UNDERSTANDING THE CAUSES OF BANK FAILURES AND SUCCESS IN KENYA

Radha Upadhyaya[1]

This paper attempts to understand the causes of financial sector instability in African countries in particular the causes for bank failures by focussing on the banking sector in Kenya.

The key policy question in Africa is - how can financial sector institutions be used to attain real economy objectives of growth and poverty eradication? Therefore there is a need for financial institutions that are able to finance long term productive investment and able to withstand contingencies and the inherent instability of growing economies. This gives the rationale for the paper – that it is important to understand the causes of bank failures as a financial system in which banks fail, cannot fulfil theses objectives.

In Africa, most countries have experienced recurrent bank closures. Kenya has experienced 42 bank failures since 1984 and the level of non-performing loans and interest rates spreads continue to be amongst the highest in the world. The paper gives an overview of literature on bank failures in Africa and shows that the explanations remain insufficient. Most of the research is based on cross-country studies that ignore the country specific peculiarities that are essential to consider in order, to get an in-depth understanding of factors.

The main departure point of this study is that it is a micro-study of the asset allocation and risk-return decision of banks. It attempts to understand specifically 'why loans go bad'. This is done by trying to understand how banks over-come the information asymmetry between themselves and borrowers, what constraints they face when making lending decisions, and in what circumstances they are not able to overcome these constraints. The study also analyses the causes of bank success in Kenya. This is done on the assumption that 'Kenyan best practice' is not typified by an Anglo-Saxon model of "arms'-length" banking. Therefore it is important to show how some successful banks overcame the agency problems faced by banks in Kenya. Finally this study is unique as it attempts to understand the impact of the segmented nature of the banking sector. The 3 main segments - foreign owned banks, government owned banks and local privately owned banks - face very different constraints and it is important to analyse the impact of this segmentation on instability in the financial sector.
The paper presents an analysis of qualitative and quantitative data gathered through primary fieldwork in Kenya in 2006.

[1] The author is PhD Candidate at the School of Oriental and African Studies, University of London. Correspondence address: radha@soas.ac.uk, radha@njora.com