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MASTER OF LAWS (LL.M) OF THE UNIVERSITY OF NAIROBI**

**PREVENTING FAILURE OF COMMERCIAL BANKS IN KENYA: AN ANALYSIS OF THE
SUPERVISORY ROLE OF THE CENTRAL BANK**

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DECLARATION

I, Alice Wairimu Mugo, hereby submit this thesis and declare that it is my original work and that it has not been presented for any award of a degree in any university.

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My classmates-turned-friends: for their advice, critiques and encouragement all through.

DEDICATION

This research project is dedicated to my dad, Ephraim Mugo Kamanga. I wish you could have seen me graduate. Keep resting in peace, Dad.

LIST OF ABBREVIATIONS

BNM	Bank Negara Malaysia
BSD	Bank Supervision Department
CAMELS	Capital Asset Management Earnings Liquidity Sensitivity to Risk
CBK	Central Bank of Kenya
CMA	Capital Markets Authority
CR	Component Rating
CRR	Composite Risk Rating
FDIC	Federal Deposit Insurance Corporation
FSA	Financial Services Authority
GDP	Gross Domestic Product
IRA	Insurance Regulatory Authority
PGs	Prudential Guidelines
RBA	Retirement Benefits Authority
RBI	Reserve Bank of India
RBS	Risk Based Supervision
UFIRS	Uniform Financial Institutions Rating System

ABSTRACT

The importance of a stable banking system in any country cannot be sufficiently underscored. This is especially true in light of the increasing complexity of banking business, and the centrality of banking to the performance of economies. The banking sector in Kenya has grown from one having a few colonial-era banks to having a robust array of local banks that are spreading their operations regionally.

However, the Kenyan banking sector has over time been faced with occurrences of bank failure that were initially systemic and are now becoming individualised. Some of the reasons for the failure of banks in the nascent industry in the 1980 and 1990s keep re-occurring in present day. This is despite an enabling legal environment for the bank supervisor, the Central Bank of Kenya (CBK). This has led to the need to re-evaluate the mode of supervision taken by the CBK and its application of the law.

This study looks at the various phases of bank failure in Kenya and the documented causes. It also looks at the legal framework under which the CBK operates. Lastly, the study interrogates the methods of supervision taken by the CBK. It further looks at the methods of supervision that have been used in other jurisdictions such as the USA, Malaysia and India and compares them to the methods applied by the CBK.

Consequently, the study establishes that the problem does not lie in the legal framework for bank supervision, but rather in how the supervisor goes about its implementation. The method used is found to be backward-looking and deficient in light of the nature of the sophisticated banking sector yet the progressive method is available but side-lined.

The study therefore proposes that the CBK improve on its current method of supervision (CAMELS) while at the same time phasing in a better method (RBS) that has been proved progressive and more effective in other jurisdictions. This is to be done with a view of eventually implementing a total migration to the RBS approach to banking supervision.

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CHAPTER 1: INTRODUCTION

1.1 Overview

The banking sector in Kenya has grown from one consisting of a few colonial era foreign-owned institutions to having locally-owned banks, which has been fuelled by economic growth and development.¹ Notably, there were not only locally-owned commercial banks but also non-bank financial institutions and development finance institutions by the early 1990s, with the owners of the latter also setting up commercial banks which contributed to expansion of the financial sector.²

A snapshot of Kenya's financial sector in 1994 showed a total of 88 financial institutions (both commercial and non-bank) with a substantial level of local ownership, and substantial deposits in relation to the GDP of the country.³ This is in contrast to the 9 foreign-owned commercial banks at independence.⁴

Supervision of the banking sector has been through the Central Bank of Kenya (CBK) which was first established in 1966 through enactment of the Central Bank of Kenya Act.⁵ Supervisory powers over banking institutions were however vested in the CBK through section 19 of the Banking Act of 1968 whose enactment followed that of the Central Bank of Kenya Act.⁶

The CBK Act has subsequently been amended as recently as 2015 and provides for the roles of the CBK to include among others, fostering the liquidity, solvency and proper functioning of a stable market-based financial system.⁷ The CBK is thus responsible for ensuring capital adequacy, liquidity and stability in the banking sector. This role includes

¹ Martin Brownbridge, 'Government Policies and the Development of Banking in Kenya' Working Paper Series 29 (Brighton: IDS, 1996) p.1

² Ibid (n1) p.2

³ Ibid (n1) p.2

⁴ Ibid (n1) p.1

⁵ Chapter 491, Laws of Kenya (Government Printer, Nairobi) at <https://www.centralbank.go.ke/index.php/about-us> accessed on 6th June 2016.

⁶ 1994 BSD

⁷ Chapter 491, Laws of Kenya (Government Printer, Nairobi) Section 4(2) at <https://www.centralbank.go.ke/index.php/about-us> accessed on 6th June 2016.

exercising its powers of supervision to prevent bank failure resulting from myriad reasons that shall be discussed further in this paper.

In fulfilling its role, the CBK is guided by the Banking Act,⁸ the Central Bank of Kenya Act⁹ as well as international standards such as the Core Principles for Effective Banking Supervision as developed by the Basel Committee on International Banking Standards.¹⁰ The CBK also operates as a supervisor of financial institutions within the afore-listed enabling regulatory framework of statutes and regulations which will be examined in detail later on in this paper.

Central banks have been recognised as having an impact on economic stability even when their main role is supervision of the financial sector.¹¹ Economic stability leads to economic development and thus the attendant consequence of creating more sophisticated financial systems.¹² This underscores the importance of the proper functioning of central banks as their influence reaches beyond the financial sector, and they are best placed to reduce risk in any financial system.¹³

This paper shall seek to substantiate the premise that the reason for the persistent occurrences of bank failure in Kenya is as a result of supervisory enforcement lacunas and ineffective implementation of regulations by the CBK. Resulting bank failures have had an effect on the entire financial system, which the CBK in its 1994 Report characterised as ‘major disruptions.’¹⁴ The CBK as a supervisor is supposed to monitor the banking sector and intervene where necessary before bank failure occurs using its powers of inspection, among others, which it has had under Section 19 and 32 of the Banking Act, 1989.¹⁵

⁸ Chapter 488, Laws of Kenya at <http://www.kenyalaw.org/lex//index.xql> accessed on 6th June 2016.

⁹ Ibid (n7)

¹⁰ Ibid (n6)

¹¹ Florence Dafe, ‘The politics of central banking and implications for regulatory reform in sub-Saharan Africa: The cases of Kenya, Nigeria and Uganda,’ German Development Institute Discussion Paper 2/2012 at https://www.die-gdi.de/uploads/media/DP_2.2012.pdf accessed on 14th March 2017

¹² Ibid

¹³ Ibid

¹⁴ Central Bank of Kenya, Bank Supervision Annual Report (1994) p13 at <https://www.centralbank.go.ke/reports/bank-supervision-and-banking-sector-reports/> accessed on 6th June 2016

¹⁵ Ibid p5 para 1.2: See the Role of the Banking Supervision Department

This paper will analyse the incidences bank failures in Kenya. It will look at the legal framework that empowers the CBK to anticipate and prevent bank failures. The paper shall also analyse how the CBK handles bank failure. Further, the paper shall look at the tools CBK has at its disposal in its preventive role.

The paper shall also have reference to international best practices. The enabling laws, the tools and their application by the CBK will be analysed in that regard. This shall lead to the conclusion and recommendations at the end of the paper.

1.2 Background to the study

Bank crises and failures have been documented in Kenya to have occurred in several phases.¹⁶ The first was in 1984-1989 prior to the passing of the 1989 Banking Act.¹⁷ It mainly affected family or community-owned banks such as Union Bank and Jimba Credit Cooperation.¹⁸ The reasons for the bank failure included mismatched lending in the case of Jimba (the bank would borrow for the short term and make long term loans), mismanagement, poor lending practices, unsecured insider loans, adverse dominant influence of the board and/or interference, undercapitalisation and lack of internal controls.¹⁹

The second phase was between 1993-1995 where 19 banks failed; a number of which did so as a result of the Goldenberg Scandal.²⁰ The reasons included lack of effective prudential regulation and those identified as causing the first phase of bank failure.²¹

The third phase occurred in 1998 involving banks such as Bullion Bank and City Finance Bank.²² In 2007 up to date, Trade Bank, Euro Bank, Charterhouse Bank and more recently Dubai Bank, Imperial Bank and Chase Bank have ended up on the chopping block.²³

¹⁶ A List of Kenyan Banks That Have Collapsed (*Infohub Kenya*) at <http://www.infohub.co.ke/2016/04/a-list-of-collapsed-kenyan-banks.html> accessed on 21 July 2016

¹⁷ Ibid

¹⁸ Ibid (n 16)

¹⁹ Central Bank of Kenya Bank Supervision Annual Report (1994) (Appendix VIII p36) at <https://www.centralbank.go.ke/reports/bank-supervision-and-banking-sector-reports/> accessed on 8 August 2016

²⁰ Ibid (n 16)

²¹ Ibid (n19) p13

²² Ibid (n 16)

²³ Ibid (n 16)

Kenya has adopted central banking as the mode of regulation of the banking sector as anchored in the Central Bank of Kenya Act.²⁴ The overarching mandate of the CBK as a supervisor is to maintain stability in the financial system which in turn stimulates economic growth.²⁵ It is a trite fact that without effective supervision, the resulting bank crises have negative effects on the economy.²⁶

The most recent incidences of bank failure have led to questions as to whether the CBK is doing enough to protect depositors.²⁷ The CBK has been accused of ‘failing the wananchi,’ and it has been suggested that even as it deals with the most recent bank failures affecting small banks, there is need to ensure that banking supervision is effective sector-wide.²⁸ This proposal will be discussed in this paper with a view to substantiating it and making recommendations on how the CBK should go about it.

1.3 Statement of the problem

The common thread running through all these phases up to 2016 is the reasons for failure. They include mismanagement, high incidences of non-performing loans, lending malpractices including imprudent insider lending, capital inadequacy, and interference by the board in management, among others.

The amendments to the banking laws that followed the first phase were aimed at strengthening the supervisory authority of the CBK. Subsequent amendments in the 1990s and the 2000s had a similar aim, including increasing the CBK’s powers over bank management. However, in spite of a highly enabling legislative and normative environment, the CBK has been unable to avert bank failures.

²⁴ Central Bank of Kenya Act, section 57

²⁵ Francis M Mwea, ‘Financial Regulation in Kenya: Balancing inclusive growth with financial stability,’ (Overseas Development Institute Working Paper 047 November 2014) at <https://www.odi.org/sites/odi.org.uk/files/odi-assets/publications-opinion-files/9279.pdf> accessed on 14th March 2017

²⁶ Ibid

²⁷ Karen Kandie, ‘More regulation needed in the banking sector,’ *The Star* (Nairobi 28th April 2016) at http://www.the-star.co.ke/news/2016/04/28/more-regulation-needed-in-the-banking-sector_c1340303 accessed on 14th March 2017

²⁸ Ken Opalo, ‘Banking regulation no longer a worry for Kenya’s minority,’ *Standard Digital* (Nairobi 16th April 2016) at <https://www.standardmedia.co.ke/article/2000198384/banking-regulation-no-longer-a-worry-for-kenya-s-minority> accessed on 14th March 2017

This paper shall focus on assessing the effectiveness of the CBK in discharging its mandate and in particular, the weaknesses in implementation of the banking laws and regulations.

1.4 Justification for the study

It is the responsibility of the CBK to watch over the financial system. This is to ensure the safety and soundness of the system and that banking institutions are managed in a prudent manner. In doing so, the CBK is not merely a reactionary bystander.

The CBK is tasked with monitoring, evaluation and inspection, and taking preventive measures. It has powers of inspection, supervision and management. The CBK is empowered through enabling legislation such as the Banking Act, the Central Bank of Kenya Act and the Prudential Guidelines, all which are based on international best practices.

It is therefore an undesirable state of affairs that as recently as 2016, incidences of bank failure continue being recorded in Kenya. The attendant consequence of such a state of affairs has negative ramifications on the economy. It reduces public confidence in the banking and financial system. The larger consequence is destabilisation of markets and reduction of the flow of money in the economy leading to reduced economic performance.

The frequency of incidences of bank failure in Kenya has proven to be disruptive. It is timely, therefore, to examine the legal regulatory framework in which the CBK, the institution charged with preventing such occurrences is operating in order to assess whether it uses its preventive powers effectively and how it responds to bank failures.

This assessment will then enable us establish that despite the presence of enabling rules and laws, the CBK is unable to effectively implement them. The resultant bank failures destabilize the banking system, thus the CBK is not discharging its mandate of maintaining a stable banking system.

1.5 Objectives

- a. To identify and analyse the incidences and causes of bank failure in Kenya.

- b. To identify and assess the enabling rules and regulations in place vesting in the CBK the power to supervise banks thereby maintaining a stable banking system.
- c. To assess the effectiveness of the supervisory role of the CBK in preventing bank failure.
- d. To identify the methods used in supervision of banks to forestall bank failure and how they have been applied in different jurisdictions.
- e. To make recommendations focusing on strengthening implementation of banking laws on the part of the CBK with a view of having the CBK discharge its mandate in a more effective manner in order to successfully prevent bank failure in Kenya.

1.6 Research Questions

- a. What have been the incidences and causes of bank failure in Kenya?
- b. What is the existing legal framework governing the supervisory role of the CBK particularly in averting bank failure in the banking sector in Kenya?
- c. Has the CBK effectively implemented the enabling laws and regulations in preventing bank failure in Kenya?
- d. What methods have been used to supervise banks in order to prevent bank failure in various jurisdictions?
- e. How can the CBK effectively utilise its supervisory powers under the existing legal framework to prevent bank failure in Kenya?

1.7 Hypothesis

The CBK has an adequate legal framework of rules and regulations and tools necessary to ensure that the banking system is functioning properly. Therefore, the reasons for bank failure in Kenya can be attributed to poor implementation of the existing legal framework and methods of supervision.

If the CBK were to effectively implement the banking laws and regulations including sanctions; and also utilise the more effective method of supervision, this will enable the CBK prevent further bank failures in Kenya.

1.8 Theoretical framework

The theories of economic regulation as espoused by various scholars²⁹ are most relevant to this study. The rationale is that regulation of the banking sector by the CBK is essentially intrusion by the government the financial sector.

There are two economic theories of regulation which flow from different assumptions as discussed by den Hertog.³⁰ The first is the public interest theory which is based on the assumptions that regulators have enough information and sufficient powers of enforcement to promote public interest, the latter being their main concern.³¹

This exposition of the public interest theory correlates with Pigou's who advanced the idea that regulation is for the benefit of society;³² and that government intervention was for purposes of acceding to public demand to influence markets in such a way as to make them more equitable.³³ Thus the basis of such regulation is to make markets more efficient since self-regulation would eventually lead to inefficiency.³⁴

With regard to the establishment and functions of the CBK, it has sufficient powers of information, and its main functions are geared towards public interest.³⁵ The nature of banking business; the attendant information asymmetry; and the close linkage between the financial sector and the economy; demand government intervention.³⁶

The second economic theory of regulation den Hertog looks at is the private interest theory.³⁷ This theory is based on the assumption that the regulator does not have sufficient information about the market to enable them intervene in such a manner that

²⁹ Richard A. Posner, *Theories of Economic Regulation*, (1974) The Bell Journal of Economics and Management Science (Vol. 5, No. 2) at <http://links.jstor.org/sici?sici=0005-8556%28197423%295%3A2%3C335%3ATOER%3E2.0.CO%3B2-A> accessed on 4th October 2014 pp. 335-358

³⁰ Johan den Hertog, *Review Of Economic Theories Of Regulation* (1992) Tjalling C. Koopmans Research Institute Discussion Paper Series nr – 10-18 at <http://www.uu.nl/rebo/economie/discussionpaper> accessed on 2nd October 2014 p2

³¹ Ibid

³² Arthur Cecil Pigou, *The Economics of Welfare* (1932) (London: Macmillan & Co., 4th ed.) at <http://www.econlib.org/library/NPDBooks/Pigou/pgEW24.html> accessed on 4th October 2014

³³ Ibid

³⁴ Ibid (note 32)

³⁵ Central Bank of Kenya Act, see generally: The CBK has power to cause an inspection to be made of banks and their books, account and records

³⁶ Alberto Heimler, *Competition Policy, Antitrust Enforcement And Banking: Some Recent Developments*, at <http://www.oecd.org/daf/competition/prosecutionandlawenforcement/38821319.pdf> accessed on 14th March 2017 p 2

³⁷ Ibid p2

promotes public interest.³⁸ Therefore regulation does not necessarily promote public interest since different players in the economy are pursuing their own interests.³⁹

In light of the powers of the CBK under the various enabling laws, it has sufficient avenues of getting information about the market.⁴⁰ Indeed, one of its main roles (setting of interest rates) is dependent on knowing the market trends.⁴¹

Posner has defined economic regulation as being government intervention in the market. He put forward his interpretation of theories on such intervention being the public interest theory and the capture or interest theory.⁴²

Posner has looked at the public interest theory as being typified by two assumptions: Firstly, economic markets are extremely fragile and likely to operate inefficiently; and secondly, that regulation by the government does not cost anything.⁴³ He argues that if this were true, then we would find government regulation in industries where there is a greater danger of abuse of monopoly power, and where there is substantial benefit standing to be gained by the public.⁴⁴ He argues that the kind of government intervention that exists is not solely anchored on correcting inefficiencies or preventing market failure, for example, in the transport, health and legal sectors.⁴⁵

Further, Posner argues that government intervention is not costless, nor is it dependable for altering market behaviour.⁴⁶ Therefore government regulation cannot be explained on the ground that it succeeds in modifying market behaviour in favour of the public.⁴⁷ Posner concludes that increasingly, it is being realised that government regulation has not resulted in any increased fairness or justice in the society.⁴⁸

³⁸ Ibid

³⁹ Ibid

⁴⁰ See generally CBK Act, Banking Act of Kenya, and the Prudential Regulations 2013.

⁴¹ Central Bank of Kenya Act section 4.(1) The principal object of the Bank shall be to formulate and implement monetary policy directed to achieving and maintaining stability in the general level of prices.

⁴² Ibid

⁴³ Ibid (note 29) p 336

⁴⁴ Ibid

⁴⁵ Ibid

⁴⁶ Ibid (n 29)

⁴⁷ Ibid (n 29)

⁴⁸ Ibid (n 29)

To some extent, Posner's arguments are valid. For example, the financial sector in Kenya would not be inefficient if the CBK did not exist. It is more probable that it would be efficient but skewed in favour of the banks, which is the case any way even with the existence of the CBK.⁴⁹ In addition, the funding provision for the CBK debunks the assumption that government intervention is costless.⁵⁰

The capture or interest theory has Marxist leanings and holds that economic regulation is not about public interest at all, but a process through which interest groups seek to promote their interests, the capitalists being the main group.⁵¹ This is contrary to a view put forward by political scientists that the interest groups in question are part of the legislative process and as such end up dominating the regulator.⁵²

Posner has criticized this explanation by arguing that it is confusingly similar to the public interest theory and that it lacks a theoretical foundation.⁵³ He argues that regulation also helps small businesses, and there is no reason given for the conquest of the regulator, nor why the regulated industry is the only one capable of exerting influence.⁵⁴ This is especially so in light of multi-sector regulators: there's no explanation for which sector conquers the regulator.⁵⁵ The capture theory fails because it lacks a foundation and gives no reasons for the hypotheses it puts forth.

For our purposes, and going by the capture theory, the CBK are arguably captured by banks and promotes their interests. This is not the case on the ground. It is especially rendered baseless by the recent passing of the cap on interest rates contrary to the anticipation of Kenyan banks. This was through the legislative process; therefore banks were even unable to influence that process.

⁴⁹ This has changed after the capping of interest rates which occurred at the instance of Parliament and was opposed by banks.

⁵⁰ Njaramba Gichuki, *Law of Financial Institutions in Kenya* (2013) (Law Africa Publishing 2nd ed.): The CBK is exempt from tax on its income and profits. It has an authorized capital of Five Billion Kenya Shillings drawn from the General Reserve Fund which is vested in the Cabinet Secretary to the Treasury. However, the bulk of its net annual profits are paid into the Consolidated Fund. (p 5)

⁵¹ Ibid Posner n 29 p341

⁵² Ibid

⁵³ Ibid

⁵⁴ Ibid

⁵⁵ Ibid

The economic theory of regulation is put forward by Stigler, who bases the theory on two suppositions: one, that the coercive power of government can be used to benefit particular individuals or groups thereby reducing economic regulation to a product whose allocation is governed by the forces of supply and demand; and two, that there are cartels which determine the demand and supply curves.⁵⁶ This suggests, then, that economic regulation serves the private interests of politically effective groups or cartels.⁵⁷

Posner critiques this theory by pointing out that the theory is not refined enough to enable prediction of industries where regulation will be found.⁵⁸ Secondly, it does not explain under which conditions the possibility of regulation is maximized.⁵⁹ Consequently, the theory is vague enough to explain many situations but not concrete enough to stand up to tests.⁶⁰

This paper seeks to argue that it is in public interest for the government to intervene in the banking sector in order to achieve the objective of protecting depositors and ensuring a stable banking sector. This is supported by the public interest theory as per the foregoing discussion. The reason for government regulation cannot however be limited to instances where injustice is likely to occur, but also where the intention is to benefit society as a whole, and where it is done without wholly compromising the interactions of market forces.

1.9 Literature Review

In his book on banking law, Cranston looks at some of the reasons behind banking sector supervision such as prudential, investor-protection and consumer protection.⁶¹ He relates these reasons to financial liberalization having made banks more aggressive and open to risks.⁶²

⁵⁶ Ibid (n 29) p 344

⁵⁷ Ibid (n 29) p 343

⁵⁸ Ibid (n 29) p 347

⁵⁹ Ibid

⁶⁰ Ibid (n 29) p 348

⁶¹ Ross Cranston, *Principles of Banking Law* (2002) (OUP 2nd Edition) p. 63

⁶² Ibid

He further notes that systemic risk is also a legitimate reason for supervision due to the interconnectedness of banks within a financial system.⁶³ Prevention of such risk averts bank failure and the consequent loss of money by depositors, costs of resolution and the negative effects on the economy.⁶⁴

In order to understand why preventive supervision is important, we can consider the two categories of prudential regulation discussed by Cranston: preventive and protective.⁶⁵ The former operates to forestall crises e.g. capital, solvency and liquidity standards while the latter are crisis-support mechanisms e.g. lender of last resort and deposit insurance.⁶⁶ However, he notes that they tend to overlap depending on how bank regulation is styled in a particular jurisdiction.⁶⁷

Cranston notes that even in jurisdictions that have one regulator of the financial sector, it is important to have a central bank as the regulator of core banking as it traditionally tasked with supervising the payment system, receiving reports and being the lender of last resort, hence it is in a better position to manage systemic risk.⁶⁸ However, despite deposit protection schemes being a disincentive for central banks not to rescue insolvent banks, they can mount rescues through financial assistance; either to keep the victim bank open or to enable a healthy bank take-over.⁶⁹

Cranston also notes that central banks are at the heart of any banking system as they ensure stability through direct and indirect tools such as reserve requirements, open market operations and discount window.⁷⁰ All these tools allow the central bank to exercise control over banks in their operations thus supporting Cranston's observation.

⁶³ Ibid at p.66

⁶⁴ Ibid; Banks lend among themselves. If a bank has large deposits with a failed bank, they may suffer low liquidity or even collapse (p. 67). Payment systems also create a risk in that if there are delays or inability in netting and settlement that can spread to other banks causing them not to meet their obligations on their end. Systemic risk can also be a problem when the public perceives that their bank is also in the same position as that other bank causing a run on their bank. Even if they are healthy, the other bank will face a liquidity crisis as customers rush to withdraw their money.

⁶⁵ Ibid (n 61) p. 82

⁶⁶ Ibid

⁶⁷ Ibid

⁶⁸ Ibid (n 61) p.83-84

⁶⁹ Ibid (n 61) p.94-96

⁷⁰ Ibid (n 61) p.110-122

However, Cranston does not go into what makes an enabling legal environment for effect supervision or regulation by central banks. He also does not look at the practical aspects of central banking are, which entails not only application of the law but also methods of supervision. He also does not consider that a central bank can be ineffective in supervision.

In their book, Ellinger et al note go into more detail with regard to the importance of effective implementation of the bank supervision laws. They note that in the United Kingdom, regulation of banking began informally under the Bank of England.⁷¹ However, the sector was influenced to formalise by the European Economic Community and the Basel Committee on Banking Supervision.⁷² In particular, the Basel Committee's initiatives were geared towards the stability of the banking sector worldwide. This precipitated the policy shift that saw the Banking Act of 1979 increasing the Bank of England's supervisory powers making it into a *de facto* central bank.⁷³

Ellinger *et al* observe that bank failures are not a unique phenomenon, especially in light of the 2007 global financial crisis, and the preceding crises in the UK in 1964, during the Depression, 1973-1976, the 1980s and the 1990s.⁷⁴ Some of the reasons for bank failures included unsound lending practices and liquidity issues as seen in the 2007 crisis.⁷⁵ The liquidity issues were due to banks attempting to protect themselves from the American sub-prime mortgage market.⁷⁶

It is noted that the collapse of any bank inevitably causes a financial panic leading to runs on other banks in the market which affects confidence in the banking system generally.⁷⁷ It is for this reason that Ellinger *et al* note that there needs to be regulation and supervision of banks to ensure stability in the banking system.⁷⁸ Emphasis is put on the adequate application of any regulatory regime, that is, effective prudential

⁷¹ E.P. Ellinger, Eva Lomnicka and C.V.M. Hare, *Ellinger's Modern Banking Law* (2010) (Oxford 5th edition)

⁷² *Ibid* p27

⁷³ *Ibid* (n 70) p28

⁷⁴ *Ibid* (n 70) p26

⁷⁵ *Ibid* (n 70)

⁷⁶ *Ibid* (n 70)

⁷⁷ *Ibid* (n 70) p27

⁷⁸ *Ibid* (n 70) p27

supervision, which, as Ellinger *et al* note, was lacking by the Financial Services Authority⁷⁹ hence leading to the collapse of the Northern Rock Bank in the UK.⁸⁰

While Ellinger *et al* emphasize on the importance of adequate application of the regulatory regime, they have not appreciated that it is possible to have a bank supervisor that is simply not effective even with an adequate regulatory regime. They have also not looked into the issue of reoccurrence of internal reasons for bank failure vis a vis the supervisor's actions.

Arguably, bank supervisors in this day and age need to appreciate that supervision entails more than prescribing the rules. In this respect, Wadsley and Penn argue that there is need for a mechanism for ensuring that prudential standards are adhered to.⁸¹ This, they argue, is because banks serve as depositories and distributors of financial resources in the economy hence their stability is in public interest, especially since the nature of banking business renders them susceptible to instability and collapse.⁸²

They note that banking business requires risk taking and depends on depositor and investor confidence.⁸³ If there is lack of confidence from any quarter, its effects are disastrous on that bank and inevitably spread through the financial system.⁸⁴ A sector-wide lack of confidence inevitably leads to bank runs as such situations are aggravated by information asymmetry between banks and depositors leading to bank failure.⁸⁵

From the above exposition, Wadsley and Penn posit that effective prudential supervision is necessary to create depositor confidence and ensure proper risk management.⁸⁶ This, they argue, has to be done by a bank supervisor who must recognise that their role has

⁷⁹ The Financial Services Authority succeeded the Bank of England as a regulator/central bank after the Labour Party took over government in 1997 and passed the Financial Services and Markets Act 2000 that transferred the Banks' responsibility for banking regulation and supervision to the FSA. In 2010, the Act was amended by the Financial Services Act which strengthened the powers of the FSA and gave it a financial stability objective.

⁸⁰ Ibid (n 70) p27; This position has been vindicated by the FSA's internal audit report dated 28th March 2008 on that particular bank.

⁸¹ Joan Wadsley and Graham Penn, *Penn and Shea: The Law Relating to Domestic Banking* (2000) (Sweet and Maxwell: London 2nd edition) p3

⁸² Ibid

⁸³ Ibid (n 80)

⁸⁴ Ibid(n 80)

⁸⁵ Ibid(n 80)

⁸⁶ Ibid(n 80) p4

become complex due to the expansion and diversification of services offered by banks, innovation, globalisation, the growing interdependence of national banking systems, and cross-border banking which increase risk, incidences of instability and the inherent vulnerability of banks.⁸⁷ They conclude that central banks have to change their supervisory techniques to support the growth of banking while at the same time ensuring that bank failures are prevented.⁸⁸

While prescribing dynamism as a key characteristic of a bank supervisor, Wadsley and Penn fail to look at why being dynamic may be such a challenge. Blair *et al* have looked at banking and financial service regulation in the UK and note that up to 1979 the Bank of England had few formal supervisory powers and operated on moral persuasion since the banking sector operated on a largely non-statutory basis.⁸⁹ This state of affairs necessitated change after the 1973-1974 banking crisis in the UK exposed banking malpractices and a disregard for the Bank of England's supervisory regime.⁹⁰

This led to various amendments of the 1979 Banking Act and subsequently to the establishment of the Financial Services Authority.⁹¹ The FSA took over responsibility for bank supervision and regulation from the Bank of England.⁹² It aimed at protecting the interests of financial services consumers (the public) as well as promoting confidence in the financial sector.⁹³

In doing so, its approach would go above and beyond issuing directives; the FSA would look at boards and senior management to ensure financial soundness and adherence to regulatory and prudential standards, ensure good management and observance of standards.⁹⁴ In effect, the FSA would, whilst relying on the enabling statute, adopt a new

⁸⁷ Ibid(n 80) p4

⁸⁸ Ibid(n 80) p4

⁸⁹ William Blair *et al*, *Banking and Financial Services Supervision* (2007) (Tottel Publishing Limited 3rd edition) p3 para 1.5

⁹⁰ Ibid (n 88) p3 para 1.7

⁹¹ Ibid (n 88) p 20 para 2.1

⁹² Ibid (n 88) p 20 para 2.6

⁹³ Ibid (n 88) p 20 para 2.10

⁹⁴ Ibid (n 88) p 20 para 2.12

supervisory approach to ensure stability of the financial system, something the CBK should be encouraged to duplicate.⁹⁵

This evolution is almost similar to the various amendments made in Kenyan banking laws from 1989 to present day. The net effect was making the CBK more dynamic and effective a supervisor. However, unlike this paper, the focus was more on moving from the Bank of England to the FSA rather than the sealing of loopholes in the law.

In this paper, it is argued that failure of banks is caused by insufficient supervision and should be rectified by greater application of the law. This is due to the centrality of banking to the economy. Interestingly, Kaufman has stated that the main reason bank failure has been deemed significant is due to the fact that failure of banks negatively affects economies and tends to spread to other banks in the financial system.⁹⁶ There is also the possibility of spreading to the domestic economy and those of other countries.⁹⁷ Thus bank failure becomes a major public policy issue thus calling for greater supervision of banks as compared to other economic enterprises.⁹⁸

Kaufman then argues that prudential regulations are often ineffective and counterproductive, and that supervisors often exacerbate the probabilities of bank failure.⁹⁹ This is because governments use the characterisation of banks as special enterprises to impose regulations that have socio-political objectives that enhance banks' risk appetite.¹⁰⁰ He also argues that the causes of bank failure can be ascribed to regulatory or government failure rather than market failure.¹⁰¹

To some extent, Kaufman is underplaying systemic risk and the effects of bank failure not only in the financial sector but also in the economy as a whole. In addition, the nature of banking business necessitates government intervention through socio-political objectives in regulation. However, Kaufman is correct when he argues that the main tool

⁹⁵ Ibid (n 88)

⁹⁶ George Kaufman, Bank Failure, Systemic Risk and Bank Regulation, (1996) The Cato Journal Vol.16 No. 1 Cato Institute at <https://object.cato.org/sites/cato.org/files/serials/files/cato-journal/1996/5/cj16n1-2.pdf> accessed on 22nd March 2017

⁹⁷ Ibid (n 95) p1

⁹⁸ Ibid (n 95) p1

⁹⁹ Ibid (n 95) p2

¹⁰⁰ Ibid (n 95) p2

¹⁰¹ Ibid

for prevention of bank failure is the supervisor.¹⁰² This aspect is a central theme in this paper and is delved into on a more detailed level.

Relatedly, Rochet has examined the fragility of banks and the justifications for public intervention.¹⁰³ He identifies four modes of intervention: bank supervision and monitoring their activities for compliance, imposing of regulations by the authorities, deposit insurance, and central banks acting as lenders of last resort.¹⁰⁴

Rochet has examined all these modes of intervention and concludes that banking crises will occur in spite of them.¹⁰⁵ He dismisses market-based discipline as being ineffective without government intervention, and proposes that an independent and accountable supervisor would be ideal, provided that there is no political pressure to bail out failing banks (a source of complacency), and that there is institutional reform geared towards preventing bank failure.¹⁰⁶

This paper instead focuses on imposing regulations and ensuring compliance, and posits that a central bank that focuses on compliance imposes sanctions and utilises effective methods of supervision can achieve a failure-free banking sector. It is important to note that researchers have yet to look specifically into why a banking sector would experience failures time and again for the same reasons even with the law providing for adequate supervision. This shall be discussed in this paper.

1.10 Research Methodology

This research is exclusively theoretical and shall mainly rely on published works, library materials such as journals and books, and resources available online such as articles and other academic writings.

The main sources shall include legislation and the annual reports issued by the CBK's Bank Supervision Department. The BSD reports are published annually and represent the information on the banking sector from the CBK intended for public consumption.

¹⁰² Ibid (n 95) p2

¹⁰³ Jean-Charles Rochet, *Why Are There So Many Banking Crises? The Politics And Policy Of Bank Regulation* (2008) (Princeton University Press Princeton New Jersey) p1

¹⁰⁴ Ibid

¹⁰⁵ Ibid (n 102) p33

¹⁰⁶ Ibid

1.11 Limitations of the study

This study shall be limited to commercial banks in Kenya and in particular those that have failed in whatever manner.

The study shall also be limited to the role of the CBK as an enforcer of safeguards and preventive measures to ensure stability of the financial system and not its general role as a regulator.

The main source of official regulator data shall be from the CBK Annual Reports on the banking sector.

1.12 Chapter Breakdown

Chapter 1 introduces the research topic and briefly touches on the background to the study. It contains a statement of the problem, the research questions, the hypothesis, objectives of the study, the theoretical framework under which the study will be carried out and the methodology to be used. It concludes with a review of existing literature.

Chapter 2 analyses the incidences of bank failure in Kenya, the reasons that have been advanced, and the pattern emerging from the causative factors. The chapter also looks at whether those factors reappear in more recent cases of bank failure. The chapter also looks at the role played by the CBK in resolving the various situations.

Chapter 3 interrogates the existing legal framework under which the CBK is empowered to foster stability and liquidity in the banking system. The various provisions under the Central Bank of Kenya Act, the Banking Act as well as the Prudential Guidelines are set out and analysed in depth. The chapter also includes a commentary on the value of these provisions in relation to the recorded causes of bank failure in Kenya and their importance in enabling an effective CBK.

Chapter 4 looks at the approaches taken in bank supervision, and how such methods are utilised in various jurisdictions. These are the CAMELS and RBS approaches to bank supervision and how they have been applied in various jurisdictions including Kenya.

Chapter 5 contains conclusions and recommendations drawn from the analysis carried out in the foregoing chapters.

CHAPTER 2: THE ANATOMY OF BANK FAILURE IN KENYA

2.1 Introduction

Bank failure refers to the inability of a bank to meet its credit obligations and liabilities either because of illiquidity or insolvency.¹⁰⁷ This simply means that the bank is unable to pay its debts.¹⁰⁸ The term ‘failure’ connotes that a banking institution is not sound and is therefore not able to carry out its normal operations.¹⁰⁹

Bank failure may originate from banking crises. These are basically major collapses of institutions in the financial system entailing the inability to provide payments or credit.¹¹⁰ One of the major causes of banking crises is runs on banks which may be derived from panic or alternatively be a source of panic themselves; either may come before the other.¹¹¹

Panic occurs when there’s a perceived risk by depositors that they may not be able to get their money from their banks, resulting in large scale withdrawals.¹¹² The main cause of panic is information asymmetry since there is no bank-specific information to create a sense of security.¹¹³ Once the news spreads, other depositors in other banks also demand their deposits leading to a system-wide run on banks.¹¹⁴ This contagion then leads to systemic failure as the failure of one bank in such an environment will often lead to the failure of its counterpart banks.¹¹⁵

In Kenya, panic spreads particularly fast thanks to social media. In October 2015, social media was awash with stories of the imminent failure of a number of banks including Credit Bank Limited, Consolidated Bank of Kenya Limited and Jamii Bora Bank Limited.¹¹⁶

¹⁰⁷ At <https://definitions.uslegal.com/b/bank-failure/> accessed on 15th March 2017

¹⁰⁸ At <http://thelawdictionary.org/bank-failure/> accessed on 15th March 2017

¹⁰⁹ Benton E. Gup, *Bank Failures in the Major Trading Countries in the World: Causes and Remedies*, (1998) (Quorum Books Connecticut: USA) p10

¹¹⁰ Ibid (n 108) p7

¹¹¹ Ibid

¹¹² Ibid (n 108) p12

¹¹³ Ibid (n 108)

¹¹⁴ Ibid

¹¹⁵ Ibid (n 108) p14

¹¹⁶ Hillary Kimuyu, CBK Denies Claims Of Imminent Closure Of Kenyan Banks, *Nairobi News* (Nairobi 14th October 2015) at <http://nairobinews.nation.co.ke/jobs/cbk-denies-claims-of-imminent-closure-of-kenyan-banks/> accessed on 15th March 2017

The CBK made a statement through its Governor dispelling the rumours thus averting a panic.¹¹⁷

In 2016, the same scenario was witnessed again with rumours on social media resulting in a serious run on Chase Bank Kenya Limited that aggravated its illiquidity and led to the bank being placed under receivership.¹¹⁸ Once again, the CBK Governor issued a statement blaming social media users of having aggravated Chase Bank's liquidity issues.¹¹⁹ However, its actions to forestall failure of the bank indicated that the failure was imminent and was just hastened by the social media rumour mill-induced panic.¹²⁰

Nevertheless, failure of commercial banks has occurred in Kenya for other reasons apart from panic-induced runs. This chapter shall look at the various incidences of bank failure in Kenya beginning from the 1980s. The reasons shall be delved into as well as the actions taken by the CBK to deal with the failures with a view to assess its effectiveness in its preventive role.

2.2 Bank Failure in Kenya and an analysis of the role of the CBK

The incidences of bank failure in Kenya have occurred in a number of phases from the 1980s up to the present day.¹²¹

2.2.1 Phase One: 1984 to 1989

This phase of bank failures was partly precipitated by the accelerated growth of locally-owned commercial banks in Kenya as evidenced by such banks being the main ones that were closed down.¹²² The banks documented to have collapsed include the Rural Urban and Credit Finance which closed down in December 1984.¹²³ The reasons given for its

¹¹⁷ Ibid

¹¹⁸ Eric Ombok, 'Malicious' Twitter Posts Blamed for Fanning Kenyan Bank Run, *Bloomberg* (Nairobi April 7, 2016) at <https://www.bloomberg.com/news/articles/2016-04-07/-malicious-twitter-posts-blamed-for-fanning-run-on-kenya-bank> accessed on 15th March 2017

¹¹⁹ Ibid

¹²⁰ Ibid (n 117)

¹²¹ Ibid (n 117)

¹²² Brownbridge p12

¹²³ Bank Supervision Annual Report (1994) p 36 at <https://www.centralbank.go.ke/reports/bank-supervision-and-banking-sector-reports/> accessed on 15th March 2017

failure were interference by the directors in the day-to-day management and a high incidence of non-performing loans.¹²⁴

In August 1986, the Continental Bank and the Continental Credit Finance were closed down having failed due poor lending practices.¹²⁵ The Capital Finance bank closed down in December of the same year with an ineffective board and management being cited as the reasons for its failure.¹²⁶

The banks that were put under the umbrella of the government-owned Consolidated Bank included Business Finance, Estate Finance, Home Savings and Mortgages, Nationwide Finance, Union Bank, Jimba Credit and Kenya Savings and Mortgages.¹²⁷ The reasons for the failure of these banks included interference by the board and shareholders, poor asset quality, insider loans, general mismanagement, and poor credit policies and lending practices.¹²⁸

Under section 19 of the 1958 Banking Act, the CBK at that time had powers to inspect the books of accounts of banks.¹²⁹ This was bolstered by the statutory requirement that banks had to co-operate and hand over all books, accounts, documents, information or statements required by the inspector.¹³⁰

In addition, the CBK also had powers to issue directions should the inspection show that the bank's affairs were being conducted in a manner detrimental to the interests of depositors or the bank itself.¹³¹ Compliance was mandatory and the relevant bank was

¹²⁴ Ibid; the Rural Urban Credit Finance bank collapsed in July 1984. It was owned by a former mayor of Nairobi who used it to fund his campaign for a parliamentary seat. He gave unsecured loans to the public and altered the books to hide the lending malpractices of the bank. See Owaah, *Why Kenyan Banks Fail*, 10th April 2016 at <http://owaahh.com/kenyan-banks-fail/> accessed on 30th March 2017

¹²⁵ Ibid (n 122) P36

¹²⁶ Ibid (n 122) P36

¹²⁷ Ibid (n 122) p36

¹²⁸ Ibid (n 122) P36; The problems faced by these banks stemmed from their owners who used them as personal banks, withdrawing funds at will from the deposits held. See Owaah, *Why Kenyan Banks Fail*, 10th April 2016 at <http://owaahh.com/kenyan-banks-fail/> accessed on 30th March 2017

¹²⁹ Section 19(1) Banking Act No. 56 of 1958

¹³⁰ Ibid (n 128); Section 19(2)

¹³¹ Ibid (n 128); Section 20(1)

required to show how it has gone about it.¹³² Banks were also required to appoint auditors on an annual basis and avail a copy of the audit report to the CBK.¹³³

From the foregoing, the CBK had the statutory power and tools at its disposal to scrutinise the affairs of banks and determine whether they were headed to imminent collapse. Issues such as poor lending practices and mismanagement would be apparent from the institutions' books. At a basic level, the Act's provisions would have been sufficient to prevent the bank failures experienced at the time.

The government responded by repealing the Banking Act of 1958 and enacting the Banking Act of 1989. Among the amendments introduced by the new Act included restrictions on the amount of share capital of a bank that could be owned by one person,¹³⁴ and on the amount that could be advanced for purchase of land.¹³⁵ The Act also strengthened the licensing, minimum capital, reserves and capital/deposit ratios requirements.¹³⁶ Directors were no longer allowed to advance unsecured loans to themselves, their families and connected companies, and were to be responsible for the losses incurred from unsecured lending.¹³⁷

The CBK's power to give directions to banks was expanded to include the power to appoint a person who would advise and assist the institution as if they were the CBK.¹³⁸ The new Act also introduced information and reporting requirements which were for purposes of enhancing the CBK's powers of supervision and surveillance.¹³⁹

Further, the Act provided that the CBK could intervene in the management of banks which warranted such intervention.¹⁴⁰ Intervention included appointing a manager, a

¹³² Ibid (n 128); Section 20(3)

¹³³ Ibid (n 128); Section 21(2)

¹³⁴ Ibid (n 128); Section 13 Banking Act 1989: one single person could only own up to 25% of the total share capital of a bank.

¹³⁵ Ibid (n 128); Section 14; Limited to 25% of the bank's total deposit liabilities

¹³⁶ Brownbridge p14

¹³⁷ Brownbridge p14

¹³⁸ Banking Act 1989 Section 33(c)

¹³⁹ Banking Act 1989 sections 27-32

¹⁴⁰ Banking Act 1989 Section 34 (1)

director to the bank's board or even removing an officer of employee who was deemed to have played a part in that bank's circumstances.¹⁴¹

Arguably, the bank failures experienced in the 1980s could be attributed to insufficient capacity at the CBK's Bank Supervision Department (BSD) occasioned by the rapid growth in the banking sector after 1980,¹⁴² weak banking laws, and the political influence on locally-owned banks.¹⁴³ The lack of capacity exacerbated by weak legislative framework, inadequate reporting requirements for banks and political interference, meant that the BSD staff could not effectively carry out surveillance and supervision of banks.¹⁴⁴ However, the supervisory system failed a second time as is discussed below.

2.2.2 Phase Two: 1992-1993

In this phase, 14 banks were recorded by the CBK as having failed in 1993 alone.¹⁴⁵ These included Trade Bank, Allied Credit, United Trustee, Inter African Credit, Exchange Bank and Thabiti Finance.¹⁴⁶ The reasons given for the collapse of these banks ranged from high levels of unsecured and non-performing loans, insider lending, mismanagement, political interference to persistent violations of the Banking Act and the CBK Act.¹⁴⁷ This is despite the raft of amendments to the banking laws that were done following the first phase.¹⁴⁸

Between 1992 and 1993, of the 14 institutions which were put under liquidation, the CBK took over the management of three of them.¹⁴⁹ The CBK's response at this point in time was to place collapsing banks under statutory management or liquidation e.g. in the case of Trade Bank and Pan African Bank, while others were recapitalised by their owners.¹⁵⁰

¹⁴¹ Section 34(2) Banking Act 1989

¹⁴² Brownbridge p15: This was not matched by a corresponding increase in capacity in the CBK's Banking Supervision Department

¹⁴³ Brownbridge p14

¹⁴⁴ Brownbridge p15

¹⁴⁵ Bank Supervision Annual Report (1994)

¹⁴⁶ Ibid

¹⁴⁷ Ibid

¹⁴⁸ It is important to note that insider lending was the greatest contributor e.g. when the Pan-African Bank collapsed in 1992 (at the time the fifth largest bank), it was discovered that half of its entire loan portfolio had gone to its chairman's company. When the International Finance Company collapsed, it was discovered that around 90% of its loans were made to the owner, then a government minister. See Owaah, *Why Kenyan Banks Fail*, 10th April 2016 at <http://owaahh.com/kenyan-banks-fail/> accessed on 30th March 2017

¹⁴⁹ Bank Supervision Annual Report (1994) p13

¹⁵⁰ Brownbridge p11-12

This number diminished in 1995 as only three were put under liquidation, with one being restructured and revived by the CBK after failing due to non-performing loans.¹⁵¹

The BSD's 1997 report analysed the Basle Committee on Banking Supervision's Core Principles for Effective Banking Supervision and concluded that Kenya had implemented the most relevant principles to a satisfactory level.¹⁵² However, the issues identified as of supervisory concern as at that time included non-compliance with the Banking Act and the prudential regulations, high levels of non-performing loans and malpractices by insiders and directors.¹⁵³

Consequently, amendments were proposed to curb director and insider loans, giving the CBK power to impose administrative sanctions and giving legal force to the prudential guidelines.¹⁵⁴ The 1997 Report was concluded by the CBK identifying the main area of improvement as working on enhancing compliance levels.¹⁵⁵

2.2.3 Phase Three: 1998

In 1998, five banks were placed under statutory management by the CBK.¹⁵⁶ These included Bullion Bank, Fortune Finance, Trust Bank, City Finance Bank and Prudential Bank.¹⁵⁷ The main causes were reckless lending, mismanagement, fraud, insider lending to directors and their associates, shareholder interference and undercapitalization.¹⁵⁸

The CBK saw the need to tighten bank supervision with a particular focus on the management of banks.¹⁵⁹ Its main supervisory concerns, especially after the placing of those banks under statutory management, became the implementation of the Basle Principles as well as corporate governance in the banking sector.¹⁶⁰

¹⁵¹ Bank Supervision Annual Report (1995) p4

¹⁵² Bank Supervision Annual Report (1997) p10; Notably, one bank, Afri Bank Corporation Limited, was placed under liquidation in the same year

¹⁵³ Ibid P14

¹⁵⁴ Ibid (n 151) P15

¹⁵⁵ Ibid (n 151)

¹⁵⁶ Bank Supervision Annual Report (1998) p3

¹⁵⁷ <http://www.infohub.co.ke/2016/04/a-list-of-collapsed-kenyan-banks.html> accessed on

¹⁵⁸ Bank Supervision Annual Report (1998) P5-6

¹⁵⁹ Ibid

¹⁶⁰ Ibid (n 157)

At this point in time, the CBK had clear supervisory roles and responsibilities as spelled out under the Banking Act.¹⁶¹ There were limits on how much equity investment one person could own in a bank limits on lending.¹⁶² In addition, the CBK had both on-site and off-site supervision teams,¹⁶³ access to banks' audited accounts, audit reports and prudential reports.¹⁶⁴

In view of this, the reasons cited as having caused upheaval in the banking sector were not satisfactory. Arguably, the CBK had sufficient legal backing to carry out its mandate yet instability in the banking sector had become the norm. The reasons for instability were similar to those in the 1980s despite an enhanced BSD and overhauling of banking laws in Kenya.

However, it is important to note that contrary to Principle 11 of the Basle Principles, banks did not have procedures for effective risk management.¹⁶⁵ Risk was evaluated by the banking supervisors during on-site evaluations on a bank-by-bank basis as there was no method for consolidated risk analysis.¹⁶⁶ Banks were not required to have comprehensive risk management programs, and the CBK did not issue any policies to be adopted for ensuring maintenance of high professional and ethical standards in the banking system.¹⁶⁷

Amendments to the Banking Act in 1998 were geared towards curbing the problems discussed above.¹⁶⁸ Firstly, loans to directors were now to be made on similar terms as those made to the public.¹⁶⁹ Such loans were to be approved by the full board, and the CBK would have to be notified within seven days of the approval.¹⁷⁰

¹⁶¹ Bank Supervision Annual Report (1998) P9

¹⁶² Bank Supervision Annual Report (1998) P10

¹⁶³ Bank Supervision Annual Report (1998) P12

¹⁶⁴ Ibid

¹⁶⁵ Bank Supervision Annual Report (1998) P11

¹⁶⁶ Bank Supervision Annual Report (1998) P12; Contrary to Principle 12 Basle:

¹⁶⁷ Bank Supervision Annual Report (1998) P12; Trust Bank, which failed in 1998, had been running an account under the directors' name which had hundreds of millions of shillings which the directors withdrew just before the bank was closed in September 1998. See Owaah, *Why Kenyan Banks Fail*, 10th April 2016 at <http://owaahh.com/kenyan-banks-fail/> accessed on 30th March 2017

¹⁶⁸ Bank Supervision Annual Report (1998) p16

¹⁶⁹ Ibid; Section 10 Banking Act

¹⁷⁰ Ibid; Section 11 Banking Act

Secondly, any director who defaulted on a loan for three consecutive months would be disqualified from holding a position in that institution.¹⁷¹ Thirdly, banks were required to publish details of insider loans and non-performing loans as public information.¹⁷² Fourthly, the CBK was empowered to remove directors of institutions in default, and suspend any bank employees who were involved in sanctioning the advance.¹⁷³

Section 33A of the Banking Act was introduced and through it, the CBK was empowered to enforce the application of sound banking practices in the operations of institutions; cause the removal or suspension of officers involved in flouting the Banking Act; and levy money penalties for non-compliance with the prudential regulations.¹⁷⁴

The failures experienced in the early 1990s could also be attributed to political interference where leading politicians and government ministers were directors and shareholders in many of the failed banks. For example, Transnational Bank was owned by KANU politicians and operated in breach of the CBK's requirements on capital adequacy, cash reserve and liquidity requirements.¹⁷⁵ It still exists to date.¹⁷⁶

Political interference took the form of directing public sector deposits to those banks, thwarting inspections and enforcement of banking regulations by the CBK, and having political considerations in licensing.¹⁷⁷ Banks with political connections often got large overdrafts from the CBK and the DPF and practised indiscriminate insider lending even though they were technically insolvent.¹⁷⁸ These risky practices led to insolvency and liquidity crises which could also be triggered by withdrawal of public sector deposits for political motives.¹⁷⁹

2.2.4 Contemporary incidences of bank failure: 2000-2006

This round of bank failures included among others, Euro Bank, Trust Bank and Reliance Bank and later Charterhouse Bank.

¹⁷¹ Ibid; Section 11(5) Banking Act

¹⁷² Ibid

¹⁷³ Ibid

¹⁷⁴ Bank Supervision Annual Report (1998) p16-17

¹⁷⁵ Brownbridge p12

¹⁷⁶ Central Bank of Kenya, List of Licenced Commercial Banks in Kenya, No. 40 at <https://www.centralbank.go.ke/commercial-banks/> accessed on 10th April 2017

¹⁷⁷ Brownbridge p12

¹⁷⁸ Brownbridge p13

¹⁷⁹ Ibid

Trust Bank first went down in 1998 when it was discovered that the directors had an account which was in debt.¹⁸⁰ At the time, most of its cash deposits were in a parallel banking system, “*shroff/chopdee*.”¹⁸¹ In order to revive it, deposits were converted into shares.¹⁸²

Trust Bank was a classic example of insider lending, which, going by the history of bank failure in Kenya, was a tool for raiding customer deposits.¹⁸³ The two directors of Trust Bank managed to siphon off Kshs. 241 million in one week after the discovery of the troubles at the bank.¹⁸⁴ The bank was then put under statutory management on 18th September 2001.¹⁸⁵

In 2013, the High Court lifted the corporate veil and ordered the two former directors of Trust Bank to pay an additional Kshs. 1.5 Billion to the Deposit Protection Fund Board.¹⁸⁶ This was after the court found the directors liable for the loss of Kshs. 241 million from the bank in 2001, there having been fraud that led to the loss.¹⁸⁷ The CBK, despite having the necessary legal backing, had not managed to detect nor prevent the fraud.

A liquidator was appointed for Reliance Bank on 12th September 2000 after a court ruling in favour of the liquidation.¹⁸⁸ This was after evidence of the directors stripping off assets, cheque kiting, money laundering and tax evasion.¹⁸⁹ Prior to that ruling, four of the banks directors together with some businessmen were also found guilty of fraud after failing to honour cheques amounting to Kshs. 304 million.¹⁹⁰ The evidence of fraud

¹⁸⁰ George Ngigi, ‘CBK secures order to auction Ajay Shah assets,’ *Business Daily Africa* (Nairobi 4 March 2014) at <http://www.businessdailyafrica.com/corporate/CBK-secures-order-to-auction-Ajay-Shah-assets/539550-2230966-lcj94d/index.html> accessed on 26th May 2017

¹⁸¹ Ibid; This was mainly to hide funds from the taxman.

¹⁸² Ibid (n 179)

¹⁸³ Ibid (n 179)

¹⁸⁴ George Ngigi, ‘Trust Bank directors ordered to pay depositors Sh1.5bn,’ *Business Daily Africa* (Nairobi 2 June 2013) at <http://www.businessdailyafrica.com/Trust-Bank-directors-to-pay-Sh2bn/-/539546/1870212/-/srek26/-/index.html> accessed on 26th May 2017

¹⁸⁵ Ibid

¹⁸⁶ Ibid (n 183)

¹⁸⁷ Ibid (n 183)

¹⁸⁸ Kenya: Reliance Bank Now Goes Under (allAfrica.com, 13 September 2000) www.allafrica.com/stories/200009130339.html accessed on 26th May 2017

¹⁸⁹ Charles Hornsby, *Kenya: A History Since Independence* (IB Tauris Publishers 2012) p648

¹⁹⁰ IPS Correspondents, *Economy-Kenya: A Run on Banks Triggers Panic Among Investors*, September 21 1998 at www.ipsnews.net/1998/09/a-run-on-banks-triggers-panic-among-investors/ accessed on 26th May 2017

and mismanagement that had emerged in 1998 necessitated placement of the bank under statutory management then,¹⁹¹ but no further action had been taken by the CBK.

In February 2003, Euro Bank was placed under liquidation by the Deposit Protection Fund Board after conceding that it had become insolvent.¹⁹² The scandal engulfing this bank came to light after the Kenyatta National Hospital filed a suit seeking winding up of the bank after it failed to honour its obligations.¹⁹³ Other public entities that lost millions of shillings included the National Hospital Insurance Fund, the National Social Security Fund and the Kenya Post Office Savings Bank.¹⁹⁴

The CBK in its annual report for the year 2003 attributed the failure of Euro Bank to insolvency caused by a huge number of non-performing loans resulting in substantial losses.¹⁹⁵ However, there were political undertones to the whole mess as when KNH filed suit, it emerged that the bank had been trusted by many public bodies due to close links with former President Moi's government.¹⁹⁶

It emerged that State corporations had deposited money in the bank hoping to earn huge profits after a short time.¹⁹⁷ Persons who were investigated in relation to the collapse included the Kenya Revenue Authority head (who was also a Eurobank director), heads of various parastatals and staff members of Eurobank, including one of the owners.¹⁹⁸ This scandal resulted in the resignation of the CBK Governor at the time and the KRA Commissioner-General.¹⁹⁹

¹⁹¹ Ibid

¹⁹² Kenya Bank Scandal Spreads, BBC News (Nairobi 27th February 2003) at <http://news.bbc.co.uk/2/hi/business/2804923.stm> accessed on 27th April 2017

¹⁹³ Daily Nation, *Time running out for millions lost in Euro Bank scandal* published 19th September 2008 at <http://www.nation.co.ke/News/-/1056/472738/-/item/1/-/900a88z/-/index.html> accessed on 27th April 2017

¹⁹⁴ Ibid (n 191)

¹⁹⁵ Bank Supervision Annual Report 2003

¹⁹⁶ Ibid (n 191)

¹⁹⁷ Ibid (n 192)

¹⁹⁸ Ibid

¹⁹⁹ Kenyan bank furore claims second scalp, BBC News (Nairobi 4th March 2003) at <http://news.bbc.co.uk/2/hi/business/2819705.stm> accessed on 27th April 2017

Charterhouse Bank was placed under statutory management by the CBK on 23rd June 2006.²⁰⁰ The reason given was breach of banking regulations such as flouting lending limits, engaging in suspicious activities, and flouting Know Your Customer (KYC) requirements.²⁰¹

Questions regarding the bank had been raised as early as 2001 when the bank ignored a request from the CBK for information on a USD 20 million transaction.²⁰² In 2006, one of the bank's internal auditors named Peter Odhiambo released information he had collected on the bank and 85 account holders who he alleged were involved in tax evasion.²⁰³

Some of the account holders included Nakumatt Holdings, Tusker Mattresses and Kingsway Tyres.²⁰⁴ A CBK report added the John Harun Group, Triton Petroleum and Kariuki Muigua & Co. Advocates to the group of account holders suspected of being involved in significant tax evasion.²⁰⁵ A joint CBK and PricewaterhouseCoopers investigation uncovered evidence of money laundering through some Italian businessmen, the bank and its clients²⁰⁶ and tax evasion under the advisement of the bank's managing director and offshore companies.²⁰⁷

Other banking malpractices that were uncovered included: the lending of both Nakumatt Holdings Limited and Triton Petroleum in excess of the single borrower limit of 25% of the core capital, insider lending without security above 20% of the core capital, suspicious

²⁰⁰ The Star Team, Central Bank Occupies Charterhouse Bank and stays mute...for 10 years, *The Star* (Nairobi 23rd June 2016) at www.the-star.co.ke/news/2016/06/23/central-bank-occupies-charterhouse-bank-and-stays-mute-for-10-years_c1368177 accessed on 26th May 2017

²⁰¹ Ibid

²⁰² Lorenzo Bagnoli and Lorenzo Bodrero, Charter House Bank: A Money Laundering Machine, (Correctiv.org, 16th April 2016) at <https://correctiv.org/en/investigations/mafia-africa/articles/2015/04/16/charter-house-bank-a-money-laundering-machine> accessed on 26th May 2017

²⁰³ Ibid

²⁰⁴ Ibid (n 201)

²⁰⁵ Ibid (n 201); In January 2001, Kshs. 2 billion was transferred from Liechtenstein to an account held by Crucial Properties Limited, a company owned by one Harun Kariuki. This attracted attention from the FBI and the local police. The CBK froze the Crucial account while demanding more information about the source of the money. Mr Kariuki insisted the transfer was legitimate and managed to have the High Court allow him to withdraw Kshs. 300 million. The anti-narcotics police obtained an order freezing the account again, and another belonging to Kariuki Muigua & Co. into which the Kshs. 300 million had been transferred. In 2001, the freezing orders were lifted and by the time the Attorney-General appealed, Mr Kariuki had already withdrawn Kshs. 1.6 billion within hours. At <http://www.nation.co.ke/news/ten-year-old-puzzle-that-was-charterhouse-bank/1056-3233030-136xk9k/index.html>

²⁰⁶ Ibid Lorenzo (n 201)

²⁰⁷ Ibid (n 204)

transactions in some accounts without customer identification information, and holding of shareholding of more than 25% by one person by the brothers behind the bank.²⁰⁸

However, curiously, the CBK Governor tabled a report in Parliament in 2010 clearing the bank of tax evasion. In 2012, the then Finance Minister Njeru Githae directed the CBK Governor to reopen the bank since it had been cleared by both the Kenya Revenue Authority (KRA) and the Kenya Anti-Corruption Commission (KACC) (now defunct).²⁰⁹

2.2.5 Contemporary incidences of bank failure: 2015 to date

Dubai Bank Kenya Limited was placed under receivership by the CBK on 14th August 2015. The reason given was that the bank had been experiencing liquidity and capital deficiencies which increased the likelihood of it being unable to meet its obligations.²¹⁰ The CBK stated that the bank had been breaching its daily cash reserve ratio, had failed to comply as requested by the CBK in correcting that situation, and had been unable to honour a financial obligation to Bank of Africa Kenya.²¹¹

In mid-2016, the High Court of Kenya gave orders allowing winding up of the bank by the Kenya Deposit Insurance Corporation.²¹² This was after the receiver-manager testified that reviving the bank was not viable even after evaluating proposals by investors. The CBK, in ordering for the liquidation of the bank, cited gross violations of industry regulations, parallel banking, interference with customer accounts, huge unsecured loans that weren't being serviced, and gaps in the bank's organisational chart as prescribed under the law.²¹³

These reasons cited by the CBK were neither new, nor incapable of being discovered by a bank supervisor imbued by the powers and authority assigned to the CBK. Dubai Bank

²⁰⁸ John Kamau, Ten year old puzzle that was Charterhouse Bank, at <http://www.nation.co.ke/news/ten-year-old-puzzle-that-was-charterhouse-bank/1056-3233030-136xkgk/index.html> accessed on 26th May 2017

²⁰⁹ Ibid The Star

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²¹¹ Business Daily Africa, 'Dubai Bank Kenya placed under receivership for a year,' on 14th August 2015 at www.businessdailyafrica.com/Corporate-News/Dubai-Bank-Kenya-placed-in-receivership-for-a-year-/539550/3832750/-/rp6vfdz/-/index.html accessed on 26th May 2015

²¹² Brian Wasuna, 'Dubai Bank top owner suffers blow after High Court allows winding up,' Business Daily 12th June 2016 at <<http://www.businessdailyafrica.com/corporate/Dubai-Bank-owner-suffers-blow-after-court-allows-winding-up/539550-3246436-ei3epq/index.html> > accessed on 30th June 2017

²¹³ Ibid

remains a classic example of poor implementation by the CBK given that the banking laws as at 2015 allowed it to take action against those violations.

Later in the same year, the CBK placed Imperial Bank under receivership on 13th October after the Board of Directors alerted it to malpractices allegedly taking place in the bank.²¹⁴ The CBK stated that it had become aware of unsafe or unsound business practices at Imperial Bank and thus had to place it under receivership under Section 34 (2)(b) of the Banking Act.²¹⁵

In a joint statement released by the CBK and the CMA, the CBK termed its action as being in accordance with the principle of prompt corrective action. This action was based on the inappropriate banking practices that had been brought to its attention by the board of directors of Imperial Bank.²¹⁶ The Kenya Deposit Insurance Corporation (KDIC) was appointed as the receivers for a period of twelve months.²¹⁷ Their work was to manage the bank, and also look into the alleged irregularities and malpractice.²¹⁸

The investigations that followed revealed that unbeknownst to the Board of Directors, the Managing Director had been lending huge sums fraudulently to friends and associates without following the formal credit processes as per the prudential guidelines and internal lending procedures.²¹⁹ The CFO was forced to cook the books presented to the board, and, curiously, a large number of the account holders did not come forward when the bank was placed under receivership.²²⁰ This raised questions as to their identities.²²¹ If the board had not alerted the CBK, then this would not have been uncovered.

²¹⁴ Abiud Ochieng, 'Imperial depositors fight wind-up bid,' at www.businessdailyafrica.com/news/imperial-depositors-fight-windup-bid/539546-3880672-w3b5d9/ April 6 2017 accessed on 26th May 2017

²¹⁵ Press Release Imperial Bank Limited (in receivership) 13th October 2015 by CBK at <https://www.centralbank.go.ke/press/> accessed on 26th May 2017

²¹⁶ Press Release Imperial Bank Limited (in receivership) 13th October 2015 by CBK and CMA at <https://www.centralbank.go.ke/press/> accessed on 26th May 2017

²¹⁷ Press Release Imperial Bank Limited (in receivership) 13th October 2015 by KDIC at <https://www.centralbank.go.ke/press/> accessed on 26th May 2017

²¹⁸ Ibid

²¹⁹ Furaha Charo, 'Imperial Bank Under Receivership!! What Went Amiss?' Transparency International Kenya 4th April 2017 at www.tikenya.org/index.php/speeches/428-the-imperial-bank-saga accessed on 26th May 2017

²²⁰ Ibid

²²¹ Ibid

Chase Bank Kenya was put under receivership for a period of 12 months by the CBK on 7th April 2017.²²² This followed weeks of speculation of the imminent failure of the bank on social media.²²³ The bank had been in talks with investors, and the due diligence carried out revealed massive insider lending and purchases of assets not benefitting the bank.²²⁴ The bank had also earlier released qualified audited reports understating its insider loans by Kshs. 8 billion, with most of that amount having been borrowed by a director.²²⁵

This information was leaked, resulting in the CBK's involvement. The CBK oversaw resignation by senior members of the bank's management, and closure of the bank following a panic-induced run on the bank.²²⁶ In June 2017, the former board chairman was arrested and charged with conspiring to defraud Chase Bank, among other charges.²²⁷ He, together with six other directors not before the court had been identified by the CBK's Banking Fraud Investigations Unit as being behind Chase Bank's woes.²²⁸

The CBK's placement of both Imperial Bank and Chase Bank under receivership was temporary; to stabilize the banks before having them acquired by other institutions. On 30th March 2017, the CBK issued a press release inviting expressions of interest from investors wishing to acquire Chase Bank.²²⁹ On 23rd June 2017, the CBK announced that Imperial Bank would remain in receivership for the additional 90 days granted by the

²²² Daily Nation, 'How whistle-blower's secret note to investors brought Chase Bank to its knees' 10th April 2016 at < <http://www.nation.co.ke/news/How-whistle-blower-letter-brought-Chase-Bank-to-its-knees/1056-3152818-5ffwewz/index.html> > accessed on 30th June 2017

²²³ Ibid

²²⁴ Ibid DN

²²⁵ Ibid DN; The CBK discovered that one director had taken Kshs. 7.9 billion mostly unsecured, which was beyond the allowed limits for any one borrower.

²²⁶ Ibid DN; The board chairman and the group managing director resigned after they were alleged to have played a role in the massive insider lending.

²²⁷ Stella Cherono, Maureen Kakah, 'Former Chase Bank boss Zafrullah Khan charged with Sh1.7 billion fraud' Business Daily, 28th June 2017 at <http://www.businessdailyafrica.com/corporate/Former-Chase-Bank-chairman-Zafrullah-Khan-arrested/539550-3990862-hxnydvz/index.html> accessed on 30th June 2017

²²⁸ Ibid

²²⁹ Central Bank of Kenya Press Release at <https://www.centralbank.go.ke/uploads/press_releases/654252239_Press%20Release%20-%20Chase%20Bank%20Limited%20EOI.pdf> accessed on 30th June 2017

High Court of Kenya.²³⁰ That period would be used to prepare the bank for acquisition by investors, beginning with receiving of expressions of interest.²³¹

For both Imperial Bank and Chase Bank, insider lending, fraud and mismanagement were the key causes of their failure. These reasons arose as early as the first phase of bank failure, and subsequent amendments to banking laws have been systematically aimed at rooting them out. This points to the CBK's ineffectiveness in implementation of a raft of enabling laws and regulations as will be discussed in the next chapter.

2.3 Conclusion

In the CBK's Banking Supervision Annual Report published in 2015,²³² the Governor acknowledged that the CBK needed to strengthen its supervisory system, upgrade its human resource and require greater transparency in terms of data.²³³ The BSD director on the other hand also recognised that his department needed to be more efficient and effective.²³⁴ Neither discussed a need to revamp the regulatory framework empowering the CBK.

The CBK also outlined its plan for 2016 as to be aimed at improving the governance in, and supervision of banks.²³⁵ This would include improving corporate governance, enhancing ICT-based and forensic audits, reviewing penalties for regulatory violations, and strengthening overall bank supervision.²³⁶

Based on the foregoing exposition of the phases of bank failure in Kenya up to 2016, there is a recurring set of causes of bank failure: poor lending practices (including insider lending), mismanagement, poor corporate governance, fraud, and regulatory malpractices on the part of banks. On the part of the CBK, inadequate supervision and

²³⁰ Central Bank of Kenya Press Release at https://www.centralbank.go.ke/uploads/press_releases/1846138910_Press%20Release%20-%20Imperial%20Bank%20-%20June%2023,%202017.pdf accessed on 30th June 2017

²³¹ Ibid

²³² Central Bank of Kenya, Bank Supervision Annual Reports at <https://www.centralbank.go.ke/reports/bank-supervision-and-banking-sector-reports/> accessed on 30th June 2017

²³³ Ibid pvii

²³⁴ Ibid n230 px

²³⁵ Ibid n230 p21

²³⁶ Ibid

consequently prevention has reduced the CBK to a reactionary bystander who is unable to effectively implement enabling laws and regulations.

CHAPTER 3: THE LEGAL FRAMEWORK FOR BANK SUPERVISION IN KENYA

3.1 Introduction

In this chapter, we shall look at the regulatory framework that empowers the CBK in relation to regulation of the activities of commercial banks. This shall flow from the constitutional basis to statute and the regulations made thereunder.

The CBK is established under Article 231 of the Constitution of Kenya, 2010²³⁷ as an independent body²³⁸ which is responsible for “formulating monetary policy, promoting price stability, issuing currency and performing other functions conferred on it by an Act of Parliament.”²³⁹ These constitutional functions are to be supplemented by powers and functions set out in the aforementioned Act of Parliament.²⁴⁰

The main focus of this chapter shall be the supervisory powers granted to the CBK over commercial banks under the Central Bank of Kenya Act,²⁴¹ the Banking Act and the CBK’s Prudential Guidelines. The other area of focus shall be the powers granted to the CBK to apply sanctions, administrative directives or any other modes of supervisory control or of penalising errant institutions.

The chapter shall conclude by setting out a multidimensional look at what the CBK can do as a supervisor geared towards ensuring stability in the banking system.

3.2 The Legal Framework for Bank Supervision in Kenya

3.2.1 The Central Bank of Kenya Act

This Act, just as the CBK itself, is rooted in the Constitution of Kenya, 2010.²⁴² The establishment of the CBK is also provided for in section 3(1) of the CBK Act which sanctions its exercise of all functions of a central bank.²⁴³

²³⁷ National Council for Law Reporting with the Authority of the Attorney-General (2010) at www.kenyalaw.org

²³⁸ Article 231(3)

²³⁹ Article 231(2)

²⁴⁰ Article 231(4)

²⁴¹ Revised Edition 2014 [2012] Published by the National Council for Law Reporting with the Authority of the Attorney-General www.kenyalaw.org

²⁴² Ibid

²⁴³

In addition to its principal object of formulating and implementing monetary policy, the CBK is also tasked with ensuring the “liquidity, solvency and proper functioning” of the financial system.²⁴⁴ This, according to Cranston, is one of the necessary and vital functions in any banking system.²⁴⁵

It is important to note that in carrying out its functions, the CBK is required to have in mind the government’s economic policy which is usually aimed at growth.²⁴⁶ This is in line with its mandate of ensuring stability in the financial system as stability breeds economic growth.

Under this Act, the CBK is empowered to act as a banker to commercial banks and other financial institutions.²⁴⁷ In this respect, it holds accounts in the banks’ names, accepts deposits from them, collects money on their behalf, and provides clearing services among others.²⁴⁸ The CBK basically acts as their banker generally.²⁴⁹

The CBK is also able to give loans or advances to commercial banks for no more than six months on the basis of pledge of government securities.²⁵⁰ It is important to note that the CBK is not allowed to give loans except as provide for under this Act, whether directly or indirectly.²⁵¹

This provision can be interpreted as setting out the CBK’s role as a lender of last resort to commercial banks and other institutions. Should a bank be experiencing liquidity challenges, it is able to seek this facility provided that the requirements as set out are met.

This role of the CBK and central banks in general is particularly important as it is triggered by the need to prevent a disruption to stability in the financial system.²⁵² However, it is

²⁴⁴ Section 4(2) CBK Act

²⁴⁵ Cranston p110-122

²⁴⁶ Section 4(3) CBK Act

²⁴⁷ Section 34

²⁴⁸ Sec 34

²⁴⁹ This role is better explained at <https://www.nbb.be/en/faq/central-bank-bankers-bank-how-does-work> accessed on 24th April 2017.

²⁵⁰ Section 36(1)

²⁵¹ Section 36(2)

²⁵² Marc Dobler, Simon Gray, Diarmuid Murphy and Bozena Radzewicz-Bak, The Lender of Last Resort Function after the Global Financial Crisis (2016) (IMF Working Paper WP/16/10) at <https://www.imf.org/external/pubs/ft/wp/2016/wp1610.pdf> accessed on 24th April 2017 page 7

tempered by a need to minimize moral hazard, which is, exercising its discretion to determine situations where it can intervene so as to prevent banks from improperly managing risk knowing that the central bank will step in to forestall a crisis.²⁵³

It has been argued that where a central bank deems it fit to intervene, such action should be followed by additional supervisory measures and conditions.²⁵⁴ This is to ensure that the borrower can repay the loan, public funds have been used properly, and that the central bank can monitor the situation for deterioration or improvement.²⁵⁵ In Kenya, the CBK Act allows the CBK to determine the terms and conditions of extending credit. This can be interpreted widely to include imposing additional supervisory requirements but within the current law.²⁵⁶

The Act also provides that the CBK can impose a requirement on institutions to deposit cash with it.²⁵⁷ The word institution as used covers banks and institutions licensed under the Banking Act.²⁵⁸ These deposits act as reserves against the deposits held by banks, and their liabilities.²⁵⁹ The instructions from the CBK usually take the form of a cash reserve requirement ratio.²⁶⁰

Should the CBK prescribe any reserve requirements, or increase the ratio, banks are allowed a period of at least thirty days within which to comply.²⁶¹ However, the CBK can impose penalties on any bank which fails to maintain the required reserves. Currently, the penalty is not more than 1% per day on the deficient amount or Kshs. 10,000/=, whichever is higher, for each day the deficiency continues.

Notably, the wording of the provision for the reserve requirement and the penalty for non-compliance are permissive.²⁶² Therefore a strict interpretation of the provision portends that it is optional for the CBK to impose both reserve requirements and the

²⁵³ Ibid p

²⁵⁴ P7-8

²⁵⁵ Ibid

²⁵⁶ Section 36(3) CBK Act

²⁵⁷ Section 38(1); The Bank may from time to time require institutions to maintain minimum cash balances on deposit with the Bank as reserves against their deposit and other liabilities.

²⁵⁸ Section 38(6); Cap 488 Laws of Kenya

²⁵⁹ Ibid

²⁶⁰ Ibid

²⁶¹ Ss2-3

²⁶² See the word 'may' in Section 38(1) and (4) CBK Act

penalty for non-compliance.²⁶³ In theory, Kenyan banks may decline to pay the fine on the basis of the reserve requirement and consequently compliance with it not being mandatory.

The CBK Act also imposes information requirements on commercial banks. Banks are required to furnish the CBK with any information and data as and when required and in the manner prescribed to enable the CBK carry out its functions under the Act.²⁶⁴ This section is worded in such a way that it can be interpreted widely to encompass any kind of record kept by banks deemed pertinent by the CBK in meeting its supervisory ends.²⁶⁵

This information can be published by the CBK but not to the extent of disclosing the financial affairs of a person who has not given their consent.²⁶⁶

3.2.2 The Banking Act

Under this Act, the responsibility of licensing institutions wishing to carry out banking business lies with the CBK.²⁶⁷ Such institutions must apply for a licence in the prescribed form, and the license can only be granted if the conditions are met.²⁶⁸

In reviewing an application for a license, the CBK must look at the character of the proposed management, the professional and moral suitability of the proposed management, and the history and financial condition of the applicant, among other criteria.²⁶⁹ Consequently, the CBK must certify that a person is fit and proper to hold a position in management in order for their names to form part of an acceptable application for a licence.²⁷⁰

These provisions were put in place in 1997.²⁷¹ Section 4 of the Banking Act was amended to introduced the requirement for application for a license to carry out banking

²⁶³ 'May' means 'a choice or not to act...', see <http://dictionary.law.com/Default.aspx?selected=1229> accessed on 24th April 2017

²⁶⁴ Section 43 (1)CBK Act

²⁶⁵ Ibid

²⁶⁶ Section 43(2)

²⁶⁷ Section 4(1) Banking Act

²⁶⁸ Section 5(1) Banking Act, see generally

²⁶⁹ Section 4(5) Banking Act

²⁷⁰ Section 4(3) Banking Act

²⁷¹ Statute Law (Repeals and Miscellaneous Amendments) Act No. 10 of 1997 at <http://www.kenyalaw.org> accessed on 26th April 2017

business;²⁷² the examination of such applications by the CBK;²⁷³ certification by the CBK as to the moral and professional fitness of the proposed managers of the applicant;²⁷⁴ the criteria as set out in the First Schedule to the Act;²⁷⁵ and the criteria to be used in assessing the applications.²⁷⁶

At this time, the Minister in charge of Finance was the person to approve the application. This was changed in 2006 to become the sole function of the CBK.²⁷⁷ A further amendment to section 4 of the Banking Act was to include the provision that any private person holding or being proposed to hold more than five per cent of the share capital of an institution, such a person would be deemed a proposed manager of the institution, and therefore subject to vetting on moral and professional grounds.²⁷⁸ This, presumably, was to cure the mischief of mismanagement of banking institutions given the occurrence of interference by directors and shareholders in the day-to-day management.

Other amendments included insertion of Section 9A which provided for the vetting and certification by the CBK of persons proposed to be appointed or elected as directors or senior officers, or persons becoming significant shareholders, of banks.²⁷⁹ If the CBK found any of these persons unfit, they were to immediately cease exercising their voting rights and reduce their shareholding in the case of shareholders,²⁸⁰ and cease holding office in the case of directors and senior officers.²⁸¹ Similarly, the mischief to be cured was the issue of mismanagement and interference by directors and shareholders in the day-to-day running of banks.

One of the major causes of bank failure in Kenya as discussed in the preceding chapter was insider loans. The Banking Act restricts the facilities that commercial banks may give to insiders. Section 11 precludes banks from giving facilities on the security of their own

²⁷² Ibid n215 Section 4(1)

²⁷³ Ibid n215 Section 4(2)

²⁷⁴ Ibid n215 Section 4(3)

²⁷⁵ Ibid n215 Section 4(4)

²⁷⁶ Ibid n215 Section 4(5)

²⁷⁷ The Banking (Amendment) Act No. 9 of 2006 p231 at <http://www.kenyalaw.org> accessed on 26th April 2017

²⁷⁸ Ibid Section 4(7)

²⁷⁹ Section 9A(1)-(2)

²⁸⁰ Section 9A(4)

²⁸¹ Section 9A(5)

shares.²⁸² This effectively means that shareholders cannot use their shares as security for loans from banks they own a portion of.

Commercial banks are not allowed to give unsecured advances to employees to shareholders.²⁸³ Where a person in management or a director wishes to take up a loan, the full board must approve and the CBK notified within seven days.²⁸⁴ As a further deterrent to reckless insider lending, a director who is in default for three consecutive months will be disqualified from holding that office.²⁸⁵

Further, the Act provides that commercial banks are not allowed to grant facilities or participate in any banking business in a fraudulent or reckless manner, or in contravention of the CBK Act.²⁸⁶ For purposes of the Act, fraudulent or reckless behaviour includes intentional deception, concealment of material facts, contravention of the CBK Act, guidelines and regulations issued by the CBK and internal policies of the bank, and misuse of senior positions in banks.²⁸⁷

Any party found to contravene the provisions of section 11 may be called upon by the CBK to indemnify the institution for any losses suffered; the CBK may remove or direct the removal of the director from the board, and may also direct that the officer or employee involved be suspended.²⁸⁸ Compliance with the CBK's directions is not optional;²⁸⁹ disobedience amounts to an offence²⁹⁰ attracting a penalty.²⁹¹

The CBK is responsible for determining the minimum liquid assets that banks should hold.²⁹² These liquid assets are as the CBK may specify but include notes and coins,

²⁸² Section 11(1)(a) Banking Act

²⁸³ Section 11(1)(c)-(d) Banking Act

²⁸⁴ Section 11(1)(e) Banking Act

²⁸⁵ Section 11 (5) Banking Act

²⁸⁶ Section 11(1)(g) Banking Act

²⁸⁷ Section 11 (1A) Banking Act

²⁸⁸ Section 11 (3) Banking Act

²⁸⁹ Ibid

²⁹⁰ Section 11 (6) Banking Act

²⁹¹ Section 11(7) Banking Act; Section 49 spells out the penalty as a fine not exceeding Kenya Shillings One Hundred Thousand for a body corporate, and to a fine not exceeding Kenya Shillings Fifty Thousand or to imprisonment for a term not exceeding two years or to both for every officer of that institution.

²⁹² S.19 (1)

balances held at the CBK, net balances held with other banks, net balances with foreign or foreign branches of banks and Kenya treasury bills and bonds.²⁹³

The penalty for non-compliance with a CBK directive on minimum liquidity levels is interest at the rate of 1% of the deficient amount per day for as long as the bank takes to comply.²⁹⁴ This provision is in line with that contained in the Central Bank of Kenya Act.

It is important to note that the Act imposes information and reporting requirements on the banks in relation to the CBK.²⁹⁵ The CBK is empowered in mandatory terms to collect such information from banks as is necessary to carry out its mandate.²⁹⁶ This includes banks submitting returns as required.²⁹⁷ It can also require banks to furnish it with any information necessary for it to carry out its functions as set out in the Act.²⁹⁸

This requirement not only applies to banks but also to their affiliates, associates or non-operating holding companies.²⁹⁹ The information that can be requested for may not only be financial but also relating to the management, structure and risk management practices of the institution.³⁰⁰ The CBK may only disclose that information without consent where it is in furtherance of discharging its functions.³⁰¹

The Act also empowers the CBK to inspect institutions and their books and records.³⁰² The information obtained in the course of inspection can only be used for the purposes of this Act and the Central Bank of Kenya Act.³⁰³ The inspection report is required to highlight any breaches of the Act, any irregularities, signs of mismanagement or any other issue necessitating further review or corrective action.³⁰⁴

²⁹³ S. 19(2) The notes and coins should be legal tender in Kenya. The monies held in foreign banks must be on short call or withdrawable on demand or on short notice, in a currency that is convertible. Lastly, the treasury bills and bonds must be of a maturity of 91 days or less, and rediscountable at the CBK.

²⁹⁴ S. 19(3)

²⁹⁵ Banking Act, See Part VI generally

²⁹⁶ Section 27

²⁹⁷ Ibid

²⁹⁸ Section 28(1)

²⁹⁹ Section 28(2)

³⁰⁰ Section 28(3)

³⁰¹ Section 31(1)-(3)

³⁰² Section 32

³⁰³ Section 32(2)(c)

³⁰⁴ Section 32(3)

The CBK has been granted powers under the Act to advise and direct where there is a contravention of the Act or the regulations made thereunder by an institution in carrying out its business; and where there's risk to depositors or members of the public.³⁰⁵ Where these conditions are satisfied, the CBK may give advice or make recommendations, issue directions or appoint an advisor to assist in correcting the situation.³⁰⁶ The CBK may also take action where a member of a group and not the institution itself if the offender.³⁰⁷

Generally, the CBK can issue directions aimed at enhancing carrying out of its functions under the Act.³⁰⁸ These directions may encompass observing standards in the conduct of business and guidelines ensuring the maintenance of a “stable and efficient banking and financial system.”

Should an inspection report show contravention of the Act or prejudice to the interests of depositors and the public at larger, the CBK may, among other measures, increase surveillance of that institution, take action against officers involved in misconduct, order reconstitution of the board, appoint an advisor or restrict the growth of assets or liabilities of the institution as it deems fit.³⁰⁹

The CBK also has power to intervene in the management of institutions that are not able to meet their financial obligations and if it is in the interest of depositors.³¹⁰ It may, among other actions, agree with the board of that institution on a plan of correction, appoint KDIC to take over management and control, remove any problematic officials or even appoint a director to the institution.³¹¹

³⁰⁵ Section 33(1)

³⁰⁶ Section 33 (1)(i)-(iv)

³⁰⁷ Section 33 (1A). See section (1C)-“The Central Bank may, in addition to the actions specified under subsection (1B), further direct the concerned party to— (a) suspend any further investment by the institution in a subsidiary company; (b) suspend the exercise of a non-operating holding company's control of the institution; (c) suspend transactions between any associated entity and the institution; or (d) suspend participation of any person in the affairs of the institution.”

³⁰⁸ Section 33(4)

³⁰⁹ Section 33A

³¹⁰ Section 34(1)

³¹¹ Section 34(2)

3.2.3 The Prudential Guidelines, 2013

This particular set of Prudential Guidelines is issued under Section 33(4) of the Banking Act³¹² and applies to all institutions licenced under that Act, which includes commercial banks. The scope of the Prudential Guidelines covers compliance with a great number of statutory requirements including capital adequacy, asset quality, management, liquidity and risk management.³¹³ It is therefore aimed at ensuring stability sector-wide and also in the individual relevant institutions.

This analysis of the Prudential Guidelines shall be limited to the provisions touching on the causes bank failure canvassed in the foregoing chapter. It is also due to the focused approach that will be taken in the next chapter.

3.2.3.1 Capital Adequacy

This is covered under a guideline similarly titled.³¹⁴ Its purpose is to ensure that financial institutions maintain adequate capital levels commensurate with the risk associated with its activities.³¹⁵ The overarching reason for this is to protect the institution's depositors and creditors, and promote public confidence.³¹⁶ The organ ultimately responsible for maintaining an adequate level of capital is the Board.³¹⁷ This has to be in conformity with the minimum capital levels prescribed by the CBK.³¹⁸

In some instances, the CBK may require an institution to deviate from the prescribed minimum capital ratio.³¹⁹ The CBK may raise an institutions minimum ratio based on, among other criteria, where it has suffered losses affecting its capital, where it has significant exposure to risk, a severe volume of poor quality assets, rapid growth, and deficiencies in ownership and management.³²⁰

³¹² Prudential Guidelines, p157

³¹³ Prudential Guidelines, p158 para 2.2

³¹⁴ Prudential Guidelines, CBK/PG/03 p86 para 2.1

³¹⁵ Prudential Guidelines, p86 para 2.1

³¹⁶ Ibid

³¹⁷ Prudential Guidelines, p86 para 2.2

³¹⁸ Prudential Guidelines, p86 para 3.0

³¹⁹ P88 g4.1

³²⁰ P89 g4.2

Failure to maintain the prescribed general or individual capital level entitles the CBK to take remedial measures³²¹ and administrative sanctions.³²² Sanctions include suspension of lending, investment, and credit extension activities, accepting new deposits and paying discretionary compensation to directors or officers.³²³

3.2.3.2 Asset Quality

This is measured by various variables including risk classification of assets and provisioning for bad loans.³²⁴ The guidelines are directed towards ensuring regular evaluation of assets.³²⁵ This is to ensure that at any time, the condition of an institution's assets reflected in its books is 'true and fair.'³²⁶ Regular evaluation also means that banks will at all times have adequate provisions for problematic assets, and that they plan accordingly to maintain stability.³²⁷

Once again, the Board is responsible for creating an effective system for reviewing assets.³²⁸ The system must be capable of identifying risk, determine the adequacy of provisions for poor quality assets, and properly reflect the actual condition of the institutions asset book in its financial statements.³²⁹ The Board is also required to come up with a credit policy to govern how loans are given, and a system of comprehensively reviewing asset performance.³³⁰

Banks are required to review their assets or loan book on a monthly basis,³³¹ based on the loan classification system provided for in this Guideline.³³² However, in addition to loans, other assets such as deposits with other institutions also have to be reviewed. The results of this review have to be reported to the CBK in prescribed form.³³³

³²¹ G5.1

³²² G5.2

³²³ Ibid

³²⁴ CBK/PG/04 p125

³²⁵ P130 para 2.1.1

³²⁶ Ibid

³²⁷ Ibid

³²⁸ P130 para 2.3

³²⁹ Ibid

³³⁰ P130 para 2.3.2

³³¹ P132 para 3.1(b)

³³² P133 para 3.9

³³³ Part VI

Under this Guideline, the CBK is entitled to take remedial measures as provided for under the Banking Act³³⁴ and also administrative sanctions.³³⁵ These sanctions can be issued against the institution itself, the Board or even the institution's officers.³³⁶ They include prohibition from forex activities and suspension from accessing the CBK's credit facilities.³³⁷

3.2.3.3 Management

This aspect is covered under several guidelines. Under the guideline on licensing of new institutions,³³⁸ one of the requirements is that the proposed directors and chief executive officer of the institution are 'fit and proper.'³³⁹ This is assessed based on information such as academic qualifications, employment record, directorships held, criminal records, history of censure by any regulatory bodies and court cases involving them.³⁴⁰

The Guideline on corporate governance is geared towards ensuring proper governance of institutions by the management and the board.³⁴¹ It also provides for minimum standards of conduct for the shareholders, directors, CEO, management and the employees, as well as to provide guidance in sound banking practices.³⁴²

Once again, the responsibility for good corporate governance rests with the board.³⁴³ The principles to be espoused include ethical leadership and integrity,³⁴⁴ with the shareholders also being tasked with holding the board accountable and responsible.³⁴⁵ However, the board has the overarching responsibility for good corporate governance both over themselves and for senior management.³⁴⁶

³³⁴ Part VII para 7.1

³³⁵ Ibid para 7.2

³³⁶ Ibid

³³⁷ Ibid

³³⁸ CBK/PG/01

³³⁹ P4

³⁴⁰ See the forms to be filled for each respective director and CEO on pages 12-23

³⁴¹ CBK/PG/02 P35 para 1.4.1

³⁴² P37 para 2.1

³⁴³ P37 para 2.3

³⁴⁴ P37 para 3.1

³⁴⁵ P39 para 3.2.1

³⁴⁶ P40-41 para 3.3

Other areas covered in this guideline include the requirement to avoid conflict of interest situations,³⁴⁷ and transparent governance for the benefit of shareholders, depositors and market participants.³⁴⁸

The code of conduct set forth in this guideline applies to the directors, CEOs and management of institutions licensed under the Banking Act. It deals with problems that have led to bank failure in Kenya such as misuse of position and information, unsecured insider loans and other practices in conflict with the interests of their bank.³⁴⁹ It also provides for evaluation of performance of board members.³⁵⁰

3.2.3.4 Liquidity

The Guideline defines liquidity as a situation where an institution is able to meet its obligations as they arise in a financially sound manner.³⁵¹ It provides for two specific requirements which banks must meet to be compliant.³⁵² The first one is the minimum liquidity ratio which is underpinned by Section 19 of the Banking Act.³⁵³ Commercial banks are required to hold a percentage of their assets as liquid assets as directed by the CBK, which is currently set by the CBK at a minimum of 20%.³⁵⁴

The second one is liquidity management.³⁵⁵ Under this heading, banks have various obligations which are part of liquidity management. These include having a liquidity management strategy.³⁵⁶ The strategy must set out its long term plan of maintaining adequate levels of liquidity.³⁵⁷ In addition, the plan should include a management structure that promotes effective execution of the liquidity strategy.³⁵⁸

³⁴⁷ P53 para 3.5.6

³⁴⁸ P65 para 3.14

³⁴⁹ See Part IV generally

³⁵⁰ Part VI p72

³⁵¹ Para 1.4 p157

³⁵² P. 158 Part IV

³⁵³ Ibid

³⁵⁴ Ibid para 4.1: Liquid assets here mean its deposit liabilities, matured and short term liabilities in liquid assets.

³⁵⁵ Ibid; para 4.2

³⁵⁶ 4.2.1

³⁵⁷ Ibid

³⁵⁸ 4.2.2

Banks are also required to put in place measures to monitor liquidity risk through cash flow analyses and projection.³⁵⁹ These measures are to be supplemented by periodic reviews and the establishment of an Asset Liability Committee whose main responsibility is liquidity an agent for that institution.³⁶⁰

Since liquidity management includes strategies for dealing with shortfalls, banks are required to set up formal Contingency Funding Plans to cater for emergencies.³⁶¹ These plans must be comprehensive and have clear demarcation of roles and responsibilities; and have procedures for dealing with all probable emergency situations.³⁶²

Even with all the above in place, banks have to carry out stress tests periodically, with the outcomes intended to be used to adjust their liquidity management structures.³⁶³ They are also required to have internal control mechanisms for liquidity, which must be part of the overall internal controls in the institution.³⁶⁴

As an accountability measure, the CBK requires banks to submit liquidity reports by the 10th day of every subsequent month.³⁶⁵

Failure by banks to comply with Section 19 of the Banking Act on holding the prescribed minimum level of liquid assets entitles the CBK to take either remedial or administrative action against the bank.³⁶⁶ The CBK is allowed to take action under Banking Circular No. 14 of 2000 and Legal Notice No. 77 of 10th June, 1999,³⁶⁷ while administrative sanctions include sanctions under the Banking Act, suspension of taking new business, and prohibition from engaging in activities the CBK determines to be contributing to the liquidity issue.³⁶⁸

However, where a bank is unable to submit its report, they must notify the CBK's Banking Supervision Department in writing giving its reasons why, and stating what it is doing to

³⁵⁹ 4.3.3

³⁶⁰ Ibid

³⁶¹ 4.2.4

³⁶² ibid

³⁶³ 4.2.5; Stress testing can be done with respect to a specific institution, or through a sector-wide approach. The scenarios focused on can be of short term problems or drawn-out situations.

³⁶⁴ 4.2.7

³⁶⁵ P. 160

³⁶⁶ P. 161 Part VI

³⁶⁷

³⁶⁸ P 161 para 6.2

remedy the situation.³⁶⁹ It is important to note that banks that submit their returns late, or submit inaccurate returns shall be penalized, and the relevant officers held liable under the Banking Act and the Prudential Guidelines.³⁷⁰

3.2.3.5 Sensitivity to Risk

This is provided for under the Guideline on Stress Testing.³⁷¹ Its purpose is to guide institutions in crafting their stress-testing systems which should form part of their risk management policies.³⁷² The risks to be covered include credit risk, probability of and exposure at default risk, market risk and liquidity risk.³⁷³

The responsibility for ensuring stress testing is done rests on the board and senior management.³⁷⁴ The board must ensure that there is a structure, while the management ensures implementation and application of remedial measures.³⁷⁵

The Guideline emphasizes that stress-testing must be an integral part of institutions' governance, and the results of such tests are to be taken into account when making strategic decisions.³⁷⁶ Consequently, stress tests should be carried out regularly, with the stress-testing system also being subjected to regular evaluations for effectiveness as well.³⁷⁷ This is to ensure that the ultimate results give a comprehensive picture of the risks facing the entire institution.³⁷⁸

The approach in crafting the tests should be aimed at covering “exceptional but plausible events,” and take into account emerging risk factors in the banking industry.³⁷⁹ Generally, the risks to be taken into account include macroeconomic factors such as interest rates, inflation and GDP growth, political factors, liquidity, and borrower and

³⁶⁹ P 161 para 6.1.2

³⁷⁰ Ibid para 6.1.3

³⁷¹ Prudential Guidelines, Guideline on Stress Testing, CBK/PG/20, p457

³⁷² Ibid para 1.4

³⁷³ Prudential Guidelines, Guideline on Stress Testing 458-459

³⁷⁴ Prudential Guidelines, Guideline on Stress Testing p459

³⁷⁵ Ibid

³⁷⁶ Prudential Guidelines, Guideline on Stress Testing p459 para 4.2.1

³⁷⁷ See Prudential Guidelines, Guideline on Stress Testing p459 para 4.2 generally

³⁷⁸ Ibid

³⁷⁹ Prudential Guidelines, Guideline on Stress Testing, p461 para 5.1

transactional risk characteristics.³⁸⁰ Institution-specific factors such as mergers or acquisitions should also be included.³⁸¹

The frequency of carrying out stress tests is not prescribed, but can be determined depending on the institution, market conditions and the risk profile of that institution.³⁸²

The Guideline however does provide for stress-testing methods for each type of risk to be adapted by banking institutions.³⁸³

Banking institutions are not required to make reports to the CBK except where the latest stress tests used “exceptional but plausible event” and “worst case scenario” setting.³⁸⁴

In this case, banks are to send a report to the BSD by the 10th day of each quarter in the standard form provided for in the Guidelines.³⁸⁵

3.2.3.6 Enforcement of Banking Laws and Regulations

The Guideline on Enforcement of Banking Laws and Regulations is aimed at guiding the banking sector on how the CBK will be issuing directives and orders in its capacity as a supervisor.³⁸⁶ It basically sets out what supervisory enforcement actions the CBK can take, in what circumstances, and what the CBK can order banks to do as remedial measures.³⁸⁷

The CBK’s supervisory directives include requiring institutions to pass board resolutions aimed at rectifying violations or remedying weaknesses, commitment letters, MOUs, and issuance of directives generally.³⁸⁸ Other actions the CBK can take include removal of officers and directors, actual intervention in management, and levying penalties.³⁸⁹ Some of the more punitive actions the CBK may take include revocation of an institution’s license, and increase in rates or termination of its involvement deposit protection.³⁹⁰

³⁸⁰ Ibid

³⁸¹ Ibid

³⁸² Prudential Guidelines, Guideline on Stress Testing, p461 para 5.2

³⁸³ Prudential Guidelines, Guideline on Stress Testing, p462 para 5.4

³⁸⁴ Prudential Guidelines, Guideline on Stress Testing, p461 para 5.5

³⁸⁵ Ibid

³⁸⁶ Prudential Guidelines, Guideline on, CBK/ p323 para 1.3

³⁸⁷ Ibid

³⁸⁸ See para 2 generally

³⁸⁹ Ibid

³⁹⁰ Ibid para 2.8-2.9

3.2.3.7 Prompt Corrective Action

The Guideline on Prompt Corrective Action is issued under sections 33 and 34 of the Banking Act.³⁹¹ It is geared towards prescribing prompt corrective actions which have to be taken by banking institutions to prevent their failure and instability generally in the banking sector.³⁹²

It applies to all institutions licensed under the Banking Act, and spells out corrective action to be taken depending on the difficulties an institution is facing.³⁹³ The aim is to restore it to a good financial state whilst also protecting depositors from the effects of systemic risk.³⁹⁴ Responsibility for adherence to this Guideline and implementation of action rests with the board and senior management.³⁹⁵

According to this Guideline, institutions are to be subjected to supervisory action if they are found to be in regular violation of laws and regulations, fail to meet the prudential guidelines, or are operating in an unsound manner.³⁹⁶ The supervisory actions are not similar across the board, but increase in severity depending on the level of violations.³⁹⁷ Some are mandatory while others have to be applied progressively should the CBK deem them manageable.³⁹⁸

The CBK's supervisory role is carried out through both on-site and off-site supervision on licensed institutions, meeting with management and exercising its powers of enforcement.³⁹⁹ Off-site supervision includes using financial indicators contained in CAMELS to ascertain the financial condition of these institutions.⁴⁰⁰ On-site supervision on the other hand involves assessing the competence of management, the operations of

³⁹¹ Prudential Guidelines, Guideline on Prompt Corrective Action, CBK/PG 21 p467

³⁹² Para 2.1

³⁹³ Para 2.2

³⁹⁴ Para 2.2

³⁹⁵ Para 2.3

³⁹⁶ Para 3.1

³⁹⁷ Ibid

³⁹⁸ Ibid

³⁹⁹ Guideline on PCA Para 3.3 p472

⁴⁰⁰ Ibid

an institution, and the risks it faces.⁴⁰¹ The outcome of this may lead the CBK to call for a meeting with the board or senior management or both.⁴⁰²

Institutions to which prompt corrective actions will be prescribed include those which fail to meet the capital requirements under the Banking Act;⁴⁰³ those which score an overall CAMELS⁴⁰⁴ and management component rating of 3 and below; those the CBK assesses to have an increased risk profile due to unsound practices, those which fail to act on CBK directives, those found to be significantly misreporting on their financial position; and those with a high overall risk rating with weak risk management practices.⁴⁰⁵

In determining which type of prompt corrective action to apply, the CBK has to establish what rating that institution has scored.⁴⁰⁶ Ratings range from ‘strong’ to ‘unsatisfactory, with the severity of remedial actions increasing as you head towards an unsatisfactory rating.’⁴⁰⁷

3.3 Summary

The CBK is a constitutionally independent body. It controls entry into banking business, prescribes how banks are to operate, and has the power to sanction those that deviate from the rules.

Prior to granting a banking license, institutions must comply with stringent requirements. These include minimum capital levels and on the calibre of persons who are to take positions in the board and senior management. Institutions seeking banking licences must demonstrate their ability to become sound banks once in operation.

Once a bank is operational, the CBK is able to maintain surveillance over its operations. It does this through mandatory information and reporting requirements, carrying out of both off-site and on-site inspections, and carrying out of audits. Through this, the CBK is able to uncover improper practices that lead to bank failure such as fraudulent and

⁴⁰¹ *Ibi*

⁴⁰² *Ibid*

⁴⁰³ *Ibid*: Section 18 of the Banking Act, and the Second Schedule underpinned in Section 7 of the Banking Act.

⁴⁰⁴ This acronym stands for Capital Adequacy, Asset Quality, Management, Liquidity and Sensitivity to Market Risk. See Part I of the Guideline on Prompt Corrective Action para 1.4 p468

⁴⁰⁵ *Ibid n*

⁴⁰⁶ Part IV

⁴⁰⁷ See ...

reckless lending, insider lending, poor asset quality, deliberate misreporting of financials, mismanagement and liquidity problems.

Periodic inspections mean that the CBK can take action before systemic bank failure occurs. The Banking Act empowers it to advise and give directions to problematic institutions, remove directors, officers or even the entire board, impose monetary penalties, and intervene in management through the board, appointing the KDIC or its own manager.

Through the Prudential Guidelines, the CBK is empowered to prescribe operational requirements for banks on capital levels, evaluating and maintaining asset quality, quality of management, maintaining adequate liquidity and evaluating and mitigating risk.

The guidelines on enforcement of regulations and imposing of prompt corrective action ensure that the CBK is guided on when and what to do regarding errant banks. It has a number of supervisory actions to choose from depending on the severity of the problem. The guidelines go further in prescribing reporting requirements where necessary, and where the CBK can issue reprimands.

In a nutshell, the CBK is an independent body with powers to: limit entry into the sector, access information, reprimand, direct, punish and even remove, and to take over completely where necessary. It is therefore perplexing that as recently as 2016 bank failure continues to occur in Kenya for reasons for which laws and regulations exist even with such a comprehensive legal framework.

It begs the question therefore, of how the CBK can effectively implement this framework to end occurrences of bank failure in Kenya.

CHAPTER 4: APPROACHES TO PREDICTING AND PREVENTING BANK FAILURE

4.1 Introduction

The CBK operates under an enabling legal framework of bank supervision and control. This framework has been interrogated in the foregoing chapters, and has proved to be detailed, comprehensive and empowering. However, the pervasive occurrence of bank failure in Kenya raises the question of whether the CBK as a supervisor effectively implements the laws and regulations at its disposal.

The exposition in Chapter 2 paints the CBK as a reactionary supervisor while the preceding chapter outlines the enabling legislative framework available to the CBK. Consequently, there is need to explore the most effective method that can be used in supervision of banks to prevent bank failure.

It is also necessary to explore how best the CBK can use its powers and authority to prevent bank failure. The ability to accurately predict bank failure will result in more efficient supervision.⁴⁰⁸ The persistence of bank failures has made the ability to predict and prevent them even more relevant, and for any central bank, the usefulness of an accurate method cannot be overemphasised.⁴⁰⁹

Various methods of analysing bank data to forecast the possibility of failure have been used. They are usually econometric data analysis techniques that grounded upon internal and external bank data or variables.⁴¹⁰ Internal data is usually collected by regulators.⁴¹¹ This data can be summarized as consisting of the following variables: capital adequacy, asset quality, management, earnings and liquidity (CAMEL).⁴¹² This data set has been expanded to CAMELS, with the 'S' standing for sensitivity to risk.⁴¹³ The CAMELS method

⁴⁰⁸ Mohammed A. SirElkhatim and Naomie Salim, 'Prediction of Banks Financial Distress'

SUST Journal of Engineering and Computer Sciences (JECS), Vol. 16, No. 1, 2015 at <http://www.sustech.edu/staff_publications/20140802073403858.pdf> accessed on 1st August 2017

⁴⁰⁹ John Taton and Reza Houston, 'Predicting Bank Failure in the Commercial Banking Industry,' Indiana State University 5th August 2011 at <https://mpira.ub.uni-muenchen.de/34608> accessed on 16th June 2017

⁴¹⁰ Ibid p3

⁴¹¹ Ibid Taton p3

⁴¹² Ibid

⁴¹³ Ibid

is among other forms of reporting on internal bank data, for example, the periodic reports the CBK receives from commercial banks in Kenya.⁴¹⁴

Internal data not falling under CAMELS includes bank size, diversification and market power.⁴¹⁵ The size can be assessed from the assets held while diversification and market power can be established from the non-lending product types and sources of non-interest income.⁴¹⁶ It has been argued on one hand that big banks are more likely to fail due to increased risk-taking.⁴¹⁷ On the other hand, others have argued that the benefits of diversification and the gains from economies of scale tilt the scale towards stability.⁴¹⁸

External data on the other hand includes economic conditions that affect a bank's income, assets and liabilities thereby affecting its solvency. This data can be collected from economic indicators and is not necessarily a function of the bank supervisor.⁴¹⁹

Although banking crises can be caused by factors such as low economic growth and high inflation rates, bank failure is usually caused primarily by other internal factors.⁴²⁰ Macroeconomic factors in of themselves cannot explain systemic and persistent problems in the banking sector leading to failure, but can assist in the bank failure prediction process.⁴²¹

The other approach to preventing bank failure emphasizes managing risk and ensuring competent management out of all the other CAMELS components. However, this does not mean that the other components are ignored. Rather, the approach recognises that management, being the control arm of institutions, is best placed to deal with the risks that lead to bank failure before they actually cause bank failure.

⁴¹⁴ See generally Part VI of the Banking Act

⁴¹⁵ Ibid Mohamed

⁴¹⁶ Ibid

⁴¹⁷ Ibid

⁴¹⁸ Ibid

⁴¹⁹

⁴²⁰ Barthélemy Kouezo, Mesmin Koulet-Vickot and Benjamin Yamb, 'Predicting the Risk of Bank Deterioration: A Case Study of the Economic and Monetary Community of Central Africa,' AERC Research Paper 265 African Economic Research Consortium, Nairobi, January 2013 at http://aercafrica.org/index.php/publications/view_document/280-predicting-the-risk-of-bank-deterioration-a-case-study-of-the-economic-and-monetary-community-of-central-africa accessed on 31st July 2017

⁴²¹ Ibid n339 Mohamed

In this chapter, we shall firstly focus on predicting bank failure based on internal data. The CAMELS method shall be the main one under consideration. This is because it contains the main variables that are used by researchers to assess bank distress and failure.

The second point of focus shall be the risk-management based approach to preventing bank failure. This approach involves assessment of risks faced by different banks and tailoring supervision to their mitigation thus preventing failure. Several case studies as well as Kenya's application of both approaches shall be covered.

4.2 The CAMELS approach as an Early Warning System for Predicting Bank Failure

The CAMELS variables are comparably the simplest to establish.⁴²² This is because the variables are the most important indicators of bank fragility, and are easily extracted from a bank's books (balance sheet and income statement).⁴²³

The CAMELS rating system was developed in the 1970s by the American Federal Deposit Insurance Corporation (FDIC) as CAMEL to assess the strengths and weaknesses of banking institutions.⁴²⁴ Each component would be assigned a value, and the aggregate rating would alert bank supervisors on what kind of intervention was needed, if any.⁴²⁵ The 'S' component was added later. The components of CAMELS are important both individually and taken as a whole. They are discussed in more detail below.

4.2.1 Capital Adequacy

This is considered the most important variable because capital functions as a mitigating factor towards market shocks and losses.⁴²⁶ For any bank, a drop in capital levels in relation to assets points to potential difficulties.⁴²⁷

⁴²² Ahlem-Selma Messai and Fathi Jouini, 'Predicting Banking Distress in European Countries', Journal of Economic and Social Studies at <http://eprints.ibu.edu.ba/2376/1/2.%20Messai%2C%20Jouini.pdf> accessed on 19th August 2017 p68

⁴²³ Ibid

⁴²⁴ David G Mayes and Hanno Stremmel, 'The Effectiveness of Capital Adequacy Measures in Predicting Bank Distress,' Reserve Bank of New Zealand, November 2012 at < <https://www.rbnz.govt.nz/-/media/ReserveBank/Files/Publications/Seminars%20and%20workshops/dec2012/session3-mayes-162502.pdf?la=en>> accessed on 19th August 2017 p4

⁴²⁵ Ibid

⁴²⁶ Ibid Mayes p11

4.2.2 Assets and their quality

The form and quality of assets in a bank's books can lead to financial distress and actually speed up the failure of that institution.⁴²⁸ A bank holding poor quality and inferior assets is more likely to make losses than one with a robust asset register.⁴²⁹

This variable can also be analysed in the sense of poor quality assets leading to an increased provision for losses.⁴³⁰ The consequent reduction or loss of capital then increases the risk of failure.⁴³¹ Other asset quality indicators include overexposure to specific risk trends in

The main business of banks is lending, thus their main asset base is made up of loans earning them interest.⁴³² Since they have to focus on making provisions for bad loans, assessing asset quality can be done by comparing the provision for bad loans to the total number of loans.⁴³³ A more accurate assessment would be from comparing the ratio of non-performing loans to the total loans.⁴³⁴ This is because provisioning for bad loans may not necessarily be linked to the quality of the loan book.⁴³⁵

The indicators for asset quality are basically overexposure to the risk of non-performing loans; and high default rates leading to high levels of provisioning for bad debts.⁴³⁶ Their usefulness rests on their being effectual pointers for asset quality in the sense that poor asset quality has a negative impact on capital and profitability, with the reverse being true.

4.2.3 Management

The ability and skills of management is directly linked to the performance and success or failure of an institution.⁴³⁷ If the management is highly skilled and competent, the risk of

⁴²⁷ Ibid

⁴²⁸ Ibid Mayes p12

⁴²⁹ Ibid

⁴³⁰ Ibid

⁴³¹ Ibid

⁴³² Ibid

⁴³³ Ibid

⁴³⁴ Ibid

⁴³⁵ Ibid

⁴³⁶ Jean Michel-Sahut and Mehdi Mili, 'Determinants of Banking Distress and merger as Strategic Policy to Resolve Distress,' Economic Modeling 2011 Vol. 28, No. 1/2, p8

⁴³⁷ Ibid n357 p13-14

poor decision making is lowered.⁴³⁸ Since this is difficult to capture with financial data i.e. skills and competence, banking supervisors have to refer to other variables such as asset quality and earnings to assess the efficiency of management, and whether their decisions are leading to profitability.⁴³⁹

4.2.4 Earnings ability

This refers to the sustainability of levels of earnings and profits.⁴⁴⁰ Higher levels of profitability give banks the ability to increase their capital base, widen their loan book and in essence improve their performance.⁴⁴¹ Low levels of earnings and profits on the other hand increase the probability of failure.⁴⁴² If a bank is unable to maintain their earnings, the resultant losses will erode their capital and lower the quality of their assets.⁴⁴³

In comparing the performance of banks within one financial market, supervisors need to ensure that the measure of earnings ability is sensible and comparable with other banks in that market.⁴⁴⁴ The most common indicator of earnings levels is the cost to income ratio which captures earning strength.⁴⁴⁵

4.2.5 Liquidity

Liquidity is essential to a bank's ability to meet and pay its short-term obligations and honour unanticipated requests for funds from creditors.⁴⁴⁶ A bank with a high level of liquid assets is unlikely to fall into distress; and the opposite is true.⁴⁴⁷

In assessing the level of liquidity, the amount of liquid assets is compared to the total assets.⁴⁴⁸ Liquid assets can be government bonds, loans or deposits, with the deposit/total asset ratio only being applicable to deposit-taking institutions.⁴⁴⁹

⁴³⁸ Ibid

⁴³⁹ Ibid

⁴⁴⁰ Ibid n357 p13

⁴⁴¹ Ibid

⁴⁴² Ibid

⁴⁴³ Ibid

⁴⁴⁴ Ibid

⁴⁴⁵ Ibid

⁴⁴⁶ Ibid n357 p13

⁴⁴⁷ Ibid

⁴⁴⁸ Ibid

⁴⁴⁹ Ibid

4.2.6 Sensitivity to risk

This element has been generally overlooked due to the difficulty in assessing it using financial and accounting information, with some quarters preferring to use bank size to approximate the sensitivity to risk.⁴⁵⁰ However, shifts or fluctuations in a financial market can impact banks differently irrespective of their size.⁴⁵¹

Vulnerability to distortions in the market, especially in relation to prices and funding, would mostly affect institutions which rely on refinancing from the market, or whose assets are highly volatile.⁴⁵² However, the deposit ratios and the type of liabilities held would be a more precise pointer to the susceptibility of a bank to failure or distress.⁴⁵³

4.2.7 Summary

Various studies have confirmed the validity of the CAMELS approach.⁴⁵⁴ It has been used to accurately predict financial distress in the US and Europe by the data collected being subjected to econometric data analysis techniques such as the logit technique and discrete survival time analysis.⁴⁵⁵ These variables have been found to be robust and stable in explaining bank failure, even where not all the variables will come into play in each specific case of bank failure.⁴⁵⁶

4.3 Use of CAMELS system by the CBK

The CBK applies the CAMELS evaluation system in order to evaluate the stability of banks and determine which prompt corrective action to prescribe.⁴⁵⁷ This is as prescribed in the Prudential Guidelines and set out in the previous chapter.⁴⁵⁸ In addition to individual assessment, the CBK also applies this test sector-wide in order to deliver an aggregate rating.⁴⁵⁹

⁴⁵⁰ Ibid n357 p13-14

⁴⁵¹ Ibid

⁴⁵² Ibid

⁴⁵³ Ibid

⁴⁵⁴ Ibid n357 p1, p15

⁴⁵⁵ Ibid

⁴⁵⁶ Ibid n357 p27

⁴⁵⁷ Prudential Guidelines

⁴⁵⁸ Ibid

⁴⁵⁹ See various BSD Annual Reports

In the period from 2011 to present day, the CBK has in its annual reports rated the Kenyan banking sector quite highly.⁴⁶⁰ In 2011, the overall rating was strong, with 18 banks getting a strong rating, 21 banks getting a satisfactory rating and 4 banks getting a fair rating.⁴⁶¹ These same numbers were maintained in 2012.⁴⁶²

In 2013, the overall strong rating was maintained, with 18 banks getting a strong rating, 20 being rated as satisfactory and 4 being rated as fair.⁴⁶³ These numbers changed slightly in 2014 with 22 being rated as strong, 16 as satisfactory and 5 as fair.⁴⁶⁴ The overall strong rating was maintained.⁴⁶⁵

In 2015, the overall rating dropped to satisfactory due to a drop in asset quality, earnings levels and liquidity of several banks.⁴⁶⁶ The numbers reflect this, with only 11 banks being rated as strong, 19 as satisfactory, 8 as fair and 2 as marginal.⁴⁶⁷ In this computation, Imperial Bank Limited and Chase Bank Limited (both in receivership at the time) were not included, and the reasons therefore were not given.⁴⁶⁸

The 2016, the overall rating went back up to strong with 11 banks rated as strong, 16 as satisfactory, 11 as fair and 1 as marginal.⁴⁶⁹ None was rated as unsatisfactory. This represented 40 banks with Charterhouse Bank, Imperial Bank, Chase Bank and Fidelity Commercial Bank excluded. The first is still in statutory management, the next two in receivership while the last was in the process of being acquired.

Noting that the number of commercial banks in Kenya stands at 44, and that Charterhouse bank was excluded from the figure since 2006, it is curious that 3 banks have encountered troubles between 2015 and 2017 for preventable reasons, despite the rosy picture given by the CBK in that time. This begs the question of how the CAMEL(S) rating system can be put to better and more effective use such that bank failure is for reasons not covered in CAMELS.

⁴⁶⁰ See various CBK bank supervision annual reports

⁴⁶¹ Central Bank of Kenya, Bank Supervision Annual Report 2011

⁴⁶² Central Bank of Kenya, Bank Supervision Annual Report 2012

⁴⁶³ Central Bank of Kenya, Bank Supervision Annual Report 2013

⁴⁶⁴ Central Bank of Kenya, Bank Supervision Annual Report 2014

⁴⁶⁵ Ibid

⁴⁶⁶ Central Bank of Kenya, Bank Supervision Annual Report 2015

⁴⁶⁷ Ibid

⁴⁶⁸ Ibid

⁴⁶⁹ Central Bank of Kenya, Annual Bank Supervision Report 2016

4.4 Use of CAMELS system in the United States of America

The Federal Deposit Insurance Corporation (FDIC) was created in 1933 by the American Congress as an independent body following numerous bank failures in the US.⁴⁷⁰ Its work includes supervision of financial institutions to ensure that they operate in a safe and sound manner.⁴⁷¹ The overarching goals are consumer protection and maintaining stability and public confidence in the financial system.⁴⁷²

The FDIC has used the Uniform Financial Institutions Rating System (UFIRS) to evaluate the financial condition of institutions since 1979.⁴⁷³ The UFIRS is based on the CAMELS rating system having been revised over the years to include a sixth component - sensitivity to risk- and updating the rating system.⁴⁷⁴

The UFIRS is uniformly applied to all institutions which the FDIC is the primary regulator.⁴⁷⁵ It helps the FDIC assess the general condition of the financial system, in maintaining stability and public confidence in the sector.⁴⁷⁶ It also helps the FDIC identify the problem institutions and deal with them accordingly.⁴⁷⁷

Under this system, banks are assigned a CAMELS composite rating as well as a component rating.⁴⁷⁸ The six components address the issues of adequacy of capital, quality of assets, capability of management, quality and level of earnings, adequacy of liquidity and sensitivity to market risk.⁴⁷⁹ In the evaluation process, the supervisor considers the size and complexity of the activities of each institution as well as its corresponding risk profile.⁴⁸⁰

The component rating runs from a scale of 1 to 5, with 1 indicating a well-run institution with good risk management and 5 indicating a weak institution requiring a high level of

⁴⁷⁰ See <https://www.fdic.gov/about/strategic/strategic/mission.html> accessed on 21st September 2017

⁴⁷¹ Ibid

⁴⁷² Ibid n475

⁴⁷³ FDIC Law, Regulations and Related Acts at <https://www.fdic.gov/regulations/laws/rules/5000-900.html> accessed on 21st September 2017

⁴⁷⁴ Ibid n478

⁴⁷⁵ Ibid n478

⁴⁷⁶ Ibid n478

⁴⁷⁷ Ibid n478

⁴⁷⁸ Ibid n478

⁴⁷⁹ Ibid n478

⁴⁸⁰ Ibid n478

supervisory action.⁴⁸¹ The composite rating is also from 1 to 5 with 1 indicating a sound institution and 5 indicating an institution with a high probability of failure.⁴⁸²

The composite and component ratings are not derived from each other.⁴⁸³ Due to the different risk profiles and dimensions of each institution's activities, a qualitative analysis is done with some components having more weight than others depending on the institution.⁴⁸⁴

The composite rating 1 is assigned to institutions which are sound all-round with minor and easily rectified weaknesses have substantially complied with laws and regulations and have a good risk management.⁴⁸⁵ A rating of 2 applies where the institution is fundamentally sound, with moderate weaknesses and demonstrates substantial legal compliance with satisfactory risk management.⁴⁸⁶ A rating of 3 applies where failure is unlikely, but there is significant regulatory non-compliance with weaknesses the management is unable or unwilling to address.⁴⁸⁷

Institutions which demonstrate unsound practices, serious management deficiencies and significant regulatory non-compliance get a rating of 4.⁴⁸⁸ This means the probability of failure is high and formal supervisory action has to be taken.⁴⁸⁹ The lowest rating of 5 applies to institutions which demonstrate extremely unsound practices, ineffective management and require external assistance to remain viable.⁴⁹⁰ Such institutions have

⁴⁸¹ Ibid n478 – The capital adequacy component is based on assessing the level of an institution's capital levels in relation to its risk profile. The asset quality component examines the credit risk profile of a bank in comparison to its loan portfolio, whether it has made adequate provision for bad loans in relation to its risk exposure and all other risks affecting the market value of its non-loan assets. The management component looks at the capability of the management to manage and control risk, provide guidance on risk management policies, procedures and practices and ensure implementation by the senior management. The earnings quality component measures the quantity and trend of earnings and the factors affecting the quality and sustainability of earnings. The last component, sensitivity to market risk, looks at the extent to which fluctuations in the market can affect a bank's earnings and capital, the ability of management to deal, and the adequacy of capital and earnings levels to cushion the bank against risk exposure.

⁴⁸² Ibid n478

⁴⁸³ Ibid n478

⁴⁸⁴ Ibid n478

⁴⁸⁵ Ibid n478

⁴⁸⁶ Ibid n478

⁴⁸⁷ Ibid n478

⁴⁸⁸ Ibid n478

⁴⁸⁹ Ibid n478

⁴⁹⁰ Ibid n478

an extremely high probability of failure, and pose a significant risk to deposit insurance.⁴⁹¹

The management component is given the most weight in the composite rating.⁴⁹² This is due to the presumed capability of management to anticipate and deal with risk which may negatively affect an institution.⁴⁹³ As a component, it is given more weight due to management's ability to affect the day to day operations.⁴⁹⁴

The ratings assigned to institutions are confidential.⁴⁹⁵ They can only be disclosed to persons other than the board and senior management of the relevant institution with prior written consent.⁴⁹⁶ The rating can also be challenged. In *Builders Bank v. Federal Deposit Insurance Corporation*,⁴⁹⁷ the FDIC assigned a rating of 4 under UFIRS.⁴⁹⁸ The bank filed suit to have the rating set aside saying that it should have been a 3.⁴⁹⁹

The FDIC argued that the assignment of ratings was lawfully discretionary for the supervisor, and that the rating was deserved due to the capital component rating, especially since it sets the capital requirements.⁵⁰⁰ On appeal, the court determined that the capital rating being discretionary did not render the other components so and the matter was referred back to the lower court for determination on whether the rating for the other five components was discretionary.⁵⁰¹

⁴⁹¹ Ibid n478

⁴⁹² Ibid n478

⁴⁹³ Ibid n478 – These risks include changes in macro-economic conditions such as inflation, reduced interest rates etc., entry of new players in the market, introduction of new products etc.

⁴⁹⁴ Ibid n478

⁴⁹⁵ Darran Ewell, Examination Process and Rating System, Federal Deposit Insurance Corporation, 2016 at https://www.uba.org/userfiles/EDP%202016/FDIC_Ewell_presentation_2016.pdf accessed on 21st September 2017

⁴⁹⁶ Ibid

⁴⁹⁷ United States Court of Appeal for the Seventh Circuit No. 16-2852. (Appeal from the United States District Court for the Northern District of Illinois, Eastern Division. No. 15 C 6033)

⁴⁹⁸ *Manatt Phelps & Philips LLP*, 'Seventh Circuit: Bank may challenge CAMELS rating,' 2nd February 2017 at <https://www.lexology.com/library/detail.aspx?g=348978ef-9f20-4dfb-94c8-9415e46f96b2> accessed on 21st September 2017

⁴⁹⁹ Ibid

⁵⁰⁰ Ibid n503

⁵⁰¹ Ibid n503

The analysis of bank failures in the US between 1984 and 1993 showed that poor management significantly increased the likelihood of failure.⁵⁰² Even where a bank exhibited low earnings and liquidity with poor assets, the likelihood of failure was exacerbated by inefficient management.⁵⁰³ In addition, those without adequate capital levels also had a greater risk of failure.⁵⁰⁴

Following the economic crisis of 2008 to 2011, the bank failures that occurred were attributed to increased credit risk taking and poor liquidity management.⁵⁰⁵ This affected the banks' ability to withstand the effects of the crisis.⁵⁰⁶ Furthermore, banks had to increase provisioning for bad loans and capital levels at a time when their ability to do so was severely compromised.⁵⁰⁷

In resolving failed banks, the FDIC has two main methods open to them.⁵⁰⁸ The first is Purchase and Assumption under which a healthy bank buys part or all of the failed bank's assets and also takes up part or all of its liabilities including insured deposits.⁵⁰⁹ The FDIC may partly reimburse the acquiring institution or shares part of the losses taken up.⁵¹⁰

The other method is the Deposit Payoff Transaction where the FDIC directly pays the failed bank's depositors the insured amounts and the right to claim is transferred to them through subrogation.⁵¹¹

⁵⁰² David C. Wheelock and Paul W. Wilson, 'Why Do Banks Disappear: The Determinants of U.S. Bank Failures and Acquisitions,' The Federal Reserve Bank of St. Louis Working Paper 1995-013B August 1995 at <http://research.stlouisfed.org/wp/1995/95-013.pdf> accessed on 21st September 2017

⁵⁰³ Ibid p3

⁵⁰⁴ Ibid p20

⁵⁰⁵ United States Government Accountability Office, 'Financial Institutions: Causes and Effects of Recent Bank Failures,' January 2013, Report to Congressional Committees GAO-13-71 at <http://www.gao.gov/assets/660/651154.pdf> accessed on 21st September 2017

⁵⁰⁶ Ibid

⁵⁰⁷ Ibid n510

⁵⁰⁸ Ibid n510 p65

⁵⁰⁹ Ibid

⁵¹⁰ Ibid n510

⁵¹¹ Ibid n510; See also Vincent Bouvatiera, Michael Brei, and Xi Yanga, 'The determinants of bank failures in the United States: Revisited,' January 2013 p2 at http://gdre2013.conference.univ-poitiers.fr/wp-content/uploads/sites/21/2014/05/Bouvatier_Brei_Yang.pdf accessed on 21st September 2017: Following the collapse of Lehman Brothers in 2008, the US government formulated a rescue package for banks through which their Treasury set aside funds for purchasing or insuring troubled assets, and to purchase equity in failing banks. The Federal Reserve responded through monetary policy tools such as interest rate cuts and discount window operations and providing funds to failing banks. Nevertheless, over 300 institutions failed and were placed under receivership by the FDIC.

The FDIC is statutorily mandated to use the method posing the least cost to the deposit insurance fund.⁵¹² Following the 2008-2011 crisis, it used the shared loss agreement mechanism.⁵¹³ This was done as it represented a lesser pay out from the deposit insurance fund as compared to liquidating the failed banks' assets.⁵¹⁴ The benefits of using this method included reduction in the immediate liquidity needs and less disruption to the depositors of the failed banks.⁵¹⁵

Using these methods, the FDIC is able to maintain stability in the financial system by resolving depositor interests. At the same time, it ensures that the failure of a bank has a minimal disruptive effect on the entire banking system.

4.5 The risk-based supervision (RBS) approach to preventing bank failure

The risk-based supervision approach to bank supervision entails identifying, assessing, monitoring and mitigating key risk factors facing individual banks and the entire banking sector.⁵¹⁶ The supervisor assesses the risk management practices of individual banks, and focuses supervisory attention on the areas that form the greatest threat to the bank's stability.⁵¹⁷ This approach allows the supervisor to apply its resources effectively since resources are targeted at specific problems.⁵¹⁸

The supervisory cycle entails creating a bank's risk profile through understanding its unique characteristics, assessing the risks the bank is facing and focusing on the most severe, developing a supervisory plan based on the risk profile, and identifying the supervisory actions to be taken at the time and in the future.⁵¹⁹

The CAMELS method has been described as backward-looking and transactional while the RBS approach has been summarized as dynamic and focused on assessing

⁵¹² Ibid n510

⁵¹³ Ibid n510

⁵¹⁴ Ibid n510

⁵¹⁵ Ibid n510

⁵¹⁶ *Banking Supervision Department, 'Risk Based Bank Supervision Manual,'* Central Bank of the Republic of Kosovo September 2015 at http://bqk-kos.org/repository/docs/2015/2016_06_07%20Risk%20based%20bank%20supervision%20manual.pdf accessed on 8th October 2017 p10

⁵¹⁷ Ibid Kosovo

⁵¹⁸ Ibid Kosovo

⁵¹⁹ Ibid Kosovo p12

implementation of regulations and risk-management practices.⁵²⁰ Use of the former results only in monitoring whether there is compliance.⁵²¹ The latter entails actually making sure there is compliance with both regulations and supervision plans whether or not the bank appears to be stable.⁵²²

The traditional CAMELS approach focuses on the accuracy of a bank's books, and takes a one-size-fits-all approach.⁵²³ It is also labour intensive and uses up a lot of the supervisor's resources.⁵²⁴ This is as compared to the RBS which, in focusing on the inherent risks faced by each bank, is able to identify the activities of highest risk and focus supervisory attention on those areas.⁵²⁵ This results in a cost-effective use of resources.⁵²⁶

Thus the RBS approach ensures that the supervisor is proactive in identifying risks at the level of individual banks and also at the systemic level.⁵²⁷ This ensures that such risks can be addressed before causing distress in an individual bank or sector-wide.⁵²⁸

4.6 The RBS approach in Kenya

The CBK issued a Risk Based Supervisory Framework in 2013 following the adoption of the RBS system in 2004 precipitated by the realisation that the old approach (CAMELS) was not as responsive.⁵²⁹ The weaknesses identified include failure to distinguish between high risk and low risk activities, being retrospective since it assessed points in

⁵²⁰ K C Chakrabarty, 'Strengthening the banking supervision through risk based approach – laying the stepping stones,' Address by Dr K C Chakrabarty, Deputy Governor of the Reserve Bank of India, at the inaugural session of the conference of non-executive directors on the boards of commercial banks, organized by Centre for Advanced Financial Research and Learning (CAFRAL), Mumbai, 13 May 2013 at <http://www.bis.org/review/r130515a.pdf> accessed on 9th October 2017

⁵²¹ Ibid

⁵²² Ibid KC

⁵²³ Nomonde Sixishe, 'Implementation of Risk Based Supervision: The Case Of Lesotho,' Macroeconomic Financial Management Institute Of Southern And Eastern Africa (MEFMI) May 2011 at http://mefmi.org/mefmifellows/wp-content/uploads/2016/10/Implementation-of-Risk-based-Supervision-The-Case-of-Lesotho_Nomonde-Sixishe_May-2011.pdf accessed on 9th October 2017

⁵²⁴ Ibid

⁵²⁵ Ibid Nomonde

⁵²⁶ Ibid Nomonde

⁵²⁷ Ibid KC

⁵²⁸ Ibid KC

⁵²⁹ Central Bank of Kenya, Risk Based Supervisory Framework Bank Supervision Department May 2013

time, prescribing solutions to problems instead of identifying their root, and giving solutions aimed at risk reduction instead of risk management.⁵³⁰

The CBK wished to shift focus to understanding banks' risk management practices on a continuous basis and increase interaction with management.⁵³¹ Thus the adoption of RBS commenced with a survey on the prevailing institution-specific risk management practices.⁵³² This survey led to the 2005 Risk Management Guideline and the direction to banks to put in place risk management systems within 6 months of the publication of the Guideline.⁵³³

The CBK's approach entailed development of institutional risk profiles, planning and scheduling supervisory activities, defining examination activities, performing examination procedures, reporting and updating of institutional information, and follow-up on findings and recommendations.⁵³⁴

The risk matrix used by the CBK covers quality of inherent risk, quality of risk management, composite risk and direction of risk.⁵³⁵ The risks covered in coming up with a rating include strategic, credit, operational, liquidity, interest rate, forex rate, reputational and regulatory risk.⁵³⁶

However, there is integration with CAMELS 'M' component rating.⁵³⁷ This is due to the fact that the same factors such as extensiveness of internal controls, oversight by board and senior management and adequacy of and compliance with policies, procedures and limits are used in assessing the quality of risk management.⁵³⁸

The regulatory tools available to the CBK include on-site examinations; off-site surveillance, prudential meetings with management; meetings with external auditors; and exchanging information with other regulators such as the Capital Markets Authority

⁵³⁰ Ibid

⁵³¹ Ibid

⁵³² Ibid

⁵³³ Ibid

⁵³⁴ Ibid

⁵³⁵ Ibid

⁵³⁶ Ibid

⁵³⁷ Ibid

⁵³⁸ Ibid

(CMA), Insurance Regulatory Authority (IRA), and the Retirement Benefits Authority (RBA).⁵³⁹

The main challenge faced by the CBK in implementation of RBS approach is the availability of skilled staff, and resources for training.⁵⁴⁰ However, the adoption of RBS has resulted in improved supervision, reduced time taken in inspections, reduction of inspectors needed per inspection, faster identification of risk and ability to identify and deal promptly with problematic banks.⁵⁴¹ Despite this, Kenya continues to experience incidences of bank failure.

4.7 Use of the RBS approach in Malaysia

The Bank Negara Malaysia (BNM) is the central bank of Malaysia tasked with, among other responsibilities, supervising banking institutions licensed under the various relevant legislations.⁵⁴² This is very similar to Kenya. The BNM has powers of supervision and control, and uses a risk-based supervisory approach to prevent bank failure.⁵⁴³ Using this approach, the BNM is able to monitor and review how banks identify, control and resolve risk.⁵⁴⁴

The Malaysian banking sector has grown from a fragmented sector with many small banks to a robust one with a few anchor banks. The sector is innovative, dynamic and represents where the Kenyan banking sector has been, is and where it should grow to.

⁵³⁹ Ibid

⁵⁴⁰ Joseph Charles Momanyi, 'The Effectiveness of Risk Based Supervision As Adopted by the Central Bank of Kenya,' University of Nairobi 2009

⁵⁴¹ Ibid

⁵⁴² Azman bin Othman Luk, Karen Foong and Elaine Heung, 'Banking regulation in Malaysia: Overview,' 1st May 2017 at [https://uk.practicallaw.thomsonreuters.com/w-0080538?transitionType=Default&contextData=\(sc.Default\)&firstPage=true&bhcp=1](https://uk.practicallaw.thomsonreuters.com/w-0080538?transitionType=Default&contextData=(sc.Default)&firstPage=true&bhcp=1) accessed on 28th September 2017. The relevant legislation is the Financial Services Act of 2013, Islamic Financial Services Act of 2013 and the Central Bank of Malaysia Act of 2009.

⁵⁴³ Ibid Othman

⁵⁴⁴ Rodney Gerard D'Cruz, 'The Banking Regulation Review- Malaysia,' The Law Reviews, 7th Ed, August 2016 at <http://thelawreviews.co.uk/edition/the-banking-regulation-review-edition-7/1136550/malaysia> accessed on 28th September 2017

Prior to 2007, just like the CBK the BNM used the CAMELS rating system while focusing on the risk profiles and risk management systems of the banks.⁵⁴⁵ The BNM used both on-site and off-site surveillance methods and based on the results they would assign a rating.⁵⁴⁶ The rating would then inform the bank on how to supervise that particular bank. The supervisory plan would be focused on the area of greatest risk.⁵⁴⁷

However, with an increasingly sophisticated and complex financial system, the BNM began facing challenges.⁵⁴⁸ Firstly, although the CAMELS rating system was thought to capture both qualitative and quantitative factors, there was found to be a tendency for the qualitative aspects to dominate resulting in a high rating which would however not be an accurate forecaster of the ability of the bank to handle distress.⁵⁴⁹

Secondly, it caused the frequency of visits to reduce for banks with high scores yet continuous engagement was found to be necessary due to a rapidly evolving financial system.⁵⁵⁰ Thirdly, this supervision model did not allow the BNM to have up-to-date knowledge of bank operations therefore it was difficult to anticipate changes to their risk profiles.⁵⁵¹ In this way, it is very similar to the CBK in terms of not being responsive.

With an increasingly complex banking sector and liberalisation of prudential standards, there was need for the supervisory function to evolve.⁵⁵² For the BNM, this evolution was in the direction of indirect supervision where the supervisor would focus more improving the banks' ability to manage risk.⁵⁵³ Therefore, from 2007 onwards, the BNM discontinued use of the CAMELS system.⁵⁵⁴

Under the risk-based approach, the different institutions are individually assessed based on their risk profiles, and the adequacy of their risk management is monitored.⁵⁵⁵

⁵⁴⁵ Uma Rajoo, 'Problem Bank Identification, Intervention and Resolution in Malaysia,' Chapter 4 at http://www.seacen.org/GUI/pdf/publications/research_proj/2008/rp73/5-chap4.pdf accessed on 28th September 2017 p11

⁵⁴⁶ Ibid

⁵⁴⁷ Ibid

⁵⁴⁸ Ibid

⁵⁴⁹ Ibid

⁵⁵⁰ Ibid

⁵⁵¹ Ibid

⁵⁵² Ibid

⁵⁵³ Ibid

⁵⁵⁴ Ibid

⁵⁵⁵ Ibid Othman n 521

Institutions are also required to have a risk profile, ensure there is application of best practices and principles of sound governance, and proper internal controls for risk management.⁵⁵⁶

This kind of supervisory structure applies across the board resulting in consistency in how banks manage similar risks.⁵⁵⁷ The approach also lays emphasis on projecting and dealing with future risks while identifying and resolving weaknesses in the risk management processes.⁵⁵⁸

The BNM relies on internal oversight and risk management controls put in place by banks to ‘anticipate and respond’ to developing risks, and to ensure they are dealt with before they escalate.⁵⁵⁹ The BNM however recognises that good management is of utmost value, and therefore has taken measures to ensure competent management of boards and senior management of institutions.⁵⁶⁰ This is particularly so because management has the capability of affecting a bank’s present and future financial condition.⁵⁶¹

This is in the form of the BNM approving the appointment of persons to the position of chairman, director, chief executive officer and other senior officers.⁵⁶² The BNM not only approves appointments but also elections, re-appointments and re-elections.⁵⁶³ It also holds banks to a higher standard of corporate governance.⁵⁶⁴ Thus the BNM has come up with a rigorous Fit and Proper Criteria Guideline and a detailed Corporate Governance Guideline to which banks have to adhere.⁵⁶⁵

The fit and proper criteria provides for the minimum acceptability levels on both personal and professional levels. These include integrity, reputation and competency.⁵⁶⁶ The BNM

⁵⁵⁶ D’Cruz Ibid n 523

⁵⁵⁷ Ibid Othman n521

⁵⁵⁸ D’Cruz Ibid n 523

⁵⁵⁹ Ibid Othman n 521

⁵⁶⁰ Ibid Othman n 521

⁵⁶¹ Evelyn Ch’ng and Fionah Sequerah, ‘Banking Regulation 2017: Malaysia,’ Global Legal Insights at <https://www.globallegalinsights.com/practice-areas/banking-and-finance/global-legal-insights---banking-regulation-4th-ed./malaysia> accessed on 28th September 2017

⁵⁶² Othman Ibid n 521

⁵⁶³ D’Cruz Ibid n 523

⁵⁶⁴ Othman Ibid n 521

⁵⁶⁵ Othman Ibid n 521

⁵⁶⁶ Ch’ng Ibid n 530

has complete discretion on whether the fit and proper requirements have been complied with.⁵⁶⁷

Under the BNM's corporate governance requirements, banks must put in place a risk management committee whose purpose is to support the board in meeting the expectations of the BNM on risk management.⁵⁶⁸ The specifications are as prescribed in the policy document on Risk Governance issued by the BNM.⁵⁶⁹ In addition, the BNM issues guidelines on credit risk management and banks are expected to establish comprehensive policies and processes for managing these risks.⁵⁷⁰

On liquidity, the BNM has issued the Liquidity Coverage Ratio which is geared towards ensuring banks hold enough 'high quality liquid assets' which would allow banks to meet increased liquidity demands for at least 30 days.⁵⁷¹ This is based on the Basel III Liquidity Coverage Ratio standard.⁵⁷²

The BNM also prescribes the Statutory Reserve Requirement which is a minimum balance to be maintained at a level equivalent to the prescribed LCR.⁵⁷³ On capital, the BNM has imposed a minimum requirement.⁵⁷⁴ This may be raised depending on the risk profile of the institution.⁵⁷⁵

On carrying out the assessment, the BNM assigns banks a Composite Risk Rating (CRR) based on the assessment of the impact of the bank's risk profile to its capital and earnings.⁵⁷⁶ In reaching the CRR, the BNM takes into account the effectiveness of management and the risk management control functions of the institution.⁵⁷⁷

The process follows the following order: identification of the bank's substantial activities; assessment of the risk intrinsic to those activities; assessment of the capability of

⁵⁶⁷ D'Cruz Ibid n 523

⁵⁶⁸ Othman Ibid n 521

⁵⁶⁹ Othman Ibid n 521

⁵⁷⁰ Othman Ibid n 521

⁵⁷¹ Othman Ibid n 521

⁵⁷² Ch'ng Ibid n 530

⁵⁷³ Othman Ibid n 523

⁵⁷⁴ Ibid, Othman. These requirements are imposed under the Capital Adequacy Framework (Capital Components) and the Capital Adequacy Framework for Islamic Banks (Capital Components).

⁵⁷⁵ Ibid

⁵⁷⁶ Rajoo p113

⁵⁷⁷ Ibid

management; and assessment of the internal risk management strategies.⁵⁷⁸ The BNM is then able to assess the extent to which the bank will be able to internally manage the risk.⁵⁷⁹ To compute the CRR, The total net risk is then offset against the capital and earnings of the institution.⁵⁸⁰ While the CRR is reviewed on an annual basis, it can be changed at any time.⁵⁸¹

In spite of radically changing its approach to supervision, it has been argued that Malaysia has to keep reviewing the system to ensure it remains effective against emerging risks.⁵⁸² This is especially true with banking becoming more complex with time and transcending geographical boundaries making transmission of risk from one market or jurisdiction to another easy.⁵⁸³

4.8 Use of the RBS approach in India

The change from the traditional approach to the RBS approach in India was precipitated by the realisation that while the banking sector had evolved, the supervisory processes and resources remained the same.⁵⁸⁴ The supervision model based on CAMELS was found to be backward-looking and ineffective.⁵⁸⁵ In addition, the global financial crisis had led to revisions in international bank supervision standards.⁵⁸⁶

A High Level Steering Committee led by the chairman of the Reserve Bank of India was established in 2011 to review the RBI's approach to supervision.⁵⁸⁷ It found that although India had piloted the RBS system between 2003 and 2006, a full-scale rollout had not been possible at the time.⁵⁸⁸ This was due to the banks' inadequate internal risk

⁵⁷⁸ Ibid

⁵⁷⁹ Ibid

⁵⁸⁰ Ibid

⁵⁸¹ Ibid

⁵⁸² Rajoo p 125

⁵⁸³ Ibid

⁵⁸⁴ Reserve Bank of India, Report of the High Level Steering Committee for Review of Supervisory Processes for Commercial Banks in India, June 2012 at <https://www.rbi.org.in/Scripts/PublicationReportDetails.aspx?UrlPage=&ID=663> accessed on 9th October 2017
High Level Steering Committee for Review of Supervisory processes of commercial banks

⁵⁸⁵ Ibid RBI

⁵⁸⁶ Ibid RBI

⁵⁸⁷ Ibid RBI

⁵⁸⁸ Ibid RBI

management systems, poor technology, inadequate human resource and lack of goodwill from boards and senior management.⁵⁸⁹

This mirrors the Kenyan experience where the RBS Framework was created in 2003 and shelved until 2013. Even if it were to be revived in 2018, the challenges of inadequate risk management systems, human resource and goodwill from management would still be a problem in Kenya just as in India.

The Committee proposed a RBS system with the following steps: understanding the bank, assessing the inherent risks, scheduling and planning supervisory activities, defining examination activities, inspection procedures and reporting findings and making recommendations and follow-up.⁵⁹⁰

The risk matrix would cover the following: credit, market, operational, liquidity and pillar 2 risks.⁵⁹¹ Depending on the assessment, the ratings would range from good, satisfactory, unsatisfactory, poor and very poor.⁵⁹² Based on the rating, banks would be grouped as needing baseline monitoring, close monitoring, active oversight and corrective actions.⁵⁹³ The level of risk vis-à-vis the supervisory objectives and the impact of failure on financial stability would determine where a bank falls.⁵⁹⁴

The Committee recommended that before the phased rollout of the RBS approach from 2013, each bank would be required to have in place an internal risk management process.⁵⁹⁵ In 2014, 30 select large banks were instructed to prepare for the shift to RBS after signifying their readiness to do so.⁵⁹⁶ Preparation for the shift entailed ensuring increased compliance and risk management, implementation of risk-focused internal

⁵⁸⁹ Anita Bhoir, 'RBI switches 30 banks to risk based supervision,' The Economic Times May 2014 at <http://economictimes.indiatimes.com/news/economy/policy/rbi-switches-30-banks-to-risk-based-supervision/articleshow/34558036.cms> accessed on 9th October 2017

⁵⁹⁰ Ibid RBI

⁵⁹¹ Ibid RBI

⁵⁹² Ibid RBI

⁵⁹³ Ibid RBI

⁵⁹⁴ Ibid RBI

⁵⁹⁵ Ibid RBI

⁵⁹⁶ Ibid n 594 Bhoir. See also The Hindu, '30 banks ready for risk-based supervision,' at <http://www.thehindu.com/business/Industry/30-banks-ready-for-riskbased-supervision/article4534760.ece> accessed on 9th October 2017

audit and improving their information management systems.⁵⁹⁷ This is because the RBS approach is data-intensive and requires up-to-date and seamless information reporting in order to assess and forecast risk.⁵⁹⁸

4.9 Summary

The CAMELS approach to bank supervision has been widely used the world over from when it was designed. It has enabled central banks carry out their mandate, including the CBK.

Nevertheless, developments in the banking industry have necessitated a forward-looking approach that is encapsulated in the risk-based approach. The CBK has attempted to use the RBS approach with little vigour. This shall form the basis of discussion in the next chapter.

⁵⁹⁷ Stuti Singh, 'Navigating through the RBI's Risk Based Supervision Regulation: Challenges and Remedies for Indian banks,' Nasscom April 2015 at <http://blogs.nasscom.in/navigating-through-the-rbis-risk-based-supervision-regulation-challenges-and-remedies-for-indian-banks/comment-page-1/> accessed on 9th October 2017

⁵⁹⁸ Ibid

CHAPTER 5: CONCLUSION AND RECOMMENDATIONS

5.1 Conclusion

The banking sector in Kenya has evolved such that Nairobi is considered the financial hub of East and Central Africa.⁵⁹⁹ This position makes the continued occurrences of bank failure for the same reasons a problem that requires to be addressed swiftly.

Chapter 2 of this paper looked at bank failure in Kenya from a historical perspective. It also traced the occurrences of bank failure up to the present day. The chapter highlighted the reasons causing Kenyan banks to fail at each juncture of history.

Notably, there was a commonality of reasons such as mismanagement, insider lending, board interference in management, political interference and risky lending practices. This is in spite of the existence of enabling laws and regulations, a CBK with sufficient powers of control, information and sanction, and a BSD with increased capacity.

Chapter 3 analysed the laws and regulations in place. This analysis established that the CBK is well-funded and has a plethora of laws and regulations at its disposal to ensure banks are compliant. The very same legal framework allows the CBK to take action where necessary.

In chapter 4, the study looked at the methods through which the CBK can prevent bank failure. The two methods that were studied have been applied successfully in other jurisdictions. It is important to note that there is now a gradual shift from the first, CAMELS, to the second, the RBS approach. This is due to the realisation that given the importance of banking in the economy, there is need to take a more proactive approach in bank supervision.

Kenya recognised the need for integration of the RBS approach in bank supervision as early as 2004. However, the CBK has failed to utilise this method. This is in spite of the enabling normative environment created by among others, the Prudential Guidelines.

⁵⁹⁹ Business Daily Africa, 'Nairobi finance hub closer to reality as Uhuru signs law' 21st July 2017 at <http://www.businessdailyafrica.com/economy/Nairobi-finance-hub-closer-to-reality-as-Uhuru-signs-law/3946234-4026580-1222sh5/index.html> accessed on 17th October 2017

The CBK revised the Prudential Guidelines in 2012 and in doing so included detailed guidelines on risk classification, enforcement of banking laws and regulations, stress testing and prompt corrective action. As it stands, the PGs represent a medley of both the CAMELS approach and the RBS approach. This is an advantage in that some of these provisions are forward-looking. However, it becomes disadvantageous since it muddles up the CBK's supervisory style such that it is not clear what supervisory direction the CBK is taking.

The main thrust or hypothesis of this paper is that the CBK has in place an enabling regulatory and policy framework to ensure bank failure is prevented in Kenya. This has been illustrated by the exposition in chapter 3. The various provisions of law and regulations actually prohibit the actions taken by banks that lead to their failure. This includes provisions on insider lending, limiting amounts borrowed by one person, limiting borrowing beyond a certain capital threshold etc. They also control persons who can set up banks and manage them. This ensures that only persons who are certified fit and proper per the stringent requirements can sit on the board or manage banks.

However, despite this enabling legal environment, bank failure continues to persist in Kenya. With the rapid spread of news via social media, the likelihood of contagion is high whenever failure of one bank is imminent. Kenyan banks have also spread their wings to other countries in the region. This makes stability of the Kenyan banking sector even more important.

It is therefore in order for the CBK to look inward, specifically at how it handles implementation of these laws, rules and regulations. The pertinent question, therefore, is how the CBK can avert bank failure on Kenya using the current legal framework. The answer lies on how the CBK can effectively implement the laws at its disposal.

5.2 Recommendations

In light of the increasingly sophisticated banking sector in Kenya, and the shift from reactive to proactive bank supervision of banks internationally, the following recommendations should be considered. The purpose of these recommendations is to re-

direct the Bank Supervision Department of the CBK in how it carries out supervision of banks in order to maintain a stable and failure-free banking sector.

5.2.1 Short-term objective: Actual application of the existing laws and regulations

The reality is that the Kenyan banking sector is not ready for an immediate total switch to the RBS method of supervision. This is due to the need to build capacity, information management and risk identification and management systems in banks first, just like in India. Therefore it is important for the CBK to ensure that banks are compliant even as the CAMELS rating system remains.

In order to do so, the CBK's BSD should increase its use of on-site and off-site surveillance and reporting and information requirements. Enforcement of the provisions of the Banking Act and the PGs needs to be done in a more effective manner. This is particularly with regard to licensing, approval of board members and senior management, as well as application of the punitive measures provided for under the CBK Act, the Banking Act and the PGs as discussed in Chapter 3 of this study.

In addition, the BSD should actually implement the 2013 RBS Framework in the areas of preparation of individual risk profiles for banks and development of supervisory plans based on the findings. This will complement the existing CAMELS rating system while at the same time steering banks towards preparing for the shift to the RBS method.

5.2.2 Short-term objective: Legislative enhancements

Whereas the study has concluded that the CBK operates within an enabling legal framework hence making implementation to be the problem, it is important to underpin the RBS approach in the law. Currently, it is simply a policy document with vague underpinnings in the PGs, and therefore not a binding document.

The Banking Act should be amended to underpin the use of RBS in bank supervision. Under this section, the CBK should be empowered to come up with the RBS Supervision Manual which should have the same legal effect as the PGs. The Act should also specifically mention the phased migration to RBS.

The provisions of the PGs should remain as currently constituted. However, the provisions that will intersect with the proposed RBS Supervision Manual should be struck

out. In essence, the two documents should be interrelated, but the latter document should be focused solely on supervision and supervisory action.

5.2.3 Long-term objective: Phased substantive implementation of the RBS approach

In Chapter 4, it was established that the CBK has already identified the importance of the RBS approach in 2004 and issued an RBS Framework in 2013. Some of the reasons it is advantageous is that it is forward-looking, encourages a deep understanding of individual banks' businesses and risk profiles, and is aimed at dealing with emerging risks before they become a problem.

Chapter 4 also sets out how India broached the idea of switching to RBS and postponed it, only to revisit the issue in 2013. Some of the reasons why the RBI chose to postpone were because most Indian banks had basic internal risk management systems, inadequate skilled human resource, low technology and unwilling management. The RBI did so because RBS is data intensive, requires modern information management systems, and an enabling board and senior management.

In the case of Kenya, the CBK has control over who becomes part of top management of banks. It also prescribes standards for good corporate governance for banks. In addition, banks are expected to have in place good risk management policies. This is through the empowering provisions of the CBK Act, the Banking Act and the PGs as set out in Chapter 3.

With the above, the CBK should first ensure compliance with the legal framework. It can thereafter give timelines based on the bank tier system.⁶⁰⁰ This is essentially giving Tier 1, 2 and 3 banks timelines for compliance based on their sizes and complexity of operation.

The CBK's BSD should borrow from India's phased implementation of RBS by identifying which tier of banks to begin with. As in India, it will be important to consult all affected

⁶⁰⁰ Tier 1 banks have been longest in the market, have assets worth hundreds of billions and millions of customers, therefore highly stable and their failure would be problematic to the wider economic system and warrant government intervention. Tier 2 are medium-sized banks; which jointly command 41.7% of the financial market compared to their rivals in Tier one, which collectively control about 50%. Tier 3 is made up of small banks that control 8.4% of the Kenyan market. See Mathew Ndungu, 'CBK ranks Kenya's banks depending on security,' 2016 at <http://www.hivisasa.com/posts/cbk-ranks-kenyas-banks-depending-on-security> accessed on 17th October 2017

parties such that banks voluntarily submit to switch to RBS. Eventually, like the BNM in Malaysia, bank supervision should be solely under the RBS approach.

The CBK should also come up with a time-frame for migration of the rest of the tiers to RBS. Some of the actions that the BSD has to take include having banks improve their information management systems and their risk management systems, undertake training of staff and management, and re-orient their operations towards risk prediction and mitigation.

5.2.4 Long-term objective: Design of an RBS Supervision Manual (overhaul of the existing 2013 RBS Framework)

The 2013 RBS Framework issued by the CBK requires an overhaul to conform to current designs of RBS supervision manuals which provide for a dynamic, efficient, structured and risk-oriented prudential supervision framework.

The 2013 Framework broadly covers the sequence of events in the RBS cycle starting from development of a risk profile, planning supervisory activities then reporting on and reviewing performance

The CBK should create a new manual that will widen the scope of the steps and contain more comprehensive requirements of the risk-based supervision process. This is essentially includes what information is to be included in each of the steps to ensure a comprehensive picture of the bank is obtained. This is summarized below:

a) Institutional Profile

Currently, the information used to come up with the institutional profile includes the present condition of the bank, the issues of supervisory concern and past supervisory findings. The CBK should expand the scope to include information on the background of the bank, the shareholding and capital structure, the staff component including the Board and senior management, the risk management framework, and the largest borrowers and depositors.

The following should also be included: results of past examinations, ratings and significant findings, external and internal audit findings, external credit ratings,

overall conclusions from periodic CAMELS ratings, environmental considerations and stress-testing results.

b) Risk Assessment Summary

Currently, the Risk Assessment Summary involves a tabular presentation of the quantity of risk, quality of risk management, and the direction of risk. It is integrated with the CAMELS rating. There is need to also look at the assets, liabilities, deposits, borrowings and loan reserves and other financial data in coming up with the risk profile. The CAMELS assessment, structure of the bank, the bank profile and business strategy, and macro-prudential stability should also be considered in preparing the profiling.

When it comes to assessing risk, there is need to start by identifying the significant activities of each bank, determine the quantity of inherent risks, assess quality of risk management then determine the net risk.

c) Supervisory activities

The existing RBS Framework only states the supervisory activities such as on-site examinations. It also provides for an examination plan for all institutions to be inspected in the year, including the time-frames. The CBK should provide for steps that include review of the most recent risk assessment, examination and CAMELS reports, review of correspondence with CBK, and determination of and listing the frequency and scope of the next on-site exam and off-site analysis. There should also be a projection of the on-site and off-site examinations for the next 12 months for each individual bank.

d) Examination Activities

In defining the examination activities, there is need to identify the key objectives and scope of examinations and the deliverables to be developed. The individual CBK and bank staff involved as well as their duties should be provided for. In a nutshell, the examination activities provided for should be tailored to meet the

characteristics of each bank, and should take into account the most recent risk assessment report, risk matrix, examination and CAMELS reports.

e) Scope Memorandum

For every institution, there should be developed a Scope Memorandum, essentially a blueprint for supervision. It should identify the key objectives and scope of examination activities, and be finalised in concert with the bank's management.

The on-site examination should cover review of CAMELS rating components, the audit function, internal controls and all identified risks such as credit, market and liquidity risks. The mode of this analysis should be comprehensive, and the CBK should be able to identify informational parameters that meet the RBS approach. Off-site examinations should involve analysis of financial data and follow-up reviews to ensure corrective actions are taken.

5.2.5 Long-term objective: Reorganisation of the BSD

The BSD is currently organised with the Director at the apex. For banks, there is an Assistant Director for Surveillance who is deputed by Portfolio Managers. There are also on site and off site surveillance teams that report to the Managers.

The CBK should re-organise the reporting structure to include an Assistant Director in charge of implementation of RBS. Under this office, there should be officials in charge of ensuring that banks are slowly improving their information management systems, risk management systems, risk-based internal audit, and training of existing human resource in those banks.

In time, this department will be merged with the existing BSD when the migration to RBS is complete. This has funding implications that have to be considered in the CBK's annual budget.

Kenya is headed towards becoming a financial services hub. It is important that the CBK modernises its approach to bank supervision in terms of being proactive and ensuring banks adopt risk-averse management methods.

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