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# The Kenyan Banking Industry: Challenges and Sustainability

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## Introduction

The banking industry plays an important role in an economy and is often regarded as the engine that drives economic development and the lifeline of the economy and society in both developed and developing nations (Adeyemi 2007; Kumbirai and Webb 2010). As such the banking industry is able to influence a country's economic development and long-term sustainability by offering different services (UNEP FI 2007). The main services provided by the banking industry include facilitating money transfers between countries and ensuring that savers and borrowers are brought together in well-organised structures, as well as borrowing and lending, agency services, trade facilitation and money control

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(Nagar et al. 2011; Kashyap et al. 2002). These services by the banking industry are instrumental in enhancing world development and financial stability.

In Africa, the banking industry is playing an increasingly important role in sustainable development. Across the African continent, numerous banks are championing sustainability and re-engineering their operations in order to integrate the environment, technology, social responsibility and governance (UNEP FI 2005). The growing trend toward sustainability is evident in countries like Botswana, Kenya, Nigeria, Senegal and South Africa. These countries have introduced strategies and mechanisms meant to make their banking industries sustainable in the long run.

Despite the importance of the banking industry for economic and social development and its focus on sustainability, the banking industry worldwide has experienced several financial challenges which have threatened to cripple the industry, thereby negatively affecting the economic performance of most countries. Notable banking crises occurred in the 1940s–1950s, 1980s–1990s and from 2007–2009. However, the 2007–2009 financial crisis is considered the worst, as it almost brought major world economies to a standstill, with most nations still recording negative economic growth, a trend that may continue for several years (Grant Thornton 2013). The period has been described as the most turbulent in relation to the world economy (Deloitte 2012).

It has been asserted that the past and present challenges facing the banking industry worldwide can be associated with lack of strong leadership and management (Donnelly 1994). The banking industries of African countries, among them Kenya, have also been victims of poor leadership and management, especially between the 1970s and the 2000s, a situation that has threatened the industry's sustainability (Waweru and Kalani 2009).

The purpose of this chapter is to examine the Kenyan banking industry in relation to performance and sustainability. First, the chapter examines the overall importance of the banking industry and the challenges it faces. Second, it focuses on the Kenyan banking industry, including its history and the reasons for its poor performance and recovery. Third, the chapter addresses the contemporary Kenyan banking industry. Finally, the future of the Kenyan banking industry in terms of performance and sustainability is explored.

## The Importance of the Banking Industry

Given the positive role played by the banking industry in a given economy, it is essential to identify the specific activities performed by the banks in order to steer development and sustainability. These activities, which include borrowing and lending, agency services, facilitating trade, and money supply control, will subsequently be discussed.

**Borrowing and Lending** The banking industry provides a number of economic services to its customers. The leading service is borrowing and lending to customers. Through its role of borrowing and lending, the banking industry facilitates money supply by taking deposits from customers and then lending the money to those who need it (Kumbirai and Webb 2010:35). These services not only increase the production capacity of the community or nation but also accelerate the pace of economic growth and sustainability (Russo and Ugolini 2008).

**Agency Services** The banking industry provides a range of investment services to its customers. Upon opening various accounts, such as current and savings accounts, the banks offer services like settling of indebtedness between customers by facilitating credit transfers, standing orders, clearing cheques, access to loans and overdraft facilities, payment of dividends and debt transfers (Hoyle and Whitehead 1982:42; Kumbirai and Webb 2010). By doing so, banks have become the lifeline of businesses and the gatekeepers to capital provision. Similarly, banks provide loans and credit to millions of businesses and individuals throughout the world (UNEP FI 2007).

**Facilitating Trade** In addition, the banking industry plays an important role in facilitating trade within and between countries and providing logistical support. This role has eased business operations and ensured the survival of businesses which would otherwise find it difficult or impossible to operate. The specific activities that the banks facilitate include: foreign exchange transactions, executorships and trust services, export trade payments, tax advice, investment management and stock blocking (Hoyle and Whitehead 1982:42). In an effort to offer overseas trading services, some banks have set up branches in foreign countries specialising in trade financing and advising. The branches, for instance, are able to provide a comprehensive network of services for businesses and persons interested in foreign transactions. The banks or their branches have also acted as sources of information on overseas trading opportunities and challenges. The results of such activities are savings in time and money, as well as smooth business transactions among businesses located in different parts of the world (Economic Commission for Africa 2011; Kumbirai and Webb 2010).

**Money Supply and Control** The banks, through the coordination efforts of the central banks, are able to facilitate money supply and regulation in an economy. This enables commercial banks to control the money available in the economy by gathering small savings from customers and combining them into larger deposits which are then channelled into the right enterprises (Kumbirai and Webb 2010). By controlling money supply, the banks are able to regulate the level of sustainable development in an economy.

## The Challenges of the Banking Industry

Although the banking industry has played, and continues to play, a critical role in facilitating world economic development, the industry still continues to face a number of challenges. The main challenges are non-performing loans, global financial difficulties, poor leadership and sustainability pressure.

**Banks' Non-performing Loans** The challenge of banks' non-performing loans continues to plague the banking industry worldwide. The problem is mostly associated with the crisis resulting from 'rapid accumulation of nonperforming loans in the banking industry and a deterioration of asset quality in the face of increased credit risks' (Fofack 2005:5). In Africa, for instance, the proportion of non-performing loans reached over 30 % of total loans. This was the highest level ever for the developing world. In fact, during the Asian financial crisis of 1997, which was said to be the worst, the rate did not exceed 25 % of total loans (Fofack 2005:5). The problem of non-performing loans is not unique to Africa. According to Kroszner (2002), non-performing loans are closely linked to banking crises and overall sustainability. In Japan, for example, the banking industry continued to suffer the effect of non-performing loans experienced in the 1990s, leading to the loss of billions in yen as a result of the collapse in asset prices (Sultana 2000). The Japanese government had to intervene to rectify the situation in an effort to regain market confidence and ensure a stable financial environment (Waweru and Kalani 2009:13). As such, non-performing loans impact negatively on the banking industry and present challenges to realising its sustainability.

**Global Financial Crisis** Between 1970 and 2000, the world witnessed several financial crises that greatly hindered smooth operations of the banking industry worldwide. Given the critical role played by the banking industry in economic development, financial crises have an adverse effect on the economic stability of countries. Many banks collapsed during the global crisis of 2007–2009, leading to worsening economic situations in many countries. In spite of the deteriorating global financial situation, some countries' banking industries were able to withstand the pressure and continued to prosper against all odds. For instance, the Canadian banks remained relatively stable, while the neighbouring US banks continued to experience major financial shocks (Elliot 2008). The global financial crisis posed a serious threat to banks' sustainability and overall performance (UNEP FI 2005).

**Poor Leadership** The role of effective leadership is instrumental in the attainment of successful performance by banks. Besides the positive role played by the banking industry, the industry has been in the spotlight due to its undesirable leadership practices. According to Donnelly (1994:12), 'management and leadership issues are critical' to bank success. It is interesting to note, however, that leadership has received very little attention within the banking industry. In fact, the biggest challenge facing the banking industry could easily be summarised as 'poor leadership' (Waweru and Kalani 2009). It is further notable that those involved in banking management 'lack the skills to provide leadership in a deregulated environment' (Donnelly 1994:12). With poor leadership, no sustainability mechanisms will work.

**Sustainability Pressure** Like elsewhere in the world, the need for sustainable banking practices has put pressure on African banks to comply. The major drivers of sustainability within the banking industry have been the development of regulatory frameworks aimed at making financial institutions responsible for their environmental and social impacts, expansion of international standards and governance code, and increasing pressures from stakeholders (UNEP IF 2005). However, even with these efforts, various challenges still hinder the attainment of the desired level of sustainability. Such challenges include corruption, currency fluctuations, political interference, inadequate infrastructures and poor technical know-how (UNEP IF 2005). These challenges threaten African banks' competitiveness and survival, a situation that also affects the Kenyan banking industry.

## The History of the Kenyan Banking Industry

Between the years 1963 and 1982, the Kenyan economy was very prosperous compared to those of its neighbouring countries. The prosperity of the industry was attributed to good monetary and fiscal policies instituted by the government. This made the financial industry very industrious, resulting in sound economic growth (Central Bank of Kenya,1994).

In the 1980s and 1990s, several countries, both developed and developing, experienced severe banking crises which affected their financial, social and economic performance. To overcome the challenges, the International Monetary Fund (IMF) demanded that countries overhaul their banking systems (IMF 1998). Kenya was no exception, and as such had its share of banking crises.

The crises in Kenya started in 1982 after the government relaxed financial control measures, making way for an increase in the number of financial institutions. Unfortunately, this action by the government opened up what had been a professional and disciplined career to non-professional business people whose interest was in profit and self-gratification

(Ambutsi 2005). As a result, professional management was replaced by poor governance, mismanagement and political interference, which led to the collapse of a number of banks (Ambutsi 2005). To rectify the situation, the Central Bank of Kenya introduced strict measures in the industry between 1994 and 2002. These measures included the establishment of a reserve and deposit protection fund, insurance schemes and an increase in minimal capital requirements for bank starters (Central Bank of Kenya 1994). However, despite these strict measures, 32 banks were liquidated or put under receivership, with 14 of them collapsing in 1993 (Central Bank of Kenya 2004). The situation deteriorated further, and by 1998 37 banks had collapsed despite the Central Bank of Kenya's efforts to salvage them (Kithinji and Waweru 2007; Ngugi 2001). In 1998, the losses arising from non-performing loans stood at Ksh. 80 billion, or 30 % of advances, an increase from Ksh. 58.4 billion in 1997 (Central Bank of Kenya, 1999). By world standards, the Kenyan non-performing loans were too high (30 %) in 1999, putting the banks at even greater risk in recovering them. By the year 2000, the Kenyan banking industry had plunged into a crisis mostly associated with under-capitalisation, high levels of non-performing loans, political interference, corruption and poor governance (Honohan and Laeven 2005). This meant that the sustainability of the banking industry was severely affected.

## Causes of Past Poor Banking Performance in Kenya

The banks' overall poor performance has been blamed on non-performing loans, weak internal control measures, political interference, corruption and lack of leadership.

**Non-performing Loans** In the past, the major challenge within the Kenyan banking industry was non-performing loans, which accounted for 42 % of banks' loan portfolios. According to the Kenyan Central Bank, non-performing loans were loans not serviced as per the contract with the borrower, thus subjecting the financial institution to potential losses (Central Bank of Kenya 2001). In an effort to address this challenge, the Central Bank of Kenya demanded to be a partner in controlling the bad debts at a manageable level (Economic Report on Africa 2002:143). However, the actions taken by the Central Bank of Kenya to assist banks in reducing non-performing loans was just one way to react to the worsening performance of the banks. Unfortunately, more banks in Kenya did not perform well and eventually closed down. Between the years 2000 and 2001, five banks were put under statutory management, while one building society was placed under investigation. Three of the banks were able to reopen, one was liquidated, while one remained under statutory management (Economic Report on Africa 2002:143). For two years the non-performing loans stood at Ksh. 73.6 billion (2001) and Ksh. 76.1 billion (2002) respectively. A summary of the Kenyan banking industry non-performing loans during the period of the worst financial crisis is represented in Table 11.1.

Table 11.1 shows an increase in non-performing loans from Ksh. 31.8 billion in 1995 to Ksh. 74.6 billion in 2003, or 134.6 %. During the same period, the year 1999 had the worst non-performing loan rate of Ksh. 97.2 billion. Similarly, the loans issued during the same period ranged from Ksh. 180.2 billion in 1995 to Ksh. 270.1 billion in 2003. Likewise, 1997 was the worst performing year, with total loans of Ksh. 284.2 billion. This indicates that compared to loans given during the same period, non-performing loans far exceeded what was issued, a very gloomy picture for the banking industry. It is also notable that the period 2001–2003 showed a

**Table 11.1** Kenyan banking industry non-performing loans 1995–2003

| Year | Non-performing loans (in Ksh. billion) | Total loans (in Ksh. billion) | Percentage (%) |
|---|---|---|---|
| 1995 | 31.8 | 180.2 | 17.6 |
| 1996 | 37.9 | 213.7 | 17.7 |
| 1997 | 69.0 | 248.2 | 27.8 |
| 1998 | 83.5 | 268.6 | 31.1 |
| 1999 | 97.2 | 284.2 | 34.2 |
| 2000 | 90.2 | 272.9 | 33.1 |
| 2001 | 73.6 | 245.0 | 30.0 |
| 2002 | 76.1 | 255.0 | 29.8 |
| 2003 | 74.6 | 270.1 | 27.6 |

(*Source*: Waweru and Kalani 2009:14).

decrease in non-performing loans compared to the three previous years. The decrease was not as a result of good policies but was attributed to the collapse of some financial institutions, including Trust Bank and Euro Bank (Waweru and Kalani 2009:15). Similarly, some banks wrote off part of their loans in order to ensure healthy balance sheets (Central Bank of Kenya 2003). According to Waweru and Kalani (2009:15), non-performing loans were attributed to poor decision-making by individual investors, although this could be caused simply by bad luck or poor economic eventualities. Comparing non-performing loans to those of developed countries like Japan and Spain, Waweru and Kalani (2009) maintain that bank managers may have been aware of the repercussions of their actions but still acted wrongly because of competition pressure and the desire for high profits. In Kenya, almost 50 % of bank failures were associated with non-performing loans resulting from insider lending during the 1980s and early 1990s (Sokpor 2006). By world standards, the Kenyan non-performing loans were too high (30 %) in 1999, putting the banks at even higher risk of recovering them. The non-performing loans for similar developing countries stood at 7.7 % for Taiwan (2002), 16.81 % for the Philippines (2001), 24 % for Zimbabwe (2000), 11 % for Nigeria (2000) and 3 % for South Africa (2000) (Batino 2001; Central Bank of Kenya 2001). The Kenyan government's inability to manage its banking crisis was alarming compared to similar economies. It is also notable that a large proportion of non-performing loans were associated with government-owned and controlled banks as well as some well-capitalised banks (Beck et al. 2009:7). Again, the banks' failures were blamed on poor management, lack of strong internal control measures and poor governance, all affecting bank stability. However, the government's efforts to reduce non-performing loans eventually worked. Since then, the percentages of non-performing loans dropped from 37.2 % in 2000 to 8.4 % in 2008 and eventually to 4.7 % in 2012, which shows improved performance and progress (Central Bank of Kenya 2012).

**Weak Internal Controls** As in the past, the poor performance of the Kenyan banking industry has been blamed on weak internal controls, bad governance and poor management practices (Sokpor 2006:5). According to the Economic Report on Africa (2002:143), poor banking performance was caused by mismanagement. The report states that although several measures continued to be implemented which seemed to yield positive results through visible improved financial effectiveness, bank operations remained a significant risk. The risks were 'compounded by economic stagnation. Thus regulatory authorities needed to maintain regulatory vigilance' (Economic Report on Africa 2002:143). It appeared that the right internal measures were not put in place and the banks suffered the consequences.

**Political Interference** External forces also played a major role in the Kenyan banking industry's problems. For instance, political leaders used their positions in government to borrow from banks without repaying the loans, a problem that led to increased non-performing loans (Sokpor 2006). According to Brownbridge (1998:16):

> Most of the larger local bank failure in Kenya, such as the Continental Bank, Trade Bank and Pan Africa Bank involved extensive insider lending, often politicians. The threat posed by insider lending to the soundness of the banks was exacerbated because many of the insider loans were invested in speculative projects such as real estate development, breaching large-loan exposure limits, and were extended to projects which could not generate short-term returns (such as hotels and shopping centres), with the result that the maturities of the bank's assets and liabilities were imprudently mismatched.

It is notable that the political pressure arising from bank ownership and external influence led to major bank failures (Brownbridge 1998).

**Corruption** Widespread corruption has continued to wreck the Kenyan economy for the last five decades. This has led to low investor confidence and insufficient foreign direct investment and other forms of foreign aid. Despite several government measures to fight corruption, the efforts have not had a significant impact. For instance, in 2006, two major scandals in government led to the resignations of three ministers. Considering this insufficient, both the World Bank and the IMF delayed their loans to the country (CIA World Factbook, 2007). The problem of corruption remains a major hindrance to the country's economic standing while at the same time affecting the confidence of investors and consumers.

**Poor Leadership** Numerous studies have indicated that lack of leadership continues to be a major challenge for most banks. Donnelly (1994:12) further pointed out that those involved in banking management lack the skills required for effective banking. The crises in the banking industry worldwide during the 1980s and 1990s corresponded to poor leadership of the banking industry in most countries (Donnelly 1994; Brannigan and de Lisser 1993; Meechan 1992). Given that failures of private banks in Kenya have mostly been associated with poor management and governance, and thus poor leadership (Sokpor 2006; Kinyua 2006), the importance of effective leadership in ensuring that banks attain their goals cannot be neglected, as it is central to effectiveness and good performance.

After struggling with dismal performance as a result of non-performing loans, weak internal controls, political interference, corruption and poor leadership, the Kenyan banking industry made a remarkable turnaround and reversed its undesirable performance. The next section discusses the banking industry recovery trend which has put the industry on a positive sustainable track (UNEP IF 2005).

## The Kenyan Banking Industry Recovery

The problem of bank failures that impacted the banking industry in the 1980s and 1990s most strongly affected the local banks rather than foreign-owned banks. It is also evident that non-performing loans, weak internal controls and political interference, all arising from poor management and leadership, were challenges facing the indigenous banking industry in Kenya (Waweru and Kalani 2009). However, it is also notable that the Kenyan banking industry started to show signs of recovery by the beginning of the 2000s.

In fact, since 2003, many Kenyan banks have reported positive growth and a turnaround in their operations, although a few banks still performed poorly until 2009. One example of a successful bank was the Cooperative Bank of Kenya, whose good performance was associated with good management and good leadership practice (Wahome 2004).

Its success was also attributed to 'aggressive cost management, focus on non-funded income, debt recovery and prudent liquidity management' (Waweru and Kalani 2009:31). The implementation of financial sustainability measures such as reducing non-performance loan portfolios, introducing basic corporate governance mechanisms and incorporating principles of sustainability in the banking system are all associated with the positive trend (UNEP IF 2005).

To ensure sustainability and sound financial performance of the Kenyan banking industry, the Kenyan government introduced additional measures to the industry. According to the *Kenya Gazette Supplement No. 90* (2008), a Financial Act 2008 which took effect in January 2009 required that all banks and mortgage institutions increase their minimum core capital to Ksh. 1 billion (US$12 million) by December 2012, up from Ksh. 250 million (US$4 million) in 2008. The aim of the Financial Act was also to make small banks become more stable by ensuring that they had adequate capital. The goal of the Financial Act 2008 was to consolidate and transform small banks into more stable organisations. By introducing financial measures, the government hoped to avert future financial crises by making sure that the banks are able to 'withstand financial turbulences and therefore increase banking industry stability' (Gudmundsson et al. 2013:3). For some banks, financial restrictions remain a challenge due to their inability to raise the required capital. Such banks may be required either to merge with other financial institutions or to sell out. The banks were also expected to deal with deposits mobilisation and reduction in trade volumes (Gudmundsson et al. 2013). The effort of the government was expected and continued to show positive fruits. With continued recovery of the banking industry, the positive performance is expected to increase.

## The Contemporary Kenyan Banking Industry

The 2007–2009 financial crisis had major implications for the world financial sector, especially the banking industry. However, while the rest of the world experienced negative to minimal growth, the sub-Saharan African countries reported average growth of 4.7 % in 2008 and 6.2

% in 2009 (United Nations 2009). Some countries did very well during this period, including Congo, Tanzania, Uganda, Ghana, Nigeria, Cameroon and Côte d'Ivoire, while others like Kenya, Ethiopia, Sudan and South Africa deteriorated in performance, falling by 5.4 %, 3.0 %, 1.7 % and 1.3 % respectively. Due to efforts by individual countries' central banks to revive the banking industry through the injection of monetary supports to the economy, the years 2009 and 2010 experienced slight economic growth (IMF 2009). Consequently, while the rest of the world continued to experience negative effects from the financial impact of 2007–2009, the sub-Saharan Africa region reported an average of 5–7 % growth, which was far above the rest of the world's economic performance (European Investment Bank 2013).

The period 2007–2009 was not favourable for Kenya. While the rest of Africa experienced substantial growth, Kenya experienced its worst political crisis arising from post-election violence (resulting from election disputes between the government and the main opposition party). The result was an economic growth slump from 7.1 % in 2007 to about 1.7 % in 2008 (Central Bank of Kenya 2008:23). In 2009, economic growth was 2 % due to the worsening financial crisis, as cited by the Kenya Institute for Public Policy Research and Analysis (KIPPRA) (2009). Likewise, the country's balance of payment declined from a surplus of Ksh. 63,250 million in 2007 to a deficit of Ksh. 33,161 million in 2008. At the same time, the capital and financial sector recorded a surplus of only Ksh. 81,055 million in 2008 compared to Ksh. 150,090 million recorded in 2007, a decline associated with deteriorating world economic performance, minimal inflows of foreign direct investment (FDI) and reduced short-term capital inflows (KIPPRA 2009). By 2013, however, Kenya had fully recovered from the 2007–2008 post-election violence and although its recovery from the global financial crisis was slow, the country remained a leader in the Eastern Africa region in terms of economic development (Njuguna 2013).

Surprisingly, despite the Kenyan economy performing poorly between 2007 and 2008 as a result of the post-election violence, the country's banking industry remained upbeat and recorded relatively positive performance. In the last 10 years, the Kenyan banking industry is said to have fared quite well overall compared to other world markets. Unlike in previous years, the contemporary Kenyan banking industry is considered the most mature and the largest financial service leader in sub-Saharan Africa. Accordingly, the Kenyan financial industry is currently one of the fastest growing in the continent (Njuguna 2013). The banking industry is governed by the Companies Act, the Banking Act, the Central Bank of Kenya Act and various prudential guidelines and instructions issued by Central Banks of Kenya as contained in the Laws of Kenya: Banking Act, 2010, Chapter 488 incorporating all the Acts from 1985 to 2009 (Central Bank of Kenya 2010).

By 2011, banking industry growth was even more encouraging, with an impressive increase of 20.4 % in total assets, which amounted to Ksh. 2.02 trillion, up from Ksh. 1.68 trillion realised in 2010. There was also a reduction in gross non-performing loans of 8 %, from Ksh. 57.6 billion in 2010 to Ksh. 53 billion in 2011 (Central Bank of Kenya 2011). In terms of branch network expansion, Kenya's banking industry registered growth of 20 %, going from 740 branches in 2007 to 887 branches in 2008. The country's capital, Nairobi, had the highest branch network growth, accounting for 41 % of all branches or 60 out of the total 147 branches (Central Bank of Kenya 2008). This means that in Nairobi, the number of bank branches grew from 293 in 2007 to 353 in 2008 (Central Bank of Kenya 2008:5–6). By 2012, the number of bank branches countrywide reached 1,272, an increase of 75 from the 1,197 branches reported in June 2011 (Central Bank of Kenya 2012).

By the end of September 2012, the Kenyan banking industry had improved its performance both in assets and customer deposits. Industry assets stood at Ksh. 2.3 trillion, up from Ksh. 2.02 trillion in 2011, an increase of 15.3 %. Similarly, customer deposits grew to Ksh.1.49 trillion in 2012 from Ksh. 1.71 trillion in 2011, an increase of 14.8 %. During the same period, profit before tax rose from Ksh. 89.5 billion in 2011 to Ksh. 107.9 billion in December 2012, a growth of 20.6 % (Central Bank of Kenya 2012). By June 2013 the banking industry had enhanced its performance and increased its assets to Ksh. 2.5 trillion, loans and advances rose to Ksh. 1.5 trillion, while bank deposits stood at Ksh. 1.9 trillion. Likewise, profit before tax was Ksh. 61.5 billion, customer deposits stood at 18.9 million, while loan accounts amounted to Ksh. 3.8 million (Central Bank of Kenya, June 2013). Similarly, the Credit Information Sharing (CIS) mechanism has advanced in terms of usage since its establishment in June 2010. By June 2013, the number of credit reports requested by institutions increased by 12 % to stand at 2,907,375, up from 2,596,600 reported in March the same year. Likewise, agency banking has seen tremendous growth since its introduction in 2010, as more and more customers are able to access the service (Central Bank of Kenya, June, 2013). The Deposit Taking Microfinance Institutions (DTM) also grew and by June 2013, DTM had gross loans amounting to Ksh. 22.5 billion while deposits stood at Ksh. 19.7 billion.

As of 31 December 2014, the Kenyan banking industry comprised 44 banking institutions, namely 43 commercial institutions and one mortgage finance company. Of the 44 banking institutions, 30 were locally owned while 14 were foreign-owned. There were also eight representative offices of foreign banks. A further breakdown of the banks shows that of the locally owned banks, three were co-owned in partnership with the government while the other 27 banks were privately owned commercial banks. The 27 privately owned financial institutions included one privately owned mortgage company. There were also 87 private forex bureaus, eight Deposit-Taking Microfinance Financial Banks (DFBs), two Credit Reference Bureaus (CRBs) and 13 Money Remittance Providers (MRPs) (Central Bank of Kenya 2014:1), as shown in Fig. 11.1.

In terms of ownership and asset control, local public commercial banks (those with government shareholding) account for 7 % of total banking assets, local private commercial banks account for 62.8 %, while foreign commercial banks account for 30.2 % of total assets, as shown in Table 11.2 (Central Bank of Kenya, Supervision Annual Report 2014:5). It is believed that the banking industry will continue to be a major player in steering economic development in Kenya, thereby emphasising its critical importance to the country (Njuguna 2013).

As Table 11.2 shows, local public commercial banks control only a small percentage of the ownership and assets of the banking industry, while local private commercial banks control the majority of total assets. It is notable that foreign commercial banks control a substantial percentage of total assets despite the fact that there are very few of them.

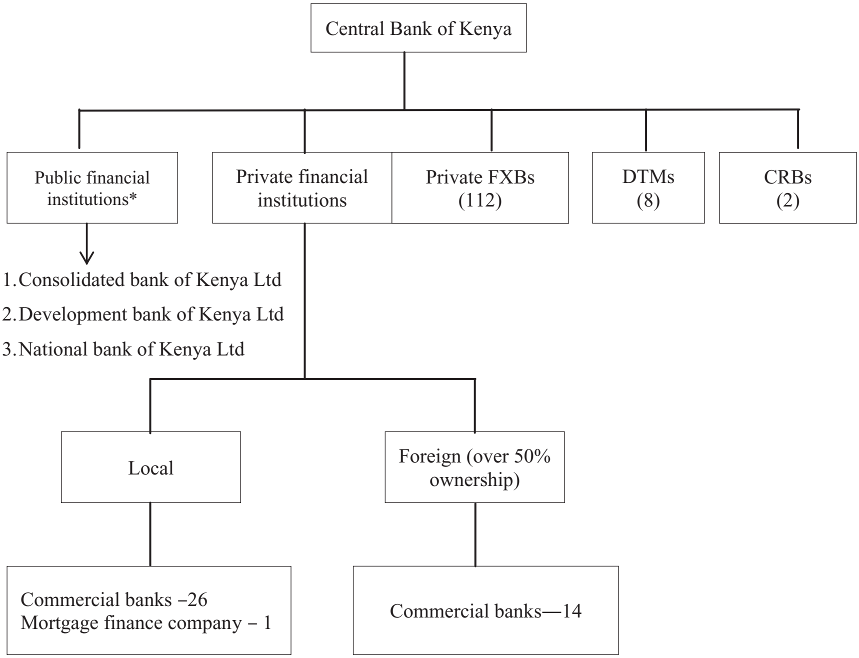


**Fig. 11.1** Structure of the banking industry (*GOK shareholding includes shares held by the state corporation) (*Source:* Central Bank of Kenya 2014:xiv)

**Table 11.2** Ownership and asset base of commercial banks (Ksh. million)

| Ownership | No. | % | Total net assets | % |
|---|---|---|---|---|
| Local public commercial banks | 3 | 7 | 154,896 | 5 |
| Local private commercial banks | 27 | 62.8 | 2,061,517 | 64 |
| Foreign commercial banks | 13 | 30.2 | 982,983 | 31 |
| Total[a] | 43 | 100 | 3,199,396 | 100 |

[a]Charterhouse Bank excluded due to being under statutory management (Central Bank of Kenya 2014: 5)

However, overall the Kenyan banking industry and the economy have greatly improved as a result of restructuring in the industry and improved governance. Given the present banking industry's positive performance, the industry is projected to continue its improved performance.

## Is the Current Positive Performance Sustainable for the Banking Industry?

The Kenyan banking industry still remains the largest and most developed in the Eastern Africa region. According to banking industry 2013 update (Central Bank of Kenya 2013), the Kenyan banking industry is expected to maintain its momentum and robust growth against the backdrop of a favourable stable macro- and microeconomic environment. Other factors associated with the positive growth include aggressive domestic and regional expansion by banks and other financial institutions, as well as increased economic activity arising from the devolved system of government as a result of the new constitutional dispensation focusing on county development (Central Bank of Kenya 2013). Despite this, the banking and financial industry still faces some challenges which may hinder its expected prosperity and strategic leadership in East Africa. The challenges arise from the threat of rampant corruption which may undermine the gains made. However, the industry is still faced with the threat of rampant corruption which may undermine the gains made. Specifically, the barriers include the bank consolidation, inaccessible banking services, fragmentation, poor leadership, rampant corruption and overall sustainability.

**Bank Consolidation** The *Kenya Gazette Supplement No. 90* (2008) requiring all banks and mortgage institutions to increase their minimum core capitalisation and consolidation aims to increase bank efficiency and stability in the future. However, the effectiveness of the new policy is dependent on the types of ownership arising from such mergers, associated competition and client response. Similarly, the banks' performance will depend on how government-owned banks are managed, quality of services and the level of financial infrastructure (Beck et al. 2009).

**Banking Services** The Kenyan banking industry is credited for its size and diversification. In relation to private credit to gross domestic product

(GDP) (a standard measure of financial development), the Kenyan banking industry stood at 23.7 % compared to a median of 12.3 % for Sub-Sahara African countries (Thorsten et al. 2010:2). It is also notable that the country has well developed financial systems including banks, insurance, stock and bond markets. However, according to Beck et al. (2009:2), Kenya has failed 'to provide adequate access to banking services to the bulk of the population' and concentrates on large private and public enterprises in urban areas while neglecting rural communities. Similarly, financial services are very expensive as evidenced by high interest rates, making them inaccessible to the majority of the population. In 2006, 23 % of the Kenyan population was still living on less than US$1/day, while approximately 10 % of the population controlled more than 42 % of the country's income (Fitzgibbon 2012). It will be essential to harmonise the economic standards of citizens and financial access across the country to ensure a stable and efficient banking industry.

**Fragmentation** In recent years the banking industry has taken major steps to ensure stability and efficiency through various efforts like writing off non-performing loans, reducing government influence and managing interest rates. However, the industry still continues to face a fragmentation challenge. There are many small banks operating in Kenya to serve specific niches but having very little impact on the industry in terms of competition and social influence (Beck et al. 2009). Although the government through its consolidation effort is expected to solve the problem of the fragmentation of small banks, the challenge still remains as the effort might divert the banks from their intended missions and objectives.

**Leadership** A major challenge facing the banking industry worldwide is lack of effective leadership. Most banking management lacks the leadership skills required to cope with the changing environment (Donnelly 1994:12). In fact, studies by Ambutsi (2005), *Kenya Magazines* (2011), Waweru and Kalani (2009) and Kaplan (2012) advocate strong leadership in the industry. The lack of effective leadership has negatively affected the Kenyan banking industry for years, as illustrated by non-performance of the locally incorporated commercial banks rather than the foreign-owned banks. It is important to ensure that effective leadership is maintained in the sector to guarantee stability and continued growth.

**Rampant Corruption** Kenya is ranked among the most corrupt countries in the world (Transparency International 2014). The government, through it anti-corruption body, needs to introduce and strictly enforce laws that impose heavy penalties on offenders. Failure in this area will undermine all achievements attained so far and in the future (Ambuts 2005; Brownbridge 1998; Kinyua 2006).

**Overall Sustainability** The financial crisis has put the financial sector worldwide under scrutiny both in terms of monetary performance and social impact. From international and local regulators to the public (clients, investors, employees), there is a growing concern and expectation that banks must not just make money but must play a positive role in national and international development agendas to promote green and low carbon economies (PWC 2012:1). This new challenge means that whether in Kenya or elsewhere, banks must adopt a multidimensional and comprehensive approach to issues relating to the environment and climate change and to social responsibility, while at the same time operating ethical and profitable businesses (PWC 2012:1).

## The Future of the Kenyan Banking Industry

Despite its positive contributions, the Kenyan banking industry has undergone several decades of financial difficulty which, in turn, have generated financial and social imbalance in the economy (Sokpor 2006; Kinyua 2006). A major obstacle to the development and stability of the banking industry during the 1980s and 1990s was the presence of high non-performing loans, resulting from heavy borrowing without good mechanisms of repayment or enforcement. As discussed previously, the industry was also open to non-bankers who established more banks, leading to an increase in non-professionalism in the industry, as investors whose interest was profit and self-gratification invested in the industry. These actions resulted in a banking industry dominated by non-performing loans, weak internal controls, political interference, corruption and poor leadership (Ambutsi 2005; Brownbridge 1998; Sokpor 2006; Kinyua 2006).

However, since the year 2000, major changes in the financial sector have led to positive performance of the Kenyan banking industry (Gudmundsson et al. 2013; Wahome 2004; Waweru and Kalani 2009). The industry is expected to continue its upward trend in the future in line with the government's 2030 Vision of ensuring that the financial sector attains stability and efficiency in service delivery and is accessible to the majority of the population. However, the achievement of these goals is still threatened by uncertainty about the proposed bank consolidation, market reactions, poor infrastructure to reach the majority of the population in rural areas, the presence of many small fragmented banks serving different niches, and finally rampant corruption (Beck et al. 2009; Brownbridge 1998; Fitzgibbon 2012; Waweru and Kalani 2009).

In an effort to address these challenges, the Financial Act 2008 recommended that the small banks should consolidate to form large banks, thus reducing costs and enhancing their operational efficiency. Again, this is a challenge that can only be met with strong effective leadership, a clear vision and the ability to propel the banking industry to the desired end. According to Kaplan (2012), the banking industry must invest in leadership because the demand for strong leadership is high. This means that the Kenyan banking industry must refocus its attention on leadership if it is to be assured of effectiveness and a positive role in enabling the country to achieve its development agenda. To further facilitate its role in enhancing the future development of the banking industry, the Central Bank of Kenya has pledged to continue with three main tasks considered critical for the future survival of the banking industry (Njuguna 2013). Firstly, the Central Bank of Kenya promises to strengthen the financial stability of the country through strict and robust supervision and regulatory mechanisms. Secondly, the Central Bank of Kenya aims to enhance financial integrity within the banking industry as a way to curb corruption in the form of money laundering and financing of terrorism-related activities in line with international best practices. Finally, the supervisory and regulatory body plans to promote financial activities aimed at strengthening banking's financial standing and development as outlined in the country's Vision 2030.

Besides the internal measures instituted by the Central Bank of Kenya and the banks themselves to safeguard their future survival, a more urgent concern relating to sustainability poses a major threat to the banking industry worldwide (including in Kenya). This is the need for banks to develop strategies for an integrated and comprehensive approach to environmental, social and profit motives and other sustainability dynamics. The banking industry is expected to be a major player in ensuring a green and lower carbon economy. How involved the banks become will determine their sustainability due to renewed demands by key stakeholders both at international and local levels (UNEP FI 2005, PWC 2012). According to International Finance Corporation (n.d.), banks can benefit immensely from reassessing their approach to business practice to focus on sustainability-oriented risk management and develop products geared toward such ends. Thus, sustainability is increasingly identified as central to bank growth and cannot be neglected, a challenge that Kenyan banks must embrace.

## Conclusion

The Kenyan banking industry has a crucial role to play in strengthening the country's financial position as a hub for the Eastern Africa region. In the last 10 years, the banking industry has experienced very significant growth and its prospects for future growth are very encouraging. However, the banking industry in Kenya has undergone both positive and negative growth. For over three decades the industry was plagued with weak internal control, poor management, political interference, poor governance and corruption. However, following the positive growth seen in the last ten years, the industry needs to maintain its upward trend by ensuring that sustainability strategies are put in place. The most appropriate moves toward sustainability are both internal and external. While maintaining the momentum of growth through the consolidation of small and fragmented banks into large institutions and the expansion of banking services to the majority of the population are important, future success and growth will mostly be determined by the banks' involvement in sustainability practices. This means that long-term business success will only be achieved by banks that contribute to healthy economic, social and environmental activities aimed at a stable society, an increasing trend that Kenyan banks must embrace.

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