1. Introduction

By African standards, Kenya banking sector has for many years been credit for its size and diversification. In spite of this strength, it has however failed to provide adequate access to banking services to the bulk of the population. While the bulk of savings comes from small depositors, the bulk of lending goes to large private and public enterprises in urban areas. Main shortcomings of the mainstream banking in the past decades were; decline in savings and investment, large increases in interest rate spreads from around 1994, a significantly riskier client base and increase dominance of the banking system within the financial sector.

In 1970s and 1980s financial sector reforms focused on promoting competitiveness. However these reforms acted as catalysts in the promotion of banking sector dominance. For example, the Development Finance Institutions (DFIs) and Non Bank Financial Institutions (NBFIs) were set up to offer long-term credit. By 1988, both DFIs and NBFIs had grown significantly but they failed in their mandate due to management problems and failure to attain autonomy from government control in financing. The mushrooming of NBFIs was attributed to weaknesses in institutional infrastructure.

The situation changed in the 1990s with the review of the Banking Act aimed at strengthening the sector’s institutional framework. However, this worked to further strengthen the position of the banks in the financial system. With this outcome, it was necessary to liberalize the financial sector with the intention of stimulating it to become more dynamic and act as an engine of the economic growth.
The sector faced major crises, in 1980s and 1990s. The main reasons for the banking crisis were under-capitalization, high level of non-performing loans and weaknesses in corporate governance. The most hit were the NBFIs, but the number of commercial banks collapsing increased in the 1990s. This is an indication of financial fragility and loss of public confidence with the financial sector.

2. Evolution of legal and Regulatory framework

An adequate regulatory framework is paramount in ensuring stability of the financial system. In Kenya, the Central Bank is responsible for supervision and has been constantly reviewing the Banking Act, Central Bank of Kenya Act and Prudential guidelines aimed at tightening and strengthening the supervisory role.

The Banking Act has been reviewed over time to give more legal powers to the regulatory authority and to broaden the responsibilities and coverage of institutions. The first comprehensive review was made in 1985 following the rapid growth of NBFIs that was mainly attributed to weakness in the regulatory framework. There was a change in the licensing procedures for banks and all institutions were required to apply for the license to the Ministry of Finance through the Central Bank.

In 1995, further amendments of the Banking Act were made aimed at further strengthening supervision of the banking industry. Prudential guidelines were revised to encourage self-regulation and covered codes of conduct for directors, chief executives and other employees; duties and responsibilities of directors, chief executives and management; duties and responsibilities of external auditors; and the definition of bad and doubtful advances and loans.
Thus, in 1998 the Central Bank revised capital requirements upwards to avoid a repeat of the banking crises experienced in the mid-1980s and early 1990s. To this end, the gearing ratio was raised to 7.5% from 5%. Further, in year 2000, Central Bank adopted the Basel I standards on capital adequacy. The adoption led to the introduction of additional capital adequacy ratios of 8% and 12% in regards to the core capital and total capital to risk weighted assets respectively. These reforms were in tandem with the then prevailing global trends that required financial institutions to maintain capital commensurate with the credit risk inherent in their business.

In response to gaps identified in the 2003 joint IMF/World Bank Financial Sector Assessment Program (FSAP), a series of legal and regulatory reforms have been undertaken. These have included significant changes to the Banking Act (Cap 488) and to prudential guidelines to strengthen arrangements in relation to bank licensing, the corporate governance, capital adequacy, risk classification of assets and overall risk management.

3. Deposit Protection Fund

Following the banking crisis of 1985/86, a Deposit Protection Fund Board (DPFB) was established to stabilize the banking industry. This was to be achieved through protecting the interests of small depositors who are disadvantaged by being unable to evaluate the financial status of the various banks. The DPFB acts as a mechanism for liquidating the assets and paying off the liabilities of collapsed banks and financial institutions. Thus, its main activities were to manage the deposit insurance scheme, maintain confidence in the financial system and carry out the liquidation of insolvent institutions (by repaying protected deposits and dividends, carrying out debt recovery, and winding up the institutions under liquidation).

The Deposit Protection Fund Board (DPFB) is a significant player in the financial safety-net for the savings, banking and payments systems. It plays the role of
protecting depositors, especially small depositors, against loss of their savings in case of a bank failure, by providing payments of insured deposits thereby ensuring depositors remain confident enough to continue keeping their savings within the banking and payments system.

The Deposit Protection Fund provides deposit insurance coverage of up to Kshs 100,000 to each depositor of a member institution. Payment is restricted to one depositor per institution. This is in line with public policy objective of protecting largely small depositors and hence stability of the banking system. Initiatives are underway to enact a law that will give the Fund autonomy.

4. Soundness of Kenya Banking Sector

As shown in table 1, all the financial soundness indicators of the banking sector have shown improvement since year 2000.

<table>
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<th>Table 1: Financial Soundness indicators (%)</th>
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<tr>
<td>Regulatory capital to risk weighted assets</td>
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<tr>
<td>Regulatory Tier 1 capital to risk weighted assets</td>
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<tr>
<td>Non-performing loans to gross loans</td>
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<td>Non-performing loans net of provisions to total capital</td>
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<td>Return on assets</td>
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<td>Return on equity</td>
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<td>Net interest income to gross income</td>
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<td>Non-interest expenses to gross income</td>
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<td>Liquid assets to total assets</td>
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Source: Central bank of Kenya
Capital adequacy as well as liquidity ratios have been maintained above the minimum statutory requirements while earning have been improving steadily.

The significant improvement on stability of banking sector has been witnessed in asset quality. The banking sector experienced high level of non-performing loans for many years averaging about 30% of gross advances before year 2003. However, the ratio declined drastically to stand at 8.4% as at December 2008. It should be noted that, a big proportion on NPLs concentrated in a few government owned and other adequately capitalized banks. Although the level of NPLs are high compared with the international standards, they do not pose a systemic threat to the Kenyan banking system as only a small portion of NPLs have not yet been provided for.

**Government Strategy for the Banking Sector**

In year 2003, the Government of Kenya (GOK) published Economic Recovery Strategy (ERS) paper on Wealth Creation and Employment that defined certain critical high-level objectives that underlied the reform efforts through 2007 in many areas including banking sector. In the ERS, the government acknowledged that the banking sector was experiencing difficulties that would undermine the achievement of the objectives set out in the ERS. These problems were:

- A comparatively high ratio of non-performing loans in some major banks;
- Inadequate competition in the banking sector;
- Persistence of wide interest rate spreads leading to a high cost of credit;
- Insufficient quantities of credit (and poor quality credit assessments);
- Absence of vibrant institutions for provision of long term finance;
- Weak legal arrangements creating long delays in contract enforcement
• Weak dispute resolution mechanism.

In 2007, GOK published “Kenya’s Vision 2030” as a long term development plan for the country which puts provision of financial services at the centre of the planned economic growth trajectory to the year 2030. Three main objectives that were articulated in Vision 2030 for the financial sector were:

• Improve stability in the sector to ensure that all banks and other financial institutions that accept deposits from the public would more safely handle the public’s savings and ensure that the chances of serious financial losses were in future kept to a minimum.

• Enhancement of efficiency in the delivery of credit and other financial services to ensure that the costs of services would become increasingly affordable and that the range and quality of services would cater better to the needs of both savers and investing businesses.

• Improve access to financial services and products for a much larger number of Kenyan households.

To deliver on these objectives, the GoK had to pursue policies that would contribute to stable macro and fiscal position aimed at lower inflation and financial sector stability.

It was anticipated that success in these areas would gradually bring about improvements in banking efficiency as well as stability and so answer some at least of the criticisms commonly levied against the sector. In particular, it was anticipated that the reforms would help to achieve lower costs feeding through to the prices banks need to charge to retain reasonable profitability; reduced interest rate spreads as well
as lower charges for other banking services; greater innovation including increased
competition across parts of the banking sector previously segmented by different risk characteristics; and competitive pressures more generally to encourage banks to offer more products suitable for smaller borrowers and savers.

**Banking Sector Consolidation for enhanced stability**

Some theoretical arguments and country comparisons suggest that a less concentrated banking sector with many small banks is more prone to financial crises than a concentrated banking sector with a few large banks (Allen and Gale, 2000; and Beck, Demirgüç-Kunt and Levine, 2004). This is partly because reduced concentration in a banking market results in increased competition among banks and vice-versa. Proponents of this ‘concentration-stability’ view argue that larger banks can diversify better so that banking systems characterized by a few large banks will be tend to be less fragile than banking systems with many small banks (Allen and Gale, 2003). Concentrated banking systems may also enhance profits and therefore lower bank fragility. High profits provide a buffer against adverse shocks and increase the franchise value of the bank, reducing incentives for bankers to take excessive risk.

Beck, Demirkurc-Kunt and Levine(2003) using data from 79 countries conclude that crises are less likely in more concentrated banking system. Consistent with this conclusion, Berger and Hannan (1998) find that banks that are not exposed to competition are able to exercise monopoly power and tend to be less efficient than banks subject to more competition.

Few strong banks may also enhance profit which may act as a buffer against adverse shocks and increase the value of banks thus reduce appetite for taking risks.
According to Beck, Demirguc-Kunt and Levine (2003), few banks are easier to monitor than small banks and therefore corporate controls of banks will be more effective and the risks of contagion less pronounced in a concentrated banking system. On the basis of the existing theories, it is evident that there is extensive impact consolidation would have on the Kenyan Banking sector.

The Kenyan banking sector is characterized by small sized fringe banks with very high overhead costs and weak capital base. The capital levels of most of the banks are below $25m which is lower than the capital base of the smallest banks in Nigeria. The sector is highly oligopolistic with remarkable features of market concentration and leadership. The fact that none of the banks features in the top 1000 banks as per the World Bank listing clearly indicates that banks in Kenya have limited capacity to support the ideals of Vision 2030.

Central bank has been trying to promote consolidation by raising the minimum capital requirements but the policy has been met with a lot of resistance. It is believed that consolidation would bring competition and improve overall stability.

On the other hand, big banks may bring problem to the regulators as they may become too big to fail. The problem could be resolved by Central bank making it clear that none of the banks will be too big to fail. Central bank should also tighten its watchdog role over the banking industry, in order to ensure that the expected gains of the exercise are truly realized.

**Conclusion.**

To achieve the objectives of having an efficient, stable and accessible banking sector, Kenyan banking sector requires strong and diversified banks which ensure safety of
depositors’ funds, play an active developmental role in the economy and capable of competing in the global financial market.