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Preventing bank failure: an assessment of the risk regulatory framework for banks in Kenya.

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Preventing Bank Failure: An Assessment of the Risk Regulatory Framework for Banks in Kenya

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Declaration

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

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Abstract

Inherently, inefficient banks should be allowed to fail. However, all banks are susceptible to failure, but not all are inefficient. The failure of a bank, whether it is considered to be efficient or inefficient, may impact the stability of other banks. Thus, it is not the failure of a bank, but the impact of its failure that may be catastrophic. Such vulnerability to failure, which may considerably affect efficient banks, has promoted the concept of safe and sound banking systems in laws, regulations, and best practice principles on a national and international level.

This paper discusses bank failure with a bias to Kenya. The objectives that it seeks to meet include establishing to what extent Kenya has adopted international best-practice standards in the regulation of banks, analysing measures to mitigate the risk of systemic failure in Kenya's banking industry and determining if and how Kenya's bank regulatory framework can be improved to foster bank stability and reduce bank failures. To put it into context, the paper reflects of the history of bank failures in Kenya and briefly highlights the most recent failures of Dubai Bank, Chase Bank Limited, and Imperial Bank Limited, all of which descended into receivership from the year 2015, and some which have since been liquidated. It establishes that in all the banks, there was a violation of market conduct and some prudential requirements that banks are mandated to adhere to by legislation and the Central Bank of Kenya. Further, that Kenyan legislation and adoption of international best practice is sufficient basis for banks generally to manage their risk profiles, and for the Central Bank of Kenya to apply the necessary supervisory interventions. However, there is an opportunity to implement and enhance existing legislative provisions. The paper concludes by putting forth various recommendations towards these, all aimed at preventing bank failure.

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List of Abbreviations

ASIC – Australia Securities Investment Commission

APRA – Australian Prudential Regulatory Authority

AFM – Autoriteit Financiele Markten

BCBS – Basel Committee on Banking Supervision

CAMELS – Capital adequacy, Asset quality, Management, Liquidity and Sensitivity to market risk

CBK – Central Bank of Kenya

CBK/PG – Central Bank of Kenya Prudential Guidelines

CMA – Capital Markets Authority

CR – Council of Financial Regulators

DNB – Dutch Central Bank (De Nederlandsche Bank)

DSB – Dirk Scheringa Bebeer

FSCA – Financial Sector Conduct Authority

GFC – Global Financial Crisis

IRA – Insurance Regulatory Authority

KDIC – Kenya Deposit Insurance Corporation

PA – Prudential Authority

PVK – Stichting Pensioen – en Verzekeringskamer

RBA – Reserve Bank of Australia

SARB – South African Reserve Bank

STE – Stichting Toezicht Effectenvekeer

USA – United States of America

List of Statutes

The Constitution of Kenya, 2010

Central Bank of Kenya Act, CAP 491 Laws of Kenya

Banking Act, CAP 488 Laws of Kenya

Kenya Deposit Insurance Corporation Act, No. 10 of 2012 Laws of Kenya

CHAPTER ONE

1.1 Background to the study

Banks play a critical role in the economy, whether on a national or global level. Their fundamental roles include liquidity transformation, maturity transformation, and credit transformation.[1] By liquidity transformation, banks ensure that investors can convert their assets into cash. They give investors access to notes and coins for known value, as well as liabilities in the form of cheques to be used as a means of payment.[2] These functions are available to investors immediately or within assured periods, and banks succeed at this by holding adequate cash reserved to meet the demand for withdrawals. By maturity transformation, banks give investors long-term investments by utilizing short-term deposits, while by credit transformation, banks allow people to access credit facilities.[3]

Owing to the fore mentioned roles, banks receive special attention from governments and therefore, they are specifically highly regulated to ensure that they undertake their business within a controlled framework. This specificity in regulation is steered towards safeguarding the interests of stakeholders and promoting general financial stability in the economy. In Kenya, supervision of banks is carried out by the Central Bank of Kenya (CBK), which is mandated with fostering the liquidity, solvency, and proper functioning of a stable market–based financial system.[4] CBK is tasked with, among other functions, licensing and supervising authorised dealers and mortgage refinance companies, formulating and implementing policies that best promote the establishment, regulation, and supervision of efficient and effective payment, clearing, and settlement systems.[5] However, despite the existing laws, regulations and policies

[1] Armour J, Awrey D, Davies P, Enriques L, Gordon J, Mayer C, and Payne J, *Principles of financial regulation*, Oxford University Press, 2016, 277

[2] Armour et al, *Principles of financial regulation*, 277

[3] Armour et al, *Principles of financial regulation*, 277

[4] Section 4 (2), *Central Bank of Kenya Act* (CAP 491 Laws of Kenya)

[5] Section 4A (1), *Central Bank of Kenya Act* (CAP 491 Laws of Kenya)

tailored to foster the safety and soundness of banks, bank failure remains a threat to financial stability.

Bank failure is not unique to Kenya but is a global phenomenon that has presented in banks in advanced, developing, and emerging economies separately and concurrently due to increased globalisation. In the year 2008, the Global Financial Crisis (GFC) reportedly resulted in the worst global economic performance since World War II.[6] It is reported that the primary cause of the GFC was insolvency challenges faced by financial institutions in the United States of America (USA) and Europe owing to USA's mortgage-backed securities crisis that caused a burst in real estate at least a decade before the GFC[7]. With a rise in the subprime mortgages, it was not clear which banks had been largely exposed to bad assets, which inevitably affected interbank money markets.[8] The distress of significant banks such as Bear Stearns, and insurance companies such as AIG leading to their bailout, and the eventual collapse of other significant banks, such as the Lehman Brothers of the USA and Northern Rock of the United Kingdom, instigated a ripple collapse of banks systemically, resulting in a crisis whose effects were felt globally.[9] To put into context the gravity of the extent of the effects of the crisis, emerging and developing economies experienced a declined growth rate of up to 2.39 percent in the year 2009 compared to a steady average growth rate of 6 percent between the years 2000 and 2008.[10] The European Union's output also took a decline of 4.08 percent as compared to the 3.16 percent average in advanced economies.[11] Generally, the global trade volume of goods and services dropped by 10.66 percent in the year 2009, cumulatively showcasing the adverse effects of the GFC.[12] Owing to the GFC and its adverse effects to the world economies, countries spearheaded by the Group of Twenty (G20) embarked on discussions towards reforms in global financial governance to arrest, address or mitigate the occurrence of another

[6]Jan Wouters, Steven Sterkx, Tim Corthaut, The European Union and Global Emergencies, chapter 7, 142
[7] Luc Laeven, Fabien Valencia, Resolution of banking crises; the good, the bad and the ugly IMF working paper 10/146, 2010, 4
[8] Prof George G Kaufman, Global Financial Crisis, a retrospective look, Journal of Financial economic policy, 2015 vol.7 pg 4
[9] Luc Laeven, Fabien Valencia, Resolution of banking crises; the good, the bad and the ugly IMF working paper 10/146, 2010, 5
[10] Jan Wouters, Steven Sterkx, Tim Corthaut, The European Union and Global Emergencies, chapter 7, 142
[11] Jan Wouters, Steven Sterkx, Tim Corthaut, The European Union and Global Emergencies, chapter 7, 142
[12] Jan Wouters, Steven Sterkx, Tim Corthaut, The European Union and Global Emergencies, chapter 7, 142

global financial crisis.[13] Similarly, the Basel Committee responded to the crisis by proposing various reforms in the prudential regulation of banks.[14]

Turning to Kenya and its experience with banking/financial crisis, CBK has experienced some turbulence in maintaining the solvency of banking institutions. The onset of challenges took place between 1984 and 1989, thereafter between 1993 and 1994, 1998 and post the year 2000. The failures that took place between 1984 and 1989 occurred before the enactment of the Banking Act, CAP 488 Laws of Kenya, in 1989 and were characterized as family-owned banks.[15] Between 1984 and 1994, 26 banks had failed for various reasons including non-performing loans, poor corporate governance by the Board of Directors, under capitalisation, insider loans, poor asset quality, credit mismatch, and a high number of unsecured loans including to bank management.[16] As of 1998, 37 banks had descended to receivership and liquidation.[17] Some scholars have observed that the deplorable state of the banking industry in the '80s and '90s could be largely attributed to the rapid growth of the sector while there lacked sufficient and or suitable laws to ensure a sound banking system.[18] The laws at the time overlooked vital aspects such as insider lending, unsecured loans, poor or ineffective management, among other factors that could destabilize banks.[19] The unpleasant experience of the '80s and '90s compelled CBK and the government to rethink bank regulation and supervision, leading to various amendments of banking laws. The state incorporated safety nets in banking, to protect the industry, depositors, and creditors in case of insolvency of a bank.

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[13] Jan Wouters, Steven Sterkx, Tim Corthaut, The European Union and Global Emergencies, chapter 7, 142

[14] Prof George G Kaufman, Global Financial Crisis, a retrospective look, Journal of Financial economic policy, 2015 vol.7 pg 4

[15] Mugo, Preventing failure of commercial banks in Kenya, 12

[16] Central Bank of Kenya Annual Supervisory Report, 1994 https://www.centralbank.go.ke/images/docs/Bank%20Supervision%20Reports/Annual%20Reports/BSD%20Report%201994.pdf

[17] Waweru, Nelson & Kalani, Victor, Commercial Banking Crises in Kenya, Causes and Remedies, *African Journal of Accounting, Economics, Finance, and Banking Research 4, (2009)*

[18] 'Thomas N Kibua on Banking Soundness and monetary policy', September 1997, https://www.elibrary.imf.org/view/IMF071/00643-9781557756459/00643-9781557756459/ch21a.xml?p=emailAEhS5sZQ0632k&d=/IMF071/00643-9781557756459/00643-9781557756459/ch21a.xml on 29th January 2020

[19] 'Thomas N Kibua on Banking Soundness and monetary policy, September 1997, https://www.elibrary.imf.org/view/IMF071/00643-9781557756459/00643-9781557756459/ch21a.xml?p=emailAEhS5sZQ0632k&d=/IMF071/00643-9781557756459/00643-9781557756459/ch21a.xml on 29th January 2020

Over the last five years, CBK has placed three banks under receivership, with one descending into liquidation shortly after being placed under receivership. On 14th August 2015, CBK appointed Kenya Deposit Insurance Corporation (KDIC) as receiver of Dubai Bank for 12 months according to Section 53 of the Kenya Deposit Insurance Corporation Act[20] (KDIC Act). CBK's justification was that Dubai Bank experienced serious liquidity and capital deficiencies which raised CBK's concerns that the Bank would most likely not be able to meet its financial obligations as and when they fall due. Ten days later on 24th August 2015, the bank descended to liquidation.[21]

Later on in October 2015, CBK placed Imperial Bank Limited under receivership for 12 months. CBK informed the public that it had become aware that Imperial Bank Limited had unsafe and unsound business practices, thus necessitating it to place the Bank under receivership as soon as it became aware of the malpractice.[22] The 12 months statutory period of receivership lapsed without KDIC having resolved the matter. Anticipating a fair resolve, CBK extended the period for another 6 months according to Section 53 of the KDIC Act. Upon expiry of that period, CBK, the shareholders and depositors of Imperial Bank Limited, along with KDIC agreed to extend the period of receivership for another 12 months. As the Act did not provide for any further extension of time save for the cumulated 18 months, the parties legalized the extension through the High Court. The parties were of the common view that an extension of time would be necessary to enable CBK and KDIC to invite Expressions of Interest from potential strategic investors with the possible resolution of the receivership.

In 2016, CBK placed Chase Bank Limited under receivership.[23] This time, CBK informed the public that Chase Bank Limited had faced liquidity difficulties following

[20] No. 10 of 2012, Laws of Kenya

[21] https://www.centralbank.go.ke//images/docs/media/2015/DubaiBankpressrelease.pdf on 29th January 2020

[22] https://www.centralbank.go.ke//images/docs/media/Press%20Releases/Joint_Press_Release_CBK_and_CMA_-_Imperial_Bank.pdf on 29th January 2020

[23] https://www.centralbank.go.ke//images/docs/MPC%20Press%20Releases/Press_Release_Chase_Bank_Limited_April_7_2016.pdf on 29th January 2020

inaccurate social media reports and stepping aside of 2 of its directors. For those reasons, the bank had failed to meet its financial obligations on April 6, 2016.[24]

The failure of these banks has harmed their depositors, stakeholders, and other shareholders. These failures are a threat to the financial stability of the Kenya economy, which is heightened by the systemic interdependence of banking institutions.

1.2 Statement of the problem

Ideally, only inefficient banks should fail. However, due to the interconnectedness of banks, the failure of an individual bank may pose a systemic risk to other banks, regardless of whether they are efficient or not. The Global Financial Crisis is exemplary of the possible extent of the systemic risk and the adverse economic effects that can result. In Kenya, the failures of Dubai Bank, Imperial Bank Limited, and Chase Bank Limited, which happened in close succession, raised concerns over the stability of the banking sector and intimated that there may be some inefficiencies in the regulation of the banking sector.

Different jurisdictions have especially since the GFC assessed and incorporated various regulations and models to make banks more stable and resultantly, minimize bank failure, or its impact. Kenya has since the GFC, and through CBK, adapted a risk regulatory framework geared towards the prevention of bank failure. However, the framework is yet to be fully implemented and failures of Dubai Bank, Imperial Bank, and Chase Bank are indicative of this or that Kenya's supervisory and safety net framework may be inadequate or inefficient in ensuring bank stability. This paper shall identify the gaps in Kenya's risk regulatory framework, which CBK has gradually implemented to avert financial crises, and discuss those which require enhancement and implementation for effective bank supervision directed towards preventing bank failure.

[24]https://www.centralbank.go.ke//images/docs/MPC%20Press%20Releases/Press_Release_Chase_Bank_Limited_April_7_2016.pdf on 29th January 2020

1.3 Justification of the study

Banks are custodians of lump sums of deposits that they hold on behalf of individuals and corporations. They are also part of the country's monetary system, whose users have integrated and actively utilise in their daily personal and economic activities. Therefore, it is necessary to ensure that banks operate safely to preserve their functionality and critical role in the economy. Bank failure may lead to a plethora of problems including disruption of financial services, not just to the directly affected depositors and stakeholders, but also to other banks and the economy as a whole.

Kenya has enacted various laws to regulate sound banking practices. CBK has also adopted some international best practices for application by its licensees to enhance a safe banking system. This study is necessary to assess whether Kenya's current regulatory framework adequately addresses the risk of bank failure. Legislators will benefit from the study as they consider possible amendments to the current laws, and players in the banking industry may consider proposing further enforcement measures that may reduce the risk of bank failure.

1.4 The central research question

Whether Kenya's legal framework has incorporated adequate measures to ensure the stability of banks and prevent individual and systemic failure.

1.5 Objectives of the study

i. To establish to what extent Kenya has adopted international best-practice standards in the regulation of banks
ii. To analyse measures to mitigate the risk of systemic failure in Kenya's banking industry
iii. To determine if and how Kenya's bank regulatory framework can be improved to foster bank stability and reduce bank failures.

1.6 Research questions

i. Which standards of international best practice has Kenya adopted in the regulation of banks?

ii. Which measures has Kenya adopted to mitigate the risk of systemic failure?

iii. Which are the specific reforms that Kenya could incorporate into its risk regulatory framework to prevent bank failure?

1.7 Hypothesis

It is hypothesized that Kenya's banking risk regulatory framework is adequate to ably measure, monitor, and detect bank failure, and therefore, where justified, make the necessary interventions to respond to the risks and threats to bank failure. However, the lack of apt implementation of the existing mechanisms already incorporated into Kenya's banking laws and regulations continues to expose banks to the risk of failure.

1.8 Research methodology

The study will take a doctrinal approach in answering the research question and attaining the objectives of the study. The paper will highlight Kenya's recent encounter with bank failure, focusing on the failures which have occurred in the commercial banks since the year 2015. It will also assess CBK's regulatory action in the banks before their failure, CBK's action or response once the failures occurred, and what measures, if any have been taken to prevent future failure.

The study will also interrogate which laws, regulations, and policies Kenya has advanced to address the safety and soundness of banks, therefore reducing bank failure. These will be measured against the international best practice, more particularly against the Basel Core Principles for Effective Banking Supervision.[25] This research will therefore shed light on whether the Basel Accord standards that Kenya has adopted are sufficient to address the threat of individual and systemic bank failure. The doctrinal research will therefore entail a review of Kenya legislation, policies and guidelines, CBK reports on banking supervision, textbooks, and journal articles on the subject.

[25] Basel committee on banking supervision (hereinafter 'Basel'), *Core principles for effective banking supervision*, 2012

1.9 Literature review

1.9.1 The role of banks in an economy

According to Armour *et al*, banks hold deposits for safekeeping on behalf of depositors under the principle of fractional reserve banking.[26] Eric De Keleuneer appreciates that in the current times, banks and other actors in the financial sector have moved from availing 'single functions' and there are now universal banks, which carry out a myriad of activities not only limited to commercial banking which involves deposit-taking and lending but also expanded to the brokerage of investment funds, securities, and investment banking.[27] The issues regarding 'banks' as discussed in this paper will focus on commercial banks as they are more dominant players in Kenya.

Banks lend the deposits which they hold in surplus to borrowers. They assume that if only some of the depositors need to withdraw their funds at any one point, banks only need to avail a fraction of the deposits for withdrawal purposes and the remainder can be utilized for lending to borrowers. Banks, therefore, provide liquidity as investors can access funds of known value for their utilisation.[28]

Banks also invest in risky assets, whereby they take low-risk liabilities and transform them into risky assets. This is known as credit transformation. They have delegated monitors who screen the quality of borrowers, their performance in loan repayment, and act accordingly premised on their observation. They may withdraw funds where the borrowers' performance may expose the bank to the risk of loss.[29]

Banks also play a part in maturity transformation, where they fund projects or loans which are long-term in nature by translating short-term deposits into long-term investments. Depositors then gain higher returns from such long-term investments.[30]

The bank's role of deposit-taking and lending is said to have led to remarkable economic prosperity as the funds have driven economic activity around the world over time in various ways.[31] Banks mobilize savings remitted by depositors and select

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[26] Armour et al, *Principles of financial regulation, 421*
[27] De Keuleneer E, "Banks at the service of the economy?" *Studia Diplomatica* 67, no. 2, 2014, 85-98,
[28] Armour et al, *Principles of financial regulation,* 277
[29] Armour et al, *Principles of financial regulation,* 278
[30] Armour et al, *Principles of financial regulation,* 277
[31] Armour et al, *Principles of financial regulation,* 287

projects for investment where the mobilized funds will be utilised before maturity. The selected projects are in various industries, such as real estate and technology, and have been completed due to financial assistance from banks. In turn, the enterprise brought about by these projects contributes to the growth of the economy. Also, individuals, traders, and small and medium enterprises can steer their business by utilising the funds lent to them by the banks.

Armour et al also appreciate that banks play a critical role in the country's monetary system. Significant numbers of transactions are made through banks by them being a financial intermediary.[32] The Bank of International Settlements also acknowledges the critical role that banks play in the economy and thus affirms the need for strong and resilient banking systems. Banks are crucial intermediaries between savers and investors, thus they are at the centre of credit intermediation. Their services are provided across the board to small and medium enterprises, large corporations locally and internationally.[33]

1.9.2 The objectives of bank regulation

According to Eric De Keleuneer, as key intermediaries in the financial sector, banks are prone to excesses, which inevitably affect the public good. It is for this reason that banks are regulated.[34] Armour et al appreciate that bank regulation is set out to achieve several goals. They posit that it ensures that the value of the stake held by shareholders in the bank is maintained, such that capital adequacy is at all times assured even as banking business is fostered. They also appreciate that with regulation, it is less likely that banks will face liquidity problems, and the probability of a bank being unable to meet demands for cash withdrawal from its depositors would be close to nil. According to them, effective regulation would also protect against systemic risk because in the absence of effective regulation, payment systems would be exposed to the risk of failure which would not only affect the bank depositors, but also the economy at large.

[32] Armour et al, *Principles of financial regulation, 287*
[33] Basel committee on banking supervision, *Consultative document -Strengthening the resilience of the banking sector,* 2009, 9
[34] De Keuleneer, E. "Banks at the Service of the Economy?" *Studia Diplomatica* 67, no. 2 (2014): 85-98, https://www.jstor.org/stable/26531619.

De Keuleneer proposes the need for activities carried out by banks to be distinctly separated and regulated by the requisite bodies.[35] For example, he states that banking and insurance do not mix well and must be separated. He also argues that commercial banking ought to be separated from investment banking and their separate simple regulation should include limits on risk concentration, lending limits, and minimal capital requirements.[36] As with the rest of the world, financial conglomerates are gradually increasing in Kenya. For example, KCB Group, which started as a licensed banking institution, has incorporated KCB Insurance Agency which provides health insurance, motor insurance, property insurance, general insurance, and life insurance services.[37] KCB Group has also incorporated KCB Capital Limited, which undertakes investment banking facilities with trading rights at the Nairobi Securities Exchange.[38] Whereas KCB Bank is regulated by CBK, KCB Insurance Agency and KCB Capital Limited are respectively regulated by the Insurance Regulatory Authority (IRA)[39] and the Capital Markets Authority (CMA).[40]

While the fore mentioned subsidiaries are under the supervision of the relevant regulatory authorities, arguably, their stability may affect the stability of other subsidiaries within the conglomerate. In response to the risk accompanying the rapid growth of banks and development of conglomerates, CBK has been in the course of establishing a consolidated supervisory framework in compliance with international standards for safe banking to ensure all risks befalling a bank and its subsidiaries, or a bank belonging to a conglomerate, are taken into account.[41] This supervision applies to those institutions that have substantial group relationships and are licensed by CBK. Where the institution is not licensed by CBK, CBK does not have direct supervisory roles over the institution but proceeds to identify the relationships between the institution and the bank, obtains the requisite information for purposes of assessing the risk that may arise elsewhere in the group entity such as in a

[35] De Keuleneer, Eric. "Banks at the Service of the Economy?" *Studia Diplomatica* 67, no. 2 (2014): 85-98, https://www.jstor.org/stable/26531619

[36] De Keuleneer, Eric. "Banks at the Service of the Economy?" *Studia Diplomatica* 67, no. 2 (2014): 85-98, https://www.jstor.org/stable/26531619.

[37] https://kcbgroup.com/insurance/ on 20th August 2020

[38] https://kcbgroup.com/capital/who-we-are/ on 20th August 2020

[39] https://kcbgroup.com/insurance/ on 20th August 2020

[40] https://kcbgroup.com/capital/who-we-are/ on 20th August 2020

[41] The Central Bank of Kenya risk-based supervisory framework, 2013, 13

significant shareholder, subsidiary or associate.[42] At the moment, CBK has only issued a prudential guideline that illustrates reporting requirements for group entities. The reporting requirements for the group's consolidated financial statements are set out along with the prudential requirements for capital adequacy, liquidity, single borrower limits, and restrictions on facilities to insiders on both a consolidated and individual basis.[43]

De Keleuneer further argues that expansion of banks beyond a certain size should be discouraged, and taxed. However, he does not bolster his argument by explaining the dangers of expanding or having big banks. Also, De Keleuneer does not present any study or data to test the inferred hypothesis that the larger the bank, the more difficult it would be to regulate, the lesser the probability that the bank would comply, and if so, why. One could argue that expansion may lead to joining the caliber of 'Too-Big – To-Fail'[44] although there is no guarantee that such banks are immune to failure. Conversely, it is not a guarantee that banks which are considered small in size are immune from failure. The impact caused by the failure of an individual small bank may be minimal compared to the failure of a bank of a bigger size, but the impact of the failure of many small banks may be far worse.

Armour *et al* propose four regulatory tools in bank supervision. Firstly, they propose that regulation should impose capital requirements on banks. If banks maintain balance sheet reserves, they can meet any shortfall arising concerning their liabilities, in the value of their assets.[45] Secondly, regulation should ensure that some of the bank's assets are held in liquid form, thus ensuring that funds will always be available to meet withdrawal by depositors. While this seems logical to do, it does not negate the risk of bank runs and there is no guarantee that the liquid assets set aside for this purpose will be sufficient to meet any irrational behavior of depositors during bank runs. A bank run is a situation where the depositors of a bank, being worried or losing confidence over the safety of their deposits in the bank, withdraw their deposits.[46] If

[42] Central bank of Kenya risk based supervisory framework, 2013, 13

[43] Central bank of Kenya, 'Prudential guidelines on consolidated supervision (CBK/PG/19)', *Prudential guidelines*, 2013, at 447

[44] These are banks that are considered very vital to the financial industry and economy that the government would intervene to prevent its collapse https://www.investopedia.com/terms/t/too-big-to-fail.asp

[45] Armour et al, *Principles of financial regulation,* 279

[46] Rajkamal Iyer, Manju Puri, Understanding bank runs; the importance of depositor-bank relationships and networks, 2012, American Economic Review, 1414

the depositors collectively withdrew their deposits from the bank, the bank's liquidity would certainly be affected and the bank would fail to meet all depositors' withdrawal requests concurrently. The European Commission acknowledges that no bank can ever have sufficient funds to redeem all deposits at a go. It may, however, possibly slow down contagion once the depositors confirm that indeed, the bank has not run out of funds. Thirdly, Armour *et al* argue that a lender of last resort must be in place and ready to assist ailing banks with short-term loans against their illiquid assets. Their final regulatory tool is ensuring that banks take out insurance against risk of losses on deposits. Noteworthy, components of these four regulatory tools are incorporated in the Kenya national law, and further reading of this paper will discuss their effectiveness.

The Basel Committee on Bank Supervision predicts that despite the structural changes adopted post the GFC and regulatory tools that are applied to safeguard sound banking systems, more efforts are necessary to ensure that banks survive the disruption of whatever form. Capital and liquidity measures have been enhanced to sustain financial shocks but banks remain exposed to risks that are beyond their control. Natural disasters, technology failures, cyber incidents, and pandemics are a significant threat to bank stability and may cause immense disruption in the financial markets. The Committee is therefore proposing measures that would increase operational resilience, thus increasing safeguards that protect financial stability. It has also made revisions and improvements towards attaining effective operational risk management.[47] Appreciating that some of these risks, such as the current Covid-19 pandemic could not have been prevented, and their eradication is beyond their control, the Committee concludes that a rational and elastic tactic to operational resilience can equip banks with the capability to survive and recuperate from possible threats.[48]

[47] Basel committee on banking supervision, *Consultative document revisions to the principles for the sound management of operational risk,* August 2020

[48] Basel committee on banking supervision, *Consultative document principles for operational resilience*, 2020

1.9.3 International standards on bank regulation

The Basel Core Principles of Banking Regulation are the international benchmark for assessing the quality of bank supervision, banking systems, and their sound prudential regulation.[49] The principles are put in place for voluntary universal use to strengthen the global financial system. They were first formulated in response to the serious disturbances in international currency and banking markets and more particularly the failure of Bankhaus Herstatt. Many jurisdictions must adopt the principles in addition to their regulations because weaknesses in banking systems anywhere in the world not only threaten the country's economy but also affect the global system. International cooperation amongst bank supervisors is therefore very crucial if the objectives of the Basel Committee are to be fulfilled.

The Basel Committee on Banking Supervision has come up with 29 principles for effective banking supervision. Principle 1 to 13 focus on powers, responsibilities, and functions of supervisors while 14 to 29 dwell on prudential regulations and requirements for banks.[50] The Committee states that a supervisor's objective should not be to prevent bank failure but to reduce the probability of bank failure, and its impact, should it so happen.[51] It would appear that the sooner that individual banks implement the Basel principles that steer financial stability, the sooner they actively put measures that mitigate operational risk and promote operational resilience in case of any hazards.

In 2014, the Committee reported that implementation of the Basel principles has been a challenge in many jurisdictions, where further guidance is needed to facilitate their implementation in various areas such as senior management oversight, risk assessment, three lines of defence, operational risk appetite and tolerance and risk disclosure.[52] However, many countries, especially in Africa, have chosen to only selectively implement the Basel principles, if at all. These countries, the majority of which are in emerging economies, only apply those principles which fit within their development levels or suit their needs. Comparatively, the majority of the countries

[49] Basel, *Core principles for effective banking supervision*, 2
[50] Basel, *Core principles for effective banking supervision*
[51] Basel, *Core principles for effective banking supervision*, 5
[52] Basel, *Consultative document revisions to the principles for the sound management of operational risk*, 1

which have fully implemented the Basel principles are developed countries. For example, in Africa, Kenya and Nigeria are integrating aspects that the Supervisors deem to be well suited for their economies.[53] One of the concerns by African states is the high cost of implementation of the principles, which may lead to an increase in the cost of capital. Nigeria, which was implementing Basel II and Basel III concurrently, acknowledged that some of the principles were divergent with the realities of the Nigerian economy and would therefore be applied with discretion.[54]

According to the African Development Bank, one of the reasons that Africa was least affected by the GFC is the continent's poor integration with the global financial system[55]. The crisis occurred while African countries were still transitioning from Basel I and Basel II, leaving questions as to whether Basel III suited the needs of African banks. Questions as to how cross-border supervision would be effectively conducted, with the continued presence of foreign banks and conflict between national and international regulation, also arose. According to the Bank, GFC exposed limitations of Basel I and II, proving that capital adequacy rules were not sufficient to reduce the risk of bank failure. Critics of the Basel principles have argued that reforms that emphasize policies that foster market discipline and monitoring would be more effective than strengthening capital standards, which do not boost efficiency, or reduce corruption in lending, all of which are vices that threaten the integrity, and therefore the stability, of the banking industry.[56]

CBK has made effort to formulate policies and guidelines that align with some of the Basel principles. For example, stricter regulations have been made on capital requirements in Tier-1 and Tier-11 banks.[57] However, despite banks in Kenya have adopted the core principles, some have still descended into risky financial exposure. Noteworthy, banks in Kenya adopted the Basel 1 Capital Adequacy Accord in 1999

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[53] https://oxfordbusinessgroup.com/analysis/accordance-africa-basel-iii-has-african-banks-reassessing-one-size-fits-all-prescription-and-their on 23rd August 2020
[54] https://oxfordbusinessgroup.com/analysis/accordance-africa-basel-iii-has-african-banks-reassessing-one-size-fits-all-prescription-and-their on 23rd August 2020
[55] African Development Bank, *Building capacity for bank regulation in the era of Basel III challenges and opportunities for Africa* Vol II, Issue III, December 2011,1
[56] African Development Bank, *Building capacity for bank regulation in the era of Basel III challenges and opportunities for Africa* Vol II, Issue III, December 2011, 3 para. 3
[57] https://oxfordbusinessgroup.com/analysis/accordance-africa-basel-iii-has-african-banks-reassessing-one-size-fits-all-prescription-and-their as of 23rd August 2020

yet in 2015, Dubai Bank failed as a result of capital inadequacies.[58] Kenya merely adopting the Basel principles will not prevent bank failures, because their adoption would be non-consequential in mitigating bank failure. Banks' strict adherence to CBK's policies and guidelines coupled with CBK's effective supervision of banks would safeguard the industry from the risks that the principle-driven policies seek to mitigate.

1.9.4 Causes and consequences of bank failure

According to the Basel Committee on Banking Supervision, before the GFC, many banks had excessively leveraged on their on and off-balance sheet leverage. Consequently, this affected their capital base, and banks tapped into their capital reserves.[59] This meant that banks had compromised their liquidity buffers and in due course, they could not maintain their trading and credit losses, especially resulting from the inefficiencies of the shadow banks linked to them. Further, the interconnectedness of the banks through complex transactions interconnected the shared weaknesses and ultimately, the market lost confidence in the financial stability and soundness of banks.[60]

Bank runs may also lead to bank failure. Traditionally, 2 theories explain why bank runs occur; the panic view and the fundamental view.[61] The panic view theory states that the reason bank runs occur is because depositors make a run for their deposits when other depositors behave in the same manner. Therefore, a bank run can occur irrespective of the reason or the soundness of a bank.[62] On the other hand, according to the fundamental view theory, bank runs occur when the depositors question the solvency of a bank premised on information available to them.[63]

The fore-mentioned causes of bank failure are not foreign to Kenya. When CBK placed Dubai Bank under receivership in August 2015, it cited that the bank had experienced serious liquidity and capital deficiencies. CBK was concerned that the bank would fail

[58] https://www.centralbank.go.ke/images/docs/media/2015/KDICPRESSRELEASE.pdf

[59] Basel, *Consultative document -Strengthening the resilience of the banking sector,* 2009, 9

[60] Basel, *Consultative document -Strengthening the resilience of the banking sector,* 2009, 9

[61] Graeve F, Karas A, 'Evaluating theories of bank runs with heterogeneity restrictions', Journal *of the European Economic Association Vol. 12 No.4* (2014), 4

[62] Graeve F, Karas A, Evaluating theories of bank runs with heterogeneity restrictions, 4

[63] Graeve F, Karas A, Evaluating theories of bank runs with heterogeneity restrictions, 4

to meet its financial obligations as and when they fell due.[64] As for Imperial Bank Limited, when CBK intervened in October 2015, CBK announced that the bank had unsafe and unsound business practices, affecting the liquidity of the entity. Thereafter in 2016, CBK placed Chase Bank Limited under receivership citing that the bank faced liquidity difficulties following inaccurate social media reports and stepping aside of 2 of its directors. For those reasons, the bank had failed to meet its financial obligations on April 6, 2016.[65] Chase bank's inaccurate reports influenced the depositors to make a run on the bank before CBK directed for the freezing of transactions and closure of the branches of the bank.

Of the effects of bank failure during the GFC was that the sectoral deficiencies spread to the real economy as a result of the critical role that banks play in the economy. Resultantly, there was significantly reduced availability of credit and liquidity. The effects of bank failure during the GFC would still occur if banks failed today. The higher the systemic risk, the worse the effect. Invariably, that is why the safety and soundness of the banking sector must start from ensuring safe banking practices among individual banks.

The fore-mentioned have been the common causes or threats of financial stability. However, presently, the banking business is gradually moving from the traditional system of banking to a digital system. As the world makes progress in technological advancements, the place of technology in banking may require safety mechanisms that could protect the system from cyber-attacks that could pose a challenge to bank stability. Forward-thinking policies rather than reactive would be instrumental in safeguarding the sector and require a more robust engagement.

1.10 Chapter breakdown

Chapter one introduces the topic of study and gives a brief background on the research area. It explains why the proposed study is worth the time, who would appreciate it, and how it will impact the area of study. It also identifies the research problem, illustrates what the aims and objectives of this paper are, and justifies the

[64] https://www.centralbank.go.ke//images/docs/media/2015/DubaiBankpressrelease.pdf on 29th January 2020
[65] https://www.centralbank.go.ke//images/docs/MPC%20Press%20Releases/Press_Release_Chase_Bank_Limited_April_7_2016.pdf on 29th January 2020

need for the research. It states the hypothesis and explains the method of research that will be undertaken in this study. A review of the literature on the subject is also carried out in this chapter, and through it, the points of convergence and divergence with various scholars are identified.

Chapter two discusses the underpinning theories of regulation, and whether regulating the banking industry safeguards public interest, promotes social welfare, and the goals of financial stability achievable through the banking industry.

Chapter three highlights the Kenya legal framework the for the banking industry, and critiques whether Kenyan banking laws meet the ideals of a sound and efficient banking system for individual banks and the banking system. The laws and policies will be measured against the international standards set out by the Basel Committee.

Chapter four explores regulatory reforms adopted in the banking industry in Australia, the Netherlands, and South Africa to reduce the risk of bank failure. It also discusses other reforms which have been adapted since the GFC, such as, judgment based regulation, risk based supervision, and recovery plans, and what they entail.

Chapter five gives the conclusion from the study and proposes recommendations for regulatory measures for adoption towards reducing the risk of bank failure.

CHAPTER TWO

THEORETICAL FRAMEWORK

2.1 Introduction

As discussed in chapter one, banks play a significant role in the economy, and they are the institutions that have been entrusted as custodians of lump sums of money belonging to the public. Thus, it is only imperative that banks are regulated in a manner that safeguards the public good. One of the theories that champion the regulation of institutions that confer the public good is the public interest theory. This chapter will discuss the public interest theory within the scope of regulation. It will explore the aims of regulation towards ensuring bank stability, and financial stability within the banking industry. It will also set the basis of the discussion in the later chapters, where Kenya's regulatory framework will be assessed in line with the aims of the theory.

2.2 Public interest theory of regulation

The public interest theory is not attributed to one specific scholar, but its components have been ascribed as dating back to Lord Matthew Hale[66] in dealing with monopolies and eventually A.C Pigou. Lord Hale believed that public interest is served when the public is served reasonably and with moderation. As there was no clarity as to what pertained to public interest, Campbell CJ[67] defined public interest as something that a community or class in a community has a pecuniary interest in, and such interest affects their rights.[68] With the progression of time, courts and scholars found that Lord Hale's description of public interest and what it sought to achieve could be extended

[66]Hale, M, *A treatise relative to the maritime law of England: In three parts. "Pars prima. "De jure maris et brachiorum ejusdem. "Pars secunda. "De portibus maris. "Pars tertia. "Concerning the customs of goods imported and exported. "From a manuscript of Lord Chief-Justice Hale*, 1787.

[67] R vs Bedfordshire (24 LJ QB 84)

[68] Hantke-Domas M, The public interest theory of regulation: non-existence or misinterpretation? European Journal of Law and Economics 15, (2003), 167

to other factors, not just monopolies because the concept of public interest was all about protecting the public's stake in its benefit.

The theory suggests that regulation seeks to protect and benefit the public. It also proposes that when markets fail, economic regulation should be imposed to maximise social welfare.[69] It is based on two assumptions; firstly, that unhindered markets often fail because of monopolies and externalities, and secondly, that governments can effectively intervene and avoid these market failures by way of regulation.[70] The theory is the justification used by most modern states and their governments, where regulation is formulated to break monopolies, regulate prices, and protect employees, consumers, and investors, cumulatively promoting social welfare.

Historically, the courts would intervene to safeguard public interest during a trade. The courts had the power to restrict the activities of a private party who undertook matters of public interest, only making their activities permissive to the extent that they were reasonable and fair.[71] The case of Allnut shed light on the criteria used by the court to impose such limitations. The courts would consider the following;

- a government license had been issued in respect of a certain trade,
- the license granted privileges or created a monopoly,
- the beneficiary of the licence was a private party
- the economic activity undertaken by the private entity was for the benefit of the public.

Indeed, anyone who applies and accepts a licence subjects themselves to the privileges and restrictions contingent on such licence. Eventually, when regulators took over specific industries, their roles and responsibilities in safeguarding public interest were more apparent and exclusively within their mandate. The courts only took a step back from intervening on behalf of the regulator, except where the regulator acted *ultra vires*.[72]

[69] Hantke-Domas M, The public interest theory of regulation: non-existence or misinterpretation? 165–194
[70] Sheifer A, Understanding regulation, *European Financial Management* Vol. 11 No. 4, (2005), 439-451
[71] Hantke-Domas M, The public interest theory of regulation: non-existence or misinterpretation? 169
[72] Hantke-Domas M, The public interest theory of regulation: non-existence or misinterpretation? 170

2.3 Criticisms of the public interest theory

Several critics have voiced their criticisms of the theory. Bentley argued that the public interest theory does not serve the public interest, but rather it serves the interests of groups who capture regulatory agencies only to protect their self-interests.[73] Other scholars who agreed with Bentley and asserted that it seemed contradictory to safeguard public interest while in reality they only safeguarded the interests of groups under the guise of public interest are Merle Fainsond and Lincoln Gordon.[74] They argued that the regulation was public-spirited, but driven by interested groups who sought to safeguard their interests from abuse by businesses and other practitioners. Thus, these groups have a stake in regulation and their views have to be considered in the regulation-making process. Fainsond found that the process must, therefore, take into account the following[75]:

a. conditioning factors such as technology, law, and institutional factors which would determine if and which role the interested party would have to play[76]
b. who are the interested parties? Are they investors, customers and what is their bargaining power in the transaction, to determine their influence in having resources allocated to them for their benefit[77]
c. whether there are any political instruments such as legislative or administrative processes that give structure to the operations[78]

Invariably, it was established that indeed the regulator and the various interest groups had their own agenda in the formulation of regulations. In subsequent years, the focus of regulation shifted to the protection of consumers.

The major criticisms of the public interest theory of regulation are largely associated with the Chicago School of Law and Economics. These criticisms dubbed the Chicago Theory of Regulation[79] are anti-regulation.[80] Firstly, the critics argue that markets and

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[73] Hantke-Domas M, The public interest theory of regulation: non-existence or misinterpretation? 179
[74] Mitnick B, The political economy of regulation. Creating, designing and removing regulatory reforms, New York: Columbia University Press, 1941
[75] Hantke-Domas M, The public interest theory of regulation: non-existence or misinterpretation? 179
[76] Hantke-Domas M, The public interest theory of regulation: non-existence or misinterpretation? 179
[77] Hantke-Domas M, The public interest theory of regulation: non-existence or misinterpretation? 179
[78] Hantke-Domas M, The public interest theory of regulation: non-existence or misinterpretation? 169
[79] Hantke-Domas M, The public interest theory of regulation: non-existence or misinterpretation? 169
[80] Andrei Sheifer A, Understanding regulation, 439-451

private firms do not need government intervention or regulation to respond to market failures; they can take care of themselves. They argue that the public interest theory is highly exaggerated because the market is inherently capable of assuring the safety of customers, investors, and employees because of competition in the market. For example, competitors would offer better, safer, and more competitive products to increase their market over fellow competitors. Those who fail to do so would lose business to their competitors, urging them to either adapt or be phased out. Secondly, they argue that private litigation can address affected parties' concerns where markets do not work efficiently. They compare this to neighbours and industry players whose common underlying factor is that they need each other, thus they find ways to reconcile amongst themselves without government intervention. This way, it is easier for insiders to combat misconduct from their counterparts. Thirdly, should the markets and courts prove inefficient in solving the market deficiencies, governments are no good at remedying the situation. The critics argue that government regulators are incompetent, corrupt, and captured, thus there is no way that regulation steered by them would improve or combat market inefficiencies.[81]

Other critics of the theory, such as Coase and Richard A Posner[82] argue that in the rare cases where the self-efficiency of markets would not be successful, impartial courts may step in to adjudicate guided by the principles of contract law and tort law. Posner asserts that when plaintiffs are adequately and correctly served, that is an incentive for any potential tortfeasors to reconsider their actions[83]. Thus, when courts are efficient, little or no government enforcement is required.

Stigler's critique of the theory is by a counter-theory; Stigler's Capture Theory. It is premised on two hypotheses; firstly, that regulation fails to control monopolies and in fact, only propels it through state intervention. Secondly, that regulators are incompetent and rarely succeed even where they seem to be promoting social welfare through regulation.[84]

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[81] Sheifer A, Understanding regulation, 439-451
[82] Posner R, Theories of economic regulation, *Bell Journal of Economics*, Vol. 5 (1974), 335 - 358
[83] Sheifer A, Understanding regulation, 439-451
[84] Sheifer A, Understanding regulation, 439-451

In response to the above theories, Sheifer argues that while the arguments are remarkable, they may be clouded by bias and over-reliance on private enforcement and courts which are assumed to be without bias while in reality that is not a guarantee. Courts are presided over by officers whose impartiality may be compromised by external political and financial forces. Therefore, their criticisms may only promote favoritism to the rich and powerful who can influence the independence or impartiality of courts and their officers.[85]

2.4 Conclusion

This paper will demonstrate that the public interest theory of regulation supports measures that would ensure bank stability. In the banking industry, social welfare would be promoted and public interest safeguarded if the industry employed regulation and strategies that ensure both are attained by banks individually and systemically. In this case, when bank regulation promotes investor protection, consumer protection, market efficiency, and financial stability, it meets the rationale of the public interest theory as these ends to financial regulation effectively protect and benefit the public. As observed by Armour Et al, the nature of the banking system, and its asymmetry of information coupled with threats to stability, make a good case for regulation of banks.[86] Armour Et al argue that the scope of bank regulation is not single faceted, but arises in various dimensions such as regulating the entry of banks into the industry, their governance, prudential requirements, and bank resolution.[87] Due to the fragilities of the banking industry, this paper disagrees with the critics of the theory who assert that markets and industries should be left alone, are self-sufficient and any intervention should be left to the courts. The model adopted in this paper will demonstrate the importance of having regulations that are binding upon banks and regulators to define and safeguard the expectations of investors, customers, and other stakeholders. With set out regulations, a channel for accountability of banks and their supervisor is provided for. Furthermore, regulations open a channel for

[85] Sheifer A, Understanding regulation, 439-451
[86] Armour et al, *Principles of Financial Regulation,* 287
[87] Armour et al, *Principles of Financial Regulation,* 287

enforceability and guide the courts on the sector-specific parameters that they should premise their outcomes on.

A bank's unique role in the economy opens it up to both positive and negative externalities. Therefore, a bank's performance is not only useful for internal use and purposes, but it is also useful for the performance of other banks and the economy as a whole. For this reason, Armour Et al assert that if banks are left to self-regulate as is the practice among some other non-bank corporations, the bank's management will likely under-assess their risk profile risking the rise of negative externalities associated with the bank failure. Thus, to forestall such an occurrence, the gap may only be filled with effective regulation.[88]

[88] Armour et al, *Principles of Financial Regulation,* 442

CHAPTER THREE:
LEGAL FRAMEWORK GOVERNING KENYA'S BANK SUPERVISION

3.1 Introduction

Regulation of banks in Kenya is premised on key statutes which lay down the tenets of conducting banking business in Kenya. The statutes and regulations set out the threshold for entry of banks into the industry, their licencing, the role of the regulators, and bank insolvency. The key statutes which will be highlighted in this paper to the extent that they seek to safeguard the safety and stability of the banking industry are as follows:

i. The Central Bank of Kenya Act, CAP 491 Laws of Kenya
ii. Banking Act, CAP 488 Laws of Kenya
iii. Kenya Deposit Insurance Act, No. 10 of 2012

This chapter will discuss the Core Principles for Effective Bank Supervision, and whether Kenya has incorporated the Core Principles for Effective Banking Supervision[89] (the Core Principles) which are the minimum recommended international standards for bank supervision, with a specific focus on supervisory and prudential requirements. Further, the chapter will discuss whether Kenyan laws entail the necessary scope of bank regulation as discussed by Armour Et al; regulation governing entry requirements, governance, prudential requirements, and bank resolution[90]. .

3.2 The Core Principles for Effective Bank Supervision

The Basel Committee on Banking Supervision[91] is the originator of the Core Principles for Effective Banking Supervision[92]. The principles consist of 29 guidelines addressing supervisory and prudential requirements for safe and sound banking systems. They

[89] Basel, *Core principles for effective banking supervision*
[90] Armour et al, *Principles of Financial Regulation,* 287
[91] The Basel Committee on Banking Supervision is the primary universal body that sets standards for the prudential regulation of banks and provides a forum for regular cooperation on banking supervisory matters

are not binding but have been embraced across numerous jurisdictions according to each jurisdiction's needs, to provide an avenue for global systemic safety and soundness of banks. The principles are discussed below;

3.2.1 Supervisory requirements

The primary objective of the principles meeting the supervisory needs of the banks and the banking system is not designed to prevent bank failures. Rather, the main objective of supervision is to reduce the probability of bank failure as well as the impact the failure may cause, should it happen. All other objectives of supervision ought to be secondary to the provision of a safe and sound banking system.

Generally, principles 1 to 13 address the supervisory powers, functions, and responsibilities of the supervisor. The first principle provides that an effective system of bank supervision must have clear objectives and responsibilities set out for the supervisor/regulator whether they are the same body or not. These need to be embodied in a legal framework that gives the supervisor the legal authority to exercise its supervisory mandate. To be able to carry out their legal mandate effectively, the supervisor needs to be independent but transparent in its operational, governance, and budgetary processes for purposes of accountability.[93]

One of the crucial roles of the supervisor is to issue, revoke or recommend the revocation of licences. The supervisor, therefore, sets the criteria that determine whether an institution is eligible to be granted a banking license. The fifth principle provides that the minimum criteria for consideration of a license should include; the supervisor's fit and proper assessment of the ownership and management of the proposed bank, its risk profile, internal controls, capital base, and financial projections.[94] On the other hand, if upon being granted the licence, the bank engages in unsafe and unsound banking practices, the supervisor should be legally empowered to revoke the licence or recommend for it to be revoked.[95]

[93] Basel, *Core principles for effective banking supervision*, 10
[94] Basel, *Core principles for effective banking supervision*, 16
[95] Basel, *Core principles for effective banking supervision*, 11

The principles also propose that the supervisor should apply a forward-looking risk assessment of the banks and banks groups by utilising the requisite supervisory techniques and tools. This will ensure that necessary plans for early intervention are ready in place and enable early intervention of the supervisor where necessary. By intervening at an early stage, the supervisor may mitigate the spread of the effects of unsafe and unsound banking practices across the banking system.[96]

3.2.2 Prudential regulations and requirements

Principles 14 to 29 provide for the prudential regulations and requirements. They entail capital adequacy requirements, credit, market, operational, and liquidity risk management by banks, concentration, and exposure, reporting, transparency, and disclosure. They set out that the supervisor should have the necessary tools and policies in place to measure and mitigate and respond to arising risks promptly.

The supervisor is mandated to ensure that banks have a robust risk management profile. This starts with ensuring that the bank's board and management have sufficient oversight over their dealing and self-assessment of risks vis a vis their liquidity and market conditions. The supervisor should review the management profile in a manner that is proportionate to the bank's risk profile and systemic importance.[97] Similarly, the capital adequacy requirements should also match the risks posed to the bank as informed by the market in which it operates and its ability to absorb losses.[98] The supervisor should also set out proper credit risk management mechanisms to identify, measure and mitigate credit risk exposure on time.[99] Mechanisms to identify, measure, evaluate, monitor, report, and control banks' exposures to single entities or single related entities, thus leading to concentrations, as well as to measure market risk appetites, are also required of the supervisor.[100] Other risks that are imperative for the supervisor to identify, measure, monitor, evaluate, report, control, and mitigate are the interest rate risk taking into account the banks'

[96] Basel Committee of Banking Supervision, *Core principles for effective banking supervision*, 10
[97] Basel Committee of Banking Supervision, *Core principles for effective banking supervision*, 11
[98] Basel Committee of Banking Supervision, *Core principles for effective banking supervision*, 11
[99] Basel Committee of Banking Supervision, *Core principles for effective banking supervision*, 11
[100] Basel Committee of Banking Supervision, *Core principles for effective banking supervision*, 12

risk profile, market risk and macroeconomic conditions, and the liquidity risk by setting out measured and appropriate liquidity requirements.[101]

It is also recommended that the supervisor ensures that banks publish their financial reports in line with internationally accepted accounting standards, and are also subjected to external audits. This should not only be limited to banks but also apply to bank groups and parent companies. They should also publish information reflecting their financial condition, performance, risk exposure, and management, as well as their corporate governance processes.[102]

As the Core Principles are the benchmark for assessing the quality of bank supervisory systems[103] here below, the paper sets out the extent to which Kenyan laws have adopted the fore mentioned principles on supervisory and prudential requirements.

3.3 The Central Bank of Kenya Act, Cap 491 Laws of Kenya.

The Central Bank of Kenya Act is the foundational statute on which the regulation of Kenya's banking industry is premised. It legally establishes the relevant offices and officials who fulfill the purpose of the CBK and provides for the minimum threshold within which it is statutorily required to operate.

Section 3 (1) of the Central Bank of Kenya Act establishes CBK. Worthy to mention is that CBK is established under the grund norm, the Constitution of Kenya 2010, under Article 231, as an independent institution responsible for formulating monetary policy, price stability, issuing currency, and attending to other responsibilities provided for by statute.[104] The constitutional pronouncement of the CBK as an independent institution led to its empowerment in 2013 to make regulations under the Banking Act.[105] As per the Act, CBK's mandate is to exercise any type of central banking function which is not prohibited under the Act. These central banking functions are not consolidated and enlisted in the Act. However, the Act enumerates the objects of CBK.

[101] Basel Committee of Banking Supervision, *Core principles for effective banking*, 12
[102] Basel Committee of Banking Supervision, *Core principles for effective banking*, 13
[103] Basel Committee of Banking Supervision, *Core principles for effective banking*, 1
[104] Article 231 (1) and (2), Constitution of Kenya, 2010
[105] Upadhyaya R, "The political economy of Basel adoption in Kenya: A case of alignment of donor, government and banking sector interests", GEG working paper, No. 131, *University of Oxford, Global Economic Governance Programme (GEG)*, (2017), 8

CBK's principal object as per Section 4 (1) is to formulate and implement monetary policy directed to achieving and maintaining stability in the general level of prices. As discussed earlier, an essential criterion of the first Core Principle which provides for the responsibilities, objectives, and powers of the supervisor is to ensure that the supervisor's primary objective is to promote the safety and soundness of banking systems, and ensure that all other objectives do not conflict with the primary objective, and are only secondary to it.[106] The statutory primary objective of CBK is not on the promotion of safety and soundness of banking systems, rather it focuses on monetary policy. Further, the Act does not incorporate financial stability as an objective of the CBK. A survey conducted by the Bank of International Settlements found that majority of central banks did not have financial stability as one of their objectives in the relevant legislation.[107] It was deemed that that responsibility is inferred from the functions of the central banks, where licensing and regulation of banks contributes to financial stability. In countries such as China whose legislation explicitly provided that financial stability was one of the objectives of the central bank, the objective was very broad and seemed far reaching.[108]

Another objective of CBK under section 4 (2) is to foster the liquidity, solvency, and proper functioning of a stable market-based financial system. From the foregoing, this objective promotes financial stability implicitly by fostering 'proper functioning of a stable market-based system.' In essence, it means that CBK is charged with ensuring a stable financial system as it partakes of all its functions. However, the objective is generic as it is directed to the overall financial system, and not attached to a specific function or task[109]. It is also secondary to CBK's principal object, which is to formulate and implement monetary policy directed towards maintaining stability in the general level of prices.[110] The challenge that may be posed with this perceived deficiency of the statute failing to endow the regulator with specific functions aligned with 'fostering the liquidity, solvency and proper functioning of a stable market based

[106] Basel Committee of Banking Supervision, *Core principles for effective banking supervision*, page 21
[107] Bank of international settlements, Roles and objectives of modern central banks, www.bis.org on 25th September 2020
[108] Bank of international settlements, Roles and objectives of modern central banks, www.bis.org on 25th September 2020
[109] Serge J, "Financial stability objectives and arrangements, what's new" in the *bank of international settlements papers no. 76*, 47
[110] Section 4 (1) Central Bank of Kenya Act (CAP 491 laws of Kenya)

financial system' is that it may be difficult to define and measure what the indicators of the ideal system envisaged in the Act.[111]

Section 4A (1) (c) of the Act provides CBK's further objective is to licence and supervise authorised dealers, which as highlighted in the foregoing, is also deemed to contribute to overall financial stability.

To safeguard its solvency as regulator and lender of last resort, CBK's authorized capital is Kshs. 5 billion, which may only be increased out of the General Reserve Fund, but not be reduced.[112] Further, towards attaining its monetary policy objectives, CBK generally acts as a banker of commercial banks[113] and provides secured loans to commercial banks on an overnight basis at the Central Bank Rate. Other loans to commercial banks, not exceeding 6 months, may also be granted by CBK to banks that offer government securities such as treasury bills.[114] These standing facilities with the CBK enable commercial banks to cater for temporary liquidity challenges, thus providing the banks with a lifeline to meet their financial obligations when they fall due. Because of this, banks can meet their credit, maturity, and liquidity transformation functions.

Additionally, the CBK may require a commercial bank to maintain minimum cash reserves with the CBK against their liabilities.[115] If a bank fails to maintain these minimum cash balances, the CBK may at its discretion penalize the defaulting bank at the rate of one percent of the deficiency, per day, or Kshs. 10,000/- per day, whichever is higher. Compliance with this requirement leaves room for a lot of discretion or leeway for enforcement by CBK, and of compliance by banks due to the permissive language of the provisions. In light of the cash penalty, banks may also calculate whether the risk of non-compliance outweighs the benefits of compliance.

Lastly, CBK is also permitted to grant a loan to the Kenya Deposit Insurance Fund (previously known as the Deposit Protection Fund Board) for a maximum period of three years, backed by treasury bills or other government securities as collateral for

[111] Serge J, "Financial stability objectives and arrangements, what's new"
[112] Section 8, Central Bank of Kenya Act (CAP 491 laws of Kenya)
[113] Section 34, Central Bank of Kenya Act (CAP 491 laws of Kenya)
[114] Section 36, Central Bank of Kenya Act (CAP 491 laws of Kenya)
[115] Section 38 (1), Central Bank of Kenya Act (CAP 491 laws of Kenya)

the loan.[116] Since the amounts advanced are loaned and not donated, KDIC's independence from CBK on this front may not be compromised. Rather, the advancement may be necessary to ensure that KDIC is adequately liquid to promote the efficiency of bank supervision.

3.4 The Banking Act, CAP 488 Laws of Kenya

The Banking Act was enacted to consolidate all banking laws into one statute. It provides for the methods and mechanisms applied in the industry to ensure a safe and sound banking system and envisages that the scope of its provisions would extend to all entities conducting banking business in Kenya. In contrast with the Central Bank Act, the Banking Act does not set out the objectives that the legislation seeks to achieve in conjunction with CBK. However, it provides for both supervisory and prudential requirements; core principles for effective banking supervision that are the mandate of the CBK. The rationale behind some of these statutory provisions is enumerated under CBK's Prudential Guidelines, 2013, which shall also be referred to under this head as they were issued under the Banking Act. Their purpose was to ensure that there is transparency between CBK and the licensees, as well as to maintain standardized practices across the banking sector.

3.4.1 Supervisory requirements

The following supervisory requirements are provided for in the Act and the guidelines;

i. Licensing

In line with the first Core Principle highlighting clear objectives, responsibilities, and powers of the supervisor, Section 4 requires all entities wishing to conduct banking business to apply for their license from CBK, the sole licensing body. It also introduces the licensing criteria to be applied by CBK. For example, CBK shall among other criteria certify whether the applicants are fit and proper, that is whether they are morally and professionally suitable to be granted a banking licence. Additionally, CBK may also consider the financial condition and history of the institution, its capital

[116] Section 46A, Central Bank of Kenya Act (CAP 491 laws of Kenya)

structure and prospects of earning, the convenience and needs of the area to be served, and the public interest which will be served by the granting of the licence.[117]

Other criteria to be followed are laid down in the First Schedule. Essentially, the First Schedule enumerates on Section 4 and provides for the criteria determining the moral and professional suitability of the proposed directors and senior management of the bank, which include; their credentials, ability to reach and render sound advise/decisions, ability to abstain from rendering a decision when they cannot be objective about a subject matter, whether they have any conflict of interest in taking up the position, whether they have any previous cases of fraud, are part of the management of an institution under liquidation, are personally in good financial standing and have not defaulted in their financial obligations and whether they have been convicted of fraud or have been in a position where their actions have defeated the protection of public interest.[118] Similarly, it also sets out the criteria for determining the professional and moral suitability of the bank's significant shareholders.[119]

In a bid to bolster the need for fit and proper persons to manage banks, an amendment to the Act by way of Section 9A provides that all persons who wish to serve as directors or senior officers of the bank must first be vetted by CBK and may only proceed for appointment or election after CBK certifies them as fit and proper.[120].[121] The same pre-condition is also placed on persons who wish to become significant shareholders of the bank; CBK must first vet them and certify that they are fit and proper to manage or control the bank.[122] Any existing significant shareholder who is suspected to not be fit and proper in light of new evidence will also be subjected to vetting by CBK.[123] If a non-significant shareholder has avenues of direct or indirect control or influence of the bank and or its shareholders, or if they have deliberately reduced their shareholding to avoid being vetted by CBK, CBK may, in any event, elect to vet them to decipher whether they are fit and proper.[124] If a shareholder is

[117] Section 4 (5), Central Bank of Kenya Act (CAP 491 laws of Kenya)
[118] First Schedule, Part A Central Bank of Kenya Act (CAP 491 laws of Kenya)
[119] First Schedule, Part B Central Bank of Kenya Act (CAP 491 laws of Kenya)
[120] Section 9A (1), Banking Act (CAP 488 laws of Kenya)
[121] Section 9A (8) (a) Banking Act (CAP 488 laws of Kenya)
[122] Section 9A (2), Banking Act (CAP 488 laws of Kenya)
[123] Section 9A (3) (c), Banking Act (CAP 488 laws of Kenya)
[124] Section 9A (3A), Banking Act (CAP 488 laws of Kenya)

found to not be fit and proper, CBK may require them to reduce their shareholding to below five percent of the shareholding[125], cease exercising their voting rights[126]. In case a director or senior officer is found not to be fit and proper, they shall cease to hold office.[127]

From the foregoing, it is evident that the law provides for comprehensive consideration of the key issues of governance of the banks by CBK, especially so to vet the persons who will be in charge of and responsible for the day-to-day management of the bank. The law expects CBK to gauge the impact that the bank will have on the society that it seeks to serve, and equally important, it assessed the financial stability of the institution. All these factors promote safe and sound banks and speak to safeguarding the public interest. They demonstrate the public interest theory of regulation in action, whereby the CBK has set up pre-conditions to entry into the banking sector on behalf of the populace who may not have the technique, tools, and skills to decipher who should qualify for a banking licence.

However, it is also evident that despite the elaborate provisions to empower CBK to detect, prevent and control poor management of banks, the most recent bank failures were marred by poor governance issues that CBK ought to have detected timely and acted promptly in to safeguard depositors, investors, and public interest. Imperial Bank Limited and Chase Bank failed due to unsound business conditions and business practices, exemplified even by the disbursement of unconscionable loans to management at the expense of the bank's stakeholders.[128] CBK may consider a continuous assessment of the fit and proper test upon bank management, subjecting the governance of banks to the test of integrity. Continuous assessment may monitor and detect poor management, thus ensuring that corrective measures are applied promptly.

At section 6, the Act provides for revocation of licences in instances is found to be in contravention of any of the banking laws or regulations.[129] This power to revoke a license also conforms with the first Core Principle, thus restricting foul banking

[125] Section 9A (4) (b) Banking Act (CAP 488 laws of Kenya)
[126] Section 9A (4) (a) Banking Act (CAP 488 laws of Kenya)
[127] Section 9A (5) Banking Act (CAP 488 laws of Kenya)
[128] https://www.cytonn.com/topicals/topical-june-25-2017 on 22nd May 2021
[129] Section 6 (1) Banking Act (CAP 488 laws of Kenya)

practices under the watch of CBK. However, revocation of a license is a considerable action that CBK should apply cautiously, as a last resort, and only in the gravest circumstances where the bank has deliberately failed to comply with the regulation. This is because mass revocation of licenses would adversely affect the economy, albeit conversely it would be an indicator of ineffective regulation and failed supervision by CBK.

CBK also regulates the expansion of banks in terms of the number of branches or subsidiaries outside Kenya, as well as mergers and acquisitions. Any element of expansion outside Kenya and/or merger within or outside Kenya must obtain regulatory approval under Sections 8 and 9 of the Act. With the expansion of financial services within and outside of Kenya, CBK must be aware of, and vets the expansion of banks before the planned expansion. This way, CBK would be able to determine whether the expansion ventures are viable, the risk factors that need to be considered, and their potential effects on individual and systemic stability.

ii. Advisory

Section 33 (1) mandates CBK to advise and direct if it reasonably believes that a bank is being operated in an unpermitted manner, which is detrimental to members of the public. The same is expected of CBK where the management of the bank is a party to a practice that is likely to occasion harm to the bank through contravention of any of the provisions of the Act.[130] In case of such an eventuality, CBK may;

- Generally, advice the bank and make recommendations concerning the conduct of business
- Direct on appropriate measures for adoption by the management concerning the improvement of business methods and attaining compliance with the Act and relevant regulations
- Appoint a competent person to advise and assist the bank with the implementation of new strategies

[130] Section 33 (1) (a) and (1) (b) Banking Act (CAP 488 laws of Kenya)

These provisions lay the basis for the Guideline on Prompt Corrective Action CBK/PG 21[131] whose purpose is to guide on which prompt corrective actions banks which are in distress may apply to avoid failure. A bank would be a candidate for prompt corrective action if;

- It fails to meet the threshold for capital requirements as prescribed in Section 18 and 7 of the Act
- The CAMELS (Capital Adequacy, Asset Quality, Management, Liquidity and Sensitivity to Market Risk) and management rating are each less than 3
- The bank is at a high risk of failure due to various factors including that it is participating in unsafe and unsound banking practices, a repeat violator of the provisions of the Act, regulations and or guidelines, has major reporting errors which do not represent the true financial status of the bank
- Generally, the bank has a high-risk rating against weak risk management

CBK conducts supervision both on-site and off-site and prepares a report on the examination. The various corrective measures that may be applicable pursuant to completion of the examination are such as;[132]

- meeting with the directors to discuss the outcome of the examination and have them acknowledge that they understand the contents and that they will execute the actions recommended therein promptly. A commitment letter may be issued by the bank to CBK in case there are delays in implementing the recommendations. These remedies are available for the highly-rated banks which are deemed to be strong.
- For fairly rated banks, they are required to enter into a Memorandum of Understanding detailing that they will develop, adopt and implement appropriate corrective measures to improve their business and business methods. The bank will also continually be monitored by CBK in the course of the remedy.[133]

[131] Central bank of Kenya, *Prudential guidelines*, 2013, 467
[132] Central bank of Kenya, *Prudential guidelines*, 2013, 471
[133] Central bank of Kenya, *Prudential guidelines*, 2013, 472-473

- For those banks which are rated 'marginal' or 'undercapitalized,' CBK may assign a resolution specialist, determine whether the institution is viable and develop a supervisory strategy. CBK may also direct the bank not to pay dividends, bonuses or increase salaries; restrict it from converting profits into capital; reconstitute or alter the management of the bank where necessary; impose restrictions on growth; CBK may conduct inspections more frequently; the bank may formulate a capital restoration plan and may appoint an advisor to the management.

In a nutshell, these provisions equip CBK to detect an ailing bank and allow it to intervene before the bank becomes a risk of failure and thereby, a risk to the stability of other banks. If followed through accordingly and the necessary interventions are made promptly, the risk of bank failure or crisis would arguably reduce. Conversely, where failure is inevitable, CBK may orchestrate proper resolution mechanisms in a manner that would protect consumers and cause the least disruption to financial stability.

3.4.2 Prudential requirements

i. Capital requirements

Regulation of capital adequacy is critical in establishing safe and sound banks. This is because, with high capital, which is essentially the shareholder's equity, the bank can be cushioned from insolvency in case of high losses. Further, it ensures that as long as the bank's losses do not exceed its capital, the bank will have assets without liabilities available.[134] Thus, the minimum capital requirement is a condition for the continuity of bank operations. However, excess capital is not recommended, as it would challenge the bank's ability to transform short-term excess cash into loans.

Basel III provides for desired quality and level of capital and offers three principal buffers to capital. They are the Capital Conservation Buffer, which applies to all banks all the time and aims that banks can withstand periods of stress, the Systemically Important Bank buffer, which applies to large systematically important banks all the

[134] Armour et al, *Principles of Financial Regulation*, 441

time due to the high risk of externalities in case of bank failure and the Counter-Cyclical Capital buffer, which may be applied to all or some of the banks sometimes or all the time.[135] The proposals under Basel III are for banks to raise the minimum common equity to 4.5% of risk-weighted assets after deductions, to include a capital conservation buffer comprising common equity of 2.5% of risk-weighted assets, therefore, totaling the common equity standard to 7%, and a counter-cyclical buffer of between 0 – 2.5% comprising of common equity applicable when the bank's growth of cretic poses a systemic risk. It also proposes capital loss absorption to reduce moral hazard. This way if a bank is deemed to be non-viable, the loss incurred will be absorbed by the capital available, rather than a bailout.[136]

The mandatory minimum capital requirements for banks are provided for under Section 7 and the Second Schedule of the Act. However, the Cabinet Secretary, with subsequent ratification of the National Assembly may amend the requirements therein.

Following the GFC in 2008, by 2012 CBK, in keeping with international recommendations on banking standards, increased the minimum capital required by banks from Kshs. 250,000,000 (USD 4 million) in 2008 to Kshs. 1 billion (USD 12 million). The GFC had revealed to regulators all over the world the failures of the banking sector and one of their reforms geared towards creating a more resilient banking system was to increase the minimum capital requirements[137]. The increase in the threshold of the capital requirements was intended to strengthen the institutional structures of individual banks. While setting the minimum capital requirement at Kshs. 1 billion, CBK set it out in phases, and in the intervening period between 2008 and 2012, it set out that banks should progressively attain the following milestones by the end of the timelines provided:[138]

- 31st December 2009 – Kshs. 350 million
- 31st December 2010 – Kshs. 500 million

[135] Armour et al, *Principles of Financial Regulation*, 464
[136] Basel Committee on banking supervision reforms – Basel III chart https://www.bis.org/bcbs/basel3/b3_bank_sup_reforms.pdf on 23rd April 2021
[137] Kenya bankers association, KBA center for research on financial markets and policy working paper series, in Gudmundsson R, Kisinguh K, Odongo M, *The role of capital requirements on bank competition and stability: the case of the Kenyan banking industry*, 2013
[138] Kenya Bankers Association, *The role of capital requirements on bank competition and stability: the case of the Kenyan banking industry*,

- 31st December 2011 – Kshs. 700 million
- 31st December 2012 – Kshs. 1 billion

The CBK Prudential Guidelines on Capital Adequacy (CBK/PG/03) reinforce the importance of the regulation and provide that it ensures that the capital recommended cushions both depositors and creditors proportionately to the risk of their investments.[139] Apart from the Core Capital and Supplementary capital which make up the total capital and are provided for under Section 2 (1) of the Banking Act, the guidelines provide for the Capital Conservation Buffer as a ratio of extra capital to risk-weighted assets over and above the minimum capital.

Section 17 of the Act prescribes the ratio between core capital and deposits at 8% of the total deposit liabilities while Section 18 and 19 of the Act mandate CBK to set out the minimum ratio of capital and assets as well as that of liquid assets. Thereby, the guidelines provide that where the CBK has not set out higher minimum capital for an individual institution, the institution must maintain capital in the following criteria[140]:

- Core capital at a rate not less than 8% of the total risk weighted asset plus risk-weighted off-balance sheet
- Core capital of not less than 8% of its total deposit liabilities
- Total capital of not less than 12% of its total risk-weighted assets plus risk-weighted off-balance sheet items

The CBK may require individual banks to maintain higher minimum capital ratios if they are found to have capital deficiency arising out of losses, rapid expansion/growth, governance deficiencies, voluminous assets of poor quality, or if the institution is exposed to high risk.[141]

The CBK monitors banks' compliance with the provisions of the Act and the prudential guidelines. For example, in 2018, CBK found that four institutions violated Section 18 of the Act and CBK Prudential Guideline on Capital Adequacy (CBK/PG/03). The provisions require an institution to have a minimum core capital to total risk-weighted assets ratio of 10.5%, a higher ratio than the default minimum

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139 Central bank of Kenya, *Prudential guidelines*, 2013, 87
140 Central bank of Kenya, *Prudential guidelines*, 2013, 88
141 Central bank of Kenya, *Prudential guidelines*, 2013, 90

stated above. Four institutions violated CBK Prudential Guideline on Capital Adequacy (CBK/PG/03), which requires an institution to have a minimum total capital to total deposits ratio of 12%. Four institutions violated CBK Prudential Guideline (CBK/PG/03) on Capital Adequacy, which requires an institution to have a minimum core capital to total deposits ratio of 8%. Three institutions violated Section 7(1) of the Banking Act and CBK Prudential Guideline on Capital Adequacy (CBK/PG/03), which requires an institution to maintain a minimum core capital of Ksh.1 billion.[142] CBK stated that there were in place remedial plans to correct the fore mentioned violations.

In 2019, three commercial banks violated Section 7(1) of the Act as they failed to maintain the minimum core capital required of Ksh.1 billion. Five banks were also in violation of Section 18 of the Banking Act and CBK Prudential Guidelines on Capital Adequacy, CBK/PG/03, Clause 4.1.2 due to failure to meet the minimum statutory required ratios for total capital and core capital to total risk-weighted assets of 14.5 percent and 10.5 percent respectively and core capital to deposit ratio of 8 percent.[143] The CBK set reportedly set out plans to ensure compliance by the affected institutions. However, the identities of the affected institutions are not disclosed to the public as a measure of stability. Therefore, we cannot ascertain whether the violations are done by the same institutions.

Clause 4.4 of CBK/PG/03 also recommends appropriate procedures and systems that would enable banks to ensure their capital adequacy. These procedures are known as Internal Capital Adequacy Assessment Process (ICAAP), and essentially aid a bank to identify, measure, aggregate, and monitor a bank's material risk, and utilize that information to build a suitable risk profile on whose basis capital would be allocated.[144] ICAAP is an adoption of Basel II standards, and ICAAP reporting was not enforced until 2017 when the first ICAAP reports were submitted to CBK in April 2017.[145]

[142] Central bank of Kenya, Supervisory annual report, 2019, 40
[143] Central bank of Kenya, Supervisory annual report, 42
[144] Central bank of Kenya, Guidance note on internal capital adequacy process, 2016, 2
[145] Upadhyaya R, "The political economy of Basel adoption in Kenya: A case of alignment of donor, government and banking sector interests", GEG working paper, No. 131, 7

The CBK Guidance Note on Internal Capital Adequacy Assessment Process[146] assists banks with the implementation of ICAAP as per the provisions of Clause 4.4 of CBK.PG/03. It recommends that the minimum requirements for an effective ICAAP should consist of 6 key components as follows;[147]

- The Board of Directors and senior management should have overall oversight and responsibility of planning, use, and review of the bank's capital and capital plan, understanding its present future and desirable capital levels and expenditures while ensuring that the bank continues to operate with adequate capital which will retain the bank as a going concern[148]
- Sound capital planning which includes setting out capital targets that require to be achieved within clear timelines and the steps which the bank will take to attain the set targets. The bank should also formulate an internal plan which it will actualize to maintain the capital adequacy levels, and provide contingency plans for unexpected events or uncertainties which may occur[149]
- Comprehensive identification and assessment of risks through comprehensive policies and procedures that should be applied continuously. The measurement systems, though not specified, should be elaborate and thorough to sufficiently capture the nature and magnitude of risk that the bank may be exposed to. To ensure consistency in the identification and measurement of risks, there need to be adequate controls to ensure that on – balance and off-balance sheet risks are captured. Thus, the bank should understand the nature of risk that they need to mitigate, and the possible effects of applying the measures and control the risks associated with applying the mitigating techniques. The bank should also invest in appropriate Management Information Systems and infrastructure to facilitate risk management and oversight. Reliance on third party measurement tools such as credit ratings needs to be validated.[150]

[146] Central bank of Kenya, Guidance note on internal capital adequacy process, 5
[147] Central bank of Kenya, Guidance note on internal capital adequacy process, 5
[148] Central bank of Kenya, Guidance note on internal capital adequacy process, 5 para. 4 (i)
[149] Central bank of Kenya, Guidance note on internal capital adequacy process, 5 para. 4 (ii)
[150] Central bank of Kenya, Guidance note on internal capital adequacy process, 5 para. 4 (iii)

- The bank should conduct forward-looking stress tests to elaborate the results of the bank's evaluation of its capital adequacy if the bank was exposed to adverse circumstances in a minimum of 3 years, and ideally in 5 years. These tests are both qualitative and quantitative, and they aim to evaluate how a bank would fair under harsh circumstances. They incorporate a sensitivity analysis which evaluates the bank's vulnerability under specific circumstances and a scenario analysis which evaluates the bank's vulnerability when exposed to joint movements of economic and financial variables under adverse circumstances. Since the stress test aims to identify and control possible risks or threats to the stability, capital adequacy or liquidity of a bank, the results of the stress tests should inform decision making by the bank's Board of Directors and senior management.[151]
- The bank should have a system of monitoring and reporting risk, which should incorporate an evaluation of the level and trend of material risks affecting their capital levels, an evaluation of the sensitivity and reasonableness of key assumptions used in capital assessment, an evaluation of whether the ban holds sufficient capital commensurate to risk exposure and whether they are in compliance with capital adequacy minimum requirements and overall goals, assess and propose whether any adjustments require to be made to their ICAAP document to address emerging risks.[152]
- The bank should regularly conduct internal audits to measure adherence to existing controls, identify gaps in risk management and ensure that there is a clear demarcation of duties and responsibilities of officials involved in risk monitoring and assessment, with a clear and transparent decision making process.[153]

The CBK is entitled to access of a bank's ICAAP report. The bank submits its ICAAP report annually, by 30th April. The report submitted by this deadline contains the bank's report of the previous year, that is, as of 31st December of the immediately previous year. However, the report contains the bank's risk strategy for the current

[151] Central bank of Kenya, Guidance note on internal capital adequacy process, 6 para. 4 (iv)
[152] Central bank of Kenya, Guidance note on internal capital adequacy process, 7 para. 4 (v)
[153] Central bank of Kenya, Guidance note on internal capital adequacy process,7 para. 4 (vi)

year, informed by the outcome of the previous year. From the report, CBK can evaluate the bank's risk profile and capital adequacy given its risk profile. The bank's capital adequacy will be determined from CBK's evaluation, and if necessary they may engage the bank on the execution of the ICAAP report.[154] Arguably, if banks premise their risk strategy on their performance in the previous year, the same may not be accurate considering the value of time and information as well as external factors that may affect the stability or trajectory of the financial sector. A more risk based, forward-looking approach in determining a bank's risk exposure, which has been incorporated in CBK'S risk regulatory framework as we shall see in chapter 4, would be more beneficial in making an informed risk assessment.

ii. Liquidity requirements

Section 19 of the Act provides for a bank's minimum required liquid assets. Essentially, a bank must comply with the minimum CBK recommendations on liquid assets, which change from time to time. These liquid assets include the bank's balances held with the CBK, the bank's balances held at other banks and if the balances are held with a bank which is abroad, the balance should be capable of withdrawal upon demand, Kenya treasury bills or bonds which do not exceed 91 days, as well as bank notes and coins.[155] If a bank fails to comply with the prevailing minimum recommendation they are liable to pay interest not exceeding 1% of the deficient amount.[156]

Basel III recommends international standards on liquidity. Its proposed Liquidity Coverage Ratio provides that banks should have high-value liquid assets to withstand 30-day stress conditions.[157] It also recommends a Net Stable Funding Ratio for purposes of addressing liquidity mismatches that may occur while encouraging banks to adapt to utilising stable sources of funding.[158] Supervisors are also encouraged to use inter-day and longer term monitoring metrics to assess the liquidity of banks both individually and systemically.

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154 Central bank of Kenya, Guidance note on internal capital adequacy process, 8
155 Section 19 (2) (b) Banking Act (CAP 488 laws of Kenya)
156 Section 19 (3) Banking Act (CAP 488 laws of Kenya)
157 Basel Committee on banking supervision reforms – Basel III chart
158 Basel Committee on banking supervision reforms – Basel III chart

CBK Guideline on liquidity management (CBK/PG/05) puts forth various guidelines that banks should adopt, and the CBK should use to monitor, to ensure that banks maintain adequate levels of liquidity and meet their obligations as and when they fall due. The bank's Board of Directors is tasked with formulating appropriate policies that will assist in achieving this.[159] The CBK may amend the minimum liquidity ratio from time to time. However, currently, all banks should maintain at least 20% of all its deposit liabilities, matured liabilities, and short-term liabilities in liquid assets.[160] The fore-mentioned policies as well as a bank's liquidity management framework should be able to identify any risks or challenges to funding, as these directly affect liquidity.[161] CBK/PG/05 recommend that an effective framework would incorporate the following:

- Liquidity management strategy[162]

This entails a bank's plan for remaining liquid in the long term, as well as what measures it will take to deal with liquidity mismatch.

- Management structure and information systems[163]

A bank should have the necessary information systems which will be integrated with the bank's overall system and whose purpose will be to measure, monitor, and control the bank's liquidity requirements. For the system to be efficient, the bank requires a dependable management reporting structure whose policies will be adhered to.

- Measuring and monitoring net funding requirements[164]

A bank should be able to assess the funds flowing into it against the funds being withdrawn from it, formulate informed assumptions and utilize all data or information collected from monitoring to assess whether there is or there is likely to be any shortfall in the bank's liquidity levels. It is provided that an Asset Liability Committee is formed to specifically monitor liquidity risk, and among its roles will be

159 Central bank of Kenya, *Prudential guidelines*, 158
160 Central bank of Kenya, *Prudential guidelines*, 158, 4.1
161 Central bank of Kenya, *Prudential guidelines*, 158, 4.2
162 Central bank of Kenya, *Prudential guidelines*, 158, 4.2.1
163 Central bank of Kenya, *Prudential guidelines*, 159, 4.2.2
164 Central bank of Kenya, *Prudential guidelines*, 159, 4.2.3

overall management of the liquidity of the bank, to ensure that the bank's operations are within the approved parameters set out by the Board of Directors and to coordinate balance sheet planning informed by the data collected.

- Contingency funding plan[165]

This plan should indicate which steps the bank will take to address any risks of a shortfall in liquidity in case of an emergency. The plan should be clear on roles and responsibilities of actions in such a situation, channels for escalation of issues, and should be robust enough to apply within various situations that would be considered to be stressful. The plan is not a one – size – fits – all but should be relevant to the banks' size and risk profile. To ensure that the plan would be useful when required, it is supposed to be tested regularly so that any deficiencies are addressed by enhancing the plan.

- Liquidity stress tests[166]

These tests are necessary to point out any emerging potential liquidity risks that had not been previously anticipated to address them, as well as to assess whether the bank is adequately prepared in case of an individual or system-wide stress situation that would pose a threat to liquidity. Effectively, stress tests ensure that the bank's management strategies and policies are up to date and relevant to the bank's actual reality.

- Foreign currency liquidity management[167]

This entails that major currencies traded should be monitored and controlled to avoid liquidity shortfalls.

- Internal controls for liquidity management[168]

To ascertain that the systems and policies put in place to address liquidity risks are effective, it is necessary to conduct independent reviews so that any recommendations

[165] Central bank of Kenya, *Prudential guidelines*, 2013, 159, 4.2.4
[166] Central bank of Kenya, *Prudential guidelines*, 2013, 160, 4.2.5
[167] Central bank of Kenya, *Prudential guidelines*, 160, 4.2.6
[168] Central bank of Kenya, *Prudential guidelines*, 160, 4.2.7

are known, considered, and applied. Further, the review should also be conducted along with the overall system review due to associated risks and the integral role of the bank's liquidity in bank stability.

iii. Governance

Section 8 (2) (b) and (c) and 9A of the Act envisages that before CBK grants an applicant with a banking licence, CBK shall be satisfied as to the moral and professional capability of its management and significant shareholders. Further, there are some restrictions of business set out under Section 10 and 11 of the Act, which prohibits insider lending by shareholders using their shares as security[169], lending in institutions where the bank holds more than 25% shareholding[170] and unsecured loans to its employees, officers, significant shareholders, or their associates or to any party who has a significant shareholder or the bank's officers as a guarantor.[171] Any advances made to the directors or management of the bank must be approved by the Board, be made within the ordinary course of business and CBK must be informed of the same within 7 days of the approval.[172] The aggregate amount lent to a particular shareholder, director, employee, or any of their associates should not exceed 20% of the bank's core capital lastly, any decision to grant a facility or enter into a contract should not be made recklessly or fraudulently.[173]

Once again, the law provides a safeguard to insider lending; that lending to insiders must be approved by the Board. However, it is evident that if the Board does not practice good corporate governance, they may not exercise this duty appropriately or in the best interest of the bank. At the time of its collapse, insider lending at Chase Bank was reported to be at Kshs. 16.8 billion against a balance sheet of Kshs. 80 billion, whose progression should have caught the attention of CBK and warranted an intervention before the escalation.[174]

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169 Section 11 (1) (a) Banking Act (CAP 488 laws of Kenya)
170 Section 11 (1) (b) Banking Act (CAP 488 laws of Kenya)
171 Section 11 (1) (c) – (d), Banking Act (CAP 488 laws of Kenya)
172 Section 11 (1) (e), Banking Act (CAP 488 laws of Kenya)
173 Section 11(1) (h), Banking Act (CAP 488 laws of Kenya)
174 https://www.standardmedia.co.ke/business-news/article/2000198316/bankers-censure-chase-bank-management-over-insider-loans on 22nd May 2021

An amendment under Section 11 (1B) was introduced to impose sanctions on bank officers who are complicit in insider lending which contravenes the provisions of Section 11 of the Banking Act. If found to be in contravention, CBK may direct for the removal of the director or suspension of a bank officer who approved the impermissible lending.[175] As for directors whose borrowing is duly approved but default in repaying their loans for 3 consecutive months, shall automatically cease from holding office.[176] These provisions underscore the importance of good leadership in banks, acknowledging that the tenets of corporate governance demand transparency and accountability, without which a bank would be left to descend into failure at the heavy expense of stakeholders.

The punitive extent of the sanctions provided for insider lending may require re-looking. Where arguably large amounts of money are the subject of transactions and facilities, officers of the bank may weigh the risks of non-compliance against the benefits of compliance, especially so because there is not recommended a pecuniary sanction. Perhaps a heavier sanction would deter bank officers from permitting such prohibited practices because even after the failure of Chase Bank and Imperial Bank, several banks are treading dangerously on insider lending. In 2019, five banks were found to violate Section 11 (1) (f) of the Banking Act, where bank officers had approved loans linked to a single insider for an amount exceeding 20% of the respective bank's core capital.[177] Four other banks were also in violation of Section 11(1) (g) of the Act, where the aggregate insider lending exceeded 100% of the respective bank's core capital.[178] Two banks were found to violate Section 11(1) (b) of the Act, as they had granted facilities to a company in which the banks had equity interest directly or indirectly, amounting to 25 percent or more of the share capital of that company.[179]

In 2018, three banks were found to violate Section 11(1) (f) of the Act while one violated Section 11(1) (c) and (d) of the Banking Act which requires all insider loans

[175] Section 11 (1B) (3) (b), Banking Act (CAP 488 laws of Kenya)
[176] Section 11 (1B) (5), Banking Act (CAP 488 laws of Kenya)
[177] Central bank of Kenya, *Supervisory annual report*, 2019, 42
[178] Central bank of Kenya, *Supervisory annual report*, 2019, 42
[179] Central bank of Kenya, *Supervisory annual report*, 2019, 43

to be secured.[180] Six banks were also found to violate Section 10 (1) of the Act, restricting lending to a single borrower for an amount exceeding 25% of its core capital.[181]

The CBK Bank Supervision Annual Report 2019 did not mention the violation of Section 11 (1) (e), which provides that all approvals of insider lending to directors and management of a bank must be submitted to CBK within 7 days of approval. Perhaps the scope should not be limited only to Section 11 (1) (e), but be expanded to include other criteria.

iv. Accounting

Under Section 21, all banks are required to keep records of accounts and financial statements, which should meet international reporting standards. Section 22 mandates the banks to publish their financial statements and meet CBK's financial disclosure requirements while Section 23 provides that within the first three months after the financial year (which ends on 31st December every year) the bank shall submit audited financial statements together with the audited reports to CBK.

v. Information and reporting requirements

Section 27 mandates CBK to access and collect all information necessary for it to discharge its mandate and if so required, it may publish the information per Section 31 as long as the information does not expose the affairs of a party without their consent

vi. Inspection and control

Vide the powers conferred upon it under Section 32, CBK may with approval of the Cabinet Secretary inspect the bank's books, accounts, and records. The inspection may lead to investigation or identification of any breach of law or regulations, which if the case CBK may take remedial action depending on the circumstances of the matter. While it would appear that this section confers CBK with the right to access and

[180] Central bank of Kenya, *Supervisory annual report*, 2018, 40
[181] Central Bank of Kenya, *Supervisory annual report*, 2018, 40

investigate, the right is contingent on the approval of the executive arm of government through the Cabinet Secretary.

vii. Deposit protection

A system of deposit insurance is a key element of systemic financial sector protection. Whereas deposit protection is not the responsibility of the regulator, it is the onus of the regulator to ensure that the relevant authority charged with effecting a proper deposit insurance system understands the extent of its importance and that it is a pre-condition for effective bank supervision.[182] The system should at the very least provide an appropriate level of protection amongst insured depositors through clear and transparent procedures. If such a public safety net is set up, it may reduce the risk of contagion in case there is bank failure.[183]

Section 36 of the Act establishes the Deposit Protection Fund Board (now known as Kenya Deposit Insurance Corporation. The Fund was established in 1989, during the heat of bank failure in Kenya, and defined Kenya's deposit protection arrangement as explicit. Previously, Kenya had an implicit deposit protection arrangement, where no laws were guiding on the protection of deposits in the event of bank failure, and the banks and depositors would assume that in case of such an eventuality, the government would intervene and come to the aid of the depositors, ensuring that they recover a portion of their deposits. The Act envisaged that the Fund would hold, manage and apply the Deposit Protection Fund per the provisions of the Act as well as levy contributions for the Fund.

According to section 39, the aggregate credit balance of any accounts maintained by the customer to an institution, less any liability of the customer to the institution, are a protected deposit. Thus, in the event of insolvency of such institution, the customer would rightfully claim for payment of the protected deposit from the Fund. Such protection is however excluded from anyone who directly or indirectly was responsible or profited from the insolvency of the institution. The provision of deposit protection under the Banking Act, although the function is carried out by a separate

[182] Basel, *Core principles for effective banking supervision*, 14
[183] Basel, *Core Principles for effective bank supervision*, 14

entity from CBK, only affirms that a public safety net contributes towards having efficient and effective banking supervision.

viii. Insolvency

The Core Principles for Effective Bank Resolution also provide that a clear framework to deal with bank crisis and resolution is key to effective bank supervision. Effective crisis management would mitigate financial disruption which could occur as a result of bank failure.[184]

Section 39 (6) sets out the nature of insolvency in banks. It elaborates that the insolvency referred to in the Act is that which is envisaged in the primary insolvency law, that is the Insolvency Act 2015, such that an institution would be deemed to be insolvent if a liquidator or provisional liquidator is appointed in respect of the institution under Part VI of the Insolvency Act, 2015; a liquidator or interim liquidator is appointed in respect of the institution under the Banking Act; or a liquidation order or administration order is made in respect of it, or a resolution for creditors' voluntary liquidation is passed, under the Insolvency Act, 2015.

From the foregoing, the Banking Act is not the primary law that deals with bank insolvency. The provisions of the Insolvency Act, 2015 as well as the Kenya Deposit Insurance Act No. 10 of 2012 would be relied on to steer the course of the insolvency procedures and proceedings.

3.5 Kenya Deposit Insurance Act, No. 10 of 2012

Having been contemplated in the Banking Act, the Kenya Deposit Insurance Act is the statute exclusively dealing with a segment of bank insolvencies, that is, ensuring that insured customers obtain a reprieve from bank failure on the strength of their protected deposits.

The institution that oversees this is the Kenya Deposit Insurance Corporation ('KDIC') established under section 4 of the Act. The statutory object of KDIC is to "provide a deposit insurance scheme for customers of member institutions and to receive,

[184] Basel, *Core principles for effective bank supervision*, 6 and 15

liquidate and wind up any institution in respect of which the Corporation is appointed receiver or liquidator per the Act."[185]

Further, KDIC is the statutory provided receiver/liquidator appointed by CBK in respect to banks. It is currently in charge of the resolution of Chase Bank Limited and Imperial Bank. Whether KDIC has succeeded in effectively discharging its mandate is not the subject of this paper. However, it is noteworthy to briefly note that KDIC may exploit loopholes in the law to resolve the individual bank failure. For example, the Act is silent on the period which it should take to pay out depositors. This flexibility on timelines may expose the depositors to potential perennial loss. This loophole could be exploited in the case of a rogue Receiver. Further, accountability by stakeholders on CBK and KDIC may be a difficult exercise that may not yield the stakeholders' desired results owing to the perceptive close-knit relationship between the regulator and the insurer. These would seem to pose a challenge as to whether the crisis management and bank resolution mechanisms underpinned by Kenya legislation are sufficient to meet what was envisioned by the Core Principles, and whether the said deficiencies touching on the pre-conditions of effective banking supervision diminish CBK's efficiency and effectiveness of bank supervision.

3.6 Conclusion

The fore-mentioned laws provide the structure of banking in Kenya and identify which tools have been laid down as a basis for safe and sound banking practices. However, CBK periodically issues guidelines and regulations which govern risk management, reporting, and supervision of banks as necessary. From the foregoing, Kenya seems to have an elaborate legal framework whose provisions are largely aligned to the recommended international standards. Despite the elaborate legal framework, the recent failures of Dubai Bank, Imperial Bank, and Chase Bank are attributed to failures stemming from prudential requirements already provided for in law. The challenge facing Kenya may be the implementation of the fore mentioned laws and regular assessment utilising the relevant supervisory tools, which is the purview of the CBK.

[185] Section 5, Kenya Deposit Insurance Corporation Act (No. 10 of 2012)

CHAPTER FOUR:

REGULATORY REFORMS TOWARDS MITIGATING THE RISK AND IMPACT OF BANK FAILURE

4.1 Introduction

The GFC was a rude awakening for central banks globally as well as the entire financial sector, and a catalyst towards reforms in banking regulation and to a larger scale, financial regulation generally. Bank failure had resulted in externalities that were spread out across various continents due to the growing interconnectedness of banks, and the sprouting of financial conglomerates which included banks. Legislation governing banks was already in place and had been developed over the years as the sector changed form to modernity. However, after the GFC, the consensus was that the then-existing regulatory structures contributed to the crisis due to their weaknesses,[186] and that there was a need for a holistic macro-prudential approach to financial regulation.[187] The regulatory architecture had revealed gaps that permitted oversight in regulation in the wake of the dynamic financial conglomerates.[188] The financial sector is required to be assessed and addressed holistically, not defined by the separate institutions' institutional identity. For example, in the United States, there was a deficiency and laxity of enforcement of consumer protection rights, while in the United Kingdom, the opacity of the responsibilities of the Bank of England and the Financial Services Authority generated failure of effective supervision and oversight.[189] Since then, some countries have adopted new models of regulation to address systemic risk posed by the interconnectedness of banks and financial

[186] Taylor M, Twin Peaks revisited – a second chance for regulatory reform, Center for the study of financial innovation, United Kingdom, 2009, 4
[187] Heerden CM, Niekerk GM, Huls NJH; '*Two takes on twin peaks, a comparative appraisal of the models of financial regulation in the Netherlands and South Africa*', Journal for contemporary Roman-Dutch law, (2020), 493
[188] Taylor M, *Twin peaks revisited – a second chance for regulatory reform*, 4
[189] Taylor M, *Twin peaks revisited – a second chance for regulatory reform*, 4

institutions, the dynamics of financial conglomerates, and also incorporated more elaborate crisis management measures in legislation.[190]

This chapter shall discuss some of the regulatory model reforms that have increasingly been adapted, including the twin peaks model of regulation adopted by Australia, the Netherlands, and South Africa aimed at reducing externalities associated with bank failure. With the increased globalization of financial products and the inter-connectedness of financial institutions, this chapter will suggest that Kenya should study closely, the shifts occurring around the world, even though Kenya may not match their actual economic conditions or have similar penetration of the financial conglomerates. This chapter shall also suggest that where appropriate, Kenya should adopt some of the measures taken especially by those countries which experienced direct adverse effects of the GFC, with the benefit that the countries have identified some deficiencies in their regulatory framework and therefore learned some lessons from the crisis.

4.2 Twin Peaks Model of Regulation

Before the GFC, various jurisdictions had been gradually altering their financial regulatory architecture to accommodate the increasing diversity and improvement of financial products as well as the growth and diversity of financial conglomerates, whose composition included banks.[191] Several jurisdictions prepared to shift to the twin peaks model of regulation.

The twin peaks model of regulation approaches the financial industry as a whole to cater to the ever-increasing financial group entities and then separates the prudential and market conduct regulation (including consumer protection), entrusting them to two separate regulators to ensure that there is a dedicated focus on the two separate aspects of regulation.[192]

The twin peaks model was first proposed by Michael Taylor in the United Kingdom in the year 1995, when he suggested that financial regulation should be objectives–

[190] Taylor M, *Twin peaks revisited – a second chance for regulatory reform*, 4
[191] Goodwin A, 'Introduction to special issue – the twin peaks model of financial regulation in South Africa,' *Law and financial markets review* (2017), 151
[192] https://www.fsca.co.za/TPNL/1/FSB/thephilosophy.html on 23rd May 2021

driven.[193]. At the time, the multiple regulators of the different financial sectors left consumers confused. Even then, Taylor's proposition seemed radical as he suggested that the regulatory separation between banking, insurance, and other sectoral financial institutions had become obsolete. He proposed that two regulators would be sufficient to discharge prudential and market conduct supervision, and suggested that there be a Financial Stability Commission for the prudential oversight and a Consumer Protection Commission for market conduct oversight.[194] He also proposed that each regulator should have clear objectives and firmly believed that if prudential regulation was mixed with market conduct regulation, supervision of prudential regulation would be inefficient. He also asserted that at all times, the structure of financial regulation should mirror the industry.[195] These were the fundamental principles on which Taylor proposed the twin peaks model be formulated. Taylor's model also proposed that in order to bring to life the proposition that financial regulation should mirror the current industry, a financial sector where the majority of the institutions are conglomerates or too big to fail requires specialized prudential regulation by a separate body which could be a subsidiary of the central bank.[196] Prudential regulation of non-systemic firms could then be handled by a separate body. Taylor also proposed that even though the various agencies would be in charge of regulation, the central bank would still be required to take leadership in ensuring financial stability and proper crisis management with the support of the regulatory agencies.

For the model to be effective, each regulator's objectives, scope, and boundaries should be clearly defined. The two regulators should also share information with each other, collaborate and coordinate their efforts to be efficient and avoid regulatory overlap.[197]

Kenya's model of regulation is institutional and functional[198] where there is a separate regulator who governs all activities undertaken by the sectoral players under it. For

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[193] Taylor M, *Twin peaks revisited – a second chance for regulatory reform*, 1
[194] Taylor M, *Twin peaks revisited – a second chance for regulatory reform*, 1, 4
[195] Taylor M, *Twin peaks revisited – a second chance for regulatory reform*, 1
[196] Taylor M, *Twin peaks revisited – a second chance for regulatory reform, 3*
[197] Godwin A, Ramsay I, 'Twin peaks – the legal and regulatory anatomy of Australia's system of financial regulation', *Center for International Finance and Regulation, University of Melbourne,* 1
[198] Gakeri J, 'Financial services regulatory modernization in East Africa; the search for a new paradigm for Kenya', *International Journal of Humanities and social science,* 166

example, the CBK regulates all banks and institutions licensed under the Banking Act, the Capital Markets Authority (CMA) regulates all participants of the securities markets to the extent of their role in the securities markets while the Insurance Regulatory Authority (IRA) regulates all insurance companies regardless of whether they are part of a financial group comprising of banks, insurance companies, and other financial institutions. Thus, financial institutions offering both bank and insurance products are regulated by the respective separate regulators, that is the Central Bank of Kenya and the Insurance Regulatory Authority. Taylor argued that this structure had become obsolete by1995. He argued that when a regulator is burdened with too many tasks and different objectives, they risk carrying them out inefficiently and are likely to give more attention to one aspect at the expense of the other.[199] Other critics have argued that burdening the central bank with supervisory roles in addition to its overall objectives may dilute regulatory energy and even pose a conflict of interest in implementing the objectives of financial stability and those of prudential regulation.[200]

Australia, the Netherlands, and South Africa are some of the countries which have since shifted their regulatory architecture to the twin peaks model. This paper acknowledges that one regulatory framework cannot be suitable or applicable universally. Thus, the paper does not suggest that Kenya should transform from its institutional and functional regulatory framework to the twin peaks model to replicate what Australia, the Netherlands, and South Africa have done. Such a shift would require to be justified by considering other determinant factors such as prevailing market and economic conditions, domestic needs, institutions, political imperatives, and circumstances of the country.[201] Some practices from the twin peaks model which the CBK may consider may be revealed from a more cursory discussion of the application of the twin peaks model of regulation in the fore mentioned countries as highlighted below: Australia

[199] Taylor M, *Twin peaks revisited – a second chance for regulatory reform*, 5
[200] Heerden CM, Niekerk GM, Huls NJH; '*Two takes on twin peaks, a comparative appraisal of the models of financial regulation in the Netherlands and South Africa*', 493
[201] Gakeri J, 'Financial services regulatory modernization in East Africa; the search for a new paradigm for Kenya', 166 and 170

Australia is lauded for having pioneered this model in 1998 and 2002, before other jurisdictions.[202] It is argued that compared to other financial systems, Australia's twin peak model significantly contributed to the resilience of its financial sector during the GFC.[203] In its model, greatly derived from the Wallis Inquiry into the Australian Financial System,[204] two regulators separate the market conduct and consumer protection obligation of regulation from the prudential obligations. The regulators are the Australia Securities Investments Commission (ASIC) and the Australian Prudential Regulatory Authority (APRA).

ASIC is the regulator in charge of market conduct and consumer protection, with powers to impose civil or criminal sanctions against entities and professionals, regulate company directors and officers, market disclosure, reporting, and protect financial customers from deceptive products related to market conduct.[205] On the other hand, APRA is in charge of the prudential regulation aided by three main regulatory tools which comprise licensing powers, supervision and monitoring powers, and crisis management[206].

The Reserve Bank of Australia (RBA), which is the country's Central Bank, is the Lender of Last Resort and is in charge of monetary policy, financial stability, and ensuring a safe and reliable payments system.[207] ASIC and APRA share financial oversight responsibility for the financial sector with the Reserve Bank of Australia and the Australian Treasury.[208]

ASIC and APRA, being the twin peaks, as well as RBA as the Central Bank thrives on strong coordination mechanisms which complement the division of functions among the agencies.[209] This coordination is particularly welcomed as oversight to systemic risk. There consists of a Council of Financial Regulators (CFR) which comprises

[202] Heerden CM et al, '*Two takes on twin peaks, a comparative appraisal of the models of financial regulation in the Netherlands and South Africa,*' 493
[203] Godwin A, Ramsay I, Kourabas S, 'Twin peaks and financial regulation, the challenges and increasing overlap and expanding responsibilities' *The International Lawyer* (2016), 281
[204] Lead to the Financial System Inquiry Final Report (Wallis Report), 1997
[205] Pan E, '*Structural reform of financial regulation,*' Transnational law and contemporary problems, 836
[206] Pan E, '*Structural reform of financial regulation,*' 836
[207] Goodwin A, 'Introduction to special issue – the twin peaks model of financial regulation in South Africa,151
[208] Pan E, '*Structural reform of financial regulation* 836
[209] Godwin A et al, 'Twin peaks and financial regulation, the challenges and increasing overlap and expanding responsibilities' *The International Lawyer* (2016), 280 jstor

representatives of ASIC, APRA, RBA, and the Treasury Department to oversee coordination between the agencies.[210] However, CFR is merely an entity without any regulatory powers. The agencies also have other informal bilateral coordination mechanisms which they apply to collaborate on their separate functions. Few criticisms on the informality of the multi-agency coordination have been made. Its informality is perceived as a weakness and steps to formalize the coordination are resisted to discourage blurred lines in terms of responsibility taken by the various agencies, and non-regulatory oversight by the coordination mechanisms which involve all agencies as participants.[211] To curb the weaknesses associated with the twin peaks model, recommendations have been made for the establishment of a Financial Regulator Assessment Board to advise the government, on an annual basis, how the twin regulators had been discharging their mandates.[212]

Without a formal coordination mechanism structure, there may be some deficiencies in information sharing, where one regulator may not fully appreciate the true reality of an entity under the scope of the other regulator. Thus, their assessment at the end of the day may fail to portray the actual compliance or non-compliance of an entity. Such coordination deficiencies are attributed to the collapse of Australia's HIH Insurance.[213] The model demonstrates that the performance of one regulator affects the performance of the other for as long as their functions are divided and they rely on each other to coordinate and share information between themselves to effectively respond promptly.

It has also been observed that with the increased complexity of financial conglomerates, there has been an overlap of regulatory functions between the agencies, thus defeating the principle behind the twin peaks model.[214] This has been addressed by defining which regulatory tools the regulators require to discharge their respective functions, considering that the respective regulators would be regulating

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210 Schmulow Andrew, 'Twin Peaks – An analysis of the Australian Architecture,' Global Forum for Financial Consumers - 2016, South Korea, November 5-6, 2016

211 Godwin A, Ramsay I, Kourabas S, 'Twin peaks and financial regulation, the challenges and increasing overlap and expanding responsibilities' *The International Lawyer* (2016), 284

212 Schmulow Andrew, 'Twin Peaks – An analysis of the Australian Architecture,' Global Forum for Financial Consumers - 2016, South Korea, November 5-6, 2016

213 Godwin A et al, 'Twin peaks and financial regulation, the challenges and increasing overlap and expanding responsibilities' *The International Lawyer* (2016), 285

214 Godwin A et al, 'Twin peaks and financial regulation, the challenges and increasing overlap and expanding responsibilities' *The International Lawyer* (2016), 283

the same entities but on different issues, and it would be inevitable for a regulator not to interact with matters outside of their regulatory authority.[215]

From the foregoing, the separation of market conduct and prudential regulation by the twin supervisors has placed Australia at a great advantage in effective supervision of banks and financial institutions generally. Indeed, its resilience during the GFC has been largely attributed to its twin peak model of regulation. However, its model presents few weaknesses which if handled improperly may pose a threat to the effectiveness of regulation by ASIC and APRA. These weaknesses are concerned with information sharing and coordination, which need to be conducted efficiently to enable the regulators to appreciate the true safety and soundness of institutions. Further, it is worthy to note that the challenges of information sharing and coordination cannot be eradicated by the choice of a regulatory model, as they are apparent in the twin peaks model. In Kenya, which poses a functional and institutional regulatory model that would arguably be more cumbersome to coordinate information sharing due to the increased number of regulators involved as compared to the twin peaks model, it is imperative that proper formal mechanisms are set down to ensure that information sharing and coordination is conducted efficiently by the various sectoral regulators. This will enable the proper monitoring of banking groups and their subsidiaries.

i) South Africa

South Africa, similar to Kenya, is an emerging market and as an African country, its dynamics are arguably more relevant to Kenya. South Africa began its financial regulation reforms in 2007, which were articulated under a policy paper 'A safer financial sector to serve South Africa better.'[216] The discussions around this policy incorporated a regulatory model shift to the twin peaks model, and at the culmination of the legislative process vide the Financial Sector Regulation Act, 2017 twin peak regulation was enacted in South Africa. South Africa became the first emerging market and African country to take steps to shift to the twin peaks model. The two

[215] Godwin A, Ramsay I, Kourabas S, 'Twin peaks and financial regulation, the challenges and increasing overlap and expanding responsibilities' *The International Lawyer* (2016), 289

[216] Godwin A, 'Introduction to special issue – the twin peaks model of financial regulation in South Africa, *Law and Financial Markets Review*, (2017) 152

regulators in charge of the prudential and market conduct respectively are the Prudential Authority (PA) and the Financial Sector Conduct Authority (FSCA).[217] However, South African Reserve Bank (SARB) has an express legislative mandate to promote and ensure financial stability.[218] SARB would also continue to be responsible for monetary policy, payment, oversight, and supervision of foreign exchange transactions.[219] Thus, in essence South Africa's twin peaks model consists of three supervisors.[220] These authorities collaborate with other institutions which were already in existence and which are collectively responsible for the financial landscape of South Africa.[221] They are;

i. The National Credit Regulator would continue to be in charge of market conduct regulation
ii. The Financial Intelligence Center, which protects the integrity of the country's financial system.
iii. The Ombudsman which deals with dispute resolution

With SARB being stripped of its traditional Central Bank mandate of inter alia monetary policy, it was clothed with new functions to aid it in achieving the financial stability mandate. It is the responsibility of SARB to consistently monitor and review the strengths and weaknesses of the financial system, along with any risks posed to financial stability. This monitoring and assessment are also extended to the risk of systemic events.[222] Further, it is expected to take steps to mitigate those risks, inform and advise the PA and FSCA, along with any other relevant bodies, of those risks. SARB is also tasked with monitoring the country's adoption or observance of international standards, and whether the financial sector is equipped with the necessary infrastructure to abide by the required standards. These findings are to be

[217] Godwin A, 'Introduction to special issue – the twin peaks model of financial regulation in South Africa, *Law and Financial Markets Review,* (2017) 152
[218] Heerden CM et al, *'Two takes on twin peaks, a comparative appraisal of the models of financial regulation in the Netherlands and South Africa,' 507*
[219] Godwin A, 'Introduction to special issue – the twin peaks model of financial regulation in South Africa, *Law and Financial Markets Review (2017),* 152
[220] Heerden CM et al,*'Two takes on twin peaks, a comparative appraisal of the models of financial regulation in the Netherlands and South Africa,*' 506
[221] Godwin A, 'Introduction to special issue – the twin peaks model of financial regulation in South Africa, *Law and Financial Markets Review*, (2017), 153
[222] Heerden CM et al, *'Two takes on twin peaks, a comparative appraisal of the models of financial regulation in Netherlands and South Africa,'* 507

shared with the Minister of Finance.[223] Every six months, SARB is also required to table a financial stability report in Parliament. The report should contain the risks to financial stability, an assessment of the said risks for at least the next 12 months, and the action steps are taken or to be taken to mitigate likely disruptions.[224]

On the other hand, the PA, although operating within the administration of SARB, is a separate entity altogether. Its objectives include promoting safety and soundness of market infrastructure, ensuring that financial services customers are protected from the risk that they may lose out on their investment with the various institutions, regulating and supervising financial institutions which provide financial products and securities, and generally contributing towards maintaining financial stability.[225] PA has an extensive regulatory toolkit where it is required to license financial institutions, issue prudential standards, issue directives for action against contravention of financial sectoral laws, and reduce risk, impose administrative fines, and investigate where necessary.[226]

On part of the FSCA, it regulates the market conduct of all financial institutions. Its objectives include enhancing the integrity of the financial services sector, promoting fair treatment of customers by financial institutions, providing financial education programs, promoting financial literacy, and generally contributing towards maintaining financial stability.[227] Its regulatory toolkit is similar to PAs.

All the 3 bodies collaborate and co-operate to achieve efficiency, whilst co-operating with other relevant authorities. This collaboration is effected by the Financial System Council of Regulators and the collaboration between the three regulators is set out in a Memorandum of Understanding between SARB, PA and FSCA.[228] Every two years, the FSRA conducts its own independent examination of the effectiveness of the

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[223] Heerden CM et al, *'Two takes on twin peaks, a comparative appraisal of the models of financial regulation in Netherlands and South Africa,' 507*

[224] Heerden CM et al, *'Two takes on twin peaks, a comparative appraisal of the models of financial regulation in Netherlands and South Africa,'* 508

[225] T Heerden CM et al,*'Two takes on twin peaks, a comparative appraisal of the models of financial regulation in Netherlands and South Africa,'* 509

[226] Heerden CM et al,*'Two takes on twin peaks, a comparative appraisal of the models of financial regulation in Netherlands and South Africa,'* 509

[227] Heerden CM et al,*'Two takes on twin peaks, a comparative appraisal of the models of financial regulation in Netherlands and South Africa,'* 509

[228] Heerden CM et al, *'Two takes on twin peaks, a comparative appraisal of the models of financial regulation in Netherlands and South Africa,' 511*

collaboration between the three regulators. In contrast with Australia, South Africa has adapted the twin peaks model to suit its financial needs and its information sharing and collaboration mechanism is more formally anchored to ensure that information is shared efficiently.

ii) Netherlands

Netherlands makes for a good study because it adopted the twin peaks model second to Australia, and in the wake of the GFC..[229] Before that, it had a sectoral approach to regulation where the Dutch Central Bank - *De Nederlandsche Bank* (DNB) supervised banks, Stichting Toezicht Effectenverkeer (STE) supervised the securities markets, and the Stichting Pensioen- en Verzekeringskamer (PVK) supervised insurance and pension funds.[230]

Similar to the Kenyan situation, the DNB did not have an express objective on financial stability, although it was deemed to have it *de facto* as a result of its varying functions. As other central banks, it also acted as the lender of last resort. However, the mandate to ensure monetary policy lay with the European Central Bank.[231] Over time, due to globalisation and lifting of the ban of a single institution carrying out banking and insurance services in 1990, the financial sector in Netherlands became more complex to define as the growth of financial conglomerates took the day. With these complex entities, the sectoral supervisors found it to be increasingly challenging to efficiently exercise their mandate. The emerging conglomerates blurred the lines of responsibility in supervision and inevitably created gaps in supervision. Supervision terribly deteriorated, objectives became unclear and there were instances of hostility between the sectoral supervisors. Supervision was unclear, inefficient, and ineffective and the sectoral approach to regulation did not have a solution to the difficulties posed by the dynamic financial entities and products.[232] Amidst these challenges, the

[229] Heerden CM et al, *'Two takes on twin peaks, a comparative appraisal of the models of financial regulation in Netherlands and South Africa,'* 509

[230] Heerden CM et al, *'Two takes on twin peaks, a comparative appraisal of the models of financial regulation in Netherlands and South Africa,'* 494

[231] Heerden CM et al, *'Two takes on twin peaks, a comparative appraisal of the models of financial regulation in Netherlands and South Africa,'* 494

[232] Heerden CM et al, *'Two takes on twin peaks, a comparative appraisal of the models of financial regulation in Netherlands and South Africa,'* 494

industry players realised that the objectives of prudential regulation and market conduct regulation were different, and required to be executed separately.

In 2001, a decision was made and the Netherlands would actively shift from sectoral regulation to the twin peaks model of regulation.[233] There are two regulators, Autoriteit Financiele Markten (AFM) is in charge of market conduct while the DNB is in charge of microprudential supervision and their supervisory powers were affirmed by legislation in January 2007. Thus, the twin peak model took effect in the Netherlands in 2007, just before the GFC. The country's financial sector's experience of the GFC taught various lessons of the weaknesses of their execution of the twin peaks model. For example, Dirk Scheringa Beheer (DSB), a bank, faced a bank run after it was exposed of its dubious payment schemes, funding of the founder's projects, among other things. The bank's failure was attributed to poor coordination between the DNB and AFM, and it was clear that there was a lack of cooperation between the two supervisors.[234] Scrutiny of what transpired also unearthed that the DNB's historical lax mode of supervision, where it regulated by way of moral suasion, occasioned the lapses that led to the bank failure. Historically, DNB had taken great pride in the fact that it did not issue warnings to banks when necessary but rather attempted to enforce its powers amicably. Unfortunately, it took the same approach during the GFC, at a time when the circumstances demanded a stricter approach to regulation and stringent enforcement measures.

Later on, the IMF vide its report on Financial Sector Assessment Plan lauded the DNB and AFM for collaborating effectively during the GFC, and commended the information sharing between the two regulators as well as the ministry for finance.[235] The twin peaks model seemed to be effective when there was collaboration, and most pertinently, information sharing, between the twin regulators. However, several improvements were made by the regulators given the lessons learned from the GFC.[236]

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233 Heerden CM et al, *'Two takes on twin peaks, a comparative appraisal of the models of financial regulation in Netherlands and South Africa,'* 495

234 Heerden CM et al, *'Two takes on twin peaks, a comparative appraisal of the models of financial regulation in Netherlands and South Africa,'* 500

235 Heerden CM et al, *'Two takes on twin peaks, a comparative appraisal of the models of financial regulation in Netherlands and South Africa,'* 500

236 Heerden CM et al, *'Two takes on twin peaks, a comparative appraisal of the models of financial regulation in Netherlands and South Africa,'* 502

For example, an enforcement department was created within the DNB to aid the detachment from supervision by way of moral suasion. Supervisors were also encouraged to utilise their supervisory powers and make use of their supervisory tools. This was dubbed 'From Analysis to Action.' Further, the macroprudential department of the DNB was expanded to increase the actual monitoring of institutions. The regulators also sought more expertise to handle areas of innovation in financial products. Risk analysis was enhanced to link macroprudential risk with an assessment of individual institutions, knowledge networks were set up to ease sharing of information amongst various departments and generally, supervision of conglomerates was intensified.[237] Legislative reforms were also undertaken, following the recommendation of the IMF. DNB and the Minister of Finance were empowered to intervene in case of bank or insurance failure to ensure their orderly resolution. DNB was also mandated to supervise financial institutions in a bid to promote financial stability.

4.3 Judgment based regulation

Judgment-based regulation focuses on *how* to regulate rather than *who* or *what* to regulate.[238] Hector Hans states that judgment based regulation drives the supervisor to decisively intervene at an early stage and such intervention should be proportionate and justified even if the bank does not agree, and if in future the action is perceived to have been in variance with its mandate, but in keeping with the spirit of regulation. Therefore, judgement based regulation is not overly reliant on rules.[239]

For it to be effective, supervisors need to focus on the big risks to their statutory objectives, the supervisor also needs to be able to apply the right judgment in the course of action they elect their supervisory profile to reduce risks to their statutory objectives and also be firm and decisive over which corrective actions require to be employed by the bank.[240] Because the judgement-based approach is more pre-emptive

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[237] Heerden CM et al, *'Two takes on twin peaks, a comparative appraisal of the models of financial regulation in Netherlands and South Africa,'* 495

[238] Lastra R, 'Defining Forward looking Judgment Based Regulation', *Journal of Banking Regulation, Macmillan Publishers* (2013), 223

[239] Lastra R, 'Defining Forward looking Judgment Based Regulation,' *Journal of Banking Regulation, Macmillan Publishers* (2013) 224

[240] Lastra R, 'Defining Forward looking Judgment Based Regulation,' *Journal of Banking Regulation, Macmillan Publishers* (2013) 224

than reactive, for it to be effective, the supervisor will require the support of the banks (supervisees). The banks must therefore endeavour to ensure that their practices and business methods align with the objectives of supervision, and when corrective measures are recommended by the supervisor, they must also endeavour to implement in a timely fashion for the aims of supervision to be attained.[241]

The judgment-based approach has had its share of criticisms, where it is seen to be diluting the necessity of clear rules and guidelines, by substituting them with human instinct/judgment. However, the judgment-based approach does not negate the existing legal framework, but only supplements it. For example, the rules governing the entry of banks into the industry must be strictly followed, and licensing may never be a discretionary issue. Similarly, for enforcement/sanctioning, for supervision to be effective the offences and sanctions need to be clear and not subject to a judgment call.

The judgment-based approach may be applicable in risk monitoring and risk control, although the judgment should be made within the existing rules governing risk. The supervisory tools applied to monitor and control risk, such as on-site and off-site inspections, require the supervisor's forward-looking judgment. Early intervention, crisis management and instances where the lender of last resort function may be applied confer both a rule-based and judgment-based approach. In crisis management, the judgment-based approach may be beneficial in articulating that the crisis will be handled according to the different circumstances, thus avoiding moral hazard. Given the great responsibility bestowed upon the supervisor in terms of judgment, the supervisor must be equipped with highly knowledgeable and impeccably skilled personnel.

4.4 Risk-based supervision

Risk-based supervision is one of the approaches taken by central banks in the current day supervision of banks as the quality and quantity of risk are crucial for the safety and soundness of banks. In Kenya, CBK has gradually transformed its supervisory approach to risk-based supervision. A survey conducted as early as 2004 indicated

[241] Lastra R, 'Defining Forward looking Judgment Based Regulation,' *Journal of Banking Regulation, Macmillan Publishers* (2013) 224

that the traditional approach towards supervision as undertaken by CBK revealed wide gaps in the efficacy of risk management, and revealed the following deficiencies were present in the banks;[242]

a. Inadequate risk management practices and procedures for non-credit risk
b. Banks would solely rely on the CBK guidelines on prudential risk, such as on liquidity to determine their level of risk
c. Numerous banks lacked dedicated resources towards risk management functions such as stress testing, modeling, and gap analysis
d. There was a lack of specifically dedicated budget allocation for risk management activities

As the traditional approach by CBK was backward-looking and reactionary, focusing on verification of the accuracy of banks' statement of financial position, comprehensive income, and adequacy of internal controls.[243] The traditional approach offered solutions towards risk reduction rather than risk management whereas risk based supervision is more forward looking, and is set out to predict and manage threats to bank stability. Thus, the Risk Based Supervision Framework seeks to set out the scope of high quality risk management that would remain relevant with the evolving financial sector and their institution's risk profile, while strengthening the interactions between the bank management and CBK.

According to CBK's risk based framework, banks are expected to have their internal risk management programmes, which the banks develop, CBK reviews, and seals any loopholes. There are several expected benefits to the risk based supervision, including;[244]

a. Enhanced and more efficient risk evaluation and risk management
b. Early identification of risk and threats to bank stability, thus allowing for appropriate and timely response measures
c. CBK would have a record of risk focussed assessments from the various banks

[242] Central bank of Kenya, Risk based supervision framework, May 2013, 3
[243] Central bank of Kenya, Risk based supervision framework, 3
[244] Central bank of Kenya, Risk based supervision framework, 4

d. Cost-effective utilisation of resources as there would be a sharper focus on risk

CBK's approach to risk based supervision entails a sequence of key events highlighted below;

- Developing the institutional profile

The Institutional Profile is a description of the institution's risk through the risk matrix and the risk assessment narrative. It contains two main parts; the Institutional Overview, and the Risk Assessment Summary. The Institutional Overview contains the institution's present condition, highlights issues of supervisory concern, and past supervisory findings.

The risk matrix entails a tabular representation of the quantity of risk, quality of risk management, and the direction of risk of various functional areas such as credit risk, liquidity risk, operational risk, regulatory risk, and strategic risk.[245] On the other hand, the risk assessment narrative contains explanations and justifications of the assessment of risk.[246]

To measure the quantity of risk management, the frequency of an occurrence, the probability of its occurrence, and the severity of the impact of an event are measured and rated as moderate, high, or low. Quality of risk management is described as either being strong, acceptable, or weak after considering whether the following have been implemented in the bank:[247]

a. Active board and senior management oversight
b. Adequate policies, procedures, and limits for managing business activities
c. Adequate risk management, monitoring, and management reporting systems
d. Comprehensive internal controls including an effective internal audit function

The measure for quality assessment as listed above resembles that of the Management facet in CBK's traditional CAMEL rating system. This shows that as per CAMEL rating

[245] Central bank of Kenya, Risk based supervision framework, 7
[246] Central bank of Kenya, Risk based supervision framework, 6
[247] Central bank of Kenya, Risk based supervision framework, 8

if a bank scores well under 'M' it will have a good score upon assessment of the quality of risk management.[248]

Lastly, the direction of risk is measured as either increasing, decreasing, or being stable. If a higher risk is anticipated over the cycle or there is a decline in the risk management systems, the direction of risk is deemed to be increasing. If CBK anticipates that the composite risk (quality and quantity of risk) will decrease over a 12-month cycle, the direction of risk is deemed to be decreasing. If the quantity of risk is stable, and the quality remains unchanged, the overall composite risk is deemed to be stable. [249]

- Planning supervisory activities

The supervisory activities to be conducted on the premise of the risk assessment are contained in the Supervisory Plan. The ratings given during the risk assessment will determine which regulatory tools are required in order to implement the Plan.[250] The various regulatory tools that CBK may deploy include regular on-site examination, off–site surveillance comprising of stress tests, reviewing of financial statements, prudential meetings with the bank management where the frequency of the meetings will be informed by the performance of the bank in the risk assessment, meeting with the bank's external auditors, information sharing with other sectoral supervisors especially when dealing with conglomerates.[251]

To effectively carry out its supervisory activities, CBK has a yearly examination plan, an inspection timetable containing the likely period the exercise may take. Generally, the risk assessment will determine the range of the supervisory cycle, usually between 6 and 24 months depending on the risk performance of the bank. The yearly plan is intended to ensure that due priority is given to institutions with a high risk profile.[252] Thereafter, CBK determines which examination activities would be most suitable, focussing on the areas that risk is highly exposed. The bank will be notified prior of the intended examination activities to ensure ample planning on part of the

[248] Central bank of Kenya, Risk based supervision framework, 9
[249] Central bank of Kenya, Risk based supervision framework, 8
[250] Central bank of Kenya, Risk based supervision framework, 9
[251] Central bank of Kenya, Risk based supervision framework, 11
[252] Central bank of Kenya, Risk based supervision framework, 11

management. CBK will then deploy the necessary examination procedures about the relevant risk areas to ensure that the main risk areas are adequately covered.

- Reporting and updating the bank's information

After the on-site examination CBK tenders a detailed report on its findings to the bank's Board of Directors, detailing what they need to implement to manage risk.[253] The period in which CBK should have tendered the report is however not indicated in the Framework. An indicative period may be necessary to ensure timely communication and remedial action in managing risk.

Upon receipt of CBK's Inspection Report, the bank is required to respond to the emerging issues as may be highlighted in the report within 15 days. In turn, this enables CBK to deduce a Supervisory Programme for the respective bank, to monitor timely corrective action.[254]

- Quarterly financial performance review

CBK monitors the performance of a bank and seeks to identify any new risk that may have arisen within the intervening period of the supervisory cycles, through reviewing analysed data submitted by the banks to CBK as per prudential guidelines. This data includes stress tests and is also compared against other peer banks.

- Implementation of consolidated supervision and supervisory colleges

This is not one of the events in CBK's risk based supervision approach, but it is part of the methods that CBK has declared to adopt in its risk based supervision. The increase in the number of financial conglomerates in Kenya as well as the expansion of Kenyan banks in the Eastern Africa region has demanded the need for consolidated supervision amongst the various financial regulators.[255] CBK is, therefore, able to obtain any relevant information pertaining to risk management of subsidiaries of interest, from their regulator, should the subsidiary not be under the ambit of CBK. The efforts to regulate cross-border banking are in appreciation of the fact that the failure of large cross-border banks such as the Lehman Brothers prominently triggered

[253] Central bank of Kenya, Risk based supervision framework, 12

[254] Central bank of Kenya, Risk based supervision framework, 12

[255] Central bank of Kenya, Risk based supervision framework, 13

the GFC.[256] Indeed, the failure of an international bank in one country may adversely affect its stability in other countries.

As for Kenyan banks which have significant cross-border operations, there are established supervisory colleges. Supervisory colleges are multilateral working groups of relevant supervisors that are formed for the collective purpose of enhancing effective consolidated supervision of an international banking group on an ongoing basis.[257] The establishment of these colleges is one way of meeting the Basel Core Principles on Consolidated Supervision and Home – Host Relationships which requires cooperation and information sharing between home supervisors and host supervisors.

Kenya has various banks which are domestically large in size; assets, market share, and which have penetrated to other jurisdictions outside of Kenya. These banks are such as KCB Bank, Equity Bank, and NCBA, and many others.[258] For example, KCB Bank has branches in Tanzania, Uganda, South Sudan, Rwanda, and Burundi;[259] Equity Bank is present in Uganda, Rwanda, Tanzania, Democratic Republic of Congo and South Sudan;[260] and NCBA has branches in Rwanda, Uganda and Tanzania.[261] Kenya is also home to foreign banks with a presence in other countries, and these banks, which are also of significant size, include Absa Bank, Stanbic Bank, and many more. The presence of these banks in different countries and regions only underscores the increased globalization of businesses, which cannot be avoided. This globalization of businesses, as experienced during the GFC may be a significant risk to disruption not only to the domestic market but the effects of any disruption may affect business stability across the border to the other jurisdictions where the banks conduct business. For developing countries, the risk of cross-border banking is higher, as other external risks such as political stability become apparent.

[256] Thorsten Beck, Regulatory cooperation on cross border banking – progress and challenges, R40
[257] Basel Committee on Banking Supervision, Good Practice Principles on Supervisory Colleges, 2010, 1
[258] Ndung'u N, "Remarks by Prof. Njuguna Ndung'u, governor central bank of Kenya", launch of the Kenya commercial bank supervisory college, Kenya school of monetary studies Nairobi, Wednesday 3 October 2012, 3
According to CBK, as of 30th June 2012, 10 Kenyan banks had 240 branches outside Kenya.
[259] https://ke.kcbgroup.com/
[260] https://equitygroupholdings.com/ke/
[261] https://ke.ncbagroup.com/

All Kenyan banks with significant cross-border operations are required to have supervisory colleges in the various jurisdictions.[262] The first supervisory college to be established was in relation KCB Bank[263] and subsequently, other supervisory colleges such as Equity Bank Limited and Diamond Trust Bank were established.[264] Since Kenyan banks continue expanding within the region, and foreign banks continue to show interest in establishing branches in Kenya, it is only imperative that their supervision across the border is effected. The supervisory colleges are intended to provide the various regulators with a better understanding of the risk profiles of banking groups set up in the respective countries, manage information sharing between the supervisors, coordinate the provisions of the Memoranda of Understanding signed between CBK as the home supervisor and other host supervisors, consider and advise on any economic conditions which may affect the conglomerates as a whole or their subsidiaries, contingency planning and crisis management that may arise, and assist CBK in meeting its obligations as a home supervisor.

Following the GFC, and appreciating the increase in cross border banking, the Basel Committee on Banking Supervision formulated the Good Practice Principles on Supervisory Colleges, 2010[265] for use by banks across different jurisdictions. The main objective of supervisory colleges is to ensure the understanding of the risk profile of a banking group. Thus, there should be enhanced and efficient information exchange and cooperation between the home and host supervisors.[266] Further, the structure of the college is important.[267] While there is no proposed standard structure, the collaboration between the supervisors should be conducted in a manner that ensures oversight, appreciating the biases of both the home and host supervisors. For example, the host supervisor may be most interested to learn of the risks or threats that the bank

[262] Central bank of Kenya risk based supervisory framework

[263] Ndung'u N, "Remarks by Prof. Njuguna Ngung'u, governor central bank of Kenya", launch of the Kenya commercial bank supervisory college, Kenya school of monetary studies Nairobi, Wednesday 3 October 2012, 3

[264] Ndung'u N, "Remarks by Prof. Njuguna Ngung'u, governor central bank of Kenya", a cocktail hosted during the supervisory college meetings for Kenya commercial bank, Equity bank and Diamond Trust bank, Hotel intercontinental Nairobi, Friday 25 October 2013

[265] Basel Committee on Banking Supervision, Good Practice Principles on Supervisory Colleges, October 2010 https://www.bis.org/publ/bcbs276.htm

[266] Basel Committee on Banking Supervision, Good Practice Principles on Supervisory Colleges, October 2010, 3

[267] There are various structures, including unitary college structure, dual-core and universal college structures, and variable structures, see Basel Committee on Banking Supervision, Good Practice Principles on Supervisory Colleges, October 2010, 4

poses to its market.[268] As the colleges coordinate, collaborate, and share information, it is also imperative that they pay attention to crisis management, which was one of the elements lacking in cross-border banking prior to the GFC. There may be perceived conflict on whose responsibility, between the home supervisor and the host supervisor, to intervene in a crisis especially appreciating their interests. The host supervisor would be interested in the exposure the bank would pose to its domestic market, while the home supervisor would be interested in supervision, generally.[269] Supervisory colleges should, therefore, offer effective crisis management for the banking group and assist in executing it as it participates as a channel for information sharing.[270]

Supervisory colleges have some challenges stemming from their legal design. For example, since there is no set down the threshold to meet their objectives on information collection and sharing, they may not be held accountable for failing to share or disclose information in a timely manner. With such loopholes, the value of information may be inadequate, diminishing the objectives of supervisory colleges. Thus, the current operation of supervisory colleges would seem to rely greatly on goodwill and collaboration between supervisors, and they are as strongest as their weakest link.[271]

Therefore, with the increased momentum on globalized finance, supervisory colleges should be formalized, be anchored and structured in law, in order to promote accountability between the home and host supervisors as well as any other relevant players.

4.5 Recovery Plans

These are commonly referred to as living wills and their aim was to control or mitigate the exposures of the systemically significant institutions, commonly known as the 'too big to fail' institutions,[272] that in modern-day comprise of conglomerates with diverse

[268] Basel Committee on Banking Supervision, Good Practice Principles on Supervisory Colleges, October 2010
[269] Thorsten Beck, 'Regulatory cooperation on cross border banking – progress and challenges', *National Institute of Economic Review,* (2016), R43
[270] Basel Committee on Banking Supervision, Good Practice Principles on Supervisory Colleges, October 2010, 13
[271]Thorsten Beck, 'Regulatory cooperation on cross border banking – progress and challenges', *National Institute of Economic Review,* (2016) R42, R43
,4[272] Suska D, 'Reappraising Dodd-Frank's living will regime', *Review of banking and financial law (2016-2017), 781*

financial products. Indeed, the GFC had shown the widespread shattering consequences of failure of a systemically important institution, and that they were not in the literal sense, too big to fail.

After the GFC, propositions led by the Dodd-Frank Wall Street Reform and Consumer Protection Act (2010) ('Dodd-Frank) provided that the systemically significant institutions would be required to provide their regulators with resolution plans. These plans would basically illustrate how the bank would be resolved, and its liabilities settled, in case of failure.[273] Section 165 (d) of Dodd-Frank provides that banks with more than USD 50 billion in assets, together with systemically important financial institutions submit their living wills detailing how the bank could be resolved in an orderly manner should it fall into distress, to the relevant regulators.[274] the wills should also incorporate how it would be executed in 3 different scenarios, each scenario with hypothetical measures of 30 economic and financial variables on a quarterly basis projected to 3 years ahead, assuming they would not receive any form of extraordinary support from the government.[275] The regulators are required to scrutinize the credibility and practicability of the will and demand revision where necessary.[276] These wills would, however, not be binding upon a court or administrator.[277]

This particular reform has received a lot of resistance from the industry, citing that it is impractical and would be inefficient to apply.[278] That it would just serve for ticking off a checklist rather than promoting financial stability. It is argued that risks develop fast and often, such that by the completion of publishing a living will, the circumstances of an institution may have changed. Further, the living will would require constant updating of data, which is in any event very expensive to do as complete data is not readily available. Even so, in case of a crisis requiring implementation of the living will, the supervisor would need to rely on up-to-date data to effect an informed resolution plan.

[273] Suska D, 'Reappraising Dodd-Frank's living will regime', 781
[274] Suska D, 'Reappraising Dodd-Frank's living will regime', 792
[275] Suska D, 'Reappraising Dodd-Frank's living will regime', 794
[276] Suska D, 'Reappraising Dodd-Frank's living will regime', 792
[277] Suska D, 'Reappraising Dodd-Frank's living will regime', 793
[278] Suska D, 'Reappraising Dodd-Frank's living will regime',782

Despite the resistance, some jurisdictions are firmly going forward with this requirement. For example, in the United Kingdom, systemically important financial institutions are required to publish their living wills by the year 2021, followed by major banks by 2022. [279] Some benefits of going forward with the will have also been recorded. For example, it promotes transparency, enhancing disclosure and communication. This detailed information adduced to the relevant supervisors and regulators is very valuable and benefits their ability to follow the right course or make better judgments affecting the institution.[280] On the other hand, one may argue that living wills do not enhance the regulator's access to information, because they have had that access just by dint of their authority and functions.[281] Another benefit derived for the regulators is that with the extent of the data received, they can tailor capital and other prudential requirements to the needs of an institution.[282] Living wills have also been seen to promote visibility and accountability on part of the regulators. If they endorsed a will as credible, and the institution eventually became insolvent by significantly deviating from the proposed course of action as contained in the will, they would have to justify their course of action, thus making them accountable for their decisions.[283] Another benefit is that it is probable that executives would take more conscious decisions in governance and their business methods having participated in a process where their reality in case of insolvency would not entail a bailout.[284]

From the Kenyan perspective, the CBK Prudential Guidelines on Business Continuity Management (CBK/PG/14) guide on the minimum holistic requirements that banks should apply to ensure that operations are reinstated on time in case of disruption. The goal of business continuity management is to ensure that the risk of adverse impacts of disruption is mitigated. The management includes developing a business continuity plan which enumerates procedures that need to be followed to restore a bank from disruption or enable it to continue operating amidst disruption.[285] The plan

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[279] Jones, H, 'Big British banks must publish living wills in 2021', https://cn.reuters.com/article/instant-article/idUKKCN1UP1I9 on 24th May 2021
[280] Suska D, 'Reappraising Dodd-Frank's living will regime', 803
[281] Suska D, 'Reappraising Dodd-Frank's living will regime', 804
[282] Suska D, 'Reappraising Dodd-Frank's living will regime', 804
[283] Suska D, 'Reappraising Dodd-Frank's living will regime', 806
[284] Suska D, 'Reappraising Dodd-Frank's living will regime', 808
[285] Central bank of Kenya, *Prudential guidelines*, 333

should be documented and available for perusal and review by the CBK, and should be reviewed by the bank's Board of Directors on an annual basis.[286]

The CBK Prudential Guidelines on Business Continuity Management (CBK/PG/14) set out the structure of crisis management, and propose that the business continuity plan should contain details of specific members of the management entrusted to implement the plan.[287] Further, upon activation of the plan by a bank, the bank should notify CBK within 24 hours of activation.

Notably, in contrast with the purpose and scope of living wills, the crisis envisaged under the CBK Prudential Guidelines on Business Continuity Management (CBK/PG/14) are those which are beyond CBK's supervisory mandate or foreseeability. The crisis envisaged are such as accidents, terrorist attacks, natural disasters, failure of technology and infrastructure; all of which threaten to disrupt the provision of banking services.[288] For such disruptions, the immediate point of intervention would be the bank on its motion, rather than according to a directive from CBK.

The requirement for banks to have in place these business continuity plans may shape more efficient governance as bank management formulates a sustainable plan to follow in case of crisis. However, appreciating that inherently, living wills were pioneered to address systemic risk, CBK may require the large systemically important banks with a high risk portfolio to craft recovery plans, especially as they continue to expand[289] through mergers and acquisitions across the borders.

4.6 Conclusion

The twin peaks model illustrates that it is imperative to have a system-wide macroprudential approach to financial regulation. Although a weakly designed twin peaks model may be susceptible to weaknesses in the overlap of functions and lack of

286 Central bank of Kenya, *Prudential guidelines*, 333 and 339
287 Central bank of Kenya, *Prudential guidelines*, 339
288 Central bank of Kenya, *Prudential guidelines*, 339
289 Various Kenyan banks such as KCB Bank Kenya Limited, NCBA Group, and Equity Bank, all of which comprise of Kenya's largest banks, have branches outside of Kenya. The various jurisdictions where branches have been set up or local banks been acquired by Kenyan banks are Uganda, Tanzania, Rwanda, South Sudan, Burundi, DRC https://www.eac.int/financial#:~:text=There%20are%20four%20(4)%20Kenyan, Uganda%20and%2016%20in%20Rwanda) ; https://ke.ncbagroup.com/; https://equitygroupholdings.com/ke/; https://ke.kcbgroup.com/

inter-agency coordination, a properly designed twin peaks structure eases the respective supervisor's tasks with clearly laid out objectives, armed with regulatory and supervisory tools for execution. The separation of the supervisors' functions and co-operation in executing them aids in the identification of possible risks, lapses and a manner promotes a system of checks and balances, which lacks a sectoral or unified regulatory structure. However, the application of the model in the different countries is unique to the country's domestic conditions. For example, on the surface, this is demonstrable with South Africa, which has three peaks of regulators. As earlier stated, this paper acknowledges that one regulatory framework cannot be suitable or applicable universally and does not suggest that Kenya should transform its institutional and functional regulatory framework to the twin peaks model to replicate what Australia, the Netherlands, and South Africa have done.[290]

Kenya's financial sector, for example, is not as interconnected as compared to Australia, the Netherlands, and South Africa. Most commercial banks have not deviated from commercial banking, the conglomerates are not complex or numerous in number and the financial products are not diversified to justify a different regulatory model from the current institutional/functional model.[291]

Despite the observation that a paradigm shift to the twin peaks model would not be suitable in mitigating the risk of bank failure, CBK could borrow some practices utilised in the application of the model to revamp supervision, increase efficiency, and effectiveness in the banking sector. Firstly, there is a need for CBK to have clear objectives with practical functions generally as an institution, and specifically within its departments. As earlier discussed in chapter 3, legislation demonstrates that the objectives of CBK are abstract, lack a specific objective on financial stability, and further, lack the designated functions that CBK would be mandated to carry out to achieve its objective. These institutional and departmental objectives and functions should be transparent and enshrined in legislation. Further, the separate dedicated

[290] Gakeri J, 'Financial services regulatory modernization in East Africa; the search for a new paradigm for Kenya', 166 and 170

[291] Gakeri J, 'Financial services regulatory modernization in East Africa; the search for a new paradigm for Kenya', 169

departments dealing with prudential risk and market conduct must also have clear objectives and practical functions that will assist them to attain their objectives. Effectively, this would rule out any blurred lines that may enable departmental gaps and overlaps, diminishing efficient supervision. The departments must also collaborate, co-operate and share information with each other even while they are internal departments of the regulator. Effectively, this would enhance supervision and ensure that the information relied on to make recommendations or enforce sanctions is accurate and up to date.

CBK's transition to risk-based supervision is a step towards effective risk management, and its forward-looking approach seeks to prevent failure rather than react to it. With proper implementation of the supervisory steps, and strict adherence to examination and corrective measure timelines, the benefits of the risk-based supervisory framework will show.

Turning to living wills, they seek to plan for a failure but are still at the nascent stage of testing. The process of formulating one is in itself, very expensive, and for it to be reliable, would require constant updating of data. However, the risks posed by the emerging financial conglomerates on financial stability may only increase. Restricting this to the systemically and significantly important institutions is, therefore, sensible. While there is no guarantee that the living will would be suitable in a time of crisis, noting also that crises do not necessarily take the same pattern, the other benefits of accountability and transparency on part of the regulator, as well as enhanced governance on part of the executives, contribute towards the aims of bank regulation.

CHAPTER FIVE

CONCLUSION AND RECOMMENDATIONS

5.1 Conclusion

From the foregoing chapters, it is evident that banks play a crucial role in the economy and their safety and soundness have a direct impact on the stability of the banking sector and the economy generally. In light of the significant role that banks play in our economy, it is imperative that individually, banks apply the recommended rules, regulations, and guidelines to measure, identify and mitigate risk promptly. Thus, the safety of individual banks would impact systemic safety.

Acknowledging that naturally, banks will strive to advance their interests, bank supervision is crucial to ensure that banks adhere to the provided rules, regulations, and guidelines. Bank supervision should also ensure that the bank's stakeholders are protected from the risk of loss, and that appropriate measures to respond to risk have been set up and can be measured by the supervisor.

Kenya's legislation on banking is elaborate as the statutory empowerment for CBK to identify, monitor, and measure risk, and intervene in bank management where necessary. The legal establishment and mandate of the Central Bank are enshrined under Article 231 of the Constitution of Kenya, 2010 and the Central Bank of Kenya Act, Chapter 491 of the Laws of Kenya while its statutory operationalization is elaborated under the Banking Act, Chapter 488 of the Laws of Kenya. Kenya has also incorporated some of the international standards surrounding among others, the most essential overall capital adequacy and liquidity requirements set out in the Basel Accords.

As we have established from literature and the workings of Central Banks, they play a critical role in promoting financial stability in the economy, by providing oversight over the banking business. Notably, the existing Kenyan statutes do not provide as one of CBK's objectives, the mandate to promote financial stability. Scholars have found that one of the major challenges facing modern Central Banks is the lack a specific mandate for financial stability, and even where the objective exists, they lack structures that would operationalize the mandate.[292] In Kenya CBK's mandate to promote financial stability is enumerated through its principal object in section 4 (1) of the Central Bank Act, which provides that the principal object of CBK is to formulate and implement monetary policy directed to achieving and maintaining stability in the general level of prices.[293] Other objectives of the CBK that seek to promote financial stability are such as its mandate to foster the liquidity, solvency, and proper functioning of a stable market-based financial system.[294] However, these objectives are not corroborated by practical functions which would be applied to achieve them.

Kenyan legislation governing the banking sector also provides CBK with the authority to intervene in the operations of a bank either for investigation or enforcement purposes. We have seen that the recent failures of Chase Bank Limited, Dubai Bank, and Imperial Bank Kenya Limited involved poor governance by the bank's management and officials. However, CBK failed to arrest the continued poor governance in a timely fashion, and also failed to recommend or remove the offending parties from office.[295] This deficiency in supervision could be attributed to poor or lack of supervision, misapplication of the tools provided to mitigate operational risk, as well as poor assessment of whether one is fit and proper to govern or manage a bank. Further, after the failure of the banks, it is not clear if and how the senior officials of the respective banks were held accountable for the bank failure. Scholars have found that it is imperative for the supervisor to actively enforce rules and regulations when they are not followed. Failure to do so may not only diminish investors' and depositors' confidence in bank regulation, but also depict to bank officials that the probability of no action or punitive sanction by the supervisor in case of non-compliance is high, and therefore worth the risk.[296]

Kenya's economy is continually growing, and banks play a big role in the growth and stability of the economy, not only within the borders but also within the East and

[292] Serge J, "Financial stability objectives and arrangements, what's new" in *bank of international settlements papers no. 76,* 47
[293] Central Bank of Kenya Act, (Chapter 491 laws of Kenya)
[294] Section 4 (2) of the Central Bank of Kenya Act (Chapter 491 laws of Kenya)
[295] This power is provided for under Section 11 of the Banking Act
[296] Banking regulation of UK and US financial markets, Enforcement powers and bank supervision, 113

Central African region. All efforts to reduce the risk of bank failure should therefore be welcome, and all pertinent parties being the banks, and supervisors, should share the vision and mission of promoting stability and mitigating the risk of bank failure. Kenya's legal framework is largely adequate and in consonance with international standards, and the only enhancements that may be necessary are drawn towards enhancing supervisory efficiency. To be significantly efficient, CBK must employ transparency, consistency, and the requisite regulatory tools to implement their statutory supervisory mandate.

5.2 Recommendations

i. Enhanced supervisory approach and supervisory tools

The reasons for the collapse of Chase Bank Limited, Imperial Bank Kenya Limited[297] and Dubai Bank[298] all share a common factor; that there seems to have been a supervisory oversight, complicity, or laxity. It is probable that if CBK had identified the malpractice early and intervened, the malpractice at the banks would have been arrested and perhaps the failure of the banks would have been avoided or their failure managed in a more orderly manner that is less disruptive. Therefore, CBK should identify banks' lapses, threats, and risks early in their supervisory cycle and ensure that they respond appropriately, promptly.

ii. Frequent liquidity risk assessments

The CBK guidelines on liquidity management[299] provides that banks should conduct stress tests regularly to inform their internal policies, contingency plans, and any necessary changes that may be made to existing strategies to ensure that they remain effective. By mandating banks to conduct the stress tests regularly without stating a definitive period, the guideline leaves banks with a lot of leeways to define what regular periods or intervals may mean to them. This would be counterproductive as individually and systemically, the periodic intervals for conducting the stress tests and for the banks and CBK to collect, assess and act on the outcomes need to be timely.

[297] https://www.centralbank.go.ke/images/docs/media/2015/ImperialBank27102015.pdf
[298] https://www.centralbank.go.ke/images/docs/media/2015/KDICPRESSRELEASE.pdf
[299] Central bank of Kenya, *Prudential guidelines*, 2013

Any delay in identifying potential liquidity strains may jeopardize the stability of a bank. Therefore, CBK should incorporate the definitive, minimum 30-day stress threshold in its liquidity stress test, as recommended in Basel III. This will shape the banks' timely response to potential risk and enhance their capacity to endure adverse conditions which could be prolonged. Effectively, there will be better timely identification, control, and management of stress points, and the bank will be better equipped to respond to liquidity issues with a lot of resilience.

iii. Development of cross border supervision

As discussed in chapter 4, Kenya has various banks which are domestically large in size; assets, market share, and which have penetrated to other jurisdictions outside of Kenya, as well as a presence of foreign banks in Kenya. This increased globalization of businesses and finance cannot be avoided and may be a significant risk to disruption to domestic and international markets. As discussed in Chapter 3, the CBK Prudential Guidelines only highlight aspects of information sharing between supervisors in different jurisdictions, such as in CBK/PG/14 on business continuity management. However, it does not set out the modalities of information sharing and how it is to be implemented because of managing risk. The CBK Risk Based Supervision Framework has on its part, proposed the establishment of supervisory colleges under the framework created by CBK in 2012 on the same. All Kenyan banks with significant cross-border operations are required to have supervisory colleges in the various jurisdictions.[300] However, the threshold used by CBK in determining what constitutes 'significant cross border presence' to establish supervisory colleges is not known, and so, not all banks with cross border presence have supervisory colleges.

To ensure that the various supervisory colleges are synchronised in terms of objective, purpose, and duties, CBK must deduce guiding principles on the same, in readiness for the continued expansion and rapid growth of cross-border banking in the region. Firstly, it should be clear that the supervisory college's objective is to enhance the exchange of information between supervisors and encourage their cooperation.[301]

[300] Central bank of Kenya risk based supervisory framework, 2013
[301] Basel committee on banking supervision, *Consultative document - good practice principles on supervisory colleges*, 2010, 8, principle 1

Secondly, the colleges need to be properly structured in a manner that will ensure that there is effective oversight. This role should be carried out by CBK, who, informed by the institutional structure and profile of the institution, should design a supervision structure, and the work to be carried out to attain the objective of a supervisory college. The supervisory college is crucial at this point to ease the interaction between the home and host jurisdictions, especially where multiple supervisors are involved[302] Thirdly, CBK should offer clear, secure, dedicated, and effective communication channels that will ensure there is timely sharing of information.[303] Fourthly, CBK should ensure that the supervisory colleges devise a crisis management plan at least annually, and as the risk profiles of the institution change.

iv. Enhanced risk based supervision

As discussed in Chapter 4, CBK has gradually incorporated a risk-based supervisory approach and is guided by the Risk Based Supervision Framework of May, 2013. However, there is a need to enlarge the scope of the framework. Firstly, the institutional profile should not only include the bank's current condition, issues of supervisory concern, and past supervisory findings but should also include a forecast of likely risk that the bank's internal management foresees to be a threat. This would require a more active and intentional participatory approach by the banks, who will not only be reporting current and historic findings to CBK but also proving their level of knowledge and understanding of risk prediction and risk management. Intrinsically, the banks actively and internally making forward-looking judgment increases the quality of risk management. It is however worthy to note that applying forward-looking judgment is not a full proof mechanism, and cannot encompass all unlikely threats to ensure ample preparation for any scenario. It provides an avenue for in-depth knowledge and understanding of risk management, an essential tool for every bank management.

Secondly, the framework provides that the Institutional Profile should comprise the Institutional Overview and the Risk Assessment Summary. However, while it communicates its expectation of the contents of the Institutional Overview, it does not

[302] Basel, *Consultative document - good practice principles on supervisory colleges*, principle 2 and 6
[303] Basel, *Consultative document - good practice principles on supervisory colleges*, principle 4

detail what a standard Risk Assessment Summary should contain. For purposes of accuracy and uniformity in supervision, the summary should at a minimum contain the following information:[304] a detailed structure of the institution, and whether it is part of a conglomerate. Where it is, the summary should detail the identity of the subsidiaries, their management structure, the identity of the senior management, the co-relation or co-dependence between the subsidiaries, and their main line of business. It should also detail an assessment of whether the current and prevailing risk management efforts have been effective, and if so, to what extent; an assessment of the institution's capital adequacy; an assessment of the profitability of the institution; financial highlights of the institution; a summary of any significant events which have occurred within 12 months, that may be essential to the institution's risk management; where the institution has an international presence, a summary of their operations and supervisory experience in the foreign country and how their operations affect the Kenya market. This summary is essential in guiding CBK from inception, the areas of priority that it may consider focussing on and dedicating more resources towards.

Lastly, considering that for effective risk management and supervision the CBK risk based supervisory framework envisions risk-based supervision to be continuous rather than a one-time exercise, CBK should require institutions to demonstrate through their budget allocations, how they have dedicated human, technology, and financial resources to this task. The human resource would essentially be a full-time point of contact between the bank and CBK, and would be responsible for ensuring that the supervisory process is carried out accordingly, and any supervisory responses followed through. Up-to-date technology would be essential for accurate and timely data collection and monitoring, while to effect all requirements, financial resources are required. This may increase budgetary needs and estimates for the institution as it recruits qualified people for the role, but the benefits of the dedicated resources may justify the need for recruitment. The human resource aspect may be more costly when it is externally required, ideally in large institutions where risk management should

[304] Central bank of Nigeria, *Supervisory framework for banks and other institutions in Nigeria*, 2008, 12

be an independent function responsible for planning, directing and controlling the impact of risk arising from its operations.[305]

Lastly, the framework needs to be developed into a singular detailed manual issuing from CBK, to guide banks and institutions under the supervision of CBK's assessment of banks' risk management should then form licensing pre-requisites for the banks.

v. Improved corporate governance by senior management

In the year 2018, 3 years after the collapse of Imperial Bank Kenya Limited, the Director of Public Prosecutions (DPP) announced that they would be pursuing the bank's management as well as CBK officials who were complicit in the poor business methods of the bank, despite numerous inspections that revealed these facts.[306] The DPP stated that the matter was of public interest and they would be revealing the extent of corruption in the institutions.[307] However, little has been shared with the public since, and the intricate details of the investigations, or their outcome, have not been shared with the public despite the matter being of great public interest. As the wheels of justice turn slowly, justice delayed would be justice denied. Effectively, this outcome may only encourage improper governance practices by senior management of banks. As part of its quality assessment in risk based supervision, CBK may consider including a mandatory requirement of continuous professional training for the institution's senior management, especially on areas of corporate governance, and fulfillment of such annual training should be a pre-requisite to their continued management roles in the institution. The bank management should, just as other leaders in the public sector, be subjected to fulfilling the requirements of Chapter 6 of the Constitution of Kenya 2010[308] on leadership and integrity before assuming office, as the persons entrusted with safeguarding the public good should at the very least, even on face value, be persons of integrity because efficient corporate governance is directly linked with integrity. While this may not be a full-proof solution to bad

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[305] Central bank of Nigeria, *Supervisory framework for banks and other institutions in Nigeria,* 23

[306] Genghis capital, 'CBK officials probed over imperial bank mega fraud', 2018 https://www.genghis-capital.com/newsfeed/cbk-officials-probed-over-imperial-bank-mega-fraud on 30th May 2021

[307] Genghis capital, 'CBK officials probed over imperial bank mega fraud', 2018 https://www.genghis-capital.com/newsfeed/cbk-officials-probed-over-imperial-bank-mega-fraud on 30th May 2021

[308] Article 73 (2), Constitution of Kenya 2010 provides that the guiding principles on leadership and integrity include selection based on personal integrity, competence and suitability, impartiality and objectivity in decision making and accountability of the decisions made

corporate governance, officials who are removed from office, or recommended for removal from office by CBK, would be refrained from seeking other similar roles on account of their record failure to comply with Chapter 6 of the Constitution of Kenya 2010.

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Appendices

Ouriginal

Document Information

Analyzed document	PREVENTING BANK FAILURE AN ASSESSMENT OF THE RISK REGULATORY FRAMEWORK FOR BANKS IN KENYA .docx (D118777605)
Submitted	2021-11-16 12:01:00
Submitted by	
Submitter email	Jean.Mwangi@strathmore.edu
Similarity	6%
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Sources included in the report

W	URL: http://erepository.uonbi.ac.ke/bitstream/handle/11295/94020/Ogutu_The%20role%20of%20central%20bank%20in%20the%20relationship%20between%20monetary%20policy%20and%20economic%20growth.pdf?sequence=4&isAllowed=y Fetched: 2021-11-16 12:07:00	1
W	URL: https://www.centralbank.go.ke/uploads/990034127_CBK%20Newsletter%20-%20Issue%205.pdf Fetched: 2021-11-16 12:07:00	7
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W	URL: https://www.centralbank.go.ke/wp-content/uploads/2016/08/CBKs-Risk-Based-Supervision-Framework-May-2013-1.pdf Fetched: 2021-11-16 12:07:00	12
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25th October 2021

Ms Mwangi Jean,
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Dear Ms Mwangi,

RE: Towards Mitigating the Risk of Bank Failure in Kenya: An Assessment of the Risk Regulatory Framework for Banks

This is to inform you that SU-IERC has reviewed and **approved** your above **SU- master's** research proposal. Your application reference number is **SU-IERC1180/21.** The approval period is **25th October 2021 to 24th October 2022.**

This approval is subject to compliance with the following requirements:

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

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

Yours sincerely,

for: Prof Fred Were,
Chairperson; SU-IERC

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