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**An Assessment of the Enforcement of Banking Supervision Framework to Avert Bank
Failure in Kenya**

By

Olinga Racheal

Reg. No.: 131976



Master of Laws

2023

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**Submitted in Partial Fulfillment of the Requirements for the Degree of Master of Laws at
Strathmore University**



Nairobi, Kenya

July 2023

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Declaration and Approval

Declaration

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Abstract

The banking sector plays a crucial role in any economy. This thesis examined the state of banking supervision in Kenya in light of the previous bank failure cases, the economic challenges and the emerging developments in the industry. The research sought to evaluate and analyze the theoretical, policy, legal, and institutional aspects of bank supervision in Kenya, discussed the most effective supervisory tools, and recommended best practices to enhance the effectiveness and efficiency of bank supervision in the country. The study found that bank supervision is justified by the economic and social necessities, including the need to protect against emerging challenges such as digital technologies, mobile money, and unstable economic realities. Additionally, the study noted that consumer protection remains a crucial aspect of supervision.

On the legal and institutional framework, the study underscored the robust laws and institutions, both domestic, regional and international, that have shaped banking supervision in Kenya. Through the CBK, these laws have enabled the adoption of international best practices for banking supervision through the implementation of risk-based supervision mode.

However, the study recognizes that the evolving challenges threaten the fabric for which bank supervision has been built and calls for the adoption of novel tools and procedures for supervision that incorporate emerging realities. There is, therefore, a need for continuous review of the laws and institutions to ensure that the supervisory framework is constantly updated, in line with the changes and developments in society.

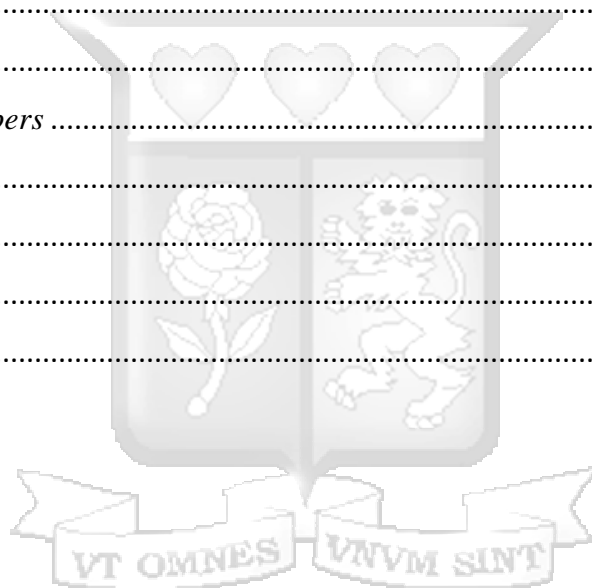
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List of Abbreviations

BNM	Bank Negara Malaysia
BCBS	Basel Committee on Bank Supervision
BCCI	Bank of Credit and Commerce International
CBK	Central Bank of Kenya
CFT	Countering the Financing of Terrorism
DLT	Distributed Ledger Technology (DLT)
EAC	East African Community
GDP	Gross Domestic Product
IAIS	International Association of Insurance Supervisors
IOSCO	International Organization of Securities Commissions
KDIC	Kenya Deposit Insurance Corporation
KYC	Know Your Customer
OECD	Organization for Economic Cooperation and Development
PRA	Prudential Regulatory Authority
RBS	Risk-Based Supervision

List of Statutes

Articles of Agreement of the International Monetary Fund, 1945

Banking Act (Chapter 488 Laws of Kenya)

Central Bank of Kenya (Mortgage Refinance Companies) Regulations, (2019)

Central Bank of Kenya Act (Chapter 491 Laws of Kenya)

Companies Act (Act No. 17 of 2015)

Companies Act (Act No. 17 of 2015)

Competition Act (Act No. 12 of 2010)

Constitution of Kenya, 2010

Consumer Protection Act (Act No. 46 of 2012)

Credit Reference Bureau Regulations, (2013)

East African Monetary Union Protocol, 2013

Microfinance Act, (Act No. 19 of 2006)

National Payment System Act (Act No. 39 of 2011)

National Payment System Regulations, (2014)

The Core Principles for Effective Banking Supervision, 2006



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To my parents and my siblings, thank you for cheering me on, it has been a marathon, and so mine is an immeasurable sense of gratitude and love. You have Loved me through it all. Thank you, mummy, for your sacrifice and labour of Love. Be blessed. Live long to witness the success of a lady you have invested in.

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Dedication

I dedicate this research project paper to all who wish for efficient and effective banking industry supervision to achieve systemic financial stability in Kenya.



Chapter I: Introduction

1.1 Background to the study

1.1.1 The Concept of Banks and their Centrality in the Economy

The discourses on the management of financial institutions have received increased attention in the past decades owing to developments affecting the industry. It is universally accepted that the banking sector plays a crucial role in the socioeconomic growth of a country.¹ The regulation of these institutions in performing their tasks, such as providing financial services to businesses and individuals, is critical to developing a thriving economy.² A significant asset-base for the banking sector, the availability of depositors' insurance, and a solid legal framework for banks to operate in are essential components of a healthy economy.³ The legal framework should protect both the banks and their clients and have mechanisms in place to anticipate and mitigate economic downturns.⁴ Notwithstanding the foregoing knowledge, banks have experienced turbulences over the years, with recent developments raising eyebrows as to whether the traditional banking system will endure.

These developments include the influence of digital technology and associated financial systems, emergence of mobile money, and more stringent monitoring and supervision to curb money laundering and related financial frauds.⁵ These challenges are exacerbated by shrinking economies characterized by the corona virus pandemic 2019 (COVID-19), the conflict in Ukraine, and continued drought and climate-related catastrophes that have slowed economic development to the level that some stakeholders predict future inflation.⁶ This volatile and chaotic environment threatens the very existence of traditional banking systems.

¹ Ellinger EP, Lomnicka E, Hare CVM, *Ellinger's Modern Banking Law*, 4th ed, Oxford University Press, Oxford, New York, 2011, 27.

² Alexandra d, Raoul M, Pierluigi M, 'Banking Development, Socioeconomic Structure and Income Inequality' 157 *Journal of Economic Behavior & Organization*, 2019, 432.

³ Dadson A, 'Theoretical and Conceptual Framework of Access to Financial Services by Farmers in Emerging Economies: Implication for Empirical Analysis' 6 *Acta Universitatis Sapientiae, Economics and Business*, 2018, 45.

⁴ Mugarura N, Namanya P, 'Supervisory mandate of Central Banks and the spate of bank failures: who to blame?', *Journal of Money Laundering Control*, 2020, 2.

⁵ David M, Samuel K, Dulacha B, 'The Determinants of Corporate Disclosures of Anti-Money Laundering Initiatives by Kenyan Commercial Banks' *Journal of Money Laundering Control*, 2020, 609–635.

⁶ Nathalie S & others, 'Understanding the Value and Limits of Nature-Based Solutions to Climate Change and Other Global Challenges' *Philosophical Transactions of the Royal Society*, 2020, 4.

1.1.2 Historical Development of Bank Failure in Kenya

The banking industry is not new to challenges. The current developments are nothing more than an advanced version of the problems the industry has grappled with. Banks have experienced failure for as long as nations have existed. For instance, Kenya stands out as one of Africa's largest economies, as evidenced by its robust banking industry.⁷ However, the country has witnessed numerous cases of bank failures which have negatively affected the industry's reputation. Recently, banks like Imperial Bank, Dubai Bank, and Chase Bank collapsed, affecting many consumers and creditors. To date, attempts to recover the loss have been futile, with close to 13.4 billion owed to depositors by failed banks dating as far back as the early 1990s.⁸

Notably, Kenya's banking issues date back to the mid-1980s culminating in major bank failures with a record 37 failing banks as of 2013 following the 1986 - 1989, 2015/2009 and 2013 crises.⁹ Among the issues attributed to the bank failures included non-performing loans. Also, the legal requirements for bank opening were minimum. For instance, non-financial banking institutions could open with as low as \$ 200 000.¹⁰

Reports and studies have shown that these issues result from various underlying factors. The factors range from ineffective loan management, inadequate or poor corporate governance framework, unsound macroeconomic policies, poor banking supervision and monetary regulation, government interference, fraud, corruption, and political patronage being at the core of it.¹¹

⁷ Central Bank of Kenya, *The year of resilience: Annual report and financial statements 2017/2018*, 2018, 29. Available at https://www.centralbank.go.ke/uploads/cbk_annual_reports/665458124_Annual%20Report%202917%2018%20low%20resolution.pdf on 7 August, 2020

⁸ Omondi D, 'Big shots, corporates vanish with Sh79b failed banks loans', *The Standard*, 29 July 2020. Available at <https://www.standardmedia.co.ke/the-standard-insider/article/2001380416/big-shots-corporates-vanish-with-sh79b-failed-banks-loans> on 07 October 2021

⁹ Nelson M. Waweru & Victor M Kalani, 'Commercial Banking Crises in Kenya: Causes and Remedies' *African Journal of Accounting, Economics, Finance and Banking Research* Vol. 4. No. 4. 2009

¹⁰ Martin B, 'The Causes of Financial Distress in Local Banks in Africa and Implications for Prudential Policy', UNCTAD/OSG/DP/132, 1998, 6 https://unctad.org/system/files/official-document/dp_132.en.pdf on 27 September 2022

¹¹ Cheserek BK, 'The determinants of bank failures: A survey of commercial banks in Kenya', Published, University of Nairobi, Nairobi, 2007.

These recurrent bank failures have greatly affected public, consumer and depositor trust in the banking business. Losses have been systemic, causing liquidity flows to be interrupted due to the amount lost.

1.1.3 Institutional Safeguards Against Bank Failure and the Rationale for Effective Supervision

The continued bank failures and the evolving nature of challenges have prompted the Central Bank of Kenya (CBK), as the sector regulator, to “reevaluate the current approach towards the regulation of the banking sector and what could be leading to sudden highly-publicized financial fall.”¹² The role played or ought to be played by the CBK as the parent regulator cannot be overemphasised. The primary role of the Central Bank in a Country is to regulate and supervise banks to promote financial stability by maintaining a well-functioning system.¹³ CBK’s core functions include ‘the development of legal and regulatory systems to promote stability’.¹⁴ Furthermore, the Central Bank attempts to put in place systems to guide banks to avoid collapse and reduce risk possibly. The other roles that the CBK is mandated to perform are: to formulate and implement monetary policy to achieve and maintain stability in the general level of prices; fostering liquidity, solvency and a stable market-based financial sector and support the economic policy of the Government¹⁵. Through subsequent amendments to the Central Bank of Kenya Act, with the recent amendment to the CBK Act in December 2021, which sought to include the regulation and supervision of Digital lenders¹⁶, the CBK has been further tasked with other objects that, when considered cumulatively will ensure an efficient and adequate banking system. In addition to the licensing and supervision of authorized dealers, the CBK has been mandated to formulate and implement foreign exchange policies. The formulation and implementation will prevent such vices as money laundering through the foreign exchange avenue. Further, CBK is tasked with other roles, such as the issue of currency notes, and this function has been executed in Kenya in the recent past.¹⁷

¹² Lubano N, ‘Testing the safety net in banking: Is deposit insurance adequate?’ Oraro & Company Advocates, <https://www.oraro.co.ke/2018/06/26/testing-the-safety-net-in-banking-is-deposit-insurance-adequate/> On 7 August 2020

¹³ Central Bank of Kenya, ‘Bank supervision’ Centralbank.go.ke/bank-supervision

¹⁴ Central Bank of Kenya, *Bank supervision annual report 2018*, 2018

¹⁵ Section 4, *Central Bank of Kenya Act*, Cap 491

¹⁶ *The Central Bank of Kenya (Amendment) Bill*, (2021).

¹⁷ Mbego S, ‘CBK unveils new generation bank notes’ *The Standard*, 1 July 2019.

Enforcement is a crucial aspect of any regulatory framework. Enforcement ensures that the regulations are being adhered to and the desired outcomes are reached. These outcomes are essential in shaping future developments in the area. Cognisant of the significance of enforcement, the banking regulatory system has embraced supervision as a core enforcement mechanism to maintain financial stability.

Supervision is an enforcement tool used to monitor the regulations, mainly to ensure that institutions maintain sound and safe business practices.¹⁸ Bank supervision is a supervisory function which is charged with ensuring the safety and soundness of the banking system. Books and affairs of every licensed, insured institution are examined to meet its supervisory mandate.¹⁹

In light of its objectives and critical roles, the CBK has set up a supervisory department; whose purpose is to ensure that all banking institutions trade within standards set by it.²⁰ The CBK further introduced supervisory guidelines and sought to shift from the traditional rule-based supervision to risk-based supervision in 2004, indicating the pros of the risk-based approach to Supervision and giving reasons as to why this approach was most preferred. For example, CBK asserted that the traditional approach only used one approach to all financial businesses regardless of the business mode. The Risk-Based Framework was then developed in 2013. This approach was most preferred as it focused on institutional risk management ability. It also encouraged a closer relationship between the institution and the CBK.²¹ RBS identifies the risk and finds the possible solution to cater to that problem. In the process, it provides the opportunity for the supervising authority to channel its resources towards the institutions and the issues that pose the greatest threat to the financial system's stability. The CBK then developed practice guidelines to give a partial approach to Supervision with provisions catering to the regulatory, conduct, risk analysis, type of

¹⁸ Curry TJ et al, 'Financially Distressed Banks: How Effective Are Enforcement Actions in the Supervision Process?' *FDIC Banking Review*, 19.

¹⁹ Nigeria Deposit Insurance Corporation, 'Types of bank supervision' <https://ndic.gov.ng/supervision/types-of-bank-supervision/> on 9 October 2021

²⁰ Central Bank of Kenya, *Bank supervision annual report* 1994. <https://www.centralbank.go.ke/images/docs/Bank%20Supervision%20Reports/Annual%20Reports/BSD%20Report%201994.pdf> on 7 August 2020

²¹ Central Bank of Kenya, *Central Bank of Kenya risk based supervisory framework*, 2013. [CBKs-Risk-Based-Supervision-Framework-May-2013-1.pdf](#) on 8th October, 2021

risks and how a bank should operate to avert failure²². The systems and policies embraced established the regulatory legal framework to protect banks from the crisis.²³

With the identified challenges in the previous regimes and the consequent bank failures, a supervisory system must be robust enough to address most of the industry's issues with minimal authority. The latter position justifies the continued discourses from the academy and industry players on the best supervisory approach to adopt. The approach should not only align with international best standards, but it should address the local challenges while also allowing the opportunity for bank growth and economic development in light of such emerging issues as digital technologies, climate change, conflict and changes in data protection laws and frameworks.

1.2 Statement of the Problem

The Kenyan banking sector has experienced a series of bank failures in recent years, resulting in severe consequences for depositors, investors, and the overall stability of the financial system. These failures have raised concerns about the effectiveness of the existing regulatory and supervisory framework in ensuring the safety and soundness of banks. The Central Bank of Kenya (CBK) and other regulatory authorities have implemented various measures to strengthen the sector's resilience, but challenges persist.

Developing States have been known to lag behind in legal and social change, with many catching up in regulatory and market practices long after the global West and East have made huge strides in the right direction. Even where such changes are made, there is always a danger of replicating international practices without considering the realities of the local markets. This lackadaisical behavior has shaped bank failure regardless of legal and policy changes. The impact of these shortcomings transcends bank liquidation and loss of client money (which are the central theme in bank failure). It affects a state's overall socioeconomic and political landscape – from poor health systems, food insecurity and limited development.

The study addresses the problem of inadequate bank supervision in Kenya. It evaluates the theoretical and policy justifications for bank supervision, analyzing the legal and institutional framework for bank supervision, discussing the most effective tools for supervisory purposes, and

²² Central bank of Kenya, *Risk management guidelines*, January 2013 [risk-management-guidelines-january-20131.pdf](#) on 8th October, 2021

²³ Section 33 B, C, D, K, J, *Central Bank of Kenya Act* Cap 491.

recommending best practices to enhance the effectiveness of bank supervision in Kenya. The research contributes to a deeper understanding of the challenges facing the Kenyan banking sector and provide valuable insights for policymakers, regulators, and other stakeholders in developing and implementing more effective supervisory strategies to safeguard the stability and resilience of the country's financial system.

1.3 Study Objectives

The study objectives are:

- i. To evaluate the theoretical and policy justification of bank supervision in Kenya
- ii. To analyse the legal and institutional framework for bank supervision in Kenya.
- iii. To discuss the best tools for bank supervision.
- iv. To recommend best practices for effective bank supervision in Kenya.

1.4 Research Questions

The study will seek to answer the following questions:

- i. What is the theoretical and policy justification for bank supervision in Kenya?
- ii. What is the legal and institutional framework for bank supervision in Kenya?
- iii. What are the best tools in bank supervision?
- iv. What are the recommended best practices for bank supervision in Kenya?

1.5 Study Justification

Ineffective redress of the causes of previous bank failures and the effect of emerging challenges presents a significant threat to the country's financial system, with the effect likely to catapult into other aspects of the economy, including access to shelter, food, medical care.

Continuous academic engagement with the developments in society is essential for the success of the various measures that the government and institutions may adopt. Research shapes policy. Policy develops law. Consequently, the observations and conclusions that the current study makes regarding the sufficiency or otherwise of the current supervisory regime to protect against bank failures shape the law on banking in different ways. For instance, the findings will facilitate

The revitalization of the banking sector by proposing increased efficiency in bank supervision in the wake of emerging development for their overall sustainability and economic development.

Parliament and the CBK may use the findings from the current discussion to evaluate the existing supervision laws, policies and practices and align them with industry best-practice.

The study recommendations will increase consumer and the country's overall confidence in the banking systems in the country. Additionally, the findings will be beneficial in developing supervision enforcement policies geared at averting bank failures in Kenya. The cumulative outcome of the study is the development of a more focused regime for bank supervision than previous approaches to averting bank failure, current practices and the evolving global developments in supervision amid the changing nature of the financial sector. Implementing the findings will also enhance investor confidence in the country's economy, which is essential in achieving the government's economic agenda under the Vision 2030 Blue Print.

1.6 Theoretical Framework

1.6.1 Public Interest Theory

Public interest theory inspires numerous contributions to the literature. Arthur Pigou first developed the theory. It is based on two assumptions – that markets collapse due to issues aligned to dominance or other factors and that the state can align the failures through regulation. Pigou asserts that regulation is availed to the public to counter inefficient or inequitable market practices. Regulations are assumed initially to benefit society rather than a particular vested interest. The regulatory body is considered to represent the interest of the society in which it operates rather than the private interest of the regulators. The politicians all claim to be fulfilling a 'common good' since it is in the public interest or suitable for the people.²⁴

The theory's leading proponents hold that government agencies are well-trained and well-informed, aiming to set up fair laws and policies that favor the common good, remove unstable and inefficient markets, and enact uncostly regulations.²⁵ Jean Jacques Rousseau opines that this theory is of a government over collective interests and considers it a general will since it tends towards the preservation and welfare of the whole. At times the citizens may not even know it, but it benefits both the private and the public.²⁶

²⁴ Heywood A, *Political Theory: An Introduction*, 3ed, Palgrave Macmillan, New York, 2004, 241.

²⁵ Pigou, *The economics of welfare*, 229.

²⁶ Heywood, *Political theory: An introduction*, 1969.

The theory assumes that markets are fragile and apt to operate inefficiently or inequitably if left alone. The government is a neutral arbiter between producers and consumers. Its function is to regulate banks to facilitate the efficient functioning of banks by ameliorating market failures for the benefit of broader civil society. In banking, the public interest would be served if the banking system allocated resources efficiently, increasing output and reducing differences.²⁷

The public interest theory is essential for the government to ensure that the banking sector is well-regulated. The government is the custodian of the public interest of its citizenry. The citizens donate to the government their rights in a social contract agreement in exchange for efficiency and protection of their rights. It is important to note that the citizens are entitled to economic development. A well-supervised financial system benefits the public and the private as there is a version of systemic risks, and confidence in the financial system increases. In the end, the economy of the country is boosted. Consequently, the theory resonates well with the country's need to regulate, supervise and enforce the bank and other financial systems.

The theory is significant to the country, especially when there are no underlying interests of those who wield political power. This is because the theory seeks to attain the common good, which is to work towards the interests that benefit the people and not a specific class. However, the common good will not be attained if it serves government officials and not the public.

Critics of this theory indicate the same when they hold that it is impractical, considering the government is often corrupt, incompetent and prone to regulatory capture. They further argue that the private sector can cater to its issues in case of market failure; in the same way, private actors can settle disputes by going to court.²⁸

Further, according to Maobe, banks have been supervised using the public interest view and the private interest view. The public interest view has the government regulating all bank operations from ownership to entry and putting restrictions on all activities and lending. On the other hand, the private interest view posits that banks are free to act in a range of markets without government intervention. The private interest view can lead to issues espoused in the principal- agent theory, where different parties are fronting their self-interest. Consequently, there are never-ending

²⁷ Pigou AC, *The economics of welfare*, 4ed, Macmillan and Co., 1932, 229.

²⁸ Shleifer A, 'Understanding regulation', *European Financial Management*, 2005, 441.

principal-agency problems in the business environment.²⁹ Whereas private interests are multiple and competing, an ideal public interest approach is unitary as the end goal is that which benefits every member of the public.³⁰

For the economic development of a nation and its citizens to be achieved, it is an excellent reason to ensure that the banking sector is adequately regulated and supervised. Adequate supervision will ensure that the deposits of the citizens are well protected. In return, banks will have increased liquidity levels and, therefore, efficient credit to the depositors. Indeed, countries develop, and the living standards of the citizens improve when well-supervised banks advance a sound credit system. Failure of banks leads to ripple effects on the state of public interest. This study places the public interest at the core of addressing the issues raised herein and asserts that tighter regulations, properly supervised methods and well-enforced tools are advantageous to the public to achieve the common good in the banking sector.

Further, the state has established regulations with a supervisory authority to ensure these regulations are adequately enforced. This can be seen in the passing of the Depositor's Insurance Regulations and the Central Bank's regulatory role of protecting customers or depositors.

Applying this theory mandates the government to protect the depositors' savings from being mismanaged by banks. The depositor here is always the least advantaged since there is a lot of information asymmetry to the advantage of the bank. Therefore, this calls for efficient supervision by the CBK to ensure that no malpractices come into play. Social-economic differences must be managed so that the least advantaged are given a higher priority.

The Kenya Deposit Insurance Corporation (KDIC) is the institution charged with protecting depositors in Kenya. The KDIC offers three primary services, the provision of deposit insurance schemes for the customers of the various banks, incentives for sound risk management, and promptly resolving problem banks to mitigate failure and thus scupper the deposits of customers.

Banking supervision is of utmost importance to entrepreneurs, banks, researchers and policy makers.³¹ This is because more excellent banking rules and policies equal a positive outcome

²⁹ Maobe A, 'Regulatory arbitrage, supervisory capacities and information sharing in the wake of cross-border banking supervision', 9(7) *Research Journal of Finance and Accounting*, 2018, 11

³⁰ Heywood, *Political theory: An introduction*, 242.

³¹ Gwartney JD et al, *Economic freedom of the world: Annual report*, Fraser Institute, 2015.

where we have fewer trading barriers, quick access to funds or capital, and fewer risks. It is beneficial to overall economic growth. Law promotes human dignity by putting together frameworks that make it easier for lay people to accomplish ordinary business without hindrances. Failure would cause injustices that would eventually affect the people's common good and happiness. This is achieved by setting up regulations to protect depositors from unscrupulous and fraudulent dealings. The Public theory will be especially evident in evaluating policy justifications for bank supervision and further advance an argument on the purpose of tighter banking regulation. The economist Adam Smith wrote, "consumption is the sole purpose of all production, and the producer's interest ought to be attended to; only so far as it may be necessary for promoting that of the consumer."³² In short, the consumer's interest and protection always override that of the producer of services, goods and other factors.

1.7 Research Methodology

The research employs doctrinal research methodology or desk research. This research method uses existing literature, documents and other secondary sources to gather information and analyze a given subject or problem. I used this method to research specific topics without needing primary data collection or fieldwork.

The research opted for desk research as it allows for a comprehensive examination of the existing literature on bank supervision and its relationship to bank failures in Kenya. This is particularly useful for identifying the critical findings by scholars, the underlying causes of bank failures, and the gaps in the literature. It also allows for identifying the relevant laws and regulations that govern the banking industry in Kenya and interrogating them.

1.8 Literature Review

Bank crises and failure is not new phenomenon. Many scholars have engaged in the challenges underlying bank failure locally and internationally. A financially healthy banking industry is an essential element of economic growth.³³ This section reviews the literature and captures the

³² Smith A, *an inquiry into the nature and causes of the wealth of nations*, 1776: Book iv, Chapter viii, vol. ii, para.49.

³³ Gathaiya RN 'Analysis of issues affecting collapsed banks in Kenya from year 2015 to 2016', *International Journal of Management and Business*, 2017, 7.

significant concepts and outcomes. The study posits the averments of the authors while identifying the loopholes and gaps in the supervision of banks

1.8.1 Literature on the State of Banking Industry Supervision

Most scholars agree on the significance of bank supervision in any economy. Any laxity in banking supervision ought to be identified as soon as possible to avoid multilayered situations. Some justification for bank supervision emanates from the identified challenges in the industry. For instance, Gathaiya has detailed the issues affecting banks, focusing on the reasons for bank collapse. For example, Dubai Bank's failure, he says, was due to capital defiance and liquidity.³⁴ Further, for Imperial Bank, he opines that it was brought down by unstable business conditions and practices of transacting business. Finally, Chase Bank collapsed due to failure to meet the statutory banking ratios, under-reporting of insider loans, and corporate governance problems. The causes of these failures ranged over several years and were only detected at a later stage.³⁵

Gathaiya further appreciates that bank supervision by the CBK was not effectively enforced against internal and external threats faced by banks.³⁶ The laxity allowed weaknesses and threats to take root and eventually cause collapse. Gathaiya notes that non-performing loans are often due to a lack of due diligence. The assessment of low-risk and high-risk credits is often waived due to the internal pressures to meet targets and the speedy processes.³⁷ Moreover, the prevailing situation and the eventual collapse of the three banks listed above, notwithstanding the presence of legal frameworks established by the CBK, revealed the need for other criteria for banking sector supervision, especially in light of evolving nature of the financial industry.

Waweru and Kalani found that an internal lack of due diligence when lending was part of the causes of bank failures. The causes of internal negligence include political pressure, under-capitalization, over-concentration in ownership, and higher interest rates over charged to borrowers operating in the high-risk segments of the credit market.³⁸

³⁴ Gathaiya, 'Analysis of issues affecting collapsed banks in Kenya from year 2015 to 2016' 9.

³⁵ *ibid.*

³⁶ *ibid*, pg 9.

³⁷ *ibid.*

³⁸ Waweru NM and Kalani VM 'Commercial banking crises in Kenya: Causes and remedies' 3 *Global Journal of Finance*, 2009, 27-28.

Also, Huertas opines that bank supervision and regulations move hand in hand and that the underlying reasons for bank regulations, which are to protect the depositors and enhance economic stability, call for societies to regulate and supervise the financial sector.³⁹ He states that if a bank is well regulated but not well supervised, there's bound to be dissonance and that when a bank is well supervised, and the shareholders do not take care of their management and governance issues, it is bound to have issues. Huerta further asserts that supervision is only there to enforce regulation and not conduct of the bank, which he says is a duty laid upon the shareholders to ensure it is well aligned.

Horvitz states that bank examination as a tool for supervision and regulation is a costly process and that examination only does not guarantee that a bank will not fail; he asserts that bank examination ought to be utilized instead by the Deposit Insurance Corporation to determine insolvency before the bank loses its capital adequacy.⁴⁰

Another contributor to this discourse is Duffie, who states in his journal that the financial crisis of 2007 started with the over leveraged home owners plus a low housing market surge. However, he asserts that a reasonably supervised financial system would have weathered the financial storm. He says that the career supervisors and the supervisors from the Federal Reserve bank failed to correctly identify the high-risk leveraged loans, causing the great crisis; the flawed regulatory and supervisory sector was ranked as the highest contributor to the financial crisis in 2007.⁴¹ Darrel further notes that before the crisis, the oversight team responsible for the capital adequacy of the larger investment banks were lax. This indicates that where supervision of the banks is not carefully or rigorously carried out, the banks will not survive a crisis.

Upadhaya⁴², while analyzing the Prudential Guidelines to a supervisory framework, states that the banks before the failure of Chase Bank, Imperial Bank and later on Dubai Bank, gave an impression of adequate supervision until they failed. This shows that while the external perception

³⁹ Huertas F. Thomas 'The rationale for and limits of bank supervision'
<file:///C:/Users/My%20Pc/Downloads/rationaleforandlimitsofbanksupervision2009Huertas.pdf> visited 08/06/2022

⁴⁰ Paul M. Horvitz 'A Reconsideration of the Role of Bank Examination' 12 no. 4 (1980): 654-659
<https://www.jstor.org/stable/1991889>

⁴¹ Darrell Duffie 'Prone to Fail: The Pre-Crisis Financial System' 33 no. 1(2019), 81-86
<https://www.jstor.org/stable/26566978>

⁴² Radha Upadhyaya 'The political economy of Basel adoption in Kenya: A case of alignment of donor, government and banking sector interests' 151 (2017)

of banks may give the impression of being supervised, they may have internal issues that require more critical review.

Ellinger et al. relate banking supervision with operational safety and sound capital management necessary to address emerging risks.⁴³ Mugarura adds to this by noting that laxity in banking supervision should be identified sooner rather than later before they become multi-layered. If that is not done, then banks and other banks are likely to continue being targeted and exploited by criminals.

Mugarura also argues that when a bank is poorly supervised, it becomes vulnerable to criminal infiltrations into the system. For instance, he references several banks that the Central Bank of Uganda failed to protect depositors' money prudently.⁴⁴ He considers the purpose of supervision not to prevent crises within banks, closure of banks, or to protect depositors but rather to ensure that banks or other financial services are well set and run and maintain adequate reserves to cover withdrawal demands and unexpected losses.⁴⁵ Supervision should be construed through this lens. Efficient supervision is aimed at establishing an efficient banking system that, in the end, will automatically protect the depositors, avail credit facilities to both the citizenry and government agencies, and ensure that banks have enough resources to be involved in corporate social responsibility activities. In the end, efficient supervision leads to a significant economic impact and improvement of the Gross Domestic Product (GDP).

Enforcement may be instigated by the supervisor's monitoring, a complaint by a customer, another regulator, or a market participant, or notification by the regulator of a breach. It will typically involve an inquiry to determine whether there has been a breach, its causes and whether further action is required. The firm may experience the power to conduct an inquiry into a breach as punishment if it involves the suspension of work or damage to reputation. Such powers may be used simply for these purposes, which, although an abuse, would be difficult to challenge.⁴⁶

Mugarura gives an example of Crane Bank in Uganda as an institution that collapsed because below the required minimum capital threshold for a bank to operate effectively. This left BOU

⁴³ Ellinger et al 'Modern Banking Law' 5 Oxford University Press, London, 362-386

⁴⁴ Gathaiya 'Analysis of issues affecting collapsed banks in Kenya from year 2015 to 2016' 174-194.

⁴⁵ Mugarura and Namanya 'Supervisory mandate of Central Banks and the spate of bank failures: who to blame?' 341-353.

⁴⁶ Financial Conduct Authority, 'SUP15.3.1R' *FCA handbook*, 2016.

with no choice but to close the operations of Crane Bank and all its branches in Uganda. The BOU is responsible for the supervision and regulation of the financial sector in Uganda under the Banks Act 2004 (as amended) and the Micro Finance Deposit-Taking Institutions Act 2003 and Implementing Regulations

Mugarura further highlighted the collapse of Crane Bank and pointed out the role of Central Banks in providing supervisory oversight of local banks. Other failed banks in other jurisdictions, for example, the Bank of Credit and Commerce International (BCCI) in 1991, had a similar fate as Crane Bank. The BCCI was an example of a poorly managed bank. It disregarded regulatory oversight, and as a result, criminals could use it for illegal purposes.⁴⁷ The BCCI underscored how criminal-minded bankers could outwit regulators and accountants with national remits. The BCCI, with its Luxembourg registration, London Headquarters, Middle Eastern shareholders and worldwide operations, was regulated by everyone but no one. The bank structure made it very difficult for regulators to provide the required oversight from the Bank of England.

Other scholars have also addressed the challenges affecting adequate bank supervision. These authors appreciate the existence of unforeseen circumstances that may hinder the implementation of prudential supervision guidelines. For instance, Calomiris and Haber introduce a new twist to the bank crises by posing that problems sometimes arise due to unforeseen circumstances. This is characterized by the inability to foresee contingencies leading to economic shocks. However, they hold that poor governance politics in the supervision of banking facilities contribute to the causes of crises. To this end, they suggest that bank stakeholders form coalitions and alliances to shape laws, policies and regulations in their favor.⁴⁸ They further argue that government policies reflect vested interests in the banking industry as government receives shares of benefits from government-invested banks. Indeed, in a contemporary business environment, it is impossible to foresee all the exigencies that may lead to business failure. In the impending time, the world is engrossed in a Coronavirus-19 pandemic that has disrupted governments and businesses. The resulting economic effects of this health crisis will be felt for some time. However, the pandemic has also presented regulators with an avenue to enhance further the supervisory mechanisms that

⁴⁷ Mugarura and Namanya ‘Supervisory mandate of Central Banks and the spate of bank failures: who to blame?’, 341–353.

⁴⁸ Calomiris CW and Haber SH, *Fragile by design: The political origins of banking crises and scarce credit*, Princeton University Press, 2014, 11-12.

can withstand future pandemics. As it is indicated above, other factors cause bank failure. However, this study will focus on bank supervision, carefully assessing the model of supervision that CBK applies and the tools of this mode of supervision and find out if they are adequate to avert bank failure.

The foregoing literature has underpinned the state of bank supervision in preventing bank failures and ensuring economic stability. The recognized causes of bank failures in Kenya include capital defiance and liquidity issues, unsound business conditions and practice, failure to meet statutory banking ratios, under-reporting of insider loans, and corporate governance problems. The scholarship also appreciates the need for other criteria for banking sector supervision in light of evolving nature of the financial industry.

The existing research is, however, not up to date with the evolutions in the financial markets. There is a lack of specific recommendations to be adopted that aligns with the changes in the industry. This has created room for further research to propose solutions to improve bank supervision and prevent future bank failures in the country.

1.9 Study Scope

Whereas several factors are attributed to bank failure, factors cause bank failure, this study will focus on bank supervision, carefully assessing the model of supervision that CBK applies plus the tools of this mode of supervision and find out if they are adequate to avert bank failure as a whole. While most studies major around deregulation, competition, mergers and reforms in the financial sector, the current research will review the supervisory landscape and the various regulatory frameworks. It will analyse the effectiveness or otherwise of the various supervision mechanisms, identify the most effective ones, and propose measures to strengthen them in light of evolving banking industry in Kenya.

1.10 Chapter Breakdown

Chapter One

The chapter gives a general background to the study, capturing the concept of banks and their centrality in the economy, the historical development of bank failure in Kenya, the institutional safeguards against bank failure and the rationale for adequate supervision. The chapter also captures the statement of the problem being addressed and outlines the study objectives and

research questions while justifying the reasons for conducting the current research. It also engages with the public interest theory and how it shapes the thesis. Further, the chapter provides for the methodology to be applied in the research before providing a detailed literature review on bank supervision. The final part discusses the scope of the study.

Chapter Two

The second chapter details the theoretical and policy justification for bank supervision and captures the reasons for exercising supervisory jurisdiction in averting the bank failure crisis in Kenya. It provides rationales and justifications for protecting a polity's weak public and economic growth.

Chapter Three

Chapter Three discusses the legal framework for enforcing bank supervision by CBK over banks in Kenya. It analyses the constitutional, statutory and policy gaps in the legal infrastructure in the enforcement and implementation of the supervisory roles.

Chapter Four

Chapter Four identifies enforcement tools for the execution of supervisory roles over banks. To make the discussion fruitful, the study undertakes to illustrate best practices from other jurisdictions on how supervisory roles over banks are enforced and executed and their applicability in the evolving state of the financial industry

Chapter Five

Chapter Five provides the conclusions on the study's findings and proposes recommendations on the law, policy, administrative actions and research areas.



Chapter 2: Theoretical and Policy Justification for Bank Supervision

2.0 Introduction

The chapter delves into the theoretical underpinnings and policy justifications that inform the need for bank supervision in Kenya. It explores the various models of bank supervision employed globally and their effectiveness in promoting a stable and well-functioning banking system. The chapter also highlights the impact of technological advancements on the banking industry and the corresponding need for robust regulatory frameworks to tackle emerging risks. Furthermore, it underscores the importance of consumer protection and public interest in shaping the rationale for bank supervision in Kenya. By examining the lessons learned from the 2008-2009 global financial crisis, the chapter emphasizes the critical role bank supervision plays in safeguarding financial stability and fostering a thriving economy.

2.1 Conceptualizing the Nature and Types of Bank Supervision

Various legal instruments and scholarship have sought to define the term supervision. However, no individual definition is universally acknowledged in practice or academia. For instance, the Nigerian Deposit Insurance Corporation defines the term as:

'A supervisory function charged with the responsibility of ensuring the safety and soundness of the banking system as a whole. Books and affairs of every licensed, insured institution are examined as a means of meeting its supervisory mandate'.⁴⁹

From the definition, bank supervision is a government agency's institutional duty to ensure a banking system's safety and soundness. It entails a review of the bank's records to determine whether it follows the applicable law.

Notably, supervision precedes regulation. Whenever regulations and laws are developed, the regulator is charged with compliance with the rules, a function achieved through supervision. The regulation may range from capital requirements and limits on interests; supervision is often to ensure that the regulations are being complied with.

The current practice recognizes three supervisory models. These models are transaction-based, consolidated and risk-based. Transaction or compliance-based supervision is an approach that mainly focuses on individual group entities which supervise the institution according to their capital requirements as set by the regulator. The model is complemented by a general qualitative assessment of the group as a whole and, usually, by a quantitative group-wide assessment of capital adequacy. Under transaction-based supervision, financial institutions are supervised periodically. Supervision relates to a provider's compliance with the established rules and policies. For instance, the regulator will occasionally undertake transaction auditing of the institution, using the same measures and rules.⁵⁰ The approach has been associated with several limitations. For instance, smaller entities suffer the disadvantages of detailed scrutiny compared to larger institutions whose scrutiny is done at face value as they meet the requirements of the rule. Secondly, the method was considered based on rigid rules that are not flexible enough to meet urgent regulatory needs. It

⁴⁹ Nigeria Deposit Insurance Corporation, 'Types of bank supervision' <https://ndic.gov.ng/supervision/types-of-bank-supervision/> on 9 October 2021.

⁵⁰ Dias D. Izaguirre J C 'Risk-Based Supervision Is Key to Financial Inclusion in 2020 & Beyond' Blog (2020)

was, therefore, challenging to make meaningful comparisons, it penalizes past regulatory issues, and the supervision focused on legal compliance rather than risk management.⁵¹

On the other hand, consolidated supervision is a group-wide approach to supervision whereby all the risks undertaken by a group of companies are taken into account in the supervisory process. The approach entails identifying the risks to which the components of the group are exposed and the impact of such risks on the group's operational activities. Consolidated supervision is the process by which the supervisor can satisfy himself about the health of the entire group's activities. The group may include bank and non-bank companies, financial affiliates, and branches and subsidiary companies. Consolidated supervision has several objectives. First, it seeks to support the principle that no banking activity, and the associated risk, regardless of location, escapes supervision. Secondly, consolidated supervision prevents over-leveraging of capital- double counting, and evaluates the strength of a group to which a licensed bank belongs to assess the potential impact of other group members on the licensed bank. Finally, the supervision model consolidates the financial returns. The latter includes consolidating accounts of the licensed entity using a quantitative approach while ensuring that the qualitative approach evaluates the material risks on the financial position of the licensed bank.

However, this supervisory method often faces several issues and risks. First, the model overlooks the conglomerate's risks arising from their associations, subsidiaries, or related groups and parties. This may make supervision fail to timely and adequately respond to their risks. Secondly, the group's structure is too complex for the supervisors to understand. It requires multi-disciplinary skills and more resources for the supervisors to understand. Thirdly a risk of transparency, contagion and arbitrage.⁵² There was also a lack of reliable consolidated information, ability and skills to supervise some of the group financial activities, and no direct access to the subsidiaries and some of the consolidated holding companies are many of the challenges faced by this type of supervision.⁵³

⁵¹ Ross Jones 'Risk-Based Supervision; IOPS Work an APRA Experience' (2009) <http://www.iopsweb.org/principlesguidelines/42154033.pdf>

⁵² Joachin Gutierrez 'Group wide consolidated supervision in banks and financial groups' Toronto Centre Global leadership in financial supervision (2016) <https://res.torontocentre.org/>

⁵³ Jose Vinals et al 'The making of Good Supervision: Learning to say No'

RBS assesses the efficacy of a bank's ability to identify, measure, monitor and control risks. It designs a customized supervisory program for each bank and focuses more attention on banks that are considered to have potentially high systemic impact. The nature of the banking business makes banks inextricably involved in risk-taking. Banks' significant business risks include credit, market, liquidity, operational, legal and reputational risks. In practice, a bank's business activities present various combinations of these risks, depending on the nature and scope of the particular activity. To the financial sector regulatory and supervisory authorities, risks threaten or endanger the achievement of given statutory objectives. The study shall further discuss this type of supervision and its adequacy in Kenya.

2.2 Economic Rationale for Heightened Supervision of Banks in Kenya

2.2.1 Increased risks of Money Laundering and Terrorism Financing

The deployment of Technology products such as the Distributed Ledger Technology (DLT)⁵⁴ and virtual currencies in the financial sphere has enhanced the risks of Money laundering and the financing of terrorism. DLT has resulted in disintermediation⁵⁵ in financial transactions. This has altered the traditional methods of delivery of financial services, leading to a widespread increase in cross-border transactions.⁵⁶ Owing to the relaxation of the traditional regulatory protocols as a result of disintermediation, the efforts in countering the financing of terrorism (CFT) are likely to be thwarted.⁵⁷ Distributor Ledge Technology is based on anonymous users and has therefore rendered public authority-monitoring of transactions more complex. The resultant financial players in the emerging digital paradigm fall beyond the traditional banking sector regulation scope, hence not subject to the rigors of the CFT rules.⁵⁸ This justifies the need for tighter regulation coupled with closer up-to-date skilled supervision.

⁵⁴ This refers to a means of recording information through a distributed ledger, i.e., a repeated digital copy of data at multiple locations. *See* European Securities and Markets Authority, *ESMA, the distributed ledger technology applied to securities markets*, 2017.

⁵⁵ Collao VV and Winship V, 'The new ICO intermediaries' *Italian Law Journal*, 2019, 5.

⁵⁶ Didenko A, 'Regulating fintech: Lessons from Africa' *San Diego International Law Journal*, 2018, 19.

⁵⁷ Arner DW, Barberis J and Buckley RP, 'FinTech, RegTech, and the reconceptualization of financial regulation' *37(3) Northwestern Journal of International Law & Business*, 2017, 37.

⁵⁸ Basel Committee on Banking Supervision, *sound practices: implications of fintech developments for banks and bank supervisors*, 2018, 23.

Further, virtual currencies such as Bitcoin⁵⁹ remain a breeding ground for money laundering. This is due to their lack of enforcement of client-identification procedures.⁶⁰ This makes the crypto currency amenable for use in money laundering. The recent announcement by the CBK of switching to Bitcoin as its reserve currency⁶¹ further drives these risks closer home. This recent move is a sharp departure from the CBK's last stand on cryptocurrencies,⁶² a testament to Kenya's gradual conformity with this global wave. Owing to the lack of well-crafted identification procedures in Bitcoin transactions, Kenyan Banks, which will be subject to implementing the CBK recommendations, are vulnerable to money laundering risks. This calls for a more focused, forward-looking supervisory framework incorporating these developments.

For instance, it is projected that the financial sector will be more affected by advancements, with world economies likely to adopt cryptocurrencies as a currency. Countries such as China have already shown indications of this acceptance. With such economies taking this path, more States are likely to take up the practice, making it the norm in the financial sector. As a result, Kenya needs to remain alert to avoid falling under a technology blackout in a dynamic field as finance

Given this, the technology revolution, similar to any novel innovative, is innately disruptive to the system of legal regulation. It is not concordant with the existing available frame works, and this begs supervisors and regulators to craft the necessary response adequately. Owing to Kenya, alongside South Africa, being the largest Technology hub in Africa⁶³, the need for enhanced supervision is far more pressing. The need to harness these benefits of technology while also managing the attendant risks justifies more heightened supervision.

⁵⁹ Bitcoin refers to a virtual currency or asset which has no one repository or single administrator. See Christians A, 'Taxation in the age of smart contracts: The cryptokitty conundrum' 16 *Ohio State Technology Law Journal*, 2020, 16.

⁶⁰ Singh K, 'The new Wild West: Preventing money laundering in the bitcoin network' 37 *Northwestern Journal of Technology & Intellectual Property*, 2015, 13.

⁶¹ International Finance Business Desk, 'Kenya plans to switch its base currency to bitcoin', 15 February 2021. <<https://internationalfinance.com/kenya-plans-switch-base-currency-bitcoin/>> accessed 21 March 2021.

⁶² Central Bank of Kenya, *Public Notice: Caution to the Public on Virtual Currencies Such as Bitcoin*, December 2015. [https://www.centralbank.go.ke/images/docs/media/Public Notice on virtual currencies such as Bitcoin.pdf](https://www.centralbank.go.ke/images/docs/media/Public%20Notice%20on%20virtual%20currencies%20such%20as%20Bitcoin.pdf) on 21 March 2021

⁶³ Chitavi M, Cohen L and Hagist S, 'Kenya is becoming a global hub of fintech innovation' *Harvard Business Review*, 2021 <https://hbr.org/2021/02/kenya-is-becoming-a-global-hub-of-fintech-innovation> 21 March 2021.

The evolution of the banking sector from the traditional deposit-taking and credit advancement channel to the modern sector offering a myriad of services renders the need for the CBK to tighten its supervisory arm to avoid bank crises.

Development in mobile banking, a system that merges banking services with telecommunication organizations, further justifies the need to review the supervisory framework for its sufficiency. The mobile money industry developed to capitalize on the millions of subscribers not served through the traditional banking system. Increasingly, there is a trend where banking-service providers move to digital platforms to escape CBK supervision. Banking clients can now remotely apply for and repay loans. New clients can now open and manage their accounts, transact cash across banks, and engage in cross-border banking. All these avenues present a penumbra ground that can be exploited by fraudulent persons and thus evade the regulations set forth. These realities call for a tighter supervisory mechanism by the CBK to catch up with the technological advancements in the banking sector.

The CBK Act was amended to include the regulation and supervision of digital lenders. The bill was passed into law in December 2021; the CBK now has the mandate to supervise and regulate digital financial products and services by licensing digital credit service providers who are not regulated under any other law.⁶⁴ This new law has provided for oversight by CBK over the now lucrative digital financial sector, and the CBK has regulated the previously unregulated sector⁶⁵.

2.1.2 Consumer Protection

Consumer protection generally connotes rules and regulations to ensure fair play between producers, service providers, and consumers.⁶⁶ The protection of consumers is an essential factor informing the supervision of financial institutions such as banks. Its overriding objective is to foster consumer-confidence in the product or service.⁶⁷ The banking sector thrives where there is a

⁶⁴ *Central Bank of Kenya (Amendment Act)*, (2021)

⁶⁵ <https://www.centralbanking.com/regulation/7906921/kenyan-central-bank-to-oversee-digital-lenders> on 08/10/2022

⁶⁶ Benston G J, 'Consumer protection as justification for regulating financial-services firms and products' *Journal of Financial Services Research*, 2000, 17.

⁶⁷ Reiss D, 'Consumer protection out of the shadows of shadow banking: The role of the consumer financial protection bureau' 7(1) *Brooklyn Journal of Corporate, Financial & Commercial Law*, 2012, 7.

consumer-confidence in the services provided. Consumer confidence motivates customer confidence with banking, taking credit and remaining true to the terms of repayment.

In this regard, self-regulation is often inefficient because the producers (banks) naturally possess a more significant asymmetric-information advantage over the consumer.⁶⁸ The information asymmetry between the customers and the banks can be exploited to the detriment of the customers. This, therefore, makes the necessity of external supervision much more crucial. This realisation informs the need for government regulation in addition to self-regulation pursued by industry players such as the Kenya Bankers Association.

The diversification of financial services in Kenya calls for adequate supervision. If banks are efficiently supervised, confidence is instilled in both the customers and the public. A healthy financial system in a given country shapes the development of small and medium-sized enterprises. This ensures proper governance in the country, and the general public is assured of affordable level process. Financial supervision of the banks ensures affordable interest rates and no varying inflation levels in the economy.

Campbell⁶⁹ posits that the maintenance of this confidence is vital for economic growth and stability. Benston⁷⁰ further delves into the importance of this confidence by citing the negative repercussions of a systematic failure occasioned by a loss of confidence in banks. Withdrawal of consumers from banks due to wanting confidence can be catastrophic to any economy. Enhanced banking supervision is tailored to boost consumers' confidence in banks and prevent their withdrawal. The reverting by customers to traditional banking modes will lead to a deterioration of the currency and trading with foreign currencies, increasing beyond what the ordinary citizens can afford. Withdrawal of money from the economy curtails the developments and improvements in the living standards of the people. Therefore, the banking sector needs to put in place effective supervisory mechanisms to maintain this confidence.

⁶⁸ Wen S, 'Banking consumer protection regulation in China' *Hong Kong Law Journal*, 2016, 46

⁶⁹ Campbell JY, 'Restoring rational choice: The challenge of consumer financial regulation' 106(5) *American Economic Review*, 2016, 106.

⁷⁰ Benston, 'Consumer protection as justification for regulating financial-services firms and products'.

Consumer protection in the financial sector dictates adequate disclosure of relevant information to the consumer. Llewellyn⁷¹ writes that a high-degree of information disclosure is vital in ensuring that consumers are effective in the financial markets. Notwithstanding the importance of this disclosure requirement, there is no universally-prescribed disclosure model due to the unique and varied experiences of different markets.⁷² Consumer protection is a constitutional decree in Kenya. This informs the move to enact various parliament statutes, including the Consumer Protection Act, to lay a framework for consumer rights protection.

The establishment of the Deposit Insurance Scheme (KDIS) under the Kenya Deposit Insurance Act⁷³ sought to realize consumer protection. Banks must take insurance for the depositors in their banks up to a certain amount to prevent moral hazard. This is also KDIS-mandated supervisory duty. For example, when Chase bank was under receivership, to save the consumers, the KDIS brought in Kenya Commercial Bank (KCB) as a bridge bank to maintain its operations until it was sold to SBN Bank. However, Chase Bank depositors are yet to receive their money fully. The bank failure and consumers' not recovering their money have greatly affected the public trust in the banking system.⁷⁴

Supervision ensures that banks or other financial services are in tandem and maintain adequate reserves to cover withdrawal demands and unexpected losses. Therefore, whenever there is an abrupt bank failure or crisis, the supervisory department must be checked. As noted in Mugarura's work earlier, laxity in supervision can have a significant impact that can lead to the bank's failure. Suppose a bank is not well supervised through close monitoring and imposing of sanctions on the violators of the regulations. In that case, it boils to a much graver impact on the economy when the bank collapses.

In sum, consumer protection informs the need for enhanced banking supervision in Kenya. The imperative need for consumer confidence in banks calls for intensified supervision. Additionally,

⁷¹ Llewellyn D 'Regulation of retail investment services' 15(2) *Economic Affairs*, 1995, 17.

⁷² Ebers M 'Information and advising requirements in the financial services sector: Principles and peculiarities in EC Law', *Electronic Journal of Comparative Law*, 2004, 8.

⁷³ Kenya Deposit Insurance Act, 2012

⁷⁴ Omay CA, 'Protection of depositors' interests within the banking sector in Kenya – an analysis of directors' duty to promote the success of the company and the suitability of the compensation fund when the bank fails' Published, Strathmore University, Nairobi, 2021, 37.

the complexities of the requirement for information-disclosure demand a different framework of supervision which is appreciative of the Kenyan experience.

2.2 Social Rationale for Banking Supervision in Kenya

2.2.1 Public interest

The need to effectively supervise banks is also based on appreciating the adverse effects of bank failures on the public. Bank supervision is therefore done in the public interest. In this regard, the study contends that financial stability is one of the most vital interests of any society and that the supervision of banks should be a means of safeguarding such stability

2.2.1.1 Bank failures, financial instability and public interest

The financial market is undoubtedly an offshoot of the socio-economic life of a people. Any alteration to the financial market has a corresponding effect on the broader society.⁷⁵ As a significant aspect of the financial market, the banking system is intricately tied to society. Bank activities affect all aspects of society. Bank supervision is justified from a public interest viewpoint due to its role in safeguarding society from the harsh consequences of bank failures.⁷⁶ Feldstein aptly captures the rationale as follows:

‘The banking system as a whole is a ‘public good’ that benefits the nation over and above the profits it earns for the banks’ shareholders. Systemic risks to the banking system are risks for the nation. Although the management and shareholders of individual institutions are, of course, eager to protect the solvency of their institutions, they do not adequately take into account the adverse effects to the nation of systemic failure’.⁷⁷

There is no gainsaying that banks hugely impact the financial system through their behaviors. A well-functioning and healthy financial system is, therefore, contingent on the proper behavior of banks. This financial stability can only be achieved through an effective supervisory mechanism. Conversely, poor banking regulation and supervision lie at the root of any financial instability. An

⁷⁵ Allen HJ, ‘Putting the financial stability in financial stability oversight council’ *Ohio State Law Journal*, 2015, 76.

⁷⁶ Macey JR and Miller GP, ‘Bank Failures, Risk Monitoring, and the Market for Bank Control’ 88(6) *Columbia Law Review*, 1988, 88.

⁷⁷ Feldstein M, *The Risk of Economic Crisis*, University of Chicago Press, Chicago, 1991.

analysis⁷⁸ of the great economic recession of 2008-2009 reveals invaluable lessons for the future of the banking industry in developing economies like Kenya. The economic depression of 2008-2009 culminated in the failure of high-profile banks. Lehman Brothers, for instance, was one of the venerated banks which went under due to the crisis. The institution's failure and others plunged the world economy into economic instability.⁷⁹ While the world economy gradually recovered from the recession, it still reeled from what was described as the “greatest bankruptcy in US history” after the great depression.⁸⁰

The repercussions of bank failures, such as unemployment and foreclosures, were also brought to the fore by this crisis. The world has posted the economic recession adopted various mechanisms geared towards the aversion of another economic crisis and thus ensures a thriving economy in the entire world.

Looking back at the economic crisis, many economists have majorly attributed its cause to banks' slack mortgage lending policies.⁸¹ The crisis became a telling testament to the devastating repercussions that any economy is bound to suffer due to a lack of proper bank-supervision. The subsequent legislative and policy adjustments adopted by the various governments targeted banks and were meant to prevent the reoccurrence of a similar crisis in the future. In most jurisdictions, such as the United Kingdom and the United States of America, there were legislative. Policy frameworks that separated the roles previously performed by one actor as both a prudential and market regulator,⁸² the separation of roles and the establishment of proper disclosure mechanisms have seen the two economies rise from the devastating effects of the recession and dominate the global economy.

By and large, banks constitute an integral part of any polity's socio-economic life. Their behavior has a corresponding effect on society as a whole. The ravaging results of bank failures, such as economic instability, cross-cutting and far-reaching to every sector of society. The stability of banks is thus in the interest of every member of society. Therefore, the supervision of banks is

⁷⁸ Dullien S et al., *The Financial and economic crisis of 2008-2009 and developing countries*, 2010, UNCTAD/GDS/MDP/2010/1

⁷⁹ Sigh M, ‘The 2007-2008 Financial Crisis in Review’, Investopedia, <https://www.investopedia.com/articles/economics/09/financial-crisis-review.asp> on 1 December 2021.

⁸⁰ Allen, ‘Putting the financial stability in financial stability oversight council’ 76

⁸¹ Arner DW, ‘the Global Credit Crisis of 2008: Causes and Consequences’ *International Law Journal*, 2009. 43.

⁸² <http://theconversation.com/after-a-long-line-of-financial-disasters-uk-banks-on-regulatory-change-13291> on 08/11/2022

justified on the account that the general populace stands to benefit from their stability and performance.

2.3 Discussion on the Findings of the Theoretical and Policy Justification for Bank Supervision in Kenya

The foregoing research reveals that bank supervision is a government agency's institutional duty to ensure the industry's safety and soundness. It involves the review of records to determine compliance with the applicable laws and regulations. The findings further underlie the existence of three main supervisory models: transaction-based, consolidated, and risk-based. Each model has strengths and weaknesses, and the most appropriate approach may depend on the specific context and regulatory objectives. The Kenyan banking sector has adopted the risk-based model based on its ability to identify, measure, monitor and control risks, focusing on banks with higher systemic impact.

The findings have also outlined the various policy justifications for bank supervision. For instance, deploying technology products such as SLT and virtual currencies in the financial sector has increased the risks of money laundering and financing terrorism. DLT has resulted in disintermediation in financial transactions, altering traditional methods of financial services delivery and leading to an increase in cross-border transactions. This has made it more difficult for public authorities to monitor transactions and has created a need for tighter regulation and closer, skilled supervision. Virtual currencies such as Bitcoin are also a breeding ground for money laundering due to their lack of enforcement of client-identification procedures. With the increasing adoption of cryptocurrencies by other economies, Kenya needs to remain alert and adopt a forward-looking supervisory framework to manage these risks, cumulatively a precursor for bank failure.

Other justifications for more focused bank supervision have been anchored on the need for consumer protection. Consumer protection and public interest are reasons for enhanced banking supervision as they ensure fair play between the consumers and the service-providers. Public interest justification for bank supervision is driven by recognizing the adverse effects of bank failures on society and the economy and the need to safeguard financial stability. The complexities of information disclosure requirements also necessitate a unique framework for supervision in Kenya.

2.4 Conclusion

This chapter has underpinned the positive relationship between bank supervision (including the various forms of supervision) and bank performance in Kenya. The CBK's supervisory framework, which includes on-site inspections and off-site monitoring, has helped improve the banking sector's overall stability and soundness. However, the chapter has also identified the need for better risk management systems in supervision and more effective enforcement of regulations. The next chapter will delve into the legal and regulatory framework for bank supervision in Kenya, including the roles and responsibilities of the CBK and other regulatory bodies in ensuring the banking system's stability.



Chapter 3: The Legal and Institutional Framework on Bank Supervision in Kenya

3.1 Introduction

Many scholars have engaged in the issue of financial market regulation. Thiemann and Lepoutre appreciate that regulation and regulatory compliance are critical in shaping financial markets and consider the financial products being traded to be 'synthetic bundles of law and measurements.'⁸³ This chapter analyses the legal and institutional framework governing bank supervision in Kenya. This discussion flows from the Constitution of Kenya 2010, statutes and regulations and international laws that the country has recognized as forming part of the Kenyan legal system.

3.2 The Domestic Legal Framework

To understand supervision in Kenya, we need to delve a bit into how the regulation is performed and passed before the tool of supervision is applied and enforced in the financial system in a country. Banking Regulation goes through four stages: drafting, debating and then the assenting stage; once assented to, it becomes an Act. Article 231(1-5) of the Constitution of Kenya sanctions the powers of the CBK and grants it the independence to supervise.⁸⁴ However, the Executive still

⁸³ Matthias Thiemann and Jan Lepoutre, 'Stitched on the Edge: Rule Evasion, Embedded Regulators, and the Evolution of Markets' (2017) 122 *American Journal of Sociology* 1775, 1776.

⁸⁴ The Constitution for Kenya 2010 Article 231

exerts its powers on the CBK, like the appointment of the Governor of the CBK and the CBK Board all appointments of; executive for example, the Governor was appointed. There was a two-year's delay in appointing the Board members, which in the end caused a few hitches, like the board could not sit because of lack of quorum.⁸⁵

Since 2000, banking regulations such as the CBK Act, the Banking act and other prudential regulations and guidelines have gradually been amended to strengthen supervision and regulation of the banking sector and keep up with international best practices, especially the Basel Core Principles. In October 2000, guidelines were issued requiring banks to conform to the Basle Capital Accord in terms of capital composition and new regulatory capital ratios were specified. The October 2000 guidelines also reinforced the single borrower limits to 25% of core capital, restricted lending to insiders to 20% of core capital, defined an extensive exposure as 10% of core capital, and further restricted the lending to all large borrowers to five times the core capital. The CBK improved regulation to supervise Kenyan banks expanding into regional countries effectively, incorporated the relevant provisions of the Constitution of the Republic of Kenya 2010, and supported the realization of other Government-driven initiatives such as Vision 2030, as already explained above. Overall, this section has shown that Kenya has adopted parts of International Banking Standards in response to internal banking and financial crises. Basel II adoption's majority of regulations were adopted between 2003 and 2013.⁸⁶

This gave the impression that between 2007 and 2014, the banking sector in Kenya was relatively calm, with only one bank failure. It was primarily attributed to improved capital holdings of banks in Kenya and the adoption of Basel Capital Standards. It has been noted that in 2012, the total capital-to-risk-weighted ratio of Kenyan banks was 23% which was well above the minimum capital requirement of 12%.⁸⁷

However, it now seems that the Kenyan banks were more fragile than these numbers portrayed, as three banks – Dubai Bank, Imperial Bank and Chase Bank were put under CBK statutory

⁸⁵ R Upadhyaya 'Analyzing the Sources and Impact of Segmentation in the Banking Sector: A Case Study of Kenya' (2011)

⁸⁶ R Upadhyaya 'Analyzing the Sources and Impact of Segmentation in the Banking Sector: A Case Study of Kenya' (2011)

⁸⁷ R Upadhyaya 'Analyzing the Sources and Impact of Segmentation in the Banking Sector: A Case Study of Kenya' (2011)

management in 2015/2016. At the same time, these banks are not systematically important; the effect of these bank failures shook the reputation of other private banks and the confidence of depositors in the banking sector.⁸⁸ The case of Imperial Bank highlighted weaknesses in supervision as reports indicated that the bank was carrying out unsafe practices for over twelve years. The current Governor of the CBK, Dr Patrick Njoroge, highlighted a need to improve supervision dramatically, and CBK had recently begun to hire more inspection employees. However, it is unclear how CBK would deal with insiders suspected of abetting malpractices in fallen banks.⁸⁹

The skills needed by supervisors were scarce and mainly required long training periods, and retaining qualified supervisors is difficult because of the salary differences between the public and private sectors. Effective regulation is also impeded by political interference. As such, regulatory policy should not rely exclusively on the imposition of prudential rules and regulations this is because unskilled human resource means poor financial crisis management.⁹⁰

The Banking Act⁹¹ confers onto the CBK the mandate to regulate and supervise banks. The Central Bank works closely with other institutions like the Capital Markets Authority (CMA), the Insurance Regulatory Authority (IRA) and other financial institutional authorities relevant to the country's financial stability and soundness. The subsequent section analyses domestic laws and institutions charged with bank regulation and supervision.

3.2.1 The Constitution of Kenya 2010

The Constitution of Kenya 2010⁹² establishes CBK as the central regulator of Banks, with a mandate to license and supervise financial institutions, among other roles. Such licensing and supervision are to be achieved through constant review and development of regulations and guidelines. The aim is to foster a robust banking sector where consumer interests are protected.⁹³ Article 10 of the Constitution also outlines the National Values and Principles of Governance as binding all state organs, officers, public officers and persons when they interpret or apply the

⁸⁸ Ngugi B, 'Moody says CBK lacks capacity to handle new crisis' Business Daily, 2016.

⁸⁹ Ngugi B, 'Kenya: Central Bank to Recruit More Inspection Employees' Daily Nation, 13 April 2017.

⁹⁰ J Vinals 'making of good supervision: learning to say "no"' IMF note 2010, 11

⁹¹ Banking Act Chapter 488

⁹² The Constitution of Kenya (2010) Article 231

⁹³ <https://www.globallegalinsights.com/practice-areas/banking-and-finance-laws-and-regulations/kenya> on 08/17/2022

Constitution, enact, apply or interpret a law or make and implement public policy decisions. These principles include good governance, integrity, transparency, accountability and sustainable development. The foregoing principles are crucial for a well-functioning financial system. They require a banking regulator or supervisor to adhere to them whenever they apply a law or a policy framework.

3.2.2 The Central Bank of Kenya Act

The CBK Act confers the CBK the power to license, supervise, and develop policies and regulations for financial institutions and to self-govern as long as it is not contrary to the CBK Act.⁹⁴ The CBK (Amendment) Act 2021, as amended to regulate the previously unregulated digital financial providers, now regulates and supervises the digital financial services providers; the CBK, in line with this amendment, further published new regulation guidelines to guide these digital institutions on how to be licensed and many other provisions.⁹⁵ The CBK must consider the government's economic policy in carrying out its obligation as part of its mandate of realizing financial stability.

3.2.3 The Banking Act Chapter 488

The Banking Act and its subsidiary legislation apply to the country's banking business, mortgage businesses and financial businesses. It regulates the licensing and supervision of banks by the CBK and provides for the minimum requirements for the functioning of banks and other financial institutions.⁹⁶ The CBK, under the powers conferred to it by the Act, has set up several regulations and guidelines and risk management guidelines for the banking sector, for example, the CBK prudential Guidelines, 2013; this is pursuant to Section 33(4) of the Banking Act, and applies to institutions intending to carry out banking business, the CBK guidance on climate-related Risk management, 2021.⁹⁷

3.2.4 The National Payment System Act

The National Payment System Act provides for the supervision of payment institutions. Just like the CBK Act, the model heavily propounded by this Act is physical or onsite supervision. Section

⁹⁴ S 3(4) Central Bank Act Chapter 491 of the Laws of Kenya

⁹⁵ <https://www.centralbank.go.ke> on 08/18/2022

⁹⁶ S 4 Banking Act Chapter 488 of the Laws of Kenya

⁹⁷ <https://www.globallegalinsights.com>

17 of the Act invites the CBK to efficiently and effectively supervise the payment clearing systems in Kenya. Also, regulation 33 of the National Payment System Regulations of 2014⁹⁸ calls for on-site supervision, which is implemented through examination. The practical examination will entail furnishing bank books and records to the CBK, which will physically review the presented records. This Act and its 2014 Regulation is the first legal framework to outline how banking supervision can be achieved. The tools provided are examinations achieved through presenting the entity's records to the CBK. The limitation is that there is no recognition of off-site supervision which can be more efficient with the evolving trends under the wheels of the fourth industrial revolution.

The challenge with on-site supervision seems to be the dominant strain on banking industry supervision in Kenya. The Microfinance Act⁹⁹ empowers the CBK to conduct on-site meetings with a financial institution to discuss supervisory responsibilities. This may be as a result of an audit on the books of the financial institution or as a result of accounting controls. The CBK is further mandated to collect, analyse and maintain supervision information and act as a watchdog on any specific institution.¹⁰⁰ It is then the right of the CBK and a resulting duty of the financial institution to access and furnish the information related to the supervision in promoting transparency. Under this framework, off-site supervision is a long distant stranger. Yet again, adopting risk-based supervision that utilizes various matrices, among them sensitivity analysis and stress testing, has alleviated an adverse event. This timely discovery will ensure that the event's occurrence and the impact on the system are inhibited at an early stage, an assessment is conducted, and there is risk management. The adoption of this mode of supervision within the Kenyan financial sector has ensured that there is averted liquidity risks, risks related to operations, and reputational risks are averted since the banking sectors services are hinged on their reputation, there is an efficient mode of combating the financing of terrorism and anti-money laundering will also get a boost.

This reality calls for a deep reflection on how supervision and its enforcement of the banking industry can be effective in Kenya. Supervision, the Banks' direct financial stability function, must be well established to avert bank failure.¹⁰¹ Firstly, adequate supervision must be fundamental to

⁹⁸ National Payment Systems Regulations, 2014

⁹⁹ Microfinance Act 19 2006 Laws of Kenya.

¹⁰⁰ Koker L, Morris N and Jaffer S, 'Regulating Financial Services in an Era of Technological Disruption', *Law Context: A Socio-Legal Journal*, 2019, 36.

¹⁰¹ Professor N Ndung'u 'Understanding Financial Stability: the role of Central Bank in Financial Stability' 5 (2013)

the changes in the global markets, having properly designed policies, rules, principles and regulations for banking industry supervision. Secondly, the specific tools must be recognized, and the practical means and implementation methods must be identified to avert future banking industry failures. Intentionally, technologically based supervision should be considered in Kenya. Kenya has always been touted as the Silicon Valley in sub-Saharan Africa.

The adoption of the RBS model of supervision ensures that the Kenyan banking sector can channel adequate resources to deserving sectors. For instance, even though it is prudent to exercise customer due diligence, an RBS approach dictates that there be procedures and policies within the legal framework that consider the level of risk posed by the specific clientele of a bank. In so doing, the banks are positioned to make informed decisions influenced by facts and redirect resources to areas that give rise to higher risks in the banking sector. Embracing this supervision mode has alleviated the bureaucratic *red tape* for lower-risk customers. Instead, it ensures that there is a dynamic and flexible structure which ensures a dynamic risk management environment adapted to the changing risk profiles of the various customers. This method also hampers money laundering and financing of terrorism.

The CBK adopted the RBS model of supervision as a new way to improve financial stability in the banking industry and borrowing. This chapter analyses the legal and institutional framework for bank supervision as defined in the various domestic and international laws and institutions and best practices.¹⁰² In achieving the objectives and answering the research questions of this study, this chapter will adopt a critical approach to the legal regime analyzed vis-à-vis their application in Kenya.¹⁰³

3.3 Regional Legal Framework

Various institutions have been placed at regional levels within Africa geared at promoting adequate bank supervision in achieving the ideals and tackling challenges facing the region and Kenya specifically. These regional measures exist within a background of integration efforts in Eastern Africa that has prospects, among others, to establish a Monetary Union in the coming days. Understanding the regional supervisory framework for the banking sector is therefore critical not

¹⁰² Thakkar H, 'Trade-off between Soft Law versus Hard Law in Developing Jurisprudence of Prudential Global Financial Regulatory Framework' *Gujarat National Law University Journal of Law, Development & Policy*, 2019, 9.

¹⁰³ Nolle DE et al., *A Cross-Country Analysis of the Bank Supervisory Framework and Bank Performance*, 2002, 22

only because of the cross-border nature of transactions but because of the future integration, which will rest of a uniform policy framework among the Member States.

3.3.1 East African Monetary Institute Act 2019

The East African Monetary Institute Act is a Protocol introduced on December 23rd 2019. The Protocol calls for the creation of the East African Central Bank, tasked with creating and implementing policies on bank supervision. One of the prerequisites of the Protocol is the need to have the central banks within the EAC harmonize their supervisory rules and procedures. Article 4 of the Protocol mandates the adoption of “common principles and rules for the monetary regulation and prudential supervision of the financial system”.¹⁰⁴ Though the progress in the implementation full implementation of the Protocol has been slow, it depicts the goal of having a viable financial institution with proper supervisory mechanisms.

3.3.2 Eastern and Southern African Anti-Money Laundering Group

Money laundering is one of the risks facing the banking industry. As such, the supervisor should design mechanisms to ensure that banks do not engage in money laundering activities.¹⁰⁵ An approach this institution takes is a Collaboratory one which enables sharing of information among Eastern and Southern Africa. This approach is justified under the BCBS core principles of bank supervision.

3.4 International Framework

This section discusses vital treaties establishing the International Monetary Fund and its influence on the Kenyan supervisory framework. Further, this will be supplemented by an extensive analysis of international customs, informing the best practices in Kenya.¹⁰⁶

3.4.1 Articles of Agreement Establishing the International Monetary Fund

These Articles entered into force on 27th December 1945. The Articles promoted international monetary cooperation among member states by providing assurance and trust. Further, their

¹⁰⁴ East African Monetary Institute Act 2019

¹⁰⁵ Morais HV, 'The War against Money Laundering, Terrorism, and the Financing of Terrorism' *Lawasia Journal*, 2002

¹⁰⁶ Jaarsveld ILV, 'Domestic and International Banking Regulation and Supervision - Defying the Challenges' *South African Law Journal*, 2002, 119

purpose is to create stable exchange stability in economic realms.¹⁰⁷ The Articles mandate member states to seek and direct proper policies on their economic and financial sectors in which the CBK and banks registered under the Banking Act fall. The ultimate aim is to ensure orderly economic growth and prevent any intermittent disruptions affecting public trust in financial institutions, more so banks.¹⁰⁸ IMF has become a watchdog on domestic financial policies, including bank supervision.¹⁰⁹ Implementing the Articles means that the Kenyan supervisory framework has real-time access to information and data on the banking industry. Kenya as a signatory is expected to design and enforce supervisory tools at par with global financial trends.

IMF has taken strict measures and challenging conditions for the banking industry in Kenya. It has specifically kept a sharp eye on CBK supervision of banks and the efficacious result of that supervision.¹¹⁰ This is primarily because of bank failures which had seen numerous banks going under and subsequently liquidated with investors' money, and public saving is taken into the shackles of loss.¹¹¹ For Kenya to continue being the attractive investment destination it has been in the past and even improve its momentum, it has shifted from the original rule-based supervision model to the Risk-Based Supervisory (RSB) and established guidelines and a framework for the RBS.¹¹²

3.4.2 CBK's Application of these Articles

The CBK adopted the RBS approach in 2004 to improve its enhancement to the global financial arena. The approach was chosen because it offered a better and much-improved model with a more practical approach to supervision than the rule-based approach. Indeed, the rule-based approach had proved to be mainly focused on transaction testing to ascertain the accuracy of the statement of financial position, statement of comprehensive income, the adequacy of internal controls and ensuring compliance with the applicable laws and regulations and had thus not yielded many results, especially with the larger institutions, due to its difficulty in separation of the high and

¹⁰⁷ Mwenda KK, 'Recent Developments in Banking Supervision and Systemic Bank Restructuring: A Legal Perspective' *Zambia Law Journal*, 1999, 31.

¹⁰⁸ Gold J, 'Exchange Contracts, Exchange Control, and the IMF Articles of Agreement: Some Animadversion's on *Wilson v. Smithett & (and) Cope Ltd. v. Terruzzi*' *International & Comparative LQ*, 1984, 33.

¹⁰⁹ Singh D, 'Role of the IMF and World Bank in Financial Sector Reform and Compliance: An Outline', *the European Business Law Review*, 2000, 18.

¹¹⁰ <https://www.elibrary.imf.org/view/books/071/12184-9781616352295-en/ch05.xml> on 5 December 2021

¹¹¹ <https://www.businessdailyafrica.com/bd/news/failed-banks-hold-sh13bn-in-customers-cash-imf-2278646> on 5 December 2021

¹¹² Central Bank of Kenya, *Risk Based Supervisory Framework, Bank Supervision Department* (2013) 3

low-risk activities undertaken by these larger institutions. It was also further considered to be backward and outdated and limited to only a few areas of the financial institutions. It never addressed the root cause of the problem but instead quantified and prescribed solutions to the symptoms making the problems reoccur to the point of institutional collapse. The solutions adopted under this Rule-Based approach tended towards risk reduction rather than management of risks through identification, measurement and monitoring of risks.

As adopted, the Risk-Based Supervisory (RBS) approach addressed several gaps that made the economy unstable. For instance, the approach focuses on understanding the adequacy of an institution's risk management systems on a going basis and encourages more significant interaction between an institution's management and the CBK. The RBS framework allows CBK to deliver consistent, high-quality supervision as the financial sector develops and institutions' risk profiles change in reaction to competitive forces. The enhanced supervisory regime further promotes competition, safety and soundness of the financial sector. This approach benefits institutions as a regulatory effort that focuses more on high-risk areas and provides more efficient supervision. RBS approach further emphasises understanding and assessing the adequacy of each institution's risk management systems which are expected to identify, measure, monitor and control risk in an appropriate and timely manner.

The framework enables CBK to be more proactive and better positioned to pre-empt any serious threat to the financial system's stability from current or emerging risks. This was one of the main areas the articles of the agreements by the IMF sought to address. CBK further developed the Risk Management Guidelines that detailed and elaborated how the RBS approach should operate.

However, banks still collapsed in 2015 and 2016 and after that. This meant that the guidelines were not adequately addressing the deep-rooted supervision enforcement issues despite the measures adopted by the CBK, including establishing a supervisory department mandated with prudential oversight and supervision. The risks and problems that have festered banking institutions could not be quickly detected and addressed in time, culminating in bank failures. The country still saw the collapse of such Banks as Imperial and Chase and the loss of billions of consumers' money.

3.4.3 Basel Committee on Bank Supervision (BCBS)

The BCBS was established in 1974 to enhance financial stability by improving the quality of global bank supervision and as a forum for regular cooperation between its member countries on banking supervisory matters.¹¹³ It provides the minimum standards for effective monetary regulation and supervision of banks in its twenty-nine (29) member jurisdictions. The guideline in the core principles outlines the following:¹¹⁴

The Core Principles are a framework of minimum standards for sound supervisory practices and are considered universally applicable. The Committee issued the Core Principles as its contribution to strengthening the global financial system. Weaknesses in the banking system of a country, whether developing or developed, can threaten financial stability both within that country and internationally. The Committee believes that implementation of the Core Principles by all countries would be a significant step towards improving financial stability domestically and internationally and provide a good basis for further development of effective supervisory systems. The vast majority of countries have endorsed the Core Principles and have implemented them.

These twenty-nine (29) cores principles include the availability of supervisory technique tools; the analysis of market, liquidity and credit risks; the disclosure and transparency requirements; and the need to have a supervisory reporting mechanism.¹¹⁵ Thus, the Committee, through applying these core principles, invites all regional and international financial institutions and donor agencies like the IMF to apply them in enforcing the supervisory arrangements in countries worldwide. The most efficient way these principles can make sense in Kenya is by reviewing every policy on supervision taken by the CBK vis-à-vis the 29 principles.

Kenya though not a member of the BCBS, has¹¹⁶ designed and incorporated some of the Basel Principles in its laws, regulations and guidelines. This departure is in pursuit of appropriate approaches to effective regulation. Indeed, the CBK revised the Prudential Regulations Management Guidelines 2013. It contained some features of BCBS's Basel II, such as the

¹¹³ <https://www.bis.org/bcbs/history.htm>

¹¹⁴ BCBS, 'Core Principles for Effective Banking Supervision' September 2012

¹¹⁵ Kim HJ, 'Financial Regulation and Supervision in Corporate Governance of Banks' *Journal of Corporation Law* 2016, 41.

¹¹⁶ Alford DE, 'Core principles for effective banking supervision: An enforceable international financial standard' 28(2) *Boston College International & Comparative Law Review*, 2005, 28.

operational and market risks regulations, which are provided for under Pillar I of Basel II. CBK also introduced supervisory provisions native to the Basel II pillar II, including stress testing by banks in 2015, quarterly reporting, and in 2017, the ICAAP reporting. CBK further incorporated the Pillar III recommendations on market discipline through quarterly disclosure of the bank's financial positions.¹¹⁷

Section 33A and 34 of the Banking (Amendment) Act give the CBK power to take measures to counter under capitalization of a bank. The Act allows CBK to develop minimum ratios, providing for sections to ensure that it follows the IFRS.¹¹⁸ However, only 18 out of 25 of the Basel II Recommendations principles have been embraced.

3.4.4 International Association of Insurance Supervisors

The International Association of Insurance Supervisors (IAIS) is a voluntary membership organization introduced in 1994 and serving in over two hundred jurisdictions in the world, including Kenya. It offers various approaches to the insurance industry in the world with the trend of fusion of insurance and banking roles¹¹⁹ or, in some cases, insurance companies acting as banks, making the impact of IAIS become vital. Thus, IAIS provides an avenue for adopting best practices with the increasing fusion of banks and insurance institutions.¹²⁰

There is a growing interest in the term 'bancassurance' in Kenya.¹²¹ This is driven by a desire by banks and insurance companies to pool resources together to offer services to customers. In the IAIS Report of April 2021,¹²² there is an analysis of models and supervision approaches which ought to be adopted due to the COVID-19 pandemic. The Report discussed the efficacy of remote supervision achieved through digitally and technologically pushed and onsite supervision. In remote supervision, banks and supervisors must invest in digital and technology-based software that enables the supervisor free and real-time access to information. This software will, if adopted,

¹¹⁷ Radha Upadhaya 'the Political economy of Basel adoption in Kenya: A case of alignment of donor, government and Banking sector interests' 131 (2017) 10-15

¹¹⁸ *The Finance Act* (Act No. 4 of 2012), Section 18(1), 21, 22 *Banking Act* (Chapter 488 Laws of Kenya).

¹¹⁹ Mwenda KK, 'Integrated Financial Services Supervision in Poland, the UK and the Nordic Countries' *Tilburg Foreign Law Review*, 2002, 10

¹²⁰ Mwenda KK, 'Unified Financial Services Supervision in Zambia: The Legal and Institutional Frameworks' *Zambia Law Journal*, 2004, 36.

¹²¹ <https://www.capitalfm.co.ke/business/2017/10/bancassurance-future-banks-insurance-firms-manjang/>

¹²² F Badat et al IAIS, 'Redefining Insurance Supervision for the New Normal' (2021)

focus on authentication and security; communication; video conferencing; and collaborative work software. The believes that the law must be geared up to these developments in ensuring the transparency needed in a fast-moving digital economy.¹²³

The IAIS Report further analyses the supervisory mechanisms adopted by the Bank Negara Malaysia (BNM), which has adopted a supervisory management system to facilitate the supervisor's obligations. The importance of adopting a digitally based supervisory platform cannot be overemphasized. Technological developments have made it easy to conduct business and ensure a thriving economy globally. Malaysia has led the way through its supervisory mechanism hinged on software. The keenness that software can exercise over a sector is infinitely superior to that of an individual.¹²⁴

3.5 Findings and Conclusion on the Legal and Institutional Framework for Bank Supervision in Kenya

The findings show that Kenya has a robust legal and institutional framework for banking supervision. This framework is established by the Constitution of Kenya 2010, the Central Bank of Kenya Act, the National Payment Systems Act, and the Microfinance Act. The CBK is the central regulator with a mandate to license and supervise financial institutions. These laws and regulations seek to foster a robust banking sector where consumer interests are protected and adhere to principles of good governance, integrity, transparency, accountability, and sustainable development. The domestic laws are further supplemented by international and regional laws and policy frameworks that the country has recognized as part of the global best practice.

However, owing to the evolving nature of the banking industry and the society at large, the legal and institutional framework for bank supervision in Kenya needs to evolve to reflect the changes in the global markets and to effectively implement policies, rules, principles and regulations for banking industry supervision. The adoption of RBS and a technologically based supervision model should be considered in Kenya to improve financial stability and sustainability in the banking industry. The next chapter underpins some of the best global supervisory tools and frameworks that can be employed to align the existing approach to the changes in the industry.

¹²³ F Badat et al IAIS, 'Redefining Insurance Supervision for the New Normal' (2021)

¹²⁴ F Badat et al IAIS, 'Redefining Insurance Supervision for the New Normal' (2021)

Chapter 4: Tools Available for Effective Supervision of the Banking Industry in Kenya

4.0 Introduction

The first three chapters have established the significance of adequate supervision in the banking sector. They have also captured the persistent challenge of bank failures regardless of domestic and international efforts to regulate the industry. What emerges, however, is that the challenges facing the banking industry are intertwined and constantly evolving. This requires interrogating the various supervisory models in light of the findings.

This chapter discusses the tools available for adequate bank supervision and its enforcement in Kenya in averting bank failures. It significantly analyses the supervision tools under the Risk Based Supervision (RBS) Model. To offer a more coherent discussion, this chapter builds on the justifications outlined in chapter one for bank supervision, which is premised on protecting national and international public interest and confidence. It later picks on the rationales for the need for bank supervision as reflected in the latest trends in the global economy. These trends include the proliferation of technology, money laundering and terrorism financing. Finally, this chapter will rely on the legal and institutional framework discussed in chapter three in analyzing effective institutional frameworks for enforcing bank supervision.

4.1 Tools for Effective Supervision

There are emerging trends which justify the need to review the laws and institutions on banking supervision in Kenya. These trends include the proliferation of technology; complexities associated with money laundering threats; terrorism financing; consumer protection concerns; and increased calls for the protection of public interest.¹²⁵ Failure to take note of these trends and adjust accordingly can lead to banking industry systemic failures. To curb them, proper supervision is an ever-urgent call. Thus, these emerging interests dictate the employment of the best approach to the supervision of banks, which will, in turn, foster global trust, public confidence and stability in the

¹²⁵ Sharkey C M, 'Agency Coordination in Consumer Protection' *University of Chicago Legal Forum*, 2013, 2013

financial industry.¹²⁶ The recommended approach should not only borrow from global best practices but also align with the realities of the Kenyan market.

The RBS approach to bank supervision, as adopted by the CBK, has had several benefits. These benefits include better evaluation of risks through separate assessment of inherent risks and risk management processes, greater emphasis on early identification of emerging risks and system-wide issues, cost-effective use of resources through a sharper focus on risk, and reporting of risk-focused assessments to institutions. The CBK overview on bank supervision indicates its intention to protect and foster the financial protection of the consumer and the country. The CBK states that:¹²⁷ it has the mandate to foster liquidity, solvency and proper functioning of a market-based financial institution, which it achieves by coming up with the necessary laws and guidelines to control the different parties in the banking industries; they continuously review the different laws and regulations to make sure that they are up to standard

A sound and robust supervisory tool and system are among the most effective ways of achieving the CBK objective and mandate.¹²⁸ The RBS Approach involves six steps.¹²⁹ The first step involves preparing and updating the institutional profile, which helps the authority to properly understand the institution, after which they assess the risk of that institution and draw a risk matrix. Secondly, supervisory activities are planned and scheduled, which are prioritized according to their risk levels and incorporated into timelines and resources.¹³⁰ The third is the definition of examination activities which yields a pre-inspection plan. Fourth, the examination procedures are carried out, and preliminary conclusions are made. The fifth step involves reporting on findings. Lastly, there is a follow-up on the findings through which a supervisory program is carried out, also allowing for the institution's profile to be adjusted.

During the development of a supervisory plan and activities, supervisory tools are applied to effect this step. Three critical tools are identified as best global practices for the effective supervision of banks. They are bank examination, monitoring, and reporting to the supervisor.¹³¹ With the

¹²⁶ Johnston A, 'Regulating hedge funds for systemic stability: The EU's approach' *European Law Journal*, 2015, 21.

¹²⁷ <https://www.centralbank.go.ke/bank-supervision/> on 4 December 2021

¹²⁸ J Vinals making of good supervision: learning to say "no" IMF note 2010, 9

¹²⁹ Central Bank of Kenya, *Risk Based Supervisory Framework*, 6.

¹³⁰ Central Bank of Kenya, *Risk Based Supervisory Framework*, 6.

¹³¹ Perkins and David W, *Bank Supervision by Federal Regulators: Overview and Policy Issues*, 2020.

increasing threats from the banking industry and the emergence of fast-moving technology, these tools must be flexible enough to ensure the desired goal is achieved with efficiency.¹³² The study will discuss these three tools as related to Kenya.

4.1.1 Examination of Banks by the Supervisor

Examination of banks as a tool for supervision entails *on-site supervision*: the supervisor undertakes physical visits to banking institutions and requests for books of records and all details associated with the bank's running. It is a traditional model of effecting supervision. It is on with the sole purpose of avoiding insolvency, poor management and dishonesty.¹³³

The goal of having examinations of banks is to enable the supervisor to access information and data in reviewing the status of banks to ensure systemic confidence and trust for the diverse and ever-expanding consumers.¹³⁴ Kenya must implement principles, rules, policies and legal frameworks that enable access to banking information derived from supervision. As identified in the third chapter Kenya does not publicize the manner, mechanism and technique of realizing the on-site examination. This information is integral for all players and consumers in the banking industry. Thus, Epstein, Scheffel and Vliestra are right to define a bank examination as: 'An inspection of a bank or other financial institution by a federal or state regulator; the purpose of a bank examination is to assess the institution's financial health and its compliance with applicable laws and regulations'.¹³⁵

Examination of banks, whether remote or on-site, includes three main principles in effecting proper and informed bank supervision; strategy and risk examination, rating of risk preparedness, and examination of compliance with the laws and regulations

4.1.1.1 Examination of the bank strategy and risks taken

Examination of banks addresses the analysis of strategic risks taken by individual banks, which would ultimately put at risk the investments by various actors in the banking industry. Thus, the

¹³² Schillig M, 'Bank Resolution Regimes in Europe - Part II: Resolution Tools and Powers' *European Business Law Review*, 2014, 25.

¹³³ P M Horvitz A reconsideration of the role of bank examination, *Journal of Money Credit and Banking*, 12 (1980)4 654

¹³⁴ Epstein EP, 'Why the bank examination privilege doesn't work as intended' *JREG Bulletin*, 2017-2018, 35.

¹³⁵ Epstein EP et al. 'Ten key points about the bank examination privilege' *Business Law Today*, 2017.

examination of banks ensures that there is a sufficient policy framework for the examination of the strategies they develop. This examination must be able to disclose the potential risks likely to face the bank and explore whether the bank's infrastructure is geared at identifying, monitoring and controlling all those risks.¹³⁶ Therefore, the policy and legal framework for bank supervision must be imbued with data and information transparency principles toward the supervisor. Transparency would entail the mandatory requirement of full and frank disclosure, ultimately bestowing a duty on the examining supervisor to ensure confidentiality. Thus, the legal infrastructure must ensure that the bank's organizational structure is in a manner that will enable the flow of information and data through both the manual channels and the electronic channels of remote examination.¹³⁷

The events of the COVID-19 pandemic and the subsequent lockdown and social distancing guidelines revealed that on-site supervision may not always be available for the regulator. Additionally, various companies onboarding into the digital platform reveal that future reference to physical documents and other forms of paperwork may not be the most efficient approach in light of data analytics, machine learning and artificial intelligence developments that have eased the speed of reviewing documents and systems for compliance. Consequently, the law, in using this tool, must ensure that the examination process does not result in a cumbersome adventure. The law must embrace remote examination of banks through the design of requisite technologies.¹³⁸ These technologies, influenced by the ideals of a digital economy, must be flexible and responsive enough to ensure consistency and confidentiality.¹³⁹ Confidentiality would entail reducing the regulatory burden in the supervisory exercise and ensuring soundness in the safety of the technologies adopted.¹⁴⁰

However, some challenges may arise from using remote technologies in the country. For instance, the lack of domestic innovations and inventions which promote safety and soundness may hinder

¹³⁶ Nelson TP, 'Cybersecurity and other risks: OCC outlines key examination areas for 2016' *Banking Law Journal*, 2016, 133.

¹³⁷ Ferretti F, 'Peer-to-Peer Lending and EU Credit Laws: A Creditworthiness Assessment, Credit-Risk Analysis or Neither of the Two?' *German Law Journal*, 2021, 22.

¹³⁸ Broome LL, 'Redistributing bank insolvency risks: Challenges to limited liability in the bank holding company structure' *UC Davis Law Review*, 1993, 26.

¹³⁹ 86 Fed. Reg. 591 (2021), Wednesday, January 6, 2020, 413 - 932

¹⁴⁰ Dommen C, 'Applying the human rights framework to economic policy: Insights from an Impact Assessment of Services Trade Liberalisation in Mauritius' *Africa Journal of International & Comparative Law*, 2021, 29.

the deployment of such technologies.¹⁴¹ Banks should be accorded the right to enter technology transfer agreements to get the technological infrastructure facilitating this examination.¹⁴² The burden will be on the supervisor to ensure that the technological infrastructure adopted is compatible and efficient with its technology.¹⁴³ In default, the supervisor can design a framework through which banks can have such technologies. These technologies must be alive to the evolutionary nature of innovation and technological strides.

4.1.1.2 Rating of Bank and Risk Preparedness

The Kenyan legal framework must candidly outline the minimum levels of disclosure needed by the supervisor to ensure that the consumer and more comprehensive public is informed on the risk preparedness of banks in Kenya. The test should be subjective to the disclosing bank by examining willingness to respond to threats. In analyzing these, this examination must bear in mind the modern changes and developments in technology and threats in terrorism and money laundering.¹⁴⁴

The monitoring of bank examinations must aim to know the ability of the bank to respond to changing environments such as mobile and electronic banking. The inception of Mpesa in Kenya has led to the evolution of banking which might further diminish the role of Know Your Customer (KYC), which had traditionally been used in curbing any money laundering or terrorist activities.¹⁴⁵ Further, the purpose of this monitoring examination should be able to disclose whether the digital identity of a customer is verified and whether it can be verifiable when the need arises. Noting the dangers of the dual risks of money laundering and terrorism, bank failures might result if these dangers are not contained.

It becomes critical that the legal infrastructure in banking supervision must monitor the ability of banks to identify these risks.¹⁴⁶ This would mean that banks can display the technologies adopted

¹⁴¹ Greenacre J, 'What Regulatory Problems Arise When Fintech Lending Expands into Fledgling Credit Markets?' *Washington University Journal of Law & Policy*, 2020, 61

¹⁴² Buckley RP, Arner D, Veidt R and Zetzsche D, 'Building Fintech Ecosystems: Regulatory Sandboxes, Innovation Hubs and beyond' *Washington University Journal of Law & Policy*, 2020, 61.

¹⁴³ Koker et al., 'Regulating Financial Services in an Era of Technological Disruption', 36

¹⁴⁴ Rudakova OS and Ipatyev K, 'Some Approaches to the Calibration of Internal Rating Models' *Review of European Studies*, 2015, 7.

¹⁴⁵ Myerson D, 'The Next Global Disruptive Innovation: Can Mobile Money Make the Journey Upmarket to Disrupt the Financial Services Industry' *Northwestern Journal of International Law & Business*, 2019, 39.

¹⁴⁶ Chiu IHY and Lim EWK, 'Technology vs Ideology: How Far Will Artificial Intelligence and Distributed Ledger Technology Transform Corporate Governance and Business?' *Berkeley Business Law Journal*, 2021, 18.

and the electronic KYC in place. Monitoring must disclose the ability of the banks to control these risks should they occur.

4.1.1.3 Examination as to Compliance with Laws and Regulations

Kenya has a robust legal regime on compliance of banks. This regime applies to five main areas. The first addresses the regulation of competition in the banking industry at the domestic and regional levels. The CAK governs this regime.¹⁴⁷ The second regime governs the requirement of the minimum deposit requirements for banks and is governed by the CBK.¹⁴⁸ The third regime governs the acquisition and mergers of banks in Kenya. Both the CAK and CBK govern this. Fourth is the regime on officials of the banks, and the Registrar of Companies regulates it.¹⁴⁹ The final regime addresses the regulation of the listed banks in Kenya. This final regime is governed by the Capital Markets Authority (CMA).¹⁵⁰

These regimes must be assessed as applied to the banks during the examination. However, the CBK is statutorily mandated to supervise all banks in Kenya. There is a technical lacuna as to whether the CBK has the wherewithal to implement such supervision fully.¹⁵¹

This paper observes the development in the United Kingdom and the United States of America of having another institution tasked with all supervision and empowered technologically and technically to coordinate all examinations in ensuring compliance with all regimes of regulations. In these two countries, their central banks are left with regulating the banks rather than supervising them.

Another element of examination on compliance is the need to ensure that the bank's activities are in harmony with the constitutional and statutory provisions on consumer protection.¹⁵² Consumers must be protected from any exorbitant interest rates which benefit the investors' coffers at the expense of innocent customers. The justification for consumer protection has been recognized under the Constitution of Kenya, 2010, the Consumer Protection Act, and the Banking Act.

¹⁴⁷ *Competition Act* (Act No. 12 of 2010).

¹⁴⁸ *Central Bank of Kenya Act* (Chapter 491 Laws of Kenya)

¹⁴⁹ *Companies Act* (Act No. 17 of 2015).

¹⁵⁰ *Capital Markets Act* (Chapter 485A Laws of Kenya).

¹⁵¹ <https://www.theeastafrican.co.ke/tea/business/kenya-s-banking-sector-was-a-crisis-waiting-to-happen-say-analysts--1348568> On 27 November 2021.

¹⁵² Wen, 'Banking consumer protection regulation in China', 46.

Finally, Kenya has a regulatory framework for managing money laundering and cyber-attacks reporting. Indeed, supervision must disclose whether the banks comply with the reporting requirement of any transaction over One Million (KES. 1,000,000.00) to the CBK.¹⁵³ Money laundering has been the cause of the collapse of many banks worldwide, leading to financial losses coupled with emotional and economic implications for customers. This frustrates and undermines public confidence.

Considering this limb of supervision in context, it can be argued that the Kenyan banking sector has undergone a cycle of changes aimed at improving service delivery, ensuring an efficient and health banking sector and assuring the economy's growth. However, bureaucratic exigencies may have contributed to rampant inadequacies in the financial sector. Far-reaching reforms must be adopted to maintain the momentum and vibrancy of Kenyan technological advancements in the financial sector. The breakout of the Covid-19 pandemic should provide a silver lining that necessitates the shift from the traditional books of account examination. The volume of onsite evaluations, examinations and reporting should now be reduced. Due to the voluminous nature of the books of account, fraudulent managers can pile together only that information that creates a glorious image of a bank and conceal the insider lending and other malpractices that hamper the efficient financial sector.

However, this kind of supervision has drastically changed over the years with emerging technologies that foster efficiency despite physical inspection's rigours. The new approach has made headway, especially in developed countries like the US. Straw comments on these developments: 'The conservative on-site approach to the monitoring of financial institutions, which had successfully prevented a major financial crisis for almost half a century, began to be viewed as an archaic and outdated relic of a past era'.¹⁵⁴

The COVID-19 pandemic has accelerated the adoption of remote examination beyond the borders of developed countries.¹⁵⁵ There is increasing use of remote bank examination in developed economies. This supervision is technologically propelled through various communication and

¹⁵³ <https://www.standardmedia.co.ke/cartoon/article/1144023496/banks-will-not-accept-cheques-above-sh1m>

See Also: <https://centralbank.go.ke/images/docs/kepss/VALUECAPPINGFAQBrochure.pdf>

¹⁵⁴ Straw C M, 'Unnecessary Risk: How the FDIC's Examination Policies Threaten the Security of the Bank Insurance Fund' *New York University Journal of Legislation & Public Policy*, 2007, 10.

¹⁵⁵ Andrew P et al., *Bank and Credit Union Regulators' Response to COVID-19*, 2020

collaborative software applications.¹⁵⁶ Thus the approaches to modern-day bank examination as a tool for supervision must appreciate the peculiar impact of the fourth industrial revolution on the global economy. Kenya gains immensely from the advancement towards the modern criteria for supervision as opposed to the traditional methods already abandoned by some jurisdictions.

4.1.2 Bank Monitoring

A brief introduction of the uptake of new forms of bank monitoring as an international best practice then relates to the issue of bank supervision in Kenya

Bank monitoring entails a continual review of the bank's practices and performance by the supervisor, mainly achieved through *off-site supervision*.¹⁵⁷ Macey and Miller, back in 1988, noted the importance of monitoring banks in a polity. They opined that:¹⁵⁸

Such monitoring would not only reduce the high incidence of bank failures due to fraud and mismanagement but would also reduce the incidence of failures due to insufficient asset diversification and fluctuations in the business cycle, as superior management teams capable of properly diversifying banks' asset portfolios replace those teams unwilling or unable to do so.

Thus, bank monitoring as a supervision tool explores banks' actions reflected through various investments or management decisions that display careless and irresponsible management.¹⁵⁹ Kenya has recently witnessed the effects of bank monitoring in the National Bank of Kenya case, which is in regulatory breach due to poor and unlawful management decisions.

Modern-day bank monitoring must incorporate technology in the supervisor accessing real-time information on decisions taken by the management.¹⁶⁰ The most efficacious manner is having a remote monitoring system in all banks and the supervisor.¹⁶¹ The technology for remote monitoring must employ predictable and accurate models that indicate whether a bank faces

¹⁵⁶ Nagy ZB and Csiszar AS, 'Aspects of the European System of Financial Supervision' *Zbornik Radova* (2016), 50

¹⁵⁷ Shepherd J M and Tung F and Yoon a H, 'What Else Matters for Corporate Governance: The Case of Bank Monitoring' *Boston University Law Review*, 2008, 88.

¹⁵⁸ Macey and Miller, 'Bank failures, risk monitoring, and the market for bank control', 88.

¹⁵⁹ Spencer T and Hipwell E, 'Coordinating, Mandating, Monitoring' *Carbon & Climate Law Review*, 2013, 2013.

¹⁶⁰ 86 Fed. Reg. 6969 (2021), Monday, January 25, 2021, 6827 – 7057.

¹⁶¹ Picciau C, 'The (Un)Predictable Impact of Technology on Corporate Governance' *Hastings Business Law Journal*, 2021, 17.

failure. Nuxoll and O'Keefe opine on the importance of these models in remote bank monitoring.¹⁶²

Generally, the models attempt to predict one of two phenomena: either that a bank will fail or that its condition has deteriorated enough that it will receive a downgrade in its supervisory rating (composite safety-and-soundness rating) during the next on-site examination.

These models include the bank failure model used to predict signs leading to bank failure; statistical models which endeavor to assess the likelihood of financial difficulty; and forecasting models, which examine risky and uncontrollable bank growth.¹⁶³ These models must be entrenched in technology to enhance efficiency. This is to ensure quick obtaining of accurate time information by banks; and real-time access of data by the supervisor.

Kenya's options are available to ensure remote bank monitoring is in technology.¹⁶⁴ The law should specifically outline, through regulations from the supervisor, the types of technologies to be used. This ensures safety and confidentiality in data analysis while preventing unnecessary information leaks to the public, which would cause unwarranted public anxiety.

4.1.3 Reporting Requirements by Banks

To ensure adequate supervision, banks must report and disclose certain information and data to the supervisor. This has been considered the mandatory disclosure of data and information by banks. This requirement for disclosure has numerous rationales for it. Majorly, it is to ensure that the systemic conditions of the banking industry are maintained for consumer protection. Huber aptly captures this in 1987 when he notes that¹⁶⁵

Disclosure of information is thought to alter corporate officials' behavior in a desired manner and provide information adequate for the public to monitor officials' conduct.

¹⁶² Nuxoll D A and O'Keefe J and Samolyk K, 'Do Local Economic Data Improve Off-site Bank-Monitoring Models' *FDIC Banking Rev* (2003), 15.

¹⁶³ Duff AWS, 'Central Bank Independence and Macroprudential Policy: A Critical Look at the U.S. Financial Stability Framework' *Berkeley Business Law Journal*, 2014, 11.

¹⁶⁴ Lugar RG, *The International Financial Institutions: A Call for Change*, 'Development Banks in Kenya: Monitoring and Procurement challenges', 2010.

¹⁶⁵ Huber SK, 'Mandatory disclosure of information about banks' *Annual Review of Banking Law*, 1987, 6.

Coincidentally, the disclosure of information allows the public to participate more efficiently in the market.

there are risks in insider trading in Kenya. The mandatory reporting tool is employed to curtail this vice in ensuring safe and relatively competitive markets. The responsibility lies with the management of banks to ensure insider trading, as a crime, does not occur. Further, mandatory bank reporting as a tool for supervision is viewed as a sublime weapon in fighting money laundering, bank secrecy and terrorism financing in the US legal framework. These threats face Kenya equally as the USA.¹⁶⁶ In 2018, Avci, Schipan and Seyhun opine that banks should attain insider trading status both under the public and private eye in protecting the wider public and consumer protection interests. They hold that:¹⁶⁷

Banks attain insider trading status and become subject to insider trading reporting requirements and trading restrictions when they are hired to provide financial advice to their clients.

4.2 The Enforcement Institution

This section discusses the institutional framework to be adopted in Kenya to ensure effective supervision and the employment of supervision tools in addressing the expanding threats to the banking industry.

Under the current Kenyan legal framework, the CBK acts as both the regulator and supervisor of banks in Kenya. Whereas monetary regulation seems effective, supervision has presented a challenge in cross-industry regulation over the years.¹⁶⁸ This is evident in the legal challenges associated with attempts to regulate technology, mobile loaning application, and Mpesa by the CBK in Kenya. The study identified three supervision approaches in chapter three: functional, institutional, and objective.

¹⁶⁶ Zagaris B, 'Money Laundering and Bank Secrecy and Counter-Terrorism Financing' *IELR*, 2021, 37

¹⁶⁷ Avci SB, Schipani CA, and Seyhun HN, 'Eliminating conflicts of interests in banks: The significance of the Volcker Rule' *Yale Journal on Regulation*, 2018, 35.

¹⁶⁸ Kenya Bankers Association, *State of banking industry report*, June 2018

[https://www.kba.co.ke/downloads/State%20of%20Banking%20Report%20200618%20\(web\).pdf](https://www.kba.co.ke/downloads/State%20of%20Banking%20Report%20200618%20(web).pdf)

See Also: Brownbridge M, 'The Causes of Financial Distress in Local Banks in Africa and Implications for prudential Policy' UNCTAD/OSG/DP/132 March 1998.

Applying the institutional approach would mean that the CBK focuses on banks only to exclude emerging trends of Bancassurance and other institutions' electronic and mobile banking services.¹⁶⁹ Applying a functional approach would mean that the CBK exercises jurisdiction over any institution offering banking facilities.¹⁷⁰ This would lead to double or triple regulation of some institutions in the telecommunication and ICT field, like online lending mobile applications which lie at the intersection such as Branch and Tala. The same scenario presents in the application of the objective approach.¹⁷¹ The ultimate effect of this situation is the ineffective enforcement of supervision on banking institutions in Kenya, making CBK's role in supervision less effective. Recourse to this dilemma will be made through the study of the United Kingdom's supervision institutional framework.

Under the UK's framework, the Board of Banking Supervision was established to aid the Bank of England in fulfilling the statutory requirements for supervision. The Board was intended "to provide for a greater say from the banking community in the process of bank supervision."¹⁷² However, the Board was not effective in discharging the intended tasks. After numerous deliberations, the Prudential Regulation Authority was established in 2013. This was informed by the need for a more robust consumer protection regime in the banking industry in the UK. The establishment and the supervisory justification of the Prudential Regulation Authority have been captured by Kleftouri when he notes that:¹⁷³

The outset of the crisis brought again forth the debate on the wisdom of separating the monetary and supervisory responsibility of the central bank, and eventually, the UK Coalition Government proposed the establishment of a new Prudential Regulatory Authority (PRA), a subsidiary of the Bank, which will act as the prudential regulator and take responsibility for the authorization, regulation and day-to-day supervision of all firms which are systemically important.

¹⁶⁹ Hofmann C, 'Shadow banking in Singapore' *Singapore Journal of Legal Studies*, 2017, 2017.

¹⁷⁰ Delimatsis P, 'Financial innovation and prudential regulation: The new basel III rules' *Journal of World Trade*, 2012, 46.

¹⁷¹ Strickland OJ, 'Seeking to Have Banks Sing to the Same Tune: The Basel Committee Addresses Credit Risk - Weighted Assets' *University of Miami Business Law Review*, 2017, 26.

¹⁷² McGuire K, 'Emergent Trends in Bank Supervision in the United Kingdom' *Mod Law Review*, 1993, 56.

¹⁷³ Kleftouri N, 'Rethinking UK and EU Bank Deposit Insurance' *European Business Law Review*, 2013, 24.

Thus, the study makes a case that CBK, as currently constituted with the constitutional and statutory responsibility, cannot effectively discharge the mandates on supervision. CBK seems more effective in the general regulation of banks and the monetary balance over its supervisory mandates.

Huerta asserts that regulation and supervisory authority are all intertwined; all need to work together, but the same entity need not conduct them all. Indeed, there is much to be said for assuring that there remains a division and a dialogue between supervision on the one hand and monetary/fiscal policy on the other.¹⁷⁴ These are all the things that CBK is mandated to do as a single regulator; even with the regulations well laid out, banks often seem to be doing great until later they fail abruptly; the regulations and guidelines are well laid out; however; there needs to be more to avoid bank failure.

Supervision ought to have the same attention as regulation to maintain an excellent financially stable economy; the department of supervision ought to be expressly provided for under the law, given as also as a corporate body responsible for the supervision of the financial institutions that the Central Bank of Kenya regulates, and with powers to handling supervision. This would entail properly employing the tools to supervise and effectively enforcing supervisory regulations. The second element would empower this body with inter and intra-banking industry supervision to respond to the challenges of technology, money laundering, terrorism financing and the ever-evolving and changing technology. Finally, this body would be fit to employ all the approaches to supervision other than just focusing on the institutional approach on banks alone.

The consequences would be that the Kenyan legal framework on supervision of banks ought to establish a subsidiary of CBK mainly geared at implementing and enforcing effective supervision of banks in Kenya.

4.3 Discussion on the Best Tools and Practices in Effective Bank Supervision

The findings from the foregoing analysis highlight vital tools and approaches to bank supervision and their effectiveness in preventing bank failure, addressing emerging issues and challenges, and promoting financial sustainability in the economy. It expounds on the importance of mandatory disclosure and reporting by banks. This is a crucial tool for ensuring the systemic stability of the

¹⁷⁴ F. Huerta, 'The Rationale for and Limits of Bank Supervision' 6

banking industry and consumer protection. Additionally, the study reveals that mandatory reporting is critical in preventing insider trading, money laundering, and terrorism financing. These measures collectively reduce the susceptibility of banks to fail.

Secondly, the study underpins the need to strengthen the supervisory role of the CBK in the wake of emerging complexities and challenges. For instance, separating Mobile Money from the Telcos will imply that the CBK will have more duties. This also extends to the evolving digital currencies and mobile money lending institutions. There is a need for a more practical approach, including establishing a supervisory body within the CBK to oversee adequate bank supervision that is specific, realistic, and relevant.

Additionally, the tools reveal the importance of maintaining different supervisory approaches, including functional, institutional and objective approaches. The institutional approach that focuses on banks alone may not be sufficient in addressing emerging challenges in the banking industry, including Bancassurance and electronic and mobile banking services. These tools should be continuously reviewed through the empirical and evidence-based study of their effectiveness within the specific geographical and socio-economic realities of the country in which they apply.

4.3 Conclusion

This chapter has underscored the need for practical tools for bank supervision and strengthened CBK that can address the emerging challenges in the banking industry. Additionally, the chapter emphasizes the importance of different approaches to supervision and the need for a clear division between supervision and monetary policy to promote sustainable development. These tools should be applied in light of the evolving supervisory landscape, noting the need for sustainability of the financial industry and public protection. The final chapter summarizes the key findings from the thesis and provides the conclusion and recommendations for future engagement.

Chapter 5: Conclusion and Recommendations

5.1 Introduction

This chapter presents conclusions and recommendations of the study through four thematic areas: summary of the study, study findings, conclusion and recommendations. The study has examined the legal and institutional framework governing bank supervision in Kenya. The legal framework, as spread across various acts of parliament, has been analyzed, and their gaps identified. This chapter details the study findings before providing recommendations to enhance banking supervision in the country.

5.2 Study Findings

Among the key findings from the discussion is that Bank supervision is integral in safeguarding the state of Kenya's financial industry. The system's condition is of interest to local and international consumers. Ultimately, consumers' interests are geared to ensure that their savings and bank-related investments are protected from the shackles of bank failures. The justification for this is that globalization of commerce and businesses has made the globe a more miniature village leading to growing international interest in Kenya's domestic bank stability. Thankfully, Kenya continues to make progressive advancements by establishing institutions such as the KDIC aimed at ensuring that the deposits by customers are insured. However, the limits for the insurance accorded to the depositors are still too low.

Secondly, it emerged from the discussion that bank supervision requires the deployment of international best practices. Cognizant of this reality, the country has adopted these best practices in its domestic legal infrastructure even though it is not a member of most of the institutions in BCBS. Kenya has adopted and put to practice most of these recommendations and guidelines on banking supervision. And it has seen a significant improvement by adopting the RBS type of supervision.

Thirdly, it emerges that the rise of financial technology is causing an evolution in the traditional concepts of KYC and physical banking. Banks are responding technologically to maintain relevance in a fast-transforming digital economy reflected through the fourth industrial revolution. The effects of the technological revolution then require a technological-based supervision of banks' operations by the supervisor in Kenya. Technological advancements will proceed into the

future. A society that remains trapped in the traditional modes of operation will soon find itself webbed in the past and therefore be thrown into irrelevance. Kenya must rise to the occasion, take advantage of its advanced internet connection and technological advancements and upgrade to the latest modes of bank supervision. In particular, there is a need to embrace software that tracks the real-time activities in the banking sector, identifies the risks and lays down proper mitigation strategies for ameliorating bank failure.

Fourth, the digitization of the economy will ultimately adjust the traditional on-site bank examination and monitoring. The information retrieved after days of data collection can now be accessed within seconds through the adoption of appropriate software technologies. The consequence would be that the future of bank supervision will be internet based rather than physical.

Additionally, risks of terrorism funding are growing more so in Kenya, which has witnessed numerous terrorist attacks. Bank supervision should thus respond accurately in accessing real-time information to check suspicious bank transactions. With the many terrorist attacks and the critical location in the region, Kenya must step ahead of the criminal enterprises that may use its banking sector to promote terrorism. Terrorism being an internationally condemned phenomenon, Kenya can take advantage of its centrality in the fight against terrorism and seek technical help from developed countries in advancing its bank supervision.

Generally, the need for real-time access to information through specialized software and infrastructures is justified by the need for supervisors to check on money laundering tendencies. Real-time reporting through technological software would make effecting the tool of bank reporting easier.

CBK, as currently constituted, is better placed to discharge duties of monetary regulation and supervision; however, this seems to be too many responsibilities for CBK. It will concentrate on one and slack on another, causing a crisis. However, bank supervision requires establishing an independent institution that will rapidly respond to the emerging technological advancements and risks associated with bank supervision. There is an urgent need to establish a prudential and market regulator. The prudential regulator can remain the Central Bank of Kenya, while the market regulator will be the body tasked with supervising the banking sector. The regulation requires real-time approaches.

5.3 Conclusion

From the summary and findings above, the study concludes that the bank supervision framework in Kenya is insufficient. Effective bank supervision should be thoroughly and rightly equipped to address modern and evolving risks in the banking industry. In ensuring this, access to banks' data and information becomes critical. The solution to access data and information should be found by incorporating technologically driven supervision models. Thus, bank examination, monitoring, and reporting supervision models should be transformed into an electronic and internet-based system. This system will use software that enables real-time access to banking information by the supervisor.

The efficacy of the roles discharged by the supervisor should be reviewed against the current threats and technological developments. Though CBK can now regulate emerging online digital lenders, CBK is seen as a single institution that cannot efficiently regulate the monetary market while simultaneously supervising banks. To this end, the study holds that an arrangement similar to the UK, as discussed above, would positively impact the Kenyan system. Kenyan law should then be developed to establish a body, preferably a subsidiary of CBK, mandated to implement and enforce bank supervision. The separation and division of roles will ensure efficiency and a properly functioning financial sector in Kenya.

In line with the IMF aspirations, the supervisory institution will have to be adequately staffed with skilled individuals who will ensure closer scrutiny of the quality and strategy management. The mechanisms highlighted above help the supervisor ensure that there are proper mechanisms for monitoring risks that may threaten the ability of a bank to remain afloat.

For an RBS to be successful, the supervisory body to be established should be fitted with the capacity to ensure proper market entry controls. In this regard, the body will be mandated to conduct thorough, professional and skillful due diligence to establish that specific minimum assurance mechanisms have been adopted by an entity that intends to venture into the banking industry. Secondly, the entity will be required to ensure that the bank consistently has an adequate capital base that can shield the customers and act as a buffer for any unexpected losses, thus safeguarding the customers' interests.

The paperwork examination exercise is proving to be a costly externality. With the advancements in technology, it will be prudent to establish portals that capture real-time transactions and raise

red flags whenever the trading patterns, the bank ratios, or any other fraudulent happening is in the vicinity. Real-time risk-based supervision will ensure transparency, provide early warnings and encourage banks to employ hawk-eyed supervision over their transactions. This systematic shift will, in the long run, ensure that there are offsite surveillance and profiling of the risk profiles of the various actors within the financial sector, remedial actions are developed based on the unique happenings in a bank and where need there will be a quick dispatch of regulators and auditors for an onsite inspection.

In a country faced with rampant corruption, adopting working systems and software will go a long way in alleviating a bank collapse due to human shortcomings. In some of the banks that have collapsed in the recent past in Kenya, acts of omission and commission by those charged with governance are responsible for the failures. In the Imperial Bank case, there were allegations of insider loaning that ballooned the credit base of the bank and left it with challenges in liquidity. In the Crane Bank of Uganda, as noted previously in this study, the bank collapsed under the inadequacies occasioned by the managers that saw its capital adequacy fall below the minimum and thus led to its closure by the Bank of Uganda.

It is imperative for CBK to avoid reactionary measures but instead thread the supervisory journey from the inception of banks, which is licensing, and keep abreast with the financial institution so that it can prescribe the right solution to a bank in time of crisis or altogether avoid a crisis.

5.4 Recommendations

To ensure that the Act is fully implemented, the study makes the following policy and administrative recommendations

5.4.1 Policy reforms

The study makes the following recommendations:

1. The CBK and the established supervision body should design regulations on access to information and data to enable the supervisor and the consumers to detect threatening activities and risks earlier before damage has evolved to the point of no return. In accessing real-time information by the supervisor, there would be easy and timely application and enforcement of the tools applied in supervisions reflected in bank examination, bank monitoring and bank reporting. In a nutshell, the information received will enable the

supervisor to examine the bank's preparedness to handle the imminent risks approaching or those risks already creeping into the banking facility. A policy guideline will establish the procedures that can be followed by the customers and the relevant bodies that should receive and address the complaints.

2. The CBK should propose supervision regulations as depicted through the international soft law practices and standards. These implemented norms will be crucial in sending confidence in Kenya's banking and financial industry to local and international consumers. The government should implement this as a matter of urgency to protect the public interest.
3. The CBK or the existing body responsible for bank supervision should design policies on remote bank examination, remote bank monitoring and internet-based bank reporting. This is due to the impacts of the fourth industrial revolution in the fast-moving digitized economy. This would prescribe the type and standards of the technological software needed by banks during supervision to ensure compatibility above data and information by both parties. Technological software would also be instrumental in supervising the activities of online lending platforms, which currently are 'roaming' away from the shadow of the CBK. There is an urgent need for the banking sector to adapt to contemporary world advancements. The developments in digital banking and lending have occasioned tensions in the market with breaches of fundamental rights such as the right to privacy. This recent occurrence brings the urgent need to ensure that CBK acts promptly to arrest the situation and ensure proper bank supervision.

5.4.2 Research

The study makes the following research initiative:

1. Research on bank supervision needs to be carried out concerning the development of technology in Kenya. Kenya is already at the forefront of technological transformation through the invention of Mpesa, which offers an integrated banking system. Ultimately, the need for studies on the supervision of these developments becomes crucial in fore-sighting any potential risks. There is a need to establish whether a hybrid supervision should be pursued in instances where banks and telecommunication companies merge to offer a banking service between Mpesa and NCBA Bank in coming up with the *Mshwari*.



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Presentations

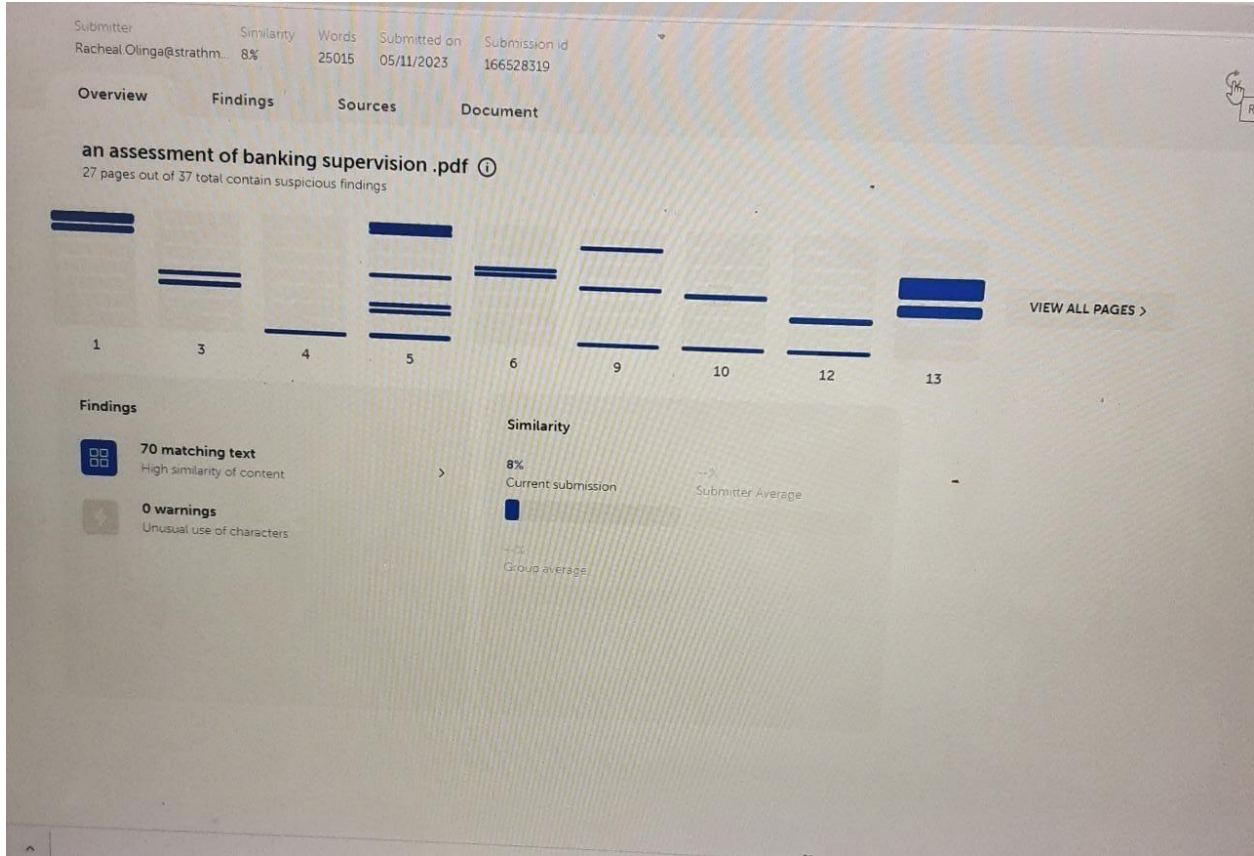
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Appendices

Appendix A: Similarity Report



Appendix B: Ethical Clearance Confirmation



26th May 2022

Ms Olinga Racheal,
racheal.olinga@strathmore.edu

Dear Ms Olinga,

RE: The Enforcement Of Banking Supervision Avert Bank Failure In Kenya


This is to inform you that SU-IERC has reviewed and **approved** your above SU Masters' research proposal. Your application reference number is SU-IERC1258/21. The approval period is **26th May 2022 to 25th May 2023**.

This approval is subject to compliance with the following requirements:

- i. Only approved documents including (informed consents, study instruments, MTA) will be used
- ii. All changes including (amendments, deviations, and violations) are submitted for review and approval by SU-IERC.
- iii. Death and life-threatening problems and serious adverse events or unexpected adverse events whether related or unrelated to the study must be reported to SU-IERC within 48 hours of notification
- iv. Any changes, anticipated or otherwise that may increase the risks or affected safety or welfare of study participants and others or affect the integrity of the research must be reported to SU-IERC within 48 hours
- v. Clearance for export of biological specimens must be obtained from relevant institutions.
- vi. Submission of a request for renewal of approval at least 60 days prior to expiry of the approval period. Attach a comprehensive progress report to support the renewal.
- vii. Submission of an executive summary report within 90 days upon completion of the study to SU-IERC.

Prior to commencing your study, you will be expected to obtain a research license from National Commission for Science, Technology, and Innovation (NACOSTI) <https://research-portal.nacosti.go.ke/> and obtain other clearances needed.

Yours sincerely,


for **Dr Ben Ngoye,**
Secretary; SU-IERC

Cc: Prof Fred Were,
Chairperson; SU-IERC

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