KENYA BANKERS ASSOCIATION
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POLICY BRIEF
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Promoting Banking Sector Stability through Appropriate Capital and Competition Policies

Executive Summary

Appropriate capital and competition policies have been emphasized both at the global and local levels through various interventions aimed at promoting banking sector stability. Evidence shows capital measures influences banking sector competition and stability conditions in Kenya. Monopolistic competition conditions remain persistent with few large banks dominating the sector. However, the sector remains stable, with considerable gain in long-term resilience. Enhanced capital requirement promotes stability and competition first, however significant increase in capital reduces competition. Therefore, interventions to promote banking sector stability should focus on implementing effective capital enhancement measures and appropriate competition conditions in the banking sector.

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Context

Globally, the aftermath of 2007-2009 global financial crisis witnessed significant focus on capital enhancement regulations. The revamping of capital aimed at enhancing banking sector competition and stability to mitigate against future financial crisis. Domestically, policy makers have over the years revised capital requirements for banks aimed at promoting stability in the banking sector. The proponents of enhanced capital regulation attempt to address the following structural banking sector issues in Kenya. First, the persistent high interest rate spread between banks' lending and deposit rate. This is largely occasioned by stickiness on deposit rate amidst rise in the lending rate driven by tightening monetary policy stance to stem out inflationary pressure and FX deprecation. Additionally, the high spread is also evidenced by interbank market tightening, posing policy concerns. Policies for enhanced capital requirements aim to trigger policy-led banking sector consolidation, creating bigger banks. Through benefits of economies of scale, the bigger banks will provide loans products at competitive rates leading to reduction in the lending rates and thus interest rate spreads.

Secondly, the persistent monopolistic competition conditions in the Kenya banking sector. The few big banks (tier 1 banks) have consistently dominated the market share despite Kenya having more than thirty licensed banks. Data shows 76.6 percent market share is controlled by only nine (9) banks categorized as large peer group (Tier 1) in 2023. The remaining market share is shared among the rest thirty (30) banks in medium (Tier II) and small (Tier III) peer group category (Table 1). Policies of increased capitalization requirements aim at leading to more banking sector consolidation, eliminating small and some medium banks which are perceived risky banks and creating competitive large banks. The big banks will have adequate resources to compete among themselves, hence reversing the declining competition levels in the Kenya banking sector. Thirdly, the elevated financial stability concerns. Despite, on overage Kenya banking sector remaining resilient over the last two decade, pockets of instability are still persistent. This is evidenced by elevated credit risks, amidst stagnation in profitability, raising long-term viability of the sector. This is evidenced by the declining profitability as shown by Return on Assets (ROA) and

Return on Equity (ROE) during the period 2006 – 2021. The significant decline in profitability leading to the banks' inability to build up reserves to support long-term bank growth (Table 2). Enhanced capital requirements aim at addressing these banking stability concerns by creating enough capital buffers to absorb any losses due to financial shocks.

***Table 1:* Trend of Banking Sector Market Share in Kenya**

Peer Group	Combined Weighted Market Share (%)	Number of Institutions	Combined Weighted Market Share (%)	Number of Institutions	Combined Weighted Market Share (%)	Number of Institutions
	2023		2013		2003	
Large (Tier 1)	76.695		2.4	6	80.81	3
Medium (Tier 2)	15.08		39.11	6	12.41	3
Small (Tear 3)	8.42	28	.5	21	6.61	7
Total 1	**00**	**39**	**1004**	**31**	**00.0**	**43**

***Table 2:* Selected Banking Stability Indicators**

	2006	2008	2010	2012	2013	2014	2016	2017	2018	2019	2020	2021
CAR (Total Capital)	17	18	21	22	23	19	19	18	19	19	19	20
CAR (Tier 1)	16	16	19	19	19	16	16	16	17	17	17	17
Gross NPLs to Gross Loans	21	8	6	5	5	5	9	11	12	12	15	14
Return on Assets (ROA)	3	3	4	4	4	3	3	3	3	3	2	3
Return on Equity (ROE)	29	29	31	34	29	27	25	21	23	21	14	22
Liquidity Ratio	45	37	45	42	39	38	41	44	49	50	55	56
Private Sector Credit Growth	12	29	20	11	20	22	5	3	2	7	8	9
Credit to Government Growth	53	3	13	64	(21)	15	30	8	(2)	9.7	43	28
Total Bank Credit as a Percentage to GDP	N/A	N/A	29	32	34	36	36	32	30	31	28	30

Policy Problem

Policy blind spots still exist on the role of capital in promoting banking sector competition and stability. There is still no unanimous evidence that increase in capital promotes banking sector competition and stability. This indicate there is no guarantee that, increase in capital requirement will yield the desired results in Kenya. Potentially, enhanced capital requirement may also lead to undesired results such as increased cost of doing business, largely driven by factors such as constrained loan book expansion, intensive equity raising activities and aggressive funding through deposits or debts. Additionally, capital requirement may lead to a rise in market entry barriers, exits and consolidation. These factors increase market power through concentration ultimately stifling competition. Stringent entry barriers for new banks coupled by policy driven consolidation may exacerbate financial stability risks through creating systemic banking distress amidst 'too big to fail' concerns. Against this policy objectives, this policy brief attempts to examine appropriate capital requirements for promoting banking sector competition and stability in Kenya.

Methods and Results

Results of a study examining the capital, competition and stability nexus, using annual bank-level data from 2001-2022 for 37 banks in Kenya, highlights the following key results. First, Kenya banking sector competition conditions is monopolistic.

This shows the few large banks still dominate the Kenya banking sector which account for almost 70 percent of the market shares. The remaining 30 percent is shared by the rest of the banks in medium and small categories. Secondly, on average the banking sector remains stable, with considerable gains in long-term resilience. Thirdly, an increase in capital promotes competition first, however significant increase in capital reduces competition. Fourth, an increase in capital promotes banking sector stability.

Policy Recommendations

To address the issue at hand policy makers may consider undertaking the following recommendations:

i. Adopting appropriate capital enhancement policy measures taking cognizance of its implication on competition and banking sector stability.
ii. Banks to adopt appropriate capitalization levels balancing profitability through balance sheet expansion and building capital buffers.

References

- Kiemo, S (2024). Capital, Competition and Stability Nexus in the Kenya Banking Sector. Kenya Bankers Association Working Paper series.

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