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THE CAUSES OF FINANCIAL DISTRESS IN LOCAL BANKS IN AFRICA AND IMPLICATIONS FOR PRUDENTIAL POLICY

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ABBREVIATIONS

BOU	**Bank of Uganda**
BOZ	**Bank of Zambia**
CBK	**Central Bank of Kenya**
CBN	**Central Bank of Nigeria**
FI	**Financial Institution**
K	**Zambian Kwacha**
KSh	**Kenya Shilling**
MNC	**Multinational Corporation**
N	**Naira**
NBFI	**Non-Bank Financial Institution**
NDIC	**Nigeria Deposit Insurance Corporation**
PAB	**Pan African Bank**
SSA	**Sub-Saharan Africa**
TB	**Treasury Bill**
USh	**Uganda Shilling**

THE CAUSES OF FINANCIAL DISTRESS IN LOCAL BANKS IN AFRICA AND IMPLICATIONS FOR PRUDENTIAL POLICY

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Banks and non-bank financial institutions have been set up by local private-sector investors in several African countries. The local banks can provide benefits to the domestic economies but they also present risks, with many having suffered financial distress and bank failure as a result of non-performing loans. The severity of bad debt problems was attributable to moral hazard on bank owners and the adverse selection of bank borrowers, with many banks pursuing imprudent lending strategies, in some cases involving insider lending. Low levels of capitalization, the political connections of bank owners, and access to public-sector deposits contributed to moral hazard. Regulatory policy should aim to strengthen prudential supervision of local banks, particularly of credit policies, to enforce banking regulations and improve the incentives on bank owners to pursue prudent management.

INTRODUCTION

Locally owned private-sector banks and non-bank financial institutions (NBFIs) - henceforth local banks[1] - have, since the mid-1980s, gained a significant share of banking and financial markets in four sub-Saharan African (SSA) countries: Kenya, Nigeria, Uganda and Zambia. Banking markets in these countries had previously been dominated by oligopolistic foreign- and government-owned banks. The local banks could provide important benefits to these economies, and facilitate the objectives of financial liberalization, by boosting competition in banking markets, stimulating improvements in services to customers and expanding access to credit, especially to domestic small- and medium-scale businesses. But the attainment of these benefits has been jeopardized because the local banks have been vulnerable to financial distress.[2] Substantial numbers of banks have failed, mainly because of non-performing loans. Poor loan quality has its roots in the informational problems which afflict financial markets, and which are at their most acute in developing countries, in particular problems of moral hazard and adverse selection.

This paper analyses the causes of financial distress in the local banks in Kenya, Nigeria, Uganda and Zambia, and suggests regulatory policy reforms to reduce the incidence of distress, especially by tackling the problems of moral hazard. It is organized as follows. Chapter I provides some relevant background data on the growth of local banks and the reasons behind this growth. Chapter II provides a brief outline of why moral hazard and adverse selection affect financial fragility. The causes of financial distress among the local banks are examined in chapter III. Chapter IV discusses the potential benefits which local banks offer for the economy, while chapter V discusses the implications for regulatory policy.

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1 The term "local banks" is used here to denote banks and other bank-like institutions (i.e. institutions which take deposits and make loans) in which the majority shareholding is held by private-sector nationals/residents of African countries. Hence it excludes banks in which foreigners and/or the public sector have a majority stake. The term "indigenous banks" is not used, so as not to exclude the banks owned by nationals/residents of Asian origin. As of recently, privatized government banks are not included in the definition of local banks, nor are the banks in Nigeria which have state government participation, although some of these have majority private-sector shareholdings. The Nigerian local banks referred to in this paper are those without any public-sector participation.

2 Banks are defined as financially distressed when they are technically insolvent and/or illiquid.

I. GROWTH AND CHARACTERISTICS OF LOCAL BANKS IN AFRICA

The emergence of banks owned by the local private sector began in the mid-1970s.[3] Financial markets in Africa in the period since independence have been dominated by foreign- and government-owned commercial banks. But deficiencies in financial intermediation provided an opportunity for local private investors to enter financial markets, especially in those countries where the domestic private sector was relatively well developed, such as Kenya and Nigeria. Between the late 1970s and the mid-1980s, 13 local banks were set up in Nigeria (mostly with established foreign banks as minority partners), and four banks and 25 NBFIs in Kenya. A few local banks were also set up in Zambia, and banks and finance houses in Uganda, in the mid to late 1980s.

The expansion of the local banks and NBFIs was temporarily retarded in Kenya by a series of bank failures in the mid-1980s, but rapid growth resumed later in the decade. In Nigeria the growth of local banks accelerated dramatically in the second half of the 1980s, with 70 commercial and merchant banks established between 1986 and 1991 when the Central Bank of Nigeria (CBN) suspended issuing new licenses: almost all of these were wholly owned by local investors. During the 1990s a further nine local banks were established in Zambia.

Table 1 provides data on the number of local banks in operation at various dates between 1980 and the mid-1990s in Kenya, Nigeria, Uganda and Zambia, and the estimated market share of the sector in the mid-1990s. By the mid-1990s, local banks had captured a quarter of the commercial bank market in both Nigeria and Kenya, a fifth in Zambia and about 15 per cent in Uganda. Local

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[3] Nigeria is an exception. Local banks were set up there during the colonial period, in the late 1920s/early 1930s and the early 1950s. But they all either collapsed within a few years of commencing operations or were eventually taken over by the regional governments in Nigeria (Nwankwo, 1980, pp. 45-53).

Table 1

Local banks and NBFIs in operation at delected dates in Kenya, Nigeria, Uganda and Zambia

Country	***Year***	***Banks***	***NBFIs***	***Country***	***Year***	***Commercial banks***	***Merchant banks***
Kenya	**1980**	**0**	**8**	Nigeria	**1980**	**3**	**1**
	1985	**4**	**24**		**1985**	**7**	**7**
	1991	**7**	**32**		**1994**	**33 (26%)**	**46 (68%)**
	1994	**17 (25%)**	**35 (50%)**				
Uganda	**1985**	**0**					
	1991	**4**					
	1995	**8 (cl 5%)**					
Zambia	**1985**	**2**					
	1990	**5**					
	1995	**11 (22%)**	**6 (67%)**[a]				

Sources: **Kenya; Kariuki (1993, p. 307) and CBK *Annual Reports*: Nigeria; Nigeria Deposit Insurance Corporation, *Annual Reports* and miscellaneous: Uganda and Zambia; miscellaneous.**

Notes:
- **Figures in parentheses give the deposit market share of the local banks. c: circa.**
- **The numbers of banks and NBFIs given for each date exclude those which were in liquidation at the time (the Zambian figure for 1995 includes Meridien BIAO, which was closed in April 1995). The Nigerian data do not include privatized former government banks nor the joint ventures between state governments and the private sector.**

a **Zambian NBFIs refers to leasing companies (data from 1996).**

NBFIs in Kenya and Zambia, and merchant banks in Nigeria, had even larger market shares. In other Anglophone African countries the local bank sector is much smaller, with new entrants being a more recent occurrence. Two local banks commenced operations in Ghana and a finance house in Tanzania in 1995. There are no local commercial banks in Zimbabwe, but several local merchant banks have been set up in the last few years. A local commercial bank was established in Ethiopia in 1994.

A few of the local banks have grown strongly to gain a significant share of their domestic banking market. Some of the larger local banks have also established subsidiaries in other African countries. But most of the local banks are small with only a few branches. Very few have shareholder capital of more than $5 million. They are predominantly urban-based. Their lending is mainly short-term and directed to local businesses, mainly small- and medium-scale, and especially traders: most do not have the capital base to lend to larger corporate clients.

The growth of local banks was mainly due to a combination of low entry requirements and the perception that banking provides opportunities for profit not available in many other sections of the economy. In all of the countries where local banks were set up in significant numbers, the regulatory barriers to entry were low. Before they were revised (which in most Anglophone African countries was not until the late 1980s or early 1990s) the banking laws did not impose stringent requirements on applicants for bank licenses in terms of relevant expertise, and did not specify grounds for rejection of applications. Political interference subverted prudential criteria in the granting of licences, notably in Nigeria, where retired military officers were directors of many banks (Lewis and Stern, 1997, p. 7), and in Kenya where many banks had prominent politicians on their boards.

The minimum capital requirements to set up a bank were low, mainly because the real value of the nominal requirements specified in the banking legislation had been eroded by prolonged inflation. Table 2 sets out the minimum capital requirements and their US dollar equivalents (at official exchange rates) at selected dates during the 1980s and 1990s. At times during the 1980s it was possible to open a bank in Kenya with the equivalent of less than $0.5 million in capital and to open an NBFI with only $0.2 million.[4] The capital requirements for banks in Nigeria were less than $0.5 million in the mid-1980s. They were

[4] The lower capital requirement for NBFIs was one of the reasons why so many NBFIs were set up in Kenya. The regulatory regime also provided NBFIs with various other advantages over the banks: they were, for example, allowed to charge higher lending rates and undertake types of lending, such as leasing, which the commercial banks were not.

even lower in Uganda and Zambia: capital requirements for banks in both countries were equivalent to less than $50,000 at times during the 1990s.[5]

Low entry barriers would not by themselves have stimulated local investors to enter financial markets unless profitable opportunities were perceived to exist in these markets. Because of the high gearing involved in banking, however, it does offer investors opportunities to make high returns to their capital provided that deposits can be mobilized and sufficiently remunerative investment outlets found. There were several reasons why banking attracted local investors.

[5] In 1988, the statutory minimum capital requirement in Uganda had fallen to the equivalent of only $2,000 as a result of the inflation and exchange rate depreciation of the 1980s.

Table 2

Minimum paid-up capital requirements to operate banks and NBFIs:
Kenya, Nigeria, Uganda and Zambia: selected years
(Local currency and US dollar equivalents)

Country and type of FI	*1985*	*1988*	*1991*	*1994*
Kenya:				
Banks	**KSh10m / KSh15m** **$0.6m / $0.9m**	**KSh15m** **$0.8m**	**KSh15m** **$0.5m**	**KSh75m** **$1.3m**
NBFIs	**KSh5m / KSh7.5** **$0.3m / $0.5m**	**KSh7.5m** **$0.4m**	**KSh7.5m** **$0.3m**	**KSh37.5m** **$0.7m**
Nigeria:				
Commercial banks	**N1.5m** **$1.7m**	**N1.5m / N10m** **$0.3m / $2.2m**	**N20m / N50m** **$2.5m / $6.2m**	**N50m** **$2.3m**
Merchant banks	**N2m** **$2.2m**	**N2m / N6m** **$0.4m / $1.3m**	**N12m / N40m** **$1.5m / $5.0m**	**N40m** **$1.8m**
Uganda:				
Banks	**USh200,000** **$30,000**	**USh200,000** **$2,000**	**USh20m** **$27,000**	**USh500m** **$0.5m**
Zambia:				
Banks	**K2m** **$0.6m**	**K2m** **$0.2m**	**K20m** **$0.3m**	**Kw1250m** **$1.9m**

Source: **Banking legislations and Central Bank annual reports.**
Notes:
- **m denotes millions.**
- **In the years in which minimum capital requirements were revised (e.g. Kenya in 1985), both the old and new requirements are shown.**

First, investors perceived opportunities to exploit gaps in financial markets. The foreign banks have generally been very conservative in their lending policies, concentrating on the multinational corporations (MNCs) and other large corporate customers. Extending access to credit to local businesses was one of the motives for the establishment of government banks and development finance institutions (Harvey, 1993). But these were often inefficiently managed and directed a large share of their lending to parastatals; therefore they had only a limited impact on the credit needs of local businesses. In addition, the oligopolistic features of banking markets meant that the retail services provided by the foreign and government banks were usually of poor quality, expensive and limited in range. Consequently, the local banks were able to gain a foothold in financial markets by targeting customers neglected by the established banks, such as small businesses, and by offering better services. Some of the Asian-owned banks have been able to utilize community links to establish a customer base among businesses from their own communities.

Second, the liberalization (or partial liberalization) of financial and foreign-exchange markets provided banks with opportunities to generate profits from treasury operations and foreign-exchange dealing. Foreign-exchange dealing offered profitable opportunities for banks in several countries, sometimes because only banks were allowed to deal in foreign exchange or were allowed access to official sources of foreign exchange. It was particularly lucrative in Nigeria, where a foreign-exchange auction was introduced in 1986, with access confined only to commercial and merchant banks. The auction system was, in effect, rigged, with ceilings placed on each individual bank's permitted allocation to ensure that the available foreign exchange was distributed widely among the banks. The banks were able to resell the foreign exchange purchased at the auction at a substantial premium on the parallel market or in the *bureaux de change*.[6] The opportunity to obtain a foreign-exchange allocation was the primary reason why so many banks were set up in Nigeria during 1986-1991.

In Kenya and Zambia the introduction of treasury bill (TB) auctions in the 1990s, combined with large government domestic borrowing requirements, led to steep rises in TB rates, enabling banks to earn large profits relatively safely by purchasing TBs. More generally, the liberalization of interest rates has allowed local banks greater freedom to compete, particularly for deposits by offering higher interest rates than the established banks. It also enabled them to charge higher lending rates to high-risk borrowers - lending

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[6] The premium averaged 33 per cent during 1987-1990 (Olisadebe, 1991, p. 178).

which may not have been profitable under a regime of regulated interest rates. There was also a *de facto* liberalization of bank licensing in Nigeria and Zambia in the second half of the 1980s and early 1990s respectively. Nevertheless it is clear that financial liberalization was not the only reason for the emergence of the local banks, significant numbers of which had been set up in Kenya, Uganda and Zambia before it took place.[7]

Third, some of the local banks in Africa have been set up with less ethical motives in mind. The extent of insider lending has been considerable, suggesting that some of the local banks were set up to enable their owners to mobilize funds for their other business ventures.

[7] Interest rates were decontrolled in Kenya in 1991, by which time 11 local banks and 40 NBFIs had already been established. They were decontrolled in Uganda in 1992, which by then had five local banks in operation, and in Zambia in 1993, with seven local banks already operating. Nigeria first decontrolled interest rates in 1987, before the majority, but not all, of the local banks had commenced operations, but subsequently reimposed some controls.

II. MORAL HAZARD, ADVERSE SELECTION AND FINANCIAL FRAGILITY

Moral hazard (or adverse incentives) is a concept with relevance to a variety of principal agent relationships characterized by asymmetric information. The moral hazard discussed in this paper concerns the adverse incentives on bank owners to act in ways which are contrary to the interests of the bank's creditors (mainly depositors or the government if it explicitly or implicitly insures deposits), by undertaking risky investment strategies (such as lending at high interest rates to high-risk borrowers) which, if unsuccessful, would jeopardize the solvency of the bank. Bank owners have incentives to undertake such strategies because, with limited liability, they bear only a portion of the downside risk but stand to gain, through higher profits, a large share of the upside risk. In contrast, the depositors (or the deposit insurers) gain little from the upside risk but bear most of the downside risk. The inability of depositors to adequately monitor bank owners, because of asymmetric information and free-rider problems, allows the latter to adopt investment strategies which entail higher levels of risk (not fully compensated for by deposit rate risk premiums) than depositors would prefer.

Moral hazard on bank owners can be exacerbated by a number of factors. First, an increase in the interest rate may lead borrowers to choose investments with higher returns when successful but with lower probabilities of success (Stiglitz and Weiss, 1981): hence, a rise in deposit rates could induce banks to adopt more risky investment strategies. A rise in bank lending rates can have similar incentive effects on the bank's borrowers.

Second, macroeconomic instability can also worsen adverse incentives, if it were to affect the variance of the profits of the bank's borrowers, especially when there is co-variance between borrowers' profits (e.g. if a large share of borrowers are in the same industry) or if loan portfolios are not well diversified among individual borrowers (McKinnon, 1988).

Third, the expectation that the government will bail out a distressed bank may weaken incentives on bank owners to manage their asset portfolio prudently and incentives on depositors to monitor banks and choose only banks with a reputation for prudent management. Deposit insurance also reduces incentives for depositors to monitor banks.

Fourth, moral hazard is inversely related to bank capital. The owners of poorly capitalized banks have little of their own money to lose from risky investment strategies. By implication, financial distress in the bank itself worsens moral hazard, because, as the value of the bank's capital falls, the incentives on its owners to pursue strategies which might preserve its solvency are reduced (Berger et al., 1995, pp. 398-99). For similar reasons, intensified competition in banking markets can also encourage moral hazard, by reducing the franchise value of banks: the present value of a bank's future profits (Caprio and Summers, 1993; Demetz et al., 1997).

Moral hazard becomes even more acute when the bank lends to projects connected to its own directors or managers (insider lending). In such cases the incentives for imprudent (and fraudulent)[8] bank management are greatly increased in that all of the profits arising from the project are internalized (in the case of loans to unconnected borrowers the project returns are split between lender and borrower), whereas that part of the losses borne by depositors or taxpayers are externalized. Not surprisingly, insider lending is a major cause of bank failure around the world (Caprio, 1997, pp. 6-7).

Moral hazard can be constrained by strict regulation and prompt action to close banks as soon as they become insolvent, but regulatory authorities are often pressured to exercise "forbearance": i.e. delay in enforcing regulations or closing insolvent banks (Garcia, 1996, pp. 25-29).

Informational asymmetries can also affect the financial soundness of a bank through the adverse selection of its borrowers. Higher lending rates and a greater volatility in expected rates of return to borrower's projects can lead to a decline in the average quality (i.e. creditworthiness) of the pool of loan applicants willing to borrow from the bank. The more creditworthy applicants are driven out of the market by higher lending rates. A prudently managed bank would therefore be wary of raising real lending rates too high because of the likely adverse impact on loan quality. Instead it would ration credit (Stiglitz and Weiss, 1981). But if it has to pay above market interest rates to mobilize funds (because, for example, it is perceived as a poor credit risk), the bank's scope for not raising lending rates may be limited without cutting margins to levels insufficient to generate profits. The bank may be trapped in a cycle of high deposit and high lending rates which lead to high loan default rates, which in turn further raises deposit rates through its impact on the perceived soundness of the bank.

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[8] Insider lending is often fraudulent because banking legislation usually imposes limits on the volume of insider loans which banks can extend.

To a much greater extent than the established foreign banks,[9] the local banks have been vulnerable to adverse incentive and selection problems. This is partly because they have operated in segments of the credit markets where these problems have been at their most acute (i.e. at the bottom end of the market, which contains the least creditworthy borrowers, often with limited, if any, collateral), and partly because of deficiencies in the institutional mechanisms for constraining adverse selection and moral hazard (banks are under-capitalized and lack adequate expertise, supervisory systems are weak, etc.). Moreover, some features of the local banks, notably close links with politicians, have exacerbated problems of moral hazard.

9 The public-sector banks have faced a different set of problems, mainly involving political interference in the allocation of credit and the pursuit of non-commercial objectives (Harvey, 1993).

III. THE CAUSES OF FINANCIAL DISTRESS AMONG LOCAL BANKS

Financial distress has afflicted numerous local banks, many of which have been closed down by the regulatory authorities or have been restructured under their supervision. In Kenya two local banks and 10 NBFIs were closed or taken over between 1984 and 1989. A further five local banks and 10 NBFIs were taken over in 1993/94, and two more local banks in 1996. In Nigeria four local banks were put into liquidation in 1994 and another had its license suspended, while in 1995 a further 13 local banks were taken over by the Central Bank of Nigeria (CBN). Many more local banks were distressed and subject to some form of "holding action" imposed by the CBN and Nigeria Deposit Insurance Corporation (NDIC) in 1995. The Bank of Zambia (BOZ) closed three local banks in 1995, including the local subsidiary of Meridien BIAO, a bank which had been founded in Zambia in the 1980s and had expanded into an international bank with subsidiaries in many African countries. Another Zambian local bank was closed in 1991, but was subsequently restructured and re-opened. The Bank of Uganda (BOU) closed down a small local bank in 1994 and took over two more local banks for restructuring in 1995. Table 3 provides estimates of the assets/deposits of the failed local banks in these countries, and, where sufficient data are available, estimates of loan losses. Failed local banks accounted for as much as 23 per cent of total commercial bank assets in Zambia. In Kenya in 1993/94 around 11 per cent of the total assets of banks and NBFIs was held by the failed local banks, while in Nigeria and Uganda the failed local banks accounted for 8 per cent and 6 per cent respectively of bank assets.

The cost of these bank failures is very difficult to estimate: much of the data is not in the public domain, while the eventual cost to depositors and/or taxpayers of most of the bank failures which occurred in the 1990s will depend upon how much of the failed banks' assets are eventually recovered by the liquidators. The costs are almost certain to be substantial. A statement in the Kenyan parliament in October 1995 revealed that the Central Bank of Kenya (CBK) lost a total of KSh 10.2 billion (equivalent to 3.8 per cent of 1993 GDP) from frauds involving the "political banks" (Economist Intelligence Unit, 1995, p. 13). The CBK had provided KSh 17.8 billion (equivalent to 6.6 per cent of GDP) in liquidity support to

three of the failed banks in 1992/93.[10] The provision of liquidity support to banks was the major cause of the loss of monetary control and the subsequent inflation during this period.

[10] The data were contained in an addendum to the CBK's 1992/93 *Annual Report and Accounts*.

Table 3

Assets/deposits and estimated losses of failed local banks
(Local currency and US$ equivalent)

Country	Assets/deposits	Approximate losses
Nigeria:		
4 banks liquidated in 1994	**N4.1 billion assets ($51 million) (1% of total bank assets)**	**N3.7 billion ($46 million)**
13 banks taken over in 1995	**c N34 billion assets (c $425 million) (7% of total bank assets)**	**c N13.5 billion (c $169 million)**
Kenya:		
9 FIs merged into Consolidated Bank in 1989	**KSh1.5 billion deposits ($69 million) (2% of total bank and NBFI assets)**	**not available**
16 FIs closed or taken over in 1993/94	**c KSh21 billion assets (c $370 million) (11% of total bank and NBFI assets)**	**not available**
Zambia:		
3 banks closed in 1995	**Kw141 billion assets ($170 million) (23% of total bank assets)**	**not available**
Uganda:		
2 banks taken over in 1995	**c USh40 billion assets (c $40 million) (6% of total bank assets)**	**c USh12 billion ($12 million)**

Sources:
- **Nigeria: author's calculation using NDIC (1994, pp. 9, 24-25, 32-33, 43 and 46-48).**
- **Kenya (1989): CBK (1995, p. 9).**
- **Kenya (1993/94), Zambia and Uganda: author's calculations from banks' balance-sheet data, Central Bank data and interviews.**

Note: **c: circa**

Most of the bank failures were caused by non-performing loans.[11] Arrears affecting more

than half the loan portfolio were typical of the failed banks.[12] Many of the bad debts were attributable to moral hazard: the adverse incentives on bank owners to adopt imprudent lending strategies, in particular insider lending and lending at high interest rates to borrowers in the most risky segments of the credit markets.

A. Insider lending

The single biggest contributor to the bad loans of many of the failed local banks was insider lending. In at least half of the bank failures referred to above, insider loans accounted for a substantial proportion of the bad debts. Most of the larger local bank failures in Kenya, such as the Continental Bank, Trade Bank and Pan African Bank, involved extensive insider lending, often to politicians.[13] Insider loans accounted for 65 per cent of the total loans of the four local banks liquidated in Nigeria in 1995, virtually all of which was unrecoverable (NDIC, 1994, p. 48). Almost half of the loan portfolio of one of the Ugandan local banks taken over by the BOU in 1995 had been extended to its directors and employees.[14] 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, breached 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.

The high incidence of insider lending among failed banks suggests that problems of moral hazard were especially acute in these banks. Several factors contributed to this.

First, politicians were involved as shareholders and directors of some of the local banks. Political connections were used to obtain public-sector deposits: many of the failed banks, particularly in Kenya, relied heavily on wholesale deposits from a small number of parastatals. Because of political pressure, the parastatals which made these deposits are unlikely to have made a purely commercial judgement as to the safety of their deposits. Moreover, the availability of parastatal deposits reduced the need to mobilize funds from the public. Hence these banks faced little pressure from depositors to establish a reputation for safety. Political connections also facilitated access to bank licences and were used in some cases to pressure bank regulators not to take action against banks when violations of the banking laws were discovered. All these factors reduced the constraints on imprudent bank management.

In addition, the banks' reliance on political connections meant that they were exposed to pressure to lend to the politicians themselves in return for the assistance given in obtaining deposits, licences, etc. Several of the largest insider loans made by failed banks in Kenya were to prominent politicians.

Second, most of the failed banks were undercapitalized, in part because the minimum capital requirements in force when they had been set up were very low. Owners had little of their own funds at risk should their bank fail, which created a large asymmetry in the potential risks and rewards of insider lending. Bank owners could invest the bank's deposits in their own high-risk projects, knowing that they would make large profits if their projects succeeded, but would lose little of their own money if they were not profitable. Of the 13 distressed local banks taken over by the CBN in 1995, all except one had paid-up share capital which barely exceeded the minimum required by law of N50 million and N40 million, for commercial and merchant banks respectively, at the end of 1994. The average paid-up share capital of the four commercial banks taken over by the CBN was N51 million compared with an average of N94 million for all 36 private-sector commercial banks, while the average paid-up share capital of the nine merchant banks taken over by the CBN was N52 million compared to an average of N68 million for all 48 private-sector merchant banks (see table 4). The paid-up share capital of these 13 failed banks amounted to an average of only about 4 per cent of their total loans.[15]

The third factor contributing to insider lending was the excessive concentration of ownership. In many of the failed banks, the majority of shares were held by one man or one family, while managers lacked sufficient independence from interference by owners in operational decisions. A more diversified ownership structure and a more independent management might have been expected to impose greater constraints on insider lending, because at least some of the directors would have stood to lose more than they gained from insider lending, while managers would not have wanted to risk their reputations and careers.

Table 4

Paid-up capital of failed local banks in Nigeria

	Average paid-up share capital: Dec. 1994 N millions
Commercial banks:	
4 failed commercial banks	**51**
all 36 private-sector commercial banks	**94**
Merchant banks:	
9 failed merchant banks	**52**
all 48 private-sector merchant banks	**68**

Source: **NDIC (1994, pp. 19-20).**
Note: **The data on failed banks refers to the 13 local banks taken over by the CBN in 1995.**

B. Lending to high-risk borrowers

The second major factor contributing to bank failure was lending, at high interest rates, to borrowers in high-risk segments of the credit market. This involved elements of moral hazard on the part of both the banks and their borrowers and the adverse selection of the borrowers. It was in part motivated by the high cost of mobilizing funds. Because they were perceived by depositors as being less safe than the established banks, local banks had to offer depositors higher deposit rates.[16] They also had difficulty in attracting non-interest bearing current accounts because they could offer few advantages to current account holders which could not also be obtained from the established banks. Some of the local banks relied heavily on high-cost interbank borrowings from other banks and financial institutions, on which real interest rates of over 20 per cent were not uncommon.[17]

The high cost of funds meant that the local banks had to generate high earnings from their assets; for example, by charging high lending rates, with consequences for the quality of their loan portfolios. The local banks almost inevitably suffered from the adverse selection of their borrowers, many of who had been rejected by the foreign banks (or would have been had they applied for a loan) because they did not meet the strict creditworthiness criteria demanded of them. Because they had to charge higher lending rates to compensate for the higher costs of funds, it was very difficult for the local banks to compete with the foreign banks for the "prime" borrowers (i.e. the most creditworthy borrowers). As a result, the credit markets were segmented, with many of the local banks operating in the most risky segment, serving borrowers prepared to pay high lending rates because they could access no alternative sources of credit. High-risk borrowers included other banks and NBFIs which were short of liquidity and prepared to pay above-market interest rates for interbank deposits and loans. In Nigeria some of the local banks were heavily exposed to finance houses which collapsed in large numbers in 1993, as well as to other local banks (Agusto and Co., 1995, p. 40).[18] Consequently, bank distress had domino effects because of the extent to which local banks lent to each other.

Within the segments of the credit market served by the local banks, there were probably good quality (i.e. creditworthy) borrowers as well as poor quality risks.[19] But serving borrowers in this section of the market requires strong loan appraisal and monitoring systems, not least because informational imperfections are acute: the quality of borrowers' financial accounts are often poor, many borrowers lack a track record of successful business, etc. The problem for many of the failed banks was that they did not have adequate expertise to screen and monitor their borrowers, and therefore distinguish between good and bad risks. In addition, credit procedures, such as the documentation of loans and loan securities and internal controls, were frequently very poor. Managers and directors of these banks often lacked the necessary expertise and experience (Mamman and Oluyemi, 1994). Recruiting good staff was often difficult for the local banks because the established banks could usually offer the most talented bank officials better career prospects. Moreover, the rapid growth in the number of banks in countries such as Nigeria outstripped the supply of experienced and qualified bank officials.

C. Macroeconomic instability

The problems of poor loan quality faced by the local banks were compounded by macroeconomic instability. Periods of high and very volatile inflation occurred in all four of the countries covered here. During the 1990s, inflation reached in Zambia 191 per cent, in Kenya 46 per cent, in Nigeria 70 per cent, and in Uganda 230 per cent. With interest rates liberalized (except in Nigeria), nominal lending rates were also high, with real rates fluctuating between positive and negative levels, often in an unpredictable manner, because of the volatility of inflation (Collier, 1993, pp. 19-20).

Macroeconomic instability would have had two important consequences for the loan quality of the local banks. First, high inflation increases the volatility of business profits because of its unpredictability, and because it normally entails a high degree of variability in the rates of increase of the prices of the particular goods and services which make up the overall price index. The probability that firms will make losses rises, as does the probability that they will earn windfall profits (Harvey and Jenkins, 1994). This intensifies both adverse selection and adverse incentives for borrowers to take risks, and thus the probabilities of loan default.

The second consequence of high inflation is that it makes loan appraisal more difficult for the bank, because the viability of potential borrowers depends upon unpredictable developments in the overall rate of inflation, its individual components, exchange rates and interest rates. Moreover, asset prices are also likely to be highly volatile under such conditions. Hence, the future real value of loan security is also very uncertain.

D. Liquidity support and prudential regulation

Deposit insurance schemes were not crucial factors in contributing to moral hazard in the failed banks. Kenya and Nigeria have provided deposit insurance since the late 1980s, but only for deposits below a specified minimum amount.[20] Many of the failed banks' deposits were not insured, because they were too large (as in the case of most of the institutional deposits) and/or because they were from sources not covered by the insurance scheme.[21] But the willingness of the regulatory authorities to support distressed banks with loans, rather than close them down, was probably an important contributor to moral hazard. Many of the failed banks in Kenya, Uganda and Zambia had been able to borrow heavily from their respective Central Banks for several months, and in some cases for more than a year, before they were closed.

The extent of imprudent management in the failed banks indicates that there were serious deficiencies in bank regulation and supervision. When many of the banks were set up in the 1980s or early 1990s, banking legislation was outdated and Central Bank supervision departments were seriously understaffed. In Kenya and Nigeria many banks avoided being inspected for long periods because the rapid expansion of banks in the second half of the 1980s overwhelmed supervisory capacities (Kariuki, 1993, pp. 300-9). Furthermore, political pressure was brought to bear on Central Banks to exercise regulatory forbearance. The Central Banks often lacked sufficient independence from the government to refuse liquidity support to politically connected banks and to strictly enforce the banking laws. In particular, for those banks with strong political connections, the expectation that regulators could be pressured to exercise forbearance must have seriously undermined discipline and incentives for prudent bank management.

IV. WHAT BENEFITS CAN LOCAL BANKS PROVIDE TO AFRICAN ECONOMIES?

Given the prevalence of failures among local banks in Africa, the contention that they can deliver important benefits to African economies requires some justification. This section develops two lines of argument to support this contention. First, local banks can provide financial services that other types of banks (foreign or government) are either unwilling or unable to supply, and can also inject much needed competition into financial markets. Second, the experience of many local banks in all four countries discussed here demonstrates that bank failure can be avoided with prudent management.

The local banks operating in Africa have improved financial intermediation in three areas in particular. First, they have extended access to credit to a segment of the market, principally small businesses, who have traditionally experienced difficulty in securing credit from the established banks. The local banks will not fill all of the gaps in the financial markets; they are unlikely to extend much credit to farmers or to provide long-term loans for investment, but they can make a useful contribution in servicing urban traders and possibly also small manufacturers with working capital. Local banks and their managers have some advantages over the established banks in servicing this sector, not least because social and community links can provide them with informal channels of knowledge about borrowers.

Second, some of the local banks provide better services than the established ones in order to attract customers. Opening hours are longer and queues in banking halls shorter. Small-scale depositors are provided with better terms than those available in the established banks, such as higher deposit rates and/or lower minimum balances. It is possible for loan applicants to see the manager, often without making an appointment. Many local banks process loan applications quickly, often sending an officer to visit a new applicant's premises within a day or so and giving a decision within a week or ten days. In contrast, a loan application can take months to be processed in the established banks.

Third, the banking markets in African countries are oligopolistic, with at most four foreign and/or government banks controlling the bulk of deposits. One of the objectives of financial liberalization is to inject greater competition into banking markets to enhance efficiency. This requires new entrants from the private sector. But new investment by foreign banks in Africa over the last decade has been very limited, and that which has taken place has been mainly directed at serving the corporate sector. Foreign banks have displayed little interest in expanding into retail banking, and one of the longest established banks, Standard Chartered, is actually disinvesting from this sector. Consequently, the local private sector is the only potential source of new investment in retail banking in most African countries, and an increase in the market share of the local banks provides the only realistic option for reducing oligopoly in banking markets.

The potential benefits outlined above will not be realized unless local banks are prudently and honestly managed. Although many of the local banks have failed, the experience of others in Africa indicates that failure is not inevitable. Two thirds of the banks and NBFIs in Kenya have not failed: many of these have been in operation for at least a decade. It is not clear how many of the local banks in Nigeria will survive, but there are several which appear to be well managed, have a good reputation and are thriving. In both Uganda and Zambia failures have afflicted fewer than half of the local banks.

The major distinction between banks which have failed and those which have not is insider lending: local banks which avoid insider lending appear to have a good chance of survival. Local banks will almost inevitably be affected by higher levels of bad debt than the foreign banks because of the nature of the markets they serve, but this need not result in financial distress provided that adequate profits can be generated to cover loan losses and that banks are sufficiently well capitalized to absorb large shocks.[22] They can further reduce the dangers of distress by ensuring that sound lending procedures are followed, internal controls are tight, that both their lending and deposit base are well diversified, and that they maintain prudent liquidity levels.

V. IMPLICATIONS FOR BANK REGULATION AND SUPERVISION

The entry of local banks poses difficult dilemmas for bank regulators. While well-managed local banks could bring important benefits to financial markets, bank failures have been costly for taxpayers and depositors. They also undermined macroeconomic stability in Kenya in 1992/93 and in Zambia in 1995.[23] The challenge facing regulators is to allow local banks enough freedom to take prudent risks in lending to what are always likely to be difficult segments of the credit market to service, while preventing incompetent, reckless and fraudulent lending of the sort which characterized many of the failed banks.

Regulatory policy reforms should encompass two elements: first, strengthening supervision and the enforcement of prudential rules, especially in the area of credit risk; and second, ensuring that the regulatory framework enhances, rather than diminishes, incentives on bank owners and managers for prudent management.

The four countries covered in this paper implemented major reforms to prudential regulation in the late 1980s and/or early 1990s. Bank supervision departments were strengthened and new banking laws were enacted, incorporating much stricter prudential regulations on, *inter alia*, capital adequacy, large loan exposures and insider lending. This has brought most aspects of their banking legislation into line with international best practice. If the new banking legislation is to be effective, close monitoring of the banks by the supervisors, particularly of their asset portfolios, and the imposition of sanctions on banks which violate the regulations, are necessary. To prevent insider lending (or at least levels of insider lending which exceed prudential limits) and other forms of imprudent lending activities, such as excessive loan concentration, supervisors must carry out regular on-site inspections and have the accounting skills to detect when bank records have been falsified. Regulators should also focus attention on identifying potential problem debts in the banks, and ensure that banks properly classify loans according to predetermined criteria based on the loan servicing record and make appropriate provisions for non-performing loans. Unless this is done, the capital adequacy requirements are virtually meaningless. The quality of bank management should also be evaluated by on-site inspectors, with regulators insisting on changes when deficiencies in personnel or procedures are uncovered. Regulators also need to be alert for indications that a bank is in distress, such as offering very high deposit rates, rapid expansion of assets and late submission of bank returns to the regulators, and intensify supervision when these are detected (Popiel, 1994, p. 61).

Regulation and supervision, however, cannot realistically be expected to provide the main defence against bank failure. The skills needed by supervisors are scarce in Africa, supervisors require long periods of training, and retaining qualified supervisors is difficult because of the salary differentials between public and private sectors. Effective regulation is also impeded by political interference. As such, regulatory policy should not rely exclusively on the imposition of prudential rules and regulations, but should focus on aligning the incentive structure facing the owners and managers of local banks with prudent and honest management (Caprio, 1996). Reforms should also aim to insulate the regulators from political interference in operational decisions.

There are several ways in which the incentive structure can be reformed to reduce moral hazard in banks. First, the minimum capital required to start a bank should be raised so that owners have more of their own funds to lose if their bank fails. This would have the additional advantage of forcing some of the local banks to merge (and prospective promoters to pool their resources), thus diluting the concentration of shareholdings in individual banks. Stricter rules limiting shareholdings by one individual or related individuals would also re-enforce this process. Larger, better capitalized banks with a more diversified share ownership would be less vulnerable to pressure from individual directors for insider loans. Their directors would then have greater incentives to hire experienced and competent bank managers.

Second, new entry should be limited by requiring applicants for bank licenses to meet stricter criteria in terms of their capital resources, relevant expertise and probity. This would have several advantages. It would raise the franchise value of holding a bank license, and thereby would increase incentives on bank owners to avoid bankruptcy or other actions, such as serious breaches of the banking laws, which would result in their losing their license (Caprio, 1996, pp. 15-16; Caprio and Summers, 1993). Higher entry requirements would also reduce the number of very small and weak banks which lack capital and human resources and have a poor reputation. It is these banks which face the highest deposit costs and lend at the bottom end of the credit market, where adverse selection pressures are at their strongest, and which lack the expertise to manage the risks in this segment of the market. It would also reduce the likelihood that sound local banks would be undermined by bank runs triggered by the failure of weaker local banks. Effective supervision will also be more feasible if the number of banks is limited, as supervisory resources will not be so thinly spread. A policy of restricting entry and thereby competition, however, might lead to a less efficient financial sector, but some trade-off between incentives for greater efficiency and incentives for prudent management may be unavoidable.

Third, moral hazard could be mitigated by imposing regulatory controls to cap real deposit interest rates, through two channels. As moral hazard is a positive function of borrowing costs (Stiglitz and Weiss, 1981), lower deposit rates would reduce the incentives on bank owners to adopt high-risk lending strategies. In addition, bank profits, and thereby the banks' franchise value, could be raised if deposit rate controls curbed competition among banks for deposits, enabling banks to increase their interest rate margins. Deposit rate controls would, however, need to be implemented with care and flexibility to avoid reducing deposit rates to negative real levels and inducing disintermediation (Hellmann et al., 1995).

Fourth, limits should be imposed on the volume of funds which a bank can mobilize from a single source (these could be computed as a share of the bank's capital, as with large loan exposure limits). The rationale for this would be to restrict the extent to which banks can rely on large deposits made by public-sector institutions subject to political influence, and which do not therefore make a commercial judgement over the soundness of the bank holding their funds. Limits on the size of deposit holdings would force these banks to diversify their source of funds. They would therefore have to rely more on mobilizing deposits in the market, without the help of political connections, which would entail establishing a better reputation for prudent management. Those banks that are unable to establish such a reputation would mobilize less deposits, and therefore have less money to lose in the event of bankruptcy.

Fifth, regulatory policy reforms should reduce the implicit protection provided to bank owners through regulatory forbearance. Bank owners have few incentives for prudent management if they expect the government to bail out insolvent banks, or allow them to continue operating while insolvent with liquidity support from the Central Bank or public-sector deposits. Insolvent banks should not receive liquidity support from the Central Bank but should be closed down or taken over by the regulators as soon as their insolvency becomes evident (although whether or not a bank is solvent is not always clear-cut). Banks which are undercapitalized but still solvent should be subject to holding actions until capital adequacy is restored.[24] Effective penalties should be imposed for infractions of the banking laws. If distressed banks are rehabilitated with government support, the existing shareholders should not benefit. The losses incurred by the bank should be charged against the shareholders' capital before the bank is restructured, so that shareholders of failed banks are not bailed out with public funds.

The difficulty with this approach is that political pressure often favours regulatory forbearance, which reduces the credibility of the strategy with bank owners. To send clear signals to bank owners, compel regulators to act decisively and protect them from pressures for forbearance, a clear set of rules stipulating the actions to be taken by the regulators in the event of bank distress should be drawn up and made public (Glaessner and Mas, 1995). The rules should, for example, specify the minimum capital adequacy ratio below which a bank will be taken over by the regulators. They should also set out mandatory penalties, including removal from office of managers and revocation of bank licenses, for specified serious violations of the banking laws.

These policy measures will not be effective unless regulators have sufficient political independence to actually enforce the rules. Insulating regulators from political interference is likely to be difficult and will not be achieved simply by passing legislation giving Central Banks greater authority to act independently of the Ministry of Finance. What is also needed is to create institutional mechanisms which give the senior management of Central Banks some protection against being penalized by the government for taking regulatory actions which threaten politically connected banks.

VI. CONCLUSIONS

Many of the local banks set up in Kenya, Nigeria, Uganda and Zambia have been closed down or taken over by their Central Banks because of insolvency and illiquidity caused by non-performing loans. The severity of bad debt problems was attributable to problems of moral hazard and adverse selection.

Moral hazard contributed to the highly imprudent, and in some cases fraudulent, lending strategies of many of the failed banks. A large share of their bad debts was attributable to insider loans, often unsecured, in high-risk ventures such as real estate. Some of the failed local banks also suffered from the adverse selection of their borrowers, driven by the high lending rates which local banks charged to compensate for their high cost of funds. These banks were forced into the bottom end of the credit market, serving the least creditworthy borrowers. Loan quality was further impaired because the local banks lacked the necessary skills to serve borrowers in this segment of the market where informational problems are at their most acute. Severe macroeconomic instability exacerbated the adverse incentives on borrowers and the difficulties banks faced in assessing the viability of loan applicants.

Several factors contributed to the moral hazard on bank owners to take excessive risks with depositors' money. These included low levels of bank capitalization, access to public-sector deposits through the political connections of bank owners, excessive ownership concentration, and regulatory forbearance.

The local banks can make a potentially valuable contribution to the development of financial markets in SSA, especially by improving access to loans for the domestic small and medium scale business sector. They can also inject much needed competition into financial markets and offer customers better services. Local banks have survived and operate as sound institutions in all four of the countries covered here despite the very difficult conditions (such as acute macroeconomic instability), which suggests that the risk of licensing local banks is worth taking, although local banks will inevitably face greater risks than the established foreign banks in view of the nature of the markets which they serve. If the probability of bank failure can be reduced by better regulatory policies, the net benefits to the economy provided by the local banks will increase.

Effective prudential supervision of the local banks and enforcement of banking legislation is essential if the incidence of bank failures in this sector is to be reduced. Supervisors should place particular emphasis on the monitoring of credit risks, especially insider lending, through regular on-site inspections. Regulatory policy should aim to enhance incentives on bank owners for prudent management. Reforms to facilitate this objective include imposing higher minimum capital requirements and stricter limits on ownership concentration. Licensing procedures should be tightened to exclude entry by weaker banks without adequate resources and managerial expertise. Large deposit exposure limits would reduce the extent to which banks could rely on wholesale deposits from public-sector institutions mobilized through political connections. Deposit rate controls could also be used, if implemented carefully, to mitigate moral hazard. To constrain regulatory forbearance, a clear set of rules should be drawn up and made public for dealing with bank distress and infractions of the banking laws. Effective regulation also requires institutional reforms to give bank regulators greater protection from political interference.

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