

**A CRITICAL ANALYSIS OF THE NEED FOR A STRONGER
LEGAL FRAMEWORK TO REGULATE BANK INTEREST
RATES IN KENYA**

**BY
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APPROVAL

A CRITICAL ANALYSIS OF THE NEED FOR A STRONGER LEGAL FRAMEWORK TO REGULATE BANK INTEREST RATES IN KENYA

In accordance with The University of Nairobi policies, this thesis is accepted in
partial fulfilment of the requirements for award of LL.M

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Supervisor

.....
Date

DECLARATION

I declare that this thesis is my original work and has not been presented to any other college or university for academic credit

.....

Signed: CATHERINE KINYA

.....

Date

DEDICATION

To the millions of long-suffering Kenyans who bear the burden of arbitrary bank interest rates; the fight for accountability and respect for the Rule of Law will soon pay off and you will be the victors.

ACKNOWLEDGEMENT

First, glory be to the Almighty God for giving me the strength I so needed during this period, for granting me the resilience and above all for watching over me till completion of my LL.M program.

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Mohamed Gulamhussein Farzal Karmali & Another v C.F.C Bank Ltd & Garam Investments,
HCCC No. 3 of 2006.

National Bank Limited v Cadon Investment & Another, HCCC No. 2015 of 2006.

Ramji Haribhai Devani Ltd v Kenya Commercial Bank [2005] HCCC No. 482.

LIST OF ABBREVIATIONS

APR	Annual Percentage Rate
AYP	Annual Percentage Yield
CBK	Central Bank of Kenya
CBR	Central Bank Rate
DPF	Deposit Protection Fund
EU	European Union
IMF	International Monetary Fund
IRAC	Interest Rates Advisory Center
KBA	Kenya Bankers' Association
MFI	Micro-Finance Institution
MPC	Monetary Policy Committee
NBFI	Non-Bank Financial Institution
NBP	National Bank of Poland
NGO	Non-Governmental Organisation
TVM	Time Value of Money
UK	United Kingdom

ABSTRACT

This research paper sought to examine the regulatory framework in place to check interest rates charged by financial institutions on their borrowers. The paper looked into the laws in place to ensure regulation and the effectiveness or lack thereof of these laws. Also looked at is the reason for the shortcomings in the regulatory framework provided by the Banking Act, Chapter 488 of the Laws of Kenya and The Central Bank of Kenya Act, Chapter 486 of the Laws of Kenya, and the possible solutions to these shortcomings. This research found that regulation is a necessary measure if consumers are to be protected from arbitrary variation of interest rates. The study also found that there exist laws and regulations, albeit weak ones, in Kenya to ensure regulation; the problem, however, is that these laws and regulations are either too lax to keep banks in check or are ignored altogether.

CHAPTER ONE: INTRODUCTION

1.0 INTRODUCTION

Interest rates, generally quoted as Annual Percentage Yield (APY)¹ are of great importance not only because they are an income earner for financial institutions, but they also determine the extent of business investments and innovation, affect inflation,² influence the decision of foreign investors to invest in a country and generally have an effect on the economic standing of a country. The importance of interest rates in an economy cannot be underestimated and it is for this very reason that this study aims at demonstrating that there is an urgent need to have a clear legal and regulatory framework for regulation of interest rates. This is not to say that currently, there exist no such legislation, but as will be discussed later in this study, it will be shown that the legislation in existence is not sufficient to govern interest rates for reasons to be discussed later in this paper.

The Central Bank of Kenya (CBK), in our case, to a large extent regulates the percentage of interest rates that banks are supposed to levy on the amount of money lent out to borrowers. This is in line with its mandate to foster a stable market-based financial system. However, the governor of CBK once noted that banks have at times failed to respond accordingly to measures prescribed by the CBK to curb high interest rates.³ This further demonstrates a need for stiffer

¹ A. Barajas, R. Steiner and N. Salazar, 'Interest Spread in Banking: Costs, Financial Taxation, Market Power and Loan Quality in the Colombian case, 1974–1988' (1996) IMF Working Paper No. 110. Washington, D.C. 8.

² Research has shown that inflation rises or falls in response to interest rates rise or fall. During inflation, banks raise their interest rates while during deflation, interest rates are lower. *See* Olga Voznyuk, 'Relation Between Interest Rates and Inflation' available at <http://www.er.ethz.ch/publications/MAS_Thesis_VoznyukOlga_final_Feb10.pdf>(accessed 21 June 2012).

³ N. Ndung'u, 'Bank Regulation Reforms in Africa: Enhancing Bank Competition and Intermediation Efficiency' (12th African Economic Research Consortium Seminar, Mombasa, 22 March 2010).

law to regulate interest rates to avoid such instances where banks blatantly fail to adhere to directives by the CBK to keep interest rates reasonable since high interest rates are likely to curb business investments and innovation, increase loan defaults in the banking system and bank vulnerability and also drive the cost-push inflation due to medium term increase in prices associated with higher costs of business financing.

1.1 BACKGROUND TO THE STUDY

In 2011, Kenyans were faced with high interest rates on loans from banks, a phenomenon most Kenyans considered unreasonable since they could not understand the justifications given by the banks for charging such high interest rates. A contrast between the high interest rates experienced in the year 2011 and previous cases of high interest rates levied by banks between 1992-1995 shows that back then, high rates were associated with macroeconomic mismanagement and fraud which led to bank failures⁴ and not formal monetary policy operations that were seen last year. The Monetary Policy Committee of the Central Bank increased the Central Bank Rate to 11% in October 2011 and a month later on November 1st to a high of 16.5%.⁵ Increasing the CBR, effective from December 15th 2011 proved a harmful move as it had a direct upward effect on the percentage of interest rate levied and this, in turn, had an adverse effect on the economy.

Build-up in inflationary pressures early in the year led to exchange rate depreciation around April 2011, and finally the rise in interest rates. Inflation eats into the value of savings and banks' capital, and in an attempt to mitigate this loss; banks often raise their interest rates on

⁴ F. Dafe, 'The Politics Of Central Banking and Implications for Regulatory Reform in Sub-Saharan Africa: The Cases of Kenya, Nigeria and Uganda' (2012) German Development Institute Research Paper 1/2012, 18.

⁵ Monetary Policy Committee Press Release, 'Monetary Policy Tightening To Protect Growth and Macroeconomic Stability' (1 November 2011).

loans. Noteworthy is that inflation rose from 4.51% in January 2011 to 19.7% by November 2011. Kenya's shilling depreciated against the US dollar from Kenya Shillings 81 to Kenya Shillings 101 to one US dollar in October of 2011.⁶ To address these problems, the CBK increased the CBR to 11% in October 2011 and again to 16.5% on November 1, 2011 leading banks to increase their lending rate to between 20% and 25%. On December 1, 2011 the CBK further increased the CBR to 18 percent in an attempt to ease up the persistent inflation; the first time that the CBR was being used to actively address inflationary pressures.

This caused fear of further increase of interest rates by banks. While the primary goal of these measures was to address inflationary pressures and the weakening of the Kenya shilling, the results were mixed and uncertain because although the exchange rate appreciated, inflation still rose to 19.7% in November of 2011.⁷ This study will show that an alternative to increasing CBR to curb inflation is having in place a law to regulate interest rates levied by banks on loans. This is for the simple reason that an adequate regulatory framework would ensure stability of the financial system. The principal role of the Central Bank of Kenya⁸ is formulating and implementing monetary policy directed towards achieving and maintaining stability in general market prices.⁹

⁶Parliamentary Service Commission, Parliamentary Budget Office, "High Interest Rates and the Risks to Economic Growth"(Dec. 2011) available at< http://www.InterestRatesDiscussionPaper-Dec_9_2011.pdf> accessed 27 August 2012.

⁷ I. Karambu, 'Kenya's Inflation Hits 19.7%' *Daily Nation* (Kenya, 29 November 2011) available at <<http://www.nation.co.ke/business/news/Kenyas+inflation+rate+hits+197+pc/-/1006/1281586/-/t49v7k/-/index.html>> (accessed 10 November 2012).

⁸ Established by the Central Bank of Kenya Act, Cap 486 Laws of Kenya, section 3.

⁹ Cap 486, s.4(1); *See also* N. Gichuki, *Law of Financial Institutions in Kenya* (2nd edn, LawAfrica Pub., Nairobi 2013) pg 3.

The current economic conditions, particularly unpredictable monetary policies, uncertainties in the economy, high cost of production, and other risks in the country which currently include uncertainties associated with elections and war could work to curtail stable investment flows.¹⁰

1.2 STATEMENT OF THE PROBLEM

High interest rates lead to fall in business profits, fall in investment which inevitably leads to lower economic growth, worsening the unemployment situation, and leading to an increase in poverty. Movements in interest rates, inflation and exchange rates in 2011 presented real dangers to economic stability in Kenya due to the fact that the economy endured steep inflationary pressures and exchange depreciation for about nine months in that year and in early 2012. With a high rate of inflation, prices of commodities shot up due to increased production costs hence putting more strain on the pockets of the average Kenyan. Banks blatantly disregarded the requirement¹¹ to seek approval from the Minister of Finance before increasing their interest rate charges and arbitrarily varied their rates. The failure by the Central Bank to exercise its supervisory role over banks enabled the banks to arbitrarily increase their rates without alarm being raised.

The Central Bank of Kenya as the regulatory authority of commercial banks, Non-Banking Financial Institutions (NBFIs), Deposit Taking Micro-Finance Institutions and Forex Bureaus has not sufficiently and effectively, in the recent years, managed to regulate interest rates due to laxity and inefficiency of the Monetary Policy Committee.¹² Similarly, the provisions¹³ of the

¹⁰ The 2013 General Elections and Kenya's war against Somali Al-Shaabab terrorists re the risks contemplated here.

¹¹ Banking Act, s.44.

¹² Report of The Parliamentary Select Committee on the Decline of the Kenya Shilling Against Foreign Currencies, February, 2012; Kenneth Mwine, 'Room for Improvement in the Banking Industry' *Daily Nation* (Kenya, 27 August 2002).

¹³ More specifically sections 44 and 44A.

Banking Act have also failed in regulating interest rates as banks have in the past failed to comply with these provisions on the question of interest rates due to the weak sanction implementation mechanisms. Regulation and control of interest rates in Kenya can only be achieved through enactment of a strong and unambiguous legal framework. There is need for a comprehensive legal framework for recourse to consumers of financial services across the whole financial sector

1.3 LITERATURE REVIEW AND THEORETICAL FRAMEWORK

1.3.1 LITERATURE REVIEW

Developing countries financial sectors are said to be characterized by unsound financial institutions with the absence of prudent regulations and supervision; uncompetitive financial markets with a few commercial banks dominating the sector; the existence of informal financing; and segmented financial institutions in terms of activities and economic sectors, sources of funding for institutions and types of assets to hold. Other characteristics are statutory interest rate ceilings, where interest rate levels are set administratively; accommodation of government borrowing; weak monetary controls;¹⁴ and excessive reliance on donor funding to run key financial sectors.

In these systems, the Central Bank typically has limited control on the sector, serving to finance government deficits, conduct foreign exchange transactions for the government and ensure that institutions do not enter into liquidity problems.¹⁵ Ikiara argues that overreliance on donor funding, for example, leads to a situation where borrowers cannot get low-interest credit when

¹⁴ D.K Asli and H. Huizinga, 'Determinants of Commercial Bank Interest Margins and Profitability: Some International Evidence' (1997) World Bank Policy Research Working Paper No. 1900. Washington, D.C, 30.

¹⁵ R. Ngugi and J. Kabubo, 'Financial Reform and Interest Rate Liberalization: The Kenya Experience' (1998) African Economic Research Consortium, Research Paper No.72, 7.

donors withdraw as was the case in Kenya in the early 1990s.¹⁶ Due to these factors, then, developing countries' financial systems are said to be financially repressed.

Gonzalez-Vega ¹⁷argues that any limitation on the interest rate level usually has counter-productive effects. Low interest rates or usury laws make institutions concentrate their portfolio on fewer, most profitable and powerful clients.

In religious, Marxist, and Keynesian understanding, high interest rates are looked upon as either intrinsically unjust or potentially harmful. Going by this and in regard to the literature review of this paper, the following discussion will be geared towards a review of what a number of authors have put forth in view of the sub- topics listed below:

1.3.1.1 Regulation of interest rates

Muganga in his work argues that regulation of interest rates is intended to guard against exorbitant interest rates and pricing of Micro Finance Institution services (MFIs) that would exploit the poor. He contends that when faced with an interest rate ceiling, companies and NGOs providing financial services to consumers of financial and credit services will often retreat from the market, grow more slowly and reduce their work in rural areas, or other, more costly market segments because they cannot cover their operating costs.¹⁸ So in effect, his argument is that the current regulatory framework on interest rates has been ineffective since banks seldom comply with it.

¹⁶ G. Ikiara, 'The Kenyan Economy at Crossroads' (April-June 2005) 28 IFRA 12.

¹⁷ C. Gonzalez-Vega, 'Interest Rate Restrictions and Income Distribution' (1997) American Journal of Agricultural Economics 5/59, 973-976.

¹⁸ D. Muganga, 'The Role of Regulation and Supervision of Microfinance Institutions: Evidence From South Africa and its Implications For The Development of Non-Deposit Taking Microfinance Regulation In Kenya' (Masters thesis, State University of Bergamo Italy 2010) 23.

Reifner argues that it is a fact that the effectiveness of interest rates regulation depends largely on the existing national culture of law enforcement and the degree of bank regulation which leaves more or less space to high-priced credit. In general small loans, revolving credit and variable interest rates are seen as a problem. The choices for effectiveness lie between stricter supervision and private law approaches. It also makes clear that the mere existence of interest rates regulation rules cannot be related to the questions of access to credit without taking into account their effectiveness.¹⁹

According to Goodwin-Groen²⁰ the interest rate ceilings discourage commercial banks from expanding into higher-cost rural or microcredit markets. For example, evidence of market contraction was seen in Nicaragua after the national Parliament introduced an interest rate ceiling for specific types of lenders, including NGO-MFIs, in 2001. Annual portfolio growth of these MFIs fell from 30% to less than 2%. The imposition of interest rate ceilings also caused several microfinance institutions to leave rural areas, where risks and operational costs are higher.

According to Gonzalez-Vega²¹ recent research in Bolivia asserts that interest rate ceilings have retarded the development of commercial microfinance in that country, primarily by discouraging microfinance NGOs from transforming into licensed financial intermediaries.

Porteous²² on his part argues that it is difficult to substantiate arguments about what specific markets might have looked like without interest rate ceilings. However, a comparison of market

¹⁹ U. Reifner, S. Clerc-Renaud, M. Knobloch, 'Study on Interest Rate Restrictions in the EU: Final Report for the EU Commission DG Internal Market and Services' Project No. ETD/2009/IM/H3/87, Brussels/Hamburg/Mannheim, iff/ZEW (2010).

²⁰ R. Goodwin-Groen, 'The National Credit Act and its Regulations in the Context of Access to Finance in South Africa' (2006) South Africa: FinMark Trust, 117.

²¹ C. Gonzalez-Vega, 'Interest Rate Restrictions and Income Distribution' (1977) American Journal of Agricultural Economics 5/59, 973-6.

penetration rates between twenty three countries with interest rate ceilings and seven countries without ceilings suggests higher penetration rates in those without interest rate ceilings. From the above discussion therefore; it is clear that interest rates regulation has not been as effective, and not only in Kenya but also in other countries around the world.

Csongor and Curtis²³ in their joint master's and bachelor's thesis put up a strong argument against regulation of interest rates. They argue that considerable or high government regulation results in low interest rates and high inflation rates which results in unfair distribution of capital. With commercial banks' ability of to grant credit regulated by the government, big firms are in a position to finance their expansions while smaller firms find it harder. This results in an unbalanced playing field for companies leading to unfair competition. This is likely to retard the growth of small and medium enterprises while at the same time promoting monopoly or near-monopoly by large firms, a situation that is not desirable for emerging economies.

1.3.1.2 Rationale for Regulation of Interest Rates

The rationale for regulating interest rates has been recognised as a sovereign duty and right of any government, even by banking systems very critical of the interest rates regime such as Islamic banking systems. Nasim²⁴ appreciates that every government has a sovereign right to regulate all economic activity within its control, including banking activities, for the greater benefit of the community. This includes the protection of the depositors and shareholders especially when the rules of a banking entity are not in conformity with the existing regulatory

²² D. Porteous, 'Is Cinderella Finally Coming To The Ball? South African Microfinance in Broad Perspective' (2003) South Africa: FinMark Trust.

²³ D. Csongor and D. Curtis, 'Banks' Loan Portfolio Diversification', (Master's and Bachelor's Thesis, University of Gothenburg 2005) 5.

²⁴ F. Nasim, 'Prospects of Islamic Banking: Legal and Other Challenges and Issues', (LL.M Thesis, Cardiff Law School, 2003-2004) 47.

system. The rationale for interest rates regulation is based on a number of factors which as, Reifner puts it, may be reduced to five legal notions which roughly correspond to three distinct goals. These goals include the ethical and religious concept aimed at preventing the exploitation of need and weakness: the market concept, aimed at regulating prices where competition either does not suffice or where it produces unwanted impacts on more vulnerable parts of society and thirdly, the unwanted credit products seen as detrimental for the national economy.²⁵

Amha Wolday contends that regulation has helped to create an enabling environment for establishment of specialized formal financial institutions that provide financial services to the unbanked.²⁶ David Llewellyn on his part argues that regulation helps to ensure solvency, safety and soundness of financial institutions.²⁷ Governments have learnt from past experiences where banks have collapsed and have, as a result, prioritized policies to ensure soundness of banks and other financial institutions; these policies include regulation.

The basis for regulation of interest rates can, therefore, be said to mainly be the protection of consumers of financial and credit services from exploitation and protect them from the risk of over-indebtedness as well as provide an opportunity for access to credit facilities by a larger number of individuals in society, across the board.

1.3.1.3 Effect of regulation of interest rates on inflation

...there is a common confusion regarding the correct definition of inflation. Inflation is not “an overall rise in prices.” That is eventually a result of inflation. Incorrectly defining

²⁵C. Gonzalez-Vega (n 20) 20.

²⁶ A. Wolday, 'Revisiting the Regulatory and Supervision Framework of the Microfinance Industry in Ethiopia' (Relief Society of Tigray (REST) Seminar on behalf of the Drylands Coordination Group in Ethiopia and Sudan, Mekelle, 25 August 2001).

²⁷ D. Llewellyn, 'The Economic Rationale for Financial Regulation' (1999) Occasional Paper 1FSA, 10.

it as such is convenient for politicians because it deflects their role in initiating inflation.²⁸

Ramogi defines inflation as a situation in which too much money is chasing very few goods.²⁹ The most appropriate definition of inflation is that it is a sustained increase in the general level of prices for goods and services.³⁰ During inflation, the unit of currency (in our case the Kenya Shilling) loses its purchasing power with time. The effect of this is that consumers will therefore need more money to purchase something over and above the amount they would have used to purchase the same thing, if there was no inflation.

The volume of money in circulation influences the levels of interest rates, and thus the relative value of the local currency against other currencies. Research has shown that price inflation greatly affects time value of money (TVM).³¹ It is a major component of interest rates which are at the heart of all TVM calculations. Actual or anticipated changes in the inflation rate cause corresponding changes in interest rates. Lenders know that inflation will erode the value of their money over the term of the loan so they increase the interest rate to compensate for that loss.

This is due to the fact that long-term loans made at the real rate of interest without an inflation premium would in the long run produce negative returns due to the declining purchasing power of the Shilling. An estimate of the inflation premium contained in interest rates can be seen by comparing two risk-free securities with the same maturity date, one with a fixed rate and the other with a rate indexed for inflation.

²⁸ M. Pento and D. Luskin debate, 5th February 2011, CNBC available at cnbc.com. (accessed on 20th February 2012).

²⁹ O. Ramogi, 'Inflation the Real Cause of Your Empty Plate' *Daily Nation* (Kenya, 12 January 2012) 13.

³⁰ O. Voznyuk, 'Relation Between Interest Rates and Inflation' available at <http://www.er.ethz.ch/publications/MAS_Thesis_VoznyukOlga_final_Feb10.pdf> (accessed 21 June 2012).

³¹ Available at <<http://www.getobjects.com/Components/Finance/TVM/concepts.html>> (accessed 22 June 2012).

During inflation, banks raise their interest rates and such a rise in interest rates directly affects the credit market (loans) because higher interest rates make borrowing more costly. Consumer spending decreases and this in turn retards economic growth.

Maintaining price stability is crucial for the proper functioning of a market-based economy. It encourages long-term investments and stability in the economy. As discussed in the background to the study, it is clear that interest rates can be and are in fact used as a tool for curbing inflation.³² Therefore, regulation of interest rates will have a direct effect on inflation in an economy. Inflation being a burning issue in most world economies as a matter of concern has devastating impacts upon individuals and society as a whole. These impacts are multi-dimensional in nature, that is social, economic and psychological. Rapid increase in the prices of daily commodities affects the general population adversely where the low income households are obnoxiously influenced. The challenges experienced with unanticipated inflation include creditors, in this case banks and other financial institutions, losing and debtors gaining if the lender does not anticipate inflation correctly. People living off a fixed-income, such as retirees, see a decline in their purchasing power and, consequently, their standard of living. The entire economy must absorb repricing costs as price lists, labels, menus and more have to be updated. If the inflation rate is greater than that of other countries, domestic products become less competitive. The economy is therefore adversely affected.

This study holds that the severity of the effects of inflation especially on the ordinary Kenyan surviving on less than a Dollar a day breeds the need for regulation of inflation which as mentioned earlier in this study, can be done through having a law in place to regulate interest

³² K.P Wong, 'On the Determinants of Bank Interest Margins Under Credit and Interest Rate Risks' (1997) *Journal of Banking and Finance*, 251– 71.

rates. This is because during inflation, the cost of living rises as the cost of most products including foodstuffs soar. The largest and most critically affected groups are the pensioners, whose pension is fixed for the remainder of their lives. Distortion of property prices is possibly one of the most adverse effects of inflation. In addition, inflation inflicts suffering on the economically frail. The people most strictly affected by inflation are individuals on fixed income.

Don Paarlberg describes inflation and its effect in the following terms;

A covert thief, inflation steals from, widows, orphans, bondholders, retirees, annuitants, beneficiaries of life insurance and those on fixed salaries, decreasing the value of their incomes. Inflation extorts more wealth from the public than do all other thieves, looters, embezzlers and plunderers combined.³³

The insurance industry of a country also suffers in times where inflation is on the rise. This is because interest rates and inflation are very important risk factors for the insurance industry due to the fact that insurance is a long-term business where premiums are collected today and claims are paid out in the future. High and unpredicted inflation is capable of seriously distorting the ability of insurance companies to cover the insured's losses. This is due to the fact that interest rates influence the ability of insurance companies to generate positive returns on the money invested. In the long run, this could lead to insolvency of insurance companies.³⁴ Inflation also influences investment and a case on point is investment in bonds. Inflation is a bond's worst enemy as it erodes the purchasing power of a bond's future cash flows. In effect, therefore, the

³³ D. Paarlberg, *An Analysis and History of Inflation* (Praeger 1993), 11.

³⁴ O. Voznyuk, 'Relation between Interest Rates and Inflation' available at <http://www.er.ethz.ch/publications/MAS_Thesis_VoznyukOlga_final_Feb10.pdf> (accessed on 21 June 2012).

higher the current rate of inflation and the higher the expected future rates of inflation, the higher the yields will rise across the yield curve, as investors will demand this higher yield to compensate for inflation risk. In addition to its effect on incomes, inflation transfers real purchasing power from creditors to debtors unless the inflation is anticipated and taken into account in setting the terms of loans.³⁵ However, while modest and mild inflation is well thought-out as an indicator of a healthy economy, inflation above these mild levels is considered to have a harmful impact on an economy.

The literature review has focussed on the impact of regulation on banking, as well as the need for or undesirability of such regulation. This study seeks to examine the already-existing regulatory framework in Kenya and to point out its inadequacies. It emphasises the need for review of the existing legal and regulatory framework to make it more effective in regulating interest rates in the country and by extension regulating inflation. This is owing to the fact that high interest rates may also lead to higher market prices associated with cost-push inflation. As such, a well thought out legal framework on regulation of interest rates would have the effect of controlling the negative effects of inflation as well as those hardships that arise as a result of rise in interest rates.

1.3.2 THEORETICAL FRAMEWORK

This study will discuss the free will theory, capitalist theory and public interest theory.

1.3.2.1 Public Interest Theory

Ideally, the main principle that should guide banks in setting interest rates especially on loans should be avoidance of over-indebtedness and transparency in setting the rates. This is because

³⁵ G.L Bach, 'The Economic Effects of Inflation' 20-33 available at <http://www.jstor.org/stable/1173632> (accessed on 2 April 2012).

banks also owe a duty to low income earners of providing them with affordable credit facilities so as to enable them transform their lives.³⁶ By this theory then banks should strive to promote and support the development of a fair, transparent, competitive, sustainable, responsible, efficient, effective and accessible credit market and industry to serve needs of the historically disadvantaged and low income persons and communities through having in place a well laid out regulatory framework for the control of interest rates.

As observed over the years, however, banks do go rogue when given the leeway to determine the maximum interest rate at which they will give loans resulting in a situation where the borrowers are at the mercy of banks. This necessitates the government to step in so as to protect the public from these unscrupulous banks. Public interest theory of regulation argues that the public needs protection from abusive practices of businesses or other market failures. Assumption is made that the economic markets are usually very fragile and bound to operate very inequitably if left to their own whims³⁷ and therefore regulation, which costs the government virtually nothing, serves the public's interest by restricting harmful business activities.

Regulation is defined by Mitnick³⁸ as the public administrative policing of a private activity with respect to a rule prescribed in the public interest, serves as its main purpose to protect the vulnerable borrowers whose bargaining power is obviously insignificant compared to the lenders. Borrowers are usually not in a position to have complete access to the information necessary to enable them make sound and informed economic decisions such as borrowing and

³⁶ M. Hudon, 'Fair Interest Rates When Lending to the Poor: Ethics and Economics' (2007) 5 Solvay Business School, Université Libre de Bruxelles, 2.

³⁷ R. Posner, 'Theories of Economic Regulation,' (May 1974) Nber Working Paper Series Working Paper No.41, 2.

³⁸ B. Mitnick, *The Political Economy of Regulation: Creating, Designing, and Removing Regulatory Forms* (Columbia University Press, New York 1980) 7.

terms thereof. This information is a preserve of the lenders who of course have the advantage of having drafted the information, and therefore the monopoly of full understanding. Regulation therefore seeks to provide information to interested parties who may not have access to complete and necessary information to make economic decisions.³⁹ Without regulation, this information disadvantage leads to information asymmetry. The only institution that can still be expected to have the power to, and be reasonably expected to efficiently protect the interests of borrowers in this situation is the government.

As Posner⁴⁰ notes however, regulatory agencies such as the Central Bank of Kenya are created for legitimate public purposes like protecting the public from exploitation but are then either mismanaged or become complacent resulting in failure to achieve these purposes. In stressing the importance of the need for stiffer law to control the levying of rates by banks, the public interest theory is therefore emphasized as a means of remedying the above failure by the existing laws and the Central Bank of Kenya.

This research study seeks to rely on this theory to justify its assertion that a more stringent law is needed to regulate interest rates in Kenya. This is because the theory provides for the interests of the public while at the same time recognizing the right to free will and appreciating the market forces of demand and supply.

³⁹ M. Gaffikin, 'Regulation as Accounting Theory' (2005) University of Wollongong School of Accounting and Finance, Accounting and Finance Working Paper 05/09, 1.

⁴⁰ R. Posner, 'Theories of Economic Regulation,' (May 1974) Nber Working Paper Series Working Paper No.41, 4.

1.3.2.2 Free Will Theory

Ideally, all persons are entitled to freedom of contract; the parties are free to enter into contracts and to set the terms and conditions of such contract. Arguably therefore persons seeking loans from banks and the banks are free to determine the terms of the loan agreement in whichever way they so agree, meaning the banks have the freedom to set interest rates and the borrowers have the freedom to choose to either accept the rates and enter into the loan contract or to reject the rates and not take the loan. The reality though is that in the case of consumers of financial and credit services, the banks and other lending financial institutions always have a higher bargaining power and in most cases, these consumers have to do with standard contracts drawn by banks hence there is no balance of bargaining power. It is for this particular reason, therefore, that this study argues that there is need for the state to intervene in certain circumstances by way of stiffer legislation designed to protect its subjects from the harsh effects of some commercial transactions induced to benefit the commercial people, in our case, the freedom of banks to control the amount of interest rates they can levy on loans.

1.3.2.3 Capitalist Theory

Economic principles in capitalist theory demand that demand, supply and prices be determined by market forces rather than by the whims of players in the market; the position being, therefore, that free market forces should determine interest rates⁴¹ as opposed to banks or the Central Bank. Healthy competition among banks in a free Kenyan economy should be able to reasonably determine the demand for loans, the repay rate and hence the interest rate charged. Reasonably therefore, one would anticipate that the amount of interest rates levied by such banks on loans

⁴¹ From the definition of capitalism by the Merrium Webster dictionary.

would be very fair in an effort to gain as many consumers of credit services as possible. However, as heavily criticized by Friedrich Engels⁴² for the amount of power and influence corporations and large business interest groups have over government policy, including the policies of regulatory agencies, capitalism has encouraged banks to use their huge influence to blatantly ignore the provisions of the Banking Act with regard to levying of interest rates. This has been abated by the ineffectiveness of the CBK in controlling the levying of interest rates on loans by the banks as was experienced in the recent past. This study therefore holds that the capitalist theory is not the best suited in the banking sector.

1.4 SPECIFIC RESEARCH OBJECTIVES

- i. To identify the extent to which the Banking Act⁴³ and Central Bank of Kenya Act⁴⁴ are adequate in regulating interest rates in Kenya.
- ii. To establish whether it is possible to justify the regulation of interest rates.
- iii. To establish whether the regulation and control of interest rates is consistent with the economic rights and consumer protection tenets under the Constitution.

1.5 SIGNIFICANCE OF THE STUDY

This study will be of great assistance to the Central Bank of Kenya in that it will reveal the gaps in the current legal framework in as far as interest rates regulation is concerned and the recommendations suggested by the study will, if implemented, go a long way in bringing reforms to the banking industry in Kenya and enhance protection accorded by law to consumers of

⁴² F. Engels 'Socialism: Utopian and Scientific' available at <<http://www.marxists.org/archive/marx/works/1880/soc-utop/ch03.htm>> (accessed 30 April 2012).

⁴³ Chapter 488 Laws of Kenya.

⁴⁴ Chapter 491 Laws of Kenya.

financial services offered by banks. The findings and recommendations of this study will seek to enlighten the government, banking industry players and consumers of banking services of the significance and need of regulation of interest rates. The government will be able to appreciate its responsibility of regulation, and the failure of the mechanisms currently in place including measures for more effective regulation. Hopefully, banks will ditch their hostile attitude towards regulatory measures and embrace the practice as a means of protecting their clients and creating uniformity and stability in the market. Consumers on the other hand will be more enlightened to their rights as consumers of financial services, including responsibilities and ways of seeking redress.

1.6 RESEARCH HYPOTHESES

- i. The current Banking Act and Central Bank of Kenya Act are not effective in regulating interest rates because of insufficient sanctions and weak institutional framework.
- ii. The regulation of interest rates is justifiable because consumers have a right to be protected against exploitation.
- iii. The regulation of interest rates is compatible with the economic and consumer protection tenets anchored in the Constitution.

1.7 RESEARCH QUESTIONS

The following will form the research questions to be answered by the study:

- i. To what extent are the Banking Act and Central Bank of Kenya Act adequate in regulating interest rates in Kenya?

- ii. To what extent can regulation of interest rates be justified in Kenya?
- iii. To what extent is the regulation and control of interest rates consistent with the economic rights and consumer protection tenets guaranteed by the Constitution?

1.8 RESEARCH METHODOLOGY

This study will rely on secondary data, that is, data that has already been collected by someone else and available from secondary sources such as books, articles, unpublished reports, journals, official letters and files.⁴⁵ The study will also rely on analysis of the relevant provisions of the Constitution of Kenya (2010) and various laws currently in place on the banking industry in Kenya. Further, the study will rely on internet sources and also judicial decisions relevant to the research topic. The researcher has ruled out the use of interviews because of biased opinion or prejudice on the part of the likely respondents which will definitely affect the outcome of the interview. Respondents in the banking industry will definitely want to be defensive about their exploitative practices and would therefore be unresponsive. Besides, they will obviously advocate for a *laissez-faire* system where they are at liberty to dictate the interest rates they charge because this has a direct bearing on their profit margins.

The regulator, Central Bank of Kenya, in as much as it might advocate for a stiffer law, is most likely to be biased in its response in an attempt to defend its dismal record in exploiting the existing law to keep banks in check the best way possible. Consumers on the other hand are most likely to advocate for very stiff laws to put caps on interest rates chargeable since they would obviously want to borrow at lower rates. Interviewing these respondents will lead to a stalemate

⁴⁵ S. Nyandemo, *Research Methodology: Methods and Approaches* (Nairobi: Richmond Designer, 2007) 85.

where either respondents are defensive and unresponsive, or their responses are emotionally motivated. This leads to data that does not reflect the desirable situation in a modern economy.

1.9 SCOPE OF THE STUDY

The research shall be looking at the need and significance of a legal and regulatory framework governing interest rates in Kenya. In this regard, this study will propose appropriate strategies in terms of laws which the banking industry and other financial institutions may adopt to enable them regulate interest rates. The study will also propose reforms to the current legal and regulatory framework to boost their ability to control interest rates.

1.10 CHAPTER BREAKDOWN

Chapter One: Introduction

This chapter will be an introduction of the research topic, statement of the research problem within which the research will be carried out, research objectives, research questions, hypothesis, significance of the study, literature review, theoretical framework, research methodology to be used, scope of the study and chapter summary.

Chapter Two: Public interest theory and its application to interest rate regulation in Kenya

Chapter two will analyse the public interest theory of regulation and examine the application to the theory in justifying regulation of interest rates and the applicability of the theory to regulation of interest rates in Kenya. The Chapter will also examine the role of government in regulation and delve into some of the criticism of the public interest theory.

Chapter Three: Regulation of Interest Rates in Kenya

This chapter will give the historical background on the regulation of interest rates in Kenya, current laws and regulations governing levying of interest rates by banks in Kenya. The Chapter will look into some of the challenges, legal and otherwise, that the government and consumers have faced in seeking to protect consumers from exorbitant interest rates charged by banks.

Chapter Four: Best Practices in Other Jurisdictions and Lessons for Kenya

This chapter will lay a comparative analysis of best practices on regulation of interest rates between Kenya other jurisdictions, France and Poland, as a way of curbing inflation. The chapter will also delve into laws in place in these jurisdictions on interest rate and will also seek to integrate some of the best ways into the Kenyan practice. The chapter will also examine lessons that the Kenyan legal framework can learn from these jurisdictions.

Chapter Five: Conclusion and Recommendations

Chapter five will make a conclusion by way of summary and set out possible recommendations on legislative framework that may help in solving or mitigating the problems encountered as a result of inflation.

CHAPTER TWO: PUBLIC INTEREST THEORY AND ITS APPLICATION TO INTEREST RATES REGULATION IN KENYA

2.0 INTRODUCTION

Public interest theory is one of the theories of economic regulation that has been advanced by scholars and economists in support of government regulation.⁴⁶ This study adopts this theory to argue its case for stricter regulation of the banking sector particularly in the setting of caps on the interest on loans advanced by banks. Public interest theory presupposes that a market characterised by imperfect information greatly affects the ability of stakeholders to bargain on an equal footing especially since markets are fragile and often operate inefficiently to the detriment of the public.⁴⁷ The assumption is that the economic markets are usually very fragile and bound to operate very inequitably if left to their own whims⁴⁸ and therefore regulation, which does not cost the government much, serves the public's interest by restricting harmful business activities.⁴⁹ Regulation of interest rates is therefore seen as being consistent with constitutional guarantees of economic and social rights⁵⁰ and consumer rights.⁵¹

2.1 ROLE OF GOVERNMENT IN REGULATION

The theory argues therefore that there is need for laws that regulate the market, labour policies and protects consumers. The focus here is to avoid market failures resulting from the adverse

⁴⁶ R. Posner, 'Theories of Economic Regulation,' (May 1974) Nber Working Paper Series Working Paper No.41, 1.

⁴⁷ Available at <http://www.unc.edu/depts/econ/byrns_web/Economicae/publicinteresttheoryofbusireg.html> (accessed 10 July 2013).

⁴⁸ R. Posner (n 42) 2.

⁴⁹ J. den Hertog, 'Review of Economic Theories of Regulation' (December 2010) Utrecht University School of Economics, Tjalling C. Koopmans Research Institute, Discussion Paper Series nr:10-18, 5, available at <<http://www.uu.nl/rebo/economie/discussionpapers>> (accessed 10 July 2013).

⁵⁰ Constitution of Kenya 2010, art.43

⁵¹ *ibid* art. 46

effects of situations such as excessive monopolies and asymmetric information.⁵² Market failure is a situation where scarce resources are not put to their highest valued uses thereby leading to a discrepancy between the price or value of an additional unit of a particular good or service and its marginal or resource cost.⁵³ Public interest theory calls for direct government intervention in monitoring the markets. This is because the government is specifically mandated to act on behalf of the people⁵⁴ and is seen as a neutral arbiter. Public interest theory therefore seeks to interrogate the government's role in regulating the market labour policies and protect consumers. This study argues that the government has abrogated the role by having weak policies. This will be shown by an interrogation of the regulatory framework put in place specifically the Banking Act and the Central Bank of Kenya Act.

2.2 NATURE AND PURPOSE OF GOVERNMENT REGULATION FROM A PUBLIC INTEREST PERSPECTIVE

As defined by Mitnick, regulation is the public administrative policing of a private activity with respect to a rule prescribed in the public interest.⁵⁵ This definition provides three key ideas. First, regulation is restrictive and directed towards private activities. Regulation here targets on private players in the concerned industry. Second, regulation is done through administrative controls undertaken on the basis of general rules. Usually, a government agency will be charged with conducting and overseeing the regulation based on a legal and regulatory framework which the agency is responsible for issuing and reviewing. Lastly, regulation is conducive to the public

⁵² Available at <http://www.unc.edu/depts/econ/byrns_web/Economicae/publicinteresttheoryofbusireg.html> (accessed 10 July 2013).

⁵³ J. den Hertog, 'Review of Economic Theories of Regulation' (December 2010) Utrecht University School of Economics, Tjalling C. Koopmans Research Institute, Discussion Paper Series nr:10-18, 5, available at <<http://www.uu.nl/rebo/economie/discussionpapers>> (accessed 10 July 2013).

⁵⁴ Constitution of Kenya 2010, art. 1

⁵⁵ B. Mitnick, *The Political Economy of Regulation: Creating, Designing, and Removing Regulatory Forms* (Columbia University Press, New York 1980) 7.

interest. It is the assumption of the public interest theory that all regulation is carried out in the interest of the public, to level the playing field for both producers and consumers, and to avoid market failures created by inequities.

As Pigou, considered the father of the public interest theory of regulation, postulates, regulations stem from public demand to correct market inefficiencies.⁵⁶ Producers normally enjoy lopsided advantages over consumers, therefore regulators are meant to serve societal rather than individual interests. Regulation is however, not assumed to be perfect as an economic measure. Rather, the theory assumes three key issues: the presence of a market failure, regulation as comparatively the more efficient institution to remedy the failure, and that deregulation takes place when more efficient institutions develop to prevent the market inefficiencies by themselves.⁵⁷ Regulation targets both naturally competitive and naturally monopolistic industries alike because both have the potential of operating in a manner that is completely oblivious of the interests of their consumers.

2.3 CRITICISM OF PUBLIC INTEREST THEORY OF REGULATION

Public interest theory has had its share of criticism particularly on the role played by the regulators. Arguments have been advanced that regulators ironically often serve the interests of the industry they are supposed to be regulating instead of actually regulating the industries for the benefit of the consuming public. Ideally, persons who run these agencies should have deep, sound knowledge and expertise of the particular industry they intend to regulate. It so follows therefore that these persons are drawn from players within the industry either as former employees, prospective employees, or current employees on secondment to the regulator.

⁵⁶ Available at <<http://myassignmenthelp.info/assignments/public-interest-theory/>> (accessed 10 July 2013).

⁵⁷ J. denHertog, 'Review of Economic Theories of Regulation' (December 2010) Utrecht University School of Economics, Tjalling C. Koopmans Research Institute, Discussion Paper Series nr:10-18, 6, available at <<http://www.uu.nl/rebo/economie/discussionpapers>> (accessed 10 July 2013).

Undeniably therefore, a close relationship therefore exists between the regulators and the industries. It is argued that these persons eventually end up being gatekeepers for industry players thus making a mockery of regulation. In what Jordan called the ‘capture theory of regulation’, the argument is advanced that regulation does not necessarily balance market inequities, but rather serves the interest of producers by creating cartels or by failing to suppress monopoly.⁵⁸

Peltzman argues that politicians who legislate are humans and therefore susceptible to self-interest.⁵⁹ Interest groups can influence regulatory processes by providing financial support to politicians or regulators in exchange for desired regulatory outcomes. All these arguments might hold water were they not so pessimistic and lacking in faith. In support of the public interest theory, agency personnel would want to prove themselves to their employers rather than the industry players. It is the employer (the government) that holds the trump-card which is performance reviews, promotions, renewal of contracts, and pay increases. These are issues central to an employee and allegiance is therefore most likely to fall to the employer. Politicians too have a duty to their electorate more than they have to interest groups. True interest groups might be potential sources of campaign funding, but politicians know better than to fully discard the wishes of their electorate for the allure of campaign funding. They therefore often strike a balance which more often than not leaves the public more protected than producers when the legislations finally come to life.

⁵⁸W. Jordan, 'Producer Protection, Prior Market Structure and the Effects of Government Regulation' (April 1972) *Journal of Law and Economics*, vol. 15, 151-76.

⁵⁹ S. Peltzman, 'The Economic Theory of Regulation after a Decade of Deregulation' (1989) University of Chicago, *Brookings Papers: Microeconomics*, 1.

Unlike what critics of the public interest theory would want us to believe, the unexpectedly poor performance of regulation cannot be attributed to any perceived unsoundness of the aims of public interest regulation. Rather, these can be explained as the result of weaknesses in personnel and/or procedures that can be remedied by enhanced public administration which is more informed, aware and focussed on the discharge of its mandate. As Posner notes, regulatory agencies such as the Central Bank of Kenya are created for legitimate public purposes like protecting the public from exploitation but then fall by the wayside through either mismanagement or laxity and complacency resulting in failure to achieve these legitimate purposes.⁶⁰ In stressing the importance of the need for stiffer laws to control the levying of rates by banks, the public interest theory is therefore emphasized as a means of remedying the above failure by the existing laws and making the Central Bank of Kenya legally and practically capable of regulating bank interest rates.

2.4 JUSTIFICATION OF REGULATION IN KENYA AND THE REGULATORY PROCESS

This study seeks to justify the regulation of interest rates in Kenya as being appropriate for the market and the consuming public. To achieve this, reliance shall be placed upon the public interest theory. The Kenyan scenario presents a case where regulations regulating interest rates do exist. The question is however, the extent to which these regulations serve their intended purpose. The study argues that due to either complacency or the inherent weaknesses of these laws/regulations, their purpose has not been achieved. Public interest theory advocates for measures to gauge the likely success of regulations so as to avoid situations where regulations end up as lame-duck. In considering new regulations or strengthening of existing regulatory

⁶⁰R. Posner, 'Theories of Economic Regulation' (May 1974) Nber Working Paper Series Working Paper No.41, 4.

framework, a cost-benefit analysis has to be carried out in order to find out the net economic value of the new/revised regulation.⁶¹ The costs and benefits of the regulation are evaluated in monetary terms. Stakeholder engagement becomes very fundamental at this point. Drafters ought to seek input from all stakeholders in order to weed out possible irrelevancies, identify shortcomings in proposed regulations and include all relevant suggested provisions. In order to find the net benefits or costs, all constants in the economy are analysed. The costs and benefits are identified in monetary terms then the future value of costs and benefits is discounted to find the net benefits and costs. In this way, and owing to the objectivity of the cost-benefit analysis, it is possible to determine the desirability or otherwise of the proposed regulation before giving it the force of law.

Regulations that fail the cost-benefit analysis test are reviewed and subjected to the cost-benefit analysis test until the proposed regulation gets a positive cost-benefit analysis score even if it means repeating the process over and over. Further, debate at the legislative level serves to further test the cost-benefit of the proposed regulation. Further fine-tuning is also done at this stage during debate prior to adoption of the regulations. Having passed through these stages, the resultant regulations are often fine-tuned enough to remedy situations that they are so designed to remedy or prevent.

Public interest theory has society's welfare as its primary concern. Ideally therefore, banks should be guided by the principle of avoidance of over-indebtedness and transparency in setting interest rates especially on loans advanced to borrowers. This stems from the banks' duty to low income earners of providing them with affordable credit facilities so as to enable them transform

⁶¹R. Rowen, R. D'Arge and D. Brookshire, 'An Experiment on the Economic Value of Visibility' (1980) 8 Journal of Environmental Economics and Management 1-19.

their livelihoods.⁶² Most importantly, financial institutions stand in a fiduciary relationship to their clients⁶³ and therefore ought to ensure that their activities are carried out in a manner that is compatible with the interests of the consumers, and also in such a manner as to prevent the failure of these institutions themselves. By this theory then banks should strive to promote and support the development of a fair, transparent, competitive, sustainable, responsible, efficient, effective and accessible credit market and industry to serve needs of the historically disadvantaged and low income persons and communities. This is facilitated by having in place a well laid out regulatory framework for the control of interest rates charged by banks.

The reality of the Kenyan banking sector however, has been observed to be motivated more by a profit motive at the expense of their duties and responsibilities to consumers. Banks have adopted a rogue attitude especially when given a freehand to determine their interest rates for advancing loans. This has resulted in a situation where the borrowers are at the mercy of banks that arbitrarily set exorbitant rates. Public interest theory therefore advocates for the government to step in at this point in order to protect the public from these unscrupulous banking excesses, abusive practices and/or other market failures. This the government does by taking full and responsible charge of the regulatory process including supervision of compliance and enforcing compliance through sanctions.

There exists a huge disparity in bargaining power between the banks as lenders and the borrowing public. Borrowers are usually not in a position to have complete and unrestricted access to the information necessary to enable them make sound and informed economic

⁶²M. Hudon, 'Fair Interest Rates When Lending to the Poor: Ethics and Economics' (2007) 5 Solvay Business School, Université Libre de Bruxelles, 2.

⁶³David Llewellyn, 'The Economic Rationale for Financial Regulation' (1999) Occasional Paper 1FSA, London, 11.

decisions such as borrowing and terms of borrowing. This information is in the possession of the lenders only who of course have the advantage of drafting and dictating what information to divulge to borrowers, and therefore the monopoly of full comprehension of and control over the information. The information asymmetry caused by the information disadvantage puts borrowers on a very unequal footing with the lenders since the borrowers are not in a position to judge the safety, soundness and viability of financial institutions and therefore their credit worth. Public interest theory seeks to ensure honest disclosure of information to both lenders and consumers so that consumers are in a better position to make sound judgments as to whether or not to contract with the lender on the basis of accurate information on the credit contracts.⁶⁴

Product options from which borrowers can choose from are also widened. Public interest theory therefore argues for regulation in order to provide information to interested parties who may not otherwise have access to complete and necessary information to make economic decisions.⁶⁵ This informs the theory's argument that only the government possesses the power, legitimacy and efficiency to protect the interests of borrowers in such situation of asymmetry and disadvantage.

Public interest theory is also advanced in this study in order to sound a wake-up call to the existing regulatory institution which in this case is the Central Bank of Kenya. The effectiveness of interest rates regulation has been said to depend to a large extent on the predisposition of the regulator to enforce regulations and the degree of bank regulation.⁶⁶ In order to enhance access to

⁶⁴David Llewellyn, 'The Economic Rationale for Financial Regulation' (1999) Occasional Paper 1FSA, London, 32.

⁶⁵M. Gaffikin, 'Regulation as Accounting Theory' (2005) University of Wollongong School of Accounting and Finance, Accounting and Finance Working Paper 05/09, 1.

⁶⁶U. Reifner, S. Clerc-Renaud, M. Knobloch, 'Study on Interest Rate Restrictions in the EU: Final Report for the EU Commission DG Internal Market and Services' Project No. ETD/2009/IM/H3/87, Brussels/Hamburg/Mannheim, iff/ZEW (2010).

credit, it therefore follows that the effectiveness of interest rates regulation rules be given due attention. This calls for stricter supervision of how regulations are implemented and may mean a reprimand of the regulator where it is found to be abrogating its responsibilities. Further, a review of the regulatory framework may also be necessary where it is determined that the framework is insufficient or ineffective.

2.5 CONCLUSION

Interest rates have been said to be a major determinant of the investment rates of a country and its ability to attract investors. This obviously has a direct link to the economic growth of a country.⁶⁷ The interest rate regulatory framework in existence in Kenya contains inherent inconsistencies which makes it insufficient to govern interest rates and keep banks in check. The CBK which is tasked with fostering a stable market-based financial system also faces handicaps that will be discussed in the study. All these demonstrate the justification of adopting a public interest approach towards regulation of interest rates. Such approach will see stiffer laws to regulate interest rates so as to avoid such instances where the regulatory framework and regulatory institutions fail to effectively keep banks in line.

There is an urgent need to remedy weaker compliance, enforcement, and sanctions mechanism through enactment of strong, clear and comprehensive legal framework to regulate the entire financial sector. In this regard, the study holds that the public interest theory is best suited to achieve this agenda. The next chapter will trace the origins of the inconsistencies and legal loopholes that have contributed to CBK's complacency and incompetence therefore making it easy for banks to flout regulatory requirements.

⁶⁷ Research has shown that inflation rises or falls in response to interest rates rise or fall. During inflation, banks raise their interest rates while during deflation, interest rates are lower.

CHAPTER THREE

REGULATION OF INTEREST RATES IN KENYA

3.0 INTRODUCTION

Kenyan law recognises the need and importance to protect consumers from unethical market practices, while at the same time endeavouring to create a favourable atmosphere for investment and trade. Regulatory measures in Kenya are ideally intended to guard against exorbitant interest rates which exploit the poor and hinder business development. The government has used direct interest rate regulation as well as rural credit programs and institutions in order to control interest rates. However, arguments have it that interest rate ceilings have the effect of making financial institutions shy away from the market thus retarding their growth.

Fry argues, in a rather lender-friendly manner, that raising the interest rate in the formal sector improves the efficiency of investment through deterring low-yield investments that would previously have qualified for funding especially where investments may have been selected by administrative rather than price selection.⁶⁸ This perhaps explains why banks have often resisted any regulations that tend to put a cap on their interest rates. This chapter sets out to give a background on how regulation of interest rates in Kenya has been carried out before as well as analyze the laws currently in place that govern levying of interest rates by banks and other financial institutions in Kenya. A history of interest rates regulation in Kenya will give a better understanding of the current inadequacies in the law and explain the consumer-oriented justification for regulation.

⁶⁸ M. Fry, *Money, Interest and Banking in Economic Development* (Baltimore, MD and London; John Hopkins University Press 1995).

3.1 HISTORICAL BACKGROUND ON REGULATION OF INTEREST RATES

In discussing the background to interest rates regulation in Kenya, this study will critically analyse interest rates regulation from the period following Kenya's independence before liberalisation of the economy, right through the period following such liberalisation. Both periods are defined by changes in the financial sector policies. The period before interest rate liberalisation was characterized by financial repression with selective credit controls and fixed interest rate spreads.⁶⁹ The post-liberalisation period, however, saw widening interest rate spread indicating inefficiency of the CBK, an uncompetitive financial market and weak legal framework.

3.1.1 Interest Rates Regulation before Financial Liberalisation

The period after independence saw the CBK pursue a low interest rate policy aimed at encouraging investment with low-cost capital. This was achieved by fixing minimum saving rates for all deposit taking institutions and maximum lending rates for commercial banks, Non-Banking Financial Institutions (NBFIs) and building societies. Before 1974, interest rates remained unchanged for fear that any changes would create uncertainty and adversely affect investment which the new nation was in desperate need of, and also because the impressive economic performance sustained positive real interest rates. The unfortunate balance of payments crisis of 1971-1972 increased inflationary pressure and as a result induced a negative real saving rate, and a control policy regime was therefore adopted. This has been attributed to unfavourable terms of trade and Kenya's expansionary budget.⁷⁰ Normally, a controlling policy

⁶⁹ A. Cukierman and Z. Hercowitz, 'Oligopolistic Financial Intermediation, Inflation and the Interest Rate Spread' (1990) Paper No. 2, The David Horowitz Institute for the Research of Developing Countries, Tel Aviv University.

⁷⁰ A. Ahmed and S. Islam, *Financial Liberalization in Developing Countries: Issues, Time Series Analysis and Policy Implications* (Physica Verlag A Springer Company, 2010) 28.

regime distorts the operation of the market and increases inefficiency. The fact that Kenya's financial market was not competitive at the time and only a few commercial banks dominated the sector⁷¹ contributed to the resulting inefficiency in the financial market, with high transaction costs attributable to control on credit and interest rates.

The first review of interest rates in the post-independence period occurred in June 1974 through the 1974-1978 Development Plan which resulted in a review of interest rates from 3%-5% in order to encourage savings and discourage speculation and misuse of savings.⁷² At that time the rise in inflation following the first Oil Crisis⁷³ made both lending and saving rates negative in real terms. Fortunately following the coffee boom (1976-1977),⁷⁴ inflation came down but with the expansionary fiscal policy, interest rates offered by government securities remained low in order to cause a shift toward quality assets.

The positive effects of the coffee boom were felt in 1979 when inflation came down and lending rates became positive in real terms, as money supply was brought under control. The structure of the market changed following the coffee boom as Kenyans started investing in the financial sector and setting up NBFIs. This was made possible by a regulatory framework with lenient entry requirements.⁷⁵ Commercial banks set up NBFIs to circumvent the stringent controls and

⁷¹ R. Ngugi and J. Kabubo, 'Financial Reform and Interest Rate Liberalization: The Kenya Experience' (1998) African Economic Research Consortium, Research Paper No.72, 6.

⁷² *ibid*, 13.

⁷³ In October 1973 members of the Organisation of Arab Petroleum Exporting Countries declared an embargo causing a world-wide oil crisis.

⁷⁴ Largely due to the smuggling into Kenya of coffee from Uganda which Kenyan traders bought at throw-away prices at the infamous Chepkube Market.

⁷⁵ The minimum capital requirement for NBFIs was relatively low compared with commercial banks and they were not subjected to the cash ratio. They were allowed to charge higher lending rates and they earned a higher margin compared with commercial banks.

NBFIs mushroomed in a sector previously dominated by commercial banks. However, the gains were minimal.

The period between 1980-1990 saw interest rates reviewed several times in an effort to allow commercial banks more room to compete and greater flexibility to meet the needs of customers. The reviews also aimed at making interest rates responsive to changes in the international markets so as to provide protection against adverse movements of funds globally. In addition, because interest rates have an important role as an instrument of monetary policy, adjustments were made to contain inflationary pressure. Minimum saving rate was increased in 1980 to a record 6%.

In 1981, the saving rate increased to 10% and in 1982 to 12.5%. The rate was reduced to 11% in 1984 following the decline in inflationary pressure. The maximum lending rate was raised to 16% in 1982 and then dropped to 14% in 1984.⁷⁶ Further reviews were made in the late 1980s following the increased inflationary pressure resulting from increased money supply. The savings rate increased to 12.5% and 13.5% in 1989 and 1990 and the maximum lending rate was raised to 18% and 19%. By 1990, the CBK had achieved its objective of harmonizing NBFIs and commercial bank interest rates, and both institutions now faced the same level of lending rate ceiling and maximum interest rate spread.

There was tremendous growth in the number of NBFIs, from 23 in 1981 to 54 in 1988. At the same time commercial banks increased from 16 in 1981 to 24 in 1988.⁷⁷ Competition intensified between the NBFIs and commercial banks in both the deposit and the credit markets. Because of

⁷⁶ R. Ngugi and J. Kabubo, 'Financial Reform and Interest Rate Liberalization: The Kenya Experience' (1998) African Economic Research Consortium, Research Paper No.72, 37.

⁷⁷ *ibid*, 6.

low entry capital requirements and inadequate supervision, however, most NBFIs were under-capitalized and poorly managed and they squeezed their margins by offering higher rates than commercial banks. Ultimately, they faced a credit squeeze, with systemic problems of illiquidity and insolvency affecting a large part of the NBFIs sector.⁷⁸ By 1989, two commercial banks and nine NBFIs were in financial trouble.⁷⁹ In response to this crisis, the Banking Act was reviewed in 1989 to enhance the regulatory and supervisory functions of the CBK. NBFIs were subjected to stringent licensing and operating regulations.⁸⁰ The Deposit Protection Fund (DPF)⁸¹ was established to enhance the stability of the banking industry by protecting the interests of depositors, especially small depositors who may not have the capacity to evaluate the financial soundness of banks.

3.1.2 Financial Liberalisation and Interest Rates Regulation

Interest rates were officially liberalised in July 1991. Although financial theory predicts an increase in interest rates in a post-liberalisation period, in Kenya the minimum saving rate declined from 13.5% in 1990 to 6.9% in 1995, while the maximum lending rate increased to a peak of 38.6% in 1993.⁸² This is attributed to the fact that interest rate liberalization was mounted amidst increasing inflationary pressure and deteriorating economic conditions, indicating a failure to meet the prerequisite for successful financial reform like fiscal discipline and financial and macroeconomic stability. The pressure was also attributed to the expansionary fiscal policy, which saw an increase in money supply.

⁷⁸ R. Ngugi and J. Kabubo, 'Financial Reform and Interest Rate Liberalization: The Kenya Experience' (1998) African Economic Research Consortium, Research Paper No.72,7.

⁷⁹ *ibid*, 8.

⁸⁰ *ibid*, 15.

⁸¹ Banking Act, s.36. Established to insure bank deposits following the banking crisis in the 1980s.

⁸² R. Ngugi and J. Kabubo, 'Financial Reform and Interest Rate Liberalization: The Kenya Experience' (1998) African Economic Research Consortium, Research Paper No.72, 30.

In addition, the financing of the fiscal deficit shifted to the domestic market using Treasury Bills and this accelerated the increase in interest rates. The ensuing confrontation between consumers and banks over interest rates indicated the unpreparedness which preceded financial liberalisation. The courts were also at a loss and instead of authoritatively clearing the air around interest rates regulation in the financial liberalisation period, they served instead to fuel the conflict between consumers and banks and added to the confusion.

3.1.2.1 Legal and Consumer Protection Challenges Following Liberalisation

Untill 1989, interest rates regulation rested upon the Central Bank of Kenya which published maximum and minimum interest rates to be applied to overdrafts, loans and mortgages. This was done pursuant to section 39(1) of the CBK Act which provided as follows;

“The bank may from time to time acting in consultation with the Minister, determine and publish the maximum rates of interest which specified banks or specified financial institutions may pay for the deposits and charge for loans or advances....”

In effect, this section provided for control of interest rates by the CBK in consultation with the Minister for Finance. In exercise of this power, the Governor of the CBK published gazette notices in 1989⁸³ and 1990⁸⁴ which prescribed the maximum interest rate on loans and advances. Later in 1990 however, the Governor purported to remove controls over interest rates through a gazette notice⁸⁵ which revoked the previous three notices. Parliament felt that CBK was attempting to usurp its powers to protect and shield consumers from unethical lenders and a serious debate arose on the legality and constitutionality of the Governor’s gazette notice.

⁸³ Gazette Notice No.4939 of 1989.

⁸⁴ Gazette Notice No.1458 of 1990 and Gazette Notice No. 1617 of 1990.

⁸⁵ Gazette Notice No. 3348 of 1990.

Parliament contended that a gazette notice was a subsidiary legislation which could not repeal an Act of Parliament.⁸⁶ Parliament maintained that section 39(1) of the CBK Act remained the only effective constitutional regime governing interest rates regulation in Kenya until and unless it was repealed by Parliament.

In a sudden change of tune beginning 18 April 1997, parliament seemed to bury the hatchet with the CBK and officially removed legal controls to interest rates. Section 39(1) of the CBK Act was repealed with the coming into force on 17th April 1997 of the Central Bank of Kenya (Amendment) Act 1996⁸⁷ which had earlier been passed by Parliament. Section 17 thereof provided that the principal Act is amended by repealing sections 39, 40 and 41.

Following the repeal of section 39(1) of the CBK Act vide section 17 of the CBK (Amendment) Act 1996 with the effect of freeing bank interest rates regime from control or regulation by the Minister for Finance and also from control by the Governor of CBK, confusion intensified as to when exactly section 39(1) of the CBK Act had ceased to operate. The banks, eager to protect their interests, maintained that section 39(1) had been repealed in 1991 vide Gazette Notice 3348 of 1991, while Parliament and borrowers maintained that the section was operational up till it was repealed in 1997 vide the CBK (Amendment) Act 1996. Resulting litigation served a blow to consumers when the court in *National Bank Limited Vs Cadour Investment and Another*⁸⁸ put forward that the controlled interest rates regime ended when Gazette Notice number 3348 of 1991 revoked previous notices on 23rd July 1991. In this case, the Court concluded that the effect of Gazette Notice number 3348 of 1991 was first, to free bank interest rates regime from control

⁸⁶ Central Bank of Kenya Act, s 39.

⁸⁷ Act No. 9 of 1996.

⁸⁸ H.C.C.C No. 2105 of 2006 (unreported).

or regulation by the Minister for Finance through the CBK. Second, the power of the CBK to issue instructions under sections 39-41 of the CBK Act was removed from the Governor by the repeal of those sections. This holding attracted criticism and outrage from consumers and consumer rights organisations as it definitely purported to strip consumers of their legal protection from arbitrary interest rates between 1991 and 1997. The main reason for this criticism was that the holding had the effect of articulating that it does not matter what Parliament legislates, the Governor or the CBK could nullify the provisions of section 39 (1) of the CBK Act, which articulation would be unsustainable in law.

The correct position, and the one advanced by consumer rights groups, was that section 39 (1) of the CBK Act was still in force up to 17th April 1997 when the amending Act [the CBK (Amendment) Act 1996] came into force. The intention of Parliament until then was that interest rates controls remain in force. To find otherwise would be to declare that the Governor can through a Gazette Notice commandeer the legislative functions of Parliament. The Holding in *National Bank* therefore added to the confusion consumers faced as regards the correct position of the interest rates charged on their borrowings.

On 7th August 2001 an amendment to section 39(1) of the CBK Act came into force with retrospective effect from 1st January 2001. Parliament, readopting what looked like its pre-1997 position, passed the CBK (Amendment) Act of 2000 (famously known as “the Donde Act”), re-introducing the control of the interest rates regime. As expected, the Act met heavy criticism from banks which argued that it was retrogressive. Upon its enactment, a constitutional reference was filed by the Kenya Bankers Association.⁸⁹ The main hullabaloo was premised on the

⁸⁹ *Kenya Bankers Association and Others v Minister for Finance and Another* (2004) 1 KLR 61.

principle that nobody should be criminalized for engaging in conduct that when it was done was not a crime according to any law. Section 39(4) of the Donde Act provided;

“A specified bank or specified financial institution which contravenes any of the provisions of this section shall be guilty of an offence under the Banking Act and be liable to such penalty as the Minister may prescribe under section 55 of that Act.”

What Section 39(4) meant was that even though the Donde Act was enacted on 7th August 2001, the retrospective commencement date of 1st January 2001 meant that the Minister for Finance could levy penalties on banks that contravened any provision of the Donde Act in terms of Section 55 of the Banking Act beginning from 1st January 2001. To this end, the Court ordered that the Donde Act was void in so far as it made criminal and penalized that which was not an offence at the time it took place contrary to section 77 of the repealed Constitution.

Failure by the CBK to step in and take effective charge of the markets⁹⁰ by explaining the implications of the court’s ruling on the Donde Act resulted in confusion as to the exact position on interest rates regulation. It was widely reported (largely by bankers), and it was considered by many, that the court had declared the entire Donde Act unconstitutional. What the CBK should have actively reassured Kenyan consumers of and which was indeed true was the fact the court had only declared the retrospective criminalisation and criminal sanctions unconstitutional, but the rest of the act remained good law. Only the criminal sanctions that could be retrospectively

⁹⁰ See also Report of The Parliamentary Select Committee on the Decline of the Kenya Shilling against Foreign Currencies, February, 2012. This report, years later, also accused the CBK of incompetence and failure to perform its functions as per the Central Bank of Kenya leading to a failure by the fiscal and monetary policy organs of the Government to take timely corrective measures to arrest inflation.

applied were found to be unconstitutional, and even then, only between 1st January 2001 and 24th January 2002 when the High Court read its judgment.

The court actually upheld and approved the Donde Act in *Mohammed Gulamhussein Farzal Karmali & Another –vs- C.F.C Bank Limited & Garam Investments*⁹¹ where it rightly stated that there is no doubt that the said Act came into force on 1st January 2001. It is consequently unambiguous that between 1st January 2001 when the Donde Act came into force and when the CBK (Amendment) Act of 2004 came into force, the banks were obligated to comply with the interest rates specified in section 39 of the Donde Act. The Donde Act provided the maximum interest rate chargeable on all loans and advances from 1st January 2001 as “the 91-day Treasury Bill rate published by the CBK on the last Friday of each month, or the latest published 91-day Treasury Bill rate, plus 4 per centum”. It went further, by way of proviso, to provide that:

“Provided that the maximum interest chargeable shall not exceed the principal sum, and that the section should only apply to loans and advances made or renewed after commencement of the Act”.

The situation is that from the date of the judgment of the High Court on 24th January 2002, the entirety of the Donde Act was held to be good law, including Section 39(4) which allowed the Minister to levy penalties on banks that failed and/or refused to comply with the interest rates prescribed by the law. As mentioned above, Parliament again changed tune by repealing the Donde Act in 2004 vide the CBK (Amendment) Act of 2004⁹² resulting in further confusion.

⁹¹ HCCC No.3 of 2006.

⁹² No. 8 of 2004.

The consequent legal problems between July 1991 and 2004 surrounding the question of interest rate controls as between Gazette Notices and Acts of Parliament, and as between contracts and Acts of Parliament was worsened by the failure by the Ministry of Finance and the CBK to stand on principle and pursue fair legal and policy solutions aimed at protecting consumers. This abdication of crucial roles has now left individual citizens and their lawyers to opt for the courts in their battle with banks.

3.2 CURRENT INTEREST RATES REGULATORY FRAMEWORK

An adequate legal and regulatory framework ensures stability and functional efficiency of the financial system. The regulatory framework incorporates regulations by the monetary authority aimed at achieving financial stability.⁹³ The financial sector in Kenya comprises the Central Bank of Kenya, as the regulatory authority,⁹⁴ commercial banks, Non-Bank Financial Institutions, Forex Bureaus and Deposit-Taking Microfinance Institutions (DTMIs) as the regulated entities. Commercial banks and Mortgage Finance Companies are licensed and regulated under the Banking Act and Prudential Guidelines issued thereunder. DTMIs on the other hand are licensed and regulated under the Microfinance Act and Regulations issued thereunder. Foreign Exchange Bureaus are licensed and regulated under the Central Bank of Kenya Act and Foreign Exchange Bureau Guidelines issued.

In addition, with regard to interest rates, section 44 of the Banking Act provides that no institution shall increase its rate of banking or other charges except with the prior approval of the

⁹³ R. Ngugi and J. Kabubo, 'Financial Reform and Interest Rate Liberalization: The Kenya Experience' (1998) African Economic Research Consortium Research Paper No. 72.

⁹⁴ Constitution of Kenya (2010), art 231 (Establishes the CBK as an independent institution and mandates it to formulate monetary policy, promote price stability, issue currency and perform other functions conferred on it by an Act of Parliament).

Minister.⁹⁵ The section does not however, contextualize the circumstances in which a bank may increase its rate of banking or other charges for that matter. Further, the courts have added to the confusion by failing to authoritatively determine whether or not section 44 applies to interest rates. Some decisions appear to suggest interest rates are not within the purview of section 44⁹⁶ while others simply acknowledge the uncertainty without attempting to solve it.⁹⁷ In this case the court stated that “the question as to whether or not the provisions of section 44 of the Banking Act limits the interest rates chargeable by banks and other financial institutions appears to be uncertain” while on the other hand, Azangalala J⁹⁸ was of the opinion that section 44 of the Banking Act also applies to increase in interest rates.

The Banking (Increase of Rate of Banking and other Charges) Regulations 2006⁹⁹ provides that all applications under section 44 shall be in the form prescribed and submitted to the Minister through the Central Bank of Kenya. Under the regulations, the Minister indicates the manner in which a bank should go about an application for increment of its banking rates. The CBK is mandated to consider every application made prior to forwarding the same to the Minister for approval or rejection.

However, discouragingly the banking industry in Kenya has over the years been more in breach than in compliance with section 44 of the Banking Act without the CBK being seen to reign in those in breach. The case of *David M. Ndeti v Daima Bank Limited*¹⁰⁰ was instrumental in bringing this to light. Evidence given by a senior official of the CBK in the case showed non-

⁹⁵ See also N. Gichuki, *Law of Financial Institutions in Kenya* (2nd edn, LawAfrica Pub., Nairobi 2013) pg.35.

⁹⁶ *Desai and Others v Fina Bank* (2004) 2 EA 46. (the court was of the view that section 44 does not apply to interest rates).

⁹⁷ *Daniel Kamau Mugambi v Housing Finance Company of Kenya* (2006) eKLR.

⁹⁸ In *Africa Eco-Camps Ltd vs. Fidelity Commercial Bank Limited* (unreported) HCCC 373 of 2006.

⁹⁹ Banking (Increase of Rate of Banking and other Charges) Regulations 2006, reg 2.

¹⁰⁰ [2000] HCCC No. 2198.

compliance with section 44 of the Banking Act. Quite depressingly in *Ramji Haribhai Devani Limited v Kenya Commercial Bank*,¹⁰¹ the court was of the opinion that banks are granted relief from section 44 of the Banking Act by virtue of the provisions of section 52 (1) of the same Act. In essence, this section provides that a bank may contravene any provisions of the Act and still enforce the contractual obligation. However, it is a well settled principle of law that where parties to a contract have agreed to do something that is expressly prohibited by statute, that contract is void *ab initio* and consequently unenforceable by either party.

It is noteworthy however, that the *in duplum* rule which operates to limit the amount of interest that may be claimed by a bank on non-performing loans, is meant to protect borrowers from exploitation by banks that permit interest to accumulate. As clearly stated by the Zimbabwe High Court in *Commercial Bank of Zimbabwe v MM Builders and Suppliers PVT Ltd*,¹⁰² the *in duplum* rule provides that interest whether it accrues as a simple or compound interest ceases to accumulate upon any amount of capital owing once the accrued interest equals the amount of capital outstanding, whether the debt arises as a result of a financial loan or out of any contract whereby a capital sum is payable together with interest thereon at a determined rate.

The rule makes servicing loans much easier and stems from a public policy/interest point of view which seeks to protect borrowers from lenders who let interests accumulate to abnormal levels

¹⁰¹[2005] HCCC No. 482.

¹⁰² 1907 (2) SA 285 ZHC.

and thereafter seek to enforce these unregulated charges.¹⁰³ This is the spirit of Section 44A of the Banking Act which only needs a bit more pragmatism from the CBK in order to implement.

3.3 CONCLUSION

In the interest rates liberalization process, a major goal is to achieve financial stability by creating a strong regulatory framework. Financial instability with unsound and improperly supervised lending practices may result in high real interest rates and a widening spread because of an information asymmetry problem.¹⁰⁴ An adequate legal framework incorporates the adequacy of commercial law and the efficiency with which the judicial system makes and enforces legal decisions. It is necessary, therefore to strengthen the institutional framework, including review of the regulatory and legal framework. This should target enhancing confidence among depositors and investors and strengthening enforceability of loan contracts. As a result, this would enhance stability in the financial sector and reduce costs of capital to investors. It also serves to strengthen the supervisory and monetary control role of the Central Bank in order to avoid the conflict between monetary and fiscal policy.¹⁰⁵ In order to achieve a strong regulatory framework for interest rates which conforms to the demands and functioning of a liberalised economy, it is necessary to study success stories of countries that have managed to achieve the above harmony. The next chapter will focus on two case studies for the above purpose.

¹⁰³ J. Campbell, 'The Cost of Credit in the Micro-Finance Industry in South Africa' (LLM thesis, Rhodes University December 2006) available at < <http://eprints.ru.ac.za/899/1/Campbell-LLM-TR07-87.pdf>> (accessed 14 November 2012).

¹⁰⁴ J. Paroush, 'The Effect of Uncertainty, Market Structure and Collateral Policy on the Interest Rate Spread' (1994) 4 Bank of Israel Banking Review, 79–94.

¹⁰⁵ N. Ndungu and R. Ngugi, 'Adjustment and Liberalization in Kenya: The Financial and Foreign Exchange Market' (1999) 11 Journal of International Development, 465–491.

CHAPTER FOUR

BEST PRACTICES IN OTHER JURISDICTIONS AND LESSONS FOR KENYA

4.0 INTRODUCTION

In order to justify the regulation of interest rates in Kenya and the need for a stronger regulatory framework, this study seeks to make a comparison with other jurisdictions where regulation of bank interest rates has had a positive impact on bank practices and consumer protection. As has been determined in the previous chapters, Kenya suffers from a weak regulatory system owing to the fact that the Central Bank of Kenya is not legally endowed with powers to impose sanctions strict enough to deter arbitrary actions by banks. The weak penal system and the fact that Kenya does not have anti-usury provisions in her Penal Code have contributed to the blatant disregard of Central Bank regulations by banks and financial institutions. This chapter seeks to analyse how the same problems as those plaguing Kenya have been dealt with and overcome in other jurisdictions.

4.1 SELECTED CASE STUDIES

In making a comparison on the best practices in other jurisdictions, the selected case studies to be looked at, France and Poland are both members of the European Union. The reasons for this choice include diversity in terms of economic characteristics, financial cultures, size and attributes of the consumer credit markets, as well as the heterogeneity of the legal framework of interest rate regulations in these countries. It is this heterogeneity in the chosen countries which enables the study to draw conclusions with regard to the effect of interest rate regulation on consumer credit markets and over-indebtedness, and to appreciate reasons for different outcomes

in credit markets beyond interest rate regulation. The case study countries have been selected based on the following criteria:

- a) **Population:** France is one of the most populous¹⁰⁶ nations in the European Union while Poland is relatively smaller in terms of population. There is therefore diversity in the population size in the case studies.
- b) **Market:** The countries included in this study differ considerably in market size and market structure. France has a large national consumer credit market¹⁰⁷ while Poland makes comparatively small contribution to the overall volume of credit to households in Europe,¹⁰⁸ but has a reasonably big domestic market.
- c) **Regulation history:** France has had regulation of consumer credit interest rates for a long time (since 1935), while Poland only recently introduced interest rate caps, in 2005. Further, in developing an efficient banking system to enable Poland transition to a market economy initiated from 1992-1997, Poland borrowed heavily from the French and American banking models.¹⁰⁹ France therefore provides a rich regulation precedent while Poland provides an appropriate test-case for a country like Kenya whose regulation history is relatively thin and which seeks to strengthen its weak regulatory system.
- d) **Anti-usury laws:** France and Poland have, in their legislations, incorporated usury, which is a term used to refer to excessive interest rates that are exploitative of consumers of credit services. Going by this definition, usury is relevant to this study because it forms

¹⁰⁶ World Population Review put the figure of Metropolitan France (France Mainland and the Island of Corsica) at 63,136,180 as at 2011 available at < <http://worldpopulationreview.com/population-of-france-2012/>> (accessed 22 November 2012).

¹⁰⁷ R. McKinnon, 'Worldwide Inflation, Bank Regulation, and Monetary Reform: Exchange Rates or Interest Rates?' (Stanford, November 2011) 14. France has been described as a developed market.

¹⁰⁸ Ibid, 5. Poland has been described as an emerging market.

¹⁰⁹ W. Colclough and R. Wolf, 'The Implementation and Review of a Polish Bank Monitoring System' available at <<http://www.wetsga.edu/~bquest/2003/polish.htm>> (accessed 23 August 2013).

the basis of the need to have in place a law that will control the interest rates charged by banks.

4.2 REGULATION OF INTEREST RATES IN FRANCE

France has had quite an interesting history with interest rate regulation starting with the abolition of usury in 1789 and the recognition of the freedom to “stipulate interest on a simple loan”.¹¹⁰ Eighteen years later interest rates were introduced at 6% for commercial matters and 5% on civil matters,¹¹¹ only to be abolished in 1886 in commercial transactions and in 1918 in civil transactions.

4.2.1 Interest rate ceiling in France

The Great Depression of 1935 saw the re-introduction of interest rate ceilings; these were revised in 1966¹¹² to provide sharper standards. Regulation is the responsibility of the Banque de France which sets rates in consideration of average rates for different types of loans. The Code de la Consommation captures both the regulation by the Banque de France and legislative regulatory framework, while the Code Civil also affects consumer loans especially its provisions on unfair contract terms.¹¹³

The ceiling is set at 33% above average rate which is the responsibility of the Banque to set quarterly based on a survey of credit institutions and other bodies making regular loans with risky profiles. These rates are set for different categories of loan by the Commission National de

¹¹⁰ Code Civil, art 105.

¹¹¹ Loi du 3 septembre 1807, art 1.

¹¹² Loi no 66-1010 du 28 décembre 1966, J.O., 29 December 1966, 11623; U. Reifner, S. Clerc-Renaud, M. Knobloch, ‘Study on Interest Rate Restrictions in the EU: Final Report for the EU Commission DG Internal Market and Services’ (2010) Project No. ETD/2009/IM/H3/87, Brussels/Hamburg/Mannheim, 65.

¹¹³ Code Civil, art 1152.

Credit, for example, for the first quarter of 2006: loans up to € 1,524; overdrafts, revolving credit and purchases by instalments over €1,524; and personal and other loans over €1,524.¹¹⁴ Apparently this €1,524 level has not changed since 1989.¹¹⁵ Currently there is a specification for a relative maximum APR of 133% of the average of rates found for different types and amounts of credit, for example by providing separate ceilings for revolving and instalment credit and for small and large sum credits. This led to a system of twelve separate ceilings, including six ceilings applicable to consumer credit.¹¹⁶

The general rule in France which is meant to protect borrowers from arbitrary increase in charges is that all compulsory charges, for example missed payment charges, are included in the APR; other non-compulsory charges like insurance can be charged to the consumer. French regulatory framework seeks to cushion consumers in financial distress. The law in France, unlike the Kenyan scenario, specifically seeks to give a distressed borrower a new lease of life in the event of a substantial fall in income leading to default in loan payment. The consumer can apply to court for a payment moratorium of up to 2 years provided the lender has not terminated the loan and demanded payment of outstanding sums.

In the event of such application, the court can adopt any one of the following measures: postponement or restructuring of the debt, remission of the debt, decrease or cancellation of interest rates, consolidation, creation or substitution of guarantees, sale of unnecessary

¹¹⁴ Policis, 'Economic and Social Risks of Consumer Credit Market Regulation: A Comparative Analysis of the Regulatory and Consumer Protection Frameworks for Consumer Credit in France, Germany, and the UK' (London: 2006), 12.

¹¹⁵ I. Ramsay, 'A Tale of Two Countries: Responding to Over-Indebtedness in France and the UK: 1985-2010: The Role of Interest Rate Ceilings' (ECPR Regulatory Governance Standing Group Conference 2010 "Regulation In The Age of Crisis" UCD Dublin (June 17-19 2010) 21.

¹¹⁶ French definition in Code Civil, art 1892: "A loan for consumption is a contract by which one of the parties delivers to the other a certain quantity of things which are consumed by use, on condition that the latter shall return as much to him in the same kind and quality."

possessions, or ban on contracting of new debts. This has the effect of giving a borrower a grace-period within which s/he is able to get her/his finances in order without the risk of banks foreclosing on her/his property. Kenyan law should expressly provide such protection to Kenyan borrowers as is enjoyed in France.

Further, an indebted borrower with multiple debts can apply to the Banque de France to have his/her debts rescheduled under the procedure provided for indebtedness. This rescheduling of debts ensures that the lenders will eventually recover their money albeit over a longer period of time, and also enables the borrower to meet her/his financial obligations without necessarily going into complete financial ruin. Kenyan law should borrow from this and empower the Central Bank of Kenya to be able reschedule debts of a multiple borrower in distress when it sees fit.

The downside of these arrangements is that they are written in the credit reference bureau at the Banque de France for up to eight years. Although criticised by the IMF as contributing to loss of competitiveness, the French system has been hailed for reducing financial vulnerabilities while preserving the capacity of banks to provide credit.¹¹⁷ The French government justifies regulation of interest rates as necessary to address the excesses of finance and the causes of financial crisis and to strengthen political and democratic oversight of the banking sector in an effort to modernise the sector.¹¹⁸

¹¹⁷ L. Yakubu, 'IMF advises France to phase out regulated interest rates' (2013) available at <http://www.investadvocate.com.ng/index.php?option=com_content&view=article&id=5761:imf-advise-france-to-phase-out-regulated-interest-rates-&catid=28:money-market&Itemid=61> (accessed 18 August 2013).

¹¹⁸ P. Moscovici, 'Speech on Regulation of Business Activities' (Debate on a Bill in Senate, Paris, 20 March 2013) available at <<http://www.ambafrance-uk.org/Economy-Minister-backs-French>> (accessed 18 August 2013).

4.2.2 Usury in France

Usury in France describes excessive interest rates. Any contractual loan granted at an annual percentage rate which, at the time of its granting, is more than one third higher than the average percentage rate applied by the credit institutions during the previous quarter for loans of the same type presenting a similar risk factor, constitutes a usurious loan.¹¹⁹ If usury is proved, the credit contract will, however, remain valid and the interest rate will be brought down to legal maximum while excessive interest already charged is set against future interest and/or capital payment.¹²⁰ Criminal sanctions will be a fine of €45,000 and/or up to two (2) years imprisonment as well as publication of the decision and temporary or permanent closure of the business.¹²¹ This law seeks to strike a balance the sanctity of contractual agreements and the need to adhere to regulations pertaining to interest rates. By downsizing excessive interest rates to the legal maximum, the law ensures that the contract remains enforceable to the extent that the interest rate is at the legal maximum. Criminal sanctions serve as deterrent for any further breach.

4.3 REGULATION OF INTEREST RATES IN POLAND

Regulation of interest rates in Poland is a function of the Monetary Policy Council (MPC) which derives its powers as one of the directing bodies of the National Bank of Poland (BNP) from the Constitution of Poland¹²² and the Act on the National Bank of Poland.¹²³ The Council is composed of a Chairperson (the President of the NBP) and nine (9) members appointed in equal numbers by the President of the Republic of Poland, the Sejm (Poland's Lower House of

¹¹⁹ French Consumer Code, art 313.

¹²⁰ Ibid, art 313- 4.

¹²¹ Ibid, art 313-5.

¹²² Constitution of Poland, art 227(2).

¹²³ National Bank of Poland Act 1997, art 6.

Parliament) and the Senate to serve a six-year term. The key functions of the Council are: Drawing up annual monetary policy guidelines and submitting them to the Sejm which submission coincides with the submission by the Council of Ministers of the draft Budget; presentation of a report to the Sejm on the performance of monetary policy guidelines within five months of the end of the fiscal year; setting NBP base interest rates; determining the procedures governing the reserve requirement and setting the reserve ratio; setting ceilings on the liabilities arising from loans and advances drawn by the NBP from foreign banking and financial institutions; approving the NBP financial plan and reporting on operation; accepting the NBP's annual accounts; determining the principles applicable to open market operations; assessing the activity of the NBP Management Board in its performance of monetary policy guidelines; and adopting accounting principles for the NBP submitted to it by the President of the NBP.¹²⁴

Since first January 2008 when the Polish Financial Supervision Authority (PFSA) became operational, the MPC is required to co-operate with the PFSA so as to complement each other in their various and coinciding functions. The Polish MPC differs in its composition from the Kenyan Monetary Policy Committee¹²⁵ which comprises of only appointees of the executive arm of government and no appointee of the legislative arm.¹²⁶ This no doubt contributes to the complacency and 'toothless-dog' nature of the Committee as has been seen in the previous chapter. This is because the Committee lacks the independence which comes from having appointees whose allegiance lies with the legislature rather than the executive. The legislature in the Kenyan scenario has no say in the operations of the Committee since it has no representation

¹²⁴ Ibid, art 12.

¹²⁵ Established vide Gazette Notice 3771 of 2008.

¹²⁶ Available at <<http://www.centralbank.go.ke/index.php/monetary-policy/monetary-policy-committee-meeting>> (accessed 24 August 2013).

therein. Further, Kenya does not have a central independent public body that is responsible for the overall supervision of banking and other financial institutions, leaving the different kinds of financial institutions to their own supervisory bodies.

4.3.1 Interest rate ceiling in Poland

Supervision of banks and financial institutions in Poland is governed by a number of laws. Key among these are the Act of 29 August 1997¹²⁷ (referred to as Banking Law) which stipulates regulatory requirements for banks, including banking secret requirements, provides structure of banking supervisory and regulates different aspects of banking activity; the National Bank of Poland Act of 29 August 1997¹²⁸ which regulates organisation of the National Bank of Poland (“NBP”) and rights and obligations of NBP which is the central bank of Poland; and the Supervision of Financial Market Act of 21 July 2006¹²⁹ which establishes the Polish Financial Supervision Authority (PFSA) which is a supervisory body over the whole financial markets.

The PFSA is an independent, central public administration body which performs overall supervision of banking and other financial institutions in the name of the state.¹³⁰ As compared to Kenya’s Banking Act and Central Bank of Kenya Act, the Polish legislations are clearer and more specific as relates to regulatory requirements, the nature and standards of supervision required, and the functions and obligations of the central bank towards banks and consumers of banking services. As has been explored in the previous chapters, the inadequacy of Kenyan

¹²⁷ This Act is a consolidated text: Journal of Laws of 2002, no. 72, item. 665, with later amendments.

¹²⁸ This Act is a consolidated text: Journal of Laws of 2005, no.1, item 2.

¹²⁹ Official Journal of 2006, no. 157, item 1119, with later amendments.

¹³⁰ Wardynski & Partners, ‘Bank Finance and Regulation Survey: Poland’ (Lex Mundi, 2011) 2.

legislation to effectively regulate banks' activities is attributable to, *inter alia*, this lack of specificity and clarity.

Poland imposes an objective control on interest rates through statutory or regulatory ceilings which are regularly reviewed.¹³¹ Interest rates regulation in Poland is guided by the Civil Code and the Consumer Credit Act. The mechanism for regulation of maximum interest rate was introduced by the Act on Amendment of the Civil Code and Amendment of Selected Other Acts of 7 July 2005.¹³² Interest rate ceiling depends on the NBP's reference rate (Lombard), the relative rate ceiling for all types of credit being calculated by reference to the Central Lombard rate multiplied by four (4). The interest rate changes with changes in the Lombard, therefore all contracts must be reviewed with every review in Lombard.¹³³

The current rate (since 6th April 2011) comes to 5.50%, so the maximum interest rate thus comes to 22% on an annual basis.¹³⁴ The ceiling is set on borrowing rate, thus this ceiling applies to just the interest rate and not the rate representing the total cost of credit i.e APR. Fees and additional charges not included in the APR but related to the conclusion of the credit contract are separately regulated and may not exceed 5% of the amount of the loan.¹³⁵ Polish law also provides a statutory right to interest on late payments such as of tax duties or liabilities at a rate fixed by regulation.

¹³¹ Eurofinas, 'Preliminary Observations on Interest Rate Restrictions' (June 2010) 2, available at <<http://www.eurofinas.org/uploads/documents/positions/Eurofinas%20Preliminary%20observations%20IRR.pdf>> (accessed 19 August 2013); The current Lombard rate is 5% giving rise to a maximum borrowing rate of 20%.

¹³² Journal of Laws of 2005, no. 157, item 1316.

¹³³ Eurofinas, 'Preliminary Observations on Interest Rate Restrictions' (June 2010) available at <<http://www.eurofinas.org/uploads/documents/positions/Eurofinas%20Preliminary%20observations%20IRR.pdf>> (accessed 19 August 2013); The current Lombard rate is 5% giving rise to a maximum borrowing rate of 20%.

¹³⁴ Wardynski & Partners, 'Bank Finance and Regulation Survey: Poland' (Lex Mundi, 2011) 18.

¹³⁵ Consumer Credit Act, art 7(a).

4.3.2 Usury in Poland

Poland prohibits usury for all transactions between persons, not only contracts between professionals and consumers. Note however, that interest rate caps in Poland are subject to regulation in the Civil Code and in the Consumer Credit Act. The maximum interest rate in Poland is a relative rate ceiling for all types of credit, calculated by reference to the central Lombard rate multiplied by four.¹³⁶

This mechanism for limiting interest rates was introduced in 2005 and the ceiling is set on the borrowing rate, and thus just on the interest rate, not the rate representing the total cost of the credit in this case the APR.¹³⁷ In line with this distinction, in addition, fees and additional charges related to the concluding of the credit contract are separately regulated as well, and cannot exceed five (5%) of the amount of the credit. The rule applies to all credit types, depending only on Central Bank decisions through the Monetary Policy Council and the rates are reviewed monthly. Decisions concerning changes are published in the statements of the Central Bank's Monetary Policy Committee.

From the above discussion, what comes out clearly is that the levying of excessive and exorbitant interest rates especially by lending institutions in an effort to cover themselves against loss is taken seriously as a breach of public morals and against public policy. The selected countries discussed above have either incorporated the offence of usury; as such excessive interest rates are termed, into their penal codes or in their civil codes. The essence of these measures has been primarily the protection of consumers of credit services from profit oriented lenders who take

¹³⁶ The current Lombard rate is 5% giving rise to a maximum borrowing rate of 20%.

¹³⁷ European Commission Expert Group Report, 'The Regulation of Microcredit in Europe' (April 2007) 20.

advantage of their weak position as borrowers. This should be the case in Kenya because economic development of a country in most cases is pegged on good relationships between lending institutions and developers or investors.

4.4 CONCLUSION

As evidence of the desirability of regulating bank interest rates, France has remained a very strong economy from which nascent economies have borrowed for decades now. Poland on her part has shaken off her communist past and is fast-becoming one of the most stable economies in the European Union. As a matter of fact, Poland was the only EU nation that posted economic growth despite the global financial crisis of 2009, posting a 1.7% and a 3.8% growth in 2009 and 2010 respectively,¹³⁸ a success attributed to, *inter alia*, strong banking regulations.¹³⁹

Poland has risen from her communist past where banks were state-owned and poorly-performing to become a stable economy with a fledgling banking industry. Even though these successes are attributable to a number of factors, the emphasis on regulating bank activities such as interest rates is a major contributor to these successes. In considering the best practices in these jurisdictions, this study has shown that the Kenyan legal and regulatory framework can borrow a useful leaf from these practices whose major effect is the effective control of interest rates. The lessons will be more clearly spelt out in chapter five of this research. This study in essence therefore, holds that a strong and well crafted legal framework would go a long way in controlling interest rates and in the long run, inflation.

¹³⁸ Thomas White International, 'Emerging Market Spotlight: Banking Sector in Poland' (September 2011) 1, available at <<http://www.thomaswhite.com/global-perspectives/banking-sector-in-poland/>> (accessed 24 August 2013).

¹³⁹ Ibid, 3.

CHAPTER 5: CONCLUSION AND RECOMMENDATIONS

5.0 CONCLUSION

This research was based on the hypothesis that the policies adopted by the CBK as well as the legal framework currently in place are not effective in the regulation of interest rates in Kenya today. Further, the research questions that the study sought to answer were the extent to which the current legal framework works to regulate interest rates in Kenya, the extent to which regulation of interest rates can be justified in Kenya and the extent to which the regulation and control of interest rates is consistent with the economic rights and consumer protection tenets guaranteed by the Constitution of Kenya 2010. It is undisputed that an adequate legal and regulatory framework works to ensure stability of the financial system in an economy. Moreover, functional efficiency is influenced by the regulatory and legal framework. The regulatory framework incorporates regulations by the monetary authority aimed at achieving financial stability. It is for this very reason that this study sought to analyze whether the current legal and regulatory framework governing interest rates in Kenya is adequate to ensure stability in the Kenyan economy, and if there is a need for a law to control interest rates in Kenya.

As discussed in the background to the study, the CBK is responsible for supervision of banks in Kenya and hence plays a regulatory role in the banking sector. This means therefore, that within its mandate then is the regulation and control of interest rates levied by banks. However, the major problem in Kenya as has been discussed is that interest rate ceilings are disregarded and this study holds that this could be attributed to the fact that such ceilings are deemed to be reflective of a repressed financial system. Kenya experienced a high rate of inflation in the year 2011 up to mid 2012 and the reasons given for the sharp rise in inflation was mainly focused on

the global economic crisis. Factors external to the domestic economy played a role in the decline of the Kenya Shilling. These included the Euro zone debt crisis, US debt crisis, and Political events in the Middle East and North Africa. However, since these conditions still persist to date, this study considers them not have been the main causes for the drastic depreciation of the shilling. To this end, this discourse holds that action needs to be taken to have a law in place to control such crisis as well as strengthen the current legal and regulatory framework already in place.

It is important to note that reference to the decline of the Kenyan shilling and inflation is related to the interest rates discussion because during inflation, interest rates rise in a move calculated to reduce inflation. It is as a result of the sharp inflationary rise that the CBK embraced an aggressive monetary policy tightening. The Monetary Policy Committee hiked the Central Bank Rate by 11% to 18% in the fourth quarter. The Cash Reserve Ratio was also raised by 0.5% to 5.25%. These measures were critical to lowering inflation and stabilizing the local currency. The consequential effect of the monetary tightening actions was an upward adjustment in interest rates. Short term rates increased as investors sought higher yields amid rising inflation. Other key rates also increased mainly due to the more strict CBK policy measures. The rise in interest rates was detrimental as it negatively affected consumers of credit services since the lending rates shot to unconscionable levels. Further, high interest rates caused a fall in economic growth, worsening the unemployment situation and increasing poverty especially since credit services had become unaffordable. Moreover, a number of developers scaled back on planned projects for the fourth quarter of 2011 on the backdrop of increasing interest rates and escalating cost of construction materials. The residential sector of the market recorded subdued growth in the

fourth quarter compared to previous quarters, which had seen a lot of activity and vibrant growth in the sector. Developers in the residential subsector also recorded fewer sales.

It is not lost on this study that the Banking Act has been reviewed several times to correct for weaknesses that became evident in the previous legislation, to give more legal powers to the monetary authorities and to broaden the responsibilities and coverage of institutions. The aim of such reviews is to strengthen the legal framework regulating banks. However banks are still reluctant to comply with MPC interest rate regulations and the CBK is yet to act decisively in dealing with banks who contravene. This failure to comply with sections 44 and 44A of this Act by banks goes against the tenets of consumer protection¹⁴⁰ because the consumers of financial and credit services are left in the hands of profit oriented banks and it is obvious that in such situations, there is no balance of bargaining power. Moreover, the pricing of loans calls for more transparency which is critical because consumers have the right to know the exact price of products in the market. Conversely, non-transparent or opaque pricing prevents consumers from making informed decisions about borrowing.¹⁴¹ Macroeconomic stability is vital for a successful financial liberalization process, thus policy actions should be taken to ensure stability and sustainable growth of the economy. Stability of key prices, including the exchange rate, commodity prices and interest rates, is crucial. This will stimulate high investment returns and reduce the credit risk, consequently reducing the risk premium tagged on to the loan interest rate. In addition, it will discourage banks from non-intermediation activities while enhancing the move towards an equilibrium position in the loans market.

¹⁴⁰ Constitution of Kenya 2010, art 46. Consumer rights are entrenched in this article of the Constitution.

¹⁴¹ The right of consumers to be supplied with adequate information to enable consumers make informed decisions is entrenched in the Constitution of Kenya 2010, art 46(1)(b).

5.1 RECOMMENDATIONS

From the research, it is apparent that the current banking laws, which have been subject to vigorous litigation,¹⁴² and the CBK as the regulatory authority has not effectively managed to control interest rate rises in favour of consumer protection and in recognizance of economic rights of the citizenry entrenched in the Constitution of Kenya.¹⁴³ This study therefore holds that a law more specific to interest rate regulation is needed to regulate interest rates in Kenya. This law should have stringent sanctions that will revise and enhance the penalties which may be imposed for breach of the CBK regulations in the interest of the consumers of financial and credit services.¹⁴⁴ This law would be effective in ensuring that although we do not have interest rate ceilings, banks do not take advantage of this fact by levying such high interest rates that make credit services unaffordable to consumers as was experienced in the year 2011. The research further holds that there should be a concerted effort to review the regulatory and legal framework currently governing the activities of banks in Kenya. This should target enhancing confidence among depositors and investors and strengthening enforceability of loan contracts. This will enhance stability in the financial sector, and reduce costs of capital to investors.

It is the recommendation of this research that Kenya should incorporate the offence of usury¹⁴⁵ into the Penal Code. The Banking Act and the Central Bank of Kenya Act as they are currently do not provide strict sanctions against banks that practice usury. As such, the Penal Code should

¹⁴² Kyalo Mbobu, 'Section 44 of The Banking Act (Cap 488 Laws of Kenya): An Analysis of the Statute & Recent Judicial & Statutory Developments' (2010).

¹⁴³ Constitution of Kenya 2010, art 43.

¹⁴⁴ The current penalty is a fine of One Million Kenya Shillings which is too lenient as especially when compared to the amount of profits realized by banks in breach of the regulations.

¹⁴⁵ Usury refers to lending loans at excessive or exorbitant interest rates. A court ruling of the Highest Court of the Czech Republic (No. 22 Cdo 1993/2001 from 08. April 2003), defines usury contracts (in Czech: "Lichevní smlouvy") as contracts which involve abusing the inexperience, intellectual weakness or distress of a party to the contract, and whereby the contract arranges for the other party, or others, to be provided or promised to be provided with a performance which is in gross disproportion to the mutual performance.

be effectively amended to incorporate the offence of usury with strict penalties thereof, sufficient to deter banks in Kenya from exploiting borrowers in the name of adjusting lending rates in response to the rise in inflation. In regard to civil sanctions, usury if incorporated in the Penal Code could lead to a reduction of the contractual interest rate to the statutory interest rate.

The courts in Kenya should be more proactive in deciding on cases where consumers have been subjected to exorbitant interest rates and void such contracts where after consideration of all material facts, it is found that a lending institution has committed usury. With such case law in place, then consumers of credit services can freely go to courts and be assured of protection from usury. This would come in highly effective especially considering the fact that consumers of credit services in Kenya do not have an organization or association through which they can lobby for their rights in reference to the levying of interest rates.

The CBK as the regulatory authority should on a periodical basis carry out a review of interest rates levied by banks in Kenya and especially on loans. This study proposes that such review can be done on a monthly or quarterly basis and if done effectively, then banks will be cautious to illegally increase their lending rates with a view to reaping supernormal profits. The Monetary Policy Committee (MPC) should be more effective in executing its mandate. The build-up to the decline of the shilling in Kenya was evident as early as January 2011, but the CBK through the MPC failed to discern the signals and stem the crisis before it reached its peak. Research has shown that there was ineffectiveness¹⁴⁶ on the part of the MPC, especially its slow reaction to the

¹⁴⁶ Tracking CBKs response to the exchange rate and inflationary pressures throughout the year provides a hint on what went wrong. The CBK firstly increased the CBR on March 23, 2011 from 5.75% to 6% which was revised again to 6.25% on 4th June, 2011. The CBR rate was not reviewed again until September 15th 2011 but this was raised to only 7% despite the fact that the Kenya shilling was rapidly losing value and inflation was rising. The CBK kept the CBR fairly flat for about 9 months. Further, belated intervention by the CBK through hiking the CBR rate

shilling's decline, failure to meet regularly, its composition and its inadequate response to the shilling's decline. It was the steady decline of the shilling that led to inflation and consequently the rising of the CBR which had the effect of increasing the interest rates charged by banks on credit. Further, in regard to the Monetary Policy Committee and to include the input of supervisory arm of CBK in monetary policy decision making, this study proposes amendment of the CBK Act to provide for an extra member to the MPC of a CBK staff responsible for Bank supervision; this should be in line with the reconstitution of the current MPC to reflect the requisite expertise that will inform the monetary policy direction in the country. Further, this study recommends that the CBK should maintain a coherent monetary policy at all times with a focus on price stability, have a policy or a law stipulating that interest rates be administratively set thus determining the maximum interest rates to be levied on loans, and also focus on enforcing the *in-duplum* Rule as provided under section 44A of the Banking Act.

In line with prioritization of consumer education, all credit providers should be required to have policies that provide for debt counsellors to enlighten consumers against over-commitment in debt to the extent that their ability to repay comfortably as well as attend to their various personal needs is limited. The study holds that the effectiveness of this move would be that consumers of credit services would be well advised and know how to handle increases in interest rates.

to 18% was too drastic and costly to the economy. This has forced the Banks to hike their lending rate to more than 30 percent for new and old loans. Kenyans are now at risk of becoming paupers due to high interest rate payments.

The enactment of the Consumer Protection Act 2012¹⁴⁷ heralded a new dawn for consumer protection in Kenya. The government should now ensure the full implementation of this Act and identify more specific non-prudential guidelines that should include, but not be limited to; protection of consumer rights;¹⁴⁸ preserving confidentiality (for personal information and consumer credit records); acceptable marketing practices; prevention of over-indebtedness and reckless lending; law-full and un-law-full agreements; alteration; rescission and termination of agreements; disclosure requirements for all agreements; consumer's liability, interest, charges and fees; collection and repayment practices and dispute resolution. This study also recommends the following legal amendments that the CBK Act can target. These include the following:

- a) On the issue of oversight over CBK, this study recommends that the CBK Act should be amended to provide that the CBK Governor appears on a quarterly basis before a relevant Parliamentary Committee of the National Assembly to expound on monetary policy and other actions related to the discharge of the CBK's core mandate of price stability and financial stability
- b) On the question of sanctions, the CBK Act should be amended to provide for punitive sanctions on the management of CBK for gross failure in attainment of important monetary policy objectives or failure which occasions the country huge losses. As for the banking penalties regulations,¹⁴⁹ this study recommends amendments to be made to the CBK Act and the Banking Act in order to revise and enhance the penalties which may be imposed for breach of CBK regulations. Such penalties should be proportionate to the

¹⁴⁷ The Act came into force on 14 March 2013 after receiving presidential assent.

¹⁴⁸ The Constitution of Kenya (2010) in its Article 46 provides for consumer protection and protection of the economic rights of consumers to which the discussion on interest rates falls are covered by this Article.

¹⁴⁹ Banking (Penalties) Regulations 1999, reg 2.

value to the bank of the malpractice at that particular time. The current amount of penalty stands at One Million Kenya Shillings (Ksh.1,000,000/=) which this study holds is too lenient and therefore recommends a more deterrent penalty of 50% of the amount involved or Twenty Million Kenya Shillings (Ksh.20,000,000/=) whichever is greater.

c) The study recommends amendment of Section 44A of the Banking Act to read as follows:

- (1) An institution shall be limited in what it may recover from a debtor with respect to a loan to the maximum amount under subsection (2).
- (2) The maximum amount referred to in subsection (1) is the sum of the following—
 - (a) the principal owing;
 - (b) interest, in accordance with the contract between the debtor and the institution, not exceeding the principal owing; and
 - (c) expenses incurred in the recovery of any amounts owed by the debtor.
- (3) This section shall not apply to limit any interest under a court order accruing after the order is made.

d) The study also recommends insertion of a new section 49A in the Banking Act immediately after section 49: Penalty for non-compliance with Central Bank directions.

The new section is to read as follows:

“49A) Any institution or other person who fails or refuses to comply with any directions given by the Central Bank under the Act shall be liable to a penalty of twenty million shillings or, if the directions relate to monetary transactions, a penalty equivalent to fifty per cent of the amount of money transacted.”

- e) Finally, this study recommends that the Central Bank of Kenya Act should be amended by inserting the following new section immediately after section 4D— Report to committee of National Assembly, which is to read as follows:

4E. The Governor shall, on a quarterly basis, appear before the relevant committee of the National Assembly to expound on the monetary policy formulated by the Bank, and to report on other actions related to the mandate of the Bank.

In conclusion, the principle of good morals or fairness should guide all lending contracts because if accorded the serious consideration it deserves in such contracts, then banks would be more reluctant to increase interest rates unconscionably.¹⁵⁰ We have experienced cases in Kenya where banks even after the Central Bank Rate was lowered continued to levy interest rates at very high levels unaffordable by borrowers in the Kenyan population. This study contends that if Kenya can adopt the recommendations incorporated in this study, then the crises experienced in the year 2011 and early 2012 in Kenya would be a thing of the past. Regulation of interest rates is a tool of consumer protection and a way of curbing malpractices by the banks. It is the submission of this discourse that regulation of interest rates in Kenya is long overdue. There is therefore an urgent need to be put in place a more stringent law to control interest rates to see to it that the regulation is for the good of both the banker and the consumer of credit services. However, there is still more room for research on the subject.

¹⁵⁰ Good faith and fair dealing connotes the duty to act in accordance with good faith and fair dealing in performing an obligation, in exercising a right to performance, in pursuing or defending a remedy for non-performance, or in exercising a right to terminate an obligation or contractual relationship. Countries that exercise the principle of good faith in lending include; Austria, Belgium, Czech Republic, Denmark, Estonia, Germany, Greece, Hungary, Italy, Lithuania, Luxembourg, Poland, Romania, Slovakia, Slovenia, and Spain.

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