.

(b) Changes in the Banking Act

69. Major changes in Banking Act of Kenya were made in 1991 and 1994. The revised Banking Act is more stringent on entry into the financial sector; minimum capital requirements; and reporting to monetary authorities on operations of financial institutions. Notwithstanding the tightening of entry into the sector, the long-term objective of the Kenyan authorities is to promote competition in the financial sector while at the same time maintaining

stability of the system.

70. The failure of nearly twenty-eight (28) financial institutions in Kenya during the late 1980s and early 1990s proved a bitter lesson to the country and a clear evidence that the legal, regulatory and supervisory framework for the financial sector was severely inadequate and needed strengthening. The major reasons cited for failures of these institutions included: under-capitalization; excessive borrowing from the institutions by shareholders; poor management; and in some cases even outright fraud.

71. The requirements for entry into the financial sector are now more stringent to ensure that those opening institutions are people of good repute and have adequate capital base. The minimum capital requirements for opening up financial institutions have been raised to Ksh 75.0 million for commercial banks and Ksh 37.5 million for non-bank financial institutions. Furthermore, ownership of commercial banks has been limited to 25 percent per person. The minimum capital requirements for building societies has also been raised to Ksh 5.0 million and with a minimum of ten shareholders. The extent to which shareholders can have access to credit from the institutions they have established has also been restricted and limits established.

72. Furthermore, amendments to the Banking Act have strengthened rules and regulations governing operations of financial institutions in Kenya. The supervisory role of the Central Bank of Kenya has been enhanced and means for sanctioning institutions not complying with rules and regulations put in place. The Central Bank of Kenya through "On-Site" and "Off-Site" inspections is now able to: determine capital adequacy of the institution and asset

quality; trends in earnings of such institutions; liquidity situations; foreign exchange operations; and general soundness of such institutions. Furthermore, the Central Bank also carries out classification of financial institutions on a regular basis to determine bad and doubtful debts as well exposure of these institutions to selected borrowers.

73. The Inspection Reports prepared by the Bank Supervision Department of the Central Bank of kenya, now are acted upon by management of financial institutions more quickly; because failure to do so could result in the license of the institution (renewable annually) being canceled by the Minister of Finance.

74. Kenya is now trying to promote "universal banking", rather than "specialized Banking". Accordingly, all finance houses have been directed to transform into commercial banks by the end of 1995 and for those affiliated to banks to integrate with their parent institution.

75. In order to improve on regulation of financial institutions which fall beyond the category of commercial banks and non-bank financial institutions, Kenya is considering establishing a **"Financial Services Board."** This would be an overall regulatory body for the financial sector in the country.

(c) Revisions in the Capital Markets Authority Act

76. The Nairobi Stock Exchange(NSE) has been in existence since 1954 and initially operated as an informal association of stockbroking firms. However, in 1990 the Government of Kenya established the Capital Market Authority (CMA) through an Act of Parliament. The Authority was created in order to provide legal,

regulatory and supervisory framework for capital markets in Kenya. Furthermore, in 1994 the Capital Market authority Act was amended and revisions made to the rules and regulations governing operations of the Nairobi Stock Exchange (NSE).

77. The Capital Markets Authority Act defines the roles and responsibilities of the various actors in the market and provides for implementation of investor protection measures by the Authority. The mandate of the CMA includes promoting the development of capital markets in Kenya.

78. Several policy and institutional measures have been introduced in recent years in order to improve the operation of capital markets and to stimulate the development of such markets. These measures have focused on enhancing the returns from equity investments in order to reduce bias favouring debt instruments and also to improve the institutional framework. Policy changes have included: removal of the Capital Issues Committee"s role in regulating share issues; elimination of the double taxation of dividends by conversion of the withholding tax into a final tax; elimination of the corporate tax on the dividend income of unit trusts; exemption of the withholding tax on the dividend income of corporate tax-exempt bodies, such as pension plans; abolition of stamp duties on retail share transactions; and deductibility of all costs incurred in issue of shares, debentures and bonds. Furthermore, rules regarding foreign participation in the Nairobi Stock Exchange have been relaxed.

79. As regards institutional framework, a number of measures have been introduced focusing mainly on restructuring the Nairobi Stock Exchange in order to make it more representative of the market and also to provide investor protection. The Board of the Capital

Markets Authority (CMA) has been converted from one controlled mainly by stockbroking firms, to a more broad-based one comprising of five stockbrokers, two representatives of listed companies, three people representing various interest groups (institutional investors and retail dealers), and the Chief Executive of the Nairobi Stock Exchange.

80. The Amendment Act of the CMA also gave the Capital Markets Authority, the powers to propose rules and regulations regarding the operations of capital markets in Kenya, including issues pertaining to foreign participation in such markets. The rules regarding foreign participation in the Nairobi Stock Exchange were previously dictated by Kenya's foreign exchange control regulations. The CMA Act also gives the Authority powers to license stockbrokers and traders on the Nairobi Stock Exchange. The CMA Amendment Act also dealt with the "rights issues" and "accounting procedures" to be adhered to by stockbrokers and dealers. In order to list on the Nairobi Stock Exchange, a company is required to produce balance sheets of its operations for the last five years, and for those that have been in operation for a lesser period balance sheets for all the years.

81. In order to enhance further the operations of capital markets in Kenya, the Government intends to create a **"Central Depository System"** for capital instruments and to encourage the establishment of **"Rating Agencies."**

82. The legal, regulatory and supervisory framework for capital markets has been significantly enhanced and improved in Kenya. Nonetheless, the markets are far from vibrant as one would have expected with the liberalization that has taken place. Activity on these markets could be even more vigorous if a **"secondary market"**

for Government Treasury Bills and Stocks were to emerge and the Government were to accelerate the process of privatization of state-owned enterprises. Indeed, activity on the Nairobi Stock Exchange was significantly buoyed by the Government of Kenya having offered some of its shares in the Commercial Bank of Kenya and the National Bank of Kenya to the public.

B. Reforms of Foreign Exchange Markets and Exchange Rate Management Policy

83. Kenya has in recent years undertaken significant reforms of foreign exchange markets with a view to removing exchange controls on most current account transactions as well as the capital account. Imports and foreign exchange allocation licenses have been abolished, except for a small negative list for security and health reasons, and most restrictions on foreign direct investment eliminated. Kenya has acceded to Article VII of the IMF Articles of Agreement, whereby all transactions on the current account are free of controls. However, foreign participation in the Nairobi Stock Exchange has not yet been fully liberalized.

84. Kenya has also progressively moved to market determined exchange rates. Exchange rates are determined by the interbank market for foreign exchange and the Central Bank of Kenya intervenes only to buy whatever foreign exchange it needs to buy for its own use or that of the Government to service external debt. Accordingly, determination of the exchange rate of the Kenya shilling has been fully liberalized. More recently, in order to enhance the convertibility of the Kenya shilling, Kenya, Tanzania and Uganda have agreed to make their currencies convertible into each other. Thus the currency of each country can be quoted in the financial markets of the other.

85. The shift to market determined exchange rates has, however, not been without problems as the value of the Kenya shilling oscillated from one end to the other depending on developments both at home and abroad. However, the currency now appears to have stabilized around Ksh 55.0 to US$ 1.0.

C. Interest rate Policy Reforms

86. Kenya has progressively moved towards market determined interest rates. This process started in late 1980s with ceilings on deposit interest rates being adjusted upward periodically and ceilings on lending rates of commercial banks being moved closer to those charged by non-bank financial intermediaries. These changes progressively led to harmonization of interest rate structure in Kenya.

87. The most notable development in the process of moving towards market determined interest rates occurred in 1990 when the Central Bank of kenya removed the requirement that ceilings on loan interest rates had to include any levies and charges imposed by commercial banks. This allowed effective interest rates on loans to significantly exceed the ceilings.

88. Kenya has at present attained full liberalization in the determination of interest rates, as these are now determined in financial markets. Commercial banks and non-bank financial intermediaries are now free to set their own interest rates based on demand and supply for financial resources.

89. Kenyan monetary authorities are of the opinion that despite the diversity of the Kenyan financial structure and the large member of institutions, the country's financial sector is far from

being competitive. This is reflected in the "wide spread" between deposits interest rates and lending rates; which at times have been as much as 12 percentage points. The authorities argue that a few major commercial banks continue to dominate the financial sector.

90. The management of commercial banks argue, however, that interest rates spreads in Kenya reflect to a large extent the following factors: high cost of raising funds and lending them; credit premium risk associated with bad and doubtful debts; and high labour costs in the industry. Furthermore, management of banks argue that because of the dispersion of the Kenyan population over a wide area, setting up branches in rural areas can be an expensive exercise. Furthermore, in 1994 the Government imposed on banks a wage increase of 45 percent which the institutions have had to filter through to clients through higher lending rates.

91. Financial institutions have welcomed the current system of determining interest rates, which is a significant improvement on the previous process where the Central Bank of Kenyan set ceilings on both deposits and lending rates. However, financial institutions in Kenya recognize that the current mechanism for determining interest rates is far from being perfect because of the underdeveloped nature and narrowness of the interbank market. Nonetheless, liberalization of the financial sector has injected greater competition for financial savings in Kenya's financial system.

V. BUILDING CRITICAL CAPACITIES IN KENYA'S FINANCIAL SECTOR NEEDED FOR EFFECTIVE RESOURCE MOBILIZATION

92. Mobilization of resources needed to support a country's development process is a **multi-faceted** and **multi-sectoral** activity

and involves operators in both the public and private sectors, domestic and external sectors. In the public sector, resources to support the development process are often mobilized through taxation, borrowing from abroad, and/or inflationary financing through the printing of money to finance fiscal budget deficits. The private sector, on the other hand raises finance through retained earnings, equity shares and issuance of debentures, and through issue of stocks on international capital markets and borrowing abroad from financial institutions.

93. The financial sector, however, has a unique role in this respect because through the process of **financial intermediation**, it is not only able to move funds from surplus sectors (savers) to deficit sectors (investors) but also to create financing through the intermediation process (i.e. the multiplier effect). Accordingly, building critical capacities needed for an effective financial sector is an imperative for most developing countries, including those in Africa. The main elements of critical capacities required for an efficient and dynamic financial system hinge on the following:

(a) the state of the legal, regulatory and supervisory framework for the financial system prevailing in the country;

(b) the state of the financial infrastructure, including the range of financial instruments available to both savers and investors, the range of financial intermediaries and the coverage of their branch networks, and availability of financial services in rural areas;

(c) the state of technological advances in the

financial sector industry, including the use of computers and electronic transfer methods;

(d) the state of human skills development in the sector, including the types and quality of training provided to staff and availability of capacities for staff to absorb new technology; and

(e) the state of solvency and liquidity of individual financial institutions as well as stability of the system as a whole.

94. Accordingly, it is imperative that Kenya intensify its efforts at improving the institutional structures for financial resource mobilization and in developing a pool of skilled financial managers. The network of financial intermediaries and capital markets will need to expanded and strengthened and human resource development in the financial sector intensified. Investments will be required to establish branch networks, to upgrade communications and information processing and to mount recurrent staff training to upgrade skills. [5] A number of financial institutions in Kenya, including the Central Bank of Kenya, have already embarked on the process of strengthening their institutional capacities and human resource development. Such a process will result in improved capacities required to mobilize and efficiently allocate financial resources and provide an efficient payments system, both essential for sustained economic growth.

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