UNCTAD/OSG/DP/132

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

Martin Brownbridge

No. 132

March 1998

The author thanks Samuel Gayi, Andrew Cornford, Richard Harrington, Charles Harvey and Saqib Jafarey for valuable comments, but accepts sole responsibility for all errors and the views expressed in the paper.

UNCTAD/OSG/DP/132

The opinions expressed in this paper are those of the author and do not necessarily reflect the views of UNCTAD. The designations and terminology employed are also those of the author.

UNCTAD Discussion Papers **are read anonymously by at least one referee, whose comments are taken into account before publication.**

Comments on this paper are invited and should be addressed to the author, c/o Editorial Assistant*, Macroeconomic and Development Policies, GDS, United Nations Conference on Trade and Development (UNCTAD), Palais des Nations, CH-1211 Geneva 10, Switzerland. Copies of the *UNCTAD Review*, *Discussion Papers* **and** *Reprint Series* **may also be obtained from this address. New** *Discussion Papers* **are available on the web site at: http://www.unicc.org/unctad/en/pressref/prdis.htm**

*** Tel. 022-907.5733; Fax 907.0274; E.mail: nicole.winch@ unctad.org**

JEL **classification: G280**

CONTENTS

* * * * *

ABBREVIATIONS

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

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

Martin Brownbridge

Office of the Special Coordinator for Least Developed Countries
United Nations Conference on Trade and Development (UNCTAD), Geneva

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

INTRODUCTION

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

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

---

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

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

I. GROWTH AND CHARACTERISTICS OF LOCAL BANKS IN AFRICA

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

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

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

---

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

Table 1

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

Country	Year	Banks	NBFIs
Kenya	1980	0	8
	1985	4	24
	1991	7	32
	1994	17 (25%)	35 (50%)
Uganda	1985	0	
	1991	4	

Country	Year	Commercial banks	Merchant banks
Nigeria	1980	3	1
	1985	7	7
	1994	33 (26%)	46 (68%)

...orts and miscellaneous: Uganda and Zambia;

...nbian figure for 1995 includes Meridien BIAO,
...e joint ventures between state governments