CONTROLLING THE BANKING INDUSTRY TOWARDS GREATER CUSTOMER PROTECTION AND PREVENTION OF BANK FAILURE.

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To my parents for their unceasing academic support

All who care for the betterment of the children's lives.

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INTRODUCTION

The overall economy of a country may depend on the efficiency and reliability of the financial sector. The relationship between a banker and his customer being a debtor- creditor (1) One, the bank depositor can not be subjected to the harsh rule of caveat emptor. It is thus a cherished requirement that our banking system provide security for depositors. A. Dale Tussing, pointing towards the necessity for customer protection asserts that:-

> "........ the rule of caveat depositor can not be generally applied in practice, because most depositors have little knowledge of banking practice ......" (2)

The world has over the years experienced bank crises which have been disruptive catastrophes on the various economies affected. Bank failures have therefore been a loathed occurrence. To this end, Tussing asserts with a clear finality that "banks can not be permitted to fail like other business firms." (3) Stressing on how banks are different from other business firms, a writer Sheshunoff notes that:-

> "...... Bankers are different from you and Me. More to the point, they have to be different, because banking is unlike any other enterprise. Banks hold a public trust. We empower them by government charter and we regulate them closely, for they bear the responsibility of safeguarding a big piece of the nations wealth and using it to nurture the economy. We ask bankers to operate with unusual care and prudence. We ask them to be different." (4)

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Kenya experienced a bank crisis in the late 1980s. In retrospect, it can be argued that the 1985 Amendment to the Banking Act (5) and the enactment to the Banking Amendment Act (6) were a clear legislative response towards this crisis, aimed at greater customer protection as well as sealing the loopholes in the banking industry to ensure that bank failure does not reccur. The bank crisis that hit Kenya in 1986 was a living proof that there were weaknesses in the control of the financial sector.

Since our Kenyan banking industry has at last entered at a new regulatory era with tighter control mechanisms, the main concern in this dissertation will be to analyse this control mechanism. The problem of study will be - what is the nature and extent, as well as the effectiveness or otherwise of the legislative control mechanisms introduced for Kenya's banking and financial sector through the 1989 Banking Amendment Act?

In answering this seemingly simple question, the study will be divided into three chapters. Chapter one is worked out in three sections, the first tracing the development of banking in Kenya, the second defining the terms `banker' and `customer' while the last section discusses the nature of the legal relationship that subsists between the banker and his customer.This is deliberately done sincein an examination of the Statutory Prrotection of the customer and prevention of bank failure much reference is made to

the two terms. It is the writer's belief that an understanding of this legal relationship will help the reader appreciate the problem of study.
Chapter Two is devoted to an examination of the legal basis of having the control mechanism in the banking industry. The chapter briefly looks into the causes of bank failure as well as the reasons for controls.

Chapter Three, the backbone of the study examines the control mechanism proper 1.4. the nature, extent as well as the effectivennes of this control mechanism.To achieve this, the legislative control mechanism is discussed under five heads namely - control through the process of bank establishment, the Central Bank of Kenya's supervisory control, Restriction on the Banks lending abilities, the deposit protection fund and lastly, the implications of the Banking Amendment Act of 1989 on the entire control mechanism is thoroughly analysed. Finally, this chapter examines the adequacy of this legislative response. The question to ask at the end of the day is - Are there any unsealed loopholes in the banking business in Kenya? These loopholes are singly identified and analysed and their probably solutions suggested.

The conclusion sums up the findings of the study.

Footnotes

1. Foley v. Hill (1848) 2 H.L. Cas.28

2. A Dale Tussing: The Case for bank failure - 1967 Vol.10 Journal of Law and Economics Pg.147.

3. Supra at Pg.129

4. Alex Sheshunoff. Why banks must say no - Fortune international No.13 June 22 1978 Pg.109.

5. Cap.488 Laws of Kenya

6. Act No.6 of 1989

CHAPTER ONE

HISTORY AND DEFINITIONS

This chapter examines the development of banks in Kenya, the meaning attached to the terms `banker'and `customer',and legal nature of the baker-customer relationship.

1.1. Development of banks in Kenya

The word `bank' is said to have been derived from the Italian word `banco' which means a bench. It is contended that the early bankers transacted their business on benches in the market. It has thus been said that modern banking started in Venice, Italy in the 13th Century. As a result of the Roman Empire, Italy became a centre for commerce for European and Mediterranean merchants who converged in Venice with different kinds of money. The Italian merchants in Venice thus acted as money changers. In the course of time, they became very popular and by the end of the 13th Century they had developed into institutions of money changing, money depositing and credit

settlers. When English merchants went to Venice, they were sufficiently impressed by the Italian merchant's institutions. They thus started such institutions back home in England and by the 15th century, money changing, money depositing and credit settling had actually developed in England. Around 17th century, the money changers started forming joint stock companies and it is from these that we see the beginning of modern banking system in England. The origin of commercial banking in Kenya was the direct result of Kenya's colonisation by Britain in the 19th century.

The first bank to be established in East Africa was the National Bank of India which came to Zanzibar in 1893. The bank established its agency through Smith Mackenzie and company limited finally opening a branch in Mombasa in 1896. This bank remained the only one in Kenya until 1911 when the Standard Bank of South Africa and the National Bank of South Africa was amalgamated with the Colonial Bank and the Anglo-Egyptian Bank Ltd to form Barclays Bank (Dominion Colonies and overseas). In 1952, the Nederlandsche Hendel-maatscheppy (The General Bank of Netherlands) a Dutch bank incorporated in the Netherlands opened a branch in Nairobi. The bank of India was established in the same year and in 1953 the bank of Baroda onpened a branch. Habib Bank (overseas) Ltd from Pakistan opened in 1956 and the Ottoman Bank as well as the Commercial Bank of Africa were established in 1958.

Most banks were in fact established in the period between 1950 and 1960. During this period it is contended that banks were attracted by bright economic prospects due to the completion of the Kenya-Uganda railway which opened the rich hinterland of Kenya. However, the period between 1961 and 1967 witnessed the establishment of very few banks in Kenya. This was the period just before and soon after independence. In fact between 1960 and 1964, only one bank was established in Kenya. This was the National Bank of Pakistan established in 1962. The reason seems to be that investors were uncertain at the prospects of operating under a new African gvernment. This fear of political and economic turmoil was further exeeceberated by the failure of the proposed East African Federaation in 1965. However, the Government assurred the foreign investors that it was not going to nationalise commercial banks as they had anticipated. The government assured them that it would adopt and pursue a policy of participation by operating side by side with existing banks. In fact in the same year, the government announced that it would peg its shilling to the British sterling pound and this created more confidence in the newly created government. This led to the gradual establishment of commercial banks between 1968 and 1983. The Co-operative Bank Ltd was set up by Africans in 1968 in response to the government policy of indigenisation of business in Kenya and as a response to the massive co-operative movement in Kenya which had bank facilities. The Cooperative bank was initially registered as a society but later it became a bank. In

the same year, on 19th June another locally owned bank was established. This was the National Bank of Kenya Ltd. It was fully owned by the government and it commenced its operations on 30th November, 1968.

The government also approached some of the existing banks with a view of acquiring some of their shares. Consequently, the Kenya Commercial Bank was formed by the government in order to acquire and hold shares in other banks on behalf of the government. An agreement dated 7th December 1971 was entered into between the Government and the National and Grindlays bank International where 40% of the shares in the latter would be allotted to the Kenya Commercial Bank to hold on behalf of the government the remaining 60% were to be held by the National and Grindlays bank international. The Kenya Commercial Bank was thus the product of this business partnership and the agreement is contained in the National and Grindlays Bank (Apportionment) Act 2.
A similar call was made to the Barclays Bank which responded and in the same year offered shares though minority on the Nairobi Stock Exchange. A remarkable period of expansion in the banking industry is the period between 1980 and 1983. In this period, developments took a new twist and a faster pace as well. Not only were most institutions branched but also local populace took active role in their establishment. The Middle East Bank of Kenya opened a branch in 1981 as well as the Bank of Oman in the same year. Banque de Lindochine El de Suez was opened in 1982.

Among those indegenously owned were the Continental Bank opened in 1983, the Pan African Bank of 1983, the Middle African Bank of 1984 and the Rural urban Credit Finance Co. of 1984.

1.2. "Banker" defined

The term `banker' is a difficult one to define. From the scanty authority we have to guide us, it seems probable that a person can not claim to be carrying on the business of banking unless he satisfies three conditions. First, he must receive money on current account, secondly, he must honour cheques and thirdly, he must collect proceeds of cheques. The Banker performs many other functions but this function of receiving money from his customers and repaying it by honouring their cheques as and when required is the one function above all other functions which distinguish a banking business from any other kind of business. Dr. Hart defines a banker or bank as:

> "a person or company carrying on the business of receiving moneys, and collecting cheques, from customers subject to the obligation of honouring cheques drawn upon them from time to time by the customers to the extent of the amounts available on their current accounts".

It seems unlikely that the term `banker' can be successfully defined otherwise than by reference to the business of banking whether or not that expression be used in the definition. The matter thus boils down to defining the expression "banking business". However, to construct a definition which would

embrace the whole of it is not manifestly possible. It is rather a question of description than of definition, of fact than of law. It is more over obvious that not every bank need conduct the same type of business as its neighbuors. Some may specialise in one aspect, others in another. It is thus accordingly necessary to extract the lowest common denominator and to decide what is the absolute essential part of such a business. If a person carries n a business involving such borrowing and the issue of cheques, it is submitted that it is a banking business; if it does not, the business is not legally banking. To this effect, in the case of Re Shields Estate, FitzGibbon, J said:-

> "If he keeps open shop for the receipt of money from all who choose to deposit with him; if his business is to trade for profit in money deposited with him for that purpose he answers to the description of a `banker'.(4)

Equally, Dr. Hart notes that a banker may be defined as:-

> "One who is the ordinary course of his business honours cheques drawn upon him by persons from and for whom he receives money on current account."(5)

In this context therefore, the terms banker and bank may be used interchangeably for they mean more or less the same thing as suggested by the Bills of Exchange Act. This Act defines banker to include any body or persons carrying on the business of banking in Kenya. Having noted that the matter boils down to defining "banking business" the banking Act is very clear as to the interpretation attached to the expression banking business.

Money Lenders Act they did not fall under the definition of a banker. In this case, the defendants had endorsed a number of bills of exchange drawn by the plaintiffs on lonsdale motors, by whom they had been accepted. These bills of exchange had been given to the plaintiffs as security for loans made to lonsdale motors and connected with the financing of hire-purchase agreements. When these bills became due,they were dishonoured by the lonsdale motors and the plaintiffs had recourse to the defendants who also dishonoured the bills, when sued, the defendants argued that the plaintiffs were moneylenders. The plaintiff claimed that they were bankers. Evidence was given by the plaintiffs to show that they had opened a number of current accounts for customers to whom they had issued cheques and for whom they had collected cheques. This however, was only a small part of their business. They further called evidence to show that they were regarded as bankers by recognised bankers in the city of London. It was held by the majority of the court of appeal that on evidence the plaintiffs were bankers and that the defence therefore failed. The plaintiffs were accordingly entitled to recover. The Banking Act S.4 also provides for this variation in meaning and empowers the minister to extend the definition so as to include any financial institution which in his opinion carries on any of the banking business although not registered as a bank. S. 4 (i) is to the effect that:-

> "The minister may, subject to such conditions as he may consider necessary, grant a licence to a bank or