UNIVERSITY OF NAIROBI

SCHOOL OF LAW

FINANCIAL SERVICES REGULATION IN KENYA: A CRITICAL ANALYSIS OF THE PROPOSED UNIFIED FINANCIAL SERVICES REGULATOR.

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DECLARATION

Student's Declaration

I hereby declare that this thesis is my original work and has not been presented for a degree in any other University.

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Supervisor's declaration

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

NAME: DR. JACOB GAKERI

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SIGNATURE:

DEDICATION

For my wonderful parents, Mr. and Mrs. Lebu

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LIST OF ABBREVIATIONS

ATM- Automatic Teller Machine

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

MVNO- Mobile Virtual Network Operator

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

ABSTRACT

Regulation of the financial sector is crucial 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 considered as the most instrumental to assist Kenya achieve its Vision 2030 objectives. The sector is today however, 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 paper 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, Germany, South Africa and Zambia.

In the circumstances, the study establishes that there is no optimal model of regulation and every jurisdiction must adopt a framework that best suits its intended objectives. The study 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.

CHAPTER ONE

1.1 Introduction

The financial services sector in Kenya comprises of different sub sectors. These include banks, insurance companies, securities markets, pension schemes and savings and credit cooperative societies (SACCOs) among others.[1] These sub sectors are regulated by different statutory bodies which include the Insurance Regulatory Authority,[2] Retirement Benefits Authority,[3] Capital Markets Authority[4] and Sacco Societies Regulatory Authority.[5] The Central Bank of Kenya[6] regulates banks and micro finance institutions.

This existing model involves several regulators exercising jurisdiction over different sub sectors. In addition, each regulator is established under its own legislation.[7] This regulatory framework fails to effectively address the challenges and emerging trends,[8] which continue to create fierce competition among the players in the sector.[9] 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.[10]

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.[11] They thus acknowledge the need for reform

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[1] Njaramba Gichuki, *Law of Financial Institutions in Kenya* (2nd edn Law Africa Publishing Limited 2013)
[2] Insurance Act Chapter 487 Laws of Kenya
[3] Retirement Benefits Act Chapter 197 Laws of Kenya
[4] Capital Markets Act Chapter 485A Laws of Kenya
[5] Sacco Societies Act No. 14 2008
[6] Central Bank of Kenya Act Chapter 491 Laws of Kenya
[7] Jacob Gakeri, '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.*
[8] 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 November 2014
[9] 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).
[10] Kenneth Kaoma Mwenda *Legal Aspects of Financial Services Regulation and the Concept of a Unified Regulator* (The World Bank 2006)
[11] Nzomo Mutuku, *Case for Consolidated Financial Sector Regulation in Kenya* (Retirement Benefits Authority 2008) http://ssrn.com/abstract=1837354> accessed 10 December 2014

in order to accelerate wider economic growth, expand industrialization, provide infrastructure, and ensure quality and timely public service delivery.[12]

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.

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.[13] Various models for regulation have been adopted by various jurisdictions as will be seen later in this paper.[14] 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]

This paper aims to analyze the existing regulatory framework in the financial services sector. It will also examine the challenges and emerging trends in the sector, which have necessitated calls for reform in the regulatory framework. The paper also seeks to analyze case studies of the frameworks in the United Kingdom, Germany, South Africa and Zambia, with a view to making comparisons with Kenya's proposed unified regulator. 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.

[12] 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 Defense Forces of the Republic of Kenya (Nairobi 2013)
[13] National Consumer Council (n 8)
[14] Republic of Kenya (n 12) 45
[15] Ibid

1.2 Background to the Study

The financial services sector plays an important role in a country's economy. For an economy to thrive, a sound regulatory framework is required.[16] Such a regulatory framework should effectively protect consumers and adequately control market abuses such as unlawful and unauthorized disclosures, insider dealing, and money laundering among others.[17]

The financial services sector in Kenya today adopts the institutional model of regulation. This model is such that each of the intermediaries in the sector is regulated by a different authority, agency or body.[18] For instance, Insurance Regulatory Authority regulates the insurance sector, Central Bank of Kenya regulates the banking sector, Capital Markets Authority regulates the securities markets and the Sacco Societies Regulatory Authority regulates the sacco societies.[19]

The institutional model of regulation for the Kenyan financial services sector has continually undergone a lot of challenges. Some of these include poor governance, insufficient regulation to adequately cater for the services offered by the sector and questions of independence of the regulatory bodies.[20] Multiplicity of regulations has equally increased cases of poor or even subjective compliance by the sector players. An instance is where a listed company provides insurance services. Such a company is of course registered under the Companies Act, and regulated by both the Insurance Regulatory Authority and the Capital Markets Authority.[21]

Globally, there is evident blurring of the boundaries of financial institutions. The financial services sector continues to evolve and different emerging trends are now being witnessed.[22] Some of these trends include cross selling of products across the different industries such as bancassurance[23] where banks are now mandated to offer insurance services on behalf of insurance companies. Others are technological advancements such as online and mobile banking services, new distribution services, mergers and acquisition activity as well as increased

[16] DT Llewellyn, *Institutional Structure of Financial Regulation and Supervision: The Basic Issues*, in *Aligning Financial Supervisory Structures with Country Needs* (World Bank Institute 2004) 36–37.
[17] Ibid.
[18] Group of Thirty, *The Structure of Financial Supervision: Approaches and Challenges in a Global Market Place*, (Washington DC 2008)
[19] Gichuki (n 1)
[20] Mutuku (n 11)
[21] National Consumer Council (n 8)
[22] Antonio Afonso and Luis Costa, *Market Power and Fiscal Policy in OECD Countries*, (Working Papers 2010-2011,Technical University of Lisbon 2011)
[23] Insurance Act (n 2)

competition across the sector. This concept of a ‘one stop shopping’ of financial services is now a reality and the Kenyan financial services sector is not an exception.

The Presidential Taskforce on Parastatal Reforms in its report to the President of the Republic of Kenya,[24] made recommendations to establish a single entity that would oversee the ownership, supervision and monitoring of government owned agencies, including those of the financial services sector.[25]In doing so, they looked at some countries which have formulated clear national policies that eventually proved successful.[26] This recommendation will be discussed in this paper, with a view to analyzing the effectiveness of the proposed unified regulator.

1.3 Statement of the Problem

This study attempts to analyze the effectiveness of the existing regulatory framework governing the financial services sector in Kenya. This current framework continues to experience several challenges in addition to the emerging trends, which curtail optimization of regulation. As such, proposals for reform have been made by different stakeholders, with recommendation for adoption of the unified financial services regulator. It is thus notable that whereas different jurisdictions employ different models of regulation, this study postulates that there is no optimal model of regulation. The study therefore critiques the proposed unified regulator for the financial services sector in Kenya[27] and makes recommendations on what would be the most appropriate framework for the financial services sector in Kenya.

1.4 Research Questions

a. How effective is the current regulatory framework governing the financial service sector in Kenya?
b. What are the challenges and emerging trends being witnessed in the financial services sector and how do they affect the regulatory framework?
c. What models of regulation exist in the financial services sector in other jurisdictions?
d. What would be the most appropriate regulatory framework that would adequately govern the financial services sector in Kenya while addressing the challenges and emerging trends?

[24] Republic of Kenya (n 12)
[25] Ibid 66
[26] Ibid 68
[27] Ibid

e. Whether the proposed unified regulator is the way to go for regulation of the financial services sector in Kenya?

1.5 Hypothesis

a. 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 will not adequately address the sector's regulatory requirements.
b. 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.

1.6 Theoretical Framework

This study relies on the economic regulation theory. Economic regulation is the imposition of rules by a government, backed by penalties that are intended to modify the behavior and actions of individual players in the private sector. Governments often apply economic regulation 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.[28] 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.[29]This theory asserts that regulation is 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.

The theory of economic regulation emanates from two broad spectrums: the public interest theory of regulation and the private interest theory of regulation, also known as the capture 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.[30] The public interest

[28] Stigler George J, The Theory of Economic Regulation (Spring 1971) vol 2, *Bell Journal of Economics and Management Science*, 3-21.
[29] Demetz Harold, Why Regulate Utilities? *Journal of Law and Economics* (1968)
[30] 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.

theory 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. It also assumes that regulators are benevolent and aim to pursue the public interest. Fundamental to public interest theories are market failures and efficient government intervention, resulting into increase in social welfare.

Public interest theories have been criticized by different scholars.[31] First, the core of the public interest theories of regulation, the market failure, has been the object of criticism. Second, the hypothesis that government regulation is efficient or effective, has been claimed to have been invalidated by empirical research. Third, it has been argued that it is impossible to test or refute the public interest theories of regulation. Finally, it has been argued that the public interest theories are incomplete. The formation of public preferences and the translation of these interests into welfare maximizing regulatory measures lacks from these theories.[32] 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.[33]

Private interest theories explain regulation from the conduct of interest groups.[34] Interest groups 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.[35] 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

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Imagine an unregulated natural monopoly firm supplying public utility services. The firm makes supernormal profits, charges different prices to different consumer groups and does not supply services to high cost consumers in rural areas. Economic theory predicts an inefficient allocation of resources. Without regulatory intervention these costs are at its highest and intervening in the market results in a decline of these welfare cost.

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

[32] Ibid.

[33] Stigler (n 28)

[34] Johan Den Hertog, *Review of Economic Theories of Regulation* (Jalling C Koopmans Research Institute 2010) http://www.uu.nl/rebo/economie/discussionpapers> accessed 23 January 2015.

[35] Ibid

conflicts with the regulated entities because it is dependent on them for its existence.[36] Furthermore, there are career opportunities for the regulators in the regulated entities. This eventually leads to the regulatory agency coming to represent the interests of the entities.[37]

The private interest theory is unsatisfactory in a number of respects.[38] Firstly, there is insufficient distinction from the public interest theory, because the capture theory also assumes that the public interest underlies the start of regulation. Secondly, it is not clear why an industry succeeds in subjecting an agency to its interests but cannot prevent its coming into existence. Thirdly, regulation 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.[39]

Fourthly, many regulatory actions are opposed by companies because of the negative effect on profitability. Finally, the private interest theory is more of a hypothesis that lacks theoretical foundations. 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. Nor does it explain why the interaction between the entities and the agency is characterized by capture instead of by bargaining.[40]

It is rather obvious that the financial services sector requires a sound regulatory framework. The different theories of economic regulation support the need for regulation in any given sector. This leads to the new emerging question of what is the best form of regulation.[41] There are principles of a sound regulatory framework, which should be applied regardless of the form of regulation. They include proportionality, certainty, flexibility, durability, transparency and accountability, capable regulators and growth supporting.[42]

This theoretical framework is fundamental in this study because it links the reasons for regulation, as well as also analyses government’s interests in a sound regulatory framework. The

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[36] Ludwig M, *A Critique of Interventionism,* (Foundation of Economic Education 1996)
[37] Stigler (n 28)
[38] Posner (n 31)
[39] Ibid
[40] Ibid
[41] Friedman Milton, *Free to Choose: A Personal Statement*, (Harcourt Brace Jovanovich, Inc. 1990)
[42] New Zealand Treasury, *The Best Practice Regulation Model: Principles and Assessments*, (2012)

economic regulation theory also assists the author in creating a nexus between the different models of regulation. It also creates an insight into the objectives of regulation as employed by different jurisdictions.

1.7 Research Methodology

The research is exclusively desktop research where library materials are the main source of information. Some of the primary sources which have been used include legislation, government policy documents and reports. Relevant secondary literature has also been reviewed and where necessary, online sources are used.

1.8 Literature Review

Sabrinna R Pellerin[43] et al conduct a case study of the United States financial regulatory system. They argue that the changes which have taken place in the US financial system have necessitated a shift from its decentralized financial regulatory system. They further review the advantages and disadvantages of regulatory consolidation and the effects of consolidation on regulators' incentive. They have also evaluated what would be the best entity to regulate the US financial markets. The authors discuss the four main goals of financial regulation consolidation. These include taking advantage of the economies of scale, eliminating apparent overlaps and duplication that are found in decentralized structures, improving accountability and transparency and adoption to the increased prevalence of financial conglomerates in the financial industry.

The paper however acknowledges that there may be disadvantages of consolidation of financial regulation. It argues that if the systems are well articulated, then consolidation is beneficial to an economy. This paper is important to the current study because it has also reviewed the transitions to consolidated regulation in the United Kingdom, Germany, Japan and Australia. This review will facilitate comparative analysis between the Kenyan approaches to consolidation and the other countries.

The Financial Regulatory Reform Steering Committee[44] in its report analyses the proposal by the Government of South Africa to integrate towards a twin peaks model of regulation, in the

[43] Sabrinna R Pellerin, John R Walter and Patricia E Wescott, *The Consolidation of Financial Markets Regulation: Pros, Cons and Implications for the United States* (Working Paper No 9-8 2009) <http://www.richmondfed.org/publications/> accessed 23 January 2015.

[44] Financial Regulatory Reform Steering Committee, *Implementing a Twin Peaks Model of Financial Regulation in South Africa* (South Africa 2013)

financial sector. It explains the policy set by its government to deal with system wide macro prudential risks. The report explains that this will be achieved by separating the oversight by market conduct regulation, from prudential regulation. It further outlines the building blocks of the new system, its governance and accountability framework and the approaches to prudential and market conduct regulation. This report will be beneficial in conducting the case study of South Africa, in its quest for consolidating its financial regulation.

Nzomo Mutuku[45] makes a relatively strong case for the need for the consolidation of the financial regulation in Kenya. 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 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]

The Presidential Taskforce on Parastatal Reforms[47] was constituted to make recommendations for the review of government owned entities. One of the proposals in its Report was to have significant transformation in the constitution and governance of state owned agencies, including those in the financial sector. The Report recognizes that for effective and complementary engagement between the state and financial sector, there must be a clear separation of policymaking, regulation and service delivery roles.

The Report makes a recommendation to the President that for the regulatory of non commercial government owned entities; efforts should be made to shield them from profit making decisions. The objective of this is to ensure that the entities are able to commercialize their operations while ultimately minimizing dependence on the Treasury for funding. In addition, efforts should be made to ensure that these entities exercise independence in their decision making, supportive of sector policies and goals.

[45] Mutuku (n 11)
[46] Republic of Kenya (n 12)
[47] Ibid

The Taskforce thus recommended the consolidation of agencies in priority sectors, most notably regulatory agencies in the financial services sector, development finance institutions, investment promotion and marketing agencies, and agencies that support small and medium sized enterprises. The affected financial sector regulatory agencies are Capital Markets Authority, Insurance Regulatory Authority, Retirement Benefits Authority and the Sacco Societies Regulatory Authority. The proposed vehicle by the Taskforce is known as **Financial Services Council**, which shall be a single unified regulator. This Taskforce Report shall be further analyzed in this study, with a view to providing concrete recommendations on the best approach to regulation in the financial sector in Kenya.

Johan Den Hertog[48] reviews the economic theories of regulation and discusses the public and private interest theories of regulation, together with the criticisms that have been leveled at them. The public interest theory of regulation is described by the author, as the best possible allocation of scarce resources for individual and collective goods and services in society. This theory advocates that the regulation of firms or other economic actors contributes to the promotion of the public interest.

The private interest theory of regulation on the other hand, assumes that in the course of time, regulation comes in to serve the interests of the industry involved. Legislators therefore only subject an industry to regulation by an agency if abuse of a dominant position is detected. In the course of time, however, other political priorities usually emerge, thereby resulting into reduced monitoring of the regulatory agency. The author goes further ahead to analyze the shortcomings of both theories while highlighting their strengths. These theories form the subject of the theoretical framework of the current study.

Richard A Posner[49] discusses both the public interest theory and the interest group or capture theory. The author attempts to explain their relation to the observed pattern of government regulation of the economy. In his analysis, the author argues that the public interest theory and the political scientists' versions of the interest group theory are unacceptable in their present form. The author obviously has a bias towards the economists' version of the interest group

[48] Hertog (n 34)
[49] Posner (n 31)

theory and discusses the same at length. In doing so, the author looks at its theoretical and empirical foundations, and he reaches the conclusion that whereas the theory is promising, the theory still requires more analytical development and new sorts of empirical investigation before it can be accepted as an adequate positive theory of regulation.

Kenneth Kaoma Mwenda[50] 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. 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. 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.

Eilís Ferran and Charles A E Goodhart [51] discuss the emerging trends in the modern financial services sector in the United Kingdom. These trends are underpinned by technological developments that have changed the way in which firms conduct their business. Technology, according to them has opened up access to information, thereby enhancing market transparency. They further state that modernization and globalization has characterized firms to carry on multiple functions.

Some of the other emerging trends identified by the authors include the growth of financial conglomerates that operate across traditional sectoral boundaries. Another one is the blurring of distinctions between financial products through secondary market techniques such as securitization and derivatives trading among others. They note that these emerging trends have

[50] Mwenda (n 10)
[51] Eilís Ferran and Charles A E Goodhart, *Regulating Financial Services and Markets in the Twenty First Century* (Hart Publishing 2001)

necessitated a shift of operations from the traditional multiplicity of regulators to the formation of a single 'one stop' regulator.

John A Tatom[52] discusses the effects of the financial crisis that hit the world economies and the failure of some large financial institutions. 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 analyzes 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. 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.

Zabihollah Rezaee [53] analyzes the fundamentals of financial services that include regulation and governance. The author notes that the past few decades have witnessed significant changes in the structure, characteristics, and types of products and services offered by financial services firms. The most significant changes, were in four areas namely consolidation, convergence, regulation, and competition. Further, the modern financial services being offered by banks, insurance companies, and mutual funds, coupled with a new trend toward combinations between banks and financial services firms, have necessitated the concept of mergers and acquisitions. She aptly explains how these have affected the development of the financial services industry. Due to these trends, she asserts, there is need for proper regulatory and corporate governance measures for the financial services industry.

The author therefore proposes for a new regulatory framework that would define boundaries, offer guidance and requirements within which banks and other financial services firms can effectively operate in generating sustainable performance. The proposals by the author will assist in coming up with proper recommendations on the effective governance practices of a sound regulatory framework.

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[52] John A Tatom, *Financial Market Regulation: Legislation and Implication* (London 2011)

[53] Zabihollah Rezaee, *Financial Services Firms Governance, Regulations, Valuations, Mergers, and Acquisitions* (3rd edn, John Wiley & Sons 2011)

Philip I Blumberg [54] examines how multinational organizations are challenging traditional concepts of corporation law and international law. This has led to the development of new legal concepts that are fashioned to serve the needs of the emerging financial services. He also introduces jurisprudential view to the legal personality of corporations, which will assist the author to come up with similar theories that are likely to affect the financial services development.

Brian Harvey and Deborah L Parry [55] discuss consumer protection elements and the importance of regulation to entities that provide consumer services. In their introductory chapter, they discuss the economic and philosophical background to the widely accepted principle that the consumer of goods and services is entitled to protection under the law. The essence of their study to the current research is that it assists to recognize the importance of consumer protection as it acknowledges that any effective regulatory framework must take the same into consideration.

The literature review above is relevant to the current study because it tackles some of the issues of financial services regulation. None of the literature reviewed however delves into addressing the dilemma of which is the most appropriate regulatory framework of financial services sector for Kenya. This study aims to fill this gap by analyzing the qualities of an effective regulatory framework for Kenya.

1.9 Chapter Breakdown

Chapter One: Introduction

This is the introductory chapter which gives a background to the study. It states the statement of the problem and presents the research questions to be addressed by the study. It further encapsulates the hypothesis to the study, by arguing that the proposed single regulator will not adequately address the challenges of the current framework. It discusses the theoretical framework and it also identifies the research methodology and literature review of the study.

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[54] Philip I Blumberg, *The Multinational Challenge to Corporation Law: The Search for a New Corporate Personality* (Oxford University Press 1993)

[55] Brian Harvey and Deborah L Parry, *The Law of Consumer Protection and Fair Trading* (6th edn, Butterworths 2000)

Chapter Two: Concept of Regulation in Financial Services

This chapter examines the concept of regulation and financial services. It briefly discusses the different types of regulation that may be adopted for the financial services sector in a country. The chapter centers on the concept of the unified regulator, its advantages and disadvantages. It also introduces the regulatory structure in Kenya, and also gives a background to the development needs in the sector. This chapter therefore sets the base for the discussion and arguments of this dissertation.

Chapter Three: Regulation of financial services in Kenya

This chapter analyzes the current regulatory framework in Kenya. The analysis is focused on the Insurance Regulatory Authority, Capital Markets Authority, Sacco Societies Regulatory Authority, Retirement Benefits Authority and the Central Bank of Kenya. It takes a look at the history of regulation in the sector, and further discusses the challenges and emerging trends affecting each sub sector. The objective of the chapter is to show that despite the existence of regulation in the financial services sector, the same is no longer adequate to effectively address the challenges and emerging trends in the sector.

Chapter Four: Comparative Analysis of Regulatory Systems

This chapter looks at the international comparative review of four countries which have employed different models of regulation. The selection of these countries for comparative study has been done primarily to provide insights on regulatory models and to make comparison with the Kenyan financial services sector. These countries include South Africa, Zambia, Germany and United Kingdom. This chapter also critiques whether the proposed single regulator is the best model of regulation for the financial services sector in Kenya.

Chapter Five: conclusion and recommendations

This chapter captures the findings of the research and proposes the most appropriate regulatory framework for the financial services sector in Kenya. In conclusion, it states whether the proposed single regulator will effectively provide regulation that will address proper governance, both in terms of direction and control, provide policy and management advice, and promote the achievement of various stakeholder objectives.

CHAPTER TWO

2.0 CONCEPT OF REGULATION OF FINANCIAL SERVICES

2.1 Introduction

The concept of financial regulation and supervision is currently the focus in many jurisdictions.[56] 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.[57] 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.[58]

These developments in the sector have exposed the shortcomings of financial regulatory models, some of which have not been restructured to reflect new business realities.[59] As such, several jurisdictions have proceeded to reform their regulatory frameworks in order to reflect these developments.[60] 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.[61]

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[56] Edgardo Demaestri and Diego Sourrouille, *Integrated Financial Supervision: Experiences in Selected Countries* (Inter-American Development Bank, 2003)

[57] Amelia C Fawcett, *Examining the Objectives of Financial Regulation: Will the New Regime Succeed? A Practitioner's View* in Ferran and Goodhart (n 36) *37-56*

[58] Group of Thirty (n 18)

[59] Sunduzwayo Madise '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 20 July 2015

[60] Group of Thirty (n 18)

[61] 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) (n 10) 3

The aim of regulating the financial sector is to ensure that there is stability of the financial system.[62] Although 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.[63] 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.[64]

This Chapter looks at the rationale for regulation and the different models of regulation in the financial service. It also looks at the broad objectives of regulation such as investor protection, ensuring fairness, protection against malpractices and maintaining consumer confidence. The chapter also analyses the pros and cons of each model of regulation. It pays attention to the unified regulator, and discusses its main strengths and weaknesses, considering that Kenya is making advancement towards this regulatory framework. This Chapter also attempts to contextualize the regulatory framework in Kenya with a focus on the arising issues affecting the sector.

2.2 Definition of regulation

Regulation has been defined as a set of binding rules issued by a private or public body.[65] They are also those rules that are applied by all regulators in the fulfillment of their functions. Such rules include, influencing the conditions of access to the market and controlling the risks associated with financial activities, corporate governance and internal control systems, conduct of business rules, and methods of supervision.[66]

For the financial sector, regulation may be considered as the sustained and focused control exercised by a public agency over activities that are valued by the public.[67] These may include rules that influence the conditions of access to the market. These rules are those which are

[62] Marc Quintyn 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 February 2015
[63] Fawcett (n 57)
[64] Gakeri (n 7) 161
[65] OECD Glossary of Statistical Terms < http://oecd.org/dataoecd/8/61/2376087.pdf > accessed 18 November 2014
[66] Mwenda, *Legal Aspects of Unified Financial Services Supervision in Germany* (n 61)
[67] Anthony I Ogus, *Regulation: Legal Form and Economic Theory*, vol 152 (Clarendon Press Oxford 1994) 1 citing P Selznick, 'Focusing Organizational Research on Regulation' in R Noll, *Regulatory Policy and the Social Sciences* (1985) 363

intended to prevent the emergence of doubtful reputation entities, which may lack the capacity for effective implementation of the intended operations of the sector.[68]

The design of a regulatory framework may be either principles based or rules based. A principles based system is one in which regulators simply issue a set of principles with which regulated businesses must comply.[69] In most jurisdictions, principles based regulation is usually known as soft law. Soft law approach is the use of the voluntary code as the main element in regulation.[70] A rule based system on the other hand, is where regulatory bodies impose principles of regulation and supplement them with detailed rules with which regulated businesses must abide in the fulfillment of those principles.[71]These rules are codified into legislation, such as the Sarbanes Oxley Act[72] and the Dodd-Frank Act.[73]

Whereas most scholars agree on the fundamental reasons for regulation, there is inevitably debate about the precise nature of intervention. This debate usually takes into consideration the particular circumstances which may be unique to a sector.[74] Thus, where a country decides to employ a specific regulatory framework, then this must achieve the specific objectives being sought.[75]

2.3 Financial services

A financial service refers to any economic service or product of a financial nature that is provided by the finance industry. A financial service is also used to describe organizations that deal with the management of money. Financial services generally include organizations in the

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[68] Ibid

[69] Mwenda, *Legal Aspects of Financial Services Regulation and the Concept of a Unified Regulator* (n 10)11

[70] Karlsson Vinkhuyzen and A Vihma, 'Comparing the Legitimacy and Effectiveness of Global Hard and Soft Law: An Analytical Framework' (2009) 3 *Regulation and Governance* 400. "Soft law" is defined by Francis Snyder as : "rules of conduct which, in principle, have no legally binding force but which nevertheless may have practical effects": F Snyder, *Soft Law and Institutional Practice in the European Community.* (Law Working Paper 93/5, Florence: European University Institute, 1993) 2.

[71] Mwenda, *Legal Aspects of Financial Services Regulation and the Concept of a Unified Regulator* (n 10) 12

[72] *Sarbanes-Oxley Act*, was enacted in 2002 and introduced major changes to the regulation of financial practice and corporate governance.

[73] The *Dodd-Frank Wall Street Reform and Consumer Protection Act* was signed into Federal Law by President Barrack Obama on 21st July, 2010. It was enacted as a response to the Great Recession and brought the most significant changes to financial regulation in the United States since the regulatory reform that followed the Great Depression. It made changes in the American financial regulatory environment that affect all federal financial regulatory agencies and almost every part of the nation's financial services industry.

[74] RD Tollison, *Regulation and Interest Groups in Regulation* (University of Michigan Press 1991) 59-76

[75]National Consumer Council (n 8)

sectors of insurance, estate, trust and agency services, securities, deposit taking, loan and investment services and all forms of financial or market intermediation not limited to the field of the distribution of financial products.[76]

The financial services sector is responsible for facilitating the transfer of funds between investors. It also oversees the allocation of resources in the corporate sector through a variety of governance mechanisms. The financial sector is therefore a critical determinant of economic performance. In designing financial regulation, it is therefore important to be aware of its repercussion on the wider economy.[77] For instance, poor economic policies may lead to the collapse of major financial sectors.

The financial services sector operates on numerous different levels and can be divided into various sub sectors. Different countries have different systems of financial services which are comprised of different market sectors, providing various forms of service in relation to different products and services.[78] Because of this nature, financial services may be governed by a public body that exercises regulatory or supervisory authority delegated by law.[79]

The sector continues to undergo unprecedented changes which are driven by different factors such as consolidation, technological advancements and market regulation. Traditionally, financial services were structurally and functionally distinct. This is no longer the case as these distinctions among banks, insurance companies, securities, and brokerage firms have diminished.[80] There are now calls by many jurisdictions to have a consolidated or unified framework, which takes into account the aforementioned developments.[81]

In general, the development of financial services regulation in many countries has followed a historic pattern. Among the factors that affect the pattern are public policy, the structure of the

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[76] Porteous Bruce and Pradip Tapadar, *Economic Capital and Financial Risk Management for Financial Services Firms and Conglomerates* (Palgrave Macmillan 2005)
[77] Collin Mayer, *Regulatory Principles and the Financial Services and Markets Act 2000* in Ferran and Goodhart (n 51) 26
[78] International Compliance Association, *International Diploma in Compliance Manual* 1 (International Compliance Association 2003)
[79] Gakeri (n 7)
[80] Rezaee (n 53) 28
[81] Ibid.

existing legal framework, the impact of international best practices on various aspects of financial regulation, movements toward regional integration, a government's response to financial scandals, pressure from the international community, and market pressure for reform in general.[82]

2.4 Rationale for regulation

Governments primarily regulate markets to protect consumers. 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.[83]

The specific manner in which an international, regional, national, or market sector regulatory authority regulates depends on a variety of factors.[84] 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.[85] Invariably, the structure and objectives supporting the regulatory framework differ from one jurisdiction to another.[86]

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

[82] Gakeri (n 7) 161
[83] Mutuku (n 11)
[84] International Compliance Association (n 78)
[85] Group of Thirty (n 18)
[86] Regulators may fulfill 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.

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.[87]

2.5 Models of financial services regulation and supervision[88]

There are four approaches to financial supervision currently employed across the world. These include functional regulation, institutional or regulation by silos, twin peaks regulation and single or unified regulation.[89]The choice of a specific regulatory framework depends on different factors, some of which may be unique to a specific country.[90]

Before designing any framework, a country must understand the role of the proposed regulator, the size and structure of the sector.[91] It may also be important to take into consideration the economic, political, legal and historic considerations. The choice of regulatory framework should ultimately be one that will be effective and efficient. It must be able to lay 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.[92]

2.5.1 Institutional approach to regulation

The institutional approach 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 model is deemed to be under strain, given the recent developments in the financial sector. Some of the jurisdictions that adopt this approach include China, Hong Kong, and Mexico.[93]

This approach suffers from potential inconsistency in the application of rules and regulations by disparate regulators. There are also 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. This

[87] Quintyn and Taylor (n 62)
[88] Group of Thirty (n 18)
[89] Mwenda, *Legal Aspects of Financial Services Regulation and the Concept of a Unified Regulator* (n 10)
[90] Ibid 6 and 11
[91] Ibid
[92] Ibid 7
[93] Quintyn and Taylor (n 62)

different regulatory treatment may take the form of different capital treatment or consumer protection.[94]

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. It also suffers from not having a single regulator that can mandate actions designed to mitigate systemic risk.[95]

2.5.2 Functional approach to regulation

This is where the supervisory oversight is determined by the business that is being transacted by the entity, without regard to its legal status. Each type of business in an organization may have its own functional regulator. This approach to supervision remains quite common and appears to work well, so long as coordination among agencies is achieved and maintained.[96]

However, there is a general awareness that this may be a somewhat suboptimal structure. Because of this, a number of jurisdictions are moving away from functional approach towards twin peaks or integrated systems. Some of the jurisdictions that apply the functional approach include Brazil, France, Italy, and Spain.[97]

The benefit of this approach to supervision is that, a single, technically expert regulator will apply consistent rules to the same activity regardless of the entity in which it is conducted. 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.[98]

One of the major challenges of functional regulation is that it can be extremely difficult to distinguish which activity comes within the jurisdiction of a particular regulator. As regulators expand the scope of permissible activities of the entities, there is a general reluctance to cede to another agency's authority. A related and quite significant concern with the functional approach is that product innovation can be inhibited as functional regulators spar over jurisdiction.[99]

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[94] Madise (n 59)
[95] Ibid
[96] Ibid
[97] Ibid
[98] Ibid
[99] Ibid

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. 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.[100]

Regulatory competition among the multiple regulators in a functional approach may lead to a race to the bottom effect. This is particularly where an institution has a choice of regulator for a particular activity and the regulator's budget is funded by the entities it oversees. At its worst, a regulator highly reliant on funding may be particularly vulnerable to regulatory capture, which can compromise its vigilance.[101]

Another disadvantage is that no regulator has sufficient information concerning all the activities of the entities to enable them monitor for systemic risk. Also, addressing systemic risk may require having a single regulator with authority to mandate actions across the entire financial system. No functional regulator may be in a position to fulfill that role.[102]

2.5.3 Integrated approach to regulation

This is where a single regulator conducts both safety and soundness oversight and conduct of business regulation for all the sectors of financial services. This approach 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.[103]

This approach has the advantage of providing a unified focus to regulation and supervision without confusion or conflict over jurisdictional lines. This clarity potentially leads to higher quality regulatory outcomes. On the other hand however, some observers believe that it may create the risk of a single point of regulatory failure. The challenges of coordination among

[100] Ibid
[101] Ibid
[102] Ibid
[103] Ibid

supervisors under turbulence appear to be evident even under the integrated approach. Some of the jurisdictions which apply this approach include Canada, Germany, and Switzerland.[104]

Another significant advantage of this approach is that it provides a more comprehensive, panoramic view of the regulated entity's business. 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. It essentially gives the regulator the ability to look holistically at an entity and to respond to changes in a timely manner.[105]

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.[106]

In terms of challenges of the integrated approach, some observers suggest there are concerns related to having a single point of failure. 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.[107]

A large integrated supervisor that regulates across all sectors will likely still have to divide its workflows into manageable functional or other business units. For example, BaFin, as the integrated regulator in Germany, is generally organized along sectoral lines, with separate departments created to handle entities that cross various lines.[108] Thus, communication among

[104] Ibid
[105] Mwenda, *Legal Aspects of Financial Services Regulation and the Concept of a Unified Regulator* (n 10)
[106] Ibid
[107] Ibid
[108] There are concrete examples of the challenges of coordination that are experienced even when the integrated approach is adopted. In Germany, notwithstanding that BaFin is an integrated regulator; the Bundesbank continues to play a role in banking supervision. This reflects historical circumstances and is due in large part to the Bundesbank's expertise in banking supervision and its interest in having an in depth view of banking activity as it relates to its monetary policy role. This has led to some overlaps and duplication in audits, issues that admittedly may be manageable through effective coordination efforts. The Bundesbank and BaFin have addressed this issue by entering into a Memorandum of Understanding regarding their respective roles. A single, integrated regulator, by definition, mitigates coordination and information-sharing problems, but the agency must still work to ensure coordination between the central bank and ministry of finance.

the various functional divisions of a large, unified regulator is as important and may be as challenging as it would be across separate organizations.[109]

Internally, this model lacks regulatory competition. Some commentators advocate for competition among regulators to ensure that they are challenged to outperform their competitors. Others also observe that 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 favor of the firms they oversee.[110]

2.5.4 Twin Peaks approach to regulation

This approach is one in which there is a separation of regulatory functions between two regulators. One performs the safety and soundness supervision function and the other, focuses on conduct of business regulation. This approach is designed to garner many of the benefits and efficiencies of the integrated approach. 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. Some of the jurisdictions which have adopted this model of regulation include Australia, Netherlands and the United Kingdom.[111]

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.[112]

This approach may be the optimal means of ensuring that issues of transparency, market integrity, and consumer protection receive sufficient priority. The approach is designed to ensure that consumer protection principles apply uniformly across all financial products, regardless of the legal status of the entity.[113]

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[109] Mwenda, *Legal Aspects of Financial Services Regulation and the Concept of a Unified Regulator* (n 10)
[110] Madise (n 59)
[111] Ibid
[112] Ibid
[113] Ibid

2.6 Regulatory independence

The concept of the independence of a regulator continues to generate considerable debate which focuses on its advantages and disadvantages. A common view is that a regulator should be operationally independent and accountable. Independence must be looked at from four related angles which include regulatory, supervisory, institutional and budgetary independence.[114]

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.[115] 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. They 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. Regardless of the detail in a country's legislation, independent regulators should be given ample discretion to set and change regulations within the broad confines of the country's laws.[116]

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.[117]

Institutional independence has to do with the agency's status outside the executive and legislative branches of government. It 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

[114] Mwenda, *Legal Aspects of Financial Services Regulation and the Concept of a Unified Regulator* (n 10) 19
[115] Ibid
[116] Ibid
[117] Ibid

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.[118]

Budgetary independence relates to the regulator not being subjected to political pressure through its budgetary needs. Should funding come from the state, then 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 who is not independent.[119]

Political pressures not only weaken financial regulation generally, but also hinder regulators and supervisors who enforce the regulations from action. History has shown that in nearly every major financial crisis, political interference was a catalyst.[120] 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.[121]

Most effective regulatory bodies, have clear responsibilities and objectives, adequate powers and resources, and also exhibit transparency and accountability.[122] Generally, the responsibilities and objectives of such a body depend in part on the regulatory model in place and the role the regulator has been established to fulfill. To facilitate effective application of regulatory powers, the law should provide the regulator with protection against any liability that may arise from the

[118] Ibid
[119] Ibid
[120] Quintyn and Taylor (n 62)
[121] Charles Goodhart and Dirk Schoenmaker, 'Should the Functions of Monetary Policy and Banking Supervision be Separated?' *Oxford Economic Papers* (47) 539
[122] Quintyn and Taylor (n 62)

proper discharge of its powers. This gives them an incentive to perform diligently, competently, independently, and professionally.[123]

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. 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.[124]

2.7 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.[125] Unification may be partial or full. Many countries who adopt this framework continue to grapple with how to structure its institutional and regulatory framework.[126]

Several commentators have advanced arguments for a unified model.[127] 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.[128]

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

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[123] Ibid
[124] Quintyn and Taylor (n 62)
[125] Mwenda, *Legal Aspects of Financial Services Regulation and the Concept of a Unified Regulator* (n 10)
[126] Ibid
[127] Mutuku (n 11)
[128] Clive Briault, 'The Rationale for a Single National Financial Services Regulator' *Occasional Paper Series* No. 2 (Financial Services Authority 1999). See also C Briault, 'A Single Regulator for the UK Financial Services Industry' *Financial Stability Review* (1998)

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.[129]

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.[130]

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.[131] 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.[132]

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

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[129] Ibid

[130] Ibid

[131] Mutuku (n 11)

[132] Alessio De Vincenzo and Andrea Generale, '*Financial System Regulation and Supervision'* (Conference in memory of Tommaso Padoa Schioppa, Oxford University 2004)

equal protection.[133] Consolidation into a single regulator may not be as straightforward as commonly believed. Some of the challenges that may be experienced in integrating the bodies are encapsulated hereunder.

2.7.1. Legal issues

Consolidation requires reviewing all the existing statutes of each sub sector to provide for the new consolidated framework or replacing all the sub sector legislations with a new comprehensive framework.[134] Some of the legal difficulties encountered by those countries that have consolidated financial regulation in the past include sources of funding, ownership of assets, powers to sign foreign treaties, powers to enforce sanctions and powers to issue and amend prudential legislation. Further, opening up legislation to changes or replacement opens an opportunity for vested interests to reopen issues that may already have been settled within the sub sector. These could be issues pertaining, for example, to exemptions from regulation. Whichever route to consolidation is adopted, the required legal reforms are likely to prove very involving, cumbersome and expensive.

2.7.2 Staffing Issues

The uncertainty of the consolidation process inevitably results in the departure of key personnel from the regulatory agencies. Once information is made available that the existing regulators will be merged, talented staff may opt to move to the private sector or retire to avoid the uncertainty and difficulty of the change.[135] Often, it is the best staff, who are critical to the success of the consolidated regulator, who may leave for more secure pastures. After the merger, even those who opt to stay may be demoralized especially if there are difficulties being experienced in implementing a new unified organization structure.[136]

2.7.3 Culture Issues

Each independent regulator will have its own culture and means of doing business.[137] Regulators will have differing procedures and tools. Some may have international standards accreditation while others may not. Bringing these divergent cultures under a unified structure is a major

[133] Mutuku (n 11)
[134] Ibid
[135] Ibid
[136] Madise (n 59)
[137] Ibid

challenge which requires a well conceived and effectively monitored change management program.[138]

2.7.4 Systems Issues

Each regulator will have its own information technology and other infrastructure for doing its core business. Regulated entities may have invested heavily in having systems that can provide data in the format required by the regulator's system. Bringing the different platforms into a unified one may not be possible without major upheavals within and without the regulators.[139]

2.8 Contextualizing Kenya's existing regulatory framework

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.[140] 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 the Sacco Societies Regulatory Authority regulates the Saccos and societies sub sector.[141]

Under this structure, each sub sector is regulated by a different regulatory entity, and in some cases one sub sector may have more than one regulatory body exercising supervisory oversight over its activities.[142] An example would be where a company is registered under the Companies Act[143] 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.[144]

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

[138] Ibid
[139] Ibid
[140] Group of Thirty (n 18)
[141] Gichuki (n 1)
[142] Gakeri (n 7)
[143] Companies Act No 17 of 2015
[144] National Consumer Council (n 8)

by the sector and questions of independence of the different regulatory bodies among others.[145] An example is the case of mobile money transfer services where although mobile phone business is regulated by the Communications Authority of Kenya[146] the money transfer services undertaken are under the banking aspects. This therefore poses several legal and financial risks which include the lack of proper coordination among the different regulators to determine the scope of each regulator. In addition, the consumers stand exposed to financial crimes, without recourse to adequate compensation.

Globally, the financial services sector continues to evolve and different emerging trends are now being witnessed.[147]Some of these trends include cross selling of products across the different industries such as bancassurance[148] where banks are now mandated to offer insurance services on behalf of insurance companies. 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).[149] 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.[150] 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.[151] The functional or institutional model therefore remains inadequate to address the issues already highlighted.

The Presidential Task Force for Parastatal Reforms, as well as other stakeholders, has continually made recommendations for the adoption of the unified financial services

[145]Mutuku (n 11)
[146] Kenya Communications (Amendment) Act 2009
[147] Afonso and Costa (n 22)
[148] Gakeri (n 7)
[149]*Davis Weddi, Kenya: Virtual Currency Bitcoin, Bitpesa Rejected in Kenya* <http://allafrica.com/stories/201512220946.html> accessed 24 March 2016
[150] Cunningham and Zaring (n 9)
[151] Ibid

regulator.[152]From the analysis of the unified regulator however, it is notable that the model has its strengths and weaknesses and thus before Kenya adopts the same, the domestic circumstances must be considered in order for the country to achieve its economic objectives as set out in the Vision 2030 pillars.[153]

2.9 Conclusion

Regulation of the financial services sector is an essential component of the progressive development of a country’s economy. 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.

Although study shows that many countries are now moving towards the unified regulatory framework, Kenya included, this model is not the most optimal. For instance, the United Kingdom adopted it and later moved to the twin peaks model. 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.[154]

The financial services sector in Kenya is proposed to adopt the unified framework. It is already argued that the market 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.[155] This among other arguments will be analyzed in the preceding chapters.

[152] Republic of Kenya (n 12)
[153] Ibid.
[154] Ibid
[155] Gakeri (n 7) 162

CHAPTER THREE

3.0 FINANCIAL SERVICES REGULATION IN KENYA.

3.1 Introduction

The financial services sector in Kenya has historically evolved since pre independence. Through the years, the sector has been regulated by the government, although at different spheres, both directly and indirectly.[156] From the onset of establishment of financial services sector, some of the sub sectors were self regulated. However, with penetration and increase of financial services there has been continued demand for efficient regulation.[157] This has created a mix of both self regulation and government regulation.[158] The different sub sectors have 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 to having independent regulators for each sub sector.[159] This chapter discusses the financial services sector regulatory framework. The chapter chronicles the history of regulation of the financial services sector and illuminates the current regulatory framework. It also analyzes the challenges that affect regulation, which appear to have been the catalyst for the clamor for an integrated regulatory framework.

3.2 History of financial services sector regulation

The different sub sectors of the financial sector have had different paces of regulation, which are discussed below.

3.2.1 Banking industry

The formal banking system in Kenya was first introduced by the British, however, after independence the banking sector continued to reflect the influence of western imperialism and globalization. The establishment of the currency system for Kenya had a direct bearing on how banking would evolve in Kenya. United Kingdom based commercial banks

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[156] Mutuku (n 11)
[157] Tumwine Mukubwa, *Essays in African Banking Law and Practise*, (2nd edn, Kampala 2009)
[158] Ibid
[159] Ibid

started operating in Kenya in the 1890s. Most of these banks had little business with the native population of Kenya and when they ventured into deposit banking, they concentrated on the immigrant settler community.[160]

At independence, the monetary and financial system in place served the colonial interest. 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. The independence Government set out to rectify the situation in the following ways: by establishing a Kenyan Central Bank to 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.[161]

Currently, the banking business is regulated by the Banking Act.[162] This Act was enacted in 1989 and it repealed and replaced the Banking Act, 1969. Prior to this, banking in Kenya was regulated under the Banking Ordinance. The Banking Ordinance was a colonial piece of legislation, which 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.

The Banking Act however, had a lot of legislative deficiencies. Upon enactment, it 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 nonperforming loans and weaknesses in corporate governance.[163]This eventually led to financial fragility as well as the loss of public confidence with the financial services sector as a whole.[164]

[160] Ibid
[161] Ibid
[162] Banking Act Chapter 488 Laws of Kenya
[163] Beck and Cull (n 93)
[164] Ibid.

The Banking (Amendment) Act, 1985 attempted to rectify these deficiencies. First, the Act 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. Second, licensing was henceforth routed through the Central Bank of Kenya with the minister's approval. The amendment also led to the establishment of the Deposit Protection Fund in 1986.[165]Third, prudential guidelines were 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.[166]

While the aforementioned reforms were in tandem with the then prevailing global trends in the Banking sector, the same were no longer viable. In 2003, it was noted further by the Central Bank of Kenya[167] 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 nonperforming 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.[168]

Although the inefficiencies experienced by the banking sector even after amendment of the Act continue to prevail, the same are attributable to 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.

3.2.2 Insurance sub sector

Prior to 1960, there was no specific insurance legislation in Kenya, when the Insurance Ordinance was promulgated.[169] The law was intended to control the establishment, working and finances of insurance companies. Before the Ordinance, insurance companies had to comply only

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[165] Ibid

[166] Ibid

[167] Government of Kenya, 'Economic Recovery Strategy Paper', *Wealth Creation and Employment* (Nairobi 2003)

[168] ibid

[169] William Olotch, 'The Kenya Insurance Market' (2006) *vol 20 The African Reinsurer*, www.africa-re.com/areport/eng_a/4a.pdf> accessed 31 August 2015.

with the Companies Act.[170] After independence in 1963 Kenya like other emerging nations in Africa realized that 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 services by and large continued to have a freehand in most of the activities which they undertook.[171]This scenario created a problematic environment that continues to be experienced to date. Some of the challenges that faced the insurance sector 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.[172]

The Insurance Act[173] was enacted in 1986 and enforced on 1st January 1987. It 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.[174] The Act established the Office of the Commissioner of Insurance, which had the mandate of licensing, supervising and regulating the industry players.[175] The Act also established an Advisory Board, to oversee the mandate of the Commissioner of Insurance. Although the Act was in place, the insurance sector continued to face many 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.[176]

The collapse of many insurance companies in the country during the 1990s coupled with the numerous problems that bedeviled the sector necessitated amendments to the relevant laws governing insurance. The first set of significant amendments to the Act was made in 2003. The amendments in 2003 sought to address corporate governance issues by expanding the number of board of directors,[177] skills competence[178] and financial transparency, among other issues.[179] In

[170] Companies Act Chapter 486 Laws of Kenya (*Repealed by Companies Act No 17 of 2015*)
[171]Yohana Gadaffi ‘Reforming the Insurance Regulatory Framework in Kenya: An Analysis’ (2014) vol 20 (6) *Journal of Research in Humanities and Social Science*
[172] Ibid.
[173] Insurance Act Chapter 487 Laws of Kenya
[174] Ibid s 3A
[175] ibid
[176] Gadaffi (n 171)
[177] Insurance Amendment Act 2003 s 27 A (a)
[178] Insurance Amendment Act 2003 s 54(1)

2004,[180] the Act was amended to establish the Policy Holders Compensation Fund to partially relieve policyholders from the suffering they undergo when insurance firms collapse and to boost consumer confidence in the insurance industry.[181]

In 2006, the Act was amended to introduce the Insurance Regulatory Authority which took over the powers of the Commissioner of Insurance.[182]The Commissioner thus became the Chief Executive Officer of the Authority, while the powers of management were 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.[183] Evidently, in addition to limiting fraud, these amendments were also aimed at promoting good corporate governance practices in insurance companies.

In 2010, the Act was further amended to include the expansion of the regulatory and supervisory power of the Insurance Regulatory Authority.[184] The 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.[185] One of its core functions set out in the amendment was to monitor the risk profile of any insurer.[186] 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.[187]

From duration of virtually no legislation in 1963 to the first Act enacted in 1984, the Insurance legislation has been amended severally to keep up with emerging trends and new challenges that faced the industry. Although the amendments have 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.[188]

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[179] Insurance Amendment Act 2003 s 31 (h)
[180] Legal Notice No 105 of 2004
[181] Insurance (Policy Holders Compensation Fund) Regulations 2004
[182] Ibid s 3
[183] Ibid s 169
[184] Finance Act 2010 s 51
[185] Finance Act 2010 s 54
[186] Finance Act 2010 s 61
[187] Gadaffi (n 171)
[188] Ibid

3.2.3 Savings and Credit Cooperative Societies (Saccos)

For a long time, Kenya had separate legal and supervisory framework for Saccos.[189] All Saccos were governed by the Co-operative Societies Act.[190] Due to the absence of regulatory supervision, there were no prudential guidelines and rules that limited risk exposure, specific disclosure norms, and no liquidity reserves. This led to maladministration of members' funds and even collapse of some Saccos.[191]

The rapid growth of the Sacco sub sector underlined the need for specific legislation hence the enactment of the Sacco Societies Act[192]to specifically regulate and supervise their operations. This Act made provisions for licensing, regulation, supervision and promotion of Sacco Societies. It also established the Sacco Societies Regulatory Authority (SASRA). The Authority was given the mandate to license and regulate Saccos as well as to provide guidelines for protection of member's deposits.[193]The Act was intended to enhance transparency, accountability and good corporate governance in the management of Saccos.[194] No amendments have been made to the Act to date.

3.2.4 Retirement/pension schemes

Before the enactment of legislation to govern and regulate the retirement benefits/ pension schemes, the interests of retirement scheme members and their beneficiaries were not sufficiently protected.[195]There was concern about the financial viability of the schemes and poor administration and investment of scheme funds. In the majority of cases, there were inadequate controls and supervision, risk of mismanagement and outright misappropriation. Further, disclosure and accountability were lacking. The National Social Security Fund (NSSF)[196] also continued to experience governance issues and concerns over its investments and payment of benefits. Generally, the confidence in the sub sector by the stakeholders was really low.

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[189] Lucy Ngaira, 'The Impact of Sacco Regulatory Authority Guidelines on Sacco Operations in Kenya: The Case of Nairobi Deposit Taking Saccos' (MBA Thesis, University of Nairobi 2011) http://erepository.uonbi.ac.ke:8080/xmlui/handle/123456789/13144> accessed 31 August 2015

[190] Cooperative Societies Act Chapter 490 Laws of Kenya

[191] Ngaira (n 189)

[192] Sacco Societies Act No. 14 2008

[193] Ibid s 5

[194] Carilus Ademba '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 31 August 2015

[195] Sundeep K Raichura, *Analytical Review of the Pension System in Kenya* (2008) www.http\\U:\oecd\OECDPaperFinal.doc> accessed 31 August 2015

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

The Retirement Benefits Act[197] was enacted in 1997 to strengthen the governance, management and effectiveness of the pensions sub sector and the National Social Security Fund. The Act led to the establishment of the Retirement Benefits Authority which was inaugurated in 2000. This marked the beginning of a regulated, organized and more responsible retirement benefits sector in Kenya.

In spite of the enactment of legislation to address the historical challenges in the various sub sectors, 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.[198]

In addition, even with the regulatory modernization of the sector, the reforms have been piece-meal and gradual in development. Further, 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.[199]

3.3 Existing financial sector regulation in Kenya

The current regulatory framework for the financial sector in Kenya is comprised of several independent regulators, exercising jurisdiction over different sub sectors.[200] Kenya's regulatory framework adopts the fragmented model where each regulatory agency is responsible for a particular sub sector.[201] This framework is also a mix of both the functional and institutional models of regulation.[202] There are several governmental agencies regulating specific sub sectors

[197] Retirement Benefits Authority Act 2007
[198] Charles Kombo Okioga **'**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
[199] Gakeri (n 7)
[200] Gichuki (n 1)
[201] Ibid
[202] Mas Ignacio and Daniel Radcliffe, 'Scaling Mobile Money' *(2011)* vol 5 (3) *Journal of Payments Strategy and Systems* <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1681245> accessed 11 March 2015

of financial services. The Ministry of Finance currently exercises oversight over these agencies.[203]

a. Central Bank of Kenya regulates all the commercial banks, non bank financial institutions, mortgage companies, forex bureaus, building societies and micro finance institutions.
b. The Retirement Benefits Authority is responsible for regulating the pension sector and regulates the retirement benefits schemes, pooled schemes, National Social Security Fund administrators, fund managers and custodians.
c. Insurance Regulatory Authority regulates all insurance companies, brokers, insurance agents, assessors and loss adjustors, and health management companies.
d. Capital Markets Authority regulates the securities markets, fund managers, central depository systems, custodians, investment banks, collective investment schemes, investment advisors, stock brokers, securities dealers, listed companies, credit rating companies and venture capital firms.
e. The Sacco Societies Regulatory Authority regulates all savings and credit co-operative societies.

3.3.1 Banking Sector

The Banking Act,[204] the Central Bank of Kenya Act[205] 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.[206] Operators in the banking sector are licensed under the Banking Act and regulated by the Central Bank of Kenya.

3.3.1.1 Banking Act.[207]

The Act is in charge of regulation of banking business.[208] The Central Bank of Kenya has been vested with wide powers to enable it discharge the functions of supervising and controlling

[203] Gichuki (n 1)
[204] Banking Act Chapter 488 Laws of Kenya
[205] Central Bank of Kenya Act Chapter 491 Laws of Kenya
[206] Ibid s 4
[207] Banking Act Chapter 488 Laws of Kenya
[208] The definition of banking business as per the Act means:

a. The accepting from members of the public of money on deposits repayable on demand or at the expiry of a fixed period or after notice.

banking institutions. These include the power to issue directions in respect of guidelines to be adhered to by institutions in order to maintain a stable and efficient banking and financial system. In this respect, the Central Bank has issued the Prudential Guidelines for institutions licensed under the Act.[209]The Guidelines cover licensing of new institutions, corporate governance, capital adequacy, risk classification of assets and provisioning, liquidity management, foreign exchange exposure limits, prohibited business, proceeds of crime and money laundering, external auditors, publication of financial statements and other disclosures, opening of new place of business, closing or changing place of business, mergers, amalgamations, transfers of assets and liabilities, and enforcement of banking laws and regulations.

The Central Bank of Kenya has been conducting a comprehensive review of the banking sector's legal and regulatory framework. There have been a number of proposed laws and regulations relevant to the sector which has been put forward. For instance, the Banking (Amendment) Bill[210] 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 was evidently seeking 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.[211] Additionally, the Bill also sought to consolidate most of the amendments that had been made in the recent past to the Act for uniformity purposes. It must however be noted that like every sub sector in the financial services, the banking industry is also fast evolving and not every amendment would permanently resolve all the existing issues.

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b. The accepting from members of the public of money on current account and payment on and acceptance of cheques.
c. The employing of money held on deposit or on current account or any part of the money by lending, investment or in any other manner for the account and at the risk of the person so employing the money.

[209] Banking Act s 33(4) (Kenya)
[210] Banking (Amendment) Bill 2011(Kenya)
[211] Sonal Sejpal and Mona Doshi, 'Banking in Kenya' *Banking Regulation* (1st edn, Global Legal Group 2012)

3.3.1.2 Central Bank of Kenya Act[212].

The Central Bank of Kenya is established by Article 231 of the Constitution of Kenya[213] as read together with the Central Bank of Kenya Act which also governs its operations.[214] The objects of the Central Bank include the supervision of authorized dealers, and formulating and implementing such policies as best to promote the establishment, regulation and supervision of banks.[215]

The Central Bank of Kenya is authorized under the Act to perform any type of banking function, for which it is mandated under the Central Bank of Kenya Act.[216]The Central Bank of Kenya enjoys all the powers of a central bank and therefore has the powers to make its own rules of conduct or procedure for its good order and proper management.[217] Through this function, the Central Bank is therefore a regulator of all banking institutions in Kenya. The Central Bank also acts as a banker to other institutions. This function enables it to monitor and provide regulations for the institutions, such as requiring institutions to furnish it with information that it may reasonably require to enable it discharge its functions.

3.3.2 Developments in the banking sector

With increased activity and developments in the sector, players in the banking industry have experienced more competition over the last few years, resulting from amongst other factors, increased innovation among the players and new entrants into the market.[218] These developments have resulted in convergence of services in the financial services generally, between banking and telecommunications, mobile money transfer services, electronic payment systems among others. This has also resulted to the enactment of the National Payment Systems Act, which aimed at legislating the regulation and supervision of payment systems and payment service providers.[219]Some of these developments are enumerated herein below.

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[212] Central Bank of Kenya Act Chapter 491 Laws of Kenya
[213] Constitution of Kenya art 231
[214] Gichuki (n 1)
[215] Central Bank of Kenya Act s 4
[216] ibid
[217] Gichuki (n 1)
[218] Sejpal and Doshi (n 211)
[219] National Payment Systems Act No. 39 2011

a. Agency banking

Agency banking was introduced in Kenya in 2010, through the Prudential Guidelines[220] which set out how banks and other financial institutions may conduct their business through agents. The Prudential Guidelines define an agent to mean an entity that has been contracted by an institution and approved by the Central Bank of Kenya to provide the services of the institution on behalf of that institution, in the manner prescribed in the Prudential Guidelines. In order for an entity to be eligible it must possess a business licence or permit for a lawful commercial activity for at least twelve months prior to the date of the application. The institution would be required to consider an agent's credit risk, operational risk, legal risk, liquidity risk, reputation risk and compliance with rules for combating anti money laundering and financing of terrorism when considering appointing a person/entity as its agent.[221]

b. E-banking

In the last few years, there has been an array of technological advancement in the sector, pioneered by mobile network operators. Customers are able to open up digital accounts on their cell phones, send and receive money, pay utility bills and obtain credit. Users are also able to withdraw money from Automatic Teller Machines (ATM) and deposit and withdraw money from a network of agents that includes airtime resellers and retail outlets acting as banking agents.[222] It must be noted that these operators are not classified as deposit taking institutions and therefore not licensed under the Banking Act.[223] The deposit held in an e-money transfer account is not protected by the Deposit Protection Fund Board.[224]To date, there are no regulations in place to regulate this popular and globally acclaimed service, which is designed to enable users to complete basic banking transactions without going to a bank.

Even though mobile phone business is regulated by the Communications Authority of Kenya[225] mobile money transfer services and mobile payment services need more due to the banking aspects and information and technology aspects. There are several legal and financial risks involved with the current framework. It is also unclear whether banks too need a

[220]Guideline on Agency Banking CBK/PG/15 February 2011.
[221] Ibid
[222] National Payment Systems Act No. 39 2011
[223]Banking Act Chapter 488 Laws of Kenya
[224] This is a department of the Central Bank of Kenya which provides cover for depositors and acts as the liquidator of a failed institution
[225] Kenya Communications (Amendment) Act 2009

Communications Authority of Kenya licence to operate money transfer services and mobile money payment systems because regulation of banking business is not under its jurisdiction.

As part of Kenya's recent move to bring in adequate measures for consumer protection and to prevent money laundering, the Central Bank of Kenya published the Money Remittance Regulations[226] for provision and regulation of electronic retail transfers and e-money. This Regulation applies to all retail transfers utilizing an electronic payment method, and to all payment service providers that are not licensed as banks or financial institutions.

The convergence of services between the banking and telecommunications sector includes products like *M-Shwari* and *M-Benki*, which are platform for savings and offering loans to consumers through mobile phones. Traditionally, loaning of money is a service offered only through banks or the Saccos. This area is yet to be regulated and as already highlighted, such consumers are not protected by the law in the event of a crisis.

The concept of the MVNO (Mobile Virtual Network Operator) licenses which allows the operators to provide mobile money services without having to build new cellular infrastructure is also a new trend. The current regulation in Kenya is centered on mobile network operators as standalone business entities, regulated by the Communications Authority of Kenya. As such, there is a very unclear regulatory model to govern its operations.[227]

Digital currency is another new emerging trend which allows for instantaneous transactions and borderless transfer of ownership. Kenya recently witnessed the use of Bitcoin as a form of virtual currency. The Central Bank of Kenya (CBK) however stated that Bitcoin and other virtual currencies are not legal tender because they are not issued or guaranteed the government. In addition, transactions in virtual currencies are susceptible to money laundering, financing of terrorism and other white collar crimes, and thereby exposing users to potential losses.[228]

[226] Money Remittance Regulations 2013
[227] Philip Mulwa and Rafe Mazer, '*Is Kenya Ready for an MVNO*?' http://www.cgap.org/blog/kenya-ready-mvno> accessed 24 March 2016
[228] *Weddi* (n 149)

c. Islamic banking

There are currently two fully fledged Shariah compliant banks in Kenya, and a growing number of conventional banks have an Islamic banking division.[229] The Central Bank of Kenya and other financial regulatory bodies are now faced with the need to harmonize and standardize regulations of Shariah compliant financial institutions and products. [230]Some of the most notable challenges facing the Islamic banking industry are identified as follows.

First, the absence of Shariah compliant legal framework is a major snag behind its low penetration in the financial market. This is attributed to the existing financial services legislations which have not been amended to bring Islamic banking into the regulatory environment. In addition, there is no supervisory body established to enhance standardization and convergence of Islamic banking products.[231] The Central Bank also faces the challenge of supervising a system that includes both interest based banking and interest free system.

Second, Islamic law also offers its own framework for execution of commercial and financial contracts and transactions. The resolution of disputes arising from Shariah compliant products are subject to the same legal system and are dealt with the same courts and judges as the conventional one while the nature of the legal system of Islam is totally different. Third, the lack of effective prudential regulation is one of the weaknesses of the Shariah compliant banking. All Islamic financial institutions offer the same basic products, but the problem is that each institution has its own group of Islamic scholars on the Shariah board to approve the product. Consequently, the very same product may have different features and will be subject to different kind of rules in these institutions.[232]There is also no proper mechanism of transparency and disclosure to the public in order to ensure consumer protection as provided by Shariah.[233]

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[229] Central Bank of Kenya, https://www.centralbank.go.ke/index.php/regulations-and-guidelines accessed 5 May 2015

[230] Abdulatiff Leila, '*The Emerging Trends in Commercial and Financial Law Banking Law, Capital Markets Law and Corporate Governance'* Financial and Legal Sector Technical Assistance Project of the Ministry of Finance (Nairobi, 2011).

[231]Salah Abdi Sheikh, 'Factors That Led to the Emergence of Islamic Banking in Kenya and the Regulatory Challenges Facing the Industry' (MBA Thesis, University of Nairobi 2009)

[232] ibid

[233] Shamim Njeri Kinyanjui, 'Challenges Facing the Development of Islamic Banking: Lessons from the Kenyan Experience' (2013) vol 5(22) *European Journal of Business and Management*.

Fourth, the uncertainty in accounting principles involves revenue realization, disclosures of accounting information, accounting bases, valuation, revenue and expense matching, among others. Thus, the results of Islamic banking schemes may not be adequately defined, particularly profit and loss shares attributed to depositors. Additionally, Shariah compliant banking has no appropriate standard of credit analysis.

Fifth, there is a shortage of experts in Shariah compliant banking. The supply of trained or experienced bankers has lagged behind the expansion of Islamic banking. The training needs affect not only domestic banks, both Islamic and non Islamic, but foreign banks as well. Similarly, there is a widespread training need involving related aspects such as financial feasibility studies, monitoring of ventures, and portfolio evaluation.[234]

d. Real Estate Investment Trust schemes

The Capital Markets Authority launched Regulations on Real Estate Investment Trusts[235] and commercial banks have been listed as one of the entities that would be entitled to act as a trustee of a Real Estate Investment Trust scheme. However, the Banking Act restricts a bank from holding any interest in land unless it is required for its business or housing its staff and, further, a bank is only permitted to carry on banking business. The Banking Act needs amendment to allow commercial banks to act as a trustee of a Real Estate Investment Trust scheme.

e. Kenya Deposit Insurance Act[236]

Following the banking crisis that started in 2008, the Kenya Deposit Insurance Act was enacted to provide for the establishment of an autonomous body called the Kenya Deposit Insurance Corporation to replace the Deposit Protection Fund Board. The Authority is an independent department of the Central Bank of Kenya. The Act provides for the setting up of a deposit insurance system, and the receivership and liquidation of deposit-taking institutions. This is meant to protect depositors from losses in the event of collapse of a deposit taking institution.

[234] Sheikh (n 231)
[235] Capital Markets Real Estate Investments Trusts Collective Investment Schemes Regulations 2013
[236] Kenya Deposit Insurance Act No. 10 2012

3.3.3 Insurance sub sector

The Insurance Act[237] was enacted to regulate the insurance sub sector. It establishes, through the 2006 amendments[238] the Insurance Regulatory Authority, which replaced the Commissioner for Insurance as the authority in charge of supervising and regulating the insurance industry. The Commissioner of Insurance was under the Ministry of Finance but the new regulatory body enjoys greater autonomy. This has enhanced its effectiveness in supervising the sub sector. In 2010, further amendments to the Insurance Act included the expansion of the regulatory and supervisory powers of the Insurance Regulatory Authority.

There is currently a proposed Insurance Bill[239] which seeks to regulate and supervise insurers on a risk sensitive basis, which is a shift from the principle basis. Once enacted, it aims to create a framework for the supervision and regulation of the insurance sector in Kenya in line with the Insurance core principles and practices. Some of the salient features of the Bill include the provision that the Insurance Regulatory Authority will only be mandated to supervise insurers.

The Bill introduces flexibility to accommodate changes in international standards and best practices to accommodate the ongoing changes in the insurance industry. The Insurance Regulatory Authority will be mandated to issue guidelines/ regulations which shall be technical and detailed with clarity on implementation. These will not be intended for compulsory usage but to be followed by the sub sector in order to achieve compliance.[240]

3.3.4 Savings and Credit Cooperative Societies (Saccos)

The Sacco Regulatory Authority (SASRA) was established in 2008 by the Sacco Societies Act.[241] 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.

Saccos are different from micro finance institutions in the sense that saccos have an intermediate broad array of financial services beyond credit. Unlike Micro Finance Institutions, they mobilize voluntary public deposits from their members on a much greater scale and are community-owned

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[237] Insurance Act Chapter 487 Laws of Kenya
[238] Insurance (Amendment) Act 2006
[239] Insurance Bill 2014
[240] Ibid
[241] Sacco Societies Act No. 14 2008

by individuals with equal ownership**.**[242] Because of the kind services saccos offer they are different from other cooperatives. Unlike other co-operatives societies saccos specialize in financial intermediation, which necessitates adherence to prudential financial standards and supervisory oversight.[243]

After enactment of the legislation, most Saccos reported recent improvement in their performance both in membership, portfolio and loan cycle and general efficiency. Even though this was attributed to a number of factors ranging from increased membership, high efficiency, high demand and quick recoveries, one can easily attribute this to be as a result of Sacco Societies Regulatory Authority regulatory framework. Most Saccos were complying with the regulator so as not to be locked out of business by the operator.

Some of the notable benefits of regulation of Saccos are integration of Saccos into the formal financial sector, enhancing confidence through effective leadership and management of Saccos, encouraging fair competition by demolishing unethical business practices, creation of new business opportunities for Saccos such as agency business[244] and shifting focus to institutional development rather than individual leaders and managers.[245]

The Sacco sector having grown over the years is instrumental in the provision of a full range of financial services to low income earners. Over the years, institutions offering microfinance services have grown both in outreach and asset base. This growth is signified to the number of borrowers, number of branch networks and the value of assets and capital. Today, many Kenyans are members of the many Saccos in the country. This has obviously increased the level of financial inclusion in the country.

Due to this growth in Saccos, conventional banks started refocusing their attention to microfinance business. They specifically targeted a share of the growing SME market which the government of Kenya also identified as the engine of growth for vision 2030. The high growth in

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[242] Kwame Owino, 'Pertinent Issues in the Regulation of MFI's in Kenya' (2002) , (54) *Bulletin of the Institute of Economic Affairs*

[243] Ibid

[244] Rachel Keeler and Abijah Kanene, 'Development in Practice' *International Development Assistance Service (IDAS) Impact Paper* 9 (2012) <http://www.kpmg.com/eastafrica/en/services/Advisory/Development-AdvisoryServices/Thought_Leadership_at_DAS/Documents/Financial%20Deepening%20and%20M4P%20%E2%80%93%20Lessons%20from%20Kenya%20and%20Rwanda.pdf> accessed 1 March 2015.

[245] Ibid

the development of Saccos in Kenya also shows that many of the Sacco institutions later transformed into banks and micro finance institutions.[246]

The growth in the sector has also seen a rise in the convergence of services that are traditionally offered by the banking sector. For instance, at the beginning of Saccos evolution in Kenya, they were only offering credit facilities, however all Saccos in the country now accept deposits and savings from its members and operate front office service activities. Additionally, Saccos are also widely utilizing mobile money services as a means of accepting deposits, offering credit facilities and acting as savings for its members. These services are also similarly offered by banking institutions.

3.3.5 Capital markets

The capital markets in Kenya are regulated by the Capital Markets Act.[247] The Capital Markets Authority is the regulating body charged with the responsibility of supervising, licensing and monitoring the activities of market intermediaries, including the stock exchange and the central depository and settlement system and all the other persons licensed under the Capital Markets Act. It plays a critical role in the economy by facilitating mobilization and allocation of capital resources to finance long term productive investments.[248]

The regulatory functions of the Authority as provided by the Act include licensing and supervising all the capital market intermediaries, ensuring proper conduct of all licensed persons and market institutions, regulating the issuance of the capital market products, promoting market development through research on new products and institutions, promoting investor education and public awareness and protecting investors' interests. The Master plan[249] by the Capital Markets Authority recognizes that a sound regulatory and legal framework is necessary for the markets to flourish.

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[246] John Kimuli Ndulu, 'Factors Affecting Institutional Transformation: A Case for a Microfinance Regulatory Framework in Kenya' (Master of Development Finance Thesis, University of Stellenbosch 2010)

[247] Capital Markets Act Cap 485A Laws of Kenya

[248] <http://www.cma.or.ke/index.php?option=com_content&view=article&id=33&Itemid=114> accessed 18 March 2015

[249] Capital Markets Master Plan 2014- 2023, 'Kenya: The Heart of Capital Markets'(Nairobi, 2014)

3.3.5.1 Products development under the Capital Markets

a. Investment banking

The Capital Markets Act defines an investment bank to mean a non deposit taking institution licensed and regulated by the Capital Markets Authority to advise on offers of securities to the public, take overs, mergers, acquisitions, corporate restructuring involving companies listed in the securities exchange, privatization of listed companies or underwriting of securities issued to the public, and to engage in the business of a stockbroker or dealer. An investment bank does not require a license under the Banking Act and is not regulated by the Central Bank of Kenya.

An investment bank in Kenya is permitted to carry on investment services and proprietary trading business, provided that it is duly licensed by the Capital Markets Authority,[250] pursuant to the Capital Markets Act. Although investment banks are licensed under the Act, some of the services carried by these banks include the mainstream taking of deposits, which is a function of the banks as provided by the Banking Act.[251]

b. Real Estate Investment Trusts

A Real Estate Investment Trust is a collective investment scheme, which enables several investors to pool their savings to invest in real estate in order to realize economies of scale, diversify their portfolio risk and invest passively by using a regulated professional Real Estate Investment Trust Manager. Kenya is the third African country to establish a real estate investment trust as an investment vehicle.[252] Real Estate Investment Trusts have two main characteristics which are that the bulk of their assets are in real estate and they distribute a large percentage of their income to their shareholders.

The management of a Real Estate Investment Trust must be undertaken by a trustee and a Real Estate Investment Trust manager. A trustee must be licensed by the Capital Markets Authority as a Real Estate Investment Trust trustee, and may be a bank, bank subsidiary or another company or corporation as may be licensed by the Capital Markets Authority. The licensed trustee must have sufficient financial, technical and operational resources and the experience necessary to conduct business effectively and carry out its obligations.

[250] Capital Markets Act Chapter 485A Laws of Kenya
[251] Banking Act, Chapter 488 Laws of Kenya
[252] Capital Markets (Real Estate Investment Trusts)(Collective Investment Schemes) Regulations 2012

c. Derivatives Markets

Derivatives are financial contracts that are designed to create market price exposure to changes in an underlying commodity, asset, or event. In general, derivatives do not involve the exchange or transfer of principal or title and are typically classified into futures, forwards, options and swaps.[253] Derivatives are a new investment vehicle in the securities market in Kenya.[254] The Nairobi Securities Exchange is in charge of Kenya's derivatives market. It enables the listing and trading of multi asset classes including equities, currency, interest rate products as well as varied forms of agricultural commodities' contracts.[255] Derivatives boost liquidity in the underlying assets and are considered to be among the most affordable and convenient means through which investors can cushion themselves against interest rates fluctuations, exchange rate volatility and commodity prices.[256]

The Capital Markets Authority issued the Nairobi Securities Exchange with a provisional licence allowing it to open a derivatives exchange in December 2014. The Nairobi Securities Exchange has developed the derivatives rules to provide the procedures necessary to establish and regulate a fair and efficient derivatives market.[257] However, there have been delays in launching the markets due to several regulatory hitches. Some of the requirements include the recruitment of a Derivatives Market Oversight Board, to oversee the market.[258]

Whereas there is a huge potential in the derivatives markets, analysts have in the past cautioned that introducing the complex instruments could pose some risks for the stock exchange. Drawing from the examples of the global financial crisis of 2008-2009 in which the collapse of several big banks was linked to exposure to mortgage backed derivatives. In order to ensure the realization

[253] Rezaee (n 38)

[254] Charles Mwaniki, 'Derivatives Trading at Nairobi Bourse Set to Start by June' *Business Daily* Wednesday 4 March 2015 http://www.businessdailyafrica.com/Derivatives-trading-at-Nairobi-bourse-set-to-start-by-June-/-/539552/2641582/-/ig3vtez/-/index.html> accessed 9 September 2015

[255] John Gachiri, 'Bourse Gets Permit for Futures Deals' *Business Daily*, Sunday 21 December 2014 http://www.businessdailyafrica.com/Bourse-gets-permit-for-futures-deals/-/539552/2564784/-/r4xwxxz/-/index.html> accessed 9 September 2015

[256] Joshua Masinde, 'Kenya to Launch Derivatives Market' *Daily Nation*, Sunday 21 December 2014 http://mobile.nation.co.ke/business/Kenya-to-launch-derivatives-market/-/1950106/2565038/-/format/xhtml/-/safsuq/-/index.html> accessed 9 September 2015

[257] NSE Derivatives Rules https://www.nse.co.ke/products-services/derivative-securities/category/70-rules-and-regulations.html> accessed 9 September 2015

[258] Mwaniki (n 255)

of full potential of the derivatives markets, the Capital Markets Authority must ensure that there is effective regulation of the market.

3.3.6 Retirement/ pension schemes

The Retirement Benefits Act[259] establishes a Retirement Benefits Authority for the regulation, supervision and promotion of retirement benefits schemes, and the development of the retirement benefits sector generally. Over the past few years in Kenya, there has been consensus on the need for further reform of the system.[260]

The current retirement benefits system in Kenya can be classified into the following scheme types: National Social Security Fund, Public Service pension schemes established under an Act of parliament, occupational schemes and individual schemes established under trusts. 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[261] 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.[262] The Act focuses on increasing coverage, benefit adequacy and the growth of retirement savings.

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. Some of the specific steps that may 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.[263]

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[259] Retirement Benefits Act Chapter 197 Laws of Kenya
[260] Raichura (n 195)
[261] National Social Security Fund (Amendment) Act 1997
[262] National Social Security Fund Act No 53 2013
[263] Raichura (n 261)

Under the Retirement Benefits Act, there have been regulations aimed at reducing concentration of risks and achieving more diversification of assets. Since the promulgation of the initial regulations in 2000, there have 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.[264]

Some of the improvements which were created in the pension sector with the existing legislation include the improvement of protection of members' rights. Key amongst the measures to safeguard members' benefits was the 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.[265]There has also been improved governance of schemes. This is through the requirement for schemes to conduct annual audits and periodic actuarial reviews and new disclosure requirements. The election/nomination of trustees has also been provided to include member participation of at least one-third of a board of trustees.

The legislation has 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. Although the developments this far have had a limited impact on the coverage of retirement benefits in the country, the positive effects of the legislation does provide a basis on which to introduce further reform to increase coverage and social protection.[266]

[264] http://www.african-exchanges.org/download/conferences/eight/Edward%20Odundo.pdf> accessed 18 March 2015
[265] Raichura (n 195)
[266] ibid

3.4 Challenges in present day regulation

The current regulatory framework has been criticized as being inadequate to effectively regulate the financial services sector today. Some of the notable challenges of the framework include duplicity of regulation. For instance, where companies are incorporated under the Companies Act,[267] and regulated by either the Banking Act[268] or the Insurance Act.[269] Those that are listed on the Nairobi Securities Exchange are further required to comply with Capital Markets Act.[270]

In this regard, governance requirements from various laws and agencies are often at conflict, which affects decision making and effectiveness.[271] 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 of laws governing Government Owned Entities, and burden of compliance with existing sometimes conflicting legislations.[272]

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,[273] 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

[267] Companies Act Chapter 486 Laws of Kenya (*Repealed by Companies Act No. 17 of 2015)*
[268] Banking Act Chapter 488
[269] Insurance Act Chapter 487
[270] Capital Markets Act Chapter 485A
[271] Republic of Kenya (n 12)
[272] Ibid
[273] Insurance Act Chapter 487 Laws of Kenya

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.[274] Furthermore, takeovers and mergers involving listed companies must be approved by the Capital Markets Authority and the Competition Authority.

Conceivably, under the current framework, 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.

3.4 The case for consolidation

The calls for a budge from the current fragmented regulatory framework to an integrated system is traceable to 1997 when the Capital Markets Authority in its Report[275] observed that it was necessary to harmonize and work towards building a consolidated framework for the financial services sector. This was in recognition of the highly fragmented sector which suffered from overlapping regulatory jurisdiction which impeded market development.[276]Despite these sentiments, there was no plausible justification for a shift in the regulatory framework. Latter developments in the sector such as the transformation of the office of the Commissioner of Insurance to the Insurance Regulatory Authority through amendments to the Insurance Act 2006 and subsequent institutionalization of the Sacco Societies Regulatory Authority in 2009 also confirmed the government's lack of commitment towards integration.

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[274] Mutuku (n 11)
[275] Capital Markets Authority Annual Report (1998) 35
[276] Gakeri (n 7)

The Finance Minister in his budget speech in 2013 reported that the government was commencing a process to establish a consolidated financial sector regulatory framework. This would bring together the Capital Markets Authority, Insurance Regulatory Authority and Retirement Benefits Authority. In addition, the Banking supervision department will be re established as an entity under a reviewed Central Bank of Kenya Act with a clear mechanism allowing for coordinated and effective financial sector supervision. This move was informed by the need to strengthen the supervisory capacity, safeguard stability and enhance efficiency of the financial sector regulators which appear to have faltered in the recent past.[277]

The most compelling argument for regulation is to enhance the effective management of systemic risks and consumer protection. For instance, if entities are conglomerates covering banking, insurance, securities and pension then it is difficult for a regulator for a particular sub-sector to draw a view of the overall risks facing the entity. A unified regulator on the other hand would be able to understand and monitor risks across the sub sectors and develop policies to address the risks facing the entire conglomerate. Under certain circumstances where the institutions are not in themselves conglomerates, the products they offer may defy conventional categorization. For instance, some banks are practicing bancassurance which poses more risks compared to conventional banking.[278]

Another argument for consolidated regulation arises from the cost efficiency gains that can be obtained by consolidating multiple regulators into a single body. A unified regulator will only have one set of service departments such as administration, finance and human resources hence reducing on staff and other overhead costs. Where there are overlaps in registration and licensing then unification will also bring reduction in cost and efficiency gains by allowing regulated entities to have a one stop licensing procedure as opposed to multiple registrations. These gains are maximized in functional regulation as opposed to institutional regulation.[279]

Integrated regulation also curbs the blame game amongst the regulators. Regulatory gaps often lead to regulators absolving themselves from certain sub sectors especially when things go wrong. Blame may be passed on from one regulator to another when supervisory failure occurs.

[277] Republic of Kenya, *Minister of Finance Budget Speech* 2013
[278]Okioga (n 149)
[279] Ibid

A unified financial regulator would be responsible for supervising all entities and products in the financial sector and would be duly held accountable.[280]Integrated regulation has been employed in other countries and has been touted to be of value for economic development. For instance the United Kingdom and Australia adopted this approach a while back. Its adoption in Kenya would be expected to address unnecessary duplication and allow regulated entities to appeal on cross cutting issues.

Despite the benefits, challenges abound in the implementation of integrated regulation. It poses many risks including reduced effectiveness and loss of focus. In addition, the actual process of integration is likely to be disruptive and expensive thereby watering down the expected benefits. The case for unification appears even weaker in Kenya as market developments are still small scale; hence do not justify a paradigm shift.[281]

Although the move taken by the Minister is praiseworthy, it is critical to appreciate that there is no one single optimal model for the organizational structure of financial regulation. The prevailing circumstances, historical factors and comparative advantages in any given country are some of the factors that determine the regulatory structure. Thus, Kenya should strive to adopt a structure that is suitable to its unique circumstances, as opposed to replicating other countries regulatory models.

This paper supports the calls for consolidation of the financial services sector in Kenya. This chapter has already analyzed the existing framework and the challenges that exist. In its discussion on the calls for consolidation, it has also highlighted the benefits of a unified framework to the country's regulatory framework. Similarly, some of the cons of a unified regulator have also been pointed out.

From the foregoing discussion, there is sufficient rationale to adopt the unified regulatory framework in Kenya. The unified regulator in the author's opinion is the most viable option, considering the recent developments in the sector. Although the unified regulator will not sort all

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[280] ibid

[281]David Wanyoike, *With technology in Business Comes Regulatory Headaches* <http://www.ey.com/KE/en/Home/2012---Press-release---July---With-technology-in-business-comes-regulatory-headaches> accessed 1 March 2015.

the cons of the existing framework, the same will guarantee a more enhanced monitoring and supervision of the stakeholders, thus advancing the country's economic objectives.

The Task Force recommends for the adoption of a partially unified regulator, where the Central Bank of Kenya will supervise banks while the other regulators will be supervised by the Financial Services Council.[282]Through this structure, it is predicted that the financial services sector will be able to address operational efficiencies and seal the gaps in the existing regulatory loopholes that have already been discussed in this paper.

Although the unified model is advocated for, it is also noted that there are external factors which may affect the implementation of the unified framework in Kenya. For instance, political interests may come into play at the structuring of the unified regulator, which may affect its execution. It is essential that the body which will be mandated to spearhead the process should have some autonomy and independence to cushion on the interference. More importantly, both the executive and legislature have their jurisdictions to shield. Arguably, consolidating the existing regulatory authorities would reduce significantly the political influence wielded by the executive over the financial services sector to the detriment of the political class.[283]

Similarly, Kenya is known for corruption issues. The culture of corruption in Kenya today is such that people perceive positions in the public service and state owned corporations as avenues for rewarding their friends, relations, tribesmen and women, and political supporters.[284] Corruption remains the largest obstacle to doing business and good corporate governance in Kenya today. Any attempt to consolidate the current regulatory agencies would obviously be met with serious political obstructions. Existing agencies have established constituencies in the industry and would endeavor to retain their sphere of influence.

Presently, the Ministry of Finance has oversight mandate to supervise the operations of the financial services sector. This status quo is deemed as prestigious since the Ministry is administratively responsible for the most prestigious and highest paying corporations such as, the Central Bank of Kenya, Capital Markets Authority, Insurance Regulatory Authority, Kenya

[282] Republic of Kenya (n 12)
[283] Gakeri (n 7)
[284] Cunningham and Zaring (n 9) 55-56

Revenue Authority and several commercial banks. It is therefore obvious that with the consolidation of the regulatory framework, the political class is unlikely to embrace an immediate shift to the unified or single regulator model as this means losing some of this prestige.[285]

In summation, the calls for consolidation of the sector are timely, however many huddles are expected to be crossed in order for the sector to achieve the optimal structure that will meet the objectives of the sector as well as the economy of the country.

3.5 Conclusion

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.[286] From the analysis of the historical developments to the current regulatory framework, it is evident that the sector is in dire need of review in order to address some of the challenges.

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. Equally, the technological developments and emerging trends such as diversification and introduction of new products and services across the sector, there have also led to calls for review of the current regulatory framework.

The analysis has identified that the current regulatory framework is a mixture of both the institutional and functional models of regulation. Although the move for unification is highly recommended by stakeholders in Kenya, the question to be addressed is whether this would be the best model for the financial services sector in Kenya today.

[285] Gakeri (n 7)
[286] Gakeri (n 7)

CHAPTER FOUR

4.0 COMPARATIVE ANALYSIS OF REGULATORY SYSTEMS

4.1 Introduction

Many economies of the world were affected by the global financial crisis of 2008.[287] The crisis was mainly as a result of weak regulatory framework and poor supervisory oversight in advanced economies.[288]Although African countries were not directly affected by the financial crisis due to its low level of financial integration,[289] there were calls from several countries to have strong financial regulatory systems[290] in order to limit the potential impact of any future financial crisis.[291]

Many countries have implemented the consolidated financial services regulation as a reaction to the global financial crisis that affected the world economies in 2008.[292] There is need to continue undertaking measures to reform the financial systems and enhance global standards for the supervision of the financial sector. Regulation in many countries has been structured on either an institutional or silos approach, depending on local conditions or the objectives of regulation.[293] The financial sector has however continuously evolved to challenge this traditional approach.[294] Different countries have employed different approaches to financial regulation, and this is dependent on varied factors such as ideological, historical, economical, and political factors.[295]

This chapter makes a detailed analysis of the different regulatory systems in some of the countries. It also looks at some of the practical challenges that these countries have experienced

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287 Eric Botha and Daniel Makina, 'Financial Regulation and Supervision: Theory and Practice in South Africa' (2011) vol 10 (11) *International Business and Economics Research Journal.*

288 Caleb Fundanga, 'Measures to Improve Financial Regulation and Supervision of the Financial System of Zambia' (United Nations Working Group Meeting on the World Economic and Financial Crisis, Zambia 2010)

289 African Development Bank, *'Working Paper Series 96: Impact of the Global Financial and Economic Crisis in Africa*[*http://www.afdb.org/fileadmin/uploads/afdb/Documents/Publications/BAD%2096%20Anglais%20%20INTERNET%20PDF.pdf*](http://www.afdb.org/fileadmin/uploads/afdb/Documents/Publications/BAD%2096%20Anglais%20%20INTERNET%20PDF.pdf) accessed 22 June 2015

290 Roelof Botha and Price Waterhouse Coopers, **'**Financial Markets in Sub-Saharan Africa Poised for Expansion'(2011) *Africa Financial Services Journal* www.pwc.co.za/financial-services-journal/html> accessed 10 June 2015

291 Ibid.

292 Gakeri (n 7)

293 Mwenda, *Legal Aspects of Unified Financial Services Supervision in Germany* (n 61) 58

294 Botha and Makina (n 288)

295 Kenneth Kaoma Mwenda,'The Regulatory and Institutional Framework for Unified Financial Services Supervision in the United Kingdom and Zambia' (2005) *vol 13 Michigan State Journal of International Law*. 347

in their consolidated framework. The countries under study include the United Kingdom, Germany, Zambia and South Africa. It also analyzes the proposed regulatory framework for the Kenyan financial services sector regulation.

4.2 The United Kingdom

The UK opted for an integrated system in the 1990s whereby the Financial Services Authority became responsible for regulating all financial services. The FSA was the result of the merging of financial services regulation announced by the Chancellor of the Exchequer in May 1997.[296] The FSA 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 rationale for this merging was that 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, confusing and costly.[297] Upon unification, the FSA worked with the Bank of England and Treasury and the responsibilities were thus divided among the three regulators.[298]

Treasury was responsible for overall institutional structure of regulation and the governing legislation. The Bank of England 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.[299] FSA on the other hand 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.[300]

However, during the 2007-2009 global financial crises, the Bank of England and Treasury came to the rescue of failing financial institutions, thereby prompting the biggest shake up since the

[296] Briault (n 128)
[297] Ibid
[298] ibid
[299] ibid
[300] Ibid.

formation of the FSA.[301] The new Chancellor announced sweeping changes which saw the abolition of the existing tripartite regime between the FSA, Bank of England and Treasury. This 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, operating as a subsidiary of the Bank of England. The PRA was to carry out prudential regulation of financial firms, including banks, investment banks, building societies and insurers.[302] Additionally, the Financial Conduct Authority was also created to regulate the conduct of every authorized financial firm providing services to consumers. These led to the creation of the current twin peaks regulatory framework which separates the prudential and conduct regulation components.[303]

The United Kingdom's financial system has had a great influence on the models of unified regulation that have been adopted by many countries.[304] Although the current regulatory framework in the United Kingdom is twin peaks, it had initially created the unified approach for regulating the sector.[305] The Financial Services Authority as the regulator is created under the Financial Services and Markets Act, 2012.[306] It combines both prudential conduct of business and market conduct regulation across the financial services sector.[307]

Prior to the introduction of the Financial Services Authority in the United Kingdom, the previous system lacked transparency and adequate accountability, partly because it was so fragmented.[308] The Financial Services Authority is divided into the Financial Conduct Authority and the Prudential Regulation Authority. The aim of the Financial Conduct Authority is to protect consumers and to ensure that the sector remains stable and to promote healthy competition between financial services providers. The Prudential Regulation Authority is part of the Bank of

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[301] Ibid

[302] Ibid.

[303] Ibid.

[304] 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 2015.

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

[306] http://www.legislation.gov.uk/ukpga/2012/21/part/2/crossheading/financial-conduct-authority-and-prudential-regulation-authority/enacted accessed 17 June 2015

[307] Ibid

[308] Ferran and Goodhart (n 51) 5

England and is mandated to provide prudential regulation and supervision of banks, building societies, credit unions, insurers, and major investment firms.

4.2.1 Financial Conduct Authority

The Financial Conduct Authority was previously known as the Financial Services Authority. In discharging its general functions it is required to act in a manner that is compatible with its strategic objective and advances one or more of its operational objectives. It must do so 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. Through this objective, the Financial Conduct Authority is meant to secure an appropriate degree of protection for consumers.[309]The second is the integrity objective, 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.[310]The third is the competition objective which requires the promotion of effective competition in the interests of consumers in the markets. This objective 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.[311]

4.2.2 The Prudential Regulation Authority

Prudential Regulation Authority Limited was renamed as the Prudential Regulation Authority. 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.[312]It has three statutory objectives which include first, a general objective to promote the safety and soundness of the firms it regulates. Second is an objective specific to insurance firms, to contribute to the

[309] HM Treasury, *A New Approach to Financial Regulation: Building a Stronger System* (The Stationery Office Limited, United Kingdom 2011) 60
[310] Ibid 61
[311] Ibid 63
[312] Ibid 67

securing of an appropriate degree of protection for those who are or may become insurance policyholders. Third, is a secondary objective to facilitate effective competition.

The Prudential Regulation Authority advances its objectives using two key tools. First through regulation, it sets standards or policies that it expects firms to meet. Second through supervision, 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 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.[313]

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.[314]

Although 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.[315] 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.

[313] Ibid 82
[314] Ibid 83
[315] Mwenda *Legal Aspects of Financial Services Regulation and the Concept of a Unified Regulator* (n 10)

4.3 Germany

In Germany, the first instance at regulation was through banking regulation which was established relatively late during the banking crisis in 1931 by emergency decree. The Banking Act established in 1961 established the Federal Banking Supervisory Office (BAKred) as a new supervisory authority on a federal level. While banking was regulated tightly, financial market regulation remained underdeveloped.[316]

After World War II, security exchanges were organized regionally and were largely self regulating. While the German federal state governments were the formal supervisory authority for their respective stock exchanges, they pursued a policy of non interference in capital markets. As a result, capital markets were dominated by a few big private banks, which had a strong position in most of the self regulating bodies of the German exchanges.[317] This regulatory framework was characterized by a lack of transparency and accountability, low protection of minority shareholders and no binding rules against insider trading. Supervision of the securities sector was only established on a federal level in 1995. It, for the first time, assigned supervisory powers of German securities markets to the Federal Securities Supervisory Office (BAWe).[318]

Prior to the 1990s the stability of the existing system was supported by the big banks and the Bundesbank. Also the other sectors of German financial system had no incentive to push for changes. Also, in terms of financial innovation Germany was rather a laggard, copying financial innovations created largely in the Anglo Saxon countries. The main regulatory changes during this time were due to weaknesses in the existing regulatory framework discovered during crises occurring in single institutions. Starting in the 1970s, but having their major impact in the 1980s and the 1990s, several developments affected the structure of the German system of financial regulation. The authorization of new financial innovations started in the 1980s. Increased investor protection and criminalized insider trading allowed new financial actors like money market funds and later hedge funds to evolve.[319]

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[316] Daniel Detzer and Hansjörg Herr, 'Financial Regulation in Germany' *Financialization, Economy, Society and Sustainable Development, Working Paper Series No 55* (Institute for International Political Economy, Berlin School of Economics and Law 2014)
[317] Ibid
[318] ibid
[319] Ibid

To sum up, the regulatory structure was changed in such a way that it got more favorable for the development of financial markets. At the same time attempts to coordinate and harmonize financial regulations at the level of the European Economic Community (EEC) as a whole impacted the German system of financial regulation. Also, the Bundesbank as one of the main factors slowing down financial innovations and securing high standards in banking regulation lost partially its capacity and willingness to affect this process.[320]

At the end of the 1990s a discussion about reforming the supervisory structure started. Supervision was regarded as weak. This was partially due to the agencies poor financial and human resources. The lack of cooperation between the agencies was a main point of criticism as well. A newly founded forum for financial supervision at the end of 2000, which was coordinated by the Bundesbank, did not improve the situation. Due to all those problems the Bundesbank started promoting a single supervisory authority integrating all three areas of supervision under its auspice.[321]

After lengthy disputes between the Bundesbank, the existing supervisory agencies and the concerned ministries, the Federal Agency for Financial Market Supervision (BaFin) was established in 2002 as a single supervisory authority. It was put under legal and professional supervision of the Federal Ministry of Finance. However, regarding its decision making and its day to day supervision it was independent from political interference. The new authority was structured according to the three former fields of supervision and included departments for securities, banking and insurance supervision. Cross departments were also established to ensure cooperation and coordination between the different fields.[322]

Prior to 2002, Germany operated under an institutional approach to regulation, with separate federal supervisors for banking, securities, and insurance.[323] The Federal Financial Supervisory Authority (BaFin)[324] is in charge of the supervision of banks and financial services providers. It

[320] ibid

[321] ibid

[322] ibid

[323] Bohra Gargi, *Regulation of Financial Services in Germany* (2013) http://ssrn.com/abstract=2342625 or http://dx.doi.org/10.2139/ssrn.2342625 accessed 29 June 2015

[324] On 1 May 2002 the Federal Banking Supervisory Office (Bundesaufsichtsamt für das Kreditwesen – BAKred) was merged with the then Federal Securities Supervisory Office (Bundesaufsichtsamt für den Wertpapierhandel – BAWe) and Federal Insurance Supervisory Office (Bundesaufsichtsamt für das Versicherungswesen – BAV)

is an autonomous institution and is subject to the legal and technical oversight of the Federal Ministry of Finance. It is funded by fees and contributions from the institutions under its supervision.[325] BaFin operates in the public interest and its primary objective is to ensure the proper functioning, stability and integrity of the German financial system.[326]

Banking, Insurance and Securities supervision and asset management are the different organizational units within BaFin, sometimes called the Directorates. They comprise of separate departments within which specialist sections supervise credit institutions, insurance institutions, financial services institutions and asset management companies. All of BaFin's international activities are pooled in the International Policy/Affairs department, which directly reports to the President. This department represents the German interests in EU and other international bodies.[327]

Functions that extend beyond individual sectors are carried out by the departments of the Regulatory Services/Human Resources Directorate. There is also a department that deals exclusively with combating money laundering and terrorist financing. These departments are responsible, among other things, for prosecuting institutions that conduct financial business without authorization and for dealing with complaints.[328]

4.3.1 Banking supervision

The Bundesbank is responsible for banking supervision. In 2013, the Financial Stability Committee was established to cover macro-prudential supervision of financial institutions on a federal level as well as those in the German States.[329]The primary objectives of banking supervision is to prevent irregularities in the banking system which adversely affect the orderly execution of banking transactions or may substantially prejudice the economy as a whole.[330]

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to become the Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht – BaFin).

[325] http://www.bafin.de/EN/BaFin/bafin_node.html> accessed 29 June 2015

[326] As of 31 December 2014, they supervise 1,780 banks, 676 financial services institutions, 573 insurance undertakings and 31 pension funds as well as about 6,000 domestic investment funds and about 260 asset management companies.

[327] Daniel Detzer and Hansjörg Herr, 'Financial Regulation in Germany' *Financialization, Economy, Society and Sustainable Development, Working Paper Series No 55* (Institute for International Political Economy, Berlin School of Economics and Law)

[328] Gargi (n 324)

[329] Detzer and Herr (n 328)

[330] Banking Act s 6 (2) (Germany)

BaFin and the Deutsche Bundesbank share banking supervision. BaFin is the administrative authority responsible for the supervision of institutions under the Banking Act.[331] The cooperation between BaFin and the Deutsche Bundesbank in the institutions' ongoing supervision stipulates that the Deutsche Bundesbank shall submit reports and returns to BanFin.[332] The same have to be submitted on a regular basis. In consultation with the Deutsche Bundesbank, BaFin has also issued a guideline on the execution and quality assurance of the ongoing supervision of credit and financial services institutions by the Deutsche Bundesbank.

4.3.2 Insurance supervision

BaFin supervises insurance institutions, based on the provisions of the Insurance Supervision Act.[333]The Federal government and the Federal States share responsibility for insurance supervision.[334]BaFin supervises on behalf of the Federal Government, those private insurance institutions operating in Germany which have material economic significance. It also supervises those public insurance institutions, engaging in open competition, which operate across the borders of any Federal State. The supervisory authorities of the Federal States on the other hand are mainly responsible for supervising public insurers, whose activities are limited to the specific Federal State as well as private insurance institutions with lesser economic significance.[335]

Pension funds have been subject to unlimited insurance supervision by BaFin under the Act since the beginning of 2002. Domestic companies engaging in reinsurance business have also been subject to supervision by BaFin since December 2004. Insurance institutions which are registered in another EU member state or in a state party to the Agreement on the European Economic Area (EEA) which conduct business in Germany are primarily subject to supervision by their home country. BaFin does, however, consult the foreign supervisory authority if it identifies breaches of general German legal principles.[336]

Social insurance institutions such as statutory health insurance funds, the statutory pension insurance fund, statutory accident insurance institutions and unemployment insurance are not subject to supervision under the Insurance Supervision Act. They are regulated by other

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[331] Ibid s 6 (1)
[332] Ibid s 7 (1)
[333]http://www.bafin.de/EN/BaFin/FunctionsHistory/InsuranceSupervision/insurancesupervision_node.html> accessed 29 June 2015
[334] Ibid
[335] Ibid
[336] Ibid

government agencies, such as the statutory pension and health insurance funds of the Federal Insurance Office.

Pursuant to section 81 of the Act, the two primary objectives of insurance supervision are to ensure that the interests of the insured are adequately safeguarded and to ensure that the liabilities under insurance contracts can be fulfilled at all times.[337] In this respect, particular importance is attached to solvency supervision. In particular, insurers must establish adequate technical provisions, invest their assets safely and profitably and observe the principles of good business practice.

4.3.3 Securities supervision and asset management

The legal basis for government supervision in securities and asset management consists of the Securities Trading Act, the Securities Acquisition and Takeover Act, the Securities Prospectus Act and the Prospectus Act. In asset management BaFin does not supervise just financial services institutions and investment companies on the basis of the Banking Act and the Investment Act.[338]

Supervision of the individual stock exchanges is the responsibility of the stock exchange supervision authorities of the Federal States. They supervise the orderly conduct of trading on the individual exchanges in accordance with the provisions of the Stock Exchanges Act. In particular, the stock exchange supervisory authorities monitor the pricing process in collaboration with the exchanges' own trading surveillance units. The stock exchange supervisory authorities are also responsible for the registration of electronic trading systems and other exchange trading systems. Operators of exchange trading systems are subject to solvency supervision by BaFin as credit institutions or financial services institutions. BaFin co-operates with the stock exchange supervisory authorities in fulfilling the functions of stock exchange regulator at the international level.

4.3.4 Cross sectional supervision

BaFin's three cross sectoral departments perform functions covering all overlapping areas of supervision. They work closely together with the Banking, Insurance and Securities Supervision

[337] Insurance Supervision Act s 81(Germany)

[338] http://www.bafin.de/EN/BaFin/FunctionsHistory/SecuritiesSupervisionAssetManagement/securitiessupervisionassetmanagement_node.html> accessed 15 June 2015

Directorates, in order to ensure that a sensible balance is always struck between their respective peculiarities and the cross-Directorate aspects of supervision.[339]They include the department of Analysis and Strategy which acts as a facilitator between BaFin's micro-prudential and macro-prudential supervision. The Consumer and Investment Protection and the Legal Affairs Unit departments also exist.[340]

All over, the supervisory structure in Germany has changed from a system that depended more on self regulation to one that puts more emphasis on state regulation. Additionally, Germany followed the general trend to an integrated single supervisory authority. Also, the strong involvement of the central bank in the supervision of banks is an important characteristic of the German supervisory system.[341]

Although the German financial sector is quite advanced compared to Kenya, the circumstances which led to the reform of its sector are not unique. Just like in Kenya's case, German financial services sector also underwent piecemeal reforms before the decision to adopt the unified structure was taken. Similarly, with Kenya, it is notable that the prior developments in its regulatory structure were as a result of financial crisis and the developing international trends, as most of the reforms were made to replicate other jurisdictions. A positive aspect of the unified regulator is the fact that although the German Ministry of Finance is in charge of supervision of BaFin, the regulator is independent from political interference. This is one hurdle which Kenya's proposed regulator must overcome in order to achieve its intended objectives.

4.4 South Africa

Prior the 1980s the South African regulatory structure took the institutional approach. It thus followed international trends whereby regulators rarely looked beyond the national borders. Consolidated supervision was an unknown concept and the financial sector components, 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. Deregulation only

[339] http://www.bafin.de/EN/BaFin/FunctionsHistory/CrossSectoralIssues/crosssectoralissues_node.html> accessed 27 June 2015
[340] Mwenda, *Legal Aspects of Unified Financial Services Supervision in Germany* (n 61)
[341] Detzer and Herr (n 328)

started to happen in the late 1980s following the commissioning of the De Kock Commission by the government in 1987.[342]

The De Kock Commission observed that institutional 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 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. However, the regulatory system has remained functional and partially integrated to the present day.[343]

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. The main policy thrust was the adoption of the twin-peak model of financial regulation in South Africa.[344]

South Africa which incidentally was contemplating adopting a single regulator model from the recommendation of the 1993 Melamet Commission decided to move in line with international trends. Given its current regulatory structure, the adoption of the twin peaks model was considered to cause the least amount disruption to both market participants and the current regulators. 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.[345]

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342 Makina and Botha (n 288)
343 Ibid
344 Ibid
345 Ibid

South Africa is a member of both the Group of 20 countries and the Bank of International Settlements. It also has one seat on the Financial Stability Board, which regulates coordination at the international level.[346] Its membership to these bodies has led South Africa to have an effective regulatory framework that is in line with international best practices. Although South Africa is at an advanced level of adopting the twin peaks model of regulation since 2011, the regulatory system has remained functional and partly integrated.[347]

South Africa's commitment for reform in the financial services sector was motivated by four policy priorities. These included financial stability, consumer protection and sound market conduct, expanding access through financial inclusion, and combating financial crime.[348] These pillars of reform led to the advancement of the twin peaks model. Through this regulatory model, South Africa applies the market conduct regulation[349] as well as prudential regulation.[350]

The prudential regulator operates within the South African Reserve Bank, which is responsible for supervision of banks and insurers. In performing its functions, the regulator is expected to interact with the Minister of Finance. 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. This regulator is funded by the market levies.[351]

In order 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 accountability 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.[352]To coordinate the efforts of maintaining financial stability and limiting systemic risks in the financial sector, there is

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[346] 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 2015*

[347] http://www.fsb.co.za/Pages/Home.aspx> accessed 26 June 2015

[348] South Africa Treasury (n 347)

[349] Market conduct in this case means the regulation of how firms conduct their businesses, design and price their products and effective customer management.

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

[351] South Africa Treasury (n 347)

[352] Public Finance Management Act, 1999 (South Africa)

established the Financial Stability Oversight Committee. The Committee's main role is playing an advisory role in crisis management and resolution of disputes.[353]

Whereas the twin peaks model allows the two regulators to jointly supervise a number of financial markets, it also allows each regulator to focus on its key mandate. It is however acknowledged that 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.[354]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[355]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.[356]

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.

While authorities were contemplating adopting the integrated approach which had become fashionable since the 1990s, the global financial crisis struck in 2007 and exposed the weaknesses of the approach. In the aftermath of the global financial crisis, the twin-peak model was viewed to be the most superior model among the alternatives so that advanced countries started in earnest to debate its merits. In line with these international trends, South Africa is in

[353] South Africa Treasury (n 347)
[354] Ibid
[355] South Africa Financial Services Law (General Amendment) Act No. 45 2013
[356] Department of the National Treasury, 'Media Statement on the Commencement Date for the Financial Services Laws General Amendment Act No 45 of 2013' (2014)

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 creating 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.[357]

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. As an African economy, South Africa has coincidentally also succumbed to the international trend of reforming its regulatory framework. This is also the case in Kenya, where the calls for reform is largely attributed to the desire to replicate the emerging trends in financial regulation. Although South Africa intends to adopt the twin peaks model the Kenyan structure, shall be partially unified.

4.5 Zambia

Since independence in 1964, the financial sector in Zambia has undergone two notable phases in its development. First, during the early 1970s through the Government's nationalization, where although commercial banks were not nationalized, all other major financial institutions were nationalized and merged to form government owned institutions. Entry of non bank financial

[357] Makina and Botha (n 288)

institutions into the financial sector became restrictive. However, Government established financial, institutions, through Acts of Parliament.[358]

The second phase was the liberalization of the sector, and the economy since 1991. This led to the entry of new financial institutions into the industry. The financial sector has since grown and now comprises the Central Bank, commercial banks, non bank financial institutions, insurance companies, pension funds and the capital markets. Despite entry of new financial institutions after the liberalization of the economy, the Zambian financial system has remained relatively small.[359]

Prior to 1991, there were no notable developments in the legal and regulatory framework of the financial sector. This was largely due to public sector led policies that did not favor private initiative. After 1991, the Government embarked on an Economic Reform Programme, which necessitated the reform of the legal and regulatory frameworks of the financial sector. However, a limited number of amendments to existing legislation to address new areas of financial sector operations and the strengthening of the existing legal and regulatory framework were effected.[360]

Financial regulation and supervision in Zambia has, over the last decade, been structured around specialist organs and apart from the Bank of Zambia, most were established after the liberalization of the economy in 1991. The enactment of the Banking and Financial Services Act,[361] Securities Act[362], the Pension Scheme Regulations Act and the Insurance Act[363] and related legislation have resulted in distinct and separate regulatory responsibilities for the banking, securities, pensions and insurance sectors.[364]

Zambia has a partially unified supervisory system.[365] It adopts the twin peaks model of unified financial services regulation.[366]The Banking and Financial Services Act[367]provides for the

[358] José de Luna Martínez, 'Access to Financial Services in Zambia' *World Bank Policy Research Working Paper* (2006) 4061.
[359] Ibid
[360] Ibid
[361] Banking and Financial Services Act 1994 (Zambia)
[362] Securities Act 2010 (Zambia)
[363] Insurance Act 2009 (Zambia)
[364] Mwenda *Legal Aspects of Financial Services Regulation and the Concept of a Unified Regulator* (n 10)
[365] Mwenda, *Legal Aspects of Unified Financial Services Supervision in Germany* (n 61)

regulation of the conduct of banking and financial services as wells as safeguards for investors and customers of banks and financial institutions.[368] The Bank of Zambia Act 1996[369] establishes the Central Bank of Zambia which regulates financial institutions[370] such as banks, building societies and bureau de change.[371]The Zambia Securities and Exchange Commission is responsible for securities regulation. The Pensions and Insurance Authority in Zambia regulates the business activities of pension funds and insurance companies.[372]

4.5.1 Bank of Zambia

The legal framework for banking and financial services supervision in Zambia is governed mainly by the Banking and Financial Services Act of 1994.[373] However, the Act was recently amended.[374] The Central Bank division of that deals with the supervision of banks and financial institutions is organized into two separate, but related units. The first focusing on the supervision of banks, while the other deals with the supervision of non banking financial institutions.[375] Bank supervisors concentrate on the supervision and regulation of banks, while the non-banking financial institutions supervisors concentrate on supervising and regulating non-banking financial institutions.

4.5.2 The Pensions and Insurance Authority

Zambia's Pensions and Insurance Authority was established in February, 1997. The institution is not a statutory body, but a department setup under the Ministry of Finance and National Planning of Zambia. Before it was established, the Registrar of Insurance was responsible for the regulation of insurance companies in Zambia. The said Registrar was a civil servant based at the

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366 Kenneth Kaoma Mwenda, 'Unified Financial Services Supervision in Zambia: The Legal and Institutional Frameworks' (2004) *Zambia Law Journal*. 67–110

367The Banking and Financial Services Act 1994 (Zambia)

368 Banking and Financial Services Act Chapter 387 (Zambia)

369 Mwenda, *Legal Aspects of Unified Financial Services Supervision in Germany* (n 61) 68

370 Bank of Zambia Act s 10

371 Bank of Zambia Act s 4

372 Mwenda and A. Fleming, 'International Developments in the Organizational Structure of Financial Services Supervision: Part I'16 (2001) (12) *Journal of International Banking Law*; and Mwenda and Fleming, 'International Developments in the Organizational Structure of Financial Services Supervision: Part II' 17 (2002) (1) *Journal of International Banking Law* .

373 Banking and Financial Services Act (1994) (Zambia)

374 Banking and Financial Services (Amendment) Act (2000) (Zambia)

375 Banking and Financial Services Act (1994) (n 374)

Ministry of Finance and National Planning. His office was also at one time responsible for the registration of banks.[376]

Prior to the establishment of Pensions and Insurance Authority, pension funds in Zambia were poorly regulated. The only major regulatory requirement for pension funds was to have them obtain an approval from the Commissioner of Taxes. To deal with this shortcoming, two regulatory bodies were initially going to be setup for the regulation of pension funds and insurance companies, respectively. But this proposal was considered not to be viable. It was argued that the business activities of pension funds and insurance companies are closely linked and that the emerging trend in the region was to have one regulator for both insurance and pension fund activities. Thus, Zambia drafted the Pension Scheme Regulation Act[377] and the Insurance Act[378] which in conjunction authorized the establishment of Pension and Insurance Authority.

The Pension and Insurance Authority has three main departments. These departments are the Pensions Department, the Insurance Department, and the Administration Department. Staff members are assigned to specific departments and do not perform functions running across different departments. The pension funds supervisor, for example, focuses solely on regulating pension funds, while the insurance supervisor is concerned with insurance companies and insurance activities only.[379]

4.5.3 Coordination and sharing of information between the regulators

A memorandum of understanding, signed in May 2003, governs the relationship between the Pension and Insurance Authority and the Bank of Zambia. The Memorandum concerns the coordination of functions and the sharing of vital information, so that a sound financial sector is promoted. The three parties to this memorandum were Bank of Zambia, Pension and Insurance Authority and the Securities and Exchange Commission.[380]

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[376] Mwenda, *The Regulatory and Institutional Framework for Unified Financial Services Supervision in the United Kingdom and Zambia* (n 296)
[377] Pension Scheme Regulation Act (1996) (Zambia)
[378] Insurance Act (1997) (Zambia)
[379] Mwenda, *The Regulatory and Institutional Framework for Unified Financial Services Supervision in the United Kingdom and Zambia* (n 296)
[380] Ibid

There exist a number of overlaps and areas of conflict in the regulatory environment of financial services in Zambia leaving room for regulatory arbitrage and bureaucratic tendencies to creep in. Just like in Kenya, Zambia also suffers from several cases of regulatory overlaps. For instance, commercial banks are involved in corporate bonds issuance and custodial services, which is a preserve of the Securities and Exchange Commission. Additionally, technological improvements and globalization have resulted in the emergence of complex financial structures which have blurred the traditional product boundaries among the banking, securities and insurance sectors as products and financial service activities are becoming more integrated.[381] This is a scenario that is similar to Kenya's existing regulatory framework.

Currently, Zambia only has a well functioning bank regulation and supervision structure. However, the lender of the last resort function is not well defined.[382] Deposit protection has been recognized as the missing link in the safety net which when introduced, would help resolve some of the problems arising from bank failures. Until recently, the Bank of Zambia had no laid down policies or procedures in place that guided whether, when and under what conditions support would be given to financial institutions in distress. Zambia currently does not have a deposit protection fund and there is no supportive legal framework in place.[383] Although Kenya does not face the exact short comings as these, there are several points of similarities in the financial services structure.

Although Zambia is already partially unified, the challenges that continue to grapple the financial services sector in the country confirm that there is no optimal model and regulatory frameworks may be developed depending on the existing needs.[384] So far in Zambia, reforms and updating of the legislations have been ad hoc and piecemeal.[385]This is also the case in Kenya, which has clearly necessitated the need for reform of the regulatory framework. There are already proposals in Zambia, to adopt the unified regulatory framework.[386]

[381] Sunduzwayo (n 59)
[382] Bank of Zambia Act (1996) s 42(3)
[383] Martinez (n 359)
[384] Mwenda , *The Regulatory and Institutional Framework for Unified Financial Services Supervision in the United Kingdom and Zambia* (n 296)
[385] Martinez (n 359)
[386] Ibid.

4.6 Proposed unified regulatory framework for Kenya

Kenya's proposal for integrated regulatory framework began even before the United Kingdom institutionalized the unified regulatory model.[387] The Capital Markets Authority in its report in 1998 alluded to harmonization and working towards building a consolidated framework in the financial services sector in order to address the fragmented position. The Report further pointed to having consultation on the appropriate modalities to help build a relevant and sustainable framework for the financial services sector.[388] This Report however, made no justification for this shift and thus the government made no commitment and the proposals were abandoned.[389]

Subsequently in 2002, the then Minister of Finance, touched on the issue of rationalizing the current regulatory regime. He recalled that the Government still wanted to move in the direction of achieving a consolidated regime that would see the regulation of the capital markets, retirement benefits and insurance sector conducted by a single regulatory institution.[390] He further justified the shift on the need to minimize both regulatory costs and to harmonize the regulatory regime for the financial services consistent with the international trend.[391]

The Cabinet Secretary for Finance during the Budget speech 2015/16[392] emphasized the government's continued focus to deepen financial sector reforms for stability, growth and creation of employment opportunities. He also expressed that the objective of financial sector reforms remains to create a robust, accessible, efficient, stable and a globally competitive financial sector that promotes mobilization of high levels of savings to finance priority development.[393]

Kenya has been on the path towards integration of the financial sector regulation. The current regulatory structure continues to be characterized by regulatory gaps, regulatory overlaps, multiplicity of regulators, inconsistency of regulations and differences in operational

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[387] Gakeri (n 7)

[388] Capital Markets Authority, *Annual Report* 1998. 35 <http://www.cma.or.ke/index.php?option=com_docman&view=docman&Itemid=186 accessed 14 July 2015

[389] Gakeri (n 7)

[390] Capital Markets Authority, *Annual Report*, 2002. 52-53 <http://www.cma.or.ke/index.php?option=com_docman&view=docman&Itemid=186 accessed 14 July 2015

[391] Ibid.

[392] Republic of Kenya, '*Budget Statement for the Fiscal Year 2015/2016 by Henry Rotich, Cabinet Secretary for the National Treasury'* (Nairobi 2015)

[393] Ibid

standards.[394] 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.[395]

4.6.1 Report of Presidential Task Force on Parastatal Reforms[396]

The Report recommended that there should a clear separation between policy, regulatory and service delivery functions by government entities. It thus considered that the integration of regulatory and sector development functions was appropriate and should be applied on a sector by sector basis.

The Report discussed the different ownership models that have been adopted by different countries. These models include the decentralized model, dual model and the centralized model. The report further noted that the general direction for reform is the centralized model. 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. Further, it allows for centralizing competencies and organizing pools of experts in relevant matters, such as financial reporting.

The Report noted that the main disadvantage of a decentralized ownership model is the difficulty in creating effective separation of the ownership functions vis the regulatory and policy roles. It noted that the centralized model has been on the increase more recently, while a slight majority of countries use the multiple ownership model. The report also acknowledged that there is no global 'one size fits all' when it comes to the appropriate ownership/shareholder management model.[397]

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[394] Mutuku (n 11)

[395] The Presidential Taskforce on Parastatal Reforms was appointed by the His Excellency the President with a mandate to conclude the current policy review on the Sector with the aim of addressing the sectoral challenges while achieving Government policy priorities. The President appointed the Taskforce on Parastatal Reforms on 23rd July 2013. The report provides a review of the history and evolution of State Corporations including legal and institutional arrangements, ownership and oversight, governance framework, performance and the impact of the Constitution of Kenya 2010 and the national development goals. The report also reviewed the challenges facing State Corporations. To address these issues various approaches have been embraced leading to a re-definition of State Corporations and an elaborate re-organization recommended rationalizing the institutions with an intention to entrench efficiency and effectiveness in the institutional structures, governance and service delivery in the sector.

[396] Republic of Kenya (n 12)

[397] Ibid 47

The Taskforce recommended the consolidation of key public agencies, with minor exceptions. The exceptions would apply to the special requirements of specific priority sectors. 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 under Vision 2030 and the Jubilee Manifesto.[398]

The Taskforce adopted the rationalization of State agencies through consolidation of agencies in priority sectors, most notably regulatory agencies in the financial services sector, development finance institutions, investment promotion and marketing agencies and agencies that support small and medium sized enterprises.

4.6.2 Consolidating financial sector regulators

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. According to the Report, 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.

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, 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.

[398] Ibid 87

4.6.2.1 Banking and Deposit Taking Microfinance

The Taskforce recommended retaining the existing regulatory and institutional framework where the Central Bank of Kenya regulates and supervises financial institutions licensed under the Banking Act,[399] the Microfinance Act,[400] the Central Bank of Kenya Act[401] and entities proposed to be regulated under the National Payments Systems Act.[402]

4.6.2.2 Capital Markets, Insurance, Retirement Benefits, and SACCOs

The Taskforce recommended consolidating the regulatory and supervisory functions in the Capital Markets, Insurance, Pensions and Retirement Benefits, and Sacco sectors under the Financial Services Council, while retaining the independence of each of the sub sector regulators. This will provide greater efficiency and effectiveness and provide the benefits of consolidated supervision which include minimizing regulatory arbitrage in the financial services industry where many large financial institutions increasingly offer universal financial services under one roof.

4.6.2.3 Reform of the National Social Security Fund[403]

There is an ongoing debate on how National Social Security Fund should be structured, including the question whether it should become a default pension scheme. Although this question was not be covered by the Report, it was proposed that NSSF should operate under Retirement Benefits Act.[404]

4.7 Lessons Learnt from the analysis

This Chapter has looked at the regulatory frameworks of different countries. 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 seems that in countries where segments of the financial sector are quite inter connected, such as Germany, a good case of moving towards unification exists.[405] On the other hand, where the markets are quite sophisticated, countries have resorted to the twin peaks model such as the United Kingdom. It is however notable that although the single or unified regulator has attracted

[399] Banking Act Chapter 488 Laws of Kenya
[400] Micro Finance Act No. 19 2006 Laws of Kenya
[401] Central Bank of Kenya Act Chapter 491 Laws of Kenya
[402] National Payments Systems Act No. 39 2011 Laws of Kenya
[403] National Social Security Fund Act No. 45 2013 Laws of Kenya
[404] Retirement Benefits Act Chapter 197 Laws of Kenya
[405] Mwenda, *Legal Aspects of Unified Financial Services Supervision in Germany* (n 61) 1012

the most attention, there is no optimal regulatory structure.[406] Different countries have taken different routes and approaches. The reasons for these differences are varied and they include ideological, historical, economical and political factors.[407]

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.[408]This seems to be the case even in Africa, including Kenya.

It is also important that the institutional structure of a regulatory system should be considered when determining the regulatory framework. Some of the issues to be put under consideration include first, the appropriate number of regulatory agencies. For smaller markets, then a unified regulator would be appropriate, whereas for larger markets, the twin peaks model should be considered. Second, the appropriate structure of regulatory agencies should be considered. For instance, which firms and functions are to be allocated to which agencies, and how the objectives for each agency are to be defined. Third, the degree of coordination, cooperation and information sharing between different agencies, such as in the case of Germany, where a joint committee is in charge of coordinated functions. Fourth, the institutional mechanisms for facilitating efficiently the international co-ordination and cooperation of national regulatory agencies, and fifth, the independence and accountability of the regulatory agencies.

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

[406] Gakeri (n 7)
[407] Mwenda, *Legal Aspects of Unified Financial Services Supervision in Germany* (n 61)
[408] Taylor (n 229)

consistency.[409] 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 conceptually and in practice between prudential and conduct of business regulation.[410]This in turn therefore generates inefficiencies as firms would still have to be authorized and supervised by more than one regulator.[411]

The regulatory framework evolution that has been witnessed in the United Kingdom and some countries is an indication that regulation continues to evolve. This means that the different circumstances of the market must always be considered before a framework is adopted. For instance, the United Kingdom opted for an integrated system in the 1990s whereby the Financial Services Authority was responsible for regulating all financial services. After the global financial crisis there was a global shift from the integrated model towards the twin peak model. South Africa which was incidentally contemplating adopting a single regulator model from the recommendation of the 1993 Melamet Commission decided to move in line with international trends.

Financial services regulatory regimes in many countries are fragmented.[412] However, this trend seems to be taking after developed countries, even though the markets of many African countries including Kenya and Zambia are exceedingly small.[413] Despite this it is argued that African countries have not been adversely affected by financial crises that have resulted from regulatory capture. Despite this, regulatory modernization must be taken into consideration if the financial markets are to develop in line with the emerging trends. It follows therefore, that even if African countries have to adopt existing regulatory frameworks, the same must consider the prevailing circumstances, historical factors and comparative advantages in any given country determine the structure of the integration.[414]

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[409] Ferran and Goodhart (n 51)
[410] Ibid 153
[411] Briault (n 228)
[412] Botha and Makina (n 288)
[413] Gakeri (n 7)
[414] Mutuku (n 11)

4.8 Conclusion

The experience in financial sector regulation in Africa shows that a good number of African countries are leaning towards partial unification.[415] 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. Further, question remains whether developing countries such as Zambia, or Kenya, are ready to adopt an integrated financial services regulatory model.[416]

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.[417]

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.[418] 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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[415] Mwenda, *Legal Aspects of Financial Services Regulation and the Concept of a Unified Regulator* (n 10)

[416] Kenneth Kaoma Mwenda, 'Are African Countries Ready for Unified Financial Services Regulation?' *Africa Growth Agenda*, (University of Stellenbosch, June - August 2006) <http://www.academia.edu/8490368/K.K.Mwenda_Are_African_countries_ready_for_unified_financial_services_regulation_Africagrowth_Agenda_University_of_Stellenbosch_Business_School_South_Africa_June_-_August_2006_> accessed 22 June 2015

[417] Mwenda, *Legal Aspects of Unified Financial Services Supervision in Germany* (n 61)

[418] Mwenda, *The Regulatory and Institutional Framework for Unified Financial Services Supervision in the United Kingdom and Zambia* (n 296)

CHAPTER FIVE

5.0 CONCLUSION AND RECOMMENDATIONS

5.1 Conclusion

The financial services sector has traditionally been regarded as vital to the nation's economic growth, development, and prosperity.[419] Nonetheless, recent financial difficulties in the sector prompted calls for the review of existing regulatory frameworks. The main objective is to conform to emerging trends in the sector.[420] Chapter two discussed the strengths and weaknesses of the four models of regulation of the financial services across the world. These included functional, institutional, twin peaks and the unified model. From the assessment, there is no optimal model and various countries continue to apply different models.

As such, some countries would benefit from unification of only a few regulatory agencies. This is replicated in Zambia and the proposed structure for the Kenyan sector. The study acknowledged that the unified model might not be appropriate in a country where there are limited connections among sector components or where there is no evidence of conglomerates. In countries where segments of the financial sector are well connected, there is a good case for moving toward unified supervision as the nature of financial services evolves to encompass more complex and multifunctional operations. This was in the case of Germany which adopted the unified model and in the United Kingdom with its twin peaks model.

In Chapter two, it was noted that the choice of regulatory model depends on a variety of factors, some of which, are country specific. Some of these factors include historical development of the financial services sector, public policy priorities and government commitment towards regional integration.[421] Although countries still retain the fragmented framework of regulation, some are now moving towards integration such as South Africa and Kenya.

Chapter three analyzed the existing regulatory framework in the sector and noted that despite Kenya having enacted, amended or reviewed legislation in the financial sector, this has not resulted in the expected realignment. The sector continues to experience many challenges including duplicity of regulation, emerging areas such as bancassurance, technological

[419] Madise (n 59)
[420] Rezaee (n 53)
[421] Mwenda, *Legal Aspects of Financial Services Regulation and the Concept of a Unified Regulator* (n 10)

advancements and product development, among others. Although the calls for consolidation have been made by stakeholders to align it to reflect these changes, the same must be done effectively in a manner that will address the objectives.

In coming up with regulatory structure, each country's framework must be structured with the objective of meeting the challenges of its own financial sector. Chapter four was the comparative analysis of different countries. It was evident that in the last few years a number of countries have moved to integrate different supervisory functions. Further, the adoption and application of the unified financial services supervision has continues to vary from country to country. Furthermore as Mwenda stated, 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.[422]

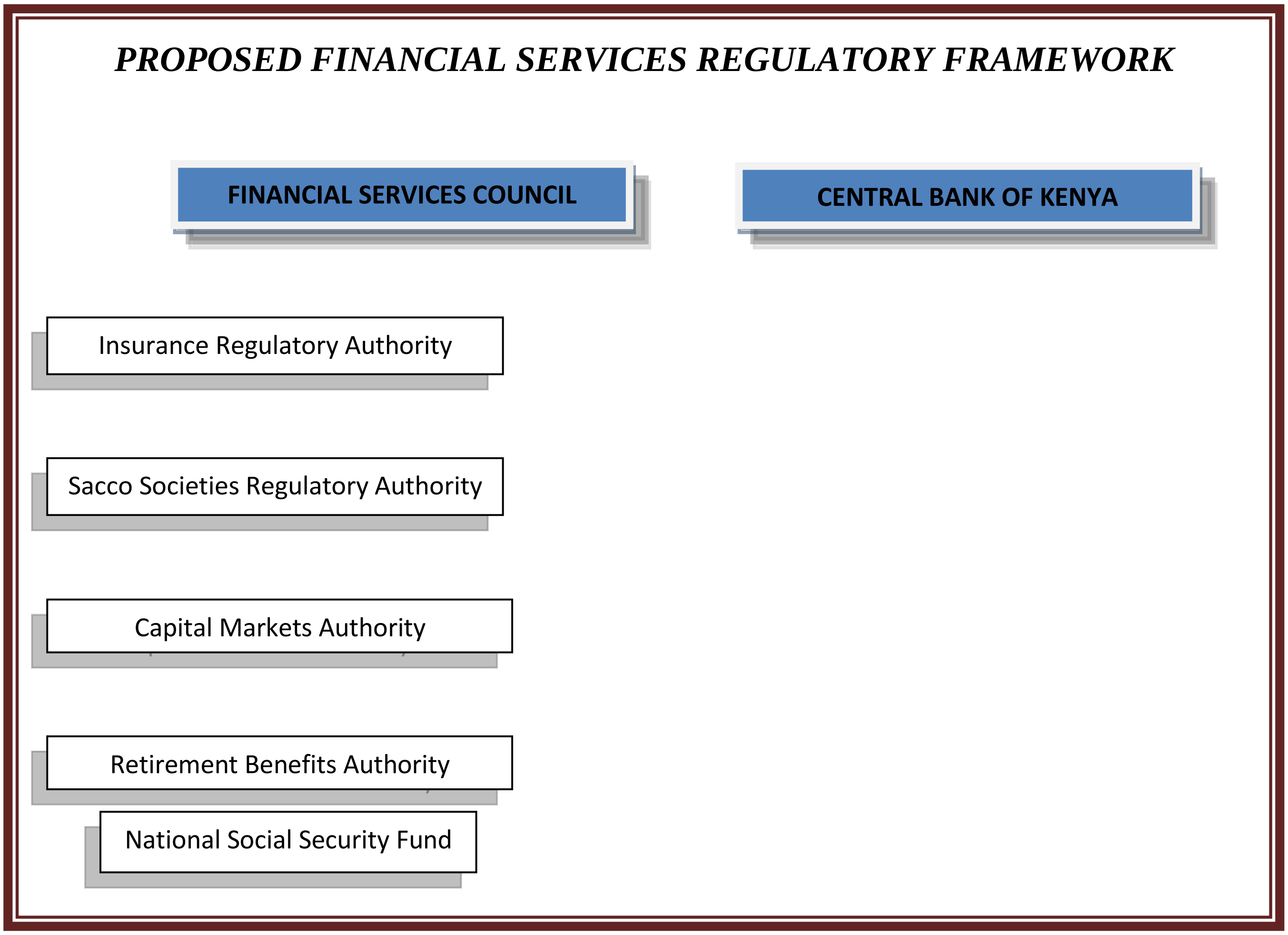
Kenya has made elaborate proposals to have a consolidated financial regulator. The Presidential Task Force Report[423] made elaborate recommendations for the adoption of the unified financial regulator. The Taskforce recognized the need to retain banking supervision under the Central Bank of Kenya while consolidating other financial regulators in the securities, insurance, pensions and cooperatives sub sectors. This model denotes partial unification.

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 Social Security Fund is proposed to operate under the Retirement Benefits Authority. This unified regulator will be known as the **Financial Services Council.** Upon unification, each of the sub sector regulators shall retain their independence.

Despite the proposal for unification of financial services, scholars have argued that many African countries have continued to replicate international models. Further they argue that the markets are exceedingly small and may not warrant unification.[424] From the foregoing, this study makes a number of recommendations that may be considered in the wake of this unification reality.

[422] Ibid
[423] Republic of Kenya (n 12)
[424] Gakeri (n 7)

Diagram 1: Proposed Financial Services Regulatory Framework in Kenya



5.2 Recommendations

In the wake of the proposals for consolidation of the sector, and the proposals that have been made by the Presidential Task Force on Parastatal Reforms, the following recommendations should be considered in order for the intended regulatory framework to achieve its objectives.

5.2.1 Independence

Chapter two identified a four-fold approach to an independent regulator, which included regulatory, supervisory, institutional and budgetary independence. The chapter also indicated that an effective regulator needs to be both independent and accountable. To achieve supervisory independence, the exclusive authority of the President to appoint the heads of the regulators should be removed and assigned to a transparent Selection Board. Such a Selection Board 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. In addition the Constitutional requirements under Chapter six must be adhered to when making any regulatory appointments.

Institutional independence should be promoted by the regulators. 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. Further, the proposed unified regulator should be an independent constitutional body. 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.

Additionally, the staff of the Financial Services Council should be adequately compensated in order to attract and keep competent staff and avoid bribery and corruption. The senior staff of the independent regulators should must be appointed by the Council and enjoy security of tenure.

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. Where there are elements of funding by the market players, then this should not encourage some form of supervisory arbitrage. The unified regulator has a role to ensure that policies are developed to enhance budgetary independence in the sector.[425]

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[425] Mwenda, *Legal Aspects of Financial Services Regulation and the Concept of a Unified Regulator* (n 10)

An independent regulator is key to a successful regulatory framework. There should be a balance between the concept of an independent regulator and that of accountability of the regulator. 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.[426]

5.2.2 Standard operating procedures

Some regulators have statutory powers only to issue regulations and to ensure, through oversight, that they are complied with.[427] The Financial Services Council should advocate having similar operational powers among the independent regulators. Some of these 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.[428]

Enforcement of the regulations and guidelines should be an essential element. The unified regulator must empower the independent regulators to enforce compliance with rules. Enforcement in this case would include investigating, gathering and sharing information among the regulators as well as imposing penalties.[429] For this function to be effective there should be a collaborative effort among the independent regulators as well as the Financial Services Council.

5.2.3 Corporate governance

Effective corporate governance, best practices, and competent and ethical culture are primary to achieving sustainable and effective financial markets.[430] This means that the Central Bank, the Financial Services Council as well as the independent regulators must adequately adhere to the corporate governance guidelines offered under the Code of Corporate Governance for State Corporations, commonly known as *Mwongozo*.[431] Additionally, the codes for corporate governance enacted by the different regulators must be consolidated to ensure uniformity in the operating procedures.

[426] Madise (n 59)
[427] Mwenda, *Legal Aspects of Financial Services Regulation and the Concept of a Unified Regulator* (n 10)
[428] Mutuku (n 11)
[429] Mwenda, *Legal Aspects of Financial Services Regulation and the Concept of a Unified Regulator* (n 10)
[430] Rezaee (n 38)
[431] State Corporations Advisory Committee, 'Code of Governance for State Corporations' *Mwongozo* (2015) www.scac.go.ke> accessed 10 September 2015

Different stakeholders including the government need to be more proactive in monitoring and scrutinizing the regulators in the sector. Equally, the directors should be held more accountable in fulfilling their fiduciary duties by overseeing management's strategic plans, decisions, risk assessment, and performance. The management of the various regulators are also expected to achieve sustainable shareholder value creation and enhancement and to enhance the reliability of financial reporting through executive certifications of internal controls and financial statements.

Some of the internal control mechanisms that should be adopted by the Financial Services Council and its independent regulators include adopting a more active role in the oversight of financial reporting, having effective board committees and audit committee that is responsible for overseeing financial reporting and related audits. This will enhance early detection and prevention of systemic risks in the sector. The senior management of the regulators, including the chief executive officers and chief financial officers must equally be held accountable for serious breaches of the guidelines and regulations, which are likely to expose the sector.

5.2.4 Signing of Memorandum of Understanding between regulators

Under the guidance of the Financial Services Council, the four independent regulators should sign Memorandum of Understanding 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.[432]

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.[433]

5.2.5 Legislative Amendments

Upon the adoption of the unified regulatory framework for Kenya, most of the legislation regulating the sector shall be amended to reflect the changes. First, an Act of Parliament should be enacted to create the Financial Services Council as the financial services regulator. This amendment will legislate the independence, regulatory powers, appointment of its members and

[432] Mutuku (n 11)
[433] Ibid

security of tenure. Similarly, legislation must be enacted to provide for the specific functions of the Financial Services Council, including its regulation of the independent regulators, powers to make legislation, operational functions, enforcement of regulation among other important provisions that will ensure the effectiveness of the regulator.

Second, the different existing legislation including the Insurance Act,[434] Banking Act,[435] Central Bank of Kenya Act,[436] Capital Markets Act,[437] Sacco Societies Act,[438] Retirement Benefits Act,[439] and National Social Security Fund Act[440] among others, will be amended, to take cognizance of the new regulator. The amendment will also restructure the powers of the current regulatory authorities, existing under those Acts. Further, the functions of those independent authorities have to be reviewed to capture the spirit and letter of the integration, while considering its intended objectives.

Kenya's financial services sector is on the verge of adopting the integrated model. It is prudent that this process is conducted in a manner that will guarantee efficiency and effective coordination of the sector. In addition, the integration must revamp the system in order to make it more responsive to the market dynamics.[441]

As postulated above, in order for Kenya to effectively manage its transition to a unified regulatory framework, independence, good corporate governance and standard operating procedures must be adopted. Finally, the proposed Financial Services Council must be established vide legislation to warrant the attainment of its intended objectives.

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[434] Insurance Act Chapter 487 Laws of Kenya
[435] Banking Act Chapter 488 Laws of Kenya
[436] Central Bank of Kenya Act Chapter 491 Laws of Kenya
[437] Capital Markets Act Chapter 485A Laws of Kenya
[438] Sacco Societies Act No. 14 2008
[439] Retirement Benefits Act Chapter 197 Laws of Kenya
[440] National Social Security Fund Act No. 45 2013
[441] Gakeri (n 7)

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