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Efficiency of financial market intermediation in Kenya: A comparative analysis

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Abstract

Wide interest margins as witnessed in Kenya are a sign of a repressed and inefficient financial sector. This paper carries out a cross-country analysis of the determinants of financial market efficiency using panel cointegration with a view to recommending policy options for improving the efficiency of the financial sector intermediation process in Kenya. The study finds that the major contributors to the differences in financial sector inefficiency in Kenya compared to the other countries in the study are high bank operating costs, default risk and financial market structure. The study recommends, among other measures, that the government through the Central Bank need to collaborate with the commercial banks and establish a working credit reference bureau to enable easy identification of credit worthy customers in order to reduce default risk; there is also need by the central bank to license more new banks to increase competition and reduce bank concentration. The study also recommends increased use of technology including phone-banking and e-banking to reduce operation costs of the banks. The paper concludes that contrary to the findings from other cross-country analysis, the factors that lead to financial market in/efficiency varies from one country to the other.

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1. Background

The ability of the financial market to efficiently allocate and reallocate loanable funds is critical for economic growth. When financial markets are efficient, the resultant competition among the financial institutions and reduced transaction and operation costs will imply higher deposit rates and lower lending rates as the financial institutions compete to attract borrowers and savers. If competition for instance is lacking in the market, there is a possibility that lending rates may be higher than the free market average and deposit rates will be lower than the free market rates. Would-be depositors will therefore not save as much. They may instead opt to consume and not save. This stifles savings mobilization and reduces funds available for investments and leads to misallocation of resources in the economy. On the other hand, investors will shy away from borrowing as the lending rates rise. Since the main role of financial institutions is to intermediate between the borrowers and lenders in the market, high lending rates and low deposit rates, and by implication, wide interest rate spreads, are indications of inefficient financial sector intermediation process. Interest rate spread is the difference between lending rates and deposit rates and has been used severally in literature to indicate the efficiency of the financial sector intermediation process (see for instance Demirguc-Kunt & Hiuzinga, 1997). Widening spreads therefore indicate increasingly inefficient financial market.

Discussions on interest rate spreads in Kenya have dominated many forums on economics and business in the recent past. The point is clear—lending interest rates in Kenya though have been falling from 2003 still remains very high while deposit rates are very low. This, as can be seen in Fig. 1 in Appendix B, has left interest rate margins relatively high and unchanged. At the gist of this discussion is the concern about the consequences that such high interest rates spreads have on economic performance of the country and on the welfare of the households and firms who must borrow to invest or save to consume in future. This concern puts to question the ability of the financial sector in Kenya to mediate efficiently between borrowers and lenders in the economy. The wide margins as witnessed in Kenya, is a sign of financial sector repression, which compromises the financial sector's role in the intermediation process of deposit mobilization and credit creation. The other concern is the implication of such wide margins on Kenya's global competitiveness. The commercial banks in Kenya levy over 12 percentage points spread between the deposit and lending rates as opposed for instance to 3.7% in South Africa, 3% in Singapore and 1% in Korea (Banking Survey, 2007). These differences jeopardize Kenya's international competitiveness as international competitors are at an advantage of at least 4% points in their cost of production against their Kenyan counterparts. A comparison of some of the fundamental determinants of interest rates with those of other countries shows no significant differences. For instance, banking sector concentrations in South Africa and Egypt are almost similar to Kenya's yet interest margins in the two countries are much lower than in Kenya. The questions that come to mind therefore are 'why are interest margins so wide in Kenya compared to the other countries and what are the driving factors?' In light of these concerns, it is important therefore to examine the relative importance of the determinants of interest rate margins in Kenya vis a vis those of other countries to determine the factors that explain the high margins and are specific to Kenya and not the other countries. Studies on interest rate margins in Kenya like Ndung'u and Ngugi (2000) have not analyzed cross-country differences in the financial sector determinants of interest rates spreads to establish whether the determinants significantly differ across countries. In addition, Ndung'u and Ngugi (2000) did not capture the influence of non-performing loans (credit risk), market power or structure, and the transaction costs which are very important variables in explaining the financial market efficiency. This study, in addition to filling this knowledge gap, attempts to inform policy

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