FINANCIAL REGULATION IN KENYA: BALANCING INCLUSIVE GROWTH WITH FINANCIAL STABILITY

RESEARCH PROPOSAL

FRANCIS M. MWEGA
SCHOOL OF ECONOMICS
UNIVERSITY OF NAIROBI
In the wake of the global financial crisis, many countries are prioritising stability by strengthening financial regulation.

Although important, this might be at the expense of inclusive growth, especially in poor countries.

This case study investigates this potential tradeoff in Kenya.
Kenya is a small open economy which is highly vulnerable to domestic and external shocks.

It has a lightly regulated financial system and a fairly open capital account.

The study will adopt an empirical approach, entailing quantitative work and focused policy analysis.
The objectives of the Kenya case study are to identify and analyze:

- Key national risks to financial stability.
- Obstacles or gaps in financial sector for funding inclusive growth.
- Adopted domestic regulatory measures and future options to support financial stability.
- Management of capital account to support financial stability prior, during and after recent global financial crisis; and
Introduction (4)

- Advantages and problems of different mechanisms for such regulation, given the country characteristics (e.g. weak institutions, governance and law enforcement, information problems).
- The framework papers for the research project identify a large number of issues that require investigation under the case study.
- These include the following.
First is size and growth of the financial sector

A lot of work has been done on the relationship between the size of the financial sector and economic performance.

Many studies find a close linkage between financial deepening, productivity and economic growth.

However, while low income countries need to increase the size of their financial sectors, there are limits to this (Spratt 2013).
Beyond a certain point, financial sector development becomes negative for economic growth, both through heightened financial instability and the misallocation of financial resources.

The same applies to a too rapid growth of private sector credit.

Kenya has a well developed financial system for a country of its income level (Beck and Fuchs 2004).
Size and growth of the financial sector

- Kenya’s level of financial development is not too far off from the predicted level in a global cross-country model (Allen et al. 2012).
- Christensen (2010) classifies Kenya as a frontier market economy whose financial market is advanced, but not to the same extent as emerging markets e.g. S. Africa.
- Its M3/GDP ratio is about 34% compared to an average of 63% for emerging market economies in 2008-10.
Size and growth of the financial sector (4)

- It is therefore unlikely the size of the Kenya’s financial sector is beyond the threshold to negatively impact on economic growth.
- Griffith-Jones (2013) also shows that credit extension in Kenya has been relatively modest in the last decade compared to some other SSA countries.
- We plan to do further analyses on these issues.
Size and growth of the financial sector (5)

- It is possible, or example, to link the various proxies of financial development to growth using VAR and Granger-causality analysis (e.g. Ncube 2009 for South Africa).

- The second issue identified by the framework papers is the role of public and foreign banks.

- According to these papers, opinion on the merits of foreign banks and public banks has shifted considerably since the 2007-8 GFC.
Role of public and foreign banks

- They postulate that there is now a consensus that foreign banks can have both positive and negative effects.
- They can have negative impacts, particularly on the supply of credit to the less lucrative sections of the country, and during crises.
- Similarly, there has been a change in the negative perception of public banks, with some studies finding that the public banks performed a valuable counter-cyclical role in some countries; while others find public banks to be associated with higher rates of economic growth.
Role of public and foreign banks (2)

- Currently, Kenya has 43 banks, of which 13 are foreign, accounting for 33.4% of commercial banks net total assets (Bank Supervision Annual Report 2012).
- There are 3 local public banks that account for 4.4% of net total assets; and
- 27 local private banks that account for 62.8% of the net total assets.
- Hence the banking system is dominated by local private and foreign banks.
Role of public and foreign banks (3)

- We therefore can study the behaviour and performance of (i) the 13 foreign banks; and (ii) the 3 public banks vis a vis other banks in the country, relying on the well-established methodology of assessing banks performance.

- This entails linking indicators such the ROA, NPLs, growth and composition of bank credit to private sector, etc, to banks-specific factors and environmental variables.
Other Financial institutions (1)

- The **third** issue identified by the framework papers is the role of other financial institutions.

- Kenya has numerous other financial institutions. These include:
  - The capital market, with the stock market the 5th largest by market capitalisation in Africa after South Africa, Egypt, Nigeria and Morocco.
  - 38 insurance companies.
  - 10 Development Financial Institutions (DFIs) that provide medium and long-term finance.
Other Financial institutions (2)

- 1 mortgage company.
- A Post Office Savings Bank, supported by 890 post offices spread throughout the country.
- About 2700 SACCOs in both rural and urban areas.
- 2 credit reference bureaus, first rolled out in 2010.
- 8 deposit-taking microfinance institutions, etc.
- The framework papers propose a detailed study of some of these financial institutions in the context of the potential tradeoff between inclusive growth and financial inclusion.
Other Financial institutions (3)

- These include the (i) capital market; (ii) the insurance market; (iii) credit reference bureaux; (iv) DFIs, etc

- The fourth issue identified by the framework papers is financial inclusion.

- Despite the proliferation of financial institutions, only 22.9% of Kenyans had access to financial services and products through commercial banks and the Post Office Savings Bank in 2009.
An additional 17.9% were served by SACCOs and microfinance institutions; while 26.8% depended primarily on informal financial services.

Almost one third (32.9%) of Kenyans were classified as ‘unbanked’ or financially excluded.

However, the last 5-6 years have seen a massive increase in access to financial services in the country.
Financial inclusion (2)

- Deposit accounts have for example increased from about 2 million to 18 million while loan accounts have increased from 1 to 3 million since 2007.

- This has been driven by (i) introduction of mobile money financial services in 2007; (ii) licensing of deposit-taking micro-financial institutions since 2009; (iii) introduction of agency banking in 2010; (iv) introduction of credit information sharing in 2010; etc.
Financial inclusion (3)

- The adoption of mobile money service M-PESA in 2007 far exceeded expectations.
- Currently, mobile money services have close to 20 million customers, handling over US$ 54.4 million worth of transactions per day.
- Research is needed to assess whether increased financial inclusion has compromised financial stability.
- The available evidence is conflicting. On the one hand, the stock of e-money is backed 100% by accounts held at commercial banks, so that increased inclusiveness has not endangered financial stability.
Financial inclusion (4)

- The mobile money e-float is also a small proportion of the other monetary aggregates in terms of size for it to matter much for monetary policy.
- Weil et al. (2011) estimate the outstanding stock of M-PESA e-float at 1.6% of M0 and 0.4% of M1.
- On the other hand, there is increased instability in monetary relationships post-2007 undermining the current conduct of monetary policy which assumes stable monetary relationships.
- Evidence shows a decline in the income velocity of circulation; an unstable money demand function; and an increase in the money multiplier.
Competitiveness and efficiency of the financial system (1)

- The fifth issue identified by the framework papers is the competitiveness and efficiency of the financial system.
- While the evidence is mixed, financial sector reforms have undoubtedly strengthened Kenya’s banking sector in the last decade or so, in terms of product offerings and service quality, stability and profitability (Kamau 2009).
- Evidence also suggests there has been increased competition and efficiency of the sector (Mwega 2011).
- An issue for study is the extent to which increased competition and efficiency has reduced the cost of financial services and enhanced financial access on a sustainable basis.
- According to Spratt (2013), the role of competition and efficiency is clear in some respects, less so in others.
Competitiveness and efficiency of the financial system (3)

- Competitive forces in finance – as in the real economy – tend towards consolidation, increasing scale and increasing homogeneity.
- Hence there is need for creating a regulatory structure that can counteract this and maintain a precarious ecosystem of financial institutions.
- The sixth issue identified by the framework papers is the cost of financial services.
- According to these papers, significant efforts need to be taken to reduce the cost of financial services in low-income countries if financial access is to be expanded on a sustainable basis.
The cost of financial services (1)

- Despite reforms in the country, the interest rate spreads in Kenya remained very high.
- While the spreads in Kenya are comparable to those in the region, they are relatively high when compared to emerging economies like Malaysia (Abdul et al. 2013).
- The study will investigate factors which explain the high interest rate spreads in Kenya, after a review of the available literature.
Banking crises (1)

- *The seventh issue identified by the framework papers is banking crises.*
- Spratt (2013) for example advocates a study of the context-specific determinants of banking crises in order to understand how financial regulation can prevent them, while not stifling economic activity in a way that damages growth.
- Kenya has so far experienced banking crises in 1986 and in 1998 which we can study.
Prudential regulations (1)

- *The eighth issue identified by the framework papers is the prudential regulation of the financial system.*
- Spratt (2013) for example advocates for (i) a unified approach to supervision, with the central bank playing a dominant role; (ii) comprehensive approach with regulators utilizing the already wide ‘tool-kit’ available to them.
- Kenya for example has increasingly moved into universal banking reflected in increasing share of net commissions and fees in the banks total income.
- The country now has banks that own insurance firms; while others own stock brokerage firms.
Prudential regulations (2)

- This poses regulatory challenges as different financial sector entities are subject to different regulatory regimes.
- The Central Bank has adopted a consolidated supervision approach, which requires information sharing and coordination amongst the various regulators in the financial sector.
- In addition, some banks have expanded their branch networks in the region.
By December 2012, Kenyan banks had established 282 branches in neighbouring countries (Uganda 125, Tanzania 70, Rwanda 51, Burundi 5, and South Sudan 31).

Central banks in these countries have therefore signed an MOU to facilitate information sharing and supervisory cooperation for regional banking groups.
The ninth issue identified by the framework papers is government borrowing.

To what extent is government borrowing unsustainable and crowd out the private sector?

What are the sustainability implications of investing in infrastructure versus other forms of expenditure, for example?
According to Adam et al (2010), a major achievement of the Kenyan authorities over the last decade has been the elimination of fiscal dominance which has allowed a coherent monetary policy to emerge. There was substantial decline in the share of public sector credit, although some of the progress was reversed during the recent global financial crisis as government increased stimulus spending.
However, the dragon of fiscal indiscipline is never completely slain, so an important consideration becomes the capacity of alternative monetary regimes (such as inflation targeting) to offer an effective bulwark against recurring fiscal indiscipline outside the role of the IMF as an agent of restraint.

The paper will address this issue.
The role of capital flows (1)

- The tenth and final issue identified by the framework papers is the role of capital flows.
- Kenya has recently experienced a large increase in the current account deficit.
- The current account balance recorded a surplus of 0.98% of GDP in 2003, and, since then, the account has been in deficit, which has widened over the years.
- By 2012, the deficit had risen to 10.4% of GDP.
The role of capital flows (2)

- The rising deficit is mainly financed by short-term net capital inflows, making the Kenya shilling highly vulnerable to external shocks.
- Other sources of finance are remittances, ODA and FDI.
- This raises a number of research questions (Spratt 2013).
- How should these inflows be managed to ensure stability and inclusive growth?
- How can the ability of developing countries to borrow internationally be increased?
The role of capital flows (3)

- What determinants the differential costs between borrowing domestically and externally?
- Is the increased investor appetite for (some) low-income country assets sustainable?
- If sustainable, how can the positive effects be maximised, with investment encouraged into sectors with the greatest development potential?
- If unsustainable, how can countries prevent the generation of asset price bubbles and protect their economies from the consequences of these?
Thank you.