**TOPIC 1 FINANCIAL INSTITUTIONS IN KENYA**

**Introduction**

Financial institutions are those organizations that are involved in providing various types of financial services to their customers. A financial institution can also be defined as that type of an institution, which performs the collection of funds from private investors and public investors and utilizes those funds in financial assets.

The financial institutions are controlled and supervised by the rules and regulations delineated by government authorities. Examples of financial institutions are the following:

* Commercial Banks and Mortgage finance Institutions.
* Stock Brokerage Firms and Investment Banks.
* Non Banking Financial Institutions
* Building Societies
* Asset Management Firms
* Credit Unions
* Insurance Companies
* Stock exchanges
* Mutual Funds.
* Hedge Funds

Some of the financial institutions also function as mediators in share markets and debt security markets. There the principal function of financial institutions is to collect funds from the investors and direct the funds to various financial services providers in search for those funds.

Financial institutions deal with various financial activities associated with bonds, debentures, stocks, loans, risk diversification, insurance, hedging, retirement planning, investment, portfolio management, and many other types of related functions. With the help of their functions, the financial institutions transfer money or funds to various tiers of economy and thus play a significant role in acting upon the domestic and the international economic scenario.  
  
For carrying out their business operations, financial institutions implement different types of economic models. They assist their clients and investors to maximize their profits by rendering appropriate guidance. Financial institutions also impart a wide range of educational programs to educate the investors on the fundamentals of investment and also regarding the valuation of stock, bonds, assets, foreign exchanges, and commodities.   
  
Financial institutions can be either private or public in nature.

**A. MONEY MARKET INSTITUTIONS**

1. **Central Bank of Kenya**

The Central Bank of Kenya was established in 1966 through an Act of Parliament - the Central Bank of Kenya Act of 1966. The establishment of the Bank was a direct result of the desire among the three East African states to have independent monetary and financial policies. This led to the collapse of the East Africa Currency Board (EACB) in mid 1960s.

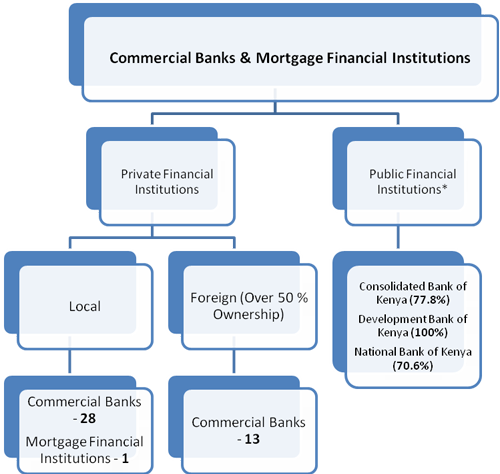
Section 4 of the Central Bank of Kenya Act states the core mandate of the Bank as follows: (1) the principal object of the Bank shall be to formulate and implement monetary policy directed to achieving and maintaining stability in the general level of prices; (2) the Bank shall foster the liquidity, solvency and proper functioning of a stable market- based financial system; and (3) subject to (1) and (2), the Bank shall support the economic policy of the Government, including its objectives for growth and employment.

**Subsidiary mandate of the CBK**

The other objectives of the Bank are enumerated under Section 4A of the Act, and empower the Bank to:-

* Formulate and implement foreign exchange policy
* Hold and manage its foreign exchange reserves;
* License and supervise authorized dealers;
* Formulate and implement such policies as best promote the establishment regulation and supervision of efficient and effective payment, clearing and settlement systems;
* Act as banker and adviser to, and as fiscal agent of the Government; and
* Issue currency notes and coins.

1. **Commercial Banks and Mortgage (S & L) Financial Institutions**

**Commercial Banks and Mortgage Finance Institutions** are licensed and regulated pursuant to the provisions of the Banking Act and the Regulations and Prudential Guidelines issued thereunder. They are the dominant players in the Kenyan Banking system and closer attention is paid to them while conducting off-site and on-site surveillance to ensure that they are in compliance with the laws and regulations. Currently there are there are 44 licensed commercial banks and 1 mortgage finance company.   
  
Out of the 46 institutions, 33 are locally owned and 13 are foreign owned. The locally owned financial institutions comprise 3 banks with significant shareholding by the Government and State Corporations, 29 commercial banks and 1 mortgage finance institution. The ownership structure of the commercial banks and mortgage finance company is as depicted in the chart below:   
 **  
\*Shareholding by the Government and state corporations**

**Agent banking**

In the past year (2010), the central bank has allowed for agent banking after drafting regulations for the agency banking. Agent means an entity that has been contracted by an institution and approved by the Central Bank to provide the services of the institution on behalf of the institution in the manner specified in the Guideline. Agent banking is aimed at:

i) Increasing financial services outreach and to promote financial inclusion to the un-banked and under-banked population without risking the safety and soundness of the banking system; and,

ii) Encouraging institutions to use agents in the provision of banking services so as to reduce the cost of financial services and to foster financial inclusion, reach and depth.

(Refer to the Central Bank of Kenya website at [www.centralbank.go.ke](http://www.centralbank.go.ke) for more details)

1. **MICROFINANCE INSTITUTIONS**

The Microfinance Act, 2006 and the Microfinance Regulations issued there under sets out the legal, regulatory and supervisory framework for the microfinance industry in Kenya. The Microfinance Act became operational with effect from 2nd May 2008.   
  
The principal object of the Microfinance Act is to regulate the establishment, business and operations of microfinance institutions in Kenya through licensing and supervision. The Act enables Deposit Taking Microfinance Institutions licensed by the Central Bank of Kenya to mobilize savings from the general public, thus promoting competition, efficiency and access.  
  
It is, therefore, expected that the microfinance industry will play a pivotal role in deepening financial markets and enhancing access to financial services and products by majority of the Kenyans.  There are 4 licensed deposit taking MFIs - Faulu Kenya Deposit Taking Microfinance Limited, and Kenya Women Finance Trust Deposit Taking Microfinance Limited, SMEP Deposit Taking Microfinance Limited, and Uwezo DTM Limited . Regulations for Non Deposit Taking Microfinance Institutions are yet to be put in place

1. **FOREX BUREAUS**

Forex Bureaus were established and first licensed in January 1995 to foster competition in the foreign exchange market and to narrow the exchange rate spread in the market. As authorized dealers, forex bureaus conduct business and are regulated under the provisions of the Central Bank of Kenya Act (Cap 491). Currently there are one hundred and thirty (130) licensed Forex Bureaus.

1. **CREDIT REFERENCE BUREAUS (Contemporary issue in Banking)**

Credit Reference bureaus complement the central role played by banks and other financial institutions in extending financial services within an economy. CRBs help lenders make faster and more accurate credit decisions. They collect, manage and disseminate customer information to lenders with in a provided regulatory framework – in Kenya, the Banking (Credit Reference Bureau) Regulations, 2008 which was operationalised effective 2nd February 2009. Credit histories not only provide necessary input for credit underwriting, but also allow borrowers to take their credit history from one financial institution to another, thereby making lending markets more competitive and, in the end, more affordable. Credit bureaus assist in making credit accessible to more people, and enabling lenders and businesses reduce risk and fraud. Sharing of information between financial institutions in respect of customer credit behavior, therefore, has a positive economic impact.   
  
The Kenyan banking sector was in the 80’s and 90’s saddled with a momentous Non-Performing Loans (NPLs) portfolio. This invariably led to the collapse of some banks. One of the catalysts in this scenario were “Serial defaulters”, who borrowed from various banks with no intention of repaying the loans. Undoubtedly these defaulters thrived in the “information asymmetry” environment that prevailed due to lack of a credit information sharing mechanism.

The Banking (Credit Reference Bureau) Regulations 2008 will govern licensing, operation and supervision of CRBs by the Central Bank of Kenya. The development of a sustainable information sharing industry is therefore recognized as a key component of financial sector reforms in Kenya and almost all developing and emerging economies. There is currently only one licensed credit reference bureau in Kenya- Credit Reference Bureau Africa Ltd.

**B. CAPITAL MARKET INSTITUTIONS**

**1. Investment Banks**

Are financial intermidiaries charged with the responsibility of garnering the savings of thrifty people and directing these funds into the business enterprises seeking capital for acquisition of plant and equipment, and for holding inventories.

**Functions of investment banks.**

1. Function concerning the formation of new capital.
   * Origination- Investment bankers assist issuing company to work out the details of financing including NSE registration statements and preparing prospectuses in case of public issue.
   * Underwriting- in underwriting, the investment banker enters into agreement with the issuer to take up all such securities that are not taken up by the public. In so doing, they save the issuer from the uncertainties of new issues. We can distinguish between **securities underwriting** and **bank underwriting**. Investments bank conduct **securities underwriting**, the selling of newly issued securities such as stock. Commercial banks and mortgage finance insitutions do **bank underwriting**, the detailed analysis preceeding the granting of a loan.
2. Function subordinate to capital formation.
   * Secondary distribution of large blocks of outstanding securities- Frequently owners of large blocks of securities like to liquidate their holdings in cash. This can be done via an investment bank. Investment banks also come handy for the purpose of negotiating an acquisition or merger.
   * Acting as a broker or dealer in security market- being a member of a stock exchange either as a broker or agent, the investment banks help security holders liquidate their holdings.
   * Advisory and technical services- Investment banks offer advice to companies and individuals for the management of their portfolio.
   * Research activities: investment banks undertake this function in ascertaining the quality/ financial soundness and prospects of companies that they underwrite.

**2. Development Banks**

The term development bank was used for the first time in the post second war period to refer to the institutional financial machinery built for fostering industarial growth in a country. These institutions are charged with supplying the basic ingridients of development- capital, knowledge and entreprenuership e.g. Development bank of Kenya, EADB.

**Functions of development banks**

1. Help alleviate endemic problems of unemployment and poverty.
2. Act as a catalyst for quickening industrial development in a country.
3. Providing term capital to entreprenuers.
4. Promote entreprenuership by undertaking potential industry surveys, identifying growth prospects, writing feasibility reports, and providing technical, and managerial to interested entreprenuers.
5. Widen entreprenuership base by organising training programmes for potential entreprenuers.

**3. Mutual Funds**

A mutual fund is an institutional device through which investors pool their funds to invest in a diversified portfolio of securities, thus spreading and reducing their risk.. The fund is usually manned by an investment manager in an investment bank. In effect, a mutual fund is an open end investment company- i.e. membership is open , and is willing to buy new securities at any time. Types of mutual funds include- Stock/ equity funds, bond fund, balanced fund, leveraged funds and taxation funds.

4. **Stock exchanges**

A stock exchange is an institution, organization or association that serves as a market for trading financial instruments such as [stocks](http://www.wikinvest.com/wiki/What_is_a_stock%3F), [bonds](http://www.wikinvest.com/wiki/Bonds) and their related [derivatives](http://www.wikinvest.com/wiki/Derivatives). Most modern stock exchanges, like [NYSE Euronext](http://www.wikinvest.com/wiki/NYSE_Euronext), JSE and the NSE have both a trading floor and an [electronic trading](http://www.wikinvest.com/wiki/Electronic_trading) system.

The first stock exchanges date back to the Middle Age in Europe with debt trading between merchants. However the first stock trading can be found in the 17th century with the creation of various companies to explore European colonies such as the Dutch East India Company. Historically stocks and bonds were traded in a physical place or building with traders gathering on the floor and exchanging financial titles by hand.

With permission of the London Stock Exchange the Nairobi Stock Exchange started its operations in 1954 as an overseas stock exchange when Kenya was a British colony and the business of shares trading was restricted only to the resident European community though Africans and Asians were not permitted to deal in securities In1963, after independence, Africans and Asians were permitted to deal in securities, but it was complicated to convince native Kenyans of the significance of the exchange.

In 1951, an Estate Agent Francis Drummond established the earliest professional Stock broking firm, and impressed upon the then finance minister of Kenya Sir Ernest Vasey the idea of creating a stock exchange in East Africa.

In1984, A Central Bank of Kenya study, "Development of Money and Capital Markets in Kenya" was known as a blueprint for structural reforms in the financial markets which helped the creation of a regulatory body 'The Capital Markets Authority' (CMA) in 1989.

The Capital Markets Authority Act was amended and known as the Capital Markets Act. In August 2000, CFC Financial Services the first licensed dealer on the Nairobi Stock Exchange started its operations.   
  
In February 2001, basic reformation of the capital market of Kenya took place and divided the market into four independent market segments: the Main Investments Market Segment (MIMS), the Alternative Investments Market Segment (AIMS), the Fixed Income Securities Market Segment (FISMS) and later Futures and Options Market Segment (FOMS).   
  
In the2001/2002 budget, the Government offered the extra incentives to capital markets investments. On17th April 2002, the CMA declared the sanction of the new NSE trading and settlement rules with amendments. On 26th July 2002, with the introducing of a New Foreign Investor Regulations, there are three categories of investor on the capital markets; local, East African and foreign.   
  
On 5th August 2002, the Nairobi Stock Exchange, the Capital Markets Authority of Kenya, the Association of Kenya Stockbrokers, the CMA Investor Compensation Fund, and 9 institutional investors through the Capital Markets Challenge Fund have signed a Shareholder Agreement for establishment of the Central Depository and Settlement Corporation (CDSC). On Monday, 11 September 2006 live trading on the automated trading systems of the Nairobi Stock Exchange was implemented.   
  
Market CapitalizationIn the 2001/2002 budget, the Government offered the extra incentives to capital markets investments. On17th April 2002, the CMA declared the sanction of the new NSE trading and settlement rules with amendments. On 26th July 2002, with the introducing of a New Foreign Investor Regulations, there are three categories of investor on the capital markets; local, East African and foreign.   
  
On 5th August 2002, the Nairobi Stock Exchange, the Capital Markets Authority of Kenya, the Association of Kenya Stockbrokers, the CMA Investor Compensation Fund, and 9 institutional investors through the Capital Markets Challenge Fund signed a Shareholder Agreement for the establishment of the Central Depository and Settlement Corporation (CDSC). On Monday, 11 September 2006 live trading on the automated trading systems of the Nairobi Stock Exchange was implemented.   
  
**Major Companies listed in Nairobi Stock Exchange**   
  
Kakuzi Limited   
Sasini Tea and Coffee Limited   
Unilever Tea Limited  
Car and General Kenya Limited   
Kenya Airways  
TPS Serena   
CMC Holdings  
British American Tobacco Kenya   
British Oxygen Company (K) Ltd Kenya Oil   
  
Barclays Bank of Kenya   
Kenya Commercial Bank   
National Industrial Credit Bank   
Pan Africa Insurance Holdings   
Housing Finance  
CFC Bank   
Standard Chartered Bank   
Diamond Trust Bank of Kenya   
ICDC Investment Company   
National Bank of Kenya

**Functions of the Stock Exchange Market**

Although the stock exchange market has multiple functions, its main activities are two:

* To promote the savings and for them to be canalized towards of carrying through investment projects that otherwise wouldn’t   be possible you need that the issuing institution of the securities to be admitted for quoting. The negotiations will be done on the primary market.
* To provide liquidity to the investors. The investor can   recuperate the money invested when needed. For it, he has to go to the stock exchange market to sell the securities previously acquired. This function of the stock market is done on the secondary market.

Other functions of the stock exchange market as an organization are:

* To guarantee the legal and economic security of the agreed contracts.
* To provide official information about the quantities that are negotiated and of the quoted prices.
* To fix the prices of the securities according to the fundamental law of the offer and the demand.
* Specifying a bit more and centering on the two main agents that intervene in the market, investors and companies, we could do the following   classification:

Functions done by the stock exchange market in favor of the investor:

* It permits him the access to the profitable activities of the big companies.
* It offers liquidity to the security investments, through a place in which to sell or buy securities.
* It permits for the investor to have a political power in the companies in which he invests its savings due that the acquisition of ordinary shares gives him the right (among other things) to vote in the general shareholders meetings of the company in question.
* It offers the possibility of diversifying   your portfolio by enlarging the field of strategy of investments due to alternative options, as could be the derived market, the money market, etc.

With respect to the function done by the stock exchange market in favor of the companies:

* It supplies them with the obtaining of long-term funds that permits the company to make profitable activities or to do determine projects that otherwise wouldn’t be possible to develop for lack of financing. Also, this funding signifies a less cost than if obtained at other channels.
* The securities quoted at the stock exchange market usually have more fiscal purpose advantages for the companies.
* It offers to the company’s free publicity, which in other way would suppose considerable expenses. The institution is objecting of attention of the media (television, radio, etc.) in case any important change in its owners (the share holders).

**C. OTHER FINANCIAL INSTITUTIONS**

**Building Societies**

A building society is a financial institution, [owned by its members](http://en.wikipedia.org/wiki/Mutual_organization), that offers [banking](http://en.wikipedia.org/wiki/Banking_institution) and other [financial services](http://en.wikipedia.org/wiki/Financial_services), especially [mortgage lending](http://en.wikipedia.org/wiki/Mortgage_loan). Building Societies are licensed under the Building Societies Act. Currently there is no licensed Building Society in Kenya.

Credit Unions

These are co-op associations whose members normally have a common bond, such as employees of the same firm. Member’s savings are loaned out only to other members. They offer the cheapest source of funds for individual borrowers. Co-ops are regulated by the co-op act.

Pension funds

Refers to retirement plans funded by corporations or government agencies for their workers. They are administered primarily by the trust departments of commercial banks or by life insurance companies. These funds are invested primarily in bonds, stocks, mortgages, and real estate.

Life insurance companies

Take deposits in the form of annual premiums: invest these in stocks, bonds, real estate and mortgages, and finally make payments to the beneficiaries of the insured parties. They also offer a variety of tax deferred savings plans designed to provide benefits to participants when they retire.

Hedge funds

An aggressively managed portfolio of investments that uses advanced investment strategies such as leveraged, long, short and derivative positions in both domestic and international markets with the goal of generating high returns (either in an absolute sense or over a specified market benchmark).   
  
Legally, hedge funds are most often set up as private investment partnerships that are open to a limited number of investors and require a very large initial minimum investment. Investments in hedge funds are illiquid as they often require investors keep their money in the fund for at least one year. For the most part, hedge funds (unlike mutual funds) are unregulated because they cater to sophisticated investors. You can think of hedge funds as mutual funds for the super rich. They are similar to mutual funds in that investments are pooled and professionally managed, but differ in that the fund has far more flexibility in its investment strategies. It is important to note that hedging is actually the practice of attempting to reduce risk, but the goal of most hedge funds is to maximize return on investment. The name is mostly historical, as the first hedge funds tried to hedge against the downside risk of a bear market by shorting the market (mutual funds generally can't enter into short positions as one of their primary goals). Nowadays, hedge funds use dozens of different strategies, so it isn't accurate to say that hedge funds just "hedge risk". In fact, because hedge fund managers make speculative investments, these funds can carry more risk than the overall market.

**TOPIC 2 SPECIFIC MANAGEMENT PROBLEMS FACING FINANCIAL INSTITUTIONS**

1. **LIQUIDITY MANAGEMENT IN FINANCIAL INSTITUTIONS.**

The art of managing funancial institutions lies in the resolution of conflicts between liquidity and profitability. Financial institutions, especially banks attract depositors cash by not only promising some return on the cash (Interest), but also by committing itself to payment on demand (Withdrawals of cash with little or no notice). Financial institutions must ensure andequate liquidity to meet any claims upon it in cash on demand.

However, cash is a sterile asset and holding it means no income at all. Income cannot be ignored since the ultimate aim of a bank is to make earnings on its business that are sufficient to cover its cost of capital, paying wages of staff and other expenses. To realise meaningful incomes, FA must employ the bulk of resources in giving loans and advances, and investing them in high yielding securities. Loans are subject to default risk, whereas investments in fixed income securities are subject to interest rate risks. In addition, a banker will not be able to meet payment on demand when funds are employed in the above investments. Once the depositors checks are not honored, the financial institution will lose confidence of the public, resulting in a mass run on the bank’s counters and further jeorpadize the liquidity position of the bank.

Theories of liquidity management

* Commercial loan theory

According to this theory, a financial institution should provide short term self liquidating loans to business firms to enable them meet their working capital requirements. Self liquidating loans refer to loans which finance the movements of goods through the successive stages of production, transportation, storage, distribution and finally consumption. Banks were urged to refrain from long term lending- to finance plant, equipment, parmanent working capital, real estate, consumer durables and speculation. The logical basis for this theory is that deposits are demand or near demand liabilities and should therefore be committed to obligations that are self liquidating. Since this theory holds that financial institutions should always lend against self liquidating papers, it came to be known as the real bills doctrine.

Criticisms of the commercial loan theory

* + - If financial insitutions decides to grant new loans only after the repayment of the old loan, production and trade for the dissapointed borrowers will suffer, leading to reduced production and trade. This will result in a fall in the purchasing power of the community, in turn leading to fall in prices. This would make it difficult for existing debtors to pay their debts in time.
    - The liquidity structure of self liquidating loans is conditioned by the economic situation in the country. In periods of economic deppression, goods do not move speedily or move at very low prices. In such circumstances, there is no guarantee that the debtor will be able to pay up the loan upon maturity.
    - The theory failed to consider that a bank can ensure liquidity of its assets only when they are readily convertible into cash wihtout any loss in value and not because the loans are made against real trade bills. The bank could achieve this by including treasury bills, bills of exchange and other highly marketable securities in its portfolio. The problem of liquidity in financial institutions is not one of maturity of loans but essentially one of shifting the assets elsewhere for cash without realising losses. It is this limitation that led to the shiftabilty theory.
  + The shiftability theory

According to this theory, financial insitutions need not rely upon maturities if it has maintained a substantial amount of such assets that can be shifted into others to meet expected cash demand. Liquidity is thus tantamount to shiftability.

According to shiftabilty theorists, an asset must be transferable to others without an appreciable capital loss for the purpose of meeting temporary liquidity crisis caused by a sudden demand on the part of customers. This would however not be possible in times of general liquidity crisis engulfing the entire industry. In such circumstances, a bank should possess such assets as can be shifted to the central bank, the lender of last resort, as the source of cash.

This theory failed to distinguish clearly the liquidity of an individual insitution and that of the industry as a whole.

* + The anticipated income theory

Commercial banks are increasingly taking part in term lending- i.e. granting of loans whose repayment period is greater than one year but less than five years. Banks use stocks, machinery and potential earnings as collateral while granting these loans. If a financial institution is satisfied that a borrower has the potential to earn a reasonably high income in the foreseeable future, it will grant a loan even though it is not self liquidating in nature, or when assets taken as collateral are not readily shiftable.

According to this theory, loan repayment schedules have to be adapted to the anticipated incomes or cash receipts of a borrower. Thus, all loans, short term or long term become liquid if the borrower have the capacity to repay the sum.

* + Liabilities management theory

According to this theory, it it unnnecesary to observe standards in regard to self liquidating loans and liquidity reserves, for reserve money can be borrowed in the money market whenever a financial institution experiences reserve defficiency.

To meet reserves defficiency, a financial institution may resort to:

* + - Isssuance of time certificates of deposit.
    - Borrowing from commercial banks.
    - Borrowing from the central bank.
    - Raising capital funds by issuing shares or by means of retained earnings.

PRIORITIES IN THE EMPLOYMENT OF FUNDS

in prioritizing funds for financial institutions, the following order is recomended.

* Liquidity (In the form of primary reserves)

Since public confidence is essential for the survival of a financial institution, it has to lay an overiding emphasis on liquidity. With that end in view, it must provide itself with andequate cash. There are also legal requirements – every commercial bank, for example is required by law to keep with the central bank some cash reserves against its deposits. The cash reserve held by the bank for legal and operational purposes is designated in banking circles as primary reserve. Excess reserves act as an insurance against costs associated with deposit outflows.

* Secondary reserves

Since cash is a barren asset, it forms only a small proportion of banks total assets. Secondary reserves- liquid but earning assets occupy the second priority. These assets can be converted to cash with little or no delay or loss of principal.

* Customers needs

The third priority is to consider its customer needs for funds- and it will extend credit to customers whose operations and needs are intimately understood and known by the institution- hence the need for guarantors and collateral.

* Purchase of investment securities in the open market

if the first three priorities have not exhausted income, the financial institution may purchase earning assets in the open market.

Reserves (Primary and secondary) are of paramount importance to a financial institution. In summary, this is what a bank can do when it does not have enough reserves?

1 Borrow from other commercial banks or corporations (Attracts interest)

2 Raising capital funds by issuing shares or by means of retained earnings.

3 Borrow from the central bank (Attracts interest).

4 Sell some securities

5 Reduce loans. This is one of the MOST costly ways of acquiring reserves. It can be done through:

1. not renewing the contract for existing loans (This antagonizes consumers).
2. sell the loan to another financial institution (Other banks may only agree to buy loans at a substantial discount).

Several tools could be employed to forecast the level of cash requirements needed. It is worthy noting, however that these are subject to forecasting risks. In applying these tools a manager should also exercise judgement.

1. **CAPITAL ADEQUACY MANAGEMENT**

Why a bank banager needs to manage the bank's capital?

* Because the regulators require it (Capital Adequacy Ratios, Minimum capital requirements).
* Because it affects the owners' return on investment.
* Because having enough capital prevents bankrupcy/ going out of business

**FUNCTIONS OF CAPITAL FUNDS IN FINANCIAL INSTITUTIONS**

* + - 1. Loss absorber

Capital is needed to finance day to day operations and provide bail out for creditors and cover possible losses. It provides a buffer and cushion to absorb possible losses and still remain solvent so that depositors are fully protected at all times. It is the ultimate final protection from the risk of insolvency. In the short run, a major portion of losses may be offset by current earnings

* + - 1. Supply working tools of banks

The cash for acquisition of fixed assets is done using capital funds. Deposits cannot be used to provide these tools.

* + - 1. Source of loan funds

Capital fund is the assurance that the financial institution will be able to fulfil credit needes of customers

**NECESITY OF ANDEQUATE CAPITAL FUND FOR A FINANCIAL INSTITUTION**

* + - 1. Public confidence

Andequate capital fund is needed to bring about solidarity, scope, operation and ultimate strength of a bank.

* + - 1. Cover normal hazards inherent in its operations

Cushion from unforeseen operation losses from time to time.

* + - 1. Social responsibility

Give credit and meet credit risk.

4.Legal requirements

**What is andequate capital fund?**

Depositors may favor the maximum amount of capital fund so that the financial institution may be able to absorb all the losses that may occur- thus leaving depositiors fully protected. On the other hand stockholders may like the bank to operate with minimum capital since excess capital prevents them from earning any reasonable return on investment. There is thus a conflict.

However, in assessing andequate capital, it is important to note that public confidence (which is essential in banks) is a function of safety of deposits. Thus in assessing andequacy of capital, emphasis should not be placed on management or corporate liabilities, but rather on the history and future prospects of the institution, its customers and the community it serves. Determination of andequate capital is imprecise and requires exercise of judgement in light of the above factors. Over time however, several tools have been developed to aid in assessment of capital andequacy.

Suppose we have 2 banks: one with high capital and another with low capital as illustrated below.

TABLE A: High capital bank

|  |  |
| --- | --- |
| ASSETS | LIABILITIES |
| Reserves Ksh. 10 million  Loans Ksh. 90 million | Deposits Ksh. 90 million  Bank Capital Ksh. 10 million |

TABLE B: Low capital bank

|  |  |
| --- | --- |
| ASSETS | LIABILITIES |
| Reserves Ksh. 10 million  Loans Ksh. 90 million | Deposits Ksh. 96 million  Bank Capital Ksh. 4 million |

Now supposing both banks write off Ksh. 5 million in bad debts. The balance sheet for both banks will be as follows

TABLE C: High capital bank

|  |  |
| --- | --- |
| ASSETS | LIABILITIES |
| Reserves Ksh. 10 million  Loans Ksh. 85 million | Deposits Ksh. 90 million  Bank Capital Ksh. 5 million |

TABLE A: Low capital bank

|  |  |
| --- | --- |
| ASSETS | LIABILITIES |
| Reserves Ksh. 10 million  Loans Ksh. 85 million | Deposits Ksh. 96 million  Bank Capital ( Ksh. 1 million) |

If capital is negative, then the bank is bankrupt.

* Banks desire to hold less capital to satisfy the owners.
* But less capital is bad for the bank in case of large withdrawals. It can go bankrupt.

Therefore, the regulators stepped in and set the capital requirements: This was the basis of the BASEL accords.

**THE BASEL ACCORDS**

The Basel Accords refer to the banking supervision Accords (recommendations on banking laws and regulations), [Basel I](http://en.wikipedia.org/wiki/Basel_I), [Basel II](http://en.wikipedia.org/wiki/Basel_II) and [Basel III](http://en.wikipedia.org/wiki/Basel_III) issued by the [Basel Committee on Banking Supervision](http://en.wikipedia.org/wiki/Basel_Committee_on_Banking_Supervision) (BCBS).

**THE BASEL ACCORD I**

In 1988, the Bank of International Settlements (BIS) which hosts the BCBS introduced the Basel Accord I which was designed to ensure minimum capital requirements for banks. It provided for the implementation of a credit risk management framework with a minimum capital standard of 8% (CAR) by the end of 1992. The min cap std is based on the Capital Andequacy ratio (CAR).

**THE BASEL ACCORD II**

As the implementation of the Basel Accord I proceeded, it was recognised that numerous shortcomings existed in the framework and in June 2004, following extensive consultation with industry, the Basel II Accord was published. This version superseded the 1988 Accord and aimed at ensuring that capital allocation is far more risk sensitive, establishing a framework for convergence of regulatory and economic capital. Additionally, it separates and quantifies risk into

credit, market and operational risk components, establishing a viable structure and measurement system for each.

The Basel II Framework describes a more comprehensive measure and minimum standard for capital adequacy that national supervisory authorities are now working to implement through domestic rule-making and adoption procedures. It seeks to improve on the existing rules by aligning regulatory capital requirements more closely to the underlying risks that banks face. In addition, the Basel II Framework is intended to promote a more forward-looking approach to capital supervision, one that encourages banks to identify the risks they may face, today and in the future, and to develop or improve their ability to manage those risks. As a result, it is intended to be more flexible and better able to evolve with advances in markets and risk management practices.

The events that began in 2007 with the sub-prime crisis have now forced regulators and financial service organizations globally to again re-examine and reassess risk management frameworks and processes.

**THE BASEL ACCORD III**

**Standards for measuring capital andequacy**

* + - 1. **Ratio of paid up capital to reserves**

This is an important index for assessing the financial strength of financial institutions. It is also a pointer to the management policy regarding retention of earnings. Paid up capital comprises of share capital, share premium and retained earnings. Reserves consist of both primary and secondary reserves held by banks. Reserves are expected to follow a rising trend since they are created out of current earnings.

This measure is simple, but it cannot measure capital andequacy. This ratio fails to measure whether capital is sufficient to absorb losses- failing to shed light on the magnitude of losses to be protected.

* + - 1. **Capital deposit ratio**

A high capital deposit ratio is indicative that bdepositors will incur low risks. The rule of the thumb is that financial institutions have a capital fund at a minimum of 10% of deposit liabilities.Though the ratio is simple, it does not measure the amount or quality of assets in which deposits are invested.

* + - 1. **Capital asset ratio**

This is the ratio of capital funds to total assets less cash and investments in government securities. A ratio of 20% is considered sufficient. In a research by the Illinois Bankers association, it was found that the amount of capital depended on i. The amount of assets subject to risk and ii. The extent of risk.

The amount of capital bears no relation to the amount of deposits, and there is no uniform risk in relation to deposits. It advised that each financial institution review its experience with various kinds of assets during deppression years

The method is complex for use by banks. It calls for a complex and time consuming analysis of each asset and fails to provide any norm that may apply to all banks because each bank’s evaluation of risk will differ from that of another.

* + - 1. **Adjusted bank assets ratio**

This is an improved version of risk assets approach. It relates capital funds to risk assets (excluding cash and investments in government securities carrying a maturity of 5 years or less, and loans guaranteed by the government and government agencies). A ratio of 16.7% is considered standard. This approach is superior to other methods in measuring capital andequacy. However, it has some pitfalls. To ascertain if a certain asset is risk free is a difficult task. Assets considered risk free may not always be risk free- e.g government securities may lack credit risk, but have money risk. Even among risk assets, extent of risks is not uniform as the assets may not carry same amount of credit risk.

For the purpose of analysis, the bank assets were classified in six broad groupings:

* + - 1. Primary and secondary reserves.
      2. Minimum risk assets.
      3. Portfolio assets.
      4. Sub standard and specially mentioned assets.
      5. Workout assets- stressed/ distressed assets- NPL, Bad debts.
      6. Fixed assets.

To each of the six assets, the specific capital requirement was assigned. The capital funds in excess of 25% of the min is considered desirable.

* + - 1. **Primary capital to risk ratio (Capital andequacy ratio)**
* **Capital Adequacy Ratio** (CAR) is a ratio that regulators in the banking system use to watch bank's health, specifically bank's capital to its risk. Regulators in the banking system track a bank's CAR to ensure that it can absorb a reasonable amount of loss.
* Regulators in most countries define and monitor CAR to protect depositors, thereby maintaining confidence in the banking system.
* Capital adequacy ratio is the ratio which determines the capacity of a bank in terms of meeting the time liabilities and other risk such as credit risk, market risk, operational risk, and others. It is a measure of how much capital is used to support the banks' risk assets.
* Bank's capital with respect to bank's risk is the simplest formulation; a bank's capital is the "cushion" for potential losses, which protect the bank's depositors or other lenders.

#### How is the Capital Adequacy Ratio CAR calculated?

* The ratio is calculated by dividing Tier1 + Tier2 capital by the risk weighted assets.
* Capital  
  Capital Adequacy Ratio = ------------  
                               Risk
* Tier1 + Tier2 capital  
                         = -----------------------------  
                              Risk Weighted Assets \* 8%
* Two types of capital are measured for this calculation. Tier one capital (Core capital) is the capital in the bank's balance sheet that can absorb losses without a bank being required to cease trading.
* Tier two capital (Supplementary capital) can absorb losses in the event of a winding-up and so provides a lesser degree of protection to depositors.

#### What values does the Capital Adequacy Ratio CAR can take?

* Minimum standard set by the Bank for International Settlements (BIS) is **8%** (comprising 4% each of Tier 1 and Tier 2 capital).

#### Advantages of using the Capital Adequacy Ratio CAR

* In early phases of Basel implementations, bank's capital adequacy was calculated as assets times ratio.  This approach did not take risk profiles of assets into account.  It is obvious that a bank should keep more capital in reserves for riskier assets.
* Since different types of assets have different risk profiles, CAR primarily adjusts for assets that are less risky by allowing banks to "discount" lower-risk assets. So, for example, in the most basic application, government debt is allowed a 0% "risk weighting".  This also means that government debt is subtracted from total assets for purposes of calculating the CAR.
* On the other hand, investments in junior tranches of instuments collateralized with subprime mortgages are very risky, and woudl be assigned 100% risk weighting.

#### Other names related to the Capital Adequacy Ratio CAR

* Capital adequacy ratio (CAR) is often also called Capital to Risk (Weighted) Assets Ratio (CRAR).

#### Other details related to the Capital Adequacy Ratio CAR

* Tier 1 Capital: This is the bank's core capital comprising of share capital, disclosed reserves and minority interests. Some institutions expand this definition to include restricted forms of "equity-like" capital instruments.
* Tier 2 Capital: This includes supplementary Capital consisting of general loan loss reserves and revaluation reserves on investments and properties held for investment purposes.
* Upper Tier 2 Capital: This is more stringent than that defined under BIS standards. This capital includes funds raised from hybrid and long-dated subordinated debt instruments which satisfy MAS conditions and a limited portion of the banks' unencumbered general provisions. Revaluation surpluses of bank's holdings in properties and equities are not allowed. Conventional subordinated debt or shorter term Tier3 debt instruments are also not allowed.
* Risk-Weighted Assets: This includes the total assets owned. The value of each asset is assigned a risk weight (for example 100% for corporate loans and 50% for mortgage loans) and the credit equivalent amount of all off-balance sheet activities. Each credit equivalent amount is also assigned a risk weight.

**LEGAL PROVISIONS FOR ANDEQUATE CAPITAL FUNDS IN KENYAN FINANCIAL INSTITUTIONS**

The Government of Kenya has set minimum core capital requirements for banks, microfinance institutions and insurance companies.

For commercial banks the minimum capital requirements is Ksh. .................................................

For deposit taking Microfinance institutions the minimum capital is Ksh. .......................................

For Insurance companies the minimum capital is Ksh. ...............................................................

Specifically, the PRUDENTIAL Guidelines for the management of financial institutions spell out clearly the minimum capital requirements for financial institutions.

1. **MANAGEMENT OF INCOME .**

**The determination of income**

The income/profit of a financial institution is the result of the revenue function and the cost function. The revenue function shows the total income of the financial institution derived from the services rendered by it. The cost function shows the total expenses incurred on producing any service rendered by it.

**Earning structure in a financial institution**

* + 1. Interest and discount

The interest made on loans and advances made by a financial institution and discounts charged on bills of exchange constitute the principal source of income.

The level of interest income depends on the volume of loans, the types of loans advanced and the rate of interest thereon. Interest rates are notoriously variable, and depend on the characteristics of the individual loan, and the demand and supply for credit in the money market.

Interest rates will also fluctuate depending on the risks associated with the loans, the status of the borrower and the size of the loan, and security. Interest on loans is also influenced by habit or custom, and the competition between banks. Future economic outlook also plays a part in the determination of interest rates.

* + 1. Dividend income

The level of dividend income depends in a large measure to the amount and composition of investments and the rates of return.

* + 1. Commission, exchange and brokerage

Financial institution generate substantial income from commissions, fees, exchange charges and brokerage fees for a wide range of services.

* + 1. Other sources of income

This includes remmitances and service charges, penalties for late payment of loans. Financial institutions also charge for the execution of mortgages or agreements securing loans.

**Structure of expenditure in financial institutions**

Banking is a highly personalised service industry. The expenses are to a large extent fixed in the short run. Unlike other industries, financial institutions cannot easily curtail expenditure by suspending operations or reducing labor force. Since financial institutions do not produce for inventory, it is not possible to reduce expenses by managing inventory more effectively. Thus, in the short run, expenses in financial institutions are not closely related with the volume of business conducted. In the long run, however, financial institutions can reduce expenditure by improving organizational structure, departmentation and automation.

Generally, expenditure in financial institutions may be divided into three broad groudss:

* + - 1. Interest on deposits and borrowings

This is the most important of a financial institution, and especiaally commercial banks. It is the amount of interest paid by it on time, savings and other deposits, and on borrowings.

The expense will depend on the volume of bank deposits, their composition and the interest rates structures.the interest rate is a function of supply and demand conditions in the capital markets, the maturity of the deposits, competition between banks and other institutional agencies (e.g bond market not developing since banks entice corporates with loans).

Besides, the ability to use funds economically and profitably determines the rates that financial institutions can be able to pay.

* + - 1. Salaries, allowances, provident funds.

This is normally the second largest expense item for financial institutions. It depends on the number of persons employed, and the wage rate. In financial institutions, where services are of a personal nature, the expense is high since it calls for the use of individuals rather than machines (ATMS exempted). Credit analysis, trust analysis and investment function require exercise of judgement- tasks that machines cant perfom. Another reason for rising wage costs iis competition for personel .

* + - 1. Other expenditure

This includes the BoD and local committee members fees, audit and law charges, taxes, insurance, deppreciation and repairs, postage, stationery, printing and advertisements.

**Allocation of income in financial institutions**

**Problem of allocation of income in financial institutions**

Financial institutions are faced with the problem of allocating income between different heads in light of present and future requirements. This may be done in the following 3 ways.

* Retaining a portion of profits for general capital accounts.
* Distributing a portion of profits to the owners in the form of dividends.
* Establishing a special reserve fund, such as valuation reserve out of the profits to protect itself from unusual losses. A prudent banker makes an andequate provision for both normal and abnormal hazards. Normal hazards in a financial institution fall into two groups
  + - Credit losses arising out of the failure of the borrower to pay as contracted.
    - Losses due to changes in the discounted values of fixed intererst bearing contracts because of variations in the interest yield or in the rates used in discounting the contracts.

Besides making provisions for normal hazards, a banker must retain a portion of his earmings in the form of general reserves in order to strenghen his capital fund used to absorb abnormal losses.

A portion of the banks income must be distributed to owners in order to maintain their confidence. Some investors have a wary of the future and prefer immadiate income.

By paying out high dividends, the shareholders react favourably, marketability of securities is enhanced and the prices of securities appreciate. This makes it very easy to obtain additional capital. On the other hand, payment of high dividends compromises the capital fund. Failure to maintain andequate capital may eventually lead to its liquidation.

To ensure safety of the financial institutiton, low dividends are recomended if larger retention is neccesary for enhancing the safety of the bank.

**Factors influencing pattern of allocation of income in financial institutions**

* + - 1. **External factors**

1. **General state of economy**

the level of business activity are subject to economic conditions in a country. In future economic outlook is bad a larger portion of income may be retained to absorb any future losses.

Financial institutions may not get enough deposits if the per capita income is low. In such situation, income is retained to enhance liquidity.

1. **Conditions of the money market**

In the event of a tight money market, a financial institution should retain more funds to meet contigencies and credit needs of customers.

1. **State regulation**

Min capital requirements may lead to retention of income in order to shore up capital to the minimum required.

1. **Tax policy**

The pattern of income distribution is also determined by the tax policy (Expalin dividend tax account). In some cases, government provides tax incentives so companies may retain larger portions of income.

**2 Internal factors**

**a. Assets structure and its risk complexion**

the amount of general and special reserve fund is closely related to the risk that the bank has assumed.large proportions of loans and security investments (Excluding investments in government securities) would mean a greater need for strenghening the reserves position.

1. **Credit and investment losses**

the loss which a financial institution can sustain into the future, both on account of failure of creditor default, and sale of securities will determine the level of income retention.

1. **Repayment of loan**

A bank that has taken a loan will either repay it by creating new obligations to replace old debt or use retained earnings. A larger portion of income is retained if the second alternative is opted for.

1. **Growth rate of the bank**

A rapidly expanding financial institution will retain a larger portion of earnings to finance its expansion.

1. **Access to capital markets**

A financial institution with ready access to capital markets based on its high and stable earnings record will retain smaller proportion of income.

**Dividend policies of finacial institutions**

**Stable dividend policy**

**Regular and extra dividends Irregular dividends**

1. **CORPORATE PLANNING.**
2. **FINANCIAL INSTITUTION RISK MANAGEMENT**

|  |
| --- |
|  |

Financial institution risk management is essential for the growth of both public and private financial organizations. With the growing competition in the financial market, the task of risk management is becoming increasingly important over the passage of time. Financial organizations face different types of operational risks. Business risks may arise due to several reasons like production loss, theft, fire, natural calamities like flood and earthquake. Reputational risk is another major threat faced by all popular financial service providers.

**Risk Management Policies of Financial Institutions**

All financial institutions make use of risk management strategies to take early precaution against unanticipated loss. Some of the widely used strategies of risk management are as follows:

|  |
| --- |
|  |

* Transfer of risk is always a better option than risk absorption for all financial institutions regardless of size.
* It is always advisable to eliminate risk-bearing assets. Financial organizations always try to use less risky resources and other means of production.
* There are some risks that are naturally associated with the activity of the financial organizations. Elimination of those inherent risks is a real challenge for all financial institutions.
* Risks are associated with different stages of business activity. Market creation, intermediation, servicing, packaging, distribution and origination are the various services, which may involve risks.

**Derivatives**

By the early 1990’s a number of further risk management failures had occurred and this led to a specific G30 initiative in 1993 which reviewed activity in the global derivatives industry. The report, “Derivatives: Practices and Principles”, recognised and addressed concerns about the products and their uses and formulated recommendations about their proper management. Importantly, it dispelled many concerns about the products and placed the emphasis on identification, management, control and monitoring of the risks as a mandatory starting point in the provision of these valuable solutions to customers. Although the report was singularly focused

on derivatives, it encompassed key aspects of risk management practice generally – these principles have come to be recognised as representing best practice.

**TOPIC 3 MANAGEMENT OF ASSETS AND LIABILITIES**

1. **MANAGEMENT OF DEPOSITS.**
2. **MANAGEMENT OF LOANS.**
3. **MANAGEMENT OF RESERVES.**

**TOPIC 4 CONTROL OF FINANCIAL OPERATIONS**

Financial Control covers all the activities of financial institutions whose data streams have an important impact on its financial position, such as credit risk, performance indicators, information and management systems, the administrative budget, ALM and market risks.

1. **PERFOMANCE EVALUATION.**
2. **PERFOMANCE BUDGETING .**
3. **MANAGEMENT INFORMATION SYSTEMS.**

**TOPIC 5 GOVERNMENT REGULATIONS AS THEY AFFECT PRACTICES OF FINANCIAL INSTITUTIONS**

**TOPIC 6 APPLICATION OF MANAGEMENT PRACTICES TO BANK AND NON BANK FINANCIAL INSTITUTIONS**

**TOPIC 7 FINANCIAL CENTRES IN EASTERN AND SOUTHERN AFRICA**