FINANCIAL CONGLOMERATES IN KENYA: A REGULATORY RESPONSE

RESEARCH PAPER

BY

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G62/82905/2015

This dissertation is submitted in partial fulfillment of the requirements for the award of the degree of Master of Laws (LL M) of the School of Law University of Nairobi

MAY 2017

DEDICATION

To my Dad and Mum

You took a huge step of faith to invest in this journey,

Your gesture of love will leave indelible marks in the highway of history,

May God prolong your life to enjoy the fruits of your labour,

May your path be like the morning sun, shining ever brighter,

May God grant you the sunset of the righteous,

May the rays of your sunset bring healing and peace to your progeny- Selah.

DECLARATION

I, the undersigned, declare that this is my original work and has not been submitted to any other college, institution or university for academic credit.

Student: ___________________________________

Signature: ___________________________________ Date:

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

Supervisor:___________________________________

Signature:____________________________________ Date:

ACKNOWLEDGMENTS

Oh Lord, my hands and mind are ever toiling at your command to fulfill your glory. You started it all and you have done it again. I needed strength and provision for the journey and you exceeded my expectations. Through it all I have learnt to trust in God, I have learnt to put my faith upon His word. I give all the glory to my Lord Jesus Christ, for whom we exist and have our being. Selah

William Arthur Ward wisely said that "Feeling gratitude and not expressing it is like wrapping a present and not giving it." Giving thanks is the highest form of thought and I cannot claim exiguity of gratitude at the conclusion of this monumental task. I am indebted to many beyond measure.

I am indebted to my supervisor, Mr. Mweseli, whose patience, positive criticism and valuable guidance have been critical in coming up with this masterpiece. The class lectures by Dr. David Gachuki who taught us 'Banking and Financial Services law' came in handy in gathering ideas for this research. The words of Dr. Njaramba Gichuki were also immensely helpful in putting this research to perspective.

My family, friends and mentors have been continually supportive and caring. Your kind words and positive gestures meant a lot. My parents and siblings believed in me. Mike Njeru, an ever available mentor told me that I could do it. The energetic Benjamin Nzulu spurred me to action in every stage. George Thuo has been a generous IT consultant. To everyone who has made this possible I am eternally grateful.

ABBREVIATIONS

CBK	Central Bank of Kenya
CEO	Chief Executive Officer
CMA	Capital Markets Authority
CMMP	Capital Markets Master Plan
FSC	Financial Services Council
IRA	Insurance Regulatory Authority
RBA	Retirement Benefits Authority
SACCO	Savings and Credit Cooperative
SASRA	Sacco Society Regulatory Authority
UK	United Kingdom
USA	United States of America
FSB	Financial Services Board
SACCO	Savings and Credit Cooperative Society
MoU	Memorandum of Understanding
FSAB	Financial Services Authority Bill
CoK	Constitution of Kenya

TABLE OF FIGURES

TABLE OF STATUTES

Legislation in Kenya

Constitution of Kenya 2010

Central Bank of Kenya Act Chapter 491 Laws of Kenya

Banking Act Chapter 488 Laws of Kenya

Banking (Amendment) Act No. 25 of 2016

Capital Markets Act Chapter 485A Laws of Kenya

Insurance Act Chapter 487 Laws of Kenya

Retirement Benefits Act Chapter 197 Laws of Kenya

Sacco Societies Act No. 14 of 2008

The Central Depositories Act No 4 of 2000

Competition Act No 12 of 2010

Companies Act No. 17 of 2015

Bills- Kenya

Financial Services Authority Bill 2016

Central Bank of Kenya Bill 2015

Legislation in South Africa

Currency and Banking Act No. 31 of 1920

South African Reserve Bank Act No 90 of 1989

Legislation in Estonia

Financial Supervision Authority Act (RT I 2001, 48, 267) 2011

Legislation in the United States of America

Banking Act 1933 (12 U.S.C. 227)

Dodd-Frank Wall Street Reform and Consumer Protection Act 2010 (Pub.L. 111–203, H.R. 4173)

TABLE OF CONTENTS

ABSTRACT

This research seeks to find out the most suitable regulatory approach for the regulation of financial conglomerates. Financial conglomerates are groups of companies that offer financial services in more than one financial services sector. Notably, the structure of such institutions creates new relationships and risks which have not been taken into account in the current regulatory framework. In proposing the necessary reforms, this research has analyzed the use of an integrated regulator, cooperation of regulators, the segregation of financial activities and the adoption of information barriers commonly known as Chinese Walls. The discussion proceeds in chapter two by examining the current regulatory framework in Kenya, while considering its response to the rise of financial conglomerates.

Chapter three examines the research question by assessing the various approaches that can be adopted in the regulation of financial conglomerates. Using examples from Estonia, South Africa and United States, this chapter further exemplifies best practices in the regulation of financial conglomerates as structured in other jurisdictions. Chapter four discusses the nature and regulation of financial conglomerates in detail while pointing out the inherent risks. Finally, chapter five makes conclusions and recommendations on the most suitable approaches and policy issues to be considered in the regulation of financial conglomerates.

CHAPTER ONE

INTRODUCTION

1.1 Background to the problem

Innovation and market developments in the financial sector have led to a rise of financial service providers that offer services outside the scope of their primary sectors. Such services are offered by institutions commonly known as financial conglomerates.[1] The organizational structure of such institutions is usually in the form of groups of companies. Such structures have led to the rise of new risks which are not accommodated under the existing laws.[2] It is instructive to note that these new forms of corporate structures have increased in Kenya and therefore there is need for requisite regulatory reforms to align the law with market developments.[3]

It is arguable whether the structure of the current financial regulatory framework in Kenya is adequate. It is characterized by multiple regulators yet financial products have become increasingly integrated. The structure does not accommodate financial conglomerates[4] owing to the nature of products they offer and the accompanying organizational structures. Particularly, the diversified regulators are unable to provide group-wide risk management for effective supervision

[1] James A Fanto, 'Breaking up Is Hard to Do: Should Financial Conglomerates Be Dismantled' (2010) 79 University of Cincinnati Law Review 553.
[2] George A Walker, 'The Law of Financial Conglomerates: The Next Generation' (1996) 30 The International Lawyer 57.
[3] Kenya has witnessed an upsurge of financial institutions diversifying into other sectors not traditionally meant for them. The response of the regulators has not been satisfactory and lacks a legal framework. The regulators first sought to have a memorandum of understanding among them so as to facilitate proper regulation of the upcoming market developments in the financial sector. However, this has been criticized for lacking legal backing.
[4] The term 'financial conglomerate' in this context is used to refer to a financial service provider offering financial services in more than one sector. This research adopts the definition used by Basel Committee in its principles for supervision of financial conglomerates. The Basel Committee has defined a financial conglomerate as "any group of companies under common control or dominant influence, including any financial holding company, which conducts material financial activities in at least two of the regulated banking, securities or insurance sectors." (Basel Committee Principles for Supervision of Financial Conglomerates, 2012). See also Xavier Freixas, Gyöngyi Lóránth and Alan D Morrison, 'Regulating Financial Conglomerates' (2007) 16 Journal of Financial Intermediation 479.

of financial conglomerates.[5] This paints a picture of the current regulation of financial services in Kenya.

The regulation of financial conglomerates has been a major concern, not only at the national level but also at the international level.[6] This has created the need for financial regulatory reforms in many countries and several measures have been adopted including the integration of regulators.[7] Many of the countries that have opted for integration have been motivated by the rise of financial conglomerates.[8] These trends and global developments have also impacted on the Kenya's financial sector regulatory framework. Njuguna Ndung'u[9] acknowledged that there is need for the current regulators to cooperate to achieve effective regulation of financial conglomerates.[10] The Report of the Presidential Taskforce on Parastatal Reforms has also identified the need to consolidate the current financial sector regulators in response to market developments, particularly the rise of financial conglomerates.[11]

There are several ways of responding to the challenges posed by financial conglomerates. Integration of financial regulators is a common approach which has been used by several countries. Other mechanisms include restriction of the activities of financial institutions and the use of

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[5] Many scholars in financial regulation agree that it is difficult to achieve group-wide risk management when the regulators are many. The success of risk management where there are multiple regulators relies on proper cooperation mechanisms among them. See Kenneth Kaoma Mwenda, *Legal Aspects of Financial Services Regulation and the Concept of a Unified Regulator* (World Bank Publications 2006).

[6] 'The Supervision of Financial Conglomerates' (A Report by the Tripartite Group of bank, securities and Insurance Regulators 1995) <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD47.pdf> accessed 28 November 2015.

[7] Kenneth Kaoma Mwenda, *Legal Aspects of Financial Services Regulation and the Concept of a Unified Regulator* (World Bank Publications 2006) 42.

[8] Mwenda, *Legal Aspects of Financial Services Regulation and the Concept of a Unified Regulator* (n 7).

[9] He spoke in his capacity as the Governor to the Central Bank of Kenya in the year 2009.

[10] Ndungu Njuguna, 'Financial Sector Performance in Kenya' (Silver Jubiliee Celebrations for Family Bank Limited, Nairobi, 22 June 2009) <http://www.bis.org/review/r090626c.pdf> accessed 27 November 2015.

[11] 'Report of the Presidential Taskforce on Parastatal Reforms' (Office of the President 2013) 87.

Chinese walls to reduce certain risks. Kenya's regulatory framework has not restricted financial service providers from diversification of their products. However, there are restrictions on the areas that financial institutions can invest in. For instance banks are only allowed to offer other services only as distribution channels.[12] This has led to diversification of financial services with banks venturing in other areas outside core banking functions. The common practice has been to provide these other services through subsidiaries held by a group holding company.[13]

The rise of group holding companies in the financial sector is specially triggered by the need for diversification as financial service providers explore ways of remaining competitive in a changing market. In fact, this trend is likely to increase as banks seek alternative sources of income following the capping of bank interest rates by the Banking (Amendment) Act 2016.[14] However, this practice is not well covered in the current regulatory framework. There is no adequate regulation at the group level and this exposes the sector to systemic risks. For instance while the Banking Act restricts investments that can be undertaken by commercial banks, the respective holding companies are not subject to bank prudential requirements and can carry out such investments. This calls for changes in the law in order to respond effectively to the changing financial landscape.

1.2 Statement of the problem

The current fragmented financial regulatory framework is inadequate for the regulation of financial conglomerates[15] thus posing a risk to the stability the financial system. Diversification has

[12] Banking Act, s 12. It restricts trading and investments of commercial banks.
[13] Several financial service providers in Kenya have diversified through incorporation of subsidiaries. Examples include Equity Group Holdings Limited, I&M Holdings Limited and CIC Group.
[14] This Act reigned on the rising bank interest rates effectively reducing the income attributable to banks. While the small banks are pursuing cost cutting measures, the large banks are likely to seek diversification into other areas as the law allows.
[15] Jacob Gakeri, 'Financial Services Regulatory Modernization in East Africa: The Search for a New Paradigm for Kenya' (2011) Vol. 1 163.

increased in the financial sector, leading to blurring of the traditional differences that have existed to segregate distinct services such as banking and insurance.[16] This has given rise to new forms of organizational structures which pose new risks to the financial system. However, there have been dismal reforms in aligning the financial supervisory framework with the rise of financial conglomerates and other market developments. While financial products have continued to evolve and develop, the regulatory system has largely remained unchanged. This has created the need to find out the ways of reforming financial regulation in Kenya to accommodate the new changes. It is needful that the regulatory system mirrors the nature of financial products in the market.

1.3 Objectives of the research

1.3.1 Main objective

To establish the most efficient regulatory reforms in response to financial conglomerates in Kenya

1.3.2 Specific objectives:

1. To establish the adequacy of the current financial regulatory framework in Kenya.
2. To analyze the regulatory issues and the nature of financial conglomerates in Kenya.
3. To assess the most appropriate regulatory models of addressing challenges relating to financial conglomerates in Kenya.
4. To find out international best practices in the regulation of financial conglomerates.

1.4 Hypothesis

1. The current financial regulatory framework in Kenya is not adequate to accommodate the emergence of financial conglomerates.

[16] Nzomo Mutuku, 'Case for Consolidated Financial Sector Regulator' (Retirement benefits Authority 2008) <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1837354> accessed 28 November 2015.

2. The organizational and operational structure of financial conglomerates poses special risks and regulatory challenges.
3. An integrated financial services regulator is the most efficient regulatory response for the regulation of financial conglomerates.
4. Kenyan can borrow considerably from the international experience on financial regulatory reforms.

1.5 Research questions

1. What is the effectiveness of restricting the activities of financial conglomerates?
2. What risks are posed by the organizational and operational structure of financial conglomerates?
3. What is the viability of an integrated regulator in regulating financial conglomerates in Kenya?
4. What lessons can Kenya learn from international experience on financial regulatory reforms?

1.6 Research methodology

This research is reform oriented and doctrinal. It sought to analyze the adequacy of the existing financial regulatory framework in Kenya and establish the requisite reforms. The study was desk-based since the relevant sources were readily accessible from online sources, reports of relevant government agencies, newspapers and library materials. It involved an analysis of financial sector laws, relevant reports and scholarly writings on financial regulation, particularly with reference to financial conglomerates. The financial sector laws are contained in various Acts of Parliament and subsidiary regulations under those laws. These laws were accessed from the online sources through the Kenya Law Reports website and websites of the respective regulatory agencies.

Importantly, the researcher analyzed the current financial sector primary and secondary laws as applied in Kenya. The laws covering the regulation of the financial sector in Kenya were examined with a view to identifying any loopholes, taking into account the rise of financial conglomerates. This analysis also covered the proposals that have been put forth by the various stakeholders and the current regulators. The proposed legislation, Financial Services Authority Bill, 2016 was also critically examined to determine its adequacy in the regulation of financial conglomerates.

This research also involved borrowing of best practices from successful jurisdictions in the regulation of financial conglomerates. This involved a review of the regulatory frameworks underpinning financial regulation in South Africa, Estonia and the USA. These countries were picked for benchmarking on international practices because they have applied the measures the research sought to examine and they can be used to establish best practices in successful regulation. Even though these countries are far developed economically, they are good illustrations of how various regulatory models can used. Estonia was picked to illustrate the working of an integrated regulatory approach, South Africa is undergoing regulatory reforms to adopt a twin peaked model while USA has widely fragmented regulatory framework but has exemplified the working of alternative approaches. After considering the workings of various approaches, the findings formed the basis for further recommendations on the best regulatory framework to apply in Kenya in response to financial conglomerates.

1.6 Conceptual Framework

The term conglomerate refers to a business organizational structure that offers services in more than one line of production.[17] The term connotes a large multinational institution but it can be used

[17] Walker (n 2).

to bring out different meanings. It is not a legal term and its definition varies depending on the circumstances of its use. Notably, it is also characterized by various categorizations and a uniform definition of the term is therefore lacking.[18]

The Basel Committee, in a report on Supervision of Financial Conglomerates defines the term financial conglomerate as:

> "any group of companies under common control whose exclusive or predominant activities consist of providing significant services in at least two different financial sectors (banking, securities, insurance)."[19]

While a variety of definitions of the term conglomerate have been suggested, this research will use the definition couched by the Basel Committee. A financial conglomerate in Kenya is therefore a financial service provider operating as a group of companies under a common control offering services regulated in more than one financial sector.[20] These are services that have been traditionally separated by law for a long time such that functions like banking could not be provided together with insurance or securities. However, many jurisdictions have embraced the idea of financial institutions diversifying their services into other sectors.[21]

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[18] ibid; Donato Masciandaro, *Handbook of Central Banking and Financial Authorities in Europe: New Architectures in the Supervision of Financial Markets* (Edward Elgar Publishing 2005).

[19] 'The Supervision of Financial Conglomerates' (n 6).

[20] This definition operationalizes the term financial conglomerate. When applied in the Kenyan context, this term would capture banks that have embraced multifunctional banking by way of incorporating subsidiaries to offer services in other areas which do not form the core activity of the institution. Examples of such institutions in Kenya include cfc Stanbic Bank, KCB Group of Companies, Equity Group Limited and Barclays Bank. See Silvia Fazio, *The Harmonization of International Commercial Law* (Kluwer Law International 2007); Basel Committee on Banking Supervision, International Organization of Securities Commissions and International Association of Insurance Supervisors (eds), *Principles for the Supervision of Financial Conglomerates: [Final Report]* (Sept 2012, Bank for Internat Settlements 2012)., 'Principles for the Supervision of Financial Conglomerates - Final Report - joint29.pdf' <http://www.bis.org/publ/joint29.pdf> accessed 19 October 2015.

[21] Walker (n 2) 58.

The Financial Services Authority Bill 2016 defines a financial conglomerate as a group of companies designated as such for purposes of prudential supervision.[22] This is a group that usually takes the structure of a holding company operating subsidiaries in more than one financial services sector. This definition is also subject to the provisions of the Companies Act[23] on what constitutes a group of companies.[24]

Financial conglomerates can also be categorized in various ways[25] based on differences in their structures but the basis is that they all deal with financial services in more than one financial sector. The structures of financial conglomerates are canvassed in more detail in chapter four.

Diagrammatic illustration:

FINANCIAL CONGLOMERATE FINANCIAL REGULATION

Figure 1 Financial conglomerate structure

Source: Researcher

The above diagram illustrates the relationship between the financial conglomerate and the regulatory framework, highlighting some of the responses employed in the regulatory framework.

1.7 Theoretical Framework

This research adopts the public interest theory in analyzing the regulation of financial conglomerates. Public interest theory is further compared and contrasted with capture theory

[22] Financial Services Authority Bill 2016(FSAB 2016), s 2.
[23] No. 17 of 2015.
[24] FSAB 2016, s 2.
[25] Masciandaro (n 18) 327.

before a conclusion is made on the adoption of the public interest theory. This is to emphasize the suitability of public interest theory over capture theory.

Public interest theory has a long history, drawing from the rise of government intervention in public affairs. It is the theory according to which the government seeks the correction of market failures.[26] Its main basis is the promotion of public interest, whereby public interest is viewed as the key to effective regulation. Notably, governments and government actors perform their regulatory roles in promotion of public interest.[27] Nevertheless, this objective has not escaped the attention of critics; some of whom have railed about the ambiguities of public interest theory, citing its lack of analytical precision.[28]

Public interest theory supports the tenets of a democratic society whereby the elected leaders are supposed to act as the guardians of public interest.[29] Passing laws that benefit the general public is part of this role. Relatedly, when these leaders come up with administrative and regulatory agencies, the underlying objective is the promotion of public interest. However, this is not always the case. It is naïve and idealistic since in practice regulators serve many interests, mostly the interests of other third parties and not necessarily public interest. This forms a basis for capture theory.

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[26] George L Priest, 'The Origins of Utility Regulation and the "Theories of Regulation" Debate' (1993) 36 The Journal of Law & Economics 289; Richard A Posner, 'Theories of Economic Regulation' (1974) 5 The Bell Journal of Economics and Management Science 335.
[27] Barry Bozeman, *Public Values and Interest* (1st edn, Georgetown University Press 2007).
[28] ibid.
[29] Priest (n 26).

Capture theory expresses skepticism with the goals of politicians, seeing them as being incapable of being trusted. [30] The concept of capture is central in regulatory theories. It refers to a situation whereby a "particular sector of the industry has acquired persistent influence disproportionate to the balance of interests envisaged when the regulatory system was envisaged."[31] Accordingly, the regulators appear 'captured' by special interested parties, despite being established to promote public interest.[32]

Capture theory comes up as a critique of public interest theory, postulating that regulators do not always act in the interests of the public.[33] Although public interest theory views the roles of regulation as the promotion of public interest in a democratic society, capture theory can also arise in a democratic society. In such a society, the elected legislators mostly act to protect their political power. Therefore regulations formulated by such legislators ends up favouring certain special interests at the expense of public interest.[34]

Even though public interest theory has been criticized, it still remains relevant in supporting the need for regulatory reforms. It explains what governments should and ought to do in a democratic society.[35] According to this theory, a regulatory body is considered to represent the interest of the society in which it operates rather than private interests of regulators. The regulators are seen as being benevolent; having an aim of pursuing public interest.[36] These theories instill on the

[30] Lawrence G Baxter, 'Capture in Financial Regulation: Can We Channel It toward the Common Good' (2011) 21 Cornell Journal of Law and Public Policy 0, 176.
[31] ibid.
[32] Priest (n 26).
[33] Baxter (n 30).
[34] ibid.
[35] Andrei Shleifer, 'Understanding Regulation' (2005) 11 European Financial Management 439, 440.
[36] Richard A. Posner, 'Theories of Economic Regulation' (Vol.5, No. 2 Autumn, 1974) 335-358 Bell Journal of Economics and Management Science.

regulators an obligation to pursue collective goals, not for private entities but for the society at large. This is what this research seeks to achieve in seeking regulatory reforms.

There are two perspectives of public interest theories: an economic approach and a politically oriented approach.[37] The economic approach promotes the elimination of market imperfections as a way of promoting public interest. This rides on the presumption that to cure market imperfections is an act in public interest. [38]

The public interest theory is significant for this research, whose aim is to seek financial sector regulatory reforms. These reforms seek to achieve the common aims of regulation, particularly investor protection, stability of the market, safety and soundness of financial institutions as well as prevention of fraud. [39]

1.8 Literature review

The rise of financial conglomerates is an emerging issue in the Kenyan financial landscape. The existing literature mainly focuses on the development of financial conglomerates in developed economies such as the United Kingdom and the United States among others. This literature review therefore borrows heavily from the countries where such institutions have emerged and thrived.

It focuses on the solutions that have been explored by scholars to address the regulatory issues arising from financial conglomerates, while pointing out the gaps in the solutions proposed.

1.8.1 Integrated Regulatory Model in response to Financial Conglomerates

A considerable amount of literature has been written on the adoption of an integrated financial services regulator in response to regulatory challenges. However, not much has been written on

[37] Bronwen Morgan and Karen Yeung, *An Introduction to Law and Regulation: Text and Materials* (1st edn, Cambridge University Press 2007).
[38] ibid 18.
[39] Ross Cranston, *Principles of Banking Law* (2nd edn, Oxford University Press 2007) 65.

the specific contribution of financial conglomerates to the adoption of an integrated regulator. This research seeks to fill this gap by focusing on financial conglomerates as a major factor that contributes towards the adoption of an integrated regulator.

Kaoma argues that the type of regulatory framework adopted depends on the circumstances of the country involved.[40] This has been reinforced by Christine Fay and Nicolas Parent who have postulated that the structure of financial regulation also changes as the financial landscape evolves, global and domestic.[41] Accordingly, the factors influencing the adoption of a unified regulator vary from one country to another. Among these factors is the rise of financial conglomerates and diversification of financial products.

Further**,** Christine Fay and Nicolas Parent**,** writing about the structure of securities market structure in Canada, have pointed out the fact that many countries have begun to question their financial regulatory frameworks, given the rapid changes in the financial landscape.[42] These changes include the rise of financial conglomerates. They have looked at various types of regulatory structures. Objective-based structure has been identified to be suitable for regulation of financial conglomerates.[43] However, this type of regulatory approach still leads to the presence of many regulators which have many challenges.

Michael Taylor argues that there is need for a new regulatory paradigm owing to the changes in the financial sector.[44] This regulatory paradigm is also informed by the upshot of financial

[40] Mwenda, *Legal Aspects of Financial Services Regulation and the Concept of a Unified Regulator* (n 7).
[41] Christine Fay and Parent, 'The Organizational Structure of Financial Market Regulation: Highlights from the Literature' (Bank of Canada 2012) <http://www.bankofcanada.ca/wp-content/uploads/2012/01/fsr-0604-fay.pdf>.
[42] ibid.
[43] ibid.
[44] Michael Taylor, 'The Search for a New Regulatory Paradigm' (1998) 49 Mercer Law Review 793.

conglomerate group structures which involve a diversity of institutions in different regulatory sectors.[45] At the time he wrote the article, Taylor acknowledged that there was a transition and only proposed that a new paradigm was needed. This research argues that this paradigm is yet to be found and therefore goes further to find out the best regulatory response specifically in light of financial conglomerates.

Clive Briault reports that the Financial Services Authority in the UK was mainly influenced by market developments such as the rise of financial conglomerates and the blurring of financial products.[46] Additionally, he argues that the use of integrated regulation was not just used in the UK but also in Germany particularly in its legislation. He observes that in order to facilitate risk management at a cross-sector level, universal regulation is the most appropriate.[47]

Nzomo, writing on the case for a consolidated financial sector regulation in Kenya, also argues that the presence of financial conglomerates lends the industry to unification of the financial regulators.[48] He reinforces this view by the fact that there is need for a mechanism to assess the overall risk of the institutions. There are several reasons why an integrated regulator is best suited to regulate financial conglomerates.[49] However, Nzomo looks at financial conglomerates superficially as one of the market developments that make the case for a single regulator. This research delves further into the issue by seeking to find out the viability of a unified regulator in solving the challenges faced by financial conglomerates, not just as a case for a unified regulator.

[45] ibid 779.
[46] Clive Briault, 'Revisiting the Rationale for a Single National Financial Services Regulator' [2002] Occasional Paper Series <www.fsa.gov.uk> accessed 5 April 2015.
[47] ibid.
[48] Mutuku (n 16).
[49] ibid.

Gakeri argues that the current regulatory framework in Kenya is ill-equipped for the regulation of financial conglomerates.[50] However, he doesn't provide a specific solution for financial conglomerates, only that he notes that Kenya is not yet ready for a unified financial regulator owing to the state of its financial market. Nevertheless, this may have been true at the time of his writing but currently the market has developed to accommodate financial conglomerates. This research seeks to argue the case for a unified regulator as a response to financial conglomerates.

Mwenda Kaoma postulates that an integrated regulator is best suited to regulate financial conglomerates.[51] Other authors such as Llewellyn have also expressed the same view and it is undeniable that there is a strong correlation between financial conglomerates and unification of financial regulators. Mwenda Kaoma also submits that some countries have moved towards adoption of a unified regulator owing to the rise of financial conglomerates.[52] It has been argued that such developments in the financial services sector have led to blurring of financial services and the need for consolidated risk management. This has been succinctly expressed: "there is a trend toward financial conglomerates in Europe which combine banks, insurance companies, and securities firms. . . . We must react to this development with an integrated and proactive supervisory system"[53]

[50] Gakeri (n 15).
[51] Mwenda, *Legal Aspects of Financial Services Regulation and the Concept of a Unified Regulator* (n 7).
[52] ibid; Kenneth Kooma Mwenda, 'Integrated Financial Services Supervision in Poland, the UK and the Nordic Countries' (2002) 10 Tilburg Foreign Law Review 144; Kenneth K Mwenda, 'Legal Aspects of Unified Financial Services Supervision in Germany' (2003) 4 German Law Journal 1009.
[53] Mwenda, *Legal Aspects of Financial Services Regulation and the Concept of a Unified Regulator* (n 7) 52.

While discussing the regulatory and institutional framework for unified financial services supervision in the United Kingdom and Zambia, Kaoma argues that there are many reasons for a unified regulator.[54] However, he further states that the presence of financial conglomerates is a strong reason for the adoption of such a regulator. He cites other reasons such as politics and financial crises but this research focuses on the rise of financial conglomerates.

Flemming argues that the emergence of financial conglomerates has made regulation of financial sector more complex.[55] There is a challenge where different parts of the same institution are regulated by different entities. He concludes that regulation is likely to be effective where a single agency is involved in regulating all aspects of the conglomerate. In case of an integrated agency, it is possible to have a group wide view of risks facing the institution.[56]

Consistently, Hofheimer argues that an integrated regulator is best suited to regulate financial conglomerates.[57] He takes the view that a single regulator is able to take a group view of the risks facing the group and mitigate them accordingly.[58] This research adopts this approach in the Kenya situation.

[54] Kenneth Kaoma Mwenda, 'Regulatory and Institutional Framework for Unified Financial Services Supervision in the United Kingdom and Zambia' (2005) 13 Michigan State Journal of International Law 347.
[55] Jeffrey Carmichael and others (eds), *Aligning Financial Supervisory Structures with Country Needs* (World Bank Institute 2004).
[56] David Llewellyn, 'Institutional Structure of Financial Regulation and Supervision: The Basic Issues' (World Bank Seminar: Aligning Supervisory Structures with Country Needs, Washington DC, 6 June 2006).
[57] George A Hofheimer, *Evaluating the Single Financial Services Regulator Question* (Filene Research Institute 2009).
[58] ibid.

Andrew Tuch adds to the debate and postulates that financial conglomerates act for numerous clients, sometimes client details in one area may conflict with the duties to other clients.[59] This calls for the adoption of a suitable organization structure of the regulator, hence making a case for financial conglomerates as a reason for an integrated regulator. This may seem to refer to very large organizations but this research also seeks find out the viability of a single regulator for the different financial services.

Richard j. Herring and Robert e. Litan have faulted the regulatory approach that focuses on specific activities regulated.[60] They have argued that this ignores the risk associated with such institutions. Indirectly, this critique supports consolidated supervision of financial conglomerates. Further, Richard j. Herring and Robert e. Litan have proposed supervision at the group level, including the imposition of capital requirements at the holding company level rather than the subsidiary level.
Josephina and Andy, while talking about supervision of Financial Conglomerates in the Phillipines, have argued that there are several methods that have been proposed to address challenges posed by financial conglomerates.[61] This includes the use of supplementary regulations for financial conglomerates like the European Directives on Financial Conglomerates and a change of the structure of the regulatory framework.[62] However, these authors have not discussed the adoption of an integrated regulator as a solution, a gap that this research seeks to explore.

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[59] Andrew F Tuch, 'Financial Conglomerates and Information Barrier' (2014) 39 The Journal of Corporation Law 564.
[60] Richard J Herring and Robert E Litan, 'Financial Conglomerates: The Future of Finance?' (*The Brookings Institution*) <http://www.brookings.edu/research/papers/2003/04/financialservices-herring> accessed 28 November 2015.
[61] T Santos and Andy Mullineux, 'The Supervision of Financial Conglomerates in the Philippines' [2009] Bangko Sentral Review <http://www.bsp.gov.ph/downloads/publications/2009/BS09b_A1.pdf> accessed 12 October 2016.
[62] ibid.

1.8.2 Other regulatory responses

Claessens argues that it has been found that countries that restrict the activities of banks are more likely to suffer bank crisis.[63] In this view, he finds that restriction of bank activities cannot be taken as a response to the problems posed by financial conglomerates. [64] However, he does not support this claim to show how it fails to achieve this. This research seeks to find out whether such restrictions can form an appropriate response in Kenya.

Arthur Wilmarth, while addressing the regulation of financial conglomerates in the USA argues that there have been rapid developments in the financial sector and technology, resulting in homogenization of securities, banking and insurance.[65] However, he has not pursued the factor of homogenization as a basis for allowing financial conglomerates. He advocates for separation of financial services but with an option of allowing diversification into areas to activities that are closely related to the core business of the institution. [66]

Mwenda Kaoma argues that Chinese walls can be used to manage confidential information in financial conglomerates but if they are poorly designed they can become ineffective.[67] It is instructive to note that Chinese walls are used only with reference to managing confidential information in a group of companies. Such a mechanism is limited and fails to address the risks posed by the financial conglomerate. This research seeks to fill this gap by finding out a more permanent response to financial conglomerates regulation.

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[63] Herring and Litan (n 60).
[64] ibid.
[65] Arthur E Wilmarth, 'Why Financial Conglomerates Are at the Center of the Financial Crisis' (2009) 3 Cornell International Affairs Review <http://www.inquiriesjournal.com/articles/1270/why-financial-conglomerates-are-at-the-center-of-the-financial-crisis> accessed 22 October 2016.
[66] ibid 74.
[67] Mwenda, *Legal Aspects of Financial Services Regulation and the Concept of a Unified Regulator* (n 7).

Andrew Tuch argues that the primary regulatory response for the challenges of conflict of interest is the use of Chinese Walls to create informational barriers. However, this research seeks to establish that the use of Chinese walls has not stood the test of time. [68] The use of Chinese Walls does not prevent the conflicts but merely restricts the flow of information among the related parts of a group of companies.[69]

1.9 Conclusion

The existing literature reveals that the adoption of an integrated financial services regulator is influenced by market developments such as the rise of financial conglomerates. However, there is little that has been explored concerning the Kenyan situation. Further, the scholars cited have not explored an integrated regulator as a response to the problems posed by financial conglomerates specifically. Other regulatory mechanisms that have been adopted in other countries include the use of Chinese Walls as well as restriction of the activities of financial institutions to limit the challenges of financial conglomerates.

There is a consensus among various scholars that an integrated financial services regulator is best suited to regulate financial conglomerates. However, this connection has not been sufficiently explored to bring out a unified regulator as a solution for regulation of financial conglomerates. This scholarship also draws from the international community with few scholars making reference to current situation in Kenya. This research therefore comes in to investigate the supervision of financial conglomerates with reference to an overall sector regulator.

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[68] Herring and Litan (n 60).
[69] Tuch (n 59).

1.10 Chapter Breakdown:

1.10.1 Chapter one

Chapter one covers the general overview of the research. It canvasses the introductory parts of the research namely the problem statement, research questions, the hypothesis of the study, literature review, theoretical framework and the research methodology that was used.

1.10.2 Chapter two

This chapter critically examines the current financial regulatory framework in Kenya. It seeks to analyze the adequacy of the institutional and legal framework underpinning financial regulation in Kenya. This analysis will take into account the response of the regulatory framework to recent market developments. Particularly, the Financial Services Authority Bill 2016 is discussed as a proposed reform for the financial sector.

1.10.3 Chapter Three

This chapter will analyze the alternative methods of addressing the regulatory challenges facing financial conglomerates. The alternative measures discussed here are the formation of an integrated regulator, cooperation among the regulators, restricting activities of financial institutions and the use of Chinese walls as information barriers in mitigating the risks facing financial conglomerates.

1.10.4 Chapter Four

This chapter will discuss the nature of financial conglomerates and the common regulatory approaches that can be undertaken in their regulation. It culminates in a study of the regulatory approaches undertaken by Estonia, United States and South Africa, noting the best practices. These countries have implemented successfully implemented the main regulatory approaches that may be adopted hence their suitability for the study. Their level of development relative to Kenya's also makes it possible to derive best practices in financial regulation.

1.10.5 Chapter five

Chapter five makes concluding remarks for of the study. The conclusion summarizes the salient arguments made in the research. The chapter also makes recommendations on efficient regulation of financial conglomerates, key policy issues that must be considered in achieving regulatory reforms.

CHAPTER TWO

KENYAN REGULATORY FRAMEWORK

2.0 Introduction

This chapter critically examines the current financial regulatory and institutional framework. It seeks to analyze the adequacy of the model underpinning financial regulation in Kenya. This takes into account the response of the regulatory framework to recent market developments. Particularly, the Financial Services Authority Bill 2016 is discussed as a proposed reform in the financial sector. It is noteworthy that the current financial services regulatory framework consists of multiple sector-based regulatory agencies, statutes and delegated legislation. It can be categorized as a mix of institutional and functional approaches of financial regulation.[70] This means that the regulatory agencies are created on the basis of the institutions regulated as well as on the basis of the functions performed by the regulated institutions. The various sub-sectors[71] of the financial system are regulated under specific laws and by distinct statutory agencies. Each sub-sector has its own regulatory agency with its own mandate and powers.

2.1 Banking Sector

The banking sector is mainly subject to the Central Bank of Kenya Act, the Banking Act and the regulations thereunder. This part seeks to analyze the adequacy of these statutes and the main regulatory institutions in light of the changing financial landscape.

[70] Gakeri (n 15).
[71] These are banking, insurance, securities, pensions, and the SACCO sectors.

Central Bank of Kenya

The Central Bank of Kenya Act establishes the Central Bank of Kenya[72] (hereinafter the Central Bank), as the principal body responsible for regulation and supervision of financial institutions[73] in Kenya. It is noteworthy that the Central Bank is also established under the Constitution of Kenya, 2010, Article 231. Further, the Act also establishes the Kenyan currency and provides for the functioning of the Central Bank and connected matters.[74] The objective of the Central Bank is encapsulated by Section 4 as "to formulate and implement monetary policy directed to achieving and maintaining stability in the general level of prices."[75] The Bank is also tasked with fostering "the liquidity, solvency and proper functioning of a stable market-based financial system."[76] Notably, the Act empowers the Bank to undertake any type of central banking unless excluded by the Act.[77] This provision lacks clarity; the objectives of a financial regulator should be clearly stated. It does not precisely set out exactly what it describes as other 'central banking functions' of the Bank.

The Act establishes the Bank as a corporate entity with the attributes associated with body corporates.[78] In addition, it is not subject to the Companies Act[79] and the Banking Act.[80] Its principal objectives are to formulate monetary policy,[81] promoting price stability, issuing currency

[72] The Central Bank of Kenya was established in 1966, under Central Bank of Kenya Act, s 3.
[73] A financial institution is defined as a body corporate or other body of persons, carrying on, whether on their own behalf or as agent for another, financial business within the meaning of the Banking Act, whether in Kenya or elsewhere.
[74] See the preliminary section of the Central Bank of Kenya Act.
[75] Central Bank of Kenya Act Chapter 491, Laws of Kenya (CBK Act 1966).
[76] ibid, s 4(2).
[77] CBK Act 1966, s 3(3).
[78] ibid, s 4.
[79] No. 17 of 2015.
[80] CBK Act 1966, s 3.
[81] ibid, s 4.

and performing other functions conferred on it by an Act of Parliament.[82] The Bank has the ability to exercise any type of central banking functions unless excluded under the Act.[83]

It can make its own rules of conduct or procedure, not inconsistent with the provisions of the Act, for good order and proper management of the Bank.[84] Additionally it is not under the direction or control of any person or authority in the exercise of its powers or in the performance of its functions.[85] This provision promotes the independence of the Central bank, which is an important aspect for effective regulation.

The Bank is managed by a board of directors comprising of a chairman, governor, two deputy governors and five non-executive directors[86] appointed by the President with the approval of Parliament.[87]The governor is the principal representative[88] of the Bank, the Chief Executive Officer and responsible for the management of the Bank.[89] Importantly, the Act disqualifies certain persons from holding office in the Board. This is important so as to constitute an effective Board that is free from political and other interferences.[90]

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[82] Constitution of Kenya 2010 (CoK 2010), Article 231(2). Other objectives of the Bank are provided under the Central Bank Act as to: Formulate and implement foreign exchange policy, Hold and manage its foreign exchange reserves, License and supervise authorized dealers, Formulate and implement such policies as best promote the establishment, regulation and supervision of efficient and effective payment, clearing and settlement systems. It also acts as a banker and advisor to, and as fiscal agent of the Government.

[83] CBK Act 1966, s 3(3).

[84] CBK Act 1966, s 3(4).

[85] CoK 2010, Article 231 (3).

[86] A person is capable of being appointed as a director if such a person is a Kenyan citizen and if they possess the relevant knowledge and experience in monetary, financial, banking and economic matters or other disciplines relevant to the functions of the Bank. See Section 11(7).

[87] CBK Act 1966, s 11.

[88] As a principal representative the governor can represent the Bank with public entities, in legal proceedings and signing documents on behalf of the Bank.

[89] CBK Act 1966, s 15.

[90] Central Bank of Kenya Act, Section 14. The disqualified persons include public officers, persons connected to financial institutions and those in elected members of the County and National Assembly. This disqualification is important in making up a board that is independent and effective.

The Principal Secretary to the Treasury is also a member of the Board but in a non-voting capacity. The board is responsible for determining the policy and objectives of the Bank. It also keeps under constant review the performance of the Bank as well as that of the governor and the use of the Bank's resources.[91] The Board provides a two tier level of accountability for the bank. The changes to introduce an independent chairman were introduced in the year 2012. However, the relevance of these amendments remains debatable since the governor is still accountable to the Parliament. At the time this study was being conducted, the board was yet to be reconstituted, with the board members having retired after the expiry of their term.[92]

The Central Bank of Kenya Act has also adopted the use of corporate governance mechanisms for the board. These involve disclosure of interest to avoid conflict of interest. The structures put in place for voting and deciding at board meetings are also set to enhance corporate governance.[93] Relatedly, the introduction of a competitive position for the chairman was also meant to enhance corporate governance of the Bank. This is because the governor used to be the chairperson to the board that was tasked with the review of the performance of the governor.

The remuneration of the governor and the deputy governor and the directors constituting the Board is determined by the President.[94] This undermines the provisions of the Constitution on the independence of the Bank. The power given to the President to determine such remuneration can be abused leading to an interference of the functions of the Bank. Such power should be exercised by an independent body. The board can also be empowered to come up with an independent

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[91] CBK Act 1966, s 10.
[92] 'Why Central Bank remains without a board one year on' <http://www.businessdailyafrica.com/Why-Central-Bank-remains-without-a-board-one-year-on/539546-3156526-ey3bjxz/index.html> accessed 3 November 2016.
[93] CBK Act 1966, s 12.
[94] ibid, s 16.

committee of the board that can determine the remuneration of the governor and the deputy governors.

Introduction of the competitive position of Chairperson

The Central Bank of Kenya (amendment) Act, 2012 introduced the position of a competitively appointed chairperson. Although the rationale behind this move was touted to be the need for improved corporate governance, the move may have other ramifications. The chairman does not have a security of tenure, a factor that has been cited as being likely to cause political influence on the position. The governor's position is shielded from any political pressure, since it has security of tenure. This is in line with the provisions of the constitution that require the Central Bank to be independent. The introduction of a chairman without a security of tenure is likely to undermine this independence. Additionally, the governor is accountable to the Parliament and therefore not likely to be influenced by the chairman.

Policy makers and commentators in the sector have also voiced concerns over the separation of the role of the chairman from that of the governor.[95] The separation is likely to cause ambiguity and is bad for policy making in the bank.[96] While debating a similar issue on the Central Bank (Amendment) Act, the Hansard records similar concerns voiced in Parliament. Oburu Odinga, raised the issue that lack of a clear separation of the roles of the chairman and the governor was likely to cause conflicts.[97]

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[95] 'Central Bank of Kenya to Get Powerful Chairman Raising Risk of Turf Wars' (*Asoko Insight*) <https://asokoinsight.com/news/central-bank-kenya-get-powerful-chairman-raising-risk-turf-wars> accessed 8 October 2016.

[96] 'Is Parliament's Push to Amend CBK Act Driven by Anger and Mischief?' <http://www.businessdailyafrica.com/Opinion-and-Analysis/Is-Parliament-push-to-amend-CBK-Act-driven-by-anger-and-mischief/-/539548/1501592/-/epw3ey/-/index.html> accessed 8 October 2016.

[97] *Kenya National Assembly Official Record (Hansard)* (2006). p 3245.

On the other hand, it can be seen as a good move in the context of corporate governance, which helps in avoiding a situation where the governor chairs a board that is required to review his/her own performance. Corporate governance requires that the position of the chairman and the Chief Executive Officer (CEO) be separated and held by different persons. Therefore the governor being the CEO of the Bank should not occupy the position of the chairman as well. The separation is a positive move, only that there is need for clarity on the two roles, to avoid any ambiguity or conflict of the roles.

Key Amendments

The Central Bank of Kenya (Amendment) Act, 2012 introduced the position of a competitively appointed chairman. This brought in a two tier- level of governance in the Board of the Bank in a bid to improve corporate governance. There are further amendments anticipated through the Central Bank Amendment Bill 2015, which are meant to bring further changes in the central bank. It is proposed that the governor of the Central Bank be appointed by the president from three among three persons recommended by the board of the Bank. This is set to give the Board more powers.[98]

Central Bank Prudential Guidelines

The Bank is empowered under the Act[99] to formulate guidelines for the discharge of its functions and powers. Following the need to address factors such as investor education and systemic risk, several prudential guidelines have been formulated.

[98] Central Bank of Kenya Bill 2015 (CBK Bill 2015) s 35.
[99] CBK Act 1966, s 57.

The Central Bank Prudential Guidelines regulate the provision of incidental businesses and prohibited activities by the banks. This is comprises the regulatory response of the Central Bank to recent developments such as the rise of financial conglomerates. There are no substantive amendments to the law to provide for the regulation of financial conglomerates. However, the Financial Services Authority Bill 2016 is set to address this gap to some extent.[100]

The regulations on prohibited businesses particularly seek to protect the deposits held by banks. Importantly, the Central Bank has also formulated guidelines on consolidated supervision, which are essential in the regulation of financial conglomerates. This is a move in the right direction, which helps in achieving effective supervision. Nevertheless, there is need for proper reforms to be entrenched in the substantive law.

Banking Act

This is the principal legal framework on the regulation of financial institutions.[101] It provides for the licensing requirements of banks and makes provisions that are relevant to the regulation and supervision by the Bank. Part III of the Act provides for prohibited business by banks. However, the Act does not make provisions to address diversification of financial services as offered by banks today. With reference to other functions, the Act provides that a bank is not allowed to engage in any wholesale or retail business except in satisfaction of a debt.[102]

[100] FSAB 2016, Part VI.
[101] The word 'financial institutions' is used here as defined in the Banking Act, section 2. These institutions include Commercial Banks, Microfinance Institutions, Mortgage Finance Companies among others.
[102]CBK Act 1966, s 12 (a).

Shortcomings of the Legal Framework

The Banking Act does not take into account the integrated financial services occurring in the market today. Today many banks are involved in activities that are outside the limits of banking business. The prudential guidelines on incidental activities have only provided for guidelines on how financial institutions can carry on activities that are incidental to banking business.

Part III of the Banking Act provides for prohibited activities by banks but these provisions have not expressly prohibited other financial services. Implicitly, the Act allows banks to undertake other activities such as insurance and capital markets services subject to the provisions of the Central Bank of Kenya regulations.

The Act also does not provide prudential guidelines for regulation of banking groups. Additionally, it does not limit the activities of the banking group. The Act empowers the Bank to exercise authority over the subsidiaries but not on the parent company of the subsidiaries. There are also no formal arrangements allowing cooperation and information sharing among domestic supervisors.

The law does not require the banks to submit consolidated information. The supervisor is not empowered to review the activity or financial reports of subsidiary or bank affiliates. Noticeably, the law fails to empower the banking supervisor to impose prudential requirements on a consolidated basis.

There are no proper legal arrangements allowing cooperation and information sharing among domestic supervisors. The only attempt that has been made to provide for information sharing among the regulators has been a memorandum of understanding signed by the regulators. This falls short of effective regulatory framework in promoting proper regulation. It would be expected that the legal framework should provide for a lead regulator who can initiate and steer the process of information sharing.

2.2 Capital Markets Sector

There are several statutes that are involved in the regulation of the capital markets but this research examines the Capital Markets Act. The main institution involved in the regulation of capital markets is the Capital Markets Authority.

Capital Markets Act

This is the principal Act that provides for the regulation of the capital markets in Kenya. The objective of the Act is provided in its preamble as an Act of Parliament to establish a Capital Markets Authority for the purpose of promoting, regulating and facilitating the development of an orderly, fair and efficient Capital Markets in Kenya and for connected purposes.[103] Consequently, the Act establishes the Capital Markets Authority which is the principal regulator of capital markets in Kenya. It also provides for the functioning of the regulator, provides for its functions and management as well as the manner in which such authority should be exercised.

The Authority was set up after the enactment of the Capital Markets Authority Act[104] in 1989. This was preceded by Capital Markets Development Advisory Council which proposed the necessary modalities of establishing an Authority to be responsible for the capital markets. The Capital Markets Authority was eventually constituted in January 1990 and inaugurated on 7th March 1990.

Importantly, the Authority is charged with the responsibility of regulating the development of orderly, fair and efficient capital markets in Kenya.[105] It is empowered to license and set

[103] Capital Markets Act 1989 (CM Act), Preamble.
[104] The Act later changed its name to be Capital Markets Act.
[105] CM Act 1989, s 11.

regulations for all the intermediaries in the market. The objectives of the Authority also touch on market development, with the Act providing that the Authority has the objective of the development of all aspects of the capital markets with particular emphasis on the removal of impediments to, and the creation of incentives for longer term investments in, productive activities[106]. The objective of investor protection is also captured, whereby the Authority is mandated to employ mechanisms to ensure that investors are protected in the market. In pursuing this objective, the Authority may also seek investor education, for education promotes protection of investors. The Authority is also mandated to ensure a nationwide system of stock market and brokerage services by licensing more intermediaries and creating the environment for intermediaries to get licensed.[107]

The Authority is managed by a board that consists of eleven (11) members who include a Chairperson appointed by the President on recommendation of the Cabinet Secretary.[108] A Chief Executive Officer is also appointed by the Cabinet Secretary in consultation with the Board. The CEO must have at least ten years' experience[109] and expertise in money matters, capital markets or finance.[110] The Cabinet Secretary appoints six other members.[111] Other persons who are members of the board by virtue of their office are the Principal Secretary to the Treasury, the Governor to the CBK and the Attorney General. These persons can also be represented by persons deputizing them.

[106] CM Act 1989, s 11.
[107] ibid, s 11(1) (b).
[108] CM Act (n 99), s 18A (3) (a).
[109] Such experience is restricted to senior management level in matters relating to law, finance, accounting, economics, banking or insurance.
[110] The CEO serves for a four-year term and is eligible for reappointment.
[111] The chairman and the six members are persons who have experience and expertise in legal, financial, banking, accounting, economics or insurance matters, serve for a period of three years and are eligible for re-appointment for another three years.

The membership of the Board has been criticized for being exceedingly large compared to other stock exchanges in the world. [112] Further, the Authority manages an investor Compensation fund that has an equally large board of directors. On this issue, Gakeri rightly argues that the fund can be easily managed under the CMA without the need for a separate board for its management.[113]

The Authority is empowered to delegate its functions to committees as it may deem appropriate. Relatedly, the Authority is required to establish a committee to hear and determine complaints of shareholders of any public company listed on an authorized securities exchange or such public company or any other person under the jurisdiction of the Authority and recommend actions to be taken in accordance with rules established by the Authority for that purpose. It is protected from legal action for acts done in good faith on the direction of the Authority.

In line with IOSCO principles for the regulator, the Authority has clearly stated objectives, enforcement and investigatory powers. Some of the functions of the Authority include advising the minister on development of the capital markets and implementing policies of the government on the sector. It is empowered to issue licenses to capital markets intermediaries, and even to make regulations for the operation of various aspects of the capital markets.[114]

The CMA has enforcement powers, which is in line with IOSCO principles for enforcement of regulations. It can levy penalties, order a person to mitigate a breach, punish any malfeasance and suspend trading or even revoke a license for the protection of investors.[115]

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[112] Jacob K Gakeri, 'Maurer School of Law, Indiana University Enhancing Securities Markets in Sub-Saharan Africa: An Overview of the Legal and Institutional Arrangements in Kenya' <http://erepository.uonbi.ac.ke/handle/11295/81970> accessed 16 August 2016.
[113] ibid.
[114] CM Act 1989, s 12(1). The CMA has issued several regulations on various aspects of the capital markets.
[115] ibid, s 26(1).

In anticipation of any contingency factors, the Capital Markets Authority is empowered under Section 12 (1) to make regulations for various aspects of the capital markets. Subsequently, the Capital Markets Authority has formulated regulations that guide the operation of specific aspects of the securities market. [116]

2.3 Insurance Sector

The Insurance Act is the principal Act that sought to amend and consolidate the laws relating to insurance and to regulate insurance business as well as other connected services.[117] It has established the Insurance Regulatory Authority as a body corporate with the characteristics of a body corporate.[118] The objectives and functions of the Authority are established under Section 3A of the Act. The Insurance Regulatory Authority has the objective of ensuring effective administration, supervision, regulation and control of insurance and reinsurance business in Kenya as well as formulating standards and licensing all persons involved in insurance business.[119] The supervision of insurers aims at promoting fair and efficient markets, protecting policy holders as well as generally promoting the development of the insurance sector.

The Authority performs various functions and ensures compliance by the insurance intermediaries with the legal requirements and sound business practices. Just like other regulators, it is also tasked with licensing of intermediaries, promotion of fair, efficient and stable markets as well as

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[116] The following is a snapshot of the regulations that have been formulated so far: Capital Markets (Licensing Requirements General) Regulations 2002, Capital Markets (Takeover and Mergers) Regulations 2002, Capital Markets Regulations (Foreign Investors) Regulations Capital Markets Tribunal Rules, 2002, Guideline on Corporate Governance Practices by Listed Companies in Kenya, Capital Markets Guidelines on the Approval and Registration of Credit Rating Agencies, Central Depository (Operational) Rules, 2003,128 Central Depository (Regulation of Central Depositories) Rules, 2004, Capital Markets (Asset Backed Securities) Regulations, Capital Markets (Registered Venture Capital Companies) Regulations, 2007; The Capital Markets (Licensing Requirements for Forex Brokers And Conduct Of Online Forex Business) Regulations 2016. 'Regulations' <http://www.cma.or.ke/index.php?option=com_docman&view=list&slug=regulations&Itemid=523> accessed 7 September 2016.
[117] Insurance Act 1985 (IA 1985), Preamble.
[118] ibid, s 3.
[119] IA 1985, s 3A.

maintaining the confidence of consumers in the market. This is done through various mechanisms that achieve investor protection. It advises the government and implements government policy on insurance sector. The Authority also issues guidelines in the performance of its functions and it does other functions all to ensure a fair and efficient market as well as promote the development of the market. The authority may also help other regulatory bodies in other jurisdictions with investigations subject to the provisions of the Act on how to offer such assistance.[120]

The Act further provides for the management of the Authority, which vests in a board whose composition is set out in the Act.[121] It also provides for the powers of the board, necessary for the discharge of its functions.[122]The office of the Commissioner of Insurance is established, who acts as the CEO of the Authority subject to the directions of the board. The Act sets out the qualifications for this office, which include professional and integrity considerations.[123]

The Board of Directors is vested with the fiduciary responsibility of overseeing operations of the Authority and ensuring that they are consistent with provisions of the Insurance Act. The office of the Commissioner of Insurance came before the establishment of the Insurance Regulatory Authority, which was established under the Insurance Act, 1986. Prior to the insurance regulation, the Companies Act 1960 was involved in the regulation.

The board is empowered to control, supervise and administer the assets of the Authority and to determine provisions for capital, recurrent expenditure and reserves. It also performs other mundane roles that amount to representation of the board such as receiving donations and grants,

[120] IA 1985, s 3A.
[121] ibid, s 3B.
[122] IA 1985, s 3C.
[123] ibid, s 3E (4).

entering into association with other organizations and even opening banking accounts for the funds of the Authority. The board is also empowered to invest the funds.

The CEO of the Authority is the Commissioner of Insurance appointed as per the Insurance Act. He is an ex officio member of the board and therefore not entitled to vote at any meeting. A person appointed as the CEO should hold at least a postgraduate degree in insurance, audit, accounting, finance, actuarial science, business studies or banking among other requirements. He serves for a term of three years and can be reappointed for another term.

The Act empowers the Insurance Regulatory Authority to make regulations for the proper regulation of the sector. This is an avenue that has been resorted to IRA to regulate bancassurance business offered by banks. Banks which are involved in offering of insurance business as agencies are also subject to the provisions of the Insurance Act.

2.4 Pension Sector

The Retirement Benefits Act was established to make provisions for the establishment of a Retirement Benefits Authority (RBA), for the regulation and supervision of the retirement benefits sector.[124] Further, the Act sets the requirements for the registration of pension schemes, managers and custodians.[125]

The Retirement Benefits Authority is established under the Retirement Benefits Act[126] as a body corporate with the characteristics of a body corporate. It is the government agency responsible for the regulation and supervision of retirement benefit schemes in Kenya. Its objectives include consumer protection and the development of the retirement benefits sector. It also advises the

[124] Preamble.
[125] Retirement Benefits Act 1997 (RB Act 1997), Part II.
[126] ibid, s 3.

Minister and implements the government policy for the sector. The Act or any other written law may expand the scope of the functions of this Authority.

The management of the Authority is vested in a board of directors consisting of ten members, five of whom are appointed by the Minister by virtue of their knowledge or experience in matters relating to administration of scheme funds, banking, law, insurance or actuarial studies. Persons appointed should also be devoid of any conflict of interest that may arise due to their affiliation with the intermediaries in the sector.

Notably, the banks that are custodians in the pension industry are subjected to the provisions of the Retirement Benefits Act. Any person seeking to act as a custodian for a registered pension scheme must be registered under the Act and issued with a valid certificate pursuant to section 22 of the Act. Additionally, section 5B of the Act empowers the RBA to investigate any custodian, registered scheme or administrator. Consequently, the banks that are licensed as custodians are subjected to such investigation by the RBA. This means that banks are subject to multiple regimes and such overregulation can be overwhelming on the banks licensed as custodians. Relevant reforms proposed in this research will avoid such onerous provisions and make regulation of financial services more efficient.

2.5 Sacco Sector

The SACCO sector has grown of over the years to attract government legislative interventions. The main legislations governing the sector are the Sacco Societies Act and the Cooperative Societies Act. The latter provides for registration of cooperatives while the Sacco Societies Act provides for the licensing of SACCOs. This study delves further into the provisions of the Sacco Societies Act, 2008, in relation to its role in the regulation of financial services.

Sacco Societies Act

This Act makes provisions for the licensing, regulation, supervision and promotion of SACCO societies. It also establishes the Sacco Societies Regulatory Authority which is the principal body responsible for licensing and regulation of deposit taking SACCOs. Particularly, it applies to deposit taking SACCOs and prescribed non deposit taking SACCOs.[127] The passage of the Act was driven by the need to address challenges posed by the governance of SACCOs. The creation of a separate legal framework was seen as a way of responding to such challenges.

The Act establishes the Sacco Societies Regulatory Authority as a body corporate to be in charge of regulation of deposit taking SACCOs. The Act further sets the objectives of the Authority, its management and governance structure. The main objectives of SASRA include the licensing of SACCO societies to carry out deposit-taking business, regulate and supervise SACCO societies, hold, manage and apply the General Fund of the Authority in accordance with the provisions of this Act, levy contributions in accordance with this Act and doing all such other things as may be lawfully directed by the Minister. Noteworthy, the Authority may do other things that may be authorized by the law.[128]

Additionally, the Act prescribes the composition of the Authority to include four members, not being public officers, appointed by the Minister by virtue of their knowledge, and possession of a minimum of ten years' experience, in co-operative practice and management, law, finance or economics. The minister then appoints the chairman of the Authority from among these members. Other members who constitute this Authority by virtue of their offices are the governor to the

[127] Sacco Societies Act 2008 (Sacco Act 2008), s 3 provides that the minister may provide for non-deposit taking SACCOs that are subject to the SACCO Societies Act.
[128] ibid, s 5.

CBK, Principal Secretary to the Treasury and the Commissioner of Insurance. A Chief Executive Officer is also appointed by the Board in consultation with the Minister. Such a person is required to have the relevant qualifications which include at least ten years' experience in financial management, co-operative practice and management, law and finance or economics.[129] The chief executive officer serves for a renewable term of four years and is eligible for reappointment. The requirements for the Chief Executive Officer imbue professionalism in the position and it is aimed at providing efficient service delivery by the office holder.

The board is empowered to supervise, control and administer the assets of the Authority, to open bank accounts and to determine provisions for the capital and recurrent expenditure and reserves of the Authority. Importantly, the board is also empowered to enter into association with other organizations in furtherance of its functions and even to award contracts.[130]

The Sacco Societies Regulatory Authority is established by the Sacco Societies Act as a body corporate. It has the qualities of a body corporate and it is charged with the object of regulating and licensing deposit taking SACCOs.[131] The Authority was inaugurated in 2009. The establishment of the Authority is part of Kenya's reform process in the financial sector, it protects interests of SACCO members and ensures public confidence towards the SACCO sector. The management of the Authority is vested in a Board consisting of nine members. Four members are appointed by the Minister, being members who are not public officers and have knowledge and a minimum of ten years' experience, in co-operative practice and management, law, finance or economics. The chairman is appointed from these members. Other members include the Governor

[129] Sacco Act 2008, s 12.
[130] ibid, s 7.
[131] Sacco Act 2008, s 5.

of the Central Bank, the Principal Secretary to Treasury and the Commissioner or their representatives.

The members of the board serve for a term of three years and are eligible for reappointment for another term. A director should not be a member of a national assembly or a local assembly or have any position in a SACCO that may cause conflict of interest.[132]

2.6 Challenges in the current regulatory framework

The current regulatory framework is fragmented and characterized by onerous legal provisions particularly for institutions seeking to diversify to other sectors. This is the source of many problems that bedevil the financial regulatory sector in Kenya. For instance, the banking institutions wishing to engage in other financial sector services face several challenges. They have to go through multiple approvals, making it costly and cumbersome. Particularly, the Capital Markets Authority has to grant approval to any banking or financial institution seeking to venture into the capital markets business. The Insurance Regulatory Authority also has to grant licenses to any person seeking to engage in the provision of insurance business.[133]

The current regulatory framework makes it challenging for the regulators to manage risks facing the financial system. Risk management in the financial sector is a key function played by the financial regulators and significantly determines the stability of the financial system. Being a fragmented regulatory framework, it is difficult for individual regulators to foresee risks in other

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[132] A director should not be an auditor of a SACCO, an employee of a SACCO or cooperative or be prohibited from taking part in the management of a cooperative or a financial institution.

[133] The Insurance Regulatory Authority regulates bancassurance in Kenya. Consequently, banks seeking to offer insurance products under the bancassurance have to be licensed by the Insurance Regulatory Authority apart from being regulated by the Central Bank of Kenya on the banking services.

sectors. The regulators have tried to deal with this problem by coming up with a memorandum of understanding on how to share information but this does not eliminate all the challenges.

Regulation involves cooperation among all the stakeholders and the regulators. Such cooperation becomes difficult when the regulatory structure is very fragmented. This is the case in Kenya where there are multiple regulators. In pursuit of this objective, the current regulators came up with a memorandum of understanding in order to facilitate better cooperation. However, this arrangement has not worked effectively and there is need to establish a better regulatory framework.

There are regulatory gaps and overlaps in the current regulatory framework which are a challenge to the users and providers of financial services. Where there are overlaps, the providers of financial services are subjected to multiple and redundant regulations. They are forced to comply with regulators in various regulators and it becomes harder to comply. Further, it becomes hard to do business and to diversify to other areas in the financial sector. For instance, custodians and fund managers are subjected to regulation by both the Capital Markets Authority and the Retirement Benefits Authority.

Notably, the current regulatory framework is faced by the ordinary challenges of a fragmented regulatory framework as explained in the next section.

Challenges out of being a Fragmented Regulatory Model

A fragmented regulatory framework presents several challenges to the regulation of financial conglomerates.

First, having many regulators poses an obvious challenge of cost, not only to the regulator but also to the regulated firms. The government incurs a lot in setting up many regulators and equipping them adequately.[134] Consequently, the taxpayers suffer from inefficient resource allocation and to a large extent, unnecessary expenditure. The regulated firms also incur the cost of regulation which is likely to be higher in case of multiple regulations and licensing.[135] This is a disadvantage to the financial conglomerates and this cost may further affect consumers in case it is included in the cost of the services offered.

The case in Kenya is no different. The current regulatory framework consists of multiple regulators each regulating a specific sector. Each of these regulators is equipped with administrative structures and personnel, thus posing an inevitable cost. Other costs may be incurred in solving problems associated with this model. For instance, when promoting effective risk management, there may be need to come up with mechanisms to promote cooperation among the various regulators.[136] Such mechanisms are likely to involve other direct and indirect costs. For instance, the financial regulators in Kenya came up with a memorandum of understanding to facilitate effective information sharing among the regulators.[137]

Second, a fragmented system is likely to leave some areas of the financial sector unregulated or overregulated.[138] This happens where the mandates of the regulatory agencies are unclear resulting in overlaps and regulatory gaps. In the case of financial conglomerates in Kenya, certain areas are left unregulated in the financial group. Particularly, the Banking Act does not impose capital requirements on the bank holding company in a financial group. This is a loophole that can be

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[134] Mwenda, *Legal Aspects of Financial Services Regulation and the Concept of a Unified Regulator* (n 7).
[135] David T Llewellyn, 'Institutional Structure of Financial Regulation and Supervision: The Basic Issues', *World Bank seminar Aligning Supervisory Structures with Country Needs, Washington DC, 6th and 7th June* (2006) <http://siteresources.worldbank.org/INTTOPCONF6/Resources/2057292-1162909660809/F2FlemmingLlewellyn.pdf> accessed 5 July 2016.
[136] Kenya's regulator's adopted a memorandum to ensure effective sharing of information among the regulators, aimed at facilitating risk management.
[137] 'Finance Regulators to Sign MoU on Converged Sector' <http://www.businessdailyafrica.com/-/539552/630936/-/view/printVersion/-/6mel4ez/-/index.html> accessed 31 October 2016.
[138] Mutuku (n 16).

exploited by financial conglomerates to undertake prohibited risky activities. While commercial banks are not allowed to engage in trading in activities other than banking services, the holding company is not legally subjected to such restrictions.

On the other hand, overlaps lead to overburdened investors, a disadvantage that goes to the industry at large. Overregulation presents the industry as unfriendly and bureaucratic and it may discourage investors. Furthermore, David Lewellyn argues that overregulation can impose unnecessary costs in the financial sector.[139]This is because consumers have no choice but to accept the cost that is imposed on them. As earlier discussed, Kenya's financial system illustrates this kind of overregulation.[140] The consequences of such costs are felt most by the consumers who have to bear the costs without a choice. In this way a fragmented system becomes unfriendly.

Third, it is unfit to regulate new financial products which have led to the rise of financial conglomerates.[141] Notable products include bancassurance, unit trusts, asset backed securities and the forthcoming derivatives. These products give an opportunity for regulation by more than one sector. For instance, insurance companies offering unit trusts are subject to the regulation of the capital markets authority apart from the IRA regulation. Given that in a fragmented system there are various regulators, all of them have to be involved to ensure there is enough cooperation needed to ensure smooth operation and avert systemic risks. This is costly and an ineffective way of achieving proper risk management.

Fourth, it may be abused for political expediency at the expense of economic growth. This is prevalent in developing countries which suffer from poor governance and institutional

[139] Llewellyn (n 135).
[140] Mutuku (n 16).
[141] Gakeri (n 15).

frameworks.[142] It is common in these countries because political players often use statutory bodies as political weapons to reward loyalty. Usually, the government of the day takes advantage of the high number of positions created under the fragmented system to reward its loyalists and regardless of their suitability. The ministry under which such regulators fall is coveted, being considered powerful due to the number of statutory agencies it oversees.

Fifth, a fragmented framework lacks adequate transparency and accountability.[143] This is caused by the fact that there are many regulators and it may not be clear on whom the responsibility lies. This problem can get worse where the sector has financial conglomerates because of the increased risk they pose to the sector.[144] It may be easier for some regulatory agencies to evade responsibility and lay the blame on another sector. For instance, in it has been reported that prior to the introduction of the Financial Services Authority, the fragmented system in the UK was characterized by lack of transparency and accountability.[145]

Sixth, a fragmented system promotes the use of inconsistent rules and standards.[146] The regulatory agencies may not adopt the same rules and standards of regulation across the financial sector. The result is that in a financial group of companies some entities may be subjected to different capital requirements, which creates a room for regulatory arbitrage, and may end up compromising competitive neutrality.[147] It may also lead to unnecessary conflicts and competition among the regulators. These challenges are solved by integration of the regulators.[148]

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[142] Mushtaq Khan, 'Corruption and Governance in Early Capitalism: World Bank Strategies and Their Limitations' <http://eprints.soas.ac.uk/2432/1/Corruption_in_Pincus.pdf> accessed 3 November 2016.
[143] Mwenda, *Legal Aspects of Financial Services Regulation and the Concept of a Unified Regulator* (n 7) 345.
[144] Wilmarth (n 65).
[145] Mwenda, 'Integrated Financial Services Supervision in Poland, the UK and the Nordic Countries' (n 52).
[146] Llewellyn (n 135).
[147] ibid.
[148] Mwenda, 'Integrated Financial Services Supervision in Poland, the UK and the Nordic Countries' (n 52).

Seventh, a fragmented system is ill-equipped to achieve effective sector-wide risk management.[149] This is mainly because of the structure of the regulatory framework that separates the sectors yet their risks are seamlessly connected. Where there are several regulators a sector-wide monitoring and management of risks is problematic.[150] This problem has been mitigated by cooperation among regulators and sharing of information. However, these are temporary measures which are costly and do not guarantee results. The solution has also been found in an integrated regulator.[151]

Eighth, this system is subject to competition among the regulators and the problems of regulatory arbitrage.[152] It occurs especially when the regulators pursue competing objectives or even overlapping objectives. In such a situation, the regulated entities seek to go where the regulation is most favourable. Financial conglomerates are likely to take advantage of such weaknesses to design their organs in such a manner as to go where there is minimal supervisory costs and oversight.[153]

2.1 Response of the current framework to financial conglomerates

The current financial regulatory framework has not provided for the regulation of financial conglomerates. In spite of notable development shaping the financial landscape, the Banking Act only restricts the activities of the banks with respect to protection of customer deposits. The holding company of such banks can venture into provision of other services, thus posing a notable risk to the financial system. The Central Bank has formulated regulations on incidental banking

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[149] ibid. See also Andrew F Tuch, 'Financial Conglomerates and Information Barriers' (2013) 39 Journal of Corporation Law 563.
[150] Mwenda, *Legal Aspects of Financial Services Regulation and the Concept of a Unified Regulator* (n 7).
[151] Mwenda, 'Integrated Financial Services Supervision in Poland, the UK and the Nordic Countries' (n 52).
[152] ibid.
[153] Llewellyn (n 135).

activities. This remains the only attempt made under the legal framework to regulate what banks can do or not do.

The Central Bank has adopted an approach of consolidated supervision in order to respond to the challenges of regulation posed by diversification of services offered by banks. This approach requires information sharing and coordination among various regulators. As for institutions that have branches outside Kenya, the Central Banks in the region have entered into a memorandum of understanding for purposes of sharing information.[154]

However, there is need for better reforms in financial regulation to help in proper management of risks posed by the rise of diversified products in the financial sector.[155] Non-binding MOUs and sharing of information in informal arrangements cannot be reliable in times of financial crises.[156]

From the foregoing, it is evident that the existing legal and institutional framework has not made any provisions for the new market developments leading to multifunctional banks.

Financial Services Authority Bill 2016

The Bill seeks to provide uniform norms and standards in relation to the conduct of providers of financial products and services. It also creates important institutions to be involved in the regulation of the financial sector. These institutions are Financial Services Authority, The Financial Sector Ombudsman and the Financial Sector Tribunal. This proposed law comes following the recommendations of the Presidential Taskforce on Parastatal Reforms. The Taskforce recommended a consolidation of the current multiple regulators in order to bring

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[154] 'The Kenya Financial Stability Sector Report, 2015' (Central Bank of Kenya 2016).
[155] Francis Mwega, 'Financial Regulation in Kenya: Balancing Inclusive Growth with Financial Stability' <http://www.odi.org/sites/odi.org.uk/files/odi-assets/publications-opinion-files/9279.pdf> accessed 27 November 2015.
[156] ibid.

efficiency in the financial sector, following recent developments that have changed the regulatory landscape.[157]

Financial Services Authority

This is established under the proposed Financial Services Authority Bill 2016 to take the roles of the CMA, IRA, RBA and SASRA. The Bill also establishes the management structure of the integrated regulator and other connected offices.[158] The objectives of the Authority are to promote safety and soundness of prudentially regulated institutions, to enhance efficiency and integrity in the sector, to promote public confidence, to protect consumers, to promote systemic stability and to support the economic objectives of the government.

The proposed bill seems to be the dawn of a new era in the regulation of financial services in Kenya. It proposes to consolidate some of the financial regulators in Kenya but leaves out the regulation of banks under the central bank, being informed by the Report of the Presidential Taskforce on Parastatal Reforms.[159] The taskforce submitted in its findings that the best approach for Kenya is to have a consolidation of CMA, RBA, IRA and SASRA into one regulatory agency. This is the approach taken by the proposed bill.

It is instructive to note that the role of the Central Bank is a key issue in considering the structure of a regulatory framework. It has been argued that the effect of involving the Central Bank in the regulation of commercial banks is to put the Central Bank in a better position to influence monetary policy. It is also an international practice to retain the regulation of commercial banks under the

[157] 'Report of the Presidential Taskforce on Parastatal Reforms' (n 11) 87.
[158] FSAB 2016, s10. This section establishes the Authority as a body corporate as an independent body not subject to the control of any other person.
[159] 'Report of the Presidential Taskforce on Parastatal Reforms' (n 11) 87.

purview of the Central Bank.[160] On the other hand, leaving the Central Bank out of regulation of commercial banks enables it to focus on risk management and financial stability.[161] When the Central Bank is not merged with the other regulators, there is also a need for inter-agency coordination. This may be challenging and the solution is found in having the Central Bank structured as a prudential regulator.[162]

Importantly, the Bill establishes the Financial Services Authority to take the roles of the CMA, IRA, RBA and SASRA. It also establishes the management structure of the integrated regulator and other connected offices.

The Authority is mandated to cooperate and collaborate with the Central Bank of Kenya in the performance of its functions.[163] This cooperation comes in to remedy the problems of multiplicity of laws and institutions that have hindered efficient financial services regulation for a long time. It involves reducing duplication of efforts, overregulation and likely conflicts in the roles of the regulatory agencies. Further, unlike informal memorandums of understanding that have been signed previously by the current regulators, the proposed law empowers the Authority to enter into a memorandum of understanding with other state organs and corresponding agencies in other countries.[164]

The Authority is managed by a board consisting of nine members. These members include a Chief Executive officer, chairperson appointed by the president and five other members appointed by

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[160] ibid.
[161] Erlend W Nier, 'Financial Stability Frameworks and the Role of Central Banks: Lessons from the Crisis' <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1378882> accessed 1 May 2016.
[162] FSAB 2016, s 4.
[163] ibid, s 14.
[164] FSAB 2016, s 15.

the Cabinet Secretary. Other persons who are members by virtue of their offices are the governor to the Bank and principal secretary to the National Treasury.

The Bill provides that the Authority is an independent entity yet leaves the appointment of its chairperson to the President. This is a contradiction and the consolidated Authority of its stature is likely to wield much power and influence. As such, it is prudent to have the chairperson being appointed by the President after a competitive process and with approval of the Parliament. The Section 20 also provides that the CEO shall be appointed by Board in consultation with the Cabinet Secretary. This is not in line with the objective of keeping the Authority an independent institution. Considering that the Cabinet Secretary has a hand in the appointment of five members of the board, there is a likelihood of a compromised appointment of the CEO. Additionally, there is need to bring in more professionalism and independence into the position.

The proposed regulator is of a stature of the class of the Central Bank, yet the appointment of the CEO does not seem to take that into consideration. The drafters seem to have taken lightly the likely impact of a consolidated regulator. The merger of three regulators under one regulator is likely to result in a mega institution that is likely to attract a lot of interests among the political class and also among the other stakeholders.

The Bill empowers the Cabinet Secretary to make prudential rules in consultation with the Authority.[165] This is another instance of watering down the independence of the Authority. The Authority should be empowered to make regulations on its own with minimal interference from the other arms of the government. This is in order to guarantee efficient implementation of its mandate.

[165] ibid s 30.

The proposed consolidated regulator falls short of the international standards on integrated regulators although it achieves some gains in financial regulation. Particularly, it leaves out the banking sector from the consolidated regulator and also retains the previous legal frameworks. This is likely to defeat the objective of reducing costs. Further, the Bill presents two regulators which would appear like a twin peaked regulator but there are provisions that lamp together prudential regulation and conduct of business regulation on the Authority. The Cabinet Secretary is quoted as saying that Kenya intends to adopt a twin-peaked regulator akin to the current framework in the UK but the regulator presents provisions that seem to present a confused consolidated regulator.

2.2 Conclusion

This chapter has explored the current regulatory framework in Kenya. The discussion has raised several issues on the suitability of the current regulatory framework in meeting the needs of the market. The current regulatory framework in Kenya is inadequate and presents various opportunities for reforms. It reveals that there are regulatory gaps as well as overlaps which need to be captured in the ongoing reforms.

CHAPTER THREE

ANALYIS OF REGULATORY APPROACHES

3.0 Introduction

This chapter will analyze the alternative methods of addressing the regulatory challenges facing financial conglomerates. The alternative measures discussed here are the formation of an integrated regulator, cooperation among the regulators, restricting activities of financial institutions and the use of Chinese walls as information barriers in mitigating the risks facing financial conglomerates.

3.1 An Overview of Regulatory Models

Regulatory approaches in the financial sector can be categorized in various ways. Importantly, there is a consensus that there is no one optimal model of regulation that can be proposed for all jurisdictions and therefore the various models depend on the circumstances of each country.[166] Broadly, they can be classified as fragmented models and integrated models. Fragmented models refer to the approaches that result in multiple regulatory agencies while the integrated model seeks to bring several regulatory agencies under one institution. The fragmented model appears to have several variants but the functional model and institutional model will be discussed in this chapter since they underpin the Kenya's regulatory framework.

The twin-peaked regulatory model is a form of an integrated model that involves having two regulators, one focusing on prudential regulation while the other focuses on conduct of business regulation. The UK has exemplified this kind of regulation whereby the Prudential Conduct Authority is the prudential regulator of banks, building societies, insurers, credit unions and

[166] Mwenda, 'Integrated Financial Services Supervision in Poland, the UK and the Nordic Countries' (n 52).

designated investment firms. On the other hand, the Financial Conduct Authority is the regulator of the conduct of financial services firms and financial markets in the UK.[167] There have been indications that Kenya should move towards this kind of model but steps are yet to be taken to achieve this.[168]

3.1.1 Institutional Regulatory Model

An institutional regulatory model consists of distinct regulatory agencies whose focus is on the institution rather than the product being regulated.[169] Each financial institution is allocated a distinct agency that is responsible for the regulation of its entire spectrum of activities.[170] This model aims at achieving the safety and soundness of institutions involved in the provision of financial services.[171]

It is characterized by inefficient resource utilization compared to a single regulator.[172] This is because it leads to the existence of many regulatory agencies. It also leads to fragmentation in supervision and it is ill-equipped to regulate financial conglomerates.[173] Competition may also exist among the regulators as a result of similar functions being regulated by different regulators.[174] It encourages the formation of departments that deal separately with all aspects of specific types

[167] 'About the FCA' (*FCA*, 20 April 2016) <https://www.fca.org.uk/about/the-fca> accessed 2 November 2016.
[168] Site designed and built by Hydrant (http://www.hydrant.co.uk), 'New Regulatory Framework Bringing Kenya in Line with International Best Practices' (*Oxford Business Group*, 24 January 2016) <https://www.oxfordbusinessgroup.com/analysis/shifting-gears-new-regulatory-framework-bringing-sector-further-line-international-best-practices> accessed 6 September 2016.
[169] Gakeri (n 15).
[170] Fay and Parent (n 41).
[171] Llewellyn T. David, 'Institutional Structure of Financial Regulation and Supervision: The basic issues' (presented at World Bank Seminar: Aligning Supervisory Structures with Country Needs, Washington DC, 6th and 7th June, 2006).
[172] Amyas Morse, *Regulating Financial Services,* (London, National Audit Office, 2014).
[173] Richard K Abrams and Michael Taylor, *Issues in the Unification of Financial Sector Supervision* (International Monetary Fund 2000).
[174] Fay and Parent (n 41).

of business activities. Notably, institutions operating as financial conglomerates are faced with the challenge of having to meet the requirements imposed by various regulators.

Kenya's financial regulatory framework is partly institutional and partly a functional approach. There is a regulatory agency for each sector and each regulator regulates distinct functions even when such are performed by institutions in another sector. As such, this model exposes institutions offering financial services in more than one sector to several regulatory challenges and increased compliance costs. These challenges are particularly due to multiple regulatory requirements. For instance a bank offering bancassurance has to be subjected to regulatory requirements of the Insurance Regulatory Authority and the Capital Markets Authority if it seeks to offer services in the capital markets sector.

Nevertheless, this approach has the ability to limit double regulation since the entire range of activities offered by a particular institution is regulated by the same regulator. Kenya does not experience this benefit because it also accommodates the functional regulatory model.

3.1.2 Functional Regulation Regulatory Model

In this model similar functions are regulated by the same agency. The focus of this model is on the function of the product or service being offered rather than the institution. [175] It is based on the premise that no single regulator can have or easily develop expertise in regulating all aspects of financial services.[176] It is persuaded by the view that similar functions should not be regulated alike. However, it underpins the idea that regulation of functions is more important than the types of the institutions that undertake those functions. The Kenyan regulatory framework is partly based

[175] Gakeri (n 15).
[176] ibid.

on this approach the same institution regulates the same functions regardless of the institution offering the same.[177] This also becomes a challenge for institutions offering diversified services.

3.2 Integrated regulator as a solution

As the financial sector grows, many countries are moving towards integrated regulatory systems.[178] However, it is instructive to note that there is no one single optimal regulatory framework.[179] Some countries have seen it fit to remain with fragmented regulatory frameworks as their domestic factors demand, while others have adopted full and partial integration.[180] Kaoma makes it clear that there are instances when it may not be desirable for a country to move towards consolidation such as where there is limited interconnectedness in its financial products.[181]

3.2.1 Nature of an Integrated Regulatory System

This is a model based on the unification of supervisory responsibilities of all sectors of the financial industry into a single regulator although the extent of consolidation may vary on case by case basis.[182] This can be represented in a continuum with a fragmented model being on one extreme end and a unified model being on the other extreme end.[183] As opposed to a two peaked model which has two regulatory institutions, this regulatory model is based on one major regulator, through some kind of consolidation of the existing regulators.

There can be two different types of integrated models, a fully integrated model and a partially integrated model. A fully integrated model is illustrated by the approach of the Scandinavian countries and it involves a regulator that takes on the roles of prudential regulation and conduct of

[177] For instance the insurance regulatory Authority regulates all insurance functions even when banks are involved.
[178] Mwenda, 'Regulatory and Institutional Framework for Unified Financial Services Supervision in the United Kingdom and Zambia' (n 50).
[179] ibid. See also Mwenda, 'Legal Aspects of Unified Financial Services Supervision in Germany' (n 52).
[180] Mwenda, 'Integrated Financial Services Supervision in Poland, the UK and the Nordic Countries' (n 52).
[181] Mwenda, *Legal Aspects of Financial Services Regulation and the Concept of a Unified Regulator* (n 7).
[182] ibid.
[183] Llewellyn (n 135).

business without the involvement of the central bank. [184] A partially integrated regulator has the central bank still involved especially in the systemic financial regulation and in the regulation of banks.[185]

The integrated model of financial regulation was first used in the Scandinavian countries in the 1980s.[186] Since then, most countries are moving towards integrated regulatory systems, abandoning fragmentation.[187] Llewellyn affirms this position by noting that there has been a general trend to move towards reducing the number of regulatory agencies involved in the regulation of financial services.[188] This is seen as a move towards positive reforms. However, not all countries need an integrated regulator.

3.2.2 Arguments for an Integrated Regulator

There are several factors that make an integrated regulator appealing to many jurisdictions in achieving the much needed financial reforms. Compared to the alternative fragmented regulatory frameworks, an integrated regulator is beneficial in many ways.

First it reduces the cost of regulation significantly.[189] By reducing the number of regulators, the cost is substantially reduced. An integrated regulator is also associated with optimal allocation and use of resources, especially administrative and human resources. This lowers institutional and

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[184] Emilia Zimkova, 'Trends in institutional Structure of financial Regulation and supervision in the European Union' BIATEC, Volume XIV, 5/2006 <www.nbs.sk/img/Documents/BIATEC/BIA0506/1821.pdf > accessed on 29th May 2015.

[185] ibid.

[186] Gakeri (n 15).

[187] Mwenda, 'Integrated Financial Services Supervision in Poland, the UK and the Nordic Countries' (n 52). Some of the countries that have embraced this type of regulatory model include Germany (2002), Norway (1986), Denmark (1988) and Sweden (1991). UK was a major economy to adopt an integrated regulator in 2001 but later abandoned it for a Twin-Peaked regulator. It shifted from a single regulator in 2013 to adopt a two peaks model focusing on conduct of business regulation and prudential regulation. Financial Services Act of 2012 created the Financial Conduct Authority and Prudential Regulation Authority to replace the Financial Services Authority from April 2013. A Twin-peaked model is one that involves one agency undertaking prudential regulation while the other undertakes conduct of business regulation.

[188] Llewellyn (n 135).

[189] ibid; Mwenda, 'Integrated Financial Services Supervision in Poland, the UK and the Nordic Countries' (n 52).

administrative costs significantly. Further, by eliminating the problems of overregulation unnecessary costs on the regulated firms and the consumers are eliminated.[190]

Cost efficiency also comes as a result of economies of scale acquired under owing to the benefits of integration.[191] The main functions of regulatory agencies are brought under one roof in an integrated regulator. Administrative and licensing functions can be done under one roof with reduced personnel and resources. Admittedly, the costs incurred in maintaining the operations of distinct agencies are largely reduced in case of integration. This factor informed the findings of the Presidential Taskforce on Parastatal Reforms on the need for consolidation of financial regulators in Kenya.[192]

Second, it is best suited for overall risk management in the financial sector. An integrated regulator is able to harmonize risk management, such that it becomes easier to monitor threats in the entire financial sector without sectoral barriers. Without such integration the agencies have to find mechanisms of exchanging information with each other in order to promote effective risk management.[193] Such measures have many challenges. They are expensive and hard to implement. This leaves an integrated regulator as the only system suitable for the management of systemic risk in the financial sector.

Third**,** it is suitable for the regulation of financial conglomerates, since it mirrors the nature of financial products.[194] The financial services products in the market have changed drastically in the

[190] Llewellyn (n 135).
[191] ibid.
[192] 'Report of the Presidential Taskforce on Parastatal Reforms' (n 11) 88.
[193] In Kenya, the regulatory agencies have employed these methods of sharing information among themselves in order to promote risk management. However, in this arrangement there is no one specific body responsible for overall risk management.
[194] Eilis Ferran, 'Examining the United Kingdom's Experience in Adopting the Single Financial Regulator Model' (2002) 28 Brooklyn Journal of International Law 257.

last several years. On this basis, many jurisdictions have opted for an integration of their financial regulatory agencies.[195] In Kenya, the Presidential Taskforce on Parastatal Reforms made reference to this fact, noting that the market developments have blurred the traditional lines separating various financial products and hence the need for an integration.[196]

Fourth, integration helps in dealing with problems of regulatory gaps and overlaps.[197] Such problems are prevalent in a fragmented system as discussed in the preceding part. When there is a distinct agency responsible for all or major financial services, gaps are eliminated because the regulator is clearly known and there is no regulatory competition. Fragmented regulators bring uncertainties about regulation and the boundaries of such regulation. This ends up causing regulatory gaps and overlaps that contribute to investor dissatisfaction. For instance, in the UK, prior to integration, the fragmented regulators was reported to cause such dissatisfaction. Eilis Ferran captures this scenario thus: "From its inception, the regulatory regime was the target of persistent criticism. It was seen to be unwieldy and bureaucratic."[198] Closer home, Kenya has also witnessed overregulation due to the presence of many regulators especially touching on the capital markets and pension sector.[199] Custodians are regulated by both the Capital Markets Authority and the Retirement Benefits Authority.

Fifth, it is superior in promoting a safe and sound financial system. This is attributed to the benefits of proper risk management and increased investor confidence following an effective integration. Additionally, the elimination of other problems like regulatory arbitrage contributes to having a

[195] Mwenda, 'Integrated Financial Services Supervision in Poland, the UK and the Nordic Countries' (n 52).
[196] 'Report of the Presidential Taskforce on Parastatal Reforms' (n 11) 88.
[197] Llewellyn (n 135).
[198] Ferran (n 194).
[199] Mutuku (n 16). The current regulatory system in Kenya causes double regulation of fund managers and custodians. This presents regulatory challenges and hurdles to the players in these sectors.

sound financial system. The adoption of a streamlined licensing of diversified products also helps in a better management of the financial system. It prevents the problem of investors having to go through unnecessarily increased financial hurdles during licensing as a result of multiple regulators regulating same products. In this way, it brings about a system that is user-friendly to institutions in the market as well as the users of financial services.[200]

Sixth, it avails the benefits of economies of scale in financial regulation. This is connected to reduction of costs of regulation. An integrated regulator is able to consolidate several overlapping functions that call for allocation of different types of resources. A single management structure affords the regulator the benefits of economies of scale.[201] This contributes to efficient allocation and use of resources. It prevents duplication of roles and therefore achieves optimal use of resources. This is especially needful in developing countries where there are many needs and economical use of resources is beneficial.[202]

Seventh, it puts the national system at par with international standards. There is a general move towards consolidation of financial regulators globally. Although there is no one optimal regulatory framework, many jurisdictions have moved towards integration and others have shown signs of adopting such reforms.[203] The experience of various jurisdictions that have undertaken such consolidation shows that it is more efficient. This has led to its global acceptance albeit in various forms depending on the nature and circumstances of the particular countries involved.

[200] Mwenda, 'Integrated Financial Services Supervision in Poland, the UK and the Nordic Countries' (n 52) 148.
[201] Hofheimer (n 57).
[202] ibid.
[203] Llewellyn (n 135); Mwenda, 'Integrated Financial Services Supervision in Poland, the UK and the Nordic Countries' (n 52); Hofheimer (n 57).

Eighth, it is able to achieve consistent objectives and avoids ambiguity in the regulatory sector. Where there are multiple regulators regulating almost similar products, there is a likelihood of turf wars directly or indirectly. Such competition is harmful and stalls important functions of regulation. With an integrated regulator, it is easier to have clear objectives especially because there is no likelihood of the mandate of the integrated regulator overlapping with another. Even where there is partial integration, the extent of overlapping is reduced.[204]

Ninth, an integrated regulator is better placed to deal with innovations in the financial sector.[205] It has been ascribed some flexibility which would be of use in accommodating new products. This is important because financial products keep developing. Such flexibility is not present in a fragmented system.

Tenth, it enhances accountability in the financial sector.[206] Unlike a situation where there are many agencies to be held accountable, where there is an integrated regulator there is clarity on where the focus of accountability should go. The buck stops with the integrated regulator and thus enhancing accountability. This is illustrated by the integration that occurred in the UK when it moved to a single regulator. After the integration, it was clear that the former system lacked transparency and accountability.[207]

An integrated regulator has many benefits but some arguments have been made against it. Some writers have argued that there is inconclusive evidence of a link between financial regulatory structure and safety and soundness of the system.[208] This counters the argument that an integrated

[204] Hofheimer (n 57). See also Llewellyn (n 135).
[205] Ferran (n 194).
[206] Mwenda, 'Integrated Financial Services Supervision in Poland, the UK and the Nordic Countries' (n 52).
[207] ibid.
[208] Mwenda, 'Legal Aspects of Unified Financial Services Supervision in Germany' (n 52).

regulatory framework promotes safety and soundness of the financial system. Nevertheless, improved risk management that integration brings is bound to lead to improved safety and soundness of the financial system.

There is a likely culture conflict. This is particularly because integration of the regulators involves bringing together formerly distinct regulators to operate as one. The differing modes of operation pose hurdle that must be dealt with sufficiently. Consequently, the anticipated synergy may fail to be realized due to this and other factors. This can be mitigated by a well-managed transition to an integrated regulator.

Integration leads to a large institution that is likely to face bureaucratic problems and rigidity. This size of the institution may also be hard to manage and requires a lot of caution in order to draw enough benefits from it. Further, an integrated regulator may neglect some key sectors under its objectives while focusing on sectors that may be assumed to be more important. To be effective in covering all the sectors, it requires vigilant management that might be hard to come by.

Transition to an integrated regulator is a key challenge. Apart from causing a regulatory gap[209], it may pose serious challenges to consolidate the distinct systems under one roof. This includes bringing harmony in the IT systems, personnel and management structure among others.[210] However, if the integration process is handled well and an effective institutional and regulatory structure crafted, these challenges can be mitigated.

It has also been argued that integration may lead to loss of specialization and expertise developed where there are distinct separate regulatory agencies. When formerly separate regulatory agencies

[209] Mwenda, 'Regulatory and Institutional Framework for Unified Financial Services Supervision in the United Kingdom and Zambia' (n 50).
[210] Hofheimer (n 57).

are brought under one roof it leads to undesirable generalization. It is also likely to cause a layoff of key specialized personnel who may not find a place in the integrated regulator.

Furthermore, integration in the financial services sector requires political goodwill which is elusive especially in developing countries like Kenya.[211] The formation of a large regulator is likely to attract a lot of interest and opposition due to many vested interests by the political class. This is rife especially in Kenya where positions to statutory bodies are used to reward political loyalty. The number of such institutions under the government is usually coveted by politicians as key incentives in the political bag which can be used to win more sycophants.

3.2.3 Arguments against integration

Integration of financial service providers seems to present a viable approach but critics have cited several challenges against its implementation.

First, an integrated regulator is prone to regulatory capture.[212] This occurs when the regulator is influenced by private industry players, thus ending up serving the interests of a few individuals at the expense of public interest. Capture theory buttresses this argument in that administrative institutions are bound to be influenced by the interests of some interest groups in the society.[213] However, other writers have observed that not all capture is bad and a fruitful relationship can be cultivated between the industry players and the regulator.

[211] There have been proposals to have an integrated regulator in the financial sector in Kenya since 2012, when the then minister for finance Njeru Githae made the proposal in a budget speech. Since then the political class have only seen it fit to toy with the idea and only implement it when there interests are safeguarded, or awaiting a tsunami of change. This reveals that an integrated regulator is likely to be compromised by the political environment of the country and must only be implemented when the conditions are ripe.

[212] Baxter (n 30).

[213] ibid.

Second, the process of bringing the change faces several challenges. With the benefit of hindsight, it can be established that a change that touches on political power is bound to attract numerous hindrances. Consequently, the process of change may become politicized and poorly managed. In the past the ministry of finance has wielded much political influence particularly due to the number of Parastatals and resources under its control. Any change of the existing structures is therefore likely to catch the interest of politicians whose eyes is on what they can get from the process.

Interferences in the implementation process may also lead to a rushed process devoid of investment in serious due diligence expected of such a change process. As politicians seek to pass their proposals within a favourable time frame, they are likely to overlook the core considerations such as the design of the proposed regulator.

Third, the process of coming up with legislation to operationalize the change is likely to pose other challenges. Moving from a fragmented regulatory framework requires a consolidated regulatory framework, a process that is likely to be politicized. From the context of the UK, Abram and Taylor have recommended a solution of enacting a simple legislation to transfer the powers in the existing bodies to the new body.[214] However, this may be a complex process that is prone to mismanagement and political meddling.

Fourth, integration causes the creation of an exceptionally large institution which is subject to diseconomies of scale.[215] Critics of integration have argued that an integrated regulator may turn out to be a large bureaucratic institution that may is likely to lack efficiency. Further, this challenge is also likely to arise from the fact that the integration involves a combination of different sectors

[214] Abrams and Taylor (n 173).
[215] Mutuku (n 16).

whose objectives are different. As such, it becomes hard to state the objectives of the integrated regulator with clarity.

Another source of diseconomies of scale is the ever increasing scope of the integrated regulator. From international experiences, integrated regulators are likely to be assigned other functions connected to their core functions. This has been the case with the United Kingdom, whose Financial Services Authority was assigned other responsibilities. The effect of this is to diver the regulator from its core functions.

Fifth, integration may result in loss of key personnel. When such a major reorganization takes place, some of the staff members are bound to be edged out to avoid redundancy and duplication of roles. This has the effect of depriving the regulator of experienced personnel whose contribution to the regulation is essential.

Sixth, integration eliminates specialization in regulation unlike in a fragmented system where the regulators focus on particular sectors, ensuring specialization.[216] The different regulators are in a position to hire their own staff members who are skilled in the specific areas of regulation. This builds capacity and enhances the effectiveness of the regulators. On the other hand, when all the sectors are brought together, specialization ceases to become a primary concern for the regulator.

3.2.4 Suitability of an Integrated Regulator in Kenya

From the experience of the countries that have adopted integrated regulatory approaches, there are different reasons for moving towards integration. In considering the suitability of integrated financial regulation in Kenya, several factors must be considered. The question that must be answered is whether there are compelling reasons for Kenya to move towards an integrated

[216] ibid.

regulator in response to the rise of financial conglomerates. The following is a discussion of some of the factors that support the adoption of an integrated regulator in regulation of financial conglomerates.

3.2.4.1 Integration of Financial Products in Kenya

It is arguable whether Kenya has attained the level of market developments that is able to necessitate the adoption of an integrated regulator. Gakeri argues that Kenya's financial sector has not reached this level and therefore only minimal reforms are needed in a move towards integration.[217] Nevertheless, other writers and policy makers have seen the impact of market developments in Kenya. The Presidential Taskforce on Parastatal reforms reported that Kenya has witnessed notable market developments and therefore there is need to move towards integration.[218]

Kenya's financial sector products have so developed that the traditional boundaries delineating financial products have become blurred.[219] Today we have financial institutions offering services in other regulated sectors. There has been an increase in the number of institutions offering diversified financial services in Kenya leading to interconnectedness of financial institutions and services.

Although integration of financial services is not so advanced currently, there are indications of more changes and innovations. The increased rate of mergers and acquisitions in the financial sector is telling.[220] The Capital Markets Authority has also set the stage for the upcoming of asset

[217] Gakeri (n 15).
[218] 'Report of the Presidential Taskforce on Parastatal Reforms' (n 11) 87.
[219] Mutuku (n 16).
[220] There has been an increase in the number of mergers and takeovers involving financial service providers. The most recent has been the merger of UAP and Old Mutual, a globally significant player. This trend is likely to increase as financial service providers seek to position themselves strategically for competition. See 'UAP to Acquire Old Mutual Firms ahead of Listing on Bourse' <http://www.businessdailyafrica.com/UAP-to-acquire-Old-Mutual-firms-ahead-of-listing-on-bourse/539552-3303352-b05y28z/index.html> accessed 2 November 2016.; Applejack.co.uk, 'Trend for Kenyan Mergers and Acquisitions Continues to Escalate' (*Commercial Risk Europe*)

backed securities. This is likely to increase the complexity of financial conglomerates and cause more homogenization.

Bancassurance has continued to gain popularity among commercial banks in Kenya. This has become even more significant as banks seek alternative sources of income after the capping of interest rates following the passage of Banking (Amendment) Act 2016. It is likely that smaller banks will merge and even look for other means of getting a return for their investment. This is likely to increase the capacity of offering bancassurance and other financial products.

Further, collective Investment Schemes have given rise to unit trusts, which are capital market products that cut across more than one financial services sector. These products are mostly offered by insurance companies, hence subjecting them to the regulation of the CMA and the IRA.

3.2.4.2 Increased number of financial conglomerates in Kenya

Financial service providers in Kenya have continued to expand and diversify into other financial service sectors. There is a significant number of such institutions in Kenya, a factor that has created the need for increased coordination and cooperation among the financial regulators. The number of banks offering financial services in other sectors has increased in the last decade. Some of the notable banks that operate as financial conglomerates in Kenya include Equity Bank,[221] Barclays Bank,[222] Standard Chartered Bank, Kenya Commercial Bank, Commercial Bank of Africa, NIC Bank, Cooperative Bank and National Bank.

<http://www.commercialriskeurope.com/cre/4130/15/Trend-for-Kenyan-mergers-and-acquisitions-continues-to-escalate/> accessed 17 August 2016.

[221] On 31st December, 2014, Equity Bank Group finalized an internal restructuring that culminated in its conversion into a non-operating holding company, Equity Group Holdings Limited (EGHL) in order to further meet its objectives. See http://equitybankgroup.com/about/our-history accessed 8th October 2016. Equity Bank Group consists of Equity Insurance Agency Limited which was incorporated in December 2006 and was licensed in May 2007.

[222] Barclays Africa ventured into the insurance with Barclays Life assurance and Barclays Bank Insurance Agency. 'Barclays Bank in Deal with Chandarias to Offer Insurance' <http://www.businessdailyafrica.com/Corporate-

I&M Holdings Limited is another bank that operates as a group of companies. It was approved as a non-operating holding company in accordance with the Banking Act, Cap 488 Laws of Kenya in June 2013.[223] Accordingly, I&M is regulated by the CMA and the CBK due to diversification covering banking and the capital markets sectors.

Further, insurance companies have spread their scope to capital market products particularly in the form of collective investment schemes. The merger of UAP and Old Mutual brings together large companies encompassing insurance and capital markets and it is likely to result in a complex institution.[224] This adds to the number of financial conglomerates that are growing in Kenya. It also reveals that there is a trend to move towards diversification through mergers and acquisitions in order to cope with the increasing competition.

The CIC Group is a listed company that fits the description of a financial conglomerate. It started off as an insurance company but it has grown to offer both life and general class of insurance as well as asset management business.[225] It offers these services through subsidiaries namely CIC Life Assurance Limited, CIC General Insurance Limited and CIC Asset Management Limited[226]. The latter was licensed by the CMA in June 2009 as a fund manager and subsequently by the

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News/Barclays-in-deal-with-Chandarias-to-offer-insurance/539550-2702448-duocji/index.html> accessed 8 October 2016. Barclays Financial Services Limited is the Securities trading arm of the Barclays Bank Kenya. See Patrick Alushula, 'Barclays' Brokerage Arm Opens Trading at NSE' (*Standard Digital News*) <http://www.standardmedia.co.ke/article/2000218845/barclays-brokerage-arm-opens-trading-at-nse> accessed 8 October 2016.

[223] 'I&M Holding Limited' <https://www.imbank.com/about-us/i-and-m-holdings/> accessed 2 November 2016.

[224] 'UAP to Acquire Old Mutual Firms ahead of Listing on Bourse' (n 220).

[225] 'CIC Group-Investment CIC Group' <http://cic.co.ke/investment/> accessed 2 November 2016. The CIC Group offers these services.

[226] The CIC Asset Management Limited has specialized in the management of investment portfolios for pension fund schemes, collective investment schemes and private clients.

RBA.[227] Clearly, CIC Group the diversification of CIC Group subjects it to the regulation of the CMA, RBA and IRA.

Equity Group Holdings Limited has also continued to expand and diversify into insurance, capital markets and even money transfer. The group therefore falls under the definition of a financial conglomerate. It owns subsidiaries offering insurance, capital markets and money transfer. Some of the financial conglomerates identifiable in Kenya also have subsidiaries in other countries. I&M Holdings operates in four countries, Kenya, Tanzania, Rwanda and Mauritius.[228]

3.2.4.3 Global standards

The global financial markets have been moving towards integration of financial regulators as market developments dictate.[229] This has been discussed and illustrated in the previous parts. As Kenya seeks to attract international players and strategic partnerships, its financial regulatory framework has to inspire confidence in the international players. This has been clearly captured in the Capital Markets Master plan, as it seeks to adopt measures to position the capital markets in the global arena.[230]

3.3 Restricting the activities of financial institutions

One of the ways of responding to challenges posed by financial conglomerates is the restriction of activities that financial service providers can undertake. However, the efficacy of such a move is debatable. In the USA, banking activities and investment banking have been separated for long following the banking crisis of 1929. The Banking Act 1933 was enacted to restrict the activities of financial conglomerates. However, the passage of the Financial Modernization Act, 1999[231]did

[227] 'CIC Group-Investment CIC Group' (n 225).
[228] 'I&M Holding Limited' (n 223).
[229] Mwenda, 'Legal Aspects of Unified Financial Services Supervision in Germany' (n 52).
[230] 'Capital Markets Master Plan 2014-2023' (Capital Markets Authority).
[231] Also known as Gramm-Leach-Bliley Act, 1999.

away with the restrictions thus ushering a new era. This brought a new regime but the financial sector is still in need of further reforms.[232] Interestingly, the debate has resurfaced since it has been an issue for discussion in 2016 US Presidential elections. Donald Trump, the Republican Presidential candidate has strongly criticized institutions described as too big to fail[233] and called for a return of the Glass Steagal Act.[234]

Today the view has changed towards restriction of financial activities. The general trend has been deregulation to allow for diversification of financial services.[235] Breaking up financial conglomerates is seen as an extreme measure[236] whose gains cannot be compared with the benefits of financial conglomerates. In fact, restriction of financial services is not attributed to prevention of financial crises, for a crisis can occur even in a system where there are such restrictions.[237]

Further, the financial landscape today is characterized by innovation and technological developments that have resulted in homogenization of financial services, insurance, securities and banking. [238]This has made it easier for financial service providers to provide services under one roof. The rise of products such as asset-backed securities and bancassurance characterizes this integration of financial services. This makes restriction of financial services less favourable as a regulatory approach.

[232] Wilmarth (n 65).
[233] Such banks include Godman Sacks, JP Morgan, Citigroup and Bank of America.
[234] The return of Glass-Steagal Act has been a subject in the American Presidential debates, with Hillary Clinton maintaining that there is need to adopt other measures than the return of Glass Steagal while Donald Trump seeks to have a return of the Act. The Act is meant to break up the large firms which have been described as being too big to fail. These sentiments have also been shared by some democrats.
[235] Harry McVea, 'Financial Conglomerates and Conflicts of Interest: Resolving a Regulatory Dilemma' (1996) 47 Northern Ireland Legal Quarterly 239.
[236] ibid.
[237] Herring and Litan (n 60).
[238] Wilmarth (n 65).

3.4 Cooperation among Regulators

Cooperation among the regulators is inevitable in a regulatory framework that has multiple regulators. The regulators in the USA were accused of failing to have a proper framework for information sharing, making it difficult to assess systemic risks.[239] Cooperation is therefore important in order to facilitate proper risk management. Through cooperation the regulators are able to share information and facilitate effective supervision of financial conglomerates.

The regulatory authorities ought to have adequate powers to share information that can aid in systemic risk management for the entire group of a financial conglomerate.[240] Walker proposes that there is need for a lead regulator to coordinate the information sharing that is to take place among the regulators.[241]

Informal MoUs are not effective because they lack a substantive legal framework. The mechanism for information sharing must be properly enshrined in the substantive statute. This is lacking in Kenya since the mechanisms of cooperation have not been specifically captured in the substantive statutes. The five regulators have coalesced under a common platform in form of a MoU that sets the pace for information sharing.[242]

The Financial Services Authority Bill 2016 has provided for mechanisms of cooperation between the proposed Financial Services Authority and the Central Bank of Kenya.[243] It recognizes the existing MoUs by providing that they will be deemed to have been created by the Authority upon

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[239] Elizabeth F Brown, 'The New Laws And Regulations For Financial Conglomerates: Will They Better Manage The Risks Than The Previous Ones?' (2011) 60 American University Law Review 1339.
[240] George A Walker, 'Law of Financial Conglomerates: The Next Generation, The' (1996) 30 International Lawyer (ABA) 57.
[241] ibid.
[242] 'The Kenya Financial Stability Sector Report, 2015' (n 154).
[243] FSAB 2016, s 77.

coming into effect of the Act.[244] Section 14 of the Bill provides that the Authority may cooperate with the Central Bank. The Authority is required to coordinate its actions with the Bank to the extent possible in relation to licensing, investigations, actions to enforce laws, information sharing, recovery resolution and reporting by financial institutions. It also provides the power for the Authority to enter into MoUs with other regulators for the discharge of its functions. Notably, the Authority is required to publish the MoU and any amendment that may occur.[245]

3.5 Use of Chinese Walls

The organizational structure of a financial conglomerate presents many opportunities where confidential information may be used for private gain.[246] This is a major challenge that regulation seeks to address. There are several other methods which have been suggested as possible approaches for the regulation of the conflict of interest that is inherent in a financial conglomerate. These include the use of market forces, deconglomeration, and reinforced Chinese walls.[247]

Chinese Walls can be described as "a set of policies and procedures to stem the flow of confidential information." [248] The usefulness of Chinese Walls in resolving conflicts of interests is arguable. Some writers have claimed that the use of Chinese Walls is the linchpin of financial conglomerates regulation[249] while others have questioned its effectiveness. Gower postulates that this mechanism fails to restrict conflicts, it just restricts flow of information.[250]The use of Chinese Walls does not agree with commercial reality, it has been described as a tool of fiction that is only used to cause

[244] ibid, s 186.
[245] FSAB 2016, s 15.
[246] Tuch (n 149).
[247] McVea (n 235).
[248] ibid.
[249] ibid.
[250] Graham F Pimlott, 'Reform of Investor Protection in the UK–An Examination of the Proposals of the Gower Report and the UK Government's White Paper of January, 1985, The' (1985) 7 J. Comp. Bus. & Cap. Market L. 141.

restrictions on paper.[251] Likewise, even critics of Chinese Walls have agreed that segregation of financial conglomerates into distinct entities is not a solution for the resolution of conflict of interest. This is a confirmation that the solution to conflict of interest is found in more comprehensive regulatory reforms. This research seeks to establish that the adoption of an integrated regulator is able to address the major regulatory challenges posed by financial conglomerates.

Andrew Tuch discredits the use of information barriers as an efficient method of responding to the challenges faced by financial conglomerates. Evidently, it is often difficult to prove that information barriers have been breached and financial conglomerates will readily stand behind the Chinese Walls in defending improper information leakage.[252]

3.6 Conclusion

This chapter has provided an analysis of the possible approaches to the regulation of financial conglomerates. The chapter extensively delved into the suitability of an integrated regulator as a response to the issues raised by the rise of financial conglomerates. Apart from the adoption of an integrated regulator, it was also argued that certain regulatory challenges can be solved by the use of Chinese walls and establishing cooperation mechanisms among the regulators. The use of Chinese Walls has been brought out as being narrow and is not suitable for comprehensive reforms. Nevertheless, it can be adopted as an additional mechanism for a comprehensive solution. Breaking up of financial conglomerates has been brought out as an unsuitable approach that may reverse the gains made in the financial sector. The chapter has presented the use of an integrated regulator as the most comprehensive regulatory approach that can take care of most policy issues

[251] Tomasic Roman, 'Chinese Walls, Legal Principle and Commercial Reality in Multi-Service Professional Firms' (1991) 14 UNSW Law Journal 47.
[252] Tuch (n 149).

and challenges arising. However, the use of more than one approach should be encouraged where better results can be achieved depending on the circumstances of the country.

CHAPTER FOUR
REGULATION OF FINANCIAL CONGLOMERATES

4.0 Introduction

The rise of financial conglomerates has come along with new challenges to the regulatory framework.[253] Financial conglomerates exist with complex structures that warrant special attention due to the risks they pose to the financial system.[254] This chapter will discuss the nature of financial conglomerates and the common regulatory approaches that can be undertaken in their regulation.

4.1 The rise of financial conglomerates

The term financial conglomerate may connote different meanings but the importance of a clear definition has been underscored in literature.[255] In competition law, a conglomerate is understood in the context of mergers with reference to mergers in different areas of production.[256] This research focuses on financial conglomerates. This occurs when an institution offering financial services in one sector provides financial services in another sector, thereby providing a corporate umbrella for more than one financial service.[257] The Basel Committee also defines a financial conglomerate as a financial institution that offers financial services in more than one regulated

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253 Santos and Mullineux (n 61).

254 Mwenda, *Legal Aspects of Financial Services Regulation and the Concept of a Unified Regulator* (n 7) 42. Mwenda argues that financial conglomerates pose the risk of contagion to the financial sector during a financial crisis.

255 Valentina Peleckienė, Kęstutis Peleckis and Gitana Dudzevičiūtė, 'New Challenges of Supervising Financial Conglomerates' (2011) 5 Intellectual Economics 289.

256 Competition Act No 12 of 2010, s 41 (2) (e).

257 Freixas, Lóránth and Morrison (n 4).

sector. [258]This definition is consistent with the definition offered by other instruments such as European Union Financial Conglomerates Directive. [259]

Financial conglomerates developed in Europe and the US in the 1960s and 1980s. The first conglomerates in UK and US are Slater Walker and Ling-Temco-Vought respectively.[260] Both are noted to have experienced an early collapse.[261] In the Mid 1970s conglomerate structures grew particularly from a rise of acquisitions and subsidiaries as well as the deregulation of many markets in Europe.[262] In the US the reign of financial conglomerates was cut short by the enactment of Glass- Steagal Act.[263] This Act brought restrictions in the US, seeking a separation of financial services such that one institution could not be involved in offering varied financial services under the same entity.[264]The need for separation was mainly motivated by the banking crisis of 1929. However, the Act was repealed in 1999 by the Financial Services Modernization Act of 1999 which removed the barriers, allowing a combination of banking, insurance, investment banking and other financial services under the same institution.

The rise of conglomerate structures can generally be attributed to developments in the global financial landscape and particularly technological developments. [265] However, this depends on country specific factors since not all countries can be said to have financial conglomerates. For instance, liberalization of the regulatory environment has contributed to the rise of financial

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[258] 'Principles for the Supervision of Financial Conglomerates - Final Report - joint29.pdf' (n 20).
[259] Y Emilie Yoo and others, 'Capital Adequacy Regulation of Financial Conglomerates in the European Union' (Institute for Monetary and Financial Stability (IMFS), Goethe University Frankfurt 2010) <https://ideas.repec.org/p/zbw/imfswp/37.html> accessed 12 October 2016.
[260] Walker (n 240).
[261] ibid.
[262] ibid.
[263] Also known as the Banking Act 1933.
[264] Walker (n 240).
[265] Yoo and others (n 259).

conglomerates in countries such as the Philippines among others.[266] The Report on Parastatal Reforms in Kenya also attributed the rise of financial conglomerates to a liberalization and deregulation in the financial sector.

As competition increases there has been a growing need to adopt the business strategy of diversification.[267] This has caused an increased appetite for financial services in other sectors. Unlike in the past when financial services were compartmentalized in their specific sectors, today financial service providers have entered into other areas traditionally reserved for specific service providers. Financial institutions are in search of new business opportunities and expansions in the financial sector due to the continued changes in the financial landscape.

The history of financial conglomerates shows a continuing trend as the financial landscape keeps changing. However, the risks posed by large financial institutions have been attributed to a scenario of too big to fail institutions which have been a recipe for crises in the past. In fact in the US there has been an ongoing debate on the need to break the large institutions by a reintroduction of the Glass Steagal Act.

4.2 Nature and structure of financial conglomerates

The organizational structures of financial conglomerates can take various forms. Some countries embrace a model whereby all the services are provided under a single entity while others would prefer to have single subsidiaries. The former is a German Model of financial conglomerates also known as universal bank model while the latter is consists of a group holding company that has subsidiaries offering services in other financial sectors.[268] The universal model allows a bank to engage fully in securities and insurance services. A holding company structure consists of some

[266] Santos and Mullineux (n 61).
[267] 'Finance Regulators to Sign MoU on Converged Sector' (n 137).
[268] Tuch (n 149).

form of restrictions whereby subsidiaries can be used to offer diversified services while making use of firewalls to prevent the inherent risks of conflict of interest.[269] However, the use of firewalls is not a sufficient mechanism to prevent the inherent risks of conflict of interest in a conglomerate model.[270]

Financial conglomerates can be structured to have one of the regulated entities being the holding company or a non-regulated entity being the holding company. The forms of structures that a financial conglomerate can take have been categorized as follows:

Holding company structure

This is a structure that involves a group of companies made up of distinct subsidiaries in the financial specific sectors. There is a holding company that holds two or more subsidiaries offering specialized services in one or more sectors. The holding company is potentially unregulated and not subject to regulations of the regulatory agencies.[271] The subsidiaries are subject to different regulatory requirements as set by the specific sectors. It is characterized by complete separateness and has also been described as the US Model.[272]

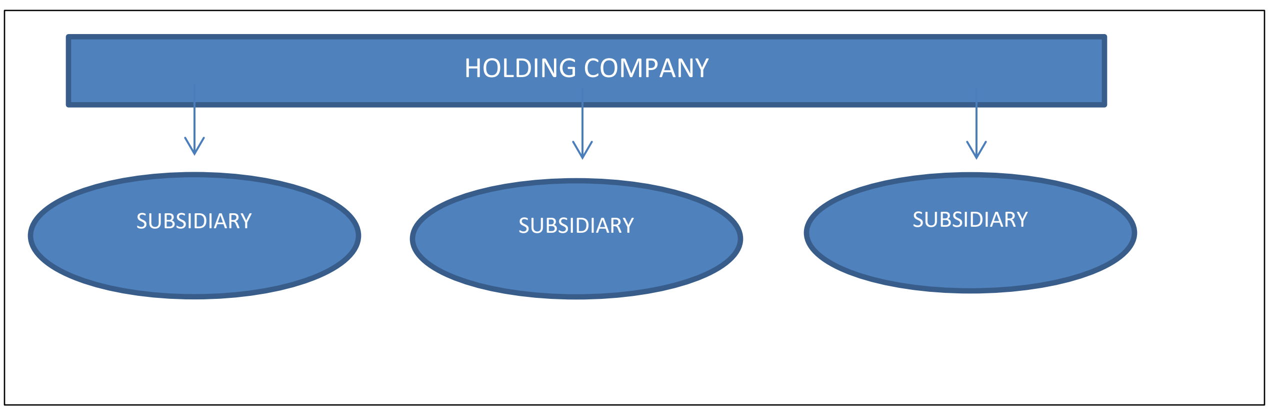

Figure 2: Holding Company Structure

[269] Walker (n 240).
[270] Tuch (n 149).
[271] Yoo and others (n 259) 4.
[272] Peleckienė, Peleckis and Dudzevičiūtė (n 246) 301.

Universal Banking Model

This is commonly known as the German Model of financial conglomerates. It is structured in such a manner that all the services are offered under the same corporate entity, with no separateness. Due to lack of separation, it is highly prone to contagion risks and conflict of interest challenges than other models.[273]

Bank parent- non bank subsidiaries

In this model the bank operates as the holding company with subsidiaries operating in other financial sectors. It has also been described as the British Model.[274]

Parent- subsidiary structure

This entails having a parent company owning subsidiaries that are legally and operationally separate.[275] However, the parent and the subsidiaries may be practically connected such that it may not be easy to separate them in the market. They may use the same brand name and even have consolidated accounts.[276]

4.3 Financial Conglomerates in Kenya

The rise of financial conglomerates in Kenya can be attributed to increased competition in the financial sector which has brought about a desire for financial institutions to diversify their services to other sectors. This is common among banks and insurance companies. This trend is expected to increase especially with the capping of bank interest rates following the Banking (Amendment)

[273] Peleckienė, Peleckis and Dudzevičiūtė (n 245).
[274] ibid.
[275] Yoo and others (n 259).
[276] ibid.

Act 2016 which has introduced restrictions on the amount of interest that banks can charge their customers.

KCB bank is already seeking to venture into the capital markets sector through a subsidiary. Previously, the bank has been operating a department that dealt only with the shares of the bank but with the changes in the financial landscape, it has become necessary for the bank to venture into provision of other financial services. The bank also has a subsidiary that is involved in the provision of insurance services under the bancassurance model and therefore subject to the regulation of the Insurance Regulatory Authority.

Equity Bank Limited entered the banking sector with radical and innovative approaches to reap from the unbanked population in Kenya, mainly middle and low income earners. It has also ventured into provision of diversified services through incorporated subsidiaries. Due to its increased diversification it has turned into a group of companies with distinct subsidiaries offering services in the insurance sector, capital markets and even money transfer services. For the purposes of this study it therefore features as an illustration of a financial conglomerate.

The report on its website shows that due to a rich portfolio of diversified investments, "Equity Group Holding's total assets grew to KShs 372.5 billion up from KShs 295.3 billion representing a 26% growth year on year." [277] This has motivated other banks to follow in the same trend, with increased acquisitions and incorporation of subsidiaries being seen in the sector. Barclays Bank Africa bought a controlling stake in First Assurance Limited with the Barclays Life Assurance

[277] 'Equity Bank Group• Diversification Strategy Pays off as EGHL posts13% Growth in PBT and Welcomes New Strategic Investor | Blog' <http://equitybankgroup.com/blog/2015/04/diversification-strategy-pays-off-as-eghl-posts13-growth-in-pbt-and-welcomes-new-strategic-investor> accessed 28 October 2016.

Kenya Ltd running the First Assurance's life assurance business. [278]Life Assurance products are underwritten by Barclays Life Assurance Kenya Ltd[279] while Barclays Bank of Kenya Ltd plays the role of a distributor.

Other banks that have diversified into other financial sectors include Cooperative Bank and National Bank Limited which have incorporated subsidiaries for provision of insurance agency services.

4.4 Regulatory Issues on Financial Conglomerates

There are several regulatory issues that arise with financial conglomerates. These include capital requirements, conflict of interest, firewalls, non- regulated entities and risk management.

4.4.1 Conflict of Interest

Financial conglomerates stand in a challenging position, where they often act as agents and principals to the same client. This provides opportunities that can be exploited by the financial conglomerate by improper disclosure of information.[280] Consequently, the principles of agency law are negated in this scenario, since they impose contradictory duties at the same time.[281] Information barriers, often known as Chinese Walls are resorted to in such instances.

Conflict of interest occurs when a person is in a position where they are likely to exploit a position for a personal benefit at the expense of public duty. Financial conglomerates often find themselves in this kind of conflict, where they are likely to have the interest of clients clashing with their

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[278] 'Barclays Africa Buys Stake in First Assurance for Sh2.9bn' <http://www.businessdailyafrica.com/Corporate-News/Barclays-acquires-First-Assurance-for-Sh2-9bn/539550-2747440-item-0-taw9nn/index.html> accessed 8 October 2016.

[279] Barclays Life Assurance Kenya Ltd. is regulated by the Insurance Regulatory Authority of Kenya, whilst Barclays Bank of Kenya Ltd. is regulated by the Central Bank of Kenya. See 'Barclays Bank Kenya | Life Assurance' <https://www.barclays.co.ke/life-assurance/index.html> accessed 28 October 2016.

[280] Tuch (n 149).

[281] ibid.

interests.[282] Undeniably, conflicts are ripe within institutions providing diversified financial services under a single entity.[283] In response to this regulatory challenge, there are several solutions that have been explored. This research looks at two approaches commonly explored, the use of Chinese Walls and the segregation of financial conglomerates into distinct entities.

4.4.2 Risk Management

The structure of financial conglomerates brings about several inherent risks. This includes contagion risks which have been attributed to close relationships among the distinct parts of a conglomerate.[284] Particularly, this risk of contagion arises where the problems of one distinct part of the conglomerate spills over to another part of the financial sector. For instance, if there is a bank failure, the other distinct parts may be affected due to damaged confidence that may spread to the entire group or even due to inter-group loans. The securities arm of the group may be involved in investments in risky areas which may end up affecting the other parts of the group as well. Insurance sector may also fail resulting in failed repayment of funds and consequently a transfer of the loss to other sectors occurs.[285]

The likelihood of transfer of losses in a conglomerate may end up causing a systemic risk which affects the whole financial system. Further, loss of confidence in one part of the financial conglomerate is likely to be transferred to the entire group of companies.[286] This is compounded by the fact that the names of the separate entities usually have a similarity in with others in the group for ease of marketing and brand selling.

[282] ibid.
[283] McVea (n 235).
[284] Walker (n 240) 66.
[285] Walker (n 240).
[286] ibid.

Where the regulatory agencies are separate, it becomes hard to undertake effective risk management in a financial conglomerate. The distinct agencies lack an overall view of the risks in each sector and therefore there is need to have a regulator that mirrors the structure of the financial services industry. This means that an integrated regulator provides the benefit of comprehensive monitoring of risks that face the financial conglomerate. It is in better placed to monitor the entire sector and it is not impeded by the difficulties of getting information from other sectors. Information sharing mechanisms should only be limited to what is necessary and more efficient approaches adopted.

4.4.3 Capital Adequacy Requirements

The question that arises with respect to capital requirements is whether there is need for the financial conglomerate to be subjected to capital adequacy requirements at the group level. Literature is replete with arguments on the risk of not imposing capital adequacy requirements at the group level. The structure of the financial conglomerate is such that there are new risks which call for additional measures. In the group structure, where services are offered under one roof there is a tendency to treat the risks imposed by various products in the same way. However, different services present different risks to the sector.

It has also been argued that diversification comes with many advantages such as economies of scale and therefore reduced risks. This may sound true on face value but the fact is that there are inherent risks in the financial conglomerate which cannot be mitigated by the existence of diversification.

The current law fails to regulate financial conglomerates at the group level, thereby leaving some blind spots in the regulatory structure. The holding company is not subjected to any prudential requirements apart from the regulations under the Companies Act. As such, it poses a risk to the financial conglomerate.

4.5 Regulation of Financial Conglomerates

4.5.1 The Viability of Integrated Regulation

The preceding chapter has discussed at length details about an integrated regulator as a regulatory approach. This section looks further at the integrated regulator as a mechanism for addressing the challenges posed by financial conglomerates, while highlighting some of the salient issues.

Agreeably, the rise of financial conglomerates calls for a regulatory paradigm that reflects the developments in the financial sector. From the onset this research has demonstrated that the organizational structure of such institutions leads to creation of new relationships which are often not captured within the traditional sector specific regulation as the case with Kenya.[287] Abrams and Taylor emphatically state that the regulator should reflect the structure of the markets being regulated.[288] Relatedly, a market that offers integrated financial services should be regulated by an integrated financial services regulated authority.[289] An integrated regulator is preferred by financial conglomerates because it is able to minimize compliance costs by the regulated entities.[290] Further, it is also in a position to provide a group-wide regulation of financial conglomerates hence reducing systematic risk posed by such structures.

An integrated regulator contemplated in this research is one that incorporates several regulatory agencies under one regulator. This is a regulator that takes over all the regulatory issues of the financial sector, thereby eliminating sector specific fragmented regulation. However, the Central

[287] ibid.
[288] Abrams and Taylor (n 173).
[289] ibid.
[290] Ashima Goyal, 'Regulatory Structure for Financial Stability and Development' [2010] Economic and Political Weekly 51.

Bank is retained as an independent organ to handle systemic regulation. The adoption of an integrated regulator can be considered as a suitable reform in response to the regulatory challenges posed by financial conglomerates. There are several arguments in favour of an integrated regulator in response to the regulation of financial conglomerates.

Kaoma argues that a unified regulator is best placed to undertake a group-wide risk management in financial conglomerates.[291] Each sector presents different risks and it becomes difficult to undertake an efficient risk management when there are different regulators regulating each sector separately. In the absence of proper coordination and cooperation among the regulators, the individual sectoral regulatory agencies are unable to achieve group-wide risk management.

A unified regulator mirrors the services provided by the financial conglomerates. There is increased integration of financial services which has resulted into continued blurred differences between the services that have been traditionally provided under distinct sectors. This has affected financial regulation in many jurisdictions. For instance, in Germany, such market developments influenced the merging of sector specific regulators.[292] In Kenya the integration of financial services is a major phenomenon in the financial sector. The products are increasingly getting interconnected leading to blurred differences. This has made it easier for financial service providers to offer more than one financial service under the same entity.

Consequently, the scenario in Kenya is that the financial services are so interconnected as to warrant the adoption of a consolidated regulator. This interconnectedness is seen with increased diversification of financial services by commercial banks and insurance companies. Insurance

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[291] Mwenda, *Legal Aspects of Financial Services Regulation and the Concept of a Unified Regulator* (n 7).
[292] Raimo Voutilainen, 'Comparing Alternative Structures of Financial Alliances' (2005) 30 The Geneva Papers on Risk and Insurance-Issues and Practice 327.

companies have increasingly continued to offer capital market products while banks have extended their scope to offer bancassurance and even investment services in the capital markets. The recent acquisition of UAP insurance Company Limited by Old Mutual is an illustration of the increased diversification that is shaping the Kenyan financial landscape. Barclays Bank Africa has also in the recent past acquired First Assurance, as earlier discussed in this research. This trend is likely to increase especially with the recent changes in interest rate regulations, increased competition, mergers and takeovers.

4.5.2 Proposed Regulation of Financial Conglomerates in Kenya

The current regulatory framework in Kenya falls short of the international standards for the regulation of financial conglomerates. As discussed in the preceding chapters, Kenya's regulatory framework consists of multiple regulatory agencies in spite of the changes in the financial sector. However, the Financial Services Authority Bill 2016 has captured important aspects on regulation of financial conglomerates. The Bill provides for the consolidation of four key regulators into one regulator in line with financial sector regulatory reforms.[293] However, it leaves out the regulation of commercial banks to be under the regulation of the Central Bank of Kenya. The established structure falls short of the full integration. It also largely retains the structure of the old regulators, which compromises the intention to cut costs of operation of the regulators as envisioned by the Taskforce on Parastatal Reforms.

Unlike the current law, the proposed Bill recognizes the regulation of financial conglomerates. Part VII of the Act provides that the Financial Services Authority may designate an institution as a financial conglomerate in order to facilitate the regulation of prudentially regulated entities in

[293] Section 10 of the Bill establishes the Financial Services Authority which will be a merger of the Capital Markets Authority, Insurance Regulatory Authority, Retirement Benefits Authority and Sacco Societies Authority.

accordance to their risk levels.[294] This provision also gives the Authority the power to change the status of a financial institution to become or cease becoming a financial conglomerate.

Further, Section 73 of the Bill provides for the licensing of the holding company in a financial conglomerate. This is aimed at enhancing the safety and soundness of the particular institutions. It is also in line with the objective of the recommendations of the joint committee which required that there should be no unregulated areas within a financial conglomerate.

Although the Bill captures some of the key aspects necessary for the regulation of financial conglomerates, it needs to be streamlined in several ways. This research seeks to promote an integrated regulator as the right solution for the regulation of financial conglomerates. The proposed Financial Services Authority misses out on full integration and it is has not sufficiently solved the problems encountered under the multiple regulators.

4.5.3 Best Practices on Regulation of Financial Conglomerates

A review of the regulation of financial conglomerates in other jurisdictions reveals that various measures have been adopted depending on the circumstances of each country. This study also makes an overview of the principles proposed by the Basel Committee to arrive at a conclusion on the best practices adopted globally in the regulation of financial conglomerates.

4.5.3.1 An overview of Basel principles on regulation of financial conglomerates

A joint forum was established in 1989 under the auspices of the Basel Committee on Banking Supervision, the International Organisation of Securities Commission and the International Association of Insurance Supervisors. The joint committee came up with recommendations that have sought to provide guidance on the regulation of financial conglomerates. This came under

[294] Section 70, Financial Services Authority Bill.

the backdrop of the financial crisis of 2007 which revealed that there were some areas of financial conglomerates that were not captured under the prevailing regulation. [295]

The joint forum captured in its report some of the key regulatory issues that underpin effective financial services regulatory framework. These include the techniques for assessing capital adequacy requirements, information sharing among the regulators, coordination among the regulators, management of the conglomerates and risk management. Importantly, the forum recommended a review of the key requirements so as to capture the key developments in the financial sector. The overarching principle enunciated in the recommendations is that the regulation should capture the entire activities of the financial conglomerate. This is in the pursuit of the aim to eliminate blind spots in regulation and other regulatory gaps. The principles have emphasized the need for supervisory cooperation, coordination, information sharing and group level supervision.[296] These are key policy and regulatory issues to be focused upon in seeking reforms for regulation of financial conglomerates. Particularly, the recommendations recognized the need to undertake group-wide risk management.

4.5.3.2 Lessons from South Africa

South Africa's financial services regulation has undergone several phases of reforms[297] and it is still undergoing significant changes. The current regulation of financial services in South Africa is mainly handled by the Financial Services Board and the central bank. The FSB is an integrated regulator handling all the financial services except banking. The South African Reserve Bank has the responsibility of regulating and supervising banks apart from handling other roles of a central bank.[298] However, there are

[295] 'Principles for the Supervision of Financial Conglomerates - Final Report - joint29.pdf' (n 20).
[296] ibid.
[297] Hans Falkena, Roy Bamber and David Llewellyn, 'Financial Regulation in South Africa' <www.resbank.co.za> accessed 9 May 2016.
[298] 'Financial Services Board' <https://www.fsb.co.za/Pages/Home.aspx> accessed 5 November 2016.

ongoing reforms to enhance the regulation. The mandate of the FSB was expanded by Financial Advisory and Intermediary Services Act in 2004 to include some aspects of market conduct for commercial banks.

In the proposed twin-peaked regulatory framework, the South African Reserve Bank is to be given the role of undertaking micro and macro prudential regulation while the FSB is set to handle the market conduct regulation.[299] The shift to this approach of regulation has been attributed to the effects of the preceding global financial crisis. There was also a need to enhance the country's regulatory system on its ability to achieve financial stability.

The ongoing reforms have instigated a debate on the suitability of an integrated regulator as a solution. An integrated regulator was preferred due to its ability to achieve consolidated risk management, quality supervision, reduction of costs and improved coordination among the regulators.[300] The Policy Board for Financial Services and Regulation undertook an investigation and acknowledged that an integrated regulator had the ability to aid in the supervision of financial conglomerates.[301]

4.5.3.3 Lessons from Estonia

The regulation and supervision of financial service providers is undertaken by a single regulatory agency, the Financial Supervision Authority. All the financial sector institutions are subject to the regulation of the Financial Supervision Authority[302], which effectively cooperates with other relevant stakeholders such as the ministry of finance. The Authority is structured as an independent entity. [303] Relatedly, it has a separate budget with which is an important factor in achieving independence.

[299] 'South African Insurance Law' <https://store.lexisnexis.co.za/products/south-african-insurance-law-skuzasku9780409052626/details> accessed 5 November 2016.
[300] Carmichael and others (n 55).
[301] ibid.
[302] 'Finantsinspektsioon - Financial Supervision' <http://www.fi.ee/?id=580> accessed 4 November 2016.
[303] Financial Supervision Authority Act (RT I 2001, 48, 267), s 4(3).

Prior to the creation of the Financial Supervision Authority in 2001, the financial system was regulated by specific sector supervisors. These were merged into the Financial Supervision Authority.[304]Notably, the reasons for merging the regulators were the need to achieve better risk management, quality supervision, cost efficiency and better coordination in regulation.[305] Similarly, the reasons for Kenya's need to merger the regulators are the same as earlier discussed.

To ensure effective cooperation among the key agencies, the Financial Supervision Authority has entered into an agreement with the Bank of Estonia and the ministry of finance. This agreement is aimed at ensuring stability, suitability and relevance of regulation to the financial sector generally.

Estonia does not have many financial conglomerates of its own,[306] which mirrors the Kenyan situation. The financial conglomerates in Estonia are therefore subjected to supervision and regulation from a common point.

4.5.3.4 United States

The regulation of financial conglomerates in the US has been under several regulatory regimes, mainly shaped by crises. Prior to the banking crisis of 1929, financial institutions were allowed to offer services in various financial sectors without restrictions. This led to the rise of large financial institutions which were diversified in several sectors. The Banking Act 1933 was enacted to circumscribe the activities of financial service providers, effectively preventing the rise of institutions commonly described as too big to fail.

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[304] Carmichael and others (n 55).
[305] ibid.
[306] Mwenda, 'Legal Aspects of Unified Financial Services Supervision in Germany' (n 52) 1014.

The Glass Steagal Act was later repealed in 1999 under the Clinton administration. This was motivated by the need for institutions to diversify. Interestingly, the debate has resurfaced; it has been an issue for discussion in 2016 US Presidential elections. Donald Trump, the Republican Presidential candidate has strongly criticized institutions described as too big to fail[307] and called for a return of the Glass Steagal Act.[308] On the other hand, Hillary Clinton has maintained that there is no need to break the large institutions. Other scholars have also argued that segregation of the financial activities does not necessarily guarantee absence of financial crises.

In regulating financial conglomerates, the US has in the past adopted a restriction of financial activities through the Glass Steagall Act but later allowed diversification. Currently, Federal and state laws allow US financial conglomerates to own securities, insurance and depository institutions.[309] The US financial sector is highly fragmented, which has been blamed for financial crises in the past.[310] The case of Enron illustrates the downside of fragmented regulation where the holding company is left unregulated.[311]

The enactment of the Dodd Frank Act came in to solve some of the challenges posed by this kind of regulation. The Act introduced a rule restricting the activities of the financial service providers and also imposed strict prudential regulations on holding companies.[312]

[307] Such banks include Godman Sacks, JP Morgan, Citigroup, Bank of America among others

[308] The return of Glass-Steagal Act has been a subject in the American Presidential debates, with Hillary Clinton maintaining that there is need to adopt other measures than the return of Glass Steagal while Donald Trump seeks to have a return of the Act. The Act is meant to break up the large firms which have been described as being too big to fail. These sentiments have also been shared by some democrats.

[309] Brown (n 239).

[310] ibid.

[311] ibid 1345.

[312] 'Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 - A Detailed Essay on an Important Event in the History of the Federal Reserve.' <http://www.federalreservehistory.org/Events/DetailView/59> accessed 4 November 2016.

The Act also establishes a forum where the regulators can share information affecting the financial system. This is through the Financial Stability Oversight Council. This was meant to help in enhancing risk management of the entire financial system, by preventing a situation where large institutions pose unseen risks.[313] In relation to financial conglomerates, the Act introduces the Volcker rule which restricts the activities of banks and requires strengthened capital for high risk practices.[314] This is also achieved by a prohibition of proprietary trading. Section 619 of the Act prohibits proprietary trading and certain relationship with hedge funds and private equity funds.

The regulatory approach in the US demonstrates that the main concern in the regulation of financial conglomerates should be on effective risk management and stability of the financial system. It also shows that financial conglomerates should not be let to undertake every possible activity. Regulation should have a room for reviewing the incidental activities and putting restrictions whenever the activities of an institution threaten the stability of the financial system.

4.6 Conclusion

This chapter has discussed the regulatory issues surrounding the regulation of financial conglomerates. This discussion has also brought out the principles that have been adopted globally as best practices. From the discussion, it is evident that financial conglomerates pose unique challenges to the financial sector regulation which should be taken into account in implementing financial sector reforms.

[313] Bobby L Rush, 'On the Dodd-Frank Act' (2011) 1 Harvard Business Law Review 0.
[314] ibid.

CHAPTER FIVE
CONCLUSION AND RECOMMENDATIONS

5.0 Introduction

This chapter makes the conclusions and recommendations of the research. The study has delved into the question of the regulation of financial conglomerates, analyzed the various regulatory issues and regulatory models and established key findings and recommendations.

5.1 Conclusion:

This study has made an attempt to address the question of the most efficient regulatory approach for financial conglomerates in Kenya. Chapter one set the stage for this study, by analyzing the background of the question which centered on the fact that the rise of financial conglomerates has come along with new regulatory challenges. With various illustrations of regulatory gaps and blind spots, the research has sought to make the conclusion that the current regulatory framework is not adequate for the regulation of financial conglomerates. The main reason highlighted in the study is the fact that it does not undertake regulation at the group level, leaving the holding company potentially unregulated. This poses a risk to the financial system especially since growth of financial conglomerates is likely to increase in the coming years.

Importantly, it is axiomatic that the rise of financial conglomerates has posed significant challenges to the regulatory framework. This challenge has been recognized even in other jurisdictions. The financial landscape has changed due to various technological developments and financial sector deregulation, leading to the rise of institutions that provide diversified financial services. The traditional limitations against diversification of financial services have been eroded and financial products have become increasingly blurred. This has led to integrated financial products which have become a factor to consider in seeking reforms in the regulation of financial services.

In spite of the rise of these changes Kenya's financial sector regulatory framework has largely remained the same. The changes that have been undertaken have been dismal. The main issues have remained unaddressed and this research has highlighted some of the regulatory issues that must be considered in undertaking the impending reforms.

Chapter two has critically analyzed the current regulatory framework in Kenya, looking at both the institutional and legal aspects of it. The fragmented regulatory framework has proved to be inadequate and insufficient in several aspects as brought out in the analysis.

A critical analysis of the legal and institutional framework reveals that the current regulatory model is fragmented and unfit to regulate financial conglomerates. It is facing a myriad of challenges that have stood in the way of efficiency and innovation in the financial sector. The study has illustrated regulatory gaps and ambiguities in especially with reference to financial conglomerates. Regulatory overlaps and multiple authorizations needed for financial service providers to diversify have become a huge hindrance to the smooth running of financial conglomerates. The institutions offering banking services and insurance or capital markets are subjected to the licensing and regulation by the three different regulators. This is cumbersome, costly and unnecessary. Banks offering custodial services in the pensions sector have to be registered by the RBA, while the CMA authorizes institutions to offer the same services in the capital markets.

Another challenge comes with the difficulties in risk management. It has been hard to undertake successful risk management under the fragmented regulatory framework. The current regulators have attempted to come up with a memorandum of understanding in the past but this is an informal mechanism that needs to be made permanent under the legislation. There is need for proper legislation of information sharing mechanism under principal legislation. This is also in line with the recommendations of the IOSCO principles on the financial regulator.

Chapter three has discussed the various approaches that can be undertaken in the regulation of financial conglomerates, while drawing illustrations from the views of Kenyan stakeholders and other countries that have attempted to regulate financial conglomerates. This research concludes that the use of an integrated regulator is the most viable response to the regulatory challenges posed by financial conglomerates. Through a discussion of the advantages of the integrated regulator, the research has demonstrated how the challenges posed by financial conglomerates can be tackled. The activities undertaken by the service providers should also remain restricted to incidental activities to avoid the institutions taking too much risk.

5.1.2 Proposed Regulatory Reforms

The Financial Services Authority Bill 2016 has come in handy to address some of the main challenges cited in this research. However, the Bill is in need of significant reforms to ensure it is in line with the requisite standards of regulation and to promote efficiency of the regulator.

The Bill proposes a consolidation of some of the current regulators but the proposed consolidation falls short of full integration. The Bill fails to eliminate the formerly existing entities and retains them to operate under the proposed Authority. This move is unlikely to address the problem of increased cost. Further, the proposals have retained the regulation of commercial banks under the Central Bank of Kenya. This gives the impression that the regulatory framework is a two- peaked approach but it misses out on the fundamentals of such an approach. The Cabinet Secretary for finance is quoted as having said that the government intends to structure the regulatory framework as a twin peaked approach akin to the current regulator in the UK. This has sent mixed signals and further changes are needed.

The structure of the Financial Services Authority fails to ensure that the proposed regulator is independent, as discussed earlier in this research. Being a mega regulator, it should be shielded from political interference. The position of the CEO should be filled competitively with an option for public vetting and Parliamentary approval. This will ensure that the regulator is not at the behest of the executive. However, the Bill has not made such provisions.

5.1.3 Regulation of financial conglomerates

The regulation of financial conglomerates should be driven by reforms in the entire regulatory framework. It is not enough to adopt piece-meal reforms that may end up providing nothing more than palliative response while the core problem remains unaddressed. From the discussion on the regulatory issues posed by financial conglomerates, it is imperative to have a kind of regulation that covers the key regulatory issues of the financial conglomerate at the group level.

A study of international practices has revealed that several countries have adopted an integrated regulator as a result of increased interconnectedness of financial services. A restriction of the activities undertaken by financial conglomerates has proved to be unsuitable especially in modern day financial landscape. Further this study has demonstrated that the use of mechanisms for cooperation among the regulators and the adoption of Chinese Walls to address key challenges have not been an exhaustive solution. It therefore follows that an integrated regulatory framework is the best response to address the problems of financial conglomerates.

5.2 Recommendations:

This research makes important recommendations on the approaches that can be adopted in the regulation of financial conglomerates. These recommendations touch on important regulatory aspects of financial conglomerates as discussed in this study.

5.2.1 Desired Regulatory Approach

This research has established that the best regulatory approach is one that takes into account the changed nature of financial landscape in Kenya. The financial products have become largely integrated and therefore the regulatory framework should change with the changing landscape. It is evident from the discussions in this research that financial services have become increasingly integrated which makes an integrated regulator more appealing. Financial conglomerates have come up as a result of such integration and regulation should ensure that regulatory issues are considered at the group level. Further, there are other countries that have moved towards integration of financial services on the basis of the rise of financial conglomerates. It is on this basis that this research proposes an integrated regulator.

The adoption of an integrated regulator comes with several challenges as earlier alluded in this research. There are many models of an integrated regulator, from partial integration to full integration. The choice of the extent of integration is likely to pose a challenge to the stakeholders as many interests come in play. The current Financial Services Authority Bill proposes a partial consolidation of some of the regulators while leaving out the banks. A decision on the extent of consolidation has taken a long time to establish because of lack of political goodwill.

5.2.2 The Structure of the Proposed Regulator

The Financial Services Authority Bill 2016 is timely and its enactment into law should be fast tracked. However, the Bill should be amended to address all the issues that characterize financial conglomerates as discussed in this research. The proposal to retain certain regulatory powers with the CBK is likely to give rise to a confused regulatory framework. This research proposes an integrated regulator that incorporates regulation of banks while the Central Bank is left to handle monetary policy issues. There should be efficient cooperation mechanism between the Central Bank and the Financial Services Authority, which should be set out in the Financial Services

Authority Act. The Authority should be independent and the chief executive appointed through a competitive process. The Act should also set out a mechanism to have the formerly distinct regulators operate as departments and headed by directors who possess the requisite professional capacity to steer the sectors.

However, it should not be lost on the stakeholders that the structure of an integrated regulator is likely to pose other practical challenges. It has been observed that integration may pose operational obstacles. It is likely to result in a large institution whose operation may be counterproductive. The capture theory

5.2.3 Transition

The transition to the integrated regulator should be done in a manner that ensures proper integration. There is need for a proper plan for post-merger integration. This research proposes that the dissolution of the existing regulators should be done in phases over a specified period so as to avoid the negative effects that come with such an operation.

The phasing out of the current regulators is also likely to be a challenging task given the magnitude of restructuring involved. Some positions are bound to be rendered redundant while more powerful positions will be created. The consequence of this is jostling for power among the current top officers as each of them seeks to be the first office holders in the new outfit. It is on this account that this research recommends a change that is phased but planned to achieve the reform objectives.

Further, it is instructive to note that if the change process is not managed well it may be prone to failure. Change is always a process that attracts resistance and multiple interests. On this account

5.2.4 Organizational Structures of Financial Conglomerates

The Act should make regulations on the recommended organizational structures of institutions offering financial services. This should be done in a manner that prevents the rise of structures that are too complex or opaque thereby making it difficult to undertake proper risk management.

While the Financial Services Authority Bill has provided provisions on financial conglomerates, more detail should be included to ensure that key aspects about financial conglomerates are captured. Particularly, the activities of the affiliates should be controlled on a group-wide basis to prevent the undermining of the safety and soundness of licensed institutions in the group.

The prudential standards that are applicable to the licensed entities should also be applied to the holding company or other entity that is at the top. Currently, the holding company is only subject to the regulations of the Companies Act, a factor that makes such group holding structures risky for the financial system.

The apex entity should be approved by the regulator or it should be a licensed institution. If it is a licensed institution there is no need for it to be subjected to further prudential requirements save for those necessary to ensure proper regulation of its group activities.

Within the group structure, there should be well defined boundaries among the entities. The regulated institutions should not be contained in complex structures which are likely to hinder risk management.

While the provisions of the Financial Services Authority Bill may solve some of the challenges highlighted in this research, it is noteworthy that the implementation is likely to face obstacles. The recommendations on the bill involve radical changes that may be face political opposition. The smooth operationalization of the proposed changes calls for political goodwill, which may not be assured. The political landscape in Kenya keeps changing and the interests of the political class cannot be wished away in the efforts to pursue substantive reforms in the regulatory framework.

5.2.5 Prudential Requirements

The apex entity of a financial conglomerate should be subjected to prudential requirements. The conditions that are applicable to the regulated entities should be the same for the apex organ as well. The application of prudential requirements on the holding company should be based on the risks inherent in the particular entity. This means that some institutions may be imposed higher requirements if they pose a higher risk to the financial system.

The basis of this recommendation stems from the need to curb systemic risks characteristic of financial conglomerates. Low capital requirements are likely to expose the financial system to significant risks and hence the need to provide new capital requirements at the group level. This has been lacking in the current regulatory framework where the group company has largely been left only to the jurisdiction of the Companies Act.

The capital prudential requirements should be revised from time to time as the circumstances and the financial landscape changes. In this way it will be possible to take care of emerging issues and trends. The regulator can be given the power to review such requirements and even expand the net for the institutions that should be subjected to the same requirements.

5.2.6 Corporate Governance

Llewellyn correctly postulates that corporate governance is a key requirement not only for the regulated entities but also for the regulators. This will ensure proper use of power and also instill confidence in the sector. Where there is proper use of power there is likely to be promotion of integrity in the market. Corporate governance comes in to ensure that power is used for the benefit of all the stakeholders.

The Central Bank of Kenya has set the pace in promoting corporate governance by a move to introduce the position of chairman. This helped to separate the role of the chairman from that of the CEO, hence making room for checks and balances.

Corporate governance is also essential for the regulated financial conglomerates. In an organizational structure that is in the form of a group of companies, the apex organ should have a board of directors that will be tasked with the responsibility of ensuring that the prudential requirements are applied on a group wide basis. The board should ensure that there are enough internal procedures aimed at ensuring proper risk management for the entire group. Additionally, the financial conglomerate should be subjected to corporate governance requirements at all levels.

5.2.7 Areas for further research

Further research can be undertaken to establish the role of the central bank in various regulatory models and the effect of leaving the central bank out of the regulation of commercial banks. A survey to establish the challenges faced by the various stakeholders will also come in handy in furthering this topic.

The current political inclination indicates that Kenya is likely to move towards adoption of a twin peaked regulator. This presents another area for further research.

5.3 Conclusion

This chapter has summarized the findings made by this study, noting that the study has focused on the main objective of finding the most appropriate reforms in the regulation of financial conglomerates. In conclusion, this study has established that there are gaps in the current regulatory framework and a change is needful to keep it in line with current market developments. After an analysis of several viable approaches that can be explored, this research concludes that there is need for the regulatory structure to mirror the nature of the financial products. The research has also made recommendations that can be pursued in the efforts to achieve the much needed reforms in the financial regulatory framework. It is instructive to note that the implementation of these recommendations is likely to face several obstacles but a proper operationalization is bound to yield significant results. This chapter has also identified areas for further research that can be pursued to for more knowledge on the research topic.

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