

# DEPOSIT INSURANCE AND BANK FAILURE IN KENYA: WHAT LESSONS CAN BE LEARNED BY SUPERVISORS?

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*Abstract:* The approach to deposit insurance (DI) and bank runs suggests the imposition of discipline on bank stockholders and debtholders. It is possible to do this by increasing the level of capital and reliance of market value accounting besides risk adjusted insurance premiums. The discipline to debtholders can be achieved through 'haircuts' for large depositors, and reduction in deposit insurance caps.<sup>1</sup>

The discussion of deposit insurance forms the basis of this paper. The paper examines deposit insurance, what it can effectively achieve and where it requires supplementary regulatory mechanism. The final section extracts lessons and where Kenya should direct its efforts.

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## BACKGROUND

Deposit insurance was introduced first in the United States in 1934 after the great depression. After its introduction, it seems to have achieved the primary objective of preventing bank runs (Milton Friedman and Anna Schwartz, 1963: 434-442) as quoted by Bernanke (1983). In U.S the Federal Deposit Insurance Corporation (FDIC) insures bank depositors against losses up to US\$ 100,000. Italy has higher rates than most European Union member countries that insure up to ECU 20,000. The United Kingdom has the cap at E20,000 with an improvement that the scheme covers 90% of the insured deposits. Banks are required to make contributions to FDIC to lower the cost of this insurance. Besides, contribution serves to reduce moral hazard inherent in risk taking by banks. Helfer (1999) argues that funding means the agency responsible will manage the fund in fiscally responsible manner. The contribution enables the agency to have the necessary working capital needed to resolve failures quickly.

## INTRODUCTION

A Bank run is the act of depositors rushing to withdraw their deposits because they expect the bank to collapse. It is this customer expectation

which can at times be self-fulfilling that leads the bank to liquidate its assets to meet the sudden withdrawals of deposits. Diamond *et al* (1986) shows that bank runs are features of the extreme crises that have been witnessed in monetary history.

Banks are financial intermediaries that bring surplus spending units and deficit spending units together. This being the case, banks never hold all their assets in liquid form. Depositors' funds constitute liabilities to the bank while investments; loans and advances form the bank's assets. Loans cannot be liquidated because the bank is experiencing economic hardships. These are legally binding contracts between banks and their customers. Most of the banks assets are therefore illiquid. In a bank run, after the liquid assets have been used to pay customers the bank is forced to sell some of its illiquid assets at a loss. Therefore, a panic causes a disruption of the monetary system. It is because of these disruptions that governments try to assure depositors of their funds in the banks.

Flannery (1998) argues that it is the unique nature of the banking industry that leads to governmental involvement in their corporate governance. Governments are motivated by perceived public interest in maintaining

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<sup>1</sup> A situation where a proportion of the uninsured deposits is transferred to another bank based on the quality of the collapsed bank's assets

financial system stability. Deposit insurance is one of the mechanisms used to allay customer fears. The government is cognizant of the debilitating effects of contraction in money supply when banks fail. Besides, governments are concerned about undermining the intermediation role. A lack of confidence in the industry could easily affect the stability of the economy. Deposit insurance, like any other form of insurance, should be the subject of risk quantification to determine the premiums payable by banks.

Garcia ('1997) argues that deposit insurance can have pitfalls as well as benefits; ill conceived schemes could seriously harm the economy. Because of the pivotal role of banks and the vulnerability to unusual risks, there is a good motive to protect deposits through an appropriate insurance scheme and in a way protect banks and the banking system.

Bank runs obviously inflict serious financial harm on individual depositors who lose their money. Bank failures also harm the economy's macro-economic stability. One bank's problems may easily spread to sounder banks if they are suspected of having lent to banks in trouble. Such a general loss of confidence in banks undermines the payment system on which the economy runs. And a rash of bank failures can bring a drastic reduction in the banking system's ability to finance investment and consumer durable expenditure, thus reducing aggregate demand and throwing the economy into a slump. A peculiar feature of banking is that its financial health depends on the confidence of depositors in the value of its assets. It is this peculiarity that necessitates prudential supervision.

The remainder of the paper is arranged as follows: Section I reviews the literature on deposit insurance in terms of institutional arrangements mainly in the UK and US with the purpose to drawing inferences on Kenya. In this section the paper also discusses why the government should provide insurance, followed by what should be done by DIs. Section II

discusses, albeit, briefly, on the moral hazard and adverse selection caused by DI. Finally Section III discusses the bank, crisis in Kenya. Recommendations and concluding remarks of the paper are presented in Section IV.

#### DEPOSIT INSURANCE: A REVIEW OF LITERATURE AND INSTITUTIONAL ARRANGEMENT

The belief that the government should intervene to protect depositors springs from a perceived externality - one bank failure involving losses to depositors may encourage depositors in other banks to withdraw their funds. The snowball effect can bring with it an epidemic of bank failures. Fear of this disruptive consequence of a wave of bank failures is the basis for government intervention.

Bank runs are a consequence of many factors. Berlin *et al* (1991) shows that sectoral shocks can cause bank runs. These sectoral shocks could be as a result of natural causes. Bernanke (1983) reinforces the argument with the example of the agricultural depression of the 1920s that affected many small rural banks in the US. These shocks accompanied by pieces of bad financial news are an impetus for depositors to go for their money.

The effect of shocks is compounded if the bank is undiversified. Following Berlin *et al* (1991), sectoral shocks can wipe out net worth for undiversified banks triggering a run. As indicated these shocks can manifest themselves in oil price collapse, or even collapse of agricultural land values. Flannery (1998) indicates that a recession in the economy can trigger runs. Bank panics can easily develop due to widespread business failures and rumours that the whole banking system is unstable. Such negative information brings about a fall in bank asset value. Kidwell *et al.* (1997) argue that fraud can cause bank runs. In fact fraud, embezzlement and poor management are frequent causes of bank runs. When such adverse information permeates the market then there is the depositors' perceived motive to withdraw their deposits before the banks are closed.

Santomero and Babbal (1998) posit that a high level of nonperforming loans can lead to runs. When depositors get information about the banks loan portfolio, this makes them take the initiative to get out their money precipitating a run. Under capitalisation too can expose banks to runs. If it is the case that the banks capital level is inadequate and the owners not ready to inject capital, the depositors become weary. Depositors will surely scramble for their deposits.

Diamond and Dybvig (1986) state that bank runs can be a consequence of rational behaviour by depositors and that runs can occur in a healthy bank. This is possible through contamination or even rumours. A run is triggered if the liquidation value of the loan portfolio is less than the value of the liquid deposits. Traditionally, runs are set off by expectation of reduced value of bank assets when deposits and loans are fixed nominal claims and when debt deflation causes higher than expected loan losses. Debt deflation lowers borrowers net worth and therefore increases defaults. The adverse effects of this are compounded by higher debt ratios. Higher loan losses lead to more bank failures and decrease money supply.

Diamond et al (1983) argue that bank runs are costly and reduce social welfare by disrupting production. Production is interrupted by the recall of loans and overdrafts that were put in productive ventures. Due to the loss of collateral the assets no longer cover the fixed liability.

Deposit insurance is a means of assuring depositors about the safety of their deposits. However, there are two facets to deposit insurance: explicit and implicit.

Most countries operate explicit deposit insurance where it is open that insurance exists. Implicit insurance manifests itself in a government action to insure deposits.

A study by Lindgren (1996) and Garcia (1998) reveal the best practice with explicit deposit insurance. In order for a well-structured deposit insurance to operate, the political and

legislative system should be formally structured. It enables the authorities avoid wrong incentives. There is also need to examine the banking structure.

Bank ownership and how banks operate in a crisis is crucial. Macroeconomic concern might suggest small banks be liquidated but this goes against equal treatment. Ownership of banks can be a structural problem. Deposit insurance could provide an opportunity for owners to abuse their banks in order to subsidise their own interests.

Deposit insurance requires legal foundation with responsibility to resolve bank failures. The agency and supervisory authority should act decisively, enforce regulation and take quick corrective action to close failed banks promptly.

Garcia (1998) argues that for DI to work effectively the scheme should be well funded. Most important of all, the system should win the confidence of the public. An insufficient amount will not win confidence and could be prone to insolvency. Besides, it could be prone to forbearance and costly forms of resolution.

A small size of deposit coverage could be an inducement for a run in case of trouble. It can be argued that a higher level of coverage would ensure no runs since depositors' funds can be paid by the insurance agency. This is because the depositors have no motivation to police the banks. So in this case the market will not discipline errant bank managers. One could also argue that the size should remain small but advise depositors to use the old economic saying: "do not put all your eggs in one basket." Due to the difficulties of isolating large depositors, most of the schemes pay the insured amount for each individual deposit. In fact a large depositor can split his account into a number of accounts to a level that each account is fully covered by the insurance.

Even with the above, opponents of deposit insurance maintain that a deregulated financial system is best for a country's economy and that deposit insurance upsets the system by

weakening incentives for bank managers, borrowers, depositors, economic policymakers and political leaders to act efficiently.

Closing banks with positive capital when they are near insolvency increases market discipline in the banking system. Managers losing their jobs and shareholders equity being wiped out in failed banks add to discipline and least cost test but does not wipe out the threat of bank collapse. Regulation is therefore still necessary even in the presence of market discipline.

However, with deregulation a country would be prepared to tolerate an occasional bank failure to a certain limit, it is bound to intervene to avoid a systemic collapse - an implicit insurance again! The government will therefore pick up the bill to avoid systemic collapse. The most effective system should minimise bank runs with least cost to banks or government and at the same time not interfere with the financial market or the economy in general.

Santomero *et al* (1998) shows that all banks in the US subscribe by paying premiums and since 1992 this premium is based on the deposit base and the level of risk, The insurance covers US\$ 100000 in each individual deposit account in the event of default. Because FDIC is insufficient, in 1991 Congress authorised it to borrow US \$ 30 billion. This bolstered the public's confidence in the ultimate safety of their deposits and therefore less likely to participate in a run. Due to the insufficiency of DI risk taking activities are limited.

Kidwell *et al* (1997) argue that federally insuring deposit removes most of the incentive to convert bank deposit into currency. The FDIC has power to inspect, regulate and if necessary expel a bank from the scheme.

In the UK all types of deposits are insured for all banks covered under the Banking Act of 1987.<sup>2</sup> The only deposits not covered are

connected<sup>3</sup> or secure deposit and deposits, which form part of the bank's capital.<sup>4</sup> Other deposits not covered are deposits by banks and building societies, insurance undertakings, other financial institutions and deposits of persons connected or charged but not yet tried for money laundering.

In UK, the Deposit Protection Board's liability is the aggregate of all accounts in the name of the depositor including the depositors share in joint accounts or client's accounts.<sup>5</sup> The scheme is administered by the Deposit Protection Board, which includes representatives from the Bank of England and representatives of participating institutions. The participating banks provide funds as and when required. The basic fund of £5-£6 million was established in 1982 by an initial call on all contributory institutions. Thereafter any institutions authorised by the Bank of England that is required to contribute to the fund must pay an initial contribution. Minimum and maximum rates are established for contribution to the scheme based on insured deposits. Miller (1995) argues that selecting a uniform schedule of insurance premiums exactly matching the value each bank derives from the guarantee is impossible. In fact the premium are bound to be high for some and low for others. Banks that seem well run will attract deposits, the higher the deposits the higher the premium if based on the level of deposit without minimum or maximum. M Berlin *et al* (1991) argue that deposit insurance should encompass the risk taking subsidy inherent in fixed rate deposit insurance assessment. Differences in risk taking across banks by itself are sufficient justification to modify the contract. There is absolutely no justification for risky banks to pay same

<sup>3</sup> These are deposits by directors' controllers' managers of insolvent institutions and their close relatives

<sup>4</sup> Deposits by companies in the same group as the collapsed institution.

<sup>5</sup> The UK Deposit Protection Scheme. Clydesdale Bank St Rollox Glasgow supplied the leaflet on the operation of the scheme.

<sup>2</sup> Extracted from deposit protection schemes in the member countries of the Basle Committee.

premium as less risky banks. If the risk is assessed *ex ante*, there is a necessity for an *ex post* discipline or settling up with errant managers and owners to create incentive compatible insurance contracts in a situation of imperfect information.

In all, the pricing of the scheme remains complicated. *Ex ante* schemes create perverse incentives for banks to reflect a favourable risk position at the beginning of the assessment so as to lower premium but engage in risky behaviour between examination dates. Bhattacharya (1995) argues for a partial government deposit insurance to enable depositors monitor the bank's health.

The differences exhibited by FDIC and the UK Deposit Protection Scheme can be explained by the fact that whereas the US has many small banks, the UK has few banks that are large, Bemanke (1983).

Deposit insurance discourages runs on banks because, knowing their losses, small depositors will be made good by the government. Thus they no longer have an impetus to withdraw their money just because others are doing so.

#### WHY SHOULD THE GOVERNMENT PROVIDE INSURANCE?

Kidwell *et al* (.....?) provide a historical background, private insurance was meant to protect creditors in the event of bank failure. One such insurance was the New York Safety Fund in 1829. Without such insurance many banks would have failed.

However, this fund was exhausted in 1840. Private insurances do not have the necessary diversification that is possible under a national plan, nor do they have supervision or examination powers necessary to maintain strength of the insured institution. The depletion of a state sponsored private insurance in Ohio confirms the pitfalls of private deposit insurance. The state had to declare a bank holiday to prevent depositors from withdrawing. Ohio Deposit Guarantee Fund failed in 1985.

Deposit insurance backed by government has the financial resources to withstand large numbers of bank failures and thereby engender confidence. The government can provide liquidity when required. The government can levy tax that charges every agent in the economy the same amount. The government can even impose tax on those who withdraw early.

Private insurance can not tax nor can it print money to avail liquidity. Diamond *et al* (1983) argue that deposit insurance guarantees that the promised return will be paid to all who withdraw.

If the guarantee is of real value, the amount that can be guaranteed is constrained: the government must impose real taxes to honour the deposit guarantee. On the other hand private insurance must hold reserves to make their promise credible since they cannot tax. Besides, the government has legal powers to examine bank books whereas private insurance are constrained.

#### What Should be Done by DIIs?

Following Garcia (1997), small depositors do not have the resources to keep track of the health of the banking system; their protection is therefore a reduction in their monitoring costs. Deposit insurance gives them the assurance that there is no need to panic. A high limit therefore gives an impetus to save and protect the retail system. Large depositors on the other hand have the resources to monitor their banks. They are therefore required to pay attention to the soundness of their deposits. Thus there is need to set a cap and warn depositors that bank runs will impose costs on owners and uninsured depositors.

The main goal of a balanced deposit insurance is therefore to create the right incentives for self-discipline in the banking system and to avoid incentives that relax discipline. Of course there are a number of players in this, the small depositors, large depositors, borrowers, bank managers, owners, politicians and economic policy makers.

Deposit insurance could have different meanings to each group. The small depositors' protection is a guarantee of confidence in the banking system. A reassurance that there is no need to panic is significant to them.

Garcia (1997) states that deposit insurance systems should state whether the cap applies to every deposit at a failed bank or to the sum of all accounts of a depositor's separate accounts owned by an individual depositor at all banks that failed during the period.

Larger depositors' complacency means less pressure on managers to fix the problem. Therefore an insurance system that avoids the high cost of bailing out large depositors also serves as the ultimate sign that an effective system of protecting deposits must be in tune with market discipline.

Accurate classification and adequate loan provisions should be made for loan losses and that banks are strongly capitalised. Borrowers should not exhibit carelessness in their personal and business practices to exploit the insurance fund at the expense of taxpayers. Bank managers and owners should be made to desist from engaging in behaviour detrimental to the banking system. Bank managers should either run the bank effectively or face failure. In a case where the bank failures are self-inflicted regulatory authorities should close the banks before they totally fail, delaying a closure could be contaminating to the system. The sanctions to the management and owners should be clear.

Economic policy makers should explicitly balance their motives by not creating the wrong incentives and that the scheme should be properly priced to avoid subsidising other industries that depend on bank financing. More often policy makers favour a system of protection designed to avoid an economic recession. The policy makers should be careful not to act as the custodian of the banking system as to underprice deposit insurance.

Lastly, political leaders must avoid procrastination on insolvent banks. A delayed action could lead to an increase in the number of failures and the cost of resolving them.

The stakeholders have different perceptions on the effectiveness of deposit insurance in preventing runs. However, should banks be allowed to get into risky business using insured funds? This puts the viability of the insurance to test. It is obvious that banks have different loan portfolios whose riskiness is different. In view of the risk taking behaviour of banks, risk adjusted D.I. premium is a possible remedy.

Diamond *et al* (1986) states that risk based insurance premium could be charged based on the level of non-performing loans, banks that have previously understated loan losses and banks paying markedly above market rates to raise money. If a bank's liabilities are deposits insured with fixed rate deposit insurance, the bank may have an incentive to select very risky assets since DI will bear the downside risk while the bank gets the benefit of the upside risk. Since fixed rate deposit insurance is necessarily underpriced for banks taking large enough risks, banks can have the incentive to pay above market rates of return to attract large quantities of deposits to scale up the investment in risky assets. The solution to this is to charge insurance premium based on risk.

The other is to impose restrictions on what banks can do and continually monitor banks suggesting ways of reducing risk.

Regulators had been reluctant to introduce risk adjusted deposit insurance due to practical difficulties. Some of the difficulties are that it is hard to get good information about the quality of bank loans.

Though problematic, risk adjusted insurance premium based on objective information can improve the incentive structure. It can be argued that less DI leads to less risk to the fund and only a little more risk to the bank. Because the owner of a deposit faces a low cost of withdrawal even a small chance of loss can cause a run because the uninsured deposits are subordinate to insured deposit. If the fraction of uninsured short-term deposits is large, such a run can be costly.

Nagarajan *et al* (1995) argue that there is no need for risk adjusted D<sub>4</sub> premiums all that

is required is a state contingent forbearance<sup>6</sup> policy in conjunction with a minimum capital requirement and fixed deposit insurance premium which are sufficient to alleviate risk shifting by banks.

Forbearance and minimum capital requirement are sufficient to alleviate the risk-shifting problem. An optimal policy needs to be used by regulators to induce banks to improve the *ex-ante* quality of assets, thus rendering nugatory the issue of risk adjusted premia.

If indeed better assets are selected by banks' *ex-ante*, the optimal forbearance policy will improve social welfare. Forbearance allows insolvent banks to continue their operations under regulatory supervision. Forbearance may be optimal when the bank's insolvency is due to factors beyond her control. Macroeconomic factors like sectoral shocks in property or real estate, shocks like the stock exchange crash of 1987 could have an adverse effect on bank's assets brought about by the diminished value of collateral and inability of borrowers to repay their loans. Nagarajan *et al* (.....?) argue that an optimal forbearance strategy should involve: Promptly closing the insolvent bank when the market return is good. Postpone closure with positive probability when the investment is successful but market return is poor.

The regulators state contingent forbearance policy will increase shareholder wealth if the banks improve *ex-ante* asset quality. If the banks investment is a failure at time  $t = 1$  while the market return is good, then there is an inference that the bank's investment is risky.

Penalty by prompt closure in such a state gives the bank an incentive to choose projects with a higher probability of success. Forbearance is costly because of the potential *ex-post* risk shifting thus the regulator may not find it optimal to exercise forbearance every time the insolvency is caused by market conditions. In

effect a state contingent policy allows the regulator to base assessment of bank performance on a relative as opposed to an absolute measure. DI's effectiveness requires supplementary regulatory mechanism as hereunder discussed.

#### DEPOSIT INSURANCE, MORAL HAZARD AND ADVERSE SELECTION

Deposit insurance may encourage bankers to make risky loans because depositors no longer have reason to withdraw their funds from carelessly managed banks. Therefore deposit insurance presents the danger that bad business judgements will distort the market. Ricki Tigert Helfer (1999) argues that anything that encourages risky behaviour by leading financial risk takers to believe that they will reap the benefits of risky investment they make while being protected from the losses is a moral hazard.

Diaz Alejandro (1985) argues that like any other insurance scheme, deposit insurance is vulnerable to moral hazard consequences i.e. it induces depositors to think that one bank is as good as another and leads bank managers to undertake riskier loans. This follows from Maxwell Fry (1995).

A bank accepts deposits at competitively determined terms that are set before the bank makes its project choices. The bank then has an incentive to invest in projects if riskier projects carry higher repayment obligations from entrepreneurs to the bank. This is asset substitution moral hazard.

Under deposit insurance there is a balancing act, assure financial stability when liquidity and solvency problems arise but at the same time minimising moral hazard. To limit moral hazard, the market place should be allowed to discipline financial risk takers by letting insolvent institutions to fail.

Those that come close to failing should pay hefty costs, this could be in the form of high interest costs on short-term liquidity support. In general insolvent banks should be left to fail and shareholders lose their equity.

<sup>6</sup> Forbearance is the practice of bending rules or delaying action by the regulator in the hope of financial recovery

In the case of too big to fail, countries have to save institutions to ward off systemic problems. As Ricki Tigert Helfer indicates a reasonable balance between moral hazard and a stable financial system would permit a very limited exception for failures that pose a systemic risk, while letting the market discipline improvident behaviour.

The 'too big to fail' doctrine imposes moral hazard on the investors. They no longer have the responsibility to investigate the soundness of the institutions in which they deposit their funds. The doctrine is immoral because it segregates the industry.

The big banks can afford to take considerable risk/moral hazard incentives whereas the small banks are constrained. Besides, it accords an unfair competitive advantage over small banks apart from reducing depositor incentive to police their banks. It also conflicts with the tenets of a discipline encouraging market friendly DI as outlined by Garcia and Carl-Johan Lindgren (1996).

The 'least cost test' as enacted in FDICIA reduces moral hazard in deposit insurance by encouraging large uninsured creditors to pay attention to the conduct of the banks with which they deal. This also means that managers of financial institutions will be more judicious about the risks they take knowing they may lose jobs if the banks fail.

Besides, wiping out shareholder equity in a failed bank, adds to the level of market discipline that the least cost test imposes.

Moral hazard remains a key aspect of incentive compatibility. The too big to fail can create difficult situations for the government and the Central Bank. The US FDICIA introduced the risk adjusted deposit insurance premium in recognition of the perverse incentive problem of the previous system. Why should a public insurer charge the same price as competitive insurance industry? It would seem plausible that an optimal level of deposit insurance is a requirement rather than a shift to risk adjusted premium. Moral hazard cannot

be eliminated it can only be controlled.

Bhattacharya (1998) argues that high capital requirements deter risky taking and make feasible the design of incentive compatible risk sensitive capital requirement and deposit insurance premia to curb risk taking in situations of information asymmetry and moral hazard.

Maxwell Fry (1995) shows that in the presence of deposit insurance banks no longer seek to reduce adverse selection by credit rationing. Instead banks choose riskier lending strategies where macroeconomic instability produces strongly correlated outcomes. It is because of this that deposit insurance requires complimentary tools like prudential regulation and supervision to in effect stabilise the banks.

DI can cause 'obsession with profit through investment in risky projects that banks seemingly perceive to be lucrative. It is because of supplementary support that it can be said that these are prerequisites to financial stability.

#### THE BANK CRISIS IN KENYA

The 1998 banking crisis in Kenya was due to: imprudent practice by banks engaging in risky, reckless and at times fraudulent lending; heavy borrowing by insiders, that is directors, senior management and other staff; and numerous negative press coverage.

CBK statistics indicate that for every 4 loans granted 1 is bound to be a bad debt.<sup>7</sup> That 25% of the industry's advances portfolio is non-performing is abnormally high and bound to cause instability.

The challenges brought about by technology and customer demands require a wellstructured approach to regulation. Ricki Tigert Helfer (1999), argues that a country needs the political will to set up an effective system of bank supervision, and the desire to gain credibility in the international financial markets is likely to be a strong incentive. In the case of Kenya,

<sup>7</sup> Central Bank of Kenya: 1998 Annual Report



87% of bank failures between 1984-1997 were due to insider abuse.<sup>8</sup> Amendments to the banking act requiring bank directors to borrow in the regular course of business have been legislated, however. In this regard it will also require full board approval for a bank director to get a loan from the bank on whose board he sits.

This suggests that the Deposit Protection Fund (DPF) and supervision department be accorded antimony. The departments also require the force of law to discipline errant owners who fraudulently misuse depositors' funds.

Bemanke (1983) is clear on this. The US suffered more during the great depression due to the fact that she had many small banks. In some areas these banks were in communities of 2500 people. Small and under capitalised banks should be discouraged.

Table 1: *Commercial Banks Assets and Liabilities (in Kenya Shillings) Market Share (%) June 1998*

| Peer Group   | Assets       | Deposits   | No. of Banks | Assets     | Liabilities |
|--------------|--------------|------------|--------------|------------|-------------|
| 10 bil+      | 269.2        | 176.2      | 8            | 67.4       | 66.0        |
| 5-10bil.     | 57.1         | 40.8       | 9            | 14.3       | 15.3        |
| 3-5bil.      | 17.6         | 9.6        | 5            | 4.4        | 3.6         |
| 1-3bil.      | 51.0         | 37.6       | 25           | 12.8       | 14.1        |
| <1bil.       | 4.3          | 2.8        | 6            | 1.1        | 1.1         |
| <b>Total</b> | <b>399.2</b> | <b>267</b> | <b>53</b>    | <b>100</b> | <b>100</b>  |

Source: Central Bank of Kenya Annual Report, 1998.

The statistics indicate that 22 banks control over 85% of deposits and have over 86% of assets in the banking industry. The balance of 31 banks share deposits at about Ksh. 1.3 billion each. Such small banks have been the trigger to bank runs and this reinforces my argument for mergers or amalgamations.

Suffice it to say, with an improved capital base most of the small banks would make a gradual expansion which would benefit the whole economy rather than the present situation where all the small banks are situated in one

city (Nairobi).<sup>9</sup> The Deposit Protection Fund (DPF) guarantees only Ksh. 100,000 which is an inadequate amount.

In order to offer hope to small depositors and others whose life savings are held in collapsed institutions, the Deposit Protection Fund should pay a maximum Ksh.0.25 million. Therefore the contributions to this fund should be a certain percentage of deposit plus a mark-up for those considered risky as per capital adequacy requirements.

Helfer (1999), argues that countries wishing to introduce Deposit Insurance should move slowly. If they move too quickly to provide deposit insurance protection, without the necessary supervisory and financial underpinnings as well as market discipline, they may find they have written a blank cheque for financial losses. That can only weaken their economics and create a strong environment of moral hazard that will increase risk taking and systemic problems while exacerbating the pains during the next crisis. This may seem like bleak news, but it is easier to digest than a bankrupt DI fund or a depleted national treasury.

## CONCLUDING REMARKS AND RECOMMENDATIONS

DPF should bail out solvent banks that are experiencing liquidity crisis. Besides, DPF can provide funds to enable a merger to take place in order to cure under-capitalisation of a particular bank. The stock can then be floated on the market when the bank eventually becomes viable. With infusion of funds from the DPF, board representation should be mandatory and even the secondment of staff to pull the banks from the woods. Inability to follow sound business practice is a catalyst for failure. The regulatory authority should design effective reporting requirements with frequent audit to forestall any problems. Besides the minimum capital requirement to set up a bank should be increased to limit proliferation of weak banks.

<sup>8</sup> See Appendix 2

<sup>9</sup> Appendix 2

The DPF should be semi-autonomous and should complement CBK efforts in bank examination. Proper policing of banks will help curb the 'thieving' behaviour of investors who open banks with intent to defraud.

Bank ownership should be such that the principle of four eyes holds. DI can help unscrupulous owners rob their own banks.<sup>10</sup> Though the banking act is clear on connected lending, this can be difficult to administer. The CBK should vet bank owners and also ensure periodic reports on loans to directors and associates. The CBK and DPF should help strengthen internal governance of banks.

Critical then are good risk control systems. Publication of non-proprietary information will help bank customers protect their own interests and will help impose market discipline.

Independence of DPF should be mandatory and should be free from political influence. The director of DPF should have powers to liquidate assets of failed banks in order to pay depositors. This will enable the liquidator sell branches and assets of institutions under liquidation.

Campaign funds to political parties by banks should be made public. It is this political allegiance that later permeates the banking system to lead to runs after banks have been used to lend without proper collateral.

Enact proper data protection act to enable a property functioning credit bureau or agency to be set up. A credit bureau will help track perpetual loan defaulters. Flannery (1998) says that credit rating agencies evaluate individual banks and this provides a market assessment of bank condition. Market valuation helps impose discipline.

Promote the formation of depositors association. This will enable bank depositors make an informed policing of banks to avoid the effects of managers' risk taking to their disadvantage.

Flannery argues that small depositors cannot effectively identify or control bank risks because

<sup>10</sup> Section 11 (c) (d) & (f) Banking Ordinance Cap 488, Laws of Kenya

of information costs and co-ordination problem. The formation of the association will eliminate the high costs to small depositors.

Banks should display notices indicating their membership of DPF and the minimum amount covered. This will help those who do not know the position of DI to be informed. Knowledge of the level of coverage and speed of DPF to pay guaranteed deposits should calm small depositors.

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Appendix 1: *Number of Kenya's commercial banks as at  
30 November 1998*

1. ABN-AMRO BANK
2. AFRICAN BANKING CORPORATION
3. AKIBA BANK
4. BARCLAYS BANK OF KENYA LTD.
5. BANK OF INDIA
6. BANK OF BARODA
7. BIA SHARA BANK
8. BULLION BANK OF KENYA
9. COMMERCIAL BANK OF AFRICA
10. CFC BANK
11. COOPERATIVE BANK OF KENYA
12. CREDIT AGRICOLE INDOSUEZ
13. COOPERATIVE MERCHANT BANK OF KENYA
14. CITIBANK NA
15. CONSOLIDATED BANK OF KENYA
16. CHASE BANK
17. CITY FINANCE BANK (UNDER STATUTORY MANAGEMENT 1998)
18. COMMERCE BANK
19. CREDIT BANK LTD.
20. DEVELOPMENT BANK OF KENYA
21. abDIAMOND TRUST BANK LTD.
22. DAIMA BANK OF KENYA
23. DELPHIS BANK
24. EQUATORIAL COMMERCIAL BANK
25. EURO BANK
26. FIDELITY COMMERCIAL BANK
27. FINA BANK
28. FIRST AMERICAN BANK
29. FIRST NATIONAL FINANCE BANK
30. GUARDIAN BANK
31. GIRO BANK
32. GUILDERS BANK INTERNATIONAL
33. HABIB AFRICAN BANK LTD.
34. HABIB AG ZURICH
35. HABIB BANK LTD.
36. INVESTMENTS AND MORTGAGES BANK
37. IMPERIAL BANK
38. KENYA COMMERCIAL BANK LTD.
39. MASHREQ BANK
40. MIDDLE EAST BANK
41. NATIONAL INDUSTRIAL CREDIT BANK
42. NATIONAL BANK OF KENYA LTD.
43. PRIME BANK
44. PRUDENTIAL BANK OF KENYA (UNDER STATUTORY MANAGEMENT 1998)
45. PARAMOUNT BANK
46. RELIANCE BANK OF KENYA (UNDER STATUTORY MANAGEMENT 1998)
47. STANDARD CHARTERED BANK OF KENYA
48. STANBIC BANK
49. SOUTHERN CREDIT BANK
50. TRUST BANK LTD.
51. TRANSNATIONAL BANK OF KENYA LTD.
52. UNIVERSAL BANK
53. VICTORIA COMMERCIAL BANK LTD.

*Source:* Central Bank of Kenya Annual Report, 1998

**Appendix 2: Failed Banks and Non-Bank Financial Institutions (1984-1998)**

| NAME                                       | STATUS | Year |
|--|--------|------|
| 1. Rural Urban Credit & Finance Ltd.       | Closed | 1984 |
| 2. Continental Bank Of Kenya Ltd.          | Closed | 1986 |
| 3. Continental Credit & Finance Ltd.       | Closed | 1986 |
| 4. Capital Finance Ltd.                    | Closed | 1987 |
| 5. Business Finance Ltd.                   | Closed | 1989 |
| 6. Estate Finance Company Of Kenya Ltd.    | Closed | 1989 |
| 7. Home Savings & Mortgages Company Ltd.   | Closed | 1989 |
| 8. Nationwide Finance Company Ltd.         | Closed | 1989 |
| 9. Union Bank Of Kenya Ltd.                | Closed | 1989 |
| 10. Jimba Credit Corporation Ltd.          | Closed | 1989 |
| 11. Kenya Savings & Mortgages Ltd.         | Closed | 1989 |
| 12. Nairobi Finance Corporation Ltd.       | Closed | 1993 |
| 13. International Finance Company Ltd      | Closed | 1993 |
| 14. Exchange Bank Ltd.                     | Closed | 1993 |
| 15. Postbank Credit Ltd.                   | Closed | 1993 |
| 16. Inter Africa Credit Finance Ltd        | Closed | 1993 |
| 17. Central Finance (K) Ltd.               | Closed | 1993 |
| 18. Middle Africa Finance Corporation Ltd. | Closed | 1993 |
| 19. Trade Bank Ltd.                        | Closed | 1993 |
| 20. Trade Finance Company Ltd.             | Closed | 1993 |
| 21. Diners Finance Ltd.                    | Closed | 1993 |
| 22. Allied Credit Ltd.                     | Closed | 1993 |
| 23. United Trustee Finance Ltd.            | Closed | 1993 |
| 24. Pan-africa Finance Corporation Ltd.    | Closed | 1993 |
| 25. Pan-africa Bank Ltd.                   | Closed | 1993 |
| 26. United Bank Ltd.                       | Closed | 1993 |
| 27. Thabiti Finance Company Ltd.           | Closed | 1994 |
| 28. Meridien Biao Bank (K) Ltd.            | Closed | 1994 |
| 29. Kenya Finance Bank Ltd.                | Closed | 1996 |
| 30. Heritage Bank Ltd.                     | Closed | 1996 |
| 31. Ari Banking Corporation Ltd.           | Closed | 1996 |
| 32. Reliance Bank Ltd.                     | Closed | 1997 |
| 33. Bullion Bank Ltd.                      | USM    | 1998 |
| 34. Trust Bank Ltd.                        | USM    | 1998 |
| 35. Prudential Bank Ltd.                   | USM    | 1998 |
| 36. Prudential Building Society Ltd.       | Usm    | 1998 |
| 37. City Finance Bank Ltd.                 | USM    | 1998 |
| Status                                     | USM    | 1998 |

NOTE: USM Stand for "Under Statutory Management"

Source: Central Bank Supervision Report 1998.