KENYA BANKERS
ASSOCIATION

"To Regulate or Not: Effects on the Financial Services Sector"

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About KBA

- KBA is the umbrella body of all financial institutions licensed under the Banking Act;
  - Micro-finance banks and Representative offices of foreign banks are eligible to join as associate members.
- Represents its members in policy engagement with the regulator, government and other stakeholders.
- Owns and runs the cheque clearing house.

KENYA BANKERS ASSOCIATION

2012

KBA restructures; launches new identity and positioning:
One Industry. Transforming Kenya.

2005

KBA

KBA introduces "Three Shillings" logo and takes on more strategic initiatives

KENYA BANKERS ASSOCIATION

1968

THE KENYA BANKERS (EMPLOYERS) ASSOCIATION

1962

KBA was registered as an employers association in 1962

KBA in the Financial System

Regulating Agencies

- CBK
- IRA
- CMA
- SASRA
- RBA

Regulated Market Players that include KBA Members

KBA Representation mandate in policy engagement

<u>Stakeholders</u>

- **Government (National Treasury, KRA, etc),**
- **Consumers of financial Services (firms and households;**
- **International Agencies (IMF, World Bank, etc)**

The subject of discussion: is financial regulation necessary?

- The answer is not a simple “yes or no”.
  - The answer lies in addressing three key considerations:

    (1) why regulate? (2) what are you regulating? (3)who regulates?
- Regulation in the financial sector have existed for as long as the financial system has been in existence:
  - Its form is dynamic – changing as the market evolves;
  - In instances regulation is inspired by:

    (1) financial crises (2) scandals (3) personalities
  - It could be undertaken by a broad and competing array of industry specific (independent agencies) and governmental units

Why regulate?

- Finance is critical for economic prosperity of any country.
  - But…if the financial system is not stable, economic prosperity is not assured.
  - Even worse… weak financial systems can destabilize local economies, making them more vulnerable to shocks (both domestic and foreign).
  - Therefore…even with sound macroeconomic management, economic prosperity can be undermined by a weak financial system; the opposite is true.
- In principle therefore, financial regulation should be seen as a reconciliation between the activities of financial market players (seeking to maximise returns) and non-financial actors (some of whom are also seeking to maximise returns and some seeking to maximise welfare).

What Occasions Financial Instability?

- Excessive risk taking during boom period and herding behaviour both during upswing and subsequent downturn.
- Market imperfections that masks real risk profile embedded in the system.
- Weaknesses in the supervisory and regulatory mechanisms that perpetrate irrational risk-taking by individual players.
- Weak governance
- Lack of Supervisory independence
- Government involvement in the financial sector
  - Directed lending to unviable propositions at artificially low rates of interest; Cross-subsidization affecting earning potential of banks; Fiscal deficits financed by borrowings from Central Bank

What is to be regulated?

- If regulation is necessary (and it is), then there has to be clarity on how it has to be done:
- First: it must seek to address systemic risks.
  - Putting in place restrictions to market forces to avoid (a) price collusion – e.g. what the Competition Authority of Kenya does (b) close monitoring (not necessarily prevention)of cross-border capital flows (c) Restrictions on the range of activities - compartmentalisation of banking/securities/insurance.
  - Putting in place prudential regulation - Supervision of Balance sheet ratios and of risk diversification; on-site inspection and external auditing.
- Second: It must seek to prevention of individual risks:
  - Having quality standards and codes of conduct; disclosure and information requirements (CIS mechanism) ; deposit protection schemes (such as KDIC)
- Third: It needs to address the promotion of systemic efficiency:
  - prohibition of restrictive business practices and cartels; regulation of mergers & acquisitions

Who Regulates?

- Assumption:
  - Banks – CBK
  - Insurance Company – IRA
  - SACCOs/Cooperatives – SASRA
  - Investment Bank/ Stock Broker etc. – CMA
  - Pension, retirement funds - RBA
- Reality:
  - There is an overlap developing on the business model;
  - There are other regulators e.g. CAK on matters competition.

Regulation as a Balancing Act: Are there Trade-offs?

- The Balancing Act:
- A balancing act between conflicting demands: There is always a trade-off in its design and formulation:
  - 1. The extent of admissible competition – determined by striking the right balance between perceived benefits and implicit social costs for various levels of competition.
  - 2. Permissible level of risk taking – trade off between low economic growth with high social stability and high economic growth (with increased risk taking) with potential for instability.
  - 3. Conflicting requirements of assuring soundness of the financial system and of obtaining allocation of resources to desired sectors.
  - 4. Liberalised Vs. Restricted entry - Entry barriers stifle competition and lead to complacency that limits initiatives for cost reduction, efficiency, improvement and innovation.

Regulation as a Balancing Act: Are there Trade-offs?

- 5. Prudential regulation Vs. Micro-regulatory controls. Micro regulation is intrusive as it goes into day-to-day functioning of the players as opposed to selective interventions (prudential regulation) whenever and wherever needed.
- 6. Government Vs. Private ownership of banks Government ownership facilitates socially desirable investments including strategic long-term investments that may yield beneficial returns only in the long-run (Recall: Government direct involvement in the financial sector as one of the potential causes of financial instability).

  Private sector initiatives, however, are generally directed towards sectors which are likely to produce immediate returns of higher-order.

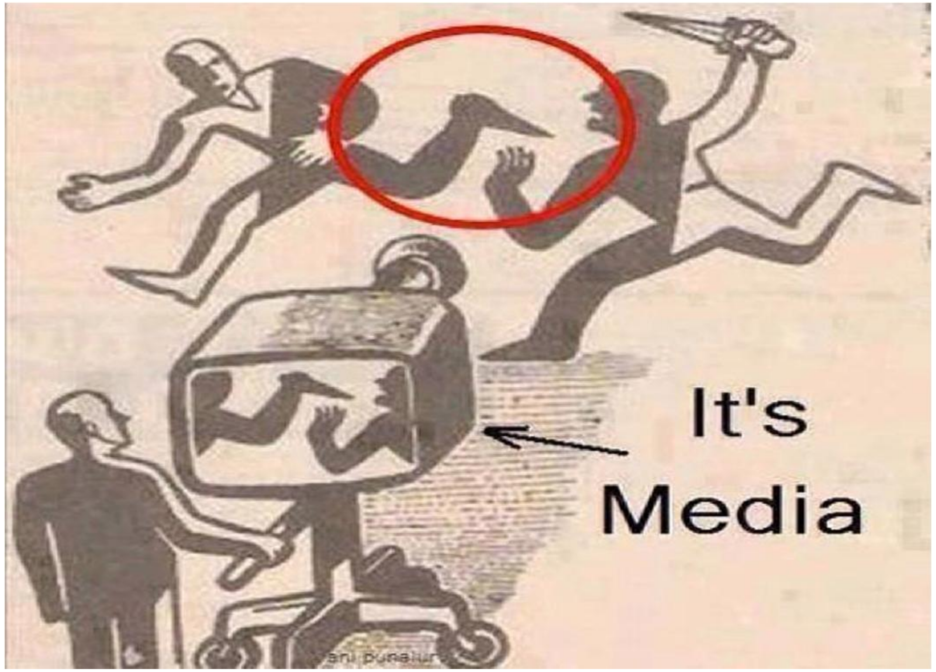
Emerging Issues

- The transparency required of financial market players and especially banks is a regulatory imperative:
  - Regular publishing of results is not a "profitability parade".
- Governance requirements – "fit and proper" requirements and others are a recognition of the unique attributes of the sector.
- Capital requirements is a key regulatory aspects – it is not an entry barrier but a risk appetite check:
- Regulation is critical but costly is there is a tendency to seek to regulate "everything" – the benefits of regulation must outweigh the costs.
- Some aspects of regulation could be distortionary:
  - Even with the myriad regulations, the temptation to regulate price (interest rate) – not fees and charges – is one such distortionary regulations; the Kenyan experience (like that of other markets) has demonstrated that.

Emerging Issues – “the Interest Rate Regulation- The debate“

- World Bank (2 studies); IMF (2 Reviews); CBK (1 study) KBA (3 Analytical Surveys).
  - All indicate that the law is not working and has adverse effects on the economy.
- ICPAK – no study
  - Still too early to appreciate the effects of the law.
- Politicians – no study.
  - We are a sovereign country so our policies cannot be dictated by “foreigners”.
  - The CBK, IMF, World Bank, are ganging up to frustrate the law

- The media:
  - “All sides have a story”



Ultimately

- Regulation is absolutely critical – a stable financial system is a prerequisite for prosperity
- It is a balancing act – therefore has trade-offs
- Some aspects of regulation (especially price regulation) are distortionary.

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