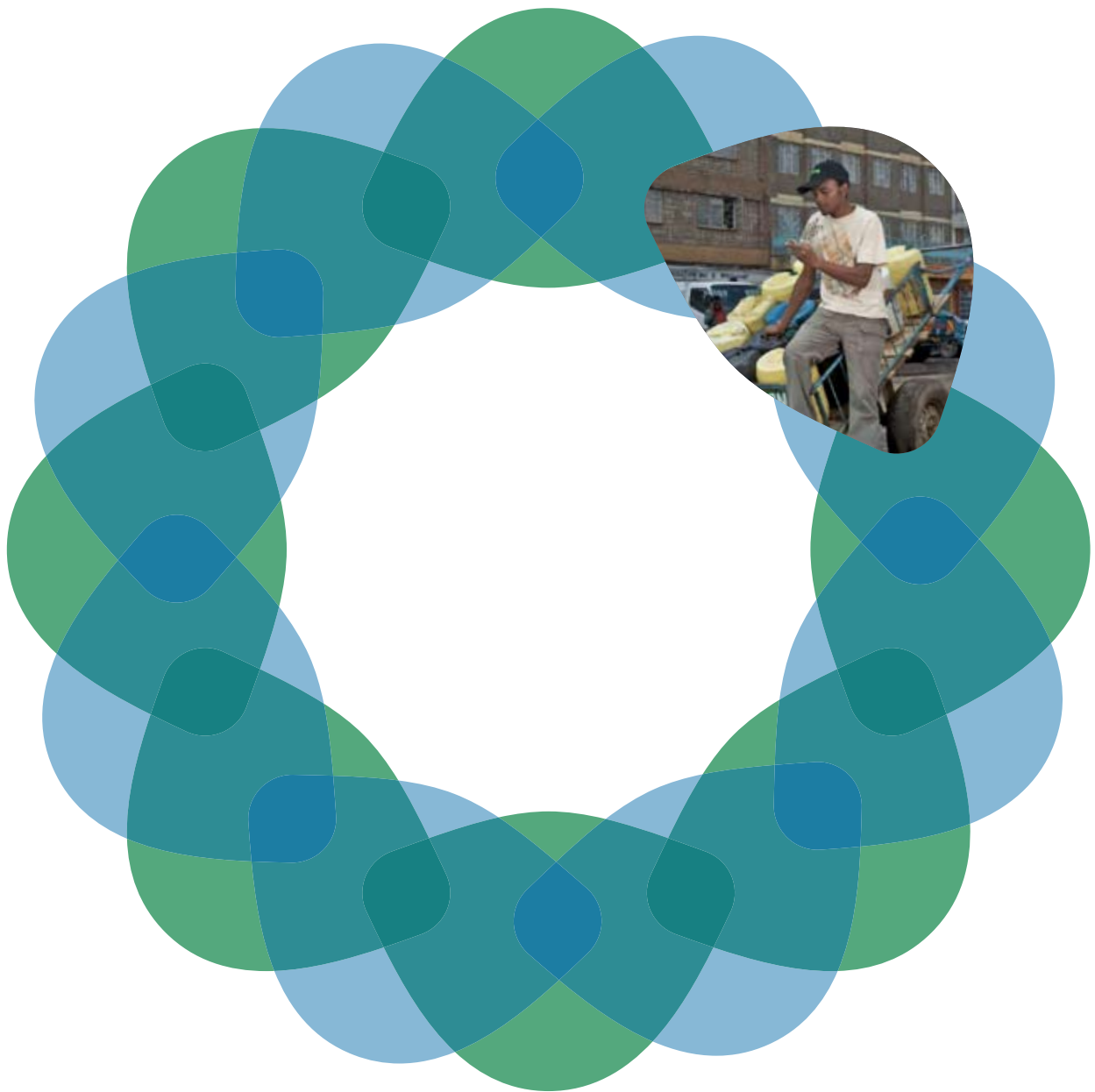




**GPI**

Global Partnership  
for Financial Inclusion

# Kenya's engagement with the standard setting bodies and the implications for financial inclusion



## ACKNOWLEDGEMENTS

This report was produced on behalf of the G20's Global Partnership for Financial Inclusion (GPFI) by the Alliance for Financial Inclusion (AFI) in its capacity as an Implementing Partner of the GPFI.

This report was supported by a grant from Australian Agency for International Development (AusAID), and was prepared by Anja Smith and Joel Carlman of Cenfri. The authors are grateful to all who participated in its development, especially the Central Bank of Kenya, for their inputs and support.

*Disclaimer:*

Suggestions made in this document do not represent the official views of any of the regulatory authorities consulted. All errors and omissions are those of the authors.



© 2011 Alliance for Financial Inclusion

# Contents

---

<b>About this case study</b>	<b>ii</b>
<b>1. Introduction</b>	<b>1</b>
<b>2. Financial inclusion context</b>	<b>1</b>
<b>3. Standard setting body membership</b>	<b>3</b>
3.1. Basel Committee on Banking Supervision (BCBS)	3
3.2. Committee on Payment and Settlement Systems (CPSS)	3
3.3. Financial Action Task Force (FATF)	3
3.4. International Association of Deposit Insurers (IADI)	4
3.5. International Association of Insurance Supervisors (IAIS)	4
<b>4. Key regulatory stories</b>	<b>4</b>
4.1. Basel Committee on Banking Supervision	4
4.2. Committee on Payment and Settlement Systems	6
4.3. Financial Action Task-Force	7
4.4. International Association of Deposit Insurers	9
4.5. International Association of Insurance Supervisors	10
<b>5. Cross-cutting issues and conclusions</b>	<b>11</b>
<b>List of tables</b>	
Table 1. Timeline for the implementation of FATF's 40+9 Recommendations in Kenya	7
<b>List of figures</b>	
Figure 1. Comparative client bases of Banks, MFIs and SACCOs (percentage of adults 16 years and older)	2
<b>List of boxes</b>	
Box 1. Using the alien card as means of identification	8

## About this case study

---

This case study highlights the experience of Kenya in implementing international standards in the financial sector and the interaction, where relevant, with the topic of financial inclusion – a topic that is of particular relevance in Kenya. It draws on a questionnaire completed by the relevant regulatory authorities, coordinated by the Central Bank of Kenya (CBK), as well as meetings with each relevant regulatory authority.

The case study aims to tell the story of Kenya’s engagement with each of the standard setting bodies (SSBs) and to highlight areas where further engagement from the standard setting bodies on the topic of financial inclusion will be welcomed. The Kenyan authorities recognize the important role played by each SSB and would like to contribute to the dialogue process as each of them engages with the topic of financial inclusion. However, the case study does not present the official position of any of the supervisory authorities consulted and should in no way be construed as making demands on the SSBs. Rather, suggestions made illustrate potential needs at the country level for SSB dialogue, information and guidance.

# 1. Introduction

---

Kenya plays a significant role in the East African economy, representing 40 percent of the region's GDP<sup>1</sup>, and 30 percent of the population<sup>2</sup>. It is classified as a low-income country, where 30 percent of the population lives under the US\$1.25/day (at purchasing power parity) threshold of extreme poverty<sup>3</sup>. A further almost 40 percent live on less than US\$2/day<sup>4</sup>.

Yet Kenya is growing quickly. For five out of the past six years, economic growth in Kenya has outpaced the average growth of both the world economy and that of sub-Saharan Africa. In 2010, the GDP growth was estimated to be 5.6 percent<sup>5</sup>, returning to the relatively rapid growth that characterized the years leading up to the global financial crisis.

Looking forward, Kenya has its sights set on

development on many fronts. One of the most important areas for development, and a topic that has both generated domestic and international excitement and posed significant challenges, is the development of the financial sector. Kenya is seeking to both broaden and deepen its financial sector, but it is primarily the former with which this case study is concerned. Kenya faces the imperative of reaching a large majority of the population which has thus far been excluded from the formal financial system.

This document highlights the relationship Kenya has with five prominent standard-setting bodies, and the implications that adhering to international standards set by these bodies has for financial inclusion. Important learnings emerge from a close examination of the nexus between international standards and the contextual application of SSB principles.

## 2. Financial inclusion context

---

Kenya has succeeded in significantly expanding the reach of financial services over the past several years. If mobile money transfer services, savings and credit cooperatives (SACCOs) and microfinance institutions (MFIs) are included, formal financial inclusion increased from 26.4 percent in 2006 to 40.5 percent in 2009<sup>6</sup>.

There are several factors that have contributed to greater levels of inclusion: the expanding reach of three major types of financial service providers, the identification of financial inclusion as a national priority (as stated in the Kenya Vision 2030 national planning document), and the accessibility brought about by innovative electronic payment systems such as M-PESA.

In total, banks, MFIs and SACCOs serve about 27 percent of the adult population – with banks reaching 22 percent of adults, SACCOs reaching 9.6 percent, and MFIs reaching 3.4 percent. Many customers take advantage of more than one type of institution, as illustrated in Figure 1.

The Kenyan banking landscape consists of 43 banks, one mortgage finance company, and 122 foreign exchange bureaus<sup>7</sup>. The bank branch network has seen significant growth in recent years, increasing 19.8 percent from 887 branches in 2008 to 1,063 in 2010<sup>8</sup>. Banks have seen rapid growth in both the value of deposits and the number of account holders over the last five years. Deposits have more than doubled from KSh573.5 billion (US\$ 6.2bn) (40 percent of GDP) in June 2006 to KSh1220 billion (US\$ 13bn) (49 percent of GDP) in June 2010<sup>9</sup>. The percentage of adults with bank accounts increased from 14 percent to 22 percent for the period 2006 to 2009<sup>10</sup>.

### *Innovation in mobile payments has had a transformational impact*

Since its launch in 2007, M-PESA, cellphone provider Safaricom's mobile payment system, has cultivated a client base in excess of 14 million users (as of April 2011) which is serviced by nearly 28,000 agents<sup>11</sup>. M-PESA's initial focus was on geographic transfers

---

<sup>1</sup> World Bank, 2010. World Development Indicators. Available at <http://data.worldbank.org/country/kenya>

<sup>2</sup> For the purpose of this report, East Africa includes Kenya, Tanzania, Uganda, Rwanda, and Burundi

<sup>3</sup> Extreme poverty is defined by the United Nations Development Programme (UNDP) as those living under \$1.25 per day (PPP). Foundation for Sustainable Development. Available at <http://www.fsdinternational.org/country/kenya/devissues>

<sup>4</sup> UNDP, 2009. Human Development Report. Available at <http://hdr.undp.org/en/>

<sup>5</sup> Kenya National Bureau of Statistics, 2011. Kenya Economic Survey 2011. Available at <http://www.knbs.or.ke/news/econ2011minister.pdf>

<sup>6</sup> Financial Sector Deepening Kenya, 2006 and 2009. FinAccess. Available at <http://www.fsdkenya.org/finaccess/>

<sup>7</sup> Information provided by the Central Bank of Kenya, August 2011.

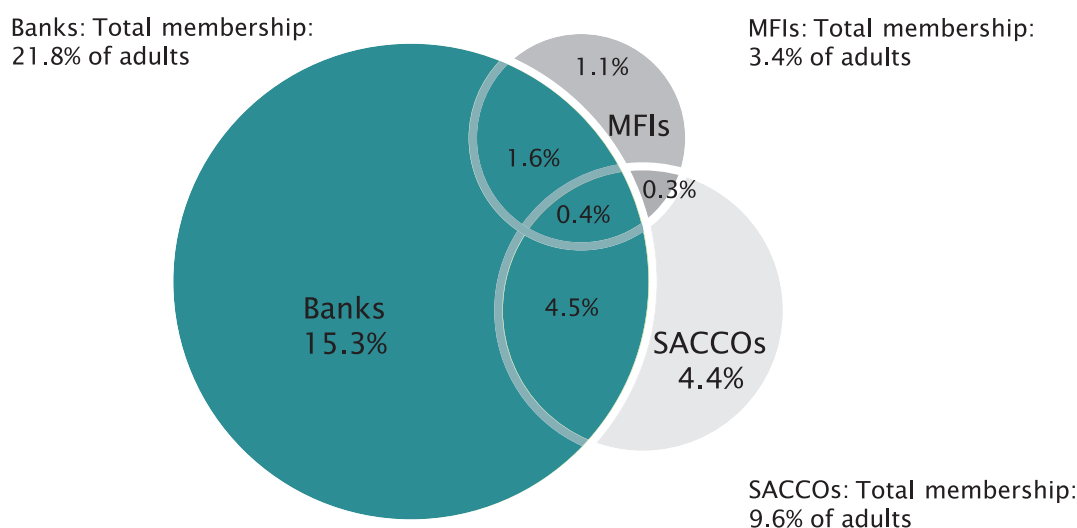
<sup>8</sup> Information provided by the Central Bank of Kenya, August 2011.

<sup>9</sup> Information provided by the Central Bank of Kenya, August 2011.

<sup>10</sup> Financial Sector Deepening Kenya, 2006 and 2009. FinAccess. Available at <http://www.fsdkenya.org/finaccess/>

<sup>11</sup> Safaricom, 2011. *M-PESA Key Performance Statistics*. May. Available at <http://www.safaricom.co.ke/index.php?id=1073>

**Figure 1. Comparative client bases of Banks, MFIs and SACCOs (percentage of adults 16 years and older)**



Source: FinAccess 2009 analysis as used in Cenfri, 2010. **Kenya Microinsurance: Market and Regulatory Analysis.** Document prepared with funding from the International Labour Organization/United Nations Capital Development Fund and Financial Sector Deepening Kenya. Unpublished

and bill payments, but the platform has recently been developed to create a link with full banking services. Equity Bank has linked M-PESA to a savings account, called M-KESHO, and has already enrolled 718,000 customers who have accumulated KSh678m in deposits in a little over a year of existence<sup>12</sup>.

**A new generation of banks and micro-finance deposit-taking institutions is leading the way**

A number of commercial banks, emerging from the microfinance arena, have shown success in extending financial services to the previously unserved. The most prominent example of this trend, Equity Bank, was registered in 1984 as a building society and transitioned to become a commercial bank in December 2004. As of July 2011, Equity had 6.5 million accounts, and accounted for over 57 percent of all bank accounts in Kenya<sup>13</sup>. Equity has focused particularly on reaching the low-income market, and has experienced success with its M-KESHO savings product, which as stated above employs a link with Safaricom’s electronic money transfer service, M-PESA. Other examples of newer players who are

making an impact include Kenya Rural Enterprise Program (K-Rep) Bank, Family Bank, KCB, and Cooperative Bank of Kenya<sup>14</sup>.

The Microfinance Act (2006, operational from 2 May 2008) allows credit-only MFIs that meet specific criteria (as well as new companies established for this purpose) to register as deposit-taking MFIs<sup>15</sup>. Such MFIs are able to expand their product offering to include deposits, thereby gaining access to additional funds for on-lending. This allows them to compete more directly with the commercial banks. To date, the CBK has issued licenses to six deposit-taking MFIs<sup>16</sup>, with the first license being awarded to Faulu Kenya in 2009. Furthermore, at the time of publication, the CBK was processing four new applications for deposit-taking microfinance institution (DTM) licenses, and an approval in principle had already been granted to one of them. DTMs have 47 branches nationwide, and total deposits of Kshs 9.3 billion (US\$ 103.3m). Combined, they also have a total loan portfolio of KShs 15 billion (US\$ 166.7m) as well as 1.3 million active deposit accounts and 0.5 million loan accounts<sup>17</sup>.

<sup>12</sup> Safaricom, 2011. *Key Performance Statistics*. May. Available at <http://www.safaricom.co.ke/index.php?id=1073>  
<sup>13</sup> Equity Bank, 2011. Available at <http://www.equitybank.co.ke/about.php?subcat=5>  
<sup>14</sup> Cenfri, 2010. *Kenya Microinsurance: Market and Regulatory Analysis*. Document prepared with funding from the International Labour Organization/United Nations Capital Development Fund and Financial Sector Deepening Kenya. Unpublished document.  
<sup>15</sup> Nationwide deposit-taking MFIs must provide minimum capital of Ksh60 million, and community-based (regional) deposit-taking MFIs Ksh20 million.  
<sup>16</sup> Other DTMs include Kenya Women Finance Trust, Remu, Smep, Uwezo and, most recently, Rafiki.  
<sup>17</sup> Information provided by the CBK in August 2011.

### *Kenya has an innovative but still limited insurance industry*

The insurance market in Kenya is small and dominated by insurance for corporate and employer groups. Only a small proportion of the client bases of banks, MFIs and SACCOs already have insurance, implying significant remaining distribution opportunities for insurers. As of 2009, 81 percent of SACCO members, 85 percent of the banked market and 90 percent of MFI clients still did not have any insurance<sup>18</sup>. If only voluntary insurance products are considered, the Kenyan insurance sector serves just 3 percent of the adult population. Only 1 percent of adults report having any form of life insurance.

During the last two years, however, a number of new microinsurance models have been launched including:

- Agricultural insurance distributed through the value chain;
- Public-private partnerships delivering a combined health and funeral product;
- Funeral insurance linking with welfare groups;

- Personal accident insurance distributed through mobile phones.

Although it is too early to judge the success of these products, insurance companies have demonstrated commitment to these experiments and have continued to invest in market research and product development.

### *Kenya Vision 2030 embodies a policy commitment to financial inclusion*

Kenya Vision 2030 is the economic development plan released by the Kenyan government in 2006. In addition to covering plans for the development of the social sector, political system, and other key elements of the economy, it gives specific attention to the development of the financial services sector. The stated intention is to “expand banking services to parts of the population that do not hold bank accounts, particularly in rural areas.”<sup>19</sup> The Kenyan leadership believes this will provide a greater pool of savings with which to finance the productive investments of the Vision. With this document, the government has committed to providing policy support for individual financial supervisors, acting in support of financial inclusion.

## 3. Standard setting body membership

### 3.1. Basel Committee on Banking Supervision (BCBS)

Kenya is not a member of the Basel Committee on Banking Supervision (BCBS), and therefore its engagement with the BCBS has been mostly indirect, taking the form of regular participation in training events hosted by the Financial Stability Institute and comments provided on draft BCBS pronouncements. However, a lack of membership does not diminish the value of BCBS guidance when it comes to the complex issues that confront the Kenyan financial sector.

### 3.2. Committee on Payment and Settlement Systems (CPSS)

Kenya is not a member of the CPSS, and has no official interaction with the standard-setting body. However, in the process of developing and modernizing the Kenyan payment system, Kenyan

regulators implicitly adhered to the CPSS Core Principles for Systemically Important Payment Systems for high-level guidance on the payment system structure and appropriate legislation.

### 3.3. Financial Action Task Force (FATF)

#### *ESAAMLG's associate membership status to FATF is an important link*

Kenya is not currently a direct member of FATF, but is a founding member of the Eastern and Southern Africa Anti-Money Laundering Group (ESAAMLG)<sup>20</sup>, through which it has access to FATF as an associate member. ESAAMLG provides an opportunity for member countries to escalate domestic issues of concern to the FATF level: before ESAAMLG was founded, Kenya had no membership status and therefore, a diminished ability to input directly to FATF.

Associate membership of FATF through ESAAMLG

<sup>18</sup> The FinAccess questionnaire did not explicitly capture credit life as a product, which will understate the insurance penetration.

<sup>19</sup> Kenya Vision 2030, 2006.

<sup>20</sup> The Eastern and South African Anti-Money Laundering Group comprises fourteen countries from the Eastern region of Africa down to the southern tip of Africa.

allows member country representatives to attend FATF meetings as observers. There is also an opportunity at meetings for the associate member representatives to meet directly with the FATF president, and associate members' comments on FATF draft papers and studies are welcomed.

FATF is also an observer to ESAAMLG and provides input to ESAAMLG discussions. In 2010, the 20th ESAAMLG Taskforce of Senior Officials meeting held in Lilongwe, Malawi in August included a private sector consultative session on the Implementation of Financial Action Taskforce (FATF) Standards and the Promotion of Financial Inclusion in the ESAAMLG region<sup>21</sup>. As part of this discussion and outreach on financial inclusion, Kenya has been requested by ESAAMLG to take the lead on financial inclusion as a regional topic.

### 3.4. International Association of Deposit Insurers (IADI)

---

#### *DPFB has a long history with IADI*

Kenya's Deposit Protection Fund Board (DPFB) is a founding member of IADI (since 2002), and Kenya is one of five countries<sup>22</sup> in sub-Saharan Africa with current IADI membership. The director of the DPFB has a seat on the IADI Executive Council and currently chairs IADI's Audit Committee. The director is also the Deputy Chair of the IADI Africa Regional Committee and a member of the IADI Training Committee.

In recognition of the importance of Financial Inclusion for economic development, IADI has set up a Financial Inclusion and Innovations sub-committee in its Research and Guidance Committee and Kenya sits in this sub-committee. Kenya has also been chosen to participate in IADI's process of training assessors in the use of the Assessment Methodology, the tool for assessing compliance with the Core Principles for Effective Deposit Insurance Systems.

### 3.5. International Association of Insurance Supervisors (IAIS)

---

#### *Kenya holds IAIS membership through the IRA*

The Kenyan Insurance Regulatory Authority (IRA) became an active member of the IAIS in 2007 when it was established as an independent entity. Other than hosting one of the IAIS' programs in 2010, the IRA's involvement with the IAIS has been limited to attending training and workshops, as well as commenting on drafts of the various IAIS pronouncements. According to the IRA, the IAIS will also provide feedback on regulatory questions and issues on which the IRA requests direction.

Some IRA staff members have also been involved in working groups within the IAIS. For example, Kenya has representation in the Microinsurance Working Group. The IRA is in the process of submitting an application to be part of a multi-lateral memorandum of understanding (MMoU) that will allow the sharing of confidential information about microinsurance provision and policy development among signatories.

## 4. Key regulatory stories

---

Below, we set out the key challenges and developments of the various Kenyan supervisory and regulatory bodies as they relate to each SSB's area of influence.

### 4.1. Basel Committee on Banking Supervision

---

Kenyan banking supervision, coordinated by the Bank Supervision Department (BSD) of the CBK, faces the challenge of regulating a fast-growing and rapidly changing sector. Banking supervision in Kenya has to deal with the following issues:

- *A fast-changing financial sector landscape.* The rapid expansion of bank branches, the licensing

of new banks and deposit-taking MFIs, the proliferation of new innovative business models and the rollout of agent banking<sup>23</sup> are all changing the Kenyan financial sector landscape. This has resulted in increased complexity in the industry, as more financial service providers offer a wider range of products. Additionally, innovation in mobile payment systems has resulted in the convergence of financial services with the telecommunications industry, further complicating the mix.

- *Kenyan banks are expanding into other countries in the region, posing new supervision challenges.* While banks pursue cross-border profits, the CBK is considering how to fully assess and manage the risks posed by Kenyan banks' presence in foreign banking markets.

<sup>21</sup> Central Bank of Kenya, 2010. *Bank Supervision Annual Report 2010*.

<sup>22</sup> Also includes Nigeria, Tanzania, Zimbabwe and Southern Sudan.

<sup>23</sup> In November 2009 the Kenyan government amended the Banking Act to allow for the provision of banking services through agents (CGAP, 2010).



- *Rapid change in the financial sector poses staffing problems.* Increased inclusion of new customers, the addition of new players offering financial services, and the advent of innovative models for the provision of those services have all highlighted the requirement for specialized knowledge on the part of the regulator (CBK). The rapid evolution of the sector has made it hard to both keep up the level of expertise and increase the number of qualified staff.
- *Protecting the consumer.* As financial service provision broadens in Kenya, the need for consumer protection and financial education becomes clear. The public has increasingly relied on regulators to both protect them and empower them to choose from a suite of sound financial products.
- *Agent banking creates a new set of players.* With the advent of measures allowing agent banking in May 2010<sup>24</sup>, access points for financial services have expanded in number and reach, and thus the eye of the regulator must extend even farther.

### *Implementation of the three Basel Accords is viewed as a journey*

The CBK is keenly aware that wholesale implementation of the Basel Accords is not possible in the developing regulatory space of the Kenyan financial sector. Rather, it is seeking to appropriately and selectively implement individual standards of Basel I and Basel II. Currently, the CBK has a roadmap toward the implementation of the remainder of Basel I standards. It has found the first pillar of Basel II as particularly challenging because of absence of rating agencies in Kenya<sup>25</sup>. Throughout this process, the BCBS has, in CBK's experience, been highly accommodating to non-member countries with regard to their non-linear implementation of the Basel Accords. The CBK and other East African Community<sup>26</sup> (EAC) member states' central banks are currently studying the Basel III recommendations, with a view to embracing the appropriate provisions at an early stage.

### *Verification of bank customers has proved a challenge*

Regarding BCBS's Principles for Effective Banking Supervision, the CBK has experienced particular challenges with Principle 18<sup>27</sup> (abuse of financial services). By implication, this principle requires

supervisors to ensure that banks have appropriate "know-your-customer" rules in place that prevent them from being used for criminal activities<sup>28</sup>. In Kenya however, verification of customers' addresses, to take just one example, often proves impossible, due to a general absence of physical addresses for most Kenyans. While FATF guidelines on anti-money laundering (AML) offer flexibility on this topic, and the BCBS paper "Microfinance and the Core Principles for Effective Banking Supervision" references this flexibility, adherence to the BCBS principle still causes problems. This ultimately becomes an assessment issue. Even though the BCBS microfinance guidance paper mentions that it is not necessary to verify customers' addresses, a country may still be assessed negatively (in FSAPs and mutual evaluations) by the international community if regulators are unable to justify their approach to customer due diligence.

### *New payment models change the overall risk landscape for banking supervision*

Mobile payment systems carry float accounts, held in trust at Kenyan banks. As mobile payment systems continue to grow, these deposits have also grown. To mitigate (diversify) associated inherent risks, the deposits are split into smaller amounts and placed as deposits in several big banks. While these amounts represent a very small proportion of overall deposits in the banking system, they represent a large number of mobile payment customers. Although currently this area is not directly under the scrutiny of the Bank Supervision Department, it is catered for under the National Payments System Oversight framework. (These services are regulated under the provisions of Section 4A 1(d) of the Central Bank of Kenya.) The inherent risks will be addressed in the proposed NPS Bill and subsequent regulations.

### *Moving beyond a silo mentality on what constitutes banking business requires rethinking of Principle 2 (permissible activities)*

Recent innovations in mobile payments highlight the systemic links between banks, mobile network operators and payment systems in the overall banking landscape. The nexus of these players creates a need for interaction between the respective regulators as well as the respective standard-setting bodies. The CBK believes that in particular, BCBS and CPSS should work together to agree to a demarcation on what constitutes bank business and deposit-taking, and confirm how mobile payment systems fit within the greater risk framework. This relates to BCBS

<sup>24</sup> Central Bank of Kenya, 2010. Guideline On Agent Banking - CBK/PG/15

<sup>25</sup> The increased risk sensitivity in respect of credit risk involves the measurement of credit risk in a standardized manner, supported by external credit assessments.

<sup>26</sup> The regional intergovernmental organization of the Republics of Kenya, Uganda, the United Republic of Tanzania, Republic of Rwanda and Republic of Burundi. Its headquarters is in Arusha, Tanzania.

<sup>27</sup> "Abuse of financial services: Supervisors must be satisfied that banks have adequate policies and processes in place, including strict "know-your-customer" rules, that promote high ethical and professional standards in the financial sector and prevent the bank from being used, intentionally or unintentionally, for criminal activities."

<sup>28</sup> Basel Committee on Banking Supervision, 2006. *Core Principles for Effective Banking Supervision*.

<sup>29</sup> "Permissible activities: The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined and the use of the word "bank" in names should be controlled as far as possible."

Principle 2<sup>29</sup> regarding permissible activities. While mobile payment systems may not constitute banking business because the collected funds are not intermediated by the payment provider, the deposits are held in Kenyan banks, implying some level of responsibility for the banking regulator.

## 4.2. Committee on Payment and Settlement Systems

In 1998, Kenya began a modernization program for its national payment system<sup>30</sup>. The major milestones in this process have been:

1. The Nairobi Clearing House was automated in 1998, which reduced the check-clearing cycle from fourteen days to four days. The adoption of Magnetic Ink Character Recognition (MICR) technology and an Electronic Funds Transfer (EFT) system facilitated this automation.
2. The Central Bank of Kenya Act was amended in 2003 and introduced Section 4A 1(d), which provided a strong basis upon which the Bank could promote modernization of payment, clearing and settlement systems, including the continuing innovations in the retail payment arena.
3. The Kenya Electronic Payments and Settlement System (KEPSS), the country's Real Time Gross Settlement (RTGS) system, was implemented in July 2005. This reduced the risks associated with the previous paper-based inter-bank settlement system, transformed the management of liquidity in the banking industry, reduced the systemic importance of the Automated Clearing House (ACH), and enhanced financial stability while providing an efficient mechanism for monetary policy transmission.
4. The Central Bank of Kenya, in conjunction with the Kenya Bankers Association (KBA) and in liaison with the Ministry of Finance, implemented a value capping policy in October 2009. The policy stopped the processing of high value payments (Ksh 1 million (US\$ 10,870) and above) using checks and Electronic Funds Transfers through the Nairobi Automated Clearing House. These transactions are now processed through KEPSS.
5. The Check Truncation Project is an ongoing project that seeks to streamline the processing of

checks. This project will remove the need to physically send bank representatives to the Clearing House. Settlement certificates will be distributed electronically and all checks deposited will be stored at the point of deposit.

### *CPSS principles have yet to find a way in to legislation*

The CPSS principles and guidance are not yet embodied in a National Payment System (NPS) Act. A draft bill has been created, and is awaiting parliamentary attention. However, it is not clear when the bill will enter the parliamentary process.

The NPS Act will provide much greater legal certainty to the CBK, the relevant private sector players and even the SSB regarding the embodiment of the CPSS principles and will also allow for the issuing of supporting regulations.

### *Regional decisions have been of more direct relevance to payment system reform than CPSS principles*

When it comes to international dialogue around standards, Kenya has found that regional participation often plays a far greater role in payment system development than global standard-setting forums. For example, with regard to payment systems, the directives issued by the Monetary Affairs Committee under the EAC offer more directly relevant and contextual guidance, and therefore have a greater impact on Kenyan payment system evolution<sup>31</sup>.

This regional cooperation is not in conflict with the principles of the CPSS. Rather, East African countries at similar stages of payment system development can move toward common goals in concert. This not only involves coordination and best practice sharing at the principle level, but also often requires discussion and consensus on more technical issues in payment system reform – which participating countries find very useful. The CPSS principles are therefore consulted as high-level guidance, while the contextual nuances are handled and fleshed out at a regional level. The political commitment associated with participation in a body such as the EAC also implies great political commitment for decisions, even technical ones, made within the body. For example, a directive was passed that requires member countries to implement Real Time Gross Settlement Systems (RTGS): all countries except Burundi have now implemented them.

<sup>29</sup> "Permissible activities: The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined and the use of the word "bank" in names should be controlled as far as possible."

<sup>30</sup> Central Bank of Kenya, 2011. Development and Regulation of Payments System in Kenya.

<sup>31</sup> Central Bank of Kenya, 2008. Under Articles 5, 82 to 85 of EAC Treaty, Partner States have undertaken to co-operate in monetary and fiscal matters in order to establish monetary stability within the Community aimed at facilitating economic integration efforts. The Monetary Affairs Committee (MAC) is one of the committees that were formed to steer these aspects of the EAC treaty.

### 4.3. Financial Action Task Force

In 2009, the Kenyan parliament passed the Proceeds of Crime and Anti-Money Laundering Act, which came into effect on June 28 2010 (a full timeline of legislative process and reform is provided below). This legislation cuts across financial institutions to:

1. Criminalize money laundering and create other related offenses;
2. Establish the FRC (Financial Reporting Centre) as the Kenyan financial intelligence unit and define its powers and functions;
3. Create AML obligations for reporting institutions;
4. Establish an AML advisory board;
5. Give the Ministry of Finance power to make regulations and implement the Act.

**Table 1. Timeline for the implementation of FATF’s 40+9 Recommendations in Kenya**

Date	Event
1996	FATF releases revised version of 40 Recommendations (originally released in 1990) to reflect the evolving nature of money laundering
2000	First guidelines on AML issued by CBK
October 2001	FATF releases its IX Special Recommendations on Terrorist Financing
2003	Kenya establishes its own AML taskforce
2007-2008	FATF annual report lists Kenya as a jurisdiction that has undertaken to implement the FATF 40 Recommendations and IX Special Recommendations.
2009	US Department of State estimates that \$100m are laundered every year in Kenya
May/June 2009	In Kenya, mutual evaluation process by ESAAMLG starts
Dec 2009	Proceeds of Crime and Anti-Money Laundering Act passed
28 June 2010	Proceeds of Crime and Anti-Money Laundering Act comes into effect
24 June 2011	Kenya identified by FATF as “jurisdiction(s) with strategic AML/CFT deficiencies that have not made sufficient progress in addressing the deficiencies or have not committed to an action plan developed with the FATF to address the deficiencies” <sup>32</sup>
September 2011	Final ESAAMLG mutual evaluation report on Kenya expected

*The AML Act has not yet led to the establishment of an FRC*

Though the AML advisory board that the Act establishes has been constituted, at the time of writing the FRC has not. This is likely to take place during the next six months. In the period before the establishment of the FRC, the AML advisory board is assisting with its setup and interim policy and regulatory development. Since the Act requires that any supporting regulations must be issued by the FRC, supporting regulations to the Act have not been issued.

In the absence of such regulations, guidelines issued by CBK (which apply to institutions licensed under the Banking Act only) dictate the AML prevention efforts of banks. Similarly, the IRA issued supporting AML regulations (under the current Insurance Act) for insurers and other institutions that fall under its ambit. There is currently no legislation for FATF’s IX Special Recommendations on terrorist financing.

<sup>32</sup> FATF, 2011. Public statement, 24 June 2011. Available at: [http://www.fatf-gafi.org/document/54/0,3746,en\\_32250379\\_32236992\\_48263734\\_1\\_1\\_1\\_1,00.html](http://www.fatf-gafi.org/document/54/0,3746,en_32250379_32236992_48263734_1_1_1_1,00.html)

### *In absence of national AML/CFT risk assessment, it is difficult to follow a risk-based approach*

The lack of a national AML/CFT risk assessment may be leading to overly conservative guidance on the part of the CBK with regard to several aspects of customer due diligence and record-keeping. In the absence of hard data on the risks associated with a particular product, transaction or financial services provider, it is difficult to justify why it deserves special treatment from an AML perspective. For example, the Banking Supervision Department of the CBK was recently faced with the question of whether it should reduce the CDD requirements for small-value transactions made at foreign exchange bureaus. Given the absence of hard data on the risks associated with these transactions, it decided to apply the same level of CDD requirements to all transactions at ForEx bureaus when it revised the ForEx Bureau Guidelines in 2011 to reflect AML requirements<sup>33</sup>. According to certain newspaper reports, this may have a negative impact on total business conducted through ForEx bureaus, as they will find it difficult to obtain identity documentation for all their clients<sup>34</sup>.

Without proper justification for decisions to place less onerous requirements on small transactions, Kenya may be assessed negatively in regard to compliance with AML principles. This raises the larger question of whether it is possible to implement a risk-based approach in the absence of a national risk assessment that covers all relevant areas of the financial sector.

### *Regulation must be crafted to match pragmatic market approaches*

In general, Kenya's AML task force is trying to shape regulation to match some of the pragmatic practices already employed in the industry towards verifying customer identity as required by Recommendation 5<sup>35</sup> of FATF. In Kenya, most people have a national identity

document<sup>36</sup>, but many have very little else to identify themselves. Physical addresses are not widespread in Kenya, and many people, particularly in peri-urban and slum areas, relocate homes frequently. In the absence of this piece of information, financial institutions have allowed customers to provide a letter of introduction (from an existing client, local leadership, or the village chief) as means of identity verification.

Rather than tightening restrictions, Kenyan regulators would like to align regulation with the pragmatic business practices that are already being employed. Kenya has also taken a quite pragmatic approach with regards to the identification of refugees without any identity documents from their home countries, as described in Box 1 below.

### *Bank agents cannot open accounts, but M-PESA agents can*

Under current rules, bank agents are permitted to physically accept new customer account application forms on behalf of the bank, but are not allowed to identify the client and originate the account themselves. However, mobile payment system agents (like M-PESA's) are allowed to originate transaction accounts on behalf of customers. Although these financial service providers are subject to different regulation, many of their clients use either type of account to the same effect.

The regulator argues that the latter approach for mobile payment agents has been followed as the account is subject to strict transaction and value thresholds. The maximum account balance is limited to KSh100,000 (US\$ 1,087), while the maximum allowable daily transaction value is KSh140,000 (US\$ 1,522)<sup>37</sup>. Similar thresholds have not been implemented for bank accounts and therefore account opening by bank agents would potentially be subject to higher money laundering risk. While Kenya's thinking on a flexible framework for

#### **Box 1. Using the alien card as means of identification**

Refugees that are able to convince the Kenyan government of their refugee status are issued a so-called "alien card" to serve as their identity document during their stay in Kenya. Often this document is issued in the absence of an original identity document (such as an identity card or passport) from their home country. Many of these cards thus rely on the honesty of the refugee. The CBK has received many questions from banks on whether the alien cards serve as a sufficient form of identification during the opening of a bank account or performance of a single transaction. The CBK Bank has left the decision regarding identification using the alien card up to each bank, though its advice is that where clients identify themselves using the alien card, banks can and should also ask for other forms of identification.

<sup>33</sup> Central Bank of Kenya, 2011. *Forex Bureau Guidelines 2011*.

<sup>34</sup> Othinga, R., 2011. New CBK rules tighten leash on forex bureaus. *Business Daily*. 24 March 2011.

<sup>35</sup> "Financial institutions should not keep anonymous accounts or accounts in obviously fictitious names. Financial institutions should undertake customer due diligence measures, including identifying and verifying the identity of their customers...".

<sup>36</sup> Under the Registration of Persons Act the Department of National Registration Bureau has been mandated to identify, register and issue identity cards to all citizens of Kenya who have attained the age of eighteen (18) years and above.

<sup>37</sup> CGAP, 2010. Update on regulation of branchless banking in Kenya. January.

mobile payments has evolved quite far, the same has not yet occurred for client identification in the context of agent banking. In the absence of a national risk assessment, this is likely to remain problematic.

### *Balancing terrorist financing standards with financial inclusion priorities is more challenging than dealing with money laundering only*

Kenya has yet to implement legislation that deals with the financing of terrorism and that gives legislative status to FATF's 9 Special Recommendations. The Kenyan regulators expressed concerns that the nature of the risks posed by terrorist financing activities is very different to those implied by money laundering activities. While the risk-based approach may be suitable to facilitate financial inclusion through the exemption of certain low-value transactions, terrorist financing can occur through even small amounts. In the absence of a law that deals with terrorist financing, FATF requires the implementation of administrative measures to assist with the prevention of terrorist financing. However, according to Kenyan regulators, they have been unable to find any guidance on these administrative measures and what impact they would have on financial inclusion.

## 4.4. International Association of Deposit Insurers

### *History of the Deposit Protection Fund Board (DPFB)*

The DPFB was established under the Banking Act in 1985 after governance problems in Kenyan banks caused a banking crisis. Although a Body Corporate with its own Board of Directors, DPFB currently operates as a department of the CBK. Currently, the DPFB is working to gain independence from the CBK, and it has produced a draft bill to this end. Independence would entail having a different management team (from that of CBK) to manage DPFB operations and restructuring the Board of Directors. The proposed regime would also grant DPFB much greater powers in taking preventative measures before its involvement in bank liquidation. This mainly involves having the power to inspect banking institutions and actively participating in problem bank resolutions, in close coordination with CBK.

### *The growth in deposits is outpacing the development of the DPFB*

The Deposit Protection Fund covers depositors in Kenyan banks, housing finance institutions, and

deposit-taking MFIs (all deposit-taking institutions supervised by the Central Bank) for up to Ksh 100,000 (US\$ 1,087). Currently, the fund covers over 16 million accounts, 94 percent of which fall under this amount. With the rapid increases in new accounts and the pace at which deposits are growing, the fund is having trouble keeping up: despite its own consistent growth<sup>38</sup>, the effective coverage is below 20 percent. This is in comparison to IADI's general guidance<sup>39</sup> to fully cover 80 percent of accounts and have the fund's balance represent 20-40 percent of total covered deposits<sup>40</sup>.

This begs the question of whether these guidelines are appropriate for Kenya. If so, the DPFB requires guidance on how to expand current insurance coverage and what the ideal level of coverage would be. Currently, it collects a flat premium of 0.15 percent of total deposits from each regulated institution. The DPFB has begun to explore the possibility of switching to a risk-based premium collection model, whereby riskier institutions are subject to higher deposit insurance premiums. However, this change is likely to require a large investment of resources to fully understand the risk landscape for each Central Bank-supervised financial services provider that contributes to the fund. The DPFB has the difficult task of balancing the need for fund growth with the desire to keep access to deposit services as inexpensive as possible, to encourage financial inclusion.

### *The risk landscape is complicated by Kenyan banks' expansion in the region*

The DPFB's mission is to protect savers in the event of bank failure, and to encourage savings by increasing confidence in the financial sector. With the recent expansion of Kenyan banks into the region (e.g. Equity Bank's expansion into Southern Sudan and Uganda), the DPFB's job has become more complex. The question that arises is: "How does the regulator assess the risk of financial difficulties in other countries and the potential impact on the local deposit protection regime?"

### *How should the DPFB handle mobile payment models?*

The DPFB expressed concern that the current model of holding the float for M-PESA accounts in trust accounts at a number of Kenyan banks does not afford those customers deposit insurance. It has also been found that M-PESA clients regularly use their M-PESA accounts for short-term savings<sup>41</sup>. What then, is the relevance of deposit insurance for these mobile payment models and how should this be implemented? Under the current model, all M-PESA funds held in

<sup>38</sup> The fund grew 16.4 percent in 2010, 15.4 percent in 2009, and 14.3 percent in 2008

<sup>39</sup> As provided in International Association of Deposit Insurers (IADI), 2009. *Deposit insurance coverage*. Draft discussion paper. August 2009.

<sup>40</sup> The document refers to these numbers as a "rule of thumb accepted at the First Annual Conference of the International Association of Deposit Insurers (IADI) in Basel, Switzerland, May 2002."

<sup>41</sup> CGAP, 2009. Morawczynski, O. & Pickens, M. *Poor people using mobile financial services: Observations on customer usage and impact from M-PESA*. CGAP Brief. August.

trust at a specific bank would only be entitled to total coverage of KSh100,000 (US\$ 1,087), should the bank experience financial difficulties and be liquidated.

#### *Non-bank financial institutions are not covered by DPFB, but SACCOs fall under Deposit Guarantee Fund*

Deposit-taking institutions not supervised by the Central Bank are not covered by the Deposit Protection Fund Board. However, SACCOs that fall under the supervision of the SACCOs Regulatory Authority are covered by their own Deposit Guarantee Fund. The Fund is managed by a Board of Trustees. Every registered SACCO Society is required to contribute to the Fund. SACCO Societies are assessed on their average savings and deposits over the course of the previous three years and required to contribute annual premiums of Ksh50,000 or 0.05 percent of total savings and deposits, whichever is the higher amount<sup>42</sup>. The Fund insures all SACCO deposits up to a value of Ksh100,000 for each member of a SACCO society<sup>43</sup>.

## 4.5. International Association of Insurance Supervisors

#### *The IRA is moving towards a more extensive insurance oversight function*

The Insurance Act was enacted in 1986 and implemented in January 1987. It was significantly amended in 2006, adding market development to the IRA's mandate. The IRA has supported the development of a microinsurance market in several ways, including exempting insurance companies and non-traditional intermediaries from various parts of the Insurance Act on a one-off basis, to allow for the implementation of innovative microinsurance models.

#### *A forthcoming Insurance Act will embed IRA's drive to modernize the industry*

A new Insurance Act is currently being drafted. This overhaul of the Act is part of an attempt to move the Kenyan insurance industry in the direction of international best practices. A draft bill was published and circulated for comment in April 2011. Following the publication of the draft bill, the IRA also hosted a workshop to test the bill with industry players and other relevant stakeholders, but it is not clear when the revision process will be completed or when the draft bill will be submitted to parliament. The initial draft of the bill did not explicitly take into account

the proportional approach to supervision espoused by the IAIS and the IRA is obtaining advice on how to craft this into the bill.

#### *The expansion of the insurance market will focus on facilitating financial inclusion*

The IRA has an explicit mandate to encourage the development of the insurance market and the up-take of insurance amongst the Kenyan population. To this end, the IRA has focused on microinsurance as a way to extend the insurance sector. Following the completion of a landscape study on the microinsurance market in Kenya in 2010, the IRA established a Microinsurance Steering Committee, involving representatives from the insurance companies, banks, MFIs and other relevant stakeholders. The Committee meets regularly to progress their thinking on the development of the microinsurance market, and has produced three discussion papers on the demand, regulation and supply of microinsurance in Kenya. It is planned that these discussion papers will form the basis of a policy document in which the IRA will set out its proposals for creating a more enabling regulatory framework for microinsurance in Kenya.

#### *The IRA has found implementation of a proportional approach to supervision challenging*

The new Act is expected to increase operating requirements to move the Kenyan insurance sector closer to international standards. In this regard, the IRA is currently receiving support from a World Bank Financial and Legal Sector Technical Assistance Project (FLSTAP) to ensure that the new Act will reflect a proportional approach to insurance supervision. However, a proportional approach to supervision will require a very detailed understanding of industry practices, a comprehensive risk assessment, and advanced management information systems (MIS) to better collect and manage information collected during the supervision process. Furthermore, the regulator acknowledges that the risks associated with informal insurance providers in Kenya are not fully understood and plans to undertake a survey of these players in the foreseeable future. In the absence of this data, it is therefore difficult to tailor resources appropriately.

Apart from these challenges, Kenya also suffers from a shortage of actuaries<sup>44</sup>. The resource intensiveness of implementing a proportional supervisory approach in the absence of clear and specific guidance indicates a challenging road ahead.

<sup>42</sup> Republic of Kenya, 2008. SACCO Societies Act Regulations. Kenya Gazette Supplement No. 39. 18 June 2010.

<sup>43</sup> Ibid.

<sup>44</sup> There are very few life insurance companies in Kenya with in-house actuaries. To increase the availability of actuaries in Kenya, the IRA has just made bursaries available for six actuaries to study in the United Kingdom:

[http://www.ira.go.ke/index.php?option=com\\_content&view=article&id=180&Itemid=197](http://www.ira.go.ke/index.php?option=com_content&view=article&id=180&Itemid=197)

*ICP 17<sup>45</sup> has been experienced as particularly challenging with regards to proportional approach to supervision in an increasingly complicated market landscape*

The ICP principles are stated at such a high level that the IRA has generally not found them to be restrictive to the development of the Kenyan insurance market. However, the IRA expressed interest in obtaining

guidance on ICP 17, which relates to the supervision of corporate groups that include insurers as part of the total holding company structure. Given the complexity of some of these groups and a lack of clear and appropriate corporate governance arrangements, it has been difficult to obtain clarity on the ownership structure of some of these groups in Kenya, as well as the role of the insurance company in the overall holding company structure.

## 5. Cross-cutting issues and conclusions

---

*The pragmatic need for development overshadows pure compliance in terms of SSB principles*

Kenyan regulators understand and acknowledge the need to adhere to the principles set by international SSBs. However, there is also a recognition that these principles and the absence of clear guidance on their implementation is somewhat removed from their domestic realities.

*Regional coordination now sets the priorities for international standards implementation*

In the absence of clear and specific guidance from the SSB on a number of technical matters, the decisions made and guidance provided at a regional body level (e.g. ESAAMLG and the EAC) is often of far greater value to Kenyan regulators. This offers a key opportunity for SSBs who want to move closer to developing countries; SSBs can work more easily with those countries which actively engage in regional bodies, whether these bodies are aimed at regional financial integration or simply coordination around a specific financial sector regulatory area.

*There is a need for a better and more explicit understanding of proportionality and the risk-based approach, and capacity building in the developing country context in this regard*

In order to implement an appropriate proportional approach to supervision in each of the relevant regulatory and supervisory spheres, regulators first need to have a thorough understanding of risk. However, once this understanding of risk has been established, more and very specific guidance is required on how to embed this within the regulatory and supervisory space. Certain Kenyan regulators have voiced concerns that a proportional or risk-based approach to supervision has the potential to be resource-intensive in an environment that is clearly

resource constrained. While SSBs have generally positioned themselves at the principle level and steered clear of specific and technical guidance, developing countries such as Kenya struggle to know how to prioritize supervisory approaches and actions in the absence of such specific guidance.

*Clear guidance is needed from SSBs on how to conduct a national risk assessment*

When it comes to preventing money laundering, a national risk assessment has been revealed to be a prerequisite for creating a risk-based regulatory regime. In insurance, proportional regulation requires a thorough understanding of the risks posed by both formal and informal players in the financial market. Furthermore, the DPF needs a deeper understanding of the risks associated with the various types of deposit-taking institutions in order to implement the tiered-premium system that it is currently considering moving to.

SSBs could work together to provide expertise in their particular areas, and so deliver guidance for conducting a comprehensive form of risk assessment across the financial sector.

*The degree of perceived SSB sanction can influence or determine financial inclusion impact*

FATF mutual evaluations carry great weight due to the threat of sanction. For example, correspondent banking relationships can be severed if a country continually chooses not to comply with the Recommendations, potentially leading to large negative economic impacts. This is, however, not the case for the other SSBs where compliance has so far been largely voluntary. In Kenya, specifically, this has meant that the standards set by the non-FATF SSBs have generally not had a negative impact on financial inclusion or, at least, less of an impact.

---

<sup>45</sup> "The supervisory authority supervises its insurers on a solo and a group-wide basis."

### *Regional expansion poses particular supervisory challenges on which SSB guidance could assist*

Kenyan financial service providers such as banks and insurance companies are rapidly expanding into the East African region and establishing themselves as regional players. Kenya's neighboring countries tend to have unpredictable business environments that could impact the stability of Kenyan banks (and other financial institutions). Many of these countries do not have deposit insurance systems and the DPF fears that large deposit insurance risk burdens may be transferred to Kenya. Furthermore, exposure of these banks to risky business environments outside Kenya may impact their stability in Kenya, putting local deposits at risk. The regional expansion of banks not only poses challenges for deposit insurance, but was also mentioned as a particular challenge facing the banking regulator.

### *The issue of deposit insurance coverage for mobile payment funds requires consideration within IADI*

The Deposit Protection Fund Board voiced its concern with regard to the lack of adequate deposit insurance coverage for mobile payment funds that belong to M-PESA customers and are kept in trust accounts in different banks in Kenya. Users of these payment systems do not currently have individual coverage for funds that are held in their accounts. In the face of evidence that Kenyans are using mobile payments as a store of value for their funds and even, in a longer term way, as savings accounts, this raises distinct questions in the Kenyan environment about whether and how deposit insurance should be extended to cover funds kept in individual mobile payment accounts. Guidance and discussion of this issue by the IADI will do much to provide the Kenyan regulator with certainty.





# GPI

Global Partnership  
for Financial Inclusion

## Global Partnership for Financial Inclusion

[www.gpfi.org](http://www.gpfi.org)

The Global Partnership for Financial Inclusion (GPI) is the main platform for implementation of the G20 Financial Inclusion Action Plan. The group engages partners from G20 and non-G20 countries, private sector, civil society, and others. It is chaired by the G20 troika countries, currently Korea, France, and Mexico. The GPI is supported by three implementing partners: the Alliance for Financial Inclusion (AFI), the Consultative Group to Assist the Poor (CGAP), and the International Finance Corporation (IFC).



**afi** Alliance for  
Financial Inclusion  
Bringing smart policies to life

## Alliance for Financial Inclusion (AFI)

[www.afi-global.org](http://www.afi-global.org)

AFI is a global network of central banks and other financial inclusion policymaking bodies in developing countries. AFI has been given the mandate to foster the participation of non-G20 developing countries in the G20's Global Partnership for Financial Inclusion as an implementing partner.

### Alliance for Financial Inclusion

AFI, 399 Interchange Building, 24th floor, Sukhumvit Road Klongtoey - Nua, Wattana, Bangkok 10110, Thailand t +66 (0)2 401 9370 f +66 (0)2 402 1122 e [info@afi-global.org](mailto:info@afi-global.org)

AFI is funded by the Bill & Melinda Gates Foundation and administered by GIZ (German International Cooperation)