

**PROTECTING THE DEPOSITORS: A CASE FOR A *SUI*  
*GENERIS* BANK INSOLVENCY REGIME**

Submitted in partial fulfilment of the requirements of the Bachelor of Laws Degree, Strathmore  
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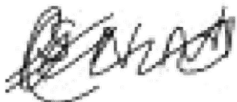
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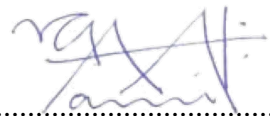
**DECLARATION**

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

Signed:  .....

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This dissertation has been submitted for examination with my approval as University Supervisor.

Signed:  .....

Marvin Oliech

## ABSTRACT

*The potential collapse of Spire Bank in Kenya gives rise to questions of bank insolvency and the potential of reviving failed banks. Over the years research has shown that several banks in Kenya have failed due to various reasons such as mismanagement and excessive insider lending. However, despite analysing the reason why banks failed, most research failed to consider the question for bank insolvency and its efficiency to revive failed banks. The current insolvency regime for banks seems to lead to the complete collapse of banks rather than revival, begging the question on whether current bank insolvency law is effective. Furthermore, in the process of winding up a failed bank, insolvency law tends to favour creditor protection over depositor protection. This paper by using a comparative study between different bank insolvency regimes found in the United Kingdom and in the United States seeks to establish the need for an adaptive and risk management framework for bank insolvency that upholds depositor protection as equally as creditor protection. Through the comparative paper, it became evident that the best insolvency regime would be one that takes the particular history and experience of a country over time into consideration, is adaptable and is efficient in risk management. Based on this the major recommendations for the Kenyan bank insolvency system is to ensure the current legal framework is one born of the past experience within the banking sector and the application of a distinct enforcement system to ensure depositor protection is upheld.*

## LIST OF STATUTES

### Kenyan Statute

*Companies Act* (No. 17 of 2015)

*Insolvency Act* (No. 18 of 2015)

*Banking Act* (Chapter 488)

*Central Bank Act* (Chapter 491)

*Insurance Act* (No. 10 of 2012)

*Consumer Protection Act* (2012)

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

*Employment Act* (No. 11 of 2007)

*Insolvency Act* (1986)

*Banking (Special Provisions) Act* (2008)

*The Banking Act* (2009)

### US Statute

*Federal Deposit Insurance Act* (Chapter 967)

*Federal Deposit Insurance Corporation Improvement Act* (1991)

*Omnibus Budget Reconciliation Act* (1993)

### UK Statute

*Northern Rock Bank the Banking (Special Provisions)* (2008)

*Insolvency Act* (1986)

*The Banking Act* (2009)

## LIST OF CASES

*Richardson and David Limited v KDIC and another* (2015) eKLR

*Kimani Waweru and 4 others v Central Bank of Kenya and 7 others* (2018) eKLR

*Thomas and Piron Grands Lacs Limited v Lighthouse Property Company Limited: Chase Bank Kenya Limited and another* (2019) eKLR.

## **LIST OF ABBREVIATIONS**

CWM- Creditor's Wealth Maximization

CB- Creditors' bargain

MV- Multiple Value Approach

EVA- Explicit Value Approach

KDIC- Kenya Deposit Insurance Corporation

## 1. CHAPTER ONE

### 1.1 INTRODUCTION/ BACKGROUND

A new dawn was heralded by the Companies Act 2015<sup>1</sup> which introduced several changes such as the allocation of takeovers and mergers to another act as opposed to the Capital Markets Act, the introduction of comprehensive financial reporting requirements in line with International Accounting best practice, among others have been relatively progressive<sup>2</sup>. However, the most relevant to this paper is the introduction of administration, liquidation and moratorium which are governed majorly by the Insolvency Act of 2015.<sup>3</sup>

This effectively replaced the knee-jerk reaction of winding up of companies as enshrined in the old Companies Act (here-in CAP 486)<sup>4</sup> with the above-mentioned legal concepts.<sup>5</sup> The Insolvency Act covers insolvency of natural persons alongside juridical persons such as companies, business entities either public or private.<sup>6</sup> The aforementioned changes of administration, liquidation and moratorium apply to juridical persons only. Hence, it is only companies, either public or private that can under-go administration, liquidation or use of a moratorium.<sup>7</sup> Banks by virtue of being business entities require formal registration as companies to fall within the ambit of juridical persons and to be applicable for administration, liquidation and moratorium.<sup>8</sup>

This is further supported by section 34 A of the Banking Act 2015 that allows banks to consider voluntary liquidation in as long as it is approved by the Central Bank of Kenya. Furthermore, under section 40 A of the Banking Act the use of voluntary liquidation and subsequent duties of a liquidator is to be determined by the Companies Act which makes refers to the use of the Insolvency Act when determining administration, liquidation and moratorium. From the above, it

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<sup>1</sup> *The Companies Act* (No 17 of 2015). This act commenced on 15<sup>th</sup> September 2015.

<sup>2</sup> Ager P and Muchiri G, 'The Companies Act (2015)', Oraro and Company Advocates, 2016.

<sup>3</sup> Section 381, 521 and 669, *Insolvency Act* ((No.18 of 2015).

<sup>4</sup> *The Companies Act* (CAP 486). This act was repealed on 18<sup>th</sup> September 2015.

<sup>5</sup> Kinyua G, 'The Companies Act (No. 17 of 2015)' Academia, 2016, 5.

<sup>6</sup> Section 2, *Insolvency Act* (No.18 of 2015). This act commenced on 18<sup>th</sup> September 2015.

<sup>7</sup> Section 2, *Insolvency Act* (No.18 of 2015).

<sup>8</sup> Section 3(1), *Companies Act* (No. 17 of 2015) states that a company refers to, 'A company formed and registered under this Act [the 2015 Companies Act of Kenya] or an existing company [one incorporated under a pre-existing or other statute e.g. CAP 486]. For banks to fall within the jurisdiction of the Companies Act it must first be a registered company. It is worth noting that the study refers to all types of banks when considering insolvency laws. These types include: Retail Banks, Commercial Banks, Investment Banks, Cooperative Banks, Shadow Banks, Financial Institutions and Credit Unions.

can be deduced that the insolvency of a Bank is governed by the Companies Act and the Insolvency Act just like any other business entity in Kenya.

The Companies and Insolvency Acts by replacing the winding-up concept ushered in a new era of liberal procedures and mind-set towards failing institutions as institutions that can be revived to normal financial health.<sup>9</sup> To which, is a reasonable cause for such changes. However, it is pertinent to note that the inevitable cannot be changed, that is all things must come to an end in the cycle of life. Therefore, companies will fail and to some extent must fail for a normal economic cycle. This, unfortunately, applies to banks as they are also business entities.

Therefore, when the reviving mechanisms fail, how does a bank become insolvent? The general rules found in the Companies Act and the Insolvency Act will apply in entirety. This implies favouring creditor and director interest over all other interests. Under the Insolvency Act in administration, the consent or approval of the creditors and company directors is required when distributing assets.<sup>10</sup> Furthermore in voluntary liquidation under section 625 of the Insolvency Act allows for voluntary liquidation by way of voluntary agreement of directors and creditors of the company.<sup>11</sup>

It is evident that the general insolvency regime in Kenya tends to uphold creditor and director interest above all other interests when a business entity is insolvent. This is reasonable when the business entity is a company that majorly started and runs on investors financial input and management of directors. However, when the business entity is a bank, the number of interests involved not only multiple to include depositor interest but also differ on the severity that insolvency has on the involved interests. This can be linked to the stakeholder theory that emphasizes that there are varying interest in organizations and all these interests should be considered as valuable.<sup>12</sup>

It would be prudent for the insolvency regime that applies to banks to weigh out these interest and trade them off on a case to case basis. This would ensure that depositor interest are weighed equally to all other interest. The Kenya Deposit Insurance Act under section 44 allows for depositors of a

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<sup>9</sup> Kinyua G, 'The Companies Act (No. 17 of 2015)' Academia, 2016, 5.

<sup>10</sup> Section 582, *Insolvency Act* (No. 18 of 2015).

<sup>11</sup> Section 625, *Insolvency Act* (No. 18 of 2015).

<sup>12</sup> Harrison SJ, Freeman ER and Cavalcanti M, 'Stakeholder theory as an Ethical Approach to Effective Management: applying the theory to multiple contexts' 17 *Review of Business Management*, 2015, 860.

bank to object to the liquidation of a banking entity in a court of law.<sup>13</sup> This to some extent makes consideration for depositor's interest but after the fact of insolvency and not during insolvency proceedings.

Consequently, for better depositor protection, there is a need for an improved insolvency regime that caters for both creditor and depositor interests on an equal basis. The prevailing general insolvency regime in Kenya does not effectively protect depositors' interest, therefore, a *sui generis* bank insolvency regime could be considered as an alternative.

## 1.2 STATEMENT OF PROBLEM

Generally, insolvency law for any entity should be able to keep a viable business operating. Insolvency law should be able to revive companies suffering from poor management choices or a temporary economic downturn.<sup>14</sup> When this happens: all stakeholders should be able to benefit. This means that creditors can recover a larger part of their investment, more employees keep their jobs and the network of suppliers and customers should be preserved.<sup>15</sup>

The insolvency regime applied to banks ought to be one that considers the special function and nature of banks in comparison to corporations. Further, through these considerations, it would seek to uphold specific interests such as creditor and consumer protection on an equally assessed scale. This would eventually lead to a trade-off of interests based on an equal and fair weighing of interests of an insolvent bank.

However, in current practice, the insolvency law applicable to banks is general insolvency law. General insolvency law tends to focus on upholding the interest of creditors above all others. Evidenced, when the distribution of assets of an insolvent institution occurs, priority is given to creditors above all else. A characteristic that is reasonable for business entities that primarily depend on investments from creditors. However, a bank functions not only on creditor support but depositors' (consumer) contribution. Therefore, such a model is inapplicable to the insolvency of banks.

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<sup>13</sup> Section 44, *Kenya Deposit Insurance Act* (No. 10 of 2012). This act commenced on 1<sup>st</sup> July 2014.

<sup>14</sup> Marinc M and Rant V, 'A cross-country analysis of bank bankruptcy regimes', *Journal of Financial Stability* 13, 2014, 135.

<sup>15</sup> Marinc M and Rant V, 'A cross-country analysis of bank bankruptcy regimes', *Journal of Financial Stability* 13, 2014, 138.

Banks are considered special as they play a unique role in a country's economy. In that, when considered collectively their functions are so important as to constitute a public service.<sup>16</sup> To justify the special attention needed to banks, reference is usually given to three characteristics. The first is that banks tend to hold high liquid liability in form of deposits that are repayable on demand. On the asset side, they hold long-term loans that may be difficult to sell or borrow against on short notice.<sup>17</sup> Under normal circumstances, this mismatch of maturities is not a problem. However, in the event the bank is subject to a large number of withdrawals, the bank may face liquidity problems.<sup>18</sup>

Secondly, banks remain the primary source of liquidity for most financial and non-financial institutions through the extension of credits taking of deposits and the processing of payments. Thirdly, banks constitute the transmission belt for monetary policy.<sup>19</sup> Therefore, care should not only be taken when signs of mismanagement arise but also during the insolvency period. Insolvency law should be able to cater to the specific interests involved in insolvent banks; such as consumer and (depositor) creditor interest.

### 1.3 JUSTIFICATION OF THE STUDY

The purpose of this study is to examine the insolvency regime that banks require to better protect depositors' interest. Statute, case law and scholarly work have made numerous contributions to creditor protection. However, rarely is depositors' protection analysed and established as of equal importance as creditor protection. Hence, this study will present an academic and policy impact. In the academic realm, it will contribute to a deeper understanding of insolvency regimes that pertain to banks, particularly open up discussions for considering sui generis insolvency laws for banks in Kenya for the benefit of depositor protection.

Within policy considerations, this study will help the government, in particular the financial sector to assess the needs of banks during failures and adequately apply laws that will ensure those needs are met in a manner that considers both creditors and depositors. Therefore, this study will

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<sup>16</sup> Marinc M and Rant V, 'A cross-country analysis of bank bankruptcy regimes', *Journal of Financial Stability* 13, 2014, 140.

<sup>17</sup> Corrigan E, 'Are banks special? A revisitation' *The Region*, Federal Reserve Bank of Minneapolis 2000, 5.

<sup>18</sup> Hupkes E, 'Insolvency- why a special regime for banks?' 3(1) *Current Developments in Monetary and Financial Law*, 2003, 461.

<sup>19</sup> Hupkes E, 'Insolvency- why a special regime for banks?' 3(1) *Current Developments in Monetary and Financial Law*, 2003, 461.

contribute to the existing body of literature on insolvency law and make recommendations in the form of policies that will cater to depositor protection under bank insolvency more effectively.

#### **1.4 SIGNIFICANCE OF THE STUDY**

An examination of the insolvency regime that banks require will ensure creditor and depositor protection are weighed as equal interests in determining the best insolvency approach. Consequently, this study will affect how depositors' and creditors' interests are viewed in insolvency, it will impact the handling of creditors and depositors during bank insolvency, and it will affect policy consideration made for insolvent banks. This study will promote a deeper understanding to insolvency principles that pertain to banks with an aim of upholding both depositor and creditor interest, ensuring efficient procedures in upholding said interest and the application of bank-specific policy.

#### **1.5 STATEMENT OF AIM AND OBJECTIVES**

The aim of the study is:

1. To investigate the suitability of an *ex-ante* sui generis insolvency regime in protecting depositors' interest in comparison to a general insolvency regime in Kenya and to that effect establish the most applicable insolvency regime for banks in Kenya.

#### **1.6 OBJECTIVES OF THE STUDY**

1. To analyse how the current insolvency laws are applied to banks in Kenya.
2. To evaluate the impact on depositors that the general existing insolvency laws applied in the banking sector have.
3. To explore whether there is a need for a sui generis system for bank insolvency in Kenya to better uphold depositor protection through a comparative study of insolvency regimes in the US and the UK.

#### **1.7 RESEARCH QUESTIONS**

1. How suitable are the existing insolvency laws to banks in Kenya?
2. Whether the current insolvency regime in Kenya sufficiently upholds depositor protection?
3. Whether banks require a *sui generis* insolvency regime to better uphold depositor protection?

## **1.8 HYPOTHESIS**

1. The current insolvency regime in Kenya is not suitable for banks as it is mainly tailored around creditor protection.
2. The current insolvency law in Kenya has an unfair effect on depositors.
3. To cater to the interest of the depositors there is a need for a sui generis insolvency system.

## **1.9 RESEARCH METHODOLOGY**

This study will take a doctrinal approach. The study will have a doctrinal approach that analyses statute, case law and relevant literature to determine what is the applicable insolvency law for banks in Kenya for maximum depositor protection.

## **1.10 LITERATURE REVIEW**

This study aims to determine the need for a sui generis insolvency system for banks in Kenya for better protection of depositors' interest. This is specifically necessary, in light of the definitive features of banks. Bank insolvency law is usually categorized into three regimes; general insolvency, free-standing bank insolvency regimes and modified insolvency regimes. Scholarly work tends to concentrate on these three, favouring the last two models over the general insolvency regime. To achieve the above-mentioned aim, this study will analyse the three existing regimes as expounded in the existing literature. Furthermore, this study will assess the theoretical underpinnings of insolvency laws that determine the type of bank insolvency law that are applicable to Kenya to better uphold depositors' interest.

The term insolvency is not defined in the Company Act 2015 or the Insolvency Act. However, Stanley Joslin defines insolvency as when an entity's liabilities exceed its assets. Joslin further emphasizes the concept of insolvency involves the balancing of assets against liabilities and the ability to pay debts. Therefore, insolvency law concerns itself with the procedures of dealing with an insolvent entity. General insolvency law refers to a system that has one applicable compilation of insolvency laws. There exists no distinction between the insolvency law of corporates and banks. This is largely the insolvency regime used in Kenya. The insolvency of banks and corporates is governed by the Companies Act 2015 and the Insolvency Act.

General insolvency law as propounded by Eva Hupkes applies to both corporates and banks. This is because many aspects of bank liquidation are similar to corporate liquidation such as the

calculations of the assets, the verification of claims, the adjudication of disputed claims, and the distribution of assets.

The free-standing bank insolvency regime refers to regimes that have provisions governing bank insolvency in a separate statute that is distinct from the general corporate insolvency regime. The bank insolvency regime is therefore predominantly bank-specific as elaborated by the report of the European Union on the study on the different bank insolvency laws. The need for such a system as propounded by Lindgren is based on three distinct characteristics of banks. The first is banks have high liquid liabilities in the form of deposits that are payable upon demand.

Additionally, they hold long-term loans that may be difficult to sell or borrow against on short notice. This mismatch of maturities usually does not pose a problem as withdrawals are subject to the law of large numbers with loans held until maturity and repaid at face value. Hence, a bank's required capitalization covers the risk of loan loss, and a cushion of liquid assets ensures its ability to cover withdrawals in normal times. However, if the confidence in a bank is disturbed leading to bank runs, according to Andrew Campbell, these massive withdrawals of deposits can cause liquidity problems that may lead to insolvency.

Secondly, banks offer an extension of credit, take deposits, and process payments for their customers. This forms a fundamental functioning of an economy making banks the primary source of liquidity for most financial and non-financial institutions. They provide direct and stand-by sources of credit and liquidity to the economy of a county, by supplying money in forms of loans or providing guarantees in the form of loan commitments. Thirdly, banks constitute the link between the monetary policy process and the economy.

A modified insolvency regime refers to general corporate insolvency laws that apply to both corporates and banks but are complemented by separate provisions that address bank specificities. The determination of an applicable regime is dependent on the insolvency model a particular country adheres to. Generally, there are four distinct insolvency models that entail the objectives to be met by any insolvency law.

The earliest theories on insolvency laws were established by Thomas H. Jackson as Creditor Wealth Maximisation (here-in CWM) and Creditor Bargain (here-in CB) theories. The main objective of insolvency law from these theories was to maximise the collective return to creditors

through a compulsory collective system and to solve the ‘common pool’ of assets problem that arises from diverse claims of limited assets. Therefore, the rehabilitation of an enterprise is not a legitimate goal of insolvency law except to the extent that it is intended to maximise returns to the creditors.

The core emphasis of these two theories is that insolvency law must respect the creditors’ rights as the first and original right that cannot be ignored for new rights of consumers. Hence, insolvency law should mainly be concerned with creditor’s interest over the interest of other parties who may be affected. These theories do not agree with the idea that law should react to social problems caused by the failure of the business entity. The entity, if rescued, incurs costs and places a heavy burden on the secured creditors. This situation is considered unfavourable and unjustifiable to the creditors.

These theories formed the basis of CAP 486 that focused more on winding up of an entity rather than potential rescue. Additionally, the focus was placed in meeting creditor needs over consumer protection. Baird theorizes that the business of insolvency law is not to solve problems that were caused by the failure of business entities. Rather, those problems are to be sort after in other laws: consumer protection should be dealt with in consumer protection law rather than insolvency law, employees interest should be catered for in employment law. This model usually applies to general insolvency laws that cater to creditor protection over any other interests.

In stark contrast, the Communitarian Vision theory focuses on more public and constituent rights and interest than the CWM and CB theories. Key and Walton define this theory as a constituent theory that upholds the rights of not only creditors but also employees, suppliers, customers, the local community and the government. Further, Gross explains the Communitarian Vision Theory as one that regards individuals as being interdependent and it is necessary for them to uphold the best interest of the community even when it prejudices their freedom. Finch, adds onto this by elaborating that this theory allows insolvency procedures to rehabilitate enterprises where this would give a better result to all or most of the affected parties. Its application is tied to free-standing bank insolvency regime that has specific bank insolvency laws that cater to the various interest of those affected by bank failures.

This theory, in as much as it upholds all rights of those affected, is usually hard to implement. To uphold the rights of the consumers usually proves to be a detriment to the rights and interest of the creditors or directors. Therefore, its application is limited.

To bring in a more practical approach Warren and Korobkin developed the Multiple Values theory (here-in MV). Warren states that what she offers is a ‘dirty, complex, interconnected view of bankruptcy from which I can neither predict outcomes nor even necessarily fully articulate all the factors relevant to a policy decision’. This means policy should focus more on values to be protected in insolvency and the effectiveness of implementing those values in assisting the decision-making process even if no specific answers are reached.

Therefore, distributional objectives are to be done with an inquiry into many issues such as who is affected by the failure of the entity, how exactly are they affected, can the effect be mitigated, at what cost can it be mitigated at, who benefits from the business failure, who may have contributed to the business failure, how and to what extent have they contributed, who can bear the costs of the business failure and who is expected to bear the cost of the business failure.

These inquiries bear different answers that necessitate different actions. Therefore, the MV model will not bear clear answers but will act as a starting point as to what values to uphold and what to ignore. Korobkin further agrees that in as much as the MV model does not produce clear results, it does not explicitly discriminate as the economic theories of CWM and CB. Undoubtedly, Warren and Korobkin seek to create an insolvency regime with wider aims than creditor interest. Despite no assured result from applying their model. This theory usually advocates for a general insolvency law that has *lex specialis* laws for bank insolvency, hence a modified insolvency regime.

The author recognises the importance of the MV theory and traces its impact to the current insolvency law that seeks to uphold the rights of creditors and also consumers. Evidenced by the Deposit Insurance Act and subsequently fund that is considered when banks under-go insolvency. However, the MV theory is based on weighing of values and does not explicitly lead to consumer protection or creditor consideration. Therefore, a fourth model known as the Explicit Values Approach (here-in EVA) better serves the foundation of bank insolvency law.

Finch introduced the EVA as a practical alternative to the existing theories of insolvency laws. Finch elaborates that the insolvency process touches on the interest of the public as decisions on

the survival or demise of an entity affect sources of revenue and funds of the public at large. Additionally, insolvency law affects private rights such as pre-insolvency property rights. Hence taking into account the impacts of insolvency on private and public rights, several explicit values that guide insolvency law must be established.

These are efficiency, accountability, fairness and expertise implications. These grounds should be used to negotiate the diverse interest of those affected before reaching a distributional decision. Further, Finch advises that when using the grounds all interests must be equally weighted and prioritised. However, when arriving at the decision a trade-off must be made after evaluation of the different values with different interests. EVA, therefore, combines the CMW, CB and Communitarian Vision approaches with foundations of the MV model to give a list of justifiable values to determine insolvency of an entity.

This model offers a more practical approach to the establishment and the use of insolvency law. However, it still advocates for a trade-off of interest based on the list of values to be used. This in itself may lead to upholding creditor interest over consumer protection. Even though both were equally considered in light of efficiency, expertise, accountability and fairness. EVA elaborates the need for special bank insolvency laws that can meet efficiency, fairness, accountability, and expert implications. However, EVA can also encourage a general insolvency law that advocates for evaluation based on these grounds for all entities be it corporates or banks.

In conclusion, the applicable insolvency regime is based on four models of insolvency and the specific interests that are to be upheld. These models are the creditor wealth maximization and creditors' bargain, communitarian vision, multiple values and explicit value theories. Each of these models portrays a different ideal bank insolvency regime such as general, free-standing and modified. Each specified regime contributes differently to upholding both creditor and consumer interests during bank insolvency. Therefore, it is of utmost importance to use the best model to develop the most efficient bank insolvency regime for maximum consumer and creditor protection. Consequently, this study will show the most applicable bank insolvency regime for maximum depositor protection in Kenya.

## 1.11 LIMITATIONS

A lot of literature has been written on bank insolvency regimes internationally. However, there is very little literature written by Kenyan authors that critique the current bank insolvency system with consideration for a sui generis bank insolvency regime that better protects depositors' interest. Therefore, the main limitation of this study is the lack of deep study into bank insolvency regimes in Kenya by Kenyan authors with the aim of depositor protection. Consequently, the literature review from local scholars is limited.

Another limitation of this study is the use of sources that are not current. The nature of the literature on bank insolvency law is that it exists post a financial crisis that heavily affected banks. This is evidenced by a large number of literary on bank insolvency law existing after the 1980s and 1990s bank failures in the US and Kenya. Consequently, the most current literature on bank insolvency exists post the 2008 financial crisis. This limits the study to the literature review that was done after major financial crises of the 1980s, 1990s and 2008.

## 1.12 CHAPTER BREAKDOWN

Chapter 1: Introduction and Background of the study

This chapter introduces the problem the paper seeks to answer: whether banks in Kenya require a sui generis insolvency system? It does this by looking at the nature of banks and the role they play in the economy. Through this, the paper establishes the importance of banks and suggests possible bank insolvency regimes that are used in the world.

Chapter 2: Insolvency regime for banks in Kenya: a look into the efficacy of depositor protection

This chapter consists of the conceptual literature review of existing bank insolvency regimes around the world and the specific concepts that enable the aims of these regimes. Additionally, this section will delve into the evolution of insolvency law in Kenya in a bid to establish the intention of most of the legislative developments towards creditor protection. This section will also assess the application of current insolvency laws to failed banks such as Chase, Dubai and Imperial Bank with a special section on the potential collapse of Spire Bank.

Chapter 3: Promoting depositor protection through a sui generis insolvency system

This chapter will have a comparative study between the United Kingdom and the United States to show a practical sui generis insolvency system (be it in the form of specialised rules in the general insolvency regime or specialised bank insolvency regime) in comparison to Kenya's bank insolvency system. This will be done to establish a possible model that Kenya can follow in bank insolvency to suitably meet depositor protection.

#### Chapter 4: Lessons learnt from the comparative study

This chapter looks at the lessons drawn from the comparative study done in chapter 3. It does this in light of the three established principles for an ideal bank insolvency regime.

#### Chapter 5: Conclusion, Findings and Recommendations

This chapter concludes by highlighting the findings of this study and offering two recommendations that would improve the bank insolvency regime in Kenya. These are the establishment of an adaptable legal framework that tackles the issues faced in the bank insolvency regime and the establishment of a distinct enforcement system for bank insolvency in Kenya. There-in this paper concludes.

## 2. CHAPTER TWO

### 2.1 HISTORICAL UNDERPINNINGS OF INSOLVENCY LAW

The Kenyan legal insolvency framework is traceable to the historical colonial legacy, just like much of the current legal system.<sup>20</sup> Therefore, the principles of English law and English concepts will be generally applicable as long as they are compatible with local circumstances.<sup>21</sup> Local law in the form of the Constitution and Acts of parliament take precedence over foreign law such as English law.<sup>22</sup>

The Companies Act (Cap 486) was taken from the English Companies Act of 1948. The statute was adopted almost in its entirety. This was mainly because the imposition of English laws was done through involuntary transplant of laws.<sup>23</sup> The involuntary transplant occurred through the re-enactment of reception clauses, local ordinances and in some instances the entire colonial legislation. Reception clauses are provisions that adopt the common law approach with English legal statute as the basis for judicial decisions.<sup>24</sup> The reception of these laws was typical among former British colonies such as Kenya.

The then adopted Companies Act (Cap 486) contained laws that pertained to the English corporate structure and was not a reflection of the current issues that Kenyan companies were facing.<sup>25</sup> The Act was in force until 2015 when the new Insolvency Act was introduced. However, before this, the country run on archaic insolvency laws that were transplanted from the United Kingdom. Ironically, the United Kingdom had overhauled the English Companies Act of 1948 with the Insolvency Act 1985, consolidated as the Insolvency Act 1986 and was further improved by the Enterprise Act 2002.<sup>26</sup>

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<sup>20</sup> Muriungi M, 'Putting New Wine in new Wine Skins: Reforming Insolvency Law in Kenya' Published, University of Nairobi, Nairobi, 2015, 2.

<sup>21</sup> Section 3, *Judicature Act (1967)*. This act commenced on 1<sup>st</sup> August 1967.

<sup>22</sup> Section 3, *Judicature Act (1967)*.

<sup>23</sup> Muriungi M, 'Putting New Wine in new Wine Skins: Reforming Insolvency Law in Kenya' Published, University of Nairobi, Nairobi, 2015, 2.

<sup>24</sup> Muriungi M, 'Putting New Wine in new Wine Skins: Reforming Insolvency Law in Kenya' Published, University of Nairobi, Nairobi, 2015, 3.

<sup>25</sup> Muriungi M, 'Putting New Wine in new Wine Skins: Reforming Insolvency Law in Kenya' Published, University of Nairobi, Nairobi, 2015, 3.

<sup>26</sup> Omar JP, 'Disclaiming Onerous Property Insolvency: A comparative Study' 19 *International Insolvency Review*, 2010, 42.

The Companies Act (Cap 486) was rigid and did not believe in the rescue of a struggling company. Hence it embodied the concepts of receivership and winding up.<sup>27</sup> Additionally, it relied on multiple laws to enact procedures of receivership or winding up. The Bankruptcy Act of 1930 governed the realm of personal insolvency.<sup>28</sup> It was considered an extensive document with 164 sections and numerous amendments that were made to reflect the Kenyan context.<sup>29</sup> However, before it was overhauled the act was considered to be archaic law that did not fully reflect the Kenyan society.

In a bid to deal with the inefficiency of the Bankruptcy Act (Cap 486) and the Companies Act (Cap 486) several Insolvency bills were introduced.<sup>30</sup> The main objectives of the new bills were to provide options for struggling companies to be revived to life, a consolidation of all laws pertaining to insolvency and establishment of clear insolvency procedures.<sup>31</sup> The reform took the form of several bills that were presented and ultimately rejected.

In the year 1992, a task force was charged with reviewing the laws that pertain to insolvency law in Kenya and make recommendations to modernize and simplify the laws.<sup>32</sup> The Kenya Law Reform Commission was tasked by the then serving Attorney General Amos Wako to review this report and draft insolvency laws that addressed the concerns raised on the Bankruptcy and Companies Act.<sup>33</sup> The Commission undertook to consult various stakeholders such as bankers, accountants and lawyers. Additionally, it did a comparative analysis between Kenya and various jurisdictions such as the United Kingdom, New Zealand, Australia and Canada.<sup>34</sup> This brought the first Insolvency Bill of 2008 that was tabled in Parliament. Subsequent bills were drafted in the years 2010, 2012 and 2014 but did not get approval from Parliament until 2015.<sup>35</sup>

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<sup>27</sup> Part VI, *Companies Act (Cap 486)*.

<sup>28</sup> Section 3, *Bankruptcy Act (Cap 53)*. This act commenced on 3<sup>rd</sup> September 1930 and was repealed on 18<sup>th</sup> September 2015.

<sup>29</sup> Muriungi M, 'Putting New Wine in new Wine Skins: Reforming Insolvency Law in Kenya' Published, University of Nairobi, Nairobi, 2015, 3.

<sup>30</sup> Muriungi M, 'Putting New Wine in new Wine Skins: Reforming Insolvency Law in Kenya' Published, University of Nairobi, Nairobi, 2015, 4.

<sup>31</sup> Muriungi M, 'Putting New Wine in new Wine Skins: Reforming Insolvency Law in Kenya' Published, University of Nairobi, Nairobi, 2015, 5.

<sup>32</sup> Too CF, 'Drivers of Insolvency Reform in Kenya' 4(1) *Nottingham Insolvency and Business Law Journal*, 2016, 7.

<sup>33</sup> Too CF, 'Drivers of Insolvency Reform in Kenya,' 7.

<sup>34</sup> Too CF, 'Drivers of Insolvency Reform in Kenya,' 7.

<sup>35</sup> Too CF, 'Drivers of Insolvency Reform in Kenya,' 8.

## 2.2 INSOLVENCY ACT 2015

From the preamble of the Insolvency Act, the Act intends to amend, consolidate the law relating to receivership, insolvency, provisional supervision, winding up and individual bankruptcy. This is so that they can provide corporate and individual insolvency to rehabilitate debtors.<sup>36</sup> A preamble sets out the intentions of the drafters and is considered the descriptive component of a statute.<sup>37</sup> It serves as a useful guide in ascertaining the intention of the lawmaker by detailing the objects, purpose, and scope of a particular statute.<sup>38</sup>

To this effect, the preamble as provided for in the Act is a good way of ascertaining the scope, objects and purpose of the Act and illuminate the type of mischief the Act intends to curb.<sup>39</sup> The preamble of the Insolvency Act reads as follows:

‘AN ACT of Parliament to amend and consolidate the law relating to the insolvency of natural persons and incorporated and unincorporated bodies; to provide for and to regulate the bankruptcy of natural persons; to provide alternative procedures to bankruptcy that will enable the affairs of insolvent natural persons to be managed for the benefit of their creditors; to provide for the liquidation of incorporated and unincorporated bodies (including ones that may be solvent); to provide as an alternative to liquidation procedures that will enable the affairs of such of those bodies as become insolvent to be administered for the benefit of their creditors; and to provide for related and incidental matters.’<sup>40</sup>

It is prudent to note that despite whatever form of insolvency is tackled, be it individual or corporate the main objective is to administer or manage affairs for the benefit of the creditors.<sup>41</sup> This is a justifiable claim for a company that primarily functions on the investment given to them in the form of loans by its creditors.<sup>42</sup> However, in the instance of a bank, there are interests at stake that do not only pertain to the creditors.<sup>43</sup> A bank maintains liquidity ratios through the deposit taking and loan advancing of its clientele. It primarily runs on a day to day basis based on

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<sup>36</sup> Preamble, *Insolvency Act* (No.18 of 2015).

<sup>37</sup> Orgard L, ‘The preamble in constitutional interpretation,’ 8(4) *International Journal of Constitutional Law*, 2010, 716.

<sup>38</sup> Orgard L, ‘The preamble in constitutional interpretation,’ 716.

<sup>39</sup> Orgard L, ‘The preamble in constitutional interpretation,’ 716. A preamble is of no legal effect. See also *Sussex Peerage* (1844), The United Kingdom House of Lords.

<sup>40</sup> Preamble, *Insolvency Act* (2015).

<sup>41</sup> Hupkes E, ‘Insolvency- why a special regime for banks?’ 3(1) *Current Developments in Monetary and Financial Law*, 2003, 461.

<sup>42</sup> Hupkes E, ‘Insolvency- why a special regime for banks?’ 3(1) *Current Developments in Monetary and Financial*, 461.

<sup>43</sup> Hupkes E, ‘Insolvency- why a special regime for banks?’ 3(1) *Current Developments in Monetary and Financial*, 461.

its depositors. The inadvertently ensure that the economy is running and trade continues both locally and internationally through the banking system. Furthermore, based on the stakeholder theory we can assert that a bank has several groups of people that hold an interest in its operation such as depositors, creditors, and the state among others.<sup>44</sup> Therefore, their interests should be considered.

### **2.3 DEPOSIT INSURANCE ACT**

Besides the Insolvency Act, there exists the Deposit Insurance Act. Its preamble establishes the objective of the Act as the establishment of a deposit insurance system for deposit-taking institutions that are undergoing receivership and liquidation.<sup>45</sup> Additionally, it aims to establish the Kenya Deposit Insurance Corporation.<sup>46</sup> The Kenya Deposit Insurance Act came in to cater to depositor interests when banks undergo insolvency. This is primarily achieved through its powers under section 6 of the Kenya Deposit Insurance Act that allows the Kenya Deposit Insurance Corporation to settle any claim against the corporation in the form of depositor's monies.<sup>47</sup> Therefore it seeks to provide some form of protection to the depositors of insolvent banks. However, this in itself is not enough as the Insolvency regime is based on ensuring creditor protection.

The aforementioned sections looked into the historical development of Insolvency law in Kenya with a concentration on the Insolvency Act of 2015 and the Deposit Insurance Act. It has established that the laws in Kenya on Insolvency have over time evolved to suit the needs of the industry. Although, this change can be considered slow. In the section below the paper will delve into the application of the above-mentioned laws to failed banks with a view of assessing whether the current insolvency laws can sufficiently protect depositor's interest.

### **2.4 BANK INSOLVENCY IN KENYA**

Chapter 1 and the beginning of Chapter 2 of this dissertation touched on the historical and legal aspect of bank insolvency in Kenya. In this section, the aim is to assess the current situation in Kenya in terms of bank insolvency through certain cases of bank failures such as that of Imperial

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<sup>44</sup> Harrison SJ, Freeman ER and Cavalcanti M, 'Stakeholder theory as an Ethical Approach to Effective Management: applying the theory to multiple contexts' 17 *Review of Business Management*, 2015, 860.

<sup>45</sup> Preamble, *Kenya Deposit Insurance Act (No. 10 of 2012)*.

<sup>46</sup> Preamble, *Kenya Deposit Insurance Act (No. 10 of 2012)*.

<sup>47</sup> Section 6, *Kenya Deposit Insurance Act (No. 10 of 2012)*.

Bank, Chase bank and the possible failure of Spire Bank.<sup>48</sup> Kenya since 1986 has experienced major bank failures with 37 failed banks by 1998.<sup>49</sup> This follows the bank crises experienced in 1986-1989, 1993-1994 and 1998.<sup>50</sup> The first major crisis would be from 1986 to 1989 when many indigenous owned banks and non-bank financial institutions failed.<sup>51</sup> These are Continental Bank, Jimba Credit, Rural Urban Finance, Thabiti Finance and Union Bank which went down due to poor lending practices and unsatisfactory asset quality.<sup>52</sup>

Since then there has been an unfortunate continuous cyclic crisis affecting Kenya every few years as between 1986 to 1997 alone, ten commercial banks collapsed while in 1998 five more commercial banks collapsed.<sup>53</sup> The banks that failed between 1998 and 1999 were Reliance Bank, Bullion Bank, Trust Bank, City Finance Bank and Prudential Bank.<sup>54</sup> Further, the collapse of banks such as Reliance Bank and Trust Bank caused a chain reaction in the economy. The ripple effects were felt by smaller banks as their deposit levels dropped in favour of the big banks that were perceived to be more stable by the public.<sup>55</sup> Additionally in 2007 to 2015 another crisis hit with several banks such as Dubai Bank, Imperial Bank and Chase bank collapsing.<sup>56</sup> The section below will look into these bank failures, the actions of the Central Bank of Kenya in addressing their collapse and the subsequent steps taken by Kenya Deposit Insurance Corporation in addressing depositor concerns.

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<sup>48</sup> Alshula P, Borrowers default 90% of Spire Bank loan book, Business daily, 2020 -<  
<https://www.businessdailyafrica.com/corporate/companies/Borrowers-default-90pc-of-Spire-Bank/4003102-5619932-lip765z/index.html>> on 10<sup>th</sup> October 2020.

<sup>49</sup> Waweru N, 'Commercial banking crises in Kenya: Causes and Remedies', 3(3), *Global journal of Finance and Banking Issues*, 2009, 23.

<sup>50</sup> Waweru N, 'Commercial banking crises in Kenya: Causes and Remedies', 24.

<sup>51</sup> Mutouta C, 'Financial Performance of Commercial Banks in Kenya', Published, United States International University, Nairobi, 2000, 14.

<sup>52</sup> Mutouta C, 'Financial Performance of Commercial Banks in Kenya', Published, United States International University, Nairobi, 2000, 14.

<sup>53</sup> Waweru N, 'Commercial banking crises in Kenya: Causes and Remedies', 24.

<sup>54</sup> Mutouta C, 'Financial Performance of Commercial Banks in Kenya', Published, United States International University, Nairobi, 2000, 14.

<sup>55</sup> Waweru N, 'Commercial banking crises in Kenya: Causes and Remedies', 24.

<sup>56</sup> Irungu V, 'Turnaround strategies influencing recovery of commercial banks under receivership programme in Kenya: A case of Chase Bank', Published, University of Nairobi, Nairobi, 2017, 4.

### 2.4.1 Dubai Bank

Dubai Bank was established in 1982.<sup>57</sup> As of December 2013, the bank's total assets were valued at US\$ 34.4 million equating to KES 2.92 billion.<sup>58</sup> However, in August 2015 the bank was put under receivership by the Central Bank of Kenya which subsequently appointed the Kenya Deposit Insurance Cooperation as the receiver of Dubai Bank.<sup>59</sup> The CBK reported that the main contributory factor leading to the collapse of Dubai Bank was capital deficiencies and liquidity.<sup>60</sup> The bank had failed to honour some of its financial obligations such as paying off KES 48 million which it owed to the Bank of Africa. Additionally, the bank had been breaching its daily cash reserve ratio requirements of 5.25 percent.<sup>61</sup>

In the case of *Richardson and David v Kenya Deposit Insurance Corporation*, the court acknowledged the worrisome status that the bank had been but took notice of the fact that the Central Bank of Kenya was aware of the problems that Dubai Bank faced since 2011. These included knowledge on the insufficient capital levels and the accumulating liabilities that did not match the bank's assets. However, Central Bank of Kenya chose to gloss over those problems and continued to pamper the bank when it had a defined and important responsibility to the depositors and public at large.<sup>62</sup>

The court linked this responsibility to Part VIII of the Banking Act that established the Central Bank of Kenya as a supervisory body that not only had the obligation to check on banking institutions but also the obligation to protect the public from mischievous financial institutions.<sup>63</sup> Therefore if the Central Bank of Kenya had done its due diligence then intervention by the Kenya Depositor Insurance Corporation would not have been necessary as an emergency whistle would have been blown two years before the catastrophic collapse of Dubai bank.<sup>64</sup>

Additionally, the Central Bank of Kenya in realizing the tremendous power it holds in depositor protection should have considered the applicants' proposal for a self-help procedure for the bank

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<sup>57</sup> Gathaiya R, 'Analysis of issues affecting collapsed banks in Kenya from year 2015 to 2016', 7 *International Journal of Management and Business Studies* 3, 2017, 10.

<sup>58</sup> Gathaiya R, 'Analysis of issues affecting collapsed banks in Kenya from year 2015 to 2016', 10.

<sup>59</sup> Gathaiya R, 'Analysis of issues affecting collapsed banks in Kenya from year 2015 to 2016', 10.

<sup>60</sup> Central Bank of Kenya, *Dubai Bank in receivership*, 2015, 2.

<sup>61</sup> Central Bank of Kenya, *Dubai Bank in receivership*, 2015, 2.

<sup>62</sup> *Richardson and David Limited v KDIC and another* (2015) eKLR.

<sup>63</sup> *Richardson and David Limited v KDIC and another* (2015) eKLR.

<sup>64</sup> *Richardson and David Limited v KDIC and another* (2015) eKLR.

rather than liquidation.<sup>65</sup> This is the least the CBK should have done as it failed in protecting the depositors before by ignoring the problem.

#### 2.4.2 Imperial Bank

Imperial Bank Limited Kenya was founded in 1992 as a finance and securities company and later transitioned into a commercial bank in January 1996.<sup>66</sup> It was put under receivership by the Central Bank of Kenya on 13<sup>th</sup> October 2015, subject to Section 43(2) of the Kenya Deposit Insurance Act.<sup>67</sup> This was after the Imperial Bank's Board of Directors submitted a report confirming the fraudulent activities and the misrepresentation of the bank's financial statements. Some of the irregular activities included the irregular granting of loans by the bank's management and the illegal transfer of funds by the bank's top officials.<sup>68</sup>

As expected, a lot of the bank's depositors and investors were frustrated by the fact that they could not access their money and as a result, sued the Central Bank of Kenya for failing to fulfil their duties with regards to licensing and regulating financial institutions. In the case *Kimani Waweru and 4 others v Central Bank of Kenya and 7 others*<sup>69</sup>, the Court held that the Central Bank had not fulfilled its mandate as per section 32 of the Banking Act in that it did not scrutinise and confirm the credibility of the audit reports that had been submitted by Imperial Bank over the years.

Secondly, the Central Bank of Kenya had been made aware of massive fraud of approximately KES 38 billion at the Imperial bank but failed to act on the information because it believed that the particular set of facts did not warrant a revocation of Imperial Bank's banking license. The Court held that where credible information is presented to the Central Bank of Kenya that a bank is being mismanaged, it falls upon the Central Bank of Kenya to act and prevent a further crisis.<sup>70</sup> Therefore, because of its dismissal of the whistle-blower's claim, it had failed to protect the depositor's and investor's interests and the perpetrators had the leeway to continue stealing.

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<sup>65</sup> *Richardson and David Limited v KDIC and another* (2015) eKLR.

<sup>66</sup> < <http://www.imperialbankgroup.com/ke/about-us/> > on 19 January 2020.

<sup>67</sup> Section 43(2), *Kenya Deposit Insurance Act* (Act No.10 of 2012).

<sup>68</sup> Central Bank of Kenya, *Bank supervision annual report*, 2015, 9.

<sup>69</sup> *Kimani Waweru and 4 others v Central Bank of Kenya and 7 others* (2018) eKLR.

<sup>70</sup> *Kimani Waweru and 4 others v Central Bank of Kenya and 7 others* (2018) eKLR.

According to various claims, the founder of Imperial Bank colluded with Central Bank of Kenya officials and created unlawful and fraudulent accounts to defraud Imperial Bank's unsuspecting depositors. These transactions were not reflected in the bank's financial statements and on the Central Bank of Kenya's end, data was edited creating the illusion that Imperial Bank was a stable and profitable institution.<sup>71</sup> The Central Bank of Kenya had therefore misused its powers and failed to meet its supervisory obligations under the Banking Act.<sup>72</sup> This subsequently led to financial loss not only to the depositors but also investors of the bank.

### 2.4.3 Chase Bank

Chase Bank was established in 1996 as a result of acquiring 60% of the investments in the United Bank of Kenya.<sup>73</sup> On April 2016 the bank was put under statutory administration under the Kenya Deposit Insurance Corporation by the Central Bank of Kenya.<sup>74</sup> This was mainly due to liquidity issues as the reports demonstrated that the profits in 2015 fell significantly in comparison to 2014. Further, the bank had non-performing loans worth KES 11 Billion.<sup>75</sup> In 2018 the Central Bank of Kenya put up an announcement that the State Bank of Mauritius had approximately acquired 75% of deposits, bank staff and branches in Kenya and was merging them with its subsidiary in Kenya, SBM.<sup>76</sup> The remaining assets and liabilities that were not acquired were transferred to Kenya Deposit Insurance Corporation for liquidation.<sup>77</sup>

Unlike previous bank failures, this time round the Central Bank of Kenya had a speedy response to the collapsing of Chase Bank and ensured it put measures in place to help its revival. This helped protect a majority of the depositors' interest as 75% of deposits were transferred and were recoverable under SBM bank.<sup>78</sup> However, the remaining depositors were not able to recover their money till to date as any claims of depositor's interest were prevented during the period of receivership.<sup>79</sup>

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<sup>71</sup> *Kimani Waweru and 4 others v Central Bank of Kenya and 7 others* (2018) eKLR.

<sup>72</sup> *Kimani Waweru and 4 others v Central Bank of Kenya and 7 others* (2018) eKLR.

<sup>73</sup> Irungu V, 'Turnaround strategies influencing recovery of commercial banks under receivership programme in Kenya: A case of Chase Bank', Published, University of Nairobi, Nairobi, 2017, 18.

<sup>74</sup> Central Bank of Kenya, *Bank supervision annual report*, 2016, 25.

<sup>75</sup> Central Bank of Kenya, *Bank supervision annual report*, 2016, 25.

<sup>76</sup> Central Bank of Kenya, *Press Release Chase Bank and SBM Bank*, 2018, 1.

<sup>77</sup> Central Bank of Kenya, *Press Release Chase Bank and SBM Bank*, 2018, 1.

<sup>78</sup> Central Bank of Kenya, *Press Release Chase Bank and SBM Bank*, 2018, 1.

<sup>79</sup> *Thomas and Piron Grands Lacs Limited v Lighthouse Property Company Limited: Chase Bank Kenya Limited and another* (2019) eKLR.

#### 2.4.4 Spire Bank

Spire Bank was established in 1983 as Equatorial Commercial Bank Limited.<sup>80</sup> It commenced its activities as a commercial bank in 1995. It merged with Southern Credit Banking Corporation in 2010.<sup>81</sup> In 2016 Equatorial Commercial Bank rebranded as Spire bank.<sup>82</sup> Spire Bank is primarily owned by businessman Naushad Merali and Mwalimu National Sacco.<sup>83</sup> Through their 2020 financial results, the number of gross non-performing loans has hit 2.69 billion in June in comparison to the 2.96 billion that has been lent out.<sup>84</sup> Additionally, Spire's non-performing loans ratio is considered to be seven times that of the entire banking industry.<sup>85</sup>

From the end of 2019 to mid-2020, the earnings of Spire bank have moved from a net profit of KES 81.48 million to a net loss of KES 556.1 million.<sup>86</sup> The bank has a negative core capital of KES 2.11 billion.<sup>87</sup> The required core capital by Central Bank of Kenya is KES 5 billion.<sup>88</sup> This means that Spire Bank is deficient in its core capital by KES 3.12 billion. In terms of its capital to risk-weighted assets ratio, Spire Bank as of June 2020 is operating at 34.61% which is above the set minimum ratio of 14.5%.<sup>89</sup> Capital to risk-weighted assets ratio is the measure of the bank's capital expressed as a percentage of its risk-weighted credit exposures.<sup>90</sup>

The main reason for assessing capital to risk-weighted assets ratio is to protect depositors and promote the stability of the financial system.<sup>91</sup> Minimum capital adequacy ratios have been

<sup>80</sup> <https://www.spirebank.co.ke/about-us/> on 10<sup>th</sup> October 2020.

<sup>81</sup> <https://www.spirebank.co.ke/about-us/> on 10<sup>th</sup> October 2020.

<sup>82</sup> <https://www.spirebank.co.ke/about-us/> on 10<sup>th</sup> October 2020.

<sup>83</sup> Alshula P, Borrowers default 90% of Spire Bank loan book, Business daily, 2020 -< <https://www.businessdailyafrica.com/corporate/companies/Borrowers-default-90pc-of-Spire-Bank/4003102-5619932-lip765z/index.html>> on 10<sup>th</sup> October 2020.

<sup>84</sup> Spire Bank, *Un-Audited financial results of the Bank 2020*, 1. Under part III, 1.0, the gross non-performing loans and advances column.

<sup>85</sup> Alshula P, Borrowers default 90% of Spire Bank loan book, Business daily, 2020 -< <https://www.businessdailyafrica.com/corporate/companies/Borrowers-default-90pc-of-Spire-Bank/4003102-5619932-lip765z/index.html>> on 10<sup>th</sup> October 2020.

<sup>86</sup> Spire Bank, *Un-Audited financial results of the Bank 2020*, 1. Under the profit/ (loss) after tax and exceptional items column of part II, 12.0.

<sup>87</sup> Spire Bank, *Un-Audited financial results of the Bank 2020*, 1. Under the total capital column of part III, 4.0 (e).

<sup>88</sup> Section 8 (2), *The Central Bank of Kenya Act* (No 41 of 2013).

<sup>89</sup> Alshula P, Borrowers default 90% of Spire Bank loan book, Business daily, 2020 -< <https://www.businessdailyafrica.com/corporate/companies/Borrowers-default-90pc-of-Spire-Bank/4003102-5619932-lip765z/index.html>> on 10<sup>th</sup> October 2020. See also, Central Bank of Kenya, *Prudential Guidelines*, 88.

<sup>90</sup> Bitar M, Pukthuanthong K, Walker T, 'The effect of capital ratios on the risk, efficiency and profitability of banks: Evidence from OECD countries', 53(C), *Journal of International Financial Markets, Institutions and Money*, 2018, 230.

<sup>91</sup> Bitar M et al, 'The effect of capital ratios on the risk, efficiency and profitability of banks: Evidence from OECD countries' 230.

developed to ensure banks can absorb a reasonable level of losses before becoming insolvent. The current ratio of capital to risk against weighted assets of Spire Bank indicates the possible collapse of the bank and the inevitable loss of money from depositors as it is above the required percentage.<sup>92</sup> Spire bank is currently in breach of the total core capital requirements and capital to weighted asset ratio set by the Central Bank of Kenya. The collapse of Spire bank seems to be inevitable within the next few years. However, the Central Bank of Kenya has not taken any mitigating steps to prevent the collapse or to anticipate the collapse of Spire Bank.

This section has assessed the status of the bank insolvency regime in Kenya by analysing the collapse of Dubai Bank, Imperial Bank, Chase Bank and the potential collapse of Spire Bank. It is evident that the laws placed for insolvency in Kenya do not cater to depositor's protection as key institutions such as the Central Bank of Kenya are unable to anticipate bank failures and react in a manner that protects the interests of depositors. Based on this the next chapter will look at the conceptual framework that is applicable in protecting various interest in the insolvency of a bank with a key focus on depositor's interest.

## 2.5 CONCEPTUAL FRAMEWORK

The conceptual framework of this study revolves around the interest of consumers and creditors with a key focus on consumer protection. It delves into the principle of consumer protection by defining who a consumer is, what rights and duties do consumers have and why it is important to uphold their interest in a credit market. Further, this study defines the creditor protection principle and assess the importance of creditors in a credit market. Consequently, the study marries the two interest not as competing but complementary to each other, in this way it ensures consumer protection is taken as seriously as creditor protection.

The word consumer in the traditional theory is on who consumes. A consumer in this view is considered to be well-informed about costs, price and quality of goods. However, this view differs in the real world. According to Galbraith, a consumer is a puppet and captive of business.<sup>93</sup> Adam Smith describes the place of a consumer as, 'the sole end and purpose of all production and the

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<sup>92</sup> Bitar M et al, 'The effect of capital ratios on the risk, efficiency and profitability of banks: Evidence from OECD countries' 230.

<sup>93</sup> Lokanathan V and Lakshmiratan A, *Business and Society*, Emerald Publishers, Madras, 1984, 187.

interest of the producer ought to be attended to only so far as it may be necessary for promoting that of the consumer.’<sup>94</sup>

Consumers are individual members of the society that purchase or use goods or services for either private or public purpose.<sup>95</sup> Consequently, anyone who spends money or exchanges articles for goods and services can be termed a consumer. In banking, an individual or entity that deposits money in a bank amounts to a consumer as they use the banks’ service of keeping money in either current, fixed deposit or saving accounts.<sup>96</sup>

The basic rights of the consumer are enshrined in the charter on consumer rights. It seeks to redress the imbalance between businesses and consumers. The basic rights of consumers were expounded by John F. Kennedy as the right to safety, the right to be informed, the right to choose and the right to be heard. All of which can be found in Article 46 of the Constitution of Kenya,<sup>97</sup> and section 4 and 16 of the Consumer Protection Act.<sup>98</sup>

These rights of a consumer are further elaborated in the case of *Richardson David v KDIC*, where depositors of a bank were considered consumers of the services offered by Dubai bank. Therefore, they had a set list of rights and duties that were enshrined in law. However, the court went on to establish that the rights of consumers can be determined in accordance with context. In this case, a depositor had the right to appeal the declaration of liquidation of Dubai bank by the Kenya Deposit Insurance as per section 44 A Kenya Deposit Insurance Act.<sup>99</sup> Consumer protection can be achieved through several avenues such as government agencies, consumer association, self-regulation, statutory regulations, ombudsman, and data collection and use.

On the other hand, there exist the creditor protection principle. A creditor according to Alijardo Jorge is an individual or entity that offers financial support to another that acquires an interest and requires payment upon maturity.<sup>100</sup> Many economist and legal experts argue that the protection of creditors’ rights is crucial for the development and optimal performance of the credit market.

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<sup>94</sup> George S, ‘Consumer Forum-Consumer Protection’, *Tamil Nadu Journal of Cooperation*, 1992, 83 (4), 193.

<sup>95</sup> George S, ‘Consumer Forum-Consumer Protection’, *Tamil Nadu Journal of Cooperation*, 1992, 83 (4), 194.

<sup>96</sup> George S, ‘Consumer Forum-Consumer Protection’, *Tamil Nadu Journal of Cooperation*, 1992, 83 (4), 194.

<sup>97</sup> Article 46, *Constitution of Kenya* (2010).

<sup>98</sup> Section 4 and 16, *Consumer Protection Act* (2012). This act commenced on 2012.

<sup>99</sup> *Richardson David v Kenya Deposit Insurance Commission and another* (2015) eKLR, 50.

<sup>100</sup> Jorge A and Requenjo A, ‘The costs and benefits of the strict protection of creditor rights: theory and evidence’ *Inter-American Development Bank*, R-384, 2009, 3-

<https://pdfs.semanticscholar.org/7668/b6145224446efa55fedbcad9011847aed9cb.pdf> on 28 February 2020.

Gertner and Scharfstein explain that the primary function of the credit market is to provide cheap funds, and this is possible only when creditor rights are protected and sanctions on non-performing debtors are enforced.<sup>101</sup>

However, this view is disputed on several grounds. According to Manove and Padilla, the functions of the credit market are primarily not to just provide cheap loans and involve: screening of projects, insuring risk-averse entrepreneurs who face large risks and protection of the consumers. Therefore, a credit market works efficiently when other interests such as consumer protection are upheld. Consequently, when considering the applicable insolvency law for banks both consumer protection and creditors' interest must be equally assessed, but not equally attained.<sup>102</sup>

It is within this background that this study will use the concepts of consumer and creditor protection to establish a need for balancing interests. Rather than the explicit discrimination enshrined in statute for creditor protection as a higher interest over depositors' interest. This, in accordance with this study's hypothesis, will assess the efficacy of a sui generis insolvency regime in better upholding depositors' protection.

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<sup>101</sup>Gertner R and Scharfstein, 'A Theory of Workouts and the Effects of Reorganization Law' *Journal of Finance*, 1991 46(4), 1189-1222.

<sup>102</sup> Manove M and Padilla J, 'Creditor Rights and Project Screening: A Model of Lazy Banks' Boston, United States, 12.

### 3. CHAPTER THREE

#### 3.1 BANK INSOLVENCY REGIMES IN THE UNITED STATES AND THE UNITED KINGDOM

As aforementioned bank insolvency regimes vary widely. Some countries tend to have general insolvency regimes that govern the insolvency of other firms and individuals.<sup>103</sup> These regimes tend to have a judicial process in which the supervisor (or the bank or the creditors) must apply to the court for the appointment of the receiver or conservator.<sup>104</sup> Whereas other countries have separate insolvency regimes that govern bank insolvency and additionally apply an administrative process for bank closure, where the bank insurer, bank supervisor or other agency has the power to appoint the conservator or receiver.<sup>105</sup> Most of these differences and their consequent effects can be demonstrated by a look at the United Kingdom and United States bank insolvency regimes.

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##### 3.1.1 STRUCTURE OF INSOLVENCY REGIMES IN UNITED STATES

In the US two distinct legal processes are used to resolve the failures of corporations and those of commercial banks.<sup>107</sup> Each regime can be presumed to have different assumptions, goals and strategies for resolution of financial issues within corporations and banks.<sup>108</sup> Taking into consideration the special nature of banks, bank insolvency resolution in the US is found under a special code for banks.<sup>109</sup> This code is contained in the Federal Deposit Insurance Act and it considerably differs from general federal corporate bankruptcy.<sup>110</sup>

The main difference between the two regimes is that the general corporate bankruptcy code in the US favours debtors over creditors especially for large insolvent firms through the use of in-place

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<sup>103</sup> Schoomer MH, 'Bank Insolvency Regimes in the United States and the United Kingdom', 18 *Transnational Lawyer Journal*, 2005, 385.

<sup>104</sup> Schoomer MH, 'Bank Insolvency Regimes in the United States and the United Kingdom', 386.

<sup>105</sup> Schoomer MH, 'Bank Insolvency Regimes in the United States and the United Kingdom', 386.

<sup>106</sup> Schoomer MH, 'Bank Insolvency Regimes in the United States and the United Kingdom', 386.

<sup>107</sup> Bliss BR and Kaufman GG, 'A comparison of U.S corporate and bank insolvency resolution' *Federal Reserve Bank of Chicago*, 2006, 46.

<sup>108</sup> Bliss BR et al, 'A comparison of U.S corporate and bank insolvency resolution' 46.

<sup>109</sup> Section 11, *Federal Deposit Insurance Act* (Chapter 967). This act commenced on 21<sup>st</sup> September 1950.

<sup>110</sup> Section 11, *Federal Deposit Insurance Act* (Chapter 967). See also Martion P, 'The Historical Evolution of Bankruptcy law in England, the US and Italy up to 1939: Determinants of Institutional Change and Structural Differences' SSRN, 2008, 265.

managers and attempted rehabilitation mechanisms rather than liquidation.<sup>111</sup> In parallel, the bank insolvency regime favours the depositors, who are considered the major class of bank creditors, over debtors.<sup>112</sup> This is seen from the emphasis placed on formalized early intervention before the insolvency of the bank through prompt termination of the bank charter and shareholder control rights.

### *3.1.1.1 Development of the bank insolvency regime*

The divergence of the two insolvency regimes began as early as 1898.<sup>113</sup> This is primarily attributed to an increase in federal involvement in the banking system that had been occurring.<sup>114</sup> Article 1 of the Constitution of the United States under section 8 establishes uniform insolvency laws. However, Congress seemed unable to pass a general bankruptcy code.<sup>115</sup> During this period most states dealt with the insolvency of banks similarly to the insolvency of a corporation.<sup>116</sup>

A permanent federal bankruptcy statute was finally passed in Congress and enacted. However, the statute exempted chartered banks from application of the statute.<sup>117</sup> This led states to deal with chartered banks by suspending or renewing their charters and appointment of a receiver.<sup>118</sup> Generally, the insolvency of chartered banks was dealt in the same manner as insolvent corporations.<sup>119</sup> The bankruptcy process was initiated by the creditor or state officials who would petition the courts for the appointment of a receiver to liquidate the bank.<sup>120</sup>

The resolution to have separate bank insolvency regime was widespread throughout the 1800s.<sup>121</sup> Several bills were introduced and proposed in Congress and this led to the widespread public debate on the need for special rules for banking insolvency given the nature of banks and their effect on the economy.<sup>122</sup> The first divergence into a somewhat specialised system occurred in

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<sup>111</sup> Bliss BR et al, 'A comparison of U.S corporate and bank insolvency resolution' 46.

<sup>112</sup> Bliss BR et al, 'A comparison of U.S corporate and bank insolvency resolution' 48.

<sup>113</sup> Riesenfeld S, 'The Evolution of modern Bankruptcy Law' 31(5) *Minnesota Law Review* 1947, 409.

<sup>114</sup> Martion P, 'The Historical Evolution of Bankruptcy law in England, the US and Italy up to 1939: Determinants of Institutional Change and Structural Differences' 265.

<sup>115</sup> Article 1, Section 8, *Constitution of the United States*.

<sup>116</sup> Bliss BR et al, 'A comparison of U.S corporate and bank insolvency resolution' 49.

<sup>117</sup> Riesenfeld S, 'The Evolution of modern Bankruptcy Law', 407.

<sup>118</sup> Martion P, 'The Historical Evolution of Bankruptcy law in England, the US and Italy up to 1939: Determinants of Institutional Change and Structural Differences' 265.

<sup>119</sup> Martion P, 'The Historical Evolution of Bankruptcy law in England, the US and Italy up to 1939: Determinants of Institutional Change and Structural Differences' 265.

<sup>120</sup> Riesenfeld S, 'The Evolution of modern Bankruptcy Law', 407.

<sup>121</sup> Riesenfeld S, 'The Evolution of modern Bankruptcy Law', 407.

<sup>122</sup> Bliss BR et al, 'A comparison of U.S corporate and bank insolvency resolution' 49.

1864 when Congress passed the National Bank Act which allowed for the Comptroller of currency to appoint a receiver for a bank that is not able to meet its debts.<sup>123</sup> This declaration of the Comptroller's power to institute such appointment showed the need to have different processes for dealing with bank insolvency.<sup>124</sup> It highlighted the need to have speedy administrative action rather than slow judicial processes.

In 1876 more changes were instituted to allow the Comptroller to appoint a receiver for a bank in the instance of not only inability to meet its debt but also the presence of unsound and unsafe operating standards.<sup>125</sup> This allowed the state regulators a greater role in bank insolvency. State regulations followed suit with the amendments and provided similar provisions. In 1933 the Federal Deposit Insurance Corporation was declared the sole receiver for insolvent national banks and gave the possibility of states agencies appointing the corporation as a receiver for state banking agencies.<sup>126</sup> The Federal Deposit Insurance Corporation is considered a major creditor for banks.<sup>127</sup> Therefore, appointing the Federal Deposit Insurance Corporation as an administrator marked a shift from the appointment of 'financially disinterested' parties as administrators.

Consequently, the Comptroller was granted powers to appoint the Federal Deposit Insurance Corporation as a conservator rather than a receiver.<sup>128</sup> This meant that in the instance the Federal Deposit Insurance Corporation preferred to attempt to rehabilitate a bank it would be granted the chance to do so.<sup>129</sup> Further, the 1933 act added onto the powers of the Comptroller by allowing for the close of a bank without explicit evidence of insolvency in as long as this is done to protect the legitimate interest of the depositors and other creditors.<sup>130</sup>

In 1987, the Competitive Equality Banking Act granted the Federal Deposit Insurance Corporation more power to provide for a temporary national bridge bank for financial struggling banks.<sup>131</sup> This

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<sup>123</sup> Bliss BR et al, 'A comparison of U.S corporate and bank insolvency resolution' 48.

<sup>124</sup> Bliss BR et al, 'A comparison of U.S corporate and bank insolvency resolution' 49.

<sup>125</sup> Riesenfeld S, 'The Evolution of modern Bankruptcy Law', 407.

<sup>126</sup> Riesenfeld S, 'The Evolution of modern Bankruptcy Law', 408.

<sup>127</sup> Bliss BR and Kaufman GG, 'A comparison of U.S corporate and bank insolvency resolution: An economic comparison and evaluation' *Federal Reserve Bank of Chicago*, 2006, 7.

<sup>128</sup> Bliss BR et al, 'A comparison of U.S corporate and bank insolvency resolution: An economic comparison and evaluation' 7.

<sup>129</sup> Bliss BR et al, 'A comparison of U.S corporate and bank insolvency resolution: An economic comparison and evaluation' 7.

<sup>130</sup> Riesenfeld S, 'The Evolution of modern Bankruptcy Law', 407.

<sup>131</sup> Bliss BR et al, 'A comparison of U.S corporate and bank insolvency resolution' 49.

acted as an alternative option to liquidation under receivership or conservatorship as bridge banks keep all part of an insolvent bank functioning under appointed management and ownership of the Federal Deposit Insurance Corporation: until the issues of the bank are resolved.<sup>132</sup> In 1991, the Federal Deposit Insurance Corporation Improvement Act grew the power of the Federal Deposit Insurance Corporation and Federal Reserve to declare banks legally closed based on insufficient assets in comparison to debts, unsafe and unsound practices or threatened losses that would considerably reduce the bank's capital.<sup>133</sup>

Additionally, the act included a section on the prompt corrective action provisions that allowed for the appropriate regulatory to appoint a receiver or conservator within 90 days after establishing that the bank's tangible capital has declined and is considered 'critically undercapitalized' in comparison to the bank's assets.<sup>134</sup> The aforementioned provisions were designed to seek resolution before actual insolvency of a bank. This acts as a departure from conventional insolvency rules for corporations that apply during insolvency and not before.<sup>135</sup> Further, in 1993 the Depositors Preference Act was established and it not only gave priority to depositors during insolvency but categorized the depositors into domestic depositors and non-domestic depositors.<sup>136</sup> It gave preference to domestic depositors during insolvency over other types of depositors to protect the US depositors over others.<sup>137</sup>

### ***3.1.1.2 Differences between bankruptcy and bank insolvency regimes***

The legal provisions and acts governing corporate bankruptcy, and bank insolvency differ in various ways. However, the section below will focus on three main ways that they differ: initiation of proceedings, timeliness and objectives and aim.

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<sup>132</sup> Bliss BR et al, 'A comparison of U.S corporate and bank insolvency resolution: An economic comparison and evaluation' 8.

<sup>133</sup> Bliss BR et al, 'A comparison of U.S corporate and bank insolvency resolution' 49.

<sup>134</sup> This value is usually set at 2% minimum the prescribed value under legislation. Implying that a bank need not be book value insolvent to be legally closed.

<sup>135</sup> Martion P, 'The Historical Evolution of Bankruptcy law in England, the US and Italy up to 1939: Determinants of Institutional Change and Structural Differences' 266.

<sup>136</sup> Bliss BR et al, 'A comparison of U.S corporate and bank insolvency resolution' 50.

<sup>137</sup> Martion P, 'The Historical Evolution of Bankruptcy law in England, the US and Italy up to 1939: Determinants of Institutional Change and Structural Differences' 266.

### *3.1.1.2.1 Initiation of proceedings*

Under corporate bankruptcy two forms of bankruptcy can occur. These are voluntary and involuntary.<sup>138</sup> In voluntary corporate bankruptcy, the firm in anticipation of a default initiates bankruptcy proceedings in the federal bankruptcy courts.<sup>139</sup> Whereas in involuntary corporate insolvency the creditors can initiate the proceedings for bankruptcy of a corporation in a federal bankruptcy court.<sup>140</sup> In stark contrast in the bank insolvency regime, the authorized bodies are tasked with instituting insolvency and subsequent resolution mechanisms with the primary authorized body being the Federal Deposit Insurance Corporation.<sup>141</sup> Additionally, the reasons for declaring insolvency or legally closing a bank are not just based on book value insolvency but apply widely to even market value insolvency to enable early detection, quick and, effective resolution mechanisms.<sup>142</sup> This can be considered an anticipatory approach to the insolvency of banks.

### *3.1.1.2.2 Timeliness*

Timeliness is considered in two ambits: the ability to initiate the process before potential losses to creditors or depositors and the ability to deploy mechanisms that will resolve the insolvency and pay the depositors and other creditors the recovery value of their claims in an efficient manner.<sup>143</sup> The corporate regime as highlighted above has no anticipatory measures for detecting possible insolvency and limit damage to creditors and other stakeholders.<sup>144</sup> However, the bank insolvency regime can detect pre-emptively the demise of a bank through market value insolvency and application of lower rates of book value insolvency than the statutory limited rates.<sup>145</sup> This enables the receiver once appointed to move with haste to ensure all interests in particular depositor interests are protected.<sup>146</sup> This enables the bank insolvency regime to meet the two-prong requirement of timeliness.

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<sup>138</sup> Levratto N, 'From failure to corporate bankruptcy: a review' 20(2) *Journal of Innovation and Entrepreneurship*, 2013, 6.

<sup>139</sup> Levratto N, 'From failure to corporate bankruptcy: a review,' 6.

<sup>140</sup> Levratto N, 'From failure to corporate bankruptcy: a review,' 6.

<sup>141</sup> Bliss BR et al, 'A comparison of U.S corporate and bank insolvency resolution' 47.

<sup>142</sup> Bliss BR et al, 'A comparison of U.S corporate and bank insolvency resolution' 48.

<sup>143</sup> Swire P, 'Bank Insolvency Law now that it matters again', 42(3) *Duke Law Journal*, 1992, 490.

<sup>144</sup> Swire P, 'Bank Insolvency Law now that it matters again,' 492.

<sup>145</sup> Swire P, 'Bank Insolvency Law now that it matters again,' 492.

<sup>146</sup> Swire P, 'Bank Insolvency Law now that it matters again,' 493.

### 3.1.1.2.3 Objectives and aim

The goals of corporate bankruptcy are not explicitly stated in the law.<sup>147</sup> However, scholars have made numerous attempts to define the goals of corporate bankruptcy. Some of these goals are the coordination of debt collection for creditors to maximize recovery, maximization of the real value of the bankrupt firm's assets, the distribution of assets equitable among the creditors, determination of liquidation of the firm and restoration of the firm to financial solvency.<sup>148</sup> The bank insolvency regime in comparison has explicitly laid out aims. The main objective is to ensure that resolution is reached with the least damage or cost to depositors, with priority given to domestic depositors first over other depositors.<sup>149</sup>

In conclusion bank and corporate insolvency in the US differs greatly. The main differences are the initiation of proceedings, timeliness and the overarching objectives of each regime. These differences reflect different priorities of each regime with one concentrating on creditor protection while the other domestic depositor protection.

## 3.1.2 STRUCTURE OF INSOLVENCY REGIMES IN UNITED KINGDOM

In the United Kingdom there exists three authorities tasked with ensuring the well-being of financial institutions.<sup>150</sup> These are the Financial Services Authority, the Treasury and the Bank of England. Collectively they are referred to as the tripartite authority and are required to deal with serious financial issues that threaten the stability of the UK financial markets.<sup>151</sup> This can be done by bailing out banks and where possible avert failure of financial institutions.

The insolvency regime prior to 2009 would be considered a general insolvency regime as all insolvency fell in the ambit of the Insolvency Act of 1986.<sup>152</sup> However, in 2008 in a bid to rescue the Northern Rock Bank the Banking (Special Provisions) Act of 2008 was put in place.<sup>153</sup> This marked a change in the treatment of failing banks as it led to the attempted rescue of Northern

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<sup>147</sup> Bliss BR et al, 'A comparison of U.S corporate and bank insolvency resolution' 47.

<sup>148</sup> Bliss BR et al, 'A comparison of U.S corporate and bank insolvency resolution' 47.

<sup>149</sup> Bliss BR et al, 'A comparison of U.S corporate and bank insolvency resolution' 47.

<sup>150</sup> Godfrey P, 'Evolution of bank Insolvency law in the UK', 20 *Eurofenix*, 2011, 1.

<sup>151</sup> Godfrey P, 'Evolution of bank Insolvency law in the UK', 2.

<sup>152</sup> Roome J et al, *Restructuring and Insolvency in the UK: overview*, Thomas Reuters, 5. [https://uk.practicallaw.thomsonreuters.com/9-501-6812?transitionType=Default&contextData=\(sc.Default\)&firstPage=true](https://uk.practicallaw.thomsonreuters.com/9-501-6812?transitionType=Default&contextData=(sc.Default)&firstPage=true) on 24 September 2020.

<sup>153</sup> Tomask R, 'Corporate Rescue, Governance and Risk taking-Northern Rock and its International Context' SSRN, 2006, 3.

Bank and gave greater powers to the Treasury to institute a rescue procedure without recourse to any court proceedings.<sup>154</sup> Additionally, the Treasury by injecting £28bn in taxpayers' money into the rescue of the bank paved way for the difference in treatment of financial institutions in stress from companies who are often allowed to fail.<sup>155</sup>

The Banking Act of 2009 came into force and ousted the Banking (Special provisions) Act 2008. The Banking Act established two insolvency procedures: Bank Insolvency and Bank Administration.<sup>156</sup> The Bank Insolvency procedures differ from normal insolvency procedures as its main objective is, where a bank fails, depositors who are eligible under the Financial Services Compensation Scheme are paid promptly.<sup>157</sup> Additionally, it gave separate procedures for building societies. These new procedures were as a result of The Special Resolution Regime that was established under the Banking Act of 2009.<sup>158</sup> The Resolution aimed at providing the Tripartite Authorities with new tools needed for handling the financial difficulties of banks and building societies.<sup>159</sup>

Although the U.K Financial Services Authority can be considered to lack authority to take control of a troubled bank.<sup>160</sup> This is because the Financial Service Authority, the bank or its directors, or the bank's creditors can apply for the appointment of an administrator for troubled banks.<sup>161</sup> However, it is up to the court to determine whether a financial institution is unlikely to pay its debt.<sup>162</sup> The courts determine insolvency through two tests. These are the balance sheet test and the cash flow or liquidity test. The balance sheet test requires a look at the value of the company assets and assessing if they are less than its liabilities.<sup>163</sup> On the other hand, the cash flow or liquidity test is satisfied when it is proved that they cannot pay for their debts as they fall due.<sup>164</sup> Additionally, the court will appoint an administrator only if it can determine that such action would

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<sup>154</sup> Tomask R, 'Corporate Rescue, Governance and Risk taking-Northern Rock and its International Context' SSRN, 2006, 4.

<sup>155</sup> Godfrey P, 'Evolution of bank Insolvency law in the UK', 2.

<sup>156</sup> Section 90 and 136, *Banking Act* (2009). This act commenced on 21<sup>st</sup> February 2009.

<sup>157</sup> Godfrey P, 'Evolution of bank Insolvency law in the UK', 2.

<sup>158</sup> Section 171, *Banking Act* (2009).

<sup>159</sup> Section 171, *Banking Act* (2009). Special focus is given to the tripartite authority such as the Treasury as the section inserts section 214B in the Financial Services and Market Act to give more powers to the Treasury in handling failing banks.

<sup>160</sup> Schoomer MH, 'Bank Insolvency Regimes in the United States and the United Kingdom', 387.

<sup>161</sup> Schoomer MH, 'Bank Insolvency Regimes in the United States and the United Kingdom', 387.

<sup>162</sup> Schoomer MH, 'Bank Insolvency Regimes in the United States and the United Kingdom', 387.

<sup>163</sup> Heaton JB, 'Solvency Test', 62(3) *The Business Lawyer*, 2007, 983.

<sup>164</sup> Heaton JB, 'Solvency Test', 984.

result in the survival of the company as a going concern or lead to a more positive realization of the company's assets.<sup>165</sup>

The UK regime can be considered a general insolvency regime that has specialised rules for banks within the general framework.<sup>166</sup> The legal framework for the general and specialised rules is considered highly structured and dependant on the court process. Additionally, the recognition of a need for a specialised set of rules for banks is based on the effects that failed large banks have on the economy such as the Northern Rock Bank.<sup>167</sup> Hence, the evolution of its general insolvency regime is based on experience and need for change in laws based on these cases of bank failures.

### **3.2 THE IMPORTANCE OF DIVERGENT REGIMES**

From the section above it is evident that national insolvency regimes remain distinct. The reasons for this are reasonable. In the US, the deposit insurance coverage comes close to \$100,000 as provided for by the Federal Deposit Insurance Corporation.<sup>168</sup> The sheer size of these insured deposits makes the Federal Deposit Insurance Corporation the largest stakeholder in the event of a banking crisis.<sup>169</sup> It is based on this stakeholder status that the Federal Deposit Insurance Corporation has far-reaching authority when it comes to bank insolvencies. Additionally, it is mandated to protect the deposit insurance fund and hence justifies the need to have the powers of receivership granted to it.<sup>170</sup>

Contrastingly, the UK established a deposit insurance scheme in the late 1900s after strong pressure was placed by the European Union through the Deposit Guarantee Directive.<sup>171</sup> The U.K Financial Services Compensation Scheme offers deposit insurance with a coverage of 100% for the first £2,000 and 90% for the next £33,000 which can be considered less in comparison to the US coverage scheme.<sup>172</sup> It can be assumed based on this the U.K Financial Services Compensation

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<sup>165</sup> Heaton JB, 'Solvency Test', 984.

<sup>166</sup> Schoomer MH, 'Bank Insolvency Regimes in the United States and the United Kingdom', 392.

<sup>167</sup> Schoomer MH, 'Bank Insolvency Regimes in the United States and the United Kingdom', 392.

<sup>168</sup> Schoomer MH, 'Bank Insolvency Regimes in the United States and the United Kingdom', 392.

<sup>169</sup> Schoomer MH, 'Bank Insolvency Regimes in the United States and the United Kingdom', 392.

<sup>170</sup> Bliss BR et al, 'A comparison of U.S corporate and bank insolvency resolution: An economic comparison and evaluation' 28.

<sup>171</sup> Schoomer MH, 'Bank Insolvency Regimes in the United States and the United Kingdom', 392.

<sup>172</sup> Bliss BR et al, 'A comparison of U.S corporate and bank insolvency resolution: An economic comparison and evaluation' 29.

Scheme does not have a role in bank insolvency as they are not as deeply affected by the potential failure of a bank.<sup>173</sup>

Additionally, in the US, the banking industry is populated by many banks albeit domination is by a few. Whereas the UK has a handful of banks that have been established.<sup>174</sup> Further, the US unlike the UK has experienced several bank failures and have established the need to treat banks differently and enable early detection through anticipatory measures.<sup>175</sup> The UK on the other hand has had little to no bank failures which has led to greater incentive to avoid insolvency regimes and use informal and formal regulation to resolve financial struggling institutions.<sup>176</sup>

In conclusion, the type of insolvency regime in a nation is dependent on the context of that nation among other factors. Through this, the UK has been able to establish a structured system of dealing with bank insolvency. However, due to its history the regulations and control set out maybe considered light regulations that control certain activities.<sup>177</sup> The US on the other hand has a formal system that is extremely specialised. This is largely based on its historical context of experiencing several bank failures and noting a need for a specialised system. Based on this the US insolvency regime for banks grants extraordinary powers to the regulatory in a bid to ensure anticipatory measures are applied for early detection of a bank in crisis or potential crisis.<sup>178</sup>

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<sup>173</sup> Schoomer MH, 'Bank Insolvency Regimes in the United States and the United Kingdom', 392.

<sup>174</sup> Godfrey P, 'Evolution of bank Insolvency law in the UK', 2.

<sup>175</sup> Schoomer MH, 'Bank Insolvency Regimes in the United States and the United Kingdom', 394.

<sup>176</sup> Godfrey P, 'Evolution of bank Insolvency law in the UK', 7.

<sup>177</sup> Schoomer MH, 'Bank Insolvency Regimes in the United States and the United Kingdom', 394.

<sup>178</sup> Bliss BR et al, 'A comparison of U.S corporate and bank insolvency resolution' 47.

## 4. CHAPTER FOUR

### 4.1 AN IDEAL BANK INSOLVENCY REGIME

An effective bank insolvency regime requires best practices in ensuring not only creditor protection but also depositor protection.<sup>179</sup> This entails the application of several principles such as compatible enforcement systems, active and efficient risk management systems and adaptable legal frameworks.<sup>180</sup> The section below will delve into these principles.

#### 4.1.1 Compatible enforcement systems

Each insolvency regime that is best suited for a country is usually coupled with a compatible enforcement system.<sup>181</sup> This entails having a legal framework that is easily understood and enforceable. It also entails having an active regulatory body with specified functions. In addition to the functions of the body, there should be specific powers the body should have such as licensing of banks and instituting insolvency procedures.<sup>182</sup> Besides from establishing a regulatory body with specific functions, the procedures that involve bank insolvency should be expeditious and easy to follow such that delays in the insolvency procedures do not occur and inconvenience depositors and creditors.<sup>183</sup> Whether the insolvency procedures are based on a judicial system or an out of court system is up to the specific country and the system it determines as most compatible. However, in both systems, the procedures are required to be easy to understand, follow and expeditiously executed with no to very little room for delay.<sup>184</sup>

#### 4.1.2 Active and efficient risk management systems

An efficient bank insolvency regime requires an active anticipatory system that monitors and assess the risk of insolvency for banks.<sup>185</sup> This involves having a mechanism whether in law or

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<sup>179</sup> International Monetary Fund and World Bank, *An overview of the legal, institutional and regulatory framework for bank insolvency*, 2009, 18.

<sup>180</sup> International Monetary Fund and World Bank, *An overview of the legal, institutional and regulatory framework for bank insolvency*, 2009, 19.

<sup>181</sup> International Monetary Fund and World Bank, *An overview of the legal, institutional and regulatory framework for bank insolvency*, 2009, 19.

<sup>182</sup> European Bank for Reconstruction and Development, *On the legal framework for the enforcement of commercial creditor claims in selected European Bank for reconstruction and development countries of operations*, 2019, 54.

<sup>183</sup> European Bank for Reconstruction and Development, *On the legal framework for the enforcement of commercial creditor claims in selected European Bank for reconstruction and development countries of operations*, 2019, 55.

<sup>184</sup> European Bank for Reconstruction and Development, *On the legal framework for the enforcement of commercial creditor claims in selected European Bank for reconstruction and development countries of operations*, 2019, 54.

<sup>185</sup> World Bank, *Principles and Guidelines for effective Insolvency and Creditor Rights Systems*, 2001, 17-24, 33.

regulation that allows for the authorized regulator to assess capital levels, market-based insolvency and determine the possible steps for the bank before it is ‘legally’ declared insolvent.<sup>186</sup> This allows for the authorized regulatory to take quick and efficient steps to ensure that the different interest of the stakeholders are met or the bank goes into recovery mechanisms.<sup>187</sup> For such a risk management system to exist, there must be access to complete, accurate and reliable information concerning bank capital status, list of assets and debts acquired, number of depositors with special interest on domestic depositors and current governance management rules applied.<sup>188</sup> The availability of such information will enable the regulator to detect possible insolvency of banks and have anticipatory measures applied before such.

#### 4.1.3 Adaptable legal frameworks

A one size fits all model for bank insolvency does not exist. There are several factors such as historical, cultural and political reasons that determine the type of bank insolvency regime that a country adopts.<sup>189</sup> Therefore no one model is usually considered the best model. However, depending on the current issues and objectives that the bank insolvency regime in a country holds, there will be an applicable model for achieving said objectives and solving the current issues.<sup>190</sup>

Therefore, countries are encouraged to have bank insolvency regimes that can assess the current issues and needs of the sector and adapt accordingly.<sup>191</sup> Further, the bank insolvency regime should be able to adequately meet the different interest that exists when a bank becomes insolvent. This would entail a system that takes care of creditor protection, depositor protection, employee protection among other interests.<sup>192</sup> Although some interests such as employee protection are taken care of in other acts such as the Employment Act.<sup>193</sup>

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<sup>186</sup> World Bank, *Principles and Guidelines for effective Insolvency and Creditor Rights Systems*, 2001, 17.

<sup>187</sup> World Bank, *Principles and Guidelines for effective Insolvency and Creditor Rights Systems*, 2001, 19.

<sup>188</sup> World Bank, *Principles and Guidelines for effective Insolvency and Creditor Rights Systems*, 2001, 33.

<sup>189</sup> International Monetary Fund and World Bank, *An overview of the legal, institutional and regulatory framework for bank insolvency*, 2009, 18.

<sup>190</sup> Brogi R and Santella P, ‘Two Measures of Bankruptcy Efficiency’, The European Money and Finance Forum, Vienna, 2004, 31.

<sup>191</sup> International Monetary Fund and World Bank, *An overview of the legal, institutional and regulatory framework for bank insolvency*, 2009, 18.

<sup>192</sup> Brogi R and Santella P, ‘Two Measures of Bankruptcy Efficiency’, The European Money and Finance Forum, Vienna, 2004, 31.

<sup>193</sup> Part IV, *Employment Act* (No. 11 of 2007). This act commenced on 2<sup>nd</sup> June 2008.

With these general principles that ensure the protection of various interest in mind, the next section will draw lessons from the case study done in chapter 3 to assess whether these three principles are present and what effect does their presence or absence have on the bank insolvency regime within the United Kingdom and the United States.

## **4.2 LESSONS DRAWN FROM UNITED KINGDOM AND UNITED STATES**

Chapter 3 of this dissertation looked at the structural aspects of the bank insolvency regimes of the United Kingdom and the United States. Through this chapter, two types of regimes were contrasted. The first regime is the use of general insolvency laws with an exemption for bank insolvency that contains specialised provisions that are found in the United Kingdom.<sup>194</sup> Whereas the second regime is specialised laws for bank insolvency that are completely separate from corporate insolvency laws found in the United States.<sup>195</sup> A comparison of these two systems brought to light several aspects that determine a functional bank insolvency regime within those countries.

### **4.2.1 Historical context influences bank insolvency**

In both the United States and the United Kingdom the eventual insolvency regime is heavily influenced by the history of the country.<sup>196</sup> In the United Kingdom, the evolution of the bank insolvency regime was not required as it had few banks and little to no bank failures prior to 2009.<sup>197</sup> However, in 2007 the Northern Rock Bank in the United Kingdom that was ranked 7<sup>th</sup> in terms of assets nationally underwent the largest bank run in the UK.<sup>198</sup> The media represented graphic images of long queues outside the bank as depositors rushed to withdraw their deposits and this elevated risk of a systemic bank run on deposits on a national scale.<sup>199</sup>

The UK government in a bid to deal with the failure of Northern Rock Bank passed the Banking (Special Provisions) Act of 2008 that provided for special rules to deal with the impending insolvency of the Northern Rock Bank.<sup>200</sup> These specialised rules lead to the establishment of the

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<sup>194</sup> Schooner MH, 'Bank Insolvency Regimes in the United States and the United Kingdom', 385.

<sup>195</sup> Schooner MH, 'Bank Insolvency Regimes in the United States and the United Kingdom', 386.

<sup>196</sup> Martin N, 'The role of history and culture in developing bankruptcy and Insolvency systems: The perils of legal transplantation', 28(1), *Boston College International and Comparative Law Review*, 2005, 88.

<sup>197</sup> Schooner MH, 'Bank Insolvency Regimes in the United States and the United Kingdom', 392.

<sup>198</sup> Balling M, The Failure of Northern bank- A multidimensional case study, 2009, <https://www.suerf.org/studies/2141/the-failure-of-northern-rock-a-multi-dimensional-case-study> on 9<sup>th</sup> October 2020.

<sup>199</sup> Balling M, The Failure of Northern bank- A multidimensional case study, 2009, <https://www.suerf.org/studies/2141/the-failure-of-northern-rock-a-multi-dimensional-case-study> on 9<sup>th</sup> October 2020.

<sup>200</sup> Balling M, The Failure of Northern bank- A multidimensional case study, 2009, <https://www.suerf.org/studies/2141/the-failure-of-northern-rock-a-multi-dimensional-case-study> on 9<sup>th</sup> October 2020.

special resolution regime within the Banking Act of 2009. The United Kingdom based on its experience of having a large bank fail and subsequent banks such as British bank (Bradford and Bingley) failing adopted to the current issues and brought in specialised rules that would lead to efficient insolvency of banks.<sup>201</sup>

In contrast, the United States has several banks with a few dominating.<sup>202</sup> It has had several bank failures amounting to a total of 559 bank failures from the year 2001 to 2020.<sup>203</sup> Particularly with 297 bank failures between the years of 2008 and 2010.<sup>204</sup> Based on these failures the bank insolvency regime has evolved to a separate legal regime that can not only anticipate insolvency of banks but also to ensure quick and efficient insolvency of failed banks.<sup>205</sup> The historical evolution of bank failures in the US has heavily influenced the need to have outside court processes of insolvency to ensure quick procedures on insolvency.<sup>206</sup> Additionally, it has led to extensive powers being granted to the Federal Deposit Insurance Corporation to legally close banks and begin insolvency procedures without the court process.<sup>207</sup>

#### 4.2.2 Aims and objectives

Both the United Kingdom and the United States have specific objectives and aims they wish to meet by implementing the type of insolvency regimes they have. However, the US has explicit objectives for the specialised bank insolvency regime.<sup>208</sup> The main objective is set out as to ensure that resolution is reached with the least damage of cost to depositors, with priority given to domestic depositors over other types of depositors.<sup>209</sup> This is found in the Federal Deposit Insurance Corporation Improvement Act and the National depositor preference principle found in

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<sup>201</sup> Tomask R, 'Corporate Rescue, Governance and Risk taking-Northern Rock and its International Context', 3.

<sup>202</sup> FDIC, Failed Bank List, <https://www.fdic.gov/resources/resolutions/bank-failures/failed-bank-list/banklist.html> on 9th October 2020.

<sup>203</sup> FDIC, Failed Bank List, <https://www.fdic.gov/resources/resolutions/bank-failures/failed-bank-list/banklist.html> on 9th October 2020.

<sup>204</sup> FDIC, Failed Bank List, <https://www.fdic.gov/resources/resolutions/bank-failures/failed-bank-list/banklist.html> on 9th October 2020.

<sup>205</sup> FDIC, *Banking Review*, 1998, 22. Shows the evolution of bank insolvency laws as the 1980s and 1990s bank crisis was happening in the US. See also Schoomer MH, 'Bank Insolvency Regimes in the United States and the United Kingdom', 389.

<sup>206</sup> Schoomer MH, 'Bank Insolvency Regimes in the United States and the United Kingdom', 389.

<sup>207</sup> FDIC, *Banking Review*, 1998, 24.

<sup>208</sup> Bliss BR et al, 'A comparison of U.S corporate and bank insolvency resolution: An economic comparison and evaluation' 8.

<sup>209</sup> Bliss BR et al, 'A comparison of U.S corporate and bank insolvency resolution: An economic comparison and evaluation' 7.

the Omnibus Budget Reconciliation Act.<sup>210</sup> The objectives of the specialised bank insolvency system are stated explicitly in the US as it seeks to tackle different issues in comparison to the corporate insolvency regime.

#### 4.2.3 Assessment of current issues

The bank insolvency systems in the United States and the United Kingdom can be considered to be adaptations of the current issues that they face. In the United States, the existence of several banks and the high rate of bank failures has resulted in the development of a robust specialised bank insolvency regime.<sup>211</sup> Whereas in the United Kingdom, the lack of bank failures and the existences of few banks has led to specialised rules under the general insolvency law rather than a separate and robust bank insolvency system.<sup>212</sup> Each country has adapted to its specific issues in a way it deems fit to meet creditor and depositor interests.

#### 4.2.4 Out of court processes

In the US due to the high rate of bank failures the country has opted for provisions that provide for out of court process of insolvency in a bid to ensure expeditious resolution of insolvency by the Federal Deposit Insurance Corporation.<sup>213</sup> Further, numerous studies have equated the use of the court process to slow reaction time.<sup>214</sup> The US contains out of court process to ensure delay in the form of court processes do not exist and expeditious resolution can be sought.<sup>215</sup> The UK through its history has not required an out of court process as the number of bank failures that have occurred is relatively low and the resolution time is considered satisfactory.<sup>216</sup>

#### 4.2.5 Risk assessment

The UK has a bank insolvency regime that steps in at the onset of insolvency. It does not have an active risk assessment system that anticipates the insolvency of banks based on certain factors.<sup>217</sup>

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<sup>210</sup> Section 141 (A) (2), *Federal Deposit Insurance Corporation Improvement Act* (1991). This act commenced on December 1991. See also Part VII, Subtitle B, *Omnibus Budget Reconciliation Act*. This act commenced on 10<sup>th</sup> August 1993

<sup>211</sup> Bliss BR et al, 'A comparison of U.S corporate and bank insolvency resolution: An economic comparison and evaluation' 8.

<sup>212</sup> Tomask R, 'Corporate Rescue, Governance and Risk taking-Northern Rock and its International Context', 5.

<sup>213</sup> Schoomer MH, 'Bank Insolvency Regimes in the United States and the United Kingdom', 389.

<sup>214</sup> Marinc M and Vasja R, 'A cross-country analysis of bank bankruptcy regimes', 13, *Journal of Financial Stability*, 2014, 149.

<sup>215</sup> Marinc M et al, 'A cross-country analysis of bank bankruptcy regimes', 150.

<sup>216</sup> Godfrey P, 'Evolution of bank Insolvency law in the UK', 2.

<sup>217</sup> FDIC, *Risk assessment for banking systems*, 2012, 8.

The US on the other hand has risk management provisions found in statute. These risk management provisions contain early detective measures such as determining insolvency based on market insolvency rather than legal insolvency, additionally, it entails active monitoring of the bank's assets and liabilities, the bank's liquidity levels and the use of sound management policies.<sup>218</sup>

From the above, it is evident that the development of a bank insolvency regime in a country is dependent on its history and the specific objectives and aims that it needs to address.<sup>219</sup> Both the US and the UK have applied the principle of an adaptable legal framework on bank insolvency to deal with current bank issues. However, the US by implementing a specialised bank insolvency regime has been able to have an active and effective risk management system to enable detection of possible failure of a bank and to apply anticipatory measures, whereas, the UK has not been able to establish such in the specialised rules for banks under the general insolvency law. Based on the three established principles we have been able to draw certain lessons from the comparison of the United Kingdom and United States bank insolvency regimes. The section below will illustrate the need to adapt the mentioned principles in the Kenyan bank insolvency regime to have a better framework for depositor protection.

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<sup>218</sup> FDIC, *Risk assessment for banking systems*, 2012, 8.

<sup>219</sup> Martin N, 'The role of history and culture in developing bankruptcy and Insolvency systems: The perils of legal transplantation', 28(1), *Boston College International and Comparative Law Review*, 2005, 88.

## **5. CHAPTER FIVE**

### **5.1 CONCLUSION**

This dissertation has established the need for depositor protection in the bank insolvency regime through chapter 1. In chapter 2, this study endeavoured to assess the historical underpinnings of the insolvency regime in Kenya by looking at the evolution of the Insolvency Act and the establishment of the Deposit Insurance Act. This chapter also delved into the conceptual framework that illustrates the various forms of insolvency regimes and the four models of creditor or depositor protection that are used to decide on a suitable bank insolvency regime. Chapter 3 compares the two bank insolvency regimes in the United Kingdom and the United States intending to establish the best practices for depositor protection. Consequently, chapter 4 draws lessons from the comparison in Chapter 3 to establish the different ways the United Kingdom and the United States have fine-tuned their bank insolvency systems to suit the needs of their countries based on some of the principles of an ideal bank insolvency system. In chapter 5 this study concludes by summarizing the findings and giving recommendations for Kenya to have a more adaptable legal framework that solves the current issues of bank insolvency through establishing a distinct enforcement system for bank insolvency in Kenya.

### **5.2 FINDINGS**

Through chapter 2, this study has highlighted the evolution of insolvency law in Kenya and established the application of general insolvency law for all financial institutions, companies and banks. Additionally, this chapter looked into the application of current Kenyan insolvency law to failed banks in Kenya such as Dubai, Chase, Imperial and, potentially failing, Spiral bank. Through this application, the study found that the current insolvency regime does not cater to depositor protection. As the recovery rate of the depositor's funds is low except for Chase bank that was able to recover 75% of depositor's money. This is despite having the Kenya Deposit Insurance Corporation as an entity to recover the deposits in an insolvent bank. In conclusion, chapter 2 confirmed the hypothesis that the current insolvency regime in Kenya is not suitable for banks as it is mainly geared towards creditor protection. Subsequently, having an unfair effect on depositor's protection.

In a bid to uphold the third hypothesis, Chapter 3 and 4 assessed the insolvency regime in the UK and US to assess the best method of ensuring depositor protection. Through these chapters, the

study was able to conclude that the best insolvency regime is: particular to the history and experience of a country, adaptable and efficient in risk management. In comparison to the UK general insolvency system and the US sui generis insolvency system, the best insolvency system seems to be the US sui generis system as it has adapted to most of the experiences in the insolvency of banks over time. This is mainly because the sui generis insolvency system is easier to change and adapt in comparison to the rigid general insolvency system of the UK.

Based on these findings the next section will provide recommendations to better equip the bank insolvency regime in Kenya to protect depositor's protection

### 5.3 RECOMMENDATIONS

In chapter 4, this study gave the three principles of an ideal bank insolvency regime as compatible enforcement systems, active and efficient risk management and an adaptable legal framework. Most of these principles could be found in both the United Kingdom and the United States as they modified their bank insolvency regimes to suit their needs. Kenya in stark contrast has had several bank failures with notable delay from the Central Bank of Kenya in its role as a regulator of banks in detecting the collapse of banks and effectively handling the insolvency of said banks.<sup>220</sup> It is on this basis that the author recommends the following in line with the principles of an ideal bank insolvency system.

#### 5.3.1 Adaptability of the legal framework based on past failures

The failures of banks such as Imperial and Dubai illustrate the need quick and effective measures by the Central Bank of Kenya.<sup>221</sup> This to some extent was illustrated in the early detection and handling of Chase Bank.<sup>222</sup> However, the unfortunate status of Spire bank and the inaction of the Central Bank of Kenya illustrates the inefficiency of the Central Bank of Kenya in detecting and handling potentially collapsing banks.<sup>223</sup> It is on this basis that the author recommends the need

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<sup>220</sup> *Richardson and David Limited v KDIC and another* (2015) eKLR, paragraph 50.

<sup>221</sup> Gathaiya R, 'Analysis of issues affecting collapsed banks in Kenya from year 2015 to 2016', 5.

<sup>222</sup> Irungu V, 'Turnaround strategies influencing recovery of commercial banks under receivership programme in Kenya: A case of Chase Bank', Published, University of Nairobi, Nairobi, 2017, 20.

<sup>223</sup> Alshula P, Borrowers default 90% of Spire Bank loan book, Business daily, 2020 -<  
<https://www.businessdailyafrica.com/corporate/companies/Borrowers-default-90pc-of-Spire-Bank/4003102-5619932-lip765z/index.html>> on 10<sup>th</sup> October 2020.

for stricter regulation of the Central Bank of Kenya in performance of its duties or the establishment of a separate body in charge of handling bank insolvency in Kenya.

This suggestion is heavily based on the fact that the inability of the Central Bank of Kenya to act in the face of a collapsing bank affects depositor protection greatly.<sup>224</sup> This is because it reduces the chance for recovery of their deposited monies in the collapsing or potentially collapsing banks.<sup>225</sup> Establishing stricter regulations for the Central Bank of Kenya may force a faster reaction from the regulatory in the face of insolvency. However, the possibility of having a separate regulatory from the Central Bank of Kenya can be considered. This regulatory could be placed under the supervision of the Central Bank of Kenya in performance of its mandate.

The mandate of the separate regulator would be to ensure the early detection of possible insolvency of banks, deploying effective measures to mitigate the possibility of insolvency and the efficient and effective handling of insolvent banks. This will enable the bank insolvency regime in Kenya to have an attentive regulatory body that could better deal with pre-insolvency and insolvency of banks in Kenya. A similar regime exists in the United States through the establishment of Federal Deposit Insurance Corporation.<sup>226</sup> A high breed version exists in the UK with three supervisory bodies: the Financial Services Authority, the Treasury and the Bank of England, with more power lying in the latter two.<sup>227</sup>

### **5.3.2 Distinct enforcement system**

Based on the first recommendation the established regulator requires clear and distinct bank insolvency procedures to follow that should be separate from the general insolvency law. This could be through specialised procedures and rules governing bank insolvency in the Insolvency Act or the establishment of a separate Act. These rules should lay out the procedures for insolvency of banks and give leeway for early detection mechanisms to be established based on governance structures, capital requirements, capital to weighted assets risk ratio, the status of non-performing loans among others. This will enable efficient handling of potentially collapsing banks in a manner that will adequately protect both depositors and creditors in the long run.

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<sup>224</sup> *Richardson and David Limited v KDIC and another* (2015) eKLR, paragraph 51.

<sup>225</sup> *Richardson and David Limited v KDIC and another* (2015) eKLR, paragraph 52.

<sup>226</sup> Bliss BR et al, 'A comparison of U.S corporate and bank insolvency resolution' 46.

<sup>227</sup> Godfrey P, 'Evolution of bank Insolvency law in the UK', 4.

In conclusion, the bank insolvency regime in Kenya should be as adaptable as possible to fit the requirements of depositors, creditors and the banking sector at that particular point. Given the continuous failure of the Central Bank of Kenya to act on potentially collapsing banks and insolvent banks, more scrutiny needs to be geared towards their performance in light of their duties to enable adequate depositor protection.

### **5.3.3 Research and Development**

It is necessary to facilitate and encourage research into the development of banks and suitable insolvency law. As demonstrated in chapter 4, the evolution of insolvency law in most countries is based on comparative and analytical studies of the performance, management practices and collapse of banks over time. Therefore, the Kenyan Government and Banks should consider investing in research and development on insolvency laws that are suitable for banks in Kenya. This will enable various stakeholders to understand and meet the needs of banks before, during and after insolvency.

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