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"PERFORMANCE OF FINANCIAL
PARASTATALS IN KENYA: 1964-1984"

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PERFORMANCE OF FINANCIAL PARASTATALS IN KENYA: 1964 - 1984

ABSTRACT

The paper analyses the performance of four parastatal financial institutions, including the KCB, NBK, HFCK and AFC. Performance is analysed in terms of the four potential beneficiary groups: depositors, borrowers, stockholders and employees. It is shown that the depository financial parastatals played an important role in the development of the Kenyan financial sector. They performed efficiently enough to compete successfully with the private sector, while remaining highly profitable. Since 1979 their performance relative to the private sector has suffered as they have been used to extend banking services into more remote rural areas. The positive performance of the depository institutions contrasts sharply with that of the Agricultural Finance Corporation. The AFC is shown to be inefficient, unprofitable and to serve mainly to transfer state funds to its rather elite clientele.

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This paper evaluates the performance of parastatals in the financial sector. It is organized in two parts. The first half of the paper covers depository institutions and the last part covers a non-depository financial firm, the Agricultural Finance Corporation.

The first part of the paper covers those firms which accept deposits from the public which they then loan out. The depository institutions include both commercial banks (CB) and non-bank financial institutions (NBFIs). The distinction will be important in assessing the performance of the parastatal firms. The period under study is 1971-84. Performance is shown to differ between the early part of the period and the later part, with the break occurring around 1979. The first section will be structured as follows. First will come background information on the growth patterns of the financial sector. Second will come an account of the entry of the Kenya government into direct participation in the sector. Third will come an analysis of the performance of the parastatal firms relative to the performance of the financial sector as a whole.

It will be shown that the depository financial institutions have functioned effectively, competing successfully with private firms and earning consistent high profits. During the seventies they pioneered in the development of general purpose NBFIs, which has contributed importantly to the development of financial

intermediation in Kenya. During recent years they have been used for more distributional goals, spreading financial intermediation to rural areas, with no apparent drop in efficiency.

The second section will provide stark contrast. It will analyze the activities of the Agricultural Finance Corporation (AFC) from 1963-83. It will show that this firm has been highly politicized and is commercially non-viable. It will be shown to be unprofitable and inefficient; mainly functioning to transfer funds to its clients, who are an elite group. The AFC has largely failed in its role of mobilizing credit to the agricultural sector, a role which has been increasingly filled by the depository firms.

Performance is analyzed in terms of the four groups who are potential beneficiaries of the parastatals: depositor, borrowers, stockholders and employees. Data relating to each will be presented.

I. DEPOSITORY FINANCIAL INSTITUTIONS

A. GROWTH AND DEVELOPMENT OF THE FINANCIAL SECTOR

Depository institutions are regulated under the Central Bank of Kenya Act, 1966 and the Banking Act of 1968. Regulations

differ between commercial banks (CBs) and non-bank financial institutions (NBFIs). However, within those categories the regulations apply uniformly to institutions which are owned by government, by foreign banks or by private citizens.

Commercial banks (CBs) accept deposits in the form of checking accounts, savings accounts and time deposits. They are not permitted to pay interest on checking deposits. Minimum interest rates are set by the Central Bank for the latter types of deposits. Commercial banks make loans, subject to maximum interest rates set by the Central Bank. Other charges, such as application fees and commitment fees are also limited by the Central Bank.

Non-bank financial institutions (NBFIs) also accept deposits and make loans. They are not permitted to offer checking accounts. Minimum interest rates paid on savings accounts and time deposits are also set by the Central Bank, at rates higher than those for commercial banks. Maximum interest rates charged on loans are also set by the Central Bank, also at rates higher than those allowed for commercial banks. Other charges, such as application fees and commitment fees are not regulated, and can be quite significant. Paulson reported that, while the maximum interest rate on NBFI loans in mid-1983 was 16%, the effective rate reported on some NBFI loans exceeded 30%.¹ Commercial banks

¹ Paulson, 1984, page 74.

have been restricted in lending for consumer durables and real estate.²

The differential interest rate regulations have thus favored the growth of NBFIs over CBs. The NBFIs can charge more for loans, which makes them more profitable. Because they can charge more for loans, they can afford to pay more to attract deposits, which they are allowed to do. Thus depositors are attracted to put their money in NBFIs rather than CBs.

One other aspect of the financial market should not escape notice. That is the tendency for CBs and NBFIs to operate as pairs. This can and does happen from either direction: some banks have found it profitable to start NBFIs subsidiaries, while some NBFIs have found it profitable to start CB subsidiaries. The latter was ruled out by the recent (1985) revision of the Banking Act. The incentive for banks to create NBFIs is clear: they can steer loan applications to the NBFIs and make more money on the loan. The incentive for NBFIs to start banks derives from the structure of the reserve requirement. NBFIs do not have accounts with the Central Bank; instead they may count as liquid reserves current account deposits held with commercial banks, cash and Treasury Bills. The reserve requirement for NBFIs has ranged from 15 to 24% from 1974-1983. Since NBFIs receive no interest on the current account deposits they are forced to keep

² Paulson, 1984, page 62.

with banks, they can profit by placing them in banks they own, which can make loans against them.

The growth in deposits in both CBs and NBFIs is shown in Table 1. The growth was much faster prior to the coffee boom than after. For purposes of discussion we will distinguish the fast growth period as 1971-79 and the slow growth period as 1979-84.

At the beginning of the period, in 1971, deposits in NBFIs were only 14% of deposits in commercial banks. Commercial bank deposits were growing rapidly, 20% p.a., compared with inflation of 10.5%. Deposits in NBFIs were growing even more rapidly, 30.6% p.a. After the coffee boom deposit growth slowed. Overall deposit growth slowed from 21.7% p.a. to 14.5% p.a. But this fall in deposit growth was very unequally distributed. Commercial bank deposit growth dropped most dramatically, from 20.0% p.a. in 1971-79 to 10.1% p.a. in 1979-84. In other words CB deposits barely kept pace with inflation after the coffee boom.

Meanwhile, NBFIs deposit growth dropped much less, from 30.6% p.a. in 1971-79 to 26.6% p.a. from 1979-84. Since NBFIs deposits grew faster than CB deposits throughout the period, they naturally increased their market share. Whereas in 1971 NBFIs

TABLE 1. GROWTH IN DEPOSITS IN CBs AND NBFIs
(millions of current shillings)

YEAR	CB deposits	NBFI deposits	Total
1971	3,186.72	442.14	3,628.86
1972	3,545.3	582.92	4,128.22
1973	4,559.12	677.01	5,236.13
1974	5,840.18	817.26	6,657.44
1975	7,157.12	1,254.06	8,411.18
1976	10,506.8	1,429.56	11,936.36
1977	12,130.48	2,106.93	14,237.41
1978	12,597.48	2,827.96	15,425.44
1979	13,711.5	3,733.19	17,444.69
1980	14,002.16	4,852.51	18,854.67
1981	15,685.98	5,691.6	21,377.58
1982	18,392.24	7,176.41	25,568.65
1983	19,449.76	8,671.91	28,121.67
1984	22,159.4	12,153.9	34,313.3

GROWTH RATES, %

PERIOD	CB DEP	NBFI	TOTAL	PRICES
71-79	20.0	30.6	21.7	10.5
79-84	10.1	26.6	14.5	9.9

Source: Central Bank of Kenya, Economic and Financial Review, various years.

deposits were only 14% of CB deposits, by 1979 they were 27.2% and by 1984 they were 54.8% as large as CB deposits.

While NBFIs have been considered a significant phenomenon and attracted a great deal of attention since the late 1970s, this is slightly misleading. NBFIs were growing dramatically throughout the 70s as well as since then. But their dramatic gain over CBs is due to a sharp decrease in growth of CB deposits since that time rather than to increasing growth of NBFIs deposits.

Interest rates have been set administratively at levels which are below market clearing rates, and also, throughout the seventies, below inflation. In the face of excess demand for loans, the Central Bank has issued guidelines to banks which have attempted to influence the allocation of available funds. These guidelines have encouraged lending to agriculture and discouraged lending for luxury consumption.³ Loans to foreigners are also restricted.⁴

Beginning with the Budget of 1980, interest rates have been adjusted upward several times.⁵ Table 2 shows that positive real

³ Central Bank of Kenya, page 20.

⁴ Swainson, page 189.

⁵ Paulson, page 74.

TABLE 2 NOMINAL AND REAL INTEREST RATES

	INTEREST RATE (Commercial banks, 9-12 month time dep.)	INFLATION RATE	REAL INTEREST RATE
1968	4.0	1.8	2.2
1969	4.0	1.0	3.0
1970	4.0	2.7	1.3
1971	4.0	4.9	-0.9
1972	4.0	7.7	-3.7
1973	4.0	9.3	-5.3
1974	5.6	18.0	-12.4
1975	5.6	10.4	-4.8
1976	5.6	16.3	-10.6
1977	5.6	18.0	12.4
1978	5.6	3.3	2.3
1979	5.6	5.1	0.5
1980	6.4	8.7	-2.3
1981	12.3	9.2	3.1
1982	13.8	10.7	3.1
1983	13.0	10.4	2.6
1984	12.0	10.3	1.7

rates were achieved throughout the eighties. As interest rates have risen this greater differential between real rates of return on interest bearing and non-interest bearing deposits has helped fuel the large shift of deposits from commercial banks to non-bank financial institutions. Unfortunately, no time series on deposit rates for NBFI are available, but their rates have exceeded those paid by CB's.⁶ In addition to paying higher interest rates, it is widely reported that NBFI engage in non-interest rate competition for deposits by offering cash payments and preferential treatment to large depositors.⁷

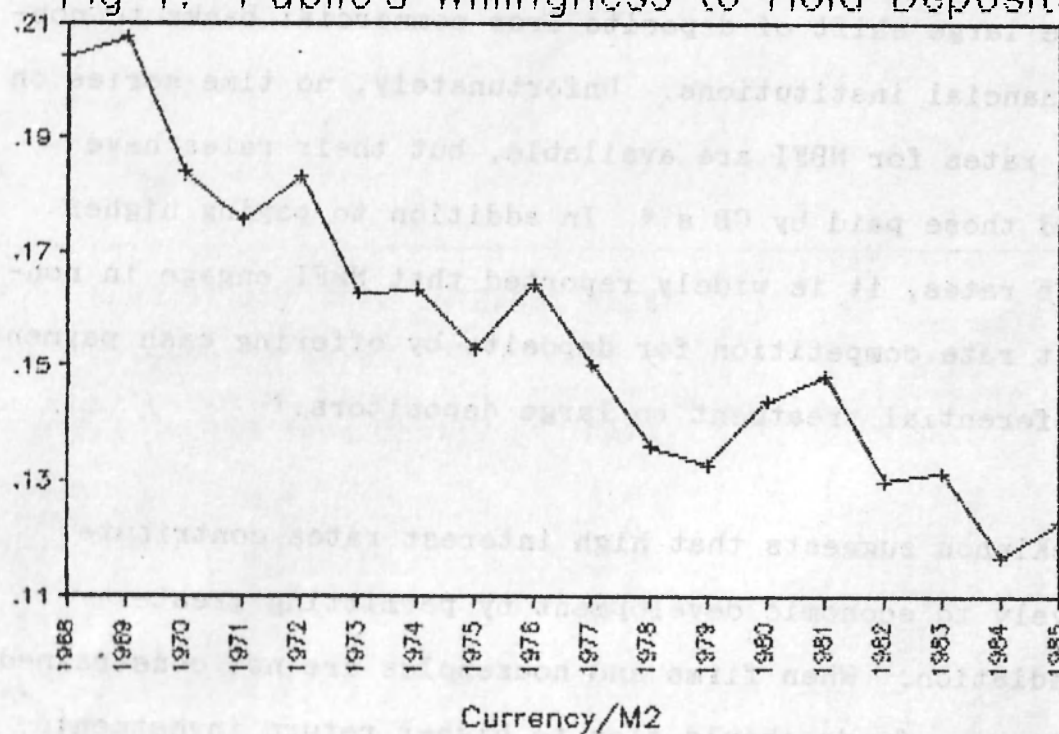
McKinnon suggests that high interest rates contribute positively to economic development by permitting greater intermediation. When firms and households are not constrained to self-finance, funds should flow to higher return investments, increasing the average quality of investment and raising the rate of economic growth.

During the years since the establishment of the Central Bank and since government began direct participation in the financial sector, substantial development of the financial structure has been achieved. Figure 1 shows that the public has grown increasingly willing to hold money in the form of deposits,

⁶ Paulson, page 75.

⁷ Paulson, page 65.

Fig 1. Public's Willingness to Hold Deposits



instead of as currency. Figure 2 shows that the ratio of money to GDP grew substantially in the period 1968-79. Figure 2 also shows that most of this growth was in time and savings deposits, included in M2, while the ratio of M1 (currency plus demand deposits in commercial banks) to GDP did not change substantially.

Although the number of banks operating in Kenya has grown, the sector is still quite concentrated, especially outside of Nairobi and Mombasa. Table 3 shows the distribution of bank branches as of 30 June, 1983. It shows that of 161 bank branches in Kenya, 123 belonged to one of the four large retail banks, Kenya Commercial Bank, Barclays, Standard, or National Bank of Kenya. Of the 87 bank branches located outside Nairobi and Mombasa, 78 belonged to one of these 4 large banks. Of these four banks, the National Bank of Kenya is in a distant 4th place. It had only 8 full branches, compared with Kenya Commercial Bank's 49, Barclays' 30 and Standard's 36. Thus the retail banking sector in Kenya is highly concentrated, with only 4 significant actors.

Fig 2. Ratios of Money to GDP

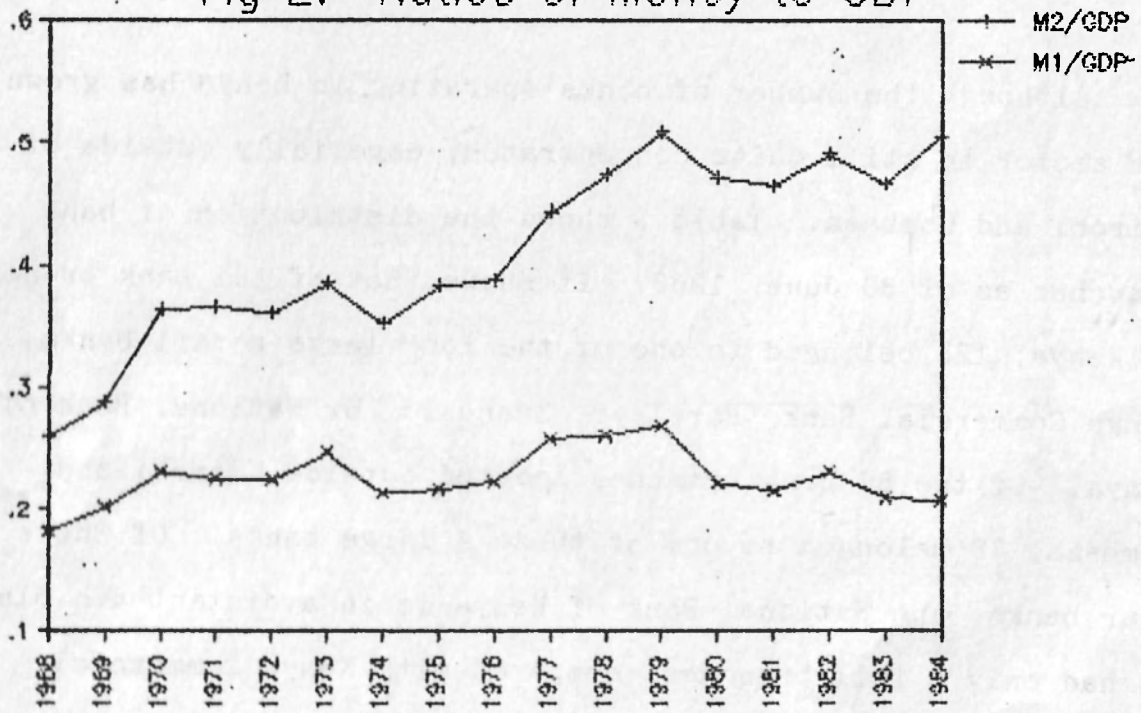


TABLE 3 DISTRIBUTION OF BANK BRANCHES
(As of 30 June, 1983)

Area	Nairobi		Mombasa		Other		Total	
	Full	Sub	Full	Sub	Full	Sub	Full	Sub
KCB	10	5	4	2	35	29	49	36
Barclays	11	4	3	1	16	24	30	29
Standard	10	-	2	1	24	-	36	1
NBK	4	1	1	2	3	-	8	3
Cooperative	1	-	1	-	4	-	6	0
Subtotal	36	10	11	6	82	53	129	69
Other Banks	17	3	10	9	5	-	32	12
Total	53	13	21	15	87	53	161	81

Source: Paulson, 1984, page 54.

B. GOVERNMENT PARTICIPATION IN THE FINANCIAL SECTOR

Participation of the Kenyan government in the financial sector dates from the late '60s. The primary goal of the government in entering the sector was to make the sector more responsive to borrowing needs of the Kenyan public. Foreign banks had lent very little to Kenyans of African origin, choosing instead to invest surplus funds abroad.⁸

It was announced at the time that takeover of control of commercial banking was not intended "to bring about new thinking or practices in commercial banking," and that government owned banks were "to operate on commercial principles."⁹ Operating on such commercial principles, the newly nationalized Kenya Commercial Bank found it possible to expand lending to Kenyans of African origin by 225% between January and September, 1971.¹⁰

The Kenyan government used a two-fold approach to entering the commercial banking field, creation de novo and acquisition of existing financial institutions.

⁸ Central Bank of Kenya, page 19.

⁹ J.N. Michuki, chairman of KCB, as quoted in Leys, page 134.

¹⁰ Quoted in Leys, page 157.

In 1965 the government, together with the Commonwealth Development Corporation, created the Housing Finance Company of Kenya. The HFCK was set up for the purpose of accepting deposits from the public which it would then reloan in the form of mortgages. The HFCK was set up with a very small initial capital base. Its size was boosted considerably in 1970 by the acquisition of another NBFIs, First Permanent (EA) Ltd.

In 1968 the government created the National Bank of Kenya. The National Bank of Kenya operates an NBFIs subsidiary, the Kenya National Capital Corporation (known as Kenyac), which was set up in 1976. The figures given below represent the consolidation of the NBK and its subsidiaries. Figures on the NBK per se are not available since 1979.

In 1970 the government acquired 60% of the shares of the National and Grindlays Bank, which was then renamed the Kenya Commercial Bank. National and Grindlays had operated in Kenya since 1904 and had an extensive branch network. The takeover was completed in 1976 when the remaining shares were acquired from Grindlays. The takeover was friendly and a contract was signed with Grindlays such that they would provide most of the high level management, with the proportions declining as Kenyans were trained to fill more and more positions. The management and training contracts were renewed several times, but finally expired in 1986, at which time the last expatriates left. The

Kenya Commercial Bank owns an NBFI, the Kenya Commercial Financial Corporation Ltd., which was set up in 1971.

The financial parastatals have in many ways enjoyed a privileged status among parastatals. They have been headed by a group of managers generally seen as astute businessmen and extremely well connected politically. This group has included John Michuki, Stanley Githunguri, Nicholas Nganga, Philip Ndegwa, George Saitoti and Benjamin Kipkorir.

These firms have enjoyed considerable operating autonomy, at least autonomy from the normal civil service bureaucratic controls, if not political autonomy. For example, while it is required that all parastatals submit development plans for approval and inclusion in the national forward budget, none of these firms has done so. Likewise parastatals are required to submit investment projects for Treasury approval. Projects which can't project financial profitability are generally unlikely to receive approval. The banks do not submit their plans for expansion of facilities for approval. Given that the Treasury is the parent ministry of the depository financial institutions, such autonomy is unusual. The KCB produces one of the least informative annual reports of any parastatal. KCB justifies its secrecy by arguing that fuller disclosure would handicap it in competing with the private Barclays and Standard banks.

The depository financial parastatals are subject to at least 3 types of political pressure which they find difficult to resist. First, they are pressured by politicians to provide loans to politicians and their friends. It is not clear to what extent such loans are made against the better judgement of the bankers. It is impressive that once the loans are made, the bankers seem to be able to pursue their recovery with full vigor. Occasionally even a minister is foreclosed on due to failure to pay. The bank staff have learned that so long as the government is advised before such stories hit the headlines, they will usually be allowed to proceed, or quiet pressure will be put on the politician to pay before the matter hits the headlines.¹¹ Paulson found that only 16% of the accounts had arrears, and all those accounts with arrears over 3 months had been turned over to lawyers for seizure of security.¹²

The second type of political pressure under which the parastatal banks find themselves is potentially more serious. The parastatal banks are naturally under pressure to act as bankers to the rest of the parastatal sector. They have loans to many other parastatals, including some of the insolvent ones who can't qualify for loans on commercial criteria. Such loans always carry government guarantees, but these guarantees are often not made good, or only after long delays. The banks have

¹¹ Interview, KCB staff.

¹² Paulson, 1984, page 187.

been given some leeway in protecting their interests in these cases. For example, Kenatco owes money to other (private) sources who seemed on the verge of moving against Kenatco. NBK was allowed to protect its interests by putting Kenatco under receivership.

Recently a few details of such bad loans came to light when Parliament discussed the guarantees. While the complete numbers for all the bad loans were not released, it is clear from the numbers which were released that bad loans to other parastatals comprise a minimum of 10-15% of the total loan portfolios of KCB and NBK.¹³ Clearly if the practice of forcing the parastatals to carry bad debts of other parastatals became too widespread, it could ruin their effectiveness as banks.

A third type of political pressure has been concentrated on the Kenya Commercial Bank. The KCB has been chosen to help decentralize resources outside of the cities by bringing banking services to the wananchi. Such a program is expensive, and if pushed too far could cause insolvency. This has not occurred. Furthermore, it could have been interpreted that since KCB must take banking to wananchi that it must extend them loans on less than commercial conditions. This also has not happened. It appears that KCB is operating in a very business-like way with

¹³ "Kenya's White Elephants: The government continues to put good money into failed projects," Financial Review, November 24, 1986, pages 3-5.

proper controls and procedures. It is just that it is opening facilities in areas which don't have enough demand to support them, using profits from more densely populated areas to subsidize them.¹⁴ It seems then, that the autonomous parastatal nature of the KCB is being used to circumvent the budget process where such inter-regional transfers receive more scrutiny and debate.

Comparison of the performance of the public and private sector banks is hindered by several limitations on data availability. Standard Bank's operations in Kenya are carried out as part of their international operations and not incorporated separately. Thus no figures are available on deposits, assets, profitability, etc. on operations in Kenya. The same was true for Barclays up until 1979, when it incorporated a local subsidiary. However, the Statistical Abstract gives data for the commercial banking sector as a whole, so we can at least track market shares for the public firms.

¹⁴ Personal interview, KCB staff.

C. PERFORMANCE OF FINANCIAL PARASTATALS

1. Returns to Depositors

How well financial parastatals treat their depositors can be assessed by comparing the growth in deposits in parastatals with growth in total deposits in all financial institutions. Those institutions which increase their market share can be assumed to be offering depositors better returns. These returns may be monetary, i.e. interest paid, or non-monetary, e.g. convenient branch locations, prompt and courteous service, etc. A great deal of information on deposits is available and is discussed at some length here. Another indirect indicator of returns to depositors is the number and location of branches, which will also be discussed.

Comparative Deposit Growth

The first aspect of performance of the financial parastatals to be assessed is their ability to compete for deposits. First we will examine the growth in the consolidated (CB plus NBFI) parastatals with growth in total (CB plus NBFI) deposits. Then we will examine the growth in commercial bank parastatals relative to the rest of the commercial bank sector. Next their success in attracting non-bank deposits will be compared with the rest of the NBFI sector.

Table 4 compares the growth of the public sector firms (consolidating the CB's with their NBFI subsidiaries) with total growth in deposits. It can be seen that during the early, fast growth period, the public firms' deposits grew on a par with total deposits. Of the three institutions the HFCK grew at about the same rate as total deposits, the NBK grew much faster and the KCB grew slightly slower.

However, during the later, slow growth period the public firms experienced a greater slow-down than the industry as a whole. Total deposits were growing at 14.5% during 1979-84, while deposits in public financial institutions were growing at only 8.8% p.a. Only the HFCK managed deposit growth faster than the sector as a whole, while KCB's growth rate was about 2/3 that of total deposits and NBK's was only one third.

It can be seen from Table 5 that during the rapid growth of the pre-coffee boom period the National Bank of Kenya grew very fast, 34.8% p.a., which was much faster than the growth of commercial bank deposits as a whole. On the other hand, deposits in the Kenya Commercial Bank grew significantly slower than total CB deposits, at a rate of only 13.9% p.a. During the slow growth period following the coffee boom, the KCB improved its relative

TABLE 4 CONSOLIDATED COMMERCIAL BANK PLUS NBFI DEPOSITS
(millions of shillings)

Year	KCB	NBK*	HFCK	Total	public share(%)
1971	1,108.2	211.8	83.3	3,628.9	38.7
1972	1,189.5	337.5	109.7	4,128.2	39.6
1973	1,568.8	528.0	128.2	5,236.1	42.5
1974	1,768.3	747.1	144.3	6,657.4	40.0
1975	1,849.8	950.3	187.2	8,411.2	35.5
1976	2,251.9	1,173.6	180.9	11,936.4	30.2
1977	3,297.0	1,461.5	213.6	14,237.4	34.9
1978	3,796.7	1,901.2	246.8	15,425.4	38.5
1979	4,033.3	2,254.7	375.7	17,444.7	38.2
1980	4,217.7	2,323.2	472.6	18,854.7	37.2
1981	4,391.4	2,316.4	688.0	21,377.6	34.6
1982	4,889.6	2,304.0	886.5	25,568.7	31.6
1983	5,333.6	2,446.6	1,020.7	28,121.7	31.3
1984	6,138.1	2,634.5	1,366.3	34,313.3	30.9

SUMMARY OF GROWTH EPISODES (growth in % p.a.)

71-79	18.8	34.4	21.6	21.7	21.5
79-84	8.8	3.2	29.5	14.5	8.8

* The NBK uses a balance sheet date of June 30, while all other firms use December 31. For purposes of comparison, the deposits reported here are the linear interpolation of the deposits they report 6 months before and 6 months after the end of each year.

Sources: Annual reports and Central Bank of Kenya, Economic and Financial Review, various years.

TABLE 5 COMPARISON OF COMMERCIAL BANK DEPOSITS
(Deposits in millions of current shillings, shares in %)

	KCB	SHARE	NBK*	SHARE	BARCLAYS	SHARE	TOTAL
1971	1,021.3	32.0	211.8	6.6			3,186.7
1972	1,083.3	30.6	337.5	9.5			3,545.3
1973	1,438.6	34.4	528.0	11.6			4,559.1
1974	1,580.5	27.1	747.1	12.6			5,940.2
1975	1,529.5	21.4	950.3	13.3			7,157.1
1976	1,866.2	17.8	1,173.6	11.2			10,506.8
1977	2,653.1	21.9	1,374.0	11.3			12,130.5
1978	2,886.7	22.9	1,669.7	13.3			12,597.5
1979	2,900.3	21.2	1,948.0	14.2	2,556.9	18.6	13,711.5
1980	2,933.4	20.9	n.a.		3,023.7	21.6	14,002.2
1981	3,252.1	20.7	n.a.				15,686.0
1982	3,682.1	19.5	n.a.		3,969.9	21.6	18,392.2
1983	3,982.7	20.5	n.a.		3,963.8	20.4	19,449.8
1984	4,611.2	22.4	n.a.		4,539.9	22.0	20,625.3

SUMMARY OF GROWTH EPISODES (growth in deposits, % p.a.)

71-79	13.9	34.8	20.0
79-84	9.7	12.2	8.5

* The NBK uses a balance sheet date of June 30, while all other firms use December 31. For purposes of comparison, the deposits reported here are the linear interpolation of the deposits they report 6 months before and 6 months after the end of each year.

Sources: Annual reports and Central Bank of Kenya, Economic and Financial Review, various years.

performance. Its deposits grew a bit faster than total CB deposits. On the other hand, the private Barclays grew almost half again as fast as total CB deposits. We do not have data on the CB deposits only for NBK during the latter period.

It can be seen from Table 6 that the public sector firms were important in the early growth of the non-bank financial sector. KCB set the pace for this growth, with its market share growing from zero in 1971 to 32% in 1978. HECK grew somewhat slower, but still contributed a large share of the absolute growth of the sector. In later years KCB turned its attention away from the non-bank sector almost entirely, with its non-bank deposits growing at only 6.1% p.a., way below the market growth rate of 26.6%. During this period however, HECK held its own, turning in a growth rate from 1979-84 of 29.5% p.a.

Deposit Growth--Summary and Conclusions

In the first period under study, the high growth years of 1971-79, the public sector firms' deposits grew at about the same rate as the market as a whole. The public sector growth was led by the newly started National Bank of Kenya, the NBFI subsidiary of the KCB (also newly started) and, to a lesser extent, by the HECK.

TABLE 6 NON-BANK FINANCIAL INSTITUTION DEPOSITS

	KCB	share	NBK	share	HECK	share	TOTAL
1971	nil.	0.0	nil.	0.0	83.3	18.8	442.1
1972	106.2	18.2	nil.		109.7	18.8	582.9
1973	130.2	19.2	nil.		128.2	18.9	677.0
1974	187.8	23.0	nil.		144.3	17.7	817.3
1975	320.2	25.5	nil.		187.2	14.9	1,254.1
1976	385.7	27.0	nil.		180.9	12.7	1,429.6
1977	643.9	30.6	87.6	4.2	213.6	10.1	2,106.9
1978	910.0	32.2	231.5	8.2	246.8	8.7	2,828.0
1979	1,133.0	30.3	nil.		375.7	10.1	3,733.2
1980	1,284.3	26.5	n.a.		472.6	9.7	4,852.5
1981	1,139.3	20.0	n.a.		688.0	12.1	5,691.6
1982	2,207.5	30.8	n.a.		886.5	12.4	7,176.4
1983	1,367.7	15.8	n.a.		1,020.7	11.8	8,671.9
1984	1,526.9	12.6	n.a.		1,366.3	11.2	12,153.9

SUMMARY OF GROWTH EPISODES (growth in % p.a.)

71-79	30.4*		20.7	30.6
79-84	6.1		29.5	26.6

* for 1972-79

Sources: Annual reports and Central Bank of Kenya, Economic and Financial Review, various years.

Under most models of oligopoly the presence of more firms leads to more competitive behavior, and this seems consistent with the evidence on the Kenyan financial industry. Up until 1970 the banking sector was seen as lacking in dynamism and unresponsive to the needs of the public. Private sector firms were free to enter throughout the period under study (and many did so). The public sector firms were competing with private sector firms for deposits. Their success at attracting funds demonstrates that they were offering depositors better terms than was the private sector.

There is one factor which might negate this interpretation of the deposit growth rates of the parastatal banks. The state controls a significant portion of deposits in Kenya directly via the national government accounts and indirectly via local government and other parastatals. The proportion of deposits controlled by the government sector grew during the fast growth period. If government gave preference to putting government funds in government owned banks, that might explain deposit growth of parastatal banks. In that case we could not conclude that the parastatal banks had successfully competed for funds.

The direct evidence which would permit us to test this explanation is not available: the data on what percentage of deposits in parastatal banks originate in the government sector

is not available. However, the importance of government deposits in explaining deposit growth of parastatal banks can be tested indirectly, econometricly.

The model estimated was the following:

$$\text{Pardep} = A_1 \cdot \text{Deppub} + A_2 \cdot \text{Depriv} \quad \text{Eq. 1}$$

where Pardep = deposits in parastatal financial institutions
 Deppub = total deposits controlled by the national & local governments & other parastatals
 Depriv = total deposits originating from the private sector

In this model A_1 can be interpreted as the portion of government deposits which it places in parastatal banks. Likewise, A_2 is the portion of deposits which the private sector puts in parastatal banks. If A_1 were 1 and A_2 were 0 we could conclude that parastatal banks depended entirely on government deposits.

The estimates for Equation 1 are shown in Table 7. Both coefficient estimates have the expected positive sign. The Cochrane-Orcutt iterative estimation technique was used to correct for the presence of autocorrelation.

The estimates reported in Table 7 allow us to reject the hypothesis that parastatal deposit growth was due solely to growth in government deposits. The coefficient on private deposits (A_2) is clearly non-zero, whereas that for public

TABLE 7 REGRESSION RESULTS

Label	Estimate	St. error	T-statistic
A ₁	0.14	0.26	0.53
A ₂	0.31	0.08	3.75

degrees of freedom=12 R²= .98

deposits is not significantly different from zero. It can be concluded that the presence of the depository parastatals made the financial sector more competitive than it would have been in their absence.

The public sector firms were especially important in the development of the NBFIs sector. When KCB entered the market for NBFIs funds the market was very small. It consisted of seven privately owned institutions plus the HFCK. Of the seven at least two were owned by and operated for the Asian community (Diamond Trust of Kenya Ltd, and Ismailia Corp Ltd).¹⁵ Several were specialized in mortgage lending. KCB immediately captured a large market share (18% in the first year of operations) which it could only have done by offering more competitive terms to depositors. They continued to perform better than the private sector, with an explosive 30.4% annual growth rate, compared with private sector NBFIs growth of 23.5%. At the end of the fast growth period, in 1979, the public firms held 48.1% of the market, compared with 18.8% at the beginning of the period. Thus, to a large extent, the public sector led the way in the creation and development of the dynamic NBFIs sector.

It is perhaps paradoxical that it was the parastatals who pioneered in the development of the general purpose NBFIs. To the public the main attraction of NBFIs was the higher interest

¹⁵ Central Bank of Kenya, page 22.

rate on deposits. Thus the development of NBFIs can be seen as a means of evading the interest rate restrictions imposed by government regulations. Their evasion permitted the growth of credit to local entrepreneurs who would not have qualified for loans from the commercial banks under the tighter interest rate restrictions applied to CBs. The success of KCB and NBK in operating these aggressive and dynamic NBFIs demonstrated the potential of this practically untapped market, in addition to providing the training ground for the personnel who would tap it. As the attractiveness of the market became apparent many private competitors followed, including firms staffed by former employees of the parastatals.

Finally, it might be noted that those parts of the public financial sector which were most dynamic during the high growth years of the 70s were very urban oriented. The commercial bank part of the KCB, with its extensive network of rural branches, grew only about 2/3 as fast as total CB deposits. The dynamism came from the KCB's NBFIs subsidiary, from the NBK and from the HFCK. All of these firms had all or most of their branches located in major urban areas, primarily Nairobi. Their growth did much to improve services in the urban areas and increase the competitiveness of the financial sector there. But little effort was devoted to extending financial services to the rural areas.

The public sector financial institutions apparently changed their strategy during the slow growth post-coffee boom period. Those parts of the public sector which primarily cater to the urban markets have exhibited the worst performance. The NBK, for example, grew at a dismal 3.4% p.a., a growth rate about one quarter of that of the total market and well below inflation. Likewise, the NBFI subsidiary of the KCB had deposit growth of only 6.1%, one fifth the rate of the NBFI sector as a whole, and also below inflation. Of public sector firms serving the urban markets, only the HFCK continued to perform on a par with the rest of the sector with which it competed.

The commercial bank portion of the KCB, with its extensive rural branch network, has performed better than the urban oriented financial parastatals during the slow-growth period. It managed deposit growth which was somewhat faster than total growth in CB deposits. Although we don't have data which differentiates KCB bank deposits by branch of origin, we conjecture that this success stemmed in part from an aggressive expansion into rural areas. This expansion into the rural areas will be discussed more below.

One source of the decline in relative performance of parastatals following 1979 undoubtedly stems from the change in interest rate policies which occurred around then. As the policy switched from low nominal rates to higher ones, commercial banks

suffered a dramatic fall in growth of deposits relative to NBFIs. Furthermore, as noted above, rumors abound of cut-throat competition among NBFIs who offer non-interest cash payments to attract large depositors. To the extent that the parastatals have refrained from these practices, which are of questionable legality, they have lost out relative to the private sector.

This switch of deposits from CBs to NBFIs is probably an unintentional effect of the high interest rate policy, and calls into question the whole existence of interest rate ceilings on the CBs and especially differential policies between the two sectors. The NBFIs operate almost entirely within the largest cities. Hence the draining of deposits from CBs toward NBFIs means that less credit is available to rural borrowers.¹⁶

District Focus and the Banking Sector

Part of the success of the parastatal banks in attracting a larger share of deposits derives from Kenya Commercial Bank's aggressive branching strategy. At December 31, 1984, KCB had 52 full branches compared to 46 for Barclays. In addition they had 42 sub-branches, compared with 16 for Barclays and 127 mobile centers, compared with 7 for Barclays. Thus part of their growth came from serving markets not otherwise served, and not merely by competing for deposits within the cities. Paulson lists 143

¹⁶ Paulson, page 67.

locations which are served by only one bank. Of those 143 locations, 130 are served by KCB.¹⁷

This aggressive branching strategy has continued and will continue. Since 1984 it has been a declared KCB goal to have at least one full branch in every district.¹⁸ Considering that in September, 1984 only 27 of the 42 districts had full branches, this represents a considerable planned expansion.

These extensive rural facilities represent a large investment in fixed assets. Since 1979 the value of these assets has expanded faster than the deposits they have attracted. In table 8 we compare the value of fixed assets to deposits. Fixed assets were re-valued so that the figure given for each year represents the replacement cost in that year. Whereas in 1978 and 1979 each shilling of fixed assets supported Shs 33 of deposits, that dropped to 20 in 1980, where it has remained since then.

2. Profitability

Table 9 shows rates of return on equity in the financial sector. A brief glance at the table reveals that the sector has

¹⁷ Paulson, 1984, Appendix C.

¹⁸ Report of a speech by the Executive Chairman of Kenya Commercial Bank, Dr. Benjamin Kipkorir, reported in the Sunday Nation, Sept 9, 1984.

TABLE 8 KCB FIXED ASSETS VERSUS DEPOSITS

	DEPOSITS (shs mil)	FIXED ASSETS* (shs mil)	DEP/ASSETS
1978	2,886.7	87.0	33.2
1979	2,900.3	87.8	33.0
1980	2,933.4	144.4	20.3
1981	3,252.1	147.7	22.0
1982	3,682.1	163.4	22.5
1983	3,982.7	185.9	21.4
1984	4,611.2	229.0	20.1

* Replacement cost, current shillings. Calculated using category of asset and appropriate inflation indices.

Source: Author's calculation from annual reports, various years.

been highly profitable for all the firms for which data is available, in almost every year. From a simple financial point of view, financial parastatals have been extremely good investments. A more detailed examination of table 9 reveals interesting details.

First, note that throughout the period 1971-79 the NBK was less profitable than the KCB or HFCK. Out of 17 comparisons of NBK's profits with those of another firm, the NBK only surpasses one of the others 4 times. This is consistent with our view of the NBK as an aggressive entrant into a highly concentrated oligopolistic market. It probably spent more than KCB to attract depositors, since it had to attract a clientele to become established.

Second, note that the HFCK has been more profitable than the commercial banks. Out of 27 comparisons, (12 with KCB, 13 with NBK and 2 with Barclays) the HFCK was higher in 20. This reflects the greater profitability of the NBEI sector. The profit rates reported for the KCB and NBK are based on the consolidated performance of the banks with their NBEI subsidiaries. Thus it is not surprising that all the instances in which the KCB and NBK surpassed the HFCK in profitability occurred in the earlier era during which their non-bank deposits were growing rapidly. In the later period, when KCB and NBK seem to have virtually withdrawn from the competition for non-bank

deposits, they are always less profitable than the non-bank HFCK.

Third, the parastatal banks were less profitable in the later era. Before 1979 KCB's rate of return only once dipped below 30%, but after 1979 it only once achieved that rate. Since 1979 the NBK has experienced two years of losses, the only losses reported by any firms in the sample. During the rest of the later period, in the four years in which the NBK reported profits, its performance was equivalent to its four worst years during the early period. On the other hand, the HFCK's profits improved a bit during the later period. Hence it seems that the worse profit performance of the NBK and KCB during the later period does not stem from worse market conditions generally. For the KCB at least, the drop in profitability is tied to its reorientation away from the urban, NBFI market and towards the rural, commercial bank sector. Through its policy of opening facilities in unprofitable remote areas it has sacrificed about half its potential profits.¹⁹

The worsening of NBK's profitability in the latter period has another cause which merits discussion. That is the matter of alleged embezzlement on the part of the bank's Executive Chairman. In 1981 allegations were made in Parliament that the Chairman had stolen KShs 293 million from the bank during 1978 by

¹⁹ Interview with KCB staff.

TABLE 9 RATES OF RETURN ON EQUITY* (%)

YEAR	BARCLAYS	HECK	KCB	NBK
1971		69.1		17.3
1972		50.5	32.9	20.5
1973		60.3	9.7	27.1
1974		61.2	42.8	29.9
1975		106.2	37.4	54.4
1976		46.2	47.1	30.6
1977		27.2	62.6	35.8
1978		31.1	62.0	38.4
1979		52.7	37.9	-128.9
1980	50.8	38.3	25.8	28.8
1981		45.3	25.1	25.0
1982		87.1	22.3	15.8
1983	67.0	52.6	32.4	21.6
1984	55.4		28.0	-3.5

* Using average of equity at beginning and end of year.

Source: Author's calculations from annual reports, various years.

taking out loans which would not be repaid. Documents were tabled showing the details of Shs 50 million of the alleged stolen money. While no charges were ever filed related to the matter, annual reports in later years confirm that large bad loans were made. These loans have been written off from 1979 clear up until 1984. By 1984 the total written off amounted to some Shs 250 million.²⁰ Table 10 shows that the bad loans written off were large relative to NBK's profits and go a long way toward explaining NBK's decline in profitability. Of course, there is no way of knowing what fraction of the bad loans were due to the alleged malfeasance; probably some were normal losses. We have no standard by which to estimate how high loan losses would normally be. The NBK didn't report writing off any loans prior to 1979. KCB and Barclays don't report their loan write-offs.

Finally, it should be noted that Barclays Bank, which is entirely private, has been much more profitable than KCB during the period 1979-84, with profit rates averaging 77% higher in each year. A large part of this difference must stem from KCB's

²⁰ In fact the total written off exceeds that amount. The accounts of the NBK are consolidated with the Kenya National Capital Corporation, its NBEI subsidiary. However, NBK owns only 60% of the Kenyac, the Kenya National Assurance Corporation owning the other 40%. Hence, of loans written off by Kenyac, only the NBK's share of the losses is reflected in the NBK accounts. Most of the 1984 writeoffs were Kenyac writeoffs. The breakdown is not available for previous years.

TABLE 10 EFFECT OF BAD LOANS ON NEK PROFITS
(millions of shillings)

Year	Reported Profit	Bad Loans Written Off
1979	-89.4	152.8
1980	21.7	22.8
1981	29.7	5.4
1982	26.6	9.4
1983	49.9	19.7
1984	-8.5	42.9

Source: Annual reports, various years.

policy of serving unprofitable rural markets, which will be discussed more below. It could also reflect differences in efficiency, but since neither KCB nor Barclays report their costs, this is impossible to assess.

3. Returns to Employees

It is frequently alleged that parastatals run for the benefit of their employees at the expense of the other potential beneficiaries. This might happen through a firm hiring more employees than it needed, or by rewarding them more than needed to retain them. Such rewards could come in the form of high salaries, fringe benefits, on the job consumption, or through opportunities to divert company assets to personal use. All of these practices can exist at any level, be it manager or sweeper. All of these practices, where they occur, will show up in a firm's accounts as an inflation of the firm's costs. Unfortunately it is difficult to evaluate whether costs are inflated by such practices, since we have no good standard by which to judge what costs should be.

Table 11 shows available data on costs relative to loans outstanding. If no upward trend in this ratio exists, then at least there is no evidence that employees are increasingly exploiting their positions at the expense of other parties.

E.A

 TABLE 11 COSTS (EXCLUDING INTEREST) AS A PERCENTAGE OF LOANS OUTSTANDING

	HFCK	NBK	NBK(excluding loan loss writeoffs)
1971	3.0		
1972	2.5		
1973	2.9		
1974	2.2		
1975	1.9		
1976	1.9	4.1	4.1
1977	2.4	3.9	3.9
1978	2.5	3.8	3.0
1979	2.9	15.4	3.5
1980	2.5	5.1	3.6
1981	2.3	4.3	4.0
1982	15.8*	5.4	4.8
1983	7.0*	5.4	4.4
1984		7.7	5.1

* Costs were arrived at indirectly in these years. They were defined as total income less profit and interest expense. It is possible that some change in accounting categories could explain the surprising jump.

The table shows the effect of the bad loans written off by the NBK in 1979 and 1984, as mentioned above. The limited data available, for NBK and HFCK, suggest that aside from the problem with NBK management mentioned above, there was no upward trend on cost margins before 1982. There may be cause for concern since then.

There is indirect evidence that, at least at managerial levels, employees are not being overpaid. Most of the mushrooming locally owned private sector financial institutions are staffed by former managers from KCB and NBK. The fact that these manager chose to leave proves that the parastatal sector is not over-compensating the value of their skills.

D. Conclusions--Performance of Depository Parastatals

The parastatal financial institutions have been used as effective tools of national development. The manner of their use differs before and since 1979 when the general government development strategy changed.

Before 1979 the parastatal firms were used to foster economic growth pure and simple. Private foreign capital was hesitant about economic prospects in Kenya following independence. Private local capital was not yet in a position to provide adequate investment and services. The parastatals filled

a vacuum then, providing financial services on terms that drew business away from private foreign firms and was highly profitable. By 1979 local financial markets were more developed and had more participants, including local entrepreneurs.

Since 1979 the financial parastatals have competed less vigorously in urban markets which are well served by private firms. Major emphasis has instead been put on expanding services to rural markets not previously served. This re-orientation of the financial parastatals is consistent with the entire government policy since 1979, which has put less emphasis on simple numerical growth and more on questions of regional distribution. This policy has been less profitable financially. The impression obtained from observing branches and interviewing staff is that it seems to have been carried out in an efficient and business-like way.

II. THE AGRICULTURAL FINANCE CORPORATION

The Agricultural Finance Corporation is a specialized non-bank financial institution. It was established in 1963 for the purpose of providing loans to Africans who purchased farms from departing white settlers around independence. It was later (1966 unofficially, 1969 officially) amalgamated with the Land and

Agriculture Bank, which had been the main source of agricultural loans to settlers before independence.

In this paper we will first analyze the performance of the AFC as reflected in its audited accounts. However, there is serious reason to doubt the accuracy of these accounts. After examining them we will comment on probable sources of error and resulting bias in the results.

A. FINANCIAL PERFORMANCE--RETURNS TO SHAREHOLDERS

The AFC was started as a small organization, with only 25 employees. By 1966 the combined AFC and Land Bank had 147 employees, including 17 expatriates. It had 9 branch offices and 7 sub-branches. In 1983 the AFC had 37 branch offices and over 500 employees.

Unlike the financial institutions discussed in the previous section, the AFC does not accept deposits from the public. The capital which the AFC lends comes from grants and loans, as well as the accumulated general reserve. Much of the capital is obtained from soft loans from international agencies such as the World Bank and USAID, which is on-lent by the government to AFC.

A. FINANCIAL PERFORMANCE--RETURNS TO SHAREHOLDERS

The AFC was started as a small organization, with only 25 employees. By 1966 the combined AFC and Land Bank had 147 employees.

Certain aspects of the financial structure of the AFC are shown in Table 12. The AFC was started in 1964 with a small equity base of Shs 7.8 million, which was then eroded away due to losses leaving only Shs 1.4 million of equity by 1969. During this early period the AFC was receiving new infusions of capital in the form of loans. The combination of eroding equity and growing net assets means that the ratio of equity to net assets fell from 15.7% in 1964 to 1.7% by 1969.

During 1970 large capital transfusions were received. Equity jumped fifty-fold, while net total assets more than doubled, giving the AFC a much more favorable equity to net assets ratio of 25.7%. Following this transfusion performance continued to be lackluster. Equity stagnated in nominal terms from 1970 to 1976, during which time price levels rose by 87%. Even this overstates the health of the AFC. Equity levels were only maintained by an inflow of interest free grants which balanced the declining general reserves as the AFC continued to earn losses.

From 1976-83 the AFC records a healthier performance. Equity grew at 13% p.a. while inflation averaged 9% p.a. While total equity slightly more than doubled, general reserves grew by an order of magnitude, the first self-financed growth the AFC ever recorded. During this period net total assets also slightly

TABLE 12 FINANCIAL STRUCTURE OF AFC

YEAR	EQUITY (mil Shs)	NET TOTAL ASSETS (mil Shs)	EQ/NET ASSETS (%)	CURRENT LIAB. /TOTAL ASSETS(%)
1964	7.8	49.7	15.7	1.5
1965	7.8	55.7	14.0	0.6
1966	6.0	65.3	9.3	7.9
1967	4.9	67.1	7.4	7.4
1968				
1969	1.4	82.8	1.7	3.5
1970	51.0	198.7	25.7	8.0
1971	50.4	211.3	23.9	9.0
1972	49.9	227.7	21.9	6.0
1973	50.4	255.8	19.7	4.4
1974	52.8	283.7	18.6	3.5
1975	49.8	329.2	15.1	3.5
1976	51.1	414.1	12.3	2.8
1977	59.0	492.0	12.0	2.6
1978	70.4	524.7	13.4	2.5
1979	83.5	625.9	13.3	2.7
1980	100.5	705.2	14.3	7.8
1981	109.4	767.8	14.2	20.2
1982	112.8	821.7	13.7	19.1
1983	120.2	829.8	14.5	23.4

Source: AFC Annual Reports, various years.

more than doubled, due to continuing infusions of loan capital.

Since 1980 there has been an alarming increase in current liabilities. Current liabilities as a share of total assets hovered in the range of 2-5% from 1973 to 1979. Then they began a rapid climb and in 1983 they were 23.4%, an astonishing ratio for an organization whose business is long term lending.

Table 13 provides data on the interest rate structure of AFC. Column 1 shows interest payable by AFC as a percentage of its interest bearing debt. These interest rates were low throughout the period. Especially in the late 70s and early 80s when interest rates elsewhere were so high, the rates the AFC was charged on its debt were highly concessionary.

Column 2 shows the interest receivable by AFC as a percentage of total loans outstanding. These figures can be contrasted with those in column 3, the maximum loan rate charged by commercial banks. AFC loan rates were consistently lower than rates charged by commercial banks, which were in turn lower than those charged by non-bank financial institutions.

A comparison of columns 1 and 2 shows that the degree to which AFC passed on its own interest rate subsidy to its clients

TABLE 13 AVERAGE INTEREST RATES AND RATES OF RETURN

	Int payable as % of debt	Int receivable as % of loans	CB Loan rate (max)	ROI	ROE
1965	3.1	8.4		2.5	0.0
1966	3.4	6.3		0.1	-3.4
1967	3.8	5.8		1.8	-2.0
1968					
1969	1.3	8.1		-2.1	-7.2
1970	6.5	9.3		4.1	-3.6
1971	5.1	6.3		3.3	-2.1
1972	5.0	7.1		3.5	-1.3
1973	4.8	7.4		3.6	-1.0
1974	4.6	7.3		4.1	2.2
1975	4.3	7.5		2.5	-6.4
1976	3.9	7.7	9.0	3.5	0.8
1977	3.8	8.9	10.0	5.1	14.5
1978	3.6	8.1	10.0	5.4	17.3
1979	3.4	8.9	10.0	5.0	15.2
1980	3.4	9.2	11.0	5.5	18.9
1981	3.2	9.1	14.0	5.5	19.3
1982	3.4	11.0	16.0	6.1	22.7
1983	3.7	11.0	15.0	5.9	19.3

Source: AFC Annual Reports, various years.

decreased markedly. During the periods 1965-67 and 1981-83 AFC's average interest rate on debt was the same, 3.4%. During the former period the average interest rate AFC charged its clients was 6.8%, while during the latter period its interest rate charges averaged 10.4%.

Column 4 shows the rate of return on investment in AFC. This is pre-tax profit plus interest payable as a percentage of total net assets. The AFC earned a small positive ROI every year but one. That such returns are inadequate can be seen by comparing column 4 with columns 1 and 5. The returns on total investment reported in column 4 are less than the average interest rate on AFC debt in column 1 every year until 1977, which explains the string of negative returns on equity (pre-tax profit over equity) reported for the first decade of AFC's existence. Even if government never intended to turn a profit from loaning money for agriculture, the financial performance of the AFC in its first decade was so poor that the capital base was being eroded away. The AFC was not even self-sustaining, let alone profit making.

Since 1977 the profit performance of AFC has improved. Over the period 1977-83 AFC reported an average ROI of 5.5%, more than double the average reported during the 1965-76 period of 2.4%. While AFC's ROI in the post 1977 period cannot be considered high, it at least surpassed the cost of borrowed funds, so that

returns on equity have been positive, mostly in the range of 15-20% for the whole period 1977-83. A large part of the explanation for AFC's improved profitability lies in the reduction of interest rate subsidy to AFC borrowers, as seen from comparing columns one and two.

The increase in interest rates AFC charges on its loans and the resulting improvement in financial performance does not reflect a decision that AFC must rely on internally generated funds. Table 14 shows sources of capital for the AFC. It will be noted that AFC has continued to receive large infusions in the form of loans as well as small infusions in the form of grants. Paulson noted that since 1976/77 appropriations from the budgets of the ministries of Agriculture and Livestock Development to AFC fell as a percentage of the total development budgets for those ministries.²¹ Table 14 shows that the transfers to AFC after 1977 were large relative to previous transfers. The reported improvement in AFC's financial performance seems to reflect one aspect of a commitment to maintaining AFC operations, not a cutting off of AFC from its access to soft funds.

²¹ Paulson, p. 118.

B. EFFICIENCY AND RETURNS TO AFC EMPLOYEES

Table 15 shows AFC costs as a percentage of AFC's portfolio of loans to farmers. These costs include Board members' fees and allowances, staff costs, general administration and depreciation. They do not include provisions for bad debts, nor the opportunity cost of low cost loans made to staff. The level of such loans outstanding is shown in Table 16. No information is available on interest charged on loans to staff. Table 15 shows no particular trend in cost levels. The figures for 1982 and 1983 are higher than average and could represent the beginning of an adverse trend, but costs have been higher before and come back down.

The AFC could have hidden excessive returns to AFC staff by giving them in the form of loans rather than salary. But the data presented in Table 16 make this seem unlikely. There is a surprising lack of upward trend in loans to staff, considering that the number of employees grew and the value of the shilling declined steadily. Even the value in 1983, which looks like a big increase, represents less in real terms than the staff loans in the early 1970s. As a percentage of loans to farmers, the staff loans have not risen. Most of the provisions for bad debts are applied against loans to farmers. Hence there is no evidence that the AFC could be making loans to its staff which it then writes off.

TABLE 14 TRANSFUSIONS OF NEW CAPITAL TO AFC ('000 Shs)

	Retained earnings	New grants	New debt	Total
1965	-18.1	-	6,000.0	5,981.9
1966	-1,763.2	-	11,390.6	9,627.4
1967	-1,101.1	-	2,874.5	1,773.3
1968				
1969	-3,508.1	-	19,246.0	15,246.0
1970	-1,683.6	51,213.7	66,328.8	115,859.0
1971	-1,087.4	549.6	13,200.4	12,662.6
1972	-673.6	166.0	16,838.2	16,330.6
1973	-481.6	996.0	27,587.9	28,102.3
1974	1,127.9	1,257.5	26,764.8	27,892.7
1975	-3,261.7	300.0	48,535.0	45,573.4
1976	392.4	874.9	83,637.5	84,904.8
1977	7,961.4	-44.9	69,906.2	77,822.8
1978	11,181.7	140.0	21,464.2	32,785.8
1979	11,668.1	1,480.4	87,962.1	101,110.6
1980	17,397.9	-402.6	62,356.3	79,351.6
1981	7,810.5	1,051.4	53,738.2	62,600.2
1982	2,465.5	996.2	50,417.2	53,878.8
1983	6,939.6	477.8	669.0	8,086.4

Source: AFC Annual Reports, various years

TABLE 15 ADMINISTRATIVE COSTS OF AFC AS A PERCENTAGE
OF LOANS TO FARMERS OUTSTANDING

1965	7.4%	1975	5.2%
1966	5.6	1976	4.6
1967	5.6	1977	4.5
1968	8.1	1978	4.5
1969		1979	4.9
1970	3.5	1980	4.4
1971	3.2	1981	5.1
1972	3.9	1982	6.2
1973	4.3	1983	7.4
1974	4.5		

Source: AFC Annual Reports, various years.

TABLE 16 LOANS TO AFC STAFF OUTSTANDING

		Shs. '000	
1964	70.9	1974	360.6
1965	155.7	1975	449.3
1966	372.8	1976	426.0
1967	341.2	1977	466.8
1968		1978	545.5
1969	542.8	1979	461.5
1970	795.5	1980	624.1
1971	778.5	1981	475.3
1972	716.2	1982	918.9
1973	466.7	1983	1,512.1

Source: AFC Annual Reports, various years.

To summarize, the data reported by the AFC give no reason to believe that AFC staff are increasingly exploiting their position and capturing increasing returns. There is no evidence that total staff costs have increased disproportionately, nor expenditure on fixed assets which would include staff housing, nor loans to staff. Comparison of data from Table 15 with that from Table 11 above shows that the AFC's costs as a percentage of loans have been in approximately the same range as those for the National Bank of Kenya. This may be an indication of inefficiency given that NBK gets its funds in a fairly competitive financial market. Its administrative costs include the costs of dealing with thousands of depositors, while AFC gets its funds in a few large transactions. Furthermore, the average size of AFC loans is higher, which should reduce its cost margins below those of the commercial banks.

C. CHARACTERISTICS OF AFC LOANS--RETURNS TO BORROWERS

In addition to loaning to Kenyans who took over large farms the AFC is supposed to loan to several groups who would not qualify for loans from commercial banks. These target groups include group ranches, borrowers without land titles, smallholders, and medium scale commercial farmers. AFC has acted as agent for the government in administering seasonal credit for

large farmers.

Data on the size, purpose and number of new loans approved each year is summarized in Table 17. The number of loans granted is small and the average size is large. The wide fluctuation in average loan size probably reflects the presence in some years of a few very large loans. Up through 1976 over half the loans approved each year were for land purchase. In other words, most of the AFC's capital was tied up in a few large loans at subsidized interest rates for a transfer of assets which could not be expected to result in increased agricultural production.

Paulson examined detailed loan data on a sample of loans given by 5 rural branches of the AFC between 1980 and 1982 and compared it with loans from a commercial bank in the same districts and in the same period. She found that AFC loans were larger on average and that they went to persons with higher incomes. This information is given in Table 18.

Despite the fact that the AFC lends to such a wealthy clientele, it suffers a high rate of default on its loans. The amount of principle and interest in arrears as a percentage of the outstanding portfolio increased steadily from 12.7% in 1975 to 25.0% in 1982. Particulars are given in Table 19. In the

TABLE 17 NEW LOANS APPROVED

	number	Total amount (mil Shs)	average loan (Shs)	average loan (1976 Shs)	% of loans for land purchase
1964	546	17.9	32,812	66,963	n.a.
1965	579	19.2	33,202	68,037	n.a.
1966	432	10.1	23,443	47,263	n.a.
1967	258	5.9	22,911	45,190	n.a.
1968					
1969	388	9.2	23,744	45,574	77.8*
1970	262	25.2	96,020	179,477	75.3*
1971	437	32.9	75,254	134,142	66.3
1972	233	42.1	180,600	299,006	63.2
1973	111	8.9	79,996	121,206	7.5
1974	129	40.4	313,327	402,218	67.8
1975	198	63.5	320,645	372,843	72.4
1976	209	52.9	252,951	252,951	87.3
1977	335	43.9	131,122	111,120	43.8
1978	628	82.7	131,766	108,094	35.0
1979	734	121.4	165,329	129,063	29.7
1980	816	110.7	135,658	96,554	20.6
1981	548	131.5	240,051	155,172	41.6
1982**	3,595	98.8	27,491	16,152	13.2
1983**	5,445	260.5	47,849	26,176	10.9

* overestimate, includes loans for "various" purposes not otherwise specified.

** includes seasonal crop and smallholder credit, which is excluded in other years.

Source: Statistical Abstract, various years.

sample of loans Paulson examined, of those loans on which some payment was due, 68% were in arrears. More than half of those in arrears were over a year in arrears. The maximum arrears on one account was over Shs 2.5 mil.²² Large loans were more likely to be in arrears than small loans.²³

The arrears position of the AFC is so serious as to endanger its viability as a source of credit. The AFC has had to impose lending embargoes several times in the last few years due to liquidity problems. In the period 1979-82 new lending was under partial or total embargo during 25 months.²⁴

Several factors contribute to the serious arrears situation AFC faces. First AFC's accounting system is faulty. Second, AFC's loan collection procedures are lax. Third, AFC loan collection has become a politically sensitive issue.

Paulson found that AFC's accounting system is so cumbersome and slow as to distort the classification of which accounts are in arrears. "The AFC accounting department is centralized in Nairobi...The head accounting office is notorious for ignoring requests from the branches to correct accounts which show arrears

²² Paulson, 1984, pages 130-133.

²³ Paulson, 1984, page 155.

²⁴ Paulson, 1984. page 123.

TABLE 18 CHARACTERISTICS OF LOANS & BORROWERS

Group Means Sample	AFC (213)	BANKS (139)
Average Loan Size (Shs)	56,025	38,279
Smallest Loan	4,000	1,000
Largest loan	1,080,000	480,000
Period of Loan (months)	66.7	29.4
Farm Income (Shs)	29,395	15,975
Non-Farm Income (Shs)	41,021	28,200
Percent that did not report a Non-Farm Income	27	37
Average Land Ownership (acres)	107	42
Average Value of Land and Permanent Improvements (Shs)	148,298	52,951

Source: Paulson, 1984, pages 173, 176, 180 and 181.

TABLE 19 TOTAL ARREARS ON AFC PORTFOLIO
(Year ending March 31, K Shs. mil.)

	Principal and Interest in Arrears and Interest on Arrears	Portfolio Outstanding	Arrears as Percent of Outstanding
1975	40.76	321.7	12.7
1976	55.96	413.1	13.5
1977	76.26	457.6	16.7
1978	74.60	502.1	14.9
1979	90.84	594.3	15.3
1980	135.80	719.6	18.9
1981	164.75	731.9	22.5
1982		871.6	25.0

Source: Paulson, 1984, p. 126.

even after payment has been received...Because of the accounting problems in the Corporation, the information on timing of repayment is faulty..."²⁵

When AFC borrowers fall into arrears, the Corporation is lax in its collection procedures. Paulson examined the record of collection efforts made in 262 loans in arrears for over 6 months. She reported that "Of the loans with arrears, about one-third have no record of loan servicing. A further 23% have only a notice from AFC...It is impossible to know what percentage of these notices ever reached the clients since, as Marende pointed out, most small borrowers have no personal postal address. Only 35% of the clients with arrears have had their farms inspected, 12% have received foreclosure notices and only 2% have had the farm advertized."²⁶ With such lax collection efforts it is hardly surprising that many clients allow their accounts to fall into arrears. Furthermore, having one's account in arrears is no impediment to repeat borrowing from AFC.²⁷

Collection efforts by the AFC are hindered by the political process. The granting of loans by AFC in the first place is a political process. This is clearly true in the case of those target groups who could not qualify for commercial credit.

²⁵ Paulson, 1984, p. 136.

²⁶ Paulson, 1984, page 157.

²⁷ Paulson, 1984, page 160.

Paulson reports that AFC loan officers are also under heavy pressure to give favorable treatment to clients "introduced" by politicians. While the commercial banks also complain of such pressures, the AFC reported it more frequently.²⁸

It is difficult for AFC to pressure either the targeted clientele of the AFC or the politically well-connected for repayment. Seizure of land from the specially targeted groups is seen as harassing wananchi and if done on a broad scale would generate substantial protest, protest the government would be unlikely to ignore.

Regarding the latter group, "...officers in AFC refer to some large borrowers as the "untouchables" because of their political connections."²⁹ Leys noted that

"In an important minority of cases, the [AFC] debtors were influential supporters of the government, so that the ultimate weapon of eviction was generally less likely to be used. On the other hand, its selective use, against prominent people who were in official disfavour, or against a limited number of "small men" on the settlement schemes who had no currently influential political protector, could serve a double purpose of strengthening the power of the regime over would-be critics or rivals, and at the same time of appeasing the credit institutions and their foreign creditors, on which the regime also depended. The parliamentary "sifting committee" which authorized the eviction of seventy six settlers down to 1969 exemplified this balance of considerations at one end of the scale. The threatened foreclosure in 1972 of a small number of

²⁸ Paulson, 1984, pages 108-109.

²⁹ Paulson, 1984, page 133.

prominent large-farm defaulters, who had in various ways recently dropped from favour, illustrated it at the other end."³⁰

There are probably at least three factors at work which explain why AFC has been so much more susceptible to political pressures than have the other financial parastatals. First is the fact that AFC has administered the seasonal crop credit schemes. Second is the fact that AFC has offered loans on concessionary terms. Third is the fact that AFC has no depositors.

The seasonal crop credit schemes in Kenya have been combined with a kind of crop insurance. The seasonal crop credit schemes have gone through several incarnations, beginning as the Medium Return Scheme (1942-67), then the Guaranteed Minimum Returns (1967-79), and, most recently, the New Seasonal Crop Credit Scheme (NSCCS, 1980-present):

"The basic characteristics of the seasonal credit programs have been similar for the various generations. The government sets the amount of credit available per acre, the minimum farm size eligible to participate in the program and the crops to be funded. The credit allotment usually covers about two-thirds of the estimated cost of production... Responsibility for loan appraisal is shared by the Ministry of Agriculture extension staff and the credit agency."³¹

Before 1980 the debts were cancelled in the event of weather related crop failure. This form of crop insurance was subject to

³⁰ Leys, 1975, page 102.

³¹ Paulson, 1984, page 114.

a moral hazard problem and was used and abused to avoid repayment. It was formally dropped in 1980, which was expected to improve repayment rates. However, those who still owed money under the previous program were allowed to continue borrowing, and government has chosen not to take court action against defaulters.³²

"AFC has argued that being forced to administer the seasonal credit program on an agency basis has weakened the institution by allowing credit discipline to decline and not giving AFC the authority to collect...Because of the accounting errors and administrative problems of the seasonal credit scheme, clients have become accustomed to being in arrears..."³³

We have seen that the terms on AFC loans have been softer than the terms on commercial bank loans. Interest rates have been lower and repayment periods longer. Hence, the AFC is a more attractive target for political pressure than are the commercial banks, and may have served to deflect pressure from them. If AFC continues to raise its lending rates toward commercial levels, and if it were to collect on its debts effectively, it may be that the banks would bear a larger share of pressure from politicians.

Finally, the fact that AFC has no depositors almost certainly makes it more susceptible to political pressure than are the other financial parastatals. If KCB, NBK, or HFCK

³² Paulson, 1984, page 114.

³³ Paulson, 1984, page 115.

suffered arrears anything like those of the AFC, they would quickly become unable to meet depositors' withdrawals. This would cause a public furor at least comparable to that which comes when the AFC tries to press for repayment. On the other hand, when AFC loses money due to arrears, those who are hurt are those who would have gotten loans if there were no lending embargoes, or the exchequer in general. Neither group is likely to complain vocally.

The AFC's failure cannot be excused by its specialized role of lending to agriculture. Within that sector it has lent mostly to an elite clientele. Meanwhile, the supposedly more profit oriented depository financial institutions have expanded their operations in the agricultural sector, partially filling the void left by the failure of the AFC. Table 20 shows that while in 1974 some 59% of agricultural lending came from the banks and NBFIs, by 1983 their share had risen to 82%.

D. AFC ACCOUNTING PROBLEMS

The AFC has failed to make adequate provisions for bad loans. As reported above, by 1982 arrears amounted to 25% of the total value of loans outstanding. Yet provisions against bad loans were only 8.4% of outstanding loans to farmers. It seems probable that this is an under-provision. Furthermore, the AFC

reports interest income when it accrues, rather than when it is received. The result of these problems with the accounts is that the picture presented here has been biased. In fact the actual financial performance has probably been significantly worse than that reported. The returns to consumers, on the other hand, have been better.

E. SUMMARY OF AFC PERFORMANCE

The AFC has been a highly politicized parastatal. It has never functioned on commercial lines, either on the supplier side or on the consumer side. It has been supported by a supply of soft credit and has never competed with other financial institutions for supplies of capital. It has loaned on concessionary terms, at low interest rates and for long terms, and the choice of who receives those loans has been politicized. Its greatest departure from commercial practice is its failure to collect on its loans. The repayment performance has been so poor as to endanger its ability to continue operations.

TABLE 20 AGRICULTURAL CREDIT OUTSTANDING

(K. Shs. m. at end of March)

Years	Commercial Banks	Cooperative Bank	NBFI	AFC
1974	319.5	-	60.4	263.2
1975	374.0	65.3	65.1	321.7
1976	684.1	97.9	71.3	413.1
1977	879.1	77.3	92.9	457.6
1978	1,186.6	156.2	109.3	502.1
1979	1,459.2	255.8	99.9	594.3
1980	1,528.2	308.2	130.8	719.7
1981	1,705.6	446.1	175.0	608.1
1982	1,885.1	374.2	562.8	886.8
1983	2,622.0	422.5	841.5	852.0

* excludes the Cooperative Bank except in 1974 when the Cooperative Bank was included

** statistics for NBFI include private-sector credit only

*** not audited

Note: AFC credit does not include the government seasonal crop credit programs

Source: Paulson, page 23.

III. CONCLUSIONS

We have examined the performance of four financial parastatals. The first three are depository institutions. The performance of these institutions during the 1970s was excellent. They were highly profitable and competed successfully with the private sector. They helped to expand the financial sector and cause it to behave more like a competitive market and less like a tight oligopoly.

During the period from 1979-84 the behavior of the parastatal commercial banks changed. Emphasis has shifted from urban markets to rural ones. Kenya Commercial Bank has embarked on a policy of aggressive branching in rural areas. This policy has been costly in terms of foregone profits, but appears to have been accomplished without sacrificing efficiency or changing from commercial criteria for loans to political ones.

Several dangers to the sector were identified. Key among these was political pressure to make bad loans. The depository institutions appear to have been successful at resisting pressure to make unsound loans to politically well connected individuals. They have been less successful at resisting pressure to loan to

bankrupt parastatals. To date the situation seems manageable, but if the situation were to worsen it could ruin the effectiveness of the banks.

The potential for trouble due to politicized loans was illustrated by the case of the Agricultural Finance Corporation. This firm was shown to be unprofitable and inefficient. Its loan procedures are politicized and its collection procedures even more so. These problems are so severe that the Corporation is not self-sufficient. Though it has continued to receive large transfusions of new capital on soft terms, the AFC is so ineffective at debt collection that it has repeatedly run out of funds and been forced to suspend new lending.

The AFC can only be seen as a mechanism to transfer resources from the exchequer to the AFC's clientele. This clientele is, on the average, far wealthier than that of the commercial banks. In contrast to the positive performance of the depository institutions, the AFC seems to have contributed little to national development. Its chronic squandering of funds and failure to mobilize finance for agriculture calls into question the use of soft funds and non-commercial criteria to allocate resources which are supposed to be invested in private sector, commercially viable agricultural enterprises.

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