BANKING SECTOR REFORMS IN KENYA: PROGRESS AND CHALLENGES

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Abstract

This paper gives an overview of the banking sector in Kenya; it highlights the reforms since the country's independence in 1963; it tracks the growth of the banking sector in response to the reforms implemented over the past four decades; and finally, it highlights the challenges facing the banking sector in Kenya. The country's banking sector consists of more than 40 commercial banks, with the Central Bank of Kenya, which is the country's central bank, at the apex. Since the 1980s, the Kenyan government has implemented a number of banking sector reforms – in order to safeguard and improve the banking sector. The response to these reforms by the banking sector has been varied. As a result of these reforms, there has been a shift in the dominance from the State-owned banks to the private commercial banks. There has also been an improvement in the Central Bank's oversight of the financial institutions, and an enforcement of the banks' capital-adequacy requirements. By the standards of African countries, Kenya currently has one of the most developed banking systems in Africa. The country has enjoyed a substantial bank-based financial sector development over the years, and its institutional framework has also grown stronger. However, like many other developing countries' financial systems, the Kenyan banking system still faces wide-ranging challenges, such as high interest rate spreads and financial inclusion challenges.

Keywords: Banks, Reforms, South Africa, Banking System, Financial Sector

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1. Introduction

Banks play a central role in the development of every economy by mobilising resources for productive investments, and by being the conduit for the implementation of monetary policy. The role of banks in economic development is widely acknowledged in the literature. In particular, Schumpeter (1911) put the role of financial intermediation at the centre of economic development. He argued that financial intermediation, through the banking system, plays a pivotal role in the economic development; and it does this by affecting the allocation of savings, thereby improving productivity, technical change and the rate of economic growth.

The endogenous growth literature also supports the argument that financial development has a positive impact on growth (Smith 1991). Well-functioning bank-based financial systems are able to mobilise household savings, to allocate resources efficiently, to enhance the flow of liquidity, to reduce information asymmetry and transaction costs, and to provide an alternative to raising funds through individual savings (Smith, 1991). In the light of these functions, it may confidently be stated that banks have a positive impact on growth.

In Kenya, the bank-based segment of the financial sector, as in any other banking sector, plays a crucial role in both financial-sector development and economic development. The banking system ensures the efficient allocation of resources in the Kenyan economy, through lending to businesses and individuals, and by using credit-scoring systems. Additionally, banks facilitate business through the settlement of funds and the provision of credit to consumers. They provide 24-hour access to funds and facilities, thereby enabling institutions and individuals to save and invest with safety (Central Bank of Kenya, 2012a).

Although Kenya has one of the most developed financial sectors in Africa, its financial development, as in many other developing countries, is largely driven by the bank-based segment. Although banks play such an important role in the economic development of Kenya, the Kenyan banking sector has not received adequate coverage in terms of research. Not much has been documented on the bank-based segment of the financial sector in Kenya. Moreover, previous studies done in Kenya tend to generalise the financial sector – without giving specific attention to the bank-based segment of the financial sector. This paper aims to put Kenya's banking sector in the spotlight – by providing an overview of the country's banking sector, its reforms, growth and challenges – since the country's independence in 1963 – and through to 2010.

The rest of this paper is organised as follows: Section 2 gives an overview of the Kenyan bank-based financial system. Section 3 outlines the reforms implemented to revitalise the banking sector. Section 4 tracks the growth of the banking sector in Kenya, in response to the reforms. Section 5 highlights the challenges facing the development of the bank-based financial sector in Kenya. This is followed by the concluding section.

2. An Overview of Kenya's Bank-Based Financial System

The Central Bank of Kenya ("the Bank") was established in 1966 through an Act of Parliament – the Central Bank of Kenya Act of 1966, after the dissolution of the East African Currency Board (EACB) (Central Bank of Kenya, 2012a). The establishment of the Bank was a direct result of the desire among the three East African states to have independent monetary and financial policies. During the colonial period of Eastern Africa, the EACB was the governing body for finances and currency for the British colonies of Kenya, Tanzania, and Uganda. This Board was disbanded in 1966, when these countries became independent and acquired their own central banks. At that point, the Central Bank of Kenya was established. The Central Bank of Kenya is headquartered in Nairobi, with branches in Mombasa, Eldoret and Kisumu (Central Bank of Kenya, 2012a).

The Central Bank of Kenya, which falls under the Minister for Finance docket, is responsible for formulating and implementing monetary policy and fostering the liquidity, solvency and proper functioning of the financial system. Thus, it plays an oversight role and its activities are governed by the Central Bank of Kenya Act of 1966. The Central Bank of Kenya Act of 1966 set out objectives and functions and gave the Central Bank limited autonomy. Since the amendment of the Central Bank of Kenya Act in April 1997, the Bank has now greater monetary autonomy, as its operations have been restructured to conform to the on-going economic reforms.

The Banking industry in Kenya is governed by, among other acts, the Banking Act of 1985, as amended, the Central Bank of Kenya Act of 1966, as amended and the various prudential guidelines issued by the Central Bank of Kenya. For decades since independence from Britain in 1963, Kenyan banking was dominated by local units. These have been, however, challenged by home-grown institutions targeting the lower end of the market. Currently, there are 43 licensed commercial banks and one mortgage finance company (Central Bank of Kenya, 2012c). Of the 44 institutions, 31 are locally owned and 13 are foreign-owned. The locally owned financial institutions comprise three banks with significant shareholding by the Government and State Corporations, 27 commercial banks and one mortgage finance institution. The banks have come together under the Kenya Bankers Association (KBA), which serves as a lobby for the banking sector's interests. The KBA serves a forum to address issues affecting members (Central Bank of Kenya, 2012a).

Over the last few years, the banking sector in Kenya has continued to grow in assets, deposits, profitability and product-offerings. The growth has been mainly underpinned by: an industry-wide branch network expansion strategy – both in Kenya and in the East African community region, and the automation of a large number of services, and a move towards emphasis on the complex customer needs rather than traditional 'off-the-shelf' banking products (Central Bank of Kenya, 2012a). As the financial sector develops, greater institutional diversity is expected, together with diversification of the services offered. Although Kenya's financial sector could be described as being relatively diversified in terms of the number of financial institutions, banking services continue to dominate the sector.

3. Bank-Based Financial Reforms in Kenya

Given the critical role of banks in a modern market economy, the opacity of banks' balance sheets and the dispersion of banks' creditors, there are limitations to market discipline, and additional sources of fragility, compared to non-financial corporations. Banking has, therefore, historically been one of the most regulated sectors, with regulation ranging from licensing requirements to on-going supervision, to a bank-specific failure regime and deposit insurance (Beck *et al.*, 2010). The banking sector is driven by numerous policies; and Kenya's banking sector is no exception. This section presents the banking sector policies in Kenya since the 1970s.

During the late 1970s, the 1980s and the early 1990s, the government of Kenya introduced a number of policy reforms aimed at gradually liberalising the banking sector. These reforms – together with the reforms aimed at strengthening the institutional framework of the financial system – were supported by the Financial Sector Adjustment Credit from the World Bank. Government intervention in the banking sector in Kenya since independence has had two major objectives. The first objective was to control monetary aggregates for macro-economic stabilisation. The second objective was the direct development of the banking sector, and in particular, the nature of its asset allocation, in accordance with political and economic priorities. The third objective, that of prudential regulation and supervision, did not initially receive much attention; but it has been the focus of increasing emphasis since the mid-1980s (IMF, 2002).

The financial system that existed at independence was dominated by foreign-owned commercial banks concentrating on trade-related finance, and serving the white settler community. As a result, financial gaps were perceived to exist, consisting of the credit requirement of African entrepreneurs and the long-term financial needs of the business sector. To close this perceived gap, the parastatal financial institutions were set up to provide finance to parastatal segments of the market (farmers, and small businesses). However, financial performance of most of them was very poor, largely because many of their clients were not profitable (Central Bank of Kenya, 2012a).

Commercial banks and other financial institutions in both the private and public sectors were largely free of formal government controls over the sectoral allocation of their lending, with the exception of a stipulation that they extend credit to agriculture, amounting to at least 17% of their deposit liability. However, compliance was low, since there were no penalties imposed on financial institutions, which failed to meet this requirement (Demirgüç-Kunt *et al.*, 2004). It can be noted that formal influence over public and private financial institutions was exerted by government and politicians through the placement of parastatal deposits in particular financial institutions (Central Bank of Kenya, 2012a).

The rapidly deteriorating terms of trade of the 1970s led to the balance of payments crises of 1974 and 1978-80, to which the Government of Kenya reacted by imposing controls on bank lending, licenses on foreign exchange transactions, and interest rate controls. While restrictions on domestic credit were later lifted, the others were made even more stringent, thereby generating important distortions in economic activity and giving rise to pervasive rent-seeking (Durevall and Ndung'u 1999). Real interest rates were negative from 1974-78; and domestic savings plummeted in 1975 and 1979, and never fully recovered (Durevall and Ndung'u 1999).

In 1978, investment efficiency fell as State-owned banks financed low-productivity public investments. Returns on public investment averaged 0.2%, as compared to a 15% return on private investments (Government of Kenya, 1982). Real interest rates followed an upward trend from 1978 onwards, and so did interest rate spreads – reflecting the higher levels of uncertainty in the economy, the increasing number of non-performing loans and low investors' confidence. Domestic savings came tumbling down from a high of 27% of GDP in 1977 to a low of 3% in the year 2000 – compared to about 15% average in sub-Saharan Africa (World Bank Indicators, 2012).

The second oil crisis and the severe droughts of 1979/80 helped trigger reforms. A change in the exchange rate policy, from a fixed to a crawling peg, was adopted to deal with the appreciation of the real exchange rate. The policy switch was accompanied by fiscal stabilisation and interest rate adjustment. In one year (1981) deposit rates doubled. Inflation fell from 21 to 11% in 1982 (Government of Kenya, 1982). This led to a double inflow of aid from international donors. In 1983, Kenya experienced its first post-independence banking crisis, when several indigenous banks developed acute liquidity problems. The crisis came as a result of conscious Government Policy to transfer economic activity into the hands of indigenous Kenyans. The banking sector was no exception – given the large number of new entrants and the low levels of expertise and experience (Central Bank of Kenya, 2012b). Despite efforts by Treasury and Central Bank to bail out the ailing institutions, one institution was closed in December 1984.

This crisis precipitated amendments to the Banking Act in 1985 – to expand the safety net and improve the bank-failure resolution mechanism. The Deposit Protection Fund Board (DPFB) was established as a deposit-insurance scheme to provide cover for depositors, and to act as a liquidator of banks, which could not be salvaged. The same amendments gave the Central Bank of Kenya the responsibility of risk minimisation through enhanced prudential regulation, supervision and surveillance. The function of curator and revival of ailing institutions was also entrusted to the Central Bank. In addition, there was a change in the licensing procedures for banks that introduced a clearer mandate for the Central Bank in the licensing process (Central Bank of Kenya, 2012b).

In order to improve the role of the DPFB in enhancing depositor confidence, initiatives are currently underway to enact a new and separate Kenya Deposit Insurance Corporation Act that should give the Fund autonomy in its operations (Central Bank of Kenya, 2012b). Among other additional roles, the draft Act provides the DFPB with powers to request the Central Bank to carry out an inspection of a member institution, and, where deemed necessary, to conduct the examination itself.

In 1990, dual exchange rate was put in place (official and market rate). Government abolished all charges and fees from the ceiling on commercial bank loan rates, allowing effective rates to exceed ceilings. In 1992, the economy went into a recession. Money supply was inflated by 76%, in order to finance the electoral campaign (Beck *et al*., 2010). A shift in policy was required to bring the economy under control. Controls on foreign exchange transactions were relaxed. A floating exchange rate was adopted.

In 1993 there was an 81% devaluation of the Kenyan Shilling, which led to an overnight jump of the external debt to 143% of GDP, and a fall in inflation to pre-1970s levels. In the same year, under pressure from the IMF, World Bank and other donors, the Central Bank of Kenya put around 16 financial institutions into liquidation, while others, including a government-owned commercial bank were recapitalised by their shareholders (Central Bank of Kenya, 2012a).

In 1995, further amendments to the Banking Act were made, aimed at increasing and strengthening supervision of the banking industry (Beck *et al*., 2010). Prudential guidelines were revised to encourage self-regulation. These prudential guidelines 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. In the same year the banking sector was liberalised and exchange controls were lifted.

The Central Bank of Kenya Act of 1966, which sets out the objectives and functions, and gave the Central Bank limited autonomy, was amended in April 1997, restructuring the Central Bank operations to conform with on-going economic reforms, and to grant it greater monetary autonomy. In 1998, the Central Bank enhanced capital requirements to avoid a repeat of the banking crises experienced in the mid-1980s and early 1990s (Beck et al., 2010). To this end, the gearing ratio was raised to 7.5% from 5% (Beck *et al*., 2010). Although monetary policy was cautious throughout most of 1998, it was relaxed in late 1998, in the context of the rescue of one of the government-owned banks. Following a sharp decline in interest rates, a 20% depreciation of the shilling, and a considerable loss of official reserves, monetary policy was tightened in mid-1999, partly reversing those developments (Central Bank of Kenya, 2012a).

In 1998, and in the first half of 1999, inflation remained subdued, but it increased in the third quarter of 1999, mainly owing to increases in fuel and food prices, as well as the lagged effects of the depreciation of the Kenyan shilling.

In 2000, the Central Bank adopted the Basel I standards on capital adequacy. This led to the introduction of additional capital adequacy ratios of 8% and 12 % for 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 (Central Bank of Kenya, 2012a).

In response to gaps identified in the 2003 joint IMF/World Bank Financial Sector Assessment Program (FSAP), a series of legal and regulatory reforms were undertaken. These have included significant changes to the Banking Act (Cap 488) and to prudential guidelines to strengthen arrangements in relation to bank licensing, corporate governance, capital adequacy, risk classification of assets and overall-risk management (FSD, Kenya, 2010).

In 2003, the Government of Kenya published the Economic Recovery Strategy (ERS) paper on Wealth Creation and Employment that defined certain critical high-level objectives that underlined the reform efforts through to 2007 (Government of Kenya, 2003). 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, including 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 the high cost of credit; insufficient quantities of credit (and poor quality credit assessments); the absence of vibrant institutions for the provision of long- term finance; weak legal arrangements, creating long delays in contract enforcement; and weak dispute-resolution mechanisms (FSD Kenya, 2010).

In 2007, the Government of Kenya published “Kenya’s Vision 2030” as a long-term development plan for the country. The Vision 2030 put the provision of financial services at the centre of the planned economic growth trajectory through to the year 2030 (Government of Kenya. 2007). The main objectives that were articulated in Vision 2030 for the financial sector were: (i) to improve stability; (ii) to enhance efficiency in the delivery of credit and other financial services; and (iii) to improve access to financial services and products for a much larger number of Kenyan households. Delivery of these objectives required the implementation of policies that would contribute to stable macro- and fiscal positions aimed at lower inflation and financial sector stability (Government of Kenya, 2007).

In 2009, calls to improve the financial inclusion by the international community and the need to implement Vision 2030, saw Kenya passing the Finance Act that became operational in January 2010. This Finance Act of 2009 further amended the Banking Act, to enable the use of third-party agents by banks (FSD Kenya, 2010). Banks were, therefore, able to leverage on additional cost-effective distribution channels to offer financial services. This initiative was informed by the need to leap-frog access to financial services in Kenya. The National Financial Access Survey of 2009 showed that 32% of Kenya's bankable population remained totally outside the orbit of financial services; and many more were being served by the informal financial system (FSD Kenya, 2010).

Although government intervention in the banking system has been wide-ranging, Kenya has managed to avoid some of the most damaging features of financial repression that characterised several other Sub-Saharan Countries (Central Bank of Kenya and FSD Kenya, 2009); and this is reflected in the expansion of the financial system in terms of both the volume of its liabilities and assets, and the diversity of its institutions over four and a half decades following independence. In 1966, broad money amounted to 22.9% of GDP; but it was at 43.3% of GDP in 1990.

In recent years, Kenya has made substantial progress in improving the stability and efficiency of its banking system (Central Bank of Kenya, 2010). An upgrade of the supervisory framework was accompanied by the write-off of non-performing loans and reduced government interference in the financial sector. Interest rate spreads, while still high in general, have been reduced recently – due to lower loan loss provisions and overhead costs. However, lower profit margins suggest that there is a certain degree of competition. These developments were accompanied by a reduction in inflation, a reduction in the fiscal deficit and stable exchange rates, which in turn facilitated not only a drop in interest rates, but also improvements in the government-managed and government-influenced institutions.

4. Banking Sector Growth in Kenya

At independence in 1963, the bank-based financial system of Kenya consisted of nine foreign-owned commercial banks, together with several non-bank financial institutions. In the decade following independence, the government established the Central Bank of Kenya, three parastatal commercial banks and a number of non-bank financial institutions. During the 1970s, the non-bank financial institution sector began to expand rapidly, stimulated by differences in the regulatory treatment of banks and non-bank financial institutions, which created market opportunities for the latter (Central Bank of Kenya, 2012a).

The growth of locally owned financial institutions accelerated during the 1980s, and began to include commercial banks, some of which were set up by the owners of existing non-bank financial institutions. During the mid-1980s, the financial system suffered its first episode of financial fragility. This saw some of locally owned financial institutions closing down, due to severe liquidity problems, as a result of mismanagement and fraud (Central Bank of Kenya, 2012a).

It is this crisis that led to a series of revisions to the banking laws and the strengthening of bank supervision (Central Bank of Kenya, 2012a).

Non-bank financial institutions set up to offer long-term credit in the 1980s increased in number over the years. By 1988, their number had almost tripled from the 1981 level, while commercial banks experienced a 50% growth. The growth of the bank-based financial segment of the financial sector in Kenya can be traced as far back as 1970, when there were only 11 commercial banks. Five years down the line, only three banks were left; but the growth momentum had picked up by 1981, registering a total of 16 commercial banks. The upward trend in the total number of commercial banks continued to dominate, with 22 banks in 1984 and 24 banks in the year that followed. However, in 1986, there was a slight drop to 23 commercial banks in the sector before they returned to the 1984 level in 1988.

By 1990, there were 26 commercial banks in Kenya. The number significantly increased to 33 in 1993, and continued to increase over the years, until they reached a peak of 53 in 1997, before falling to 49 the following year. Currently, there are 43 commercial banks in Kenya (Central Bank of Kenya, 2012c).

With the review of the Banking Act in 1990, aimed at strengthening the sector's institutional framework, the position of the banks in the financial system was further strengthened. In the 1990s, four banks continued to dominate the sector. With the review of the Banking Act in 1990, the financial sector was liberalised with the intention of stimulating it to become more dynamic. From 1996, many of the non-bank financial institutions converted to banks, as indicated by the increase in the number of banks in the same period.

However, the banking crisis of 1998 and 1999 saw the collapse of some of the smaller of these banks (Beck *et al*., 2010).

Kenya's banking sector faced major crises in the 1980s and 1990s, due to under-capitalisation, high levels of non-performing loans and weaknesses in corporate governance. Non-bank financial institutions were mostly affected, but the number of failing commercial banks increased as well in the 1990s. The crisis culminated in 1992, when – according to Honohan and Laeven (2005) – Kenya suffered a systemic banking crisis.

Although the banking sector in Kenya has faced challenges, like domestic financial crises, it has grown, both in number of institutions and quality of offerings. The percentage of non-performing loans decreased from 33.3% in year 2000 to a low of 7.8% in 2010, as measured by bank non-performing loans to total gross loans (World Bank, 2012). This development is commensurate with an improvement in the knowledge of credit-related information, as evidenced by credit depth in the information index.

On a scale of zero to six, where 0 represents low and six represents high, the index was zero (0) in 2004, and improved to two (2) in 2005, and further improved to four (4) in 2007, but was stagnant up to 2010. Although the index has not yet reached six (6), there has been development in terms of credit information, a tool which also determines access to financial services (World Bank, 2012).

The development of the banking sector in Kenya is also evidenced by the growth in private sector credit. The late 1970s saw a modest increase in the credit provided by financial institutions to the private sector. Kenya did well from 1975 to the early 1990s. It had a steadily increasing lending rate until 1995, when the rate fell from slightly above 50% to 40%; thereafter, the private sector lending was around 40% of GDP until 2009. While this number is no higher than it was in 1994, the quality of lending has significantly improved, as shown by the increasing ratio of loans net of provision, relative to GDP (World Bank, 2012).

With the growth of the banking sector, came a shift in the dominance of foreign versus local banks in the banking sector. Foreign banks had dominated the banking sector in Kenya, since its independence; but their share of the market has been decreasing gradually, while that of the locally owned banks is increasing (World Bank, 2012). This is clearly portrayed by the share of banking assets among three major participants: foreign, private local and government-owned banks. The government market share in the banking sector is also decreasing.

Table 1 illustrates some of the banking indicators, showing the development of Kenya's banking sector, and the increase in the number of locally owned financial institutions

Table 1. Growth of Banking Sector in Kenya (2000 – 2010)

Indicator	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
Domestic Credit Provided to Private Sector by Banking Sector as a Percentage of GDP	39.2	37.5	40.3	39.8	40.2	38.4	38.0	37.3	40.5	44.8	51.0
Loans (Net of Provisions)/GDP (%)	20.9	20.2	20.9	20.5	22.8	23.5	23.6	24.8	-	-	-
Bank Non-performing Loans to Total Gross Loans (%)	33.3	13.1	18.1	34.9	29.3	25.6	21.3	10.9	9	7.9	6.3
Credit Depth of Information Index (0=low to 6=high)	-	-	-	-	0	2	2	4	4	4	4
Share of Banking sector Assets											
Foreign (%)	44.3	46.3	48.3	48.7	45.3	43.4	43.8	43.5	-	-	-
Private Domestic (%)	21.9	22.7	22.6	24.1	25.7	28.7	29.9	31.0	-	-	-
Government (%)	7.1	7.1	6.6	6.0	6.2	5.6	5.3	4.8	-	-	-

Source: World Bank Development Indicators (2012)

The growth of Kenya's banking sector can also be portrayed by the increasing number of Automated Teller Machines (ATMs). Technological innovations have transformed the Kenyan financial sector landscape in the years since 2002, by helping to extend financial services to millions of poor people at relatively low cost. For example, since 2006, automated teller machines have become a major feature of the landscape, with 1,510 ATMs in the country by December 2008. Competition at the lower end of the market has clearly intensified because of the expansion of microfinance into rural areas. Having realised that microfinance is a potentially profitable activity, a number of mainstream banks have started to open branches in rural areas (in some cases, having closed them only a few years earlier) and to downscale the design of some products to provide microfinance services – either on their own account – or by looking for strategic partnerships to do so (FSD Kenya, 2010).

5. Challenges Facing Bank-Based Financial Development in Kenya

Although Kenya's financial system is by far the largest and most developed in East Africa, and its stability has improved significantly over the past years, many challenges still remain (Popiel, 1994). Kenya's banking sector has, for some years, faced several inter-related challenges, including high interest rate spreads, high overhead costs and relatively high profit margins (FSD Kenya, 2010). One factor in this has been the lack of credit information-sharing, which is seen as one of the several reasons for the high incidence of non-performing loans. Further factors are the deficiencies in the legal and institutional framework that limit the range of assets available to banks as acceptable collateral. There has also been periodic uncertainty in the policy environment relating to the control and regulation of interest rates and related bank fees (FSD Kenya, 2010).

Financial access remains a challenge in the banking sector. By African standards and in comparison with the other East African economies, Kenya's banking sector has for many years been credited for its size and diversification, as partly evidenced by Private Credit to GDP averaging 23.7% in 2008, when compared to a median of 12.3% for Sub-Saharan Africa (FSD Kenya, 2010). Notwithstanding this relative advantage, Kenya's financial system has failed to provide adequate access to banking services for the bulk of its population. Efforts are, however, being made by the government and the banking industry to improve access, especially to those in rural and remote areas by innovative banking solutions, like M-Pesa and the introduction of agent banking – where banks can improve their presence in remote areas via an agent (Central Bank of Kenya and FSD Kenya, 2009).

FinAccess 2009, a household survey conducted by the FSD Kenya, jointly with the Central Bank of Kenya (2009), confirmed three previously assumed conclusions on the access to financial services, which are: (a) a large proportion of the Kenyan population has no access to financial services, whether formal or informal; (b) there is a general tendency for access to services from formal and semi-formal to decline, as one goes from urban to rural, from high-income to low-income, and from better-educated to uneducated; and, (c) although the percentage of the population that is served is similar in urban and rural districts, the mix of those services is different. In urban areas, respondents rely more heavily on services from banks and semi-formal sources, while in the rural districts, there is a greater reliance on the services provided via informal groups (Central Bank of Kenya and FSD Kenya, 2009).

Another challenge faced by Kenya's banking sector is unfair lending practices. While the larger proportion of savings comes from small depositors, lending is skewed in favour of large private and public enterprises in urban areas (Central Bank of Kenya and FSD Kenya, 2009). Like most of the African countries, Kenya is faced with expensive financial services, as evidenced by high interest rate spreads and account fees. This challenge has had a feedback loop on access to financial services. The more expensive it is to have a bank account, the more likely one is excluded from accessing financial services (Capital Markets Authority *et al*., 2011).

Although there is a deposit insurance scheme, DPFB, to provide cover for depositors and act as liquidator of banks which could not be salvaged, insurance coverage is still very low in relation to the total exposure of the Fund. Consequently, there is a need to continue building the fund, as well as ensuring that the financial system is sound. On the one hand, loan recovery is hampered by slow and costly court processes in which debtors have undue advantage of procedural technicalities to the detriment of creditors and the financial sector. On the other hand, the operations of the Fund are governed by different laws, including the Central Bank Act; the Banking Act and the Companies Act, and this has presented a lot of limitations to its smooth operations; and hence, the now urgent need to harmonise the relevant sections into a single piece of legislation (FSD Kenya, 2010).

The banking sector in Kenya is less competitive, partly due to limited information-sharing (Beck and Fuchs, 2004). Thus, lack of information-sharing on debtors has increased banks' credit risk over the years; and it has reduced the competitiveness of the banking system (Beck and Fuchs, 2004). On the other hand, the absence of reliable information on potential borrowers has increased the adverse selection risk for banks, resulting in higher credit risks and loan-loss provisions, which in turn have raised interest rate spreads (Beck and Fuchs, 2004).

Another challenge is the inability of borrowers to build up a positive credit history, which prevents them from accessing bank finance, and increases the costs of switching lenders, effectively tying borrowers to one bank. The resulting rents increase the profit margin of banks, and thus of interest rate spreads (IMF, 2002).

The banking sector in Kenya faces human-resource challenges. Better financial regulation requires a system that can readily identify weaknesses and emerging vulnerabilities; is capable of analysing risks, and so adequately pricing risks; provides appropriate incentives (and penalties) to induce prudent behaviour in the market place; building strong institutions that can withstand shocks and give confidence to the market; and strong institutions of the regulated and strong institutions of the regulator.

These pillars hinge on human-resources capital availability and application. The challenges call for enhanced human-capital development to cope with this changing dynamic world. The Governor of the Central Bank of Kenya, in his speech at the opening ceremony of the Joint Kenya School of Monetary Studies and COMESA Monetary Institute Symposium for Central Banks' Human Resource Directors (2012), said that Kenya's banking sector is facing human-resource challenges; and he encouraged the human-resources specialists in attendance to formulate capacity development initiatives to equip banking staff with the necessary skills and competencies to effectively manage these challenges in a manner that would guarantee a balance between efficiency and stability (Central Bank of Kenya, 2010). The industry also continues to experience accounting challenges; the lack of a uniform chart of accounts, unrealistic or lack of provisioning, and poor compliance with International Financial Reporting Standards (IFRS) (Capital Markets Authority *et al*., 2011).

6. Conclusion

This paper has given an overview of the banking sector in Kenya; it has highlighted its reforms since the country's independence in 1963; it has tracked the growth of the banking sector in response to the reforms implemented over the past four decades; and it has highlighted the challenges facing the banking sector in Kenya. Since the onset of financial reforms in developing countries, the Government of Kenya has implemented a number of reforms, in order to safeguard and improve the banking sector in Kenya. These reforms have focused on increased risk-management procedures and enhanced corporate governance, in order to strengthen and reposition the banking industry, to enable it to contribute effectively to the development of the real sector through its intermediation process. In addition, these reforms have also involved a process of substantially improving the regulatory and surveillance framework, fostering healthy competition in banking operations, and ensuring an efficient framework for monetary management. Although the banking sector responded positively to some of these reforms, it still faces a number of challenges. These challenges include high interest rate spreads, high overhead costs and financial access/inclusion challenges.

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