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The Adequacy of Kenya's bank resolution framework in managing bank failures.

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Declaration and Approval

Declaration

I declare that this work has not been previously submitted and approved for the award of a degree by this or any other university. To the best of my knowledge and belief, the thesis contains no material previously published or written by another person except where due reference is made in the thesis itself.

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Approval

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Abstract

An effective bank resolution framework is crucial to the realisation of financial stability in an economy. This flows from the appreciation that failure of one banking institution if not well managed could have a crippling effect to an entire banking industry and the financial system at large as witnessed during the global financial crisis. This study examines the egal and regulatory framework for resolving problem banks in Kenya to determine whether the framework is adequate to manage bank failures. In its analysis the study focuses on the statutory provisions encapsulated in the Banking Act, the Central Bank Act, the Kenya Deposit Insurance Act, the Companies Act 2015 and the relevant regulations and the role of the key resolution authorities.

The need for existence of a special resolution framework at a national level to deal with problem banks as highlighted in this study cannot be overstated. The study evaluates the significant contributions of the Financial Stability Board in formulating guidelines and recommendations for an effective resolution regime against which the effectiveness of existing national bank resolution frameworks are bench marked. Reforms to the United States of America and the United Kingdom's bank resolution regimes following the global financial crisis are analysed to draw lessons that could be applied to strengthen Kenya's bank resolution regime.

The findings from this study establish that despite the various reforms implemented to the bank resolution framework resting with the enactment of the Kenya Deposit Insurance Act in 2012 and the Companies Act 2015, the bank resolution process in Kenya has continued to be marred by delayed intervention by the resolution authorities, protracted legal disputes and inconsistency in judicial decisions. The study further establishes a lack of transparency, accountability and integrity in the resolution process. To this end, this study proposes various reforms to strengthen Kenya's bank resolution framework in line with international best practices.

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List of Abbreviations

BOE	Bank of England
BRDD	Bank Recovery and Resolution Directive
CBK	Central Bank of Kenya
CBL	Crane Bank Limited
CFPB	Consumer Financial Protection Bureau
CIC	Continental Illinois Corporation
DPFB	Depositor Protection Fund Board
FCA	Financial Conduct Authority
FDIC	Federal Deposit Insurance Corporation
FDICIA	Federal Deposit Insurance Corporation Improvement Act
FIA	Financial Institutions Act
FRB	Federal Reserve Bank
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
GDP	Gross Domestic Profit
HMT	Her Majesty's Treasury
IADI	International Association of Deposit Insurers
KBA	Kenya Bankers Association
KDIA	Kenya Deposit Insurance Act
KDIC	Kenya Deposit Insurance Corporation
PRA	Prudential Regulation Authority

RAF	Resolution Assessment Framework
SBM	State Bank of Mauritius
SIFI	Systemically Important Financial Institutions
SRR	Special Resolution Regime
UK	United Kingdom
USA	United States of America

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Constitution of Kenya (2010)

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Companies Act (No.17 0f 2015)

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Kenya Deposit Insurance Act (Act No.10 of 2012)

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Kenya Deposit Insurance (amendment Act) (Act No. 16 of 2022)

Law of Contract Act, Chapter 23 Laws of Kenya

Transfer of Business Act, Chapter 500, Laws of Kenya

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Banking Act 2009

Banking Act 2009: Special Resolution Regime Code of Practice (revised December 2020)

Insolvency Act (1986)

United States of America Statutes

Dodd-Frank Wall Street Reform and Consumer Protection Act 2010

Federal Deposit Insurance Act (Chapter 967)

Federal Deposit Insurance Corporation Improvement Act (1991)

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I am also indebted to my husband for his unwavering support, insights and constructive criticism that have contributed to the success of this study.

Dedication

This desertion is dedicated to my children, Alma and Aaron who give me reason to keep pressing on.

CHAPTER 1: INTRODUCTION

1.1 Introduction

The Kenya Vision 2030 which is the country's development blueprint propagated in 2008 succinctly articulated the pivotal role of the financial industry in spurring the growth and development of Kenya's economy.[1] To achieve the key objectives and development goals, Vision 2030 appreciates the need to promote stability in the banking industry and promote a savings culture to realise the projected growth in bank deposits from 44% to 80% of the country's GDP.[2] The banking industry is one of the critical financial sector players in Kenya that contribute to the country's growth and development. It is credited for the biggest percentage of Kenya's financial industry contribution, being 60.87% through various fronts including: employment creation, value addition and tax revenue.[3] Hence stability of the banking industry is crucial to the realisation of the developmental goals envisaged in Vision 2030.[4]

Of the factors underpinning stability in the banking sector is having in place an efficient and robust legal and institutional framework that provide for adequate supervision, regulation and timely resolution in the event of a bank failure or distress. The framework should also be free from political interference to allow for independence of the resolution authorities. The failure of banking institutions, if not well managed, can trigger significant disruptions to an economy, as witnessed during the Global Financial Crisis (GFC) when the failure of some major commercial and investment banks, such as Lehman Brothers and Bear Stearns in the United States of America (USA), Northern Rock, Bradford & Bingley and Icesave in the UK sent the global economy reeling.[5] The GFC exposed inadequacies of resolution frameworks that were in place in these leading financial economies as they grappled with the failures of critical financial institutions.[6] It was evident from the global financial crisis that existing corporate insolvency procedures were ill-suited to manage distressed banks.[7] Several countries have since reformed their banking crisis management laws and key among the reforms has been the

[1] Government of the Republic of Kenya, *Vision 2030*, 2007.
[2] Government of the Republic of Kenya, *Vision 2030*, 2007.
[3] Kenya Financial Sector Stability Report, Central Bank of Kenya Annual Report, September 2021.
[4] Government of the Republic of Kenya, *Vision 2030*, 2007.
[5] Bavoso V, 'Review of The Oxford Handbook of Financial Regulation' 8 Journal *of International Banking Law and Regulation*, (2016), 1.
[6] Avgouleas E and Goodhart C, Bank resolution 10 years from the global financial crisis: A systematic reappraisal, working paper 7 /2019, School of European Political Economy (2019), 3.
[7] Swire P 'Bank Insolvency law now that it matters' *Duke Law Journal* (1992), 478.

establishment of special resolution regimes to manage distressed banks. Recognising the need for collaboration at the international level in promoting financial stability, the G20 [8]heads of states and governments established the Financial Stability Board (FSB) in 2009.[9] The FSB was assigned with the primary goal of coordinating the work of national financial authorities and international standard-setting bodies at the international level in order to establish and promote the implementation of effective regulatory, supervisory, and other financial sector policies. The FSB has since created common standards through soft law to guide countries in establishing country-specific resolution regimes for effectively managing bank failures.[10]

In view of the importance of banks as vital economic and societal institutions, a robust legal and institutional framework providing for regulation and supervision is essential to ensure that they discharge their mandate effectively and in the best interest of their key stakeholders who include depositors, shareholders, creditors, employees, regulators and the society at large. Effective supervision and regulation of the banking industry further promotes stability in the financial system. Timely and orderly intervention by the regulators in resolving problem banks is key to averting systemic risk in the financial sector. It also ensures that the various stakeholders' interests are protected, maintains continuity of a bank's critical functions and where possible, averts failure of distressed banks through appropriate resolution tools such as open bank assistance and purchase and assumption. An effective resolution regime also allows for the departure of ineffective banks from the banking industry in an orderly manner.

1.2 Background to the Study

The GFC, which started in mid-2007 and intensified in 2008, highlighted the importance of a robust resolution regime in the financial industry. The crisis, sparked by deregulation in the financial industry and mis-selling of risky sub-prime mortgages nearly crippled the entire financial system in the USA market and the effect of the crisis were shortly thereafter experienced globally due to the interconnectedness of the financial system.[11] In the aftermath of the crisis various stakeholders in the financial services industry had to not only contend with economic factors that had contributed to the crisis but other contributing factors including

[8] The G20 is an intergovernmental forum which was comprised of 19 countries and the European Union (EU) in 2009. It works to address major issues related to the global economy, such as international financial stability, climate change mitigation, and sustainable development.
[9]Financial Stability Board Charter, 2009

https://www.fsb.org/wp content/uploads/r_090925d.pdf?page_moved=1 accessed on July 2, 2022.

[10] https://www.fsb.org/about/ on July 2, 2022.
[11] Hudson A, *The law of finance*, Sweet & Maxwell, United Kingdom, 2013,1312.

regulatory failures, corporate governance failures, fraud and negligence.[12] To stem the crisis, governments responded through ad hoc measures and vast bailouts of the financial institutions considered 'too big to fail', leading to a global recession.[13] The bailouts by the governments using taxpayers' money were criticised mainly for benefiting the shareholders who had ventured into high-risk investments at the expense of the public.[14]

The GFC exposed the inadequacy of national corporate insolvency laws to handle failed financial institutions.[15] For example, in dealing with the bankruptcy petition filed by Lehman Brothers following its collapse, the bankruptcy judge was restrained by law, to confine his focus on adjudicating creditors' claims against the company. The bankruptcy court lacked the tools or the mandate to mitigate the effects of the failure on the financial system or the economy at large.[16] In the USA, neither the Federal Reserve Bank (FRB) nor the Federal Deposit Insurance Corporation (FDIC) nor the treasury had a distinct framework for dealing systematically with the failing financial institutions.[17] These inadequacies sparked a debate by the key global regulators in the financial industry on the need for a special bank resolution framework, as will be outlined immediately below, and considered more effective in responding to problem banking institutions. There was need to consider a resolution framework that would ensure the continuity of critical banking functions and promote orderly resolution of failed banks whilst preserving financial stability with minimal economic disruptions.[18] In the United Kingdom, a special regime for resolving problem banks was established in the wake of the GFC under the Banking Act which was enacted in 2009.[19] Its provisions were broadly similar to those in the Dodd-Frank Wall Street Reform and Consumer Protection Act which

[12] Hudson A, *The law of finance*, 1313.
[13] Crotty J 'Structural causes of the global financial crisis: A critical assessment of the new financial architecture' 33 *Cambridge Journal of Economics* 4 (2009), 563.
[14] Crotty J 'Structural causes of the global financial crisis: a critical assessment of the 'new financial architecture', 575.
[15] Geogosouli A 'The transnational governance of bank resolution and the treatment of national regulatory variation in the EU', *The Cambridge Law Journal* 1 (2021), 74.
[16] Geogosouli A 'The transnational governance of bank resolution and the treatment of national regulatory variation in the EU', 74.
[17] Bernanke Bs, 'Ending "too big to fail": What's the right approach?' Bookings Institution blog, Washington DC United States of America, 13 March 2016, https://www.brookings.edu/blog/ben-bernanke/2016/05/13/ending-too-big-to-fail-whats-the-right-approach/ on 12 August 2022.
[18] Geogosouli A 'The transnational governance of bank resolution and the treatment of national regulatory variation in the EU', 74.
[19] Murdock CW, 'The Dodd-Frank Wall Street Reform and Consumer Protection Act*:* What caused the Financial Crisis and will Dodd-Frank prevent future crises', 64 *Southern Methodist University Law Review 1243* (2011).

was enacted in the USA following the GFC to restore financial stability through robust financial industry regulation.[20]

Although the banking industry in Kenya did not suffer the severity of the direct adverse effects of the GFC, the industry has experienced a significant number of bank failures post the GFC, with a resulting negative impact on economic growth and development. These bank failures have consequently disrupted livelihoods by depriving depositors of access to their funds held in the collapsed institutions for an extended period.[21] According to KDIC, seventeen banks remain under liquidation as of January 2018. According to an IMF report of 2020, the total assets held by failed banks as of January 2020 amount to Kenya Shillings 84.6 billion,[22] depriving the economy of its circulation to boost economic growth and development.

The banking crisis witnessed in Kenya in the 1980s was attributed mainly to malpractices and irregular lending in favour of top management and politically exposed persons. Whereas the failures of Dubai Bank Kenya limited, Imperial Bank Kenya limited, and Chase Bank Kenya limited experienced between 2015 and 2016 were attributed to a number of reasons including; liquidity and capital deficiencies with respect to Dubai Bank limited,[23] unsound business practices with respect to Imperial Bank limited and Chase Bank Kenya limited, the resolution of the failed banks in both the earlier and latter period were plagued by untimeliness and lack of transparency in the process.

CBK, the primary supervisor and regulator of banks licenced under the Banking Act, categorises banks in Kenya into three classifications namely, large, medium and small banks. This classification is informed by market share, asset base and the number of customer deposit base.[24] Failure of any bank in this category if not well managed would present a systemic risk to the economy. These banks may compare to the Systemically Important Financial Institutions (SIFI) global classification that was adopted post the global financial crisis between 2007 and

[20] Murdock C W, 'The Dodd-Frank Wall Street Reform and Consumer Protection Act*:* What caused the Financial Crisis and will Dodd-Frank prevent future crises', 12.

[21] Otiato G, Failed banks hold Sh 13 bn in customers Cash- IMF, Kenya Business Daily, 31 January 2020.

[22] Business Daily, Failed Banks Hold Sh 13bn in Customer's Cash- IMF, 31 January 2020. https://www.businessdailyafrica.com/bd/news/failed-banks-hold-sh13bn-in- customers-cash-imf-2278646 on 19 July 2021.

[23]Central Bank of Kenya, Press Release, Dubai Bank Kenya Limited, 14 August 2015, https://www.centralbank.go.ke/images/docs/media/2015/DubaiBankpressrelease.pdf accessed on 13 November 2021.

[24]Central Bank of Kenya, *Bank Supervision Annual Report* 2021, https://www.centralbank.go.ke/uploads/banking_sector_annual_reports/1033515790_2021%20Annual%20Report.pdf, on 8 March 2022.

2009. Although the failed banks in Kenya during the periods earlier mentioned were not the large commercial banks, the frequency of failure and the manner in which the failures were resolved did not inspire public confidence as evidenced by the panic withdrawals by the depositors in response to rumours of the respective banks' distress[25] and the several cases filed against the CBK and KDIC by aggrieved parties.

Following the first major banking crisis of the 1980s in Kenya, the Deposit Protection Fund Board (DPFB) was established under the Banking Act in 1985 to foster public confidence and promote stability in the banking industry.[26] The Kenya Deposit Insurance Corporation (KDIC), a successor of the DPFB, was established in 2012 and plays a major role, complementary to CBK's role in the bank resolution process. Part of its primary mandate is to maintain an explicit deposit insurance scheme to cushion bank depositors against any losses in the event of bank failures and to promote stability in the financial services industry. KDIC is also empowered to manage, receive or liquidate problem financial institutions following its appointment to undertake any of these functions by CBK. Although KDIC is an independent statutory body, it can only step in to manage a failed or failing bank institution on appointment by CBK as the primary regulator and supervisor of all banking institutions licenced under the Banking Act and the lead bank resolution authority.

1.3 Statement of the Problem

Following the GFC, leading global economies most impacted by the crisis mandated the Financial Stability Board to lead in formulating guidelines that would assist countries in reforming their insolvency laws to better respond to failures of financial institutions. In 2011, the FSB formulated the Key Attributes for Effective Resolution Regime for Financial Institutions. The FSB's Key Attributes have since been used by countries globally as a benchmark for reforming their bank resolution frameworks. In Kenya, various reforms have been instituted to the bank resolution framework since the earlier bank failures in the 1980s including: establishment of the Deposit Protection Fund in 1985 through an amendment to the Banking Act and post the GFC and enactment of the Kenya Deposit Insurance Act in 2012. The Kenya Deposit Insurance Act provided for the establishment of the Kenya Deposit Insurance Corporation which plays a complimentary role to Central Bank of Kenya's role in

[25] https://www.the-star.co.ke/news/2016-04-07-panic-withdrawals-haunted-chase-bank-causing-receivership/ on 8 June 2022.

[26] *Kenya Deposit Insurance Corporation 2018 Annual Report and Financial Statement for the Financial Year Ended 30 June 2018.*

resolving problem banks. Despite the reforms to the framework for bank resolution in Kenya, the process of resolving problem banks continued to be riddled with untimely intervention by the resolution authorities, a lack of transparency, certainty and accountability contributing to a diminished confidence by the public in the resolution process. Some of these weaknesses in the bank resolution framework were evident during the recent failures of Dubai Bank Kenya Limited, Imperial Bank Kenya Limited and Chase Bank Kenya Limited between 2015 and 2016. The resolution process has also been protracted by a barrage of legal suits filed in court by stakeholders challenging the resolution authorities for failure to protect their interest pre and post the bank failures. Doubts have also been cast on the credibility of CBK as an independent arbiter and regulator of the banking industry following claims of collusion with some of the failed banks' senior officials in malpractices that contributed the banks' failures. The lack of transparency, integrity and credibility in the resolution process are contrary to the guidelines laid down by the FSB in the Key Attributes. Some of the failed banks have continued to be in receivership for a prolonged length of time with continued extension of the receivership period beyond the twelve-month period provided for under the law. CBK as the primary resolution authority appears to wield unfettered powers to extend the receivership periods for failed banks beyond the periods stipulated by statute. There is also a lack of a clear framework providing specifically for the recovery and resolution plans which is vital to promoting the realisation of the aims of a robust resolution framework as outlined in FSB's Key Attributes.

1.4 Research Objectives

The research objectives of the study are as follows:

i. To analyse the adequacy of Kenya's current legal, regulatory, and supervisory framework for bank resolution in realising the key objectives and complying with the attributes postulated in the FSB Key Attributes, focusing on provisions of the Banking Act, CBK Act, CBK Prudential Guidelines and the Kenya Deposit Insurance Act and the implementation of statutory mandate by the resolution authorities.

ii. To appraise the relevant reforms to the United Kingdom's and the United States of America's bank resolution regimes post the GFC with a view to drawing lessons that can inform the implementation of a robust bank resolution regime in Kenya.

iii. To make recommendations for possible reforms to address any identified shortcomings and strengthen the framework for bank resolution in Kenya.

1.5 Hypothesis

The research will proceed on the following hypothesis:

The FSB's Key Attributes have been instrumental guidelines for countries in reforming their national bank resolution regimes to effectively manage problem banking institutions. Although Kenya has a resolution regime with designated resolution authorities equipped with necessary legal powers and operational capacity to intervene in managing and resolving financial institutions that are no longer viable, the resolution process has been characterised by delayed intervention, lack of transparency and accountability by the resolution authorities. These weaknesses are attributable to the failure by the resolution authorities to implement their statutory mandate and failure of the framework to fully adopt the guidelines issued by the FSB in its Key Attributes. The effectiveness of resolution process has also been impeded by protracted court cases and inconsistent judicial decisions which have contributed to uncertainty and lack of confidence by the public in the resolution process.

Full adoption and implementation of the FSB's Key attributes in Kenya's bank resolution framework including providing for early intervention, speedy resolution, transparency, accountability and predictability through legal clarity in the framework and providing for advance plans for orderly resolution are key to strengthening the resolution framework to manage bank failures in a more effective manner.

1.6 Research Questions

The research will seek to interrogate the following questions:

1. What is the legal and institutional framework for resolving problem banks in Kenya?
2. Does Kenya's bank resolution framework contain the essential elements postulated by the FSB for an effective resolution regime?
3. What lessons can Kenya draw from the UK's and the USA's reforms to their respective bank resolution regimes post the global financial crisis?

1.7 Justification for the Study

With the ever-increasing financial integration, bank resolution has gained global attention with authorities and policy makers in the financial sector converging regularly both at national and international forums to review developments made in strengthening their national bank resolution regimes to enhance their preparedness to effectively manage bank failures and foster financial stability. This study will examine Kenya's bank resolution regime, with a view to identify the gaps that exists in the framework and propose viable reforms to strengthen the

framework in line with international best practices. In its recommendations the study will highlight key reforms that have been implemented by the United Kingdom and the United States of America in strengthening their national resolution frameworks and demonstrate how the adoption of these reforms can address the weaknesses existing in Kenya's bank resolution framework.

This study seeks to provide valuable insights for consideration by policymakers and regulators in reforming the bank resolution framework in Kenya to enhance its effectiveness in conformity with international best practices. The study will also benefit researchers, legal practitioners, law and finance students by adding to existing knowledge and laying a basis for further research on strengthening the bank resolution framework in Kenya.

1.8 Theoretical Framework

This study is premised on the public interest theory of regulation.

1.8.1 Public Interest Theory

Regulation refers to application of legal tools for the realisation of socio-economic policy objectives.[27] Regulation may be categorised into social and economic regulation.[28] Economic regulation is often exercised on market monopolies and marker structures with excessive or limited competition.[29] It is primarily geared towards regulating the market structures in various aspects including market entry and exit. It also extends to the regulation of market behaviour in different aspects such as price control and quality standard for various products.[30] Social regulation on the other hand is directed towards areas such as consumer protection and environmental safety.[31] Regulation of the banking industry is critical to the realisation of a country's developmental goals as it ensures that banks conduct their businesses in a sound manner that takes into account the various stakeholders' interests. It further provides a framework for managing bank failures, ensuring that problem banks that can be salvaged are salvaged in a timely and orderly manner and those banks that cannot be salvaged are allowed to fail with minimal disruption to the banking industry.

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[27] Hertog J A 'Review of Economic Theories of Regulation' Discussion Paper series 10-18Utretcht School of Economics Tjalling C. Koopmans Research Institute (2010), 5.

[28] Viscusi, Vernon, and Harrington, Economics of regulation and antitrust, Cambridge: MIT Press, 3d edition (2000) 297.

[29] Hertog J A 'Review of Economic Theories of Regulation' Discussion Paper series 10-18Utretcht School of Economics Tjalling C. Koopmans Research Institute (2010) 1.

[30] Hertog J A 'Review of Economic Theories of Regulation' Discussion Paper series 10-18, 1.

[31] Hertog J A 'Review of Economic Theories of Regulation' Discussion Paper series 10-18Utretcht School of Economics Tjalling C. Koopmans Research Institute (2010), 1.

The public interest theory of regulation was first propounded by Arthur Pigou in 1938.[32] The theory is premised on the assumptions that unregulated markets often fail due to market imperfections such as monopolies and that governments are best placed to redress these imperfections through regulation.[33] This theory presupposes the existence of an efficient political process that ensures efficient regulatory institutions are in place to promote market efficiency.[34] According to the proponents of the public interest theory, the primary aim of regulating fundamental economic institutions is to promote the public's best interest, defined as the optimum feasible allocation of finite resources for individual and collective goods and services in a society.[35] Consumer protection is equally considered to be the at the heart of regulation of various industry players by governments as they seek to address imperfections in the market and undesirable market outcomes.[36]

In the context of this study, it is evident that there exists imperfections in the banking industry that necessitate the imposition of a regulatory framework to address these imperfection and manage the undesirable outcomes in the industry such as bank failures. Competing interests among the various stakeholders ranging from equity holders, bank depositors, creditors and the general public call for government oversight through various regulations that ensure all stakeholders interests are protected in both healthy and failed banks. Information asymmetry in the banking industry is another factor that necessitates regulation to ensure that the bank owners and management with access to more information, do not use their advantaged position to the detriment of bank depositors, creditors and the general public. In most jurisdictions, Central Banks are charged with the responsibility of regulating commercial banks. This regulatory structure is aimed at promoting transparency between banking institutions, individual consumers and corporations with whom they conduct business.[37]Prudential regulation of banks further protects depositors against the various risks that they are exposed to. Systemic risks which may result from adverse trading conditions are also managed through effective regulation to avert major bank failures.[38]

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[32] Djankov S, La Porta R, Silanes F and Shleifer A, 'The regulation of entry' 1 *The quarterly journal of economics* CXVII, (2002) 2.

[33] Andrei Shleifer 'Understanding Regulation' 11 *European Financial Management*, 4 (2005), 439.

[34] Hertog J A ''Review of Economic Theories of Regulation' Discussion Paper Series 10-18.

[35] Hertog J A 'Review of Economic Theories of Regulation' Discussion Paper series 10-18.

[36] Shleifer A, 'Understanding Regulation' 11 *European Financial Management*, 4 (2005) 440.

[37] Shleifer A, 'Understanding Regulation' 440.

[38] Central Bank of Kenya, *The A-Z of licensing a commercial bank, a mortgage finance company or a non-bank financial institution*, https://www.centralbank.go.ke/images/docs/Licensing%20Procedures/A-Z%20for%20Licensing%20Banks.pdf on 24 April 2023.

In relation to market entry, the public interest theory postulates that the governments screen new market entrants to ensure that the products they offer to consumers are of good quality and from credible sellers. The theory supports registration of new market entrants as a stamp of social approval that renders these companies reputable enough to conduct business with the general public and other entities.[39] Regulation of banks is crucial in view of the interconnectedness of the banking industry and the reliance the national and global economy hold on banks. In Kenya, CBK as the regulator of commercial banks is charged with the statutory responsibility of screening new entrants. Before issuing a banking licence the new entrants are required to comply with the relevant statutory regulations and guidelines.[40]

The public interest theory has faced a number of criticisms from scholars with some of the critics arguing that the theory overstates the extent of market collapses and fails to appreciate that markets and private entities are capable of addressing market failures without any intervention by the government.[41] Secondly, critiques of the theory argue that private litigation can address conflicts that may arise amongst market players in the limited instances of market imperfections.[42] Thirdly the critiques argue that, even where the markets and the courts are not able to satisfactorily redress resulting market failures, government regulators are not best suited to redress the market failures as they are incompetent, corrupt and captured.[43]

Despite the criticisms levied on the public interest theory, the governments' oversight role in vital industries such as the bank industry through legislation, policy formulation, supervision and managing resolution of failed banking institutions cannot be overlooked. Regulation anchored on a robust legal and regulatory framework that establishes the requisite institutions and clothes such institutions with the adequate powers and tools is fundamental to promoting stability within the banking industry and protecting various stakeholders' interests in the event of a banking crisis. The government has the coercive power to ensure compliance with enacted legislation and policies within banking institutions. The responsibility of redressing failures of a critical industry such as the banking industry cannot be left entirely to the courts as the courts may not have the requisite expertise to manage the resulting failures. The process of redressing bank failures also requires timeliness in intervention to avert systemic risks of which the

[39] Shleifer A, 'Understanding Regulation' 440.
[40] Central Bank of Kenya, *The A-Z of licensing a commercial bank, a mortgage finance company or a non-bank financial institution*, https://www.centralbank.go.ke/images/docs/Licensing%20Procedures/A-Z%20for%20Licensing%20Banks.pdf on 24 April 2023.
[41] Shleifer A, Understanding Regulation' 11 European Financial Management, 440.
[42]Shleifer A, Understanding Regulation' 11 European Financial Management, 4 (2005), 440.
[43] Shleifer A, Understanding Regulation' 11 European Financial Management, 4 (2005), 440.

resolution authorities are best suited to handle using the statutory powers and the appropriate resolutions tools. The critics also fail to appreciate the checks and balances that are available in law to ensure that the government bodies discharge their mandate within the confines of the law such as the Constitution[44] and the Fair Administration of Justice Act in Kenya.[45]

The current bank resolution framework in Kenya is provided for under the Banking Act,[46] Central Bank of Kenya Act[47] and the Kenya Deposit Insurance Act.[48] The Banking Act is the primary legislation that confers the banking industry's regulatory and supervisory powers on the CBK.[49] In the event of bank failures, CBK, as the primary resolution authority in consultation with the National Treasury, intervenes to resolve the failed banks.[50] CBK will often appoint KDIC, a statutory body charged with managing receiving or liquidating problem banks to facilitate the effective management of a bank failure.[51] KDIC manages an insurance fund that provides an insurance buffer to safeguard depositors' interests in its member institutions in the event of a bank failure. [52]

The public interest theory of regulation is fundamental to this study as it is a reflective of the present-day reality where regulation through legislation and by statutory institutions has become crucial in the highly intertwined social, economic and political activities. The theory appreciates that market failures such as bank failures necessitate government intervention through a legal and regulatory framework intended to address such failures. A robust resolution framework is desirable in managing bank failures as it promotes market efficiency by equipping the resolution authorities with the requisite powers and tools to intervene in ensuring that inefficient banks safely exit the market without triggering a systemic risk. The framework further promotes the process of rescuing viable problem banks in a manner that preserves such banks' critical functions, restores public confidence by preserving and safeguarding the banks' assets from deterioration, providing timely access for depositors to their funds held with failed banks, and laying out a clear procedure for managing failed banks.

[44] *Constitution of Kenya* (2010).
[45] Act No. 4 of 2015, Laws of Kenya.
[46] Chapter 488, Laws of Kenya.
[47] Chapter 491, Laws of Kenya.
[48] Act No. 10 of 2012.
[49] *Banking Act*, (Chapter 488) Laws of Kenya.
[50] Section 34, *Banking Act* (Chapter 488) Laws of Kenya.
[51] Section 34 (2) (b), *Banking Act* (Chapter 488) Laws of Kenya.
[52] Section 20, *Kenya Deposit Insurance Act* (Act No. 10 of 2012).

1.9 Methodology

This study employs a doctrinal approach to analyse Kenya's statutes, regulations, case law, and publications relating to bank resolution and depositor protection. Through this method, the research seeks to identify the gaps in the bank resolution framework in its entirety with a view to make recommendations for adoption to enhance its effectiveness. Other sources of data include online journal articles, past academic theses, newspaper articles and financial institutions' reports. These sources enrich the study by providing valuable data relating to resolving problem banks in Kenya, the effect of the process on key stakeholders, the economic system's reality, and its dependency on stable banking institutions for the country's growth and development.

In evaluating the role of the CBK and KDIC as the two institutions mandated by statute to resolve problem banks, this study relies on a case study approach on the two institutions' responses to the latest failures of three banks in Kenya namely, Dubai Bank Kenya Limited, Chase Bank Kenya Limited, and Imperial Bank Kenya Limited. The case study of the three named banks whose failure was in quick succession will enrich this study by testing and establishing the extent to which the existing bank resolution framework was effective in resolving the failed banks. Through a case study of the three failed banks, the study also highlights the strengths and weaknesses in the current resolution regime in Kenya benchmarking the regime with the international best practices postulated in the FSB's Key Attributes.

The study also analyses the experiences of the USA and the UK, both of which have implemented bank resolution reforms in line with the FSB's Key Attributes of an Effective Resolution Regime to their respective frameworks in recent years. This analysis aims to draw lessons that can inform reforms to strengthen Kenya's bank resolution framework in line with international best practices. The USA has experienced a number of financial crises that have allowed it to test and review its framework for resolving banks. The USA was also at the epicentre of the GFC. Following the aftermath of the crisis, it has implemented reforms to its bank resolution framework that will be analysed, and appropriate recommendations made for adoption to strengthen Kenya's resolution regime. The FDIC effectively handled 500 banks between the GFC of 2007 and the 2014 financial crisis. The UK also implemented a special bank resolution framework in 2009 following the GFC and with the collapse of Northern Rock

at the height of the credit crunch in 2007, whose effectiveness has been commended by the FSB.[53]

1.10 Limitations of the Study

As the study is primarily based on the doctrinal research methodology, analysing the existing law on bank resolution as encapsulated in the statutes and different regulations, no primary data will be collected from banks or the statutory bodies tasked with resolving banks in Kenya. It is the researcher's view that the existing laws, regulations and formal press releases by the statutory bodies tasked with bank resolution will suffice for this study.

This study will also be confined to commercial banks in Kenya licenced and regulated by the CBK under the provisions of the Banking Act.[54] While appreciating that bank failures in Kenya date back to early 1980's, this study will focus on the resolution process relating to three Kenyan banks that have collapsed in the most recent years namely; Dubai Bank Kenya Ltd, Imperial Bank Kenya Limited and Chase Bank Kenya Limited following the enactment of the Kenya Deposit Insurance Act in 2012 and the establishment of the KDIC under the Act .

1.11 Literature Review

There is limited literature relating to the legal and regulatory framework for bank resolution in Kenya. The available literature focuses on the special nature of banks, depositor protection, the adequacy of Kenya's deposit protection scheme, CBK's supervisory mandate in relation to preventing bank failures and evaluation of the factors contributing to failures in commercial banks. There is need to holistically consider the process of managing bank failures to appreciate the importance of a robust bank resolution framework in Kenya which ensures that inefficient banks are allowed to safely exit the industry without jeopardising the stability of the banking industry. A robust resolution framework should also ensure that problem banks which can be rescued are rescued in an effective manner that does not burden taxpayers with costly bail outs, inspires public confidence, averts the possibility of a systemic risk, protects the bank depositors and fosters stability in the banking industry and the financial system at large.

Kalani VM and Waweru NM, in their study on the Causes and remedies for commercial banking crises in Kenya, conclude that the national economic downturn coupled with lack of disclosure by customers of crucial information during loan applications and the absence of a strong debt collection policy are the major factors attributed to the nonperforming debt problem

[53] Financial Stability Board, *Key Attributes of effective resolution Regimes for financial institutions'* 2014.
[54] Chapter 488, Laws of Kenya.

in most of Kenya's commercial banks.[55] In their study, Kalani and Waweru do not evaluate the process of resolving banking crises in Kenya nor does the study examine CBK's role in managing banking crises and the tools availed by statute to resolution authorities for managing such bank crises. This is the gap that this study seeks to fill by examining Kenya's legal and regulatory framework for resolving framework focusing on the objectives of a robust bank resolution framework and how the current framework can be reformed to align with international best practices. Kalani and Waweru's study does not analyse the legal and regulatory framework provided for under the Kenya Deposit Insurance Act for managing failed banks as the Act was enacted post their study.[56] It is imperative that the legal and regulatory framework is analysed to determine whether the it adequately provides for the requisite powers and tools to manage bank failures in Kenya.

Mugo AW, in her dissertation on Preventing failures of commercial banks in Kenya, analyses the supervisory role of the CBK, focusing on the legal framework that the CBK operates under. She further examines the different stages of bank failures in Kenya and the causes attributed to the banks' collapses with a view to establish the extent to which CBK has succeeded in executing its supervisory mandate. She compares the Capital Asset Management Earnings Liquidity Sensitivity to Risk (CAMEL) supervisory method employed by the CBK and draws a comparison with the supervisory approach employed by the USA, Malaysia and India with a view to determine how the CBK can improve its supervisory mandate to stem bank failures. In her dissertation, Mugo does not delve into the subject of resolving failed banks in Kenya and the framework in place for bank resolution which is the focus of this study.

Dewatriport M and Freixas X refer to a bank resolution procedure as any public intervention meant to reinstate a failing bank institution to its ordinary working conditions or liquidate it, reinstating normal business operations for all other banking institutions.[57] In Kenya, the CBK is the public body mandated to intervene in managing a problem banking or financial institution licenced by it and regulated under the Banking Act under various circumstances stipulated under section 34 of the Banking Act. Upon intervention, CBK may, in consultation with the cabinet secretary, National Treasury and Planning ministry, take various measures, including appointing KDIC as receiver to take over management, control and conduct of the respective

[55] Waweru N and Kalani VM, 'Commercial banking crises in Kenya: Causes and remedies' 3 *Global Journal of finance and banking issues* (2008).
[56] Act No. 10 of 2012, Laws of Kenya.
[57] Dewatriport M and Freixas X, 'Bank resolution: A framework for the assessment of regulatory intervention" 27 *Oxford Review of Economic Policy* (2011), 3.

institution's operations and business. The resolution authorities are clothed with statutory powers to either liquidate and wind up the banking institution or to nurse it back to normal business condition as a healthy bank.

Effective management of bank failure has received global attention subsequent to the GFC that was witnessed between 2007 and 2009, with authorities focusing on reviewing their national and cross border resolution frameworks to increase their preparedness to effectively respond to bank failures. Various authors and authorities opine that bank failures are more critical and warrant special tools for their management unlike failure of other corporate entities. Koufman GG, in his journal article, posits that banks should be handled differently from other commercial corporate entities due to their close interconnected through their dealings with each other in lending and borrowing, holding deposits with each other and through the payment clearing system.[58] Kaufman further advances three reasons as to why banks are regarded as more fragile than other corporate entities. Firstly, he opines that banks have high leverage due to low capital to asset ratios and that this presents little accommodation for losses. Secondly, banks have low cash to assets ratios which may necessitate the sale of earning assets to honour deposit commitments and thirdly that the debt ratios present a high risk for a run on a bank which may necessitate a hurried asset sale to pay off running depositors resulting to large fire sale losses.

Unregulated financial markets are more predisposed to failure as witnessed during the GFC where financial institutions were permitted to engage in risky ventures following deregulation in the financial industry in the United States of America.[59] PetitJean M, in his journal article considers key components of an effective regulatory regime and opines that regulatory arbitrage was one of the key factors contributing to the gravity of the global financial crisis witnessed between 2008 and 2009.[60] He argues that a rules-based regulatory framework does not equate to a guarantee against bank failures and warns against a regulatory framework that is focused on reducing the probability of individual bank failures. In his recommendations, the essential features of an effective regulatory regime include the Basel-type rules robust to off-balance-sheet arbitrage; little tolerance in monitoring and supervision by regulatory agencies, focusing on systemic risk control; automatic and prompt intervention and resolution

[58] Kaufman GG, 'Bank failure, systemic risk and bank regulation' 16 *The Cato journal 1*, Cato Institute (1996).
[59] Claessens s and Kodres L, *The regulatory responses to the global financial crisis: Some uncomfortable Questions*, IMF Working Paper WP/ 14/46.
[60]Petitjean M, 'Bank failures and regulation: A critical review' 21 *Journal of Financial Regulation and Compliance*, 1 (2013), 20.

mechanisms. In his view, these attributes must be coupled with international coordination for the realisation of an effective regulatory framework.[61] These views resonate with the guidelines set out by the FSB's Key Attributes which have gained global acceptance as a benchmark against which the effectiveness of national resolution regimes are assessed. These attributes shall be reviewed in this study with a view of evaluating the extent to which Kenya's bank resolution regime has adopted the elements of an effective resolution regime recommended therein. PetitJean also appreciates the interconnectedness of the financial industry globally in advocating for the inclusion of international coordination within the resolution framework.

Lastra MR, in examining the legislative framework and regulatory responses of the UK to the Northern Rock failure and reviewing the UK government response to the GFC, stresses on the importance of having in place a clear and predictable legal framework to govern the reorganisation or liquidation of financial institutions in the event of a financial crisis to promote financial stability.[62] Prior to the Northern Rock bank failure in the UK, the UK regime relied on procedures set out under the corporate insolvency law to resolve problem banks.[63] The failure of Northern Rock exposed the insufficiency of the corporate insolvency laws to deal with banking crises.[64] In reforming the bank resolution framework, the Special Resolution Regime (SRR) was established in the UK through the enactment of the Banking Act in 2009. The SRR provides for orderly resolution of a failing UK bank in a manner that seeks to preserve confidence in the banking sector, promote financial stability and protect depositors and the taxpayers. [65]

Following the rise in number of failed banks between 1980 and 1991, legislators in the USA enacted the Federal Deposit Insurance Corporation Improvement Act (FDICIA) in 1991 to strengthen its bank resolution framework. The FDICIA advocated for timely corrective action and the resolution approach that is least costly to responding to problem banks. This Act was an improvement of the FDIC established under the FDIA, whose mandate is to maintain stability and foster public confidence in the country's financial system.[66]Hogan TL and Johnson K, in their journal article argue that the state level-based framework for resolving

[61]Petitjean M, 'Bank failures and regulation: A critical review' 21.
[62] Lastra, MR, 'Northern Rock, UK bank insolvency and cross-border bank insolvency', *Journal of Bank Regulation* 9 (2008) 165.
[63] Brierley P 'The UK special resolution regime for failing banks in an international context', *SSRN Electronic Journal* (2009).
[64] Brierley P 'The UK special resolution regime for failing banks in an international context'.
[65] Brierley P 'The UK special resolution regime for failing banks in an international context'.
[66] https://www.fdic.gov/about/ on 20 April 2022.

problem banks in the USA which is informed by the country's experience with bank failures dating back to the great depression of the 1930s and the establishment of the FDIC in 1933 have contributed to instability in the banking industry.[67] They further opine that insurance systems that relied on self-regulation in the pre- FDIC insurance era, which were made credible by mutual liability, were more successful in promoting stability in the banking industry as opposed to compulsory state-run insurance systems.[68] Although there is room for self-regulation in the financial services industry, the importance of statutory sanctioned regulation in a critical industry such as the banking industry cannot be overlooked. A regulatory framework providing for depositor protection takes into account the information asymmetry in the banking industry that places depositors in a disadvantaged position and the risk posed to these depositors in the event of bank failures. It seeks to guarantee the insured depositors of availability and access to their insured deposits through a centralised framework for regulating the deposit insurance schemes.

As earlier stated, during the GFC, authorities in the countries most affected by the crisis such as the USA resorted to bailing out financial institutions which were perceived too important to fail through huge government bailouts using taxpayers' funds. Barth JR and Wihlborg C, define a too big to fail bank as one that, if it were to default on its obligations, would generate an unacceptable risk not only to the banking system but to the economy owing to its substantial exposure to other banks through the payment system and other financial commitments.[69] Knee jerk reactions to managing banking failures through bailouts by the state, such as witnessed in the bailout of the Continental Illinois Corporation (CIC) have been considered to exacerbate the moral hazard by encouraging banks to take uncalculated risks to the depositors and taxpayers detriment.[70]

Kleftouri N opines that the employment of public funds in support of a resolution should only be in exceptional circumstances where the preservation of financial stability takes precedence over the other objectives provided for under the BRDD.[71] Lastra supports Kleftouri's views by opining that the Central Bank, as a lender of last resort, should only intervene through bailout

[67] Hogan TL and Johnson K 'Alternatives to the Federal Deposit Insurance Corporation' 20 *The Independent Review*, 3 (2016),440.
[68] Hogan TL and Johnson K 'Alternatives to the Federal Deposit Insurance Corporation', 3.
[69] Barth JR and Wihlborg C, 'Too big to fail and too big to save: Dilemmas for banking Reform' 235 *National Institute Economic Review* (2016).
[70] Barth J R and Wihlborg Clas, 'Too Big to Fail and Too Big to Save: Dilemmas for banking Reform' 3.
[71] Kleftouri N 'European Union Bank Resolution Framework: Can the objective of financial stability ensure consistency in resolution authorities' decisions?' https://link.springer.com/content/pdf/10.1007/s12027-017-0469-0.pdf on 15 October 2021.

of institutions in exceptional circumstances to curb the increase in moral hazard associated with bailouts. She further recommends that the Central Bank as a lender of last resort, should conduct a cost benefit analysis to establish its risk exposure to loss of funds in the event that it opts to bail out an institution and the moral hazard that would result from such a bailout.

In Kenya, CBK as the lender of last resort, runs a discount window facility that allows banks that are unable to borrow from the interbank market to borrow from the regulator as lender of last resort as a means of providing temporary liquidity to banks with temporary liquidity problems.[72] Where the regulator establishes that a bank is in distress and that temporary liquidity cannot be a cure, it is paramount that such an institution should not be allowed to continue with market operations. The regulator should trigger the resolution of such institutions to see to it that depositors' funds are safeguarded and that depositors recover as much of their deposits as possible. Such timely intervention also bolsters public trust in the banking industry and prevents the contagion effect of a bank failure on other banks and the financial industry.

According to an IMF report of 2020, the cost of liquidating banks and selling off assets of failed banks to settle liabilities remains significantly high, leading to prolonged retention of customer deposits in failed Kenyan banks and depriving the economy of assets that would boost economic growth.[73] The IMF in its report further opined that with an effective resolution regime, such assets ought to have been acquired by healthy commercial banks for inclusion as deposits in their books to increase the percentage of money available in circulation in the economy.[74] This study resonates with the IMF findings in this report and argues that the high costs associated with resolving failed banks and the protracted process of liquidation highlight part of the weaknesses in Kenya's current bank resolution framework.

Following the GFC, most countries have reviewed their bank resolution frameworks, adopting reforms that are more suited to manage bank failures, including the 'too big to fail' banks. The USA implemented the Dodd-Frank Wall Street Reform and Consumer Protection Act 2010, which lays out procedures for resolving large problem banks classified as (G SIBs).[75] These reforms are in line with the FSB's Key Attributes that recommend systemically important global financial institutions to have in place a recovery and resolution plan to ensure that

[72] Central Bank of Kenya, *Monetary Policy*, https://www.centralbank.go.ke/monetary-policy/ 31 January 2022.
[73] Guguyu O 'Failed banks hold 13bn in customers' cash- IMF 31 January 2022.
[74] Guguyu O 'Failed banks hold 13bn in customers' cash- IMF 31 January 2022.
[75] Martin NB, Aaron K, and Justin S. "The Impact of the Dodd-Frank Act on Financial Stability and Economic Growth.' 3 *The Russell Sage Foundation Journal of the Social Sciences* (2017), 20.

failures for such institutions are resolved in a timeous manner with minimal disruption to the economy and without burdening the taxpayers.[76] Seal K opines that living wills, also known as recovery and resolution plans (RRPs), make a valuable contribution to the resolution frameworks for SIFIs.[77] In her view, the RRPs promote contingencies preparedness by individual institutions and resolution authorities, reducing the moral hazard associated with SIFIs. [78] The requirement for RRPs should not only be limited to the SIFIs but extended to all banking institutions to promote sound corporate governance and mitigate the risks associated with bank failure.

Bank resolution authorities within the European Union banks are equipped with essential resolution tools and powers to resolve failing financial institutions by the Bank Recovery and Resolution Directive (BRRD), which was agreed upon in 2014.[79]The BRDD directive, which the UK adopted into its national law, requires resolution authorities to undertake resolution planning to safeguard financial stability and realise resolution objectives.[80] These objectives include ensuring continuity of critical functions, avoiding substantial adverse effects on the financial system, protecting taxpayers by minimising bailouts, depositor protection and safeguarding clients' assets.

Silver K, in his dissertation, analyses inter alia, the financial crisis management framework in Uganda. He observes that the Bank of Uganda's Financial Stability Department has in place a Financial Crisis Management Plan to promote the orderly resolution of a bank crisis while mitigating losses to the various stakeholders and the economy. The plan encompasses three stages: financial crisis detection, management of the crisis by the crisis management team, and crisis resolution.[81] The plan aligns with the international best practices for bank resolution as

[76]Key Attribute no. 1.3 of Effective Resolution Regimes for Financial Institutions (2011).

[77]Seal K, Recovery and Resolution Plans (Living wills): A Solution to the TITF Problem? Building a More Resilient Financial Sector, Reforms in the Wake of the Global Financial Crisis 2012, *International Monetary Fund,* 290.

[78]Seal K, 'Recovery and resolution plans (living wills): A solution to the TITF Problem?' Building a more resilient financial sector, reforms in the wake of the global financial crisis 2012', 290.

[79]Andersen J V, Lintner P Schroeder and S Andelskassen 'Resolution via bridge bank and bail-in including unsecured depositors, in bank resolution and bail-in' in the EU: Selected case studies pre and post BRRD, World Bank Group Washington (2016).

[80]Article 31, Bank Recovery and Resolution Directive, European Commission.

[81] Kayondo S, 'Legal aspects of distressed bank rescue: Lessons for Uganda from South Africa and English experience', 150.

entailed in the FSB's Key Attributes of Effective Resolution Regimes for Financial Institutions. In February 2021, Uganda also published an elaborate framework for identification, supervision and regulation of Domestic Systemically Important Banks (D-SIBS).[82] Although Silver K does not explicitly deal with the issue of bank resolution, he highlights key developments in the banking industry in addressing bank failures in various jurisdictions, including South Africa and the United Kingdom, geared towards promoting financial stability. The Kenyan banking sector is increasingly becoming sophisticated in the wake of the technological developments and innovations in the industry, with banks in Kenya having branches or affiliates in other countries within the African region and beyond. It would be imperative for Kenya to align its bank resolution framework to the international best practices recommended by the FSB to promote effective bank resolution.

From the literature reviewed, none of the authors have comprehensively interrogated the bank resolution framework in Kenya and more particularly the extent to which the implementation of legal, regulatory and supervisory aspects of the resolution framework have realised the objectives of an effective bank resolution framework as provided for by the FSB in its Key Attributes of an Effective Resolution Regime for Financial Institutions, being the soft law reference point on international best practice for resolving bank failures.

1.12 Chapter Breakdown

1.12.1 Chapter One: Introduction

This chapter provides an introduction and sets the background for the study. The chapter further presents the statement of the problem, points out the study's objectives, and outlines the research questions to be addressed in the study. The chapter also encapsulates the hypothesis that although Kenya has adopted some of the FSB's Key Attributes of an Effective Resolution Regime for Financial Institutions in reforming its legal and regulatory framework for managing banking failures, weaknesses have been exhibited in the process of resolving problem banks. These weaknesses include: delayed intervention, lack of transparency and accountability by the resolution authorities. The weaknesses are attributable to the failure to fully adopt the guidelines issued by the FSB and a lack of commitment by the resolution authorities to the implementation of the resolution powers provided for in the legal and regulatory framework.

[82] Bank of Uganda, "Framework for the identification, regulation and supervision of domestic systemically important banks' February 2021.

The resolution process has also been marred by protracted court cases and inconsistent judicial decisions which have contributed to uncertainty and lack of confidence by the public in the resolution process. The chapter further identifies the methodology to be employed in the study, discusses the theoretical framework and provides a literature review in relation to this study.

1.12.2 Chapter Two: Rationale for a Special Resolution Regime for Managing Bank Failures

This chapter evaluates the special nature of banks highlighting the critical functions performed by banks and the systemic risk that could arise from a banking crisis if bank failure is ill managed. It further discusses the rationale for a special resolution regime to deal with banks in distress, pointing out the unsuitability of corporate insolvency laws in managing bank failures. The concerted efforts by financial authorities from leading global economies to reform national bank resolution regimes following the GFC, culminated in the FSB being mandated with formulation of guidelines to inform the establishment of robust resolution regimes. This chapter also reviews the FSB guidelines as outlined in the FSB Key Attributes of an Effective Resolution Regime for Financial Institutions.

1.12.3 Chapter Three: Kenya's Bank Resolution Framework

This chapter critically examines the legal and regulatory framework for resolving problem banks in Kenya, highlighting the historical background, challenges and the reforms implemented through the relevant legislation, including the Banking Act, the Kenya Deposit Insurance Act and the Companies Act of 2015. The criteria for classifying banks as failing or failed banks in Kenya by CBK as provided in the Banking Act and the Kenya Deposit Insurance Act, that necessitate the intervention by the resolution authorities will be examined in this chapter. The chapter further delves into an analysis of CBK's and KDIC's responses to the failures of Dubai Bank Kenya Limited, Imperial Bank Kenya Limited and Chase Bank Kenya Limited, being recent bank failures that occurred in quick succession post enactment of reforms to the bank resolution laws in Kenya. This chapter aims to demonstrate that despite the existence of a legal and regulatory framework for the resolution of problem banks in Kenya, the framework does not fully align with the international best practices for an effective bank resolution regime. It is also established in this chapter that there are lapses in the implementation of the resolution mandate by the relevant authorities which have contributed to the delays, inconsistencies and opaqueness witnessed in the resolution process and dented public confidence in the resolution process.

1.12.4 Chapter Four: Analysis of the UK and USA Bank Resolution Regimes

This chapter will examine the UK and USA bank resolution regimes highlighting key reforms with a view to draw lessons that Kenya can borrow in reforming its bank resolution framework in line with international best practices.

1.12.5 Chapter Five: Research findings, Recommendations and Conclusion

This chapter presents the research findings, recommendations and conclusion. It proposes reforms to Kenya's legal and institutional framework to address the inadequacies of Kenya's bank resolution regime to realise the objectives of a sound resolution framework.

CHAPTER 2: RATIONALE FOR A SPECIAL RESOLUTION FRAMEWORK FOR MANAGING BANK FAILURES

2.1 Introduction

As discussed in the preceding chapter, banks play an important function in a country's economic growth and development. With increased financial integration and cross border trade, most commercial banks have continued to expand their business operations beyond their host countries. Stability in the banking industry as stated in the previous chapter, is crucial for the realisation of a country's development goals as espoused in Kenya's vison 2030, being the country's blueprint for economic growth and development.[83] A robust legal and regulatory framework is key to stability in the banking industry. However, a robust legal and regulatory framework does not rule out failure of banking institutions. This necessitates having in place an adequate bank resolution framework with adequate tools to promptly detect such failures and manage them in a manner that protects depositors and other stakeholders' interests, promotes public confidence in the banking industry and promotes stability in the banking industry and the financial system at large.

This chapter evaluates the special nature of banks and sets out the case for a special resolution regime to effectively manage bank failures. It begins with an overview of the critical functions that banks discharge in an economy and the systemic risks that are associated with banking crisis, necessitating an effective bank resolution framework. The chapter then proceeds to discuss the limitations of the corporate insolvency laws in resolving failed banking institutions pointing out the challenges that resolution authorities had to contend with in managing the failed financial institutions during the global financial crisis of 2008. This chapter further analyses the steps taken by the G20 members post the GFC through their collaborative efforts in the FSB and Basel Committee on Banking Supervision in an endeavour to promote financial stability through effective resolution regimes for financial institutions.

2.2 Special Nature of Banks

2.2.1 Banking Functions

Banks contribute significantly to a country's economy through provision of essential banking services which encompasses the operating payment systems, receiving deposits, loan repayments, and application of the money so collected in lending through various lending

[83] Government of the Republic of Kenya, *Vision 2030*, 2007.

instruments.[84] These essential functions of banks make them financial reservoirs through which streams of currency are received and issued to where and as required to sustain and aide commercial, industrial or other economic ventures in a society.[85] Banks further provide an avenue for the transmission of monetary policies within an economy.[86]

Liquidity is critical in the performance of the banks' vital functions. It enables banks to fund their asset growth whilst maintaining the ability to meet obligations to their creditors as they fall due. [87] A sound regulatory framework is also critical to the realisation of stability in the banking industry. It ensure that banks manage their businesses in a safe and sound manner that inspires public confidence, protects the various stakeholders' interests. It is critical that banks put in place robust liquidity risk management tools to ensure that they are able to meet their cash flow obligations, as a liquidity shortfall at one banking institution could trigger a systemic risk as witnessed during the GFC.[88]

2.2.2 Systemic Risk

Systemic risk refers to the risk associated with the failure of a participant in the financial industry to meet its contractual obligation resulting in other players defaulting with a chain reaction resulting to broader financial difficulties.[89] A sound regulatory framework in the banking industry should take cognisance of the systemic risk associated with bank failures and ensure that adequate measures are put in place to mitigate such risks. These risks may result from a number of factors including panic withdrawals, asset price falls, contagion and foreign exchange matches in the banking system.[90] An analysis of each of these factors follows below to give a clear appreciation of the special nature of banking crises and the need for an adequate resolution framework suited for managing crises in the banking industry.

2.2.2.1 Panic Withdrawals

Panic withdrawals can be detrimental to a bank's solvency as witnessed during the global financial crisis and other subsequent banking crises witnessed in various countries. Bank depositors place their deposits with banking institutions in exchange for a demand deposit

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[84] Cranston Ross, *Principles of banking law, second edition*, Oxford University Press, United Kingdom, 2002, 5.
[85] Cranston Ross, Principles of banking law, 2002, 5.
[86] Cranston Ross, Principles of banking law, 2002, 5.
[87] Bank of International Settlement, Basel Committee on Banking Supervision, *Principles for sound liquidity risk management and supervision*, 25 September 2008.
[88] Bank of International Settlement, Basel Committee on Banking Supervision, *'Principles for sound liquidity risk management and supervision*, 25 September 2008.
[89] Bank for International Settlement, 64th Annual report, Basel, Switzerland. 1994.
[90] Allen F and Carletti E, 'What is Systemic risk?' 45 *Journal of money, credit and banking* (2013) 122

contract and these deposits are essential for supporting the banks' liquidity needs. It is often expected that depositors will withdraw their deposits at varying intervals, according to their consumption needs making it possible for banks to satisfy their depositors' demands without liquidating their long term assets.[91] However, in a panic situation, depositors of a banking institution seek to withdraw their deposits prematurely on the apprehension of that other depositors will run, leaving no assets in place for those who do not run, leading to the collapse of an institution.[92] The failure of significant banking institutions can have a ripple effect on the larger financial industry precipitating undesirable externalities such as a liquidity crunch and spill overs in the interbank market, as witnessed during the GFC. Various policy measures have been enacted in various jurisdictions in an attempt to contain panic withdrawals, restore public trust and guarantee depositors of the safety of their deposits. An explicit deposit protection insurance such as that provided for under the FDICA[93] in the USA and the KDIA[94] in Kenya is one of such measures as the deposit insurance schemes guarantees the member institutions' depositors of access to their insured deposits in the event that a member institution fails.

2.2.2.2 Asset Price Falls

Banks hold assets in various forms including loans, government securities and reserves. The fall in security prices of these assets may result in significant solvency problems for banks leading to a systemic risk. Some of the factors that may contribute to the fall of asset prices include: increases in interest rates, mispricing occasioned by inefficient liquidity provision and limits to arbitrage, bursting of real estate bubbles, sovereign default and the business cycle.[95] Firstly, a fall in bank asset price may be triggered by a rise in interest rates occasioned by either monetary policy decisions by central banks to mitigate inflation or market dynamics in anticipation of inflation.[96] Secondly, assets mispricing can contribute to asset price falls. Asset mispricing are inevitable in incomplete and imperfect markets with irrational agents. In these markets the financial system fails to provide an efficient level of liquidity and banks are unable to hedge completely against liquidity shocks leading to mispricing of assets below their fundamental values.[97] Thirdly, financial crises such as the GFC have been attributed to collapses in real estate prices in a number of countries such as witnessed in the USA, Spain

[91] Allen F and Carletti E, 'What is Systemic risk?', 122.
[92] Bryant J, 1980. "A model of reserves, bank runs and deposit insurance." *Journal of Banking and Finance,* 4(1980): 335–44.
[93] Chapter 967 of the 81st Congress; 64 Stat. 873, United States of America.
[94] Act No. 10 of 2012, Laws of Kenya.
[95] Allen F and Carletti E, 'What is systemic risk' 45 *Journal of Money, Credit and Banking (2013), 124.*
[96] Allen F and Carletti E, 'What is systemic risk?', 124.
[97] Allen F and Carletti E, 'What is systemic risk?' 124.

and Ireland between 2007 and 2009.[98] Following the bursting of the real estate bubble in these countries, a collapse in the securitized mortgage market ensued leading to severe problems in financial institutions with spill over effects to the wider economies.[99] Fourthly, sovereign defaults may contribute to a fall in asset price that would significantly affect stability of the banking system. This was the case witnessed in Greece following a default on its sovereign debt in 2011.[100] Fifthly, an outgrowth of a business cycle may trigger an asset price fall leading to a banking crisis that may result in a systemic risk. In the event that bank depositors of a particular bank get wind of an impending asset price fall due to an outgrowth of business cycle they may attempt to withdraw their deposits precipitating a banking crisis.[101]

2.2.2.3 Contagion

A contagion is another factor that may contribute to systemic risk leading to a banking crisis. A contagion effect occurs where one bank's financial distress spills over to other financial institutions causing a systemic risk such as was witnessed following the collapse of Lehman Brothers in the USA in 2008. The failure of Lehman Brothers generated a contagion with the effects rapidly spreading to the money market funds. This resulted in dwindling of public confidence in other financial institutions leading to the global financial crisis.[102] The likelihood of a contagion should trigger regulatory intervention by the central bank to manage a problem institution in a timely and effective manner to avert a contagion effect that could lead to instability in the financial system. In Kenya the contagion effect was witnessed in 2016 following public apprehension and the eventual collapse of Chase Bank Kenya Limited in 2016. An in depth analysis of Chase Bank Kenya Limited's failure is provided in the next chapter.

2.2.2.4 Currency Mismatches in the Banking System

A systemic risk may also be triggered by a currency mismatch in the banking system. Currency mismatch was one of the major factors linked to the Asian financial crisis in 1997.[103] During this crisis the central banks in the Asian market lacked enough foreign exchange reserves and they were not able to borrow in the markets to meet the deficit. They were forced to seek

[98] Willian A, Allen and Moessner, *Central Bank cooperation and international liquidity in the financial crisis 2008- 9*, Monetary and Economic Department BIS Working Papers No. 310, May 2010.
[99] Allen F and Carletti E, An Overview of the Crisis: Causes, consequences and solutions presented at the conference on Global Market Integration and Financial Crises at Hong Kong University of Science and Technology, 26 November 2009.
[100] Allen F and Carletti E, '*What is systemic risk*?' 124.
[101] Allen F and Carletti E, 'What is systemic risk?' 124.
[102] Allen F and Carletti E, 'What is systemic risk' 125.
[103] Allen F and Carletti E, 'What is systemic risk' 126.

lending from the IMF. As one of the conditions to lending, the IMF required the borrowing countries to raise interest rates in order to maintain the exchange rate. The rise in interest negatively impacted countries such as South Korea that run bankrupt due to a huge exposure in trade credit, leading to closure of businesses, increase in unemployment and a long recession in the country.[104]

2.2.3 Inadequacy of Corporate Insolvency Laws in Managing Bank Failures

The filing of a bankruptcy petition by one of the largest global financial services firms, Lehman Brothers Holding Inc in the USA, under Chapter 11 of the United States of America's Bankruptcy Code, following its sudden failure in September 2008 was a watershed moment of the GFC.[105] This petition and the subsequent market turmoil across the globe exposed the absence of or the inadequacy in the scope of existing resolution mechanisms to manage failing financial institutions in the USA and other leading world economies most affected by the crisis. During the GFC, the available options for the authorities in addressing the financial crisis were seemingly limited to either corporate bankruptcy or unanticipated bailouts by governments using public funds, both of which proved costly and ineffective in managing bank failures.[106] For large international financial institutions, the authorities lacked the legal instruments to impose losses on equity holders while keeping the financial conglomerate running.[107] The existing framework for information sharing and policy coordination between the home and host resolution authorities was also found wanting. These inadequacies in the resolution framework were further compounded by the lack of a pre-arranged plan for funding to aide in resolving failed financial institutions.[108]

Corporate insolvency laws are considered inappropriate for managing bank failures due to the following reasons:

Firstly, corporate insolvency laws provide for negotiated settlements between the distressed firm and its creditors, where various formal and informal firm rescue options may be pursued

[104] Allen F and Carletti E, 'What is systemic risk' 126.
[105] Fitzpatrick TJ IV, Kearny-Marks M and Thomson JB, 'The history and rationale for a separate bank resolution process', 1.
[106] Charles G, Gabor D, 'Vestergaard J, and Ertürk I, Central Banking at a Crossroads: Europe and Beyond'. Anthem Press, (2014), 111.
[107] Knot Klas, Planning is everything: the FSB's Key Attributes and what we have learnt from them, 10 Years of the FSB Key Attributes of Effective Resolution Regimes for Financial Institutions, Financial Stability Board, 7 December 2021.
[108] Knot Klas, Planning is everything: the FSB's Key Attributes and what we have learnt from them, 10 Years of the FSB Key Attributes of Effective Resolution Regimes for Financial Institutions, Financial Stability Board,7. December 2021.

to allow a distressed firm to turn around. These corporate rescue options often call for lengthy negotiations between the shareholders and creditors while some formal rescue options necessitate judicial intervention which also prolongs the process.[109] Whilst corporate rescue options such as debt restructuring, reorganisation and administration may be desirable for a distressed corporate firm, these rescue options may not be viable for a bank in distress as they focus on individual companies in isolation disregarding the fact that delayed or prolonged intervention could cause a loss of confidence by a bank's depositors that triggers a bank run. The delay in intervention may also contribute to a rapid deterioration of the bank's financial position and lead to a contagion, undermining the financial stability of an economy.[110]

Secondly, the insolvency practitioners or bankruptcy courts appointed to conduct a proceeding under corporate insolvency laws are not obligated to take into consideration the public policy objectives related to maintenance of financial stability. The actions of the insolvency practitioners of bankruptcy courts in discharging their statutory mandate may exacerbate the negative effects of a bank failure.[111]

Thirdly, corporate insolvency laws are not designed to realise the objective of ensuring the continuity of key banking function such as payments and access to credit facilities as these functions would likely be suspended by a moratorium under corporate insolvency proceedings.[112]

Fourthly, corporate insolvency procedures are not designed to provide for real time decision making which is desirable in the management of risks that banks are susceptible to.[113]

Fifthly, the corporate insolvency procedures do not recognise the unique and special nature of bank depositors' and their claims on banks. These depositors are often many and their bank deposits play a major role in the functioning and stability of the wider economy.[114]

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[109] Finch V and Milman D, *Corporate Insolvency law: Perspectives and principles*, 3rd edition, Cambridge University Press, United Kingdom (2017), 207.

[110] Finch V and Milman D, Corporate Insolvency Law: Perspectives and Principles

[111] Brierly P *The UK Special Resolution Regime for Failing Banks in an International Context'* Financial stability paper No. 5, July 2009.

[112] Brierly P, *The UK Special Resolution Regime for Failing Banks in an International Context,* Financial stability paper No. 5, July 2009.

[113] Brierly P, *The UK Special Resolution Regime for Failing Banks in an International Context',* Financial stability paper No. 5, July 2009.

[114] Brierly P, *The UK Special Resolution Regime for Failing Banks in an International Context,* Financial stability paper No. 5, July 2009.

Due to the inadequacies highlighted above of corporate insolvency laws to manage bank failures, a distinct robust bank resolution framework is desirable in ensuring that bank failures are manged in an effective manner to avert a banking crisis. As witnessed in Japan, a weak bank resolution framework could be a catalyst for a financial crisis that could potentially destabilize a country's economy. It took Japan a decade to stabilise its economy following the financial crisis that rocked the country between 1990 and 2000 due to its inadequate framework for restructuring problem banks.[115] The Japan government's intervention through rushed bank bailouts, which provided banks with money without assessing their financial conditions and capital needs, was faulted for costing the country a decade of economic downturn.[116] Similar knee jerk responses by governments in jurisdictions most affected by the GFC such as the USA and the UK faced public criticism for the excessive burden to tax payers, increasing the moral hazard risk resulting from the huge bailouts of the 'too big to fail financial institutions' by governments and nationalisation of failed financial institutions.[117]

Financial stability is considered a public good owing to the correlation between financial stability and the health of an economy. A credible bank resolution framework seeks to bolster financial stability by ensuring that problem banks are resolved in a timely and orderly manner that minimises contagion, loss to depositors and safeguards stability in the banking system, and the economy at large. A special resolution regime empowers expert resolution authorities to make quick and timely decisions in respect to a failed banking institution. It further makes it possible for the resolution authorities to handle financial contracts, outstanding payments and securities transactions, and financial collateral while preserving the financial position of a distressed institution.[118] An explicit deposit insurance scheme is also provided for under the special resolution framework and in most cases the central banks as the primary resolution authorities collaborates with the deposit insurance schemes to ensure that the depositors of a failed institution are guaranteed access to their insured deposit in a timely manner. A special insolvency framework further makes it possible for the subrogation of a deposit insurance agency to the claims of depositors to the extent of the reimbursed amounts. Through a special

[115] International Monetary Fund, *Regional Economic Outlook, Asia and Pacific*, 2009, 110.https://www.elibrary.imf.org/configurable/content/books$002f086$002f10011-9781589068407-en$002fch04.xml?t:ac=books%24002f086%24002f10011-9781589068407-en%24002fch04.xml on 5 May 2022.

[116] International Monetary Fund, *Regional Economic Outlook, Asia, and Pacific*, 110.

[117] Grant KJ, 'Planning for the death of a systemically important financial institution under title 1 section 165 (d) of the Dodd Frank Act: The practical implications resolution plans and living wills in planning a bank's funeral' 6 *Virginia Law and Business Review journal'*, 3 (2012) 471.

[118] Hupkes E, 'Insolvency, why a special regime for banks?' 5.

resolution framework, consistency is maintained between the authorities involved in the bank resolution process due to the close cooperation among the authorities tasked with various supervisory and insolvency related function.[119]

Having recognised the inadequacies of the resolution tools employed during the GFC to stem the financial turmoil and the moral hazard concerns associated with the huge government bailouts, various countries embarked on reviewing their national bank resolution frameworks, with most countries preferring to establish a distinct bank resolution framework, separate from the general corporate insolvency framework. Leading financial bodies such as the FSB and the Basel Committee on Banking Supervision (BCBS) were mandated by the G20 member countries to propose viable measures to address the too big to fail problem , the moral hazard concerns identified during the GFC with a view to bolster stability in the financial industry.[120] The two bodies have continued to play an instrumental role in advocating for special resolution regimes for resolving financial institutions in the aftermath of the GFC and making recommendations for adoption by countries in strengthening the bank resolution frameworks at the national levels which recommendations are discussed below.

2.2.4 The Financial Stability Board and its Recommendations for Effective Resolution Regimes to Manage Failures of Financial Institutions.

International cooperation is paramount in the quest for financial and monetary stability, considering the interconnectedness of financial institutions and advancement in technology that have seen the expansion of cross border banking and increase in diversity and complexity of businesses undertaken by various financial institutions. The FSB, an international body established in 2000 by the G20 members continues to play an instrumental role in promoting a safe and stable financial environment for cross border banking to thrive.[121] The FSB is charged with monitoring and making recommendations about the global financial system. [122]

Following the GFC, upon request from its member countries, the FSB embarked on developing a policy framework to mitigate the major risks identified from the crisis namely: moral hazard associated with bail outs by governments due to disorderly failures of systemically important

[119] Hupkes E, 'Insolvency, why a special regime for banks?',5.
[120] Grant KJ, 'Planning for the death of a systemically important financial institution under title 1 section 165 (d) of the Dodd Frank Act: The practical implications resolution plans and living wills in planning a bank's funeral' 6 *Virginia Law and Business Review journal'*, 3 (2012) 471.
[121] https://www.fsb.org/about/ on 5 May 2022.
[122] About the FSB - Financial Stability Board on 5 May 2022.

financial institutions and the predisposition to systemic risks and contagion effect resulting from such failures. [123] Among the recommendations made by the FSB was the need to subject globally and domestically systemically important financial institutions (SIFIs) to a more intensive co-ordinated supervision and resolution planning to reduce the likelihood and impact of their failure.[124] In its report, the FSB further recommended that all the jurisdictions of its member states establish a clear policy framework for SIFIs geared towards reducing the risks and externalities associated with SIFIs.[125] Among the essential elements of the recommended policy framework were; a resolution framework that would facilitate safe and prompt resolution of all financial institutions without jeopardising the stability of financial system or burdening the taxpayers with the risk of loss associated with the failure of a financial institution; a higher loss absorbency for such SIFIs; strong core financial market infrastructures to mitigate contagion risks associated with failure of an institution and the subjecting of financial institutions that are disposed to cause systemic risks to a more intensive supervisory oversight.[126] These recommendations laid an important road map for jurisdictions across the globe to consider in designing and reviewing their national resolution frameworks to better provide for prompt and orderly resolution of failed financial institutions and to mitigate the contagion effect that would arise from such failures.

In 2011 the FSB published the Key Attributes of Effective Resolution Regimes for Financial Institutions which set out the fundamental elements that the FSB considers necessary for an effective resolution regime.[127] The successful implementation of the FSB's Key Attributes to a jurisdiction's resolution framework ought to promote the orderly resolution of problem financial institutions in a manner that safeguards taxpayers from loss associated with solvency support and to ensure continuity of such an institutions key economic functions.[128] The FSB's

[123] Financial Stability Board, *Reducing the moral hazard posed by systemically important financial institutions FSB Recommendations and Timelines,* 20 October 2010, 3.

[124] Financial Stability Board, *Reducing the moral hazard posed by systemically important financial institutions FSB Recommendations and Timelines,* 1.

[125] Financial Stability Board, *Reducing the moral hazard posed by systemically important financial institutions FSB Recommendations and Timelines,* 2.

[126] Financial Stability Board, '*Reducing the moral hazard posed by systemically important financial institutions FSB Recommendations and Timelines',* 2.

[127] Financial Stability Board, '*Key Attributes of Effective Resolution Regimes for Financial Institution*s' 2011.

[128] Financial Stability Board, '*Preamble to Key Attributes of Effective Resolution Regimes for Financial Institutions',* 2011.

Key Attributes contain a set of guidelines that should provide for the orderly resolution of financial institutions by the authorities without exposing taxpayers to solvency support losses while guaranteeing the continuance of their essential economic functions.[129] An effective resolution framework as envisaged by the FSB's Key Attributes should be credible to promote market discipline; provide incentives for market based solution; ensure the continuation of systemically essential financial services, payments, settlements and clearing functions while allowing nonviable financial enterprises to exit the market in an orderly way; protect depositors and ensure rapid return to the protected depositors' funds in co-ordination with the relevant insurance schemes; apportion losses among shareholders, secured and unsecured creditors in compliance with hierarchy of claims under insolvency law; avoid reliance on public solvency support or creating expectations on the availability of such support; avoid unnecessary value destruction, seeking to minimise the costs associated with a resolution and losses for creditors; make legal provisions for cooperation, information sharing and coordination with relevant resolution authorities both domestic and foreign before and during the resolution process and it should have in place clear laws and procedures that provide for an orderly, speedy, transparent, predictable resolution process in its legal framework.[130]

The FSB's Key Attributes further advocate for the vesting of resolution authorities at the national levels with a broad set of powers and choices for resolving financial entities that are no longer sustainable or have no realistic chances of viability.[131] The inclusion of stabilisation and liquidation options in the resolution framework is also recommended. The stabilisation options should be geared towards promoting the continuity of systemically important functions of a failed institution by way of share sale or share transfer to a third party either directly or through a bridge institution or through bail in by creditors to recapitalise a firm that continues to provide the critical functions.[132] The FSB's Key Attributes also recommend the incorporation of liquidation options that provide for the orderly closure and wind down of all

[129] https://www.fsb.org/wp-content/uploads/r_141015.pdf on 18 July 2022.

[130] Financial Stability Board, '*Preamble to Key Attributes of Effective Resolution Regimes for Financial Institutions*', 2011.

[131] Financial Stability Board, '*Preamble to Key Attributes of Effective Resolution Regimes for Financial Institutions'*, 2011.

[132] Financial Stability Board, 'Preamble to Key Attributes of Effective Resolution Regimes for Financial Institutions', 2011.

parts of an insolvent financial institution's business in a way that safeguards insured depositors, insurance policy holder s and other retail customers.[133]

The FSB's Key Attributes, although non-binding, provide a basis for establishing and reviewing existing national resolution frameworks to ensure that they are in line with international best practices. These attributes are also employed by the International Monetary Fund and World Bank in assessing the effectiveness of a country's bank resolution framework. The G20 member countries embarked on aligning their resolution framework to the recommendations of the FSB's Key attributes and the member countries are committed to the FSB thematic or country peer review of national level resolution regimes to determine their compliance.

2.2.5 Recommendations by the Basel Committee on Banking Supervision on Strengthening Bank Resolution Regimes

The Basel Committee on Banking Supervision (BCBS) is a committee tasked with setting global standards for the prudential regulation of banks and providing a forum for regular cooperation on banking supervisory matters.[134] Post the GFC the BCBS initiated reforms geared at strengthening regulation, supervision and risk management in the banking industry. These reforms are included in the Basel III framework with the key objective being to reduce excessive variability of risk-weighted assets (RWA) and regain credibility in the workings of the RWA.[135]

The BCBS also developed an indicator based methodology for identifying Globally Systemic Important Banks(G-SIBs) pegged on the effect of a banking institution's collapse on the global financial system and Domestically Systemic Important Banks (D-SIB) which classification is based on the impact that failure of a bank would have on the national financial system.[136] This framework is useful in determining a bank's additional loss absorbency requirements by the respective authorities.

Under the Basel III framework, the BCBS in consultation with the FSB further sets a minimum total loss absorbency capacity requirement which banking institutions are required to adhere to

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[133] Financial Stability Board, 'Preamble to Key Attributes of Effective Resolution Regimes for Financial Institutions', 2011.

[134] https://www.bis.org/bcbs/index.htm accessed on 6 March 2023.

[135] Bank of International Settlement, Basel III- *finalising post crisis reforms,* https://www.bis.org/bcbs/publ/d424.htm 6 April 2023.

[136] Bank for International Settlement, *Bank Resolution Framework- Executive summary,* https://www.bis.org/fsi/fsisummaries/brf.pdf accessed on 6 April 2023.

making it possible for an orderly resolution in the event of failure, that promotes financial stability, ensures continuity of critical bank functions and avoids burdening the public with the cost of resolution in the event of failure.[137] The framework also places a disclosure obligation on financial institutions with regard to on and off balance sheet transactions to foster transparency and reduce the institutions' exposure in shadow banking activities.[138]

The Basel III framework is an improvement of the Basel II framework that takes cognisance of the interconnectedness of the financial system globally and of the challenges presented by the GFC mainly the moral hazard, systemic risks and crisis control in a manner that promotes financial stability.

2.2.5 Conclusion

Based on the above evaluation, it is evident that banks perform critical functions that contribute greatly to an economy's growth and development. This special nature of banks call for a strong bank regulatory framework that equips central banks with the requisite powers and tools to discharge their regulatory and oversight mandate over banking institutions. Effective discharge of the banking functions may be impaired by banking crises, which if not well managed can destabilise an entire financial system. A special resolution regime becomes crucial in the effective management of bank failures to ensure continuity of a bank's critical functions, protect the depositors, avert the likelihood of a systemic risk and to foster financial stability.

The importance of an effective resolution framework well suited to manage banking crises has continued to receive more appreciation post the GFC following the realisation by financial authorities in the countries most affected by the crisis that corporate insolvency laws are inadequate to effectively manage bank failures. More countries across the globe are determined to strengthen their bank resolution frameworks to promote financial stability globally and to better prepare to respond to future financial crises. The G20 members have continued to collaborate at the international level through bodies such as the FSB and the BIS which are mandated by the members to promote international financial stability by coordinating the efforts of national financial authorities and international standard-setting bodies in implementing effective regulatory, supervisory, and other financial sector policies.[139] Post the GFC the FSB and the BCBS developed guidelines for resolution regimes that are effective

[137] Bank for International Settlement, *Bank resolution framework- executive summary,* https://www.bis.org/fsi/fsisummaries/brf.pdf accessed on 6 April 2023.
[138] Bank of International Settlement, Basel III: A *global regulatory framework for more resilient banks and banking systems* - revised version June 2011.
[139] https://www.fsb.org/about/#mandate, accessed on 27 March 2023.

which are contained in the FSB's Key Attributes and the Basel III framework as discussed above. These guidelines continue to be implemented by countries at their national level in reforming their bank resolution frameworks.

CHAPTER 3: KENYA'S BANK RESOLUTION FRAMEWORK: EVALUATING THE CURRENT INSTITUTIONS, LEGAL, REGULATORY AND SUPERVISORY ASPECTS OF THE FRAMEWORK

3.1 Introduction

As established in the preceding chapter, a special resolution framework is a vital component of bank insolvency laws owing to the special nature of banks, the systemic risks posed by bank failures and the need to foster financial stability through timely intervention to ensure continuity of critical functions and avert systemic risks that could result from bank failures.[140] In order for the resolution regime to be effective it requires to interact with a well-established legal and regulatory framework that incorporates essential business laws and regulations including contract, corporate, private property, consumer protection, corporate insolvency, anti-corruption/bribery laws supported by a proper functioning judiciary.[141] The key institutions constituting the special resolution regime in most jurisdictions are the central banks working closely with deposit insurance schemes to effectively manage the failure of banking institutions. These institutions provide a financial safety net through the functions of prudential regulation, supervision, lender of last resort, resolution and deposit insurance for member institutions' depositors.[142]

Post the GFC, the FSB formulated guidelines that have been used as a benchmark for in establishing effective resolution regime by authorities in the financial sector globally. This chapter evaluate Kenya's current bank resolution framework, to determine its compliance with these guidelines set by the FSB in the Key Attributes, to identify gaps in the resolution framework and make recommendations for reforms to strengthen the bank resolution framework. In evaluating Kenya's bank resolution framework an analysis of the role of CBK and KDIC as the resolution authorities tasked with resolving bank failures in Kenya is undertaken focusing on their respective mandates as stipulated in the Banking Act, the CBK Act and the KDIA. A review of CBK and KDIC's responses to the failures of Dubai Bank Kenya Limited, Imperial Bank Kenya Limited and Chase Bank Kenya Limited is conducted in this chapter using the three banks' failures as case studies to establish the extent to which the

[140]Financial Stability Board, *Key Attributes of Effective Resolution Regimes for Financial Institutions*, 2011.

[141]International Association of Deposit Insurers, *IADI Core principles for effective deposit insurance systems*, November 2014.

[142]International Association of Deposit Insurers, *IADI Core principles for effective deposit insurance systems*.

resolution authorities were effective in discharging their resolution mandate. Through this analysis gaps in the statutory instruments are identified and the failures in the implementation of mandate by the relevant authorities are highlighted. The chapter concludes with recommendations aimed at addressing the identified gaps to strengthening Kenya's bank resolution framework in line with international best practices.

3.2. The Role of Central Banks in Resolving Problem Banks

A strong regulatory, supervisory and resolution framework is paramount to the stability of the banking industry. As regulators of the banking industry, central banks are charged with the mandate of formulating rules and regulations to govern the banking business and manage associated risks.[143] The renewal of bank licences is pegged on compliance with the requirements prescribed by the licencing authority. Central banks also prescribe reserve requirements where commercial banks are required to maintain prescribed minimum reserves against their deposit liabilities, mostly in the form of balances at the central banks. These reserves are in line with the Basel Framework recommendations by the BCBS on minimum capital requirements and serve several purposes including providing protection against liquidity and solvency risks.[144]

Central banks carry out their supervisory mandate through monitoring of banks' activities and enforcement of banking regulations to ensure that stability is maintained in the banking industry. The monitoring of banks' activities is often conducted through regular audits and examination of the banks' books and processes. The supervisory role of central banks ensures that the central banks have sufficient and timely information on banks' financial position, systems and processes making it possible for early detection and intervention to manage a bank crisis.[145] In executing their supervisory mandate central banks should devote extensive competent staff resources to ensure that banks operate in a secure and sound manner. This makes it possible for early detection of unsound practices and weaknesses that could threaten the stability of a banking institution and prompt intervention in requiring for corrective action or closure of unviable problem institutions without threatening the stability of the banking

[143] Barth JR, Caprio G, Levin R, 'Banking systems around the globe: Do regulation and ownership affect performance and stability Prudential Supervision: What Works and What Doesn't', University of Chicago press, 2001,31.

[144] Gray S, *Central Bank balances and reserve requirements*, IMF working paper WP/11/36, Monetary and Capital market department, 2011.

[145] Restoy F, Central Banks and financial oversight, https://www.bis.org/speeches/sp180618.htm on 25 August 2022.

industry.[146] It is also imperative that central banks work closely with banks to ensure that the banks have in place contingency resolution plans that are periodically reviewed and approved by the central banks to increase their preparedness for resolution in the event of failure.[147]

The Bank of International Settlement through its BCBS has formulated core principles for effective banking supervision, of which principles are the international benchmark for effective prudential regulation and oversight of banks and banking systems.[148] These principles are used by countries as a benchmark for assessing the quality of their supervisory systems. The BCBS also has in place guidelines for bank supervisors on dealing with weak banks that recommend a range of corrective actions and resolution techniques to be employed in resolution of weak banks which would vary depending on the nature and seriousness of the difficulties encountered by a bank and the level of cooperation from management.[149] These guidelines envisage the need for cooperation between bank supervisors with banks' directors and major shareholders in effectively resolving bank failures.

3.3. Central Bank of Kenya as the Primary Resolution Authority

3.3.1 Regulatory and Supervisory Mandate of Central Bank of Kenya

In Kenya, CBK is the primary resolution authority charged with formulation of regulations and supervision of banks to promote safe and sound banking practices. It is statutorily mandated to discharge the central banking functions which include formulation and execution of monetary policy aimed at creating and sustaining price stability, encouraging liquidity, solvency, and the correct operation of a stable market-based financial system and supporting the government's economic policy for growth and employment.[150] The reserve requirement and discount window operation are some of the key tools utilised by the CBK to foster financial stability. The reserve requirement is key to facilitation of commercial banks liquidity management and guard against solvency risks that would trigger bank failures. The discount window operations facilitate the discharge of lender of last resort function by the CBK.[151]

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[146] Quintyn N and Masciandaro D, 'Measuring financial supervision architectures and the role of Central Banks' *Applied finance Journal, The Capco Institute Journal of Financial Transformation* (2011), 11.

[147] Bank for International Settlement, Basel Committee for Banking Supervision, *Core Principles for Effective Banking Supervision (The Basel Core Principles)*, September 2012, https://www.bis.org/publ/bcbs213.pdf.

[148] Bank for International Settlement, Basel Committee for Banking Supervision, *Core Principles for Effective Banking Supervision (The Basel Core Principles).*

[149] Bank of International Settlements, Basel Committee on Banking Supervision, *Supervisory guidance on dealing with weak banks*,2014.

[150] Section 4, *Central Bank of Kenya Act*, Chapter 491, Laws of Kenya.

[151] Central Bank of Kenya, *Monetary Policy*, https://www.centralbank.go.ke/monetary-policy/# accessed on 28 March 2023.

CBK is currently established under the Central Bank Act (CBK Act)[152] and anchored in the Constitution of Kenya (the Constitution).[153] Both the Constitution and the CBK Act stress on the autonomy of the CBK in carrying out of its responsibilities.[154] The Banking Act further details the licencing, regulatory and supervisory mandate of the CBK.[155] Further to the powers bestowed upon CBK by the Constitution, the Banking Act and the CBK Act, the CBK Act[156] expressly excludes CBK from being subject to the provisions of the Banking Act[157] and Companies Act.[158] This is aimed at promoting the independence and autonomy of the CBK in carrying out its functions which includes the supervision of the establishment of stable and well managed banking institutions in the interest of financial stability.

CBK as the primary regulator of commercial banks formulates prudential guidelines and regulations that provide specific guidelines, requirements, and restrictions to be adhered to by banks.[159] The regulatory framework is intended to promote transparency between banking institutions and their individual and corporate customers; protect bank depositors; reduce the risk of disruption emanating from adverse trading conditions for banks that could trigger major bank failures and prevent the use of banks in furtherance as conduits for criminal activities such as money laundering and to protect banking confidentiality credit allocation by ensuring that banks lend to the appropriate sectors and provide commendable customer service to their pool of customers.[160]

The supervisory mandate is carried out by the Bank Supervision Department (BSD) through various measures to ensure that banks under its regulatory ambit comply with the stipulated legal provisions, guidelines and regulations. These actions include; the requirement for banks to submit annual audited accounts and any other information and reports that may be required by the CBK for purposes of supervision and surveillance of a banking institution's affairs, the

[152] Section 4 (1), *Central Bank of Kenya Act* (Chapter 491) Laws of Kenya.

[153] Article 231, *Constitution of Kenya* 2010.

[154] Article 231 (3) *Constitution of Kenya 2010* read together with Section 3 (5) of the *Central Bank Act.*

[155] Chapter 488, Laws of Kenya.

[156] Section 5, *Central Bank of Kenya Act*.

[157] Chapter 488, Laws of Kenya.

[158] Act No.17 of 2015.

[159] Central Bank of Kenya, Prudential Guidelines for Institutions Licenced under the Banking Act, https://www.centralbank.go.ke/images/docs/legislation/prudential_guidelines_2006.pdf, accessed on 14 April 2023.

[160]Central Bank of Kenya, Legislations and guidelines, https://www.centralbank.go.ke/policy-procedures/legislation-and-guidelines/ 31 August 2022.

requirement for the bank auditors to notify the CBK of any breaches, serious irregularities, noncompliance, substantial losses incurred by a banking institutions that reduce the bank's core capital by fifty per cent or more or a bank's insolvency position unravelled in the course of their duties as provided for under the banking Act,[161]and regular inspection of the banking institutions' books, accounts and records by persons authorised by the CBK. Upon conducting an inspection, the person appointed by the CBK is required to submit his or her report to the CBK highlighting any contraventions of the provisions of the Banking Act or any other regulations which govern the conduct of banking business and propose remedial action or further investigation by the respective institution.[162]

Prior to 2004, CBK employed the CAMEL rating in its supervisory approach to determine an institutions' financial condition. This approach focused on transaction testing to ascertain the correctness of the financial statement, statement of comprehensive income, the effectiveness of internal controls and to ensure that institutions complied with the relevant laws and regulations. However, taking into account the special nature of banks, this approach was found to be ineffective in respect to identifying and managing the risks associated with banking institutions as it was backward looking and failed to differentiate activities that are high risk from those activities that bear low risk which are carried out by banking institutions. To improve the supervisory approach, CBK introduced a Risk Based Supervisory (RBS) approach in 2004 which focused on appreciating the effectiveness of a bank's risk management systems on a continuing basis and promoted greater engagement between the management team of an institution and the CBK. The RBS was designed to enhance competition, safety and soundness in the banking industry and benefit banking institutions by emphasizing on high-risk areas to identify threats to stability, providing for more efficient supervision and timely intervention by CBK. [163]

In discharging its supervisory authority, the CBK also employs the fit and proper test in assessing the moral and professional suitability of the promoters, directors and senior officials of banks being the key persons managing and directing the affairs of the financial institutions licenced by it.[164] This is key to ensuring that banking business is competently run by persons

[161] Section 24, *Banking Act*, Chapter 488 Laws of Kenya.

[162] Section 32, *Banking Act*, Chapter 488 Laws of Kenya.

[163] Bank Supervisory Department, Central Bank of Kenya, Central Bank of Kenya Risk Based Supervisory Framework, 2013.

[164] Section 32A, *Banking Act* (Chapter 488) Laws of Kenya.

of impeccable character to protect depositors and the various stakeholders within the banking industry.

In the matter of **Imaran Limited & 5 others v Central Bank of Kenya & 4 others,**[165] while remarking on the supervisory mandate of the CBK as encapsulated in section 32 of the Banking Act, the court held that CBK exercises this power in the interest of fostering safety of the banking institutions to safeguard integrity of the banking systems and the interest of the deposit holders while seeing to it that there exists a healthy banking system that promotes growth of the economy. The court further opined that CBK should not simplify this mandate to that of a channel for transmission of decisions made by institutions within its regulatory ambit, but it should analyse such reports with a view to determining their correctness. The court disapproved the position advanced by the CBK, that the execution of supervisory mandate is only reliant on the information provided by the bank's senior management in its period reports which are approved by the banks' board.

In discharging its mandate CBK contributes to stability of the financial industry. CBK should strive to carry out its statutory mandate effectively and efficiently adhering to the principles of integrity, accountability and transparency outlined in the Constitution of Kenya[166] and the FSB's Key Attributes.[167]

3.3.2 Central Bank of Kenya's Intervention in Management of Problem Banking Institutions

The CBK is the primary resolution authority in Kenya mandated by statute to resolve problem banking institutions, in coordination with the KDIC. A problem institution is defined under the KDI Act as an institution that places the interest of its depositors or the banking sector at risk.[168] The main provisions relating to resolution of problem banks are encapsulated in the Banking Act, KDI Act and the CBK Act. The Banking Act incorporates the Insolvency Act by reference, with the provisions of the Insolvency Act coming into play whenever a liquidator or administrator is appointed over the affairs of a problem bank.[169]

[165] [2016] eKLR.

[166] Article 10, *Constitution of Kenya* 2010.
[167] https://www.fsb.org/wp-content/uploads/r_111104cc.pdf.
[168] Section 2, *Kenya Deposit Insurance Act* (Act No. 10 of 2012).
[169] Section 35, *Banking Act*, (Chapter 488) Laws of Kenya.

In exercising its resolution mandate, CBK is empowered to intervene in the management of problem banks under the following circumstances as stipulated in section 34 of the Banking Act:[170]

i) Where an institution fails to meet any financial commitment when it becomes due including an obligation to pay any depositor;

ii) Where a petition is filed, or a resolution recommended, for the winding up of the institution or if any receiver or receiver and manager or similar officer is appointed in relation the institution or in respect of all or any part of its assets;

iii) Where an institution's auditor makes a report to the Central Bank in relation to; uncertain solvency position of the institution, serious breach or non-compliance by an institution with the provisions of the Banking Act, Central Bank Act, stipulated guidelines, regulations or any other matters as required by the CBK, commission of criminal offences relating to fraud or dishonesty by the bank's officers, losses that reduce the bank's core capital by fifty percent or more and serious irregularities in the banks books or operations that jeopardise security of its depositors and creditors;

iv) where an institution is seriously undercapitalised.

v) where an institution fails to remit a plan for capital restitution plan or for resolving all deficiencies detected upon inspection by the CBK or to add more capital or comply with any order as directed by CBK.

It is paramount that CBK intervenes promptly in the event that an institution under its regulatory remit is in distress or is found to be conducting its affairs in unsound manner to avert any adverse effects of such distress or regulatory breaches to the institution's stakeholders who include the depositors, customers, shareholders and the public at large. Prompt intervention is also key to maintaining stability within the wider financial system owing to the systemic importance of banks. Upon intervention in the management of a problem bank, CBK may take various measures including appointing the KDIC to take over the management, control and the administration of the respective institution's activities to the exclusion of its management.[171]

Where CBK determines that an institution is insolvent and non-viable, following consultation with KDIC, the Banking Act vests CBK with the power to appoint KDIC as liquidator over such an institution.[172] Such an appointment is akin to the appointment of a liquidator by the

[170] Chapter 488, Laws of Kenya.

[171] Section 34, *Banking Act* (Chapter 488), Laws of Kenya.

[172] Section 35, *Banking Act* (Chapter 488) Laws of Kenya.

high court over companies incorporated under the Companies Act, 2015,[173] as stipulated under the Insolvency Act.[174] Once appointed, the liquidator is required to ensure value preservation of the problem bank's assets for the benefit of its creditors. Under certain circumstances CBK also has the power to place a distressed banking institution under administration if it considers that the administration process is likely to realise at least one of the objectives of administration.[175] Administration is a corporate rescue procedure with its objectives akin to the objectives of administration encapsulated under the Insolvency Act.[176] These objectives include maintaining the institution as a going concern; realising a better outcome for the institution's creditors as a whole than would have been achieved if the institution was directly liquidated without being placed under administration and realising the property of the institution for purposes of effecting a distribution to one or more secured or preferential creditors.[177] The court intervention in the appointment of a liquidator or administrator for a failed bank can only be invoked either in consultation with CBK or directly only where CBK has failed to appoint a liquidator or administrator within a stipulated period.[178] CBK should endeavour to discharge its mandate in conformity with the law to promote credibility of the institution and inspire market confidence in the banking industry.

As part of its resolution mandate, CBK is also empowered in consultation with the Cabinet Secretary National Treasury, to facilitate the transfer of assets and liabilities of a failed banking institution to an acquiring bank upon conclusion of the requisite agreements.[179] The transfer envisaged under this section is in line with the resolution powers recommended to be vested in a resolution authority recommended under the FSB's Key Attributes.[180] Once a successful transfer is effected customers of a failed bank are able to access some essential banking functions through the acquiring bank subject to the terms of the transfer agreement.

[173] Act No. 17 of 2015, Laws of Kenya.

[174] Part VI, *Insolvency Act* (Act No. 18 of 2015).

[175] Section 35, *Banking Act*, (Chapter 488) Laws of Kenya.

[176] Act No. 17 of 2015, Laws of Kenya.

[177] Section 35 b (2) *Banking Act* (Chapter 488) Laws of Kenya.

[178] Section 35 & 35 (b), *Banking Act* (Chapter 488) Laws of Kenya.

[179] Section 9, *Banking Act (*Chapter 488) Laws of Kenya.

[180] Section 3.3, Financial Stability Board, *Key Attributes of an Effective Resolution Regime for Financial Institutions*, 2011.

3.3.3 Central Bank of Kenya as a Lender of Last Resort

As a Lender of Last Resort (LOLR) to banking institutions, CBK runs a discount window facility aimed at providing temporary liquidity to banks in extreme circumstances to meet temporary liquidity shortages attributable to internal or external disruptions.[181] For a bank to qualify for the liquidity support, CBK must be satisfied that the institution's liquidity challenges are temporary and that the institution requiring the liquidity support is a solvent viable institution. The primary aim of this liquidity assistance is to support a viable banking institution allowing it breathing space to restore normal functioning. This liquidity support is also key to maintaining stability in the financial sector as reiterated by the CBK in 2016 following the placement of Chase Bank Kenya Limited under receivership owing to the bank's inability to honour its financial commitments among other factors. [182]

In exercise of this statutory power, CBK in 2020 extended a loan facility to Cooperative Bank of Kenya Limited to aid in the acquisition of Jamii Bora Bank which was experiencing liquidity challenges.[183] CBK further extended a liquidity support facility to Kingdom Bank (formerly Jamii Bora Bank Limited) to boost the bank's liquidity position. This measure was key to averting the failure of the then Jamii Bora Bank and in restoring public confidence in the banking industry. The successful acquisition of Jamii Bora bank by one of Kenya's leading banks with credit and temporary liquidity support from the CBK is a clear illustration of the vital role that central banks play in promoting stability within the banking industry and the wider financial system.

3.3.4 A Summary of the Weaknesses in the Framework Providing for Central Bank of Kenya's Role in Resolving Problem Banks

Despite the elaborate statutory provisions discussed above that equip CBK as the primary resolution authority with supervisory, regulatory and resolution powers over banking institutions, there exists a lacuna in the legal framework in failing to comprehensively provide for the various stabilisation tools available to the resolution authority in discharging its mandate over a problem financial institution. The only stabilisation tool expressly provided for under the Banking Act relates to the transfer of assets and liabilities of a failed bank to an acquiring

[181] Kitili MJ, Central Bank of Kenya, *Banking Circular No. 6 of 201 to chief executives of commercial banks, Guidelines on the use of Central Bank of Kenya Discount Window*, 11 July 2011.
[182] Central Bank of Kenya, *Central Bank of Kenya introduces a liquidity support framework for commercial and microfinance banks.*
[183] Cooperative Bank Kenya Limited, *Integrated Annual report 2021.*

bank.[184] The stabilisation tools recommended by the FSB include: merger with or acquisition of a weak bank by a healthy bank, purchase and assumption deal, open bank assistance or the establishment of a bridge bank.[185]

The legal framework also fails to clearly state the objectives to be realised by the resolution authorities in discharge of the statutory powers. The omission of these tools and objectives creates opaqueness in the resolution framework and this has not inspired public confidence in the resolution process as shall be highlighted in the case studies relating to three Kenyan banks that failed in quick succession between 2015 and 2016.

Regulatory lapses have also contributed to some of the weaknesses that shall be highlighted in the three case studies, where the CBK has been faulted by bank depositors and shareholders for colluding with some of the failed banks' management team to commit fraud and conceal unsound practices.[186]

3.4 The Role of the Kenya Deposit Insurance Corporation in Resolving Problem Banks in Kenya

The banking crisis witnessed in Kenya in the early 1980's triggered some amendments to the Banking Act in an effort to restore the dwindling public confidence in the banking industry. These amendments birthed the Deposit Protection Fund (DPF) and the Deposit Protection Fund Board (DPFB) established in 1985 as a department within the CBK.[187] The DPF was an insurance scheme aimed to cushion bank depositors against loss of their insured deposits in the event of a bank failure.[188] The DPF transited to the Kenya Deposit Insurance Corporation in 2012 as an autonomous body established under the Kenya Deposit Insurance Act in 2012 and a deposit insurance system was established under the Act to replace the Fund previously existing under the Deposit Protection Fund Board's management.[189]

KDIC plays a significant and complimentary role to that of CBK in the process of resolving problem banks in Kenya. Its statutory mandate is to; receive, liquidate and wind up an institution in respect of which it is appointed receiver or liquidator by the CBK and to provide

[184] Section 9, *Banking Act*, Chapter 488, Laws of Kenya.
[185] Financial Stability Board, '*Key Attributes of an Effective Resolution Regime for Financial Institutions*'2014.
[186] Fayo G, *Probe turns to CBK staff linked to collapse of Imperial, Chase banks*, Business Daily, 19 August 2018.
[187] Mwega K, Deposit Protection Fund Board Kenya, Investment management for deposit insurance agencies, Mumbai, India, 20-23 February 2013.
[188] Mwega K, Deposit Protection Fund Board Kenya, Investment management for deposit insurance agencies.
[189] Act No. 10 of 2012.

a deposit insurance scheme for customers of member institutions.[190] In discharging its statutory mandate KDIC should endeavour to work in consultation with CBK to promote prompt resolution of problem banks through timely corrective action that is in compliance with the relevant laws. The corrective action should also be geared at protecting the interest of the various stakeholders and promoting stability within the banking industry.

Upon CBK's intervention in management of a banking institution under any of the circumstances contemplated under the Banking Act and considers it necessary to place such an institution in receivership, it will in consultation with the cabinet secretary, national treasury appoint KDIC as receiver manager over such an institution. [191] The legal effect of the appointment of KDIC as receiver manager in accordance with the provisions of the Banking Act, is that KDIC takes over the management conduct and control of the affairs of the subject bank to the exclusion of the bank's management.[192] KDIC is required to administer the affairs of such an institution in consultation with the CBK and in the interest of promoting financial stability. The term of KDIC as receiver manager for a banking institution is restricted to a twelve-month period from the date of appointment and this term may only be extended for a maximum period of six months by CBK as the appointing authority.[193]

To enable KDIC discharge its mandate effectively the KDI Act provides KDIC with special examination powers where KDIC considers such examination to be necessary in determining the accurate condition of a bank institution under its management.[194] This provision does not usurp but compliments the powers of CBK as the primary regulator of banking institutions licenced under the Banking Act. Upon concluding a special examination of an institution under its management, KDIC is required to submit a written recommendation to CBK for enforcement action against such an institution.[195]

In the discharge of its mandate as receiver manager, KDIC is deemed to be acting as agent for the problem banking institution[196] and enjoys statutory protection against legal suits relating to the management of the institution to promote effective discharge execution of its mandate.[197] The KDI Act also provides for the autonomy of the KDIC in the discharge of its statutory

[190] Section 5, *Kenya Deposit Insurance Act* (Act No.10 of 2012).
[191] Section 43, *Kenya Deposit Insurance Act (*Act No. 10 of 2012
[192] Section 43, *Kenya Deposit Insurance Act* (Act No. 10 of 2012)
[193] Section 53, *Kenya Deposit Insurance Act* (Act No. 10 of 2012)
[194] Section 39, *Kenya Deposit Insurance Act*.
[195] Section 41, *Kenya Deposit Insurance Act.*
[196] Section 45, *Kenya Deposit Insurance Act.*
[197] Section 46, *Kenya Deposit Insurance Act.*

mandate.[198]This statutory protection and autonomy accorded to KDIC promotes effective discharge by KDIC of its mandate once appointed as receiver manager.

The courts in Kenya have been keen to protect the statutory mandate and autonomy of KDIC as was evidenced in the matter of **Kenya Deposit Insurance Corporation v Richardson & David Limited & another**,[199] where the directors of Dubai Bank had filed suit against CBK and KDIC following statutory intervention by CBK and subsequent appointment of KDIC by CBK as receiver manager and later as liquidator of Dubai Bank The directors of the failed bank sought judgement against CBK and KDIC arguing that section 46 (1) of the KDI Act which removes the court's powers upon appointment of KDIC as receiver manager was unconstitutional. The directors further sought a declaration that the CBK was wrong in purporting to grant the KDIC powers provided for under section 54(1)(a) of the KDI Act 2012 being powers to liquidate the failed bank before full adherence to Section 53 of the Act which provides for the receivership terms. In its judgement, the court of appeal ruled in favour of KDIC and CBK holding that the KDI Act is mandated by the Constitution and the Act ousts the court's power to grant the reliefs sought by the failed bank's directors.

The Kenya Deposit Insurance Regulations 2015, provide for the regulatory framework of the deposit insurance scheme administered by the KDIC. Contribution to the Deposit Insurance Fund by its member institutions is determined by KDIC and may vary among its member institutions. Where KDIC forms the view that the business of any of its member institutions is being conducted in a manner that would jeopardise its own interests or its depositors' interests KDIC may increase such an institution's contribution to the Fund beyond the rate stipulated under the act.[200]

Once the KDIC is appointed as a receiver of a problem financial institution, CBK is required to furnish KDIC with details of such an institution's depositors with payable liabilities.[201] These liabilities include deposits held by the member institution's customers under current accounts, savings accounts call deposits, fixed term deposits and foreign currency deposits. The activities of the banking institution over which KDIC is appointed remain suspended once KDIC is appointed until the receivership process ceases. These activities include: receiving and payment of deposits, issuance of loans and any other business activities of the institution under

[198] Section 51, *Kenya Deposit Insurance Act.*
[199] [2017] e KLR.
[200] Section 27 (4), *Kenya Deposit Insurance Act.*
[201] Section 14, *Kenya Deposit Insurance Regulations*, 2015.

receivership save for the collection of loans from the institution's debtors and any other activity that KDIC may authorise in writing. An exception to the suspension of an institution's activities may issue where CBK and the National Treasury are of the view that such a suspension would pose a systemic risk.[202]

As a resolution authority, KDIC is vested with the power to commence an exclusion and transfer of part or total deposits and some liabilities of the institution and part or total assets, to another solvent and well managed institution, in consultation with CBK.[203] The exclusion and transfer process is required to be completed within a period of sixty days from the date of entering into receivership and in the event that the process is not concluded within the stipulated time, KDIC is required to recommend to CBK the liquidation of such an institution.[204] This power is in line with the FSB's Key Attributes for an Effective Resolution Regime for Financial Institutions and crucial for the preservation of the good bank part of a failed banking institution.[205] In the resolution of Chase Bank Kenya Limited, KDIC in consultation with CBK was able to successfully conclude the acquisition of certain assets and assumption of certain liabilities of Chase Bank (in receivership) by SBM Bank (Kenya) Limited. [206]

Where KDIC recommends an institution for liquidation to CBK, CBK may appoint KDIC as the liquidator of such an institution.[207] In carrying out the role of a liquidator, KDIC is required to comply with the provisions of the Banking Act, KDI Act and the relevant provisions of the Insolvency Act 2015. In executing its mandate KDIC is obligated to administer the affairs of an institution in liquidation in consultation with the CBK and in the interest of promoting stability of the banking industry and the financial system at large.

As recommended by the BCBS, liquidation should be a measure of last resort to be employed in resolving a bank in financial distress. It should be considered where satisfactory corrective action plans from the bank's shareholders are lacking or where no investor steps up or where reimbursement to depositors is considered as the least costly option in resolving the bank's

[202] Section 14, *Kenya Deposit Insurance Regulations.*
[203] Section 15, *Kenya Deposit Insurance Regulations.*
[204] Section 15 (4), *Kenya Deposit Insurance Regulations*.
[205] Attribute 3.3, Financial Stability Board, *Key Attributes*, 15 October 2014.
[206] Central Bank of Kenya, Press Release, Chase Bank (Kenya) limited (in receivership) and SBM Bank (Kenya) Limited,https://www.centralbank.go.ke/uploads/press_releases/1236253842_Press%20Release%20-%20Chase%20Bank%20(Kenya)%20Limited%20(In%20Receivership)%20and%20SBM%20Bank%20(Kenya)%20Limited.pdf.
[207] Section 15, *Kenya Deposit Insurance Regulations*.

failure to pave way for liquidation.[208] This recommendation has been echoed by the courts in Kenya in several matters challenging the actions on KDIC.

The insured deposit payable to a failed bank's depositors was recently revised from the previous amount of Kenya shillings one hundred thousand (Kshs 100,000) to Kenya shillings five hundred thousand (Kshs 500,000) through an amendment to the KDI Act.[209] The revised limit aimed to provide full deposit insurance coverage for over 99% of deposit accounts in Kenya. Despite the insured amount being revised upwards, this provision does not adequately provide for protection of bank customers with funds over the stated insured limits who may remain prejudiced by the safety net capping provision. The capping of the limit is based on the presumption that depositors with huge deposits in financial institutions should be sophisticated enough to assess the risk profiles of the financial institutions from time to time. However, this is not always possible due to information asymmetry in the banking system where the respective banks or the regulator may withhold vital information from the public. The amendments to the Act also introduced a timeline of six months for payment of the stipulated amount to the insured depositors following the conclusion of liquidation of an insured institution.[210] Although this is a progressive amendment geared towards enhancing depositor confidence, the six months timeline still falls short of the international best standards for bank resolution that advocate for promptness of the resolution process. The UK, the Financial Services Compensation Scheme provides for the reimbursement of a failed financial institutions depositors within a maximum period of seven days of a bank's failing.[211] There is need to review the statutory provisions capping the limit of insured deposits payable and the time frame for reimbursement in line with international best practices.

3.5 Case Studies of CBK's Response to the Failures of Dubai Bank Kenya Limited, Imperial Bank Kenya limited and Chase Bank Kenya Limited

3.5.1 Case study (I): Dubai Bank Kenya Limited

The CBK placed Dubai Bank Kenya Limited (Dubai Bank) under receivership on August 14, 2015, in exercise of its statutory mandate to intervene in management of a banking institution, pursuant to Section 43(1) & (2) and 53(1) of KDI Act , appointing KDIC as receiver manager for a maximum period of twelve months.[212] The bank was placed under receivership mainly

[208] Bank for International Settlements, Basel Committee on Banking Supervision, Supervisory guidance on
[209] Section 2 (a) The *Kenya Deposit Insurance (Amendment) Act*, 2022.
[210] Section 2 (2) *The Kenya Deposit Insurance Amendment Act*, 2012.
[211]Financial Services Compensation Scheme, https://www.fscs.org.uk/what-we-cover/banks-building-societies/.
[212] Gazette Notice No. 5968 volume CXVII No.80, Republic of Kenya, Nairobi, 1871.

due to liquidity and capital deficiency challenges which exposed various stakeholders of the bank and the banking industry to financial risk.[213] CBK further indicated that Dubai Bank had failed to honour its monetary commitments to one of its main corporate customers. Bank of Africa and that Dubai Bank had been violating its daily cash reserve ratio having monitored the bank's daily cash reserve ratio for a month prior to its decision to place it under receivership.[214]

On 24 August 2015 barely two weeks after placing the bank in receivership, CBK proceeded to appoint KDIC as liquidator for Dubai bank following a report submitted to it by KDIC recommending the bank's liquidation and winding up.[215] This decision was challenged in court by the banks' shareholders and one of Dubai Bank's depositors, Richardson & David Limited. In the matter of **Richardson & David Limited v Kenya Deposit Insurance Corporation and Central Bank of Kenya**,[216] the plaintiff, Richardson & David Limited who was one of the bank's large depositors argued that the decision by the CBK to liquidate Dubai bank was haste and premature as CBK had not given Dubai bank a chance to be salvaged by an investor who had expressed an interest in injecting funds to save the bank as a going concern.[217] The high court of Kenya ruled in favour of the applicant, suspending the liquidation process approved by CBK for a period of 60 days, directing CBK and KDIC to inter alia, consider the proposal by potential investors aimed at salvaging the bank from its eminent failure.[218]

In his ruling the judge faulted CBK for negligence in failing to act on Dubai Bank's problems despite having prior knowledge that the bank was flouting some of the statutory regulations which in his view contributed to the failure of Dubai Bank. The court found that CBK had failed to prudently exercise its supervisory jurisdiction over Dubai Bank as provided for under part VII of the Banking Act and this failure had occasioned loss to the bank's depositors. The court further opined that the regulator's decision to liquidate the failed Dubai Bank in haste was aimed at covering its tracks and escaping blame for its failure to act on the regulatory breaches that contributed to the bank's collapse. [219]

[213] Kenya Deposit Insurance Corporation Press release, 18 August 2015.

[214] The Standard, *Central Bank of Kenya places Dubai Bank under receivership*, 14 August 2015.

[215] Central Bank of Kenya, *Dubai Bank Kenya Limited, Press Release*, 24 August 2015.

[216] Civil Suit No. 482 of 2015.

[217] Civil Suit No. 482 of 2015.

[218] Civil Suit No. 482 of 2015.

[219] Civil Suit No. 482 of 2015.

Although the high court's decision, was overturned by the court of appeal in **Kenya Deposit Insurance Corporation v Richardson & David Limited & another**,[220] with the court of appeal holding that the two resolution authorities were in the best position to handle the ills of Dubai Bank and the high court judge had erred in imposing his own views in place of the CBK'S views,[221] this case is illustrative of the failure by the CBK in discharging its supervisory mandate. Effective supervision would have led to earlier detection of the regulatory breaches and timely intervention to prevent weakening of the bank's financial position. Timely intervention would have protected the bank's depositors and shareholders from the loss suffered following the bank's failure and eventual liquidation.

3.5.2 Case study II: Imperial Bank Kenya Limited

Imperial Bank Kenya Limited (Imperial Bank), a medium sized bank was placed under receivership in October 2015 following a recommendation by some of the bank's directors to CBK on grounds of unsafe and unsound business conditions at the subject bank. This was barely three months after the CBK had intervened in the management of Dubai Bank as highlighted above. In exercise of its statutory mandate as provided for under the Banking Act,[222] and the KDI Act,[223] CBK appointed KDIC to take over management, control and the running of the affairs of the bank and advise of the necessary resolution measures as soon as reasonably possible but not longer than a period of twelve months following the appointment[224]. This action was aimed at safeguarding the bank depositors, creditors and the public's interests whilst fostering stability within the banking industry.[225] CBK further engaged its Banking Fraud Investigations Department and the Anti-corruption Commission to conduct investigations with a view to investigate and unearth the perpetrators of massive fraud that had allegedly been committed by officers of Imperial Bank.

Upon its appointment as receiver manager, KDIC proceeded to engage Imperial Bank's shareholders with a view to reaching a viable solution that would allow prompt resumption of the bank's normal activities. KDIC further engaged a forensic audit firm to conduct a forensic

[220] [2017] eKLR.

[221] Kenya Deposit Insurance Corporation v Richardson & David Limited & another [2017] eKLR.

[222] Section 34 (2) (b) *Banking Act* (Chapter 488 Laws of Kenya).

[223] Section 43 and section 53 (1) *Kenya Deposit Insurance Act* 2012, Chapter 487C, Laws of Kenya.

[224] Central Bank of Kenya *Press release* 13 October 2015.

[225] Central Bank of Kenya *Press release* 13 October 2015.

review and audit the business of Imperial Bank. According to KDIC, the bank's shareholders failed to table a viable proposal to facilitate reopening of the bank prompting the CBK and KDIC to take the requisite measures to ensure stability in the financial sector which included working on a plan that would allow the bank's depositors access to their deposits. On 2 December 2015, KDIC in consultation with CBK allowed Imperial Bank's depositors to access their deposits to a maximum limit of Kenya shillings one million per depositor with a view to alleviate the depositors' anguish and restore confidence in the banking sector. The payment to depositors was facilitated by Kenya Commercial Bank and Diamond Trust Bank in the payment function, a move that made it possible for 80% of the bank's depositors to access their deposits in full.[226]

On 21 June 2016, CBK endorsed the appointment of NIC Bank Limited (NIC) by KDIC as the asset and liabilities consultant for Imperial Bank (in receivership).[227] NIC bank was tasked with the responsibility of facilitating the disbursement of an additional tranche of funds to Imperial Bank's depositors following a successful sale of Imperial Bank's shares in Imperial Bank Uganda with the assistance of Bank of Uganda and other asset recoveries.[228] It was further agreed that NIC would assume certain assets and liabilities of Imperial Bank from KDIC subject to negotiations and contract.[229]

On 2 June 2020, CBK announced the acquisition of some of Imperial Bank (In receivership)'s assets and the assumption of liabilities of the equivalent value of the bank by KCB Bank following approval by CBK and the Cabinet Secretary for the National Treasury and Planning pursuant to Section 9 of the Banking Act.[230] The proceeds of the sale were to be utilised in paying the bank's depositors across a period of four years.[231]

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[226] Central Bank of Kenya, *Press Release*, 31 March 2016.

[227] Central Bank of Kenya, *Press Release, Imperial Bank Limited* (in receivership) 8 November 2016, https://www.centralbank.go.ke/uploads/press_releases/1667799689_PRESS%20RELEASE%20Imperial%20Bank%20in%20Receivership%20November%208%202016.pdf on 27 July 2022.

[228] Gathaiya G.N, Analysis of Issues Affecting Collapsed Banks in Kenya from Year 2015 to 2016, 7 *International Journal of Management and Business Studies* 3 (2017).

[229] https://www.kbc.co.ke/imperial-bank-limited-in-receivership/ on 27 July 2022.

[230] Central Bank of Kenya, *Press Release,* 22 May 2020

[231] https://www.standardmedia.co.ke/business/news/article/2001431370/imperial-bank-assets-to-be-sold-proceeds-shared-among-depositors-cbk on 27 July 2022.

Following an external audit on Imperial Bank's books at the request of the CBK, the external auditors submitted a report on 7 December 2020 to KDIC recommending the liquidation of Imperial Bank on grounds of being insolvent. Subsequently CBK appointed KDIC as liquidator of Imperial Bank asserting that liquidation would be in the best interest of the bank's depositors, creditors and the wider public.[232]

It is worth noting the cross-border effect that the failure of Imperial Bank Kenya Limited had on the bank's subsidiary, Imperial Bank Uganda Ltd in which Imperial Bank Kenya was a major shareholder. The Bank of Uganda in response to concerns relating to the placement of Imperial Bank Kenya limited under receivership by the CBK, promptly took precautionary measures by taking over the control and management of Imperial Bank Uganda Ltd in exercise of their statutory mandate as provided for under the FIA.[233] The Bank of Uganda's intervention was in the interest of averting a run on the bank by its deposit holders that would threaten stability in the banking industry, protecting all stakeholders interests and allowing for continuity of Imperial Bank Uganda's operations and services. The Central Bank of Uganda was able to promptly conclude the resolution of Imperial Bank Uganda by selling the majority stake of Imperial Bank Kenya Limited to Tanzania's Exim Bank Limited within a period of four months from the date of its intervention.[234]

The timeliness in intervention by the Bank of Uganda in the management of Imperial Bank Uganda was a commendable precautionary measure as the regulator was able to safeguard the bank's stakeholders' interests and avert a possible run on the bank following the collapse of its regional affiliate bank in Kenya. The Bank of Uganda was also able to provide for seamless continuity of the banking operations under its control which boosted public confidence in the Central Bank as a resolution authority.[235] The successful sale of Imperial Bank of Uganda's majority stake to Tanzania's Exim bank provided a market-based solution without burdening taxpayers, which is advocated for by the FSB.[236]

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[232] https://www.standardmedia.co.ke/business/news/article/2001431370/imperial-bank-assets-to-be-sold-proceeds-shared-among-depositors-cbk on 27 July 2020.

[233] Section 82, *Financial Institutions Act*, Act no. 2 of 2004, Laws of Uganda.

[234] Prof Mutebile TE, *'Exim Bank Uganda takes over Imperial Bank Uganda Ltd' Bank of Uganda*, 7 March 2016. https://www.bou.or.ug/bou/bouwebsite/bouwebsitecontent/MediaCenter/press_releases/2016/Mar/Exim-Bank-Takes-over-Imperial-Bank.pdf .

[235] Prof Mutebile TE, Bank of Uganda, *Press release, Imperial Bank of Uganda Limited*, 13 October 2015, https://www.bou.or.ug/bou/bouwebsite/bouwebsitecontent/MediaCenter/press_releases/2015/Oct/Imperial-Bank.pdf .

[236] Key Attributes of Effective Resolution Regimes for Financial Institutions, October 2014.

Claims levied against the CBK and civil suits challenging the CBK's actions in respect of Imperial Bank Kenya Limited

In the matter of **Imaran Limited & 5 others v Central Bank of Kenya & 4 others,** an application for judicial review was filed in court, by Imperial bank Kenya's shareholders challenging among others, the exclusion and transfer of assets of Imperial Bank Kenya by KDIC. The shareholders opposed an eminent exclusion and transfer of the bank's assets to another banking institution, NIC, as part of the resolution process initiated by KDIC in conjunction with KDIC on several grounds including; that KDIC and CBK had acted unfairly by failing to evaluate and involve shareholders in their recovery strategy in the interest of salvaging the bank and that KDIC and CBK had not been transparent in their administrative actions post their intervention to place the bank in receivership contrary to international best practices on bank resolution, the Constitution of Kenya 2010 and the Fair Administrative action Act..[237]

In its determination the high court ruled in favour of the shareholders granting several orders sought by the shareholders including; an order restraining the exclusion and transfer of the bank's assets and liabilities by KDIC and CBK, from taking measures that would lead to liquidation of Imperial bank, directing KDIC and CBK to furnish the shareholders with relevant information relating to the receivership process and an order compelling CBK and KDIC to engage with all the relevant stakeholders, including the shareholders, bond holders and the banks depositors with a view to finding a solution favourable to the bank and its various stakeholders.[238]

Although the suspension of any process that would lead to the transfer and exclusion of assets and liabilities of Imperial Bank by KDIC and CBK was later lifted and the resolution authorities allowed to proceed with the process, it highted the obligation for recognition and protection of the shareholders, depositors, creditors and other stakeholders' rights by the resolution authorities and their obligation to comply with the due process of the law in discharging their resolution mandate. This is in the interest of promoting transparency and public confidence in the resolution process and in line with international best practices.

In yet another blow to the resolution of Imperial Bank, the high court in December 2021, temporarily halted the liquidation of the bank following a suit filed by two of the bank's

[237][2016] eKLR.
[238]Imaran Limited and 5 others v Central bank of Kenya and 5 others, [2016] eKLR.

depositors alleging that CBK had failed to honour an agreement entered into with the subject depositors in which CBK agreed to pay the two depositors their dues held with the bank.[239] The court further suspended the payment to depositors by KDIC in execution of CBK's directive. The two depositors had challenged CBK's decision prompting the consent with CBK to pay the subject depositors prior to commencing the liquidation process. The halting of the liquidation process by the court exposes failure on the part of CBK and KDIC to comply with due process in discharging their statutory mandate to resolve a failed bank. These failures have prolonged the resolution process and resulted in prolonging the period which the depositors of the failed banks with deposit claims will have to wait before they can access their deposits.

The above claims brought against CBK over its actions in the resolution process also highlight the failure on the part of CBK in adhering to the principles of transparency and cooperation which are fundamental in an effective resolution process.

3.5.3 Case Study III: Chase Bank Kenya Limited

The CBK intervened in the management of Chase Bank in April 2016, following panic withdrawals by its customers across the bank's branch network countrywide and the resultant liquidity difficulties.[240] The panic withdrawals were triggered by rumours on social media alluding to the bank's ill financial health.[241] These rumours were fuelled by the bank's conflicting financial statements following a directive from CBK for the bank to restate its financial statement to accurately reflect the insider loans to its directors. CBK's directive was in response to an audit report of the bank that had revealed irregular loan facilities advanced to the bank's directors which had been grossly understated in the initially released financial statements.[242]

In the interest of the bank's depositors, creditors and members of the public, CBK appointed KDIC on 7 April 2016, as receiver of Chase Bank pursuant to the provisions of the KDI Act.[243] This move by the CBK spurred public anxiety as many of Chase Bank's customers were unable

[239] Ashok L Doshi & another v Central Bank of Kenya & another [2016] eKLR.

[240] Central Bank of Kenya, Press release, April 2016.

[241] https://www.bbc.com/news/world-africa-35989394 on 19 July 2022.

[242]How Deloitte audit row caused a run on Chase Bank, https://www.businessdailyafrica.com/bd/corporate/companies/how-deloitte-audit-row-caused-a-run-on-chase-bank--2113296 on 19 July 2022.

[243] Section 43 (1) (2) and 53 (1) *Kenya Deposit Insurance Act* read with section 34 (2) b *Banking Act*, Chapter 488, Laws of Kenya.

to withdraw their funds. The anxiety spilled over to other small and medium sized banks culminating in panic withdrawals of deposits by these banks' depositors resulting in the banks' violation of the Banking Act and Prudential Guidelines on capital adequacy requirement for banks to maintain minimum core capital to total weighted asset ratio of 10.5% and total capital to total risk-weighted assets ratio of 14.5 per cent.[244] This evidently attests to the need to guard public confidence in the banking industry through an effective resolution regime to avert systemic risks and foster stability in the banking industry.

On April 20, 2016, with the approval of CBK, KDIC appointed Kenya Commercial Bank (KCB) as receiver manager of Chase Bank (in receivership) to allow for the resumption of limited operations at Chase Bank, leveraging on KCB's strong brand reputation in the market coupled with KCB's human resource capital and wide branch network across the country. On 27 April 2016, Chase Bank resumed limited operations following the appointment of KCB as manager and Chase Bank's customers were allowed access to their deposits to the maximum amount of Kenya shillings one million per depositor.

In April 2018, CBK and KDIC signed an agreement with the SBM Bank Kenya Limited for the acquisition of certain assets and assumption of deposits of Chase Bank following a transparent expression of interest process. The acquisition was completed in August 2018 with SBM Bank Kenya Limited acquiring 75 percent of Chase Bank's assets.[245] This allowed Chase Bank's depositors to access a substantial portion of their frozen deposits under the terms stipulated by SBM Kenya Limited. Following the partial acquisition, the management agreement appointing KCB as manager was concluded and management of the remainder 25 percent of Chase Banks' assets and liabilities reverted to KDIC.

In furtherance of the principle of transparency and accountability in the resolution process, an external audit was conducted on the books of Chase Bank post the partial acquisition by SBM Bank. The external auditors' report was submitted to CBK in September 2020 highlighting some gaps in the Chase Bank's books. Subsequently CBK directed KDIC and KCB to resolve

[244] https://www.theeastafrican.co.ke/tea/business/kenyan-lenders-breached-rules-after-chase-bank-collapse-1372464 on 19 July 2022.

[245] Central Bank of Kenya *Press Release, Chase Bank (Kenya) limited (in receivership) and SBM Bank (Kenya) limited*, 20 August 2018, https://www.centralbank.go.ke/uploads/press_releases/1236253842_Press%20Release%20-%20Chase%20Bank%20(Kenya)%20Limited%20(In%20Receivership)%20and%20SBM%20Bank%20(Kenya)%20Limited.pdf .

the gaps identified in the external auditors' report within a period of sixty days.[246] On April 7, 2021, KDIC submitted a report to CBK confirming resolving of the gaps and recommending the liquidation of Chase Bank owing to the bank's weak financial position. Having considered KDIC's report recommending the liquidation of Chase Bank, CBK was agreeable to the liquidation of the residual assets and liabilities of Chase Bank in the interest of an orderly resolution that protects the interests of depositors, creditors and the wider public. Consequently, CBK appointed KDIC as the liquidator of Chase Bank pursuant to the provisions of the KDI Act.[247]In the discharge its mandate as liquidator KDIC embarked on paying protected depositors of the bank, in liquidation in accordance with the KDI Act.[248] KDIC further invited the bank's creditors to lodge a claim of debt for verification and payment.[249] KDIC is currently engaged in recovery plans which include tracing and selling of assets of the bank's debtors. Proceeds of successful recoveries are to form part of the pool of assets available for distribution by the liquidator to the various creditors in compliance with the priority stipulated in law.

Case law relating to the acquisition of certain assets and assumption of certain liabilities by SBM Bank Kenya Limited

Following the successful acquisition of certain assets and assumption of certain liabilities of the failed Chase Bank Kenya Limited, there has been litigation surrounding the procedure for the transfer of assets and liabilities of a banking institution licenced and regulated by CBK as provided for under the Banking Act. Section 9 of the Banking Act provides for the procedure for concluding such a transfer of assets and liabilities. The transfer process is to be effected through shareholder resolutions of both the transferor institution and receiving institution shareholders passed at their respective general meeting duly convened. Subsequently the notices of the resolutions passed together with the transfer agreement should be forwarded to CBK by the transferor and receiving institutions. Upon receipt of such notices, CBK is required to publish a notice of the subject agreement. The written approval of the cabinet secretary is required for such an agreement to have legal force.[250]

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[246] Central Bank of Kenya, Press release, Liquidation of Chase Bank Kenya Limited (In Receivership).

[247] Section 53 (2) and 54 (1*), Kenya Deposit Insurance Act* (Act No. 10 0f 2012).

[248] Section 33 and 34, *Kenya Deposit Insurance Act*, (Act No. 10 of 2012)

[249] Press release-commencement of payment of protected deposits for chase bank limited in liquidation and lodging of claims by creditors, 12 May 2021, https://kdic.go.ke/press-release-commencement-payment-protected-deposits-chase-bank-limited-liquidation-and-lodging.

[250] Section 9, *Banking Act*, Chapter 488, Laws of Kenya.

In the case of **SBM Bank (Kenya) Limited v Singh,**[251] SBM bank had filed suit against the defendant seeking to recover a debt owing from him. The debt had been acquired by the defendant from Chase Bank prior to its failure. It was SBM Bank's argument that the debt was part of the assets and liabilities it had acquired subsequent to the successful completion of the agreement entered into on 17 April 2018 which was published under Gazette Notice 6833 for the acquisition of certain assets and assumption of certain liabilities of Chase Bank Kenya Limited (in receivership). The defendant had tasked SBM Bank to produce documentary proof confirming that his liabilities to Chase Bank Kenya Limited (in receivership) had been part of the rights and obligations acquired in the transfer of assets and assumption of certain liabilities agreement. The court ruled in favour of SBM bank holding that the transfer of assets and liabilities of a banking institution is governed by section 9 of the Banking Act and that the Gazette Notice published by CBK was prima facie evidence of the transfer of the defendant debt due to Chase Bank Kenya Limited's debt.

This ruling seems to have been upset by a varying interpretation by the courts on the process of transfer of assets and liabilities as contemplated by section 9 of the Banking Act in the case of **Afrasia Bank Limited v SBM Bank (Kenya) Limited**.[252] In this case, Afrasia Bank Limited filed suit seeking to recover a deposit asset of USD 7,500,000 which was held by Chase Bank prior to the acquisition of certain assets and assumption of certain liabilities of Chase Bank by SBM Bank Limited. The plaintiff argued that the failure by SBM Bank Kenya Limited to publish notices on the Kenya Gazette and local dailies as provided under the provisions of Section 3(1) of the Transfer of Business Act and Section 4 of the said Act, disclosing the liabilities assumed should be construed to mean that SBM Bank had assumed all liabilities of Chase Bank. SBM Bank Limited in their defence argued that the Transfer of Business Act was not applicable to the subject claim as the acquisition of Chase Bank was only subject to the Banking Act and the Kenya Deposit Insurance Act. SBM Bank Limited also contended that Afrasia Bank Limited's deposit of United States Dollars seven million five hundred thousand (USD 7,500,000) was not included in the asset which it had acquired. The court ruled in favor of Afrasia Bank Limited holding that SBM Bank Kenya Limited was liable to pay the claim of USD 7,500,000.00 by failing to publish the notices contemplated by the Transfer of Business Act.

[251] (Civil Case E503 of 2020) [2022].
[252] [2019] eKLR.

3.5 Chapter Conclusion

From the foregoing analysis on CBK's and KDIC's respective statutory mandates and their responses to the most recent failures of Dubai Bank, Imperial Bank and Chase Bank, it is evident that Kenya has in place designated resolution authorities equipped with legal powers and operational capacity to intervene in resolving problem banks. However, several gaps have been identified in the process of managing bank failures. The notable failures highlighted in this study include an abdication by CBK of its supervisory mandate which is a key tool for early detection of red flags in the health of banks. This has contributed to delays in intervention to resolve failed banks.

The resolution authorities have further been faulted for non-adherence to the principles of integrity, transparency and accountability which are enshrined in the Constitution[253] and the FSB's Key Attributes. Courts have emphasised the need for CBK and KDIC to adhere to the due process of law is discharging their statutory mandate. They have also stressed on the importance of recognition of the various stakeholders' interests by the resolution authorities in discharging their resolution mandate, citing the key stakeholders to include the banks' shareholders, creditors and depositors. [254]

There is also a lack of a proper resolution planning provision within the resolution framework as recommended by the FSB. Resolution plans have gained prominence in leading global economies where banks are mandated to submit resolution plans to the resolution authorities and these plans are evaluated regularly to promote viability. Resolution planning is key in identifying and addressing a myriad of legal and operational challenges that could potentially hinder an orderly resolution of problem banking institutions.

The effectiveness of the legal and institutional framework has also been impaired by the inconsistencies in court decisions as illustrated in the contradicting decisions arrived at by the courts in the case of **Afrasia Bank Limited v SBM Bank (Kenya) Limited** and **SBM Bank (Kenya) Limited v Singh**. These inconsistencies do not inspire investor confidence in the resolution process and can impede market-based solutions to a successful resolution of a non-viable banking institution. The barrage of legal suits challenging actions by the resolution authorities has protracted the resolution process to the detriment of the stakeholders of the failed banks.

[253] Article 10, *Constitution of Kenya 2010.*
[254] Imaran Limited & 6 others v Central Bank of Kenya & 5 others [2016] eKLR

CBK should endeavour to adhere to international best practices as outlined in the FSB and the BIS in execution of its supervisory regulatory and bank resolution mandate. This would promote timely intervention and orderly resolution of problem banks. Effective discharge of its statutory mandate by CBK would also inspire public confidence in the process of resolving bank failures, promote certainty and transparency in the resolution process, manage the costs of resolving bank failures and avoid spill over effects of problems associated with bank failure.

The courts in adjudicating over disputes relating to bank resolution should endeavour to render expeditious and consistent decisions as this would inspire public confidence in the judicial process.

CHAPTER 4: KEY REFORMS TO THE UNITED STATES OF AMERICA (USA), THE UNITED KINGDOM (UK) BANK RESOLUTION REGIMES AND LESSONS FOR KENYA

4.1 Introduction

The UK and the USA are key international financial centres that continue to influence financial and economic policy direction globally. These two countries have taken the lead in implementing reforms recommended by the FSB in 2011 to strengthen national and cross-border bank resolution frameworks in their respective countries. In response to the early bank failures witnessed in Kenya's banking industry in the 1980s, Kenya borrowed heavily from the USA's bank resolution framework in reforming its bank resolution framework to restore public confidence in the banking industry and safeguard depositors' interests.[255] The reforms initiated in the 1980s led to the establishment of the DBFB through an amendment to the Banking Act.[256] The legal and regulatory framework for bank resolution has continued to undergo reforms in response to challenges and developments in the financial industry as illustrated in the previous chapter. The reforms have particularly been influenced by recommendations by the FSB on effective bank resolution frameworks and developments in the UK and the USA on their respective bank resolution regimes.

This chapter analyses the key reforms to the USA's and the UK's bank resolution frameworks that have strengthened these countries' responses to bank failures with a view to draw lessons that Kenya can borrow in reforming its current bank resolution framework to enhance its effectiveness.

4.2 The USA Bank Resolution Regime

The history of a distinct national bank resolution framework in the USA is traceable to the creating of a national banking system and a uniform national currency through the enactment of the National Currency Act of 1863 and National Banking Act of 1864, following the failure of the First and Second Bank of the United States.[257] These Acts vested the Office of the Comptroller of the National Currency with power to charter national banks.[258] Further, the acts provided a process for winding up national banks that were involuntarily or voluntarily wound

[255] Kimanthi MC 'Strategic responses by deposit protection fund board to changes in the external environment' unpublished LLM thesis, University of Nairobi, October 2010.
[256] Chapter 488, Laws of Kenya
[257] Fitzpatrick TJ IV, Kearny-Marks M and Thomson JB, 'The history and rationale for a separate bank resolution process', 2012-1 Federal Reserve Bank of Cleveland Economic Commentary (2012), 3.
[258]

up.[259] The solvency test applied during this period was based on notes redemption. National banks that failed to redeem their notes promptly would have their charters withdrawn by the Comptroller of the Currency and thereafter subjected to an administrative receivership process.[260] During this period, a separate resolution process was also in place for resolving state chartered banks.[261] As such, banks were excluded from the Bankruptcy Act of 1898, being one of the earlier enactment of the USA Congress that established a uniform system of bankruptcy throughout the USA.[262]

The bank resolution process continued to evolve in response to developments and crises in the financial industry with legislation tilting towards segregation of bank insolvency laws from the insolvency laws for other corporates under the Bankruptcy Code.[263] In 1933, the Federal Deposit Insurance Corporation (FDIC) was established by the Banking Act 1933 in response to the massive bank failures in the USA in the early 1930s.[264] The Act aimed to restore public confidence in the financial industry by establishing a deposit guarantee fund and promoting the stability of the payments system.[265] The Act inter alia empowered the comptroller of the currency to restrict operations of a bank with impaired assets and to appoint a conservator, to take possession of the books, records, and assets of every description of such bank, and take such action as would be necessary to conserve the assets of such bank pending further disposition of its business.[266] FDIC as the primary resolution authority was charged with insuring depositors' bank accounts, and for failed banks, FDIC would operate and administer their receivership.[267]

Further reforms to the bank resolution framework in the USA were undertaken in 1991 through the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) following the savings and loans crisis in the USA that highlighted the high costs associated with resolving a

[259] Fitzpatrick TJ IV, Kearny-Marks M and Thomson JB, 'The history and rationale for a separate bank resolution process'3.
[260] Fitzpatrick TJ IV, Kearny-Marks M and Thomson JB, 'The history and rationale for a separate bank resolution process'3.
[261] Fitzpatrick TJ IV, Kearny-Marks M and Thomson JB, 'The history and rationale for a separate bank resolution process'3.
[262] 1898 Bankruptcy Act (repealed).
[263] Fitzpatrick TJ IV, Kearny-Marks M and Thomson JB, 'The history and rationale for a separate bank resolution process', 2.
[264] Banking Act 1933, United States of America (repealed).
[265] Emergency Banking Act of 1933, https://www.federalreservehistory.org/essays/emergency-banking-act-of-1933, accessed on 22 April 2022.
[266] Title II Emergency Banking Act of 1933, (repealed) United States of America.
[267] Fitzpatrick TJ IV, Kearny-Marks M and Thomson JB, 'The history and rationale for a separate bank resolution process', 3.

financial crisis.[268] Among the reforms encapsulated in the FDICIA were the provisions for the federal banking agencies to take timely remedial supervisory actions whenever there was a decline in a banking institution's capital and the requirement for FDIC to prefer a least cost resolution method that minimised the costs of a bank failure to the taxpayers. [269]

With the fast-evolving financial industry, the traditional banking services such as maturity transformation and liquidity transformation were no longer a preserve of commercial banks. Some of the failings within the financial industry that led to the GFC were linked to shadow banking activities by investment banks that were not subject to regulation by the central banks.[270] The securitization of home mortgages by the investment banks suffered a big blow at the height of the GFC as investors withdrew their investments having lost confidence in the value of the long term assets held by the shadow banks forcing the shadow banks to dispose of these assets in fire sales.[271] Some commercial banks were forced to bail out shadow banks in which they had a controlling stake. Funding to some commercial banks was also impaired by the closure and withdrawal of the shadow banks in some markets to which these banks sold short term debts and commercial papers.[272] In response to the GFC failures within the increasingly complex financial industry that had been highly deregulated and ever more lightly regulated, the USA congress enacted the Dodd Frank Consumer Protection and Wall Street Reform Act of 2010 (Dodd Frank Act). The Act aimed to promote the financial stability by improving accountability and transparency in the financial system; to end the "too big to fail" phenomenon; to safeguard the taxpayer by ending bailouts and to protect consumers from abusive financial services practices, among other purposes.[273]

Cognisant of the limitations of the corporate Bankruptcy Code which limited the adjudication of claims to focusing on creditors' claims against an insolvent company with no provisions on mitigating the effects of a failure on the largely interconnected financial system or economy, Title II of the Dodd Frank Act provided for the establishment of the Orderly Liquidation Authority (OLA) that equipped the FDIC with tools for safely resolving failing financial firms

[268] Fitzpatrick TJ IV, Kearny-Marks M and Thomson JB, 'The history and rationale for a separate bank resolution process', 2.
[269] *Federal Deposit Insurance Corporation Improvement Act* of 1991, United States of America.
[270] Fitzpatrick TJ IV, Kearny-Marks M and Thomson JB, 'The history and rationale for a separate bank resolution process', 2.
[271] Kodres LA,' Shadow Banks: Out of the Eyes of Regulators' International Monetary Fund, 52.
[272] Kodres LA, 'Shadow Banks: Out of the Eyes of Regulators' International Monetary Fund, 53.
[273] https://www.govinfo.gov/app/details/COMPS-9515, on 7 May 2022.

which was similar to the FDIC's approach for resolving failing banks.[274]The FDIC developed a Single Point Of Entry (SPOE) that focused on resolving insolvent financial institutions that are large and complex by placing the holding company at the apex of the firm's structure under FDIC receivership, while allowing for the continuity of the subsidiary companies' operations under the management of a bridge holding company with managers and directors appointed by the FDIC.[275] The Dodd Frank Act also provided for the establishment of an Orderly Liquidation Fund (OLF) to provide temporary liquidity to the bridge company where necessary to allow for the smooth running of the company's operations whilst preserving the value of entities within the group structure and by extension averting a systemic risk that would be occasioned by failure of one systemically important financial institution.[276]

4.2.1 Key reforms to the USA legal framework for bank resolution

The most notable reform post the GFC was the enactment of the Dodd-Frank Act, which was intended to, among other objectives, enhance transparency and accountability in financial systems, end the 'too big to fail' dilemma posed by the Systemically Important Financial Institutions (SIFI) that were beneficiaries of the costly government bailouts at the height of the GFC and the moral hazard challenge presented in applying public funds to bail out problem financial institutions.[277] Key players in the USA financial industry have lauded the Dodd-Frank Act for enhancing financial stability through the introduction of higher prudential standards for adherence by financial institutions. Key among these standards is the introduction of a new resolution authority characterised by a single-point-of-entry (SPOE) strategy through the FDIC, creating the Consumer Financial Protection Bureau (CFPB)and advocating for enhanced transparency and oversight in financial transactions.[278]

4.2.1.1 Single Point of Entry Strategy

Under the SPOE strategy, the Act establishes a regulator-led approach and standard procedures for safely resolving failed financial institutions to foster financial stability and address the too big to fail phenomenon. The SPOE strategy provides for the resolution of insolvent large complex financial institutions through placement of the top tier holding company of such a

[274] Ailey NM, Klein A and Schardin J, 'The Impact of the Dodd-Frank Act on Financial Stability and Economic Growth' *The Russell Sage Foundation Journal of the Social Sciences,1* (2017),24.
[275] Ailey NM, Klein A and Schardin J, 'The Impact of the Dodd-Frank Act on Financial Stability and Economic Growth', 25.
[276] Ailey NM, Klein A and Schardin J, 'The Impact of the Dodd-Frank Act on Financial Stability and Economic Growth', 25.
[277] The ''Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111-203, July 2010, USA.
[278] Baily MN, Klein A and Schardin, 'The impact of the Dodd- Frank Act on financial stability and economic Growth', 21.

group under the FDIC receivership as the single point.[279] Through the SPOE strategy, a bridge holding company is created as the failed holding company of the SIFI is eliminated and the newly created bridge holding company controls the remaining financially sound subsidiaries that new managers appointed by the FDIC run.[280]

4.2.1.2 Resolution Plans

Another key reform introduced under the Dodd-Frank Act is the requirement for SIFIs, bank holding companies with total consolidated assets of fifty billion US dollars or more, to periodically submit resolution plans to the Federal Reserve, the Financial Stability Oversight Council (FSCO) and the FDCI.[281] This reform aligns with the recommendation by the FSB requiring country's to establish an ongoing recovery and resolution planning process to enhance resolvability in the event of failure of a financial institution.[282]

Insured depository institutions (IDIs) with fifty billion united States Dollars or more in total assets are required under the FDIC's regulations to submit resolution plans to the FDIC. The regulations further provide guidance on the content of the resolution plans and procedures for review by the FDIC. The resolution plans are meant to facilitate effective resolution of a failed institution by the FDIC upon intervention as a receiver under the Federal Deposit Insurance Act (FDIA).[283] in a manner that safeguards the depositors' interest, ensuring that depositors receive access to their insured deposits within one business day of an institution's failure.[284] In 2021 the FDIC issued a policy statement detailing its framework for implementation of certain aspects of this rule with respect to the insured depository institutions with one hundred billion USD or more in total assets. The policy statement detailed FDIC's plan to streamline content requirements for the resolution plans submissions emphasizing regular engagement with the FDIC to provide greater collaboration in planning for resolution.[285]

The resolution plans are required to detail steps to be implemented by the financial institutions to achieve a swift and orderly resolution in the event of financial distress or failure. Further,

[279] Baily MN, Klein A and Schardin, 'The impact of the Dodd- Frank Act on financial stability and economic Growth', 25.
[280] Baily MN, Klein A and Schardin J, The impact of the Dodd-Frank Act on financial stability and economic growth',25.
[281] Section 165 (d), *Dodd-Frank Wall Street Reform and Consumer Protection Act* (Public Law No. 111-203 of 2010, United States of America.
[282] Key Attribute 11, Key Attributes of an Effective Resolution Regime, Financial Stability Board, 2014.
[283] Section 11 and 13, *Federal Deposit Insurance Act*.
[284] 12 Code of Federal Regulations rule 360.10., 2012.United States of America.
[285] Federal Deposit Insurance Corporation, Statement on Resolution Plans for insured depository institutions, 25 June 2021.

the plans are required to state the nature and extent of credit exposures to significant bank holding companies and significant non-bank holding companies.[286] Under this resolution plan provision, the FDIC and the Federal Reserve Board are required to determine whether a plan submitted by a company is credible and would facilitate an orderly resolution of the company under the Bankruptcy Code. Where the FDIC and the Federal Reserve Board jointly determine that the plan is not credible or would not facilitate an orderly resolution of the company under the Bankruptcy Code, the regulators may impose restrictions on the company's operations. Where necessary they may require such a company to restructure and divest operations.[287] The public elements of the resolution plans are disclosed to the general public to promote transparency.

In accordance with the requirement for resolution planning, the Federal Reserve System and the FDIC required eight banks to submit targeted resolution plans by 1 July 2021. These banks included: Bank of America Corporation, Citigroup Inc, The Goldman Sachs Group, Inc, JPMorgan Chase & Co, and Morgan Stanley, The Bank of New York Mellon Corporation, State Street Corporation, and Wells Fargo & Company.[288] These resolution plans are required to be divided into public and confidential sections. To foster transparency, the US agencies are required to make public the non-confidential portion of the resolution plans.[289]

4.2.1.3 Orderly liquidation Authority and Orderly Liquidation Fund

The Dodd Frank Act provided for the establishment of the Orderly Liquidation Authority (OLA) and the Orderly Liquidation Fund (OLF) as a backup source of temporary liquidity for the bridge holding company in the event that private sources of equity are unavailable. This is designed to prevent financial stress resulting from the failure of a financial institution from escalating into a systemic crisis.[290] The OLA is required to safely resolve failing systemically important financial institutions through reliance on information from and the expertise of the key financial regulators. In resolving the failing institution, the OLA strives to ensure that private equity holders and debt holders bear all losses resulting from such failure instead of relying on taxpayers' funds to bail out the institution.[291] Unlike the ordinary bankruptcy

[286] Section 165 (d) Dodd-Frank Wall Street Reform and Consumer Protection Act.
[287] 76 FR 22648, Resolution plans and credit exposure reports required, Federal register volume 76, issue 78, 22 April 2011.
[288] Moodys Analytics, US Agencies Release Public Parts of Resolution Plans for Large Banks, 19 July 2021.
[289] https://www.federalreserve.gov/supervisionreg/resolution-plans-search.htm accessed on 17 April 2023.
[290] Baily MN, Klein A and Schardin J, The impact of the Dodd-Frank Act on financial stability and economic growth',25.
[291] Baily MN, Klein A and Schardin J, The impact of the Dodd-Frank Act on financial stability and economic growth',25.

procedures which are presided over by court judges, under the OLA the resolution process is managed through financial regulators with the requisite knowledge and expertise to oversee a timely and speedy resolution.[292] This reform is crucial as it increases the level of preparedness, timeliness of response and effective management of a failed bank with the existence of a resolution plan that is readily available and sanctioned by the regulator. The reliance on the shareholders' equity and debt instrument of the institution owners to resolve such failures promotes market discipline. It also reduces the moral hazard such as witnessed during the GFC where the financial institutions would engage in risky investment ventures with the reliance on government bailouts in the event of failure.

4.2.1.4 Financial Stability Oversight Council

The Dodd-Frank Act further established the Financial Stability Oversight Council (FSOC), an inter-agency body that monitors and mitigates emerging risks to the USA financial system that could derail the economy.[293] It also monitors regulatory gaps and overlaps to identify emerging sources of systemic risk and ensures greater coordination among the financial regulators in the USA. The FSOC makes policy recommendations to the member agencies or congress as may be appropriate.[294] By providing an oversight role over financial institutions, the FSOC has been instrumental in promoting market discipline by constraining excessive risk taking by financial institutions and disabusing expectations that existed during the GFC that the government would intervene with bailouts in the event of failure. The monitoring role of the FSOC also enhances the country's preparedness to manage any resulting risks in the financial industry.

4.3 The UK Bank Resolution Framework

4.3.1 Introduction

Just like the USA, the UK was at the epicentre of the GFC, with key banking institutions such as Northern Rock, Bradford & Bingley and Icesave being among the initial causalities of the crisis. The failure of Northern Rock in 2007 which was triggered by liquidity challenges and a subsequent bank run was the first major banking crisis that the UK bank regulators had to

[292] Baily MN, Klein A and Schardin J, The impact of the Dodd-Frank Act on financial stability and economic growth',25.
[293] section 111(e)(2), Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203.
[294] U. S. Department of Treasury, *Rules of organization of the financial stability oversight council*, 24 April 2018.

contend with during the GFC.[295] This was followed by the failure of Bradford & Bingley in September 2008 and Icesave's failure in October the same year.[296]

During the crisis period, the UK lacked a special regime for dealing with the banks in distress just like the USA, leaving the country with the undesirable choices of extending public assistance through extension of emergency liquidity to the failed banks, guaranteeing all the customers' deposits and eventual nationalization of the failed banks.[297] Ordinary corporate insolvency procedures also proved inadequate in resolving failed banking institutions. The public assistance measures employed in resolving the banking crises were criticised for being lengthy, slow and inefficient, tarnishing the UK's reputation as a sophisticated financial hub.[298] This necessitated a review of the regulatory responses that culminated in reforms to the UK's legal and regulatory framework for responding to bank failure to provide for a better framework to resolve failed banks in an orderly manner that would among other things, enable a failed bank's shareholders and creditors to bear losses emanating from such failure and ensure continuity of a failed bank's critical operations where possible.[299]

In 2009, the UK established a special resolution regime (SRR) through an act of parliament designating the Bank of England (BOE) as the primary resolution authority.[300] The SRR has since evolved to align with the FSB's Key Attributes. According to a recent FSB report, the UK is one of the jurisdictions leading in implementing the key resolution tools recommended in the FSB's Key Attributes. [301]

The SRR further incorporated the EU Bank Resolution and Recovery Directive (BRRD) which sets out common EU rules for the European Union member countries in dealing with troubled

[295] Lastra RM, "Northern Rock and banking law reform in the UK'135 in Bruni F and Franco Bruni and Llewellyn DT, The failure of Northern Rock: A multi-dimensional case study, *SUERF, Vienna*, 2009, 135.
[296] Hindmor A and Maconnel A 'Who saw it coming? The UK's great financial crisis'35 *Journal of Public Policy*, Volume 1 (2015) 63 – 96.
[297] Lastra RM, "Northern Rock and banking law reform in the UK'135 in Bruni F and Franco Bruni and Llewellyn DT, The failure of Northern Rock: A multi-dimensional case study, 134.
[298] Lastra RM, "Northern Rock and banking law reform in the UK'135 in Bruni F and Llewellyn DT, The failure of Northern Rock: A multi-dimensional case study', 135.
[299]Financial Services Compensation Scheme, FSCS Reflects, 10 years after bank failure. https://www.fscs.org.uk/media/press/2018/sep/10-years-after-failures/#:~:text=FSCS%20reflects%20on%20the%2010,bank%20accounts%20in%20the%20UK on 9 September 2022.
[300] *Banking Act 2009*.
[301] Financial Stability Board, *2021 Resolution report, Glass half full or still half empty*, 7 December 2021, https://www.fsb.org/wp-content/uploads/P071221.pdf . On 9 September 2022.

financial institutions as the UK was still a member of the EU.[302] THE BRDD also details measures to be taken by resolution regimes of its member states including prevention measures such as recovery and resolution plans, early intervention measures such as the appointment of a temporary administrator to manage the affairs of a troubled financial entity and resolution measures to minimise the cost of bank failures to taxpayers. [303]

4.3.2 Key features of the UK special resolution regime

4.3.2.1 Clearly outlined resolution objectives

The Banking Act 2009 which establishes the SRR succinctly sets out the objectives that the SRR should pursue in resolving a failing or failed bank.[304] These objectives mirror the objectives outlined by the FSB in the FSB's Key Attributes.[305] These objectives are outlined in section 4 of the Banking Act 2009 and they include: protecting and maintaining the stability of the UK financial system by preventing a contagion and ensuring continuity of banking services;[306] protecting and enhancing public confidence in the UK's financial system's stability;[307] protecting public funds;[308] protecting depositors and investors to the extent covered by the compensation schemes;[309] protecting relevant client assets and avoiding interference with property rights in contravention of the European Convention of Human Rights.[310] The BOE as the resolution authority is required to consider balancing the stated resolution objectives on a case-to-case basis and in the event of a conflict in the objectives, BOE is mandated to decide on the objective to take priority.[311] The Special Resolution Regime Code of Practice supports the legal framework of the special resolution regime by providing guidance on to how the objectives set out in the Banking Act 2009 may be achieved by outlining the factors that the authorities may consider in relation to them.[312]

[302] Bank Recovery and Resolution Directive (BRRD): DIRECTIVE 2014/59/EU (BRRD), https://www.eba.europa.eu/regulation-and-policy/single-rulebook/interactive-single-rulebook/100546 on 9 September 2022.
[303] Bank Recovery and Resolution Directive (BRRD): DIRECTIVE 2014/59/EU (BRRD),
[304] Section 4, Banking Act 2009, United Kingdom.
[305] Financial Stability Board, Key attributes of an effective resolution Regime 2014.
[306] Section 4 (1) *Banking Act 2009.*
[307] Section 4(5*) Banking Act 2009*.
[308] Section 4(7) *Banking Act 2009*.
[309] Section 4(6) *Banking Act 2009*.
[310] Section 4(8*) Banking Act 2009*, United Kingdom.
[311] Bank of England, Statement of policy, The Bank of England's approach to setting a minimum requirement for own funds and eligible liabilities, 3 December 2009, https://www.bankofengland.co.uk/paper/2021/the-boes-approach-to-setting-mrel-sop .on 9 September 2022.
[312] Section 3 (3), Banking Act 2009: Special resolution regime code of practice, December 2020

4.3.2.2 Triggers for the Special Resolution Regime

Section 7 of the Banking Act outlines the conditions that would trigger a resolution under the special resolution regime. The first condition is that the subject bank must be failing or likely to fail.[313] The Prudential Regulation Authority (PRA) as the banks' prudential supervisor is charged with the mandate of assessing whether a bank meets the first condition that would trigger a resolution.[314] The second condition provides that, taking into account timing and other relevant circumstances, it would not be reasonably likely that action will be taken by or in respect of the bank (save for the stabilisation powers provided under the SRR) that would enable the bank to meet the threshold conditions.[315] This condition is assessed by the BOE in its capacity as the primary resolution authority for banks in the UK. The action that would be taken by the management of a bank in distress may be triggered by either the bank's shareholders or the prudential supervisor and may include a reduction of dividend payments, a liability management exercise or a sale of part of the bank's business.[316] The SRR allows for resolution of a bank before it is balance sheet insolvent and the conditions outlined above as triggers for resolution aim to strike a balance between facilitating of an orderly resolution before erosion of the bank's value and avoiding placing a bank into a resolution before all viable options for a market base solution have been exhausted.[317] The threshold conditions are useful to the authorities in the UK in exercising their regulatory judgement over banks and taking prompt action in recommending for non-viable banks to promptly be placed into the special resolution regime.

4.3.2.3 Distinct Roles of the Authorities

The legal framework clearly outlines the roles of each statutory body involved in the resolution process and a close cooperation of the authorities is fundamental to the realisation of the objectives of an effective resolution as provided for under the Banking Act 2009.[318] In the event of an eminent failure, the PRA will make its assessment on the bank's condition as provided under section 7 of the Banking Act and make a recommendation to the BOE.[319] BOE as the primary resolution authority will then make the decision to put a firm into the resolution regime

[313] Section 7 (2) Banking Act 2009, UK General Acts 2009.
[314] Bailey A, Breeden S and Stevens G, Bank of England, Quarterly Bulletin; London' 52 *Trade journal* 4 (2012)
[315] Section 7 (3) Banking Act 2009, UK General Acts 2009.
[316] Gracie A, Chennels L and Menary M, 'The Bank of England's approach to resolving failed institutions' Bank of England Quarterly Bulletin, 2014, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2539510 on 11 April 2023.
[317] Gracie A, 'Chennels L and Menary M, 'The Bank of England's approach to resolving failed institutions'.
[318] UK Public General Acts.
[319] Section 7, *Banking Act 2009*.

upon consulting with the HM Treasury (HMT). The BOE is mandated with deciding on the appropriate resolution tools to be applied in the resolution process.[320] HMT is responsible for the decision to place a problem bank under temporary public ownership or to provide public equity support.[321] The Financial Services Compensation Scheme (FSCS) is charged with paying out or funding the transfer of deposits protected under the deposit guarantee scheme up to the statutory limit.[322] There is in place a memorandum of understanding on financial crisis management which sets out the procedure for cooperation among the PRA, the BOE and HMT in the run up to and during the resolution of a failed financial institution.[323]

4.3.2.4 The Resolution Tool Kit

The UK bank resolution framework provides the authorities with various resolution tools that may be utilised in resolving a failed bank. A brief overview of each of the resolution tools is provided below.

4.3.2.4.1 Stabilisation Options

The Banking Act 2009 outlines various stabilisation options available to the SRR in resolving failed or failing banking institutions. These options are in line with the FSB recommendations in its Key Attributes of an Effective Resolution Regime for Financial Institutions.[324] The stabilisation options include: private sector purchase; the establishment of a bridge bank; asset management vehicle; bail-in option and temporary public ownership.[325] A brief overview of the listed stabilisation tools is outlined below to give an appreciation of their importance in the resolution process:

4.3.2.4.2 Private Sector Purchase

This stabilisation tool involves the sale of all or part of the subject bank's business to a commercial purchaser through one or more share transfer or property transfer instrument (s).[326] In effecting the private sale of the failed bank's business, the BOE is mandated to provide to the general public details of the securities, property, rights or liabilities that are subject of the

[320]The Bank of England, 'The Bank of England's approach to resolution' 2017, https://www.bankofengland.co.uk/-/media/boe/files/news/2017/october/the-bank-of-england-approach-to-resolution.pdf?la=en&hash=FC806900972DDE7246AD8CD1DF8B8C324BE7652F
[321] The Bank of England, 'The Bank of England's approach to resolution' 2017.
[322] https://www.fscs.org.uk/what-we-cover/banks-building-societies/ accessed on 11 April 2023.
[323]HM Treasury,' Memorandum of Understanding on resolution planning and financial crisis management' October 2017, https://www.bankofengland.co.uk/-/media/boe/files/memoranda-of-understanding/resolution-planning-and-financial-crisis-management.pdf.
[324] https://www.fsb.org/wp-content/uploads/r_111104cc.pdf on 11 April 2023.
[325] Section 11, Banking Act 2009.
[326] Section 12, Banking Act 2009.

sale through a property transfer instrument.[327] This process promotes transparency in the sale process, a desirable value of an effective resolution regime.

4.3.2.4.3 Bridge Bank

This stabilisation option involves the transfer of all or part of the business of a failed or failing bank to a company which is either; fully or partially owned by the BOE or controlled by the BOE or created for the purpose of receiving a transfer of certain assets and liabilities of the bank under resolution. The transfer of assets to the bridge bank is a temporary measure to maintain access to a failed or failing bank's critical functions before the bank or its business is eventually sold. [328]

4.3.2.4.4 Asset Management Vehicle

This option involves the transfer of all or part of the failed or failing bank or bridge bank's business to an asset management vehicle. This asset management vehicle is either fully or partially owned by the BOE or treasury or controlled by the BOE or established for the purpose of receiving part or all assets of the failed bank or bridge bank.[329]

4.3.2.4.5 Bail-in option

This option as detailed under the UK Banking Act involves divesting a failed or failing bank's shareholders of their shares and a cancellation or reduction of creditors' claims to restore the failed or failing bank to a financially viable position. The divested shares are transferred by BOE or a person appointed by BOE to a resolution administrator, or an appointee of the BOE.[330] This option is intended to revive a failed bank without reliance on taxpayers' funds through emergency liquidity support. It also curbs the moral hazard associated with the taking of excessive risk by banking institutions and the reliance of government bailouts in the event of failure as witnessed during the GFC.

4.3.2.4.6 Temporary Public Ownership

This is exercised as a last option where the failed bank is taken into temporary public ownership by a nominee of the treasury, or an entity wholly owned by the treasury as a temporary stabilisation measure.[331]

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[327] Section 12, Banking Act 2009.
[328] Section 12, Banking Act 2009.
[329] Section 12ZA, Banking Act 2009.
[330] Section 12 A, Banking Act, 2009, UK General Acts.
[331] Section 13, Banking Act 2009, UK.

The above tools are designed to be employed as alternatives or used as complements depending on the resolution cases and considering the resolution objectives. In the resolution of Dunfermline Building Society, the first UK institution to be resolved under the provisions of the Banking Act 2009, the resolution authorities employed both the private sector purchase and bridge bank resolution tools.[332]

The Banking Act 2009 considers that the available stabilisation options can potentially interfere with a failed bank's stakeholders' rights and put several statutory safeguards in place. These safeguards include the requirement for independent valuations and the principle that no shareholder or creditor should be left worse off in resolution than they would have been in an insolvency process.[333]

4.3.2.5 Bank Insolvency Procedure

This strategy is preferred where the use of the stabilisation tools is unjustifiable and where the resolution authority considers that either the subject bank is unable, or likely to become unable, to service its debt obligations or that the winding up of a bank would be in the public interest or the winding up of a bank would be fair. The application for a court order for the insolvency procedure to be commenced in relation to a bank is made by either the BOE, FSA or the Secretary of State.[334] In the application of the insolvency procedure, the subject bank's protected depositors' interests are protected by either payment of their protected deposits by the FSCS up to the statutory maximum within a maximum period of seven days or having their accounts transferred to another healthy institution using the FSCS funds. Subsequently, the failed bank is wound up in a normal insolvency process using the procedures adopted from the Insolvency Act 1986 to achieve the best results for the creditors as a whole.[335]

4.3.2.6 Bank Administration

The Banking Act 2009 provides for the bank administration procedure under part 3 of the Act. This procedure is applicable where part of a bank's business is sold to a commercial purchaser or transferred to a bridge bank in accordance with the respective provisions of the Act. [336] The BOE is mandated under the Act to apply to court for the appointment of an administrator. Upon his appointment, the bank administrator must ensure that the non-sold or non-transferred part

[332] Brierley P 'The UK special resolution regime for failing banks in an international context' Financial stability paper no. 5 July 2009, Bank of England.
[333] Brierley P 'The UK special resolution regime for failing banks in an international context'.
[334] Section 96 (1) *Banking Act 2009*, UK.
[335] Section 99 (3) *Banking Act 2009*, UK.
[336] Section 136, *Banking Act 2009*, UK.

of the bank ("the residual bank") continues to discharge the services or provide facilities that would aid the commercial purchaser or the transferee to operate effectively. The rules for the bank administration procedure are detailed in the Bank Administration (England and Wales) Rules 2009. [337]

4.3.2.7 Depositor Protection

In its endeavour to promote the effectiveness of the UK resolution process, the FSCS works with the BOE to ensure that depositors of failed banks under the BOE resolution mandate are compensated within seven days of a bank's failure up to the maximum insured amounts subject to the terms prescribed by the FSCS.[338] The prompt reimbursement of protected depositors is key to enhancing public confidence in the banking industry and preventing bank runs that could potentially trigger a systemic risk in the banking industry. Public confidence in the soundness of a banking system plays an important role in building and sustaining financial system stability.

The Financial Services (Banking Reforms) Act 2013 makes further provision about banking and other financial services, including provision about the FSCS and provision for the amounts owed in respect of certain deposits to be treated as a preferential debt on insolvency.[339] The express statutory provision on preferential treatment in the law relating to bank resolution promotes transparency. The preferential treatment of depositors during resolution of banks is justified by the distinct legal features of the bank deposits held in banks and in furtherance of public policy objectives. Unlike other credit facilities owed by the bank, the customer deposits are considered distinct for various reasons. Firstly, the bank is deemed to acquire ownership title to the deposited funds. Secondly, the bank is at liberty to use the money to further its banking business. Thirdly, these deposits may attract little interest compared to other commercial loan facilities. Fourthly, the bank is required to repay the deposits upon demand or on maturity of contract where the finds are held as term deposits. Fifthly, retail depositors who form a majority of the bank depositors for commercial retail banks generally lack the requisite expertise to assess bank risks arising from the failure of a bank and the costs associated with this assessment may be disproportionately high compared to the value of their deposits.[340] The public policy objectives that support depositor preference include: containing the

[337] United Kingdom, Statutory Instruments 2009, No 357.
[338] Financial Services Compensation Scheme, https://www.fscs.org.uk/what-we-cover, on 29 September 2022.
[339] Title of the Financial Services (Banking Reform) Act 2013, Chapter 33, United Kingdom.
[340] Dobler M, Emre E, Gullo A and Kal D, 'The case for depositor preference' International Monetary Fund, Monetary and Capital Markets Department and Legal Department, December 2020.

likelihood of systemic disruption that may result through panic withdrawals in the event of bank failure; protecting the payment system and economic activities during resolution and eventual liquidation and reducing the cost of protecting depositors during the resolution process.[341] The preferential treatment of depositors should be effected while ensuring that there is no creditor who is left in a worse position than they would be in liquidation.[342]

4.3.2.8 Resolution Planning

Similar to the USA resolution regime, the UK resolution regime mandates banks to prepare and maintain resolution packs which are submitted to the Prudential Regulation Authority (PRA).[343] The resolution plans are required to provide adequate information that would aid the process of resolution in the event of the bank's failure. Banks are required to review their resolution plan annually. They are also obligated to keep their resolution plans and packs up to date, notifying the PRA of any material developments in their business and that of any member of a group where appropriate.[344] The responsibility of overseeing that banks prepare and submit resolution plans vests in the BOE as the primary resolution authority in coordination with the HM Treasury as the treasury is responsible for authorising the use of any of the stabilisation powers that would have an implication on public funds. The BOE is required to provide adequate notice to the treasury of the resolution plans that would require liquidity support to enable the treasury to assess the risk to public funds that would be triggered by a bank failure.[345] The requirement for resolution plans mirrors the recommendation by the FSB on recovery and resolution planning.[346]

4.3.2.9 Resolvability Assessment Framework

The BOE is charged with conducting resolvability assessment on UK banks and firms under its regulation to ensure that such firms are resolvable in accordance with their respective resolution plans.[347] The Resolution Assessment Framework (RAF) enhances the resolution process's transparency and promotes banks' preparedness to effectively manage their failure.

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[341] Dobler M, Emre E, Gullo A and Kal D, 'The case for depositor preference.

[342] Lenihan, Niall J., Maike B. Luedersen, and Schulte M, 'The hierarchy of creditor claims in bank Insolvency, Recent developments and the advisory functions of the European Central Bank', Revue de Droit Bancaire et Financier, VI, 2016.

[343] Bank of England, Prudential Regulation Authority, Recovery and resolution plans, policy statement ps8/13, December 2013.

[344] Bank of England, Prudential Regulation Authority, Recovery and resolution plans, policy statement ps8/13, December 2013.

[345] HM Treasury, 'Memorandum of Understanding on resolution planning and financial crisis management'

[346] Financial Stability Board, Key Attributes of an Effective Resolution Regime, 2014.

[347] Bank of England, The Bank of England's approach to assessing resolvability, 30 July 2019, https://www.bankofengland.co.uk/paper/2019/the-boes-approach-to-assessing-resolvability.

Through this RAF, any barriers to resolution are identified and addressed promptly. The findings of the resolvability assessment for the major UK banks are required to be made public to enhance public and promote transparency and public awareness. In June 2022, the BOE published the findings from its first resolvability assessment of eight major Banks in the UK and reiterated its commitment to continued public awareness.[348]

4.3.2.10 Minimum Requirement for own funds and Eligible Liabilities (MREL)

To enhance the effectiveness of its bank resolution framework, the Banking Act 2009 was amended to introduce the MREL provision for banks to have additional capacity to absorb losses if they collapse necessitating entry into resolution.[349] In December 2021 the BOE issued a statement of policy on its approach to setting the MREL, elaborating on how it would exercise its powers in relation to the MREL.[350] The MREL aimed at enhancing the resolution of failed banks in a manner that minimises damage to the real economy and any recourse to public funds in bailing out a failed bank. Systemically important banks in the UK are required to hold primary loss-absorbing capacity in addition to the required statutory capital. The Loss absorbency requirements are in line with the FSB guidelines on the Total loss Absorbency capacity (TLAC). These guidelines are designed to ensure that if a systemically important bank fails, it has sufficient loss-absorbing and recapitalisation capacity available to implement an orderly resolution which minimises impacts on financial stability, ensures the continuity of critical functions and avoids exposing public funds to loss.[351]

4.3.2.11 Stakeholders' Safeguards

In addition to the protection accorded to the depositors, the UK SRR takes into account other bank stakeholders and explicitly outlines several safeguards designed to protect these stakeholders who include: creditors, counterparties and shareholders of a failed bank. A resolution fund is provided for under Section 58 of the Banking Act 2009. This provision requires that the net proceeds from the operations and sale of a bridge bank or a bank under temporary public ownership revert to the bank's creditors and any surplus is availed to the

[348]Bank of England, Resolvability assessment of major UK, 10 June 2022, https://www.bankofengland.co.uk/financial-stability/resolution/resolvability-assessment-framework/resolvability-assessment-of-major-uk-banks-2022 .on 29 September 2022.

[349] Section 3A (4), *Banking Act 2009*.

[350] Bank of England, Statement of Policy: Bank of England's Approach to setting a minimum requirement for own funds and eligible liabilities, December 2021, https://www.bankofengland.co.uk/-/media/boe/files/paper/2021/mrel-statement-of-policy-december-2021-updating-2018.pdf?la=en&hash=513F77100E9424C7F4019928FEFA42AC2C025AA0 .

[351] Financial Stability Board, Guiding Principles on the Internal Total Loss-Absorbing Capacity of G-SIBs ('Internal TLAC') 6 July 2017.

failed bank's shareholders. The SRR provides further creditor safeguards through the set off and netting arrangements that prevent the BOE from cherry picking financial contracts with certain counterparty that are covered by set off and netting arrangements.[352]

In adherence to one of the SRR objectives the resolution authorities are required to refrain from interfering with property rights safeguarded by the European Commission on Human Rights[353] and enshrined under the Human Rights Act.[354] Compliance with this objective extends protection to shareholders, creditors and counterparties contractual and property rights.

4.3.2.12 Oversight of Conduct of Banks' Personnel

The Financial Services and Markets Act of 2000 (FSMA) introduced a senior management conduct and certification regime aimed at improving personal responsibility by senior management in the banking industry.[355] The Act requires that persons charged with senior management functions are subjected to the fit and proper evaluation.[356] Banks are required to obtain regulatory approval for persons charged with carrying out various senior management functions. Their applications for approval to the regulators should detail the responsibilities that the senior manager will be tasked with together with a statement of the persons' competence to undertake such responsibilities. In its evaluation the regulator must ascertain that the persons proposed for senior management roles have the requisite competence and personal traits desirable for the subject roles as provided for under the applicable rules.[357] The Act further imposes criminal liability to persons responsible for a financial institution's failure.[358] These provisions promote accountability by banks' senior managers and encourage professionalism in the discharge of their various responsibilities.

To further promote effective regulation and supervision within the banking industry, the Senior Management Regime (SMR) was implemented by the PRA and the FCA in March 2016.The SRM is designed to ensure that financial institutions adhere to exemplary standards of governance and accountability.[359] The SMR requires banks to produce and keep an up to date

[352] Brierley P, 'The UK special resolution regime for failing banks in an international context'12.
[353] Section 4 (8) *Banking Act 2009*, United Kingdom.
[354] Protocol 1, Article 1, Human Rights Act 1998, United Kingdom.
[355] Section 59, *Financial Services and Market Conduct Act, 2000*, United Kingdom.
[356] Section 60 A (1) *Financial Services and Markets Act 2000*, United Kingdom.
[357] Section 60 A (2) *Financial Services and Markets Act 2000*, United Kingdom.
[358] Section 36 (1), *Financial Services and Markets Act 2000*, United Kingdom.
[359] Bank of England, Senior Managers Regime, https://www.bankofengland.co.uk/about/people/senior-managers-regime accessed on 18 April 2023.

a Responsibility Map which outlines the bank's management and governance structures together with details of allocation of the various senior management responsibilities.[360]

4.4 Chapter Conclusion

The USA and the UK have spearheaded reforms in their respective bank resolution frameworks since the GFC with a view to align their bank resolution frameworks with the international best practices contained in the FSB's Key Attributes. These reforms are aimed at promoting public confidence in the banking industry, promoting transparency, accountability and enhancing stability of the banking industry in the major world economies.

The Dodd-Frank Act was enacted in the USA post the GFC to among other objectives, provide for effective resolution of Systemically Important Financial Institutions. Although the Act has been subjected to various criticisms since its enactment with some critiques perceiving the Act as restrictive, it has been instrumental in reforming the USA bank resolution framework. Some of the reforms implemented through the Dodd Frank Act as discussed in this chapter include: providing for a Single Point of Entry; introduction of the requirement for banks to prepare and maintain resolution plans for their respective banks; establishment of the Orderly Liquidation Authority and the Orderly Liquidation Fund and the establishment of the Financial Stability Oversight Council.

In the UK, the Special Resolution Regime established under the Banking Act 2009 has been lauded for strengthening the bank resolution framework in the UK. Under the Act, the BOE is the primary resolution authority in the UK and it discharges its resolution mandate in collaboration with the Treasury and the FCA. Among the notable reforms introduced by the Banking Act 2009 as earlier outlined include encapsulating clear objectives to be pursued by the SRR; providing the resolution authority with various stabilisation tools and powers; requirement for banks to formulate resolution plans; providing for depositors and other key stakeholders' safeguards; introduction of the Minimum Requirement for own funds and Eligible Liabilities and the introduction of the Resolvability Assessment Framework. The UK bank resolution framework also adopted recommendations introduced by the European Union under the Bank Recovery and Resolution Directive (BRRD) in 2014. The Directive requires banks to introduce recovery plans and introduces resolution funds to assist during the process of restructuring.

[360] https://www.bankofengland.co.uk/about/people/senior-managers-regime accessed on 18 April 2023.

CHAPTER 5: ANALYSIS OF THE RESEARCH FINDINGS AND RECOMMENDATIONS

5.1 Introduction

This chapter presents a summary of findings of this study and concludes by outlining recommendations for adoption to enhance the effectiveness of Kenya's bank resolution framework in managing bank failures.

5.2 Research Findings

It is evident from this study that owing to the special functions performed by banks and the systemic risks associated with their failures, there is need for a distinct legal and regulatory framework providing for their resolution. Developing an effective bank resolution framework has remained a key priority with countries committing to reforming their national and cross border bank resolution frameworks. As highlighted in chapter one, a robust bank resolution framework makes it possible for the resolution authorities to resolve problem banking institutions in a timely and systemic approach that protects the banks' key stakeholders without burdening the taxpayers and ensures the continuity of failed banks' critical economic functions.

In the wake of the GFC, the G20 most countries embarked on reforms geared towards strengthening their resolution frameworks for financial institutions, With mandate from the G20 members, the FSB developed the Key Attributes of an Effective Resolution Regime for Financial Institutions which have gained global acceptance as the international standard for resolution regimes for financial institution. The standard consists of twelve key elements. Most leading economies across the globe have adopted the FSB recommendations as a benchmark in reforming their national and cross-border bank resolution frameworks.

In most jurisdictions globally, central banks are considered the most suitable to oversee the process of resolving failed or failing banks under their regulatory and supervisory ambit. Their resolution mandate is carried out right from policy formulation geared to promoting financial stability and supervisory role to ensure that banking business is conducted in a safe and sound manner. As lenders of last resort, central banks are also inherently equipped with the power to respond to bank failures. The central banks carry out their resolution mandate in collaboration with other entities to realise the objectives of an effective resolution regime. It is imperative that the central banks and the entities they collaborate with in managing bank failures such as the deposit insurance schemes are equipped with comprehensive resolution powers and tools for early detection and management of bank failures.

Both UK's and USA's bank resolution frameworks have evolved since the GFC to align with the international best practices desirable for an effective bank resolution regime as recommended by the FSB in the FSB's Key Attributes for an effective resolution regime and the subsequent guiding principles issued by the FSB in relation to the implementation of the FSB Key Attributes. The statutory frameworks on bank resolution in both the UK and the USA have elaborate details on the implementation of the statutory provisions relating to bank resolution providing clarity, certainty and transparency in the resolution process

In the USA, the FDIC as the primary resolution authority is adequately equipped to manage bank failures. The FDIC works closely with the FRB, whereas in the UK, the Banking Act 2009 providing for the special resolution framework under which the BOE as the designated primary resolution authority is clothed with the requisite powers and tools to effectively manage bank failures both in the UK. The resolution frameworks for both countries have continued to be reviewed and improved to ensure that the bank resolution frameworks align with the international best practices, specifically the FSB Key Attributes and that the countries are well prepared to effectively respond to bank failures. In the UK there is close coordination and collaboration between the BOE, the PRA, the FSCS and the HM Treasury to align its resolution regime with the international best practices, whereas in the US the FDIC works closely with the FRB towards aligning its bank resolution framework with international best practices. Both countries also have in place effective mechanisms for cross-border cooperation taking cognisance of the global interconnectedness of the financial services industry.

Although Kenya has implemented reforms to its bank resolution framework since 1985 when an explicit deposit insurance fund was established in response to a series of bank failures in the early 1980's to better manage bank failures, there are weaknesses in the framework which are highlighted in chapter 2 of this thesis. These weaknesses include the lack of provisions stipulating clear objectives to be pursued in the resolution process, failure to provide for resolution planning, lack of a framework to manage failure of domestically important banks, lack of transparency accountability and certainty in the resolution framework.

In relation to depositor protection, both the USA and UK have in place mechanisms to ensure that depositors of failed banks and reimbursed on a timely basis. In the USA, the FDIC has in place mechanisms to ensure that insured depositors are reimbursed within a day following a bank's failure while in the UK the framework provides for reimbursement of insured depositors by the FSCS within a period of seven days. In Kenya the legal framework provides for

reimbursement of insured depositors within thirty days of KDIC's appointment as liquidator. This period is relatively longer compared to the reimbursement time frame under the USA and the UK bank resolution frameworks.

5.3 Recommendations for Kenya from the UK and the US Bank Resolution Regimes

Kenya could borrow the following lessons from the resolution frameworks adopted by the USA and the UK to strengthen its framework in line with international best practices:

5.3.1 Clearly outlining the objectives of bank resolution in the resolution framework

The UK Banking Act of 2009 lists the statutory objectives of the SRR which objectives are based on public interest.[361] The Act further states explicitly that the objectives are to be balanced as appropriate by the authorities depending on the subject case. This contributes to the clarity of the resolution regime and enhances the effectiveness of the SRR. Further clarity in the framework is availed through a Code of Practice published by the HM Treasury on the local resolution regime which inter alia provides guidance on the matters to be taken into account in the process of resolving bank failures. [362] In the same breath, the Dodd- Frank Act details the objectives to be pursued in resolving problem banks.[363] The FDICIA further specifies the criteria for invoking the systemic risks exceptions in resolving problem banks. The detailed objectives contained in the respective statutes of the UK SRR and the US bank resolution regime provide clarity to the resolution authorities involved in resolving problem banks and also enhance public confidence in the resolution process.

On the contrary, Kenya's resolution regime which is encapsulated in the Banking Act[364] and the KDIA,[365] fails to expressly list the objectives that the resolution framework seeks to realise upon intervention to manage bank failures. This regulatory gap deprives the framework of certainty desirable in an effective resolution framework. Express inclusion of the objectives in the statutory framework would enhance clarity and certainty while bolstering public confidence in the resolution framework.

[361] Section 4, Banking Act 2009, United Kingdom.
[362] Banking Act 2009: Special Resolution Regime Code of Practice, United Kingdom.
[363] The Dodd–Frank Wall Street Reform and Consumer Protection Act, United States of America, 2010.
[364] Chapter 488, Laws of Kenya
[365] Act No. 10 of 2010

5.3.2 Formulating a resolution framework for Domestically Systemically Important Banks.

Although Kenya's banking industry is not dominated by as many sophisticated, large and complex systemically important and highly interconnected financial institutions as those in the USA and the UK, the banking sector in Kenya has witnessed a number of mergers and acquisition with banks seeking to enhance their market share and competitive advantage in the industry.[366] The competition in the banking industry has also prompted financial innovation and increased interconnectedness and complexities in the Kenyan banking sector giving rise to a number of domestic systemically important banks. These are the banks classified by CBK as tier 1 banks, based on their respective net assets, customer deposits, capital reserves, number of deposit accounts, number of loan accounts with a weighted composite index of 5 per cent and above and a combined market share of 74.6 per cent.[367] The ownership structure for some of the tier one banks post is complex with a group holding company and subsidiaries spread across various countries.[368] Failure of any of these banks, if not effectively managed, could trigger a systemic crisis and threaten the stability of the greater economy. It is important for CBK, being the banking industry regulator in Kenya to design a special legal framework for the resolution of such institutions. This framework should incorporate the requirement for such institutions to periodically submit their comprehensive resolution plans to the regulator. This requirement would ensure a proactive response to the banks' failures as opposed to knee jerk responses to bank failures that may have crippling effects on the bank depositors and the country's economy through huge government bailouts. This process should consider key factors including the size of the institution, its complexity and nature of its business transactions and the interconnectedness of such institutions with other local and cross-border financial institutions. Special reporting and accounting obligations should also be included in the statutory provisions for these institutions.

5.3.3 Enhancing the Principles of Transparency, Certainty and Accountability in the Bank Resolution Process

The UK SRR clearly indicates its commitment to adhere to the principles of Integrity transparency and accountability through the detailed provisions of the UK Banking Act 2009.

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[366] Kiemo S and Mugo C, 'Banking sector consolidation and stability in Kenya, 11 *Journal of Applied Finance & Banking 3*, 2021 Scientific Press International Limited, (2021) 132.
[367] https://www.centralbank.go.ke/bank-supervision/, accessed on 11 January 2023.
[368] An example of the tier 1 banks with a complex ownership structure is the NCBA, Link to its ownership structure : https://ncbagroup.com/wp-content/uploads/2021/12/NCBA-Group-Shareholding-Structure.pdf

Additionally, the BOE continues to promote public awareness of the resolution process through its publications including its Approach to Resolution, which sets out how the SRR works and how the BOE would implement a resolution in case of a bank's collapse; the SRR Code of Practice which supports the legal framework of the SRR and gives guidelines as to how and when the authorities will employ the special resolution tools and the Memorandum of Understanding between the HMT and the BOE which details the cooperation between the HMT and BOE.[369] Transparency and accountability are also promoted in the USA bank resolution framework through availing to the public the nonconfidential aspects of the resolution and recovery plans submitted by banks to the USA agencies. The FDIC is also committed to making available to the public comprehensive information on its functions and the resolution process through regular publications on its website to promote public awareness transparency and accountability on the resolution of failed financial institutions under its regulatory ambit.[370]

Although the principles of transparency and accountability are enshrined in the Constitution of Kenya 2010,[371] Kenya's resolution authorities have been challenged for nonadherence to these principles in the process of resolving failed banks as highlighted in the case study of Chase Bank Kenya limited. There is need for the resolution authorities to commit to promoting transparency and accountability of the resolution process through public disclosure of information relating to the various steps of the resolution moreso, regarding the resolution tools employed in managing a failed bank. This would boost public confidence and promote stability in the banking industry.

Legislative clarity is also crucial to enhancing certainty in the resolution process. In particular, the law relating to the transfer of assets and liabilities of an institution licenced under the Banking Act and in particular, the interpretation of section 9 of the Banking Act vis a vis the provisions of the Transfer of Business Act which have been the subject of recent litigation relating to the bank resolution process should be clarified. In their interpretation of statutes, the courts should endeavour to promote certainty through accurate and consistent determinations to inspire investor confidence in providing market-led solutions to managing bank failures.

5.3.4 Resolution Planning

Notwithstanding the best supervision, banks are still susceptible to failure. It is vital that the regulatory framework for resolving banks anticipates such failures and provides adequate tools

[369] Special Resolution Regime Code of Practice, Banking Act 2009, HM Treasury.
[370] https://www.fdic.gov/transparency/resolutions.html, on 17 April 2023.
[371] Article 10, *Constitution of Kenya* 2010.

for a prompt and orderly resolution. This is made possible through resolution planning where banks are mandated to prepare resolution plans containing strategies for managing their failures The resolution authorities ensure that such plans are regularly reviewed and updated. The resolution plans should be feasible, providing a roadmap on how a bank could be allowed to fail without disrupting the stability of the financial industry.

In the UK, the BOE is responsible for resolution planning for each banking and financial institution subject to the SRR, which makes the firms responsible for their resolvability.[372] These resolution plans prepared and submitted by banks outside of a crisis are subjected to annual review and updated where necessary. The BOE is also able to assess and ascertain whether banks and other firms under the SRR in the UK are prepared for resolution through its Resolution Assessment Framework (RAF) with recent findings of the RAF being made public. In its resolution assessment published in June 2022, the BOE found that the Lloyds Banking Group and Standard Chartered had problems with their resolution plans that could "impede" efforts to resolve them.[373] Similarly, in the USA the Dodd Frank Act requires systemically important U.S. banks and other designated financial entities to each prepare a resolution plan to allow for their orderly failure.[374] The living will plans submitted by the financial institutions are required to include information relating to: the financial institution's strategy for an orderly resolution in bankruptcy during financial distress; the spectrum of measures they seek to take during the resolution, as well as their liquidity and capital requirements and resources; description of their organizational structure, material entities, interconnections and interdependencies and the corporate governance procedure.[375] This necessitates a change to a bank's structure and operations to facilitate orderly failure.

In Kenya, neither the Banking Act, which is the primary legislation providing for the supervision, regulation and resolution of failed banks by the CBK nor the KDI Act which provides for the establishment of KDIC charged with the primary responsibility of receiving and liquidating of failed banks, clearly sets out the requirement for resolution planning to facilitate orderly failure.[376] It is important that Kenya's bank resolution framework is reviewed

[372] Bank of England, Resolvability Assessment of major UK Banks, https://www.bankofengland.co.uk/-/media/boe/files/financial-stability/resolution/resolvability-assessment-of-major-uk-banks.pdf.
[373] Central Banking Newsdesk, BoE finds 'shortcomings' in three UK banks' resolution plans, 10 June 2022.
[374] Dodd-Frank Wall Street Reform and Consumer Protection Act
[375] https://www.federalreserve.gov/supervisionreg/resolution-plans.htm accessed on 17 April 2023.
[376] Rule 15, The Kenya Deposit Insurance Regulations, 2015.

to align with the international best practices encapsulated in the FSB's Key Attributes by expressly providing for the requirement for banks to prepare and submit resolution plans and further provide for a resolution assessment framework. A clear resolution framework would also incentivise investors, promote orderly failures and market-based solutions to failed or failing banks.

5.3.5 Explicit Statutory Inclusion of the Bank Resolution Tools

Kenya's bank resolution framework fails to explicitly provide for the stabilisation tools and powers provided for in the FSB's Key Attributes in relation to the utilisation of these tools in resolving failing or failed banks. There is a need to expand the powers availed to the CBK and the KDIC under the Banking Act and the KDI Act to explicitly include the various stabilisation powers outlined in the FSB's Key attributes. These powers include merging the failed institution with another bank, bail-in through recapitalisation by the bank's shareholders or conversation of creditor claims to equity to aid continuity of key functions and the establishment of a bridge bank to take over and continue operating identified vital functions and feasible operations of the failed bank. Including these stabilisation tools in the statutes providing for the resolution framework would enhance the framework's certainty, credibility and transparency.

5.3.6 Reducing Incidences of Judicial Action

The barrage of legal suits instituted against the resolution authorities by various stakeholders aggrieved by their actions and alleged impropriety by the regulator have impeded the effective resolution of the failed bank as they have considerably protracted the resolution process. This is a reflection of the low level of public confidence in the resolution regime and the authorities mandated to manage problem banks. To reduce the incidences of judicial action and inspire public confidence in their resolution mandate, CBK working with the KDIC should see to it that they adhere to the established legal and regulatory procedures in resolving problem banks to ensure that the resolution process is credible, transparent and promotes accountability. There is also need to take into account the interests of the various stakeholders in the process of resolving problem banks. Transparency can be enhanced through the issuance of detailed guidelines on the implementation of the resolution powers as provided for under the relevant statutes.

5.3.7 Depositor Reimbursement

Drawing from the UK and the US bank resolution frameworks on depositor protection, there is need to review the time frame provided for depositor reimbursement under Kenya's bank resolution framework. Section 12 (10 of the Kenya Deposit Insurance Corporation Regulations 2015 currently provide for a time frame of thirty days for reimbursement of insured deposits following the appointment of KDIC as liquidator. This time frame should be revised to allow for a shorter time frame for reimbursement of the insured deposits to enhance public confidence in the resolution framework.

5.4 Conclusion

Overall, Kenya's current bank resolution framework is better placed to respond to bank failure than it was in the nascent years of bank failures witnessed in the early 1980s. Some of the progressive legislative measures taken to increase the adequacy of the legal and regulatory framework in Kenya post the GFC include; the enactment of the KDI Act in 2012 which provided for the establishment of KDIC as one of the key safety net players in the resolution process with autonomy in carrying out its mandate as detailed in the KDI Act and the subsequent Kenya Deposit Insurance Regulations 2015 providing for among other things, the regulatory framework of the deposit insurance, expounding on the role of the KDIC as a receiver and the corporation's role as a liquidator.

However, there is to need to address the weaknesses discussed in chapter three borrowing lessons from the UK and the USA that have strengthened their bank resolution frameworks. This would ensure that the resolution authorities in Kenya are well equipped to resolve banks in an effective way without exposing taxpayers to loss associated with government bailouts, while ensuring continuity of their key economic services. A strong bank resolution framework would also inspire public confidence and restore public trust in the ability of the resolution authorities to effectively manage bank failures.

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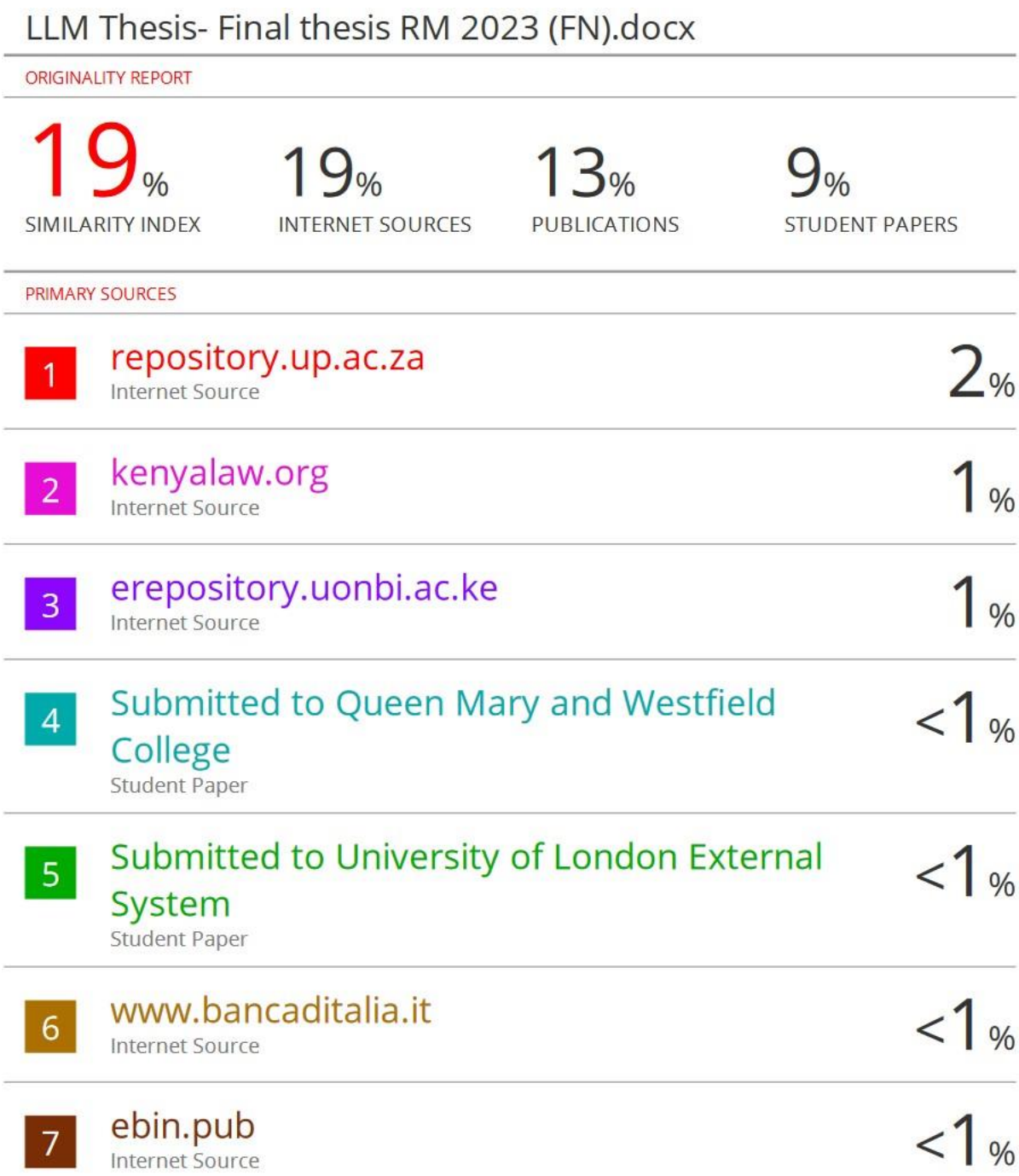
APPENDICES

Appendix A: Similarity Report



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Appendix B: Ethical Clearance Exemption Letter

Strathmore UNIVERSITY

24th September 2022

Rose Moraa Omundi

Student Number: 138440

rose.omundi@strathmore.edu

Dear Rose,

RE: The Adequacy of Kenya's Bank Resolution Framework in Managing Bank Failures in Kenya

This is to inform you that the Strathmore University Institutional Scientific Ethics Review Committee (SU-ISERC) and the Research Services Office received your above Thesis for Ethical Clearance. However, as communicated to you by SU-ISERC via email and further referred to the Office of Graduate Studies, your study cannot be reviewed since you have already collected data and written the Thesis. The ethics approval process is ONLY done before any collection of primary or secondary data. Additionally, ethical clearance is mandatory for all studies including desktop research.

The office notes that: On the grounds of not having completed the ethical clearance process, with reason of documented supervision challenges and henceforth having already proceeded to data collection and defended your Thesis before ethical clearance. This is a letter for you to proceed with the next steps of your academic requirements.

Please be advised, that in future, all research proposals should be submitted to the SU-IERC through the RHInnO Ethics platform: https://strathmoreuniversity.rhinno.net/login

Disclaimer: 1) This is not in any way an ethical approval letter. 2) Should there be any legal implications/actions emanating from the research in terms of any ethical violations, you will be personally liable.

Yours sincerely,

Dr. Bernard Shibwabo
Director of Graduate Studies

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