THE IMPACT OF LIBERALIZATION ON THE FINANCIAL PERFORMANCE OF THE KENYAN BANKING INDUSTRY.

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DECLARATION.

This research paper is my original work and has not been presented for a degree in any other University. Furthermore all references have been fully acknowledged.

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This research paper has been submitted for examination with our approval as University Supervisors.

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DEDICATION.

This research paper is dedicated to the glory of God Almighty, for his grace and timely intervention which saw me through at the time all seem lost.

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ABBREVIATIONS AND SIGNS.

CBK	Central bank of Kenya.
CMA	Capital Markets Authority.
CAAR	Capital Asset Adequacy Ratio.
COMESA.	Common Market for Eastern Southern Africa.
DFP.	Deposit Protection Fund.
EAC	East Africa Community.
FDI	Foreign Direct Investment.
FDIC	Federal Deposit Insurance Corporation.
FSAP.	Financial Sector Adjustment Programme.
GDP	Gross Domestic Product.
IMF	International Monetary Fund.
KBA	Kenya Bankers Association.
MDA	Multivariate Discriminant Analysis.
MSEs	Medium and Small Business Enterprises.
NPLs	Non performing Loans.
NBFIs	Non- Bank Financial Institutions.
OECD.	Organization for Economic Cooperation and Development.
OMO	Open Market Operations.
ROA	Return on Assets.
ROE	Return on Equities.
SAPS	Structural Adjustment Programmes.
WB	World Bank.

%	Percentage.
=	Equal to.

TABLE OF CONTENTS.

LIST OF TABLES AND FIGURES.

TABLES. **PAGE**

ABSTRACT

Financial Sector reforms in Kenya began in 1989, as a continuation of structural adjustment programmes sponsored by the International Monetary Fund and World Bank. Prior to liberalization, the financial system was highly repressed, with heavy government intervention in the banking sector through credit and interest rate controls. Financial sector reforms led to the removal of credit ceilings and interest rate controls and opened the banking system to new competition.

A sound banking system is necessary for the conduct of monetary policy and for the operation of the payment system. The financial system facilitates and encourages intermediation by mobilizing the transfer of funds between lenders and borrowers transmitted through money and capital markets and indirectly through financial institutions. The study presents a methodology which can be used to measure financial performance of the Kenyan commercial banks. The study focused on profitability ratios and the findings of the study indicate that contrary to market perception, the profitability of the Kenyan commercial banks has been low with an average ROA far below 2 % in most cases .The results further indicate that smaller banks in peer-group four continued to be less profitable compared to bigger banks in peer-group one. In addition the study established that government owned banks recorded the lowest profitability in terms of ROA and ROE during the study period. Operating expenses continues to undermine the profits of the banks and that foreign owned banks were more efficient in the utilization of resources thereby posting the lowest managerial efficiency ratio. The study however, could not solely attribute the poor performance of the commercial banks to the

implementation of the financial liberalization programme, but rather to the weak management of the financial sector and inadequate supervision and regulatory mechanism together with an incosistent macroeconomic framework.

The study examines, the effect of financial sector reforms on bank profitability as measured by capital adequacy, asset quality, earnings, liquidity and managerial efficiency ratios. The evidence in this study show that some signs of financial repression still exist, although some positive developments have taken place. The results show that, financial liberalization has not significantly increased financial performance of the banking industry. Furthermore it revealed the existence of excess liquidity in the local banking industry due to low demand for loans by individuals and businesses and scarcity of profitable investment opportunities. Government owned banks were found to be less profitable compared to private banks.

The study finds a significant positive relationship between management quality and commercial bank profitability. The study recognizes the dualistic nature of the financial system in Kenya and proposes as a policy recommendation the linkages of the formal banking system with the informal components of the financial sector as one way of enhancing financial intermediation and encouraging optimal sectoral credit allocation in order to promote economic growth. Various policy implications are drawn from the results of the study.

The study recommends government divestiture in Kenya commercial bank, National bank of Kenya, Industrial Development Bank, Consolidated Bank of Kenya and the recapitalization of Co-operative bank. The study also recommends that to solve the excess liquidity, the government should refrain from giving large amounts of money to the development banks through CBK and instead should be encouraged to mobilize their own funds at the prevailing market price.

CHAPTER ONE

1.0 INTRODUCTION AND BACKGROUND.

Banks play a pivotal role in the process of financial intermediation by mobilizing the transfer of funds between the surplus units and the deficit units. However, financial policies adopted in the past only stifled intermediation and growth in the banking industry. Due to this there arose a need by the government to liberalize the financial sector so that full benefits could be realized. However, the fruits of financial liberalization has often been beguiled by low profitability of banks and in some cases bank failures, due to increased competition and excess liquidity in the local banking sector emanating from low demand for loans by individuals and businesses and the scarcity of profitable investment opportunities. This happened a few years after financial sector liberalization in some developing countries for instance in Ghana. In addition the positive association between the development of banking system and economic growth may be attributed to the various functions performed by the banks. Economic reform programmes have been launched in many developing countries including Kenya.

The massive liberalization programme in Kenya commenced in the 1990s and has been characterized by economic reforms that cover, financial markets liberalization, external trade liberalization, foreign exchange market liberalization, domestic price decontrols, capital accounts liberalization, and domestic marketing liberalization. As the prime movers of economic life banks occupy a significant place in the economy of every nation. It is therefore not surprising that their operations are perhaps the most heavily regulated and supervised of all businesses.(Soyibo and adekanye,1991). Policy makers, economists, and monetary authorities recognize that the ability of banks to achieve the desired results and to continue to play the role earmarked for them depends on the existence of an enabling environment and number of operating banks and their performance from one financial year to another. The greater the number of operating banks that are resistant to adverse financial conditions, the better for the monetary policy and the economy. The financial sector reform programme encompassed, restructuring and rehabilitation of weak Commercial banks by mergers, opening the banking sector to healthy competition both domestic and foreign, privatization of government owned banks, establishment and consolidation of the institutions for prudential regulations and supervision of banks and the application of best practices in bank management, development of stock exchanges that provide an easy way to trade shares, privatize state -owned enterprises and offer institutional investors (pension funds, insurance companies) with interest in emerging markets an opportunity to place their money where there is growth potential. Other aspects of financial sector reform comprised, independence and accountability of the CBK with freedom from political interference, development of innovative and efficient forms of extending credit to the rural sector and ultimately the legal provisioning for loan recovery was to be rationalized and fully observed. According to the Institute of Economic Affairs (IEA 2002), the massive liberalization of the Kenyan financial sector has failed to have any impact on the banking industry with banking services still being costly due to high interest rates. On the other hand the burgeoning non-performing loan portfolio and low earnings continues to choke banks performance leading to low growth.

Kenya Bankers Association(KBA) postulates that, failure by banks in the past to meet their obligations in the clearing house, attracted strong action from the CBK. This was prompted by failure of most banks to meet the minimum capital adequacy and liquidity requirements. Njuguna.S.N(2001) noted that, the liberalization experience in Kenya during the 1990s showed that domestic interest rate remained high even when inflation was low and stable and the exchange rate has been very volatile. The Kenyan banking industry is in a fragile state. The industry tends to be dominated by half a dozen names whilst the rest operate in niche areas of the sector. Contrary to market perception the banking industry has not been experiencing growth over the past few years. Private sector credit demand has slackened in direct correlation to economic trends, contributing to the advent of bad debts plaguing the industry. Consequently margins have been squeezed as lenders converge towards the blue chip client base and have to offer increasingly sophisticated products to keep a head of the game. Many institutions are in acute distress with portfolio problems and erosion of capital not reflected in their accounts. The non-performing loan portfolio currently stands at 30% and could be higher if the country adopted international standards of provisioning.

IMF (2001) study, found that Kenyan reporting requirements for non-performing loans and provisioning standards were significantly weaker than international good practice. This state of affairs was attributed to the fact that Kenyan banks operated within judicial environment that made it extremely difficult to realize security held against non-performing loans. CBK was severely hampered in enforcing remedial action or exit of failing banks, particularly public sector ones owing to insufficient legal and operational authority. The study further found that the financial condition of Kenyan banks was far weaker than the Asian banking systems that suffered a crisis in 1977.The study noted that the Deposit Protection Fund (DPF) operated in an even more adversarial judicial environment than the banks, unlike most countries the DPF is not established under a comprehensive deposit insurance statute, it lacked the legal authority to negotiate and reach a compromise with a debtor without court sanction. Banking supervision and regulation remain weak particularly in terms of loan classification and the Treasury rather than the CBK decides on entry or exit, resulting in severe compromising of the CBK. The immediate former governor of the CBK asserted that. ' *The role of the CBK and the governor in the Euro bank affair had been politicized'*. He thus appealed for greater autonomy of the monetary institution observing. " *There will be no independence of the CBK as long as one has to consult Treasury before making a move. While we have had no major problems,* there *is simply no latitude for action"* .To further corroborate lack of independence of the CBK, the IMF study (2001) found that, CBK's financial situation was alarming due essentially to the fact that , of the CBK's aggregate kshs. 143 billion assets in July 2001, kshs. 36.9 billion reflected anon-interest bearing government debt and another kshs. 18.6 billion in a revaluation account. CBK Act section 46, required that any advances by the CBK to the government bear market interest rates and be limited to 25% of the government's current revenue. The Act also provided that any advance outstanding prior to the effectiveness of the act in 1996 was to be converted into a loan at terms greed between the two. Despite attempts by the CBK the treasury had refused to pay up. In addition to this CBK had advances to the National Bank of Kenya which is unrecoverable unless paid off by the government. Then there is the case of the Times Towers Building constructed by the CBK and taken over by the government without compensation but still remained in CBK books. It concluded that if these items were treated according to international accounting standards the CBK's assets would reduce by a large margin.

Political banks have been behind instability in the local financial system and were key to two crises in 1986 and 1992 when a number of small banks collapsed. According to IMF (2001) study insured deposits in Euro bank amounted to a mere Kshs.33 million. With a market share of 0.3% the deposits at risk are not enough to cause a tremor in the banking system. In a sense the Euro bank problems are reflection of bank supervision weaknesses. The business and accounting practices of small banks are particularly suspect. The regulation of Kenyan banks is weaker than international norms especially in interest accrual, loan classification and provisioning. CBK's disciplinary actions are weak and the supervision department mainly uses persuasion than enforcement. CBK's (2000) annual report indicates that total assets of the banking system increased from ksh. 417.9 billion in Dec 1999 to ksh. 434.5 billion or 4% increment in Dec 2000. The proportion of non - performing loans to total loans rose from 34% to 38%. The level of provisioning for the non-performing loans increased by 24% from ksh 54.6 billion in Dec 1999 to kshs 67.8 billion in Dec 2000. The increased level of NPLs necessitated high provisions that have continued to impact negatively on the institutions earnings and capital.

CBK (2003) January survey stated that there was a 4.5% decline in pre-tax profits for the banking system to ksh. 8.4 billion. At the end of the year 2002, NPLs were estimated at kshs. 76 billion or 29.8% of the gross total .The survey states that corporate lending remains a risky venture, banks are increasingly moving into personal loans mostly unsecured emulating K-Rep Bank and other micro-finance institutions that have since the early 1990s proven the case for unsecured loans to small scale businesses. The default rate among MSE clients of the micro-finance institutions is below 10% a far cry from the major banks rate of 40%. The MSE has been identified as the engine of growth for the Kenyan economy. According to the National Baseline (1999) Survey, there are close to 1.3 million MSEs employing nearly 2.3 million people or 29% of the country's total employment and contributing 18% of overall GDP and 25% of non-agricultural GDP. Despite this important contribution only 10% of the MSEs sector received credit and other financial services from the formal banking system. Lack of adequate extension of financial services is mainly because the formal banking sector in Kenya has over the years perceived the informal sector as risky and not commercially viable. CBK (2000) annual report indicates that the financial system has not always distributed credit optimally to the various sector of the economy. The agricultural sector which contributes 24.5% of GDP enjoyed 8.7% credit, manufacturing sector with 13.2% of GDP received 21.4% of credit while the trade sector with a contribution of 12.5% of GDP received 18.9% of credit. With oligopolistic financial structures, the existing structure of the banking sector is such that only 8 out of 49 banks control 69% and 70% of the market share in terms of net assets and deposits respectively. Small and medium sized banks that are the majority only in terms of numbers are not able to compete favorably with the few big banks in terms of offering full range of products and services. This lack of an effective competitive environment has led to inefficiencies that translates to high interest rates. Distribution among the non-bank financial institutions was more skewed with one institution controlling more than 50% of the market share in terms of both total net assets and deposits. Despite the fact that implementation of the core principles for effective banking supervision has gained prominence due to their importance as global standards for prudential regulation and supervision, Kenya is still making gradual efforts to implement the principles.

According to the government's Economic Recovery Strategy Paper unveiled in March 2003,the government is contemplating measures to assist the financial services sector to aid in the creation of 500,000 jobs annually. The government of Kenya acknowledges the financial sector as a key player in the recovery process and identifies major players as Commercial banks, NBFIs, the retirement benefits institutions, the capital market, insurance industry and the development finance institutions. To strengthen the financial sector, the government of the Republic of Kenya proposes, the reduction of domestic borrowing, privatization of remaining public banks to increase competition. This study sought to analyze financial performance of the Kenyan banking industry and to investigate the determinants of bank profitability after the financial sector liberalization.

1.1 STRUCTURE OF THE KENYAN BANKING SYSTEM.

The banking system comprised 43 commercial banks, 2 non-bank financial institutions, 2 mortgage finance companies ,4 building societies and 48 Forex bureaus .

Table 1, Commercial banks, NBFIs and Forex bureaus.

Type of institution	
Commercial banks: Operating	43.
Commercial banks: Under CBK Statutory management	0
Building societies:	4
Mortgage finance companies:	2
Non Bank Financial Institutions: Operating	2
NBFIs Under CBK statutory management	0
Total	51.
Foreign Exchange Bureaus	48
Banks and Financial Institutions in Liquidation	22.

Source:CBK bank supervision department.

1.2 EFFECTS OF BANKING ON THE ECONOMY.

Due to intermediation, the individual and aggregate paths of consumption and savings and the overall growth path of the economy shifts. Therefore financial development catalyses investment which also leads to increased income and hence economic growth. The effect of banking and finance on economic growth was demonstrated by Adam Smith. He noted that trade in the city of Glasgow doubled in about 15 years after the erection of the first banks there and trade of Scotland more than quadrupled since the first opening of two public banks at Edinburg.Thus the banking sector's capacity to supply initiative and enterprise in addition to credit creation enables it to transfer resources from less productive sectors to more economically rewarding sectors of the economy. Smith concluded that, once the beneficiaries of bank credit were entrepreneurs the productive capacity of these entrepreneurs to generate new flows of goods and services would prevent inflationary pressures. He intimated that bank credit must necessarily be output generating if it was to promote economic growth. Economists, often argue that if entrepreneurs rely solely on self- financing investment would be constrained by the ability and willingness of each entrepreneur to save and to invest, leading to a depressed investment. Banking therefore plays a formidable role in socio-economic development of any country

1.3 EFFECTS OF REPRESSIVE FINANCIAL POLICIES.

These are policies which the monetary authority pursued during the post- independence era prior to the advent of financial sector adjustment programmes (FSAP). Interest rate controls and high inflation resulted in negative real interest rates. This discouraged savings and compelled agents to shift to inflationary hedges. It also reduced the real price of credit and consequently created a high demand for credits. This also increased bank risks and discouraged active intermediation. Credit ceiling also discouraged saving mobilization drive by banks ostensibly, because once the credit limit was reached, banks did not have any use for the money, as a result the need to compete for deposits diminished. Therefore in away financial innovation was not encouraged. Credit ceilings combined with interest rate controls made banks more cautious and prudential leading to excess liquidity in the banking system in the midst of high demand for credit.

The effects of high reserve requirements was that substantial amount of available funds were diverted away from potential borrowers. This contributed to the expansion of the informal financial sector. It also served as a tax on deposits and forced banks to hold large amount of deposits in low or zero yielding assets. Banks then resorted to high service charges which increased transaction costs to users of financial services and also widened the gap between deposits and lending rates.

The state also continued dominance of major banks leading to lack of competition and inefficiencies that translated to high interest rates. This period was also characterized by unfavorable macroeconomic conditions such as monetary expansion, high and increasing inflation.

1.4 FINANCIAL SECTOR REFORMS IN KENYA

As a result of the problems associated with financial repression the government saw the need through advice from the Bretton woods institutions to embark upon financial sector reform programme (FSAP). These measures included, development of money and capital markets, divestment of state owned banks, that is the Kenya commercial bank and the National bank of Kenya in accordance with the principle of financial liberalization and deregulation, development of innovative and efficient forms of extending credit to the rural sector, restructuring and rehabilitation of weak commercial banks by mergers and opening the banking sector to healthy competition both domestic and foreign. Other aspects of the financial deregulation comprised consolidation of the institutional structures of CBK by ensuring accountability and transparency with freedom from political interference. The following are some of the financial sector reforms that have been undertaken by the government over the past years of the reform process.

1989.

FSAP credit approved: FASP credit effective and indirect monetary policy initiated; legislation providing for establishment of capital markets Authority passed by parliament; maximum saving and deposit rate repayable by banks and NBFIs raised by 0.5 percent and maximum lending rate for loans and advances not exceeding three years raised by 15.5 percent; banking act (1968) was revised strengthening the activities of the Central bank of Kenya.

1990

Capital markets Authority rate on treasury bond increased by 0.5 percent to increase attractiveness; minimum saving deposit rate increased by one percent together with the maximum lending rate for loans with maturities up to three years. Treasury bill rate increased by one percent and requirements removed that ceilings on loan interest include all lending related charges and fees, permitting institutions to set their lending rates to reflect current market conditions and treasury bill rate fully liberalized.

1991

Consolidated bank of Kenya act effected, providing for the transfer of assets and liabilities of banks and NBFIs with solvency problems to consolidated bank of Kenya , and interest rates fully liberalized. Convertible foreign exchange bearer certificates (Forexes) introduced. This was a milestone in foreign exchange liberalization. Exchange control account partially relaxed by withdrawing the clause covering the declaration of foreign currency held by incoming travelers

1992

Minimum capital to asset ratio raised from 5.5 percent to 7.5 percent, and prudential guidelines for self regulation including code of conduct of Directors, Chief executives and other employees duties and responsibilities of external auditors and provisions for bad and doubtful advances and loans. Central bank of Kenya acquired shillings five hundred million in treasury bills to replenish its stock of trading portfolio and secondary market for Forexc's established. Marginal cost raised by one percent for additional fifty million shillings in advances and rediscounting of treasury bills and other government securities to ensure that commercial banks with overdrafts at Central bank exceeding fifty million shillings are appropriately sanctioned. Retention scheme introduced allowing one hundred percent retention of foreign exchange earnings from non- traditional exports. Commercial banks allowed to borrow foreign exchange currency to finance tea and coffee purchases in auctions and banks allowed to send dollars accounts for coffee and tea buyers and sellers. New penalties announced for commercial banks failing to observe the cash ratio and liquidity ratios and retention scheme extended to cover traditional exports of goods at five percent.

1993

Retention scheme extended to service sector at 50 percent while foreign exchange allocation by Central bank of Kenya abolished. Foreign certificate made redeemable at market exchange rate and official exchange rate devalued by 25 percent. Retention account suspended and margin on Central bank advances and discounts to banks increased. Cash ratio increased from 6 to 8 percent while the shilling devalued by 33 percent. Maturity life for securities to be eligible for rediscounting reduced to 45 days or less. New penalties announced for banks failing to observe the mandatory cash ratio. Reintroduction of retention scheme at 50 percent of all foreign exchange and commercial banks allowed to effect foreign payments for their private clients without referring to the Central bank. Import licensing system prohibited and restriction on imports. Revolution of restrictions on importation of assembled commercial vehicles and maximum import tariff reduced from 60 percent to 50 percent and tariff rate bands from 9 to 7. One way foreign exchange system introduced and cash ratio raised fro 8 percent to 10 percent. Paper eligible for rediscounting restricted by lowering maturities treasury bills (half way), treasury bonds 45 days or less and securities accepted as collateral for overnight loans.

A two- tier foreign auction system introduced and Nairobi clearing house new arrangements effected to eliminate automatic provisions of Central bank credit to banks. During this period, there was introduction of registration of foreign exchange certificate holders with banks in order to buy them back at negotiated or market price and ultimately the registration of foreign exchange certificate by banks with Central bank. Flexible exchange rate policy introduced allowing the shilling to float freely. Cash ratio raised from 10 percent to 12 percent with balance above, the minimum requirements to earn interest at 35 percent per annum and Central bank commenced daily foreign exchange transactions with commercial banks. Commercial banks allowed to continue purchasing foreign exchange for oil and petroleum products from the market and Central bank and Central bank continued entering into forward contracts for purchase of oil and related products at market rates. Credit guidelines abolished and cash ratio raised from 12 percent to 14 percent with excess balance paid 35 percent interest per annum. Introduced, restrictions on remittances of profits, dividends and expansion earnings and residents allowed to borrow a broad up to US dollars one million.

1994

Cash ratio increased from 14 percent to 16 percent with interest paid on bank balances by Central bank in excess of 10 percent reduced to 20 percent from 25 percent. Foreign exchange retention raised to 100 percent and residents allowed to open foreign currency accounts with banks in Kenya. Restrictions on local borrowing by foreign controlled companies removed and foreigners allowed to pay hotel bills and air tickets in either foreign or local currency. Liquidity ratio for banks and NBFIs maintained at 5 percent and 10 percent respectively. Cash ratio raised from 16 percent to 20 percent and interest payments on commercial bank deposits at the Central bank abolished. Open market operations sale of treasury bills to be at least 0.5 percent below the weekly average tender rate. Commercial banks to borrow from Central bank for a maximum of four consecutive days and no more than ten days in any one month. Kenya accepted obligations of Articles of the International Monetary Fund and foreign currency account holders encouraged to retain some of their deposits overseas under the case of commercial banks, Commercial banks required to back the funds retained overseas with 100 percent foreign assets. Restatement of the determination of the shilling exchange rate by market forces and cash ratio lowered from 20 percent to 18 percent. Announced requirements for NBFIs to open accounts with central bank for purposes of maintaining cash ratio.

1995

Authorization and licensing of foreign exchange bureaus announced and foreign investors allowed to participate in stock exchange under guided policy on ownership. Reaffirmation that the regulatory body of the stock exchange would be CMA. Commercial banks required to observe foreign exchange exposure limit of 20 percent of the paid up capital plus unimpaired reserves. Newly converted NBFIs to observe 18 percent of the cash ratio and later required to observe 18 percent towards December the same year. Conditions for overnight loans and rediscounting at the Central bank were tightened and treasury bills held at 50 percent of life to maturity for overnight loans or 75 percent for rediscounting were made eligible. Bills to hold for two clear working days to maturity while banks lending in the inter- bank market not allowed to borrow overnight from the Central bank. Commercial banks required to submit weekly foreign currency returns every Monday. Off – balance sheet items excluded from computation of foreign currency exposure aiming to minimize foreign currency exposure risk and enhance the stability of the financial system. Investment compensation fund established to protect investors against losses arising from equity trading. Foreign capital regulations revised to enable foreigners to own up to 40 percent of local company listed in NSE and equity participation by a single investor increased from 2.5 percent to 5 percent. Liquidity ratio fixed at 25 percent for both banks and NBFIs and 20 percent for mortgage finance companies. Minimum investment in treasury bills under OMO lowered to Kenya shillings 100,000 from Kenya shillings 1,000,000. Procedures for renewal of licenses by banks and NBFIs modified with licenses for branches to be computed on a pro-rata basis thereafter full year license fees to be paid for the Head office and all branches simultaneously. Commercial banks allowed to exclude deposits of financial institutions from cash ratio base and *commercial banks to submit monthly breakdown of government parastatal deposits in* addition *to monthly statistical returns.* The Central bank launched a redesigned treasury bill that conforms with the magnetic ink character recognition cheque clearing system. Banking act amended raising the minimum paid up capital and Central bank started paying 5 percent on all balances held by commercial banks and NBFIs at the Central bank to facilitate a reduction in bank lending rates.NBFIs required to invest in treasury bills a minimum of 50 percent of their total assets withdrawn and exchange control act repealed.

1996

Central bank to display OMO rates on the Reuters screen to encourage independent decision on quotation for purchase of the treasury bills. Measures were taken to improve effectiveness of secondary trading in financial instruments and replaced treasury bills for 30, 90 , and 180 days with 28 , 91 an 182 days while discontinuing the 60 and 270 days treasury bills. Cash ratio requirement relaxed to allow fluctuations up to minimum but an average of 18 percent for 14days. Five percent interest that commercial banks received on the cash balances with central bank discontinued.

2000

Capital markets Authority given more powers to regulate the market with the enactment of the CMA Act. CMA can appoint statutory managers to run any of its licenses such as stockbrokers instead of suspending them as was in the case before. CMA given powers to vet share offers routed through the internet and also powers to regulate investment schemes, mutual funds and unit trusts. The unit trust Act repealed and CMA granted more powers to appoint statutory managers, force listed companies to hold annual general meetings and to carry out special audits. This measures were meant to put a tight hold on the operations of the capital markets and to help streamline the operations of the Nairobi stock Exchange.

2003

Capita requirements for commercial banks reduced from Kenya shillings 500 million to Kenya shillings 250 million while for NBFIs reduced from Kenya shillings 375 million to

Kenya shillings 200 million. Cash reserve requirements reduced and the government announced intentions to reduce domestic borrowing. The non- performing loan was converted into restructured capital. These measures were meant to spur competitiveness in local financial sector thereby reducing the lending interest rate and enhancing economic growth.

Source: Ngugi and Kabubo (1998) others, authors compilations from Bank supervision and annual reports various issues and authoritative announcements by Minister of Finance and Governor Central bank of Kenya.

1.5 CAUSES OF FINANCIAL DISTRESS.

In the process of financial liberalization, many countries have been confronted by acute financial system stress. They faced a crises of domestic and international confidence in the safety and soundness of their financial systems resulting in acute stress for individual institutions and the regulator. The following factors could be vital in predicting financial stress thereby helping to elicit prompt and quick action by the regulator.

1.5.1 Systemic solvency:

Economic solvency implies that an institution's unrealized credit losses exceed its capital reserves and realistic near-term earnings prospects. If a large proportion of a system's banks are insolvent, there is risk that some spark will trigger a depositor to creditor panic.

1.5.2 Accounting transparency:

Opaque and bogus accounting increases vulnerability to stress and reduces the capacity to withstand stress because it prevents depositors and creditors from discriminating between the sound and the unsound financial insititution.The following are some games employed by banks to masquerade as solvent.

- Minimizing reported delinquencies by lending to finance interest payments or by accruing unpaid interest.
- Establishing and financing unconsolidated subsidiaries to purchase bad assets from troubled borrowers and overvaluing collateral.
- Transferring problem loans to subsidiaries in locations beyond the jurisdictions of banks regulators.
- Moving bad assets from branch to branch in advance of the bank examiners and miscalculation of problem loans to minimize loan loss reserves. Therefore bogus accounting is an artifact of regulation.

1.5.3 Quality of Supervision:

Insolvent banks are able to masquerade as solvent and to publish bogus accounts because their supervisors permit it or lack the authority to prevent it. A central element of the supervisor's job is to examine a bank's books to ensure their accuracy and should a bank be found to be insolvent it should be removed from the financial landscape.

1.5.4 Funding Stability:

Excessive reliance upon hot or non- core funding may cause alarm to the future of a bank. Such funding may come from institutional investors, parastatals, the inter-bank market, foreign bank or non-bank depositors or commercial paper holders. This funding is confidence sensitive and subject to withdrawal in the event of credit concerns. The presence of such funding may not be readily apparent on a bank's books since many banks make no distinction in their reporting between wholesale and retail deposits .Many of such banks are often used as conduits to siphon resources from the public domain. Political banks in kenya have been placed under receivership and subsequent liquidation with billions of depositors money mostly Government parastatals. The following is an illustration of the collapsed Euro bank.

TABLE 2:

Parastatal deposits in collapsed Euro Bank 2003.

NAME OF INSTITUTION.	30th Sept 2002. Principal kshs million.	30th Sept 2002 including interest kshs.million
1.Kenyatta National Hospital.	363	492
2.National Hospital Insurance Fund.	474	493
3.National Social Security Fund.	-	256
4. Pyrethrum Board of Kenya	153	159
5.Kenya Tourism Dev Corporation	59	61
6.Kenya post Office Savings bank.	59	66
7. Kenya sugar Authority	50	55
8. Postal Corporation of Kenya.	51	53
Kenya Pipeline Co. Ltd.	50	55
TOTALS	**1,259**	**1,690**

Sources: Central bank supervision department and authors compilation.

1.5.5 Injudicious Introduction of Market Discipline:

The market can play a constructive role by rewarding the prudent and successful and by punishing the imprudent and unsuccessful. What is prophylactic for a healthy banking system can prove lethal when introduced into an unhealthy one. The abrupt introduction of credit risk into a weak but previously risk less financial system will almost surely produce a banking crisis. Market discipline should come after a period during which prudential supervision has resolved the system's solvency and transparency problems- not before.

15.6 External Payment crises.

The explosive combination of heightened risk sensitivity and mixed signals about creditor risk can produce a domestic depositor panic forcing the authorities to choose between bailing out the hopelessly insolvent or allowing the panic engulf the entire system. Thus an external payments crisis can lead to a domestic banking crises

1.6 STATEMENT OF THE PROBLEM

Modern market economies cannot function properly without an efficient banking system intermediating between public savings and investments and providing other essential services to the public. Also proper and efficient functioning of the financial markets, payments and securities transfer systems depends on banking services. A sound banking system is necessary for the conduct of monetary policy and for the operation of payment system. The basic objective of the financial system is to facilitate and encourage intermediation by mobilizing the transfer of funds between lenders and borrowers. This transfer of funds occurs directly through money and capital markets and indirectly through intermediation market via financial institution.

Depository institutions play a key role in transmission of monetary policy to the financial markets, borrowers, depositors and the real economy. Further the existence of broad based active financial markets is important to Central Bank's policy implementations by facilitating open market operations enabling the Central Bank to make large –sized reserve adjustments quickly. The financial sector forms the benchmark against which Central Bank in the management of money supply largely implements the monetary policy. Stability in the financial system thus becomes a very important attribute for promoting an efficient payment system. The crucial link of the financial sector to the whole macroeconomic system implies that failure of any institution is bad news for the payment system and the economy. The Kenyan economy has undergone drastic economic policy changes since early '90s geared towards free market economy under the banner of trade liberalization and the financial sector reform programme advocated by the Bretton woods institutions.

Despite the progress made in restructuring the financial sector in Kenya, the Central Bank still lacks autonomy, banking institutions remain by and large weak and inefficient and the financial sector is thin and intermediation inadequate. The collapse of the Banking system and high interests continues to have negative ramifications on the flow of funds while financial intermediation is still characterized by shallowness and institutional weaknesses with little or no linkage between the formal and informal components. Consequently the sector is ill-equipped to effectively mobilize savings. Experiences in other parts of the word indicate that financial failures takes up a sizable proportion of a country's resources.

It is true that the massive liberalization of the financial sector has failed to have any impact on the banking industry. Banking services are still costly, real interest rate high, bad debts and low earnings continues to choke the banks performance.

TABLE 3:

Financial Failures In Sampled Countries:

YEAR.	COUNTRY.	COLLAPSED.	COST.
1930-1933	USA	9000	N/A
1980-1994	USA	1000	US$ 132 bn
1980-1984	Argentina	71	10% of GDP
1981-1983	Chile	16	19% of GDP
1994-1997	Brazil	17	18% of GDP
1997-1998	Japan	1	US $ 91 bn
1984-1997	Kenya	30	10% of GDP
1987-1995	Tanzania	1	10 of GDP

Source; Murugu (1998) " Bank Failures and Supervisory responses.

1.7 OBJECTIVES OF THE STUDY:

This study was conducted to analyze the financial performance of the kenyan banking industry and to investigate the determinants of bank profitability after the financial sector reforms. This is because, for most countries that suffered financial crises in the past, their troubles commenced after financial sector deregulation. This study sought to examine the behavior of banks after the financial sector reforms, looking for connection if any between liberalization and bank profitability. The profitability ratios that were computed and analyzed were return on assets (ROA), return on equity (ROE), capital adequacy ratio, asset quality ratio, earnings ratio and liquidity ratio. Other pertinent objective included measuring management quality by using managerial efficiency ratio as a proxy for management quality.

1.8 SIGNIFICANCE OF THE STUDY.

The outcome of this study will provide a comprehensive material on the performance of the financial system in Kenya and help to form a basis for suggesting policy changes necessary for the Kenyan banking sector. Based on the findings, the results will provide a vital source of information to the regulatory institutions, that is, the Central Bank and Capital Markets Authority and also provide guideline information to the international and development institutions such as International Monetary Fund, world Bank, researchers and the general public .The research findings will provide knowledge to investors on how to analyze the performance of the industry when making investment decisions. Ultimately, the findings will guide managers of the financial institutions on the analysis of the performance of the industry.

1.9 DATA TYPES AND SOURCES:

The study relied entirely on secondary data of published financial results of the financial institutions .Information contained in the annual financial statements of the banks from 1996 – 2002 was collected from the banks. Where a financial statement was not available, the information was obtained from all issues of the CBK annual reports.

CHAPTER TWO:

LITERATURE REVIEW.

2.0 THEORETICAL LITERATURE REVIEW.

According to Montiel (1995), many developing countries are at a stage of financial development in which commercial banks are the dominant financial institutions. Policies, directed to the financial system in such countries, can often be summed up by the term " financial repression". As described by MC Kinnon (1973) and Shaw (1973),financial repression contains several key elements, such as restrictions on entry into banking ,often combined with Public ownership of major banks ,high reserve requirements on deposits, legal ceilings on bank lending and deposit rates, quantitative restrictions on the allocation of credit ,restrictions on capital transactions with foreigners. Montiel (1995) asserts that, the removal of such regulations is the adoption of financial liberalization. Montiel points out that, financial liberalization affects growth through three channels, which are improved efficiency of intermediation, improved efficiency of the capital stock and increases in the saving rate. Montiel observes that, with financial liberalization, financial institutions are able to identify the marginal product of capital in alternative uses and channel funds in such away as to give priority to high productivity projects.

According to Turtleboom (1991), to be successful financial liberalization should follow a sensible four-step sequence. He states that, there should be simultaneous restoration of macroeconomic equilibrium and restructuring or liquidation of insolvent financial institutions with the latter process, being initiated early because it takes time. Secondly, the introduction of indirect instruments of monetary controls with freely determined interest rates such as treasury bills sold at auction. Instantaneously, the establishment of supervisory guidelines regarding loan classification, provisioning of bad debts, interest rate capitalization, capital adequacy and limits on portfolio concentrations. Thirdly, there should be an increment of competition by granting more bank licenses, permitting the entrance of foreign banks, and privatizing government owned banks. Ultimately, the removal of interest rate controls and direct ceilings. He observes that, this sequence involves putting the institutional and macroeconomic conditions in place before liberalization proper is attempted. "Countries that have recently liberalized or are in the process of liberalization have encountered financial system instability, due to weaknesses of supporting financial policies."(IMF 2000).The study further underscores the significance of sound sequencing and coordination of various reforms in the course of liberalization of the current account, and that prudent and sustainable macro economic policies, need to be in place and appropriate supervisory regimes and market infrastructure are most paramount. In the process of liberalization foreign direct investment (FDI) and longer-term flows should be liberalized first and that the liberalization of short-term inter-bank transactions should be meticulously implemented.

Johnston and sundararajan (1999) identified several tenets to govern appropriate sequencing of different components of domestic financial liberalization. The study states that financial sector reforms that support or reinforce monetary policy and macro economic stabilization, for instance reforms of monetary and exchange operations and public debt management and related Central Banking reforms should be given priority. Financial sector reforms that are technically interdependent and that affect common policy goals have to be coordinated and implemented together to ensure policy consistency and credibility, thirdly, monetary and exchange reforms should be closely coordinated with appropriate financial policy measures to support stability. Forth, the pace and scope of liberalization should be adjusted to take into account the initial risk exposures in the financial and non-financial sectors and ultimately, the reform, that require adequate lead time for technical preparations, public consultations and capacity building should be initiated sufficiently early to ensure the timely and effective completion of the overall reform program.

Alexander and others (1995) argued that steps towards market based monetary arrangements and the associated Central Banking reforms have to be implemented early in the reform sequence because of the benefits for monetary control and the catalytic role Central Banking reforms play in fostering broader financial liberalization. A particularly fascinating issue is that liberalization itself is not the cause of financial crisis but rather the weak management of the financial sector and inadequate supervision together with an inconsistent macroeconomic framework.

Campenero and Leone (1991) noted that, due to implementation of broader liberalization reforms in the 1970s, Uruguay experienced a severe crisis in 1982 that undermined the stability of the financial sector with far reaching implications for the banking structure and the real economy in the subsequent years.

Dudley (1984) noted that, in the United States many bank failures occurred because of poor bank management, making risky loans that went sour and couldn't be recovered. He alluded that, primarily because of the nature of bank failures, in 1966 Congress passed the Financial Institutions Supervisory Act which considerably broadened the powers of the federal banking agencies to enforce their control over the banking system. He points out that the purpose of regulating the banking system is to eliminate bank failures and depositor protection. From 1934 to 1980, a total of 568 banks failed in the United States with the Federal Deposit Insurance Corporation(FDIC) suffering a loss of $ 253 million or 4% of deposits.

Tobias (2001) notes, that during the last two decades the deregulation of domestic and international banking transactions and the growth of national and international capital markets, have had profound effects on the business of banking. The continued financial integration of national economies has brought many benefits including dramatic increases in global investments and consumption that have stimulated global trade and prosperity, however, the expansion of international banking activities has facilitated the spread of domestic financial problems throughout the international monetary system He states that, in some cases such as Russia and Indonesia, the collapse of the domestic banking worsened the financial crisis, impeded debt workouts and postponed the resumption of international capital flows to the countries concerned. Thus building and maintaining the confidence of domestic and foreign investors requires a credible bank regulatory system that closely supervises banks, strictly enforces banking law, helps restore ailing banking institutions to financial health and expeditiously expels insolvent banks from the financial system. He asserts that to be successful, legal reforms must follow a holistic approach, that is, the legal reform must elicit voluntary respect for and compliance with the rule of law by the population as a whole.

Since the financial crisis of 1997-98 the IMF has been working on a wide range of architecture related issues aimed mainly at strengthening and consolidating the institutions capacity in preventing crises, improving the functioning of the domestic and international financial markets and providing temporary and appropriate financial assistance. The IMF takes a keen interest in understanding issues related to risk measurement and management in financial markets, in measures to improve the efficiency with which those markets function, as well as in the design of public policy to prevent and contain financial crisis.

2.1 BANKING PROFITABILITY AND PERFORMANCE.

Profits are the foundations upon which the two main pillars of banking (capital adequacy and management competence) rests. This is because a bank's new capital is generated from profits (Stiglitz 1983). A bank's capital is regarded as one of its main pillars of prudential strength and its prime purpose is to act as a cushion against unforeseen and severe losses. Retained earnings is the main source of the cushion since accumulated non- performing assets can be written against this account to ensure that the bank is not placed under statutory management, receivership or into liquidation. Adequate profit performance is needed to attract new capital through public share issues. New capital issues are required to acquire new infrastructure or to satisfy regulatory requirements. Banks with very poor profitability records are unlikely to obtain capital cheaply.

In order for a bank to expand to meet the needs of a growing economy new capital issues are required to purchase new infrastructure and to maintain balance sheet ratios. The terms on which a bank can do this are influenced strongly by the profit performance. Thus banks with poor profits record are likely to incur high costs of capital. Bank profits provide the first line of defense against the risk inherent in banking and thus gives assurance to depositors and shareholders on the safety of their investment in times of economic adversity. Thus in an economic system profits perform various useful functions such as, allocating capital, compensating investors for the risks taken, rewarding efficiency resulting from price- output decisions and providing for future expansion. Since profit making is central to growth and survival of banks, bank managers are often under pressure to work for satisfactory profit margins causing them to make strides into new markets and initiating programmes for their clients through persistent product innovation and engineering. Performance of banks has always been the concern of management, shareholders, regulators as well as researchers. In assessing bank performance there is need to take into account factors that actually influence their performance. These includes, economic conditions, managerial and operational factors, demographic and location factors and market structure.

2.2 VARIABLES USED IN DETERMINING BANK PROFITABILITY.

Fraser et all (1974), identified urban rural population ratios and population density. Urban locations have higher levels of economic activity and consequently a lager volume of funds for intermediation and raising profitability.

Market structure variables which relates to market concentration, bank size, bank ownership and number of branches. Market concentration is the extent to which most of the market's output is produced by a few banks. The most common measures of market concentration are the deposit concentration ratio (cr) and the Herfindahl index of deposits or assets. Abdulla (1994) found significant positive evidence of bank assets being an important factor for bank performance in Bahrain. Bourke (1989) found that liquidity ratio, concentration ratio and growth in the money supply were significant in determining commercial bank profitability.

Bank size is another determinant of profitability. The larger the bank the better it is positioned to diversify portfolio and absorb shocks that smaller banks would crunch under. Abdulla (1994) defined bank size as a logarithm of bank's total assets. Other studies defined it as total deposits or an average measure based on total assets as in Chirwa (1996). Agu (1992) found a positive significant relationship between profitability and bank size in the Nigerian banking system. Market share measured as a ratio of deposits to total deposits of the banking industry and branch network are also used to measure bank size.

Bank specific risk measured as the ratio of total loans to total deposits is also another determinant of bank profitability. Abdulla (1994) has stated that the high performance banks would be conditioned by certain management practices which include minimizing loan losses through maintenance of proper procedures of measuring the credit worthiness of prospective borrowers, excellent monitoring control procedures for existing loans. Risk was measured using two variables, the ratio of total advances to total deposits and total advances to total assets. Capital asset ratio is a measure of risk based on capital to total assets. Abdulla used the book value of shareholder's equity to total assets. A positive but weak significant relationship was observed between the variable and profitability. Empirical evidence was adduced to the effect that well capitalized banks face lower expected bankruptcy costs and thus eventually reduced the cost of funding. Abdulla (1994) pointed out that cost was another major determinant of bank profitability. The cost was measured as a ratio of total operating expenses to total deposits.

The proportion of deposits that go into income generating activities other than loans and advances is used as a proxy for diversification also determines bank profitability. Caves (1981) observed that diversification is positively associated with changes in concentration because concentration engenders predatory tactics and economies of scale. The risk of portfolio decreases with increasing diversification. Therefore a higher level of diversification is expected to result in higher profitability.

Deposit insurance as a determinant also impacts significantly on the level of profitability. This is because with deposit insurance banks find themselves in a better position to finance riskier projects than they would have done without it. Demirguc-Kunt and Detragiache (1997) found that deposit insurance positively affect profitability. Demirguc-Kunt and Huizinga(1999) concluded from their study that contrary to earlier findings, deposit insurance impacts negatively on profitability.Barth et,al. ,(1993) , however found that no significant impact of deposit insurance on bank's return on equity for a sample of 142 banks. Stover et al., (1997) estimates that deposit insurance lowers the deposit rate by 25 basis points using aggregate deposit interest rate data for 13 OECD countries during the 1985-1990 period. Thus for a given risk, deposit insurance may lead banks to lend more money cheaply than they otherwise would, depressing net interest margins and hence profitability. Also banks that do not engage in risky lending strategies may experience a diminishing interest margins leading to low profitability.

As a determinant of bank profitability inflation impacts bank profitability in a number of ways. High rates of inflation tends to reduce real rates of returns at times resulting in negative returns. Due to this investors often respond by moving into inflation hedges (property, livestock, commodity) and nominal rates also become very high thereby increasing cost of capital .The resultant effect is to reduce banking activities which also reduces profitability.Infalation also impacts on the cash flow of businesses adversely making it difficult to service their loans thus worsening the already bad non-performing asset portfolio of the banks.

Reserve requirements, also influences bank profitability since reserves constitute a tax on bank's funds thus impacting significantly on a bank's profitability. Rose and Rose (1979), and Gilbert and Rasche (1980), found evidence that Federal Reserve membership of US commercial banks affected their profitability. Fed membership subjected banks to high reserve requirements reducing their cash base. Consequently non- member banks were more profitable. Competition among the two categories of membership in the same market made it difficult for the member banks to pass on their higher reserve costs onto their customers. Demirguc- Kunt and Huizinga (1999) discovered that the negative relationship is more pronounced in developing countries than in developed countries. This underscores the fact that the opportunity cost of holding money or reserves is higher, relatively, in poorer and inflation hit countries than in developed countries.

Type of bank ownership is also a very useful variable for measuring bank profitability especially in developing countries. Foreign owned banks are found to be more profitable than state banks and indigenous banks. Characteristics of state owned banks such as higher operating costs, overstaffing, ineffective control measures and lower staff productivity are factors accounting for the lower level of profitability. Foreign owned banks are efficient and are able to acquire international and technical expertise from foreign partners. Demirguc Kunt and Huizinga (1999) introduced for the first time legal and institutional indicators in studies on bank profitability, using as variables, contract enforcement, law and order index and corruption index. From the results obtained, the contract enforcement variable, which measures the degree to which contractual agreements are honored and not subject to mentality language and differences has a negative and significant relationship with profitability. Thus a lower degree of contract enforcement in a particular country may prompt banks to require higher returns to compensate it for additional risks. The law and order index captures the extent to which the legal system works well in dispensing justice. A higher value of the law and order index is thus significantly associated with lower profitability since an effective legal system has the potential of reducing the required risk premium on bank lending. The corruption Index indicates that countries with cleaner governments are associated with lower banking profitability because banks require lower risk premium on their investment.

Another variable that impacts on bank profitability and has the tendency to entrench market power in the banking industry is barriers to entry. There are various forms in which barriers to entry can take place. Of particular mention is the capital requirement. This is the minimum capital required by the minimum efficient bank size in the banking industry. For instance the government in June 2003 reduced the capital requirements for banks from Kenya shilling five hundred million to two hundred and fifty million and for the NBFIs from three hundred and seventy five million to two hundred million. Chirwa (1996) used capital adequacy advantage ratio (CAAR) in his study of the Malawian banking industry and found a significant relationship between it and profitability. CAAR is calculated as the ratio of shareholder's funds (equity and reserves) to the statutory minimum capital requirements for licensing commercial banking activities. The minimum capital licensing requirement can affect entry especially when existing shareholders capital is far above the statutory minimum capital, in which case banks are able to reap supernormal profits without attracting entry since they are protected by the entry barrier. According to Barth et al., capital or equity performs a dual function of financing the purchase of fixed assets and protects creditors as away of deposit insurance against risk of bank failure. Importantly banks with higher capital base are in a better position to diversify portfolio and engage in sales promotion activities, both of which deter new entry.

2.3 EMPIRICAL LITERATURE REVIEW

Empirical work consists of simulation studies based on calibrated models or case studies. The empirical literature on liberalization and financial sector reform in emerging markets economies can be traced back to early 1980s. Sobodu and Akiode (1998) analyzed the implementation of structural adjustment programme in Nigeria commencing July 1986.The financial deregulation and liberalization policy came as a major component of the broad economic restructuring programme. The paper notes, that since deregulation private banks have performed better than the public banks, consequently, the call for a divestment of government interest in public banks has been made in line with the policy thrust of the SAPS. Due essentially to bureaucracy and inefficiencies, the policy of privatization of government, parastatals was incorporated into the economic restructuring programme to correct some of the distortions that characterize the economy and to aid effective resource allocation. They argued that continued government involvement in the ownership and operation of banks especially the larger ones (which by their age account for about 40% of the total assets of all banks) hindered their effective supervision thereby increasing the risk of failure and erosion of public confidence in the banking system.

Adekanye (1993) represents, a notable attempt to isolate the factors that distinguishes vulnerable from resistant commercial banks in. The study, which covered the period 1984 to 1989 and adopted both multivariate discriminant analysis (MDA) and the log it regression technique confirmed managerial efficiency to be the overriding determinant of commercial bank performance .There is a consensus in the literature that management quality is the ultimate determinant of a bank's long-term survival (cates, 1985 ,Pantallone and Platt 1987), Honer, 1988, Seballos and Thompson 1990, Siems 1991. From the result of their analysis they found out that the return on assets (ROA) of Nigerian commercial banks averaged 1.15% over the pre-SAP period compared with 2.36% during SAP. Generally industry profits took an upward trend. The average cost of deposit was 4.07% before SAP compared with 9.76% over the SAP period. They noted that asset structure of commercial banks changed significantly over the liberalization period. As a proportion of total assets, loan and advances reduced markedly from an average of 40.9% pre SAP to 26.3% during the SAP period. Cash and short-term funds as proportion of total assets increased from an average of 44.5% pre SAP to 55.5% during the SAP era. Loans equally reduced significantly as a ratio of deposits from 53.6% pre SAP to 38.9% during SAP while commercial banks fixed assets as a proportion of total assets increased from 2.64% to 4.27%. They further, noted that fixed assets averaged 76.2% during the SAP period compared with about 65% over the pre SAP era. This fear is further corroborated by the significant decline in the proportion of banks earning assets from 87.5% pre SAP to 83.7% in the SAP era. Whereas the assets of banks in nominal terms grew over time, the shift in structure away from the traditional loans towards liquid assets was accompanied by a significant jump in loan loss provision as a ratio of total loans The ratio jumped from an average of 2.3% pre SAP to 6.8% during SAP. Capital to loan ratio increased to 35.8%

during SAP from 24.7% pre-SAP, while capital to asset ratio increased to 6.6% during SAP from 5.8% pre-SAP. They concluded that Private banks were observed to be more profitable than government banks with the return on assets for Private banks averaging 3.3% while that for government banks averaged 1.1%, thus Private banks appeared to be better capitalized than Public banks. Ultimately the study concluded that the efficiency of Nigerian commercial banks tended to decline quite significantly during the period of a deregulation compared with the period prior to SAP.A recent paper by Roubini and Sala-i-martin (1992b) examined alternative indicators of financial repression (a real interest rate dummy, the reserve ratio and inflation). The study found them all to be negatively correlated with growth.

King and Levine (1993) carried out a comprehensive study. In a sample of 77 countries with data averaged from 1960 to 1989 they found out that, their financial indicators were closely correlated with each other as well as with measures of GDP growth, capital accumulation and total factor productivity.

King and Levine (1992b) explored the channels of influence between financial liberalization and growth. Using the same indicators of financial depth as king and Levine (!992a), they found that average financial depth was robustly correlated with both the Investment/GDP ratio and a measure of the efficiency of investment in a cross section sample while initial financial depth was insignificantly correlated with both.

Montiel (1995) observed that financial liberalization experience of the southern cone countries in South America failed because the process was undertaken in an unstable macroeconomic setting under an unsatisfactory regulatory framework. He says, that the financial liberalization in Asian countries during the 1980s as provided in Tseng and corker (1991) and World Bank (1994) experienced the following. Liberalization was accompanied by measures to promote competition, such as increased freedom of entry, expanding the scope of permissible activities for different institutions and relaxing restrictions on foreign banks. The supervisory framework for the financial system was consolidated by centralizing supervisory responsibilities, developing and unifying the regulatory framework (as well as extending it to non-banks and providing explicit deposit insurance). Money markets were fostered by creating new instruments such as Central Bank and government securities with flexible interest rates. The paper, observed that the financial results of liberalization have not been disruptive as they were in the Southern cone. Liberalization of interest rates tended to increase nominal rates but not necessary enough to establish positive real rates.

King and Levine (1993) carried out a firm-level studies to examine the effect of financial liberalization on the distribution of bank credit among firms of varying degrees of efficiency. The study used firm level data to estimate production functions and then measure each firm's technical efficiency by looking at how far it is from the production frontier. The study found that financial liberalization tended to redirect credit to the more efficient firms.

Montiel (1995) observed that, widening spreads between lending and deposit rates appear to have been a problem in several sub-Saharan African countries that liberalized interest rates, during the 1980s (Ghana, Gambia, Malawi and Nigeria)), and also lack of competition as reflected by the burgeoning non- performing loans. He notes, that re-capitalization operations have tended to be expensive, recovery of non- performing assets has been poor and restructuring operations have had to be repeated in several cases (World Bank 1994b). In Ghana, for instance non- performing assets restructured under a plan undertaken in 1989 amounted to 41% of total bank credit to the non-government sector (Kapur et al, 1991).

Njuguna (2001) points out that, the liberalization process of the foreign exchange market in Kenya was plagued by a few handicaps. The whole period of liberalization was characterized by a shift in attention away from the real economy to one in which trade in financial assets predominated . He further observed that the interest rate differential, exchange rate expectations and forecasts on inflation and general instability were such that holders of foreign exchange abroad capitalized on the liberalized regime to profit by bringing funds back, converting them to shillings and benefiting from the high treasury bill rate .He concludes that the treasury's concern in the wake of the problems emanating from the liberalization process was to assist the Central Bank of Kenya to control the money supply , which made it imperative to re-establish the credibility of its macroeconomic programme in order to be able to replace high cost-domestic borrowing with concessionary programme funds from abroad.

Jebuni ,Oduro and Tutu (1994) observed that, external capital flows could be crucial to the success or failure of a liberalization crusade. In the case of Korea for instance, it has been documented that substantial external inflows contributed to the success of the liberalization experience (Helleiner 1988). The paper notes that, the Ghanaian experience was boosted by colossal external support when putting together the liberalization package. External support went to the foreign exchange operations. The finances of the foreign exchange auction by foreign sources increased from 40.6% in 1986 to 69.3% in 1988. The significant inflow of foreign financial resources financed the current account deficit and built up international reserves. The paper further observes that, foreign direct investment (FDI) played a more instrumental role in the liberalization period. It averaged US$ 31.4 million p.a. between 1967-71. The liberalization programme in Ghana also encouraged and facilitated the inflows of private transfers by Ghanaian residents abroad .In 1983, these transfer were approximately US $ 4.02 million and tripled to US $ 15.9 million the following year and by 1987 had risen to US $ 122.4 million (IMF 1990). The paper concludes that, from the Ghanaian experience substantial external assistance over ascertain period may be essential for the success and continuation of a liberalization programme.

Velasco (1991) observed that, the process of financial reform in Chile included institutional, regulatory and international aspects. The institutional aspects involved liberalization of the financial sector from the controls by the government and leaving it with the private sector. Regulatory aspects dealt with the administration of the legal framework in an attempt to promote rapid growth and increase competition. Various controls on interest rates and credit were abolished and the central Bank started paying competitive interest on reserves held by commercial banks so as to help reduce the cost of holding them especially under inflationary conditions. The financial system consequently moved towards multipurpose banking whereby distinction between commercial, investment, mortgage and development activities was abolished with foreign banks allowed to open branches in Chile and purchase Chilean Banks. The process led to financial widening as new regulations increased the powers of the bank supervisory agency. The international reforms dealt with capital flows after the capital account was liberalized allowing capital flows in and out of the country. The reform process in Chile led to tremendous expansion of financial intermediation as financial assets of the country rose; consequently the domestic debt expanded especially the stock of the non-Government sector, which grew from 5% to 61.7% of GDP after the reform process. The financial and real estate sectors appeared to be making progress for several years before a major financial crisis developed. By 1981, the financial system was submerged in major crisis with the non-performing assets of banks reaching the level of 22% of capital and reserves The ratio went up to 47% by end of 1982 and 113% in May 1983.

Thomas (1991) considered the financial sector reform in the USA following the collapse of the banking system in 1933 at the depth of the great depression. There were over 25,000 banks at the start of the depression in 1929, however, by 1933,the lower turning point of the economic decline less than 15,000 banks were still in existence. In the wake of this collapse of the banking and financial system a large body of legislation was enacted to restructure the financial system. In the late 1979, with the emergence of financial reform in both the conduct of monetary policy and the structure of financial system, certain steps were taken to improve the conduct of monetary policy, in particular interest rates ceilings were abolished. In the USA, financial reforms directed towards the financial system were initiated by the government and also by the Private financial institutions and markets as they sought ways to enhance profit opportunities .

IMF (2000) study analysed Finland's economic and financial crises in the first half of the 1990s following financial liberalization. The study noted that the Finish crisis in 1990s is a typical example of a severe financial crises that quickly evolved into a macro economic public sector and banking crisis. GDP fell by 15% in (1991-1993). Unemployment increased from 4% to 20%.The Public deficit increased rapidly and the losses of the banking sector were enormous. The fixed exchange rate was replaced by a flexible system and that public support had to be given to the entire banking sector. The estimated cost of the support given to the banks was about Fin 50 billion or 7% of GDP.

Fischer (1997), discussed the issues of banking soundness as noted by the G-7 summit in Lyon (June 1996) through a communique." The globalization of the financial market has contributed to the creation of a more complex financial environment. Better prudential regulation and supervision in the financial markets are essential elements in preserving the stability of the international monetary and financial system" .He observes that the communique welcomes the progress on the strengthening of capital standards for bank's exposure to market risk, improved disclosure and enhanced surveillance. Fischer further notes that the concern of the G-7 countries arose from the startling frequency, scale and consequences of the banking crises in the prior ten years when well over half of international monetary fund's membership experienced significant banking problems. The spread of the crises was among the United States, Latin American countries, Africa, Asia and Europe. The fiscal cost of resolving the direct banking sector crises amounts to over 10% of GDP in some countries.

Thomas (1991) traced the financial crisis in Argentina from march 1980 consequent to financial liberalization. He outlined the causes of the crisis to; inadequacies of free market economies, inappropriate monetary policy and inherent instability of the financial system. The root cause of the crisis was default on bank loans by firms arising from enterprise failures .In a prior research, Drizzen (1984) found out that between 1977 and 1983 the financial structure of firms, became increasingly fragile and had to endure strong destabilizing shocks emanating from the financial market. These shocks were as a result of restrictive monetary policy, bank failures and devaluations.

Tomas (1991) noted that Damil and Frenkel (1987) had suggested that the negative real rates of 1979 prompted firms to borrow more thereby increasing their fragility. The fragility arose from short maturities of loans that made firms vulnerable to "exogenous shocks " such as higher interest rates induced by changes in exchange rate expectations. The study further notes that interest rates dramatically jumped after controls were lifted In 1977 where upon deposits and lending rates more than doubled. The liberalization of the foreign sector had significant effects on the soundness of the financial system impacting on the capital flows as well as the value of foreign debt owed to the firms. On the measures to dealing with failing and ailing institutions the paper notes that such measures should aim at arresting the propagation of the crisis, restoring depositors confidence and protecting the payments systems so as to bring out an orderly restructured banks and recapitalization of problem banks. The measures suggested for dealing with banking crisis depend on a country's legislative framework, the structure of the banking system, the presence or absence of a deposit insurance agency and the magnitude of each bank's losses. The paper suggests both emergency and long-term measures for dealing with banking crisis. Emergency measures comprising of lender of last resort, Central bank's intervention in the management of the ailing institution ,lending freely at a penalty by the central bank in times of illiquidity caused by sudden surge in demand for reserves and setting up of special credit facilities for access by the problem institutions .Long term measures suggested included liquidation, mergers restructuring of bank activities and recapitalization, take-overs by government owned financial institutions by a deposit insurance agency or temporary nationalization of the institutions together with its conglomerates.

Humphrey(1984) and (1986) carried out a simulation study of a systemic financial crisis. The study presented an innovative analyses of the process of transmissions from a settlement failure. The used the actual data of transactions and traced the effects of the removal of all payments to and from a large settling participants. Then he showed that the unwinding processes of credit-debt operations could cause serious deterioration in the net debt position of financial institutions and in one of his examples (Humprey 1986) demonstrated how 50 institutions could end up in a day with net debt position exceeding their capital.

Furfine (1999) noted that some financial shock caused a set of markets or institutions to simultaneously fail to function efficiently. He further noted that the risk of failure of one or a small number of institutions will be transmitted to others due to explicit financial linkage a cross institutions .By taking the buffter- stock function of the federal funds market into account Furfine(1999) noted that the degree of contagion that takes place when triggered by a fall of major bank depends on such factors as bilateral federal funds exposure, the loss rate of bankrupt bank and the capitalization of other banks. He stated that the incidence of bank failures becomes small when loan facilities from the federal funds market mitigate the incidence of fund shortages among banks. Assuming a generous (at least according to Furfine) non recovery rate of 40%, his simulation results showed that the fall of a significant bank will lead to a failure of 2-6 other important banks and only 0.8% of total commercial banking assets .

Sundararajan and Tomas (1991) studied financial liberalization in Argentina. They observed that immediately after liberalization, the country suffered from rising real cost of credit .increase in the share of non-performing loans .increase in bank losses(due to foreign exchange exposure, interest rate mismatch and contingent liabilities) and decrease in the value of investments causing solvency problems in the financial system leading to liquidation ,mergers or restructuring. Among the immediate economic effects of banking crises as observed by the paper included, disturbance of the normal credit relationships and raising the cost of credit, intermediation, inducing a flight to quality by both banks and their creditors, weakening both the monetary and budgetary controls and generating large and pervasive uncertainty which lowers the perceived return on real estates leading to depressed real investments and growth.

Johnston (1991) explored the financial system in Thailand where financial crisis was experienced in the first half of 1980s due to poor financial management practices, inadequate regulations and supervision. The rescue framework adopted included continued management restructuring, the build up of capital and reserves and strengthening of the powers to supervise and restructure financial institutions. An analysis of the financial performance of Thailand banks denoted declines in the net profits from 25% to 7% and capital to assets ratio from 6.4% to 5.7 % in the period 1980 to 1986.The capital to assets ratio of most banks were relatively low by international standards of 8%.The return on equity in 1986 fell by between 3% and 5% to an average of 7%.The paper outlined causes of weak financial performance as, institutional framework where banks operated as oligopolies allowing them to make profits for many years while ignoring efficiency and safety precautions, in the industry most managers were not professionals, credit and guarantees were extended to businesses in which directors and shareholders were heavily involved. lavish offices were constructed as the headquarters and banks failed to diversify their share ownership. The lending was concentrated to a few large interrelated enterprises and industries and competition was not promoted in the industry. Other factors comprised, inadequate legislative framework for regulation, supervision and intervention, lack of regulatory standards and enforcement guidelines by the regulatory authorities and economic conditions emanating from the downturn in the economic activities during the first half 1980s.

2.4 OVERVIEW OF LITERATURE

An experience of financial liberalization in Chile (Velasco 1991), Argentina (Sundararajan and Tomas 1991), Thailand (Johnstone 1991), Uruguay (Campenero and Leone 1991), Finland (IMF 2002) indicate that the economies experienced banking crisis consequent to liberalization. Based on the literature review many issues have been shown to explain the impact of liberalization on the soundness of the financial system and the economy as a whole. Most of the studies reviewed have found that liberalization itself is not the cause of financial crisis but rather the weak management of the financial sector and inadequate supervision and regulatory mechanism together with an inconsistent macroeconomic framework. However most of the studies reviewed confirmed that no single study has analyzed financial performance by taking into consideration all the determinants of bank profitability and in most cases, the studies concentrated only on four variables.

CHAPTER THREE.

RESEARCH METHODOLOGY:

3.0 THEORETICAL FRAMEWORK:

As stated earlier various researchers have adopted several forms of the structure to suit their own specific requirements. Civelek and Al-Alami (1991) used four of the variables described above in their study on bank profitability of the Jordanian banking system. Ogiogio (1991) also used similar variables to do a similar study on the Nigerian banking system.

According to the CBK annual report (June 2001-July 2002) the performance of the banking sector is assessed using several ratios based on the CAMEL rating system. Pandey (1997) describes ratio analysis as a very useful tool in predicting the financial performance of a company. Financial ratios denote relationships between two financial variables helping to ascertain the financial condition of a firm. This is accomplished either through a trend analysis of the firm's ratios with its nearest competitors and with the industry. Beaver (1966) identified ratios which have discriminating power. Altman (1968) being the first person to apply discriminant analysis in finance to study bankruptcy, identified five ratios: Net working capital / total assets(%), retained earnings/ total assets (%), EBIT total assets (%), market value of total equity/ book value of debt (%) and sales/total assets (times) that were efficient in predicting bankruptcy and developed a model from a sample of 66 firms half of which were bankrupt. Keige (1991) carried out a research similar to Beaver (1966) and was able to develop a discriminating function that was able to predict failure with up to 90% accuracy two years prior to the occurrence of the event. The study identified key categories of ratios that were crucial to bankruptcy prediction in the Kenyan context as liquidity, leverage and activity ratios. However, by observing the trend of the banking industry over a period of time it became apparent that these variables would not sufficiently explain the behavior of the Kenyan banking system in view of the policies implemented by the Government in the past. However, for the purposes of this study the ratios used by the Central bank of Kenya was applied.

Financial ratios were examined and analyzed under groups reflecting different operating characteristics of banks. Popular ratios under the CAMEL rating that were examined included, capital adequacy, asset quality, earnings and liquidity. Managerial efficiency ratio was also computed to assess managerial quality.

3.1 ESTIMATION PROCEDURE.

The four financial ratios of profitability are assumed to be crucial in influencing financial performance of banks. Performance ratios and averages for each institution were computed based on annual data. Composite annual financial ratios for each institution giving an indication of the financial strength of the institutions were calculated based on the profitability ratios. The profitability ratios and managerial efficiency ratios were derived as follows.

1. Capital adequacy (Ca) = Total Shareholder's funds / Total Assets.
2. Asset quality = Loans and advances/ Total deposits.
3. Earnings (ROA) = Profit after Taxes/ Total Assets.
4. Earnings (ROE) = profit after tax / Total shareholders funds.
5. Liquidity = Loans and advances / Total deposits
6. Managerial efficiency ratio = Total operating expenses/ Total operating income.

Descriptive statistics such as the mean were computed using excel statistical package and tables and graphs were drawn to show trends in the performance and managerial efficiency ratios over the years.

CHAPTER FOUR

DATA ANALYSIS AND INTERPRETATION

4.0 ANALYSIS OF RESULTS.

Analysis concentrated on five ratios which included profitability and performance ratios (capital adequacy, asset quality, earnings and liquidity ratio) and managerial efficiency ratio which was used to measure management quality. The sample comprised 23 commercial banks that operated within the seven year period covering 1996 to 2002. The choice of the sample was largely informed by the availability of data and the need to base the analysis, as much as possible on a consistent and uniform sample. The sample of banks comprised old and new banks, private and government owned varying in size and capital adequacy. Private banks were defined as those banks without any government equity participation. The main results of profitability ratios are shown in tables 4, 5,6 and 7.Table 5 depicts means of annual financial performance ratios for the periods 1996 to 2002.Trends in these ratios (charts 1 and 2) indicate stable but growing capital adequacy ratio way above the minimum statutory requirement of 7.5 percent, low and fluctuating earnings ratio and high and fluctuating liquidity ratio above the minimum statutory requirement of 20 percent

SOME CHARACTERISTICS OF KENYAN COMMERCIAL BANKS 1996-2002.

(APPENDIX C TABLE 4 NOS. 1 TO 23)

SIZE CHARACTERISTICS.

For the purpose of isolating the relationship between a bank's size and its efficiency banks were categorized into four groups on the basis of their asset portfolio. Indeed ,of the 23 banks in the sample 7 had assets over k shs 10 billion and were classified as peer-group one. Two banks had asset portfolio between 5 billion to 9.9 billion kshs. and were classified as peer-group two. Peer-group three had 7 banks with their asset size ranging between 3 billion to 4.9 billion k shs. Peer-group four was the last category representing small banks with their asset size ranging between 1 billion to 2.9 billion kshs. The study revealed that the profitability of bigger banks is higher than that of smaller banks when the ROAs are compared. With respect to capital adequacy, the capital to asset ratio suggests that bigger banks are better capitalized than the smaller banks.

BANK PROFITABILITY

In respect of asset quality , less profitable banks have a significantly higher loan loss proportion when compared with profitable banks. The comparative analysis also reveal that operating expenses to operating income ratio for less profitable banks is significantly higher than that for profitable banks.

BANK CAPITALIZATION

The peer-group profitability ratios also confirm that profitable banks have a higher capital cushion than the less profitable banks. Generally most banks had a higher capital to asset ratio well in excess of the 7.5 % statutory requirements. The ratio of loan to deposits and loan to assets is significantly higher for less capitalized banks than for well capitalized banks

OWNERSHIP CHARACTERISTICS.

The distinction between private and government owned banks provides an interesting investigation into the widely held belief that private banks are usually more efficient than government banks and also that by adopting a market driven economy and simultaneously divesting government equity in the sector, the efficiency of the banks can be enhanced and by implication that of the entire sector. From the profitability ratios managerial efficiency ratio. ROA and ROE differ significantly between private and government owned banks. These banks do no differ in size and are all categorized in peer-group one. Not surprisingly, private banks are observed to be more profitable than government owned banks. While ROA for private banks averaged 3.08 % that for government banks averaged 3.6 %. On managerial efficiency , the results indicate that private banks are more efficient in the utilization of resources . Managerial efficiency ratio for the private banks averaged 65.03 % compared to 102.4 % for the government owned banks. This shows that management quality for private banks is higher than for the government owned banks , implying that private banks are able to attract highly qualified personnel who are able to minimize operating expenses.

TABLE 5. Means of selected overall financial ratios in percentages.

	1996	1997	1998	1999	2000	2001	2002
FINANCIAL RATIOS							
RETURN ON ASSETS	2.25	2.36	1.68	1.08	0.51	0.75	2.48
RETURN ON EQUITIES	17.76	15.08	11.77	5.27	(2.46)	5.38	(15.37)
LOAN TO ASSETS	51.28	52.58	50.90	52.23	49.52	47.34	46.57
CAPITAL TO ASSETS	18.40	22.85	17.68	18.09	18.89	16.23	16.21
LOAN TO DEPOSITS	113.92	160.44	128.51	134.35	138.20	98.76	89.68
LIQUID ASSETS / TOTAL ASSETS	22.58	20.16	19.43	15.56	17.08	18.48	17.03
EXPENSES / INCOME	72.07	73.73	80.41	79.56	82.42	76.10	75.32
FIXED ASSETS / TOTAL ASSETS	4.48	4.77	6.58	7.37	6.82	5.17	3.85
FIXED ASSETS / CAPITAL	32.47	33.14	36.10	39.61	42.62	48.00	35.30

Source: Authors computations from annual data of financial statements.

TABLE 6. Means of computed overall profitability and managerial efficiency ratios.

YEAR	ROA	ROE	ME
1996	2.25	17.76	72.07
1997	2.36	15.08	73.73
1998	1.68	11.77	80.41
1999	1.08	5.27	79.56
2000	0.51	-2.46	82.42
2001	0.75	5.38	76.1
2002	2.48	-15.37	75.52

Where, ROA = Return on assets.

ROE = Return on equity.

ME = Managerial efficiency.

Source: Authors computations based on annual data of banks financial statements.

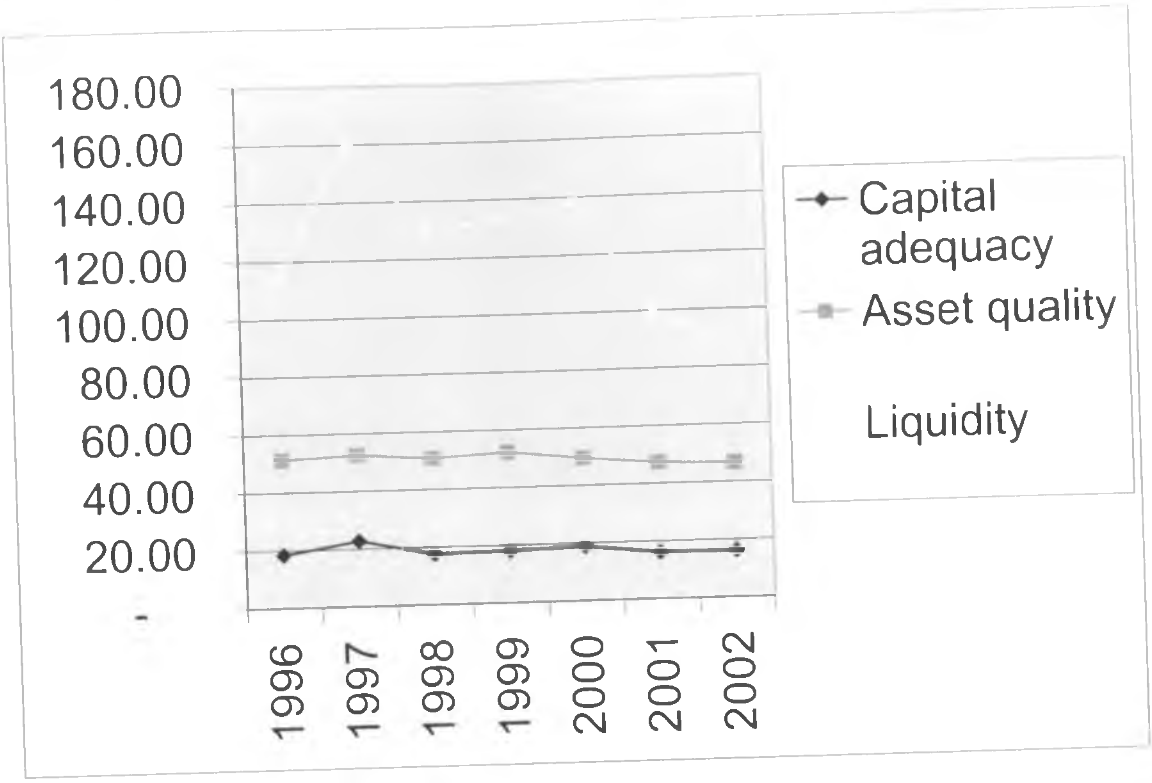
TABLE 7: OVERALL BANKS CAEL PROFITABILITY RATIOS.

YEAR	Capital adequacy	Asset quality	Liquidity	Earnings
1996	18.40	51.28	113.92	2.25
1997	22.85	52.58	160.44	2.36
1998	17.68	50.90	128.51	1.68
1999	18.09	52.23	134.35	1.08
2000	18.89	49.52	138.20	0.51
2001	16.23	47.34	98.76	0.75
2002	16.21	46.57	89.68	2.48

Source: Authors computations based on data from banks annual financial statements.

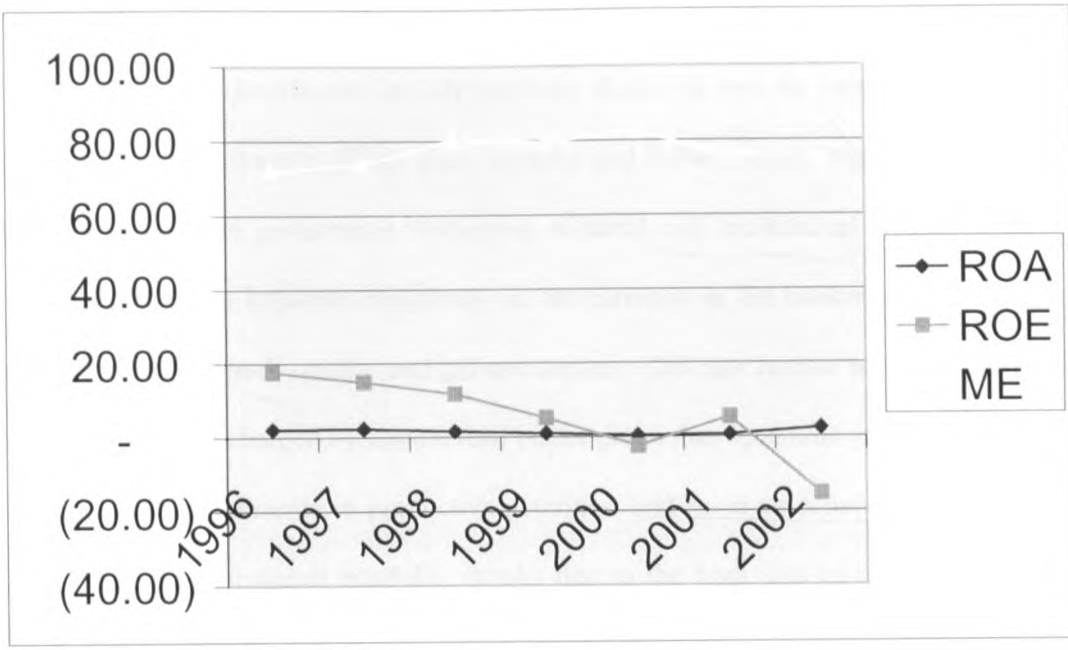
Liquidity ratios as shown in table 7 above are high and erratic over the period of study. The high liquidity ratios are influenced by the portfolio holdings of government securities by the banking sector. The holdings on government securities have been high due to the improvement in the rate of return of the 91 days treasury bill and excessively high lending interest rates. The study revealed that the excess liquidity in the local banking sector has been occasioned by low demand for loans by individuals and businesses due high interest rates and scarcity of viable investment opportunities

Chart 1. Graphical illustration of overall capital adequacy, asset quality and Liquidity.



Source: Research Data.

Chart 2. Overall trends in profitability and managerial efficiency of banks 1996-2002.



Source: Research Data.

Where, ROA = Return on assets.

ROE = Return on equity.

ME = Managerial efficiency.

4.1 Trends In Performance Ratio for Banks.

The earnings ratio as measured by ROA and ROE have been low and erratic. It is widely accepted that a profitable bank is one whose ROA is at least 2 percent while less profitable ones are those with lower ROA (Adekanye and Soyibo 1998). On the basis of 2 percent ROA , the profitability of Kenyan banks has been low for most of the period under study. Table 6 above shows that both ROE and ROA have been low between 1998 to 2001, with ROA averaging 1.59 percent, recording below 2 percent the standard requirement for profitable banks. This low earnings has been attributed to the increasingly high levels of non-performing loans and advances assets of commercial banks. By 1999 the total non-performing advances stood at 103.5 billion or 37 percent of gross loans according to CBK (2000). The earnings were affected by the growth rate of the economy as measured by the GDP growth rate. Growth rate in GDP has been declining over the years due to low levels of foreign direct investments (FDI) poor security and infrastructure, high levels of corruption and poor corporate governance worsening bilateral and multilateral donor relationships. These factors have impacted negatively on the earnings in the banking industry due to low credit demand by both public and private sectors. This has further been aggravated by the high lending rates charged by commercial banks given that economic growth is influenced by the growth in investments in productive activities, and so in an economy that is not rapidly expanding, the investment portfolio shrinks due to the high cost of credit as investors shy away from borrowing. Ultimately sectoral credit allocation has been highly skewed and sub-optimal. The rural sector which is predominantly agriculture and medium and small business enterprises, with significant contribution to employment and GDP continued to receive low credit from the formal banking sector due to their perceived risk.

Popular ratio analyzed to assess management efficiency was the ratio of operating expense to operating income. The comparative analysis revealed that the ratio was high during periods of low profitability. From table 3 above it can be shown that periods when the managerial efficiency ratio was high between 1998 to 2001 that is 80.41%, 79.56 % 82.42 % and 76.10 % recorded low profits for both ROA and ROE. This finding conforms with prior results of Adekanye (1993) Who confirmed managerial efficiency to be the overriding determinant of commercial bank profitability in Nigeria. Other studies which found out that management quality is the ultimate determinant of bank's long-term survival included. cates,1985, Pantallone and Platt 1987 ,Honer 1988, Seballos and Thompson 1990 and Siems 1991.

Table 7 also shows that assets quality ratios have been high and declining over the period. This ratio measures the efficiency of earning assets mainly loans and advances to total assets. The asset portfolio has been shrinking as a result of rising levels of non- performing loans and advances.

CHAPTER FIVE

CONCLUSSIONS AND RECOMMENDATIONS.

5.0 CONCLUSSIONS.

Banks play a central role in the allocation of financial resources towards economic growth. They facilitate commerce in the areas of smother transfer of funds and other payments both locally and internationally. Some government policies are better implemented by the assistance of banks for example monetary and fiscal policies. Economic theory also has it that efficient financial intermediation begets economic growth and that the causality works in both ways. However, due to certain policies implemented in the past, the country is still characterized by low growth rates and under developed financial system. Furthermore in the process of diversification of the economy the financial system should be developed instantaneously, that is at the same time and level. This is because diversification of the economy would best be facilitated by a well developed and efficient banking system. From the results of the study appendix C table 4 it was shown that the profitability of bigger banks is higher than that for smaller banks and that bigger banks are better capitalized than small banks and thus the need for small banks to merge so as to derive economies of scale. Less profitable banks recorded high operating expenses and thus rated lowly in terms of management quality and utilization of financial resources.

Generally most banks had a higher capital to asset ratio, above the 7.5 % statutory requirement as depicted in appendix C table nos. 1 to 23. The ratio of loan to deposit and loan to assets is significantly higher for less capitalized banks than for well capitalized banks. The study concludes that , foreign owned banks are more efficient and profitable than the government owned banks. Private banks recorded the lowest managerial efficiency ratio averaging 65.03 % compared to 102.4 % posted by government banks. Private banks also recorded the highest profitability with the ROA averaging 3.08 % compared to -3.6% recorded by government banks. Ultimately from the results of the study it was concluded that there is excess liquidity in the local banking system which has been influenced by portfolio holdings of government securities by the banking sector and low demand for loans by individuals and businesses and also due to high interest rates and depressed economy. The excess liquidity was shown to be prevalent within the development banks appendix C table 4 nos 13, 14 and 18. Development bank of Kenya, National Industrial credit bank and Industrial development bank recorded the highest liquidity ratios as shown from the loan to deposit ratio. This high liquidity emanated from the availability of cheap credit facilities from the government through the CBK.

5.1 RECOMMENDATIONS:

In view of the above observations, it is recommended that to solve excess liquidity problems the development banks should not be given large amounts of money by the CBK for their operations such as through the pre-export financing. To increase competitiveness they should be encouraged to mobilize their own funds at the prevailing market rates. This is because it makes commercial banks less aggressive in their deposit seeking efforts since they could obtain funds cheaply from the CBK. As a result it is further recommended that the CBK should refrain from procuring foreign loans for private firms through the commercial banks. This will ensure that these firms would obtain their credit requirements from the banks and the excess liquidity in the banking system would be reduced considerably. Banks should increase their capital base since this is one way of ensuring a healthy banking environment because it acts as a guarantee to a bank's continued existence as a going concern. According to economic theory capital is a measure of risk of the bank, Barth, et al., (1995). A bank with a low capital base is risky to depositors, shareholders and the economy.

The government should strive to expand the provision of resources for smallholder farmers and MSEs credit by improving the services offered by the Post Office Savings Bank (POSB) to enable it to mobilize more resources. In addition the government should enact legislation to empower POSB to extend credit to MSEs and manufacturing enterprises. Presently POSB lends money to government only. Extending credit to MSEs will need considerable modification to buildings and retraining of employees. As such the full benefits from this project, if implemented will only be felt in the long term. The government should also as a matter of urgency divest its equity participation in the Kenya commercial Bank, National Bank of Kenya Limited, Industrial Development Bank, Consolidated Bank of Kenya and recapitalization of the Cooperative Bank. This will spur competitiveness in the financial sector by making these banks more competitive thereby increasing their profitability.

Operating expenses continues to be a major threat to performance of the banking industry. Banks should improve performance by efficiently and effectively managing operating expenses. This can be achieved through reduction of overhead costs, efficient screening of loan applicants and closing down of branches which are not profitable. Also to reduce the cost of employee selection, recruitment and training banks need to pay higher salaries to qualified staff in order to retain them. Without sufficient remuneration for workers banks stand the risk of losing them to their competitors.

Another recommendation is that banks should create more loans in order to increase the size of their loan portfolios so as to enjoy high profitability. Consequently loan customers should be closely monitored to recover the loans and also ensure that they are used for the intended purpose which will ideally foster prompt repayment. To make monitoring easier banks should strive to create a long- term relationship with their clients. This is because long-term relationship would ensure that certain covenants in loan agreement are not violated. To enhance performance banks should create a credit rating agency or information pool where details of all defaulters and other undesirable customers would be put for any bank wishing to make as reference. Such a data bank should be kept and updated by the CBK. Any bank which has a problem with any of its customers, could notify other banks in respect of that customer. This effort should ensure that banks reduce considerably the levels of non-performing asset portfolios because high non- performing assets in the banks may lead to further fragility and weakening of the financial system.

An incentive package should be formulated to encourage false dichotomy between the formal and the informal sectors in order to enhance their capabilities. The formal sector should develop products that are friendly and acceptable to the informal sector.
To enhance coordination the informal sector should strive to keep proper books of accounts and to channel their business transactions through banks as a versed to cash transactions.

The CBK should reduce its reserve requirements and the base rate to an appreciable level. The rural sector which is predominantly agriculture and MSEs should be encouraged through legislation to keep proper books of accounts so as to attract lending from the formal financial sector. In that way many wealth holders, would move out of the inflation hedges such as inventories and residential buildings and hold newly created financial assets. Where wealth kept in inventories and other real assets is not available for intermediation, there is a high cost involved due to losses from pilferage and spoilage. Such incomes kept in real assets and jewelery should be freed for transformation into productive capital. People hold their wealth in inflation hedges due to restrictions on the financial system and price instability. With the creation of conditions, conducive for banking and finance wealth in inflation hedges will be transformed into productive assets for economic development. Sufficient funds would be injected in the financial system and hence cost of production would become very low leading to higher investment expenditure and ultimately translating to higher economic growth. Effective intermediation will generate the impetus for a general reduction in the effective interest rate. This reduction will induce a further reduction in the cost of investment. Through financial product innovation a wide variety of financial products would be developed by banks and if savers respond positively to them then more loanable funds would be availed to the entrepreneurs.

Thus there is need for the informal sector to be commercialized and sensitized to maintain at least some minimum level of record keeping in order to access credit from the formal sector, for it is the reason why they find it difficult to access finance from the banks even though the nature of their business stands to increase the country's output. If real output increases, then businesses would demand more outside funding for expansion thereby increasing financial intermediation and bank profitability. The increased credit to the rural sector will thus enhance linkage between agriculture and industry, so that for instance the rural farmer with cheap access to credit should be able not only to produce tomatoes but also process it into tomato sauce thereby adding value to the agricultural raw materials. This will make the agricultural and domestic industrial sectors more productive by commercializing and monetizing them for sustained economic growth. Through the Local Governments appropriate legislations should be enacted to ensure that medium and small business enterprises operate in conducive business environment. *Kiosks, vibanda and hawking* should be allocated designated permanent locations and be licensed to carry on their businesses without invariable harassments. Essentially, the nature of their business *nomadism* has often discouraged banks from lending to this sector which if properly managed has the potential of fulfilling the ruling party's election pledges of employing half a million Kenyans annually. Commercial banking will flourish if there are opportunities for enterprise development. Steps must also be taken to diversify the export sector in order to increase the country's earnings from exports so as to generate export surplus in the long-term. Thus in a nutshell the country needs and appropriate legal framework, streamlined bureaucracy and economic environment conducive for the promotion of commerce and exchange.

With regional and international economic integration, the case of COMESA and EAC the business community needs to tailor their structures and products to satisfy the expanded and competitive market. Measures need to be put in place to improve the prices of agricultural products and outputs of small enterprises. It is an open secret that even though EAC charter guarantees free movement of people and goods across national borders in the sub- region, the situation is different on the ground. A recent scenario is the arresting and prosecution of Kenyan fishermen by Ugandan and Tanzanian authorities, casting aspersions to the commitment of member sates in regional integration.

The government should ensure the existence of a strong legal framework providing banks certainty concerning their rights and obligations under the law and permitting them to enforce their financial claims expeditiously and effectively against counter parties in default. Also there should be a proper corporate framework for banks that is characterized by good governance, adequate internal risk management and financial control systems, market based decision making and respect for shareholders rights. Proper incentives and disincentives for bank's owners, managers and directors ranging from the effects of market forces on bank's financial position to personal liability for gross negligence and willful misconduct.

The government should also ensure the existence of a well developed and efficient financial markets that not only enable banks to meet their ordinary liquidity needs and to calibrate their overall risk profile by disposing of assets and hedging liabilities, but also support reasonable asset valuations for accounting and risk management purposes. Ultimately no banking system can function properly without public trust. Thus it is important for the monetary authority to build and maintain public confidence in the banking system through prudential regulation of banks. This should be achieved by educating the public about the banking industry by explaining to them the risk of banking and the prudential standards applied to mitigate those risks, publishing important decisions of the bank regulator and fostering reasonable expectations among the public about the continuing safety and soundness of banks.

5.2 LIMITATIONS TO THE STUDY.

The study was originally intended to cover a wider range of issues such as making comparisons between the pre- and post reform periods. However, due to problems of unavailability of data, it was not possible to cover all what was intended to be investigated. Since financial ratios as measures of profitability are calculated from accounting numbers ,caution needs to be applied while interpreting them owing to the fact that accounting numbers suffer from accounting policy changes, arbitrary allocation procedures and inflation.

APPENDIX A.

DEFINITIONS OF SOME BANK PROFITABILITY RATIOS.

1.) Net Interest Margin = Interest received – Interest paid.

2.) Gross Earnings = Net Interest margin + Commission + Fees + Exchange Gains + Other Income.

3.) Transaction Cost = Intermediation costs + Default costs.

4.) Intermediation Cost = Operational Expenses / Gross Earnings.

5.) Default Cost = Provisions for Bad Debts / Gross Loans.

6.) Spread = Net Interest Margin / Total Asssets.

7.) Return on Assets = Net Profit / Total Assets.

8.) Return on Equity = Net Profit / Shareholders Funds.

9.) Deposit Concentration = Total Deposit of Major banks / Total Deposits

10.) Loan Concentration = Total Loans of Major banks / Total loans

11.) Asset Concentration = Total Assets of Top Banks / Total Assets.

12.) Spread Utilization Ratio = Total Dividend Paid / Net Profit.

13.) Spread Utilization Ratio = Capital or Shareholders Funds / total assets.

APPENDIX B.

BANKS AND FINANCIAL INSTITUTIONS IN LIQUIDATION

NO.	INSTITUTION	LIQUIDATION DATE
1	Postbank Credit	20.05.1993
2	Trade bank Limited	18.08.1993
3	Pan African Bank Limited	18.08.1994
4	Thabiti Finance Limited	19.12.1994
5	Middle Africa finance limited	20.08.1993
6	Pan African Credit & Finance Ltd	18.08.1994
7	Dinners Finance Limited	20.08.1993
8	Nairobi Finance Limited	20.08.1993
9	International Finance Limited	16.04.1993
10	Allied Credit Limited	20.08.1993
11	Inter Africa Credit & Finance	31.01.1993
12	Trade Finance Limited	18.09.1993
13	Central Finance Limited	19.05.1993
14	Meridien Biao Limited	15.04.1996
15	Heritage Bank Limited	13.09.1996
16	Kenya Finance Bank Limited	29.10.1996
17	Ari Bank Corp	05.12.1997
18	Prudential Bank Limited	05.05.2000
19	Reliance Bank Limited	12.09.2000
20	Fortune Finance Limited	14.09.2000
21	Trust Bank Limited	15.08.2001
22	Euro Bank Limited	21.02.2003

APPENDIX C:

PROFITABILITY OF INDIVIDUAL BANKS 1996-2002.

TABLE 4 FINANCIAL RATIO ANALYSIS FOR INDIVIDUAL BANKS 1996 –2002.

FINANCIAL RATIO ANALYSIS FOR INDIVIDUAL BANKS 1996- 2002.

PEER -GROUP 1 CATEGORY.ASSET PORTFOLIO OVER 10 BILLION KSHS

1 **BARCLAYS BANK KENYA LIMITED.**

S/N	FINANCIAL RATIOS	1996	1997	1998	1999	2000	2001	2002
1	Return on assets	4.32	4.44	4.26	3.25	2.94	4.01	2.08
2	Return on equities	39.7	39.1	36.7	25.8	19.2	25.9	17.9
3	Loan to asset	51.8	48.1	41.1	53.7	60	62	58.4
4	Capital to asset	10.9	11.3	11.6	12.6	14.7	15.5	11.6
5	Loan to deposit	70.8	64.5	56.4	69.1	79.5	80.4	72.8
6	Liquid asset to total asset	14.8	12.5	11.4	13.4	14.6	13.7	10.9
7	Operating expenses/ op .Income	68.4	67.4	69.3	73.1	73.2	62.4	77.8
8	Fixed assets / total assets	4.25	4.21	3.79	3.12	2.68	2.38	1.66
9	Fixed assets / Capital	39.1	37.1	32.7	24.7	18.3	15.3	14.9
10	Bank size= Log of Asset portfolio	4.72	4.78	4.85	4.84	4.85	4.87	4.93
11	AVERAGE ROA =3.61							
12	BANK SIZE= 4.83							

2 **KENYA COMMERCIAL BANK LIMITED**

S/N	FINANCIAL RATIOS	1996	1997	1998	1999	2000	2001	2002
1	Return on assets	3.66	3.49	1.43	-2.1	-0.6	0.16	-50
2	Return on equities	30.7	26.2	1087	-18	-5.5	1.3	-570
3	Loan to asset	50.2	58.4	61.4	59.7	52.8	53.8	35
4	Capital to asset	11.9	13.3	13.1	11.7	11.3	12.6	8.82
5	Loan to deposit	62.8	76	87.5	81	74.3	69.5	42.8
6	Liquid asset to total asset	16.1	12.7	12.5	14.4	14.2	14.9	19.8
7	Operating expenses/ op .Income	69.3	70.5	80.9	80	73.6	95.5	146
8	Fixed assets / total assets	3.95	3.82	3.77	4.29	3.82	4.4	4.58
9	Fixed assets / Capital	33	28.7	28.8	36.7	33.8	35.1	52
10	Bank size= Log of Asset portfolio	4.85	4.87	4.9	4.88	4.87	4.81	4.78
11	AVERAGE ROA =-6.3							
12	BANK SIZE= 4.85							

3 **THE COOPERATIVE BANK OF KENYA LIMITED**

S/N	FINANCIAL RATIOS	1996	1997	1998	1999	2000	2001	2002
1	Return on assets	1.08	1.41	-0.1	-2.8	-8.1	-2.8	0.96
2	Return on equities	3.49	50.1	-0.4	-2.3	-157	-40	10.7
3	Loan to asset	44.9	54.1	60.5	60.7	57.3	62.7	61.8
4	Capital to asset	31	27.8	14.4	12.8	5.13	6.84	8.99
5	Loan to deposit	77.1	91	93	83.3	72.7	79.3	77.2
6	Liquid asset to total asset	20.2	21.1	14.2	13.4	13.7	13	12.2
7	Operating expenses/ op .Income	84.8	81.3	84.2	91.6	190	139	96.5
8	Fixed assets / total assets	12.8	12.3	9.86	9.96	8.84	10.6	8.64
9	Fixed assets / Capital	41.2	44.3	68.4	78.1	172	155	96.1
10	Bank size= Log of Asset portfolio	4.21	4.29	4.33	4.38	4.37	4.37	4.46
11	AVERAGE ROA =-1.46							
12	BANK SIZE= 4.34							

4 **STANDARD CHARTERED BANK KENYA LIMITED**

S/N	FINANCIAL RATIOS	1996	1997	1998	1999	2000	2001	2002
1	Return on assets	3.73	3.25	4.23	4.1	3.77	3.59	3.58
2	Return on equities	41.4	33	40	38.8	30	33.7	38.8
3	Loan to asset	55.9	56.3	43.2	42.1	34.4	27.1	27
4	Capital to asset	9.03	9.86	10.6	10.6	12.6	10.7	9.23
5	Loan to deposit	69.8	70.2	53.2	51.5	42.9	32.6	32
6	Liquid asset to total asset	16.2	14.5	10.7	12.2	9.99	9.8	10.4
7	Operating expenses/ op .Income	65.7	66.1	71.1	63	49	50.4	51.9
8	Fixed assets / total assets	6.18	5.26	4	3.38	3.54	3.43	2.5
9	Fixed assets / Capital	68.5	53.3	37.9	32	28.2	32.3	27.1
10	Bank size= Log of Asset portfolio	4.49	4.52	1.58	1.63	4.69	4.74	4.79
11	AVERAGE ROA =3.75							
12	BANK SIZE= 4.63							

5 **NATIONAL BANK OF KENYA LIMITED**

S/N	FINANCIAL RATIOS	1996	1997	1998	1999	2000	2001	2002
1	Return on assets	1.64	1.25	-8.9	-8.7	-9.2	1.24	0.79
2	Return on equities	12.6	11.6	-53	-104	-102	12.1	10.3
3	Loan to asset	64.1	67.4	77	76.1	76.8	76.3	76.3
4	Capital to asset	13.1	10.7	16.7	8.43	8.99	10.2	7.6
5	Loan to deposit	85.3	91.4	103	93.5	94	92.5	89
6	Liquid asset to total asset	18.7	16.1	4.41	5.43	6.75	5.29	6.06
7	Operating expenses/ op .Income	84.5	89.3	107	93.4	192	113	88.7
8	Fixed assets / total assets	4.97	3.92	4.75	5.01	5	5.56	3.76
9	Fixed assets / Capital	38.1	36.7	28.5	59.5	55.6	54.4	49.5
10	Bank size= Log of Asset portfolio	4.39	4.49	4.44	4.4	4.38	4.38	4.4
11	AVERAGE ROA = -3.13							
12	BANK SIZE= 4.41							

6 **CITI BANK KENYA LIMITED**

S/N	FINANCIAL RATIOS	1996	1997	1998	1999	2000	2001	2002
1	Return on assets	2.49	3.02	2.49	1.94	1.83	1.51	2.61
2	Return on equities	19.1	24.2	17.9	15.3	17.7	10.4	19.4
3	Loan to asset	51.5	44.8	43.4	42.2	44.3	43.7	37.2
4	Capital to asset	13	12.5	13.9	12.7	10.3	14.5	13.5
5	Loan to deposit	63.7	53.3	51.1	49.5	52.2	54.4	45.3
6	Liquid asset to total asset	7.01	10.1	8.74	8.86	35.7	22.4	28.8
7	Operating expenses/ op .Income	73.4	75.4	76	72.7	58.6	59.6	52.1
8	Fixed assets / total assets	1.9	3.73	5.75	4.56	2.99	2.46	2
9	Fixed assets / Capital	14.6	29.9	41.3	36	29	17	185
10	Bank size= Log of Asset portfolio	3.99	4.03	4.06	4.17	4.35	4.44	4.48
11	AVERAGE ROA = 2.27							
12	BANK SIZE= 4.2							

7 **COMMERCIAL BANK OF AFRICA LIMITED**

S/N	FINANCIAL RATIOS	1996	1997	1998	1999	2000	2001	2002
1	Return on assets	3.76	3.87	3.1	2.5	2.06	2.18	1.52
2	Return on equities	29.9	30.4	27.1	20	15.8	18.7	14.9
3	Loan to asset	44.3	50.1	37.8	38.9	35.1	26.7	30.6
4	Capital to asset	12.6	12.8	11.4	12.5	13	11.7	10.3
5	Loan to deposit	54.2	62.2	44.2	46.4	41.6	31.7	35.3
6	Liquid asset to total asset	21.5	22	28	27.1	30.7	33	35.5
7	Operating expenses/ op .Income	48	48.9	76	74.2	70	60.4	67
8	Fixed assets / total assets	5.57	5.02	4.02	3.96	3.63	2.66	2.43
9	Fixed assets / Capital	44.4	39.3	35.1	31.6	27.9	22.8	23.7
10	Bank size= Log of Asset portfolio	3.9	3.97	4.08	4.07	4.11	4.21	4.22
11	AVERAGE ROA = 2.7							
12	BANK SIZE= 4.08							

FINANCIAL RATIO ANALYSIS FOR INDIVIDUAL BANKS 1996- 2002.
PEER -GROUP 2 CATEGORY.ASSET PORTFOLIO (5 - 9.9) BILLION KSHS.

8 **DIAMOND TRUST BANK KENYA LIMITED**

S/N	FINANCIAL RATIOS	1996	1997	1998	1999	2000	2001	2002
1	Return on assets	-1	2.18	2.26	1.74	3.18	0.74	1.2
2	Return on equities	-7.6	19.7	13.5	9.14	13	3.28	5.95
3	Loan to asset	57.8	59.6	43.9	40.4	28.8	32.4	43
4	Capital to asset	13.4	11.1	16.7	19	24.4	22.6	20.2
5	Loan to deposit	70.9	72.2	56.4	53.5	40.5	44.5	56.6
6	Liquid asset to total asset	26.3	20.9	24.9	13.6	18	38.3	20.4
7	Operating expenses/ op Income	104.	92.7	87.1	84.1	72.6	84.1	75
8	Fixed assets / total assets	1.02	3.15	3.33	3.49	3.49	3.31	2.38
9	Fixed assets / Capital	30	28.4	19.9	18.4	14.3	14.6	11.7
10	Bank size= Log of Asset portfolio	3.95	3.86	3.82	3.78	3.71	3.74	3.8
11	AVERAGE ROA = 1.47							
12	BANK SIZE= 3.8							

9 **CFC BANK LIMITED**

S/N	FINANCIAL RATIOS	1996	1997	1998	1999	2000	2001	2002
1	Return on assets	3.12	4.37	4.05	2.71	2.36	1.83	1.89
2	Return on equities	15.9	22	18.2	12.3	12.5	9.94	11.2
3	Loan to asset	54.1	43.2	44.4	40.6	53.1	50.5	52.1
4	Capital to asset	19.6	19.8	22.2	22.1	18.8	18.5	16.9
5	Loan to deposit	75.9	78.8	105	98.9	102	95.8	86
6	Liquid asset to total asset	28.3	25.6	21.2	16.8	13.5	17.8	13.6
7	Operating expenses/ op .Income	77.3	69.2	76.9	79.9	75.1	83.6	80.6
8	Fixed assets / total assets	1.59	4.39	6.95	8.7	5.6	5.43	4.24
9	Fixed assets / Capital	8.11	22.1	31.3	39.4	29.7	29.4	25
10	Bank size= Log of Asset portfolio	3.78	3.83	3.84	3.88	4	4.02	4.07
11	AVERAGE ROA = 2.90							
12	BANK SIZE= 3.9							

FINANCIAL RATIO ANALYSIS FOR INDIVIDUAL BANKS 1996- 2002.
PEER -GROUP 3 CATEGORY.ASSET PORTFOLIO (3 - 4.9) BILLION KSHS.

10 **VICTORIA COMMERCIAL BANK LIMITED**

S/N	FINANCIAL RATIOS	1996	1997	1998	1999	2000	2001	2002
1	Return on assets	1.08	1.05	1.43	0.31	0.43	0.36	0.45
2	Return on equities	16.3	11.6	12.1	2.49	2.86	2.15	2.92
3	Loan to asset	44.9	54.3	58.7	52.9	55	54	42.7
4	Capital to asset	6.61	9.1	11.9	12.5	15.1	16.9	15.4
5	Loan to deposit	49.7	63	68.7	61.8	66.5	66.8	51.4
6	Liquid asset to total asset	42.6	30.9	23.1	23	25.9	19.5	20.8
7	Operating expenses/ op .Income	43.8	46.5	90.6	95.8	87.8	88.8	86.3
8	Fixed assets / total assets	1.82	2.92	1.1	2.44	2.55	3.15	3.41
9	Fixed assets / Capital	27.5	32.4	9.3	19.5	16.9	18.7	22.1
10	Bank size= Log of Asset portfolio	3.56	3.61	3.56	3.55	3.48	3.44	3.49
11	AVERAGE ROA = 0.73							
12	BANK SIZE= 3.5							

11 **CREDIT AGRICOLE INDOSUEZ BANK**

S/N	FINANCIAL RATIOS	1996	1997	1998	1999	2000	2001	2002
1	Return on assets	1.01	-2	2.42	2.27	0.68	0.52	0.62
2	Return on equities	14	-27	26.2	17.4	6.05	4.15	3.87
3	Loan to asset	50.7	54.2	58.2	63.6	49.8	39.8	41.4
4	Capital to asset	7.24	7.58	9.24	13.1	11.3	12.5	16.1
5	Loan to deposit	60.4	68.1	77.4	81.4	64.9	60.4	67.3
6	Liquid asset to total asset	25.5	21.2	13.8	15.4	7.97	19.2	9
7	Operating expenses/ op .Income	85.3	85.3	79.8	76.2	86.7	85	87.2
8	Fixed assets / total assets	0.81	0.88	0.91	1.47	1.26	1	0.79
9	Fixed assets / Capital	11.2	11.6	9.85	11.2	11.2	8.02	4.92
10	Bank size= Log of Asset portfolio	3.54	3.58	3.62	3.67	3.76	3.76	3.67
11	AVERAGE ROA = 0.79							
12	BANK SIZE= 3.66							

12 **INVESTMENTS AND MORTGAGES BANK LIMITED**

S/N	FINANCIAL RATIOS	1996	1997	1998	1999	2000	2001	2002
1	Return on assets	2.46	3.39	2.71	1.21	1.33	0.96	0.84
2	Return on equities	14.8	19.2	15.6	6.92	7.78	6.08	5.27
3	Loan to asset	59.7	59.2	58.6	63.2	56.6	50.4	46.7
4	Capital to asset	16.6	17.7	17.4	17.4	17.1	15.8	15.9
5	Loan to deposit	77.6	77.3	74.2	79.9	69.3	60.6	56.1
6	Liquid asset to total asset	34.6	30.5	23	21.2	21.4	20	16.1
7	Operating expenses/ op .Income	75.9	75.3	81.5	87.3	69.2	73.1	72.3
8	Fixed assets / total assets	3.72	4.41	5.08	7.87	13.5	3.72	1.73
9	Fixed assets / Capital	22.4	25	29.3	45.1	78.7	23.6	10.9
10	Bank size= Log of Asset portfolio	3.69	3.72	3.77	3.78	3.81	3.85	3.86
11	AVERAGE ROA = 1.84							
12	BANK SIZE= 3.78							

13 **DEVELOPMENT BANK OF KENYA LIMITED**

S/N	FINANCIAL RATIOS	1996	1997	1998	1999	2000	2001	2002
1	Return on assets	2.7	3.59	3.34	2.36	1.49	2.04	1.61
2	Return on equities	2.94	4.41	9.91	7.36	4.18	5.82	3.78
3	Loan to asset	55.3	56.2	61.3	68.3	61.7	52.4	53.1
4	Capital to asset	92	81.5	33.7	32.1	35.5	35.1	42.6
5	Loan to deposit	1636/0	1000	417	411	501	267	214
6	Liquid asset to total asset	19.1	1.72	2.2	1.54	11.5	9.51	15.8
7	Operating expenses/ op .Income	25.3	33.4	70.3	78	78.8	69	81.6
8	Fixed assets / total assets	19	17.2	15.5	15.7	15.7	14.1	5.44
9	Fixed assets / Capital	20.6	21.1	45.9	48.9	44.3	40.1	12.8
10	Bank size= Log of Asset portfolio	3.47	3.52	3.56	3.58	3.56	3.54	3.42
11	AVERAGE ROA = 2.45							
12	BANK SIZE= 3.52							

14 **NATIONAL INDUSTRIAL CREDIT BANK LIMITED**

S/N	FINANCIAL RATIOS	1996	1997	1998	1999	2000	2001	2002
1	Return on assets	4.9	4.97	3.94	4.16	4.04	3.02	2.46
2	Return on equities	34.8	23.4	15.3	14.7	13.6	10.5	9.17
3	Loan to asset	77.8	71.9	64.7	59.4	52.9	48.8	50.5
4	Capital to asset	14.1	21.3	25.7	28.3	30.9	28.7	26.8
5	Loan to deposit	95.5	98	93.3	91.5	83.8	73.7	72.6
6	Liquid asset to total asset	14.2	12.2	18.4	11.2	16.9	17.8	17.4
7	Operating expenses/ op .Income	71.3	74.2	77.2	67.5	52.1	55.9	59.1
8	Fixed assets / total assets	2.3	5.3	5.72	6.14	6.02	4.86	3.95
9	Fixed assets / Capital	16.3	24.9	22.3	21.7	19.5	17	14.7
10	Bank size= Log of Asset portfolio	3.86	3.91	3.86	3.86	3.87	3.93	3.97
11	AVERAGE ROA = 3.90							
12	BANK SIZE= 3.89							

15 **AFRICAN BANKING CORPORATION LIMITED**

S/N	FINANCIAL RATIOS	1996	1997	1998	1999	2000	2001	2002
1	Return on assets	0.97	0.64	0.69	0.75	0.79	0.93	0.89
2	Return on equities	13.9	7.58	6.63	6.98	7.27	7.84	7.89
3	Loan to asset	55.2	54.1	54.8	51.9	49.8	42.5	46.7
4	Capital to asset	6.95	8.5	10.4	10.7	10.9	11.9	11.3
5	Loan to deposit	62.8	63.3	65.4	62.2	59.6	51.2	55.2
6	Liquid asset to total asset	30	16.2	25.1	13.9	14.1	15.3	17.9
7	Operating expenses/ op .Income	92.3	94.4	87.4	93.1	87.6	85.5	82
8	Fixed assets / total assets	4.41	7.9	9.3	9.14	8.29	7.88	3.08
9	Fixed assets / Capital	63.5	93	89.6	85.4	76.2	66.3	27.3
10	Bank size= Log of Asset portfolio	3.54	3.49	3.43	3.45	3.47	3.47	3.53
11	AVERAGE ROA = 0.809							
12	BANK SIZE= 3.48							

16 **FINA BANK LIMITED**

S/N	FINANCIAL RATIOS	1996	1997	1998	1999	2000	2001	2002
1	Return on assets	0.47	0.93	1.17	0.71	0.72	0.72	0.87
2	Return on equities	6.92	12.7	12.1	7.03	7.08	6.56	8.29
3	Loan to asset	51.5	53.7	59.4	54.1	49.9	57.9	48.9
4	Capital to asset	6.74	7.32	9.71	10.1	10.2	10.9	10.5
5	Loan to deposit	58.1	59.8	67.5	61.6	56.5	66.4	55.8
6	Liquid asset to total asset	22.6	22.6	14.5	16.2	13.8	12.2	14.9
7	Operating expenses/ op .Income	91.5	93.5	88.2	93.3	80.8	82.6	80.3
8	Fixed assets / total assets	2.44	2.67	3.17	4.81	4.12	4.38	2.13
9	Fixed assets / Capital	36.3	36.4	32.7	47.9	40.3	40.1	20.4
10	Bank size= Log of Asset portfolio	3.67	3.69	3.62	3.64	3.67	0.37	3.72
11	AVERAGE ROA = 0.799							
12	BANK SIZE= 3.67							

FINANCIAL RATIO ANALYSIS FOR INDIVIDUAL BANKS 1996- 2002.
PEER -GROUP 4 CATEGORY.ASSET PORTFOLIO (1 - 2.9) BILLION KSHS.

17 **IMPERIAL BANK LIMITED**

S/N	FINANCIAL RATIOS	1996	1997	1998	1999	2000	2001	2002
1	Return on assets	1.21	1.65	2.01	2.48	2.6	2.8	3.04
2	Return on equities	16.8	18.1	16.6	17.4	17	18.2	19.5
3	Loan to asset	69.1	63.3	62.2	64.6	63.8	65.6	61.9
4	Capital to asset	7.18	9.07	12.2	14.3	15.2	15.4	15.6
5	Loan to deposit	77.9	74.1	79	80.1	79.9	80.7	77
6	Liquid asset to total asset	19.7	20.9	12.6	18.9	14.5	14.4	21.5
7	Operating expenses/ op .Income	90	88.9	88.2	82.2	68.1	63.8	59.7
8	Fixed assets / total assets	2.56	2.45	2.09	1.2	2.37	3.65	3.33
9	Fixed assets / Capital	35.7	27	17.2	8.42	15.5	23.8	21.3
10	Bank size= Log of Asset portfolio	3.3	3.35	3.41	3.43	3.48	3.56	3.62
11	AVERAGE ROA = 2.26							
12	BANK SIZE= 3.45							

18 **INDUSTRIAL DEVELOPMENT BANK LIMITED**

S/N	FINANCIAL RATIOS	1996	1997	1998	1999	2000	2001	2002
1	Return on assets	1.42	4.35	1.23	0.54	-3.6	-13	-4.9
2	Return on equities	3.34	3.03	2.45	1.09	-4.8	-54	-22
3	Loan to asset	27.7	53.3	53.3	55.3	64	61.4	75.1
4	Capital to asset	42.5	143	50.2	49.8	75.2	23.3	21.9
5	Loan to deposit	1087	1106	1085	1209	1328	730	640
6	Liquid asset to total asset	8.87	22.5	21.1	17.7	16.1	21.8	9.67
7	Operating expenses/ op .Income	2.25	8.28	9.95	12.5	11.3	1.99	1.61
8	Fixed assets / total assets	5.28	5.78	19.8	25.1	15	8.54	7.34
9	Fixed assets / Capital	88.8	78.3	88.9	96.5	84.8	340	245
10	Bank size= Log of Asset portfolio	3.51	3.2	3.21	3.22	3.24	3.24	3.21
11	AVERAGE ROA = -1.94							
12	BANK SIZE= 3.26							

19 **CONSOLIDATED BANK OF KENYA LIMITED**

S/N	FINANCIAL RATIOS	1996	1997	1998	1999	2000	2001	2002
1	Return on assets	1.44	0.85	0.47	0.57	-1.4	-48	2.85
2	Return on equities	3.59	2.18	1.39	1.53	-4.2	-2.4	12.4
3	Loan to asset	40.4	37.7	32.7	28.6	28.3	26.1	37.9
4	Capital to asset	39.9	39.2	34	37.3	32.6	19.6	23
5	Loan to deposit	102	98.3	84.8	79.6	66.5	43.8	57.2
6	Liquid asset to total asset	12.9	13	11.4	4.97	14.2	23.4	22.3
7	Operating expenses/ op .Income	89.6	94.9	92.5	95.5	113	105	87.9
8	Fixed assets / total assets	4.28	4.11	32.3	37.1	38.3	21	21.2
9	Fixed assets / Capital	10.7	10.5	95	99.3	118	108	91.9
10	Bank size= Log of Asset portfolio	3.3	3.31	3.33	3.36	3.4	3.47	3.43
11	AVERAGE ROA = 0.62							
12	BANK SIZE= 3.37							

20 **BANK OF INDIA KENYA BRANCHES**

S/N	FINANCIAL RATIOS	1996	1997	1998	1999	2000	2001	2002
1	Return on assets	3.71	2.18	2.2	2.74	2.32	2.28	1.3
2	Return on equities	21	12.2	16	17.5	18.4	18.6	7.9
3	Loan to asset	39	38.2	33.1	33.9	26.5	25.9	22.3
4	Capital to asset	17.7	17.9	13.8	15.7	12.6	12.2	16.5
5	Loan to deposit	54	54.4	42.7	44.1	31	30.4	27.2
6	Liquid asset to total asset	15.6	17	9.72	9.06	8.84	13.1	7.08
7	Operating expenses/ op .Income	70.5	81.4	83.9	73.1	64.6	59.3	78.9
8	Fixed assets / total assets	3.43	2.8	2.52	2.67	2.31	1.37	0.99
9	Fixed assets / Capital	19.4	15.6	18.4	17	18.3	11.2	6.03
10	Bank size= Log of Asset portfolio	3.37	3.42	3.46	3.41	3.4	3.5	3.67
11	AVERAGE ROA = 2.39							
12	BANK SIZE= 3.46							

21 **BIASHARA BANK OF KENYA LIMITED**

S/N	FINANCIAL RATIOS	1996	1997	1998	1999	2000	2001	2002
1	Return on assets	3.31	2.03	1.91	1.98	1.98	2.03	1.42
2	Return on equities	29	17.8	12.8	11.5	11.6	12.1	8.89
3	Loan to asset	31.6	26.7	28.8	38	38.5	38.2	29.7
4	Capital to asset	11.4	11.4	14.9	17.3	17.1	16.9	16
5	Loan to deposit	39.9	33.4	35.7	50.1	49	47.7	36.2
6	Liquid asset to total asset	52.2	51.2	52.2	35.9	15.7	30.3	18.4
7	Operating expenses/ op .Income	73.9	82.5	84.7	81	81.5	68.6	76.1
8	Fixed assets / total assets	2.64	2.6	3.04	3.06	2.5	1.44	0.7
9	Fixed assets / Capital	23.1	22.9	20.5	17.8	14.6	8.54	4.39
10	Bank size= Log of Asset portfolio	3.29	3.3	3.36	3.31	3.33	3.38	3.41
11	AVERAGE ROA = 2.09							
12	BANK SIZE= 3.34							

22 **PRIME BANK LIMITED**

S/N	FINANCIAL RATIOS	1996	1997	1998	1999	2000	2001	2002
1	Return on assets	1.95	1.47	0.91	1.4	1.26	1.29	1.34
2	Return on equities	17	11.7	5.47	8.31	8.32	8.53	9.25
3	Loan to asset	52.6	53.2	46.4	60.4	52.5	49	51.2
4	Capital to asset	11.5	12.5	16.5	16.9	15.1	15.1	14.4
5	Loan to deposit	158	171	57.8	84.8	65.1	62	65
6	Liquid asset to total asset	20.4	22.2	49.4	25.8	33.2	22.7	21.9
7	Operating expenses/ op .Income	87.1	89.3	94	87.9	77.4	78.3	76.4
8	Fixed assets / total assets	2.46	2.43	1.69	3.7	2.84	1.81	1.06
9	Fixed assets / Capital	21.4	19.4	10.2	21.9	18.8	12	7.34
10	Bank size= Log of Asset portfolio	3.26	3.32	3.22	3.33	3.44	3.5	3.58
11	AVERAGE ROA = 1.37							
12	BANK SIZE= 3.38							

23 **EQUATORIAL COMMERCIAL BANK**

S/N	FINANCIAL RATIOS	1996	1997	1998	1999	2000	2001	2002
1	Return on assets	2.39	1.84	1.24	0.61	0.84	0.76	1.76
2	Return on equities	29	18.2	7.5	3.35	5.04	4.66	10.6
3	Loan to asset	49.2	51.6	45.9	52.7	47.2	41.7	41.2
4	Capital to asset	8.22	10.1	16.6	18.3	16.7	16.3	16.6
5	Loan to deposit	67.5	63.6	57.2	66.7	57.9	51.3	510
6	Liquid asset to total asset	32	26.3	34.4	18	21.7	17.8	21.4
7	Operating expenses/ op .Income	84.3	87.2	92.9	94.4	83.2	85.6	67.6
8	Fixed assets / total assets	2.71	2.47	2.87	2.6	2.5	1.84	1.28
9	Fixed assets / Capital	33	24.5	17.3	14.3	14.2	11.3	7.67
10	Bank size= Log of Asset portfolio	3.33	3.33	3.32	3.29	3.35	3.36	3.4
11	AVERAGE ROA = 1.35							
12	BANK SIZE= 3.34							

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