UNIVERSITY OF NAIROBI

SCHOOL OF LAW

MULTIPLE LEGAL AND REGULATORY FRAMEWORK IN THE BANKING AND FINANCIAL SECTOR IN KENYA: ADDRESSING RESULTANT COMPLEXITIES, DISHARMONY AND CONFLICTS IN POLICY GOALS

By:

TOM OCHIENG NDALO

G62/ 8192 /2017

A Thesis Submitted for Examination in Partial Fulfilment of the Requirements for the Award of the Degree of Master of Laws, (LL.M), of the University of Nairobi.

2019

DECLARATION

Student's Declaration

I hereby declare that this thesis is my original piece of work and has never been submitted elsewhere for examination or any other learning institution for the award of any Degree Certificate or publication, by either me or any other person, whatsoever.

NAME: TOM OCHIENG NDALO

DATE: …………………………….

SIGNATURE: ……………………..

Supervisor's Declaration

This thesis has been submitted for examination with my approval as the research supervisor:

NAME: DR. JACKSON BETT

DATE: ……………………………..

SIGNATURE: ……………………..

DEDICATION

This work is dedicated to my immediate family Jael, Poloh, Wenwah, Amani and Imani. I dedicate it to all the members of my extended family, relatives and friends as well and finally to my colleagues.

ACKNOWLEDGMENT

I must begin by thanking the God the Almighty for all that He has done for me this far and for all that He has promised he will continue to do.

I must however specifically mention my spouse Jael Hawala without whose encouragement and support this thesis would never have been completed. Thanks Jael. It has become a reality for which I am eternally grateful.

A heartfelt and very special thanks to my supervisor, Dr. Jackson Bett. Thank you very much for walking with me through every step of the process. Despite your busy schedule, you always made time to discuss with me my progress and advise me on the way forward. Without your guidance and support this thesis would not have been completed.

To them all, I am grateful.

LIST OF STATUTES

Constitution of Kenya 2010

Constitution of the Republic of South Africa of 1996.

Central Bank of Kenya Act Chapter 491 Laws of Kenya

Banking Act Chapter 488 of the Laws of Kenya

Microfinance Act 2006 of the Laws of Kenya

Insurance Act Chapter 487 Laws of Kenya

Capital Markets Act Chapter 485A Laws of Kenya

Retirement Benefits Act Chapter 197 Laws of Kenya

Sacco Societies Act No 14 0f 2008

Companies Act No 17 of 2015

Banking (Amendment) Bill 2011(Kenya)

Finance Act 2010

National Social Security Fund Act No. 45 2013

Retirement Benefits Authority Act 2007

Public Finance Management Act, 1999 (South Africa)

South Africa Financial Services Law (General Amendment) Act No. 45 2013

ABSTRACT

Financial services play a catalytic role in the efficient allocation of productive resources and in the economic development of third world countries. This study focuses on Kenya's financial regulatory framework, which has continually grown. The financial sector is critically important in any economy if supported by sound laws and regulatory regime which is effective to protect consumers and adequately control market abuses, however, the sector is today marred by a lot of regulatory inefficiencies as well as emerging trends, which are also witnessed globally. These challenges have resulted into appeal for reform of the regulatory framework, in order to enhance its supervision.

This study looks at the rationale for regulation, the different models of regulation in the financial services and what they are aimed to achieve. The research narrows on unified theory of financial service regulation, which has greatly been recommended to be adopted for the Kenyan financial regulatory framework. It further interrogates the efficacy of the existing regulatory framework, and conducts a comparative study of the regulatory models in the United Kingdom and South Africa. The insights obtained from the analysis will then lead to the conclusion and recommendations for the most viable regulatory framework for the financial services in Kenya.

The study establishes that there is no optimal model of regulation and every jurisdiction must adopt a framework that best suits its intended objectives and thus postulates that the proposed unified Financial

Services Council is the most viable model to be adopted for Kenya's regulatory framework. However the same must be structured taking into account the existing challenges and the intended objectives.

ABBREVIATIONS

Ban Fin- Bank of Bundesbank

CMA- Capital Markets Authority

CBK- Central Bank of Kenya

EU- European Union

EEA- European Economic Area

IRA- Insurance Regulatory Authority

MFI- Micro Finance Institutions

NSSF- National Social Security Fund

NSE- Nairobi Securities Exchange

RSA- Republic of South Africa

RBA- Retirement Benefits Authority

SACCO- Savings and Credit Cooperative Society

SASRA- Sacco Societies Regulatory Authority

UK- United Kingdom

US- United States

NBFIs- Non-bank financial institutions

SMEs- Small and medium enterprises

FSA- Financial Services Authority

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CHAPTER ONE

1.0 Introduction

Financial systems stand on unstable ground, hence, they need to be well regulated in order to avert financial crises.[1] They facilitate the flow of funds from the providers of funds (primarily households) to the users of funds (generally firms and companies) by a process which involves the intervention of an intermediary since it is a rare occurrence for funds to flow from the providers to the users.[2] This intermediary is referred to as a financial institution and there are different types of financial intermediaries which differ in their special functions which include banks, microfinance institutions, Savings and Credit Co-operative Societies, finance companies and mutual funds, life insurance companies, pension funds and securities exchanges. Each of the aforementioned institutions provides the service of financial intermediation that is uniquely attributed to the particular institution.[3] The role of financial services is the efficient allocation of productive resources which contributes to trade, investment and economic growth, therefore, the Government aims at creating a vibrant and globally competitive financial sector promoting high-levels of savings and financing investment needs. Safeguarding financial system stability is an integral part of preserving monetary and macroeconomic stability in an economy, therefore, the financial sector is critically important in any economy since a sector supported by sound laws and regulatory regime effectively protects consumers and adequately control market abuses.[4]

In Kenya, the CBK regulates and supervises commercial banks, mortgage finance companies, deposit taking MFIs, forex bureaus, credit reference bureaus, and the payments and settlement systems but financial system stability is much wider than institutions regulated by CBK, hence the need for system-wide approach to financial stability to cover capital markets, non-bank financial institutions (NBFIs), non-financial institutions and financial infrastructure such as trading platforms, payments infrastructure and settlement systems. Without effective regulation, financial systems can become unstable, triggering crises that can devastate the real economy as evidenced by the recent GFC that

[1] Spratt S (2013), Financial Regulation in Low-Income Countries: Balancing Growth with Stability. Part 1 and 2. Unpublished.

[2] Cornett, M.M & Saunders A (1999), *Fundamentals of Financial Institutions Management International Edition*, Irwin/McGraw-Hill.

[3] ibid.

[4] Gakeri J, 'Financial Services Regulatory Modernization in East Africa: The Search for New Paradigm for Kenya ', Vol 1 No 16 November 2011 *International Journal of Humanities and Social Sciences*

began in 2007.[5] The primary purpose of finance is to facilitate productive economic activity, on the other hand, the aim of regulation is to maintain financial stability and to promote economic growth. There are two different ways that regulation could impact on growth and stability. The first is by influencing the day-to-day behaviour of financial market actors so that financial regulation has direct effects, for example, on how much a bank chooses to lend to small and medium enterprises (SMEs). The second is by influencing how the financial system evolves structurally, thereby creating indirect effects.[6]

This research focuses on the banking sector, although capital markets, pension funds and other financial institutions may facilitate more long term finance if banks do not provide sufficiently. The Terms of Reference for the research project identifies a number of issues that require investigation. This chapter mainly focuses on the background of the study herein, the statement of the problem which will define key concepts and terms, give a justification why this research is worth carrying out, identify a theoretical framework on whose bedrock the research stands in achieving the objectives of the study and answering the research questions. The research further explains the methodology to be employed in achieving the purpose of this research, reviewing and analysing the limited but available literature and conclude by giving a scope of the study. Regulation of the financial sector is crucial in the economic development of third world countries. The research focuses on Kenya's financial regulatory framework, which has continually grown since the financial sector is considered as the most instrumental to assist Kenya achieve its Vision 2030 objectives. However, the sector is today marred by a lot of regulatory inefficiencies as well as emerging trends, which are also witnessed globally which have resulted into appeal for reform of the regulatory framework, in order to enhance its supervision. The research also looks at the rationale for regulation, the different models of regulation in the financial services and what they are aimed to achieve and narrows on the unified theory of financial service regulation, which has greatly been recommended to be adopted for the Kenyan financial regulatory framework. It further interrogates the efficacy of the existing regulatory framework, and conducts a comparative study of the regulatory models in the United Kingdom and South Africa.

1.1 Background of the study

There are multiple laws and players in the financial sector in Kenya which includes banks, microfinance institutions, insurance companies, securities markets, pension schemes and credit

[5] Spratt S, (2013), Financial Regulation in Low-Income Countries: Balancing Growth with Stability. Part 1 and 2. Unpublished.

[6] Ibid.

cooperative societies (SACCOs) with many having separate regulatory regimes.[7] The Financial Sector Regulators Forum was established in 2009 (under an MoU) to foster cooperation, share information and enhance policy coordination among financial regulators in Kenya[8] and comprises of the Central Bank of Kenya (CBK),[9] Banking Act[10], Microfinance Act (2006) [11], Insurance Regulatory Authority (IRA) [12], Capital Markets Authority (CMA)[13], Retirement Benefits Authority (RBA)[14] and the Sacco Societies Regulatory Authority (SASRA) [15] with the National Treasury as an observer where each regulator exercises their own and separate jurisdiction leaving the challenges and emerging trends in the banking and financial sector not fully addressed.

For a long time in many jurisdictions, financial supervisions has been executed around multiple laws and agencies, however, due to changes in the global landscape in this sector, there is an emerging trend towards restructuring and creation of a more harmonious and unified laws and regulatory agencies. Scholars and analysts have, therefore, argued for or against certain laws and regulatory models and have noted the inadequacy of the Kenyan functional or institutional model with obvious evidence of disharmony (conflict) in policy direction and duplication of roles at other times within the segmented sectors in the banking and financial sector.[16] Kenya's national treasury has tried to respond to the emerging trends by championing the removal of a merged financial services regulator as recommended in the report of the Presidential Taskforce on Parastatal Reforms (October 2013)[17], which is also known as the Financial Services Authority (FSA) but the enthusiasm, urgency and speed of execution has been weak. In any case the FSA is proposed to be a merger of only four regulators in the sector, which includes, the Retirement Benefits Authority (RBA), the Insurance Regulatory Authority (IRA), the Capital Markets Authority (CMA) and the Sacco Societies Regulatory Authority (SASRA). Examples of the challenges created by multiplicity of laws and regulations has been the increase in cases of poor or even subjective compliance by the sector players, for instance, where a listed company provides

[7] Gichuki N, Law of Financial Institutions in Kenya (2nd Edition Law Africa Publishing Limited 2013)
[8] Article 231 of the Constitution of Kenya 2010.
[9] Central Bank of Kenya Act Chapter 491 Laws of Kenya.
[10] Banking Act Chapter 488 of the Laws of Kenya.
[11] Microfinance Act 2006 of the Laws of Kenya.
[12] Insurance Act Chapter 487 Laws of Kenya.
[13] Capital Markets Act Chapter 485A Laws of Kenya.
[14] Retirement Benefits Act Chapter 197 Laws of Kenya.
[15] Sacco Societies Act No 14 0f 2008.
[16] Mutuku N, *Case for Consolidated Financial Sector Regulation in Kenya* (Retirement Benefits Authority 2008) http://ssrn.com/abstract=1837354> accessed 10 December 2018.
[17] Republic of Kenya, Report of the Presidential Taskforce on Parastatal Reforms Presented to His Excellency President Uhuru Kenyatta (Nairobi, 2013).

insurance services. Such a company is registered under the Companies Act, and regulated by both the Insurance Regulatory Authority and the Capital Markets Authority.[18] Globally, the boundaries within the financial sectors is being broken continually with innovations, emerging trends and cross-selling of products across the different industries for example Bancassurance [19] where even banks are now mandated to sell insurance products and services on behalf of insurance companies . We also have the technological advancements and overlaps amongst sectors that is making the 'one stop shop' concept in the financial sector a reality but creating complexity and challenges in supervisions and compliance.

1.2 Statement of the Problem

The regulatory structure in Kenya is organized along sectoral lines, with each sector having its own regulator, however, many countries have reformed and continue to reform their regulatory frameworks in a bid to cope with changes in their financial systems (markets) and the developments within financial institutions, in particular diversification of services offered by financial institutions, consolidations within the banking sector, conglomerations of institutions to form one stop financial services companies, and the common phenomenon of financial crisis. These developments have led to the blurring of distinctions between financial institutions and the responsibility of the different regulators in a framework built along sectoral lines also becomes blurred.[20] In light of these changes the adequacy of Kenya's regulatory structure and supervisory activity assumes significant importance. This study addresses the concerns on whether Kenya should adopt a single regulator system or whether it should retain the current multiple regulator system. It interrogates the selected laws in the financial sector in Kenya, highlighting the complexity, disharmony and burden created by the application of multiple laws and regulations and comes up with recommendations that will help ameliorate the multiple laws and players in the financial sector in Kenya.

1.3 Significance of the Study

The findings of this study will be important to the following:

[18] Mutuku N, *Case for Consolidated Financial Sector Regulation in Kenya* (Retirement Benefits Authority 2008) (n 15) pp 13.

[19] Insurance Act Chapter 487 Laws of Kenya.

[20] Shen C, (2005): Determinants of the Financial Supervision System: Global Evidence, Department of Money and Banking, National Chengchi University, Mucha, Taipei.

1) Policy makers in Government in enhancing their understanding of the regulation and supervision of financial institutions and providing a basis to consider whether there is a need to reform the regulatory and supervisory structure of the financial services industry.

2) Regulators in the financial services industry in understanding their central role in maintaining the stability and efficient operation of the financial services industry and the financial institutions.

3) Financial intermediaries in enhancing their appreciation of the goals and objectives of regulation and supervision and the benefits and cost of regulation and supervision. 4) Researchers or academics who will use the findings as a basis for further research.

5) Students of finance and management who will be provided with further information in the area of regulation and supervision of financial institutions.

1.4 Research Objectives

The main study objective is to critically examine the different laws and regulations in Kenya's banking and financial sector with a view to recommending improvement in the identified areas that will enhance unity and harmony within the sector. The specific objectives of the study include the following:

1. To determine whether there is need to restructure Kenya's financial regulatory framework and to identify the key drivers of this need.

2. To determine the financial intermediaries in Kenya regarding the case for a single financial regulator.

3. To determine whether the current regulatory structure is appropriate and allows the effective operation of financial institutions.

4. To determine if there is a need for reform and if so, what direction should the reform action take i.e. which regulatory structure or model ought to be adopted and what other jurisdictions have done.

1.5 Research Questions

This research seeks to answer the following questions:

1. Does Kenya need to adopt a single regulatory system or should it retain the current multiple regulatory system in the financial sector?

2. Is the current regulatory structure in Kenya appropriate and does it allow for the effective operation of financial institutions?

3. Is there a need to reform in the current regulatory structure in Kenya and if so, what direction should the reform action take i.e. which regulatory structure or model ought to be adopted and what other countries have done?

4. Are there areas that can be recommended for adjustment to achieve optimum harmony in policy and satisfaction in the Kenyan financial sector?

1.6 Hypotheses

1. Even though the current regulatory framework governing the financial services sector in Kenya is not appropriate to effectively address the challenges and emerging trends in the sector, the proposed single regulator does not adequately address the sector's regulatory requirements.
2. Whereas many countries are moving towards unification and adopting the integrated model of financial regulation, the same is not the most optimal model of regulation.

1.7 Theoretical Framework

The concept of bank regulations has been in existence for so many years all over the world. However, it was not developed as it is today due to some factors like increase in competition from other financial institutions, changes in customer demands among others. Bank regulations are of growing importance in financial institutions, particularly in management of bank's operation. There are number of theories that have been developed in describing the effect of bank regulations on financial performance of financial institutions.

1.7.1 Economic regulation Theory

Economic regulation is the imposition of rules by a government, backed by penalties that are intended to modify the behaviour and actions of individual players in the private sector. This theory is applied to improve the efficiency with which society's resources are allocated, to alter the distribution of income and to achieve broad social and cultural goals.[21] By regulation, the government narrows choices in certain areas, including prices, supply, rate of return, disclosure of information, mode of production, standards of products or services and conditions of service.[22] This theory asserts that regulation is

[21] Stigler George J, The Theory of Economic Regulation (Spring 1971) vol 2, *Bell Journal of Economics and Management Science*, 3-21.
[22] Demetz H, Why Regulate Utilities? *Journal of Law and Economics* (1968).

instituted primarily for the protection and benefit of the public at large, and addresses three main issues which include market power, interest group and government opportunism. In Kenya the existing model involves several regulators exercising jurisdiction over different sub sectors. In addition, each regulator is established under its own legislation.[23] However this regulatory framework fails to effectively address the challenges and emerging trends,[24] which continue to create fierce competition among the players in the sector.[25]

There have been recommendations for the consolidation of regulatory agencies in the financial services sector, to be governed by a unified regulator in Kenya. Despite this proposal for consolidation, a clear framework is yet to be established by the Ministry of Finance on how the same will be actualized. In addition, the proposed unified regulator will not be an end to itself as there are other determinant factors which must be considered in order to achieve an effective and globally competitive financial sector regulation. In Kenya, the single regulator proposed by the Taskforce for Parastatal Reforms is one that aims to address the duplication, conflicting provisions, different founding legislation, and sometimes serious omissions that are experienced due to the inadequacy of the law to capture emerging trends.[15]

1.7.2 Public Interest Theory

Public interest can be described as the best possible allocation of scarce resources for individual and collective goods and services in society. Where market failure occurs, government regulation comes in to achieve efficiency in the allocation of resources.[26] It makes several assumptions which include the prevalence of a market failure, the assumption of a benevolent regulator or, alternatively, an efficient political process and the choice of efficient regulatory institutions. The public interest theory assumes that regulators have sufficient information and enforcement powers to effectively promote the public interest.

The core of the public interest theories of regulation, the market failure, has been the object of criticism and the hypothesis that government regulation is efficient or effective, has been claimed to have been invalidated by empirical research. It has also been argued that it is impossible to test or refute the public

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[23] Gakeri J, Financial Services Regulatory Modernization in East Africa: The Search for a New Paradigm Shift (2011) vol 1(16) *International Journal of Humanities and Social Science.*

[24] National Consumer Council, *Models of Self-regulation: An overview of models in Business and the Professions* <http://www.talkingcure.co.uk/articles/ncc_models_self_regulation.pdf.> accessed 10 March 2019.

[25] Lawrence A, Cunningham and Zaring D, The Three or Four Approaches to Financial Regulation: A Cautionary Analysis against Exuberance in Crisis, *George Washington Law Review,* vol 78 (1) (2009).

[26] A market failure is a situation where scarce resources are not put to their highest valued uses. In a market setting, these values are reflected in the prices of goods and services. A market failure thus implies a discrepancy between the price or value of an additional unit of a particular good or service and its marginal cost or resource cost.

interest theories of regulation since they are incomplete. The formation of public preferences and the translation of these interests into welfare maximizing regulatory measures lacks from these theories.[27] Furthermore, facts are observed in social reality which are not well accounted for by public interest theories. These may include reasons why companies should support regulation intended to stifle excess profits.[28] In Kenya, the existing model has however failed to effectively address the challenges and emerging trends, therefore, a sound regulatory framework which ensures effective prudential and risk based regulation is thus necessary. Such regulation should be one that guarantees consumer protection, in addition to ensuring fair and equitable competition.[29] Many commentators and scholars in the sector have noted that the current regulatory framework is inadequate and displays evidence of conflict and duplication of legislation, among other challenges as well as emerging trends in the sector.[30]

1.7.3 Private Interest Theory

Private interest theories explain regulation from the conduct of interest groups[31] which could be firms, consumers, regulators, legislators and unions among others. This theory assumes that in the course of time, regulation comes to serve the interests of the industry involved. Legislators subject an industry to regulation by an agency if abuse of a dominant position is detected.[32] In the course of time, other political priorities appear on the agenda and the monitoring of the regulatory agency by legislators is relaxed. The agency then tends to avoid conflicts with the regulated entities because it is dependent on them for its existence.[33] This theory is not clear as to why an industry succeeds in subjecting an agency to its interests but cannot prevent its coming into existence. It often appears to serve the interests of groups of consumers rather than the interests of the industry. Regulated companies are often obliged to extend their services beyond voluntarily chosen level of service.[34]

The private interest theory is more of a hypothesis that lacks theoretical foundations since it does not explain why an industry is able to take over a regulatory agency and why, for example, consumer groups fail to prevent this takeover. It also does not explain why the interaction between the entities

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[27] Posner A, Theories of Economic Regulation‟ (1974) vol 5 (2) *The Bell Journal of Economics and Management Science.*335-358.

[28] ibid.

[29] Mwenda K, *Legal Aspects of Financial Services Regulation and the Concept of a Unified Regulator* (The World Bank 2006).

[30] Mutuku N, *Case for Consolidated Financial Sector Regulation in Kenya* (Retirement Benefits Authority 2008) http://ssrn.com/abstract=1837354> accessed 10 December 2018.

[31] Hertog J, *Review of Economic Theories of Regulation* (Jalling C Koopmans Research Institute 2010).

[32] ibid.

[33] Ludwig M, *A Critique of Interventionism,* (Foundation of Economic Education1996).

[34] ibid.

and the agency is characterized by capture instead of by bargaining. The current regulatory framework is inadequate and displays evidence of conflict and duplication of legislation, among other challenges as well as emerging trends in the sector.[35] Many scholars thus acknowledge the need for reform in order to accelerate wider economic growth, expand industrialization, provide infrastructure, and ensure quality and timely public service delivery.[36] Whereas most scholars agree that regulation is important to adequately manage the affairs of the financial services sector, the most effective model and approach to regulation remains an issue for consideration.

1.8 Research Methodology

The study exclusively relied on qualitative and doctrinal research where library materials are the main source of information. Several policy documents relating to multiple legal and regulatory framework were be developed and adopted and the population of the study on the side of the regulated institutions comprised all institutions licenced under the Banking Act, the Insurance Act and carrying on insurance business, the Capital Markets Act and pension funds registered under the Retirement Benefits Act. Relevant secondary literature are reviewed and where necessary, online sources are also referred to. A desktop study was undertaken to interrogate the multiple legal and regulatory framework in Kenya.

Finally, the study takes a look at some of the best practices from around the world and makes a detailed analysis of the different regulatory systems in some of the countries compared to the ones we have in Kenya and the countries reviewed included the United Kingdom and South Africa, with a view to making comparisons with Kenya's proposed unified regulator for the purpose of finding the most viable regulatory framework for the financial services in Kenya. The research also looks at some of the practical challenges that these countries have experienced in their consolidated framework.

1.9 Literature Review

Llewellyn summarises the core aims and objectives of financial regulation which is to sustain systemic stability, to maintain the safety and soundness of financial institutions, and to protect the consumer.[37] Di Giorgio et al, state that a wider framework might however be set by particular regulatory agencies.[38]

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[35] Mutuku, N. *Case for Consolidated Financial Sector Regulation in Kenya* (Retirement Benefits Authority 2008) http://ssrn.com/abstract=1837354> accessed 10 December 2018

[36] Republic of Kenya, *Report of the Presidential Taskforce on Parastatal Reforms* Presented to His Excellency Hon Uhuru Kenyatta CGH President and Commander in Chief of the Defence Forces of the Republic of Kenya (Nairobi 2013).

[37] Llewellyn D (1999): The Economic Rationale for Financial Regulation, FSA Occasional Paper Series Number 1 (www.fsa.gov.uk).

[38] Di Giorgio G, Di Noia C (2001): Financial Regulation and Supervision in the Euro-Area: A Four-Peak Proposal, Wharton Working Paper Series, Wharton Financial Institutions Centre.

Indeed, other objectives have been postulated including the need to maintain and enhance competition in the financial services industry.[39] Llewellyn goes on to say that the case for regulation, which also determines its objectives, depends on various market imperfections and failures (especially externalities and asymmetric information) which, in the absence of regulation, produce sub-optimal results and reduce consumer welfare. In other words, the purpose of regulation should be limited to correcting for identified market imperfections and failures.[40]

1.9.1 Financial Regulation

Barth et al. have posited that a bank regulation is not something new in financial institution and can be defined as a form of government or a state commands that subjects banking sectors into certain requirements, restrictions and guidelines as formulated by their Regulators such as Central Bank in order to ensure market transparency between banking industry and individuals or between banking institution and other corporation with whom they conduct business with.[41] According to Richard R.J, banks' regulators keeps on revising Banks' regulations and guidelines in order to respond effective to the adverse changes in business environment, which if not properly dealt with, it may lead to financial problems.[42]

Banking institutions in Kenya is governed by two Acts; Banking Act and Central Bank of Kenya Act. According to Sonal, Anjarwalla and Khanna,[42] banking institution in Kenya is governed under the Banking Act[43] and by Central Bank of Kenya Act.[44] Central Bank of Kenya (CBK) is the main financial institutions regulator in Kenya which came into operation since 1966 through the Act of Parliament, to carry out its functions free from any interference of the individuals, group of persons or politics. Nzomo M. makes a relatively strong case for the need for the consolidation of the financial regulation in Kenya.[45] He outlines the different models of regulation that would be considered if Kenya were to consolidate its financial regulation. He further gives general reasons for and against consolidation of the financial sector regulation in Kenya. Although the author went at great lengths to make policy

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[39] ibid.

[40] Llewellyn D (1999): The Economic Rationale for Financial Regulation, FSA Occasional Paper Series Number 1 (www.fsa.gov.uk).

[41] Barth J, Daniel E. N, Triphon P and Glenn Y (2003), .*A Cross-country Analysis of the Bank Supervisory Framework and Bank Performance*. Financial Markets, Institutions & Instruments12.Malden, MA: Blackwell Publishing Inc. [42] Richard R. J (2001), *The relationship between regulators and the regulated in banking*. Federal Reserve Bank of Chicago.

[42] Sejpal S & Doshi M., Anjarwalla & Khanna, *Banking Regulation: Kenya, Global Legal insights*, 1st Edition Special Issue, Kenya Gazette, Supplement No. 169 (Acts No. 41).

[43] Chapter 488, Laws of Kenya.

[44] Chapter 491, Laws of Kenya. CBK Act.

[45] Mutuku N, *Case for Consolidated Financial Sector Regulation in Kenya* (Retirement Benefits Authority 2008).

recommendations that would be considered in consolidating financial regulation, his study was conducted more than five years ago, and hence fails to capture the emerging trends such as the proposals by the Presidential Taskforce on Parastatal Reforms in 2013.[46]

Mwenda K. argues that there has been an emerging trend in some countries towards restructuring the financial supervisory function, and in particular the creation of unified regulatory agencies.[47] To this end, he examines the policies that different countries continue to adopt and the various regulatory and institutional models of unified financial services supervision. He goes further to addresses some of the key characteristics of these models. He also highlights the progress achieved by the unified regulators in adopting a consistent framework for the regulation and supervision of all the financial intermediaries that they oversee.[48] This book is important because it identifies the practical problems being faced by countries in setting up unified regulators, and it also highlights important legal and policy issues that should be considered when developing regulatory and institutional models of unified financial services supervision.

John A Tatom discusses the effects of the financial crisis that hit the world economies and the failure of some large financial institutions.[49] He states that because of these effects, many financial stakeholders called into question the legitimacy of their existing financial structure and its regulation, and whether there was need for reform. He provides an overview of recent and prospective financial legislation and its effects in the United States, and analyses empirical evidence of the global effects of the financial crisis on banks and insurance companies. He also looks at the issues that continue to affect financial regulation and further establish how the same issues are being dealt with through legislation.[50] This book is essential to the current study, because it shows that despite legislation and regulation being made to capture the emerging trends, the same is not sufficient, as challenges still crop up.

1.9.2 Conduct of business regulation

Kenya's financial sector has historically been segmented into a number of sections. Therefore, the sector has been characterised by Banking Sector, Insurance Sector, the Capital Markets and the Retirement Benefits Sector. Other financial market sectors which however play a relatively minor role

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[46] Republic of Kenya, *Report of the Presidential Taskforce on Parastatal Reforms* Presented to His Excellency Hon Uhuru Kenyatta CGH President and Commander in Chief of the Defence Forces of the Republic of Kenya (Nairobi 2013).

[47] Mwenda K, *Legal Aspects of Financial Services Regulation and the Concept of a Unified Regulator* (The World Bank 2006).

[48] ibid.

[49] Tatom J, *Financial Market Regulation: Legislation and Implication* (London 2011)

[50] ibid.

in the formal sector are building societies, Savings and Credit Co-operative Societies and microfinance institutions. The regulatory structure of the Kenyan financial markets flows from the aforesaid sectoral division. Thus each sector has its own specialized regulator and legislation governing it. The banking sector is regulated by the Central Bank and the governing legislation is the Banking Act.[51] The insurance sector is regulated by the Commissioner of Insurance and the governing legislation is the Insurance Act.[52] The securities sector is regulated by the Capital Markets Authority and the governing legislation is the Capital Markets Act.[53] The pensions sector is regulated by the Retirement Benefits Authority and the governing legislation is the Retirement Benefits Act.[54]

The research focuses mainly on the banking sector within the financial market. The Banking Sector operates under the ambit of the Banking Act[55] and the Central Bank of Kenya Act.[56] To a marginal extent the Building Societies Act[57] by the laws of Kenya also applies. The Central Bank of Kenya is the principal regulator in the banking sector. It is the Central Bank which is mandated to regulate and supervise banks and financial institutions and mortgage finance companies and generally ensure that they comply with the provisions of the Banking Act. The Central Bank of Kenya is a key player in the promotion of the country's socio-economic development agenda and has made a significant contribution in this respect. It serves a pivotal role in steering the financial sector and economic growth. Its role in supporting the growth of the financial sector through supervision and monitoring of its performance cannot be downplayed nor ignored. The Banking Act empowers the Central Bank to issue guidelines to banks and other financial institutions on specific matters. The Act also gives the Central Bank discretionary powers in the aforesaid issues provided in the Act.

In the recent past, the regulatory framework of the banking industry in Kenya has witnessed the enactment of novel policies and regulations as well as amendments of the existing statues and regulations in an effort to promote financial inclusion in Kenya. Remarkably, the government of Kenya has enabled a conducive environment for policymakers and regulators in establishing a benchmark in the regulations influencing financial inclusion. Notably, in February 2017, the government of Kenya debuted Huduma cards, a fintech initiative that aims to leverage partnerships with MasterCard and several prominent banks to help enrol more citizens in government services like health insurance,

[51] Cap 488 of the Laws of Kenya.
[52] Cap 487.
[53] Cap 485A.
[54] Act No. 3 of 1997.
[55] Chapter 488 of the Laws of Kenya.
[56] Chapter 491 of the Laws of Kenya.
[57] Chapter 489.

facilitate adoption of digital financial services among unbanked individuals, and streamline the distribution of the services.[58]

1.9.3 Financial stability

The World Bank Group states that financial stability denotes a financial system that is not prone to failure (crises) due to its resilience to stress.[60] A stable financial system is characterised by efficient allocation of resources, efficient assessment and management of financial risks, effective maintenance of employment levels close to the economy's natural rate and elimination of relative price movements of real or financial assets that potentially affect monetary stability or employment levels. The financial system is considered to be stable where it is able to absorb the shocks resulting from adverse and unforeseen events through self-corrective measures.[59]

Due to the increased volume of financial transactions and integration of institutions within the financial sector and capital markets, there has been growth in the interdependence of the institutions thereby bringing to fore systemic risk. Crockett A. argues that the role of regulation in promoting financial stability through establishing diagnosis, remedies and allocation of responsibilities is paramount in ensuring economic growth.[60] The regulation is segmented into macro-prudential and micro-prudential regulation. Macro-prudential regulation limits the costs that the economy can incur due to financial distress and economic shock thereby inhibiting the likelihood of economic failure and financial instability. Micro-prudential regulation, on the other hand, serves the purpose of protecting the depositors from the likelihood of failure of the individual institutions.[61] Hence, financial stability can be considered to be assured where every institution is financially sound. The costs and set-backs incurred due to financial instability call for a strengthening of the financial regulation including, but not limited to macro- and micro-prudential guidelines. The disruption caused by financial instability calls for a strengthening of the supervisory and regulatory framework within the financial industry through policy co-ordination.

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[58] Lewis J. R., Villasenor, D. J., & West, M. D. (2017, August).*The 2017 Brookings Financial and Digital Inclusion Project Report: Building a Secure and Inclusive Global Financial Ecosystem.* Retrieved September 30, 2017. [60]

World Bank Group. (2017). Retrieved July 25, 2017, *from Financial Stability: http://www.worldbank.org/en/ publication/gfdr/background/financial-stability.*

[59] ibid.

[60] **Crockett, A. (2000, September 21). *Marrying the Micro- and Macro-Prudential Dimensions of Financial Stability.* Retrieved July 25, 2017, from https://www.bis.org/review/rr000921b.pdf**

[61] ibid.

1.10 Chapter Outline

1.10.1 Chapter One: Introduction

This is the introductory chapter and presents the background to the study. It states the statement of the problem and presents the research questions to be addressed by the study. It also includes the hypothesis to the study, by arguing that the proposed single regulator will address the challenges of the current framework. It discusses the theoretical framework and identifies the research methodology and literature review of the study.

1.10.2 Chapter Two: Challenges facing the current regulatory structure in Kenya

This chapter analyses the current laws and regulatory framework in Kenya focussing on the Insurance Regulatory Authority, Sacco Societies Regulatory Authority, Retirement Benefits Authority and the Central Bank of Kenya going down the history lanes looking at the capabilities and inadequacies of the present regulatory regimes.

1.10.3 Chapter Three: Kenya's Financial Regulatory Framework

This chapter critically examines the regulation of the financial sector in Kenya. It discusses the types of regulations and controls that may be adopted in the financial services sector in Kenya. The chapter delves into the concept of the unified regulator, merits and demerits. It also introduces the regulatory structure in Kenya and sets up the importance of this paper.

1.10.4 Chapter Four: Contextualizing Kenya's existing regulatory framework vis-à-vis other Jurisdictions

This chapter makes a detailed analysis of the different regulatory systems in some of the countries compared to the ones we have in Kenya. It analyses case studies of the frameworks in the United Kingdom and South Africa, with a view to making comparisons with Kenya's proposed unified regulator. The insights obtained from the analysis leads to the conclusion and recommendations for the most viable regulatory framework for the financial services in Kenya. The chapter also looks at some of the practical challenges that these countries have experienced in their consolidated framework.

1.10.5 Chapter Five: Conclusion and Recommendations

From the findings and deductions of the research, this chapter concludes whether a single consolidated regulatory regime would lead to better harmony and unity in the financial sector than it currently is and helps in recommending any further areas that needs to be looked at for better development and unity in the sector.

CHAPTER TWO

CHALLENGES FACING THE CURRENT REGULATORY STRUCTURE IN KENYA

2.0 Introduction

The financial services sector in Kenya has historically evolved since pre-independence where the sector has been regulated by the government, although at different spheres, both directly and indirectly.[1] Some of the sub-sectors were self-regulated, however, with penetration and increase of financial services there has been continued demand for efficient regulation[2] which has created a mix of both self-regulation and government regulation.[3] The different sub-sectors have therefore experienced different paces for development and regulation. With the growth of the Kenyan economy, and the palpable need for proper regulation of the sector, the Ministry of Finance has played the oversight role. However, with subsequent development, the regulatory framework developed from the different departments have independent regulators for each sub-sector. This chapter analyses the current laws and regulatory framework in the financial services sector in Kenya and the challenges of the current regulatory framework, which appear to have been the catalyst for the clamour for an integrated regulatory framework. The chapter focuses mainly on the Insurance Regulatory Authority, Sacco Societies Regulatory Authority, Retirement Benefits Authority and the Central Bank of Kenya.

2.1 Challenges in regulation

The current regulatory framework has been criticized as being inadequate to effectively regulate the financial services sector today as a result of duplicity of regulation, for instance, where companies are incorporated under the Companies Act,[4] and regulated by either the Banking Act[5] or the Insurance Act.[5] In this regard, governance requirements from various laws and agencies are often at conflict, which affects decision making and effectiveness.[6] The review by the Presidential Task Force on Parastatal Reforms has identified some core issues and challenges with the existing legislations and regulations. These include the absence of a single overarching law, adverse effect of the multiplicity

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[1] Mutuku N, *Case for Consolidated Financial Sector Regulation in Kenya* (Retirement Benefits Authority 2008) http://ssrn.com/abstract=1837354> accessed 10 July 2019.

[2] Mukubwa T, *Essays in African Banking Law and Practise*, (2nd edn, Kampala 2009)

[3] Ibid.

[4] Companies Act Chapter 486 Laws of Kenya (*Repealed by Companies Act No. 17 of 2015).* [5] Banking Act Chapter 488.

[5] Insurance Act Chapter 487.

[6] Republic of Kenya, *Report of the Presidential Taskforce on Parastatal Reforms* Presented to His Excellency Hon Uhuru Kenyatta CGH President and Commander in Chief of the Defence Forces of the Republic of Kenya (Nairobi 2013).

of laws governing Government Owned Entities, and burden of compliance with existing sometimes conflicting legislations.[1]

The Central Bank of Kenya was established in 1966 because of its prominent role in the country's monetary policies. However, the establishment of other regulatory bodies over the years has been haphazard and chaotic. For instance, the insurance industry which is more advanced than the securities markets was not subject to any form of oversight before July 1987 when the Insurance Act,[2] came into operation. Even, then, it was under the supervision of the Commissioner of Insurance. It was not until 2006 when the industry had a regulatory authority. The Capital Markets Authority was established in 1989, while the Retirement Benefits Authority was established in 1997. Finally, although savings and credit cooperative societies had been an integral part of both rural and urban communities, it was not until 2009, that the Sacco Societies Regulatory Authority was created.

Instances of regulatory duplication are also rampant across the different sub-sectors. For instance, fund managers are regulated by both the Retirement Benefits Authority and Capital Markets Authority. Fund managers and custodians are required for financial institutions regulated by the Capital Markets Authority, Retirement Benefits Authority and Central Bank of Kenya. Bancassurance which allows banks to sell insurance products is regulated by both the Insurance Regulatory Authority and the Central Bank of Kenya. Premium financing is done by both the Insurance Regulatory Authority and Central Bank of Kenya, while brokers and administrators are both regulated under the Retirement Benefits Authority and Insurance Regulatory Authority. Listed banks are regulated by both the Central Bank of Kenya and the Capital Markets Authority, and listed insurance companies by both the Insurance Regulatory Authority and Capital Markets Authority.[3]

2.2 The Banking Sector

The establishment of the currency system for Kenya by the British had a direct bearing on how banking would evolve in Kenya. In the long run, the United Kingdom based commercial banks started operating in Kenya in the 1890s and had little business with the native population of Kenya and when they ventured into deposit banking, they concentrated on the immigrant settler community. After independence, emphasis was placed on ensuring that there was proper control of the financial and monetary system to facilitate the attainment of economic, social and political objectives where the independence Government set out to rectify the situation by establishing a Kenyan Central Bank to

[1] ibid.

[2] Insurance Act Chapter 487 Laws of Kenya.

[3] Mutuku N, *Case for Consolidated Financial Sector Regulation in Kenya* (Retirement Benefits Authority 2008) http://ssrn.com/abstract=1837354> accessed 10th July 2019.

take over the control of monetary and financial policy, the introduction of Kenyan currency, entering into the community banking sector by establishing state owned community banks or buying shares in existing banks, and creating banking legislation in Kenya.[4] Currently, the banking business is regulated by the Banking Act[5] which was enacted in 1989 and it repealed and replaced the Banking Act, 1969 where banking in Kenya was regulated under the Banking Ordinance which was a colonial piece of legislation, and was inherited by the government at independence. The Act gave the Minister of Finance responsibility of licensing banks and non-financial institutions and to the Central Bank of Kenya, the responsibility of inspecting all financial institutions. Upon enactment, the Banking Act was aimed at strengthening the sector's institutional framework, however, it failed to achieve this objective as was evidenced by the major crises that affected the sector in 1980s and 1990s, where many banking institutions collapsed. The main reasons cited for the banking crisis were under capitalization, high level of non-performing loans and weaknesses in corporate governance which eventually led to financial fragility as well as the loss of public confidence with the financial services sector as a whole.

The Banking (Amendment) Act, 1985 attempted to rectify these deficiencies which was reviewed to give more legal powers to the regulatory authority and to broaden the responsibilities and coverage of institutions including the Micro Finance Institutions. Licensing was henceforth routed through the Central Bank of Kenya with the ministers' approval which also led to the establishment of the Deposit Protection Fund in 1986. Prudential guidelines were also revised to encourage self-regulation and enhance the corporate governance, capital adequacy, risk classification of assets and overall risk management of the banking sector in order to avoid a repeat of the deficiencies.[6] In 2003, it was noted further by the Central Bank of Kenya[7] that the banking sector was still experiencing difficulties that would undermine the achievement of the objectives set out in the Economic Recovery Strategy. These problems included a comparatively high ratio of non-performing loans in some major banks; inadequate competition in the banking sector; persistence of wide interest rate spreads leading to a high cost of credit; insufficient quantities of credit and poor quality credit assessments; absence of vibrant institutions for provision of long term finance; weak legal arrangements creating long delays in contract enforcement; and weak dispute resolution mechanisms.[8] Although the inefficiencies experienced by the banking sector even after amendment of the Act continue to prevail, the same are attributable to

[4] ibid.

[5] Banking Act Chapter 488 Laws of Kenya.

[6] ibid.

[7] Government of Kenya, „Economic Recovery Strategy Paper‟, *Wealth Creation and Employment* (Nairobi 2003).

[8] ibid.

the emerging trends being witnessed across the world, and it is notable that some of these inefficiencies also affect other institutions in the financial services sector. The Banking Act,[9] the Central Bank of Kenya Act[10] and the various prudential guidelines issued by the Central Bank of Kenya, governs the banking sub sector. The Central Bank of Kenya is responsible for formulating and implementing monetary policy and fostering the liquidity, solvency and proper functioning of the financial system.[11] Operators in the banking sector are licensed under the Banking Act and regulated by the Central Bank of Kenya.

The Central Bank of Kenya has been conducting a comprehensive review of the banking sector's legal and regulatory framework. There has been a number of proposed laws and regulations relevant to the sector which has been put forward. For instance, the Banking (Amendment) Bill[12] has been published to amend the Banking Act so as to put a cap on the rate of interest charged by banks and financial institutions for loans or monetary advances. The Bill also proposes to fix the minimum rate of interest that banks or financial institutions must pay on deposits held in interest-earning accounts. The Bill passed through its first reading on 10th November, 2011 however it never progressed from that stage. The Bill seeks to cure the challenges experienced by the consumers of banking services and to strengthen corporate governance and risk management frameworks. This would enable the sub sector deal with cross border risks and also enable banks to boost their liquidity management, loans management and enhance their resilience to withstand macro-economic shocks.[13] The Bill also sought to consolidate most of the amendments that had been made in the recent past to the Act for uniformity purposes.

2.3 The Insurance Sector

There was no specific insurance legislation in Kenya prior to 1960, when the Insurance Ordinance was promulgated[14] which was intended to control the establishment, working and finances of insurance companies. Before the Ordinance, insurance companies had to comply only with the Companies Act[15] and after independence in 1963, there was need to introduce legislation on insurance to guide the growth of the industry and make it relevant to the national economy. However, providers of insurance

[9] Banking Act Chapter 488 Laws of Kenya.

[10] Central Bank of Kenya Act Chapter 491 Laws of Kenya.

[11] ibid s 4.

[12] Banking (Amendment) Bill 2011(Kenya).

[13] Sejpal S and Doshi M, Banking in Kenya "*Banking Regulation*" (1st edn, Global Legal Group 2012).

[14] Olotch W, The Kenya Insurance Market" (2006) *vol 20 The African Reinsurer*, www.africare.com/areport/eng_a/4a.pdf> accessed 31st July 2019.

[15] Companies Act Chapter 486 Laws of Kenya (*Repealed by Companies Act No 17 of 2015*).

services by and large continued to have a freehand in most of the activities which they undertook[16] which created a problematic environment that continues to be experienced to date. The insurance sector experienced numerous challenges which included the growth of industry wide cartels, a temperamental judicial system, inadequate use of technology, insurance companies formed with a fraudulent intent, and poor mobilization of investment capital.[17]

The Insurance Act[18] was therefore enacted in 1986 and enforced on 1st January 1987 and was aimed at streamlining the insurance industry by providing for the supervision of insurers, promoting the maintenance of a fair, safe and stable insurance sector, protecting the interest of the insurance policyholders and beneficiaries, and promoting the development of the insurance sector.[26] The Act established the Office of the Commissioner of Insurance, which had the mandate of licensing, supervising and regulating the industry players.[27] The Act also established an Advisory Board, to oversee the mandate of the Commissioner of Insurance. Even though the Act was in place, the insurance sector still continued to face numerous challenges, most notably being the third party liability system, which was aimed at ensuring compensation for accident victims. These contributed to the worsening of the sector among other factors, which led the collapse of many insurance companies[19]in the country during the 1990s coupled with the numerous problems that bedevilled the sector and this necessitated amendments to the relevant laws governing insurance.

The first set of significant amendments to the Act was made in 2003 which sought to address the regulatory framework and corporate governance issues by expanding the number of board of directors,[20] skills competence and financial transparency, among other issues.[21] Therefore in 2004, the Act was amended to establish the Policy Holders Compensation Fund to partially relieve policy-holders from the suffering they undergo when insurance firms collapse and to boost consumer confidence in the insurance industry.[22] Furthermore in 2006, the Act was amended to introduce the Insurance Regulatory Authority which took over the powers of the Commissioner of Insurance[23] and thus he became the Chief Executive Officer of the Authority, while the powers of management were

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[16] Gadaffi Y, Reforming the Insurance Regulatory Framework in Kenya: An Analysis" (2014) vol 20 (6) *Journal of Research in Humanities and Social Science*
[17] ibid.
[18] Insurance Act Chapter 487 Laws of Kenya
[26] ibid s 3A. [27] ibid.
[19] Gadaffi Y, Reforming the Insurance Regulatory Framework in Kenya: An Analysis" (2014) vol 20 (6) *Journal of Research in Humanities and Social Science*
[20] Insurance Amendment Act 2003 s 27 A (a).
[21] Insurance Amendment Act 2003 s 54(1).
[22] Insurance (Policy Holders Compensation Fund) Regulations 2004.
[23] ibid s 3.

subsequently placed on the Board of Management of the Authority. The Act also established the Insurance Tribunal, which has the mandate to hear and determine disputes from the market players.[24]

In 2010, the Act was further amended to include the expansion of the regulatory and supervisory power of the Insurance Regulatory Authority.[25] These amendments also enhanced the supervisory role of the authority and also sought to spell out the functions of the board of the Policy Holders Compensation Fund.[35] In 2011 and 2013, the Act was further amended to enhance the mandate of the Insurance Regulatory Authority and to provide a more coherent document to capture the numerous previous amendments.[26] Since then, the Insurance legislation has been amended severally to keep up with emerging trends and new challenges that faced the industry which has created an insurance regulatory framework which not only addresses peculiar Kenyan concerns, but also attempts to keep up with international best practices as far the insurance sector is concerned, the industry continues to evolve and thus reform continues to be ongoing.[27]

The path tracing the growth of the insurance sector in Kenya is littered with numerous problems as discussed above we have seen that between 1963 and 1984, there was no legislation that specifically addressed insurance in Kenya, thus leaving a gap. As a result, the insurance sector was characterized by chaos and confusion from the very onset where the providers of insurance services by and large had a freehand in most of the activities they undertook. This scenario provided fertile breeding grounds for the problems that continue to bedevil the industry up to date. By the time legislation was enacted in 1984, the damage had already been done and the enactment of the Insurance Act in 1984 was aimed at streamlining the hitherto ungoverned sector but this objective was hardly realized. On the contrary, the Act contributed to an increase in the problems facing the sector because it was adopted from the British Insurance Laws of 1948.[28] Therefore, it did not fully take into account the local situation in which it was to be applied, for instance, one of the key provisions of the British Insurance laws was a mandatory third party liability system for public service vehicles. Such a system opened the floodgates for fraud as various players in the industry sought to unscrupulously capitalize on the provisions to the detriment of insurance companies which found themselves having to pay out huge claims which severely weakened their financial position and ultimately led to the collapse of many.[29] The Act also provided

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[24] ibid s 169.

[25] Finance Act 2010 s 51. [35]
Finance Act 2010 s 54.

[26] Yohana Gadaffi „Reforming the Insurance Regulatory Framework in Kenya: An Analysis" (2014) vol 20 (6) *Journal of Research in Humanities and Social Science.*

[27] ibid.

[28] Geoffrey Njenga, *Thriving on Borrowed Time* (Hope Centre International, 2011) 24.

[29] Ibid.

for a fault system which has worked to the disadvantage of insurance companies as they have been forced to operate in an uncertain environment with regard to the levels of risk they are exposed to.[30] Prof. Njenga notes that other challenges that have faced the insurance sector include: the growth of industry wide cartels, a temperamental judicial system, inadequate use of technology, insurance companies formed with a fraudulent intent, run-away road traffic accidents and poor mobilization of investment capital.[31]

In an industry as complicated as that of insurance, no simple formula can be used to regulate and shield insurers from the challenges that hinder development of the sector. The Government developed vision 2030 to guide the country's development strategy. The vision seeks to transform Kenya into a globally competitive and prosperous nation by 2030. It is envisaged that with increased growth in gross domestic product, the contribution from the Insurance sector will increase from the current 2.5% to 5%.[32] To achieve this growth, the challenges encountered by the insurance industry and the Regulator need identification and strategic responses formulated and implemented in order to realise the anticipated growth. Today's insurance industry is characterised by intensified competition with forty four (44) insurance companies competing for insurance business worth Ksh: 47.39 billion.[33] In spite of underwriting such business, the industry suffered an underwriting loss of Ksh 1.218 billion during the same period. The 2007 Kenya Insurance Survey revealed that the insurance business is facing the challenge of meeting policy-holders claims when they fall due. As a result, the public has perceived the industry negatively. The other challenge is on generation of growth for an industry that has significant potential for growing yet has been stagnant. Other challenges facing the insurance industry in Kenya include: lack of liquidity leading to collapse of some firms, poor governance and industry saturation.[34]

The business environment within which the insurance industry operates has been very volatile. The political anxiety, competition from new entrants, social reforms, technological advancement and global changes are some of the challenges that have greatly affected the growth of the industry. During its inception, IRA was charged with the mandate to effectively supervise, regulate and develop the insurance industry. To be effective, IRA has to deal with various challenges that hamper development

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30 Mwang'ombe O.B, A Feasibility Study of the Insurance (Motor Vehicles Third Party Risks) (Amendment) Bill 2010 and Its Impact on Kenya's Insurance Industry‟ <available at http:// ssrn.com/abstract=1857906> accessed 24 July 2019.

31 ibid pp 94.

32 Insurance Regulatory Authority, *Strategic Plan 2008-2012.*

33 ibid.

34 Makove S (2003), *The challenges ahead*. The Insurance Journal, June issue, 2-4.

of the sector. Political challenges have had great impact on the insurance industry, being semiautonomous, IRA's decision making process is slowed down because of a lot of bureaucracy.[35] The current legal framework is inadequate and does not accommodate new channels of distributing insurance such as Banc assurance and Micro insurance. In addition, it does not accommodate modern supervisory frameworks such as Risk Based Supervision that are currently in use and working well in other jurisdictions. The Public Service Vehicle (PSV) underwriting continues to pose major challenges to the sector. Collapsing of some of the PSV underwriters has worsened the already negative perception of the insurance industry. This is mainly attributed to poor corporate governance coupled with huge and unpredictable awards made by the courts.[36] The environmental turbulence in the insurance sector has not spared IRA as a regulator. The Authority has no control over challenges in the external environment and the best it can do is to strategically respond to these challenges to reduce their undesirable effects on the organization. It therefore has the onerous task of strategically responding to the challenges of regulating the insurance sector to ensure that it lives up to its mandate.[47]

2.4 Savings and Credit Cooperative Societies (Sacco's)

Kenya had separate legal and supervisory framework for Sacco's[37] where were all governed by the Co-operative Societies Act.[38] There were no prudential guidelines and rules that limited risk exposure, specific disclosure norms, and no liquidity reserves due to the absence of regulatory supervision which led to maladministration of members' funds and even their collapse.[39] The rapid growth underlined the need for specific legislation hence the enactment of the Sacco Societies Act[51] to specifically regulate and supervise their operations. This Act made provisions for licensing, regulation, supervision and promotion of Sacco Societies and established the Sacco Societies Regulatory Authority (SASRA). The Authority was given the mandate to license and regulate Sacco's as well as to provide guidelines for

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[35] Chelimo, K. (2008). *Strategic responses to challenges of energy regulation in Kenya by the energy regulatory commission.* Unpublished MBA project, University of Nairobi.

[36] ibid. [47]
ibid.

[37] Ngaira L, The Impact of Sacco Regulatory Authority Guidelines on Sacco Operations in Kenya: The Case of Nairobi Deposit Taking Sacco's" (MBA Thesis, University of Nairobi 2011) http://erepository.uonbi.ac.ke:8080/xmlui/handle/123456789/13144> accessed 31st July 2019.

[38] Cooperative Societies Act Chapter 490 Laws of Kenya.

[39] Ngaira L, The Impact of Sacco Regulatory Authority Guidelines on Sacco Operations in Kenya: The Case of Nairobi Deposit Taking Sacco's" (MBA Thesis, University of Nairobi 2011) http://erepository.uonbi.ac.ke:8080/xmlui/handle/123456789/13144> accessed 31st July 2019.

[51] Sacco Societies Act No. 14 2008.

protection of member's deposits.[40] The Act was intended to enhance transparency, accountability and good corporate governance in the management of Sacco's.[41]

The Sacco Regulatory Authority (SASRA) was established in 2008 by the Sacco Societies Act.[42] The authority is mandated to license Sacco Societies to carry out deposit taking business, regulate and supervise deposit taking Sacco societies, manage the Deposit Guarantee Fund under the trustees appointed under the Act and advise the Minister on national policy on deposit taking Sacco societies in Kenya. Many countries in Africa have focussed attention on the legislation of microfinance and non-banking financial institutions, some have adopted prudential standards specific to SACCOs while others uses existing banking laws to regulate SACCOs. Others such as Kenya and South Africa have independent regulators with specific regulations- SACCO Societies Act and Co-operative Banking Act respectively.[43] SASRA was inaugurated in 2009 and was charged with the prime responsibility to licence and supervise D.T.S in order to protect the interests of SACCO members and ensure that there is confidence in the public towards the SACCOs.

According to Ademba, of the 19 million Kenyan adult population 22.5% are served by commercial banks and micro financial institutions (MFI) while 17.6% are served by SACCOs.[44] It is therefore due to the combination of providing retail services to the low income population and having a large coverage that SACCOs must be regulated. There are challenges to regulation compliance by D.T.S in Kenya. These relate to corporate governance, management information systems, senior management skills, legal environment and resource availability. The Kenyan SACCO sector is the largest in Africa and the seventh worldwide.[45]About 63% of the Kenyan population depend on SACCO related activities for their livelihood.[46] Owen argues that governance in Kenyan SACCOs is typically weak because of

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[40] ibid s 5

[41] Ademba C, Challenges Facing Sacco Regulations in Africa" (11th Savings and Credit Co-operative Association of Africa Congress, Swaziland 2012) www.scu.sc/media/.../SACCA_Congress_2010_Swaziland_Report.pdf> accessed 31st July 2019.

[42] Insurance Bill 2014.

[43] Ademba, C. (2010, October 5), Challenges facing SACCO regulations in Africa. Paper presented at the 11th SACCA Congress, Swaziland. Retrieved from African Confederation of Cooperative Savings & Credit Associations Website, http://www.accosca.org

[44] Ademba, C. (2012b). *The scope of board accountability in financial co-operatives.* Paper presented at the 2nd Annual Financial Co-operatives Indaba, Durban. Retrieved from African Confederation of Cooperative Savings & Credit Associations Website, http://www.accosca.org

[45] Ademba, C. (2010, October 5). Challenges facing SACCO regulations in Africa. Paper presented at the 11th SACCA Congress, Swaziland. Retrieved from African Confederation of Cooperative Savings & Credit Associations Website, http://www.accosca.org

[46] Ondieki, A.N., Okioga, C., Okwena, D.K., & Onsase, A. (2011). *Assessment of the effects of performance management practices on provision of financial services by Savings and Credit Cooperative Societies: A case of Gusii Mwalimu SACCO,* Kisii Central District, Kenya.

their „Management Board" system which results in the absence of clear division between roles of the board and management.[47] The boards and management capacity of most SACCOs is weak with board membership largely seen as a stepping-stone into politics. This causes board membership to be occupied by individuals not necessarily interested in enhancing member interests. Okwee found that a significant number of SACCOs comply less with corporate governance guidelines which may explain the relatively poor financial performance of these SACCOs.[48] SASCCO (2010) found that in some instance, an attempt to implement good corporate governance is perceived by leaders as an act of questioning their ability.[49] According to Owen lack of good computerised systems is a major constraint in efficient operations. In its absence, it is very difficult to track loan delinquencies, aging, provisioning, write offs, and ensure that accountants and financial managers apply business rules consistently.[50] Makori noted that an inadequate ICT system and underdeveloped MIS is a challenge facing regulatory compliance in SACCOs.[51] This is a significant challenge for the sector, given that large SACCOs have several thousand clients and a wide variety of products. New products require sophisticated cash flow loan management systems that allow staff and managers to generate the necessary types of reports for proper loan monitoring and recovery management.

This unfortunately is lacking in most SACCOs. The operating regulations and prudential standards define new ways of doing business thus requiring heavy investments by the SACCOs in upgrading the existing management information systems for effective compliance.[52] The pace of the upgrade is however slow, importantly as well is that data generated by SACCOs is not entirely without integrity issues on its accuracy and consistency. Capacity gaps in terms of senior management skills and competence have been noted in majority of SACCOs. This is reflected in many SACCOs inability to meet the minimum regulatory requirements. Makori noted that inadequate managerial competence is

[47] Owen, G. (2007). *Rural outreach and financial Cooperatives: SACCOs in Kenya.* World Bank, Washington, DC, USA.
[48] Okwee, A. (2011). *Corporate governance and financial performance of SACCOs in Lango sub region.* MSc. Thesis, Makerere University, Uganda.
[49] SACCO (2010). *2010 Annual Savings and Credit Co-operative Association of Africa (11th SACCA Congress) Report*. Retrieved from African Confederation of Cooperative Savings & Credit Associations Website, http://www.accosca.org.
[50] Owen, G. (2007). *Rural outreach and financial Cooperatives: SACCOs in Kenya.* World Bank, Washington, DC, USA.
[51] Makori, J. (2013). The challenges facing Deposit-Taking Savings and Credit Cooperative Societies" regulatory compliance in Kenya. A case of the Gusii region. *Interdisciplinary Journal of Contemporary Research in Business, 4*(12).
[52] SASRA Annual Report (2012). Nairobi, Kenya.

a challenge facing regulatory compliance in SACCOs.[53] Ondieki *et.al*, revealed that the major challenges inherent in the SACCO movement in Kenya include limited transparency in the management of co-operatives and lack of capacity in management.[54] Magali observed that SACCOs had poor management, lack of competence and accountability of staffs and SACCOs‟ leaders.[55] Owen noted that the majority of SACCOs have no operational manuals detailing policies and procedures for accounting, cash flow management, credit and savings operations, internal controls, procurement and risk management.[56] This makes it almost impossible for auditors to assess compliance or detect fraud. Internal audit capacity in most SACCOs is therefore very weak. A study by Ombuki, Arasa, Ngugi, & Muhwezi showed a positive and significant relationship between environmental factors and compliance with procurement regulatory act.[57] Further results in their study indicated that having various interests, objectives and beliefs, interest groups are involved in regulations in several ways such as lobbying legislative bodies to pass or alter procurement statutes, influencing implementation of these statutes, influencing budget authorisation and appropriations processes. For example, the umbrella body for SACCOs, KUSCCO, has been consistently advocating for sound co-operative policies and legislation but has also not shied away from siding with SACCOs and holding different positions from SASRA regulations.

According to Ademba environmental factors that influence regulation compliance in SACCOs include competition, political government, technology, social values, globalisation, non-performance of the economy and the common bond.[58] SACCO (2013) further asserts that the opening up of membership introduces new business risk including the guarantee mechanism whose strength is anchored on social collateral is becoming less effective.[59] Owen further argues that SACCOs face considerable competition from banks which provide loans quicker, with less paperwork, less charges and less

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[53] Makori, J. (2013). The challenges facing Deposit-Taking Savings and Credit Cooperative Societies‟ regulatory compliance in Kenya. A case of the Gusii region. *Interdisciplinary Journal of Contemporary Research in Business, 4*(12).

[54] Ondieki, A.N., Okioga, C., Okwena, D.K., & Onsase, A. (2011). *Assessment of the effects of performance management practices on provision of financial services by Savings and Credit Cooperative Societies: A case of Gusii Mwalimu SACCO*, Kisii Central District, Kenya.

[55] Magali, J.J. (2013a). The impacts of credits risk management on profitability of Rural Savings and Credits Cooperative Societies (SACCOs): The case study of Tanzania. *International Journal of Management Sciences and Business Research, 2(*12), 62-77.

[56] Owen, G. (2007). *Rural outreach and financial Cooperatives: SACCOs in Kenya.* World Bank, Washington, DC, USA.

[57] Ombuki, K., Arasa, R., Ngugi, P., & Muhwezi, M. (2014). Environmental factors influencing procurement regulatory compliance by Kenya's public universities. *International Journal of Social Sciences and Entrepreneurship, 1*(9), 407417.

[58] Ademba, C. (2012b). *The scope of board accountability in financial co-operatives.* Paper presented at the 2nd Annual Financial Co-operatives Indaba, Durban. Retrieved from African Confederation of Cooperative Savings & Credit Associations Website, http://www.accosca.org.

[59] SACCO Supervision Report (2013). *SACCO Supervision Annual Report: Deposit Taking SACCOs.* Nairobi, Kenya.

collateral requirements.[60] The major threat to SACCOs is thus the competition from Banks and MFIs as they make efforts to increase outreach among low and middle income clients in both rural and urban areas due to a more flexible legislative environment as opposed to that of SACCOs. The initial requirement by the Government of Kenya that SACCOs be based on a check off system based on employment and commodities allowed many SACCOs to build up membership and assets, which give them a basis to compete in a liberalised environment with some SACCOs developing assets larger than banks. However the opening up of the legislative restrictions on common bonds led to cannibalising of members as the SACCOs now compete directly with one another. Furthermore, the Co-operative Bank of Kenya which was launched to support the cooperative movement has also become commercialised and directly competes with SACCOs. There is also no unity of purpose among SACCOs which are at different stages of growth and compliance. This will call for continued monitoring and evaluation efforts from the SASRA and continuous engagement of stakeholders in working together to address the shortcomings.[61] This has led to SACCOs not having a common stand on various legal policy issues affecting the SASRA compliance in the sector and thus at times being subjected to unfair laws by the regulator. The legal environment has also seen other banks which as are the biggest SACCO competitors continue to lobby for stronger regulations against the SACCO sector. The new regulatory framework brings immense challenges to SACCOs as they are expected to conduct business in a different way. The effective implementation of the new legal and regulatory framework requires a new set of skills and knowledge. This requires financial resources and time besides the attitude change amongst the leaders and other stakeholders.[62]

According to Ondieki et.al, lack of funding has been identified in a number of studies as one of the main constraint hindering the growth of the SACCO sector.[63] Owen argued that while all SACCOs are required to have annual external audits by certified accounting firms, there is a paucity of good-quality audit firms.[64] Outside of the top two or three large accounting firms, the technical capacity of other firms is weak. Furthermore, most SACCOs lack the resources to pay for thorough external audits. Other regulators such as the Institute of Certified Public Accountants of Kenya have also raised issue

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[60] Owen, G. (2007). *Rural outreach and financial Cooperatives: SACCOs in Kenya.* World Bank, Washington, DC, USA.
[61] SASRA Annual Report (2012). Nairobi, Kenya.
[62] ibid.
[63] Ondieki, A.N., Okioga, C., Okwena, D.K., & Onsase, A. (2011). *Assessment of the effects of performance management practices on provision of financial services by Savings and Credit Cooperative Societies: A case of Gusii Mwalimu SACCO,* Kisii Central District, Kenya.
[64] Owen, G. (2007). *Rural outreach and financial Cooperatives: SACCOs in Kenya.* World Bank, Washington, DC, USA.

with the manner of hiring Auditors through acclamation during Annual General Meetings. While some SACCOs satisfy the minimum licensing requirements namely capital adequacy, physical infrastructure and internal controls, there are notable resource challenges for the effective compliance with the Act and Regulations.[65] Majority of SACCOs face liquidity challenges due to the very nature of their business that involves lending up to three times their depositors savings. This is further exacerbated by the continuous push by SACCO shareholders for higher dividend pay offs and the cutthroat competition that has seen SACCOs borrow exorbitant bank funds and re-lend at much lower interest rates to members. Further all aspects of the SACCO require resources and this is scarce.[66]

2.5 Retirement/pension schemes

The pre-RBA era in Kenya saw a retirement benefits sector with little effective regulation and supervision. The interests of retirement scheme members and their beneficiaries were not sufficiently protected. There was concern about the design and financial viability of certain schemes in the country unless appropriate remedial action was taken. There was poor administration and investment of scheme funds with particular concerns on concentrations of investment, particularly in property. In the majority of cases, this was inadvertent and unintentional, but without adequate controls and supervision, there was always a risk of mismanagement and outright misappropriation. Further disclosure and accountability were lacking. The NSSF had also been riddled with governance issues and concerns over its investments and payment of benefits. Not surprisingly, confidence in the sector was low.[67] The primary motivation for reform and enactment of the retirement benefits legislation in Kenya in 1997 was thus to strengthen the governance, management and effectiveness of the NSSF and of the occupational pensions sector. The enactment of the Retirement Benefits Act ('RBA') (1997) and the establishment of the Retirement Benefits Authority ('the Authority') in 2000 marked the beginning of a regulated, organized and more responsible retirement benefits sector in Kenya. The interests of retirement scheme members and their beneficiaries were not sufficiently protected before the enactment of legislation to govern and regulate the retirement benefits/ pension schemes. There was concern about the financial viability of the schemes and poor administration and investment of scheme funds and also there were inadequate controls and supervision, risk of mismanagement and outright misappropriation where disclosure and accountability were lacking. The National Social Security Fund

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[65] SACCO Supervision Report (2012). *SACCO Supervision Annual Report: Deposit Taking SACCOs.* Nairobi, Kenya.
[66] ibid.
[67] Sundeep K Raichura, *Analytical Review of the Pension System in Kenya* (2008). www.http\\U:\oecd\OECDPaperFinal.doc> accessed 31st July 2019.

(NSSF)[68] also continued to experience governance issues and concerns over its investments and payment of benefits.[69]

The Retirement Benefits Act[70] was enacted in 1997 to strengthen the governance, management and effectiveness of the pensions sub-sector and the National Social Security Fund which, in the long-run, led to the establishment of the Retirement Benefits Authority which was inaugurated in 2000 and marked the beginning of a regulated, organized and more responsible retirement benefits sector in Kenya. The enactment of the legislation was to address the historical challenges in the various sub-sectors, but there has been no concerted effort towards addressing the regulatory complexities that have evolved over the time. The existing framework for the financial services sector in Kenya consists of a number of independent regulators each charged with the supervision of their particular sub-sectors. This regulatory structure has been characterized by regulatory gaps, regulatory overlaps, multiplicity of regulators, inconsistency of regulations and differences in operational standards.[71] The reforms have been piece-meal and gradual in development. The need for regulatory reform in the financial services sector in Kenya has also largely been occasioned by the desire to replicate developments in other jurisdictions.[72] The Retirement Benefits Act[73] establishes a Retirement Benefits Authority for the regulation, supervision and promotion of retirement benefits schemes, and the development of the retirement benefits sector generally but over the past few years, there has been consensus on the need for further reform of the system.[74]

The National Social Security Fund was established under an Act of Parliament as a provident fund operating on a defined contribution basis. An amendment to the NSSF Act in 1997[87] defined the NSSF as a retirement benefits scheme and thus brought the NSSF into the regulatory ambit of the Retirement Benefits Authority. The NSSF is currently the only scheme mandated to receive mandatory contributions. The NSSF Act was subsequently amended in 2014, to enhance its governance and institutional framework and also it focuses on increasing coverage, benefit adequacy and the growth

[68] National Social Security Fund Act No. 45 2013.
[69] Ibid.
[70] Retirement Benefits Authority Act 2007.
[71] Okioga C.K, 'The Upshot of Financial Sector Regulation on the Financial Market Performance in Kenya Perspectives from Kisii County, Kenya‟ (2013) Vol 2 (9) *Business Management Dynamics.* 1-14.
[72] Gakeri J, Financial Services Regulatory Modernization in East Africa: The Search for a New Paradigm Shift‟ (2011) vol 1(16) *International Journal of Humanities and Social Science.*
[73] Retirement Benefits Act Chapter 197 Laws of Kenya.
[74] Sundeep K Raichura, *Analytical Review of the Pension System in Kenya* (2008) www.http\\U:\oecd\OECDPaperFinal.doc> accessed 31st July 2019. [87] National Social Security Fund (Amendment) Act 1997.

of retirement savings.[75] The NSSF is currently the only scheme mandated to receive mandatory contributions. This structure has been grappled with a lot of inefficiencies and priority should be made to strengthen the governance and institutional framework of the NSSF, and in particular, the management of the NSSF's investments. The specific steps to be considered in this regard include regulatory oversight by the RBA; implementing rigorous governance framework setting out roles and responsibilities and principles for accountability, transparency risk management and independent oversight; appointing of external fund managers and custodian, and implementing cost management strategies to reduce overall operating costs.[76]

Under the Retirement Benefits Act, there has also been regulations aimed at reducing concentration of risks and achieving more diversification of assets. Since the promulgation of the initial regulations in 2000, there has been additional regulations to improve the protection of member's benefits. Reforms have been undertaken and spearheaded by the Retirement Benefits Authority to offer economic security to beneficiaries and dependents', creation of strong links between contribution to and benefits from pension arrangement, generation of long-term savings, ensuring proper regulation and supervision of pension administration and investment of pension schemes‟ funds.[77]

Some of the improvements which were created in the pension sector with the existing legislation include the improvement of protection of members' rights, separation of roles between scheme sponsors, trustees and professional advisors and providing for a prescribed time period within which benefit payments are to be processed and provision for interest on late payments.[78] The legislation has also seen a number of local and international asset management and pension administration firms enter the market resulting in an increase in competition, lower fees and enhanced service levels. Pension schemes have also had a positive influence on the expansion of the capital markets in the country, due to the investments that the schemes place in the capital markets. The challenges surrounding the implementation of RBS have impacted on the full implementation of the new model. RBS is still fairly new and untested in the retirement benefits sector and thus, there is very little supporting documentation to assist in the implementation of RBS. In addition to this, there is no standard framework or minimum requirements that must be satisfied by RBS and stakeholders are unclear

[75] National Social Security Fund Act No 53 2013.

[76] Sundeep K Raichura, *Analytical Review of the Pension System in Kenya* (2008) www.http\\U:\oecd\OECDPaperFinal.doc> accessed 31st July 2019.

[77] http://www.african-exchanges.org/download/conferences/eight/Edward%20Odundo.pdf> accessed 18 March 2015

[78] Sundeep K Raichura, *Analytical Review of the Pension System in Kenya* (2008) www.http\\U:\oecd\OECDPaperFinal.doc> accessed 31st July 2019.

concerning their level of involvement and their role in RBS; leading to unmatched expectations and demands.[79]

The effectiveness of the RBA to date evaluated through the IOPS Principles of Pension Supervision can be rated as satisfactory. Overall, the RBA has been sufficiently equipped to fulfil its roles and has shown itself to be a proactive and responsive regulator and this is reflected in the outcomes to date. Clearly, the success or failure of the RBA is judged on its primary responsibility of ensuring effective regulation of the sector. It is important that its sector development responsibilities do not detract the RBA from remaining focused on its primary regulatory objective. Under the legislation, the NSSF is deemed a retirement scheme and thus subject to the new legislation and under the regulatory ambit of the RBA. In the early years following the implementation of the new legislation, there was considerable friction between the NSSF and the RBA with the former contesting the basis of the regulatory oversight by the new regulator and the latter adopting a lukewarm approach to enforcement. In recent years, a more harmonious relationship and more consultative approach to addressing the issues has emerged and it is hoped that this will result in a better appreciation of each side's view points and enable effective solutions to be found. Whereas clearly there are weaknesses in the solvency standard as currently defined in the legislation, the RBA has been instrumental in encouraging the development and implementation of remedial plans to restore many of the schemes to financial balance through a combination of benefit redesign and financing plans.[80]

Although not the primary driver, the additional legislative requirements for defined benefit schemes have accelerated the trend from defined benefit to defined contribution schemes in Kenya. Contrary to initial fears, the new regulatory framework does not appear to have dramatically increased the costs of running pension schemes. Indeed an analysis of the available data does suggest that the expense ratios of most occupational pension schemes other than for smaller schemes are well within and in fact lower than international benchmarks. Nevertheless there is a need for continual and enhanced education to increase members' as well as trustees understanding of their retirement benefits schemes and the factors impacting the levels of benefits, particularly for defined contribution schemes. The legislation has thus far had a limited impact on the coverage of retirement benefits in the country but the positive effects of the legislation does provide a basis on which to introduce further reform to increase coverage and social protection. The reform of the pension system in Kenya to date has had a positive impact on

[79] ibid.

[80] Okioga C.K, 'The Upshot of Financial Sector Regulation on the Financial Market Performance in Kenya Perspectives from Kisii County, Kenya" (2013) Vol 2 (9) *Business Management Dynamics.*

the occupational pension sector, but a more limited impact in terms of addressing the key weaknesses of the current system of poor overall levels of coverage and benefit adequacy.[81]

As the pensions industry in Kenya evolves and grows, it is also becoming more complex. Benefit and investment options are becoming more innovative and complex and choices are wider. The financial markets are becoming more sophisticated. Individual schemes are becoming larger and so are there exposures. If broader reforms to introduce higher mandatory contributions are introduced, the regulatory capacity will need to be correspondingly increased. Continuous improvement to the regulatory framework (e.g. through the introduction of risk based supervision) and enhancements to the regulatory capacity are necessary to ensure that the regulatory framework remains effective. Both the regulatory framework and the regulatory capacity of the RBA will need to be strengthened in anticipation of a wider and stronger supervisory role for the RBA in an extended pension system.

2.6 Conclusion

This research shows that no governmental agency has the capacity to adequately monitor systemic financial risk across the sector. Despite this, the most notable change in the regulatory regime has been the development of the prudential guidelines in the various sub-sectors which are intended to address emerging risks and ensure the continued stability and integrity of the sector. Further, there have been proposals to have a regulatory shift in the sector. The fundamental question however is whether the foregoing challenges are sufficient enough to spearhead the motion for the shift in regulatory paradigm. The development of regulatory framework in the financial services sector in Kenya has been piece meal and characterized by the pressure to replicate the developments in other jurisdictions.[95] Some of the arguments that have been advanced include the challenges of multiplicity of regulation and the lack of the current framework to adequately capture the operational hitches and systemic risks that have inevitably cropped up.

[81] Gakeri J, Financial Services Regulatory Modernization in East Africa: The Search for a New Paradigm Shift" (2011) vol 1(16) *International Journal of Humanities and Social Science.* [95] ibid.

CHAPTER THREE

THE CONCEPT OF FINANCIAL REGULATION AND SUPERVISION IN KENYA

3.0 Introduction

The concept of financial regulation and supervision is currently the focus in many jurisdictions.[1] As a result, the past few years have experienced vast transformation in the financial services sector. The sector has witnessed a shift from institutions offering distinct services such as banking, securities, and insurance businesses to more integrated services where conglomerates are now offering a broad range of financial products across the globe. Additionally, there is substantial blurring of the traditional products, as they continue to seek to maximize profits through business expansion and financial innovation.[2] There has also been massive growth in the globalization of the financial services sector due to technological advancements, which has enabled a virtually borderless marketplace. The regulatory framework is however not uniform and there are even instances of deregulation or government control in some sectors. In many countries, financial regulation and supervision continues to be organized around specialist agencies with distinct responsibilities for each sector. This trend is however shifting towards unified regulatory agencies.[3]

The aim of regulating the financial sector is to ensure that there is stability of the financial system.[4] Even though regulatory models may be similar, each regulatory framework will always be specific and unique to the financial system under which it operates. This means that the design of any framework must inevitably take into consideration domestic conditions. Kenya is no exception to the discussions on unified regulatory framework. The proposals to have the unified regulator must thus be considered based on the local conditions, which are unique to the sector, as well as by considering the recent developments in the sector. This chapter critically examines the regulation of banking and financial services. It discusses the types of regulations and controls that may be adopted in the banking and financial services sector in Kenya. The chapter delves into the concept of the unified regulator, merits

[1] Demaestri E and Sourrouille D, *Integrated Financial Supervision: Experiences in Selected Countries* (Inter-American Development Bank, 2003).

[2] Amelia C Fawcett, *Examining the Objectives of Financial Regulation: Will the New Regime Succeed? A Practitioner's View* in Ferran and Goodhart *37-56.*

[3] Mwenda K, Legal Aspects of Unified Financial Services Supervision in Germany" vol 4 (10) 1009 *German Law Journal*.

[4] Quintyn M and Michael W Taylor, *Should Financial Sector Regulators be Independent?* (IMF Economic Issues, 2004) http://www.imf.org/external/pubs/ft/issues/issues32/#1 accessed 28th July 2019.

and demerits and also introduces the regulatory structure in Kenya and then sets up the importance of this paper.

3.1 Aims of Financial Regulation

Llewellyn summarises the core aims or objectives of financial regulation as the following: firstly, to sustain systemic stability, secondly, to maintain the safety and soundness of financial institutions, and thirdly, to protect the consumer.[4] A wider framework might however be set by particular regulatory agencies. Indeed, other objectives have been postulated including the need to maintain and enhance competition in the financial services industry.[5] Llewellyn goes on to say that the case for regulation, which also determines its objectives, depends on various market imperfections and failures (especially externalities and asymmetric information) which, in the absence of regulation, produce sub-optimal results and reduce consumer welfare. In other words, the purpose of regulation should be limited to correcting for identified market imperfections and failures.[6]

3.2 Types of Regulation

According to Llewellyn there are two generic types of financial regulation and supervision: prudential regulation, which focuses on the solvency and safety and soundness of financial institutions, and conduct of business regulation which focuses on how financial firms conduct business with their customers.

3.2.1 Prudential regulation

In this case, consumers are not in practice in a position to judge the safety and soundness of financial firms but it is necessary because of imperfect consumer information, agency problems associated with the nature of financial institutions' business, and because the behaviour of a financial firm after consumers have dealt with it affects the value of their stake in the firm. No amount of information at the time contracts are signed and purchases made protects against subsequent behaviour of the firm.[7]

3.2.2 Conduct of business regulation

Conduct of business regulation and supervision focuses upon how financial firms conduct business with their customers. It focuses upon mandatory information disclosure, the honesty and integrity of

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[4] ibid

[5] Di Giorgio, G., Di Noia, C. (2001): Financial Regulation and Supervision in the Euro-Area: A Four-Peak Proposal, Wharton Working Paper Series, Wharton Financial Institutions Centre.

[6] Llewellyn, D. (1999): The Economic Rationale for Financial Regulation, FSA Occasional Paper Series Number 1 (www.fsa.gov.uk)

[7] ibid.

firms and their employees, the level of competence of firms supplying financial services and products, fair business practices, the way financial products are marketed, etc.[8] It can also establish guidelines for the objectivity of advice, with the aim of minimising those principal-agent problems that can arise when principals (those seeking advice) and agents either do not have equal access to information, or do not have equal expertise to assess it. Conduct of business regulation is designed to establish rules and guidelines about appropriate behaviour and business practices in dealing with customers.

3.3 Prudential regulations in Kenya

The Basel Committee issued the Basel I Accord in 1988 which assesses banks capital adequacy requirements in the context of the credit risk they face and advocates risk-based supervision. Basel I emphasized a set of minimum capital requirements for banks in order to address credit risk and in 2004, the Committee issued the Basel II Accord which contained further recommendations on banking laws and regulations by setting up rigorous risk and capital management requirements designed to ensure that a bank holds capital reserves appropriate to the risk the bank exposes itself to through its lending and investment practices. The Accord was to be implemented from 2007 by G10 countries, with more time given to developing countries, as they were yet to satisfy the prerequisites for the new accord. In December 2010, the Committee announced proposals dubbed Basel III which are currently being reviewed for regulatory and supervisory suitability to financial systems[9] which include the strengthening of capital adequacy and liquidity requirements as well as countercyclical macro prudential measures.

The CBK continues to regulate banks mainly based on Basel I but was in the process of formulating a policy position on Basel II implementation.[10] New guidelines that came into force in January 2013 contain some features of Basel II and Basel III on capital adequacy requirements.[11] Overall, Kenya has endeavoured to implement the Basel accords for ensuring financial stability of the country's financial sector. The Kenyan banking system has continued to record compliance with the minimum capital and liquidity prudential requirements. The prudential and financial stability indicators have shown that the financial sector is sound. All the banks have in the recent past met the four minimum capital

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[8] ibid.

[9] Kasekende L.A., Bagyenda J. and Brownbridge M. (2011), Basel III and the Global Reform of Financial Regulation: How Should Africa Respond? A Bank Regulator's Perspective. Available at *www.new-rules.org/storage/documents/g20fsb-imf/kasakende.docx*.

[10] KPMG 2012.

[11] Ochieng O. (2013), Banking Survey 2013. Think Business Ltd, Nairobi.

requirements and based on the unaudited financial statements for 2012, almost all banks had met the enhanced minimum core capital requirement of Ksh.1 billion, according to CBK.[12] This is however a minimum threshold and several banks already hold capital way above the minimum of Ksh.1 billion. The key determinant of capital for an institution is the needs of the market niche it serves.

One theory is that increased capital base is important for financial sector stability and may lead to cost reduction from economies of scale which may lead to lower lending rates. On the other hand, a further increase the capital requirement will only create more concentration, making the banking sector more oligopolistic. Gudmundsson et al.[13] conclude that capital regulation improves the competition, performance and financial stability of Kenyan banks.[14] Implementation of the CBK's capital requirements for banks to build their core capital can therefore be expected to enhance financial sector stability and lead to cost reduction from economies of scale and ultimately lowering lending rates.

CBK has focused more on micro-prudential regulation which relates to factors that affect the stability of individual banks and less so on macro-prudential regulation which relates to factors which affect the stability of the financial system as a whole. In the latter case, changes in the business cycles may influence the performance of banks, hence the Basel III proposal for countercyclical capital changes to provide the way forward for future macro-prudential regulation, which should take into account the growth of credit and leverage as well as the mismatch in the maturity of assets and liabilities. Murinde[15] however argues that review of macro-prudential regulations should encompass the broader aspects of financial services regulation, such as depositor protection or deposit insurance and the safety of the payments system which have received attention from CBK. The regulatory toolkit in Kenya has also

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[12] Interview with CBK Governor in Oloo (2013).

[13] Gundmundsson, Ragnar, Ngoka-Kisinguh K. and Odongo M.T (2013), The Role of Capital Requirements on Bank Competition and Stability: The Case of the Kenyan Banking Industry. KBA Working Paper WPD 05 12/2.

[14] They estimate the Lerner index and the Panzar and Rosse H-statistic as measures of competition and relate them to core capital. The panel estimates show the log of core capital is positive and significant while squared log of core capital is negative and significant. This implies that an increase in core capital reduces competition up to a point and then increases competition so that the benefits of increasing capital requirements on competitiveness are realized once consolidation in the banking sector takes place. They then use return on equity to capture bank performance and stability and the estimation results confirm a positive relationship supporting the evidence that capital regulation improves the performance of banks and financial stability.

[15] Murinde V (2012), Bank Regulation in Africa: From Basel I to Basel II, and Now at Crossroads. In Victor Murinde (Ed), *Bank Regulatory Reforms in Africa*. Palgrave MacMillan, 2012.

relied substantially on other variables such as structure of banking assets and liabilities such as restrictions on banks' large loan concentrations and foreign exchange exposure limits.[16] As well, according to KPMG, Kenya has a highly skilled workforce and the banking sector is able to secure banking staff with relevant training, and finance-related profession certification. In addition, the country has returning citizens with international professional experience to add to an already diverse talent pool. Capacity for implementing different regulations and supervision, such as lack of information and insufficient staff do not seem to be a major constraint. Among other regulatory issues, Kenya has increasingly moved into universal banking reflected in increasing share of net commissions and fees in the banks' total income. The country now has banks that own insurance companies, others have set up insurance agencies to push forward their concept of bank-assurance; while others own stock brokerage firms. Hence there have been increased synergies between the banking, insurance and securities sectors with removal of regulatory barriers between the different segments of the financial sector. This poses regulatory challenges as different financial sector entities are subject to different regulatory regimes. Given the convergence and consolidation of the financial services, some players have called for the established of an overall services regulatory authority, as in UK.[17]

According to the Central Bank, the convergence of financial services is a global phenomenon, with among its key drivers being the customer demands for a "one stop financial services super markets" and competition. This poses regulatory challenges as different financial sector entities are subject to different regulatory regimes. The Central Bank has adopted a consolidated supervision approach, which requires information sharing and coordination amongst the various regulators in the financial sector. This is consistent with Spratt[18] who advocates for a unified approach to supervision, with the central bank playing a dominant role; and a comprehensive approach that should utilize the already wider 'tool-kit' available to regulators.

3.4 Structure of Regulation in Kenya

The financial services sector in Kenya comprises of different sub-sectors which include banks, insurance companies, securities markets, pension schemes and savings and credit cooperative societies

[16] Kasekende L.A., Bagyenda J. and Brownbridge M. (2011), Basel III and the Global Reform of Financial Regulation: How Should Africa Respond? A Bank Regulator's Perspective. Available at *www.new-rules.org/storage/documents/g20fsb-imf/kasakende.docx*.

[17] Mutuku K (2008), Presidential Task Force on Parastatal Reforms in Kenya 2013.

[18] Spratt, S (2013), Financial Regulation in Low-Income Countries: Balancing Growth with Stability. Part 1 and 2. Unpublished.

(SACCOs) among others.[19] These sub-sectors are regulated by different statutory bodies which include the Insurance Regulatory Authority,[20] Retirement Benefits Authority,[21] Capital Markets Authority[22] and Sacco Societies Regulatory Authority.[23] The Central Bank of Kenya[24] regulates banks and micro finance institutions. This existing model involves several regulators exercising jurisdiction over different sub-sectors and each regulator is established under its own legislation.[25] This regulatory framework fails to effectively address the challenges and emerging trends,[26] which continue to create fierce competition among the players in the sector.[27] A sound regulatory framework which ensures effective prudential and risk based regulation is thus necessary and such regulation should be one that guarantees consumer protection, in addition to ensuring fair and equitable competition. The current regulatory framework is thus inadequate and displays evidence of conflict and duplication of legislation, among other challenges as well as emerging trends in the sector.[28]

Kenya's Financial Markets have historically been segmented along sectoral lines. Thus there has been a Banking Sector, an Insurance Sector and more recently, the Capital markets and the Retirement Benefits Sector.[29] Other financial market sectors which however play a relatively minor role in the formal sector are building societies and micro-finance institutions. The regulatory structure of the Kenyan financial markets flows from the aforesaid sectoral division. Thus each sector has its own specialized regulator and legislation governing it. The banking sector is regulated by the Central Bank and the governing legislation is the Banking Act, Cap 488 of the Laws of Kenya. The insurance sector is regulated by the Commissioner of Insurance and the governing legislation is the Insurance Act Cap

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[19] Gichuki N *Law of Financial Institutions in Kenya* (2nd edn Law Africa Publishing Limited 2013)

[20] Insurance Act Chapter 487 Laws of Kenya.

[21] Retirement Benefits Act Chapter 197 Laws of Kenya.

[22] Capital Markets Act Chapter 485A Laws of Kenya.

[23] Sacco Societies Act No. 14 2008.

[24] Central Bank of Kenya Act Chapter 491 Laws of Kenya.

[25] Gakeri J, Financial Services Regulatory Modernization in East Africa: The Search for a New Paradigm Shift" (2011) vol 1(16) *International Journal of Humanities and Social Science.*

[26] National Consumer Council, *Models of Self-regulation: An overview of models in Business and the Professions* <http://www.talkingcure.co.uk/articles/ncc_models_self_regulation.pdf.> accessed 10 June 2019.

[27] Lawrence A Cunningham and David Zaring, „The Three or Four Approaches to Financial Regulation: A Cautionary Analysis against Exuberance in Crisis", *George Washington Law Review,* vol 78 (1) (2009).

[28] Mutuku N, *Case for Consolidated Financial Sector Regulation in Kenya* (Retirement Benefits Authority 2008) http://ssrn.com/abstract=1837354> accessed 10 June 2019.

[29] Gakeri J, Financial Services Regulatory Modernization in East Africa: The Search for a New Paradigm Shift" (2011) vol 1(16) *International Journal of Humanities and Social Science.*

487. The securities sector is regulated by the Capital Markets Authority and the governing legislation is the Capital Markets Act, Cap 485A. The pensions sector is regulated by the Retirement Benefits Authority and the governing legislation is the Retirement Benefits Act, Act No. 3 of 1997.

There have been recommendations for the consolidation of regulatory agencies in the financial services sector, to be governed by a unified regulator in Kenya. Despite this proposal for consolidation, a clear framework is yet to be established by the Ministry of Finance on how the same will be actualized. In addition, the proposed unified regulator will not be an end to itself as there are other determinant factors which must be considered in order to achieve an effective and globally competitive financial sector regulation.[30] Whereas most scholars agree that regulation is important to adequately manage the affairs of the financial services sector, the most effective model and approach to regulation remains an issue for consideration.[31] In Kenya, the single regulator proposed by the Taskforce for Parastatal Reforms is one that aims to address the duplication, conflicting provisions, different founding legislation, and sometimes serious omissions that are experienced due to the inadequacy of the law to capture emerging trends.[32]

3.4.1 The Banking Sector

The Banking Sector operates under the ambit of the Banking Act[33] and the Central Bank of Kenya Act.[34] The Central Bank of Kenya is the principal regulator in the banking sector. It is the Central Bank which is mandated to regulate and supervise banks and financial institutions and mortgage finance companies and generally ensure that they comply with the provisions of the Banking Act. The Ministry of Finance also plays a principal role in the regulation of the banking sector. In fact many of the functions exercised by the Central Bank over the banking sector are merely to facilitate the exercise of ultimate responsibility by the Ministry of Finance. An example of this is in the licensing of banks where responsibility for issuing banking licenses lies with the Ministry of Finance with the Central Bank only vetting applications and forwarding them to the Minister with its recommendations. The Banking Act empowers the Central Bank to issue guidelines to banks and other financial institutions

[30] ibid.
[31] National Consumer Council, *Models of Self-regulation: An overview of models in Business and the Professions* <http://www.talkingcure.co.uk/articles/ncc_models_self_regulation.pdf.> accessed 10 June 2019.

[32] ibid.
[33] Chapter 488 of the Laws of Kenya.
[34] Chapter 491 of the Laws of Kenya.

on specific matters.[35] The Act also gives the Central Bank discretionary powers in the aforesaid issues provided in the Act. The Central Bank of Kenya itself is established under the Central

Bank of Kenya Act.[36] Section 4 of this Act provides for the principal object of the Central Bank which will be to formulate and implement monetary policy directed to achieving and maintaining stability in the general level of prices.[37] Further, the Bank shall foster the liquidity, solvency and proper functioning of a stable market based financial system. Section 3 (1) provides that the bank shall exercise any type of central banking function unless specifically excluded under this Act and shall enjoy all the prerogatives of a central bank. Indeed the Act, in section 4A, goes on to state the other objects of the bank which include formulating and implementing foreign exchange policy, holding and managing its foreign exchange reserves, licensing and supervising authorized dealers, promoting the smooth operation of payments, clearing and settlements schemes, acting as banker and adviser to, and as fiscal agent of the Government and issuing currency notes and coins.[38]

3.4.2 Insurance Sector

The main regulator of the insurance sector is the Commissioner of Insurance which is an office created by Section 3 (1) of the Insurance Act.[39] The Commissioner of Insurance is appointed by the Minister of Finance and it is not an independent institution but is an Office within the Ministry of Finance. The duties of the Commissioner are stated in Section 5 of the Act and include the formulation and enforcement of standards in the conduct of the business of insurance with which a member of the insurance industry must comply, directing insurers and reinsurers on the standardization of contracts of compulsory insurance, directing an insurer or a reinsurer, where he is satisfied that the wording of a particular contract of insurance issued by the insurer or reinsurer is obscure or contains ambiguous term or terms and conditions which are unfair or oppressive to the policy holders, to clarify, simplify, amend or delete the wording, terms or conditions as the case may be, in respect of future contracts, the approval of tariffs and rates of insurance in respect of any class or classes of insurance and such other duties as the Minister may assign to him. The Insurance Act and the regulations made there under are very comprehensive and go to minute details of the operations of members of the insurance industry. Not only are the institutions regulated, but prescriptions are given for the product as well. This is in contrast with the Banking Act, which only regulates the players, not the product offered.

[35] Chapter 488 of the Laws of Kenya.
[36] Chapter 491 of the Laws of Kenya.
[37] ibid.
[38] ibid.
[39] Cap 487 of the Laws of Kenya.

3.4.3 The Capital Markets

The principal regulatory authority of the capital markets is the Capital Markets Authority which is established under section 5 of the Capital Markets Act. The Authority is a body corporate with perpetual succession and common seal. The objectives of the authority are stated in section 11 of the Act as being the development of all aspects of the capital markets with particular emphasis on the removal of impediments to, and the creation of incentives for longer-term investments in productive activities, to facilitate the existence of a nationwide system of stock market and brokerage services so as to enable participation of the general public in the stock market, the creation, maintenance and regulation, of a market in which securities can be issued and traded in an orderly, fair and efficient manner, through the implementation of a system in which the market participants are self-regulatory to the maximum practicable extent, the protection of investor interests, the operation of a compensation fund to protect investors from financial loss arising from the failure of a licensed broker or dealer to meet his contractual obligations, the development of a framework to facilitate the use of electronic commerce for the development of capital markets in Kenya.[40] Section 11 (3) of the Act lists the powers, duties and functions of the authority to enable it carry out its objectives, and section 12 of the Act empowers the Authority to issue rules, regulations and guidelines.

3.4.4 Retirement Benefits Sector

The Retirement Benefits sector is governed by the Retirement Benefits Act.[41] The principal regulatory body in this sector is the Retirement Benefits Authority (RBA). The RBA is established under section 3 of the Act. It is a body corporate with perpetual succession and a common seal. The objectives and functions of the RBA are given in section 5 of the Act. These are to regulate and supervise the establishment and management of Retirements Benefits Schemes, protect the interests of members and sponsors of retirement benefits sector, promote the development of the retirement benefits sector, advise the Minister on the national policy to be followed with regard to retirement benefits schemes and to implement all Government policies relating thereto and to perform such other functions as are conferred on it by the Act or any other written law. What clearly stands out in the different pieces of legislation governing the respective sectors of the financial services industry is that there is a similarity in the types of regulation imposed by the governing legislation in each sector. Thus, there is entry and licensing regulation, prudential regulation, including minimum capital requirements, reporting

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[40] National Consumer Council, *Models of Self-regulation: An overview of models in Business and the Professions* <http://www.talkingcure.co.uk/articles/ncc_models_self_regulation.pdf.> accessed 10 June 2019.

[41] Act No 3 of 1997.

obligations and conduct of business, and deposit/policyholder/investor protection regulations and liquidation regulations.[42]

3.5 Rationale for regulation

In the financial sector, an additional motivation for regulation is maintaining financial stability, which is a clear public good. Financial sector supervision thus requires a more elaborate framework and tends to be more rigorous and intensive than is the case in other sectors.[43] The specific manner in which an international, regional, national, or market sector regulatory authority regulates depends on a variety of factors.[44] Though there is admittedly no unified theory of financial services regulation, some of the broad objectives for regulation include protecting investors to help build their confidence in the market, ensuring that the markets are fair, efficient, and transparent, reducing systemic risk, protecting financial services from malpractice by some consumers such as money laundering and maintaining consumer confidence in the financial system.[45] Invariably, the structure and objectives supporting the regulatory framework differ from one jurisdiction to another. One key objective of regulation is to redress the information imbalance that sometimes exists between consumers and financial services. This is usually done by imposing upon financial services entities the minimum standards of business conduct. Moreover, the fairness of the financial markets depends in part on the degree of consumer protection. Overall, regulation attempts to strike a balance of protecting the markets, without stifling legitimate business. This may be achieved through preventing business failures by imposing capital and internal control requirements, such as ensuring that entities have sufficient liquidity to meet their obligations.[46]

3.6 Types of financial services regulation and supervision

Types of financial supervision include functional regulation, institutional or regulation by silos, twin peaks regulation and single or unified regulation. Before designing any framework, a country must understand the role of the proposed regulator, the size and structure of the sector and the economic,

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[42] National Consumer Council, *Models of Self-regulation: An overview of models in Business and the Professions* <http://www.talkingcure.co.uk/articles/ncc_models_self_regulation.pdf.> accessed 10 June 2019.

[43] Mutuku N, *Case for Consolidated Financial Sector Regulation in Kenya* (Retirement Benefits Authority 2008) http://ssrn.com/abstract=1837354> accessed 10 June 2019.

[44] International Compliance Association, *International Diploma in Compliance Manual* 1 (International Compliance Association 2003).

[45] Regulators may fulfil the following functions: lay down rules or principles that determine who can conduct a financial services business, authorize financial services businesses to operate. Supervise compliance with the rules through supervision and onsite inspections. Investigate suspected breaches of the rules, sometimes in conjunction with other law enforcement bodies. Cooperate and exchange information with other regulators. In some jurisdictions with less developed regulatory regimes, regulators have been given a business development role.

[46] Quintyn, M. and Michael W Taylor, *Should Financial Sector Regulators be Independent?* (IMF Economic Issues, 2004) http://www.imf.org/external/pubs/ft/issues/issues32/#1 accessed 28 June 2019.

political, legal and historic considerations. The choice of regulatory framework should be one that will be effective and efficient which lays down rules or principles of conduct of financial services, as well as ensuring that there are high levels of compliance and supervision in the sector.[47]

3.6.1 Institutional approach to regulation

This is where an organization's legal status determines the regulator which is tasked to oversee its activities from both a safety and soundness and a business conduct perspective. This approach suffers from potential inconsistency in the application of rules and regulations by disparate regulators. It also has challenges associated with inter agency coordination, which may include duplicity of regulation. Because the same or economically similar activity may be conducted by entities that are legally authorized and overseen as banks, insurance companies, or securities firms, the separate institutional regulators may regulate the activity differently taking the form of different capital treatment or consumer protection. The institutional approach is limited from not having a single regulator with an all-round overview of a regulated entity's business or of the market as a whole and also suffers from not having a single regulator that can mandate actions designed to mitigate systemic risk.[48]

3.6.2 Functional approach to regulation

In Functional approach to regulation, the supervisory oversight is determined by the business that is being transacted by the entity, without regard to its legal status and each type of business in an organization may have its own functional regulator. This approach to supervision appears to work well, so long as coordination among agencies is achieved and maintained. Its benefit is that, a single, technically expert regulator will apply consistent rules to the same activity regardless of the entity in which it is conducted hence regulatory arbitrage is avoided under this approach. The regulator is able to attract and retain highly qualified experts who can interpret and apply applicable rules to the same functions across different legal entities. As a challenge is that it can be extremely difficult to distinguish which activity comes within the jurisdiction of a particular regulator because when regulators expand the scope of permissible activities of the entities, there is a general reluctance to cede to another agency's authority. Another disadvantage is that it forces financial institutions to deal with multiple regulators, which is often more costly in terms of time and effort. There is a tendency for multiple regulators to duplicate efforts to some degree.

[47] ibid.

[48] Madise S, Rationale of Regulating the Financial Services, Models of Regulation and Need for Regulator Independence (2014)*MalawiLawJournal*http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2538437> accessed 20 July 2019.

In rare instances, supervisors may take disparate regulatory positions relative to the same activity, putting the regulated institution in an untenable situation. Multiple regulatory agencies also expend much time and effort coordinating and communicating among themselves. There is also no regulator which has sufficient information concerning all the activities of the entities to enable them monitor for systemic risk and addressing systemic risk may also require having a single regulator with authority to mandate actions across the entire financial system hence no functional regulator may be in a position to fulfil that role.[49]

3.6.3 Integrated approach to regulation

In this approach, a single regulator conducts both safety and soundness oversight and conduct of business regulation for all the sectors of financial services. It can be effective and efficient in smaller markets, where oversight of the broad spectrum of financial services can be successfully conducted by one regulator. It has also been adopted in larger, complex markets where it is viewed as a flexible and streamlined approach to regulation.[50] The advantage of this approach is that it provides a unified focus to regulation and supervision without confusion or conflict over jurisdictional lines which leads to higher quality regulatory outcomes. The challenges of coordination among supervisors under turbulence appear to be evident even under this approach. This model also provides a more comprehensive, panoramic view of the regulated entity's business where the regulator can test for compliance with regulatory requirements and also review business issues, management quality, risk management, and control issues on a prudential basis.[51]

Oversight of financial institutions that are involved in multiple business lines can be vastly simplified and presumably more efficient and cost effective with a single regulator. This is due to the consistent application of rules leading to fewer jurisdictional disputes between regulators. If an integrated regulator fails to identify an issue, there is not another agency to potentially fill the void. Defenders of fragmented regulation additionally maintain that overlapping jurisdiction potentially may increase the likelihood of a supervisor recognizing a problem or issue, due to lack of checks and balances. Thus, communication among various functional divisions of a large, unified regulator is as important and may be as challenging as it would be across separate organizations. This model lacks regulatory competition among regulators to ensure that they are challenged to outperform their competitors and

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[49] ibid

[50] ibid

[51] Mwenda K, *Legal Aspects of Financial Services Regulation and the Concept of a Unified Regulator* (The World Bank 2006).

there is no certainty that the opposite will not occur, where there will be a race to the bottom as regulators compete to be in the favour of the firms they oversee.

3.6.4 Twin Peaks approach to regulation

In this approach there is a separation of regulatory functions between two regulators where one performs the safety and soundness supervision function and the other, focuses on conduct of business regulation. It is designed to garner many of the benefits and efficiencies of the integrated approach and at the same time, it also focuses on addressing the inherent conflicts that may arise from time to time between the objectives of safety and soundness regulation and consumer protection and transparency.[52] Where the two objectives of regulation are divided among separate regulators, tensions may remain, especially when prudential and systemic stability concerns are seen to override consumer protection issues in the case of institutional failures. Such decisions concerning which goals take precedence are ultimately subjective, based on the institutional positions of the respective actors and regulatory agencies. This is the optimal means of ensuring that issues of transparency, market integrity, and consumer protection receive sufficient priority and is designed to ensure that consumer protection principles apply uniformly across all financial products, regardless of the legal status of the entity.[53]

3.7 The concept of a unified regulator

In many countries, the unified regulator is structured on either a functional or an institutional model, depending on local conditions and the objectives of regulation. Many countries which adopt this framework continue to grapple with how to structure its institutional and regulatory framework. Several commentators have advanced arguments for a unified model. The arguments relate to such factors as the economies of scale, increased efficiency in allocation of regulatory resources across both regulated firms and types of regulated activities, the ease with which the unified regulator can resolve efficiently and effectively the conflicts that inevitably emerge between the different objectives of regulation, the avoidance of unjustifiable differences in supervisory approaches and the competitive inequalities imposed on regulated firms when multiple specialist regulators have inconsistent rules and, where a unified regulator is given a clear set of responsibilities, the possibility of increased supervisory transparency and accountability.[54]

[52] ibid.

[53] ibid

[54] Briault C, The Rationale for a Single National Financial Services Regulator" *Occasional Paper Series* No. 2 (Financial Services Authority 1999). See also Briault C, A Single Regulator for the UK Financial Services Industry' *Financial Stability Review* (1998).

Some of the benefits of a unified regulator include first, the harmonization, consolidation, and rationalization of the principles, rules, and guidance issued by existing regulators or embedded within existing legislation. Second, a single process for the authorization of firms and for the approval of some of their employees, using standard processes and a single database. Third, a more consistent and coherent approach to risk based supervision across the financial services sector, enabling supervisory resources and the burdens placed on regulated firms to be allocated more effectively and efficiently on the basis of the risks facing consumers of financial services. Fourth, a more consistent and coherent approach to enforcement and discipline, while recognizing the need for appropriate differentiation. Some of the preconditions for establishing a unified regulator include sound and sustainable macroeconomic policies, the necessary political will among stakeholders, cooperation and sharing of information among financial services regulators as a country moves toward a single unified regulator and skilled human capital to support establishment and operation of the unified regulator, financial resources to support establishment and operation of the unified regulator.[55]

The shortcomings of the model include first, the possibility that a unified regulator may erode traditional functional distinctions between financial institutions and that it may not have a clear focus on the objectives and rationale of regulation. Second, there is also a fear that a unified regulator could lead to cultural conflict within the agency when regulators come from different sectors. Third, setting up a unified regulator may create an overly bureaucratic agency that has excessively concentrated power. Here, even the merits of economies of scale would be watered down where the unified regulator is seen as supervising almost everything under the sun and thus becoming monopolistic. Such effect may lead to inefficiencies, such as bureaucracy and possibly corruption if the regulatory and institutional framework does not provide for effective checks and balances. Fourth, a consolidated regulatory framework gives a false impression that all financial instruments have similar risks. For instance, when banks and securities are regulated by the same regulator consumers may fail to differentiate the very different risks in these two markets. Similarly, all institutions licensed by the regulator may be assumed by the public to be receiving equal protection.[56]

3.8 The concept Regulatory Independence

A regulator should be operationally independent and accountable. Independence must be looked at from four related angles which include regulatory, supervisory, institutional and budgetary

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[55] ibid

[56] Mutuku N, *Case for Consolidated Financial Sector Regulation in Kenya* (Retirement Benefits Authority 2008) http://ssrn.com/abstract=1837354> accessed 10th August 2019

independence. Regulatory independence implies that the regulator has wide autonomy in setting at a minimum, prudential rules and regulations that follow from the special nature of financial intermediation. These rules and regulations concern the practices that financial institutions must adopt to maintain their safety and stability. Regulators who are able to set these rules independently are more likely to enforce them and are also able to adapt the rules quickly and flexibly in response to changing conditions in the marketplace without having to go through a lengthy, high pressure political process.[57] Supervisory independence denotes that the supervisory agency has independence to supervise the financial sector without undue influences. Whilst supervisory independence is crucial in the financial sector it is also difficult to establish and guarantee the same because supervisors work quite closely with financial institutions, not only in inspecting and monitoring them but also enforcing sanctions and revoking licences. Much of their activity takes place outside public view, and interference with their work, either by politicians or by the industry can be subtle, and can take many forms. Steps to protect integrity include indemnifying supervisors from being personally liable and providing financial incentives that allow supervisory agencies to attract and keep competent staff.[58]

Institutional independence concerns the agency's status outside the executive and legislative branches of government and has three critical elements. First, senior personnel should enjoy security of tenure. Additionally, clear guidelines must be employed to govern their appointment and dismissal. Secondly the regulator's governance structure should consist of multi-member commissions composed of experts and thirdly decision making should be open and transparent to the extent that is consistent with commercial confidentiality, whilst enabling both the public and the industry to scrutinize regulatory decisions. Budgetary independence relates to the regulator not being subjected to political pressure through its budgetary needs. In any case if funding comes from the state, it should be proposed and justified by the regulator following an objective market based criteria. Some regulators are funded through industry fees, a practice that minimizes political interference but risks dependence on and attracting interference from the industry. Regulators should therefore be allowed to build up reserve funds as insurance. Although an independent regulator may not avoid a financial crisis from occurring, what is clear is that an independent regulator has more chance of managing a crisis than one which is not independent.[59]

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[57] ibid.

[58] Mwenda K, Legal Aspects of Unified Financial Services Supervision in Germany‟ vol 4 (10) 1009 *German Law Journal*.

[59] ibid

Political pressures not only weakens financial regulation generally, but also hinders regulators and supervisors who enforce the regulations from action. History has shown that in nearly every major financial crisis, political interference was a catalyst. It is now increasingly recognized that political meddling has consistently caused or worsened financial instability. Thus, there is a shift by policymakers and policy analysts to shield financial sector regulators from political pressure to improve the quality of regulation and supervision with the ultimate goal of preventing financial crises.[60] Most effective regulatory bodies, have clear responsibilities and objectives, adequate powers and resources, and also exhibit transparency and accountability.[61] Generally, the responsibilities and objectives of such a body depend in part on the regulatory model in place and the role the regulator which has been established. To facilitate effective application of regulatory powers, the law should provide the regulator with protection against any liability that may arise from the proper discharge of its powers which gives them an incentive to perform diligently, competently, independently, and professionally.[62] Lack of resources can compromise a regulator's independence if the regulator is heavily reliant on the State to fund its operations. In many jurisdictions therefore, the regulators are funded by the entities being regulated.[63] Another area where some regulators face resource constraints relates to an inability to hire experts to perform certain supervisory tasks. Equally important as the human resource constraint is the lack of suitable infrastructure and technology to process information in a timely and reliable manner. Again, many regulatory agencies in developing countries and emerging economies are confronted by this problem.[64]

3.9 The Current Regulatory Framework in Kenya

Kenya currently employs both the institutional and functional regulatory frameworks. This model is such that each of the intermediaries in the sector is regulated by a different authority, agency or body.[65] For instance, Insurance Regulatory Authority regulates the insurance sub-sector, Central Bank of Kenya regulates the banking sub-sector, Capital Markets Authority regulates the securities markets and

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[60] Goodhart C and Schoenmaker D, Should the Functions of Monetary Policy and Banking Supervision be separated? " *Oxford Economic Papers* (47) 539.

[61] Quintyn M and Michael W Taylor, *Should Financial Sector Regulators be Independent?* (IMF Economic Issues, 2004) http://www.imf.org/external/pubs/ft/issues/issues32/#1 accessed 28 June 2019.

[62] Ibid.

[63] Goodhart C and Schoenmaker D, Should the Functions of Monetary Policy and Banking Supervision be separated? *Oxford Economic Papers* (47) 539.

[64] ibid.

[65] Group of Thirty, *The Structure of Financial Supervision: Approaches and Challenges in a Global Market Place*, (Washington DC 2008)

the Sacco Societies Regulatory Authority regulates the Sacco's and societies sub-sector.[66] Under this structure, each sub-sector is regulated by a different regulatory entity, and in some cases one subsector may have more than one regulatory body exercising supervisory oversight over its activities.[67] An example would be where a company is registered under the Companies Act[68] and licensed to operate under the Insurance Act. Such a company is subject to regulation by the Insurance Regulatory Authority. Further, if the company was to be listed publicly then it would further be regulated by the Capital Markets Authority.[69] This existing regulatory model is affected by several challenges some of which include subjective interpretation, leading to lack of compliance and poor governance, duplication of regulations, insufficient regulation to adequately cater for all the businesses and services offered by the sector and questions of independence of the different regulatory bodies among others.[70]

Globally, the financial services sector continues to evolve and different emerging trends are now being witnessed.[71] Some of these trends include cross selling of products across the different industries such as bank assurance where banks are now mandated to offer insurance services on behalf of insurance companies.[72] Others are technological advancements such as online and mobile banking services, new distribution services, such as digital currencies, mergers and acquisition activity as well as increased competition such as the recent introduction of Mobile Virtual Network Operators (MVNO‟s).[73] Some of these emerging trends do not even have clear regulatory framework to govern their operations. This fragmented model has developed over time and with the growth in the financial services sector in Kenya, there have been calls for reform. These challenges and emerging trends encapsulated above continues to exhibit inefficiencies, complexities, confusion and cost ineffectiveness which ultimately affect the economic development of the country. The functional or institutional model therefore remains inadequate to address the issues already highlighted. The Presidential Task Force for Parastatal

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[66] Gichuki N, *Law of Financial Institutions in Kenya* (2nd edn Law Africa Publishing Limited 2013)
[67] ibid.

[68] Companies Act No 17 of 2015.
[69] National Consumer Council, *Models of Self-regulation: An overview of models in Business and the Professions* <http://www.talkingcure.co.uk/articles/ncc_models_self_regulation.pdf.> accessed 10 June 2019.

[70] Mutuku N, *Case for Consolidated Financial Sector Regulation in Kenya* (Retirement Benefits Authority 2008) http://ssrn.com/abstract=1837354> accessed 10 June 2019.

[71] Afonso N and Costa L, *Market Power and Fiscal Policy in OECD Countries*, (Working Papers 2011, Technical University of Lisbon 2011).
[72] Gakeri J, Financial Services Regulatory Modernization in East Africa: The Search for a New Paradigm Shift‟ (2011) vol 1(16) *International Journal of Humanities and Social Science.*
[73] *Weddi D, Kenya: Virtual Currency Bitcoin, Bitpesa Rejected in Kenya* <http://allafrica.com/stories/201512220946.html> accessed 3rd July 2019.

Reforms, as well as other stakeholders, has continually made recommendations for the adoption of the unified financial services regulator.[74]

3.10 Conclusion

Effective regulation of financial services minimizes systemic risks and other market related shortcomings, which may lead to financial crisis. Many countries have thus adopted a model of regulation, which may suit their circumstances. However so, it must be noted that there is no optimal model of regulation and each has its own strengths and shortcomings. Many countries are now moving towards the unified regulatory framework which is not the most optimal. This confirms that regulation is ever evolving and what suits a country today may not be the same case in the future. Further, the unified model has also several complexities which may affect the integration process.[75] The financial services sector in Kenya is exceedingly small, lacks sophisticated financial investment products and is also not significantly globalized. In addition, the major financial crises that have affected the world markets, thus calling for review of national regulatory frameworks, has not affected Kenya.[76]

[74] Republic of Kenya, *Report of the Presidential Taskforce on Parastatal Reforms* Presented to His Excellency Hon Uhuru Kenyatta CGH President and Commander in Chief of the Defence Forces of the Republic of Kenya (Nairobi 2013).

[75] ibid.

[76] Gakeri J, Financial Services Regulatory Modernization in East Africa: The Search for a New Paradigm Shift (2011) vol 1(16) *International Journal of Humanities and Social Science.*

CHAPTER FOUR

CONTEXTUALIZING KENYA'S EXISTING REGULATORY FRAMEWORK VIS-À-VIS OTHER JURISDICTIONS

4.0 Introduction

The diversity of financial systems, as well as other factors like history and governmental institutions, regulatory structures vary widely. In some of the countries that will be examined in this study the revealed preference is for a regulatory structure based on specialist agencies, with the banking, insurance and securities sectors each supervised by a dedicated agency."[1] A group of recent studies has considered the issue of whether a single supervisory authority is to be preferred to multiple supervisory authorities although the literature relies primarily on theory or logical argument and does not provide much empirical evidence.[2] This chapter analyses the existing regulatory framework in the financial services sector. It also examines the challenges and emerging trends in the sector, which have necessitated calls for reform in the regulatory framework. The chapter analyses case studies of the frameworks in the United Kingdom and South Africa, with a view to making comparisons with Kenya's proposed unified regulator. The insights obtained from the analysis then leads to the conclusion and recommendations for the most viable regulatory framework for the financial services in Kenya. The chapter also looks at some of the practical challenges that these countries have experienced in their consolidated framework.

4.1 The United Kingdom

In UK, an integrated system was adopted in the 1990s whereby the Financial Services Authority (FSA) became responsible for regulating all financial services. It merged the Securities and Investment Board and also took over the supervisory responsibilities of the Bank of England, to adopt the unified regulatory framework. The then existing arrangements of financial regulation involved a large number of regulators, each responsible for different parts of the industry and a glowing blurring of the distinctions between different kinds of financial services made financial services regulation complex, inefficient and very costly. The FSA worked with the Bank of England and Treasury upon notification and the responsibilities were thus divided among the three regulators where the treasury was responsible for overall institutional structure of regulation and the governing legislation. The Bank of

[1] Abrams, R.K. & Taylor M.W. (2000): Issues in the Unification of Financial Sector Supervision, IMF Working Paper, December, 2000, International Monetary Fund.

[2] Barth, J. R., Dopico L.G., Nolle, D.E., & Wilcox, J.A. (2001):An International Comparison and Assessment of the Structure of Bank Supervision, A Paper presented at the Conference "The Future of Financial Regulation in Taiwan" Taipei, Taiwan, July 6, 2001.

England on the other hand was responsible for overall stability of the financial system including the stability of the monetary system; financial infrastructure as well as for being able in exceptional circumstances subject to the agreement of the Treasury to undertake official financial support operations; efficiency and effectiveness of the financial sector. FSA was responsible for authorization and supervision of financial services firms; supervision of financial markets and of clearing and settlement systems; conduct of market based support operations and the development of regulatory policy in all of these areas.[3]

The Bank of England and Treasury came to the rescue of failing financial institutions during the 20072009 global financial crises, thereby prompting the biggest shake up since the formation of the FSA which saw the abolition of the existing tripartite regime between the FSA, Bank of England and Treasury. This eventually led to the amendment of the structure of FSA where prudential regulation was hived off to the newly created prudential regulator, the Prudential Regulatory Authority (PRA), operating as a subsidiary of the Bank of England. The PRA's function was to carry out prudential regulation of financial firms, including banks, investment banks, building societies and insurers. The Financial Conduct Authority was also created to regulate the conduct of every authorized financial firm providing services to consumers which led to the creation of the current twin peaks regulatory framework which separates the prudential and conduct regulation components.[4]

In July 2010, in response to the financial crisis, the government published a consultation document[5] outlining proposals to overhaul the UK financial regulatory system in favour of more specialised and focused regulators. The consultation document identified a number of problems with the existing regime which include the following:

- The Financial Services Authority (FSA) had too broad a remit and insufficient focus to identify and tackle issues early.
- The Bank of England (BoE) did not have the tools or levers to fulfil its responsibility for ensuring financial stability.

[3] Briault, C. (1999): The Rationale for a Single National Financial Services Regulator, FSA Occasional Paper Series Number 2 (www.fsa.gov.uk).

[4] ibid.

[5] A new approach to financial regulation: judgement, focus and stability, 26 July 2010.

- HM Treasury (the Treasury) had responsibility for maintaining the institutional framework but no clear responsibility for dealing with a crisis which put public funds at risk.

- No single institution had the responsibility or authority to monitor the system as a whole, to identify risks to financial stability and act decisively to tackle them.

Following the consultation, a White Paper was published in June 2011,[6] including a draft Financial Services Bill, which came into force as the Financial Services Act 2012 (FS Act) on 1 April 2013. The FS Act implements a new regulatory framework for financial services in the UK. It is primarily concerned with the institutions that oversee the industry, rather than with the subject-matter of the rules and regulations for which those institutions are responsible. Changes introduced by the FS Act include separating the prudential and conduct regulation of banking operations. Both forms of regulation were previously carried out by the FSA. From 1 April 2013, prudential regulation of banking operations has been carried out by the Prudential Regulation Authority (PRA), which was established by the FS Act, and conduct regulation by the Financial Conduct Authority (FCA), which replaces the FSA. In addition to the changes to the regulatory framework brought about by the FS Act, the Financial Services (Banking Reform) Act 2013 (FSBRA) enacted a number of further reforms related to the UK's banking sector. In particular, FSBRA gave the Treasury and the relevant regulators, primarily the PRA, powers to implement some of the recommendations made by the Independent Commission on Banking[7] (ICB), in particular, the ICB's recommendations for ring-fencing requirements for banks. It also provided for the establishment of the Payment Systems Regulator (PSR). The Bank of England is the central bank of the UK. Its stated mission is to ‘promote the good of the people of the UK by maintaining monetary and financial stability’. The FS Act brought about a major expansion of the BoE’s main responsibilities, which are now clearly defined by Parliament. The FS Act established both the FPC and the PRA, and gave each of these bodies new responsibilities for the supervision of financial institutions. The BoE also plays a role in the regulation of payment systems.

[6] A new approach to financial regulation: the blueprint for reform.

[7] The Independent Commission on Banking was a UK government inquiry looking at possible reforms to the banking industry in the wake of the financial crisis of 2007-08. It was established in June 2010 and published its final report and recommendations in September 2011. It was chaired by Sir John Vickers. Its headline recommendation was that banks should 'ring-fence' their retail banking divisions from their investment banking arms, to safeguard against riskier banking activities, The UK government announced the same day that it would introduce legislation to implement the recommendations.

The United Kingdom's financial system has thus had a great influence on the models of unified regulation that have been adopted by many countries.[8] Even though the current regulatory framework in the United Kingdom is twin peaks, it had initially created the unified approach for regulating the sector.[9] The Financial Services Authority as the regulator is created under the Financial Services and Markets Act, 2012.[10] It combines both prudential conduct of business and market conduct regulation across the financial services sector.[11] The United Kingdom prior to the introduction of the Financial Services Authority lacked transparency and adequate accountability, partly because it was so fragmented.[12] The Financial Services Authority is divided into the Financial Conduct Authority and the Prudential Regulation Authority. The aim of the Financial Conduct Authority was to protect consumers and to ensure that the sector remains stable and to promote healthy competition between financial services providers.

The Financial Conduct Authority was previously known as the Financial Services Authority and was required to act in a manner that is compatible with its strategic objective and advance one or more of its operational objectives. It did this in a manner that enables it discharge its general functions and in a way which promotes effective competition in the interests of consumers. The Financial Conduct Authority has three major objectives in regulation that include the consumer protection objective where it is meant to secure an appropriate degree of protection for consumers.[13] Another objective is integrity which aims at protecting and enhancing the integrity of the United Kingdom financial system. Integrity in this case includes soundness, stability and resilience, not being used for a purpose connected with financial crime, not being subject to market abuse, the orderly operation of the financial markets, and the transparency of the price formation process in those markets.[14] The competition objective requires

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[8] Briault Clive, Revisiting the Rationale for a Single National Financial Services Regulator" (2002) *FSA Occasional Paper in Financial Regulation* http://www.fsa.gov.uk> accessed 23 August 2019.

[9] Michael W. Taylor, „The Road from Twin Peaks and the Way Back" (2009) vol 16 (1) *Connecticut Insurance Law Journal.62.*

[10] http://www.legislation.gov.uk/ukpga/2012/21/part/2/crossheading/financial-conduct-authority-and-prudentialregulation-authority/enacted accessed 17 August 2019.

[11] ibid

[12] Ferran E and Charles A E Goodhart, *Regulating Financial Services and Markets in the Twenty First Century* (Hart Publishing 2001).

[13] HM Treasury, *A New Approach to Financial Regulation: Building a Stronger System* (The Stationery Office Limited, United Kingdom 2011) 60.

[14] ibid 61.

the promotion of effective competition in the interests of consumers in the markets. It covers the need for information that enables customers to make informed choices, access to those services, and the ease with which new entrants can enter the market.[15]

The Prudential Regulation Authority is also part of the Bank of England and is mandated to provide prudential regulation and supervision of banks, building societies, credit unions, insurers, and major investment firms. The PRA works alongside the FCA creating a 'twin peaks' regulatory structure in the UK,[16] with the FCA carrying out conduct regulation of deposit-takers, and prudential and conduct regulation of other financial firms. In total the PRA regulates around 1,700 financial firms. It is a subsidiary of the BoE.[17] Prudential Regulation Authority Limited was renamed as the Prudential Regulation Authority and its general objective is promoting the safety and soundness of authorized persons, in a way which avoids any adverse effect on the stability of the United Kingdom financial system.[18] It has three statutory objectives which include a general objective to promote the safety and soundness of the firms it regulates, an objective specific to insurance firms, to contribute to the securing of an appropriate degree of protection for those who are or may become insurance policyholders and a secondary objective to facilitate effective competition. The PRA prioritises its resources to focus on those firms with the greatest potential to affect financial stability adversely, whether through the failure of those firms or through the way in which they carry on their business.

The PRA has a secondary objective to facilitate effective competition in relevant markets, so far as reasonably possible. The PRA has no concurrent competition powers, and this secondary objective only applies when the PRA is advancing its primary objectives and therefore does not operate as a self-standing objective. For example, the PRA would consider possible effects on competition when introducing new rules for authorised firms, but it would not on its own initiative introduce rules aimed purely at promoting competition.[19] The Prudential Regulation Authority advances its objectives through regulation where it sets standards or policies that it expects firms to meet and through supervision where it assesses the risks that firms pose to the Prudential Regulation Authority's objectives and, where necessary, take action to reduce them. For synergy of regulatory functions, the

[15] ibid 63.

[16] The FCA is a separate institution and not part of the BoE.

[17] The BoE recently announced plans to change the legal status of the PRA from a subsidiary to a full part of the Bank of England on a similar footing as the MPC and FPC. See Transparency and Accountability at the Bank of England, 11 December 2014, p7.

[18] ibid 67.

[19] The obligation on the PRA is only to facilitate competition, not to behave as a competition advocate, promoting competition in markets.

regulators must coordinate and consult in the exercise of their respective functions. Each regulator should obtain information and advice from the other regulator in relation to matters of common regulatory interest. Further, where either regulator exercises functions in relation to matters of common regulatory interest, both regulators shall comply with their respective duties.[20]

In order to create clear boundaries between the two regulators, the Act requires that Treasury may by order specify matters that may be the responsibility of one regulator rather than the other. The order may indicate which regulator may handle specified matters when exercising specified functions or to require consultation among the regulators.[21] Even though the decision to change the regulatory framework from unified to twin peaks was deemed as political by analysts, the same was also attributed to the financial crises that rocked major world economies and thus led to regulatory failure.[21] In comparison to Kenya's regulatory reforms, the case of the evolution of UK's regulatory structure is one which has undergone several phases, unlike Kenya which has undergone piece meal reforms, to replicate the developing trends. The adoption of the different regulatory frameworks by the UK is a confirmation that regulatory frameworks are dynamic and may change from time to time depending on the existing developments being experienced by a sector. Similarly, a country like Kenya which is on the verge of reforming its regulatory framework should be guided by the unique circumstances affecting its sector as opposed to adopting a framework from another jurisdiction. In order for Kenya to adopt an effective framework, and following UK"s experience, the solution lies in designing and implementing more effective regulatory frameworks for financial institutions.

4.2 South Africa

The South African regulatory structure took the institutional approach prior to the 1980s and thus followed international trends whereby regulators rarely looked beyond the national borders. Consolidated supervision in this country was an unknown concept and the financial sector components including banks, insurance and the capital markets were regarded as separate entities nationally and regulated separately. Between 1965 and 1980 the financial sector was heavily regulated and deregulation started to happen in the late 1980s following the commissioning of the De Kock Commission by the government in 1987.[22] The De Kock Commission observed that institutional

[20] ibid . [21]
ibid .

[21] Mwenda K, *Legal Aspects of Financial Services Regulation and the Concept of a Unified Regulator*.
[22] Botha, E. and Makina D, Financial Regulation and Supervision: Theory and Practice in South Africa (2011) vol 10 (11) *International Business and Economics Research Journal.*

regulation had resulted in over regulation in the banking sector making the sector inefficient and not competitive and recommended functional regulation. These recommendations were implemented through the Banking Act of 1990 that was based on the Basel rules that focused on risk management and the regulatory structure became partially integrated with the central bank regulating the banking sector and a multi-sector regulatory approach for other non-banking financial services.

In South Africa, the principal legal instrument which seeks to achieve credibility, stability and economic growth, is the Banks Act.[23] Further, South Africa has 17 registered banks, two mutual banks, 12 Branches of international banks in the Republic of South Africa, 43 representative offices and 15 controlling companies.[24] South Africa has a developed and well-regulated banking system which compares favourably with regulatory environment applied by the developed countries. The South African banking sector has undergone several numerous changes in the past 20 years. The period in the early 1990s was characterised by a process of consolidation resulting from mergers of a number of banks including Allied, Volkskas and United to form ABSA and the proposed merger between Nedcor and Stanbic which failed eventually.[26]

In 1993, the Melamet Commission recommended that South Africa adopt the unified regulatory approach to be in line with developments in European countries whose financial systems are similar.[25] In 2008 the International Monetary Fund (IMF) and the World Bank performed a Financial Sector Assessment Program (FSAP) whereby they conducted a joint assessment of the South African financial system. In an effort to address shortcomings in the regulatory structure identified by the IMF, the Government issued the National Treasury Policy Document in February 2011 that set out proposals for strengthening the financial regulatory system which led to the main policy thrust with the adoption of the twin-peak model of financial regulation in South Africa.[26] South Africa was contemplating to adopt a single regulator model from the recommendation of the 1993 Melamet Commission, therefore, decided to move in line with international trends. The adoption of the twin peaks model was considered to cause the least amount disruption to both market participants and the current regulators.

[23] No. 94 of 1990 (the Banks Act).

[24] South African Reserve Bank (SARB). (2001). *Bank Annual Report: 2001*. Bank Supervision Department, SARB. [26]

The Banking Association of South Africa. (2012). *South African Banking Sector Overview*. The Banking Association of South Africa**.**

[25] Botha E and Makina D, Financial Regulation and Supervision: Theory and Practice in South Africa (2011) vol 10 (11) *International Business and Economics Research Journal.*

[26] ibid

Furthermore, given the country's historical neglect of market conduct regulation, the twin-peaks model was seen as the optimal means of giving sufficient priority to transparency, market integrity and consumer protection.[27]

South Africa's commitment for reform in the financial services sector was motivated by four policy priorities which included financial stability, consumer protection and sound market conduct, expanding access through financial inclusion, and combating financial crime.[28] These pillars of reform led to the advancement of the twin peaks model. Through this regulatory model, South Africa applies the market conduct regulation as well as prudential regulation.[29] The prudential regulator operates within the South African Reserve Bank, which is responsible for supervision of banks and insurers. The regulator in performing its functions is expected to interact with the Minister of Finance and the market conduct regulation is done by the Financial Services Board, which is governed by an executive management team appointed by the Minister of Finance and funded by the market levies.[30] The South African Reserve Bank (the Reserve Bank) has an important role in banking regulation and supervision. The primary objective of the Reserve Bank is to protect the value of the South Africa currency in the interests of balance and sustainable economic growth. As part of this objective, the Reserve Bank is tasked generally to take such steps as may be necessary to establish, conduct, monitor, regulate and supervise payment, clearing or settlement systems.[31] Further, the South African Reserve Bank is also tasked with regulating and maintaining minimum reserve balances that South African banks must hold on account with the Reserve Bank. The registration of banks; the regulation of payments, clearing or settlement systems; and the keeping of determined minimum reserve balances by South African banks, are effectively delegated by the governor of the Reserve Bank to the "Office of Banks". This statutory office is part of the Reserve Bank and the Registrar of Banks (the registrar) is its principal official. The

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[27] ibid

[28] South Africa Treasury, "Reviewing the Regulation of Financial Markets in South Africa", *Policy document explaining the Financial Markets Bill,* 2011 www.treasury.gov.za/.../FMB/FMB%20policy%20documents/html> *accessed 13 July 2019.*

[29] Prudential regulation on the other hand means the regulation of financial institutions solvency and liquidity reserves.

[30] South Africa Treasury, "Reviewing the Regulation of Financial Markets in South Africa", *Policy document explaining the Financial Markets Bill,* 2011 www.treasury.gov.za/.../FMB/FMB%20policy%20documents/html> *accessed 13 July 2019.*

[31] South African Reserve Bank (SARB). (2012a). *Mandate*. Retrieved from http://www.resbank.co.za/AboutUs/Mandate/Pages/Mandate-Home.aspx.

registrar is charged with, among other things, the administration of the Banks Act.[32] The main objective of the Banks Act,[33] is to create the legal framework for the regulation and supervision of the business of accepting deposits from the South African public. To this end, the Banks Act governs the establishment of banks; the security of the investments of depositors; and the protection of the integrity of banks in the interest of the South African financial system. The Banks Act establishes the supervisory authority of the registrar by making registration a prerequisite for conducting the "business of a bank" in South Africa.

Conducting the "business of a bank" in South Africa without being registered is an offence which attracts severe penalties. The Banks Act sets out a number of prudential requirements which are aimed at the efficient management of banking related risks. In this regard, the registrar possesses extensive regulatory and supervisory powers. The Banks Act further regulates the conducting of the business of a bank by foreign banking institutions in South Africa. An institution which has been established in a country other than South Africa, and which lawfully conducts in that other country a business similar to the business of a bank, may conduct the business of a bank by means of a branch or a representative office of the foreign institution in South Africa. This is only with the prior written authorisation of the registrar and subject to whatever conditions, if any, the registrar may deem necessary.[34]

The South African banking industry has implemented Basel II Accord in its entirety.[35] The implementation of the Basel II has involved the amendment of the Banks Act by the Banks Amendment Act,[36] (the Banks Amendment Act), and the adoption of "the Regulations relating to Banks" issued under section 90 of the Banks Act. The Basel II framework has been subject to continuous refinement, resulting in what is commonly referred to as Basel III. Basel III is a comprehensive set of reform measures, developed by the Basel Committee on Banking Supervision (primarily in response to the global economic crises) to strengthen the regulation, supervision and risk management of the banking sector. These measures basically aim to: improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source; improve risk management and governance; and strengthen banks" transparency and disclosures.

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[32] ibid.

[33] No. 94 of 1990.

[34] The Banking Association of South Africa. (2012). *South African Banking Sector Overview*. The Banking Association of South Africa.

[35] Scholtz, J and de Villiers, D. (2012). *Banking Regulation and Supervision*. Webber Wentzel, South Africa.

[36] No. 20 of 2007.

The reforms target bank-level, or micro-prudential, regulation, which is designed to help raise the resilience of individual banking institutions to periods of stress; and macro prudential, system wide risks that can build up across the banking sector as well as the pro-cyclical amplification of these risks over time. In view of the changing landscape, the Bank Supervision Department (the Department) of the South African Reserve Bank commenced a formal process to amend the regulatory framework in accordance with the latest internationally agreed regulatory and supervisory best practices and standards.[37] To ensure accountability by the regulators under the twin peaks model, the regulators are required to have operational independence, while accounting to external authorities. This is achieved by ensuring that stakeholders in the sector are consulted, as well as tabling before Parliament their strategic plans and budgets. The Regulators are further required to provide regular flow of information to the National Treasury and Minister of Finance and to conduct audits as per the Public Finance Management Act, 1999.[40] To coordinate the efforts of maintaining financial stability and limiting systemic risks in the financial sector, there is established the Financial Stability Oversight Committee whose main role is playing an advisory role in crisis management and resolution of disputes.[38]

The twin peaks model allows the two regulators to jointly supervise a number of financial markets and also allows each regulator to focus on its key mandate, however, for a twin peaks model to work effectively there should be cooperation between the regulators to form a consolidated view of risks in a particular sector and to implement coordinated actions.[39] Some of the challenges with this approach include bureaucracy as the process of consultation may take a long time thus decision making may be delayed in some instances. The Financial Services Law (General Amendment) Act, 2013[40] aims to ensure that even during the transition to the twin Peaks system, South Africa has a sounder and better regulated financial services industry which promotes financial stability by strengthening the financial sector regulatory framework and enhancing the supervisory powers of the regulators.[41] South Africa is

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[37] South African Reserve Bank (SARB). (2012b). *Matter related to the implementation of Basel III*. Guidance note 2/12 issued in terms of section 6(5) of the Banks Act, 1990. [40] Public Finance Management Act, 1999 (South Africa).

[38] South Africa Treasury, „Reviewing The Regulation of Financial Markets in South Africa" *Policy document explaining the Financial Markets Bill,* 2011 www.treasury.gov.za/.../FMB/FMB%20policy%20documents/html> *accessed 13 July 2019.*

[39] ibid.
[40] South Africa Financial Services Law (General Amendment) Act No. 45 2013.

[41] Department of the National Treasury, „Media Statement on the Commencement Date for the Financial Services Laws General Amendment Act No 45 of 2013" (2014).

in the process of changing its regulatory structure from the partly integrated functional approach to the twin peak regulatory approach. With the twin peak approach South Africa will have a separate regulator for prudential regulation and market conduct regulation. It is hoped the system will increase the coordination and flow of information between the different entities in the financial market and therefore create better risk management structures which is the main goal of supervision.

The South African financial regulatory and supervisory system has historically evolved through almost all the stages of the extant regulatory structures. Having started as an institutional approach, it metamorphosed into a functional approach in the late 1980s. In the 1990s the regulatory structure transformed itself into a partially integrated system whose main tenet entailed the central bank regulating the banking sector and a multi-sector regulatory approach for other non-banking financial services. The evolution of the South African regulatory structure has been largely driven by international trends and market imperatives.[42] South Africa has a developed and well-regulated banking system which compares favourably with regulatory environment applied by the developed countries.[43] However, it was cautioned that further regulation such as the recently announced 'Twin Peaks' approach to financial regulation could result in unintended consequences, such as driving a larger share of activity into the shadow banking sector.

In comparison to Kenya's regulatory framework, the South African model has a number of disparate regulators coordinated through statutory bodies, advisory bodies and standing committees. It is also follows the functional model and presently does not have an overarching coordinating authority. South Africa has coincidentally also succumbed to the international trend of reforming its regulatory framework. This is also evident in Kenya, where the calls for reform is largely attributed to the desire to replicate the emerging trends in financial regulation. South Africa intends to adopt the twin peaks model whereas the Kenyan structure, is partially unified.

4.3 Lessons for Kenya

Kenya has been on the path towards integration of the financial sector regulation since the current regulatory structure continues to be characterized by regulatory gaps, regulatory overlaps, multiplicity

[42] Gargi B, *Regulation of Financial Services in Germany* (2013) http://ssrn.com/abstract=2342625 or http://dx.doi.org/10.2139/ssrn.2342625 accessed 29 July 2019.

[43] The Banking Association of South Africa. (2012). *South African Banking Sector Overview*. The Banking Association of South Africa.

of regulators, inconsistency of regulations and differences in operational standards.[44] The calls for reform have been strongly made by the Task Force that was set up by the President to oversee Parastatal Reforms in Kenya. This report recommended that there should a clear separation between policy, regulatory and service delivery functions by government entities and thus considered that the integration of regulatory and sector development functions was appropriate and should be applied on a sector by sector basis.[45] It discussed the different ownership models that have been adopted by different countries which include the decentralized model, dual model and the centralized model. It further noted that the general direction for reform is the centralized model and the main rationale for this proposal was that it makes possible the separation of the ownership function from the policy function. The centralized model also facilitates a greater unity and consistency of the ownership policy, such as in implementing unified guidelines regarding investment and further allows for centralizing competencies and organizing pools of experts in relevant matters, such as financial reporting.[46]

The main disadvantage of a decentralized ownership model is the difficulty in creating effective separation of the ownership functions with the regulatory and policy roles therefore the purpose and rational of consolidation as per the Report is to increase efficiency and effectiveness, rationalize areas of overlapping mandates, improve service delivery, enhance the ability of public agencies to meet their core regulatory and developmental mandates and to maximize contribution to sectoral and national development goals. The Taskforce recognized the need to retain bank supervision under the Central Bank of Kenya while consolidating other financial regulators in the securities, insurance, pensions and financial cooperatives sub sectors. This was in line with the growing international consensus and best practices, following the recent global financial developments of monetary authorities retaining oversight and supervision of banking sector.[47]

The agencies proposed to be consolidated include the Capital Markets Authority, Insurance Regulatory Authority, Retirement Benefits Authority and the Sacco Societies Regulatory Authority, under a single unified Financial Services Council. Some of the arguments set by the Report for consolidation include the increasing integration and convergence in the financial services industry of products and services,

[44] Mutuku N, *Case for Consolidated Financial Sector Regulation in Kenya* (Retirement Benefits Authority 2008) http://ssrn.com/abstract=1837354> accessed 10 August 2019.

[45] Republic of Kenya, *Report of the Presidential Taskforce on Parastatal Reforms* Presented to His Excellency Hon Uhuru Kenyatta CGH President and Commander in Chief of the Defence Forces of the Republic of Kenya (Nairobi 2013).

[46] ibid.

[47] ibid.

increasingly blurring lines between banking, insurance, capital markets and long term pensions sectors. Many financial sector providers are increasingly producing and distributing financial products and services traditionally associated with other subsectors, for example bancassurance. Technology including telecoms platforms, mobile banking and the internet is also driving convergence of the financial services sector both locally, regionally and globally.

4.4 Conclusion

The introduction and implementation of the unified supervision of financial services differs from one country to another. Some have adopted the unified framework, whereas others have adopted the twin peaks model. It is notable that although the single or unified regulator has attracted the most attention, there is no optimal regulatory structure. Different countries have taken different routes and approaches. The reasons for these differences are varied and they include ideological, historical, economic and political factors.[48] From the comparative analysis, it is observed that the introduction of a unified regulator in each country inevitably reflects country specific factors and the currently prevailing institutional structure. Some of the factors which have influenced countries to set up unified regulators include the emergence of financial innovation and structural change in the financial system, the emergence of financial conglomerates, the occurrence of financial failures, the complexity and extensiveness of objectives behind regulation in some countries, the emergence of new financial markets and the increasing internationalization of financial operations.[49] This seems to be the case even in Africa, including Kenya.

Both the unified and twin peaks models of regulation have their strengths and weaknesses. For instance, in Germany, it is noted that a single regulator will not necessarily deliver optimum efficiency in regulation. This is because in a unitary model, specialist divisions still exist, thus creating potential problems in communication, information sharing, coordination and consistency.[50] In the case of the United Kingdom's twin peaks model, the distinction between prudential and conduct of business regulation is not in practice as neat and simple. In addition, there exists a considerable overlap both

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[48] Mwenda K, "Legal Aspects of Unified Financial Services Supervision in Germany" vol 4 (10) 1009 *German Law Journal*. See also Mwenda K, *Legal Aspects of Financial Services Regulation and the Concept of a Unified Regulator* (World Bank 2006).

[49] Taylor MW, "The Road from Twin Peaks and the Way Back" (2009) vol 16 (1) *Connecticut Insurance Law Journal.*

[50] Ferran E and Charles A E Goodhart, *Regulating Financial Services and Markets in the Twenty First Century* (Hart Publishing 2001).

conceptually and in practice between prudential and conduct of business regulation.[51] This in turn therefore generates inefficiencies as firms would still have to be authorized and supervised by more than one regulator.[52]

The experience in the financial sector regulation in Africa shows that a good number of African countries are leaning towards partial unification.[53] Although unified supervision of financial services has been adopted differently in many countries, its application has varied from country to country. Commentators have also argued that there is no optimal approach to implementing integrated models of supervision of financial services. Experience seems to suggest that, in order for a country to manage effectively the transition to a unified supervisory agency, one of the factors to consider include the effective and efficient coordination of information sharing among the major stakeholders in the unified supervisory system, namely, the Ministry of Finance, the Central Bank, and the unified supervisory agency. Coordination and consultation provides for efficient means of sharing information between the various stakeholders.[54] The conclusion drawn from these comparative studies is that there is no strong evidence of the best practices in the structure of unified regulation. It may be argued that until there is a longer track record of experience with unified regulation, it is difficult to come to firm conclusions about the restructuring process itself, and the optimal internal structure of unified regulators.[55] The calls by Kenya for reform of its financial services regulatory framework has to take place, considering the different approaches taken by the other countries. In conclusion, the success of the proposed framework will be determined by consideration of the unique circumstances of the Kenyan financial market.

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[51] ibid at 153.

[52] Mutuku N, *Case for Consolidated Financial Sector Regulation in Kenya* (Retirement Benefits Authority 2008) http://ssrn.com/abstract=1837354> accessed 10 August 2019.

[53] Kenneth Kaoma Mwenda, „Legal Aspects of Unified Financial Services Supervision in Germany‟ vol 4 (10) 1009 *German Law Journal*. See also Mwenda, *Legal Aspects of Financial Services Regulation and the Concept of a Unified Regulator* (World Bank 2006).

[54] Mwenda K, "Legal Aspects of Unified Financial Services Supervision in Germany" vol 4 (10) 1009 *German Law Journal*.

[55] Mwenda K, *The Regulatory and Institutional Framework for Unified Financial Services Supervision in the United Kingdom and Zambia.*

CHAPTER FIVE

FINDINGS AND RECOMMENDATIONS

5.0 Findings

This research study has found that although the current regulatory framework governing the financial services sector in Kenya is not appropriate to effectively address the challenges and emerging trends in the sector, the proposed single regulator does not adequately address the sector's regulatory requirement whereas many countries are moving towards unification and are adopting the integrated model of financial regulation, the same is not the most optimal model of regulation. The financial services sector in Kenya is vital to the nation's economic growth, development, and prosperity but it is marred by financial difficulties which has prompted calls for the review of existing regulatory frameworks.[1] From the models of regulation of the financial services across the world, there is no optimal model and various countries continue to apply different models. The choice of regulatory model depends on a variety of factors, some of which, are country specific where some countries still retain the fragmented framework of regulation, some are now moving towards integration such as South Africa and Kenya.[2] Despite Kenya having enacted, amended or reviewed legislation in the financial sector, this has not resulted in the expected realignment because the sector continues to experience many challenges which include duplicity of regulation.

The adoption and application of the unified financial services supervision has continued to vary from country to country and it is important to determine the size and structure of the sector, the role of the regulator as well as take consideration of economic, political, legal and historical consideration when designing a regulatory framework.[3] Kenya has made elaborate proposals to have a consolidated financial regulator.[4] It recognized the need to retain banking supervision under the Central Bank of Kenya while consolidating other financial regulators in the securities, insurance, pensions and cooperatives sub sectors. The agencies proposed to be consolidated include the Capital Markets Authority, Insurance Regulatory Authority, Retirement Benefits Authority and the Sacco Societies Regulatory Authority. The National

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[1] Madise S, "Rationale of Regulating the Financial Services, Models of Regulation and Need for Regulatory Independence" (2014) *Malawi Law Journal* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2538437> accessed 10 September 2019.

[2] ibid.

[3] ibid.

[4] Republic of Kenya, *Report of the Presidential Taskforce on Parastatal Reforms* Presented to His Excellency Hon Uhuru Kenyatta CGH President and Commander in Chief of the Defence Forces of the Republic of Kenya (Nairobi 2013).

Social Security Fund is proposed to operate under the Retirement Benefits Authority. This unified regulator will be known as the Financial Services Council and upon unification, each of the sub sector regulators shall retain their independence. From the foregoing, this study makes a number of recommendations that may be considered in the wake of this unification reality.

5.1 Recommendations

The following recommendations should be considered in order for the intended regulatory framework to achieve its objectives.

5.1.1 Legislative Amendments

An Act of Parliament should be enacted to create the Financial Services Council as the financial services regulator which will legislate the independence, regulatory powers, ensure the appointment of its members and security of tenure. The enacted legislation must provide for the specific functions of the Financial Services Council, including its regulation of the independent regulators, powers to make legislation, operational functions and enforcement of regulation among other important provisions that will ensure the effectiveness of the regulator. The different existing legislation which include the Insurance Act,[5] Banking Act,[6] Central Bank of Kenya Act,[7] Capital Markets Act,[8] Sacco Societies Act,[9] Retirement Benefits Act,[10] and National Social Security Fund Act[11] among others should also be amended to take cognizance of the new regulator. This will restructure the powers of the current regulatory authorities, existing under those Acts and the functions of those independent authorities have to be reviewed to capture the spirit and letter of the integration, while considering its intended objectives. It is also prudent that the process of adopting the integrated model in Kenya is conducted in a manner that will guarantee efficiency and effective coordination of the sector and the integration must revamp the system in order to make it more responsive to the market

[5] Insurance Act Chapter 487 Laws of Kenya.

[6] Banking Act Chapter 488 Laws of Kenya.

[7] Central Bank of Kenya Act Chapter 491 Laws of Kenya.

[8] Capital Markets Act Chapter 485A Laws of Kenya.

[9] Sacco Societies Act No. 14 2008.

[10] Retirement Benefits Act Chapter 197 Laws of Kenya.

[11] National Social Security Fund Act No. 45
2013

dynamics. Finally, the proposed Financial Services Council must be established vide legislation to warrant the attainment of its intended objectives.

5.1.2 Independence

To achieve supervisory independence, the exclusive authority of the President to appoint the heads of the regulators should be assigned to a transparent Selection Board which should only be constituted to spearhead the selection and appointment of the regulatory heads as well as the board members to sit in those Boards. The Financial Services Council should be set up as a separate agency from the Ministry of Finance with an independent representative board as part of its governance structure. Legislation should be enacted to establish the Financial Services Council, as an independent authority with mandate to promote effective, transparent and efficient regulation of the sector. In terms of budgetary independence, the Financial Services Council must be able to formulate and justify its budget to parliament. Similarly, the independent regulators should justify their budgets to the unified regulator which has a role to ensure that policies are developed to enhance budgetary independence in the sector.[12] There should be a balance between the concept of an independent regulator and that of accountability of the regulator and to achieve this will require some statutory amendments as well as major institutional setup and changes. However, a more important requirement will be a change of culture and a lot of political will.[13]

5.1.3 Similar operational powers

The Financial Services Council should advocate having similar operational powers among the independent regulators which include the power to issue regulations or guidelines and practice notes to the sector, giving exemptions to areas that currently has duplicity such as multiple registration and powers to set adequate remuneration levels, among others.[14] The unified regulator must empower the independent regulators to enforce compliance with rules and in this case, it will include investigating, gathering and sharing information among the regulators

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[12] Mwenda K *Legal Aspects of Financial Services Regulation and the Concept of a Unified Regulator* (The World Bank 2006).

[13] Madise S, "Rationale of Regulating the Financial Services, Models of Regulation and Need for Regulatory Independence" (2014) *Malawi Law Journal* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2538437> accessed 10 September 2019.

[14] Mutuku N, *Case for Consolidated Financial Sector Regulation in Kenya* (Retirement Benefits Authority 2008) http://ssrn.com/abstract=1837354> accessed 15th August 2019.

as well as imposing penalties.[15] There should be a collaborative effort among the independent regulators as well as the Financial Services Council for this function to be effective.

5.1.4 Signing of Memorandum of Understanding between regulators

The four independent regulators should sign Memorandum of Understanding under the guidance of the Financial Services Council for cooperation in some areas which could enhance the efficiency of the sector. Some of these areas include creating 'one stop' registration and licensing to remove overlaps, joint inspections of service providers, sharing of risk assessment and review tests, joint financial literacy campaigns, coordinated public education and collaboration in research among others.[16] Additionally, to ensure effective coordination and implementation of the policies and regulations, the chief executives of the independent regulators should be members of the boards of all the other financial sector regulators.[17]

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[15] Mwenda K, *Legal Aspects of Financial Services Regulation and the Concept of a Unified Regulator* (The World Bank 2006)

[16] Mutuku N, *Case for Consolidated Financial Sector Regulation in Kenya* (Retirement Benefits Authority 2008) http://ssrn.com/abstract=1837354> accessed 15th August 2019.

[17] ibid.

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