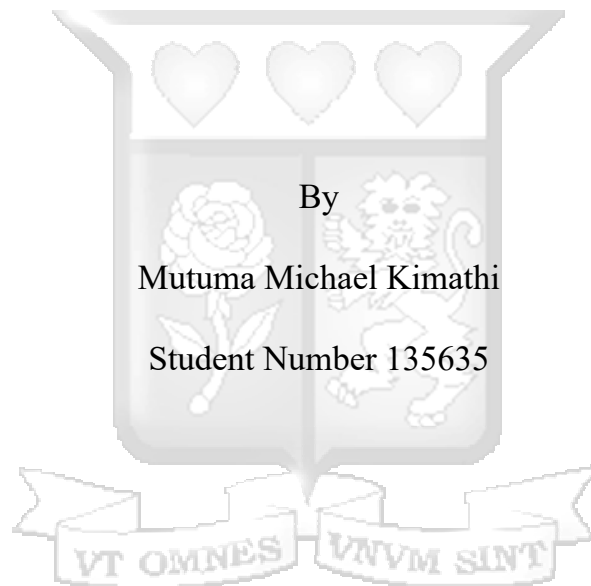


**THE FEASIBILITY OF THE IMPLEMENTATION OF THE TWIN-PEAKS  
MODEL OF FINANCIAL REGULATION IN KENYA.**

Submitted in partial fulfilment of the requirements of the Bachelor of Laws Degree,

Strathmore University Law School



By

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2025

## DECLARATION

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

Signed: .....

Date: .....10 April 2025.....

This dissertation has been submitted for examination with my approval as university supervisor.



Signed: MAO..........

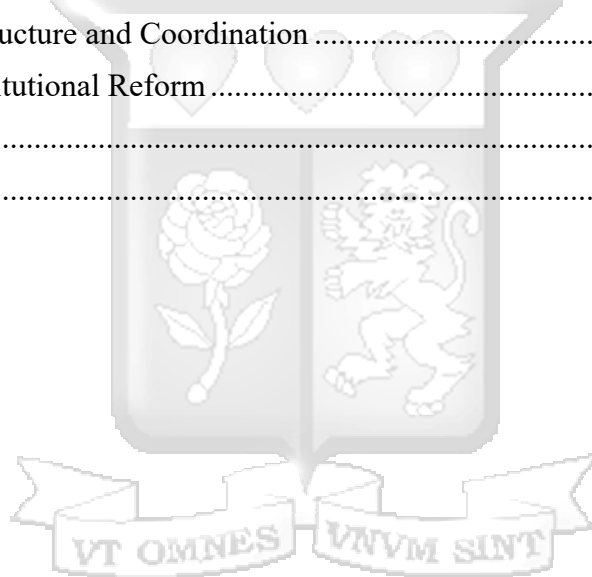
Moses Antony Odhiambo

## TABLE OF CONTENTS

DECLARATION.....	i
ACKNOWLEDGEMENT.....	v
TABLE OF CASES.....	vi
LIST OF STATUTORY AND LEGAL INSTRUMENTS .....	vii
LIST OF ABBREVIATIONS & ACRONYMS.....	ix
ABSTRACT .....	x
CHAPTER ONE: INTRODUCTION .....	1
1.1 BACKGROUND.....	1
1.1.1 Introduction of The Concept of The Twin-Peaks Model .....	1
1.1.2 Historical Background and Development of Kenya’s Financial Regulatory System .	3
1.1.3 Importance of Financial Services in Kenya and The Current Financial Regulatory Framework .....	4
1.1.4 Pending Shift in Financial Regulatory Systems .....	5
1.2 PROBLEM STATEMENT.....	6
1.3 RESEARCH OBJECTIVES.....	7
1.4 RESEARCH QUESTIONS.....	7
1.5 HYPOTHESIS.....	8
1.6 JUSTIFICATION.....	8
1.7 LITERATURE REVIEW.....	8
1.7.1 On the Challenges Present in The Current Prevailing Financial Regulatory Environment in Kenya.....	9
1.7.2 On the Success of The Implementation of Alternative Regulatory Regimes in Another Jurisdiction Against its Historic Background.....	11
1.7.3 The Impact of Kenya’s History of Financial Regulation.....	13
1.7.4 The Gaps Existent in Current Literature That Are Filled by This Study.....	15
1.8 METHODOLOGY.....	15
1.9 CHAPTER BREAKDOWN.....	16
CHAPTER 2: THEORETICAL FOUNDATIONS OF FINANCIAL REGULATION: RISKS AND CHALLENGES IN THE SECTORAL MODEL.....	18
2.1 Introduction .....	18
2.2 Institutional Theory of Regulation .....	18
2.2.1 Implicit Regulation .....	20

2.2.2 Explicit Regulation .....	21
2.2.3 Criticisms of the Institutional Theory .....	22
2.2.4 Risks and Challenges of the Sectoral Model as Identified by The Institutional Theory .....	22
2.3 Economic Theory of Regulation (R. Posner) .....	24
2.3.1 Criticisms of the Economic Theory of Regulation .....	24
2.3.2 Risks and Challenges of the Sectoral Model as Identified by The Economic Theory of Regulation.....	25
2.4 Conclusion.....	25
<b>CHAPTER 3: THE CURRENT LEGAL AND REGULATORY FRAMEWORK OF THE FINANCIAL SERVICES SECTOR IN KENYA AND ITS CHALLENGES. ....</b>	<b>27</b>
3.1 Introduction .....	27
3.2 Current Legal and Regulatory Framework Governing the Financial Sector in Kenya .....	27
3.2.1 Legal Framework Governing the Financial Sector in Kenya .....	28
3.2.2 Regulatory Framework Governing the Financial Sector in Kenya.....	30
3.3 Challenges Facing the Current Legal and Regulatory Framework in the Financial Services Sector in Kenya .....	34
3.3.1 Regulatory Arbitrage .....	35
3.3.2 Regulatory overlaps .....	36
3.3.3 Insufficient Resources Available to the Regulatory Agencies .....	37
3.3.4 Differences in Powers Delegated to Various Regulators by the Applicable Laws to the Regulatory Bodies.....	38
3.4 CONCLUSION .....	38
<b>CHAPTER 4: A BENCHMARK ANALYSIS BETWEEN AUSTRALIA’S TWIN-PEAKS MODEL AND KENYA’S SECTORAL MODEL.....</b>	<b>39</b>
4.1 Introduction .....	39
4.2 COMPARATIVE ANALYSIS BETWEEN KENYA’S SECTORAL MODEL AND AUSTRALIA’S TWIN-PEAKS MODEL .....	41
4.2.1 Comparison of Regulatory Approaches .....	41
4.2.2 Evaluation of the Strengths and Weaknesses of the Regulatory Models with Respect to Each Other .....	44
4.3 LESSONS THAT KENYA CAN DRAW FROM AUSTRALIA’S IMPLEMENTATION OF TWIN-PEAKS MODEL.....	50
4.3.1 Streamlining Organisational Structure .....	50
4.3.2 Adopting a Principles-Based Approach .....	50

4.3.3	Improving Efficiency Through Specialisation .....	50
4.3.4	Boosting Systemic Risk Responsiveness .....	51
4.3.5	Building on Proven Resilience .....	51
4.6.6	Tailoring to The Local Context.....	51
4.4	CONCLUSION .....	51
CHAPTER 5: CONCLUSION AND RECOMMENdaTIONS.....		53
5.1	INTRODUCTION.....	53
5.2	SUMMARY OF FINDINGS.....	53
5.3	RECOMMENDATIONS .....	54
5.3.1	Stakeholder Engagement and Resistance Management.....	55
5.3.3	Human Capital Development and Integrity .....	56
5.3.4	Regulatory Structure and Coordination .....	56
5.3.5	Legal and Institutional Reform .....	57
5.4	CONCLUSION .....	58
BIBLIOGRAPHY .....		i



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The Capital Markets Authority Act CAP. 485A.

The Central Depositories Act, 2004.

The Co-operative Societies Act, CAP 490.

## Bills

The Financial Services Authority Bill, 2016.

The Financial Markets Conduct Bill, 2018.

## International instruments

The Basel Framework.

International Association of Deposit Insurers Core Principles for Effective Deposit Insurance Systems

Insurance Core Principles (ICPs) and The Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame.)

International Financial Reporting Standards (IFRS) Accounting Standards.

The IOPS Principles of Private Pension Supervision.

The IOSCO Objectives and Principles of Securities Regulation  
The OECD Core Principles of Private Pension Regulation.



## LIST OF ABBREVIATIONS & ACRONYMS

<i>APRA</i>	Australian Prudential Regulation Authority
<i>ASIC</i>	Australian Securities and Investments Commission
<i>CFSC</i>	Corporations and Financial Services Commission
<i>APRC</i>	Australian Prudential Regulation Commission
<i>NBFIs</i>	Non-Banking Financial Institutions
<i>CBK</i>	Central Bank of Kenya
<i>FinTech</i>	Financial Technology
<i>SACCOS</i>	Savings and Credit Co-operatives Societies
<i>SASRA</i>	Sacco Society Regulatory Authority
<i>RBA</i>	The Retirement Benefits Association of Kenya
<i>IRA</i>	Insurance Regulatory Authority
<i>CMA</i>	Capital Markets Authority
<i>UK</i>	United Kingdom
<i>GFC</i>	Global Financial Crisis
<i>FSA</i>	Financial Services Authority
<i>FCA</i>	Financial Conduct Authority
<i>PRA</i>	Prudential Regulatory Authority
<i>BCBS</i>	Basel Committee on Banking Supervision
<i>ICPs</i>	Insurance Core Principles
<i>ComFrame</i>	The Common Framework for the Supervision of Internationally Active Insurance Groups
<i>IFRS</i>	International Financial Reporting Standards
<i>IADI</i>	International Association of Deposit Insurers
<i>IAIS</i>	International Association of Insurance Supervisors
<i>IASB</i>	International Accounting Standards Board
<i>IAASB</i>	International Auditing and Assurance Standards Board
<i>FinCoNet</i>	International Financial Consumer Protection Network
<i>IMF</i>	International Monetary Fund
<i>IOPS</i>	International Organisation of Pension Supervisors

## ABSTRACT

*This study investigated the inefficiencies of Kenya's fragmented sectoral financial regulatory system and its vulnerability to systemic collapse, hypothesizing that adopting the Twin-Peaks model, which features two specialized regulators, could enhance stability and consumer protection. The sectoral model, where regulators oversee specific institutions regardless of industry, suffers from overlap and confusion, undermining its effectiveness amid potential economic crises. The research explored whether the Twin-Peaks model could address these flaws by examining its application elsewhere. Key research questions included: how does Kenya's sectoral model impact financial stability; what benefits has the Twin-Peaks model delivered in other jurisdictions with a similar financial sector history; and is transitioning to this model feasible for Kenya? Data was collected by applying the doctrinal legal research method in the performance of a comparative analysis; reviewing the Twin-Peaks model's implementation in a similar jurisdiction, alongside Kenya's financial performance metrics and regulatory reports. Findings revealed that the sectoral model's inefficiencies heighten risks of instability, while the Twin-Peaks model, with its streamlined dual-regulator structure, fosters transparency, competition, and resilience, as evidenced in the selected jurisdiction. The study recommends Kenya adopt the Twin-Peaks model to eliminate regulatory overlap, strengthen oversight, and safeguard against economic shocks. A phased transition, supported by stakeholder collaboration and capacity building, is advised to ensure successful implementation.*

# CHAPTER ONE: INTRODUCTION

## 1.1 BACKGROUND.

### 1.1.1 Introduction of The Concept of The Twin-Peaks Model

Financial regulation is the application of fiscal policies within the financial sector, through regulators and laws with the goal of ensuring the optimal functioning of the system<sup>1</sup>. The concept of the Twin-Peaks regulatory model (Twin-Peaks model) is based on the idea that financial regulation can be more effective when it is divided into separate prudential regulation and market conduct regulation functions in order to check systemic risks arising from adverse economic conditions and information asymmetry between the stakeholders and regulators<sup>2</sup>. Financial systems cannot operate effectively in the absence of credit, but the existence of credit recursively indicates leverage, and leverage means there's a risk of failure, which sometimes triggers a chain reaction within the whole financial sector; this is systemic risk. In these conditions, expectations can change quickly, leading to swings in asset prices, which in turn may be worsened by the possibility of crowd behaviour.

The Twin-Peaks model was first introduced by economist Michael Taylor<sup>3</sup>, who proposed that in the instance of financial services regulation, it should be done with the goals of protecting the stability and integrity of the financial system (systemic protection) and to ensure that the interests of individual depositors, investors and policy-holders are protected<sup>4</sup> (consumer protection).

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<sup>1</sup> Armour J, 'The Goals and Strategies of Financial Regulation', in Armour J, Awrey D and others, *Principles of Financial Regulation* Oxford Academic, London, 2016, 51.

<sup>2</sup> Taylor M, 'The Search for a New Regulatory Paradigm,' 49(3) *Mercer Law Review*, 1998, 8.

<sup>3</sup>Taylor M, "'Twin-Peaks": A Regulatory Structure for the New Century,' paper presented at the Centre for the Study of Financial Innovation in London, 20 December 1995, 1-18.

<sup>4</sup> Taylor M, 'Twin-Peaks": A Regulatory Structure for the New Century,' 1-18.

It was first implemented in Australia in the 1990s by the Australian government to reform its financial regulatory framework<sup>5</sup> following a series of financial crises<sup>6</sup>. The Australian Prudential Regulation Authority (APRA) is charged with the prudential regulation of banks, insurance companies and superannuation funds (pension funds), while the Australian Securities and Investments Commission (ASIC) is responsible for conduct regulation, regulating securities and financial markets as well as providing consumer protection. The model was later adopted by other countries such as The Netherlands<sup>7</sup>, New Zealand<sup>8</sup>, Belgium<sup>9</sup>, The United Kingdom<sup>10</sup> (UK) and South Africa<sup>11</sup> in that order.

In the Twin-Peaks model, one peak is responsible for prudential regulation, which focuses on ensuring the safety and soundness of financial institutions. It ensures compliance with various requirements such as capital adequacy, risk management and liquidity in order to prevent financial institutions from conducting themselves in a manner that leverages the stability of the financial system in favour of profit-maximization. On the other hand, the other peak is responsible for monitoring market conduct of firms, which aims to protect consumers and promote market integrity. This includes issues related to market manipulation, consumer protection and the fair treatment of customers<sup>12</sup>.

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<sup>5</sup> The Wallis Inquiry recommended the establishment of the Corporations and Financial Services Commission (CFSC) and the creation of the Australian Prudential Regulation Commission (APRC).

<sup>6</sup> The system was introduced in 1998 by the Howard government in response to the Financial System Inquiry Final Report (“Wallis Report”). Fin. Sys. Inquiry, Financial System Inquiry Final Report (2014) [hereinafter Wallis Report]

<sup>7</sup> Kremers J and Schoenmaker D, ‘Twin-Peaks: Experiences in the Netherlands,’ LSE Financial Markets Group, Special Paper 196, 2010, 1 -< <https://www.fmg.ac.uk/sites/default/files/2020-10/SP196.pdf>>- on 27 March 2024.

<sup>8</sup> Dervan H and Jensen S, ‘Twin-Peaks Financial Regulation in New Zealand,’ in Godwin A and Shmulow A, *Twin-Peaks Financial Regulation in New Zealand*, Cambridge University Press, 2018, 93.

<sup>9</sup> Godwin A, ‘A Jurisdictional Comparison of the Twin-Peaks Model of Financial Regulation,’ 18(2) *Journal of Banking Regulation*, 2017, 110.

<sup>10</sup> Godwin A, ‘A Jurisdictional Comparison of the Twin-Peaks Model of Financial Regulation,’ 104.

<sup>11</sup> In December 2014, the National Treasury published ‘Treating Customers Fairly in the Financial Sector: A Draft Market Conduct Policy Framework for South Africa’. This document outlines the implementation of the market conduct framework.

<sup>12</sup> De Jager, ‘The South African Reserve Bank: Blowing winds of change (Part 2),’ 2013 SA Merc LJ 492 508.

### 1.1.2 Historical Background and Development of Kenya's Financial Regulatory System

The subsequent growth of Kenya's financial system was shaped by various factors such as the commercial banking efforts between East Africa and India in the 19<sup>th</sup> Century<sup>13</sup>, the rise of non-banking financial institutions (NBFIs) in the 1940's<sup>14</sup>, rapid economic growth and development and social and political influences. Kenya's attainment of independence in 1963 saw the establishment of several locally owned banks, beginning with the Central Bank of Kenya (CBK) as the primary regulator<sup>15</sup> to provide a revitalised regulatory framework for the financial sector, the Co-operative Bank of Kenya and the Bank of Kenya<sup>16</sup>. This intemperate boom was the result of the concerted efforts by the independence government to promote indigenous entrepreneurship and expand access to financial services for all citizens. Also, between 1970-1986, the number of non-banking financial institutions rapidly increased thus providing more competition to the commercial banks by offering more competitive interest rates<sup>17</sup>.

In the subsequent decades, Kenya embarked on a path of economic liberalisation and structural reforms<sup>18</sup>. A gradual shift of dominance from the state-owned banks to private commercial banks occurred in the 1990s, which saw the introduction of policies aimed at deregulating the financial sector, liberalising interest rates which would ultimately foster competition among the market players. This period witnessed the emergence of local banks alongside foreign-owned

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<sup>13</sup> Frediani, L. "The Liquidity Policy of Deposit Banks in Kenya", in *The Credit Markets of Africa*, Dell'Amore, G. Milan, 1975.

<sup>14</sup> The private NBFIs: Diamond Jubilee Investment Trust, Credit Finance Corporation and National Industrial Credit were the only NBFIs in the financial sector at this time. In addition to this, there were two private housing finance companies: Savings and Loans established in 1949 and East African Building Society established in 1959 (Central Bank of Kenya, 1972, 1986). Though it has not been possible to find the exact figures for the asset bases of these financial companies at independence, it would be reasonable to assume that they were very small compared to the banks. These NBFIs were restricted from raising deposits and were also single branch institutions.

<sup>15</sup> *The Central Bank of Kenya Act of 1966*.

<sup>16</sup> O'Connor A, 'The Economy of Kenya: the Kenyatta Era. By Arthur Hazlewood' 51(1), *Africa*, 1981, 543-544.

<sup>17</sup> Ngugi R and Kabubo J 'Financial Sector Reform and Interest Rate Liberalization: The Kenyan Experience' African

Economic Research Consortium, Research Paper 72, 1998 .

<sup>18</sup> Upandayaya R and Johnson S, 'Transformation of Kenya's Banking Sector 2000-2012' in FSD Kenya, Kenya's Financial Transformation in the 21st Century, FSD Kenya, 2012, 40.

institutions, signalling a shift towards a more diversified and competitive banking landscape. The onset of the 21<sup>st</sup> Century saw Kenya's financial sector continued to evolve, propelled by technological advancements and innovations in both the banking and non-banking financial institutions. Following the acceptance and broadening of the use of the internet world-wide, Financial Technology (FinTech) was born. The mobile money services known commercially as M-Pesa was born in 2007 and it revolutionized access to financial services for millions of Kenyans, particularly those in underserved rural areas. This technological leap fostered financial inclusion and also improved the economic landscape. In the East African economic landscape today, Kenya has set an example as having a robust financial regulatory framework, diverse financial institutions as well as a culture of innovation and entrepreneurship<sup>19</sup>.

### **1.1.3 Importance of Financial Services in Kenya and The Current Financial Regulatory Framework**

Banks effectively mobilise money from savers to borrowers<sup>20</sup>. Non-banking financial institutions offer specialist financial services that are designed to unbundle the services offered by banks such as the pooling of risks for insurance companies and alternative saving options<sup>21</sup>. These financial services contribute to increased economic efficiency. In Kenya, the prevailing regulatory framework follows the sectoral model of financial regulation,<sup>22</sup> also known as the institutional model. This model directs its attention to the specific form and structure of the legal entity under regulation,<sup>23</sup> such as commercial banks, and establishes distinct, independent regulatory bodies for each type of institution<sup>24</sup>; in other words, financial regulation is based on

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<sup>19</sup> Nyasha S and Odhiambo N, 'Banking Sector Reforms in Kenya: Progress and Challenges' 10(1) *Corporate Ownership & Control*, 2010, 88.

<sup>20</sup> Schwert M, 'Bank Capital and Lending Relationships', 73(2), *The Journal of Finance*, 2018, 788.

<sup>21</sup> Jeffrey C, and Pomerleano M, 'Development and Regulation of Non-Bank Financial Institutions,' *World Bank Publications*, 2002, 12.

<sup>22</sup> Gakeri J, 'Financial Services Regulatory Modernization in East Africa: The search for a new paradigm for Kenya', 1(16), *International Journal of Humanities and Social Science*, 2011, 162 -167.

<sup>23</sup> Schmulow A, 'The Four Methods of Financial System Regulation: An International Comparative Survey' University of the Witwatersrand - School of Law Research Paper, 2017, 152 -<  
<https://ssrn.com/abstract=3082092>>- on 21 September 2024.

<sup>24</sup> Retirement Benefits Authority, *Case for Consolidated Financial Sector Regulation in Kenya*, 2008, 4.

the type of financial institution. In adherence to this model, the relevant regulator oversees all operations conducted by the relevant institutions falling under its jurisdiction, regardless of the market or industry in which the activities occur. The compartmentalization of regulatory oversight being based on the type of financial institution creates ‘sectoral silos,’ where each sector operates independently with its own regulatory body and rules.

The Constitution of Kenya (2010) has established the CBK as the chief regulator of banks and other related financial institutions<sup>25</sup>. Statutory regulation is also done by the Banking Act.<sup>26</sup> Prudential and risk management guidelines and regulations have been published<sup>27</sup> in order to make the banking sector more resilient to systemic shock that may arise out of a volatile and inefficient financial system<sup>28</sup>. Apart from the Banking Act, other regulatory mechanisms exist which are responsible for every individual financial sector. Each subsector has its own regulator based on the services it offers or the role it serves in the overall financial sector. Savings and Credit Co-operatives Societies<sup>29</sup> (SACCOS), banking services, pension plans, insurance and securities markets are all respectively governed under the Sacco Society Regulatory Authority<sup>30</sup> (SASRA), The CBK, The Retirement Benefits Authority of Kenya<sup>31</sup> (RBA) the Insurance Regulatory Authority<sup>32</sup> (IRA), the Capital Markets Authority<sup>33</sup> (CMA) and so forth.

#### **1.1.4 Pending Shift in Financial Regulatory Systems**

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<sup>25</sup> Article 231, *Constitution of Kenya* (2010).

<sup>26</sup> Section 33(4), *Banking Act* (Act No.9 of 1989)

<sup>27</sup> The Central Bank of Kenya Prudential Guidelines, 2013 and the Central Bank of Kenya Guidance on Climate-Related Risk Management, 2021.

<sup>28</sup> Brownbridge M and Kirkpatrick C, “Financial Regulation in Developing Countries”, 37(1), *Journal of Development Studies*, 2000, 1 -24.

<sup>29</sup> Governed by *The Co-operative Societies Act*, CAP 490.

<sup>30</sup>The authority is established under the *Sacco Societies Act* (Act No. 4 of 2008) and is mandated with the responsibility to license SACCOS to undertake Deposit Taking business and to supervise and regulate SACCO Societies.

<sup>31</sup> Established under part ii of the *Retirement Benefits Act* (Act No. 3 of 1997)

<sup>32</sup> Established under part ii of the *Insurance Act*.

<sup>33</sup> *The Capital Markets Authority Act* CAP 485A and *The Central Depositories Act*, 2004.

The Kenyan national treasury has recently proposed a shift in systems to the Twin-Peaks model. This is proposed to be done through the Financial Services Authority Bill (2016) and the Financial Markets Conduct Bill (2018) by establishing the Financial Services Authority<sup>34</sup> for prudential regulation and Financial Markets Conduct Authority<sup>35</sup> for consumer protection and market conduct regulation. The Bills are yet to be enacted. This could potentially solve the legal uncertainty plaguing Kenya's financial regulatory system that was created by the *status quo*, that is, the sectoral division of regulatory functions among the various authorities in regulation. Legal uncertainty occurs when the applicable law in a jurisdiction or field is unclear, which can undermine the rule of law as well as the law's ability to achieve its goals<sup>36</sup>.

The legal uncertainty herein is a by-product of the sectoral fragmentation (that lacks a unified approach to cross-sectoral risks or financial innovation), which has led to financial institutions, investors and consumers being unable to clearly identify their legal obligations, protections or the applicable regulatory authority.

## **1.2 PROBLEM STATEMENT.**

An effective financial regulatory model should ensure stability, fairness, efficiency, and innovation while safeguarding consumers and minimizing systemic risks. Ideally, regulation should transcend institutional boundaries, focusing on objectives like consumer protection and market integrity. The Twin-Peaks model exemplifies this by consolidating oversight into two specialized regulators, reducing sectoral silos, legal uncertainties, and inconsistent enforcement. This streamlined approach fosters a resilient, transparent financial system capable of supporting diverse services and adapting to emerging trends like fintech, all while maintaining price stability and equitable taxation.

In contrast, Kenya's current sectoral regulatory model fragments oversight across multiple regulators, each governing specific institutions irrespective of industry. This creates inconsistent legal and regulatory standards, with similar financial products facing different rules based on

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<sup>34</sup> Part II, *The Financial Services Authority Bill*, 2016.

<sup>35</sup> Part II, *The Financial Markets Conduct Bill*, 2018.

<sup>36</sup> Kerhuel A and Raynouard A, 'Measuring the Law: Legal Certainty as a Watermark,' 8(4), *International Journal of Disclosure and Governance*, 2010, 364.

the provider. Regulatory overlap and gaps persist, leading to confusion, inefficiencies, and heightened systemic risks, especially in a crisis. Left unchanged, this fragmentation risks regulatory arbitrage, where firms exploit gaps, amplifying vulnerabilities in unregulated areas and potentially triggering disputes or economic instability. This study investigates whether transitioning to the Twin-Peaks model could feasibly resolve these inconsistencies, strengthen Kenya's financial system, and mitigate the looming threats posed by its current regulatory framework.

### **1.3 RESEARCH OBJECTIVES.**

1. How do the Institutional Theory and Economic Theory of Regulation identify and explain the risks and challenges inherent in the sectoral model of financial regulation?
2. To analyse the legal and regulatory challenges associated with the sectoral regulatory model in Kenya's financial sector.
3. To benchmark the implementation of the Twin-Peaks model in Australia and perform a comparative analysis between Australia's and Kenya's financial regulatory models.
4. To recommend policy measures that can be implemented to address the challenges that may arise during the implementation of the twin peak model in the Kenyan financial sector.

### **1.4 RESEARCH QUESTIONS.**

1. How do the Institutional Theory and Economic Theory of Regulation identify and explain the risks and challenges inherent in the sectoral model of financial regulation?
2. What are the key challenges posed by the sectoral regulatory model in Kenya's financial sector?
3. How has the Twin-Peaks model been implemented in Australia, and which lessons can Kenya learn from the transition?
4. Which policy measures can be implemented to address the challenges that may arise in implementing the Twin-Peaks model in Kenya's financial sector?

## **1.5 HYPOTHESIS.**

The implementation of the Twin-Peaks model in the Kenyan financial sector can feasibly address the inconsistent legal standards and regulatory challenges and can potentially improve financial stability and consumer protection.

## **1.6 JUSTIFICATION.**

The proposed study would be useful to government institutions, regulators, financial institutions, legal professionals and academics. The National Treasury and Parliament, being the key institutions responsible for developing and enacting financial regulations, would benefit from the insights provided into the feasibility, advantages and potential challenges of adopting the Twin-Peaks model in Kenya. The Central Bank of Kenya (as the primary regulator under the current sectoral model) could use the study to evaluate the potential impact of the Twin-Peaks model on its regulatory responsibilities and decision-making processes. Entities such as the Capital Markets Authority (CMA), Insurance Regulatory Authority (IRA), Retirement Benefits Authority (RBA) and Sacco Societies Regulatory Authority (SASRA) would benefit from understanding how the Twin-Peaks model can address challenges related to jurisdictional overlaps and inconsistent regulatory standards.

Banks, insurance companies, fintech firms and other financial service providers would gain clarity on how the Twin-Peaks model might affect their compliance obligations, risk management practices and interaction with regulators. Advocates who specialise in financial regulation would find the study useful for advising clients on the evolving regulatory landscape and preparing for potential legal reforms. Also, the study's focus on reducing legal uncertainty and addressing regulatory conflicts would be valuable for legal professionals in dealing with financial institutions. The study would contribute to the broader body of knowledge on financial regulation, particularly in an emerging economy such as Kenya. This would benefit scholars and academics alike in understanding financial regulatory models.

## **1.7 LITERATURE REVIEW.**

The financial regulatory environment in Kenya has undergone significant scrutiny in recent years, driven by the need to address systemic risks, enhance consumer protection and adapt to

rapid innovations in the financial sector, such as fintech and mobile money. Scholars and analysts have increasingly questioned the effectiveness of Kenya's current regulatory framework, which combines elements of institutional and functional models, highlighting its struggles with regulatory overlaps, gaps and an inability to keep pace with emerging market dynamics. This has sparked a broader debate about the suitability of alternative regulatory models, such as the Twin-Peaks model, successfully implemented in jurisdictions like Australia and South Africa, and the unified model, which consolidates oversight under a single regulator. This literature review explores these challenges and compares Kenya's regulatory landscape with international experiences, while also examining the historical context that has shaped its financial oversight. By synthesising key analyses, this section sets the stage for understanding the complexities of Kenya's financial regulation and the potential pathways for reform.

### **1.7.1 On the Challenges Present in The Current Prevailing Financial Regulatory Environment in Kenya.**

Ndichu Lilian analyses the effectiveness of the prevailing regulatory framework in the financial services sector in Kenya and its inherent challenges.<sup>37</sup> Using the findings as metrics of evaluation, she compares Kenya to other States and their financial regulatory models.<sup>38</sup> The author observed that the Twin-Peaks model, as applied in the UK and South Africa, has proven to be more efficient in managing systemic risks and ensuring financial stability. By separating prudential regulation and business conduct, the model allows regulators to focus on different aspects of financial market oversight, making it easier to detect and mitigate risks early.<sup>39</sup> The model was found to be especially effective in the UK since its adoption after the global financial crisis, where no significant systemic risks have emerged.<sup>40</sup> The author, however, ultimately

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<sup>37</sup> Ndichu L, 'Evaluating the case for a unified model of regulation in the financial services sector in Kenya', unpublished LLM Thesis, Strathmore University, Nairobi, 7.

<sup>38</sup> Ndichu L, 'Evaluating the Case for a Unified Model of Regulation in the Financial Services Sector in Kenya', 65.

<sup>39</sup> Ndichu L, 'Evaluating the Case for a Unified Model of Regulation in the Financial Services Sector in Kenya', 66.

<sup>40</sup> Ndichu L, 'Evaluating the Case for a Unified Model of Regulation in the Financial Services Sector in Kenya', 66.

favoured the unified model of financial regulation (consisting of a single regulator for the whole market) as a viable replacement to the current sectoral regulatory model.

Kenya currently applies a mix of the institutional and functional models of regulation, which have several weaknesses, such as regulatory overlaps and gaps. These issues are particularly evident in emerging sectors like fintech and online lending services, where regulatory arbitrage has occurred due to the inability of the current model to adapt to rapid innovation. Lemperre Solomon conducts a critique of the current regime in consumer protection<sup>41</sup>. He posits that the sectoral system of financial regulation in Kenya is too ineffective to guarantee consumer protection because of inherent inadequacies that adversely affect consumer protection. To this end, he notes that the Twin-Peaks model is a better suit because of the balance it offers between consumer protection and financial stability.

Gakeri Jacob examines regulation in the financial services sector, categorising it into three key types and discussing the distinct models employed by various jurisdictions<sup>42</sup>. He contends that countries possessing a substantial financial services sector tend to utilize either the functional or institutional model, the unified model, or the Twin-Peaks model. Despite its prevalence, the unified model has not effectively dealt with the financial crisis, while the Twin-Peaks model has been adopted by various nations after the Global Financial Crisis (GFC), such as the UK and Australia.

Gakeri maintains that most jurisdictions that have adopted the unified model have been influenced by market developments, like heightened market conglomerates. Additionally, he details the drawbacks of Kenya's existing functional regulatory framework, which include regulatory gaps and inconsistent rules. In his conclusion, he argues that Kenya may not be ready to adopt the unified regulation model, given the limited connections between different sub-sectors of the financial market. However, this conclusion may not be valid, as the study was

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<sup>41</sup> Lemperre S, 'Consumer Protection in the Kenyan Financial Sector: A Case for a Twin-Peaks Model of Financial Regulation,' unpublished LLM Thesis, University of Western Cape, Bellville, 85.

<sup>42</sup> Gakeri J, 'Financial Services Regulatory Modernization in East Africa: The search for a new paradigm for Kenya' 162 -167.

conducted nine years ago and does not account for current market developments in the financial services sector.

Ferrarini and Chiarella discuss the challenges faced by functional and institutional models in emerging markets in the Eurozone especially during the GFC, which parallels Kenya's fintech and online lending challenges. . They contend that the lack of coordination and cooperation among national regulatory authorities during the emergency situation further exacerbated the crisis.<sup>43</sup> Regulatory fragmentation, according to them, contributes to systemic risk, as national authorities often struggle to coordinate effectively during crises<sup>44</sup>.

### **1.7.2 On the Success of The Implementation of Alternative Regulatory Regimes in Another Jurisdiction Against its Historic Background.**

Rawlings Phillip delves into the history of financial regulation in the UK, elucidating how each regulatory regime was instituted to effect reforms after a financial crisis, strengthening the stability of financial institutions<sup>45</sup>. Following the banking crisis of 1973 to 1975, which witnessed the collapse of numerous small banks in the UK, the Bank of England, the sole regulator at the time, introduced internal changes that resulted in the creation of a Supervision Division<sup>46</sup>. The primary aim of this division was to enhance data collection. In 1984, the Johnson Matthey Bank collapsed, and an investigation into the cause revealed that the Bank of England did not act promptly as it should have, given that the Bank's collapse would have had an impact

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<sup>43</sup> Ferrarini G and Chiarella L, 'Common Banking Supervision in the Eurozone: Strengths and Weaknesses of the ECB Single Supervisory Mechanism,' *ECGI - Law Working Paper No. 223/2013*, 2013, 8 — [https://www.ecgi.global/sites/default/files/working\\_papers/documents/SSRN-id2309897.pdf](https://www.ecgi.global/sites/default/files/working_papers/documents/SSRN-id2309897.pdf) on 23 December 2024.

<sup>44</sup> Ferrarini G and Chiarella L, 'Common Banking Supervision in the Eurozone: Strengths and Weaknesses of the ECB Single Supervisory Mechanism,' 9.

<sup>45</sup> Rawlings P, Georgosouli A and Russo C, 'Regulation of financial services: Aims and methods' Queen Mary University of London, Centre for Commercial Law Studies, 2014, 11-14.

<sup>46</sup> Bank of England Quarterly Bulletin, *The Secondary Banking Crisis and the Bank of England's Support Operations*, June 1978, 230–239.

on the financial system<sup>47</sup>. Consequently, the Banking Act 1979 was amended by the Banking Act 1987.

Rawlings also emphasizes that in the late 1990s, there were doubts about the effectiveness of the existing regulatory structure and, specifically, the Bank of England's effectiveness. As a result, the Labour Government decided to make the Bank of England independent and responsible for overseeing monetary policy. Meanwhile, the regulatory functions of the Bank of England, insurance, and building societies were transferred to a single regulator, the Financial Services Authority (FSA) (UK). However, following the 2008 financial crisis, the Coalition government blamed the poor regulatory approach adopted by the FSA and abolished it in 2010. This gave rise to the Twin-Peaks regulatory model, where two financial regulators were introduced - the Financial Conduct Authority (FCA) responsible for market conduct and the Prudential Regulatory Authority (PRA) responsible for prudential regulation. The Bank of England maintained its supervisory role over banks. This study will be essential for a comparative analysis between Kenya's sectoral model approach and the approach adopted by other nations.

Godwin Andrew examines the regulatory reforms that were implemented in South Africa, resulting in the adoption of the Twin-Peaks regulatory model<sup>48</sup>. The reforms were initiated with the publication of a policy paper titled "A safer financial sector to serve South Africa better," which led to legislative amendments to the regulatory framework. The amendments introduced two regulators: the Prudential Authority and the Financial Sector Conduct Authority, established in January and October 2018, respectively. Godwin proceeds to outline the advantages and disadvantages of the Twin-Peaks model in South Africa, noting that it was a significant reform aimed at promoting financial stability.

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<sup>47</sup> Hall M, 'UK Banking Supervision and the Johnson Matthey Affair,' In Goodhart C (eds) *The Operation and Regulation of Financial Markets*, Palgrave Macmillan, London, 1987, 1–24.

<sup>48</sup> Godwin A, 'Introduction to special issue-The Twin-Peaks model of financial regulation and reform in South Africa' 11 *Law and Financial Markets Review*, (2017) 152-153.

Additionally, Godwin compares the establishment of the Twin-Peaks model in Australia to that of South Africa<sup>49</sup>, citing the emergence of product innovation and financial conglomerates as the driving factors. In Australia, the prudential regulator, the Australian Prudential Regulation Authority, operates independently from the Reserve Bank of Australia, which oversees monetary policy. In contrast, the South African Reserve Bank works closely with the prudential regulator. Godwin highlights that the Twin-Peaks model facilitates information sharing and coordination among regulators. This analysis will enable the assessment of the effectiveness of the Twin-Peaks model across various jurisdictions.

### **1.7.3 The Impact of Kenya's History of Financial Regulation.**

Francis Mwege argues that the CBK has adopted a consolidated supervisory approach which prioritises information sharing on the sectoral level<sup>50</sup>. institutional model of law is subject to regulatory demanding situations due to the unique regulatory regimes carried out to exclusive institutions. However, he neither demonstrates nor justify whether or not the unified model of law is most suitable for the economic offerings area in Kenya.

Mutuku Nzomo discusses the challenges posed by the fragmented regulatory framework currently implemented in Kenya and advocates for the adoption of a unified model of regulation<sup>51</sup>. He also examines the pros and cons of this model, while analysing the various regulatory models employed by other nations, such as Australia and the UK. Mutuku asserts that no single regulatory model is perfect, and that several factors, including historical circumstances and the current market climate, determine the most effective regulatory approach for a given jurisdiction. However, the study has limitations, as it fails to identify the reasons behind the push for a unified model of regulation in Kenya's financial sector, such as the emergence of business conglomerates and modern technological advancements.

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<sup>49</sup> Godwin A, 'Australia's Trek towards Twin-Peaks- Comparison with South Africa,' 11 Law and Financial Markets Review, (2017) 183-185.

<sup>50</sup> Mwege F, Financial Regulation in Kenya: Balancing Inclusive growth with financial stability', (2014) 1 working paper.

<sup>51</sup> Nzomo Mutuku, Case for Consolidated Financial Sector Regulation in Kenya (Retirement Benefits Authority 2008) available at -[https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1837354](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1837354)- on 11 July 2020.

Caprio and Honohan analyse the evolution of financial regulation in developing economies and point out the challenges facing such fragmented systems. They actively push for the consolidation of financial regulatory institutions' key functions.<sup>52</sup>

Beck and Fuchs identified some historical structural issues plaguing Kenya's financial system as government ownership of financial service providers like banks. They observed that state-owned banks generally underperform and have generally prevented, especially developing economies, from building market-based financial systems. The States with a higher share of government-owned banks have experienced lower GDP per capita growth and a corresponding poor-performing economic environment, especially where there are weak regulatory and supervisory institutions. The solution to such a situation is proposed as the privatisation of these institutions. However, the authors noted in many developing countries, particularly when assets are transferred to well-connected insiders or occur in environments lacking effective oversight by market participants and bank supervisors, can lead to compromised government policies, fraud, looting, and even banking crises. They ultimately offer insight into Kenya's historical financial regulation challenges, particularly the issues arising from a fragmented regulatory system.<sup>53</sup>

Rosa María Lastra examines the evolution of financial regulatory structures, emphasising how historical circumstances significantly influence the choice of regulatory models. She argues that financial systems often adapt regulatory frameworks in response to past crises, economic transitions or shifts in political landscapes, shaping the models they adopt. This discussion is particularly relevant to Kenya, where historical factors such as colonial legacies, post-independence economic policies, and the evolution of its financial sector have influenced the regulatory frameworks in place today. For instance, Kenya's reliance on a sectoral regulatory model stems from its historical economic structure, where distinct financial sectors were regulated separately.<sup>54</sup> As the financial services sector evolves with modern innovations like

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<sup>52</sup> Caprio G and Honohan P, *Finance for Growth: Policy Choices in a Volatile World*, Oxford University Press and World Bank Publications, Washington D.C, 2001, 78.

<sup>53</sup> Beck T and Fuchs M, 'Structural Issues in the Kenyan Financial System: Improving Competition and Access' World Bank Policy Research Working Paper 3363, 2004,

<sup>54</sup> Lastra R, *International Financial and Monetary Law*, 2<sup>nd</sup> ed, Oxford University Press, London, 85.

mobile banking and fintech, understanding these historical underpinnings will help assess the suitability of potential future regulatory models, such as the Twin-Peaks approach in this instance, for Kenya's current and probable future needs.

#### **1.7.4 The Gaps Existent in Current Literature That Are Filled by This Study**

First, the prevailing literature fails to consider a situation where the Twin-Peaks model is implemented in Kenya and the potential challenges it may face during the transitional period. This study does this, on top of examining the current inconsistent legal standards and regulatory challenges. While significant research exists on the twin-peaks regulatory model in developed economies like Australia and the UK, there's limited focus on its applicability to developing countries like Kenya. This study will examine how Kenya's unique historical, political and socio-economic background will affect the potential applicability of the Twin-peaks model.

Also, few studies examine how Kenya's unique financial innovations, such as mobile money and fintech, intersect with its fragmented regulatory framework. Additionally, little attention has been given to the Twin-Peak model's feasibility under the circumstances and the resultant potential impact within Kenya's socio-economic and institutional context. Ultimately, this study addresses these gaps by analysing Kenya's current regulatory framework and evaluating the proposed alternative model to enhance financial stability and inclusion.

#### **1.8 METHODOLOGY.**

This research study will employ the doctrinal legal research method. The primary objective of this method is to collect, arrange and describe the applicable law in the chosen field of study, while offering insights drawn from relevant, related principles, theories and rules. Subsequently, the method will proceed to discern and expound upon the relevant underlying system, describing the interconnectedness of each source of law with the theme under discussion. The doctrinal legal research methodology is effective in fields of law characterised predominantly by black letter law.<sup>55</sup>The study will engage in critical analysis of legal materials to substantiate a formed hypothesis.

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<sup>55</sup> Bhat P, 'Doctrinal Legal Research as a Means of Synthesizing Facts, Thoughts, and Legal Principles,' in Bhat P Idea and Methods of Legal Research, 3rd ed, Oxford Academic, 2020, 155.

The doctrinal legal research method relies on the ongoing continuity of law<sup>56</sup>. This continuity is partly ensured and supported by the enduring nature of the society subject to a particular legal system, as well as the legal order itself<sup>57</sup>. The doctrinal legal research method allows the study to focus specifically on legal rules found in primary sources such as statutes, regulations and case law, which are essential for assessing the compatibility of the Twin-Peaks model with Kenyan law. Analysis of the Australian financial sector would also best be done by the doctrinal legal research method, which is crucial for identifying any legal barriers, gaps or inconsistencies that may impact the implementation of the Twin-Peaks model.

Justification for Australia as an ideal comparative study candidate is hinged on it being one of the first countries to adopt the Twin Peaks model, which gives it a significant advantage as a case study. The Australian financial system has remained resilient over the past two decades, having surviving major financial disruptions such as the 2008 Global Financial Crisis with relatively less damage than countries with other regulatory models. This provides strong evidence for the effectiveness of the Twin-Peaks approach in promoting financial stability, which will be drawn later in this study from empirical research such as reviews conducted by the International Monetary Fund.

## **1.9 CHAPTER BREAKDOWN.**

The initial chapter of this study will be Chapter One. This chapter establishes the foundation for the subsequent chapters by presenting the background of the study, the problem statement, research objectives, research questions, the hypothesis, the study's justification, the theoretical frameworks, the literature review and the methodology.

Chapter Two will look at the theoretical framework forming the foundation of financial regulatory models, including the conceptual framework and the different forms of regulatory models generally adopted by countries.

Chapter Three will examine the financial regulatory system in Kenya and consequently assess the legal and regulatory challenges currently plaguing it.

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<sup>56</sup> Varuhas J, 'Mapping Doctrinal Methods' in Daly P and Tomlinson J (eds), *Researching Public Law in Common Law Systems*, Edward Elgar, 2023, 6.

<sup>57</sup> Raz J, *The Concept of a Legal System*, 2<sup>nd</sup> ed, Oxford University Press, New York, 1980, 187.

Chapter Four will review the implementation of the Twin-Peaks model in Australia and perform a comparative analysis between it and Kenya's Sectoral model in order to determine its overall success in prudential regulation and consumer protection.

Chapter five will be the final chapter and it will conclude this research. It will recommend policy measures that can be implemented to address the challenges associated with implementing the Twin-Peaks model in the Kenyan financial sector.



## **CHAPTER 2: THEORETICAL FOUNDATIONS OF FINANCIAL REGULATION: RISKS AND CHALLENGES IN THE SECTORAL MODEL.**

### **2.1 INTRODUCTION**

Financial regulatory models are essential for ensuring the stability, integrity, and efficiency of a country's economy. The interconnected and overlapping nature of modern financial sectors creates a complex regulatory landscape, demanding adaptive and efficient models to effectively serve the financial system. Different theoretical frameworks shed light on the principles and challenges underpinning these models, offering insights into their design and implementation. The Institutional Theory of Regulation posits that regulations are shaped not only by economic goals but also by broader social and political influences, while the Economic Theory of Regulation views regulators as rational actors striving to maximize social welfare by balancing costs, benefits, and unintended consequences, despite constraints like limited resources and imperfect information.

The objective of this chapter is to examine how the theoretical frameworks underpinning financial regulatory models highlight the risks and challenges associated with the sectoral regulatory model. This shall be achieved first through tracing the evolution of financial regulatory approaches to contextualize the sectoral model's development, before reviewing key principles such as institutional design and economic optimization from the two theories. Finally, the chapter will analyse how these frameworks expose specific vulnerabilities, such as regulatory fragmentation and systemic risk in the sectoral model, with a focus on Kenya's experience.

### **2.2 INSTITUTIONAL THEORY OF REGULATION**

According to the Institutional Theory of Regulation, the outcomes of regulation are not only determined by the formal rules and regulations issued by regulatory agencies, but also the larger institutional framework within which these organisations function. This theory highlights how many institutional elements, such as the way regulatory agencies are organised, how they interact with other governmental and non-governmental actors, and the norms, values and beliefs that are prevalent in society, all influence regulatory behaviour.

The foundations of the Institutional Theory of Regulation lie in the Neoclassical Theory of Economics; it identifies efficiency concerns as the main justification for economic regulation (formal rules and regulations.) However, the theory at its inception narrowly identified the triggers of market failure by inadequately mentioning the place of ethical considerations<sup>58</sup>. Adam Smith noted that while society could endure even if not in optimal conditions without acts of kindness, the widespread presence of injustice would inevitably lead to its complete destruction, in reference to equity<sup>59</sup>. Similarly, Alfred Marshall asserted that economic principles and arguments constitute only a portion of the materials used by conscience and common sense to address practical challenges and establish guiding principles for life. Ethical considerations are also integral to the economist's analysis, as the prevalent theoretical construct of an economic man, driven solely by self-interest and monetary gain, fails to accurately reflect human behaviour as it neglects the complexities of moral influences and selflessness<sup>60</sup>. Later renditions of the theory have grown and developed to include these synergistic aspects.

Proponents of the institutional theory essentially argue that institutions play a crucial role in shaping the behaviour of agents and stakeholders which in turn determines the effectiveness of regulatory interventions<sup>61</sup>. These institutions are dynamic because they are dependent on physical, psychological and social mechanisms of human behaviour<sup>62</sup> as well as habits. These social institutions include, but are not limited to, customs, ethics and values of individuals and laws<sup>63</sup>. Habits are recognised as being intertwined with institutions since they mould individual behaviour and attitudes in such a manner that fulfil a purpose<sup>64</sup>. On a related note, John Dewey stated that the essence of a habit is the formation of a tendency toward particular ways or patterns of reacting, as opposed to actions, unless those actions clearly represent a specific pattern of

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<sup>58</sup> Reynolds L, 'Foundations of an Institutional Theory of Regulation,' 15, *Journal of Economic Issues*, 1981, 654.

<sup>59</sup> Smith A, *The Theory of Moral Sentiments*, 6<sup>th</sup> ed, Metalibri, Brazil, 2006, 127.

<sup>60</sup> Marshall A, *Principles of Economics*, 4<sup>th</sup> ed, Macmillan, New York, 1898, viii.

<sup>61</sup> Adams J, 'Institutions and Economic Development: Structure, Process, and Incentive' in Tool M, *Institutional Economics: Theory, Method, Policy*, 1<sup>st</sup> ed, Springer Dordrecht, 2007, 245.

<sup>62</sup> Myrdal G, 'Institutional Economics,' 12(1), *Journal of Economic Issues*, 1978, 174.

<sup>63</sup> Ciriacy-Wantrup S, 'Resource Conservation: Economics and Policies,' 48(2), *American Political Science Review*, 1954, 598.

<sup>64</sup> Tool M, *The Discretionary Economy*, Goodyear Publishers, California, 1979, 74.

behaviour, particularly in special situations<sup>65</sup>. From the discussions, it is clear that institutions are heavily reliant on individualistic tendencies.

The Institutional Theory postulates that there are two sub-classifications of institutional regulation, that is, implicit and explicit regulation.

### **2.2.1 Implicit Regulation**

Implicit regulation refers to regulatory systems that operate based on informal norms, customs, traditions and ethical standards specific to a particular jurisdiction that are enforced through societal institutions, rather than explicit rules or laws. Acceptance of implicit regulation is reflected through habit. These implicit regulations are split into market and non-market regulations.

For market regulations, the market is viewed as the primary regulator of economic activity. Individuals and firms are guided by the market forces of supply and demand, competition, and profit motives. Compliance with market movements and rules is rewarded, while deviation may lead to losses. However, it is acknowledged that the efficiency of the market as a regulator depends on the proper functioning of specific institutions, including well-defined property rights, healthy market competition<sup>66</sup>, consumer sovereignty and motives of optimization of both consumers and producers. These are, in turn, complemented by non-market implicit regulations, which are institutions enforcing ethical standards and moral principles. Non-market regulations encompass various societal mechanisms such as customs, traditions, religion, education, propaganda, and public opinion<sup>67</sup>. These mechanisms shape individual behaviour by promoting generally accepted moral or ethical standards, which are subsequently rewarded through recognition, better societal standing, higher self-esteem and prestige, while violations are typically punished or frowned upon by society.

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<sup>65</sup> Dewey J, *Human Nature and Conduct*, 1<sup>st</sup> ed, Modern Library, New York, 1930, 40.

<sup>66</sup> Preamble, *The Competition Act*, (2010) contains provisions relating to the promotion and safeguard of competition in the Kenyan national economy as well as consumer protection from unfair and misleading market conduct.

<sup>67</sup> Smith A, *The Theory of Moral Sentiments*, 128.

According to Douglass North, one of the proponents of this theory, institutions are “the ‘rules of the game in society, or, more formally, are the humanly devised constraints that shape human interaction<sup>68</sup>.’” In the context of regulation, institutions shape the incentives and constraints facing firms, consumers as well as regulators, influencing their behaviour and the eventual outcomes of regulatory policies. Another proponent of the institutional theory of regulation is Elinor Ostrom. In her work on the governance of Common Pool Resources, Ostrom highlighted the importances of implicit regulatory structures such as property rights and community norms in managing resources sustainably and efficiently. She aptly demonstrated that effective regulation in a sector often involves a combination of implicit and explicit regulation of institutions in order to reflect the specific context and needs of stakeholders.

### **2.2.2 Explicit Regulation**

On the other hand, explicit regulation refers to the deliberate development and implementation of regulations by the government or specific groups with the intention of influencing economic activities. These regulations are intentionally selected and enforced through mechanisms such as coercion, indoctrination or statutory means. The process of selecting and implementing explicit regulations mostly involves the exercise of power by individuals or groups, typically within a political setting. Explicit regulations take various forms, including those created by governmental authorities as well as private organisations such as corporate entities, labour unions, trade associations, cartels and professional associations. Collusion to fix prices, allocate markets, limit entry and other forms of concerted action aimed at regulating economic activities are examples of explicit regulation. Monetary policies developed by Central Banks also qualify as a form of explicit regulation because they are drafted and implemented with the intention of influencing economic activities. These regulations can be classified based on their intended function, such as revenue-augmenting regulations or cost-augmenting regulations. Revenue-augmenting regulations are aimed at influencing the revenue or demand side of economic units subject to regulation, most of the time with the objective of redistributing wealth or income. On the other hand, cost-augmenting regulations directly impact the cost or supply side, potentially raising or stabilizing costs for the regulated entities. Explicit regulations may be imposed to

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<sup>68</sup> North D, *Institutions, Institutional Change and Economic Performance*, Cambridge University Press, St. Louis, 1990, 3.

improve efficiency or to adjust the distribution of benefits, costs or liability in accordance with the prevailing societal views of equity.

### **2.2.3 Criticisms of the Institutional Theory**

One criticism of the theory is that it focuses on the complex nature of regulatory decision-making without providing precise criteria for comprehending or forecasting regulatory outcomes, which tends to be unduly descriptive and predictive<sup>69</sup>. Furthermore, some academics contend that the theory favours implicit elements like norms and culture over the importance of power dynamics in political and industry institutions as well as economic incentives in determining regulatory behaviour.

There are arguments levelled that coordination issues between institutions inevitably arise from the institutional theory. Contracts are typically established among institutions to facilitate their day-to-day functioning. However, in practical terms, contracts cannot account for every potential occurrence. Because of this, regulatory contracts are inherently incomplete and inevitably give rise to the 'hold-up problem'<sup>70</sup>. Transactional problems will hinder regulatory activities within the market<sup>71</sup>. This suggests that costs related to market regulation will be relatively high in the event that the institutional framework is unable to facilitate efficient coordination<sup>72</sup>.

Finally, although the theory recognizes the idea of regulatory capture, it has drawn criticism for its imprecise formulation and scant empirical backing in specific situations.

### **2.2.4 Risks and Challenges of the Sectoral Model as Identified by The Institutional Theory**

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<sup>69</sup> Suddaby R, 'Challenges for Institutional Theory,' 19(1), *Journal of Management Inquiry*, 2010, 16.

<sup>70</sup> The hold-up problem refers to a scenario where two parties could achieve optimal efficiency through cooperation, but choose not to do so due to fears that cooperating might grant the other party greater bargaining leverage, thereby diminishing their own profits. (Schmitz P, 'The Hold-Up Problem and Incomplete Contracts: A Survey of Recent Topics in Contract Theory,' 53(1), *Bulletin of Economic Research*, 2001, 1–17.

<sup>71</sup> Williamson O, 'Transaction-Cost Economics: The Governance of Contractual Relations,' 22, *Journal of Law and Economics*, 1993, 233-261.

<sup>72</sup> Williamson O, 'Transaction Cost Economics: The Governance of Contractual Relations,' 22, *Journal of Law and Economics*, 1979, 3-61.

The institutional theory highlights the importance of aligning regulatory objectives with institutional capacities and incentives to achieve desired outcomes. Because financial markets are complex systems that are sometimes characterized by asymmetric information distribution, agency problems, externalities, *etc.*, they require robust regulatory frameworks to ensure stability and to protect the consumers. The institutional theory sheds light on the role of regulations and regulatory institutions in shaping market behaviour, protecting the consumers and mitigating systemic risks. Financial regulatory models must also take into account the institutional context in which they operate. These are the market forces, the cultural norms and traditions, the legal frameworks in place and the supervisory structures. It thus follows that the effectiveness of regulatory policies depends not only on their design, but also on their implementation and enforcement within the specific institutional settings elucidated.

The theory highlights the coordination issues that inevitably arise from a fragmented model. In it, where multiple regulators oversee distinct financial sectors, coordination problems are characterised as a natural extension. Each regulator operates within its own institutional silo, potentially leading to inconsistent rules, overlapping jurisdictions and/or gaps in oversight which is explicitly highlighted as a challenge in fragmented systems like Kenya's.

The discussion of implicit vs. explicit regulation and the need for alignment with institutional capacities suggests that misaligned frameworks can fail to address complex market needs. The sectoral model's fragmented nature in terms of oversight implies inconsistent standards across sectors e.g., banking vs. insurance, as each regulator operates under its own norms and priorities. This can confuse market participants, weaken consumer protection and exacerbate systemic risks when uniform responses are required.

The theory also emphasises the need for regulation to mitigate systemic risks and align with institutional contexts, insinuating that poorly coordinated systems may fail here. The sectoral model's fragmentation implicitly heightens systemic risk, as no single authority has a holistic view to address cross-sector spillovers such as in the instance where a banking crisis would affect insurance. This lack of integration could amplify vulnerabilities during economic shocks.

## 2.3 ECONOMIC THEORY OF REGULATION (R. POSNER)

Richard Posner's Economic Theory of Regulation is hinged on the belief that the emergence of regulation is a direct response of market failures which occur when the free market fails to allocate resources efficiently. The theory critically analyses the traditional models of regulation (Public Interest Theory and Capture Theory), where he argues that they are based on an 'idealised' model of government and market behaviour<sup>73</sup>. These traditional models, according to the theory, fail to account for the complex interactions between regulators and the regulated agencies as well as the limitations inherent in the regulated agencies. Posner premised that regulation is designed to maximize social welfare and that the regulators act as rational actors who seek to balance the costs and benefits of regulation<sup>74</sup>.

Also featuring prominently in the Economic Theory of Regulation is the concept of regulatory capture that draws prominently from Stigler's work, whereby regulated industries and other interested parties with a stake exert influence over regulatory agencies to formulate regulatory policies that shift overall benefits to themselves<sup>75</sup>. Stigler argued that regulatory agencies are susceptible to capture due to 'rational ignorance' by consumers (informational asymmetries), bureaucratic lobbying or the revolving-door policy<sup>76</sup>. As a result, regulatory decisions or policies may be skewed in favour of the regulated industry's interests at the expense of the consumers. Posner's framework looks into the incentives driving regulatory institutions (the desire to increase their regulatory power, prestige and budgets) as well as the regulated financial institutions (profit-maximization).

### 2.3.1 Criticisms of the Economic Theory of Regulation

Some scholars argue that the theory fails to account for the political and institutional constraints that regulators face, including interest groups pressure, unchecked bureaucratic inertia and

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<sup>73</sup> Posner R, *Theories of Economic Regulation*, 1<sup>st</sup> ed, Little Brown and Co., New York, 1973, 335-358.

<sup>74</sup> Posner R, 'Theories of Economic Regulation,' 5(2), *The Bell Journal of Economics and Management Science*, 1974, 340.

<sup>75</sup> Posner R, 'Theories of Economic Regulation,' 341.

<sup>76</sup> Stigler G, 'The Theory of Economic Regulation,' 5, *Bell Journal of Economics and Management Science*, 1971, 3-21.

political divisions<sup>77</sup>. Others have criticised it for its narrow focus on efficiency as well as its failure to consider other values such as fairness and distributive justice<sup>78</sup>.

### **2.3.2 Risks and Challenges of the Sectoral Model as Identified by The Economic Theory of Regulation**

The theory explicitly highlights regulatory capture, drawing from Stigler's work. In a sectoral model, where regulators oversee specific industries, the close relationship between each regulator and its sector increases the risk of capture. For instance, a banking regulator might prioritise bank profits over systemic stability, which is a challenge explicitly tied to fragmented oversight. By recognising the likelihood for regulatory capture, policymakers and regulators must take contingency measures to limit the influence of industry interests on their regulators and ensure that regulatory decisions are made with consumer interests in mind. There is a further need to design regulatory mechanisms that align the incentives of regulators with the objectives of financial regulation.

Closely tied to regulatory capture is Stigler's concept of 'rational ignorance by consumers' (informational asymmetries), which is noted as a factor enabling capture. In a sectoral system, consumers may lack awareness of regulatory discrepancies across sectors, leaving them vulnerable to exploitation. Each regulator's narrow focus exacerbates this, as no single authority ensures consistent consumer protection, an explicit risk when industries leverage this ignorance.

## **2.4 CONCLUSION**

This chapter explored how theoretical frameworks reveal the sectoral model's challenges, showing through Institutional Theory its coordination challenges, inconsistent standards from the fragmentation, vulnerability to systemic risks, and through Economic Theory its susceptibility to flawed decision-making, information asymmetry and regulatory capture.

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<sup>77</sup> Posner R, 'A Review of Steven Shavell's Foundations of Economic Analysis of Law,' 44(2), *Journal of Economic Literature*, 2006, 410.

<sup>78</sup> Cooter R, 'The Two Enterprises of Law and Economics: An Introduction to Its History and Philosophy' Berkley Law School, August 26 2015, -< <https://www.law.berkeley.edu/wp-content/uploads/2015/04/The-Two-Enterprises-of-Law-and-Economics.pdf>> on 10 April 2024.

The Institutional Theory of Regulation is instrumental in understanding how institutions shape regulatory outcomes and how social norms influence them. However, it fails to account for the coordination problems that arise from the theory. On the other hand, the Economic Theory of Regulation illuminates the flaws present in the traditional understanding of regulation by demystifying the long-held assumption that regulators have perfect knowledge of the market and can, therefore, make decisions that are in the best interest of consumers. Instead, it sheds reality on the fact that regulation may be shaped by various factors, including public opinion and the personal interests of regulators. Nonetheless, however, it discounts political and institutional constraints experienced by regulators.



## **CHAPTER 3: THE CURRENT LEGAL AND REGULATORY FRAMEWORK OF THE FINANCIAL SERVICES SECTOR IN KENYA AND ITS CHALLENGES.**

### **3.1 INTRODUCTION**

The financial services sector in Kenya operates under a sectoral regulatory model, characterized by distinct, independent regulatory bodies overseeing specific types of institutions, regardless of the markets or industries they serve. Anchored in the Constitution of Kenya, this framework empowers statutory authorities to establish regulators through Acts of Parliament, such as the Banking Act, Capital Markets Act, Insurance Act, Retirement Benefits Act, and Co-operative Societies Act. These laws define the powers and responsibilities of bodies like the Central Bank of Kenya (CBK), the primary regulator for banking stability, alongside other authorities including the Capital Markets Authority (CMA), Insurance Regulatory Authority (IRA), Retirement Benefits Authority (RBA), and SACCOs Society Regulatory Authority (SASRA). Together, they ensure compliance, transparency, and consumer protection across the financial landscape.

The objective of this chapter is to examine how the theoretical frameworks underpinning financial regulatory models highlight the risks and challenges associated with Kenya's sectoral regulatory model. This will be achieved first by tracing the historical and legal development of Kenya's sectoral framework to understand its structural foundations, before reviewing theoretical principles such as institutional influences and economic efficiency from the Institutional and Economic Theories of Regulation. Finally, the chapter will look at how these frameworks reveal vulnerabilities like regulatory gaps, overlaps, and funding constraints, assessing their implications for systemic stability and consumer welfare in Kenya's financial sector.

### **3.2 CURRENT LEGAL AND REGULATORY FRAMEWORK GOVERNING THE FINANCIAL SECTOR IN KENYA**

Gakeri Jacob asserted that Kenya's financial regulatory model is a heavily politicised regulatory framework<sup>79</sup> that has evolved incrementally rather than through deliberate planning, resulting

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<sup>79</sup>Owens J, Government Failure in Sub-Saharan Africa: The International Community's Options, 43 VA. J. INT'L L. 103 (2003)

in ‘a fragmented structure characterised by piece-meal reforms.’ He justifies this position by observing that apart from the long-established Central Bank of Kenya, which has played a central role in shaping the country's monetary policies since 1966, the establishment of other regulatory bodies has been represented by a lack of organisation and coherence. For instance, the insurance industry, which was more developed than the securities markets, operated without any regulatory oversight until July 1987 when the Insurance Act, Cap. 487 was enacted. Even then, it fell under the supervision of the Commissioner of Insurance within the Ministry of Finance. It wasn't until 2006 that the industry gained its own regulatory authority. Similarly, the Capital Markets Authority was only established in 1989, followed by the establishment of the Retirement Benefits Authority in 1997. Furthermore, although savings and credit co-operative societies have long been integral to both rural and urban communities, it wasn't until 2009 that the Sacco Societies Regulatory Authority was established<sup>80</sup>. Following this realisation, the following sub-chapters will look at the current legal and regulatory frameworks of the financial sector in Kenya respectively.

### **3.2.1 Legal Framework Governing the Financial Sector in Kenya**

The *grundnorm* of Kenya is The Constitution. From it, all laws of the land draw their authority. This includes the laws governing the financial sector in Kenya. Article 43 of The Constitution ensures that every citizen has economic and social rights<sup>81</sup>. Article 46 of the same enshrines consumer rights, and provides for the formation of the Consumer Protection Act which protects consumers from unfair/unethical business practices<sup>82</sup>. The Constitution also establishes the Central Bank of Kenya in Article 231 an independent regulatory body<sup>83</sup>. Along with its establishment is the provision for an Act of parliament that gives the Central Bank its mandate.

The Banking Act CAP 488<sup>84</sup> is the statutory instrument legally responsible for all the banks in the country. The Act provides for the power of the Central Bank to issue licenses to banking

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<sup>80</sup> Gakeri J, ‘Financial Services Regulatory Modernization in East Africa: The Search for a new paradigm for Kenya,’ International Journal of Humanities and Social Science Vol. 1 No. 16; November 2011, 166.

<sup>81</sup> Article 43, *Constitution of Kenya*, 2010.

<sup>82</sup> Article 46, *Constitution of Kenya*, 2010.

<sup>83</sup> Article 231, *Constitution of Kenya*, 2010.

<sup>84</sup> The *Banking Act*, CAP 488.

institutions<sup>85</sup>, provided they meet the minimum requirements. The Kenya Deposit Insurance Act 2012 establishes the Kenya Deposit Insurance Corporation<sup>86</sup> (KIDC) to provide a deposit insurance scheme for customers of banks and financial institutions in Kenya in order to protect them in the event that a bank becomes insolvent. The Central Depositories Act facilitates the establishment of central depositories and the corresponding legal regulation of their activities<sup>87</sup>. The Competition Act No. 12 of 2010<sup>88</sup> repealed the Restrictive Trade Practices, Monopolies and Price Control Act (Chapter 504 of the Laws of Kenya). The Competition Act contains provisions relating to the promotion and safeguard of competition in the national economy as well as consumer protection from unfair and misleading market conduct<sup>89</sup>. Cartel practices are prohibited under section 21 of the Act<sup>90</sup>. The Act establishes the Competition Authority of Kenya<sup>91</sup> (CAK), whose main functions include applying, promoting and enforcing compliance with the Act. The Act also establishes the Competition Tribunal<sup>92</sup> (the Tribunal) which hears appeals from decisions of the Authority.

The Capital Markets Authority Act Chapter 485A contains the substantive laws governing the operations of the capital markets in Kenya. The Act establishes a Capital Markets Authority for the purpose of promoting and facilitating the development of an orderly, fair and efficient capital market in Kenya and for connected purposes<sup>93</sup>. The Central Depositories Act 2004 is the central provider of the framework for clearing and settlement services in the Kenyan capital markets. Central depositories are also approved and licensed pursuant to the Act. The Act also makes provisions for opening and maintaining securities accounts (CDS accounts), immobilization of shares (conversion from share certificates to electronic form), dematerialization, records keeping and confidentiality.

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<sup>85</sup> Section 3(b), *The Banking Act*, (2012).

<sup>86</sup> Section 4, *The Kenya Deposit Insurance Act*, No. 10 of 2012.

<sup>87</sup> Part II, *Central Depositories Act*, 2000.

<sup>88</sup> *The Competition Act* (No. 12 of 2010) amended as at 2019.

<sup>89</sup> Preamble, *The Competition Act*, 2010.

<sup>90</sup> Section 21, *The Competition Act* 2010.

<sup>91</sup> Section 7, *The Competition Act* 2010.

<sup>92</sup> Section 71, *The Competition Act*, 2010.

<sup>93</sup> Section 5, *The Capital Markets Act*, CAP 485A.

The Insurance Act<sup>94</sup> legally oversees insurance firms. The Act establishes the Insurance Regulatory Authority as a body corporate in charge of, among other things, supervisory and regulatory oversight of insurance and reinsurance firms<sup>95</sup>. The Retirement Benefits Act<sup>96</sup> regulates and supervises retirement benefits schemes. It also establishes the Retirements Benefits Authority as a supervisory body that oversees the management and investment of the large pools of funds held by retirement schemes to maximize returns for all parties<sup>97</sup>. The Co-operative Societies Act<sup>98</sup> contains provisions relating to the formation and registration of cooperative societies and societies formed at the national level by the cooperative movement in Kenya to promote cooperative development. It defines functions, powers, rights and obligations and the internal organisation of registered societies.

The Sacco Societies Act<sup>99</sup> is the primary law governing the licensing, authorization, supervision and regulation of SACCO societies in Kenya<sup>100</sup>. The Act also establishes the SACCO Societies Regulatory Authority<sup>101</sup> which is in charge of overseeing and regulating SACCO societies. The Microfinance Act of 2006<sup>102</sup> regulates microfinance business. In other words, the business of receiving money, by way of deposits or interest on deposits, which is lent to others or used to finance the business or providing loans or other facilities to micro or small enterprises and low-income households.

### **3.2.2 Regulatory Framework Governing the Financial Sector in Kenya**

Prudential guidelines are issued by CBK as regulatory tools aimed at safeguarding the consumers against potential macroeconomic risks or systemic shocks that can arise due to un-

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<sup>94</sup> *Insurance Act* CAP 487.

<sup>95</sup> Section 3, *Insurance Act*.

<sup>96</sup> *The Retirement Benefits Act*, No. 3 of 1997.

<sup>97</sup> Section 3, *The Retirement Benefits Act* No. 3 of 1997.

<sup>98</sup> *The Co-operative Societies Act*, CAP 490.

<sup>99</sup> *Sacco Societies Act* No. 14 of 2008.

<sup>100</sup> Preamble, *Sacco Societies Act*.

<sup>101</sup> Section 4, *Sacco Societies Act*.

<sup>102</sup> *Microfinance Act*, CAP 493D.

coordinated fiscal activity by financial institutions. These guidelines require adherence and enforcement of the rules and policies set out by them.

The Capital Markets Authority is responsible for overseeing and promoting fair and effective capital markets. This regulatory framework is overseen by a governmental entity that holds significant influence over the industry. Under regulatory oversight by the CMA, the Nairobi Securities Exchange (NSE) serves as the primary trading platform for publicly listed companies. The regulatory framework governing the market consists of various regulations such as the Capital Markets Licensing Requirements General Regulations of 2002, the Capital Markets Registered Venture Capital Companies Regulations of 2007, the Capital Markets Foreign Investors Regulations of 2002, and the Capital Markets (Securities) (Public Offers Listing and Disclosure) Regulations of 2002, among others established by the Central Bank of Kenya (CBK). The Investor Compensation Fund, as established by the Capital Markets Act<sup>103</sup>, is meant to provide compensation to investors who suffer losses as a result of the failure of a licensed stockbroker or dealer, to meet his contractual obligations as well as paying beneficiaries from collected unclaimed dividends when they resurface.

The Banking (Credit Reference Bureaus) Regulations, 2008 govern the establishment and supervision of Credit Reference Bureaus by the Central Bank. Prospective Credit Reference Bureaus must be established and incorporated as a limited liability company under the Companies Act and licensed under these regulations. The Central Bank collects an annual License Fee before the anniversary date of the bureau. The Deposit Protection Fund is established by the Banking Act to protect consumers in the event that an institution holding their deposits becomes insolvent<sup>104</sup>.

The Sacco Societies Act provides for the establishment of the Sacco Societies Regulatory Authority<sup>105</sup> (SASRA) which is responsible for licensing SACCOs to undertake deposit-taking business and the general supervision and regulation of Sacco Societies. Furthermore, the Act

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<sup>103</sup> Section 18, The Capital Markets Act.

<sup>104</sup> Section 37, The Banking Act, 2012.

<sup>105</sup> Section 4, Sacco Societies Act, 2008.

establishes a fund known as the Deposit Guarantee Fund<sup>106</sup> which protects members' deposits, but not shares, up to an amount of one hundred thousand shillings in respect of each member in the event that the SACCO society undergoes liquidation while it still has the members' deposits.

The Insurance Act establishes the Insurance Regulatory Authority that serves as the regulatory authority in charge of insurance and reinsurance businesses in Kenya<sup>107</sup>. In addition to this, the Act also contains a provision for the establishment of a Policyholders Compensation Fund<sup>108</sup> to provide compensation to the claimants of an insurer placed under a manager appointed under section 67C (2) or whose license has been cancelled under the Act.

The Microfinance (deposit-taking) Regulations of 2008 supplement the Microfinance Act through prescribing how licensing of microfinance institutions should be conducted and the general regulatory provisions governing them<sup>109</sup>.

### **3.3 THE ADVANTAGES OF THE CURRENT LEGAL AND REGULATORY FRAMEWORK IN THE FINANCIAL SERVICES SECTOR IN KENYA**

Kenya's current framework presents some strengths that contribute to market stability and regulatory clarity within individual sectors. This section explores the key advantages of the existing legal and regulatory architecture, highlighting how it promotes specialisation, regulatory independence, *etc.*

#### **3.3.1 Specialisation Because of Sector Specific Knowledge**

According to some scholars, specialised regulators better understand the unique risks and dynamics of the industry sectors they oversee, ensuring that tailored regulatory measures are put in place to address sector-specific challenges<sup>110</sup>. The sectoral model allows each regulatory

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<sup>106</sup> Section 55, Sacco Societies Act, 2008.

<sup>107</sup> Section 3, *Insurance Act*.

<sup>108</sup> Section 179, *Insurance Act*.

<sup>109</sup> Microfinance (Deposit-Taking) Regulations 2008.

<sup>110</sup> Briault C, 'The Rationale for A Single National Financial Services Regulator' 6 Financial Services Authority Occasional Paper No. 2, 1999 -<http://Www.Fsa.Gov.Uk/Pubs/Occpapers/OP02.Pdf>.- on 1 May 2024.

body to develop in-depth expertise and specialised knowledge in the financial sector it oversees, ensuring regulatory diversity. This leads to more informed, effective regulation tailored to the unique characteristics of different financial markets<sup>111</sup>. The CBK, under the guidance of the Central Bank of Kenya Act, specialises in banking regulation, giving it the expertise to address issues like liquidity, credit risk and capital adequacy in banking institutions.

### **3.3.2 Regulatory Independence**

It was theoretically stated earlier in Chapter Two that because in a sectoral model regulators oversee specific industries, the closeness of the interactions between each regulator and its sector increases the risk of capture. Nonetheless, it is also because of this separation of sectoral regulators that regulatory capture becomes difficult in a real-world scenario. The tendency of regulatory overlaps to occur in a sectoral model decreases the chances of the industries affected to attempt regulatory capture across all the regulators and hence ensuring that decision-making is based on sector-specific considerations, rather than political pressure or other interests<sup>112</sup>. Under the sectoral model, each regulatory authority tends to have a degree of independence from the others, which also prevent conflicts of interest and increase the objectivity of regulatory decisions. In Kenya, the independent operation of the CBK ensures that its monetary policy and banking oversight functions are carried out without undue influence from other financial regulators.

### **3.3.3 Less Bureaucratic Overload**

As Taylor notes, the distribution of regulatory authority across multiple sectoral regulators can prevent bottlenecks and reduce the risk of one large regulator becoming overwhelmed or overly politically influenced<sup>113</sup>. Distributing responsibilities can improve regulatory efficiency and allow for quicker decision-making.

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<sup>111</sup> Taylor M, 'Twin-Peaks': A Regulatory Structure for the New Century,' 7.

<sup>112</sup> Llewellyn, D. T. , 'Institutional Structure of Financial Regulation and Supervision: The Basic Issues,' In D.T Llewellyn (eds) *Aligning Financial Supervisory Structures with Country Needs*, World Bank, Washington DC, 2006, 31-33.

<sup>113</sup> Taylor M, 'Twin-Peaks': A Regulatory Structure for the New Century,' 7-8.

### **3.3.4 Customisation Flexibility**

Each financial sector adopts regulatory approaches best suited to its needs and risk profiles<sup>114</sup>. For instance, capital markets may require a different set of regulations than banks or microfinance institutions; provided that there is no regulatory overlap from the financial products being offered. This enables a more ‘curated’ approach to regulation, particularly useful when sectors are at different stages of development or when regulatory uniformity would be inappropriate.

The Capital Markets Authority in Kenya enforces regulations around securities trading, disclosures and investment schemes, while the Central Bank of Kenya enforces regulations related to banking operations, liquidity and credit risk; these functions are tailored for two different sectors with different needs and a separation might benefit them. Some scholars argue that sectoral regulators are better placed to customise rules and enforcement mechanisms to reflect the operational realities, risks and compliance cultures of each individual sector<sup>115</sup> as well as to promote more efficient and effective oversight<sup>116</sup>.

## **3.4 CHALLENGES FACING THE CURRENT LEGAL AND REGULATORY FRAMEWORK IN THE FINANCIAL SERVICES SECTOR IN KENYA**

While Kenya’s sectoral regulatory framework has supported growth and specialization within the financial services industry, it has also given rise to significant legal and regulatory challenges. Fragmentation, regulatory overlaps and gaps in oversight have increasingly exposed the system to inconsistencies and legal uncertainty, particularly in the face of financial innovation and convergence. This section critically examines the structural and operational shortcomings of the current framework, pointing out the pressing need for reform in order to enhance stability, efficiency and systemic resilience.

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<sup>114</sup> Australian Government Department of Finance, *Comcover Information Sheet*, 2016, 1.

<sup>115</sup> Lastra R, *The Legal Foundations of International Monetary Stability*, Oxford University Press, London, 2006, 203.

<sup>116</sup> Kregel J, ‘Emerging Market Economies and the Reform of the International Financial Architecture: Back to the Future,’ Levy Economics Institute, 2015, 139.

### 3.4.1 Regulatory Arbitrage

The growing capacity of financial institutions (as aided by technological advancements) in contemporary times to generate intricate financial instruments and distribute risks across different markets and institutions is an important profit-making strategy. However, it also underscores the importance of moving away from a fragmented regulatory framework from a macroeconomic regulatory perspective. Financial institutions, especially within such regimes, tend to devise innovative methods to circumvent government regulations, thereby perpetuating an ongoing cycle of rulemaking and evasion<sup>117</sup>. These activities are purposely structured to minimise expenses or exploit profit potentials arising from overlapping regulations or laws within a fragmented system, and are what defines regulatory arbitrage<sup>118</sup>. The removal of regulatory arbitrage opportunities is dependent on achieving harmonization of financial products that are offered under the same functionality of service, but could be possibly categorised differently, in other words, as falling under different regulatory approaches. Financial regulatory rules and laws should also reflect the same ethos across the board<sup>119</sup>.

Harmonisation, however, is a difficult process that is contingent on having a single prudential regulator. This is due to the intricate and worldwide scope of the modern-day Kenyan financial market which makes any unilateral governmental efforts to regulate it through strict command-and-control methods via multiple independent regulators bound to confront the inherent challenge of regulatory arbitrage<sup>120</sup>. Harmonisation is also not just confined to national efforts but is also heavily reliant on international standards, notably those formulated by entities such as the Basel Committee on Banking Supervision (BCBS), International Organization of Securities Commissions (IOSCO), International Association of Insurance Supervisors (IAIS) and the Committee on Payment and Settlement Systems (CPSS). These standards constitute a

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<sup>117</sup> Schmulow A 'Financial Regulatory Governance in South Africa: The Move Towards Twin Peaks' 23(3) *African Journal of International and Comparative Law*, 2017.

<sup>118</sup> Frank Partnoy, 'Financial Derivatives and the Costs of Regulatory Arbitrage,' 22, *The Journal of Corporate Law*, 1997, 211-227.

<sup>119</sup> Chaffee E, 'Contemplating the Endgame: An Evolutionary Model for the Harmonization and Centralization of International Securities Regulation,' *University of Cincinnati Law Review*, 79, 2011, 587.

<sup>120</sup> Omarova S, 'Wall Street as Community of Fate: Toward Financial Industry Self-Regulation,' *University of Pennsylvania Law Review*, 159, 2011, 411, 416.

substantial body of ‘soft law,’ varying in ambition from setting a baseline aligned with the existing national regulations to surpassing them, as seen in Basel II.

While voluntary in nature, some standards entail significant intrusion. Aligning these broad global principles with Kenya’s financial system framework, while preserving a common framework poses challenges spanning from the specific to the general. For instance, corporate governance norms face obstacles due to variations in supervisory board structures across nations. Additionally, Basel II's encouragement for uniform risk management approaches across borders raises concerns about mispricing credit risks in different jurisdictions. Tailoring a model to adequately reflect market-specific risks is imperative but risks undermining the benefits of standardisation. Harmonising rules and regulations with international markets may stifle the motivation for diverting trading and capital raising activities from the domestic market to international markets. Complete harmonisation, including enforcement, might prevent financial institutions from opting to list in international financial centres to subject themselves to higher corporate governance or disclosure standards.

### **3.4.2 Regulatory overlaps**

Regulatory overlaps in Kenya’s sectoral regulatory model typically arise when the multiple financial regulatory agencies within the State share jurisdiction over certain aspects of the financial system such as the instruments being traded or the types of transactions being conducted. This occurs because of the fragmented form of regulatory responsibilities, where different agencies are assigned oversight of specific sectors or activities within the financial industry<sup>121</sup>. As a result, gaps in coordination and communication between regulatory bodies may result in overlapping mandates, leading to inefficiencies and inconsistencies. Moreover, divergent regulatory approaches or interpretations among the various agencies can further exacerbate overlaps, creating confusion for financial institutions and consumers alike<sup>122</sup>.

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<sup>121</sup> Schooner H, *Regulating Risk not Function*, 66 U. CIN. L. REV., 1998, 441-459.

<sup>122</sup> Hupkes E, ‘Regulation, Self-regulation and Co-regulation,’ *Journal of Business Law*, 5, 2009, 427.

In Kenya, not all regulatory bodies within the financial services sector are exempt from the regulations stipulated in the State Corporations Act<sup>123</sup>. Instances of regulatory overlap are evident, particularly in the case of listed banks and insurance companies. For instance, fund managers find themselves subject to regulation by both the Retirement Benefits Authority and the Capital Markets Authority. Moreover, the approval of takeovers and mergers involving listed companies necessitates scrutiny from both the CMA and the Commissioner of Monopolies and Prices<sup>124</sup>. Consequently, due to the absence of any single regulator with the capacity to oversee the entire market comprehensively, no governmental entity possesses all the requisite information to effectively monitor systemic financial risk<sup>125</sup>.

### **3.4.3 Insufficient Resources Available to the Regulatory Agencies**

The inadequacy of resources poses a significant challenge to the regulatory agencies in Kenya due to several reasons. Firstly, the allocation of resources to regulatory bodies is inadequate, according to a study conducted by , leading to limitations in their capacity to effectively monitor and enforce regulations within the financial sector. Insufficient funding can constrain the recruitment and retention of skilled personnel, hinder technological advancements needed for efficient oversight, and limit the scope of regulatory activities such as inspections and investigations<sup>126</sup>. The financial resources available to regulatory agencies is also subject to fluctuation, a result of constantly shifting government budgetary priorities and prevailing economic conditions. In times of fiscal austerity or competing demands for funding from other government mandates, regulatory bodies face budget-cuts that impede their ability to fulfil their functions satisfactorily.

Moreover, the ever-growing complexity and sophistication of the financial sector in Kenya brought about by globalisation require continuous investment in training, technology and infrastructure by regulatory agencies in order to be sufficiently responsive to systemic risks

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<sup>123</sup> Gakeri J, 'Financial Services Regulatory Modernization in East Africa: The Search for a new paradigm for Kenya,' 1(16) *International Journal of Humanities and Social Science*, 2011, 167.

<sup>124</sup> Capital Market (Take Overs and Mergers) Regulations 2002, Reg. 4 (1) (d).

<sup>125</sup> Cunningham L and Zaring D, 'The Three or Four Approaches to Financial Regulation: A Cautionary Analysis Against Exuberance in Crisis Response,' 78(39), *George Washington Law Review*, 2009, 50.

<sup>126</sup> Ndichu L, 'Evaluating the case for a unified model of regulation in the financial services sector in Kenya' 41.

along with the prevailing market conditions. Inadequate funding impedes these efforts, often leaving the regulatory bodies ill-equipped to address emerging challenges such as cybersecurity threats, money laundering or financial fraud.

#### **3.4.4 Differences in Powers Delegated to Various Regulators by the Applicable Laws to the Regulatory Bodies**

In Kenya, there exists a disparity in the extent of legislative power delegated to various regulators, with some possessing such powers while others do not. For instance, the Retirement Benefits Authority, Insurance Regulatory Authority, and Sacco Societies Regulatory Authority lack the authority to create laws. This responsibility rests with the relevant Cabinet Secretary, who has the power to enact legislation pertaining to these regulatory bodies<sup>127</sup>.

### **3.5 CONCLUSION**

This chapter assessed the key challenges of Kenya's sectoral regulatory model, revealing that despite a robust legal framework, issues like regulatory gaps, overlaps and funding constraints persist, necessitating reform. Kenya's financial services sector is reflective of a complex inter-relationship between legal regimes and regulatory powers. The framework, sanctioned by the Constitution of Kenya and implemented through various Acts of parliament, empowers regulatory institutions like the Central Bank of Kenya, the Capital Markets Authority, the Insurance Regulatory Authority, the Retirement Benefits Authority and the SACCOs Society Regulatory Authority to oversee and regulate specific segments of the financial sector. Despite the legal and regulatory provisions in place, challenges persist, including regulatory gaps, overlaps, and funding constraints. These challenges underscore the need for ongoing evaluation and potential reforms within Kenya's financial regulatory framework.

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<sup>127</sup> Section 55(1), *Retirement Benefits Authority Act*; Section 68, *Sacco Societies Act*; and Section 197E, *Insurance Act*.

## **CHAPTER 4: A BENCHMARK ANALYSIS BETWEEN OTHER JURISDICTIONS' TWIN-PEAKS MODEL AND KENYA'S SECTORAL MODEL.**

### **4.1 INTRODUCTION**

The Twin-Peak model, characterised by the separation of prudential regulation and conduct supervision into distinct regulatory authorities, has gained prominence globally for its purported ability to enhance regulatory efficiency, promote financial stability, and safeguard consumer interests. Australia was the first country in the world to implement the Twin-Peaks regulatory model in 1998. Australia's model is lauded as an international paragon, especially after its financial sector's resilience in the face of the Global Financial Crisis, which formed the basis of other countries reform to this model<sup>128</sup>. This success has inspired regulatory reforms in other nations, spotlighting the model's potential to address modern financial challenges.

Closer to Kenya's context, the implementation of the Twin Peaks Model in South Africa was initiated following a publication by the South African National Treasury in 2014, which outlined the rationale and necessity for adopting this regulatory framework. Subsequently, a policy document was developed to provide a comprehensive assessment of the financial sector and establish guidelines for regulatory reform. It was argued that this shift was largely a precautionary response to the Global Financial Crisis. The Twin Peaks Model was formally enacted through the Financial Sector Regulation Act 9 of 2017 (FSRA)<sup>129</sup>, marking a departure from the previous sectoral regulatory approach. With the introduction of the FSRA, South Africa became the first developing jurisdiction to adopt the twin-peaks model.

In contrast, Kenya's sectoral model, with its fragmented approach to oversight, struggles to adapt to evolving market dynamics, raising questions about its effectiveness in ensuring stability and consumer welfare. The objective of this chapter is to review the implementation of the Twin-Peaks model in Australia and South Africa and thereafter perform a benchmark analysis between Australia's and Kenya's financial regulatory models. This will be achieved by

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<sup>128</sup> Botha E and Makina D, 'Financial Regulation and Supervision: Theory and Practice In South Africa,' 10(11) *International Business & Economics Research Journal* 2011, 35.

<sup>129</sup> Godwin A and Schmulow A, 'The Financial Sector Regulation Bill in South Africa: Lessons from Australia.,' 132, *South African Law Journal*, 2015, 756.

comparing Australia's Twin-Peaks framework with Kenya's sectoral model, highlighting how the differences expose vulnerabilities like regulatory overlap and systemic risk in Kenya's system.

## **4.2 THE IMPLEMENTATION OF THE TWIN-PEAKS MODEL IN SOUTH AFRICA**

The National Credit Regulator (NCR) conducted a formal review of South Africa's financial sector in 2007, triggered by the Global Financial Crisis and the country's commitment to the G20's financial regulatory reform agenda<sup>130</sup>. Following this review, a comprehensive policy paper was published which examined lessons from the GFC and identified the Twin Peaks Model as the most suitable framework for future financial regulation in South Africa<sup>131</sup>. Subsequently, on 1 February 2013, the National Treasury released a detailed policy document which outlined the proposed regulatory transition and underscored the critical importance of separating prudential and market conduct supervision<sup>132</sup>. The primary objectives of this reform were to reduce regulatory conflicts and arbitrage while enhancing consumer protection in the financial sector<sup>133</sup>.

A distinctive feature of South Africa's Twin Peaks Model is its explicit financial stability mandate for the South African Reserve Bank (SARB), while simultaneously removing its direct bank regulatory functions<sup>134</sup>. The model established the Prudential Authority (PA), a separate

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<sup>130</sup> Moodley A, 'The Twin-Peaks Model: A Critical Analysis of Its Effectiveness in South Africa' Published LLM Thesis, University of Witwatersrand, Johannesburg, 2018, 43.

<sup>131</sup> Godwin A, 'Introduction to special issue – The Twin Peaks Model of financial regulation and reform in South Africa,' 11(4) *Law and Financial Markets Review*, 2017, 151-153.

<sup>132</sup> Republic of South Africa National Treasury Department, *Implementing a Twin-Peaks Model of Financial Regulation in South Africa*, 1 February 2013.

<sup>133</sup> Niekerk, V and Heerden V, 'Twin Peaks: The role of the South African central bank in promoting and maintaining financial stability,' J80(2), *Journal of Contemporary Roman-Dutch Law*, 2017, 636-656.

<sup>134</sup> Moodley A, 'The Twin-Peaks Model: A Critical Analysis of Its Effectiveness in South Africa,' 2018, 43.

juristic entity housed within the SARB, responsible for supervising all financial institutions. Additionally, the Financial Services Board (FSB) was replaced by the Financial Sector Conduct Authority (FSCA), an independent body tasked with overseeing market conduct across all financial institutions, including banks. Meanwhile, the NCR retained its role as an independent credit market regulator<sup>135</sup>. The success of this model hinges on mandatory collaboration and coordination among these three regulatory entities.

### **4.3 COMPARATIVE ANALYSIS BETWEEN KENYA'S SECTORAL MODEL AND AUSTRALIA'S TWIN-PEAKS MODEL**

#### **4.3.1 Comparison of Regulatory Approaches**

##### *Similarities of the models*

The first observable similarity between the two systems is that both models aim to ensure the stability and integrity of their respective financial systems<sup>136</sup>. Whether through the Twin-Peaks model's focus on prudential regulation and conduct supervision or Kenya's Sectoral model's oversight of banking, capital markets, and insurance sectors, the primary goal remains the same: to safeguard the interests of financial institutions and consumers while maintaining overall financial stability<sup>137</sup>.

Secondly, both regulatory frameworks prioritize consumer protection and market integrity<sup>138</sup>. In Australia's Twin-Peaks model, ASIC's role in conduct regulation is centred on ensuring fair and transparent market practices, protecting consumers from misconduct, and upholding market integrity. Similarly, Kenya's Sectoral model, through agencies like the CMA and the IRA, seeks

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<sup>135</sup> Moodley A, 'The Twin-Peaks Model: A Critical Analysis of Its Effectiveness in South Africa,' 2018, 44.

<sup>136</sup> Llewellyn, D. T. , 'Institutional Structure of Financial Regulation and Supervision: The Basic Issues,' In D.T Llewellyn (eds) *Aligning Financial Supervisory Structures with Country Needs*, World Bank, Washington DC, 2006, 17-93.

<sup>137</sup> International Monetary Fund Country Report No. 19/49, *Australia: Financial System Stability Assessment*, 2019, 24.

<sup>138</sup> Godwin A and Ramsay I, 'Twin Peaks – The Legal and Regulatory Anatomy of Australia's System of Financial Regulation,' 26, *Journal of Banking and Finance Law and Practice*, 2015, 240-266.

to protect investors, policyholders, and other stakeholders from fraud, misrepresentation, and other unethical practices within their respective sectors<sup>139</sup>.

Moreover, both regulatory models emphasize the importance of regulatory oversight and enforcement to uphold compliance with established rules and standards. Whether it's APRA's supervision of prudential requirements for financial institutions in Australia<sup>140</sup> or the CBK's monitoring of banks' capital adequacy and liquidity<sup>141</sup>, regulatory authorities in both countries play a crucial role in overseeing compliance and taking enforcement actions when necessary to maintain market discipline.

Additionally, both the Twin-Peaks model in Australia and Kenya's Sectoral model recognise the need for ongoing regulatory reform and adaptation to evolving market dynamics and risks<sup>142</sup>. Whether it involves updating regulatory frameworks to address emerging technologies, financial innovations, or systemic vulnerabilities, both regulatory regimes prioritize agility and responsiveness to ensure regulatory effectiveness and relevance in a rapidly changing financial landscape.

#### *Differences of the models*

The Twin-Peaks financial regulatory model, as implemented in Australia, stands in stark contrast to Kenya's Sectoral financial regulatory model in several key aspects. In Australia, the Twin-Peaks model is characterized by the division of regulatory responsibilities into two primary agencies: the Australian Prudential Regulation Authority (APRA) and the Australian Securities and Investments Commission (ASIC). APRA is entrusted with overseeing the prudential regulation of financial institutions, ensuring their stability and soundness, while ASIC

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<sup>139</sup> Mwega, F, 'The Competitiveness of the Financial Services Sector in Kenya,' 23(1), *African Development Review*, 2011, 45-59.

<sup>140</sup> Schmulow A, 'Twin Peaks: A Theoretical Analysis,' Centre for International Finance and Regulation, working paper number 18, 1 July 2015 - <https://ssrn.com/abstract=2625331> on 1 July 2015.

<sup>141</sup> Gakeri J, 'Enhancing Financial Regulation in Kenya: Challenges and Opportunities,' 56(2), *Journal of African Law*, 2012, 249-250.

<sup>142</sup> The Financial Sector Regulators Forum, *The Kenya Financial Stability Report*, September 2021, 9.

focuses on conduct regulation, safeguarding market integrity, and protecting consumer interests<sup>143</sup>.

In contrast, Kenya's Sectoral financial regulatory model adopts a more traditional approach, where regulatory responsibilities are distributed across multiple agencies with sector-specific mandates<sup>144</sup>. The CBK plays a central role in prudential regulation and supervision of banks and other financial institutions, including microfinance institutions and mortgage finance companies. Additionally, the CMA regulates and oversees capital markets activities, such as securities exchanges, collective investment schemes, and investment advisers, while the IRA is responsible for supervising the insurance industry<sup>145</sup>.

One of the primary differences between the Twin-Peaks model in Australia and Kenya's Sectoral model lies in the organizational structure and regulatory focus. In Australia, the Twin-Peaks model adopts a clear separation of prudential and conduct regulation, with dedicated agencies responsible for each aspect<sup>146</sup>. This division aims to prevent conflicts of interest and ensure a more focused approach to regulation. In contrast, Kenya's Sectoral model involves multiple agencies with overlapping mandates, potentially leading to coordination challenges and regulatory gaps<sup>147</sup>.

Moreover, the Twin-Peaks model emphasizes a principles-based regulatory approach, prioritizing outcomes and market integrity, while allowing for flexibility in compliance<sup>148</sup>. This

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<sup>143</sup> Taylor M, 'Twin Peaks: A Regulatory Structure for the New Century,' 10.

<sup>144</sup> Gakeri J, 'Financial Services Regulatory Modernization in East Africa: The Search for a new paradigm for Kenya,' 165.

<sup>145</sup> Ndung'u N and Ngugi R, 'Banking Sector Development in Kenya: Challenges and Opportunities,' In Cull R (ed) *Banking in Sub-Saharan Africa*, World Bank, Washington DC, 2015, 123-145.

<sup>146</sup> Godwin A and Schmulow A, 'The Financial Sector Regulation Bill in South Africa: Lessons from Australia,' CIFR Working Paper No. 052, 2015.

<sup>147</sup> Mutuku N, 'Challenges of Financial Regulation in Kenya: A Sectoral Perspective,' 12(10), *African Journal of Business Management*, 2018, 252.

<sup>148</sup> Black J, 'Principles-Based Regulation: Risks, Challenges and Opportunities,' LSE Legal Studies Working Paper Number 4, 2007, 11.

approach is evident in ASIC's focus on conduct regulation, where principles such as fairness, transparency, and efficiency guide regulatory interventions. In contrast, Kenya's Sectoral model tends to rely more on rules-based regulation, prescribing specific requirements and standards for compliance by financial institutions<sup>149</sup>.

Another notable difference is the level of regulatory coordination and cooperation between agencies. In Australia's Twin-Peaks model, there is a strong emphasis on inter-agency collaboration, with mechanisms in place to facilitate information sharing and joint policy development<sup>150</sup>. This coordinated approach enhances regulatory effectiveness and reduces duplication of efforts. In contrast, Kenya's Sectoral model may face challenges related to regulatory fragmentation and siloed decision-making<sup>151</sup>, potentially hindering the ability to address systemic risks comprehensively.

#### **4.3.2 Evaluation of the Strengths and Weaknesses of the Regulatory Models with Respect to Each Other**

##### *On the efficiency of the model*

Australia's Twin-Peaks model is lauded for its efficiency and effectiveness in the organisation of its supervisory activities and in the allocation of scarce resources<sup>152</sup>. With the clear division of regulatory responsibilities between the two regulators, that is, the Australian Prudential Regulation Authority and the Australian Securities and Investments Commission, the regulatory agencies capitalise on the economies of scale and scope that result<sup>153</sup>. APRA, tasked with prudential regulation, can focus its resources on supervising the stability and soundness of financial institutions, leveraging its expertise and specialised knowledge in this area.

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<sup>149</sup> Gakeri J, 'Regulatory Approaches to Financial Markets in Kenya: A Rules-Based Perspective,' 41(1), *East African Law Journal*, 2015, 89-95.

<sup>150</sup> Council of Financial Regulators Australia, *Annual Report*, 2019, 7.

<sup>151</sup> Caprio G and Honohan P, 'Financial Regulation in Developing Economies: Challenges and Opportunities,' 46(5), *Journal of Development Studies*, 2010, 795.

<sup>152</sup> Briault C, 'FSA Revisited and Some Issues for European Securities Markets Regulation,' EU Conference on Financial Supervision of Banks and Specialized Banks, European University Institute, 15 December 2001, 1.

<sup>153</sup> Taylor M, 'The Road to "Twin Peaks" – and the Way Back' 16(1) *Connecticut Insurance Law Journal*, 2009, 79.

Meanwhile, ASIC, responsible for conduct regulation, can direct its attention towards ensuring market integrity and consumer protection, drawing upon its proficiency in overseeing fair and transparent market practices. This division of labour allows each regulatory agency to concentrate on its specific mandate, optimising resource allocation and avoiding duplication of efforts<sup>154</sup>. By having clearly defined regulatory aims, APRA and ASIC can minimize areas of overlap and duplication, ensuring a more streamlined and efficient regulatory framework<sup>155</sup>. The separation of the prudential regulator from the Central Bank further ensures that the deposit-taking, insurance and superannuation regulatory roles are carried out more efficiently while also allowing the Central Bank to focus on regulating bank activities<sup>156</sup>.

In contrast, Kenya's sectoral regulatory model presents significant challenges to efficiency in both the organisation of supervisory activities and the allocation of resources. Because of the multiplicity of the regulatory agencies overseeing different segments of the financial services sector, coordination and collaboration among these entities become inherently and unavoidably complex. Unlike in the twin-peaks model, where there is a clear demarcation between prudential regulation and consumer protection, Kenya's sectoral model exhibits overlapping jurisdictions, differing regulatory approaches and potential gaps in supervision. This fragmentation results in inefficiencies as regulatory agencies may duplicate functional efforts, leading to unnecessary processes and wastage of resources. The lack of a centralized regulatory authority also impedes timely information sharing and coordination of regulatory actions, thus curtailing the ability to address systemic risks effectively. Moreover, the fragmented nature of Kenya's regulatory landscape leads to inconsistencies in regulatory standards and enforcement practices across the different sectors, hence undermining market confidence and investor protection.

#### *On the regulatory diversity of the model*

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<sup>154</sup> Godwin A, Introduction to the special issue- The Twin Peaks Model of Financial Regulation and Reform in South Africa, 11(4) *Law and Financial Markets Review*, 2017.

<sup>155</sup> Taylor M, 'The Road to "Twin Peaks" – and the Way Back,' 3.

<sup>156</sup> Australian Government Productivity Commission, *Superannuation: Assessing Efficiency and Competitiveness*, 21 December 2018, 459.

Kenya's sectoral regulatory model benefits from regulatory diversity brought about by the sector-specific knowledge and expertise held by individual regulators<sup>157</sup>. Regulatory responsibilities, by design, are distributed across the multiple agencies such as the Central Bank of Kenya, the Capital Markets Authority, and the Insurance Regulatory Authority, each focusing on overseeing specific sectors of the financial services industry. This fragmented approach makes it such that the regulatory bodies end up possessing in-depth understanding and expertise tailored to their unique respective sectors. For example, the CBK specializes in banking supervision, the CMA focuses on regulating capital markets activities, and the IRA oversees the insurance sector. By having dedicated regulators for each sector, Kenya's regulatory framework benefits from a diverse range of perspectives, insights and specialised knowledge, enabling more targeted and effective oversight. This regulatory diversity enhances the responsiveness of the regulatory system to sector-specific risks and challenges, ultimately contributing to the resilience and stability of Kenya's financial services industry.

Australia's Twin-Peak model, with its consolidation of regulatory functions into a unified prudential regulator, presents a potential drawback in terms of regulatory diversity. It delegates prudential regulation to a single authority i.e., the APRA. This inadvertently leads to a lack of critical sector-specific knowledge and expertise. Unlike the sectoral regulatory approach, the Twin-Peak model centralises regulatory functions under APRA, effectively limiting the depth of understanding and nuanced oversight within individual sectors. This may result in a regulatory framework that lacks the diversity of perspectives and insights necessary to address sector-specific challenges effectively. Ergo, identification and address of said sector-specific risks and vulnerabilities is compromised up to the degree where regulatory diversity and sector-specific expertise may be required, highlighting a potential limitation in the model's ability to address the complexities of Australia's diverse financial services landscape.

#### *On the model's adaptability to changing conditions*

Australia's Twin-Peak model is better positioned to adapt to the growing complexity of financial markets and the emergence of financial conglomerates<sup>158</sup>. The model's division of regulatory

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<sup>157</sup> Nyabanda M, 'Is time ripe for a single regulator?' Business Daily, 1 February 2010, 17.

<sup>158</sup> Godwin A, 'Introduction to special issue-The Twin peaks model of financial regulation and reform in South Africa,' 152-153.

responsibilities between the APRA and the ASIC allows for a more specialized and focused approach to supervision. APRA, as the prudential regulator, can concentrate on ensuring the stability and soundness of financial institutions, including large conglomerates, by imposing stringent capital adequacy requirements and risk management standards. Meanwhile, ASIC, responsible for conduct regulation, can oversee the conduct of financial conglomerates, ensuring fair market practices, transparency, and consumer protection. This division of labour enables each regulator to develop expertise in their respective areas, thereby enhancing their ability to adapt to the evolving complexities of financial markets and the diverse business models of conglomerates. Furthermore, by avoiding the concentration of regulatory power in a single integrated super-regulator, the Twin-Peak model minimizes the risk of conflicts of interest that may arise from regulating both prudential and conduct aspects within the same entity. This separation of regulatory functions promotes greater accountability, transparency, and regulatory effectiveness, ultimately contributing to the resilience and stability of Australia's financial system in the face of increasing market complexity and the rise of financial conglomerates.

*On the responsiveness to systemic risks by a model*

Australia's Twin-Peak regulatory model demonstrates a relatively high level of responsiveness to systemic risks in real time, facilitated by the proactive monitoring and collaboration between the two regulatory bodies: APRA and ASIC. APRA focuses on monitoring the prudential health of financial institutions while ASIC oversees market conduct and integrity.

Additionally, the Twin-Peak model provides for regular communication and information sharing between APRA and ASIC, allowing for a co-ordinated response to systemic risks. Moreover, Australia's regulatory framework empowers APRA and ASIC with a range of regulatory tools and powers to respond effectively to systemic risks. These tools include the ability to issue prudential standards, conduct onsite inspections, impose sanctions and intervene in the operations of financial institutions or market participants if necessary.

#### **4.4 DISADVANTAGES WHICH MAY ACCRUE TO A COUNTRY THAT ADOPTS THE TWIN-PEAKS MODEL**

The Twin-Peaks model is characterised by separating prudential regulation and market conduct supervision into two distinct agencies, something that has been praised for enhancing regulatory efficiency and financial stability (as seen in jurisdictions like Australia.) However, scholars have

identified several actual and potential disadvantages that may accrue to a country adopting this model. This section will address them in detail.

#### **4.4.1 Loss of Sector-Specific Expertise and Regulatory Diversity**

Because the Twin-Peaks model consolidates regulatory functions into two agencies, scholars argue this centralisation may reduce the depth of sector-specific knowledge that regulators like Kenya's CBK, CMA, or IRA currently possess under a sectoral model. Michael Taylor noted that consolidating oversight risks losing "specialised expertise" inherent in sector-focused regulators, potentially weakening nuanced supervision<sup>159</sup>. Similarly, a 2019 report on Australia's model highlighted that APRA's broad prudential mandate sometimes overlooks sector-specific risks, such as insurance underwriting nuances, compared to dedicated regulators<sup>160</sup>.

As acknowledged earlier in this paper, Kenya's sectoral model benefits from regulatory diversity due to regulators' tailored expertise, while Twin-Peaks' consolidation under two agencies may limit this, which can potentially compromise oversight of Kenya's diverse sectors. Adopting Twin-Peaks could challenge Kenya's ability to address sector-specific risks, such as continuing fintech innovation, unless mitigated by counter-measures like human capital development and training.

#### **4.4.2 Risk of Regulatory Capture**

Consolidating oversight into two regulatory agencies may increase the risk of regulatory capture, where industry players influence regulators. Stigler's work on regulatory capture, which was referenced in Chapter Two via Posner's Economic Theory, suggests that fewer, larger regulators can become targets for industry lobbying. It has been separately noted that Australia's ASIC faced criticism for being 'too cozy' with financial giants, though mitigated by strong governance<sup>161</sup>. With Kenya's history of corruption, concentrating power in two regulators could amplify capture risks unless robust checks are enforced.

#### **4.4.3 Coordination Challenges Between the Twin Regulators**

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<sup>159</sup> Taylor M, 'Twin-Peaks': A Regulatory Structure for the New Century,' 13.

<sup>160</sup> Australian Prudential Regulation Authority, *Capability Review Report*, June 2019, 77–82.

<sup>161</sup> Harris J, 'Is ASIC the Watchdog That No One Fears?' The University of Sydney News, 22 February 2019 - <https://www.sydney.edu.au/news-opinion/news/2019/02/22/is-asic-the-watchdog-that-no-one-fears-.html> - on 22 February 2019.

While Twin-Peaks aims to streamline regulation, the separation of prudential and conduct functions can create coordination issues between the two agencies, especially if mandates overlap or communication is ineffective, leading to gaps or conflicts in regulation. Australia's APRA and ASIC occasionally faced 'turf wars' over issues like financial product regulation, requiring formal mechanisms to resolve disputes<sup>162</sup>. The 2014 Financial System Inquiry (FSI) in Australia also recommended tweaks to improve APRA-ASIC coordination, suggesting inherent challenges. Given Kenya's history of regulatory silos, transitioning to the twin-peaks could replicate coordination issues if the new agencies' roles aren't precisely defined, potentially undermining systemic risk management.

#### **4.4.4 High Implementation and Transition Costs**

Shifting to the twin-peaks model would require significant upfront costs, including legislative reforms, restructuring agencies, retraining staff and aligning with international standards. These costs can strain public budgets, especially in resource-constrained countries. Some emerging economies adopting twin-peaks, like South Africa, faced high transition costs due to institutional overhauls and capacity building<sup>163</sup>. It thus makes sense to assume that smaller markets may struggle to justify these costs relative to benefits. Kenya's limited budget could make the switch to the twin-peaks prohibitive without at least having either some external support or phased implementation, which risks delays or even incomplete reforms.

#### **4.4.5 Potential Challenge Adopting to the Local Context**

The twin-Peaks, as is developed in advanced economies, may not fully suit emerging markets with a large informal economy, informal sectors, limited regulatory capacity or unique risks, requiring significant adaptation that could dilute its benefits. Some scholars argue that Twin-Peaks' success in Australia and the UK relied partly on having mature markets and strong institutions. They warn that emerging economies may struggle to adapt it without compromising

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<sup>162</sup> Jones E, 'The Politics of Regulatory Convergence and Divergence,' in Jones E, *The Political Economy of Bank Regulation in Developing Countries: Risk and Reputation*, Oxford University Press, 2020.

<sup>163</sup> Melecky M and Anca P, '.Financial sector strategies and financial sector outcomes : do the strategies perform?' World Bank Group, Policy Research Working Paper| Number WPS 8315, 18 January 2018 <- <http://documents.worldbank.org/curated/en/731031516722333398>>- on 18 January 2018.

effectiveness<sup>164</sup>. South Africa's 2017 adoption faced delays due to local complexities<sup>165</sup>. Kenya's informal sector, largely dominated by SACCOs and the emergence of fintech dominance, will require a customised Twin-Peaks design but misalignment could lead to ineffective oversight or resistance, hence delaying benefits.

## **4.5 LESSONS THAT KENYA CAN DRAW FROM AUSTRALIA'S IMPLEMENTATION OF TWIN-PEAKS MODEL**

### **4.5.1 Streamlining Organisational Structure**

Australia's Twin-Peaks model divides responsibilities between APRA (prudential) and ASIC (conduct), unlike Kenya's multiple sector-specific agencies (CBK, CMA, IRA, etc), which face coordination challenges. Kenya can reduce regulatory overlap and gaps by consolidating into two focused regulators, mirroring Australia's clear separation. This could simplify oversight, minimise conflicts as well as enhance systemic coherence, addressing the sectoral model's inefficiencies.

### **4.5.2 Adopting a Principles-Based Approach**

Australia's principles-based regulation like ASIC's focus on fairness and transparency contrasts with Kenya's rules-based, prescriptive approach. Kenya could shift to a principles-based framework under Twin-Peaks, allowing flexibility in compliance and fostering innovation while maintaining oversight, a departure from the sectoral model's rigid, sector-specific rules that struggle with modern financial products.

### **4.5.3 Improving Efficiency Through Specialisation**

Australia's Twin-Peaks model excels in efficiency due to APRA and ASIC's specialised roles, leveraging economies of scale, while Kenya's sectoral model suffers from duplication and

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<sup>164</sup> Godwin A and Kourabas , 'Financial Crisis Management Under the Twin Peaks Model of Financial Regulation – Australia and the UK Compared' Melbourne University, Melbourne Legal Studies Research Paper No. 938, 2020, 73 -<https://ssrn.com/abstract=3739716> or <http://dx.doi.org/10.2139/ssrn.3739716>- on March 3 2020.

<sup>165</sup> Moodley A, 'The Twin-Peaks Model: A Critical Analysis of Its Effectiveness in South Africa,' 47.

resource waste. Kenya can enhance efficiency by adopting Twin-Peaks' division of labour, focusing resources on prudential stability and market conduct rather than spreading them thinly across multiple agencies, addressing the sectoral model's inefficiencies.

#### **4.5.4 Boosting Systemic Risk Responsiveness**

Australia's Twin-Peaks model responds effectively to systemic risks through APRA-ASIC collaboration and proactive tools, while Kenya's sectoral model lags due to poor coordination. Kenya can draw from Australia's real-time risk monitoring and inter-agency synergy, equipping Twin-Peaks regulators with tools such as prudential standards and interventions to address systemic threats holistically, overcoming the sectoral model's siloed limitations.

#### **4.5.5 Building on Proven Resilience**

The 2014 FSI affirmed Australia's Twin-Peaks model as resilient, requiring only minor tweaks post-Global Financial Crisis, unlike Kenya's untested sectoral model in major crises. Kenya would benefit from adopting a model with a track record of stability, tailoring it to local needs, confident in its ability to withstand economic shocks; a critical upgrade from the sectoral model's vulnerabilities.

#### **4.6.6 Tailoring to The Local Context**

Australia's success is tied to its institutional context, while Kenya's sectoral challenges reflect its unique environment. Kenya must customise Twin-Peaks implementation by addressing challenges specific to it such as resource constraints or political resistance, drawing from Australia's framework but adapting it to local realities in order to ensure feasibility over the sectoral model's entrenched weaknesses.

## **4.6 CONCLUSION**

This chapter addressed how the Twin-Peaks model was implemented in South Africa and Australia, and identified lessons for Kenya, suggesting tailored adoption to enhance efficiency and coordination over its sectoral model's weaknesses. The model's operation is still in its infancy stage in South Africa, meaning that there is more to learn from observing its real-time performance. As earlier stated, the Financial System Inquiry (FSI) Final Report published in

2014 concluded that the Twin-Peaks model in Australia worked relatively well and only required minor tweaks and adjustments, reflecting the conclusions previously reached by various international agencies<sup>166</sup> that Australia's financial system is robust, resilient, and well-managed, demonstrating a high level of compliance with international standards within its regulatory and supervisory framework. The FSI's recommendations instead shifted to ways in which certain areas, such as coordination and regulatory overlap, could be strengthened and improved.

Interestingly, the most significant recommendations of the FSI related to those aspects that were evidently common to all models; that is, the objectives of the regulators, the accountability framework governing financial sector regulators, funding arrangements and regulatory tools such as enforcement powers. These examples, in addition to the ones illustrated in this chapter, highlights the potential benefits that can accrue from the adoption of the model in Kenya. Through the benchmark analysis conducted, insights have been gained into the strengths and weaknesses of Kenya's sectoral model in contrast to Australia's twin-peaks model. While Kenya's sectoral approach benefits from regulatory diversity, it faces inefficiencies and coordination challenges. The adoption of elements from Australia's twin-peaks model, tailored to Kenya's institutional context, presents an opportunity to enhance Kenya's financial regulatory sector.

Specifically, the lessons that Kenya can draw from the Australian context suggest that switching to Twin-Peaks could address Kenya's sectoral model's inefficiencies, fragmentation, and risk vulnerabilities, provided implementation is strategic and context-sensitive, as exemplified by Australia's experience. Thus, there is a compelling case for policymakers and regulators in Kenya to consider reforms aimed at modernising and strengthening the regulatory framework to better address the evolving dynamics and challenges of the financial services industry.

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<sup>166</sup> International Monetary Fund, *Australia: Financial System Stability Assessment*, November 2012, 5.

## **CHAPTER 5: CONCLUSION AND RECOMMENDATIONS.**

### **5.1 INTRODUCTION**

The findings of this study strongly recommend the implementation of the Twin Peaks regulatory model in Kenya as a viable replacement for the current sectoral model. While the Twin Peaks model offers numerous advantages in enhancing regulatory effectiveness and aligning with international best practices, it is important to acknowledge the challenges that may arise during its implementation. These challenges, including resistance from industry players, resource constraints, coordination issues among regulators and legal considerations, cannot be overlooked.

The objective of this chapter is to suggest proactive measures and recommendations that offer viable solutions which will address these setbacks. This shall be achieved first by examining the limitations of the sectoral regulatory model, including issues of fragmentation, overlapping mandates, and regulatory arbitrage. Next, the chapter will explore the principles and structure of the Twin Peaks model, highlighting its potential benefits for Kenya's financial sector. By adopting a collaborative and proactive approach involving all relevant stakeholders, Kenya can overcome these challenges and pave the way for the successful implementation of the Twin Peaks model. Ultimately, this will contribute to the establishment of a robust and effective regulatory framework that promotes financial stability, fosters market integrity and safeguards the interests of consumers and investors in Kenya's financial sector.

### **5.2 SUMMARY OF FINDINGS**

This study's findings provide a comprehensive examination of the theoretical underpinnings, current regulatory framework in Kenya and comparative insights into financial regulation with another jurisdiction, highlighting critical areas for reform in Kenya's financial sector.

Chapter Two established the theoretical framework that informs this research, drawing primarily on the Institutional and Economic Theories of Regulation. The Institutional Theory highlights its coordination difficulties, inconsistent standards due to fragmentation and vulnerability to systemic risks, stemming from its reliance on institutional norms and structures that fail to align regulators effectively. Conversely, Economic Theory exposes the model's susceptibility to flawed decision-making, driven by information asymmetries and regulatory capture, where

regulators, influenced by public opinion or personal interests rather than perfect market knowledge, may prioritise industry over consumer welfare. Together, these theories underscore the sectoral model's inefficiencies and risks, indicating a need for a more cohesive regulatory approach.

Chapter Three examined Kenya's financial regulatory framework, revealing a system marked by a complex interplay between constitutional mandates, statutory provisions and regulatory institutions. Key regulatory bodies, including the CBK, CMA, IRA, RBA and SASRA, operate within a sectoral regulatory model. Despite its strengths, this framework faces persistent challenges such as regulatory gaps, overlaps, and resource constraints, which hinder its ability to effectively oversee the ever-changing and evolving financial services sector. These findings illuminate the present urgent need for reforms to enhance coordination, efficiency and responsiveness within Kenya's regulatory framework.

Chapter Four provided a glimpse behind Australia's shift to the Twin Peaks model as well as a comparative analysis of Australia's Twin Peaks regulatory model, as highlighted in the Financial System Inquiry (FSI) Final Report of 2014. The report demonstrated the model's success in achieving robust financial system oversight while complying with international standards. Although minor adjustments were recommended to address coordination and regulatory overlaps, the model's principles, such as clear regulatory objectives, accountability frameworks, funding arrangements, and enforcement powers, were shown to be effective. Insights from this analysis reveal that while Kenya's sectoral model benefits from regulatory diversity, it is plagued by inefficiencies and coordination challenges. Adopting elements of the Twin Peaks model, tailored to Kenya's unique institutional and market context, presents an opportunity to modernise its regulatory framework and enhance its ability to address emerging financial sector challenges.

### **5.3 RECOMMENDATIONS**

The recommendations for transitioning Kenya to a Twin-Peaks financial regulatory model emphasise a multi-pronged approach to ensure a smooth and effective reform process. They advocate for a coordinated stakeholder engagement framework led by the Central Bank of Kenya to address industry resistance, alongside comprehensive cost-benefit analyses and targeted capacity-building initiatives to manage compliance costs, particularly for smaller

institutions like SACCOs and capital market entities. Investments in human capital development through specialized training programs, retention strategies, and a Financial Sector Integrity Code are proposed to build capacity and combat systemic issues like corruption. Structurally, a Twin-Peaks Financial Regulation Act is recommended to delineate prudential and conduct mandates, supported by enhanced inter-agency cooperation and international standards like Basel III and IOSCO principles. Finally, a thorough legal review by a Financial Regulation Review Taskforce, drawing on Australia's and South Africa's experiences, and a clear legislative roadmap gazetted by the National Treasury are suggested to align existing laws with the new model, ensuring practicality and global best practices guide Kenya's regulatory evolution.

### **5.3.1 Stakeholder Engagement and Resistance Management**

In addressing resistance from industry players during implementation of the Twin Peaks model, regulatory authorities must establish a coordinated and collaborative approach to engage stakeholders consistently. Kenya should create a stakeholder engagement framework to manage industry resistance to the Twin-Peaks model, involving all the relevant players. This framework would ensure inclusivity while addressing fears of regulatory capture.

The Central Bank of Kenya Act can be amended via the insertion of a provision in Section 4A mandating the CBK to lead a Financial Sector Stakeholder Forum, coordinating with CMA, IRA, RBA, and SASRA for periodic consultations on Twin-Peaks transition, ensuring transparency under Article 10 of the Constitution. In order to reduce the risk of capture, parliament can enact a 'Financial Sector Training Act,' establishing a fund under part III of the Public Finance Management Act for workshops and seminars, reducing capture risk by equipping industry players with Twin-Peaks compliance skills that are aligned with Basel standards.

### **5.3.2 Cost Management and Support for Compliance**

The high costs associated with regulatory compliance should be managed through a comprehensive cost-benefit analysis. This analysis should consider both the direct financial costs and long-term benefits, such as enhanced financial stability, consumer protection, and economic growth. The results of such analyses can justify necessary financial commitments and

garner broader industry support. To support smaller institutions with limited resources, targeted capacity-building initiatives should be introduced. These include technical assistance, financial grants, training programs and access to shared technology platforms to ensure compliance without imposing undue financial burdens.

SACCOS form a large percentage of NBFIs used by the common *mwananchi*. Because of this, The SACCO Societies Act should be amended to add a section requiring SASRA to conduct a biennial cost-benefit analysis of regulatory changes, drawn from the Regulatory Reporting Returns published under the Act's reporting obligations, justifying Twin-Peaks costs to SACCOs. In the same spirit, an amendment of Section 15 of the Capital Markets Act to empower the CMA to provide technical assistance grants to smaller capital market entities from the General Fund, would ease Twin-Peaks adoption without overburdening them.

### **5.3.3 Human Capital Development and Integrity**

Human capital development is a cornerstone of successful regulatory reform. Investments in education and training programs tailored to the financial sector's needs should be prioritized. This includes developing specialized curricula and certification programs in partnership with universities, professional associations, and international organisations. The Public Service Commission should establish a training institute focused on financial regulation under Article 232(1)(g,h,i) (merit-based appointments); partnering with major public and private institutions of higher learning like the University of Nairobi and Strathmore University, as well as global bodies like the IMF for Twin-Peaks-focused curricula.

Retention strategies for qualified professionals must also be strengthened, including competitive compensation, career advancement opportunities, and fostering a work environment that prioritizes meritocracy and integrity. Addressing systemic issues such as corruption, nepotism, and tribalism within public institutions can be done by instituting a 'Financial Sector Integrity Code' under the Public Finance Management Act, requiring annual audits of regulator hirings by the Ethics and Anti-Corruption Commission in order to maintain the system's credibility.

### **5.3.4 Regulatory Structure and Coordination**

To resolve conflicts of interest between prudential regulation and market conduct oversight, clear legislative guidelines and protocols should delineate the respective responsibilities and areas of focus for regulatory agencies. This can be done by the enactment of a ‘Twin-Peaks Financial Regulation Act.’ This new statute would consolidate the CBK, CMA, IRA, RBA and SASRA’s supervisory roles into two agencies, with one section defining prudential and conduct mandates, supported by Chapter 12 of the Constitution of Kenya.

Enhanced mechanisms for cooperation and information sharing should be established, supported by regular communication, joint working groups, and formal conflict-resolution procedures. Common standards and best practices should guide regulatory decision-making to ensure consistency across different domains. The Banking Act can have Section 33(4) amended in order to adopt Basel III prudential standards and IOSCO conduct principles as binding guidelines on top of the ones issued by the Central Bank so as to ensure international-standard consistency across Twin-Peaks regulators.

### **5.3.5 Legal and Institutional Reform**

Finally, a thorough review of existing laws and regulations is necessary to identify and amend provisions that hinder the adoption of the Twin Peaks model. This review process should include consultations with regulatory authorities, industry associations, and legal experts to ensure proposed changes are practical, comprehensive, and aligned with international best practices. Parliament should establish a Financial Regulation Review Taskforce under Article 261 of the Constitution that includes all the industry players’ experts and legal experts to draft Twin-Peaks amendments within a prescribed timeline.

The Taskforce should adopt Australia’s APRA-ASIC coordination (per the 2014 FSI) and South Africa’s Financial Sector Regulation Act (2017) principles to integrate them into the new Twin-Peaks Act. A clear legislative roadmap outlining milestones, timelines, and responsibilities should be gazetted by the National Treasury in order to guide the reform process. Lessons from a jurisdiction like Australia, which has successfully implemented similar reforms, should inform Kenya’s transition to a more integrated and efficient regulatory framework.

## 5.4 CONCLUSION

This chapter investigated which policy measures can address challenges in implementing the Twin-Peaks model in Kenya, identifying resistance, resource constraints, and coordination issues as key hurdles. It concludes that collaborative stakeholder engagement and other tailored policy reforms, such as reworking the funding mechanisms, ensuring common standards and best practices and legal reforms can overcome these, enabling a stable regulatory framework.

The findings of this study strongly suggest that the Twin-Peaks model of financial regulation can *feasibly* address the inconsistent legal and regulatory challenges inherent in the current backdrop of the financial sector in Kenya. It is capable of serving as a viable replacement for the current sectoral model. However, there are challenges that may arise during its implementation. The challenges include resistance from industry players, resource constraints, coordination issues among regulators and legal considerations.

In order to address these setbacks, proactive measures and recommendations discussed in this Chapter offer viable solutions to address them. Once Kenya has adopted a collaborative and proactive approach involving all relevant stakeholders, it can overcome these challenges and pave the way for the successful implementation of the Twin Peaks model. In the long run, this will contribute to the establishment of a stable, sound and effective regulatory framework that promotes financial stability, fosters market integrity and safeguards the interests of consumers and investors in Kenya's financial sector.



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