BCOM 430: MANAGEMENT OF FINANCIAL INSTITUTIONS

Attempt any THREE questions.

1. Briefly discuss the following financial institutions found in Kenya, highlighting their functions and distribution in Kenya.
   1. Commercial banks and mortgage finance institutions (4 marks).

***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 45 institutions, 32 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, 28 commercial banks and 1 mortgage finance institution.*

*Commercial banks and mortgage finance institutions among others,*

* *Offer mortgages.*
* *Offer custodial services.*
* *Mobilise savings.*
* *Issue loans to firms and households.*
  1. Credit reference bureaus (4 marks).

*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 licenced credit reference bureau in kenya- Credit Reference Bureau Africa Ltd.*

* 1. Credit unions (3.5 marks).

*These are co-op associationa whose members normally have a common bond, such as employees of the same firm. Members 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.*

* 1. Microfinance institutions (4 marks)

*The Microfinance Act, 2006 and the Microfinance Regulations issued thereunder 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 mobilise 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 2 licensed deposit taking MFIs - Faulu Kenya Deposit Taking Microfinance Limited, and Kenya Women Finance Trust Deposit Taking Microfinance Limited. Regulations for Non Deposit Taking Microfinance Institutions are yet to be put in place*

* 1. Investment banks (4 marks).

*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.*
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.*
   1. Development Banks (4 marks).

*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.*
6. “The art of managing funancial institutions lies in the resolution of conflicts between liquidity and profitability”.
   1. Discuss this statement with reference to FOUR theories of liquidity management (16 marks)

*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.*

*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.*
  1. Outline the recomended order of priority to be observed in the employment of a bank’s funds (7.5 marks).

*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.*

1. “Banks need to maintain andequate capital in order to cater for unforeseen losses”. With regard to capital andequacy, discuss:
   1. The Basel I Accord (4 marks).

*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% by the end of 1992. The min cap std is based on the Capital Andequacy ratio (CAR).*

* 1. The Basel II accord (7 marks)

*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.*

* 1. The minimum capital requirements as per the laws of kenya for the following financial institutions:
     1. Commercial banks (4 marks).
     2. Micro- finance institutions (4 marks).
     3. Insurance companies (4.5 marks).
* *General Insurance companies- Ksh. 300,000,000.00 by June 2010.*
* *Composite Insurance companies- Ksh. 450,000,000.00 by June 2010.*
* *life insurance companies- Ksh. 150,000,000.00 by June 2010.*
* *Commercial banks/ mortgage finance institutions- Ksh. 1,000,000,000.00 by December 2012.*

1. “The income/profit of a financial institution is the result of the revenue function and the cost function”.
   1. In light of the above statement, discuss the structure of:
      1. Income for a financial institution (8 marks).
      2. *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.*

* + 1. Expenses for a financial institution (8 marks).

*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.*

* + 1. Factors influencing pattern of allocation of income in financial institutions (7.5 mks)
       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.*

1. “The existing regulatory framework for the financial sector in Kenya consists of a number of

independent regulators each charged with the supervision of their particular sub sectors”.

Discuss the structure of financial sector regulation in Kenya and highlight GAPs and OVERLAPS. (23.5 marks)

*The existing regulatory framework for the financial sector in Kenya consists of a number of independent regulators each charged with the supervision of their particular sub sectors. The recent creation of the Insurance Regulatory Authority has completed the shift from having departments under the Ministry of Finance to having independent regulators for each sub-sector.*

*The current regulatory structure is characterized by regulatory gaps, regulatory overlaps, multiplicity of regulators, inconsistency of regulations and differences in operational standards. For example, some of the regulators have at least partial exemption from the State Corporations Act while others do not, some have tax exemption, others do not. Some regulators have powers to issue regulations while in other cases the power is retained by the Minister for Finance.*

**THE GAPS IN THE REGULATORY FRAMEWORK**

*The Kenya Post Office Savings Bank (KPOSB)*

*The Kenya Post Office Savings Bank (KPOSB) was incorporated in 1978 under the KPOSB Act (Cap 493B). The mission of the bank is “to sustainably provide savings and other financial services to our customers, through a countrywide branch network, by use of modern technology in delivery of efficient and effective customer service, and to the satisfaction of all stakeholders.”*

*Section 8(1) KPOSB Act that provided for the Government guarantee over the deposits placed with the savings bank was repealed via the Finance Bill 2001. The repeal of the section implies that new avenues should be found for deposit protection. It also implies that the bank should be adequately capitalised as a first step to protect deposits against possible losses.*

*Companies Act (CAP 486)*

*The Companies Act, which is a holdover of pre-colonial British Law, is creating problems for private sector activities in Kenya and indeed the financial services sector. Old-fashioned UK companies’ law, currently in use, is complicated, cumbersome, inconsistent and at odds with modern “enabling” regulation of corporations. Another layer of complexity and compliance is added to an already burdensome structure, leading to multiple disclosure requirements, overlap and expensive duplication. The regulation of companies is currently under the Registrar of Companies in the Office of the Attorney General but could be brought under the financial sector regulatory framework for more responsiveness to market dynamism.*

*Development Finance Institutions (DFIs)*

*DFIs have always provided the impetus for economic development be it in the developed or developing countries. In Kenya, DFIs were specifically established to spearhead the development process by:*

*Availing credit funds to those venturing into commerce, tourism and industry.*

*• Assisting those wishing to venture into small-scale manufacturing enterprises.*

*• Assisting in the initiation and expansion of small, medium and large-scale industrial and tourist undertakings.*

*• Provide long-term lending (Project financing) to sustain economic development*

*• Provide Technical Assistance/Co-operation extension services*

*• Provision of special Financing and Support services to stimulate Private Sector to live up to its potential and create jobs and wealth, develop and expand indigenous skills*

*The existing framework has potential for disharmony as they fall under different regulators. For example ICDC/KIE are under the Ministry of Trade and Industry, IDB is under the Central Bank of Kenya and AFC the Ministry of Agriculture.*

*Premium and Other Financing*

*A number of premium finance companies have evolved in the Kenyan market. These companies offer financing to companies and individuals to meet insurance premium payments. This is clearly a financial service but is currently not regulated by any of the existing regulatory institutions. Similarly, there are other money lenders and financers who are totally unregulated. There is also need for regulation of leasing which is a developing financial service.*

*E- Banking and Mobile banking/ cash transfer*

*The advent of electronic banking has raised new concerns for banking regulation, specifically about security and privacy*

*Three Kenyan mobile telephone firms have ventured into m-banking- Yu, Zain and Safaricom. The services provided range from cash transfer to payment of bills to shopping. A number of banks also operate e- banking solutions where a customer may access his/ her account through the internet.*

*There exists a regulatory gap in mobile banking, especially when such services are being offered by telecommunication firms as opposed to mainstream financial institutions. There is a lack of a precise definition of the supervisory structure for mobile phone banking entities as regards customer protection, distinction between payments and deposits, and provision for cash deposits/ withdrawals by agents.*

*Worries about the security of electronic banking and e-money are an important barrier to their increased use. With electronic banking, you might worry that criminals might access your bank account and steal your money by moving your balances to someone else’s account. Indeed, a notorious case of this happened in 1995, when a Russian computer programmer got access to Citibank’s (USA) computers and moved funds electronically into his and his conspirators’ accounts. Private solutions to deal with this problem have arisen with the development of more secure encryption technologies to prevent this kind of fraud. However, because bank customers are not knowledgeable about computer security issues, there is a role for the government to regulate electronic banking to make sure that encryption procedures are adequate. Similar encryption issues apply to e-money, so requirements that banks make it difficult for criminals to engage in digital counterfeiting make sense.*

*Electronic banking also raises serious privacy concerns. Because electronic transactions can be stored on databases, banks are able to collect a huge amount of information about their customers—their assets, creditworthiness, what they purchase, and so on—that can be sold to other financial institutions and businesses. This potential invasion of our privacy rightfully raises customer concerns.*

*Problems in Regulating International Banking*

*Particular problems in bank regulation occur when banks are engaged in international banking and thus can readily shift their business from one country to another. Bank regulators closely examine the domestic operations of banks in their country, but they often do not have the knowledge or ability to keep a close watch on bank operations in other countries, either by domestic banks’ foreign affiliates or by foreign banks with domestic branches. In addition, when a bank operates in many countries, it is not always clear which national regulatory authority should have primary responsibility for keeping the bank from engaging in overly risky activities.*

*The difficulties inherent in regulating international banking were highlighted by the collapse of the Bank of Credit and Commerce International (BCCI). BCCI, which was operating in more than 70 countries, including the United States and the United Kingdom, was supervised by Luxembourg, a tiny country unlikely to be up to the task. When massive fraud was discovered, the Bank of England closed BCCI down, but not before depositors and stockholders were exposed to huge losses.*

*Cooperation among regulators in different countries and standardization of regulatory requirements provide potential solutions to the problems of regulating international banking. The world has been moving in this direction through agreements like the Basel Accords and oversight procedures announced by the Basel Committee in July 1992, which require a bank’s worldwide operations to be under the scrutiny of a single home-country regulator with enhanced powers to acquire information on the bank’s activities.*