THE EFFECT OF PRUDENTIAL REGULATION ON THE STABILITY OF COMMERCIAL BANKS IN KENYA

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DECLARATION

This research project is my own original work and has not been presented for a degree in any other university.

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Supervisor's Approval

This research project has been presented for examination with my approval as the university supervisor.

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DEDICATION

I dedicate this research project to my sister Mercy who has been very inspiring throughout my Masters Degree course at the University of Nairobi. Her encouragement and best wishes were an enormous inspiration to me in this noble undertaking.

ABSTRACT

The contribution of commercial banks to the growth of Kenya's economy lays great emphasis on sound management of the institutions. Achieving stability in the banking industry has taken great effort from the government through its regulatory body, the Central Bank of Kenya. It is in recognition of their importance to the economy and the desire to ensure their continued existence that various measures have been taken to protect these institutions from financial instability. They include the introduction of prudential regulations which have guided commercial banks in conducting their business while cultivating a culture of fair competition in the industry.

This research evaluated the impact of prudential regulations on the stability of commercial banks in Kenya. It involved a census study of the forty four commercial banks operating in the country. Secondary data obtained from the Central Bank of Kenya and the Deposit Protection Fund Board was used. The supervisory and regulatory role of the CBK as well as measures taken to enhance banking stability in other continents such as Australia was comprehensively examined.

The concepts of Financial and Prudential regulation were studied and their contribution to enhancing banking stability highlighted. Also covered were theories on bank regulation, the CBK prudential guidelines as well as the core principles for effective banking supervision.

For the prudential regulations to achieve the intended results there is need for commitment and active participation of all stakeholders in the industry.

The research underscored the need to strengthen and improve the institutional environment for regulation. In the event of financial distress, various bank intervention measures were recommended with great attention to prompt corrective action. The role of the Deposit Protection Fund Board was highlighted with emphasis on its contribution in protecting depositors' funds and enhancing investor confidence in the banking industry.

The performance of the commercial banks was measured by the Return on Assets (ROA) with the Standard Deviation of the Return on Assets being used to evaluate their stability. The higher the Standard Deviation, the less stable the banks were deemed to be. The effect of prudential regulations was assessed by comparing the Standard Deviation of the Return on Assets for the period prior to implementation to that of the period after implementation of the regulations.

The study covered the period running from 1995 to 1998 (prior to implementation of prudential regulations) as well as 1999 to 2002 (after implementation of the regulations). The Standard Deviation of the Return on Assets for the period stretching from 1995 to 1998 was compared to the Standard Deviation of the ROA for the period running from 1999 to 2002.

The research showed that the Standard Deviation for the period after implementation was lower than that for the period prior to implementation of prudential regulations.
From the results, it was concluded that the implementation of prudential regulations in 1998 substantially enhanced the stability of commercial banks in Kenya.

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ABBREVIATIONS

AML	– Anti-Money Laundering
BCP	– Basel Core Principles
CBK	– Central Bank of Kenya
CMA	- Capital Markets Authority
DoC	– Department of Commerce
DPFB	– Deposit Protection Fund Board
FIRST	– Financial Sector Reform and Strengthening
FIU	– Financial Intelligence Unit
FSAP	– Financial Sector Assessment Programme
IFRS	– International Financial Reporting Standards
IMF	– International Monetary Fund
IOSCO	- International Organization of Securities Commissions
NBFI	- Non Bank Financial Institution
NEPAD	– New Partnership for Africa's Development
NPL	– Non-Performing Loans
ROA	- Return on Assets

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CHAPTER ONE

INTRODUCTION

1.1 Background of the study

Commercial Banks form an important part of financial markets, which play a crucial role in the growth of Kenya's economy. They support virtually all sectors of the economy by offering diverse services which go a long way in fostering the growth of these sectors. The roles played by commercial banks include: providing a payment system for the exchange of goods and services, providing finance and financial advice to the businesses and the general public and offering safe custody for deposits (CBK Bank Performance Report, 2010).

The country currently has forty four registered commercial banks. The banks have their target markets ranging from individuals, small scale businesses to large companies and the government. They are of utmost significance since they provide means by which financial resources move from one sector of the economy to another thereby enhancing the ease of financial transactions.

The banking industry in Kenya is governed by the Companies Act, the Banking Act, the Central Bank of Kenya Act and the various guidelines issued by the Central Bank of Kenya (CBK). The banking sector was liberalized in 1995 and exchange controls lifted. Over the last few years, this sector has continued to grow in assets, deposits, profitability and products offered. The number of registered commercial banks has also risen sharply over the last decade (Getenga, 2009).

In the period between 1989 and 1995, many Kenyan commercial banks were closed down and others placed under statutory management after experiencing financial crises. The situation was mainly caused by unethical and improper management of the institutions. It was in a bid to contain the trend of bank closures that the government, in the year 1995, through the Central Bank of Kenya instituted various measures, among them prudential regulations. The CBK was mandated to ensure compliance with the regulations by all commercial banks (DPFB Report, 2006).

Prudential regulation is an appropriate legal framework for financial operations. It is a significant contributor to preventing or minimising financial sector problems. Evidence shows that the absence of prudential regulations in some key areas can lead to bank failures and systemic instability, while establishing sound, clear and easily monitored rules for financial activities both encourages managers to run their institutions better and facilitates the work of supervisors (Brownbridge, 2002).

A major weakness of some financial systems is the fact that various financial institutions, especially cooperatives and intermediaries in rural areas, operate completely outside prudential regulations (Brownbridge, 2002).

Some countries have one single general banking law, which tries to assemble all regulations, but in many countries the operational issues are left to statutory notes, circulars or even simply the routine decisions of the supervisory institution. Various other laws can have an impact on the operations of financial institutions, for example, company laws, securities laws, debt recovery laws and laws on liquidation and bankruptcy.

Bank regulations are a form of government regulation which subject banks to certain requirements, restrictions and guidelines (Kirkpatrick, 2002).

In Kenya, commercial banks are regulated by the Central Bank of Kenya, which publishes prudential guidelines regularly and relays these to all commercial banks. It also ensures compliance with the guidelines through close monitoring.

The emergence of many commercial banks in Kenya is a measure of the growth and expansion of the sector. It is important to evaluate the effect of the prudential regulations on the stability of the industry.

1.2 Statement of the problem

Kenya has forty four registered commercial banks, all of which have diverse objectives and master plans for growth and expansion. They also have different profit targets, are in competition with each other and are each endeavouring to establish in the market in terms of customer base. Banks offer almost similar products to the public. Their main business is to be custodians of customers' money while providing finance to individuals and businesses in the form of loans for various development projects geared towards promoting economic growth and stability (Gatere, 2009).

The diversity of their objectives, profit targets and customer segments coupled with the large number of intermediaries with different objectives is likely to introduce malpractices in the industry which could have serious implications on the image of the financial institutions as well as stability of the economy. These include: information asymmetry, moral hazard, hoarding of foreign currency reserves, undue increase in interest rates on credit facilities, excessive lending to the public giving rise to inflation and money laundering. If not controlled, these may have severe consequences on the economy. Some of the effects are: banking sector collapse, poor and inequitable distribution of funds to the various sectors of the economy, exploitation of the public owing to inadequate information when investing, instability of the local currency and capital scarcity for business investments arising from high interest rates on loans among others (Viterbo, 2007).

The banking sector in Kenya, if not protected, may also be vulnerable to external hazards such as the global financial crisis that affected nations like the United States of America. The effects of such crises are not easy to contain and thus prevention through regulation remains the best remedy (Gatere and Randa, 2009). Banks play a great role in facilitating international trade by providing an easy payment system thus simplifying financial transactions between nations. Out of these transactions, the CBK is able to obtain the balance of trade and balance of payment statistics, information that is useful to the government since it enables it to correct trade imbalances and in the process protect the Kenya currency from depreciation.

Owing to the great importance of commercial banks to Kenya's economy and the hazards they are exposed to, there is need to protect them and ensure their stability. It is therefore, in public interest, for the government to play a significant role in taking appropriate measures to guarantee efficiency and stability of this crucial industry. To facilitate this, the government has established a regulatory body for commercial banks in Kenya. The Central Bank of Kenya is the monitor and supervisor of the activities of commercial banks and has, in the performance of this role, instituted various prudential regulations which include: monetary policy guidelines, guidelines on Agent Banking, Foreign Exchange Bureau guidelines, guidelines on Business Continuity Management (BCM) and guidelines on Deposit Protection (CBK Act, 1998).

A number of research studies have been carried out on the stability of Kenya's commercial banks. Some of the researchers include: Thorsten, Jared and Peter (2009) who conducted a study on the stability, efficiency and outreach of banks in Kenya; Teimet, Ochieng and Aywa (2009) whose study was on performance of commercial banks in Kenya and Nzomo (2009) who studied financial sector regulation in Kenya.

This research endeavours to establish the extent to which prudential regulations have contributed to cushioning the banks against financial crises, reputational damage, investor apathy and collapse thus enhancing their stability.

1.3 Research Objectives

The objective of the study was to evaluate the effect of the prudential regulations on the stability of commercial banks in Kenya.

1.4 Significance of the Study

Commercial Banks enhance their understanding of the factors leading to the introduction of prudential regulations to govern their operations in Kenya. It is with this understanding that all commercial banks will embrace the prudential regulations which will in turn improve their performance and internal control mechanisms.

The general public will have more confidence in the sector since, with the knowledge of the prudential regulations that govern the institutions, they will feel protected and that their funds in the commercial banks are safe.

The study will evaluate whether all the prudential regulations are practical or whether there is need for amendment or repeal of any of the regulations.

The study will also establish whether there is need for the introduction of more stringent regulations to curb any malpractice that may arise.

CHAPTER TWO

LITERATURE REVIEW

2.1 INTRODUCTION

This chapter includes the theories of financial and prudential regulations, the factors underpinning their introduction, enforcement and the effect of the regulations on the stability of commercial banks in Kenya. It also covers the need for close supervision of commercial banks to ensure strict adherence to the regulations. The chapter as well includes a review of the consequences of non-adherence to the regulations by commercial banks in Kenya.

2.2 THE CONCEPT OF PRUDENTIAL REGULATION

Prudential regulation is monitoring of deposit-taking institutions, supervision of the conduct of these institutions and laying down requirements that limit their risk-taking. The aim of prudential regulation is to ensure the safety of depositors' funds and maintain the stability of the financial system (Brownbridge, 2002).

Regulations refer to the rules and policies set by a legally authorised body governing the activities of institutions under its supervision. The body has legal powers to take disciplinary action against institutions found to be contravening the regulations set (Brownbridge, 2002). In Kenya the body mandated to monitor and supervise the operations of commercial banks is the Central Bank of Kenya.

2.3 THE CONCEPT OF FINANCIAL REGULATION

Financial regulation is a form of regulation or supervision, which subjects financial institutions to certain requirements, restrictions and guidelines, aiming to maintain the integrity of the financial system. This may be handled by either a government or non-governmental organisation (http://en.wikipedia.org/wiki/Financial regulation, 18/09/2011)..

Financial regulatory authorities regulate all financial activities, but in some cases, there are specific authorities to regulate each sector of the finance industry, mainly banking, securities, insurance and pensions markets. For example, in Australia, the Australian Prudential Regulation Authority (APRA) supervises banks and insurers, while the Australian Securities and Investments Commission (ASIC) is responsible for enforcing financial services and corporations laws (http://en.wikipedia.org/wiki/Financial regulation 09/09/2011).

Sometimes more than one institution regulates and supervises the banking market, normally because, apart from regulatory authorities, central banks also regulate the banking industry. In the USA banking is regulated by many regulators, such as the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the National Credit Union Administration, the Office of Thrift Supervision, as well as regulators at the state level (Trandafir, 2009).

The structure of financial regulation has changed significantly in the past two decades, as the legal and geographic boundaries between markets in banking, securities, and insurance have become increasingly globalised.

Recent experience in emerging markets has shown that financial crises can be highly damaging to economies, government budgets and living standards. This realisation has reinforced interest in improving financial sector regulation and supervision. The objective of prudential regulation is to protect the stability of the financial system and deposits. The main focus of prudential regulation is on the safety and soundness of the banking system and on non-bank financial institutions that take deposits. Their research showed that in low income countries, effective prudential regulation is impeded by: Weak accounting standards, poor quality of financial information available, acute shortage of necessary professional skills poor public sector pay, politicisation of regulatory processes, difficulty in enforcing bureaucratic and legal regulations which is partly due to political interference in the regulatory process. Small financial systems do not offer opportunities for economies of scale in data collection and information technology systems (Brownbridge, Kirkpatrick and Maimbo, 2002).

The prudential reforms in developing countries are usually based on upgrading banking laws in accordance with international best practice such as bringing minimum capital requirements in line with Basel Capital Accord and strengthening the supervisory capacities of regulatory agencies. Many developing countries are setting up deposit insurance schemes. Some researchers have however suggested that 'best practice' regulatory reforms may not significantly reduce the probability of a banking crisis (Barth, Caprio and Levine, 2001).

2.4 OBJECTIVES OF BANK REGULATION

The emergence of the many commercial banks in Kenya places great need on regulation to streamline the industry and achieve the following objectives among others: To reduce the level of risk to which bank creditors are exposed (to protect depositors), systemic risk reduction—to reduce the risk of disruption resulting from adverse trading conditions for banks causing multiple or major bank failures, avoid misuse of banks—to reduce the risk of banks being used for criminal purposes such as laundering the proceeds of crime, to protect banking confidentiality, credit allocation—to direct credit to favored sectors, to protect the general public from exploitation and fraud; to enhance public confidence in the banking sector (Demirguc-Kunt and Detragiache, 2000).

2.5 THEORIES OF FINANCIAL REGULATION

Many theories have been advanced regarding the concept of Financial Regulation.

2.5.1 Staged Approach Theory

According to the theory, regulatory failure causing financial crises had occurred with great frequency in the period between 1995 and 2005 in both advanced and emerging nations (Currie, 2006). The author was of the view that theories of regulation had failed to define and describe the meanings of deregulation, the range of regulatory models and their goals, the significance of regulatory failure, how to measure and prevent it. The paper was motivated by the perception that incorrect design and failure to conduct ongoing performance monitoring of regulatory models in emerging economies as well as in some advanced industrial states was precipitating financial crises. The theory redefined deregulation in a framework that recognised the diversity between financial systems that existed due to differences in regulatory models. in the ability to comply with best international structure. in the ownership of the means of production and in the calibre of human and social capital (Currie, 2006).

Case studies of regulatory failure in advanced and emerging nations illustrated the necessity for a staged approach to liberalisation of a financial system, which takes account of the capacity of the underlying economy and society to conduct effective prudential supervision before attempts are made to remove protective measures. The theory emphasised the need for correct embodiment of government goals in regulatory models and the importance of feedback mechanisms such as the establishment of early warning systems (Currie, 2006).

2.5.2 The Green Lantern Theory of Financial Regulation

The Green Lantern theory of financial regulation suggests that financial regulation is fundamentally a question of the administration's will. The theory places great emphasis on the need for governments to strongly support financial regulation. However there is a limitation to the success of the administration in instituting regulation; the legislative body of a country must also play a role in the success of the regulations (Durbin, 2008). Senator Durbin argued that when evaluating the financial regulation package, it would be useful if people were a bit clearer when distinguishing between what the administration thinks about the financial sector and what the administration thinks it can get through a country's legislative body. The US government was willing to institute regulation to protect the interests of Americans who had taken bank mortgages at the height of the financial crisis in 2008, but the senate stood in the way (Durbin, 2008).

2.5.3 Microprudential Regulation Theory

According to the theory, traditional microprudential regulation of banks is based on the logic that banks finance themselves with government-insured deposits (Samuel, Anil and Jeremy, 1981).

While deposit insurance has the valuable effect of preventing bank runs, it also creates taxpayer exposure and an accompanying moral hazard problem for bank managers. The goal of capital regulation is to force banks to internalize the losses on their assets, thereby protecting the deposit insurance fund and mitigating moral hazard. Thus if the probability of the deposit insurer bearing losses is reduced to a low enough level, microprudential regulation is by definition doing its job (Diamond and Dybvig, 1983).

2.5.4 Macroprudential Regulation Theory

According to this theory, macroprudential approach to capital regulation is an effort to control the social costs associated with excessive balance-sheet shrinkage on the part of multiple financial institutions hit with a common shock. It follows that in order to make a compelling case for macroprudential regulation, it is necessary to answer two questions. First, the exact costs imposed on society when many financial firms shrink their assets at the same time should be understood. Secondly, it should be established why individual banks do not properly internalise these costs (Samuel, Anil and Jeremy, 1981).

There are two primary costs of generalised asset shrinkage: credit-crunch and fire-sale effects. If banks shrink their assets by cutting new lending, operating firms find credit more expensive, and reduce investment and employment, with contractionary consequences for the macroeconomy (Samuel, Anil and Jeremy, 1981).

Thus there is a strong presumption that macroprudential capital regulation should be applied to more than just insured deposit-taking institutions. The broader point is that regulators need to pay attention to all the channels through which the actions of financial institutions can cause damage, and must take steps to contain the various channels (Tucker, 2010).

2.6 CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

Kenya is a regional financial and trade centre for Eastern, Central, and Southern Africa. There are many principles that the country's regulatory bodies find useful in performing their supervisory role. The principles are discussed below:

2.6.1 Clear responsibilities and objectives for each supervisory agency

The CBK is the regulatory and supervisory authority for Kenya's deposit-taking institutions, as well as mortgage companies and other financial institutions. The main responsibility of the CBK is to foster a stable market based financial system. This includes enhancing the legal and regulatory framework for the banking sector. The Banking (Amendment) Act, which became operational on May 1, 2007, effectively ceded the authority to issue or revoke licenses from the MoF to the CBK (CBK Annual Report, 2007).

2.6.2 Operational independence and adequate resources

The Central Bank of Kenya Act provides for the CBK's operational autonomy, and strengthens its bank supervision functions (U.S. DoC's Country Commercial Guide, 2007).

2.6.3 A suitable legal framework for authorization and ongoing supervision

The 2007 Address by the Governor of the CBK, published in the BIS Review, recognises the need to bring the legal framework for regulating the banking sector up to speed with international developments. As reported in the CBK's 2007 Annual Report, the CBK has undertaken a comprehensive review of the Banking Act to address shortcomings, and bring it in line with the BCPs (CBK Annual Report, 2007).

2.6.4 Clearly defined permissible activities for banks and control of the use of the word 'bank'

The CBK provides detailed guidelines on, among others, preventing prohibited business practices as specified under the Banking Act. The guidelines apply to all transactions conducted by an institution and reflected on the balance sheet or reflected as off-balance sheet items (CBK Prudential Guidelines Report, 2006).

2.6.5 Criteria for structure, directors, operating plan, controls, financial condition and capital base

The CBK provides for detailed guidelines on, among others, corporate governance. The guidelines stipulate the minimum standards required from directors, chief executive officers and management of an institution so as to promote proper standards of conduct and sound banking practices, as well as to ensure clarity and effectiveness in the exercise of their duties and responsibilities.

Pursuant to the guidelines, shareholders are responsible for the appointment of a competent and dedicated board of directors, and management responsible for taking decisions in accordance with prudent banking practices (CBK Prudential Guidelines Report, 2006).

2.6.6 Authority to review and reject transfer of ownership

The CBK provides for detailed guidelines on licensing of new institutions. The guidelines further authorise the CBK to appraise the application upon receipt and make appropriate recommendations to the MoF (CBK Prudential Guidelines Report, 2006).

2.6.7 Authority to review major acquisitions and investments

There are detailed guidelines on mergers, amalgamations and transfer of assets and liabilities as specified under the Banking Act. Pursuant to the guidelines, shareholders and directors are responsible for ensuring that the provisions are adhered to by the institutions intending to merge, amalgamate or transfer assets and liabilities. The guidelines further authorize the CBK to appraise the name under which financial institutions intend to register in case of change of name and make appropriate recommendations to the MoF (CBK Prudential Guidelines Report, 2006).

2.6.8 Minimum capital adequacy requirements (meet Basle Capital Accord for internationally active banks)

There are detailed guidelines on capital adequacy. The Banking Act empowers the CBK to prescribe the minimum ratios to be maintained by financial institutions, as well as determine the method for asset valuation and classification (CBK Prudential Guidelines Report, 2006).

2.6.9 A method for the evaluation of procedures related to loans, investments and portfolio management

The ratio of NPLs to total loans in the Kenyan banking sector remains relatively high, although it has significantly declined over the years. According to the CBK's 2007 Annual Report, the ratio of NPLs to total loans declined from 14.9 percent in 2006 to 8.1 percent in 2007. There are detailed guidelines on risk classification of assets and provisioning as specified under the Banking Act (CBK Prudential Guidelines Report, 2007).

Pursuant to the guidelines, financial institutions are required to maintain adequate provisions for bad and doubtful debts prior to disclosing profits or dividends. The 2007 CBK Governor's Address states that the Banking (Amendment) Act of 2006 requires licensed institutions to share credit information on NPLs.

2.6.10 Arm's length rule and monitoring for connected lending

The banking act prohibits institutions from granting or from permitting to be outstanding any advance or credit facility to any of its directors or other person participating in the general management of the institution (CBK Prudential Guidelines Report, 2006).

2.6.11 Policies and procedures for country risk and transfer risk

The CBK provides detailed guidelines on foreign exchange exposure limits. The guidelines stipulate that, as a general rule, the overall foreign exchange risk exposure of an institution should not exceed 20 percent of the institution's core capital (CBK Prudential Guidelines Report, 2006).

2.6.12 Comprehensive risk management processes

The CBK Risk Management Guidelines provide guidance to financial institutions on the development of risk management systems and frameworks. The CBK states that the guidelines are in line with international best practices. As the guidelines spell out, institutions that do not have independent risk management structures must immediately set up units to concentrate fully on the risk management function which, in order to ensure independence, reports directly to the board (CBK Risk Management Guidelines, 2005).

2.6.13 Adequate internal controls

The Risk Management Guidelines stipulate that the risk management programs of each financial institution should contain adequate internal controls (CBK Risk Management Guidelines, 2005).

2.6.14 Strict "know-your-customer" rules and high ethical and professional standards

Kenya has not developed an effective AML regime. In November 2006, the government of Kenya published a proposed Proceeds of Crime and Anti-Money Laundering Bill. The proposed Bill authorises the establishment of a Financial Intelligence Unit (FIU), and requires financial institutions to file suspicious transaction reports. The bill does not explicitly mention terrorism, nor does it define criminal activities (US DoS report, 2009).

2.6.15 Effective supervisory system consisting of on-site and off-site supervision

The Banking Supervision Department of the CBK has a well-founded off-site and on-site supervision programme. Upon licensing, the CBK visits all authorised institutions, and carries out on-site inspections to confirm existence of comprehensive risk management policies (CBK Prudential Guidelines Report, 2006).

2.6.16. Consistent accounting policies and practices that provide a true and fair view of the financial condition of the bank

Kenya has adopted the International Financial Reporting Standards (IFRSs) in 1998, thereby closing the gap between national and international accounting standards.

The Institute of Certified Public Accountants of Kenya (ICPAK), in its 2005 self-assessment prepared as part of the International Federation of Accountants' member body compliance program, points out that the Banking Act and the Central Bank Act set out minimum disclosure requirements whose compliance is verified by the CBK (World Bank Report, 2001).

2.6.17 Adequate supervisory measures to ensure timely corrective action

The CBK has the authority to take remedial measures and impose administrative sanctions on financial institutions, their board of directors or their officers. The CBK prudential guideline on enforcement of banking laws and regulations has been formulated to provide information and guidance to the banking industry on the approach the CBK will take in issuing supervisory directives and corrective orders to institutions. It also provides an outline of specific corrective and remedial measures (World Bank Project Appraisal Document, 2004).

2.7 THE CENTRAL BANK OF KENYA PRUDENTIAL GUIDELINES FOR INSTITUTIONS LICENSED UNDER THE BANKING ACT

The CBK has published prudential guidelines governing institutions licensed under the banking act.

2.7.1 Licensing of New Institutions

The guidelines outline the terms, requirements and procedure for licensing new financial institutions (CBK Prudential Guidelines, 2006).

2.7.2 Corporate Governance

The guideline stipulates that the commercial banks must be corporate entities. It outlines the structure of bank management and requires them to have a constitution or articles of association (CBK Prudential Guidelines, 2006).

2.7.3 Capital Adequacy

Section 18 of the Banking Act empowers the Central Bank of Kenya to prescribe the minimum ratios that shall be maintained by institutions as between their core capital and total capital on one hand and their risk weighted assets and off-balance sheet items on the other, and for that purpose, may also determine the method of classifying and evaluating assets (CBK Prudential Guidelines, 2006).

2.7.4 Risk Classification of Assets and Provisioning

The Guideline is issued under Section 33(1) of the Banking Act, which empowers the Central Bank to advise and direct business of institutions for the general carrying out of the purposes and provisions of the Banking Act (Cap.488). Central Bank of Kenya is authorised under Section 20 of the Banking Act to prescribe guidelines and ensure institutions maintain adequate provisions for bad and doubtful debts prior to declaring profits or dividends (CBK Prudential Guidelines, 2006).

2.7.5 Liquidity Management

The objective of liquidity management is to ensure that an institution is able to meet, in full, all its obligations or commitments as they fall due. An institution is required to hold adequate liquid assets to fund maturing claims for prudent business management. It is therefore important for management to not only measure liquidity on an on-going basis, but also to examine ways of how to fund liquidity requirements during distress situations (CBK Prudential Guidelines Report, 2006).

2.7.6 Foreign Exchange Exposure Limits

This Guideline is intended to ensure that the potential risk of loss arising from foreign exchange rate fluctuations to a bank's capital base is within prudential limits.

2.7.6.1 Limit on overall foreign exchange risk exposure

The overall foreign exchange risk exposure as measured using spot mid-rates and shorthand method shall not exceed 20% of the institution's core capital.

2.7.6.2 Limit on Single currency foreign exchange risk exposure

The foreign exchange risk exposure in any single currency, irrespective of short or long position, will be determined by the individual institution provided it remains within the overall exposure limit of 20% of its core capital (CBK Prudential Guidelines, 2006).

2.7.6.3 Limit on intra-day foreign exchange risk exposure.

Intra-day foreign exchange risk exposures, both in single currencies and overall, shall be maintained within prudent limits as established by a bank's board of directors in a written policy covering foreign exchange risk exposure (CBK Prudential Guidelines, 2006).

2.7.7 Prohibited Business

This guideline is intended to prevent prohibited business practices as specified in Part III of the Banking Act and as restricted elsewhere in the Act. It applies to all transactions conducted by an institution and reflected on the balance sheet or reflected as off-balance sheet items (CBK Prudential Guidelines, 2006).

2.7.8 Guideline on Proceeds of Crime and Money Laundering (Prevention)

The purpose of this guideline is to provide guidance regarding the prevention, detection and the control of possible money laundering activities and terrorism financing. This guideline shall apply to all institutions licensed to transact business under the Banking Act. It highlights methods of prudent customer identification, record keeping, identification of suspicious activities and the need to report such activities to the appropriate authority for further investigation (CBK Prudential Guidelines Report, 2006).

2.7.9 Guideline on appointment, duties and responsibilities of external auditors

The registered public accounting firm's opinion lends credibility to the institution's financial statements and thereby assists in promoting confidence in the financial system. It is in recognition of this important role that the Banking Act, stipulates that the registered public accounting firm being appointed by the institution be approved by the Central Bank annually (CBK Prudential Guidelines Report, 2006).

2.7.10 Guideline on publication of financial statements and other disclosures

This regulation is intended to enhance market discipline in the banking and financial sector in general. As custodian of public funds, banking institutions have the responsibility to safeguard their integrity and credibility in order to maintain public confidence. It is under these considerations that institutions are required to periodically publish their financial statements in order to avail timely information to all stakeholders. This would also encourage institutions to enhance prudent management of their affairs and exercise self- regulation (CBK Prudential Guidelines Report, 2006).

2.7.11 Guideline on opening of new place of business, closing existing place of business or changing location of place of business

This guideline has been issued to assist institutions applying to open new places of business, close the existing places of business or change location of business in or outside Kenya. This guideline provides clear regulatory requirement that should be fulfilled prior to an institution being granted an approval to open, close or change location of an existing place of business.

2.7.12 Guideline on mergers, amalgamations, transfers of assets and liabilities

This guideline has been prepared pursuant to section 9 and section 13(4) of the Banking Act to assist institutions intending to merge or amalgamate and/or transfer assets and liabilities, and facilitate transfer of significant shareholding (CBK Prudential Guidelines Report, 2006).

2.7.13 Guideline on enforcement of banking laws and regulations

This Guideline is intended to provide information and guidance to the banking industry on the approach the Central Bank will take in issuing prompt supervisory directives and corrective orders to institutions.

Supervisory enforcement actions have attempted to set forth the banking practices, conditions, and violations of law giving rise to the particular problems or weaknesses identified, ordinarily through on-site examinations. Supervisory enforcement actions are also to be used to provide an outline of specific corrective or remedial measures, including appropriate time frames and goals for achievement of compliance (CBK Prudential Guidelines Report, 2006).

2.8 WHY PRUDENTIAL REGULATIONS ALREADY IMPLEMENTED IN DEVELOPING COUNTRIES HAVE FAILED TO ENHANCE BANKING STABILITY

2.8.1 Weak regulations and gaps in regulation

The loan classification and provisioning rules in the East African countries hit by the financial crisis of 1997/98 were much laxer than international norms especially for secured loans. For banks with impaired asset portfolios, provisions were insufficient to cover losses and as a result regulatory capital was overstated. Stricter rules would have helped reduce East Africa's financial distress because banks would have either had to raise more capital earlier, to meet minimum capital standards or they would have had to reduce the rate of growth of their loan portfolios (Martin, Colin and Samuel, 2002).

2.8.2 Weak enforcement of regulations

Weak enforcement of regulations has led to several problems in the banking sector. This includes failing to penalise insider lending and large loan exposures and failing to intervene promptly in insolvent banks and NBFIs.

Several factors contribute to the weak enforcement of regulations. First, the banking laws lack clear rules mandating the type and timescale of intervention in problem banks which regulators should make. Instead the laws allow the regulators the scope to exercise discretion, leading to forbearance. Secondly, the regulators are not fully independent from politicians even in situations where they have legal independence. Often the finance minister's approval is required before a bank can be intervened (Martin, Colin and Samuel, 2002).

2.8.3 Supervisory capacity constraints

Supervisory capacities have improved significantly in many low income developing countries since the 1980s due to recruitment and training of bank supervisors, better supervisory methodologies and improved reporting formats for off-site supervision. Nevertheless regulators still face capacity constraints. They often lack skills such as forensic accounting and the ability to evaluate the quality of bank management. As banks and NBFIs engage in more sophisticated financial activities - such as the use of derivatives - regulators' skills will need to be continuously upgraded (Martin, Colin and Samuel, 2002).

2.9 STRENGTHENING PRUDENTIAL REGULATIONS

For developing countries, prudential regulations need to be easy to understand and enforce in situations where accurate financial information is at a premium and supervisory capacities are weak. They should reward prudent risk management and punish reckless and abusive management.

The minimum capital adequacy levels should be set higher than the eight per cent minimum of the Basle Capital Accord (Martin, Colin and Samuel, 2002).

Tougher bank licensing procedures - especially scrutinising the fit and proper status of applicants, their financial resources and the managerial and technical expertise they can mobilise - have several potential advantages as well as the obvious one of denying licences to banks with weak ownership and management which are likely to fail (Martin, Colin and Samuel, 2002).

According to their study, reducing the number of small, poorly managed banks and NBFIs by screening them out at the licensing stage will help to reduce the supervisory workload. However, licensing policies should not be so restrictive as to stifle entry from banking investors able to serve small and medium sized enterprises which are often poorly served at present by the international banks in low income developing countries (Viterbo, 2007).

2.10 BANK INTERVENTION POLICIES

2.10.1 Closure of insolvent banks

In general when banks become insolvent, unless this poses a risk to the whole banking system, the regulator should intervene promptly and close the bank. This is because the chances of successfully rehabilitating an insolvent bank are likely to be poor. Its losses are probably far higher than the regulator realises and private investors are very unlikely to inject capital into an already insolvent bank. Keeping an insolvent bank open is likely to lead to further losses at the expense of its depositors or taxpayers. Liquidity support to distressed banks should be restricted in terms of both quantity and timeframe. Other than in situations of systemic banking crisis, insolvent banks should not be propped up with liquidity support (Viterbo, 2007).

2.10.2 Restriction of statutory management of banks

Central Banks must develop clear guidelines for managing banks in crises. Sometimes, rather than close a bank, the regulator places it under statutory management. This allows the existing unsuccessful management to be removed but poses many problems for the regulator who is then forced either to assure uninsured creditors that their money is safe or to provide the liquidity support needed when such investors withdraw their funds. Keeping a distressed bank open under statutory management is likely to protect uninsured creditors at the expense of public funds and should be avoided in all cases except where the government has already guaranteed bank liabilities, such as in the case of a government owned bank (Viterbo, 2007).

2.10.3 Formulation of mandatory intervention rules

The banking laws should include a clear set of mandatory intervention rules, such as the Prompt Corrective Action (PCA) rules in the U.S. where specified regulatory intervention is automatically triggered by reductions in a bank's regulatory capital. Such rules should mandate regulators to force capital impaired banks to take remedial action immediately and should permit regulators to close banks even when their reported capital is still positive (Martin, Colin and Samuel, 2002).

2.11 DEPOSIT INSURANCE

The Deposit Protection Fund Board (DPFB) is a significant player in the financial sector as it provides a safety-net for the savings, banking and payments systems in the Republic of Kenya. It plays the role of protecting depositors against loss of all their deposits in case of a bank failure, by providing payments of insured deposits thereby ensuring depositors remain confident enough to continue keeping their savings within the banking and payments system (CBK Bank Supervision Report, 2010).

The Board was established in response to challenges presented by banking crises and bank failures in the country and it has proved its worth during the twenty years of its existence.

Moral hazard caused by government guarantees of financial institutions' liabilities makes a major contribution to banking crises. Many developing countries have set up deposit insurance schemes in the last decade. If the alternative is implicit deposit protection without clear rules then such schemes may have advantages. Deposit insurance for small deposits may also be justified on grounds of equity because it protects the savings of poor investors. Nevertheless there is much cross-country evidence to suggest that the more generous the deposit insurance scheme is the higher the likelihood of a banking crisis. Therefore the size of protected deposits must be strictly limited so that a substantial share of the banks' deposit base is uninsured (Dewatripont and Tirole, 1994).

Following the banking crisis of 1985/86, Kenya established a Deposit Protection Fund Board (DPFB) with a wide mandate. Specifically, the DPFB's main tasks are to manage the deposit insurance fund and carry out the liquidation of insolvent institutions once they have been closed by CBK (by repaying protected deposits and dividends, carrying out debt recovery, and winding up the institutions under liquidation). DFPB offers protection to small depositors up to Kshs 100,000 (USD 1,250) against loss of their savings in case of a bank failure. Institutionally, DFPB is part of CBK and relies on staff from CBK, but also on information from CBK's supervisory department.

In order to improve the role of the DPFB in enhancing depositor confidence, initiatives are underway to enact a new and separate Kenya Deposit Insurance Corporation Act that will give the Fund autonomy in its operations. Among other additional roles, the draft Act provides the DFPB with powers to request the Central Bank to carry out an inspection of a member institution and, where deemed necessary, to conduct the examination itself (Dewatripont and Tirole, 1994).

2.12 IMPROVING THE INSTITUTIONAL ENVIRONMENT FOR REGULATION

Strengthening prudential regulation requires institutional reforms which not only protect the regulators from political interference but also stimulate the regulators to act in the best interests of depositors and the public. Regulators need an unambiguous legal mandate to protect deposits and the stability of the financial system, and should not be given potentially conflicting mandates such as promoting economic development. This mandate, and the operational independence of the regulator to carry it out, should be explicitly set out in the relevant legislation such as the written constitution of the country. However this legal independence will be meaningless unless the head of the regulatory agency has a legal guarantee of job security for the duration of his or her contract.

More effective regulation will also require continuous strengthening of supervisory capacities (Martin, Colin and Samuel, 2002).

2.12.1 Risk Based Supervision

Risk based supervision involves the regulators focusing on those aspects of the financial system which pose the greatest risk to its stability. Since supervisory resources are very scarce in developing countries, regulators should concentrate on those banks that present the largest risk and on the business activities that pose the greatest threat to the safety and soundness of the bank (Brownbridge, Kirkpatrick and Maimbo, 2002).

2.12.2 Market Based Approaches to Regulation

Some researchers have called for greater use of the market to monitor banks. because they doubt that public regulators will ever have strong enough incentives or resources to monitor banks as effectively as would private investors with their own money at stake. One proposal for a market based approach entails banks being required to finance a minimum percentage of their assets with subordinated and unsecured debt carrying a yield capped at a maximum premium above the riskless market interest rate (Calomiris, 1997).

2.13 EMPIRICAL REVIEW

A study on the stability. efficiency and outreach of Kenya's banking system highlighted that while Kenya's financial system was by far the largest and most developed in East Africa and its stability had improved significantly over the past years, many challenges remained. The challenges included a fragmented banking system and non-performing loans. This was caused by; under-capitalization, high levels of non-performing loans and weaknesses in corporate governance (Thorsten, Jared and Peter, 2009).

Several measures by the government had contributed towards the stability of Kenya's commercial banks including; the government reform strategy, consolidation of small banks, increasing banks' capital requirements, reducing government borrowing, introducing a limited deposit insurance scheme and provisioning aggressively against non-performing loans (Thorsten, Jared and Peter, 2009).

A research study carried out by Teimet, Ochieng and Aywa in 2009 titled: 'Income Source Diversification and Financial Performance of Commercial Banks in Kenya', attributed the stability of commercial banks in Kenya to diversification of income sources. The study highlighted that banks no longer relied solely on their traditional income sources: proceeds of the inter-mediation transactions between demanders and suppliers of money at a given consideration. The institutions had opened new income avenues (Teimet, Ochieng and Aywa, 2009).

The findings revealed that large banks enjoyed economies of scale and could take risky projects which medium and small banks could not undertake. Ownership did not influence income source diversification level of commercial banks in Kenya, since private and public banks were at par in diversification. The Islamic banks were also diversified though at early phases of product development. Large banks may have more developed risk management techniques or may be involved in fundamentally different types of activities with different distributions

The stability of commercial banks in Kenya has been attributed to the stability of non-interest income diversification level. Larger banks have greater ability to diversify risk and should be safer in operation and thus have lower cost of funding than smaller ones. Larger banks may have relatively better profitability, hence are more stable than smaller ones (Teimet, Ochieng and Aywa, 2009).

In October 2009, Nzomo, a manager for research and development at the Retirement Benefits Authority, conducted a research on the effect of financial regulation on the performance and stability of financial institutions in Kenya. His study also covered: Financial sector regulatory structure in Kenya, Principles of financial sector regulation, Case for and against consolidated regulation, Way forward for financial sector regulation.

There were many regulatory overlaps which needed to be addressed in order to strengthen Kenya's financial sector. The following were the areas of overlap in regulation: Commercial banks that conducted Bancassurance and Insurance Premium Financing were being regulated partially by the Insurance Regulatory Authority as well as the CBK, listed insurance companies were regulated by both the Capital Markets Authority as well as the Insurance Regulatory Authority, listed commercial banks also had two regulators – CMA and CBK (Nzomo, 2009).

The study highlighted that the overlaps substantially reduced the independence of each of the regulators. The reduced independence implied that none of the regulators could take action against the companies under their supervision without influence from the other parties. This had an effect on the stability of the financial sector since the policies of the regulators were not uniform. These overlaps, the research revealed, also brought with them regulatory gaps and as a consequence, some players in the sector were not adequately regulated leading to poor performance and instability. The regulatory gaps affected: The Savings and Credit Cooperative Societies, The Kenya Post Office Savings Bank (KPOSB) and Development Finance Institutions (Nzomo, 2009).

The findings showed that the performance and stability of the financial sector in Kenya was not at its best owing to the regulatory overlaps and gaps. Recommendations to address this included: the regulator should have a clear mandate set out in its enabling legislation to enable it discharge its mandate, decisions by the regulator within its sub-sector should not be subject to undue influence from the ministry of finance or any other party; the regulator must have adequate funding, preferably through industry levy, so as to ensure independence and enable the industry have a role in checking the regulator's spending; the regulator must be able to take enforcement measures against all the players that it is required to regulate; regulation should be comprehensive and not leave any regulatory gaps and the direct cost of regulation in terms of levies and fees as well as indirect compliance costs should be reasonable and not an undue burden on the regulated institutions.

The study further emphasised the need for co-operation between the various regulatory bodies in Kenya, CBK, IRA, CMA and RBA. The co-operation would be in such areas as: Information sharing, Joint onsite supervision, Registration and licensing, Staff exchange programmes, Research and statistics, Coordinated review of emerging products, Review of legal and compliance framework, Consolidated strategy to influence policy and legislation.

The research also highlighted the following lessons from the global financial crisis: There is a regulatory deficit in global finance, financial liberalisation must be accompanied by stronger prudential regulation and supervision, international cooperation is needed in regulation, regulation must be comprehensive to cover all financial activities, instruments and actors (Nzomo, 2009).

To improve banking sector stability, several recommendations were brought forth: Increasing domestic savings from 17 to 30 percent of GDP, increasing access to finance from below 75 to 85 percent of the population, increasing bank deposits from 44 to 80 percent of GDP, increasing market capitalization from 50 to 90 percent of GDP (Nzomo, 2009).

2.14 SUMMARY OF LITERATURE REVIEW

The many reports and findings on prudential regulations have gone a long way in improving the way commercial banks conduct their business. The findings have underscored the need to continuously evaluate the effect of regulations on commercial banks. The regulator of commercial banks, the Central Bank of Kenya has in the reports published given an account of the outcome of the various guidelines on the performance of banks. The recommendations of some of the research findings have also emphasised the need to protect local commercial banks from global crises. Kenya has experienced banking sector crises in the past and these recommendations thus assist in addressing the matter.

Kenya's post-independence period was one of tremendous economic growth characterised by conscious government policy to transfer economic activity into the hands of indigenous Kenyans. The banking sector was no exception and given the large number of new entrants and low levels of expertise and experience, disaster was bound to strike at any time.

Twenty years after independence, in 1983, the stage was set for Kenya's first post-independence banking crisis when several indigenous banks developed acute liquidity problems. In spite of efforts by Treasury and Central Bank to bail out the ailing institutions, one institution was closed in December 1984. This crisis and failure exposed the inadequacy of the safety-net and failure resolution mechanisms existing at the time, which precipitated amendments to the Banking Act in 1985 to expand the safety net and improve the bank failure resolution mechanism. The DPFB was established as a deposit insurance scheme to provide cover for depositors and act as liquidator of banks which could not be salvaged. The same amendments gave Central Bank of Kenya the responsibility of risk minimization through enhanced prudential regulation, supervision and surveillance. The function of curator and revival of ailing institutions was also entrusted to the Central Bank (CBK Bank Supervision Report, 2010).

The early 1990s were characterized by intensive political activity with the resurgence of multi-party politics. An unfortunate by-product of this activity was a mushrooming of banks licensed for political exigencies. In 1993 alone, eleven institutions were placed under liquidation. Ten of these were under the DPFB while one went into voluntary liquidation. After this, the DPFB has grown from strength to strength and it has managed to deal with subsequent bank failures as follows: two in 1994, three in 1996, one in 1997, five in 1998, one in 1999, one in 2001, two in 2003, and two in 2005. There were a total of twenty four (24) institutions under liquidation out of which four (4) have been wound up (CBK Bank Supervision Report, 2010).

The CBK introduced prudential regulations in 1995. Twenty four institutions experienced financial crises prior to this year while fifteen had distress after the introduction of regulation (CBK Bank Supervision Report, 2010).

The chapter has dealt with literature, from other researchers, related to this study. The findings have focused on regulations stipulated by the Central Bank of Kenya and regulatory bodies in other countries. The regulations have been discussed together with reports for the years 2007 to 2009. In the reports, the CBK has outlined the measures it is taking to enhance compliance with the regulations as well as the principles for effective banking supervision.

Without the prudential regulations it would be difficult to evaluate the performance of banks or harmonise their activities to ensure they meet international standards. It would not be easy to take prompt corrective measures in the event of a financial crisis in the commercial banks. Regulation and close supervision of banks is thus imperative in guaranteeing smooth operations of the institutions.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 INTRODUCTION

This section covers the methodology that was used in the research to address the objectives of the study. It covers the target population, data collection instruments and data analysis techniques that were used in the study.

3.2 RESEARCH DESIGN

The design indicates the plan of the study. It shows all the sections making up the research project. These sections include: the population and means of carrying out the study.

In this research, a census study method was used to examine the effect of prudential regulations on the stability of commercial banks in Kenya.

3.3 POPULATION

This study focused on all the 44 registered commercial banks operating in Kenya.

3.4 DATA COLLECTION

Secondary data was used in the study. The data was obtained from the Central Bank of Kenya and the Deposit Protection Fund Board (DPFB).

The researcher obtained data on profitability and asset base of the banks over a period of four years prior to and four years after the implementation of prudential regulations in Kenya. Prudential regulations were introduced in 1995 and implemented at the end of 1998. The study thus covered the period between 1995 and 2002. Since the regulations were implemented at the end of 1998, the four years prior to implementation of the regulations were 1995, 1996, 1997 and 1998 while the four years after implementation were 1999, 2000, 2001 and 2002. The first financial results of the post-implementation period were published in 1999.

3.5 DATA ANALYSIS

The performance of the banks was measured by the banks' Return On Assets: (Profit before Tax ÷ Total Bank Assets) %.

The stability of the banks was measured by the variability in the Return on Assets (ROA) of the banks. The higher the variability in the ROA, the less stable the bank was considered to be.

The Standard Deviation was used to measure the variability of the ROA of the banks. The greater the standard deviation the higher the variability of the ROA.

The stability of the banks in the period running from 1999 to 2002 (after the implementation of the prudential regulations) was compared to their stability in the period running from 1995 to 1998 (prior to the implementation of the regulations).

This enabled evaluation of the effect of prudential regulations on the stability of commercial banks in Kenya.

CHAPTER FOUR

DATA ANALYSIS, RESULTS AND DISCUSSION

4.1 RETURN ON ASSETS FOR THE COMMERCIAL BANKS

Table 4.1.1 below shows the Return on Assets of banks for the period: 1995 to 1998

Table 4.1.1

4.1.1 : Return on Assets of Commercial Banks for the years 1995 to 1998

Figures in Ksh Million

Year	1 Profit Before Tax	2 Total Assets	Return on Assets (1÷2)%
1995	15,346.00	321,163.00	4.78
1996	14,885.00	322,672.00	4.61
1997	17,425.00	395,115.00	4.00
1998	9,261.00	386,353.00	2.00
TOTAL	**56,917.00**	**1,425,303.00**	**15.39**

Source: Research Data

The return on assets was relatively stable during the period 1995 to 1997 but deviated significantly in 1998 as indicated by the ratio of profits to total assets.

Table 4.1.2 below shows the Return on Assets of banks for the period: 1999 to 2002

Table 4.1.2

4.1.2 : Return on Assets of Commercial Banks for the years 1999 to 2002

Figures in Ksh Million

Year	1 Profit Before Tax	2 Total Assets	Return on Assets (1÷2)%
1999	3,496.00	378,887.00	0.92
2000	2,799.00	530,726.00	0.53
2001	8,941.19	555,930.00	1.61
2002	5,630.00	595,847.00	0.94
TOTAL	**20,866.19**	**2,061,390.00**	**4.00**

Source: Research Data

Return on assets measure indicates volatile returns during the period 1999 to 2002

4.2 STANDARD DEVIATION AND VARIANCE OF RETURNS

The Standard Deviation of the Return on Assets is the measure of the stability of the commercial banks. This is an indication of the variability of the profits of the banks for the period under review. The Standard Deviation is computed below:

4.2.1 Standard Deviation of the Return on Assets for the period 1995 to 1998

From table 4.1.1,

Total Return on Assets = 15.39%

Mean Return on Assets = 15.39% ÷ 4

= 3.85%

The variance of the ROA is computed as: $(X-3.85)^2$, where X is the ROA for each year.

The table below shows the Variance in Return on Assets for the four-year period:

Table 4.2.1: Variance of the Returns for the period 1995 to 1998

Year	1995	1996	1997	1998	**TOTAL**
ROA %	4.78	4.61	4.00	2.00	**15.39**
Variance of ROA	0.86	0.58	0.02	3.42	**4.88**

Source: Research Data

The Standard Deviation is computed by obtaining the square root of the sum of the Variance of ROA for the four year period. From the above table, the Standard Deviation is found to be:

$SD = \sqrt{4.88} = 2.21$

Profits were most unstable in 1998 and were most stable in 1997 as indicated in table 4.2.1

4.2.2 Standard Deviation of the Return on Assets for the period 1999 to 2002

From table 4.1.2,

Total Return on Assets = 4.00%

Mean Return on Assets = 4.00% ÷ 4

= 1.00%

The variance of the ROA is computed as: $(X-1.00)^2$ where X is the ROA for each year.

The table below shows the Variance in Return on Assets for the four-year period:

Table 4.2.2: Variance of the Returns for the period 1999 to 2002

Year	1999	2000	2001	2002	**TOTAL**
ROA %	0.92	0.53	1.61	0.94	**4.00**
Variance of ROA	0.01	0.22	0.37	0.00	**0.60**

Source: Research Data

The Standard Deviation is computed by obtaining the square root of the sum of the Variance of ROA for the four year period. From the above table, the Standard Deviation is computed below:

$SD = \sqrt{0.60} = 0.77$

The profits were relatively stable for the period 1999 to 2002.

4.3 DISCUSSION OF RESULTS

The results above reveal that commercial banks registered lower variability in the Return on Assets during the period 1999 to 2002 compared to the four-year period stretching from 1995 to 1998. There was thus reduced volatility of returns for commercial banks in the years 1999 to 2002 compared to the period between 1995 and 1998.

It is noted from the results that, while the total profit before tax was higher in the period prior to 1999 (Ksh 56.917 Billion) than in the period running from 1999 to 2002 (Ksh 20.866 Billion), there was higher fluctuation in the profits during the period before introduction of prudential guidelines compared to the period after introduction of the prudential guidelines. In the first period, the standard deviation of the Return on Assets was 2.21% while in the second period (1999 to 2002), the standard deviation of the returns was 0.77%.

The results also reveal that in the period 1995 to 1997, there was a gradual increase in assets of the commercial banks before a decline was registered in 1998. This could be attributed to the closure of some banks owing to financial distress during the period. In the years from 1999 to 2002, there was a steady growth in the asset base of the banks. The asset base grew from Ksh 378.887 Billion in 1999 to Ksh 595.847 Billion in 2002. This may have been occasioned by the reliability and consistency of returns in the second period compared to the volatile first period.

The better performance in the years 1999 to 2002 could have been as a result of closer supervision of the operations of banks as well as stringent measures taken by the banking industry regulator, the Central Bank of Kenya. The reduction in the asset base in the first period under review could have been occasioned by bank closures arising from lack of close supervision of the way banks conducted their business, thus exposing them to various market hazards such as non-performing loans and financial losses.

CHAPTER FIVE

SUMMARY OF FINDINGS, CONCLUSIONS AND RECOMMENDATIONS

5.1 Summary of Findings and Conclusions

5.1.1 Summary of Findings

The Commercial Banks in Kenya have come a long way, growing in leaps and bounds to become great contributors to the stability of the country's economy. Many of the banks have survived difficult times to become major determinants of the stability of Kenya's economy.

To achieve success in the banking industry, many measures had to be taken by the government through the industry regulator, the Central Bank of Kenya. This was part of the government strategy of addressing the numerous bank crises that were experienced in the period between 1983 and 1998. This was a difficult time for commercial banks in independent Kenya.

It was in the light of the high incidence of bank closures that the Central Bank of Kenya introduced Prudential Regulations to govern the activities of commercial banks. Apart from addressing bank closures, the regulations also played a significant role in maintaining public confidence in the country's financial system. The regulations were introduced in 1995 and implemented at the end of 1998.

The findings of the study reveal that, with the implementation of prudential regulations, the objective of stabilising the commercial banks in Kenya was achieved. It is seen from the results that the variability of the Return on Assets was lower in the years that followed the implementation of the regulations than before. The Standard Deviation of the ROA after implementation of regulations was only 0.77 compared to 2.21 for the period before implementation.

5.1.2 Conclusions

The success of the Prudential Regulation is highlighted by reduced bank closures. Fewer banks have been closed since implementation of prudential regulation than before. Between 1995 and 1998, nine banks were closed compared to two in the period running from 1999 to 2002. Since implementation of prudential regulations in Kenya; there are fewer incidents of commercial banks being placed under statutory management. This is an indication that prudential regulations have enhanced the stability of commercial banks in Kenya.

5.2 Limitations of the Study

Data on the profitability of some commercial banks in the period 1995 to 1999 could not be obtained from the CBK. The CBK began compilation of the profitability and asset base data on individual banks in the year 2000. Consolidated reports, obtained from the CBK, on the profitability and asset base of all commercial banks during the period were used.

5.3 Recommendations

While there has been success with the implementation of prudential regulations, more needs to be done in streamlining bank operations. The recommendations to the industry regulators include

Closer supervision of the activities of commercial banks with branches outside Kenya in relation to trade in foreign currency will help curb the likelihood of some banks exporting foreign currency to their branches abroad while causing a shortage of the same in the local market. This shortage causes depreciation in the value of the local currency.

Commercial Banks should be compelled to declare their financial results at the same time. To avoid the likelihood of falsification of financial statements for business advantage, the banks should be compelled to submit their statements to the CBK for declaration to the public. It should be the CBK's mandate to declare the financial results after receiving the statements from all the commercial banks and proper audit done.

5.4 Suggestions for Further Research

This study focused on prudential regulation of commercial banks in Kenya. There is need to conduct further research on regulation of financial markets in other countries.

Since Kenya is a member of trading blocs such as the Common Market for East and Southern Africa (COMESA), it is necessary to study the effect of regulation on the financial markets in the other countries that form the trading blocs. It is important to study the regulations in the other countries since this will help Kenya strengthen her regulatory structures.

While prudential regulations play a great role in enhancing the stability of commercial banks in Kenya, there is need to study the effect of these regulations in other areas such as growth of commercial banks and other financial institutions.

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APPENDICES

APPENDIX A

Commercial Banks registered in Kenya

1. Bank of India	2. Citibank N.A. Kenya
3. Habib Bank A.G. Zurich	4. Habib Bank Ltd.
5. Bank of Baroda (K) Ltd.	6. Barclays Bank of Kenya Ltd.
7. Diamond Trust Bank Kenya Ltd.	8. K-Rep Bank Ltd.
9. Standard Chartered Bank (K) Ltd.	10. Ecobank Ltd
11. Gulf Africa Bank (K) Ltd	12. First Community Bank
13. UBA Kenya Bank Limited	14. Consolidated Bank of Kenya Ltd.
15. Development Bank of Kenya Ltd.	16. Kenya Commercial Bank Ltd.
17. National Bank of Kenya Ltd.	18. CFC Stanbic Bank Ltd.
19. African Banking Corporation Ltd.	20. City Finance Bank Ltd.
21. Commercial Bank of Africa Ltd.	22. Co-operative Bank of Kenya Ltd.
23. Credit Bank Ltd.	24. Charterhouse Bank Ltd.
25. Chase Bank (K) Ltd.	26. Dubai Bank Kenya Ltd
27. Equatorial Commercial Bank Ltd.	28. Equity Bank Ltd.

29. Family Bank Ltd.	30. Fidelity Commercial Bank Ltd.
31. Fina Bank Ltd.	32. Giro Commercial Bank Ltd.
33. Guardian Bank Ltd.	34. Imperial Bank Ltd.
35. Investment & Mortgages Bank Ltd.	36. Middle East Bank (K) Ltd.
37. NIC Bank Ltd.	38. Oriental Commercial Bank Ltd.
39. Paramount Universal Bank Ltd.	40. Prime Bank Ltd.
41. Southern Credit Banking Corporation Ltd.	42. Trans-National Bank Ltd.
43. Victoria Commercial Bank Ltd.	44. Bank of Africa (K) Ltd.

APPENDIX B

Foreign owned, locally incorporated banks

1. Bank of Baroda (K) Ltd.	2. Barclays Bank of Kenya Ltd.
3. Diamond Trust Bank Kenya Ltd.	4. K-Rep Bank Ltd.
5. Standard Chartered Bank (K) Ltd.	6. Ecobank Ltd
7. Gulf Africa Bank (K) Ltd	8. First Community Bank
9. UBA Kenya Bank Limited	

Foreign owned but not locally incorporated banks

1) Bank of Africa (K) Ltd.	2) Bank of India
3) Citibank N.A. Kenya	4) Habib Bank A.G. Zurich
5) Habib Bank Ltd.	

Locally owned banks (with government participation)

1) Consolidated Bank of Kenya Ltd.	2) Development Bank of Kenya Ltd.
3) Kenya Commercial Bank Ltd.	4) National Bank of Kenya Ltd.
5) CFC Stanbic Bank Ltd.	

Locally owned banks (without government participation)

1) African Banking Corporation Ltd.	2) City Finance Bank Ltd.
3) Commercial Bank of Africa Ltd.	4) Co-operative Bank of Kenya Ltd.
5) Credit Bank Ltd.	6) Charterhouse Bank Ltd.
7) Chase Bank (K) Ltd.	8) Dubai Bank Kenya Ltd
9) Equatorial Commercial Bank Ltd.	10) Equity Bank Ltd.

11) Family Bank Ltd.	12) Fidelity Commercial Bank Ltd.
13) Fina Bank Ltd.	14) Giro Commercial Bank Ltd.
15) Guardian Bank Ltd.	16) Imperial Bank Ltd.
17) Investment & Mortgages Bank Ltd.	18) Middle East Bank (K) Ltd.
19) NIC Bank Ltd.	20) Oriental Commercial Bank Ltd.
21) Paramount Universal Bank Ltd.	22) Prime Bank Ltd.
23) Southern Credit Banking Corporation Ltd.	24) Trans-National Bank Ltd.
25) Victoria Commercial Bank Ltd.	

APPENDIX C

Number of Institutions that have experienced financial distress in Post Independence Kenya

Year	Number of Institutions in Financial Crisis
1984	1
1986	2
1987	1
1989	7

1993	11
1994	2
1996	3
1997	1
1998	5
1999	1
2001	1
2003	2
2005	2
TOTAL	**39**

Source: Central Bank of Kenya – Bank Supervision Report, 2010

APPENDIX D

Profitability of the Commercial Banks in the year 2000

(Figures in Ksh Million)

	Bank	1 Profit Before Tax	2 Total Assets	3 Return on Assets (1 ÷2)%
1.	Standard Chartered Bank (K) Ltd	3,119.00	59,846.00	5.21
2.	Barclays Bank of Kenya Ltd	2,983.00	84,118.00	3.55
3.	Citibank, N.A.	619.00	22,500.00	2.75
4.	ABN-AMRO Bank	489.00	16,546.00	2.96

5.	National Industrial Credit Bank Ltd.	451.00	8,738.00	5.16
6.	Commercial Bank of Africa Ltd.	370.00	14,482.00	2.55
7.	CFC Bank Ltd	243.00	9,773.00	2.49
8.	Diamond Trust Bank Kenya Ltd.	175.00	5,494.00	3.19
9.	Investment & Mortgages Bank Ltd	138.00	8,658.00	1.19
10.	First American Bank Ltd.	121.00	7,480.00	1.62
11.	Imperial Bank Ltd	113.00	3,613.00	3.13
12.	Middle East Bank of Kenya Ltd	111.00	5,062.00	2.19
13.	Habib AG Zurich	106.00	3,473.00	3.05
14.	Bank of India	94.00	3,019.00	3.11
15.	Development Bank of Kenya Ltd.	84.00	4,513.00	1.86
16.	Habib Bank Ltd	79.00	3,247.00	2.43
17.	Charterhouse Bank Ltd	77.00	1,524.00	5.05
18.	Credit Agricole Indosuez	68.00	8,122.00	0.84
19.	Biashara Bank of Kenya Ltd	60.00	2,410.00	2.49
20.	Guardian Bank Ltd	56.00	5,258.00	1.07
21.	Fina Bank Ltd.	51.00	5,514.00	0.92
22.	Prime Bank Ltd	47.00	3,181.00	1.48
23.	Bank of Baroda	47.00	3,806.00	1.23
24.	African Banking Corporation Ltd.	34.00	3,612.00	0.94
25.	Equatorial Commercial Bank Ltd	30.00	2,523.00	1.19

26.	Chase Bank Ltd.	26.00	908.00	2.86
27.	Credit Bank Ltd.	26.00	2,011.00	1.29
28.	Akiba Bank Ltd	26.00	3,309.00	0.79
29.	Transnational Bank Ltd.	22.00	2,578.00	0.85
30.	Victoria Commercial Bank Ltd	21.00	3,652.00	0.58
31.	Giro Commercial Bank Ltd	20.00	4,704.00	0.43
32.	Paramount-Universal Bank Ltd.	17.00	1,716.00	0.99
33.	Euro Bank Ltd.	15.00	1,960.00	0.77
34.	K-Rep Bank Ltd.	14.00	972.00	1.44
35.	Fidelity Commercial Bank Ltd	2.00	1,558.00	0.13
36.	Dubai Bank Ltd	-1.00	686.00	-0.15
37.	Consolidated Bank of Kenya ltd.	-14.00	3,253.00	-0.43
38.	Southern Credit Banking Corp. Ltd	-14.00	1,997.00	-0.70
39.	Daima Bank Ltd.	-46.00	1,292.00	-3.56
40.	Industrial Development Bank Ltd.	-65.00	2,449.00	-2.65
41.	City Finance Bank Ltd.	-122.00	875.00	-13.94
42.	Co-operative Merchant Bank Ltd	-156.00	4,362.00	-3.58
43.	Bullion Bank Ltd	-249.00	1,697.00	-14.67
44.	Stanbic Bank Kenya Ltd.	-439.00	9,078.00	-4.84
45.	Kenya Commercial Bank Ltd	-693.00	93,518.00	-0.74
46.	Delphis Bank Ltd.	-731.00	5,553.00	-13.16

47.	Co-operative Bank of Kenya Ltd	-1,414.00	27,852.00	-5.08
48.	Trust Bank Ltd.	-1,582.00	13,300.00	-11.89
49.	National Bank of Kenya Ltd	-1,631.00	44,934.00	-3.63
	TOTAL	**2,799.00**	**530,726**	**0.53**

APPENDIX E

Profitability of the Commercial Banks in the year 2001

(Figures in Ksh Million)

	Bank	1 Profit Before Tax	2 Total Assets	3 Return on Assets (1 ÷2)%
1.	Barclays Bank of Kenya Ltd	4,215.49	89,923.00	4.69
2.	Standard Chartered Bank Ltd	3,205.07	67,479.00	4.75
3.	Citibank, N.A.	699.24	41,850.00	1.67
4.	Commercial Bank of Africa Ltd	477.11	20,374.00	2.34
5.	National Industrial Credit Bank Ltd	377.04	9,821.00	3.84
6.	First American Bank Ltd.	227.50	8,386.00	2.71
7.	Transnational Bank Ltd.	221.09	2,762.00	8.00
8.	Kenya Commercial Bank Ltd	169.47	89,904.00	0.19
9.	Imperial Bank Ltd.	147.62	4,370.00	3.38
10.	CFC Bank Ltd.	145.22	10,569.00	1.37

11.	Bank of India	115.53	3,572.00	3.23
12.	Habib AG Zurich	112.85	3,946.00	2.86
13.	Development Bank of Kenya Ltd.	106.66	4,269.00	2.50
14.	Investment & Mortgages Bank Ltd	101.10	8,848.00	1.14
15.	Habib Bank Ltd.	98.10	3,514.00	2.79
16.	Charterhouse Bank Ltd	92.21	2,474.00	3.73
17.	Middle East Bank of Kenya Ltd	80.10	5,173.00	1.55
18.	Biashara Bank of Kenya Ltd	70.81	2,751.00	2.57
19.	Credit Agricole Indosuez	62.76	8,803.00	0.71
20.	K-Rep Bank Ltd.	56.89	1,202.00	4.73
21.	Guardian Bank Ltd.	55.64	4,850.00	1.15
22.	Prime Bank Ltd.	55.29	3,862.00	1.43
23.	Bank of Baroda	52.09	4,391.00	1.19
24.	Fina Bank Ltd	51.60	5,846.00	0.88
25.	African Banking Corporation	40.94	3,717.00	1.10
26.	Diamond trust Bank Ltd	38.23	6,232.00	0.61
27.	Credit Bank Ltd.	37.62	1,881.00	2.00
28.	Chase Bank Ltd	30.00	1,038.00	2.89
29.	Giro Commercial Bank Ltd.	29.59	5,272.00	0.56
30.	Equatorial Commercial Bank Ltd	27.39	2,677.00	1.02
31.	Fidelity Commercial Bank Ltd.	25.85	1,517.00	1.70

32.	Akiba Bank Ltd	22.01	4,527.00	0.49
33.	Victoria Commercial Bank Ltd	20.01	3,275.00	0.61
34.	Paramount-Universal Bank Ltd.	12.09	1,771.00	0.68
35.	Dubai Bank Ltd	10.15	963.00	1.05
36.	City Finance Bank Ltd.	1.51	1,008.00	0.15
37.	Consolidated Bank of Kenya ltd	(13.14)	4,368.00	(0.30)
38.	Daima Bank Ltd	(38.81)	1,255.00	(3.09)
39.	Southern Credit Banking Corp. Ltd	(64.11)	3,936.00	(1.63)
40.	Euro Bank Ltd.	(76.90)	2,506.00	(3.07)
41.	Industrial Development Bank Ltd	(221.38)	2,905.00	(7.62)
42.	Stanbic Bank Kenya Ltd.	(290.44)	8,456.00	(3.43)
43.	National Bank of Kenya Ltd	(322.58)	50,934.00	(0.64)
44.	Co-operative Merchant Bank Ltd.	(365.91)	4,242.00	(8.63)
45.	Co-operative Bank of Kenya Ltd	(439.28)	30,786.00	(1.43)
46.	Delphis Bank Ltd.	(518.13)	3,725.00	(13.91)
	TOTAL	**8,941.19**	**555,930**	**1.61**