Njuguna Ndung'u: Bank regulation reforms in Africa: enhancing bank competition and intermediation efficiency

Keynote address by Prof Njuguna Ndung'u, Governor of the Central Bank of Kenya, at the 12th Seminar by African Economic Research Consortium, Mombasa, 22 March 2010.

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Prof. William Lyakurwa, Executive Director, African Economic Research Consortium;
Senior Policymakers here present;
Distinguished Guests;
Ladies and Gentlemen;

I am delighted to be with all of you here in Mombasa and to speak on ***Bank Regulatory Reforms in Africa: Enhancing Bank Competition and Intermediation***. But before I make my remarks, let me take this opportunity to thank the African Economic Research Consortium (AERC) for their invitation to give the keynote address at this seminar. This is indeed a timely topic as we continue to assess the effects of the global financial crisis and find long term solutions to mitigate and prevent recurrence. I am informed that approximately 70 senior policymakers from over 20 countries in Sub-Saharan Africa (SSA) are in attendance. This signals the importance of this seminar and the policy spin-offs it will generate.

At the outset, ***Ladies and Gentlemen***, I would like to recognize the important role that AERC has played in strengthening local capacity for managing economies within Sub Saharan Africa. The Consortium has contributed to advanced policy research and graduate training in economics. Most institutions of policy in Sub-Saharan Africa today are led by AERC alumni. I am happy to be part of this group myself.

Ladies and Gentlemen; this seminar is taking place at a time when countries in Africa are taking stock of the second and third round effects of the global financial crisis. You will agree with me that the crisis which initially hit African countries with stronger financial linkages to international capital markets; significant trade relations with the Western world and rich natural resource countries set the stage for challenging times in policy making and implementation.

Africa's prospects in the post-crisis period are contingent on the behaviour of policymakers. Indeed, there is need for better regulation that can readily identify emerging vulnerabilities; properly price risks; and strengthen incentives for prudent behaviour. It is tempting after the crisis to call for more regulation – but we should emphasize better regulation. Second, we should emphasize building strong institutions. Globally, the remedial actions taken by governments to deal with the crisis have borne fruit and the green shoots of recovery are beginning to sprout.

For us here in Kenya, we remain committed to fostering a stable market-based financial system as mandated by law. An efficient financial system collects and collates deposits from micro-savers and channels them to investors. This is the intermediation process. This process allows economic agents to evaluate the risks and prices in the market and align their investment portfolio and investment gestation.

The Kenyan case is both interesting as well as a policy strategy. It reflects a case of segmented markets. But the cost of credit and interest rates spread remains high. The spread is a major challenge in the banking sector because it acts as an impediment to expansion of credit and development of financial intermediation and signals inefficiency in the sector.

The challenge for a policymaker is to develop a financial sector that answers to the challenges of the economy. In order to address market inefficiencies, the Central Bank and other stakeholders have undertaken significant reforms for the banking sector. These reforms include the operationalisation of the credit reference bureaus, payment systems improvements, opening of new currency centres, automation of trading system for treasury bonds, and the activation of horizontal repos. I will spend the next few minutes to highlight these initiatives.

Operationalisation of credit referencing mechanism: The Banking (Credit Reference Bureau) Regulations were operationalised on 2nd February 2009. This will facilitate the sharing of credit information by institutions licensed under the Banking Act. This link will allow the industry to build information capital that is critical in the credit market. It will also enhance access to credit by SMEs and individuals that have been constrained by lack of physical collateral. Further, the Banking Sector will be able to address the problem of non-performing loans at the origination point as credit history of applicants will be taken into account during the credit appraisal process.

Licensing of deposit taking microfinance institutions: The Microfinance Act was operationalised effective May 2008. Currently, one institution has been licensed and eight applications for license are being processed. With the unique business models of microfinance institutions mainly targeted at the lower end of the market, bringing them under the purview of the Central Bank will not only give them a legal basis in dealing with depositors but will also boost access to formal financial services by the populace. Deposit Taking Microfinance Institutions are free to be community-based or nationwide.

The national payments system sits at the centre of the financial system. It is imperative that payments systems are secure and efficient. The Central Bank continues with its initiatives to modernize the national payments system. Accordingly, from 1 October 2009, value capping was effected with all payments above Kshs.1 million being made through the Real Time Gross Settlement System (RTGS). This initiative enhanced the security and efficiency of high value payments.

The celebrated ***MPESA*** falls under this category of reforms. As we have seen this market unfolding, MPESA account holders have soared to 9 million, total transactions surpassed Ksh.48 billion a month (or averaging Ksh.1.6 billion a day) and agents increased to 17,000 in the last 3 years.

Ladies and Gentlemen; on the monetary policy front, the CBK has observed that despite signalling efforts by the Monetary Policy Committee to bring down the rates of interest by lowering the Central Bank Rate (CBR), banks have not responded accordingly. Further, the failure of the banking system to extend the maturity of their loan products is a consequence of the characteristic nature of their deposits which are largely short term, but also their assessment and pricing of risk. To support economic development, there is need for the development of banking products that support long term lending. These development banking products will play a significant role in influencing a downward trend in commercial banks lending rates. The Central Bank will therefore explore how development banking products can be introduced into the market to enhance the monetary policy transmission mechanism and lengthen the maturity profile of commercial bank term loans.

Developments in the bond market: The Central Bank has successfully raised funds for infrastructure development for the Government through infrastructure bonds. These infrastructure bonds have not only facilitated financing of the Government's infrastructure program but also set the pace for the issuance of similar bonds by corporate entities such as KENGEN and Safaricom. This, coupled with automated trading in the Nairobi Stock Exchange will be important for a vibrant bond market. In addition, to deepen and widen the bond market, the Central Bank implemented the following measures:

- ***Issuance of benchmark bonds:*** The Bank together with Market Leaders Forum adopted 2, 5, 10, 15 and 20 year maturities as benchmark bonds. This move has not only firmed up the yield curve, but has improved pricing, reflected through improved secondary market trading.

- ***Reopening of benchmark bonds:*** This has increased trading activities in the secondary market.
- ***The shape and position of the yield:*** The vibrant bond market has led to a downward shift in the Yield Curve with an upward gentle slope reflecting stability. This has created reliable pricing benchmark for corporates, many of who raised required capital via issuance of corporate bonds in 2009/10. It is also a useful tool in pricing credit facilities as it signals the direction of interest rates.

You will recall that the Central Bank of Kenya, the Nairobi Stock Exchange and the Capital Markets Authority collaborated in the automation of trading of Treasury Bonds through the NSE. The main objective of this initiative was to make bonds trading secure, efficient and to create a vibrant market. The expected improvement in market activity will also improve market liquidity and encourage more investors to participate in the bond market.

Operationalisation of the horizontal repos: We have introduced the Interbank Master Repurchase Agreement otherwise known as the Horizontal repo which is aimed at deepening the capital and money markets and enhancing the intermediation process. I am happy to note that the horizontal repo as a tool of redistributing liquidity in the market has also provided a useful barometer on the status of liquidity in the banking sector. The horizontal repo is an additional facility for commercial banks to use alongside the vertical repo which is an instrument between commercial banks and CBK.

Other initiatives: The changing market dynamics in the Kenyan Banking Sector has necessitated the Central Bank to reinvent itself and become proactive in detecting opportunities and threats to financial sector stability. With a view to not only enhance intermediation and competitiveness of the banking sector but also to increase efficiency and access, the Central Bank has been in the forefront in encouraging various financial services providers e.g.

- mobile phone money transfer providers such as M-PESA and ZAP
- SACCOs and Agency Banking models
- ***Shariah compliant banking products*** – we have seen the introduction of two Shariah compliant banks and growing interest in a number of institutions seeking to offer Shariah compliant products.

Ladies and Gentlemen; we have now started to realize the dividends of the reforms we have undertaken in the financial sector. Kenya now has a healthy, sound and strong banking system. The size of the banking system has been enhanced both in terms of deposits mobilised, credit growth and competition. Specifically:

- Deposit accounts have increased from 2.6 million (end 2005) to 8.4 million (end 2009) and deposits have doubled from Ksh.545 billion (US$7.2 billion) to Ksh.1,065 billion (US$14 billion) in the same period.
- Lowering barriers to entry – via removal of minimum balances has supported financial reach.
- Banks have taken their services to the customers due to increasing competition and improvements in the delivery channels. Banks are opening and re-opening branches in areas with none or few branches.

Efficiency is achieved when there are strong institutions with requisite capacity to satisfy market needs while complying with statutory and prudential requirements.

Ladies and Gentlemen: One of the main challenges of monetary policy has been the presence of currency outside banks. In March 2008, it was Ksh.9 billion above the Central

Bank target. However, in March 2010 it was Ksh.4.9 billion below CBK target as a result of banks increased coverage of rural and low income areas.

Ladies and Gentlemen; Financial sector reforms are far from being accomplished. Given the changing dynamics of the economy and its growing complexities, the financial industry has to remain responsive and supportive of the broader economic ambitions and agenda. All the major players and stakeholders in the banking system will have to strive for continuity, broadening and deepening of reforms; build and sustain the already implemented reforms and fill the remaining gaps. The growing competition along with increasingly diversified services both across the regions and sectors, as well as improved access to customer-base on the back of progressive reliance on technology, are the harbingers of the changing and efficient intermediation role of banks in the days ahead.

The Central Bank is committed to reforms in the banking industry towards enhanced competitiveness. In line with this, the Central Bank has earmarked amendments to the Banking Act and Microfinance Act going forward. The amendments to the Banking Act and Microfinance Act are expected to further enhance efficiency and competitiveness of our financial sector. CBK in collaboration with the Government and the market players will enhance its efforts in addressing other structural rigidities that contribute to market inefficiencies to take stock of developments as well as other emerging constraints.

Before I conclude, ***Ladies and Gentlemen***, let me once again take this opportunity to reiterate the critical role of the financial sector in Africa's economic development. This potential can only be realized when African policymakers implement reforms to remove binding constraints in the sector. I am sure that in this gathering we have the capacity to identify those constraints to unleash Africa's potential.

Finally, I do hope that you will find time in your busy schedules to enjoy our world renown beaches. I wish you fruitful deliberations.

Thank you!