AN EXAMINATION OF THE KENYAN REGULATORY FRAMEWORK IN PROMOTING TOO BIG TO FAIL IN RELATION TO MERGERS IN THE BANKING SECTOR

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DECLARATION

I, **NGUGI SAMUEL THEURI**, do hereby declare that this research is my original work and that to the best of my knowledge and belief, it has not been previously, in its entirety or in part, been submitted to any other university for a degree or diploma. Other works cited or referred to are accordingly acknowledged.

Signed: ..............S.T.N..

Date: ....3/3/2021.......................................

This dissertation has been submitted for examination with my approval as University Supervisor.

Signed: ....

Mr. Marvin Oliech

DEDICATION

I dedicate this work to my parents, Mr. Elias Ngugi and Mrs. Isabel Ngugi, who have loved me abundantly and dedicated their lives to ensuring I have a wholesome life. I also dedicate this work to my siblings, from those who have paved the way for me and to those I pave the way for: Joseph Ng'ang'a, Gertrude Wamaitha, Mary Mumbi and Ikinya Kambo for their constant motivation. I also dedicate this work to everyone else who uttered a prayer for me and shared words of wisdom with me, I am deeply grateful.

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// ABSTRACT
ABSTRACT

Kenya's banking industry has witnessed a surge in mergers over the past decade as globalization continues to soar. The appetite for growth by financial institutions is expected to rise due to positive trade environment providing wider market access and potential revenue streams. In late 2020 and 2021 alone, the African Continental Free Trade Agreement was partly operationalized, Kenya signed a Kenya - UK Free Trade Agreement and is negotiating a trade agreement with the USA.

As a country's financial system is the backbone of its economy, it is pertinent to examine the soundness of Kenya's regulatory system and its role in promoting the growth of systematically important banks that have the potential of 'tanking' the entire economy, should they fails, as witnessed in the 2008 financial crisis; this will form the subject matter of this research. The study examines the effectiveness of the Kenyan regulatory framework in creating a sound environment to protect the financial system against the dangers of systematically important banks. The study also aims to assess the impacts of TBTF banking institutions on an economy and assess the challenges regulators face with regards to protecting the interests of the nation against the effects of these banks failure. Additionally, this paper will explore the available measures in regulating Too-Big-To-Fail banks providing recommendations based on research findings. This research also encompasses a study that aspires to identify what leads to bank mergers. The research design is purely qualitative and data was collected on a desk review process from primary and secondary sources; legislation to published report, journals, books and internet resources. The study hypothesis was that bank mergers are a cause for the growth of TBTF banks and the Kenyan regulatory framework is not adequate in governing TBTF banking institutions. The research supports the views that bank mergers are a major cause of TBTF banks and that the regulatory framework has failed to identify this issue whilst monitoring bank mergers. The study recommends strict merger regulations, systemic tax and limiting bailouts and the size of the banks aimed towards regulating growth of, and managing TBTF banks.

LIST OF ABBREVIATIONS

CAK	Competition Authority of Kenya
CBA	Commercial Bank of Africa
CBK	Central Bank of Kenya
CMA	Capital Markets Authority
COMESA	Common Market for East and South Africa
EAC	East African Community Central Bank of Kenya
NCBA	NCBA Bank Kenya Plc.
NIC	National Industrial Credit
SIFI	Systematically important financial institutions
TBTF	Too-Big-To-Fail

CHAPTER 1: INTRODUCTION

1.1. BACKGROUND

"*I sincerely believe that banking establishments are more dangerous than standing armies, and that the principle of spending money to be paid by posterity, under the name of funding, is but swindling futurity on a large scale*." Thomas Jefferson.

The primary purpose of finance is to facilitate productive economic activity.[1] Consequently, various types of financial institutions have emerged over the years to provide financial services including deposit- taking, credit provision, investment among others.[2] Banks are considered the oldest and most common category of financial institutions and may categorized into retail banks, commercial or corporate banks and investment banks.[3]

Important to note is that financial institutions primarily strive to act in their best interest and those of its shareholders by maximizing profits.[4] This notion was enounced by Milton Friedman when he published an article in the New York Times Magazine entitled 'The Social Responsibility of Business is to Increase its profits.'[5] In this article Friedman argued that it was the sole objective of firms to increase profits for their shareholders by growing and expanding their capital, liquidity and profit ratios.[6]

As financial services play a pivotal role in any economy coupled with their drive to make profit, they make a good case for regulatory intervention and this is where legal and regulatory frameworks come in handy.[7] The goals of such financial regulation include investor protection, consumer protection, financial stability, market efficiency, fair competition, prevention of financial

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[1] Mwega F, 'Financial regulation in Kenya: Balancing inclusive growth with financial stability' Overseas Development Institution, Shaping policy for development, Working paper 407, 2014, 11.

[2] Benston G, 'Economies of Scale of Financial Institutions' 4(2) *Journal of Money, credit and Banking,* 1972, *320.*

[3] Armour *et al, Principles of financial regulation*, 23.

[4] Zeb S and Sattar A, 'Financial Regulations, Profit Efficiency and Financial Soundness: Empirical Evidence from Commercial Banks of Pakistan' 56(2) *The Pakistan Development Review*, 2017*, 90.*

[5] Friedman M, 'A Friedman doctrine: The Social Responsibility of Business is to increase its profits' The New York Times 13 September 1970, 17.

[6] Friedman M, 'A Friedman doctrine: The Social Responsibility of Business is to increase its profits' The New York Times 13 September 1970, 17.

[7] Merton R, 'Financial innovation and the management and regulation of financial institutions' 19(3-4) *Journal of Banking and Finance*, 1995, 465.

crimes and fairness.[8]

The "Too-Big-to-Fail" (TBTF) doctrine is a widely accepted hypothesis that argues that large firms benefit from implicit bail-out guarantees because no government is willing to hazard the consequences of a large bank's default on a financial system and on the economy.[9] It emerged primarily in the US under the Roosevelt administration as a policy for protecting uninsured depositors in large bank failures in order to prevent adverse effects of the financial system.[10] It was further popularized in the 2008 financial crisis with the cases of Bear Stearns, Goldman Sachs, Morgan Stanley and the Lehman Brothers.[11]

The lure for "size" embedded in "economies of scale" have important risk consequence and results in the growth of industrial and financial firms to sizes that may be both too large to manage and losses too large to bear.[12] This is the case for industrial giants such as Exxon Mobil, General Motors, General Electric and Royal Dutch Shell that have grown into a complex and diversified global enterprises with extremely large risk externalities.[13] This is also the case for large banks that bear risks with systemic consequences in an economy such as JP Morgan, Chase, Deutsche Bank, Bank of China and Bank of America among others.[14] For such large entities, their size provides a safety net and a guarantee by public authorities that whatever their policy, their survivability is assured at the expense of public funding through government bailout.[15] The strategic pursuit of economies of scales can therefore be misleading, based on fallacies that negate the risks of size, lack of accountability for latent and dependent risks, their moral hazard and significant risk externalities.[16] TBTF institutions are also referred to as SIFI (Systematically

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[8] Armour J, Awrey D, Davies Enriques L, Gordon J, Mayer C, & Payne J, *Principles of financial regulation,* 3rd ed, Oxford University Press, London, 2016, 22.

[9] Barth A and Schnabel I 'Why banks are not too big to fail – evidence from the CDS market' 28 (4) *Oxford University Press,* 2013, 337.

[10] Dabos M, *Too big to fail: Policies and practices in government bailouts,* Greenwood Publishing Group, Westport, 2004, 141.

11 Moosa Imad 'The Myth of too big to fail' 11(4) *Journal of Banking Regulation, 2010, 321.*

[12] Ijiri Y and Simon H, *Skew distributions and the size of business firms,* North Holland Publishing Company, New York, 1977, 24.

13 Moosa Imad 'The Myth of too big to fail'*, 321.*

[14] Moosa Imad 'The Myth of too big to fail', *322.*

15 Bouchaud J. P and Potters M, *Theory of Financial Risks and Derivatives Pricing, From Statistical Physics to Risk Management*, 2nd Ed., Cambridge University Press, 2003, 12.

16 Bouchaud and Potters, *Theory of Financial Risks and Derivatives Pricing, From Statistical Physics to Risk Management*, 12.

important financial institution).

Closer home, Kenya has several industries that have been "accorded" the TBTF status and their failure resulted in governments' intervention. Most notably, Kenya Airways (KQ) required significant government intervention through bailouts and governance.[17] In the Banking industry, the desire to amass economies of scale can be evidenced by the prevalence of mergers of financial institutions.[18] The Central Bank of Kenya, the main regulatory institution governing banks in Kenya, classifies banks according to Tiers based on their weighted index; notably, Tier 1 banks are considered TBTF.[19]

Consequently, this research suggests that the legal framework governing the mergers of banks is a potential catalyst for creation of TBTF banks and provides measures that may govern such growth aimed at curbing the negative effects of TBTF.

1.2. STATEMENT OF PROBLEM

It is expected that legislation and its implementation through relevant institutional framework results in proper governance of banks by ensuring that licensed banks adhere to principles of healthy banking including capital adequacy, asset quality, proper management, protected earnings, liquidity and discerning market risk without much supervision.[20] However, this does not appear to be the case as envisioned by legislators and policy makers as banks are still plagued by issues of corruption, mismanagement, misappropriation and a plethora of other reasons concerning transparency and accountability.[21] It follows that TBTF banks face the same kind of challenges but pose more adverse consequences to the economy due to their integral role and extensive scale in an economy. Consequently, there is an urgent need to mitigate the growth of TBFT banks and the

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[17]Wafula B, 'Troubled KQ gets Kshs. 4.2billion from government' Citizen Digital, 2nd September 2015 https://www.google.com/amp/s/citizentv.co.ke/business/troubled-kq-gets-ksh-4-2-billion-from-government-99682/%3famp on 10th September 2020.

[18] Chepngenoh F and Muriu P 'Does Risk-Taking Behavior Matter for Bank Efficiency' 3(4) *Journal of Economics and Business*, 2020, 1550.

[19] Halima R and Wepukhulu J 'Effect of Financial Innovation on Financial Perfomance of Tier One Commercial Banks in Kenya' 3(6) *International Academic Journal of Economics and Finance*, 2020, 182.

[20] Hartmann P, Straetmans S and De Vries C, 'Banking System Stability: A Cross-Atlantic perspective' National Bureau of Economic Research, Working Paper 11698, 2005, 12.

[21] Gichuki J, Oduor J and Kosimbei G, 'The choice of optimal monetary policy instrument for Kenya' 1(9) *International Journal of Economics and Management Science,* 2012, 10.

potential risk they pose to Kenya's economy.

Drawing from the above, this study investigates regulations enabling banks to grow both in size and complexity thus ultimately achieving TBTF status. Further, it evaluates the current legal framework and its efficiency in preventing the negative externalities caused by TBTF banks in the event of a financial crisis.

1.3. STATEMENT OF AIM & OBJECTIVES

The primary aim of this study is to understand the role of the Kenya's regulatory framework in promoting growth of TBTF banks. Further, this research aims to ascertain:

a. Whether bank mergers are a cause of banking institutions attaining TBTF status.
b. The role of the regulatory framework in promoting bank mergers.
c. The impacts of TBTF banking institutions in an economy.
d. Reforms to limit the growth of TBTF banking institutions.

1.4. RESEARCH QUESTIONS

a. How are bank mergers a major cause of banking institutions to attain TBTF status?
b. How does the Kenyan regulatory framework promote bank mergers?
c. What are the impacts and effects of TBTF banking institutions?
d. What reforms can be proposed to limit the growth of TBTF banking institutions?

1.5. SIGNIFICANCE OF THE STUDY

Studies have proven that TBTF policy was at the core of the 2008 financial crisis.[22] In Kenya, there is has been a surge of bank mergers and it is predicated that more mergers are yet to occur.[23] The purpose of this study is to investigate the cause of TBTF banks, examine the role of regulation in promoting the growth of TBTF banking institutions, how the size and risk externalities may be too big to bear— in which case a firm may be too big to fail. Such firms are "polluters" either by design when they overleverage their financial bets or speculative positions and are struck by a Black Swan.[24] A Black Swan is an unpredictable event that is beyond what is normally expected

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[22] Wallison P, 'Cause and effect: government policies and the financial crisis' 21(2-3) *Critical Review, 366.*

[23] Mori A and Tomotsun A, 'Overview of Mergers and Acquisition in Kenya' Lexology, 21st October 2020 https://www.lexology.com/library/detail.aspx?g=42e12f87-5438-4ed7-94dc-93b7a64a76a9 on 10th November 2020.

[24] Taleb N, *The Black Swan: The Impact of the Highly Improbable,* Penguin Books Publishing Company, London,

of a situation and has potentially severe consequences.[25]

1.6. RESEARCH METHODOLOGY

The research will employ a qualitative research technique through conducting extensive analysis of literature. It will use primary sources including the Constitution of Kenya, legislation and policies which will provide the legal and institutional framework in relation to the subject and a brief case study of the CBA-NIC merger. Further it will employ secondary sources such as articles, books, journals, case law, newspapers and online internet resources. The said approach is advantageous as it is both cost and time efficient. Notably, the study will not involve any fieldwork due to timelines set for the completion of the study.

1.7. LITERATURE REVIEW

The term TBTF dates back to 1984 following a statement made by the U.S Comptroller of the currency in relation to the failure of U.S. bank continental Illinois in reference to the size of the large U.S. money centers that caused financial instability due mandating government intervention.[26] Since then, the TBTF doctrine has evolved and birthed several areas of studies on the effect of systematically relevant banks such as government exposure, creation of moral hazard where market discipline is distorted as taxpayers bears the externalities of bank risk taking behavior, among others. [27] More recently, the 2007-2008 financial crisis was instrumental in shedding the spotlight on the risks of TBTF thus motivating a wave of research on the area.[28]

The proponents of TBTF argue that the existence of systematically important banks is necessary for an economy and should therefore be freely allowed to exist.[29] Such advantages include cheaper loans, market diversity and public confidence. [30]At the core of their argument is the idea that TBTF

2008, 12.

[25] Taleb N, *The Black Swan: The Impact of the Highly Improbable,* Penguin Books Publishing Company, London, 2008, 12.

[26] Moenninghoff S, 'Consequences of Government Guarantees for Banks – A survey of the the TBTF doctrine' 6 (23) *Journal of Governance and Financial Regulation*, 2018, 1.

[27] Moenninghoff S, 'Consequences of Government Guarantees for Banks – A survey of the the TBTF doctrine' 2018, 1.

[28] Umlauft T 'The paradoxical genesis of Too-Big-To-Fail: How Distrust Towards Banks led to TBTF' Explorations in Financial History Working Paper 1, 2013, 1.

[29] Omondi G and Orwaru J, 'Bank Size and Financial Stability of Commercial Banks in Kenya: Empirical Evidence' 7(1) *Journal of Emerging Issues in Economies, Finance and Banking, 2018, 2669.*

[30] Moenninghoff S, 'Consequences of Government Guarantees for Banks – A survey of the the TBTF doctrine' 8.

banks should not be allowed to fail due to the immediate and ripple effect on other institutions, the real economy and global relations thus warranting government intervention as a necessary action.[31] However, the opponents of the TBTF doctrine opine that government intervention may seem like an attractive idea but the long-run financial costs are higher.[32] Further, the doctrine negatively influences policies around competition, market risk- behavior among others.[33]

Goodlet Clyde in his article 'Too Big to Fail: A Misguided Policy in Times of Financial Turmoil' highlights the inevitability of bank failures, the benefits of, and challenges of TBTF policy in the context of the USA and Canada.[34] He conducts and in depth analysis of the 2008 financial crisis and provides evidence which backs up the idea that existence of TBTF policy tends to be engrained in financial systems at both a policy level by governments engaging in bailouts and legislative level where governments avoid regularization of TBTF banks on the basis of free market principles.[35] In the end, Clyde finds that despite the numerous benefits, TBFT policy neither creates a stable nor efficient economy and further the policy results in huge financial and market losses.[36]

In Kenya, Odundo Geoffrey and Orwaru James explore the impact of the growth of banks to TBTF status on the bank's financial stability. The research employs quantitative method, correlation design technique, in analyzing 10 publicly-listed banks including Kenya Commercial Bank of Kenya, Equity Bank, Cooperative Bank, I&M Bank amongst others .[37] Relevant to this research, the study found that bank size has a negative effect on the stability of a bank due to the high-risk decisions taken by such TBTF banks premised on assured government guarantees. [38]

This research will provide a Kenyan context to studies conducted by the likes of Clyde. Further it will build on Odundo's and Orwaru's research by looking at the cause of TBTF and its impact on

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[31] Labonte M 'Systematically important or "Too Big To Fail" Financial Institutions', 2(56) *Congressional Research Service*, 2014

[32] Umlauft T 'The paradoxical genesis of Too-Big-To-Fail: How Distrust Towards Banks led to TBTF' 1.

[33] Labonte M 'Systematically important or "Too Big To Fail" Financial Institutions', 2(56) *Congressional Research Service*, 2014

34 Goodlet C, 'Too Big to Fail: A Misguided Policy in Times of Financial Turmoil' 1(311), *C.D Howe Institute,* 2010, 1.

35 Goodlet C, 'Too Big to Fail: A Misguided Policy in Times of Financial Turmoil' *22*.

36 Goodlet C, 'Too Big to Fail: A Misguided Policy in Times of Financial Turmoil' 27.

37 Omondi G and Orwaru J, 'Bank Size and Financial Stability of Commercial Banks in Kenya: Empirical Evidence' 2672.

38 Omondi G and Orwaru J, 'Bank Size and Financial Stability of Commercial Banks in Kenya: Empirical Evidence' 2678.

not only financial stability of individual banks but the wider externalities of TBTF policy on the economy.

1.8 THEORETICAL FRAMEWORK

This study relies on positive theories of law which examine why regulation occurs and the need for such regulation.[39] The aforesaid theories of regulation include theories of market power, interest group theories that describe stakeholders' interests in regulation and theories of government opportunism that describe why restrictions on government discretion may be necessary for a sector to provide efficient services for customers.[40] In general, the conclusions of these theories are that regulation occurs because the government is interested in aligning banks' interest with the government's interest, customers desire protection from market power when competition is non-existent or ineffective, banks desire protection from rivals, or banks desire protection from government opportunism.[41]

Hobbes, a social contractarian, believed that the law had peoples' implied consent and society was formed from a state of nature to shield persons from the state of war that would exist otherwise.[42] In *Leviathan*, Hobbes maintains that without an ordered society life would be chaotic. According to Austin and Bentham, a sovereign governs society through de facto authority.[43] Laws come through the sovereign's authority, defined by Austin and Bentham as orders backed by sanctions for non-compliance.[44] The law is made up of primary rules and secondary rules said Hart, primary rules demand individuals to act or not act in certain ways and create duties for the governed to obey whereas secondary rules are rules that confer authority to create new primary rules or modify existing ones.[45] Secondary rules are then divided into rules of adjudication; how to resolve legal disputes, rules of change; how to amend laws and the rule of recognition; how laws are recognized

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39 Pojanowski J, 'Redrawing the dividing lines between natural law and positivism(s)' 101(4), *Virginia Law Review,* 2015, 1025.

40 Krecke E, 'Posnerian Economic Analysis of Law and Kelsenian legal positivism: How similar are they?' 23(3) *History of Economic Ideas*, 2015, 165.

41 Beck T, Demirgüç-Kunt and Levine R, 'Legal Theories of Financial Development' 17(4) Oxford Review of Economic Policy, 2001, 490.

42 Hobbes T, *The Leviathan*, Penguin Books, Baltimore,1968, 79.

43 Hobbes, *The Leviathan*, 79.

44 Austin J, *The province of jurisprudence determined*, Cambridge University Press, New York, 1995, 18.

45 Hart H.L.A., *The Concept of Law*, Claredon Press, Oxford 1961, 81.

as valid.[46]

In instances where TBTF banks fails, the necessary consequence includes bailout at the expense of the taxpayer in order to cushion austerity and hardship that results from the bank's network.[47] The moral obligation for financial intervention promotes risky practices rather than deter the practices because the bank knows that there is a safety net for them. Consequently, there is need for regulation of banks from attaining TBTF status.

1.9 HYPOTHESES

The research is based on the following hypotheses:

1. That bank mergers are a cause for growth of TBTF banks
2. That the prevailing Kenyan regulatory framework is not adequate in governing TBTF banking institutions.
3. That TBTF pose a huge threat to the financial system.

1.10 CHAPTER BREAKDOWN

a. Chapter 1 - Introduction

This chapter provides a background to the study, the statement of the problem, the literature review, the objectives and questions, the hypothesis, the conceptual framework and the methodology of the study.

b. Chapter 2 – Legal Framework governing banks in relation to mergers

This chapter introduces the regulatory framework governing banks with specific focus on regulation of bank mergers.

c. Chapter 3 – Case study of NCBA Bank Kenya

Chapter 3 will briefly analyze the case of the NCBA bank with the aim of demonstrating how bank mergers result in the growth of TBTF institutions. The aim of the chapter is to expound the problem as introduced in chapter one by drawing a link between bank mergers and the growth of TBFT banking institutions.

d. Chapter 4 – Effect and impact of TBTF banks

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[46] Hart, *The Concept of Law*, Oxford University Press, 81.

[47] Moosa Imad 'The Myth of too big to fail' 321.

This chapter will delve into a discussion on the impact of TBTF banking institutions based on Kenya's and other jurisdiction's experience.

e. Chapter 5- Recommendations and conclusion

This final chapter will conclude the arguments in this research and provide recommendations for better management of growth of banks and TBTF banks.

CHAPTER 2: LEGAL FRAMEWORK GOVERNING BANKS IN RELATION TO BANK MERGERS

2.1 HISTORY OF REGULATION OF BANKS IN KENYA

The financial journey dates back to pre-colonial Kenya when Indian money lenders provided quasi bank services.[48] From colonization to gaining of independence, the banking sector faced various changes that mirrored Kenya's political and economic transformation.[49] Pre-independence, the industry was characterized by foreign-owned banks whereas post-independence, the industry witnessed growth of state owned banks and an increase in banks and other non-bank financial institutions during the first and second president's terms respectively.[50]

The post-independence government prioritized establishment of the Central Bank of Kenya (CBK) in 1966 and in the same year introduced Kenya's first currency.[51] Additionally it aimed to;[52]

a. Create the local banking sector by establishing state owned community banks and buying shares in existing banks; and
b. Establish specialized credit institutions or development finance institutions.

The government then embarked on establishing local owned banks without nationalization of the financial sector which promoted foreign investment.[53] However, the growth of the banking industry was characterized by ill factors such as low regulatory barriers, political interference which subverted prudential criteria in the awarding of licenses as many banks had prominent politicians on their boards thus using their network to obtain public sector deposits cheaply, and the Central Bank of Kenya had very little capacity to supervise the growth of non-bank financial institutions. Consequently, about 12 banks during the 1980's failed.[54]

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[48] Martin D., 'The Transition in Smallholder Banking in Kenya: Evidence from Rural Branch Bank Loans' 16(1) *The Journal of Developing Areas*, 1981, 72.

[49] FSD Kenya, *Kenya's Financial Transformation*, 2015, 7.

[50] FSD Kenya, *Kenya's Financial Transformation*, 2015, 8.

[51] Tyce M 'The Politics of Central Banking in Kenya: Balancing Political and Development Interest' Manchester: Effective States and Inclusive Development Research Center, ESID Working Paper 130, 2020, 12 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3523035 on 5th December 2020.

[52] Tyce M 'The Politics of Central Banking in Kenya: Balancing Political and Development Interest', 14 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3523035 on 5th December 2020.

[53] Gichuki J *et al*, 'The choice of optimal monetary policy instrument for Kenya' 9.

[54] Gichuki J, Oduor J and Kosimbei G, 'The choice of optimal monetary policy instrument for Kenya' 11.

In 1985, the Banking (Amendment) Act was enacted in an attempt to rectify the deficiencies suffered during this period by the financial sector.[55] The aforesaid Act gave more legal powers to regulatory authorities; the CBK was mandated with licensing authority through the minister's approval.[56] Additionally, the Deposit Protection Fund was established in 1986 and prudential guidelines were revised to encourage self-regulation and further enhance corporate governance, capital adequacy, risk clarification of assets and overall risk management of the banking sector.[57]

Currently, the banking in Kenya is regulated by various legislations including the Constitution of Kenya (CoK) 2010, the Central Bank of Kenya Act (2015), the Central Bank Prudential Guidelines, the Banking Act (2015), the Microfinance Act (2006), the National Payment System Act (2011), the Kenya Deposit Insurance Act (2012), the Competition Act (2010) and the Capital Markets Act (Chapter 485 A). These laws and regulations govern banks, bank accounts, bank transactions amongst others.

Notably, the Central Bank of Kenya guidelines, 2015, highlights the following objectives of the CBK:[58]

a. Prudential measures aimed at reducing the level of risk exposure for depositors;
b. Systemic risk reduction aimed at managing the risk of disruption resulting from adverse trading conditions for banks causing multiple or major bank failures;
c. Avoid misuse of banks which involves setting sound monetary policies in order to avoid crimes such as money laundering which has become a rampant globally; and
d. Protection of confidentiality of depositors.

[55] Barako D and Tower G, 'Corporate Governance and bank performance: Does ownership matter? Evidence from the Kenyan banking sector' 4(2) *Virtus Interpress*, 2007, 134-135.
[56] Barako D and Tower G, 'Corporate Governance and bank performance: Does ownership matter? Evidence from the Kenyan banking sector' 134-135.
[57] Barako D and Tower G, 'Corporate Governance and bank performance: Does ownership matter? Evidence from the Kenyan banking sector' 135.
[58] Barako D and Tower G, 'Corporate Governance and bank performance: Does ownership matter? Evidence from the Kenyan banking sector' 135.

2.2 BANK MERGERS

As a prerequisite to the analysis of regulation governing bank mergers, this section will define mergers, discuss their causes and the role they play in the creation of Too-Big-To-Fail (TBTF) banks.

a. Definition of a merger

The Competition Act, 2010, is the instructive law on mergers in Kenya. Specifically, it provides that a merger occurs when one or more undertakings acquire or establish a direct or indirect control over the whole or part of the business of another undertaking.[59] The legislation provides different ways in which a merger occurs including share and asset purchases, obtaining of controlling interest, vertical integration, share swaps, amalgamations, takeovers amongst others.[60] Additionally, the Act established the criteria for determining control of another undertaking; for example beneficial ownership of more than one half of shares, assets or business of the said undertaking. [61]

b. Why bank mergers?

Globally, the last decade has witnessed the reshaping of several industries through mergers. Notably, the surge in mergers within Kenya's banking industry may be attributed to the following reasons:

i. Globalization and deregulation of trade barriers

As economies desire to expand trade and market access, governments have introduced favorable legislation and eliminated stringent trade restrictions with the aim of liberalizing trade, diversifying markets and increasing geographical reach.[62] Notably, trade in Africa is set to increase due to the operationalization of certain aspects of the African Continental Free Trade Agreement on 1st January 2021.[63] Consequently, banks gain access to global markets and increased competition resulting in merging.

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59 Section 41 (1), *Competition Act* (Act No. 12 of 2010).
60 Section 41 (2), *Competition Act* (Act No. 12 of 2010).
61 Section 41 (2), *Competition Act* (Act No. 12 of 2010).
62Arestis P, Chotareas E and Pelagidis T 'Trade flows revisited: further evidence on globalization' 36(2) *Cambridge Journal of Economics*, 2012, 487.
63 Kuwonu F, 'Africa's free trade areas opens for business' United Nations: Africa Renewal, 7th January 2021 https://www.un.org/africarenewal/magazine/january-2021/afcfta-africa-now-open-business on 10th January 2021.

ii. Peer bail-outs

Peer bail-outs refers to the practice amongst banks to acquire its peers under receivership. [64] A common example is chase bank which was placed under receivership by the CBK on 7th April 2016 and thereafter acquired by the State Bank of Mauritius. [65]

iii. Competition

The competitive nature of the financial sector has caused several banks to merge with aim of reducing their operational costs and increasing market share by merging with other competitors in the industry.[66]

iv. Synergy

Synergy may be classified into managerial synergy and operational synergy; operational synergy refers to combining activities, product and markets of the merging firms whereas managerial synergy exists where one of the banks has managerial problems and the other possesses superior monitoring and planning abilities hence replacing the management of the other firm due to its inefficiencies.[67] They are both aimed at maximizing value .[68]

c. How do bank mergers create TBTF banks?

As discussed, mergers result in the acquiring undertaking obtaining more assets, shares or other forms of control thus increasing market access. From a business perspective, such decisions are largely motivated by desire to increase profitability of the bank's business through increased efficiency in banking operations and wider geographical footprint.[69]Additionally, banks desire to attain TBTF status as it comes with certain implicit and explicit government guarantees as

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[64] Gathaiya R, 'Analysis of issues affecting collapsed banks in Kenya from year 2015 to 2016' 7(3) *International Journal of Management and Business Studies*, 2017, 10.

[65] Gathaiya R, 'Analysis of issues affecting collapsed banks in Kenya from year 2015 to 2016' 11.

[66] Bishnoi T and Devi S, 'Mergers and Acquisitions of Banks in Post-Reform India' 50 (37) *Economic and Political Weekly,* 2015, 54.

[67] Boley B and Uysal M, 'Competitive synergy through practicing triples bottom line sustainability: Evidence from various case study' 13(4) *Tourism and Hospitality Research,* 2013, 229.

[68] Bishnoi T and Devi S, 'Mergers and Acquisitions of Banks in Post-Reform India', 55.

[69]Shull B, 'Too big to fail in financial crisis: motives, countermeasures and prospects' Levy Economic Institute, Working paper Number 601, 2010, 11, < https://www.econstor.eu/bitstream/10419/57000/1/629700370.pdf> on 10th December 2020.

witnessed in the 2008 financial crisis where governments across USA and Europe bailed out several financial institutions.[70] Consequently, increase in financial strength invites political and legislative networks due to acquired influence affording such banks the advantage of deregulation.[71] Bank mergers need to be allowed sufficient time to materialize for them to show their significance through improvements in concentration of funds and profitability.[72] This can only be viewed from studying long term effects of the merger rather than the short term effects..

2.3 LAWS AND INSTITUTIONS GOVERNING BANK MERGERS

Like most industries, the banking industry is regulated by the government in order to protect consumers.[73] The main laws that regulate bank mergers in Kenya are :Banking Act ,Capital Markets Act, Companies Act, Competition Act, East African Competition Act and the COMESA Competition Rules. For most of these legal frameworks, a regulatory framework has been established.

a. Competition Act and the Competition Authority of Kenya (CAK)

This is the primary legislation governing mergers in Kenya; it provides that no person may implement a proposed merger without approval of the Competition Authority of Kenya (CAK) and further mandates parties to a merger to comply with any conditions as provided by the CAK.[74]

Parties submitting to undertake a merger have to notify the CAK in writing.[75] However, it is important to note that approval by them does not relieve the concerned entities of the obligations to comply with any other applicable laws.[76] The CAK after being notified of the merger proposed,

[70] Spagnolo G, Carletti E, Ongena S and Siedlarek J, 'The impacts of stricter merger legislation on bank mergers and acquisitions: Too-Big-To-Fail and competition' Centre for Economic Policy Research, Financial Economics and Industrial Organisation Discussion Paper DP 14449, 2020, 16, https://scholar.google.com/scholar?hl=en&as_sdt=0%2C5&q=Mergers+and+creation+of+Too+big+too+Fail&btnG=#d=gs_qabs&u=%23p%3DOMrYl4Z64XEJ on 7th December 2020.

[71] Spagnolo G, Carletti E, Ongena S and Siedlarek J, 'The impacts of stricter merger legislation on bank mergers and acquisitions: Too-Big-To-Fail and competition' 18.

[72]Shull B, 'Too big to fail in financial crisis: motives, countermeasures and prospects', 12.

[73] Mutuku N, 'Case for Consolidated Financial Sector Regulation in Kenya'RBA Research Papers, 2011, 16.

[74] Section 42(2), *Competition Act* (Act No. 12 of 2010).

[75] Section 43, *Competition Act* (Act No. 12 of 2010).

[76] Section 49(1), *Competition Act* (Act No. 12 of 2010).

they are required to review and make a determination within sixty days from the date of notification.[77]

If the parties proposing to merge provide materially incorrect or misleading information, or fail to comply with the material information, the Authority may revoke its decision approving implementation.[78] Parties that are not satisfied with the decision of the Authority may submit their grievances to the Competition Tribunal.[79] If dissatisfied with the decision of the Tribunal, they may take their case to the high court, whose decision will be final.[80]

b. *Companies Act and the Registrar of Companies*

The 2015 act part XXXV provides a framework of handling mergers and acquisitions of public companies. The directors of companies that are merging need to prepare terms of the scheme of the proposed merger with information about their share of exchange ratios, particulars, and amount of cash to be paid.[81] The directors of each merging parties are required to lodge the terms of proposed merger with the Registrar of Companies.[82]

c. *Capital Markets Act and the Cabinet Secretary for Finance*

This Act regulates Public Companies listed on the Nairobi Securities Exchange including commercial banks.[83] Section 12 of the Act gives power to the Cabinet Secretary for Finance to make regulations necessary to regulate various aspects of the capital market in Kenya. Hence, the Capital Markets (Mergers and Takeovers) Regulations were made. The CMA regulations guide the parties on information to be provided to various agencies during the merger and lays out the obligations of the parties during the merger.[84]

[77] Section 44, *Competition Act*, (Act No. 12 of 2010).
[78] Section 47, *Competition Act* (Act No. 12 of 2010).
[79] Section 48, *Competition Act* (Act No. 12 of 2010).
[80] Section 49(2), *Competition Act* (Act No. 12 of 2010).
[81] Section 934, *Companies Act*, (Act No. 17 of 2015).
[82] Section 935, *Companies Act*, (Act No. 17 of 2015).
[83] Nanyama M.M, 'Evaluating the Legal Framework Governing Mergers and Acquisitions of Commercial Banks in Kenya,' Unpublished LLM Thesis, University of Nairobi, Nairobi, 2017, 35.
[84] Nanyama M.M, 'Evaluating the Legal Framework Governing Mergers and Acquisitions of Commercial Banks in Kenya,', 35.

d. The Banking Act, the Central Bank of Kenya and the Cabinet Secretary for Finance

The institutions that are licensed under the Banking Act shall not amalgamate, transfer their assets or liabilities without the approval of the Cabinet Secretary for Finance.[85] Section 33(4) of the Banking Act, confers power to the Central Bank of Kenya to issue guidelines to be followed by institutions in order to maintain a sound banking and financial system.

The Prudential Guidelines on Mergers, Amalgamations, Transfers of Assets and Liabilities apply to commercial banks licensed under the Banking Act.[86] Merging or amalgamating institutions should seek first approval from the Central Bank of Kenya for the name they intend to use in case of a change in name. They should then ascertain with the Registrar of Companies that the selected name is available and is appropriately reserved for their use.[87]

Parties are also required to provide a long list of information and a letter of approval of the merger from the Competition Authority of Kenya.[88] The merger will only be approved by the Central Bank if the application meets its very strict assessment approval requirement[89]

e. East African Community Competition Act and the EAC Competition Authority

This Act applies to all economic activities and sectors having cross border effects.[90] Part IV of the Act deals with cross border acquisitions and mergers within the EAC. The Act establishes the East African Community Competition Authority.[91] Any entity seeking for cross-border merger must notify the Authority.[92]

Whereas the Competition Act requires each of the parties to notify the Authority in writing, this Act only requires one party to make the notification.[93] Upon making the application, the Authority

[85] Section 9, *The Banking Act* (CAP 488).
[86] CBK Prudential Guidelines on Mergers, Amalgamations, Transfers of Assets and Liabilities, CBK/PG/12.
[87] Rule 3.1.2, *CBK Prudential Guidelines on Mergers, Amalgamations, Transfers of Assets and Liabilities*, CBK/PG/12.
[88] Rule 3.1.3, *CBK Prudential Guidelines on Mergers, Amalgamations, Transfers of Assets and Liabilities*, CBK/PG/12.
[89] Rule 3.2, *CBK Prudential Guidelines on Mergers, Amalgamations, Transfers of Assets and Liabilities*, CBK/PG/12.
[90] Nanyama M.M, Evaluating the Legal Framework Governing Mergers and Acquisitions of Commercial Banks in Kenya, 36.
[91] Section 37, *The East African Community Competition Act*, (2006).
[92] Section 11, *The East African Community Competition Act*, (2006).
[93] Section 11(3), *The East African Community Competition Act*, (2006).

should notify the applicant of its decision within forty-five days failure to which the proposed merger shall be implemented.[94]

A merger or acquisition shall only be approved by the Authority if that merger or acquisition leads to the creation, or strengthening of an already subsisting dominant position, and thereby substantially lessening competition in the relevant market.[95]

f. COMESA Competition Rules, 2004 and the COMESA Competition Commission

These rules are applicable to mergers that fulfil the criteria below:

i. Regional dimension which refers to a merger in which either one party or both parties to a merger operate in at least 2 COMESA member states; and[96]

ii. The combined annual turnover or combined value of assets, whichever is higher, in all Common Market of all parties to a merger equals or exceeds USD 50 Million or where the annual turnover or value of assets, whichever is higher, in the Common Market of each of at least two of the parties to a merger equals to, or exceeds USD 10 Million, unless each of the parties to a merger achieves at least two-thirds of its aggregate turnover or assets in the Common Market within one and the same Member State. [97]

Notably, if parties to a merger fulfil the above condition, they are required to notify the COMESA Competition Commission, the institutional body mandated to implement the COMESA Competition Rules. [98]

[94] Section 12, *The East African Community Competition Act*, (2006).
[95] Section 13(1), *The East African Community Competition Act*, (2006).
[96] Rule 23 (4), *COMESA Competition Rules* (2004).
[97] Rule 23 (4), *COMESA Competition Rules* (2004).
[98] Rule 23 (4), *COMESA Competition Rules* (2004).

2.4 EFFICACY OF EXISTING LEGAL FRAMEWORKS IN PROMOTING BANK MERGERS IN KENYA

This section of the study aims to evaluate how the existing legal frameworks play a role in promoting the ease and prevalence with which banking institutions merge in Kenya. The research identifies that there are certain legal and regulatory elements, requirements and procedures in Kenya that have contributed to the efficacy and frequency of bank mergers.

a. Merger threshold

Until 2013, Kenya lacked clearly defined thresholds for mergers that required notification to the CAK. Following that, in 2013, the CAK announced merger thresholds, requiring commercial banks undergoing a merger to acquire clearance from the CAK if the combined threshold is less than 1 billion shillings and the turnover target undertaking is greater than 100 million shillings. This was the main criteria to meet.[99]

In 2019, the Competition (General) Rules[100] were revised and with that came changes in the merger threshold. Under the new rules, while the merger threshold now is that the banking undertakings must have a minimum combined turnover or assets (whichever is higher) in Kenya of KES 1 billion and the turnover or assets (whichever is higher) in Kenya of the target undertaking is above KES 500 million; key among the new threshold regulations is the waiver of the need to notify CAK of mergers conducted by small and medium banking institutions or those that have already notified or met the requirements of the Common Markets for East, Central, and Southern Africa, (COMESA).[101]

Banking institutions whose combined value and assets which do not exceed US$5 million or KSh500 million are not required to notify the CAK. This also applies to companies whose majority of business—up to two thirds—is not based in Kenya do not have to inform CAK of a merger.[102]

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[99] Mayabi, Mercy. Evaluating the Legal Framework Governing Mergers and Acquisitions of Commercial Banks in Kenya. Diss. University of Nairobi, 2017.

[100] https://cak.go.ke/sites/default/files/202003/The%20Competition%20%28General%29%20Rules%2C%202019.pdf accessed 16 July 2019.

[101] https://theexchange.africa/investing/kenya-relaxes-rules-on-mergers-acquisitions/ accessed 16 July 2021

These factors and legal regulations opens up the threshold to an unlimited criteria of banking institutions thus making mergers an option that is easily accessible.

It should also be noted that, these Threshold Guidelines however, are not binding and do not automatically exclusion parties from the provisions of the Act or from merging, but provide parties with an indication of what class of merger they are eligible for.[103] This gives banking institutions yet again, a significant amount of wiggle room to make their merger applications, be compelling and plead their case. More often than not if the economic advantage is significantly greater than the detriment to public interest then the merger will be approved.

b. The COMESA threshold

For the first time, according to the 2019 Competition Rules, certain mergers are exempt from notification to the CAK. One of these are mergers: where the COMESA Competition Commission Merger Notification Thresholds are met, and at least two-thirds of the turnover or assets (whichever is higher) is not generated or located in Kenya.[104]

Prior to the 2019 Competition rules, the number of entities issuing clearance for commercial bank mergers had continued to rise over time, requiring parties to secure several approvals. In Kenya, the regulatory framework controlling commercial banks is already fragmented, with each regulatory agency responsible for a specific area.[105] Even when a merger satisfied the COMESA regional dimension standards and a merger filing had been submitted to the COMESA Commission in the past, the CAK insisted on domestic merger filings. Where a merger meets the COMESA regional dimension merger thresholds, however, undertakings are only required to notify the CAK in writing that a transaction has been notified to the COMESA.[106]

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103 Mayabi, Mercy. Evaluating the Legal Framework Governing Mergers and Acquisitions of Commercial Banks in Kenya. Diss. University of Nairobi, 2017

104 Gumede, Nomfundo Pretty. A comparative analysis of mergers and acquisitions in South Africa, Botswana and Kenya: how can we achieve successful integration in Africa?. Diss. 2019

105 Ombaka, C., and A. Jagongo. "Mergers and acquisitions on financial performance among selected commercial banks, Kenya." International Academic Journal of Economics and Finance 3.1 (2018): 1-23.

106 Rudman, Desmond, and Robert Wilson. "COMESA Competition Law—A New Regional Merger Regime for Eastern and Southern Africa." Journal of European Competition Law & Practice 4.4 (2013).

While there is still a need to consolidate competition regulation under one authority to reduce the burden of obtaining multiple approvals currently faced by commercial banks seeking to merge, the exemption provided by the 2019 COMESA threshold exemption is a significant factor in encouraging regional banks to merge by eliminating cross border competition approvals. Larger corporate banks that have subsidiaries and franchise institutions in other countries among the COMESA member states that meet this criterion therefore have the luxury to merge with other without wasting time and resources on the various approvals.

c. Revised filing fees for mergers

In Kenya, the filing fees for notifiable mergers has been removed in favour of entities and undertakings with up to a combined value of assets of 500 million shillings and turnover of 1 billion shillings. This elimination of filing fees for this threshold simply means that the merger process is less financially and procedurally taxing which may have been one of the factors limiting the prevalence of bank mergers in Kenya due to intensive costs.[107]

2.5 CONCLUSION

In this chapter we have examined the existing frameworks pertaining to bank mergers in Kenya. The final part of this chapter has noted and identified some of the strengths in the legal approaches to mergers that are contributing factors to ensure that legal environment is conducive for bank mergers. It is evident that the legislators and policy makers continue to maintain these frameworks and the regulations that follow at a standard that continuously favours banks at all financial statuses to consider mergers with other undertakings as a means to ensure continuity or enhanced profitability. From the findings of this chapter it is evident that Kenya's legal environment is conducive to mergers within the banking industry.

[107] https://www.bowmanslaw.com/insights/competition/kenya-competition-general-rules-2019-and-merger-threshold-guidelines-in-effect/

CHAPTER 3: CASE STUDY OF NCBA BANK KENYA

Kenya has a long history of bank mergers; there have been a total of over forty bank mergers between the nineties to date.[108] Some bank mergers include: Consolidated bank of Kenya which was incorporated in 1989 as a result of a merger of nine insolvent financial institutions, National Industrial Credit and the African Mercantile Bank in June of 1997, Diamond Trust Bank and Premier Savings and Finance, Universal Bank and Paramount Bank to form Paramount Universal Bank, NIC and Commercial Bank of Africa to give rise to NCBA Bank ("the Bank").[109] Upon merging, most banks are either categorized as tier 1 banks or fall shy of falling under the tier category.

Notably, 2019 Kenya's banking sector witnessed several mergers and acquisitions and according to Central Bank of Kenya Governor, Patrick Njoroge, more are predicted in the next two years as options to raise capital diminish for the small lenders who are struggling.[110] With as many as over 40 banks in the market, a number of analysts in the financial sector have for several years now said the sector is overbanked and that consolidation is the way out, especially for mid and lower-tier lenders.[111]

The focus of this chapter will be the recent bank merger between NIC and CBA to form NCBA which is considered a tier 1 bank and the third largest bank in East Africa with TBTF status.[112]

3.1. BACKGROUND OF NIC/CBA MERGER

NIC Bank Kenya Plc traces its roots back when its parent company, NIC Group, was formed as a joint venture by Standard Bank Limited of South Africa and Mercantile Credit Company Limited of the United Kingdom in 1959; NIC was initially a non-bank financial institution (NBFI).[113] NIC

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[108] Central Bank of Kenya 'Mergers & Acquisitions' Central Bank of Kenya, n.d. https://www.centralbank.go.ke/commercial-banks/mergers-and-acquisitions/ on 4th December 2020.

[109] Central Bank of Kenya 'Mergers & Acquisitions' Central Bank of Kenya, n.d. https://www.centralbank.go.ke/commercial-banks/mergers-and-acquisitions/ on 4th December 2020.

[110] Central Bank of Kenya 'Mergers & Acquisitions' Central Bank of Kenya, n.d. https://www.centralbank.go.ke/commercial-banks/mergers-and-acquisitions/ on 4th December 2020.

[111] Chepngenoh F and Muriu P 'Does Risk-Taking Behavior Matter for Bank Efficiency' 1550.

[112] Halima R and Wepukhulu J 'Effect of Financial Innovation on Financial Performance of Tier One Commercial Banks in Kenya' 182.

[113] Ouma P, 'Increasing Bank Mergers' Business Daily, 15 August 2019, 12.

Bank Kenya Plc was incorporated in 2016 as a result of the corporate reorganization of NIC Bank Group. In December 2018, NIC Group announced that it would be merging with Commercial Bank of Africa (CBA).[114] The Transaction was approved by the Kenyan regulators and shareholders in April 2019. The two banks announced the deal publicly in January 2019, in which current NIC Group shareholders would own 47% of the merged entity and CBA shareholders 53%.[115] In March, Commercial Bank of Africa said its shareholders had accepted a share swap with NIC Group. The merger was agreed by NIC Group's shareholders on April 17, to allow the two companies to create the third-largest bank by assets in East Africa.[116] Following the merger, effective October 1, 2019, all subsidiaries began to operate under a non-operating holding company, NCBA Group Plc; the central bank said the merged entity will have a combined market share of 9.9% and a customer base of over 40 million people in East Africa.[117]

3.2. NCBA'S COMPLIANCE WITH THE LAW

As illustrated in the previous chapter, approval from relevant authorities is a mandatory pre-requisite for a merger. This section will analyze NIC's and CBA's compliance with the relevant legal requirements.

a. Compliance with the Banking Act

Section 9 of the Banking Act requires parties to get approval from the Central Bank of Kenya. The Central Bank of Kenya gave the go ahead for the merger, and the approval was published in the gazette on 27th September 2019, making the entity Kenya's third-largest lender by asset base.[118] Central Bank of Kenya also issued a press release stating their approval guided under section 13(4) of the Banking Act and approval by the Cabinet Secretary, National Treasury on September 20, 2019, for the merger under Section 9 of the Banking Act.[119] They also approved the name NCBA

[114] Otuki N, 'NIC and CBA Merger' Daily Nation 2 October 2019, 14.
[115] Chepngenoh F and Muriu P 'Does Risk-Taking Behavior Matter for Bank Efficiency' 1549.
[116] Otuki N, 'NIC and CBA Merger' Daily Nation 2 October 2019, 14.
[117] Chepngenoh F and Muriu P 'Does Risk-Taking Behavior Matter for Bank Efficiency' 1549.
[118] Ilako C, 'CBK, Treasury Greenlight CBA-NIC Merger' Star Newspaper, 29 September 2019 - < https://www.the-star.co.ke/business/kenya/2019-09-29-cbk-treasury-green-light-cba-nic-merger/ > on 11 February 2020.
[119] Central Bank of Kenya, 'Press Release- Merger of Commercial Bank of Africa Limited and NIC Group PLC' 2019.

guided by rule 3.1.2 CBK Prudential Guidelines on Mergers, Amalgamations, Transfers of Assets and Liabilities.[120]

b. Compliance with the Competition Act

The Competition Authority plays a key role when it comes to approval is highlighted in section 42(2) of the Competition Act. They approved the merger on condition that no employee would be declared redundant within a year of transaction.[121] In the month of April of 2019, the NIC Group issued a public notice informing citizens that the shareholders of NIC had approved and ratified the merger agreement.[122] Further, the disclaimer indicated that the notice had been issued subject to the Capital Markets Authority. The needed approval from this authority is also highlighted in Part II of the Capital Markets Act.

3.3. CREATION OF TBTF BANK

The newly formed bank, NCBA bank, has total assets that equals at least 30% of the country's gross domestic product (GDP).[123] Before the merger, neither of the banks exceeded this size and thus the newly formed entity now poses a great threat to the financial stability of the nation if it fails thus requiring the government's help to bail them out. Additionally, NCBA holds 10.67 per cent of Kenya's market share comprising of former CBA's and NIC's 6.05 and 4.62 per cent of market share respectively.[124] Notably, the bank is considered a Tier 1 bank and third largest bank in the country. [125]

Notably, one of NCBA's predecessor CBA is known to have significant political ties. [126] Currently, NCBA's top shareholders include Uhuru Kenyatta, Mama Ngina Kenyatta and Muhoho Kenyatta with a combined a stake of approximately 13 per cent valued at 8.5 Billion Kenyan Shillings.[127]

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[120] Indeje D, 'Central Bank of Kenya, Treasury Approves Name Change of NIC and CBA Following Bank Merger' Khusko, 27 September 2019, - < https://khusoko.com/2019/09/27/central-bank-of-kenya-treasury-approves-name-change-of-nic-and-cba-following-bank-merger/ > on 12 February 2020.

[121] Competition Authority of Kenya, *'The Proposed Merger Between Commercial Bank of Africa Limited and NIC Group PLC'* 2019, 1.

[122] Competition Authority of Kenya, *'The Proposed Merger Between Commercial Bank of Africa Limited and NIC Group PLC'* 2019, 1.

[123] Gakii M 'Staff cushioned for one year in CBA-NIC merger' The Star, 14th May 2019, 3.

[124] Gakii M 'Staff cushioned for one year in CBA-NIC merger' The Star, 14th May 2019, 3.

125 Juma V, 'The top shareholders in CBA-NIC bank merger' Business Daily, 12th February 2019, 2.

126 Juma V, 'The top shareholders in CBA-NIC bank merger' Business Daily, 12th February 2019, 2.

127 Juma V, 'The top shareholders in CBA-NIC bank merger' Business Daily, 12th February 2019, 2.

Consequently, the Bank enjoys both TBTF status and deep political connections. NIC and CBA banks were exempted from paying share transfer tax running into hundreds of millions of shillings; the tax relief is speculated to be tied to banks' political network.[128] This move was unsuccessfully challenged in court on grounds that Kenyans would lose money by activist Okiya Omtatah. It is peculiar that such a tax break would be awarded whilst the targets set for tax collection are not being met.[129]

As banks grow to TBTF status, strict merger regulations targeting banking sector as well as regulation of TBTF regulations should be prioritized in order to prevent banks from having a leverage on size and political might.

3.4 IMPACT OF TBTF BANK TBTF BANKS

This section will look into the negative impact of TBTF Banks on Kenya's economy, financial system, its citizenry and the banking industry.

3.4.1 TAXPAYER'S EXPOSURE – A MORAL HAZARD

The existence of TBTF banks increases taxpayers' financial exposure as they are the government's primary source of income.[130] As it stands, Kenya's taxpayers' face heavy financial obligations due to high national debt which stands at approximately 6.6 Billion Kenyan Shillings; creation of further risks will thus results in reduced quality of life for Kenyans among other effects.[131]

The 'moral hazard' is premised on the idea that TBTF banks take risks that they would otherwise avoid with the assurance that they will receive financial deliverance when 'things get thick'.[132] The active occurrence of the moral hazard is then presented when taxpayers bear the burden of the consequences of TBTF banks' actions.[133] It follows that relieving institutions from their poor or risky decisions instills the idea that their actions are risk free and promotes the continuation of their actions as they stand to gain without loss.

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128 Juma V, 'The top shareholders in CBA-NIC bank merger' Business Daily, 12th February 2019, 2.
129 Mutai E, 'Kenya's debt repayment down KES 199 billion on cheaper loans' Business Daily, 28 October 2020.
130 Morrison A, 'Systemic Risks and the too-big-to-fail' problem' 27(3) *Oxford Review of Economic Policy,* 2011, 502.
131 Mutai E, 'Kenya's debt repayment down KES 199 billion on cheaper loans' Business Daily, 28 October 2020, 6.
132 Stern G, *Too big to fail: the hazards of bank bailouts*, Brookings Institution Press, 2009, 21.
133 Stern G, *Too big to fail: the hazards of bank bailouts*, 21.

3.4.2 WEAKENING COMPETITION

TBTF has a negative impact on market competition as large institutions, due to their economies of scale, have access to a wider and more confident market access.[134] It is a common practice for a Kenyan looking to open a bank account to conduct search and decide to bank with a Tier 1 bank based on the basis that it will not fail and should it fail, the government will intervene.[135] Additionally, TBTF Banks have an unfair advantage due to the implicit credit guarantee they receive from governments and as such receive more funding at subsidized rates from their creditors.[136] The said advantages hinder competition and could substantially monopolize the banking industry due to such barriers of entry.

3.4.3 CORRUPTION

True to the notion that 'power corrupts and absolute power corrupts absolutely', TBTF banks tend to engage in unethical and corrupt activities without regard for regulations governing it.[137] The prevention of corruption is equally tasked to regulators and market industry players.[138] It follows that where laws of, and regulators in, a country are committed to anti-corrupt practices, the TBTF banks, forming the largest pool of market industry players in the banking sector, must be committed to the same cause.[139] However, in many cases, TBTF banks are uninhibited due to their influence.[140] In Kenya, where the government including legislators and policy makers engage in corrupt activities, it is perceivable that TBTF banks may have influence over its regulation thus engaging in corrupt activities without consequence.

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[134] Halme L, Hawkesby C, Healey J, Saapar and Soussa F, *Financial Stability and Central Banks: Selected Issues for Financial Safety Nets and Market Discipline,* Center for Central Banking Studies, London 2000,11.

[135] Obura F, 'What Kenyan youth look into before choosing a bank' The Standard digital, 30th June 2015 https://www.google.com/amp/s/www.standardmedia.co.ke/amp/business/article/2000167545/what-kenyan-youth-look-into-before-choosing-a-bank on 10th January 2021.

[136] Halme L *et al, Financial Stability and Central Banks: Selected Issues for Financial Safety Nets and Market Discipline*,12.

[137] Miller S, 'The Global Banking Sector: Corruption, Institutional Purpose and Economic Justice' 37(1) *Business and Professional Ethics Journal,* 2018, 14.

[138] Miller S, 'The Global Banking Sector: Corruption, Institutional Purpose and Economic Justice'14.

[139] Miller S, 'Trust Me…I'm a (systematically Important) bank! Institutional corruption, market based- industries and financial benchmarks' 8(4) *Law and Financial Markets Review, 2014, 322.*

[140] Miller S, 'Trust Me…I'm a (systematically Important) bank! Institutional corruption, market based- industries and financial benchmarks' *322*

Additionally, due to their size, huge banks conducting money laundering activities may not be easily spotted by regulators.[141] For example, in 2012, HSBC hit the headlines for failing to implement an effective anti-money laundering program having been a victim of hundreds of millions being laundered through the bank for Mexican drug cartels.[142] In Kenya, Standard Chartered was involved in facilitating the movement of hundreds of millions for sanctioned countries such as Sudan and Iran unnoticed.[143]

In addition to the market power, TBTF banks, more often than not, have strong political backing making it difficult to hold the bank, its managers or shareholders accountable upon any wrong doing. [144] Supposing, HSBC managers and shareholders of the bank were publicly charged with matters relating to banking irregularities, this may cause a panic resulting in account holders and investors disassociating themselves; ultimately, the bank may 'go under' and disrupt the entire financial system.[145] In most cases, settlements are the most available cause of action against these banks resulting in an implicit semi-immunity policy that has been nicknamed 'too big to jail' and translates to additional economic advantage.[146]

3.4.4 SOVEREIGN FINANCIAL RISK

As globalization continues to sour, the soundness of an economy's financial system is constantly under scrutiny by investors and trading partners.[147] Notably, the designation of TBTF can affect stability and efficiency of an economy by conveying implicit guarantees to TBTF banks' creditors thus creating shareholder incentives to shift more risk to the government.[148]

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[141] R. Harding, 'Problems of banks seen as too big to fail still unsolved', Financial Times, 2014,4.

[142] *United States V HSBC USA* (2013), United States Court of Appeals.

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[146]Arthur E, 'Turning a blind eye: Why Washington keeps giving into Wall street,' 81(4) *University of Cincinnati Law Review*, 2013, 34.

[147]Alfonso G, Santos J and Traina J, 'Do 'Too-Big-To-Fail' Banks Take on more risk' *Economic Policy Review, 2014, 17.*

[148]Alfonso G, Santos J and Traina J, 'Do 'Too-Big-To-Fail' Banks Take on more risk' *Economic Policy Review,* 2014, 17.

Additionally, prior chapters in this research, have illustrated the interconnectedness of TBTF banks and an economy's financial system. As such, in the event of a TBTF bank failing, the entire economy of Kenya stands to crumble.

CHAPTER 4: RECOMMENDATIONS

TBTF banks raise concern due to both their political and economic connectedness. [149] This section will provide recommendations aimed towards regulating growth of, and managing TBTF banks.

a. Strict merger regulations

Strict merger regulations have to be put in place to limit the growth of TBTF. From the foregoing discussion, it has been proven mergers result in creation of TBTF institutions in the banking industry. The regulators approach should be aimed at restricting the size of the merged banks by limiting mergers of two banks that result in tier one banks. Strict merger regulations will then decrease the propensity for mergers and ultimately TBTF banking institutions.[150]

Bank mergers also need to be regulated to protect the bank-customer relationship.[151] As was highlighted in the *Evans Aseto v the National Bank of Kenya & Central Bank of Kenya*, the objectives of regulation and supervision are to promote the soundness of the financial institution and to protect integrity of the banking system and interests of the depositors while ensuring an effective and efficient banking system that finances economic growth.[152]

b. Systemic tax regime

A systemic tax refers to a cost to be levied on TBTF banks; the tax will serve to cater for the cost of future crisis and deter institutions from acquiring TBTF status. [153]Additionally, the tax will serve as an aid in the financial system by absorbing shocks caused to the market by the practices of these large institutions. Size creates negative externalities and taxation has proven as an effective remedy in dealing with such externalities.[154]

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149 McDonell B, ‘ Financial regulation and too big to fail’, 113.

150 Freixas X and Rochet, ‘Taming Systemically Important Financial Institutions’ 45 (1) Journal of Money, Credit and Banking, 2011, 39.

151 <https://www.mumakanjama.com/index.php/team/64-legal-framework-for-mergers-in-kenya>Muma & Kanjama Advocates, on 15 November 2020.

152 *Evans Aseto & another v National Bank of Kenya & another; Central Bank of Kenya & another (interested parties)* [2019] eKLR.

153 Freixas X and Rochet, ‘Taming Systemically Important Financial Institutions’ 41.

154 Umlauft T ‘The paradoxical genesis of Too-Big-To-Fail: How Distrust Towards Banks led to TBTF’ 12.

c. Limiting bailouts

Government bailouts are done at the tax payers' expense making it an unjust and unfair practice.[155] Limiting bailouts will incentivize better risk-taking culture as these institutions will have to finance their own losses. Notably, bailouts have proven necessary to forestall systemic threat and is used as a rescue operation when policies fail to prevent institutional failure.[156] To deal with this practice, the government may introduce regulations that provide for the manner of conducting bail outs including a long-term payment plan. Additionally, it is important to promote legislation that deals with resolution when bailouts will not be available, such as where the relevant institution was in breach of laws and prudential guidelines.[157] An example of a TBTF institution that did not gain from government intervention in the 2008 financial crisis is Lehman Brothers which was declared insolvent; it is in such circumstances that there is need for quick resolution having noted the systemic effects from the failure of Lehman Brothers.[158]

d. Limiting size of banks

This solution is put forward based on economic and political arguments: breaking up or limiting large banking institutions lets tax payers off the hook in relation to funding expensive bailouts and reduces the political influence of the banks.[159] This is a structural remedy aimed at distributing the interests of the public to more banks, as opposed to having only few banks with disproportionate and an increasing concentration of financial resources; this also reduces the dependence of an economy on a few institutions.[160]

e. Special insurance regime for depositors for TBTF banks

A significant aspect for the financial system is a financial safety, deposit insurance, that is intended to promote financial stability. This insurance guarantees the depositor that his debt with a bank will be honored in the event the bank becomes bankrupt. This approach to regulating TBTF banks

155 Umlauft T 'The paradoxical genesis of Too-Big-To-Fail: How Distrust Towards Banks led to TBTF' 12.

156 Shull B. 'Too big to fail in financial crisis: motives, countermeasures and prospects', 18.

157 Buiter W, 'Too big to fail is too big,' The Financial Times, 24 June 2009, 5.

158 Buiter W, 'Too big to fail is too big,' The Financial Times, 24 June 2009, 7.

159 Corton G and Santommero A, 'Market discipline and bank subordinated debt.' 121.

160 Shull B, 'Too big to fail in financial crisis: motives, countermeasures and prospects' 20.

refers to a funded deposit insurance with risk related premiums paid by banks. It will allow banks to pre-plan for when a crisis occurs or they become bankrupt. The aim of this is to create a system where when big banks fail, bondholders and shareholders are not underwritten by taxpayers which creates an incentive for them to prudently monitor the bank's management.

CHAPTER 5: CONCLUSION

This chapter presents a summary of the key findings and discussions. The study had four main objectives; (1) To ascertain whether bank mergers are a cause of banking institutions attaining TBTF status. (2) The role of the regulatory framework in promoting the growth of TBTF banking institutions. (3) The impacts of TBTF banking institutions in an economy. (4) Reforms to limit the growth of TBTF banking institutions. Chapter one introduces the problem whereas Chapter two builds on the problem by providing the legal and institutional framework governing mergers of banks. Chapter three then proves that there is a causal link between bank mergers and creation of TBTF banks through examining the CBA-NIC merger creating NCBA, a Tier One bank. The study in Chapter four discusses and proves that TBTF banks pose possible negative externalities on Kenya's economy.

Following the research findings and discussions in the preceding chapters; this study concludes that there is a clear correlation between bank mergers and creating too big to fail banks which pose a huge threat to the stability of a financial system. Bank mergers enable banks to spread their networks deep into the financial system creating concern on their threat to the economy upon failure. The success of a financial system is measured by its efficiency and the ability to withstand adverse effects from negative externalities. It is thus the goal of financial regulation to offset any unnecessary risk and this includes limiting the size of banks to become TBTF.

5.1 Areas of further research

TBTF banks are mainly created through conventional ways of banking. Islamic banking on the other hand provides a completely different way of banking governed by Islamic faith. Islamic banks have proven to promote a sound banking and financial system and very few close to none of Islamic banks have fallen. It would be of interest to economists, lawyers and regulators to conduct research study to determine why the Islamic banking system would help curtail the growth and failure of TBTF banks through its governing practices. This will help analyze whether an adoption of this banking approach is more effective so as to come up with a sound, efficient and sustainable financial system.

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