

I **PHYLLIS MUTUA** registration number **G62/76635/2009** do hereby declare that this project report is my original work and has not been submitted either in part or in whole and is not being currently submitted for a degree in any other University

Dated at Nairobi this <sup>18<sup>th</sup></sup> day of November 2011

Signed..... *Phyllis Mutua* .....

**Supervised by Tim Mweseli**

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**DEDICATION**

*I dedicate this thesis to:*

*My loving and supportive husband*

*Charles Ukumu;*

*and*

*My son Kors Ukumu*

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## ABBREVIATIONS AND ACRONYMS

1. AML.....Proceeds of Crime and Anti-Money Laundering Act
2. ATM.....Automatic Teller Machine
3. BoP.....Base of the Pyramid
4. BSP.....Bangko Sentral ng Pilipinas
5. CBK.....Central Bank of Kenya
6. CDD.....Customer Due Diligence
7. CFT.....Combating Financing of Terrorism
8. CITSG.....Core Information Technology Supervisory Group
9. CGPA.....Cumulative Grade Point Average
10. DIFD.....Department for International Development
11. DTI.....Deposit Taking Microfinance Institution
12. FSD.....Financial Sector Deepening
13. FATF.....Financial Action Task Force
14. ICT.....Information and Communication Technologies
15. KYC.....Know Your Customer
16. MFI.....Microfinance Institutions
17. NPS.....National Payment System
18. RFID.....Radio Frequency Identification
19. UK.....United Kingdom
20. UNCTAD.....United Nations Conference on Trade and Development
21. UNCITRAL.....United Nations Commission on International Trade Law
22. USA.....United States of America

# 1 CHAPTER ONE

## REGULATING MOBILE BANKING IN KENYA: TOWARDS A PROPORTIONATE REGULATORY POLICY

### 1.1 Background

The recent days have seen a lot of interest in the opportunities that mobile telephony offers in the quest for financial services solutions that can both fit and function according to the needs of the broader African populace. Mobile telephony in Africa is growing faster than in any other part of the world. UNCTAD noted in a recent Report that since 2003, mobile phone subscriptions have grown faster in Africa than in any other region of the world. There are now more than 10 times as many mobile subscriptions as fixed lines in Africa, and more than 20 times as many in Sub-Saharan Africa.<sup>1</sup>

According to the World Bank, the African mobile market has been the fastest-growing market of all regions, expanding at twice the rate of the global market.<sup>2</sup> There is, therefore, every reason to see mobile telephony as an avenue towards delivery of financial services to the largely unbanked population of Africa. This is possible through development of mobile banking infrastructure that is geared towards availing banking services to the poor and residents of marginalized areas.

The Economist has already forecasted the “end of the cash era” commenting on the high-tech electronic substitutes for cash that are taking the world by storm.<sup>3</sup> Even developing and transition countries are not left behind as the transformation from cash to electronic value stored and conveyed by mobile phones has already become a phenomenon in developing countries.<sup>4</sup>

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1 UNCTAD, Information Economy Report 2009: Trends and Outlook in Turbulent Times (United Nations, New York: 2009) p. 1. (accessed on 30/4/2010)

2 Shawn Mendes *et al*, “The Innovative Use of Mobile Applications in the Philippines-Lessons for Africa” A Working Paper published by SIDA, September 2007; available at: [http://siteresources.worldbank.org/extedevelopment/Resources/20071129-Mobiles\\_PH\\_Lessons\\_for\\_Africa.pdf](http://siteresources.worldbank.org/extedevelopment/Resources/20071129-Mobiles_PH_Lessons_for_Africa.pdf) (accessed on 30/04/2010).

3 Editorial, “The End of Cash Era”, (Economist, London, 15<sup>th</sup> February, 2007).

4 Ibid.

Here in Kenya, the Mpesa and Airtel Money services offered by Safaricom Limited and Airtel KE respectively have attracted millions of registered users in the short time they have been in existence. There are now over 8,000 cash-in and cash-out agency centres translating to over 8,000 mobile banking outlets around the country within a span of three years since inception.<sup>5</sup> This compared to the number of conventional branches and ATM Machines which stand at 876 and 1424 according to a 2008 study<sup>6</sup> implies that in the duration of less than three years operation the M-banking outlets have tripled those of traditional banks.

The reason behind the fast growth of mobile banking services is that they are generally cheaper to set up especially where mobile telephone network infrastructure is already in place. This means mobile banking services can be adopted and adapted to the largely unbanked population in Africa which has been shunned by the mainstream financial services providers due to prohibitive costs and low returns involved in providing services to them. For instance, a significant number of Mpesa and Airtel Money services are rural residents who have hitherto been ambivalent about joining the mainstream banking.

According to Financial Sector Deepening Kenya (FSD Kenya), the most recent data available indicates that only 19% of adult Kenyans reported having access to a formal, regulated financial institution while over a third (38%) indicated no access to even the most rudimentary form of informal financial service. This leaves a percentage of more than 80% outside the bracket of the reach of mainstream banking.<sup>7</sup>

The advent of mobile financial services promises to bring many more poor people into an economic mainstream where safer and less costly financial services (such as person-to-person payments and remittances) are delivered over the cell phone. Alluding to this fact,

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5 Adrian Kamotho Njenga, "Mobile Phone Banking: Usage Experiences in Kenya". Available at: <http://www.docstoc.com/docs/14787965/Mobile-phone-banking-Usage-experiences-in-Kenya> (accessed on 30/04/2010).

6 Central Bank of Kenya, "December 2008 Survey on Bank Charges and Lending Rates". Available at <http://www.centralbank.go.ke/downloads/bsd/Survey2009.pdf> (accessed on 30/04/2010).

7 Financial Sector Deepening (Kenya) Annual report, 2000; Available: [http://www.fsdkenya.org/pdf\\_documents/2007\\_FSD\\_Annual\\_Report.pdf](http://www.fsdkenya.org/pdf_documents/2007_FSD_Annual_Report.pdf) (accessed on 30/04/2010).



a recent article in the Guardian called mobile banking in developing countries “potentially revolutionary.”<sup>8</sup> The research firm Gartner predicts “high speed of adoption by consumers of new mobile finance facilities and particularly by those currently without access to any form of banking.”<sup>9</sup> Gartner further estimates that 41.5 billion mobile financial transactions will be made by the end of 2011.<sup>10</sup>

Mobile banking promises to impact positively on the lives of many poor and unbanked people who make up the majority of the population in most developing countries. Household surveys conducted in South Africa and Kenya from 2006 indicated that only about 40% of the adult population in South Africa and as low as 10% in Kenya have formal bank accounts. On the other hand, mobile phone penetration in those countries is above average at 70% for Kenya and 96% for South Africa.<sup>11</sup>

There is now a raging debate on how mobile banking may be tapped as a means of banking the unbanked members of developing countries like Kenya. Increasingly, policy makers and regulators in developing and transition countries are embracing mobile banking and the use of information and communication technologies (ICTs) and non-bank retail channels to deliver financial services to clients beyond the reach of traditional banking. It is also emerging that the form of regulation policy adopted may significantly determine the future growth of mobile banking and also influence the use of innovation in the sector to spur efficiency.<sup>12</sup>

Essentially, the terms Mobile Phone banking and mobile banking (M-Banking) are used interchangeably. The term M-Banking is used to denote the access to banking services

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8 Richard Wray, “Cash in Hand: Why Africans are banking on the Mobile Phone”, The Guardian (London), 17<sup>th</sup> June, 2008; Available at: <http://www.guardian.co.uk/business/2008/jun/17/telecoms.telecoms> (accessed on 30/04/2010).

9 Gartner Report “Dataquest Insight: Mobile Payment, 2007-2012.” The report is available on Gartner’s Web site at [http://www.gartner.com/DisplayDocument?ref=g\\_search&id=950812 & subref=simple\\_search#h30](http://www.gartner.com/DisplayDocument?ref=g_search&id=950812 & subref=simple_search#h30). (Accessed on 30/04/2010).

10 Ibid.

11 Katrin Verclas, “Is Mobile Banking Really Reducing Poverty?”, Article Published in Orascom’s Talk Magazine; Available at: <http://mobileactive.org/mobile-banking-really-reducing-poverty-close-look-promise-v-reality> (accessed on 30/04/2010).

12 David Porteous “The Enabling Environment for Mobile Banking in Africa”, (London: DFID, 2006) <http://www.bankablefrontier.com/assets/ee.mobil.banking.report.v3.1.pdf> (accessed on 30/04/2010).

and facilities offered by financial institutions such as account-based savings, payment transactions and other products by use of an electronic mobile device.

Mobile banking has yielded a multiple effect on the number of solutions available to clients. This is in addition to more efficient transactional environment and the high substitution of banking point.<sup>13</sup>

There is no debate that an appropriate banking environment is a key pillar as well as an enabler of economic growth. The emerging wave of information driven economy has meant that the banking industry in Kenya must engage technology to expand its client base and serve its customers better. The need for convenient ways of accessing financial resources beyond the conventional norms has seen the recurrent expansion and modernization of banking patterns. And given the huge demand for finance oriented services, institutions beside the historical banks have joined the fray in an attempt to grab a piece of the perceived cake of opportunity within the banking industry. The most prominent of these is mobile banking which promises to be the future of banking in Kenya and the rest of the world.<sup>14</sup>

Porteous<sup>15</sup> distinguishes two aspects of mobile banking: additive and transformational characteristics. The additive aspects are those in which the mobile phone is merely another channel to an existing bank account, for example, when mobile banking merely adds to the range of choices or enhances the convenience of existing customers of mainstream financial institutions.<sup>16</sup> Transformational characteristics of mobile banking involve the financial product linked to the use of the phone being targeted at persons who do not hold formal bank accounts with the conventional banking institutions.<sup>17</sup> The

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<sup>13</sup> Ibid.

<sup>14</sup> CGAP, "Notes on Regulation in Kenya" A Summary of CGAP Technology Forum conducted in February/March 2007; Available at: <http://www.cgap.org/gm/document-1.9.2321/Kenya-Notes-On-Regulation-Branchless-Banking-2007.pdf> (accessed on 30/04/2010).

<sup>15</sup> Supra note 12.

<sup>16</sup> The recent additive services include checking account balances on phone, purchase of airtime, withdrawals from the account etc.

<sup>17</sup> Ibid.

emphasis in regulation has generally been focused on the additive aspects as against the transformational characteristics of mobile banking.<sup>18</sup>

In Kenya, the regulation of mobile banking features a lot of outstanding issues which stand in the way of effective regulation of the sector. Foremost, M-banking sits on top of a number of regulatory issues: banking and financial transactions, telecommunications, and anti-money laundering are just a few of these complex domains.<sup>19</sup>

Currently, legislation and regulations in most of these areas are inconsistent or even contradict each other. Industry experts are increasingly calling for a risk-based and coordinated approach that protects customers and does not prejudice unduly against small customers. Likewise, there is need to ensure that regulation secures continued innovations in order to tap the transformational potential idea of M-banking and create an enabling environment where mobile banking can thrive. According to David Porteous “enablement [of m-banking] is about managing the delicate balance between sufficient openness and sufficient certainty, not least in the minds of customers who must entrust money to the bank or telcom.”<sup>20</sup>

Balancing the need for adequate capital and the liquidity that ensures stability of the innovation and the need for the service to be tapped by the poor folks in the rural settings without necessarily hindering growth is a delicate issue. The collapse of some financial institutions including Banks, Insurance Companies, and Stock Brokerage firms has been attributed to the low capital base which did not guarantee their stability. The fear is and has been that the economy might suffer an irreparable damage if the service of the mobile money banking collapses. This is due to the fact of the huge number of the end users of the service and the amount of money currently in circulation. Though there is no law regulating the capital liquidity, some of the service operators have taken some inventing steps in ensuring the stability of the service. Safaricom, for example, has set out the minimum cash investment for the prospective agents who want to operate the service. An

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18 Supra note 12.

19 Supra note 14.

20 Supra note 12.

agent will be expected to invest the following amounts: Kshs 100,000 per outlet for float; Kshs 100,000 for SIMEX (SIM replacement cards); and Kshs 100,000 per outlet for additional outlets for float. The successful agents are required to deposit this money within one month of signing the contract, failure to which the contract stands revoked.<sup>21</sup> On whether to fix the amount or vary it depending on other factors that ensure stability of the service is a question for discussion in this research.

On the liquidity, there has been a controversy on the amount of the liquid cash that should be allowed to float in the market and how the customers' funds should be and are kept. As in Banks this study will show that it is prudent that there be a calculation based on the amount of cash collected on a specified period. The issue now is how to safely keep the customers cash. Should it be held with other banks, in form of assets, government securities, insurance firms or the setting up of some deposit protection fund entity? In most countries, Liquid assets are most often required to be maintained as accounts with a prudentially regulated bank but sometimes they may be maintained as other "safe assets," such as government securities, although such securities may not always be as liquid as bank accounts.<sup>22</sup> However, Funds held in prudentially regulated banks are not risk-free, as has been painfully proven by the collapse of several banks in the 1980s. When banks fail, they cannot always pay their depositors, often leaving small value depositors exposed.

Another risk associated with liquidity is the use of customers' deposits to trade hence exposing them to attachment by creditors in case of default in loans. Forward looking regulations have tended to limit or place a restriction on the use of customers' cash deposits. In Malaysia, for example, issuers are expressly prohibited from using such funds for any purpose other than "cashing out" against electronic value or executing funds transfers to third parties pursuant to customer request. Other limitations on the use of customer funds are more indirect. The Philippines expressly prohibits nonbank issuers

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<sup>21</sup> Available at <http://www.mpesaagentadmin@safaricom.co.ke>. (Accessed on 14<sup>th</sup> November, 2011).

<sup>22</sup> Michael Tarazi and Paul Breloff. Nonbank E-Money Issuers: Regulatory Approaches to Protecting Customer Funds. (accessed on 5/4/2010)

from engaging in the extension of credit, effectively ensuring customer funds are not endangered through intermediation by an entity that is not fully prudentially regulated.<sup>23</sup>

The questions surrounding regulation of mobile banking targeting the unbanked poor have only recently begun to receive comprehensive and systematic attention. Research shows that policy makers and regulators in countries like Kenya, South Africa, Philippines, India, Pakistan and Brazil among others are on the frontlines of policy making about regulation of branchless banking targeted at the unbanked poor.<sup>24</sup> The common challenge among all those countries is how to formulate proportionate regulatory policy that gives space for innovation and permits branchless banking to scale up safely.

## **1.2 Statement of the Problem**

There is yet to be formulated a comprehensive regulatory policy for mobile banking in Kenya although the process is on-going. The current regulatory regime falls short of adequately addressing the emergent issues in mobile money banking including capital liquidity of mobile banking agents, an appropriate regulatory authority and the evidence and security of the mobile money banking transactions. It should be noted however, that the mobile money banking is a recent innovative step that needs to be nurtured and given room for growth. It is thus not too late to secure for Kenya a regulatory policy that gives space for innovation and guarantees growth for mobile-banking in Kenya.<sup>25</sup> The question is how to achieve a proportionate regulation for mobile banking in Kenya.

According to the Committee on Payment and Settlement Systems and the World Bank, proportionate regulation means that the regulatory framework that is not “overly restrictive and burdensome relative to the possible issues it is designed to tackle or the number and value of [transactions] involved.... In considering this, it is important to

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<sup>23</sup> Ibid.

<sup>24</sup> Mark Pickens, David Porteous and Sarah Rotman, “Scenarios for Branchless Banking in 2010”, <http://www.dfid.gov.uk/Documents/news/FocusNote-BranchlessBankingin2020.pdf> (accessed on 30/04/2010) p. 3.

<sup>25</sup> Supra note 14.

realize that the public policy objectives may not always point in the same direction.... Proportionality means that any such inconsistencies are recognized and resolved in a way that, in light of the country's overall priorities, achieves an appropriate balance."<sup>26</sup>

This study examines the question of what is the appropriate regulatory policy for mobile banking to ensure it contributes to the transformation of banking for the benefit of the unbanked poor. The appropriate framework must balance the need to guarantee the interests of customer protection and safety and giving regulatory incentives for innovation of mobile banking in Kenya. The study discusses the concept of proportionate regulation and how it may be applied in formulating a regulatory policy to ensure the transformational capacity of mobile banking is tapped to maximum effect in turning around financial services provision in Kenya.

### **1.3 Objectives of the Study**

The study will seek to achieve the following objectives:

- (i) To determine the relevant regulatory issues that need to be addressed in regulating mobile banking in Kenya.
- (ii) To analyse the concept of proportionate regulation, its relevance and its application in formulating a regulatory policy for M-banking in Kenya.

### **1.4 Research Questions**

The following research questions will be addressed in the study:

- (i) What is the appropriate form, nature, powers, duties and functions of the M-banking regulatory authority?
- (ii) What is the appropriate process of formulating an M-banking regulatory framework that will encourage development, innovation and fair competition?
- (iii) What are the relevant regulatory requirements of M-banking service providers?

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<sup>26</sup> Committee on Payment and Settlement Systems and the World Bank, "General Principles for International Remittance Services." (Basel, Switzerland: Bank for International Settlements, 2007) cited in Mark Pickens, "Regulating Transformational Branchless Banking: Mobile Phones and Other Technology to Increase Access to Finance", CGAP Focus Note No. 43, January 2008; p. 6.

- (iv) What are the fundamental issues that need to be addressed by the M-banking regulatory framework to ensure consumer protection?
- (v) How can the concept of proportionate regulation be applied in formulating a regulatory policy for M-banking in Kenya?

## **1.5 Hypotheses**

The hypothesis of the study is:

A proportionate regulatory framework for M-banking in Kenya can effectively address the emergent issues in M-banking services that are currently not adequately regulated by the scattered pieces of regulatory framework that regulate financial and communication services industry.

## **1.6 Justification of the Study**

Mobile-banking is a fast-growing sector in Kenya. This is despite the absence of a comprehensive regulatory framework addressing issues arising in the area. However, there are reported efforts by regulatory agencies in Kenya led by the Central Bank of Kenya in formulating policy to guide the sector in future.<sup>27</sup> This study seeks to explore how to design a regulatory policy on mobile banking that is proportionate. The study is thus justified in that it furthers efforts to formulate a regulatory framework for mobile banking in Kenya that guarantees the sector's growth and innovation while ensuring customer protection and transactional safety.

The study is also relevant as a test case of how the emergent principles-based regulation may be adapted in regulation of the financial services sector in Kenya. The principles-based regulation has replaced rules-based regulation in the United Kingdom. However, much of the regulation in the financial sector in Kenya is still rules-based. Thus, a study to review how principles-based regulation may work out for the financial sector in Kenya is necessary. The mobile-banking sector represents a fertile ground as a case study for such applicability of principles-based regulation in Kenya.

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<sup>27</sup> Njuguna Ndung'u, "Mobile Phone Banking Services in Kenya", Address at the Launch of Equity Bank Mobile Phone Banking Service, Nairobi, 3<sup>rd</sup> September 2008.

## 1.7 Literature Review

The literature discussed below was reviewed in preparation for this study:-

The CGAP and DFID in a recent report discusses the future of "branchless banking." The research sought to answer the question "How can government and private sector most affect the uptake and usage of branchless banking among the unserved majority by 2020?"<sup>28</sup> The study involved a six-month scenario-building project in which they engaged almost 200 experts from more than 30 countries around the world.<sup>29</sup>

The report defines branchless banking as the delivery of financial services in essentially any way other than through the traditional brick and mortar bank branch. According to the report, a big component of branchless banking is, of course, mobile-banking (M-Banking), that is, banking with a mobile phone.<sup>30</sup>

The paper identified four forces most likely to shape the answers to the question of how government and private sector can most affect the uptake and usage of branchless banking among the unserved majority by 2020. These forces are; the changing demographics of users, the actions of increasingly activist governments, rising crime and the spread of Internet access via data-enabled phones even in poor countries and communities.<sup>31</sup> Further, the paper isolated four key regulatory uncertainties surrounding branchless (as well as mobile) banking. These include which types of entities will be allowed to provide branchless financial services, whether providers will in future craft viable business models for services beyond payments, how the competition in mobile-banking will play out and how consumer, business, and regulator confidence will be affected by the inevitable failures of mobile-banking that will happen in future.<sup>32</sup>

The basic conclusion of the paper is that there is massive, latent, underserved demand for mobile/branchless banking. Further, if mobile operators, banks, and governments can work harmoniously to create a legal regime that is clear and stable, a policy environment

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28 Supra note 19.

29 Ibid.

30 Ibid. p. 1.

31 Ibid, p. 7.

32 Ibid, p. 13.



that supports innovation and experimentation, and products that are functional and secure, this decade will witness widespread adoption of mobile and branchless banking.

Infogile Technologies in a recent paper describes the basic concepts, services offered, market survey and technology which enables Mobile Banking.<sup>33</sup> The paper argues that the mobile and wireless market has been one of the fastest growing markets in the world and it is still growing at a rapid pace. As a result, there are now many financial institutions offering or interested in offering value added services in mobile-banking. With mobile technology, banks can offer a wide range of services to their customers such as doing funds transfer while traveling, receiving online updates of stock price or even performing stock trading while in transit.<sup>34</sup>

The paper also discusses the various evolving models of Mobile/branchless banking. Accordingly, models of mobile-banking can be classified into three broad categories, namely bank-focused, bank-led and non-bank-led model. The bank-focused model emerges when a traditional bank uses non-traditional low-cost delivery channels to provide banking services to its existing customers. Examples range from use of automatic teller machines (ATMs) to internet banking or mobile phone banking to provide certain limited banking services to banks' customers. This model is additive in nature and may be seen as a modest extension of conventional branch-based banking.<sup>35</sup>

The bank-led model offers a distinct alternative to conventional branch-based banking in that a customer conducts financial transactions at a whole range of retail agents (or through mobile phone) instead of at bank branch or through bank employees. This model uses different delivery channels including retailers and mobile phones and usually target market distinct from traditional banks, and may be significantly cheaper than the bank-based alternatives. The non-bank-led model is where a bank does not come into the

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33 Infogile Technologies, "Mobile Banking-The Future" A White Paper on Mobile Banking and Prospects for Future Growth, published in August 2007; Available at: [http://www.infogile.com/pdf/Mobile\\_Banking.pdf](http://www.infogile.com/pdf/Mobile_Banking.pdf) (accessed on 30/04/2010).

34 Ibid, p. 1 (abstract).

35 Ibid, p. 2.

picture except possibly as a safe-keeper of surplus funds and the non-bank firms (for example Telcom companies) perform all the functions.<sup>36</sup>

Essentially, the paper thus underscores the need to properly regulate mobile banking, so as to manage the risk associated with it and to protect consumers and guarantee innovation. In addition, the discussion on the models of mobile-banking lays groundwork for the discussion undertaken in the study on the approaches to be taken in regulating transactions and operations in each of the models. The paper is in line with the objective of this study of laying the framework for formulation of proportionate regulation of mobile-banking in Kenya.

Manuel Bueno argues that the developed world represents an ever-shrinking portion of the world market. There are now more than 6 billion people on the planet of which 4 billion have an income per capita below \$3,000 per year. This represents two thirds of the population. According to World Bank projections, the 4 billion population could become 6 billion by 2040. These four billion people constitute the Base of the Pyramid (BoP).<sup>37</sup>

Most of those falling in the BoP are people with unmet need for financial services. Historically, financial services in the BoP were the sole realm of microfinance institutions. However, recent studies have proved that at the BoP level there are significant unmet basic needs, such as in modern financial services. BoP customers are capable and willing to pay for financial services outside microfinance provided that the terms of the contract adapt to their situation.<sup>38</sup>

Bueno argues that the rapid changes in technology are reducing the transaction costs in financial services, expanding markets, and catching the attention of large financial institutions for markets previously ignored. Technology is bringing nontraditional players

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<sup>36</sup> Ibid, p. 3.

<sup>37</sup> Manuel Bueno, "An Overview of the Mobile Phone Banking Industry", A Publication of the IE Business School, No. MK2-128-1, published on 05/02/2008; Available at [http://www.nextbillion.net/archive/files/An%20Overview%20of%20the%20Mobile%20Banking%20Industry%20by%20Manuel%20Bueno%200%20\(IE%20Teaching%20Note\)\\_0.pdf](http://www.nextbillion.net/archive/files/An%20Overview%20of%20the%20Mobile%20Banking%20Industry%20by%20Manuel%20Bueno%200%20(IE%20Teaching%20Note)_0.pdf) (accessed on 30/04/2010).

<sup>38</sup> Ibid, p. 2.

into the financial services markets. As the nature of the services is being transformed we are now witnessing the rise of a dynamic financial services industry. One financial service that has emerged with the new technology is mobile phone banking which is increasingly acknowledged as an important means to offering financial services through mobile phones, instead of via banking branches.<sup>39</sup>

According to Bueno, a study on the regulatory framework for mobile-banking is needed to ensure that the government and private sector are able to work together in a well-coordinated manner to ensure that the benefits of mobile-banking trickle down to the poor. He argues that the market needs regulation to clarify whether financial institutions have to be involved in all transactions and where the legal bucket stops. In his view, this will just be the first step in developing a healthy market that will allow M-banking to flourish. Other important policy and regulatory issues that will have to be tackled in the development of this new market are payment systems regulation, competition, consumer protection and possible macroeconomic implications.<sup>40</sup> The current study takes up this challenge in that it is focused on interrogating the fundamentals of regulating mobile-banking in Kenya.

Kamotho Njenga has authored an insightful paper based on a study conducted on existing mobile banking services in Kenya alongside mobile banking experiences of different countries.<sup>41</sup> The paper notes that the uptake of mobile phones in Kenya has been unprecedented. Further, this uptake has been accompanied by rapid absorption of mobile based banking services. Indeed, the trend of continued reliance on mobile devices to execute monetary transactions is steadily gaining momentum.<sup>42</sup>

The paper traces the evolution of mobile banking in Kenya starting with the creation of services by banks which could be accessed through the mobile phone. It notes that

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<sup>39</sup> Ibid, p. 4.

<sup>40</sup> Ibid, p. 11.

<sup>41</sup> Adrian Kamotho Njenga, "Mobile Phone Banking: Usage Experiences in Kenya", Available at: <http://www.docstoc.com/docs/14787965/Mobile-phone-banking-Usage-experiences-in-Kenya> (accessed on 30/04/2010).

<sup>42</sup> Ibid, p. 1.

subsequent innovations have seen the mobile banking phenomena continue to grow steadily. At present, mobile banking takes several dimensions of execution all representing a new distribution channel that allows financial institutions and other commercial actors to offer financial services outside traditional bank premises.<sup>43</sup>

The mobile banking services in Kenya are available to mobile phone users of all mobile service providers. However, the services provided by Safaricom and Airtel which have been branded “Mpesa” and “Airtel Money” respectively are the most popular and widespread. The latest entrants in the mobile market in Kenya, that is Orange / Telkom and Econet wireless, have also rolled out their mobile banking services but they are yet to pick pace especially in rural areas.<sup>44</sup>

Currently Safaricom has over 5,000 agents across the country while Airtel prides itself of having over 3,000 agency set ups in the short span it has operated the Airtel money service. This translates to over 8,000 mobile banking outlets around the country within a span of three years since inception. A Central Bank of Kenya survey CBK (2008) sets the number of conventional branches at 876. In addition to these branches there are only 1424 ATM machines in total implying that within the short duration of operation the M-banking outlets have tripled that of traditional banks.<sup>45</sup>

In an effort to gauge the implications of the mobile phone phenomena in Kenya, this study brings to light the critical issues arising from the emergent mobile technology innovations. The paper offers strategic insights into the current state of mobile phone banking service as well as a review of emerging service provider, customer traits as well as tactical and policy implications. Illuminative cases are also featured to drive home the point that mobile banking services industry in Kenya is now well-established. The paper concludes that there is an urgent need to devise policies and strategies to reverse gaps in

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43 Ibid, p. 4.

44 Ibid, p. 5.

45 Ibid.

terms of gender, income levels and rural - urban demographics in the use and adoption of mobile phone banking in Kenya.<sup>46</sup>

The current study builds on the conclusion to argue that given the progressed state of development of mobile-banking in Kenya, an elaborate regulatory framework needs to be formulated for the industry to guide its future growth and penetration especially into rural areas. The current study seeks to explore how to design a regulatory policy on mobile banking that can help exploit this rapid growth of mobile banking in Kenya to guarantee delivery of services to the currently unbanked members of the Kenyan society while insuring customer protection and transactional safety.

Rogelio Ancinas has discussed extensively the efforts to regulate mobile banking in Philippines.<sup>47</sup> In the paper, he highlights the key features, the enabling factors and the regulatory environment of mobile phone banking in Philippines. There are 36 Million (43%) of Filipinos who own a mobile phone, an estimated 90% of whom are rural banks clients.<sup>48</sup> Most of the mobile phone owners entail bottom of the pyramid banking customers who are very willing to adopt new technologies. The mobile phone banking in Philippines has developed to the extent that it allows users to purchase, pay and receive domestic payments and receive remittances from bank accounts into mobile phones by way of electronically reloading a pre-paid card. There are also cash-in and cash-out outlets accredited by banks for converting actual money to e-money.<sup>49</sup>

The mobile-banking industry in Philippines has been found to have potential of reaching the poor and unserved market. The regulation of the industry is thus geared at achieving this potential and particularly to manage the risks associated with mobile-banking while not hampering useful innovation and experimentation.

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46 Ibid, p.14.

47 Rogelio Ancinas, "Regulating Mobile Banking: The Philippines Experience", A Publication of the Bangko Sentral ng Pilipinas, January 2009; Available at: <http://www.docstoc.com/docs/3873235/Regulating-Mobile-Banking-The-Philippines-Perspective>.(accessed on 30/04/2010).

48 Ibid, p. 4.

49 Ibid, p. 6.

Thus, the regulatory framework for mobile-banking in Philippines focuses on guaranteeing underlying soundness of the banking institutions and adequate risk management of surrounding mobile-banking activity. Mobile banking is regulated by Electronic Commerce Act of 2000<sup>50</sup> which lays the basic legal and regulatory framework for e-commerce in general including aspects of mobile-banking. Further, the General Banking Law of 2000<sup>51</sup> also deals with regulation of mobile banking by mandating the Bangko Sentral ng Pilipinas (BSP) to regulate mobile-banking activities.<sup>52</sup>

According to Ancinas, the regulation of mobile banking should essentially focus on ensuring the availability of appropriate risk-management oversight, adequate security, education of customers and procedures for regulatory review of security arrangements. The regulation is also aimed at ensuring the mobile banking services are not used for money laundering purposes.<sup>53</sup>

In this regard, the BSP has built up its capacity to respond to the needs of mobile-banking environment through the creation of the Core Information Technology Supervisory Group (CITSG) within the BSP as the central group to address mobile-banking regulatory issues in Philippines.<sup>54</sup> Further, the BSP issued Circulars 511 (on Technical Risk Management) and 542 Series 2006 (Consumer Protection for Electronic Banking).<sup>55</sup> Further, the law provides for imposition of monetary penalties and suspension of mobile banking activities or both on erring banks, dealers and officers.<sup>56</sup>

The paper notes a marked improvement and increase in mobile-banking systems in Philippines following the formulation and institution of the improved regulatory framework for mobile-banking. These positive results reflect significantly on growth and development of financial services in rural areas which were hitherto unbanked. For

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50 Republic Act 8792, Laws of Republic of Philippines.

51 Republic Act 8791, Laws of Republic of Philippines.

52 Supra note 38, p. 11.

53 Ibid, p. 16.

54 Ibid, p. 17.

55 Ibid, p. 20.

56 Ibid, p. 23.

instance, more than half of the rural banks in Philippines now have introduced mobile-banking services since enactment of the regulatory framework.<sup>57</sup>

The Ancinas paper discussion of the improvement in the state of mobile-banking in Philippines after enactment of a regulatory framework goes to confirm the benefits that accrue from the certainty and security arising from a dedicated regulatory framework for mobile-banking. This is in tandem with the main argument in this study that a regulatory framework that offers security while allowing innovation and experimentation to thrive is urgently needed for the mobile-banking industry in Kenya. The findings in this paper will, therefore, provide vital insights in generating guidelines for formulation of mobile-banking in Kenya given that the regulatory terrain in Philippines is almost similar to that in Kenya.

The CGAP Note on regulation of branchless banking in Kenya was compiled after painstaking diagnostic work which involved widespread consultations with stakeholders.<sup>58</sup> The Note points out that Kenya is yet to seize the opportunity to establish a regulatory environment to support the development of branchless banking. However, it also acknowledges that the Government of Kenya and the Central Bank have shown a strong interest in branchless banking and have expressed their commitment to institute legal and regulatory changes that will support new technology-based products and services and enable increased outreach.<sup>59</sup>

Further, it is noted that branchless banking in Kenya is in its early stages, with a limited number of providers that are operational and at least one additional provider expected to enter the market in the very near future. It emerges that the initial forays into branchless banking have been undertaken with the tacit acceptance of the government and financial regulators. Indeed, the nonbank-based model of branchless banking in Kenya appears to be free of any financial regulation as long as services provided are not deemed to fall

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<sup>57</sup> Ibid, p. 24.

<sup>58</sup> Supra, note 14, p. 1.

<sup>59</sup> Ibid.

within the definition of banking business under the Banking Act. This is due, in part, to the particular language of the banking law as well as the lack of a legal framework for nonbank e-money issuers and payment service providers.<sup>60</sup>

The general lack of regulatory guidance and oversight over such activities is problematic and presents the possibility of increased risk to branchless banking customers as well as to the financial sector, generally, if less responsible actors enter the field. Appropriate regulation of e-money issuers and payment service providers would include reporting regulations, minimum capital and liquidity requirements, and restrictions on how e-money proceeds may be held or, for payment service providers, restrictions on permitted investments of funds held pending transfer.<sup>61</sup>

Finally, although the current regime for anti-money laundering (AML) and combating financing of terrorism (CFT) is thin and generally not problematic for branchless banking, a draft AML/CFT bill would impose burdensome requirements on small-value transactions and remote account openings. Ideally, these requirements will be revised to provide a risk-based approach that will permit both the bank-based and non-bank-based models to thrive.<sup>62</sup>

Having analysed the various literature materials on the subject matter, it is evidently clear that this study will be of utmost importance in seeking to address the solutions to the emergent regulatory challenges identified in the various literature materials discussed. The literature materials are economic based and fall short of discussing the appropriate regulatory regime for mobile money banking which will guarantee better returns to the economy generally but also to the various players in the mobile money banking including the mobile phone operators, the government, the various agents and more importantly the consumers. Therefore, the study will identify the pitfalls associated with the mobile

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<sup>60</sup> Ibid, p. 5.

<sup>61</sup> Ibid, p. 7.

<sup>62</sup> Ibid.



money banking and then provide a robust solution to the same. These shall be addressed in chapter five which identifies the pillars of capacity, corporate governance and the protection of the common law duty of banker customer relationship.

### **1.8 The Theoretical Framework of the Study**

Essentially, there are diverse approaches that inform regulation of securities market around the world. The main approaches are four, namely, rule-based regulation, principles-based regulation, management-based regulation and risk based approach. Each of these regulatory approaches has a host of features that make it ideal or otherwise for application in any given regulatory set-up. The most popular approaches are rule-based regulation and principles-based regulation.

The rules-based regulation is based on a set of detailed rules that govern banks' behavior.<sup>63</sup> Such rules enable banks to aim at meeting specific minimum requirements to guarantee compliance with law.<sup>64</sup> The principles-based regulation looks to principles first, and uses principles rather than detailed rules wherever feasible. It is a regulatory approach that does not respond to every new situation in the banking sector by adding more detail to the written law.<sup>65</sup>

The main advantage of a rules-based regulatory regime is its predictability and certainty. The regulated entities are able to make decisions without worrying that their actions will be second-guessed by regulators.<sup>66</sup> The problem with the rule-based approach is lack of flexibility and the inability to provide for new regulatory challenges which may from time to time arise in the course of securities regulation. Principles-based regulation of capital markets is generally more flexible and more sensitive to context, but potentially less certain.<sup>67</sup> There are also challenges of enforcement under the principles-based

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63 Anita I. Anand, "Rules v. Principles as Approaches to Financial Market Regulation," 49 *Harvard International Law Journal* 111 (2009).

64 James J. Park, "The Competing Paradigms of Securities Regulation," 57 *Duke Law Journal* 625 (2007), at p. 628.

65 Cristie L. Ford, "Principles-Based Securities Regulation", A Research Study Prepared for the Expert Panel on Securities Regulation of the British Columbia Securities Commission submitted on 18<sup>th</sup> December 2008, p. 9.

66 *Supra* note 59, p. 635.

67 *Ibid.*

approach given that in most cases violation of a principle alone may not justify punitive action in jurisdictions which require specific provision of law for regulatory offences to lie.

The principles-based system of regulation is known to exhibit some basic features. First, a principles-based regulator focuses on defining broad themes, articulating them in a flexible and outcome-oriented way, accepting input from industry, and managing incoming information effectively. Secondly, in order to be able to take advantage of the benefits of principles-based regulation, industry needs reasonable lead times to adjust to the new model, education and support, and the ability to rely on legacy rules during the transition period. Further, the regulator's conduct must be reasonable, predictable, and responsive and it must have the statutory power to promulgate principles and interpret them.<sup>68</sup>

In management-based regulatory approach, the regulator focuses on providing incentives to regulated parties to achieve socially desired goals. This shifts the centre of decision-making from the regulator to regulated entities, by requiring them to do their own planning and decision making about how to achieve goals. Management-based regulation focuses on the planning stage; that is, the regulated entities' internal compliance processes including monitoring, risk assessment and training among others.<sup>69</sup>

One advantage of management-based regulation is that it involves higher management in decision-making and accountability around such processes. However, management-based regulation has the potential of imposing high costs on small firms. This is because it requires smaller market actors to implement sophisticated compliance mechanisms and thus imposes a considerable burden which often outweighs the risks that any individual small issuer or firm poses to the market or investors.<sup>70</sup>

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<sup>68</sup> *Supra* note 60, p. 3.

<sup>69</sup> Cary Coglianese & David Lazer, "Management-Based Regulation: Prescribing Private Management to Achieve Public Goals" 37 *Law & Society Review* 691(2003).

<sup>70</sup> *Ibid.*

On the other hand, risk-based regulation refers to a regulatory approach that uses risk analysis to proactively identify those market actors that need the most hands-on oversight, because of the risk they pose to regulatory goals. It is a method for trying to allocate regulatory resources efficiently. The regulator in risk-based regulation system uses risk analysis as a tool for gauging the overall arrangement of regulatory interventions and guidance. The approach aims at ensuring the regulatory framework reflects real problems in the markets and offers a proportionate, rational regulatory response.<sup>71</sup>

The question is, of these four approaches enumerated above, which is ideal for regulation of mobile-banking in Kenya. Generally, common law legal regimes are comprised of both principles and rules.<sup>72</sup> In evidence, the statutory regimes for financial regulation contain both rules (for example, fixing the minimum capital requirements) and principles (for example, the principle of regulator (central bank) independence). Thus, the debate on which approach between is best for regulation of mobile-banking may seem somewhat unwarranted.<sup>73</sup>

However, the regulation of mobile-banking in Kenya seems more suited for principles-based regulation approach which proportionately incorporates the best practices from the other approaches. This is because the industry is young and still in the formative stages and therefore difficult to predict its regulatory needs with certainty. Given the innovation and creative energies that are going into mobile communications industry all over the world, it is hard to predict with certainty what turn the mobile-banking industry will take in future. As a result, fixing rules to regulate the industry may not only be an arduous task, but it may prove to be an exercise in futility if the industry outgrows the rules in a short duration of time.

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71 Mary Condon, "Risk-Based and Principles-Based Regulation" Paper presented to the Joint Annual Meeting of the Canadian Law and Society Association and the U.S. Law and Society Association, Montreal, 30 May 2008.

72 Ibid.

73 Ibid.

The approach that is utilised in this study entails a proposal to first formulate principles to guide the transactions and operations in mobile-banking industry in Kenya for the future. Further, the best practices in rules-based regulation, management-based regulation and risk-based regulation should be drawn to come up with a framework for mobile-banking regulation that is best described as proportionate. Here, proportionality implies that the proposed regulation for mobile-banking is one that seeks to resolve the regulatory issues facing mobile-banking in Kenya in the best interest of the industry and consumers while seeking to achieve an appropriate balance between risk-management, consumer-protection, economic growth and innovation.

### **1.9 Research Methodology**

The study is library-based and involves analysis and review of relevant primary and secondary data on mobile banking and its regulation. The study relies mainly on secondary data available in the library.

In this regard, the research will entail exploration of secondary material including books, articles, and other relevant literature on the law on mobile-banking and regulation in Kenya and elsewhere in the world. The study will, also, analyze legal instruments including the main statutes and delegated legislation on regulation of banking and mobile-banking in Kenya including the Central Bank of Kenya Act<sup>74</sup> and the Kenya Communications Act.<sup>75</sup>

Most of the material required for the study is available in the Internet. However, additional material is sourced from government agencies including the Central Bank of Kenya and the Communication Commission of Kenya. Additional material will be obtained from local libraries and resource centres including the Private Sector Corporate Governance Trust Library, University of Nairobi School of Law (Parklands) Campus Library, High Court of Kenya at Nairobi Library and Jomo Kenyatta Memorial Library.

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<sup>74</sup> Chapter 491 laws of Kenya.

<sup>75</sup> Act No. 2 OF 1998.

### **1.10 Chapter Breakdown**

Chapter One gives a brief background of mobile banking in Kenya and discusses the need for an effective regulatory policy for mobile banking in Kenya. It incorporates the proposal. The aim of the chapter is to lay a foundation for the entire study by introducing key concepts relating to mobile banking and proportionate regulation.

Chapter Two reviews the existing framework for regulation of mobile banking in Kenya. In this regard, the Chapter explores the regulation of the communication aspects of mobile banking as well as the banking regulation under which operators are currently licensed and regulated.

Chapter Three discusses the emergent issues surrounding regulation of mobile banking in Kenya. In particular, the chapter discusses the relevant regulatory issues that need to be addressed in regulating mobile banking in Kenya. In so doing, the chapter outlines urgent issues that must be addressed by any system of regulation of mobile banking for it to be effective including need for innovation, addressing customer protection issues, dealing with risks, the agency problems of mobile banking and the relationship with the wider financial sector.

Chapter Four explores the scope of the concept of proportionate regulation and how it may be applied in addressing the issues relating to regulation of mobile banking in Kenya. The Chapter, particularly, discusses the meaning of proportionate regulation and principles-based regulation of financial services and the relevance and applicability of the two concepts to the regulation of financial services and particularly mobile banking in Kenya. Further, the concept of proportionate banking is applied in formulating effective solutions to the regulatory issues highlighted in chapter three.

Chapter Five offers conclusions and recommendations on the study. The Chapter sums up the findings in the preceding Chapters and explains how they are relevant and effective in the formulation of an effective regulatory framework for mobile banking in Kenya.

## 2 CHAPTER TWO

### FRAMEWORK FOR REGULATION OF MOBILE BANKING IN KENYA

#### 2.1 Introduction

As stated in the previous chapter, the advent and incorporation of technology in the banking sector has raised legal concerns as to the use of mobile banking as a mode of transacting banking business between the bank and its customers and also between non-bank service providers and the consumers of such services. Technology supersedes legislation and thus the legal vacuum which has characterised the Kenyan legal framework as far as the practice of this mode of banking is concerned. In this respect John Solomon<sup>76</sup> stated that “innovative technologies almost always outpace government’s regulatory responses to them” showing the fast rate at which technology is adopted and practised without a good regulatory framework and in the end causing a lot of risks to the consumers of such services.

In Kenya telecommunications regulations require that a mobile network operator offer only the telecommunication services listed in its license and mobile banking falls under the definition of telecommunication service in law. However, the primary regulator with respect to a mobile network operator’s mobile banking activities is the banking regulator which is the Central Bank of Kenya.<sup>77</sup>

This chapter considers the various steps the Kenyan lawmakers have taken to ensure that this mode of banking is well regulated with the end results being that the risks engulfing this mode of banking will be reduced to a minimum and also provide a channel through which consumer and banks concerns can be addressed.

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<sup>76</sup> John Solomon, Trends in Terror Finance, the unregulated sector. Available at: <http://www.c-cft.org/publication/index.html> (accessed on 10/7/2010)

<sup>77</sup> Established under the Central Bank of Kenya Act, Chapter 491 of the Laws of Kenya.

More specifically, this chapter deals with the *Banking Act*<sup>78</sup>, *Kenya Communications [Amendment] Act*<sup>79</sup>, the *Proceeds of Crime and Anti-Money Laundering Act*<sup>80</sup> and the *Consumer Protection Bill, 2011*. The discussion entails giving a comprehensive look of the Act, and the two bills in order to consider whether they adequately cater for mobile banking and address the issues surrounding this practice.

## **2.2 The current state of regulation of mobile banking in Kenya**

The practice of mobile banking in Kenya has encountered a lot of controversy as far as its legal stand in the Kenyan legal framework is concerned. Notably, this mode of banking has been embraced by many consumers as statistics show that more Kenyans are giving preference to this form of banking<sup>81</sup> despite the legal vacuum it is facing. It is as a result of the concerns raised in chapter one of this work that many including members of the legal fraternity, the banking industry, technological experts and even the legal drafters have called and seen the need to come up with a legislation that will regulate this form of banking. In this respect, the significance played by technology in the banking industry has been appreciated and its role in economy building hence the need for a comprehensive regulatory framework.

### **2.2.1 Banking Act**

In November 2009, Kenya amended the Banking Act to include provisions on financial institutions' use of agents to provide banking services. Prior to the 2009 amendment, the Banking Act did not specifically address the issue of banks using agents to carry out banking activities, nor were there any regulations explicitly governing the outsourcing of functions by banks. Instead, CBK approved such arrangements on a case-by-case basis.

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78 Chapter 488 Laws of Kenya.

79 Act No. 1 of 2009

80 Act no. 9 of 2009.

81 For example statistics show that there are now over 8,000 cash-in and cash-out agency centres translating to over 8,000 mobile banking outlets around the country. (Adrian Kamotho Njenga, "Mobile Phone Banking: Usage Experiences in Kenya", Available at: <http://www.docstoc.com/docs/14787965/Mobile-phone-banking-Usage-experiences-in-Kenya>. (Accessed on 1/7/2010).

The amended law establishes “agency” as an entity contracted by an institution and approved by the Central Bank to provide the services of the institution on behalf of the institution, in such manner as may be prescribed by the Central Bank.<sup>82</sup> This is in line with the mobile banking outlets owned by various mobile network operators in the country.

Further, details on the manner in which agents may be engaged is provided in regulations issued by CBK.<sup>83</sup> As drafted, the regulations facilitate the use of third-party agents by banks to provide banking services, but present a cautious approach to the expansion of agent models. Banks will need to obtain annual approvals from CBK as to the overall use of agents. They will also need to provide CBK with details about engaging particular agents, including names, locations, pre-existing commercial activities, a sample contract, and the services to be rendered.

Furthermore, banks will need to obtain CBK approval before closing any agent locations and will be permitted to do so only for particular reasons or offences, in the interests of reputation and service continuity. A range of entities are permitted to be agents, subject to two requirements: an agent must be a commercial entity (this criterion could be satisfied by sole proprietorships or by a partnership) and must have carried out commercial activities for at least two years.<sup>84</sup>

Also, banks will remain ultimately responsible and liable for the actions of the agent and for all compliance responsibilities with technical specifications. Examples of technical specifications include two-factor authentication, real-time coded transmission, ability to generate an audit trail under AML and other areas of law.

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<sup>82</sup> Finance Bill, 2009, Section 52.

<sup>83</sup> See [http://www.centralbank.go.ke/downloads/acts\\_regulations/draft\\_agentbanking\\_proposal.pdf](http://www.centralbank.go.ke/downloads/acts_regulations/draft_agentbanking_proposal.pdf) (accessed on 10/5/2010)

<sup>84</sup> The list of eligible entities includes post offices, shops or retail outlets, pharmacies, supermarkets, Internet/communication centers, financial institutions (e.g., SACCOs or MFIs), courier companies, wholesale distributors, and other similar entities



### 2.2.2 The Kenya Communication [Amendment] Act, 2008

The Kenya Communication [Amendment] Act, 2008 was an amendment of the Kenya Communication Act 1998 which aimed at facilitating the development of the information and communications sector including broadcasting, multimedia, telecommunications and postal services and electronic commerce.<sup>87</sup> This Act is relevant to this discussion mainly because mobile banking is a mode of electronic commerce. Notably, the functioning of this Act is bestowed upon the Communications Commission of Kenya which shall be independent except as provided for under the Act or any other law.<sup>88</sup> This in essence means that the Act is not supreme and is subject to other laws. This should not be the case especially having regard to that fact that this law is the only one of its kind regulating this sector.

Electronic transactions are provided for under part VIA of the Act which seeks to address some of the key issues of electronic banking. As mentioned in the foregoing paragraph, the Communications Commission of Kenya has the mandate to oversee the functioning of this Act and as far as electronic transactions are concerned, the Commission does have several functions geared towards facilitating such transactions by ensuring the reliable use of electronic records; facilitating and eliminating barriers of electronic commerce; promoting public confidence integrity and reliability of electronic records and electronic transactions; fostering the development of electronic commerce through the use of electronic signatures to lend authenticity and integrity to correspondence in any electronic medium; and developing sound frameworks to minimize the incidence of forged electronic records and fraud in electronic commerce and other electronic transactions.<sup>89</sup>

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<sup>87</sup> This is expressed under article 2 of the Act.

<sup>88</sup> Section 5B

<sup>89</sup> Section 83C

From the foregoing it can be deduced that the Commission has a major role in instilling consumer confidence in the use of mobile banking. This is mainly because the Commission will seek to deal with legal issues facing mobile banking such as authenticity of such electronic contracts and fraud. Further, by the Act making a provision that an institution has to be awarded a license by the Commission before it can undertake any electronic services and failure to do that attracts serious sanctions,<sup>90</sup> this acts as a precautionary measure to ensure that such services are not offered haphazardly. Notably, in its granting of the licence, the Commission has the mandate to require the institution to take such necessary precautions of ensuring that the consumers of such services are protected. This includes requiring the institutions to install such software and data protection mechanisms all aimed at ensuring privacy.<sup>91</sup>

Further the Act provides for the recognition of electronic records. This actually means that in case of a dispute as in the case of unauthorised transactions or identity theft, it can be construed that such evidence in the form of electronic records can be presented in the courts as evidence. In this respect, the Act provides that, "where any law provides that information or other matter shall be in writing then, notwithstanding anything contained in such law, such requirements shall be deemed to have been satisfied if such information or matter is rendered or made available in an electronic form and accessible so as to be used for a subsequent reference."<sup>92</sup>

In regard to the above, the Act recognises the validity of contracts entered into electronically. As such, electronic transactions are not void for all intents and purposes.<sup>93</sup> This essentially means that in an instance that a bank customer takes up an offer to contract a business with the bank, for example a loan application, such a bank cannot deny the existence of such an application merely because it was done electronically and

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90 Section 83D

91 Section 83E

92 Section 83G

93 Section 83J which provides inter alia that "in the context of contract formation, unless otherwise agreed by the parties, an offer and acceptance of an offer may be expressed by means of electronic message is used in the formation of a contract, the contract shall not be denied validity or enforceability solely on the ground that an electronic message was used for the purpose".

vice versa. This provision has been reaffirmed by section 83K which further provides that, "As between the originator and the addressee of an electronic message a declaration of intent or other statement shall not be denied legal effect, validity or enforceability solely on the ground that it is in the form of an electronic message." This is to the effect that just because an intention to contract is done electronically, does not make it less of an intention.

As far as authentication of electronic documents or electronic messages is concerned, the Act provides that such documents shall be evidenced through the use of electronic signatures and in this regard, such an electronic signature shall be held to be satisfactory if; "it is generated through a signature-creation device if the signature data are, within the context in which they are used, linked to the signatory and to no other person, the signature creation data were, at the time of signing, under the control of the signatory and of no other person, any alteration to the electronic signature made at the time of signing, is detectable and where the purpose of the legal requirement for a signature is to provide assurance as to the integrity of the information to which it relates, any alteration made to that information after the time of signing, is detectable."<sup>94</sup>

The above are the requirements that an electronic signature must fulfil such that if it does not meet these prerequisites then it will not be held to amount to an electronic signature as far as authentication is concerned. These are meant to prevent forgery and fraud and at the same time ensuring data protection. Such security steps are very useful in the field of electronic banking especially bearing in mind that there is a likelihood of technology related crimes being committed.

The aforesaid provisions are further strengthened by the provisions of section 83P which recognises the validity of such signatures and provides that "where any law provides that information or any other matter shall be authenticated by affixing a signature or that any document shall be signed or bear the signature of any person, then, notwithstanding anything contained in that law, such requirement shall be deemed to have been satisfied if

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94 Section 83O

such information is authenticated by means of an advanced electronic signature affixed in such a manner as may be prescribed by the Minister.” In the same line the Act empowers the Minister to prescribe regulations regarding; “the type of electronic signature, the manner and format in which the electronic signature shall be affixed, the manner and procedure which facilitates identification of the person affixing the electronic signature, control of the processes and procedures to ensure adequate integrity, security and confidentiality of electronic records or payments and any other matter which is necessary to give legal effect to electronic signatures.”<sup>95</sup>

These provisions seek to resolve the legal issue that has been surrounding the validity of electronic signatures in authentication of documents. However it is important for the law drafters to come up with a law that specifically deals with the use of electronic signatures. In doing this the drafters can borrow a leaf from either the United States of America<sup>96</sup> or the United Kingdom<sup>97</sup>, among others. This will add more weight to these provisions. In like manner it is important not to bestow too much power on the Minister since such power can be subject to abuse. The best procedure would be to leave such matters to an independent commission whose mandate is to check and regulate the practice of technology based services.

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95 Section 83R

96 The Congress passed The Electronic Signatures in Global and National Commerce Act in June 30 2000.

This law permits the use of electronic signatures and records, and pre-empts many state laws that would otherwise limit the use of electronic signatures. A signature, contract, or other record relating to such transaction may not be denied legal effect, validity, or enforceability solely because it is in electronic form; and a contract relating to such transaction may not be denied legal effect, validity, or enforceability solely because an electronic signature or electronic record was used in its formation.

97 The Electronic Signatures Regulations 2002 in UK have been made under the Electronic Communications Act of 2000. The Act deals with the legal recognition of electronic signatures and the process under which they are verified, generated or communicated, and the removal of obstacles in other legislation to the use of electronic communication and storage in place of paper.

As far as the issue of unauthorised transactions and unauthorised access to computer data is concerned, the Act has to some extent catered for such incidences. In this regard, the Act makes it an offence to commit such an unauthorised act and prescribes sanctions in form of a fine of two hundred thousand shillings or imprisonment of a term not exceeding two years or both.<sup>98</sup> It also provides for circumstances that will not amount to unauthorised access to data.<sup>99</sup> In this regard these rules can be construed as catering for mobile banking mainly because unauthorised transactions do fall under the umbrella of unauthorised access to computer data. This provision acts as a deterrent to any person who would want to commit such an offence. However considering the nature of such an offence and the trauma faced by the victims such sanctions should be enhanced.

As regards identity theft and fraud through electronic means as may happen in instances of electronic banking the Act prescribes the same measures as above but further goes on to state that as long as the act was committed with intention to commit a crime or offence under any law, then it matters not whether the access was authorised or unauthorised.<sup>100</sup> This provision seeks to protect customers data from being fraudulently accessed by, for example, employees of an institution offering electronic banking services.

From the above analysis, it can be stated that the Act has to some extent sought to lift the dark cloud engulfing the practice of electronic banking by seeking to address some of the key issues affecting the acceptance and practice of this mode of banking. This Act is very general and does not specifically address the issue of mobile banking, hence the need to come up with a regulatory framework for mobile banking.

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<sup>98</sup> Section 83U(1)

<sup>99</sup> Section 83U(2) provides inter alia that, 'a person shall not be liable under subsection (1) where he:-

- a) Is a person with a right to control the operation or use the computer system and exercises such right in good faith
- b) Has the express or implied consent of the person empowered to authorize him to have such an access
- c) Has reasonable grounds to believe that he had such consent as specified under paragraph (b) above; or
- d) Is acting in reliance of any statutory power for the purpose of obtaining information, or taking possession of any document or other property.

<sup>100</sup> Section 83V

### 2.2.3 Proceeds of Crime and Anti-Money Laundering Act

In December 2009, Kenya's Proceeds of Crime and Anti-Money Laundering Act (AML) was passed and assented to. The AML establishes the Financial Reporting Centre as Kenya's Financial Intelligence Unit to receive and analyze reports of unusual or suspicious transactions, draft the regulations required there-under and generally work with other bodies to identify proceeds of crime and combat money laundering.<sup>101</sup> The Finance Minister is authorized to adopt regulations on various matters, including identification and verification particulars and record-keeping requirements.<sup>102</sup>

The AML obligations under the AML Act apply to financial institutions and designated non-financial businesses and professions (collectively referred to as "reporting institutions"). The term "financial Institutions" is defined to include "any person or entity, which conducts as a business, one or more of the following activities or operations; accepting deposits and other repayable funds from the public..., transferring of funds or value, by any means, including both formal and informal channels..., issuing and managing means of payment (such as credit and debit cards, cheques, travellers' cheques, money orders and bankers' drafts, and electronic money)..."<sup>103</sup> The term "designated nonfinancial business or profession" includes specifically identified professions as well as any other activity or operation specified by the Minister by notice in the Gazette.

Under the AML Act, all reporting institutions are required to monitor and report all complex, unusual, suspicious, large, or other transactions, including all cash transactions exceeding US\$10,000 or its equivalent.<sup>104</sup> The following information must be collected by reporting institutions (and the records held for at least seven years) with respect to each person opening an account or conducting a transaction or on whose behalf a transaction is conducted: name, physical and postal address, and occupation (or where

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<sup>101</sup> AML Bill, Part III.

<sup>102</sup> AML Bill, Section 130

<sup>103</sup> AML Act, Section 2

<sup>104</sup> AML Act, Section 42 and Schedule 2

appropriate, business or principal activity).<sup>105</sup> The requirements of physical and postal address will be a challenge for people living in slums and informal settlements as well as those living in housing estates, which typically do not have street names, especially those in low-income neighbourhoods. However, relaxed requirements for small-value transactions could be created pursuant to guidelines issued pursuant to the law.

When verifying customer information, the reporting institution must take reasonable measures to satisfy itself as to the true identity of the applicant, including requiring the customer to produce an official identity record, such as a birth certificate, national identity card, driver's license, passport, or other official means of identification.<sup>106</sup> Currently, these identification documents are widely available, and most people engaged in small-value transactions have them. Furthermore, identification validation is not required for transactions completed after the initial verification.<sup>107</sup> However, and not insignificantly, the Act requires all reporting institutions to undertake Customer Due Diligence (CDD) on its existing customers.

As noted, reporting institutions must keep records of each person opening an account or conducting a transaction. The record of identification can be satisfied by either "a copy of the evidence or such information as would enable a copy of it to be obtained."<sup>108</sup> This requirement could prove a challenge for account opening in remote locations. Institutions must also record, for each transaction, the nature, time, and date of the transaction; the type and amount of currency involved; the type and number of any account involved; and the name and address of the institution's officer, employee, or agent who prepared the

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<sup>105</sup> AML Act, Section 44(3).

<sup>106</sup> AML Act, Section 43(1). The law mandates the identification, registration, and issuance of identity cards to Kenyan citizens age 18 or older. The current national identification card system in Kenya is paper based. The Ministry of Immigration and Registration of Persons intends to introduce a new generation card system, known as Third generation Card System, that will be electronic and plastic based.

<sup>107</sup> AML Act, Section 43(7).

<sup>108</sup> AML Act, Section 44(1)(b)

record.<sup>109</sup> These records must be kept for at least seven years from the date of the relevant business or transaction.<sup>110</sup>

Having examined this legislative document, it can be argued that though it sought to regulate electronic transactions under which mobile banking falls, this Bill does not address key issues that affect and come up as a result of mobile banking hence the need to come up with a regulation that specifically deals with these issues. However, it is acknowledged that the spirit behind the documents is that they are bound to streamline the practice of electronic transactions in Kenya though they are not comprehensive enough as far as mobile banking is concerned.

#### **2.2.4 Draft Retail Transfers Regulation, 2011**

This regulation has been proposed by the Central Bank of Kenya in terms of section 57(1) read together with section 4A of the Central Bank of Kenya Act which requires the Central Bank (the Bank) to formulate and implement policies to promote the establishment, regulation and supervision of efficient and effective payment, clearing and settlement systems.

The regulation is relevant to mobile money banking in that it would facilitate the provision of electronic payment services without compromising the safety and efficiency of the national payment system. It further provides minimum standards for consumer protection and risk management to be adhered to by all providers of retail transfers.

The regulation provides for authorization of the payment of service providers before commencing business.<sup>111</sup> The Central Bank before issuing the authority has to consider issues of ownership structure, the geographical location and the character and the capacity of the management.

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<sup>109</sup> AML Act, Section 44(1) and (3).

<sup>110</sup> AML Act, Section 44(4).

<sup>111</sup> Clause 5.0



The regulation provides for more stringent capital requirements including a startup capital of at least 10 million Kenya shillings. At the operation level the regulation requires that notwithstanding the core capital requirement at the time of authorization, payment service providers shall at all times hold core capital equal to the greater of; Ten Million Shillings, or an amount equal to 1% of one twelfth of the total amount of payment transactions executed by the payment service provider in the preceding financial year.<sup>112</sup> The import of this clause is that it ensures the stability of the service provider without necessarily limiting the provision of the service.

On the issue of agency relationship which is a more prevalent mode in execution of the service, the regulation provides for the use of cash merchants to perform cash services, provided the payment service provider can execute the retail transfers that support the cash services in real time. The conditions provided for authority include the maintenance of an oversight role over them, the provision to the Central Bank of Kenya the recruitment details in terms of the merits and procedure, and the financial reporting system. Cash merchants and wholesale cash merchants contracted to payment service providers shall comply with the Anti-Money Laundering and Combating the Financing of Terrorism controls imposed in terms of the Proceeds of Crime and Anti-Money Laundering Act.<sup>113</sup> Outsourcing in the provision of the service is also allowed on the strength of information to the Central Bank of Kenya at least 30 days to the implementation of duly executed outsourcing agreement.<sup>114</sup>

To ensure the continued protection of the consumers, the regulation proposes a raft of measures. Compliance with the technical and risk management standards as shall be determined by the Central Bank of Kenya from time to time are to be undertaken by the service providers.<sup>115</sup> The regulation provides that a payment service provider engaged in retail transfers as well as other commercial activities shall safeguard the funds which have been received from payers or from other payment service providers for the

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<sup>112</sup> Clause 6.0

<sup>113</sup> Clause 7.0

<sup>114</sup> Clause 8.0

<sup>115</sup> Clause 9.0

execution of retail transfers. It prohibits the transfer the neither of funds to its own account used for normal business operations nor commingle the funds with the funds of any person other than payers and payees on whose behalf the funds are held. It further provides that the funds shall be deposited in a separate account with a bank; and the payment service provider shall obtain insurance cover or some other comparable guarantee, payable in the event of bankruptcy to payees on whose behalf money is held by the payment service provider, from an insurance company or a bank, which does not belong to the same group as the payment service provider, for an amount equivalent to the aggregate daily balance held in the separate bank account during the preceding calendar month, provided that this sub-clause shall not apply to a bank or financial institution.<sup>116</sup>

The regulation makes it mandatory for the full disclosure of the terms and conditions of trade, the transaction process details and the evidence of payment details.<sup>117</sup> The import of these requirements is to provide the customers with a reference point to verify their transactions.

#### **2.2.5 Consumer protection Bill, 2011**

This is a private member's bill by Gem MP and Joint Chief Whip Mr. Jakoyo Midiwo.<sup>118</sup> The Bill is in line with Article 46 of the Constitution which provides for a Bill to develop a one-stop shop consumer protection mechanism.

The Bill aims at establishing a regime of consumer protection law, in order to provide a comprehensive consumer protection and an appropriate legal recourse to aggrieved consumers. If passed, the law will apply to all companies and other persons dealing with consumers in Kenya whether or not they have a physical presence in the country.

Suppliers are deemed to warrant any services they supply under a consumer contract provided they are of a reasonably acceptable quality including estimate quality where the

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<sup>116</sup> Clause 10

<sup>117</sup> Clause 11

<sup>118</sup> Dated 9th September 2011.

final price will have to fall within ten percent of such an estimate. Under the bill, demanding for payment for unsolicited goods or services would be illegal. Giving false, misleading or deceptive representations would be outlawed. Suppliers who hold onto consumer's goods to pressure the consumer into re-negotiating the terms of a transaction will find themselves on the wrong side of the law. Future performance agreements, personal development services, direct sales and credit agreements, leases, trade-ins and other types of consumer transactions will be covered by the proposed law. The law will also cover online transactions. Charging of advance fee (deposits) will be prohibited in certain sectors. Motor vehicle repairers will no longer be over-charged arbitrarily by vehicle repairers if the new law passes. Banks and financial institutions will have the burden to fully disclose and limit the liability of a borrower to pay charges that were not previously disclosed.

### **2.3 Conclusion**

Mobile banking and payments are an important development because they have the potential to broaden and deepen the reach of banking and non-cash payment services. They make possible cost effective services to the unbanked and deepen the reach of payment services to transactions previously not cost-effective to pay for using non-cash payments.

In conclusion it can be stated that the foregoing regulations have sought to provide a general overview on all electronically and technologically related services but there is need for a more comprehensive legal framework that seeks to address mobile banking specifically.

### 3 CHAPTER THREE

#### THE EMERGENT ISSUES IN REGULATION OF MOBILE BANKING IN KENYA

##### 3.1 Introduction

The field of M-Banking is fairly new and fast evolving and rests at the overlap of several domains including those of banking, telecommunications and security. According to Adrian Kamotho Njenga there is rapid absorption of mobile based banking services in Kenya.<sup>119</sup> In the past years the banks dominated in terms of offering financial services. Other institutions besides the banks have also come up to offer these financial services.<sup>120</sup> Mobile banking is one of such institutions which have been seen to offer the same financial services at a cheaper rate and at a convenient place and way which has resulted in a great reliance thereon. According to Central Bank Survey (2008), there are over 8,000 mobile banking outlets around the country whereas the conventional branches stand at 876.<sup>121</sup>

Mobile money has significant implications for economic activity across the board which has led to a net effect in its contribution to the economy in terms of enhanced Gross Domestic Product. It reduces the cost and risk inherent in dealing with cash and also facilitates the flow of money from one party to another using a communication infrastructure that already connects billions of customers around the world far more

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119 Adrian Kamotho Njenga, "Mobile Phone Banking: Usage Experiences in Kenya". Available at: [http://www.w3.org/2008/10/MW4D\\_WS/papers/njenga.pdf](http://www.w3.org/2008/10/MW4D_WS/papers/njenga.pdf). (accessed on 10/06/2011)

120 Including Microfinance institutions.

121 Supra note 116.

customers than currently have bank accounts. These advantages are particularly pronounced in developing countries.<sup>122</sup>

Mobile banking is offered through mobile devices which have resulted in great growth in reliance to the mobile devices. This trend of continued reliance on mobile devices and the need to execute monetary transactions is steadily gaining momentum. The emergent mobile technology innovations have resulted in critical issues which need to be addressed.

The main unresolved issues in the development of mobile payment systems for the unbanked include the entry of new players such as the telecommunications, who already have mobile phone customers. This issue raises questions about who should be offering the services. A purely mobile scenario is not possible, users will need to have access to cash-in and cash out facilities, which in remote areas cannot be offered by bank branches, so there is a need for local non-bank correspondents that can host and offer these services. There is also great uncertainty surrounding the specific demand for these services and the expected adoption rate, which makes it difficult to define a sustainable business model for the roll-out of M-Banking services primarily targeted to the unbanked population. Further, the possible impact of each country's regulatory framework needs to be assessed before any initiative is likely to take off.<sup>123</sup>

This chapter discusses the emergent issues surrounding regulation of mobile banking in Kenya. In particular, it discusses the relevant regulatory issues that need to be addressed in regulating mobile banking in Kenya. In so doing, the chapter outlines urgent issues that must be addressed by any system of regulation of mobile banking for it to be effective including the need for innovation, addressing customer protection issues, dealing with

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122 Nick Hughes, "Mobile banking: The key to building credit history for the poor". Available at: <http://www.docstoc.com/docs/21369847/mobile-banking---the-key-to-building-credit-history-for-the-poor> (accessed on 10/06/2011).

123 See Jim Rosenberg, "How can regulators protect funds held by mobile money providers". Available at <http://technology.cgap.org/category/cgap/> (Accessed on 11/07/2011).

risks, the agency problems of mobile banking and the relationship with the wider financial sector. It should be noted that the issues shall not be exhaustively discussed as the mobile money transaction is an experience which still has room for undergoing several innovative steps and hence a learning experience.

### **3.2 Emergent issues**

Under this heading the glaring gaps and problems experienced with the mobile money banking are outlined and discussed. The gaps as shall be discussed revolve around the unregulated emerging technological innovations under the mobile money banking and the issue of exposure to consumers in terms of the technological advances. These as shall be discussed might result to contractual and even tortuous injury to the consumers. As shall be discussed in chapter Four, the regulations envisaged for adoption as a regulatory regime for mobile money banking shall be more of a liberal and proportionate regulatory regime rather than a rule based regulatory regime without any room for growth of the innovation to make the idea better.

#### **3.2.1 Inadequate statutory protection**

The success of M-banking depends on three key determinants-policy and regulation, profitable/sustainable business case for all actors, and client uptake. Primarily, policy and regulation sets the foundation stone of the M-banking model. Regulation is essential for creating and maintaining an enabling environment for business, and mobile money is no exception. Dominic Peachey reminds us that, *“The first concern of the regulator is to maintain, and if necessary restore, public confidence in financial services and markets.”*<sup>124</sup>

As discussed in Chapter Two Kenya has no laws, regulations or policies dealing directly with mobile banking. There is no payment legislation giving authority to a regulator. Due to the lack of a law on the payments system, the National Payment System (NPS) Division does not currently have the necessary tools including specific regulations to

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<sup>124</sup> See Beth Jenkins 2008, “Developing Mobile Money Ecosystems”. Available at: <http://siteresources.worldbank.org/extinformationandcommunicationandtechnologies/Resources/282822-1208273252769/mobilemoney2008.pdf> (accessed on 20/06/2011)

supervise the payment system.<sup>125</sup> The Government of Kenya is keenly aware that the existing legal and regulatory framework including banking, payment systems, and telecommunications does not offer an optimal situation for the development and use of branchless banking models.<sup>126</sup> As such customers are left exposed to the dangers associated with the technological innovative step.

Policy and regulatory frameworks are of utmost importance when considering M-banking business models. The field of M-payments and M-banking is not only new and fast evolving but also sits at the overlap of several regulatory domains namely those of banking, telecommunication and payment system supervisors, and anti-money laundering agencies. The overlap substantially raises the risk of coordination failure, where legislation or regulatory approaches are inconsistent or contradictory.

The regulatory and policy environment for Mobile banking is complex and often ill-defined since it cuts across various regulatory domains. For example, the AML/KYC/CFT<sup>127</sup> legislation has been criticized for being unclear.<sup>128</sup> It is not clear whether they are perspective or risk based. They only apply to banks which allow for risks but with no guidance.

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125 See "Notes on regulation of branchless banking in Kenya November 2007". Available at <http://www.docstoc.com/docs/15720761/Outline-for-Summary-of-Initial-Findings> (accessed on 20/07/2011)

126 A Survey by CGAP - CGAP Policy Advisory Consultant Stefan Stachen and CGAP staff member Mark Pickens conducted the field portion of the mission, with technical input and logistical support from MicroSave's David Cracknell and Mary Ngugi. Available at <http://www.cgap.org/technology/technology@cgap> (accessed on 9/07/2011)

127 M-1 (KYC) and M-2 (AML) describe 'the minimum identification / introduction requirements for taking in a new customer' and 'measures to safe guard against Money Laundering activities' respectively. See 'policy guidelines for KYC and AML available at [http://www.mcb.com.pk/includes/aml\\_kyc.pdf](http://www.mcb.com.pk/includes/aml_kyc.pdf) (accessed on 11/07/2011).

128 Government Gazette, Regulation Gazette No.: 8103, Vol. 473, Department of Finance, Government of South Africa (Exemption 17). Available at [http://www.spidercenter.org/files/m-banking\\_study.pdf](http://www.spidercenter.org/files/m-banking_study.pdf) (accessed on 13/06/2011)

The technological problems associated with the innovation have now complicated the regulation of the mobile money banking thereby leading to a much bigger vacuum. In a nutshell technological innovations discussed below pose danger to regulation.

### 3.2.1.1 The issue of distinction between payments and deposits

Soundness and stability of the banking system and national payment system are central to financial regulation of any country. The lack of law in Kenya that expressly govern the payment system<sup>129</sup> has led to banks and non-banks engaged in similar activities (e.g., payment services, issuance of payment cards) which are subject to widely divergent regulatory regimes. Although banks are subject to the requirements of the Banking Act and CBK regulations issued thereunder, CBK does not have the authority to regulate or supervise nonbank payment service providers.<sup>130</sup> Non banks also are not subject to restrictions on the use of agents. This differential treatment leads to significant risk of regulatory arbitrage.

The payment system needs deliberation. An efficient payment system helps in effective implementation of the monetary policy operations and financial stability. A core principle is important. The core principles suggest the key characteristics that all systemically important payment systems should satisfy. The Banking Act recognizes M-pesa services as a deposit taking financial service.<sup>131</sup> However, Vodafone claims<sup>132</sup> that M-Pesa is a payment service, and not a deposit taking financial service. Similarly, the regulation of M-Pesa services is not yet formalized by the Central Bank, which has agreed to allow the transactions under the assumption that “remittance is not banking.”<sup>133</sup> This is done through the CBK department, which is the NPS which permitted experimentation with the non-bank based

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129 Supra note 124.

130 Ibid.

131 Banking Act, Cap 486 of the Laws of Kenya, Sec. 16.

132 Vodafone, M-Pesa Mobile Money Transfer, Regulating Transformational Branchless Banking, Windsor, UK, March 2008.

133 M-Pesa's legal position is clarified against definition of a financial service according to the Banking Act (Chapter 488 of the Laws of Kenya) (Source Vodafone, 2008). According to CGAP, the Kenyan financial sector is not well regulated. [www.spidercenter.org/files/m-banking\\_study.pdf](http://www.spidercenter.org/files/m-banking_study.pdf) (accessed on 6/7/2010)



model of m-banking . The CBK has taken the view that mobile banking<sup>134</sup> services are not covered under the legal definition “banking business”<sup>135</sup> as long as the services do not place the subscribers’ funds at risk and does not earn interest from the funds.

The regulations applicable to depositary MFIs would also require CBK approval of all agents.<sup>136</sup> In contrast, nonbank institutions do not face such restrictions. The Banking Act requires approval by the Minister of Finance (who has delegated this power to the CBK Governor) for increases in interest rates and other charges.<sup>137</sup> This can be particularly burdensome for branchless banking models that charge various fees for services offered.

### 3.2.1.2 Electronic signature

The use of electronic signature is indispensable in the conduct of mobile money banking. This mode of banking necessitates the replacement of personal relationship management with man to mobile devices-handsets. The use of electronic signature in this form of transaction assumes the character of message authentication. The message authentication code is in fact a security procedure applied to electronic payment systems verified by the service provider.<sup>138</sup> Though deemed and designed to serve as electronic signature, the authentication code or the personal identification number remains an open ended question whether they are electronic signature within the remit of the law.

The United Nations General Assembly Resolution 56/80 adopted the United Nations Commission on International Trade Law (UNCITRAL) Model Law on Electronic Signatures in 2002.<sup>139</sup> “Electronic signature” means data in electronic form, affixed to or logically associated with, a data message, which may be used to identify the signatory in relation to the data message and to indicate the signatory’s approval of the information

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134 Report by FSD Kenya .Available at <http://www.fsdkenya.org/pdf> accessed on (12/07/2011)

135 Consumer Protection diagnostic study Kenya January 2011 Available at: [http://www.fsdkenya.org/pdf\\_documents/11-02-22\\_Consumer\\_diagnostic\\_study.pdf](http://www.fsdkenya.org/pdf_documents/11-02-22_Consumer_diagnostic_study.pdf) (accessed on 20/07/2011)

136 Supra note 124.

137 Sec. 44 of the Banking Act

138 Kethi D. Kilonzo, An analysis of the legal challenges posed by electronic banking. Available at <http://www.kenyalaw.org> (Accessed on 14/9/2011).

139 Ibid.

contained in the data message.”<sup>140</sup> However, only three countries have adopted the Model Law namely Thailand, Mexico, and China. Electronic signature Legislation has also been drafted or adopted in several Latin American countries, including Argentina, Colombia, Chile, Ecuador, and Peru. In Africa, Egypt is the only country other than South Africa to have drafted electronic signature legislation.<sup>141</sup>

Kenya has adopted the electronic signature in line with the recommendation of the United Nations General Assembly Resolution 56/80 which adopted the United Nations Commission on International Trade Law (UNCITRAL) Model Law on Electronic Signatures in 2002. The Kenya Communication Amendment Act, 2009<sup>142</sup> recognizes advanced electronic signatures and electronic records as equal to written signatures and written (physical) records respectively. However, in its definition of banking business, the Banking Act<sup>143</sup> only refers to the cash and cheque payment systems. The Act provides no definition and makes no reference to electronic banking. It may be said that the parties to an electronic contract regulate its use. A comprehensive law regulating electronic signatures would ensure that they are legally recognized and that they are admissible as evidence.

Under the Central Bank of Kenya Act, CBK has a broad mandate to “formulate and implement such policies as best to promote the establishment, regulation and supervision of efficient and effective payment, clearing and settlement systems.”<sup>144</sup> Legislation aimed at protecting all the stakeholders should be developed. In particular, there should be robust but simple mechanisms for consumer protection, covering problems with retail agents, redress of grievances, price transparency, and consumer data privacy. Appropriate

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140 UNCITRAL Model Law on Electronic Signatures Article 2. Available at <http://www.steptoe.com/...html/.../Commentary on UNCITRAL Model Law> (accessed on 12/07/2011).

141 David Porteous, “The Enabling environment for cell phone banking in *Africa*”, (London: DFID, 2006). Available at: <http://www.qdocuments.com/enabling-environment-for-cell-phone-banking-in-africa--doc>. (accessed on 26/07/2011)

142 Section 4

143 Chapter 488 Law of Kenya

144 Section 4A (1) (d) of the Central Bank of Kenya Act. It is important to note that the Act vests CBK with policy-making authority but does not explicitly provide CBK with regulatory or supervision authority.

regulation of e-money<sup>145</sup> issuers and payment service providers would include reporting regulations, minimum capital and liquidity requirements, and restrictions on how e-money proceeds may be held or, for payment service providers, restrictions on permitted investments of funds held pending transfer

Generally, the existing legal and regulatory framework on M-banking does not offer an optimal situation for the development and use of branchless banking models. It is clear that the existing regulation, given that it was not developed with the convergence of telecommunications and finance in mind, apparently leaves many regulatory gaps and ambiguities. Hence Grameenphone's Azad laments that, "*Except regulation, all other challenges are within our control [to solve]. We cannot live with the present Banking Act – we cannot serve the population within its present parameters.*"<sup>146</sup>

Given the above discussion, the use of personal identification code or details as a mandate is fundamental in the service provider customer relationship. Within the wide range of paperless transfer, it poses a number of questions. Can a signature effectively verify an electronic transmission and will such transmission make it harder to see alterations? How effective legally is a replacement of the customer's signature by his personal identification number?

As a rule, instructions given to the service provider by its computers are authenticated by means of security procedures. The instruction to the service provider is the customer's mandate and is communicated through electronic means. The security procedure herein is analogous to a digital signature for it constitutes the service provider's authority to execute the mandate.<sup>147</sup>

A law regulating electronic signatures would ensure that they are legally recognised and that they are admissible as evidence. Consequently, electronic signatures will not be denied legal

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<sup>145</sup> See Mexico Branchless Banking Notes PDF available at <http://www.cgap.org/technology> (accessed on 11/07/2011)

<sup>146</sup> Supra note 123.

<sup>147</sup> Alan Urbach & John Storck "Alternatively, Electronic Technology and the Law," the 1984 Computer Law Symposium Conference Transports 21<sup>st</sup> and 22<sup>nd</sup> May, 1984, London, p.173.

validity, effect, or enforcement solely on the grounds that they are in the form of electronic data. They will be recognised in the same manner as hand written signatures.

### 3.2.1.3 Documentation of transaction

The documentation of electronic funds transfers is very important. The documentation should be in two forms: the issuance of a confirmation of a transaction; and the ability to get a confirmation of the transaction history.<sup>148</sup> The import of the same is for the customer to confirm that that his or her account has only been credited or debited as appropriate by the amount of the transaction authorised by him or her through the input of his personal identification secret code or number. The documentation should clearly clarify the amount of the transaction, the calendar date the consumer initiated the transaction, the time and the balance in the customer's account.

The financial consumer protection entails ensuring a fair exchange between the consumers and service providers. There should be a security system allowing customers and service providers to view their transaction histories at any time via their mobile handsets, and reducing the chance of loss as compared with cash. A policy framework is required to protect consumers against the power, information and resources of their providers. Consumers are exposed to many risks hence the need for a regulation which imposes a duty on institutions offering electronic money transfer to put in place mechanisms meant to protect the consumers.

The level of risks varies with the nature of the product offering.<sup>149</sup> For example, sometimes consumers may mistakenly send large sum of money to another person which may be difficult to retrieve if immediate action is not taken.<sup>150</sup> Currently, there is a tracking system to effectively protect consumers from such scenarios. However, very few

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148 However, currently one gets a message alert of the transaction done which if deleted cannot be retrieved unless you check only your account balance.

149 See for example, the publication on the best practice in managing security risks, available at [http://www.mobilepaymentforum.org/pdfs/MPF\\_Security\\_Best\\_Practices.pdf](http://www.mobilepaymentforum.org/pdfs/MPF_Security_Best_Practices.pdf), (accessed on 23/06/2011)

150 Note that it is sometimes difficult to get through customer care for the money to be reverted to a customers' account. Due to this difficulty the money might have been withdrawn by the time a customers' call gets through customer care hence the money is lost. And also it takes long before the money is reverted back to the customer sometimes causing delays and inconvenience to the customer.

consumers know the telephone number to contact for the tracking. The service providers rarely display such information as the telephone numbers to be used by consumers in case they send money to wrong recipients. Sometimes there may be problems with the payment due to unexpected delay .The payment service providers rarely inform the payer of the anticipated time of waiting hence the payer may leave without ensuring that the payment is effective which may later turnout to be defective.

Mobile devices are increasingly becoming mini-computers, which are capable of carrying out a growing range of operations. There may be ways for hackers and others to obtain data from mobile devices (*e.g.* Bluetooth, Radio Frequency Identification (“RFID”) chip) and infect mobile devices (*e.g.* through application downloads). Although spam is currently not as prevalent on mobile devices as on computers, as the use and value of mobile transactions grows, so will interest in obtaining personal and financial data and using mobile devices for spam scams, identity and theft.

#### **3.2.1.4 Inability to effect transactions on demand**

AML<sup>151</sup>/CFT guidelines for Agents’ liquidity may result in future insecurity problems. Normally agents finance M-Pesa transactions with liquidity from their other business activities, such as selling air- time, or merchandise in a small shop. When their own liquidity is not sufficient to cover for M-Pesa withdrawals for example on a pay day, problems start.<sup>152</sup> The agent may not have sufficient money to cover for M-Pesa withdrawals. There has to be a strategy to prevent such occurrences which are frequent. Further, M-Pesa customers can get irritated when they cannot withdraw their cash at the vendor in question. The vendor also may face the problem that his other business activities are being affected negatively. Since a large number of transformational M-Banking clients are first time customers with low financial literacy, the risks become even higher .Appropriate consumer protection against risks of fraud, loss of privacy and even loss of service is extremely critical for growth of M-banking.

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<sup>151</sup> Proceeds of Crime and Anti-Money Laundering Act, 2010.

<sup>152</sup> Pulver, Caroline (2008), FSD Kenya ‘The Performance and Impact of M-PESA’. Available at: [http://www.technology.cgap.org/technologyblog/.../fsd\\_june2009\\_caroline\\_pulver.pdf](http://www.technology.cgap.org/technologyblog/.../fsd_june2009_caroline_pulver.pdf), ( accessed on 12/07/2011)

### 3.2.1.5 The Regulatory Authority

As pointed out, many of the mobile initiatives are partially in some cases wholly led by non-bank organisations that are traditionally outside the scope of financial regulation, and with whom the financial regulator has traditionally had little or no contact. This has naturally led to concern amongst the mobile money transaction stakeholders with the end result of threat to the economy without proper regulation.

The financial regulator plays a crucial role in the economy of any country including economic stability, consumer protection, and promoting a country's social objectives by attempting to ensure that suitable financial services are available to as many of his fellow citizens as possible and that the range and sophistication of those services increases in step with the country's needs.

### 3.2.1.6 SIM Card Control

This is a technical matter which revolves around SIM Card control to ensure security of transactions. As technology stands today, there is only one way of doing end to end encryption for branchless banking-using the SIM.<sup>153</sup> Since the SIM is under the control of the mobile operator, this effectively means that only a mobile operator-led scheme can offer full security. It is not possible for consumers in different networks to carry out payment unless they are of the same network.<sup>154</sup> To resolve this there is need for relaxation of SIM controls and relaxation of security.<sup>155</sup>

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<sup>153</sup> Paul Makin, Consult Hyperion; Regulatory issues around branchless banking. Available at <http://www.oecd.org/dataoecd/40/2/44005585.pdf> (accessed on 9/7/2011).

<sup>154</sup> Note that Safaricom has launched an international money transfer system through Western Union and M-PESA International Money Transfer Service. It is also possible for an M-PESA account holder to sent money to an Airtel KE customer.

<sup>155</sup> Supra note 150.

### 3.2.2 Innovation

Policy-makers need to make some strategic decisions about how best to leverage the opportunity that mobile banking represents. The regulatory environment should be open and clear to foster innovation and growth and that regulators are able to engage in adequate oversight to ensure the safe and healthy development of branchless banking. In order to allow innovation, regulators, on the other hand, have to learn quickly to grapple responsively and flexibly with new issues that appear to extend beyond their domains of expertise.

The transformational mobile banking is made available by mobile phone service providers as part of their value added services. The mobile banking sector, driven by rapid advances in technology is evolving in ways that will be problematic hence there is need for regulatory measures. The regulatory authorities should provide systems to maintain consistent application of policy as the sector is becoming populated with new products every day.

Striking the balance between stability and innovation is particularly difficult in the mobile money space, because of multiple regulatory domains as far as banking and telecommunications are involved.<sup>156</sup> The only access and barrier to M-banking services is through the mobile phone.<sup>157</sup> It is embedded among other services within the service providers menu. The perceived difference between mobile service providers mainly lies on the pricing strategy, quality and scope of services.<sup>158</sup> To develop and adapt technologies that mobile banking utilizes takes time, which is not surprising considering the lack of standards in M-banking.

The Kenyan case offers sufficient evidence to the claim that competition triggers creativity and innovation. To survive in a competitive market firms must maintain new

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<sup>156</sup> Ibid.

<sup>157</sup> Sarker & well (2003): "M Mobile Telephony in Sub-Saharan Africa". Available at <http://www.igi-global.com> (accessed on 15/07/2011)

<sup>158</sup> Supra note 138.

products.<sup>159</sup> The sustained presence of mobile products being floated to customers on a consistent basis depicts high standards of innovativeness. Continuous innovation not only yields new products but also promotes efficiently in performance of activities. As a result the price for new services introduced to the market declines consistently.

### 3.2.3 Illiteracy on phone usage

It is clear that population categories with lower levels of education happen to be the larger user category of mobile banking services.<sup>160</sup> Therefore, many of them are curtailed by not being fully conversant with all that they can accomplish through the mobile to facilitate m-banking transactions. Most of them are uneducated as most educated persons opt to use the bank's services most of the time.<sup>161</sup>

Customers illiteracy is at three levels, namely reading illiteracy where the majority of poor clients cannot read or write and can only trust voice services or what the sales agents say, technological illiteracy where prospective customers who might be a good match for the product may feel that the product is technologically too complex for them, and financial illiteracy where the target customers may often be unaware of the terms and the conditions that underlie the financial agreements they agree to with the financial service provider.

There has been no adequate strategy by the M-banking service providers to enable Kenyans use the M-banking services well. M-banking can only benefit from having a wider pool of informed, literate potential customers. Greater literacy may speed adoption, and may reduce the risks of abuse. As literacy is an issue, the diffusion of the technology is driven by being 'shown'.<sup>162</sup> The effects of illiteracy have resulted in a lot of fraud on

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159 Ibid.

160 Adrian D Kamotho Njenga: Mobile phone banking: Usage experiences in Kenya [http://www.w3.org/2008/10/MW4D\\_WS/papers/njenga.pdf](http://www.w3.org/2008/10/MW4D_WS/papers/njenga.pdf) (accessed on 6/7/2011)

161 Ibid.

162 Supra note 131.



the consumers from the agents or rather from the various persons they seek help on use of these services effectively.<sup>163</sup>

Efficient communication and interaction is required across organizations to sort out question-marks as M-banking treads in unknown territory. Deliberate interventions must be undertaken to successfully ensure that the targeted persons particularly the rural residents and females are empowered not only with technology but with skills and finance as well.<sup>164</sup> Consumer education may speed adoption; but more likely, adoption on scale will happen as it has happened with mobile phones: by person to person transfer of the knowledge necessary to operate.

To ensure proper use of mobile banking services, people must be familiarized with the benefits and opportunities of mobile banking. Proper strategies to educate the public should be developed to overcome hindrances in mobile banking transactions. Well informed consumers not only protect their own interest but also provide a market discipline to their financial providers.

#### **3.2.4 Network Coverage**

Despite the existence of mobile banking services by providers in Kenya such as Safaricom, and Airtel, there are areas which do not have good network coverage. Access becomes a serious issue of concern in some other underdeveloped regions where network signals are extremely sparse.

Network delay leads to delay in accessing mobile banking services which is also a challenge to the growth of economy. The number of enlisted mobile phone service users contributes to network failure. The mobile banking services largely depend on services of mobile operators. Where network coverage is inexistent or poorly established it follows that mobile banking implementation is low in form.

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163 Keith Epstein and Geri Smith, "The Ugly Side of Micro lending", Business Week, December 13th 2007.

164 Ibid.

CCK puts the current mobile phone penetration at 63.2% of the populace as at 2011. Sharp concentrations of those with access are within urban areas at 20%.<sup>165</sup> This reveals a spectacular mobile banking divide highly skewed against the rural population.

### 3.2.5 Access

Concentration of M-banking is evidently heavier in urban settings. Universal access in rural areas is faced with numerous challenges including how to manage the float (Cash) in light of prospected demand. Operators have tended to focus mainly on the densely populated economic zones. With the latest government move to encourage operators to develop services in the rural areas, with promises to support these efforts it is reasonable to expect a better environment for mobile activities.

For the mobile banking agents to open or close its branches, depends mainly on the mobile operators' ability to develop adequate network services in the rural areas, to create a better environment for mobile activities.

### 3.2.6 Agents related risks

Agents often lack even the most basic business skills, such as business planning, accounting, and cash management. A CGAP study in Colombia, for instance, showed cash piling up above the Central Bank-imposed ceiling on the amount of cash an agent could handle. The more times that happened, the more times that agent had to close up shop and go to the bank, forfeiting business and inconveniencing customers.<sup>166</sup>

From a typical banking regulator's perspective, entrusting retail customer contact to the types of retail agents used in both the bank-led and nonbank-led models would seem riskier than these same functions in the hands of bank tellers in a conventional bank branch. These retail agents may operate in hard-to reach or dangerous areas and they lack

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<sup>165</sup> See "New business model to save African cybercafés – higher bandwidth, higher margins and transactions". Available at: <http://www.balancingact-africa.com/news/en/issue-no-558> (accessed on 16/07/2011)

<sup>166</sup> Ignacio Mas and Hannah Siedek, 2008, "Extending Financial Services with Banking Agents". CGAP Focus Note No. 47. Washington, DC: CGAP. Available at: <http://www.idlo.int/MF/Documents/Publications/62E.pdf>, (accessed on 10/07/2011).

physical security systems and specially trained personnel. The lack of expert training may seem a particular problem if retail agents' functions range beyond the cash-in/cash-out transactions of typical bank tellers to include a role in credit decisions.<sup>167</sup>

Banking regulation typically recognizes multiple categories of risk that bank regulators and supervisors seek to mitigate.<sup>168</sup> Five of these risk categories—credit risk, operational risk, legal risk, liquidity risk, and reputation risk—take on special importance when customers use retail agents rather than bank branches to access banking services. The use of retail agents also potentially raises special concerns regarding consumer protection and compliance with rules for combating money laundering and financing of terrorism.<sup>169</sup>

Banking and non-banking agents who are engaged in similar activities are subject to totally different regulatory regimes in the same country. This affects their ability to compete on a level playing field.

Another issue is deposit taking. In order to prevent scenarios in which consumers' deposited money gets lost due to the fact that the deposit taker is bankrupt, insolvent or simply vanished, regulators exercise control regarding entities to enter the market as deposit takers. The public is supposed to trust the financial system and its actors, and should not be required to make such risk assessments themselves. It is vital for the government to outline clearly the nonbank retail outlets which should serve as agents and place restrictions on the range of permissible activities they can carry out.<sup>170</sup>

Risks of losing deposited money can be mitigated by entering into mobile banking activities through known and meticulously regulated players and agents. Providers may therefore enjoy positive externalities from creating appropriate levels of consumer

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167 Adria Kamotho Njenga, "Mobile Phone Banking: Usage Experiences in Kenya," Available at: [http://www.docstoc/docs/1487965/Mobile-phone-banking-Usage-experiences-in-kenya-\(accessed on 10/06/2011\)](http://www.docstoc/docs/1487965/Mobile-phone-banking-Usage-experiences-in-kenya-(accessed%20on%2010/06/2011)).

168 Banking Act, Cap 486 of the Laws of Kenya.

169 *Supra* note 163.

170 *Supra* note 137.

protection which help create trust, leading to more rapid adoption. However, there may also be negative externalities from inappropriate protection. By imposing higher costs on providers, certain protective measures may result in small balance accounts becoming unviable and therefore not offered. Those already holding accounts may be better protected by these measures; but those who cannot qualify as a result are without access to the product, and may be forced to use unregulated alternatives. Therefore a balance must be struck on this issue. Mobile banking systems must be able to recover themselves from error conditions. Quality service should consider that first time customers are mostly poor with low educational attainment, hence guidelines on proper documentation, privacy protection, and redress mechanisms must also consider that kind of situation.<sup>171</sup>

### 3.2.7 Interoperability in the emerging diversification of mobile money service

Some degree of interoperability will be required if a critical mass of mobile money services is to develop. Mobile network operators and other companies are conscious of their core competencies and often, quite rightly, want to focus on their core businesses. As a result, some interoperability, in the sense of collaboration or partnership, will be needed to expose consumers to a broad range of players so collectively they can get the full package of financial services.<sup>172</sup> Interoperability in the diversification of mobile money services is also important from the perspective of consumer choice. Offering consumers choice can be a key part of the value proposition.

In M-pesa, money collected by agents is deposited in a trust account in one of the leading commercial banks in Kenya. This trust account provides the legal protection for the beneficiaries. The money in this trust account is not under the control of Safaricom and cannot be employed for purposes such as lending, investing or in any other manner for the account.

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171 Environmental Impact Assessment (Project Report), available at: [www.nema.go.ke/index2.php?option=com\\_docman&task=doc](http://www.nema.go.ke/index2.php?option=com_docman&task=doc) (accessed on 10/07/2011).

172 Ignacio Mas, Adviser, CGAP 2008. Remarks at GSMA Mobile Money Summit in Cairo May 15. Available at: [http://www.hks.harvard.edu/mrcbg/papers/jenkins\\_mobile\\_money\\_summer\\_008.pdf](http://www.hks.harvard.edu/mrcbg/papers/jenkins_mobile_money_summer_008.pdf) (accessed on 16/07/2011).

Legal protection of the money in the trust account is provided for in the trustee deed. Various legal instruments pertaining to this service, including the trustee deed have been presented to the Central Bank and reviewed accordingly. Further to this, funds in the trust account deposited in the designated commercial bank are regulated by the Central Bank of Kenya under the Banking Act. The Trustee holds funds on behalf of all M-pesa System participants under a Declaration of Trust (the Trust Deed). A number of critical issues and risks have been reviewed during the Ministry of Finance audit in 2009 that could compromise the safety, efficiency, integrity and effectiveness of the M-pesa system.<sup>173</sup> These will be helpful in this study in terms of the recommendations that will be made in Chapter Five.

### **3.2.8 Dispute Resolution**

Mobile banking is mainly done through agents. Many subscribers may not understand proper procedure to report any disputes. Mobile banking subscribers do not understand how to make calls to the customer care service providers for any solution to their problems. Similarly the mobile banking service providers do not publicize the recourse options for lodging complaints against agents.

There has been no independent customer care service provider which would enable consumers file their complaints. It becomes difficult for the consumers of m- banking services to solve their problems as it is only available in the same department as the mobile devices customer care or through a specific telephone number which most consumers are not aware of due to poor publication of such information to consumers. There are no processes through which consumers can lodge their complaints.<sup>174</sup>

### **3.3 Conclusion**

It is noted that the challenges regarding m-banking to policy-makers and regulators is two-fold: Firstly, to encourage banks and mobile operators to develop solutions that are not proprietary, and secondly, to allow access to potential new entrants that can disrupt

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<sup>173</sup> See Ministry of Finance Findings on M-Pesa money transfer services, Available at: <http://kenyapolitical.blogspot.com/2009/01/ministry-of-finance-audit-findings-on-m.html> (accessed on 26/07/2011)

<sup>174</sup> Ibid.

the lucrative business models of the banks and mobile operators. It is observed that the key challenge is to do this while at the same time ensuring high levels of security and trust. These genuine concerns of banking regulators about mobile payments and mobile banking must therefore be addressed in any framework touching the financial system of a country. In addressing them it is important to take into consideration what has been discussed in this chapter.

## 4 CHAPTER FOUR

### THE CONCEPT OF PROPORTIONATE REGULATION TO THE REGULATION OF MOBILE BANKING IN KENYA

#### 4.1 Introduction

The regulatory regime has a crucial impact on the successful development of mobile banking, which depends on the establishment of a more accommodative type of regulation that will nurture growth in terms of innovation without necessarily exposing the end users of the service to unnecessary challenges. To enable efficient usage of mobile banking services, policy makers should create an environment that will enable proper access to such services. This will be possible through enacting a balanced regulatory framework that will mitigate risks and ensure development in mobile banking service delivery.<sup>175</sup>

Decision making in respect of adopting a given type of regulatory regime should be timely, transparent and relevant for market participants and be implemented only after an intense civic education to all mobile banking users.<sup>176</sup> The regulation should support innovation, ensure consumer protection and create a facility for consumer education on mobile banking. The issues of money laundering and terrorist financing risks should also be addressed. The need to comply with international standards to mitigate these risks has further created market fears that the cost of regulatory compliance could be prohibitive, creating a disincentive to expand mobile financial services and, resultantly, undermine development. It is established that the choice of regulation depends on the cost of

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175 Paul Makini, "Regulatory issues around mobile banking."  
Available at <http://www.chyp.com> (Accessed on 14/9/2011).

176 Janis Sarra : Proportionate Securities Regulation: The Potential for Scaled Treatment of Junior Issuers. Available at <http://www.expertpanel.ca/documents/research-++studies/Proportionate%20Securities%20Regulation%20-%20Sarrra.English.pdf>. Accessed on (12/9/2011)

compliance, the market capitalization, and the kinds of stakeholders and the issue of documentations.<sup>177</sup>

It is therefore against this background that this Chapter addresses the scope of the concept of proportionate regulation and how it may be applied in addressing the issues relating to regulation of mobile banking in Kenya. The Chapter discusses the meaning of proportionate regulation, its applicability in other jurisdictions and the other types of financial services regulations and the relevance and applicability of the concepts to the regulation of financial services and particularly mobile banking in Kenya. The applicability of this concept of proportionate based regulation shall be discussed in Chapter Five where the concept of proportionate regulation will be applied in formulating effective solutions to the regulatory issues highlighted in chapter three.

Regulation of any given sector can be of several kinds including the risk based regulation, the rule based regulation, the principle based regulation and the proportionate based regulation. Though the main aim of this chapter is to discuss the issue of proportionate based regulation as being appropriate in regulating the mobile money transactions, a discussion of the principle based regulation is helpful in appreciating the best mode of regulation to adopt in this case. The choice of discussion of the two is because it is generally accepted that for a less capitalised venture and for the venture that is still undergoing transformational innovation the two are acceptable.

## **4.2 Proportionate Regulation**

A proportionate regulation means a range of options, from exemption to particular regulatory compliance to a range of measured or scaled adjustment of specific requirements for particular size or type of issuer.<sup>178</sup> Proportionate regulation as a policy option requires consideration of the interplay between a rules-based and a principles-based regulatory regime.<sup>179</sup> For a proportionate regulation to be uniformly applied, there

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177 Benel P. Laguna, "Proportionate Regulatory Policies for the MSME Sector." Available at <http://www.sbgfc.org.ph>. (Accessed on 25/8/11).

178 Supra note 173.

179 Ibid.



is need for national cooperation otherwise standards would be too fragmented and create prohibitive cost barriers to raising capital in more than one jurisdiction.

#### **4.2.1 Proportionate Regulation in other Jurisdictions**

The study of the applicability of the proportionate regulation will help inform the idea of the applicability of the same in Kenya. The study will show that other jurisdictions have attempted to adopt the proportionate regulation in critical sectors which still undergoes tremendous growth and innovation. This has been achieved without compromising the rights of the end users. This section focuses on the applicability of the proportionate regulation in the Philippines and Canada because of the success stories and the almost similar features with Kenya.

Since the year 2009, the Philippines Central Bank (BSP) has adopted and experimented on the proportionate regulation in regulating the non-banks money issuers.<sup>180</sup> Before the proportionate regulation was adopted, the BSP allowed for several years of close dialogue and mutual learning between BSP and mobile operators. The mobile operators were allowed to experiment and to develop their business model within existing regulation (money transfer and AML/CFT regulation) under close supervision of the BSP. Prior to the adoption of the proportionate regulation, non-bank institutions engaged in mobile money transfers were being regulated by the BSP as money transfer agents and by the Anti-Money Laundering Council as covered institutions.<sup>181</sup> This has led to the fertile regulatory environment, where market players are closely supervised without initial regulation specific for e-money. Once the learning and innovation in the market had been implemented and satisfied the needs of regulators and mobile operators, regulation was created to provide legal certainty to the status quo and to open the level playing field to new entrants.<sup>182</sup>

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180 This has been done through the 'e-money' circular that open e-money issuance to non-banks.

181 Benel P. Laguna- Proportionate regulations to boost MSMEs. Available at <http://phildevfinance.blogspot.com/2011/06/proportionate-regulations-to-boost.html> (accessed on 20/8/2011)

182 Industry's recommended regulatory practices: Philippine E-Money Circular. Monday 22 June 2009(Barcelona).

In Canada the peculiar features of Canada's capital market informed the consideration of moving towards a more proportionate regulatory system.<sup>183</sup> Specifically, Canada has a large number of small public companies; its market cap is concentrated largely in four provinces; it has a particular focus on mining, resources and technology; and a significant number of issuers are cross-listed on US exchanges. Canadian securities regulators have already recognized some measure of proportionate regulation in their national instruments, based on the type of listing. One example of where Canada has put proportionate regulation to use is in the continuous disclosure rule - Venture Issuers have a slightly longer period to file their annual financial statements - 120 days instead of 90. This modest accommodation recognizes a very real resource problem - small cap issuers lack both the in-house expertise and the relative influence with external auditors that large cap issuers have. Giving Venture Issuers a bit more time to prepare and file their financial statements is a practical response which does not compromise investor protection.<sup>184</sup> Canada's securities regulators have also adopted proportionate-based securities regulation to specifically address barriers to early-stage financing. For example, securities regulators have an agreement with the TSXV to allow capital pool companies to list on the TSXV subject to specific conditions.<sup>185</sup> This agreement provides nascent companies with the opportunity to access public capital markets to fund investments in growth-oriented activities. An additional example, albeit on a smaller scale, is the effort of the Government of Nova Scotia to simplify reporting requirements to encourage the establishment of investment funds that are aimed at providing early-stage financing to businesses located in Nova Scotia.<sup>186</sup> The program provides streamlined regulatory requirements to facilitate the establishment of, and investment in, these investment funds, which in turn support economic development in the region. These features suggest that

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183 Janis P. Sarra (UBC Faculty of Law, 2008) *Proportionate Securities Regulation: The Potential for Scaled Treatment of Junior Issuers*. (Accessed on 10<sup>th</sup> November, 2011).

184 Stephen P. Sibold, Q.C., October 24, Submission to The IDA Taskforce to Modernize Securities Legislation in Canada. *Addressing the Burden of Regulation in Canada -The Case for Proportionate Regulation*. Available at [http://www.tfmsl.ca/docs/T46187-V7\\_267-275.pdf](http://www.tfmsl.ca/docs/T46187-V7_267-275.pdf) (6/10/20110)

185 Capital pool companies have no assets (other than cash) and have not commenced business activity.

186 This initiative is known as the "Community Economic Development Investment Funds" (CEDIF).

Canada is cognizant of the different growth standards of different sectors in the economy which don't require a uniform regulation but a more proportionate regulation.

Some critical principles could be discerned from the case study of proportionate regulation in other jurisdictions. The adoption of the regulation in all cases was preceded by a close dialogue and representations by various stakeholders. In Philippines for example, the process was centered on close dialogue with all the relevant stakeholders who assured the acceptability of the regulatory regime. Once the regulatory requirements had been developed, BSP created legal certainty which formalised the rules in a formal regulatory framework. The result is a combination of openness and legal certainty that allows the regulator to follow closely new developments without preventing innovation. In such a regulatory framework, the industry has incentive to innovate and to invest. The consumers are both protected and benefit from innovation and competition. The proportionate regulation is concerned with the regulation of the various services and the products offered by the players and the market players themselves. These rules are proportionate to the risks of the actual type of service. The advantage of this approach is that mobile money services can be offered by anybody who complies with regulation which mitigates the risk of the actual service. This allows non-banks to enter the market if they are able to comply with appropriate regulation.

#### **4.2.2 The need for proportionate based regulation**

Proportionate based regulation is essential in eradicating impediments in the payment system. It also facilitates market development and innovation. Proportionality is a key principle of good regulation, although it is often hard to apply in practice, especially in new and fast evolving markets.<sup>187</sup> Proportionate regulation balances access to capital and the long term sustainability of the market. Proportionate regulation can be used to reduce disproportionate compliance costs by eliminating regulatory compliance requirements where they do not add value to the integrity of the market.

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<sup>187</sup> David Porteous- The enabling environment for mobile banking in Africa. Available at [http:// www.gamos.org.uk/.../Final Report](http://www.gamos.org.uk/.../Final Report) (Accessed on 06/09/2011).

Financial Action Task Force (FATF) identified Kenya as having strategic AML/CFT deficiencies.<sup>188</sup> They reported that despite Kenya's high-level political commitment to work with the FATF to address its strategic AML/CFT deficiencies, the FATF was not satisfied that Kenya had made sufficient progress in implementing its action plan, and certain strategic AML/CFT deficiencies remained.

A proportionate regulation ensures that there is an operational and effectively functioning Financial Intelligence Unit. A proportionate regulation also establishes and implements an adequate legal framework to raise awareness of AML/CFT issues within the law enforcement community and be efficient in implementing effective, proportionate and dissuasive sanctions in order to deal with natural or legal persons that do not comply with the national AML/CFT requirements. The FATF encouraged Kenya to address its remaining deficiencies.

There should be efforts put in place to facilitate formulation of a single mobile banking regulation instead of the continued separate regulations. A properly designed outcomes-based regime will provide sensible outcomes for all market participants without having to devise separate regimes.<sup>189</sup>

### **4.3 The Case against the Rule Based and the Principles Based Regulation**

#### **4.3.1 Meaning**

Rule based regulation is concerned with detailed prescriptive rules and supervisory actions how firms should operate.<sup>190</sup> The Principle based regulation on the other hand is a distinct form of regulatory approach that contrasts with the rules-based approach. It involves moving away from dictating through rule based regulation. The Principles are largely behavioral standards as they are concerned with integrity, skill care, diligence and

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188 FATF-GAFFI report- Improving Global AML/CFT Compliance: update on-going process (accessed on 25/8/11).

189 Brent W. Aitken -Another Way Forward for Securities Reform. Available at <http://www.tfmsl.ca/Documents/BCSC.pdf> (accessed on 22/08/2011)

190 The FATF report was made in Paris on 25 February 2011(accessed on 24/8/11).

reasonable care with which authorized firms or approved persons conduct and organize their businesses and the fairness with which they treat customers and manage conflicts of interest. Under the rules-based approach, businesses must adhere to a strict body of rules to achieve compliance.<sup>191</sup> Principle based regulation takes different forms in different contexts, countries and regulatory domains .These forms include; formal, substantive, full and polycentric.<sup>192</sup>

Principle based regulation can be formal, in the sense that there are principles in the rulebooks that may include; legislation, codes of practice, but it may not be substantive. Substantive principle based regulation is where a regime has characteristics but not have principles in the rulebooks. Where it is both, it is described as full principle based regulation. Polycentric is full principle based regulation with the additional element that it is characterized by the enrolment of others, beyond regulators and firms, in the elaboration of the meaning and application of principles.<sup>193</sup>

It is noteworthy that principles-based regulation fits well with the organized regulatory strategies or those of new governance associated with the decentralized analysis. Breach of the set principles always involves an element of fault and such breach can be sanctioned through public enforcement action. However, in order to determine whether a principle has been breached, one has to consider the standard of conduct required by the principle in question.<sup>194</sup>

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191 Power, *Organized Uncertainty: Designing a World of Risk Management* (Oxford: Oxford University Press, 2007). Available at <http://www.oup.com/us/catalog/general/subject/Business/Management/?view=usa&ci=9780199253944> (accessed on 17/8/2011)

192 *Forms and Paradoxes of Principles Based Regulation* Julia Black LSE Law, Society and Economy Working Papers 13/2008 London School of Economics and Political Science Law Department available at <http://www.lse.ac.uk/collections/law/wps/wps.htm> (accessed on 17/8/2011)

193 *Ibid.*

194 *Ibid.*

#### 4.3.2 Appropriateness of the Rule and the Principle based Regulation

Principles provide the framework in which firms can organize their own processes to achieve the outcomes the regulator seeks. The regulator in turn depends on firms to adopt an attitude to the regulatory regime that is one which aims to go beyond minimal compliance with the rules. Principle based regulation thus both relies on and reinforces the image of the self-observing, responsible organization, which is a central feature of governance strategies.<sup>195</sup> Principle based regulation might achieve better regulatory outcomes since it would give businesses greater flexibility to adapt compliance practices to the latest innovations in the capital markets.<sup>196</sup>

As for the detailed rules, they are certain, clear and non retrospective. However, they are rigid and the rule maker has to anticipate as to how the rule will be applied in the future.<sup>197</sup> New situations and innovations may arise that were not anticipated when the rule was written and the rule may be interpreted and applied in ways that were not intended. The flexibility of a principle therefore helps close the new gaps with ease. It gives benefits to consumers by fostering a more innovative and competitive financial services industry. Principles-based regulation also offers effective protection as senior managers' drive the changes necessary for their firms to meet the principles. In a quickly changing marketplace, principles are far more durable.

As changes continuously take place in the financial market, principle –based regulation will be more appropriate as it is flexible and not bound by strict rules. The continuous innovation and new products in the market are likely to be profitable to consumers as the developments take place, hence the principle-based regulation will cover such changes. It is important that regulation respond rapidly to the pace of change in markets and so allow them to continue to develop for the benefit of their use. A regulation that focuses on

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195 See e.g. C. Parker, *The Open Corporation* (Cambridge: Cambridge University Press, 2002), chapter 9; Available at [http://www.2007amsterdamconference.org/Downloads/AC2007\\_Gunningham.pdf](http://www.2007amsterdamconference.org/Downloads/AC2007_Gunningham.pdf). (Accessed on 12/09/2011).

196 *Supra* note 173.

197 Herbert Smith ;Principles-based regulation In principle and in practice Preliminary observations: February 2007 .Available at [http://www.lse.ac.uk/collections/law/projects/lfm/lfmr\\_13\\_blacketal\\_191to206.pdf](http://www.lse.ac.uk/collections/law/projects/lfm/lfmr_13_blacketal_191to206.pdf). (accessed on 07/09/2011)

outcomes rather than prescription is more likely to support such development and innovation. Any set of prescriptive rules will be unable to address changing market circumstances and practices at all times, and it inevitably delays, and in some instances prevents, innovation. In a quickly changing market place, principles are far more durable. Principles-based regulation might facilitate better enforcement actions by being able to hold businesses accountable for rule infractions as well as actions that, although technically compliant, violate the public interest.<sup>198</sup>

Principle based regulation will enhance the ability to meet consumer protection objectives. It will also allow the Central Bank of Kenya to deliver better regulatory outcomes in a proportionate way that is more efficient and effective. Principles can enable strict compliance where new innovations are likely to take place and can prompt more substantively compliant behaviour, particularly if the penalties for non-compliance are high<sup>199</sup> Principles thus have the benefit of congruence: of communicating the regulatory objectives and promoting behaviour which will achieve those objectives, and of minimizing the scope for drafting rigid rules that might not address future problems.

### **4.3.3 Challenges to Rule and Principle Based Regulation**

Rules-based regulation is comparatively rigid. Detailed rules impose requirements that are not always appropriate for all entities regulated by the relevant scheme and, further, they do not always cover all of the entities or activities that are intended to be regulated.<sup>200</sup> Rules based regulation can lead to gaps, inconsistencies, rigidity and are prone to 'creative compliance', to the need for constant adjustment to new situations and to the ratchet syndrome, as more rules are created to address new problems or close new

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198 Ibid

199 M.W. Nelson, "Behavioural Evidence on the Effects of Principles- and Rules-Based Standards". (2003) 17 (1) American Accounting Association 91. Available at <http://www.herbertsmith.com/NR/rdonlyres/...B64C.../5924PBRBrochureD3.pdf> . (Accessed on 09/09/2011)

200 J Black, Principles Based Regulation: Risks, Challenges and Opportunities (2007) London School of Economics and Political Science. Available at <http://www.alrc.gov.au/publications/4.%20Regulating%20Privacy/regulatory-theory>. (Accessed on 10/11/2011).

gaps, creating more gaps and so on.<sup>201</sup> The disadvantages of a principles-based system on the other hand centre on problems of ambiguity, which can undermine the system's intended protections and accountability. Principles are criticised for not providing certainty; for creating an unpredictable regulatory regime in which regulators can act retrospectively; for allowing firms to 'backslide', and get away with the minimum level of conduct possible; and thus for providing inadequate protection to consumers or others.<sup>202</sup>

Some of the other criticisms usually raised against Principles-based regimes are that they do not give the industry the comfort of knowing where it stands because the meaning of the Principles is not sufficiently certain.<sup>203</sup> Principles are usually expressed in many different sources. Each new piece of guidance express a new idea hence the overall sum of guidance is never assessed. Use of precedents to interpret principles may lead to development of a body of law which is complex and inaccessible.<sup>204</sup>

#### **4.4 Relevance and applicability of the two concepts to the regulation of financial services and particularly mobile banking in Kenya**

Although rules-based and principles-based regulations are very different in their approach, in many instances they can operate as a hybrid system, providing regulated entities with the benefits of both systems. In many established systems of regulation, high-level principles that can be applied flexibly to new situations and promote a best practice approach to regulation are complemented by detailed rules providing clarity.

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201 *Ibid.*

202 *Ibid.*

203 John Tiner ; Reviewing the Enforcement and Decision Making Manuals. Available at [http://www.lse.ac.uk/collections/law/projects/.../lfmr\\_13\\_blacketal\\_191to206.pdf](http://www.lse.ac.uk/collections/law/projects/.../lfmr_13_blacketal_191to206.pdf). (Accessed on 09/09/2011).

204 T. Murphy, - *The Oldest Social Science?* (Oxford: 1997). Available at <http://ukcatalogue.oup.com/product/9780198265597.doc> (accessed on 10/08/2011)



The UK applies a mixed proportionate and principles- based regulation in the AIM.<sup>205</sup> The UK sets broad principles with guidance on compliance and standards where necessary, measuring the value of regulatory intervention by assessing outcomes and milestones, the cost effectiveness of regulation, and the effectiveness of enforcement.<sup>206</sup>

In Kenya, the most practical way to address the issue of regulatory burden in mobile banking is to adopt proportionate regulation as an overarching regulatory principle. The consideration of principles -based regulation on a proportionate basis will facilitate the engagement of those that are affected, creating opportunities for their participation in policy discussion, guidance and tools for practice. Through these mixed regulation, there will be involvement by all mobile banking service providers in making important decisions in the mobile banking industry.<sup>207</sup> Expectations will then be clear, accessible and relevant, based on the outcomes sought that have been articulated as public policy goals.

Through the application of a proportionate regulation in mobile banking, the economic costs imposed on regulated mobile banking service providers will be outweighed against the benefits achieved by consumers.<sup>208</sup> As organisations, regulators by applying a proportionate regulation through adhering to the set principles, become efficient and well run, maximising the benefit they can deliver.<sup>209</sup> The regulators are then able to deliver desired outcomes in the least burdensome way, based on the established best practice for designing regulation. This results from imposing requirements only where necessary,

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205 Sridhar Arcot, Julia Black and Geoffrey Owen, From Local to Global, The Rise of AIM as a Stock Market for Growing Companies, September 2007, Available at <http://www.londonstockexchange.com/aim>. (Accessed on 01/09/2011).

206 The FSA mandate under the UK Financial Services and Markets Act 2000 is to promote efficient, orderly and fair markets; help retail consumers achieve a fair deal; and improve business capability and effectiveness. FSA Handbook .Available at <http://fsahandbook.info/FSA/html/handbook/Glossary/S> (accessed on 07/09/2011)

207 Julia Black, "Involving Consumers in Securities Regulation", in Canada Steps Up, Final Report of the IDA Task Force to Modernize Securities Legislation in Canada (2006), Volume 6 at 543, Available at [http://www.tfmsl.ca/docs/V6\(9\)%20Black.pdf](http://www.tfmsl.ca/docs/V6(9)%20Black.pdf). (Accessed on 28/08/2011)

208 Principles for Economic Regulation-April 2011 .Available at <http://www.bis.gov.uk> (accessed on 12/9/2011)

209 Ibid

considering alternatives to regulation and minimising the risk of unintended consequences.

When an effective and proportionate regulation is devised to regulate mobile banking transactions, such regulation allows not only innovation and consumer protection, but also provides legal certainty and the necessary confidence to invest in the long-term. In order to achieve effective and proportionate regulation there is need for close cooperation between mobile banking service provider and the regulator, which allows for a 'test and learn period for both the regulator and mobile banking service provider.'<sup>210</sup>

In particular the proportionate based regulation is applicable in the following instances to the mobile money transaction.

#### **4.4.1 In electronic contracts (Address AML/CFT)-**

The mobile banking industry in Kenya comprises a wide range of players such as M-pesa, Airtel money, YU cash and Orange money and it is therefore important that the Anti Money Laundering/ Combating the Financing of Terrorism (AML/CFT) manage the risks to financial system integrity to ensure easy access.<sup>211</sup>

International (AML-CFT) standards set by the Financial Action Task Force require that adequate customer due diligence (CDD) be undertaken on all new accounts and on single payment cash transactions. This process is part of Know Your Customer (KYC) procedures so that suspicious transactions can be identified. Thus, the mobile banking regulation should give effect to the standards set by FATF. There should be simplified KYC requirements for small value transactions only. A proportionate regulation should also leverage on KYC of other authorized institution in identifying and suppressing

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210 Mobile Money for the Unbanked Industry Position on Anti-Money Laundering (AML) and Combating of Financing of terrorism  
[http://mmublog.org/wpcontent/files\\_mf/finalmmupositionpaperamlcft090622forcamilo.pdf](http://mmublog.org/wpcontent/files_mf/finalmmupositionpaperamlcft090622forcamilo.pdf). (accessed on 19/8/11).

211 Eduardo Carbral Jimenez - Technological innovation and Phone banking-The BPS Experience(2011) available at  
[http://www.uncitral.org/pdf/english/colloquia/microfinance/cabral\\_jimenez.pdf](http://www.uncitral.org/pdf/english/colloquia/microfinance/cabral_jimenez.pdf) (accessed on 10/09/2011)

illegal activities .Therefore, a proportionate regulation should be developed which recognizes the use of technology in mobile banking services.<sup>212</sup>

The high KYC requirements for low risk transactions are disproportionate and a major barrier for consumer adoption. To promote mobile banking services with low transaction values and low transaction volumes the KYC requirements need to be modified in such a way that it is easy for customers to register and to use the service but still provides protection for the integrity of electronic payments. The mobile money service should be able to adjust the service levels to consumers based on their KYC profile. The AML/CFT rules should be able to reflect and adjust appropriately for the higher level of risk. This will be possible through reviewing the current "Know Your Customer" rules in order to see whether and how the Financial Institution providing a Mobile Banking service can accurately determine the identity of an existing customer.<sup>213</sup>

This issue applies across all types of bank accounts. In addition, transformational mobile banking models often involve the opening of accounts by agents outside of bank premises, known as remote account opening. This approach reduces the cost of origination considerably. Although there may be higher risks involved, international AML-CFT frameworks do not rule this out, proposing that a risk-based approach be followed.<sup>214</sup>

Mobile Banking services should fall under general AML laws. Whilst AML/CFT regulation should be technology-neutral, it should also be risk-based. Central Bank of Kenya (CBK) should recognize the development of technology in mobile banking service delivery and develop clear rules and guidelines to monitor mobile banking service

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212 CGAP/DFID Focus Note 43 "Regulating Transformational Branchless Banking: Mobile Phones and Other Technologies to Increase Financial Access <http://www.cgap.org/gm/document-1.9.9810/Branchless%2> (accessed on 24/8/11).

213 Frederick ("Rick") M. Joyce, Esq Mobile Banking Task Force Available at <http://www.venable.com/files/Publication/3188a11e-fbaa-45fe.../2010.pdf> (accessed on 12/9/2011)

214 Supra note 192.

providers. The sector regulators should improve inter-sectoral collaboration to effectively follow developments in converging industries. The mobile banking service providers should collaborate with the governing authorities to facilitate a safe, pro-business environment with self-regulation of the mobile banking industry.

#### **4.4.2 Consumer Protection**

Mobile banking brings in new consumers who are potentially vulnerable.<sup>215</sup> Customers should be adequately protected against fraud and abuse in the M-banking environment. Mobile banking requires appropriate regulation and supervision to ensure integrity of financial system and protection of vulnerable consumers. Consumer protection thus can be achieved by ensuring that all mobile banking service providers are properly regulated to uphold consumer protection and financial system integrity.<sup>216</sup>

There is need to provide consumers with appropriate information and increase their capacity to use mobile banking services to their best interest. Therefore, a proportionate regulation should be adopted which addresses issues of price transparency and fair treatment to all consumers.

There should be a mandatory mobile banking education by all institutions offering mobile banking services. This will be possible through developing such principles-based regulation that encourages wide-spread public education regarding the different services offered by mobile banking service providers.

#### **4.4.3 Competition**

Competition issues in retail payments, critical to branchless banking are growing more complex. This has been a major problem to consumers. Appropriate, proportionate

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215 CGAP/DFID Focus Note 43 “Regulating Transformational Branchless Banking: Mobile Phones and Other Technologies to Increase Financial Access <http://www.cgap.org/gm/document-1.9.9810/Branchless%2> (accessed on 24/8/11).

216 Nestor A. Espenilla, Jr. - Financial Regulation and Financial Inclusion(2010) Available at [http://siteresources.worldbank.org/financialsector/Resources/Session\\_10\\_Nestor\\_Espenilla.pdf](http://siteresources.worldbank.org/financialsector/Resources/Session_10_Nestor_Espenilla.pdf) (accessed on 24/8/11)

regulation is therefore essential in ensuring that consumers can continue to benefit from a competitive market.<sup>217</sup> Price discrimination has in some way affected most mobile banking consumers in a large way. The application of a proportionate regulation will help control competition in a multi-player environment that is both bank and nonbank institutions such as Mobile Banking institutions. Consumer redress mechanisms should also be well defined and the procedures to access such redress should be clear.<sup>218</sup> Competition in the market and consumer empowerment is usually the most efficient and effective way of delivering benefits for consumers. Where this is not possible, regulation needs to be a cost-effective alternative.

The most effective way to deal with issues arising from competition in the market is to impose a proportionate regime on a particular payment system.

#### **4.4.4 Inter-operability should be encouraged**

Interoperability ensures that mobile banking service providers' access payment platforms and those consumers are able to switch financial providers. Proportionate regulation is necessary to avoid stifling innovation and to allow the market to grow.

#### **4.4.5 Account opening procedures**

Customer due diligence procedures for account opening should be risk-based, and not unduly prejudice remote account openings by small customers. Clearly, a risk-based approach to CDD has the potential to be sufficiently flexible. However, if national regulators give no guidance on what constitutes acceptable risk-based approaches, banks may be left vulnerable to subsequent reprisal; and this may encourage undue conservatism.

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<sup>217</sup> Ibid

<sup>218</sup> Timothy Lyman-Framing the policy and regulation issues (2009). Available at <http://www.cgap.org> (accessed on 5/09/2011)

#### 4.4.6 Retail agents

Customers should be able at least to make deposits and withdraw cash through agents and remote points outside of bank branches. There should be clear delineation between deposit-taking transactions and receipt of funds for fund transfer purposes and consequently regulated proportionately. Adequate provision must be made for the issuance of e-money by appropriately capitalized and supervised entities which are not necessarily banks.<sup>219</sup>

#### 4.4.7 Safety and Soundness

The deposits should be well protected by the governing regulation to ensure safety of the money invested by a mobile banking service provider. The regulation should however accommodate the low-income persons by not imposing undue regulatory burden to such persons. A proportionate regulation if adopted will help limit safety and soundness supervision to entities with deposit taking activities.<sup>220</sup> The regulation will also help in distinguishing deposit taking activities from fund transfer activities.

The proportionate regulation can be implemented by ensuring adequate supervisor capacity through training mobile banking service providers and through close coordination with other financial regulation.<sup>221</sup> Sound internal governance arrangements are an essential pre-condition to complement proportionate regulation and to maintain order and discipline in potentially large ecosystems.<sup>222</sup>

### 4.5 Conclusion

It is only a matter of time before the mobile money transaction is brought under the full regulatory umbrella of Kenya's laws and it is likely to be regulated as an electronic money issuer. As such we should develop a mobile banking regulation that is effective as

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<sup>219</sup> Ibid.

<sup>220</sup> Supra note 212.

<sup>221</sup> CGAP/DFID Focus Note 43 "Regulating Transformational Branchless Banking: Mobile Phones and Other Technologies to Increase Financial Access". Available at <http://www.cgap.org/gm/document-1.9.9810/Branchless%2> (accessed on 24/8/11)

<sup>222</sup> Pia Bernadette Roman, "Mobile Phone/ Branchless Banking and Financial Inclusion in the Philippines" available at <http://www.idlo.int/MF/Documents/Publications/43E.pdf> (accessed on 23/8/20110)

enablement in the policy and regulatory sector means a move towards greater certainty and greater openness.<sup>223</sup> It is important therefore that a proportionate regulation and principle based regulation should be adopted which is accompanied by consistent and rigorous compliance and enforcement, to ensure integrity of the market.<sup>224</sup>

Owing to the that the mobile money banking is still undergoing great innovation and dynamism, it is important as stated out in this chapter that Kenya develops a proportionate based regulation. This will make the stakeholders to wholesomely enjoy the benefits accruing from the same without compromising on the quality. Indeed it was noted that Kenya has an excellent opportunity to establish a regulatory environment that will support the development of a variety of branchless banking models.<sup>225</sup>

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223 Ibid

224 Supra note 222.

225 Regulations on Branchless Banking in Kenya - CGAP's available at <http://www.cgap.org/.../Kenya-Notes-On-Regulation-Branchless-Banking-2007.p>(accessed on 12/06/2011)

## **5 CHAPTER FIVE**

### **CONCLUSIONS AND RECOMMENDATIONS**

#### **5.1 Conclusions**

As has been discussed in the previous chapters, the potential of the mobile phone money transfer is enormous. The mobile phone infrastructure itself has undergone a great revolution. The arrival of the fiber cable network is even expected to increase the capacity of the mobile phone infrastructure.

Since the introduction of the mobile banking services in Kenya the country has experienced tremendous growth and dynamism. Mobile payment platforms involve not only funds transfers but also payment for retail goods and services. Mobile payment services are specifically used to top-up mobile phone credits, airtime transfers between mobile phones and corporate bill payments for instance water and electricity.

This thesis has observed that Kenya has no basic law to regulate the mobile money infrastructure and if the trend continues then the country might be faced with great dangers such as money laundering, default in payment and increased electronic theft through phone hacking. All these pose great danger to the economy. Analysts are already questioning the strictness of the existing laws and regulations towards prevention of any possible illicit activity such as money laundering and terrorism financing that might engulf the mushrooming mobile phone-based transactions.

It has further been observed that the growth and dynamism of the mobile money infrastructure depends on the type and kind of regulatory regime. Chapter one of this thesis defined the scope of the research in terms of the problem of the study, the hypothesis, the justification and the methodology employed in the research. The study of the various literature materials helped in identifying the researched area of mobile money banking which informed the discussion in subsequent Chapters in terms of the existing and unexplored gaps which needed to be addressed. Chapter two discussed the various



regulatory regimes applicable to mobile money banking. In this Chapter, it was found and articulated that the various pieces of legislation are inadequate, overlapping and tend to be weak in their enforcement. There is no clear recognition of the mobile money banking in form of its current innovation status. Chapter three discussed the emergent issues in regulation of Mobile money banking in Kenya. In particular it discussed the problems posed with this innovative step to the consumer and the other stakeholders. The issue of the acceptance and recognition of the transaction process in terms of electronic signature, transaction documentation, confidentiality and the network coverage were discussed as some of the issues that are not yet recognized and catered for under the existing pieces of legislation hence prompting this study. The Chapter further discussed the vulnerability of the consumers in terms of illiteracy, access and agency relationship hence its call for regulation. As such it was proposed in Chapter Four that a proportionate regulatory regime would be appropriate because it would give room for that growth dynamism within the regulated context. The need for regulation which is the focus of this study is not only because of the necessity to deal with the dangers but also to legalise and facilitate the mobile money banking.

In conclusion this research validates the view that the Kenyan mobile banking sector presents a delightful outlook of exploitation in terms of the benefits to the users and the economy at large. Depending on the nature of activities and requisite levels of expediency in the usage of M-banking there is need for effective regulatory policy for mobile banking in Kenya. The conclusion arrived at is that application of the concept of proportionate regulation in formulation of the regulatory framework is necessary for effective regulation of mobile banking in Kenya.

## **5.2 Recommendations**

The recommendations in this chapter are geared towards securing the opportunity of growth and innovation of the mobile banking in Kenya. I propose a five tier recommendation. The need for a survey, the need for a stakeholders review forum, the need for continuous education, the need for research and the need for a regulatory framework.

### 5.2.1 Survey

Mobile money banking is a new and fast growing concept with various diverse impacts not only to the economy but also to the end users at large. Therefore in order to properly determine, the concept and the degree of the regulatory framework, it is imperative that a survey be done by experts. The survey should capture the usage of the technology, the benefits accruing, and the dangers posed.

Increasingly, policymakers and regulators recognize the need to develop evidence-based approaches to identify and promote drivers for financial inclusion. Creating appropriate data sets that accurately measure the state of financial inclusion can serve to “focus the attention of policymakers and allow them to track and evaluate efforts to broaden access”.<sup>226</sup>

There is also a strong need for regulators and the private sector to better understand the needs and behaviors of individuals. The current lack of available sub-scriber data raises concern. Due in part to the fact that early stages of mobile financial services development, consensus on which metrics to monitor and manage has not yet been achieved.

It would therefore be in order for consultancy experts to be engaged to carry out the mandate of survey. There should be a clear mandate and time frame given in order to ensure continuity. The results of the survey should later be appraised by all stakeholders to ensure acceptance and ownership.

### 5.2.2 Stakeholders forum

There is need for the government to invite a much more representative stakeholder’s workshop bringing together all the players in the mobile money transfer industry to air their views on the way forward. The import of this will be twofold; to make sure that the

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<sup>226</sup> Alliance for Financial Inclusion 2010. Financial inclusion measurement □ or regulators—Survey design and implementation.

regulatory framework proposed is not only owned and informed but to also make it more acceptable to all.

The recommendations of the workshop should ensure that there is an ever collaborating forum within which all stakeholders at their convenient intervals meet to discuss the issues affecting the industry. Through this there will be an informed decision on how the industry would move forward.

### **5.2.3 Proposed regulatory framework**

Under this heading I propose a more proportionate regulatory framework covering the following areas; the objectives, the licensing, the regulatory authority, the capitalization requirements, corporate governance, financial reporting and disclosure requirements and miscellaneous provisions dealing with offences. Once enacted, the law would boost mobile commerce and also ensure security. The proposed regulations should contain provisions that would help enforce compliance with the lucrative mobile banking platforms in the country. These issues of compliance are best dealt with under the proportionate based regulation based on the fact that the innovative step in mobile money banking is recent and is yet to undergo full discovery in terms of dynamism and innovation. Of course, the proportionate based regulation would capture the specific services/products to be controlled in a certain way, what would be different however, would be the flexibility in enforcement in terms of duration and the full compliance requirements.

#### **5.2.3.1 Objectives**

The objectives of the proposed regulations should lay emphasis on protecting consumers, reduce the risk of disruption resulting from adverse trading conditions for banks causing multiple or major bank failures, reduce the risk of the platform being used for criminal purposes, for example laundering the proceeds of crime, and ensure innovation and protection of the established principle of confidentiality. These are the objectives that will guide the various parts of the regulation discussed hereunder.

### **5.2.3.2 Licensing**

Licensing requirements ensures compliance with the set standards and measures. It is a precautionary tool which ensures the satisfaction and stability of the platform rather than deal with the problem that has occurred and caused effects to the end users. Under the licensing I propose that there should be a provision that deals with the application process accompanied by relevant documents before granting a license.

The license in this case should be in two parts. There is the license due to the agents and the license due to the service provider. I propose that a license due to the agent be granted by the service provider who should later forward the beneficiaries to the Regulatory Authority which is the Central Bank of Kenya. The license due to the service provider should be granted by the Central Bank of Kenya.

As a tool to monitor the progress of the industry in terms of the compliance with the requirements there should be a provision that the license be renewed on yearly basis. This should be after doing an assessment survey by the regulators in terms of the technical capacity and the financial ability.

In order to make the licencing requirement be proportionate to the risks I propose that requirements be flexible. For example, licensing will depend on issues such as the capital liquidity, the reporting system, the disclosures which should be flexible in terms of amount and the duration respectively.

### **5.2.3.3 The Regulatory Authority**

The dilemma that props up under this is whether to have a unified regulatory authority dealing with both the regulation of financial transaction and communication infrastructure. In Kenya basically, the Communication Commission of Kenya was meant to deal with the communication infrastructure while the fiscal and monetary issues are meant to be dealt with by the Central Bank of Kenya.

Therefore, in order to enhance expertise and specialisation, I propose that there be two regulatory authorities that is the Central Bank of Kenya and the Communications Commission of Kenya. There should be clarity on the identity of the regulating authorities and the scope of duties/powers in order to avoid conflicts. The financial transaction should be left under the control of Central Bank of Kenya because of its overall mandate in maintaining fiscal and monetary policies of Kenya.<sup>227</sup> The two authorities will ensure that they exercise their supervisory role on a well-reasoned and flexible approach without unnecessarily being bogged buy laid down rules and regulations which might hinder innovation hence unbalanced growth.

#### **5.2.3.4 Privacy and Data Protection**

Right to information privacy is a foundational principle of privacy and constitutional law<sup>228</sup>. Personal privacy and data security are key emergent issues which are engendering trust in mobile phone transactions. There should therefore be a regulated collection, storage and use of personal information in mobile money transactions.

I propose that there should be a regulation that captures the basic Fair Information Practice Principles including Notice/Awareness, Choice/Consent, Purpose specification, Access/Participation, Integrity/Security, and Enforcement/redress. The regulation in this case should deal with the functioning of the data protection and privacy in order to allow more innovation.

#### **5.2.3.5 Corporate Governance**

Corporate governance has been attracting a great deal of public interest because of its importance for the economic growth, stability and welfare of society. It represents the relationship among stakeholders that is used to determine and control the strategic direction and performance of organizations. Corporate governance therefore can be defined as the system by which business corporations are directed and controlled.<sup>229</sup>

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227 Section 4 of the Central Bank of Kenya Act, Cap491 of the Laws of Kenya.

228 Article 31 of the Constitution of Kenya, 2010.

229 Definition of OECD (Organisation for Economic Corporation and Development, 1999.)

Corporate governance requirements are intended to encourage corporate institutions to be well managed, and is an indirect way of achieving the objectives of the corporate institutions for the benefit of the various stakeholders including the shareholders, the government, the customers and the public at large in form of economic stability and job creation. Corporate governance is critical to business integrity and to maintaining investors' trust in the entity.

In order to promote the spirit of proportionate regulation, there should be requirements that firms show their commitment to corporate governance which incorporates the following: the management, auditing processes which provides for the company's risk management process and adequacy of internal controls; and the financial reporting and approval of the annual financial reports.

#### **5.2.3.6 Security**

Security of financial transactions, being executed from some remote location and transmission of financial information over the air, are the most complicated challenges that need to be addressed jointly by mobile application developers, wireless network service providers and the banks' IT departments.

The following aspects need to be addressed to offer a secure infrastructure for financial transactions over wireless network:

##### **5.2.3.6.1 Physical Security**

The regulatory authority should ensure that it grants licenses to business entities that show the establishment of the business in a more secure area. The business model should demonstrate the arrangements designed to be in place to ensure the physical protection of not only the mobile money infrastructure but also the physical person.

#### **5.2.3.6.2 Authentication**

There should be some form of security of any client application running on the mobile phone device. In case the device is stolen, the hacker should require at least an ID/Password to access the application. There should also be authentication of the device with the service provider before initiating a transaction. This would ensure that unauthorized devices are not connected to perform financial transactions. The authentication in this case will act as electronic signature which should be recognised under the proposed regulation.

#### **5.2.3.6.3 Data Encryption**

There should be encryption of data being transmitted over the air and the data that should be stored in the device for later / off-line analysis by the customer. The import of this will be to ensure that the consumer has an opportunity and platform to verify the transaction made and also act as evidence of such transaction.

#### **5.2.3.6.4 Personalization**

In order to make the mobile money transfer more consumer friendly and to ensure proper understanding of the transaction made it would be expected from the mobile application to support personalization such as Preferred Language, Date / Time format, Amount format, Default transactions, Standard Beneficiary list and Alerts.

#### **5.2.3.7 Capital requirements**

The capital requirement sets a framework on how financial institutions must handle their capital in relation to their assets. Internationally, the Bank for International Settlements' Basel Committee on Banking Supervision influences each country's capital requirements. In 1988, the Committee decided to introduce a capital measurement system commonly referred to as the Basel Capital Accords<sup>230</sup>. The latest capital adequacy framework is

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230 Adopted by the Central bank of Kenya in December, 2008. Available on [www.bis.org](http://www.bis.org).

commonly known as Basel III. This updated framework is intended to be more risk sensitive than the original one, but is also a lot more complex.

To ensure that the disadvantaged poor are in a position to access the mobile money payment service I propose that a reasonable capital requirement to the tune of about Kshs. 100,000 be put for agents<sup>231</sup>. For the service provider I propose, because of the amount of money under the transaction, that the figure be equivalent to that offered by the banks.

#### **5.2.3.8 Financial Reporting and Disclosure**

The provision on this will help the mobile banking industry in ensuring transparency and accountability necessary for the stability of the economy and the protection of the users. The appropriate reporting channels should be put in place and that the regulator will have access to the necessary levers. The scheme should be fully auditable and controls should be put in place. With this the scheme would be properly secure and presents little risk to customers.

Because the two tier system in the operation of the mobile banking system, there should be a well-coordinated approach. The agents who should be equipped with basic accounting and financial skills and should report to the operating firm who in turn should report and disclose to the regulatory authority.

#### **5.2.4 Education**

Based on the fact that the mobile banking is still undergoing revolution, innovation and growth, it is important for the stakeholders supervised by the two proposed regulatory authorities to insist on continuous education on the technology usage. This will not only lead to understanding of the whole concept but make sure that it is owned and appreciated.

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<sup>231</sup> This is the current requirement for agents operating M-Pesa service run by Safaricom. In Kenya, where applicable regulation is currently being drafted, Safaricom maintains fund liquidity by placing collected cash in prudentially regulated banks pursuant to a prior agreement with the Central Bank of Kenya (CGAP 2010).



### **5.2.5 Research fund**

In order to aid in innovation and growth of the mobile money banking, there should be established a fund contributed to from the percentage of the proceeds of the mobile banking. This will ensure that there is sponsorship on research. It is hoped that with this kind of research innovative products on the usage and benefits of the mobile money banking would come up.

### **5.2.6 Implementation**

From the above findings and recommendations, it is hoped that the stakeholders in the mobile money banking industry would be helped a great deal in steering the industry to greater heights in terms of innovation and dynamism. The findings of this research and the recommendations together with other research work of similar nature if appraised and implemented would go a long way in aiding economic growth through the access and flow of money. This is in addition to the employment opportunities that come with the service in terms of the agents who are employed. Indeed the potential of mobile money banking as has been observed is enormous. It is therefore up to the stakeholders including the regulatory authorities proposed to nurture and make the concept work better without rivalry and unnecessary competition among the service providers.

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#### **Bills**

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#### **6.4 Regulations**

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