
Financial Distress in Local Banks in Kenya, Nigeria, Uganda and Zambia: Causes and Implications for Regulatory Policy

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An important development in the banking markets of a number of sub-Saharan African countries has been the emergence, since the mid-1980s, of locally owned private sector banks and non-bank financial institutions (NBFIs), henceforth local banks.¹ These have gained a significant share of banking markets in four countries, Kenya, Nigeria, Zambia and Uganda, which are the focus of this article. The growth of local banks could provide important benefits to these economies, and facilitate the objectives of financial liberalisation, 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 jeopardised because the local banks have been vulnerable to financial distress,² a major cause of which has been moral hazard, with the adoption of high-risk lending strategies, in some cases involving insider lending.

This article analyses the causes of financial distress in the local banks in Kenya, Nigeria, Uganda and Zambia and suggests ways in which regulatory policy reforms might mitigate the problems of moral hazard and therefore reduce the incidence of financial distress. It is organised as follows. The next section provides some relevant background data on the growth of local banks, the reasons behind this growth and the potential benefits which local banks offer for the economy. This is followed by a brief outline of why moral hazard

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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 to include banks owned by nationals/residents of Asian origin. Recently privatised government banks are not included in this definition, nor the banks in Nigeria with State government participation, although some of these have majority private sector shareholdings.
2. Banks are defined as financially distressed when they are technically insolvent and/or illiquid.

affects bank management. The causes of financial distress among the local banks are then examined, followed by a discussion of the implications for regulatory policy.

Growth and salient characteristics of local banks

With the exception of Nigeria, which experienced an indigenous banking boom in the early 1950s (Nwankwo, 1980: 45–53), the entry of the local private sector into banking markets was a relatively recent occurrence in Anglophone SSA (excluding South Africa). Local banks were set up in Nigeria and Kenya in the mid-1970s and early 1980s, with new entry accelerating in the second half of the 1980s and the early 1990s. In Uganda and Zambia, local banks were first set up in the mid to late 1980s, but new entry also accelerated in the early 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% in Uganda. Local NBFIs in Kenya and Zambia, and merchant banks in Nigeria, had even larger market shares. Table 1 provides data on the number and market shares of local banks in these four countries.

Entry by local entrepreneurs into banking markets was stimulated by various factors. The established foreign- and government-owned banks had a narrow operational focus on large-scale multinational and parastatal businesses, and were also inefficient. This left gaps in banking markets, especially in credit markets, which new entrants could exploit. Local banks attracted business from domestic entrepreneurs unable to access credit from the established banks. The emergence of profitable opportunities to trade in foreign exchange and invest in treasury bills also stimulated entry. In Nigeria a rigged foreign-exchange market created highly profitable arbitrage opportunities for banks.

In all four countries covered here, the regulatory barriers to entry were low. Until the banking laws were revised in the late 1980s or early 1990s, the minimum capital requirements had been eroded by inflation to such an extent that it was possible to set up a bank in Uganda and Zambia with the equivalent in local currency of less than \$50,000. Minimum capital requirements were higher in Kenya and Nigeria, but in both countries it was possible to start a commercial bank with \$0.5 million or less. Nor did the banking laws, prior to their revision, impose stringent requirements on applicants for bank licences in terms of relevant expertise and experience. Political interference also subverted prudential criteria in the granting of licences, notably in Nigeria, where retired military officers were directors of many banks (Lewis and Stern, 1997: 7), and in Kenya where many banks had prominent politicians on their boards.

Table 1
Local banks and NBFIs in operation at selected dates in Kenya, Nigeria, Uganda and Zambia

<i>Kenya</i>	<i>Banks</i>	<i>NBFIs</i>	<i>Nigeria</i>	<i>Commerical banks</i>	<i>Merchant banks</i>
1980	0	8	1980	3	1
1985	4	24	1985	7	7
1991	7	32	1994	33 (26%)	46 (68%)
1994	17 (25%)	35 (50%)			
<i>Uganda</i>	<i>Banks</i>		<i>Zambia</i>	<i>Banks</i>	<i>NBFIs^a</i>
1985	0		1985	2	
1991	4		1990	5	
1995	8 (c.15%)		1995	11 (22%)	6 (67%)

Figures in parentheses give the deposit market share of the local banks.

a) Refers to leasing companies (data from 1996).

Numbers given for each date exclude institutions 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 privatised former government banks nor joint ventures between State governments and the private sector.

Sources: Kenya: Kariuki (1993: 307) and CBK *Annual Reports*; Nigeria: NDIC *Annual Reports* and miscellaneous; Uganda and Zambia: miscellaneous.

Although local bank entry into banking markets began several years before, financial liberalisation provided a stimulus to further new entry, as did liberalisation of the foreign-exchange market. *De facto* liberalisation of bank licensing occurred in Nigeria and Zambia in the second half of the 1980s and the early 1990s respectively. Interest-rate liberalisation allowed local banks more freedom to compete for deposits by offering higher rates than the established banks. It also enabled them to charge higher rates to high-risk borrowers, lending which might not have been profitable under a regime of regulated interest rates. A further benefit was the sharp rise in treasury bill (TB) rates, investment in which enabled banks to generate high profits with much less risk than by lending to the private sector, as in Zambia.

The entry of local banks has brought economic benefits, although it has also entailed costs arising from the bank failures discussed below. First, the local

banks extend credit to borrowers, mainly small urban-based businesses, which face difficulties in securing credit from the established banks. Second, some of the local banks offer better services than the established banks in order to attract customers. Opening hours are longer, queues in banking halls shorter and depositors are offered higher deposit rates and lower minimum balances. The local banks provide a more personalised service and loan applications are processed more quickly than in the established banks.

Moral hazard and financial fragility

Moral hazard (or adverse incentives) is a concept with relevance to a variety of principal-agent relationships characterised by asymmetric information. The moral hazard discussed here concerns the adverse incentives for bank owners to act in ways contrary to the interests of their 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 jeopardise the solvency of the bank. There are incentives for bank owners 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 deposit insurers) gain little from the upside risk but bear most of the downside risk. The inability of depositors to monitor bank owners adequately, 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 could 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 might induce banks to adopt more risky investment strategies. 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 (for instance, 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 for bank owners to manage their asset portfolios prudently and incentives for depositors to monitor banks and choose only those 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 capitalised banks often 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 for its owners to pursue strategies which might preserve its solvency are reduced (Berger et al., 1995: 398–9). 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; Demsetz et al., 1997).

Moral hazard becomes even more acute when the bank lends to projects connected with its own directors or managers (insider lending). In such cases the incentives for imprudent (and fraudulent³) bank management are greatly increased in that all of the profits arising from the project are internalised (in the case of loans to outside borrowers the project returns are split between lender and borrower), whereas that part of the losses borne by depositors or taxpayers is externalised. Not surprisingly, insider lending is a major cause of bank failure around the world (Caprio, 1997: 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: 25–9).

Causes of financial fragility among local banks

Financial distress has afflicted numerous local banks, many of which have been closed down by the regulatory authorities or restructured under their supervision. In Kenya 2 local banks and 10 NBFIs were closed or taken over between 1984 and 1989. A further 5 local banks and 10 NBFIs were taken over by the Central Bank of Kenya (CBK) in 1993/4, with 2 more local banks in 1996. In Nigeria, 4 local banks were put into liquidation in 1994 and another had its licence suspended, while in 1995 a further 13 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 the Nigeria Deposit Insurance Corporation (NDIC) in 1995. The Bank of Zambia (BoZ) closed 3 local banks in 1995. Another Zambian local bank had been 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 2 more for restructuring in 1995. Table 2 provides estimates of the assets/deposits of the failed local banks in these countries, and, where sufficient data are available, estimates of the loan losses.

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

Table 2
Assets/deposits and estimated losses of failed local banks (local currency and US\$ equivalent)

<i>Country</i>	<i>Assets/deposits</i>	<i>Approximate losses</i>
Nigeria: 4 banks liquidated in 1994	N4.1bn (\$51m.)	N3.7bn (\$46 m.)
13 banks taken over in 1995	c. N34 bn (c. \$425 m.)	c. N13.5 bn. (c. \$169 m.)
Kenya: 9 FIs merged into Consolidated Bank in 1989	Ksh1.5 bn deposits (\$69 m.)	n.a.
16 FIs closed or taken over 1993/94	c. Ksh21 bn (c. \$370 m.)	c. Ksh9 bn (c. \$158 m.)
Zambia: 3 banks closed in 1995	Kw 141 bn (\$170 m.)	n.a.
Uganda: 2 banks taken over in 1995	c. Ush40 bn (c. \$40 m.)	c. Ush12 bn (\$12 m.)

Sources: Nigeria: NDIC (1994: 9, 32–3, 43, 46–8); Kenya (1989): CBK, *Monthly Economic Review*, November 1995: 9; Kenya (1993/94), Zambia and Uganda: author's calculations from banks' balance sheet data, *Economic Review* (various issues), Central Bank data and interviews.

The available information on the causes of these bank failures indicates that in the majority of cases failure was the result of non-performing loans.⁴ Arrears affecting more than half the loan portfolio were typical of the failed banks.⁵

4. Information on the failed banks was obtained from the following sources: Kenya: local magazine reports, especially the *Economic Review* and *Weekly Review* and interviews with bank officials; Nigeria: NDIC (1994); Uganda: interviews with bank officials; Zambia: BoZ (1995) and interviews with bank officials.

5. A rough estimate of the scale of non-performing loans in the distressed Nigerian local banks can be derived from data in NDIC (1994). The 45 distressed banks, which include both public and private sector banks, had total loans of N39.4 bn and classified (i.e. non-performing) loans of N26.2 bn in December 1994 (NDIC, 1994: 43). The State government banks, most of which were distressed, had total loans and classified loans of N21.1 bn and N12.7 bn respectively (ibid: 9). As most of the distressed banks are either State government banks or local banks (a few are owned by the Federal Government), subtracting the second set of

Many of the bad debts were attributable to moral hazard: the adverse incentives for 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. The rest of this section outlines how moral hazard affected bank lending strategies.

Insider lending

The single biggest contributor to the bad debts 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.⁶ Insider loans accounted for 65% of the total loans of the four local banks liquidated in Nigeria in 1995, virtually all of which has been unrecoverable (NDIC, 1994: 48). Almost half of the loan portfolio of one of the Ugandan local banks taken over by the Bank of Uganda in 1995 had been extended to its directors and employees (data provided by bank officials). The threat posed 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 the 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 assets and liabilities were imprudently mismatched.⁷

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, which, because of political pressure, were unlikely to have made a purely commercial judgement as to the safety of their deposits. Moreover, the availability of such deposits reduced the

figures from the first indicates that the distressed local banks had classified loans of about N13.5 bn, 74% of their total loans of about N18.3 bn.

6. For details of insider lending in failed banks in Kenya see: *Economic Review*, 7–13 March 1994: 8–9; *Finance*, 1–15 February 1991: 12–17; and *Weekly Review*, 23 April 1993: 13–18.

7. Three of the failed banks in Kenya were also involved in huge frauds in 1993 which included irregular borrowing and claims for export finance from the CBK, and the fraudulent claim for export compensation known as the Goldenberg scandal. A statement in the Kenyan Parliament in October 1995 revealed that the CBK lost a total of Ksh10.2 bn (equivalent to 3.2% of 1993 GDP) from these frauds (Economist Intelligence Unit, 1995: 13).

need to mobilise 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 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.

Secondly, most of the failed banks were undercapitalised, in part because the minimum capital requirements in force when they had been set up were very low. Many 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. 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 Central Bank of Nigeria in 1995, all except one had paid-up share capital barely exceeding the minimum legal requirement of N50m. and N40m., for commercial and merchant banks respectively, at the end of 1994. The average paid-up share capital of the 4 commercial banks taken over by the CBN was N51m., compared with an average of N94m. for all 36 private sector commercial banks, while the average paid-up share capital of the 9 merchant banks taken over was N52m., compared with an average of N68m. for all 48 private sector merchant banks.

A 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 some at least of the directors would have stood to lose more than they gained from insider lending, while the managers would not risk their reputations and careers.

Lending to high-risk borrowers

The bad debts of local banks were also attributable to credit strategies characterised by lending, at high interest rates, to borrowers in high-risk segments of the credit market. This was in part motivated by the high cost of mobilising funds. Because they were perceived by depositors as being less safe than the established banks, local banks had to offer depositors higher deposit

rates.⁸ 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% were not uncommon.⁹

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 serious consequences for the quality of their loan portfolios. The local banks almost inevitably suffered from the adverse selection of their borrowers, many of whom 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. As a result credit markets were segmented, with the local banks operating in the most risky segment, serving borrowers prepared to pay high lending rates because they did not have access to alternative sources of credit. The adverse incentives for the banks to pursue such risky lending strategies were further exacerbated by high rates of inflation and because there was often a high degree of co-variance among borrowers due to lending being concentrated on a single sector, such as the road transport industry.

High-risk borrowers included other banks and NBFIs which were short of liquidity and prepared to pay above-market interest rates for interbank deposits. In Nigeria many 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: 40). 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.¹⁰ 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 often very poor. Managers and directors

8. It is difficult to make a precise estimate of how much more expensive it is for the local banks to raise funds because there is considerable variation between them, but a difference of 10 percentage points on the average cost of deposits (a figure given to the author by banks in both Kenya and Zambia) is probably not uncommon. The local NBFIs have to pay even more as they cannot usually offer current accounts to depositors.

9. Interbank deposits were especially important as a source of funds in Nigeria. Two of the failed merchant banks had mobilised 84% and 68% of their total deposit liabilities respectively from interbank deposits (Manu, 1994: 20).

10. The fact that many local banks have not failed suggests that there is a demand for loans among creditworthy small- and medium-scale businesses which the local banks can meet.

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 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 officials.

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 maximum amount. 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.¹¹ 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.¹²

The extent of insider lending and 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 lacked sufficient resources. In Kenya and Nigeria many banks avoided inspection for long periods because the rapid expansion of banks in the second half of the 1980s overwhelmed supervisory capacities (Kariuki, 1993: 300–9). In addition, political pressure was brought to bear on Central Banks to exercise regulatory forbearance. The Central Banks often lacked sufficient autonomy from government to be able to refuse liquidity support to politically connected banks and to enforce the banking laws strictly. Especially for those banks with strong political connections, the expectation that the regulators could be pressured to exercise forbearance must have seriously undermined discipline and the incentives for prudent management.

11. Of the total liabilities of the 4 failed banks in Nigeria put into liquidation by the CBN in 1994, less than 2% was accounted for by insured deposits (NDIC, 1994: 46).

12. An addendum to the CBK's 1992/93 *Annual Report and Accounts* reported that it was owed Ksh17.8 bn (approximately 17% of the total liabilities of all the commercial banks in the country) from the overdrawn accounts of 3 banks which it subsequently placed under statutory management or put into liquidation. Other failed banks in Kenya obtained loans from the Deposit Protection Fund.

The four countries covered in this article implemented major reforms in prudential regulation in the late 1980s and/or early 1990s. New banking laws were enacted, which brought most aspects of the legislation into line with international best practice, and supervision departments were strengthened. Effective regulation remains problematic, however. 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 the public and private sectors (Caprio, 1996). Moreover, there is still political pressure for regulatory forbearance, although the fact that Central Banks have taken over or closed down so many distressed banks since 1993, including some with strong political connections, is an indication that prudential regulation has been accorded much greater priority by governments. The following section discusses how, given the political and resource constraints on regulators, regulatory policy might be further strengthened.

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 both taxpayers and depositors. They also undermined macroeconomic stability in Kenya in 1992/3 and in Zambia in 1995.¹³ 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 characterised many of the failed banks.

If this difficult balance is to be achieved, regulatory policy must address the underlying causes of much of the financial distress among local banks, in particular the moral hazard for bank owners. Strict prudential supervision by the Central Banks is needed, with supervisors paying particular attention to detecting and punishing insider lending and other imprudent lending practices through regular on-site inspections. But supervision cannot realistically be expected to provide the main defence against bank failure, because of the severe human resource and political constraints faced by the regulators, noted above. As such, regulatory policy cannot rely exclusively on the imposition of prudential rules and regulations, but should focus on aligning the incentive structure facing the owners of local banks with prudent and honest management (Caprio, 1996). Reforms could also aim to insulate the regulators from political interference in operational decisions.

13. In both countries the provision of large amounts of credit to distressed banks from the Central Banks was a major source of monetary expansion and inflation.

There are several ways in which the incentive structure can be reformed in order to reduce moral hazard in banks. First, the minimum capital required to start a bank could be raised so that owners risk losing more of their own funds 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 reinforce this process. Larger, better capitalised 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.

Secondly, new entry could be limited by requiring applicants for bank licences 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 licence and thereby increase the incentives for bank owners to avoid bankruptcy or other actions, such as serious breaches of the banking laws, which would result in their losing their licence (Caprio, 1996: 15–16; Caprio and Summers, 1993). Higher entry requirements would also reduce the numbers 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. They would also reduce the likelihood of sound local banks being undermined by bank runs triggered by the failure of weaker local banks. Effective supervision will also be more feasible if the numbers of banks are limited, as supervisory resources will not be so thinly spread. A policy of restricting entry and thereby competition might lead, however, to a less efficient financial sector, but some trade-off between incentives for greater efficiency and incentives for prudent management may be unavoidable.

Thirdly, moral hazard could be mitigated by imposing regulatory controls to cap 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 for 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 them to increase their interest-rate margins. Deposit-rate controls would need, however, to be implemented with care and flexibility to avoid reducing deposit rates to negative real levels and inducing disintermediation (Hellmann et al., 1995).

Fourthly, limits could be imposed on the volume of funds which a bank can mobilise 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 from public sector institutions subject to political influence, and which do not therefore make a commercial judgement about 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 have to rely more on mobilising deposits in the market, without the help of political connections, and this would entail establishing a better reputation for prudent management. Those banks unable to establish such a reputation would mobilise fewer deposits, and therefore have less money to lose in the event of bankruptcy.

Fifthly, regulatory policy reforms could reduce the implicit protection provided to bank owners through regulatory forbearance. Owners have few incentives for prudent management if they expect that the government will 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. Banks which are undercapitalised but still solvent could be subject to holding actions until capital adequacy is restored.¹⁴ Effective penalties could be imposed for infractions of the banking laws. If a distressed bank is rehabilitated with government support, the existing shareholders should not benefit. The losses incurred could be charged against the shareholders' capital before the bank is restructured.

The difficulty with this approach is that political pressure often favours regulatory forbearance, which reduces the credibility of the strategy with bank owners. In order 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 needs to be drawn up and made public (Glaessner and Mas, 1995). The rules could, for example, specify the minimum capital adequacy ratio below which a bank will be taken over by the regulators. They could also set out mandatory penalties, including dismissal of managers and revocation of bank licences, for specified serious violations of the banking laws.

These policy measures will not be effective unless the regulators have sufficient political independence actually to 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 giving the senior management of Central Banks some

14. Holding actions are restrictions imposed by the regulators on a bank's activities (such as restrictions on new lending) or remedial action to rectify violations of the regulations or imprudent management.

protection against being penalised by the government for taking regulatory actions which threaten politically connected banks.

Conclusions

Much of the financial distress which afflicted local banks in Kenya, Nigeria, Uganda and Zambia has its roots in moral hazard on bank owners. Adverse incentives encouraged many of the failed banks to pursue highly imprudent, and in some cases fraudulent, lending strategies. A large share of the bad debts of many of the failed banks were attributable to insider loans, often unsecured, in high-risk ventures such as real estate.

Several factors contributed to the adverse incentives on bank owners to take excessive risks with depositors' money. These included low levels of bank capitalisation, access to public sector deposits through the political connections of bank owners, excessive ownership concentration, and regulatory forbearance. In addition, the costs of deposit mobilisation for many of the local banks were high, which encouraged them to lend at high interest rates to inevitably high-risk borrowers in an attempt to generate profits.

The local banks can make a potentially valuable contribution to the development of financial markets in sub-Saharan Africa, especially by improving access to loans for the domestic small and medium-scale business sector. Local banks have survived and operate as sound institutions in all four of the countries covered here, despite being set up in very difficult conditions (such as acute macroeconomic instability). This suggests that the risk of licensing local banks is worth taking, although they will inevitably face greater risks than the established foreign banks because 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 be increased.

Regulatory policy must aim to enhance incentives on bank owners for prudent management, i.e. reduce moral hazard. Reforms which can facilitate this objective include imposing higher minimum capital requirements and stricter limits on ownership concentration. Licensing procedures need to be tightened to exclude entry by weaker banks without adequate resources and managerial expertise. Limits on large deposit exposure would reduce the extent to which banks could rely on wholesale deposits from public sector institutions mobilised 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 needs to be drawn up, and made public, for dealing with bank distress and infractions of the banking laws. Regulators must pay particular attention to detecting and penalising insider lending and other

imprudent lending practices. Effective regulation also requires institutional reforms to give bank regulators greater protection from political interference.

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