Martin Brownbridge. 1998. The causes of financial distress in local banks in Africa and implications for prudential policy. UNCTAD discussion paper 132 (March).

A study of local banks (no foreign participation nor state ownership) in 4 African countries (Kenya, Nigeria, Uganda and Zambia) shows that:

- there are severe debt problems associated with:
    - *moral hazard*: adverse incentive to bank owners to act against the interest of bank creditors (depositors, the state, the central bank, etc) and undertake high risk, high interest rates loans, which also have higher probability of failure. In the case of success, the banks have huge gains. However, the incidence of failure is so high that banks face serious financial distress;
    - *adverse selection:* given adverse incentives to bank owners, prudent borrowers are crowded-out by high risk borrowers;
    - the main causes of these problems are:
        - capital scarcity, which encourages banks to gamble and to use a high proportion of the deposits in high risk projects;
        - limited managerial skills, ability and experience of the owners and managers;
        - deficient regulation and supervision by the financial authorities.

- the implication of this problem is that the establishment of a very strong system of regulation and supervision to ensure prudential lending has to be at the core of financial reform in Africa. African countries should be more concerned with supervision, regulation and prudential policy to create an efficient and prudent banking system, rather than to engage in complete liberalisation of the financial system and the establishment of volatile capital markets.