KENYA ACCESS TO RURAL FINANCE

IMPLEMENTATION OF THE PROCEEDS OF THE CRIME AND ANTI-MONEY LAUNDERING ACT

CENTRAL BANK OF KENYA

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BACKGROUND

At the request of the Central Bank of Kenya (CBK) the Centre for Financial Regulation and Inclusion (Cenfri[1]) was contracted to provide strategic input on the direction of the new guidelines/regulations to be issued under the Proceeds of Crime and Anti-Money Laundering Act (the Act) that will come into operation on 1 July 2010. Cenfri was contracted by DAI[2] under the Kenya Access to Rural Finance Program, funded by USAID Kenya.

Between 25 and 27 May 2010, the Cenfri team consisting of Hennie Bester and Herman Smit, conducted a number of meetings with banks, microfinance institutions, forex bureaus and other players in Nairobi to obtain primary input on current AML practices amongst financial institutions supervised by the CBK. Cenfri provided preliminary feedback to the CBK at a meeting in Nairobi on 28 May 2010.

This note contains strategic recommendations to the CBK on how to proceed.

Mandate

The CBK indicated that they wish to formulate guidance applicable to the institutions under their supervisory jurisdiction. These institutions include:

- Banks and other financial institutions regulated under the Banking Act.
- Deposit-taking microfinance institutions regulated under the Microfinance Act.
- Forex bureaus regulated under the Central Bank of Kenya Act.
- Non-bank payment service providers currently supervised by the Payment Services Department of the CBK.

The CBK further indicated that the strategy should be formulated with the twin objectives of stability and financial access in mind.

Current Regulatory Framework

To date, and prior to the coming into operation of the Act, the CBK had issued the following guidelines regarding AML control to institutions under its supervision:

- Prudential Guidelines for institutions licensed under the Banking Act, 2006 (Section 8, Proceeds of Crime and Money Laundering).[3]
- The Microfinance (Deposit-Taking Microfinance Institutions) Regulations, 2008 (section 37).
- Forex Bureau Guidelines, 2006 (Section 6, Minimum Terms of a License).
- The Guideline on Agent Banking[4], 2010 (sections 5.4 and 5.5).

The CBK has also prepared the National Payment System Bill, 2009, which will regulate, amongst others, non-bank payment service providers, such as Zap and M-Pesa. Pending approval of the NPS Bill by the Parliament, the CBK supervises non-bank payment service providers and

[1] Cenfri is a non-profit think-tank based in Cape Town, South Africa. Cenfri's mission is to support financial sector development and financial sector inclusion through facilitating better regulation and market provision of financial services. See www.cenfri.org
[2] Development Alternatives, INC (DAI). DAI's mission is to make a lasting difference in the world by helping developing nations become more prosperous. See www.dai.com
[3] Guideline on the Proceeds of Crime and Money Laundering (Prevention) CBK/PG/08
[4] CBK/PG/15

issuers of electronic money in terms of the general power to oversee payment systems contained in section 4A of the CBK Act. The CBK approval in terms of which these non-bank operators provide services to the public requires them to comply with basic AML controls.

Financial Action Task Force

Kenya committed itself to meeting the international AML/CFT standards set by the Financial Action Task Force (FATF). It is a member of regional FATF-style body, the Eastern and Southern Africa Anti-Money Laundering Group (ESAAMLG). In May/June 2010 Kenya underwent an ESAAMLG mutual evaluation to determine the levels of its compliance with the international standards. Kenya is also closely monitored by the FATF. It was identified earlier in 2010 as a jurisdiction with strategic AML/CFT deficiencies. The government furnished the FATF with a written high-level political commitment to address these deficiencies.

New Act

The Proceeds of Crime and Anti-Money Laundering Act was passed by the Kenyan Parliament during December 2010 and assented to by the President on 31 December 2010. It will come into operation 6 months after assent, i.e. on 1 July 2010. As far as AML controls are concerned, the critical provisions of the Act are as follows:

- It criminalizes money laundering and creates various related offences (section 3).
- It establishes the Financial Reporting Centre (FRC) as the Kenyan financial intelligence unit and defines its powers and functions (s.21 and following).
- It creates AML obligations for reporting institutions (ss.44- 48).
- It establishes an Anti-Money Laundering Advisory Board (s.49).
- It confers the power on the Minister of Finance to make regulations to implement the Act (s.134).

Table 1 below lists the reporting institutions under the Act, legislation pertaining to each institution, its supervisory authority and KYC rules required in applicable regulation. It is worth noting that most reporting institutions currently do not have any AML regulation applying to them.

Reporting institution	**Applicable law(s)**	**Supervisory Authority**	**Current AML Client Identification and Verification**
Banks	Banking Act, 1995	CBK	Identification by identity document, proof of address and source of income.
Post Bank	Kenya Post Office and Savings Bank Act, 1978	Ministry of Finance	None, however, Post Bank opts to follow prudential guidelines of banks closely.
Deposit-taking Microfinance Institutions	Microfinance Act, 2006. Microfinance (Deposit taking Microfinance institution) Regulation, 2008	CBK	Identification by identity document.
Other MFIs	Microfinance Act, 2006	None	None

SACCOs	SACCO Societies Act, 2008	SASRA – Ministry of Cooperative Development and Marketing	None
Foreign exchange Bureaus	Guidelines on foreign exchange, 2002	CBK	Identification by identity document and proof of source of funds above $10 000.
Electronic Money Issuers	None, currently.	CBK	None
Insurers	Insurance Act	Insurance Regulatory Authority	None
Money transfer operators	None, currently.	CBK	None
Non-bank payment service providers	None, currently.	CBK	None
Casinos	Betting, Lotteries and Gaming Act, 1991	Betting and Licensing Control Board	None
Real estate agents	Estate Agents Act	Estate Agents Registrations Board, Ministry of Lands	None
Accountants	Accountants Act, 2008	Institute of Certified Public Accountants of Kenya	None
Retirement funds	Retirement Benefits Act	Retirement Benefits Authority	None

Table 1: Summary reporting institutions, laws and supervisory authority applicable to reporting institutions and relevant AML regulation

Source: Various Acts applicable to the reporting institution

The following Table 2 provides a first high level comparison between the applicable AML obligations of reporting institutions contained in Part IV of the Act, with the current regulatory regimes as contained in the three sets of guidelines/regulations mentioned above. In each case an indication is given whether the current guidelines are similar to, less stringent, or more stringent than the new requirement in the Act. Where the current guidelines do not contain a comparable requirement, this is indicated as "not addressed".

AML obligations in the Act	Prudential Guidelines for banks	MDI Regulations	Forex Bureaus
1. Monitoring for suspicious transaction, s.44(1)	Similar	Not addressed	Less stringent
2. Reporting suspicious transaction, s.44(2)	Similar	Not addressed	Less stringent
3. Report cash transaction above $10 000, s. 44(3)	Not addressed	Not addressed	Similar
4. Client identification and verification using official records, s45(1)	More stringent	Similar	Less stringent
5. Once off CDD on existing clients, s.45(2)	Not Addressed	Not Addressed	-
6. Maintain records of transaction, s.46(1)	Similar	Similar	Less stringent except for cash transaction above $10 000, telegraphic transfers, bank drafts and personal checks
7. Maintain records of identification, s.46(1)	Similar	Less stringent	Less stringent
8. Establish internal controls to facilitate internal reporting, s.47	Less stringent	Not addressed	Not addressed

Table 2: Comparison of current AML regulatory regime to the Proceeds of Crime and Anti Money laundering Act, 2009

Source: Various Acts applicable to the reporting institution

It is worth noting that the only currently existing AML rule that is more stringent than the Act, is the verification of identity requirement applicable to institutions registered under the Banking Act and subject to the Prudential Guidelines issued under the Banking Act. All the other guidelines are either similar or less stringent than that contained in the Act.

MARKET ANALYSIS

This section briefly discusses the current usage of financial services in Kenya and profiles key characteristics of both those served and unserved by formal financial services. The second part discusses current AML practices amongst institutions supervised by the CBK. The profiling[5] will primarily focus on those characteristics that will best inform us of the ability of individuals and financial institutions to comply with AML controls.

Current Usage of Financial Services

Usage of formal financial services: The use of formal financial services (Banks, MFIs, SACCOs), - as a percentage of the total adult population 18 and older (18.7 million) - increased from 18.9% in 2006 to 22.6% in 2009. Those individuals excluded from the formal financial system decreased by approximately 2.6 million, from 74% to 60% of the adult population.

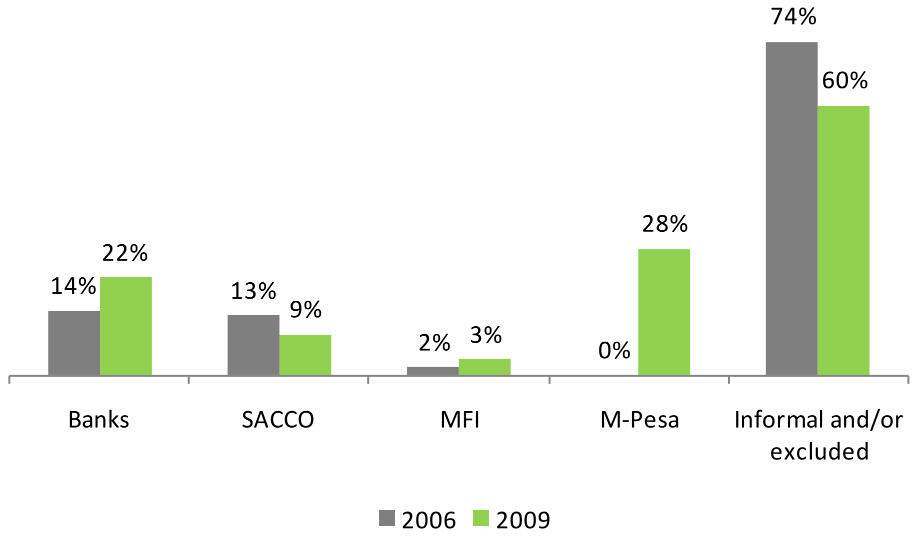

Figure 1: Access to financial services, adult population over the age of 18 for 2006 and 2009

Source: FinAccess data 2009/06

Of the three institutions under the regulation of the CBK, M-Pesa is the most widely used (28%[6]) followed by Banks (22%) and deposit taking MFIs (2.4%[7]). It is currently unclear how many of the 252 SACCOs who offer Front Office Service Activities (FOSAs) will register as banking agents, making them subject to the Guideline on Agent Banking and thus CBK supervision.

[5] The data used in this section was obtained from the FinAccess 2006, 2009 national representative financial usage survey

[6] This survey was conducted during May 2009. Rapid growth in M-Pesa usage has seen this figure increasing significantly.

[7] This figure was derived as the total number of KWFT and Faulu Kenya clients.

Significant Overlap in Financial Services Usage

As depicted in Figure 2, below, a significant overlap exists between Banks, MFI and SACCO usage. At the time of the survey (May 2009) 0.4% (82,364, adults over the age of 16[8]), made use of Bank, SACCO and MFI services; 1.3 million bank users also used MFI and SACCO services and 3.15 million only made use of bank services. 1.19 million (5.8% of adults) MFI and SACCO users do not make use of bank services.

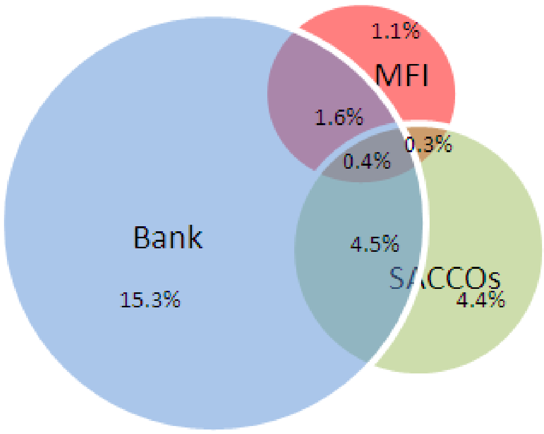

Figure 2: Bank, MFI and SACCO usage, 2009, for adult population over the age of 16

Source: FinAccess data 2009/06

Lack of Formal Employment as an Impediment to Income Verification

Formal employment is limited to 12% of the total labour force. It would be reasonable to assume that the remaining 88% of the labour force (15.37 million people) will have difficulty in providing proof of income. In addition, those individuals who fall outside of the labour force (3.12 million adults) would also struggle to provide proof of income, bringing the total number of adults unable to provide formal proof of income to 18.49 million.

[8] From this point forward all adult figures refer to persons over the age of 16.

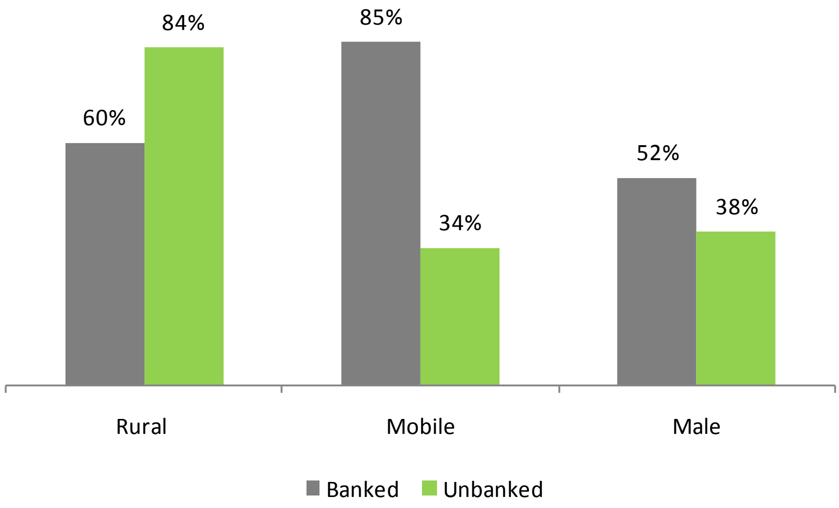

Figure 3: Profile of the banked and unbanked

Source: FinAccess data 2009

Verification of Physical Address as an Impediment to Accessing Financial Services

The unbanked are more likely to be female and rural than their banked counterparts. As address verification is likely to be more onerous in rural than urban areas (due to the limited reach of utility service providers), and the utility bill is usually issued in the name of the husband, as opposed to the wife, address verification requiring a utility bill or any other formal document could prove to be a significant access barrier to the unbanked.

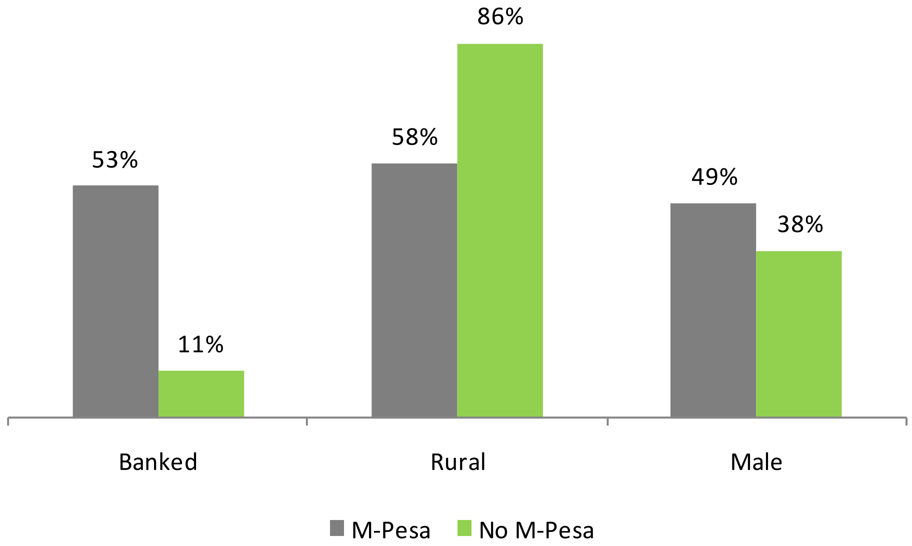

Figure 4: Profile of M-Pesa and non-M-Pesa users

Source: FinAccess data 2009

The largest non-bank electronic payments system, M-Pesa, has an estimated 9,4 million users (CGAP 2010). M-Pesa users are more likely to be banked, female and rural. As in the case with the unbanked, the possible impact of physical address verification on access should be considered, as those individuals who do not currently use M-Pesa are located predominantly in rural areas (86%).

Income Distribution of SACCO, MFI and Bank Clientele

Figure 5 below plots MFI, bank and SACCO accounts (as a percentage of totals) across their clients' monthly incomes. The account spread across income categories is in fact quite consistent across all three types of financial institutions suggesting that, from an income perspective, high, medium and low risk clients are to be found across all financial institutions and that risk cannot be demarcated by institution.

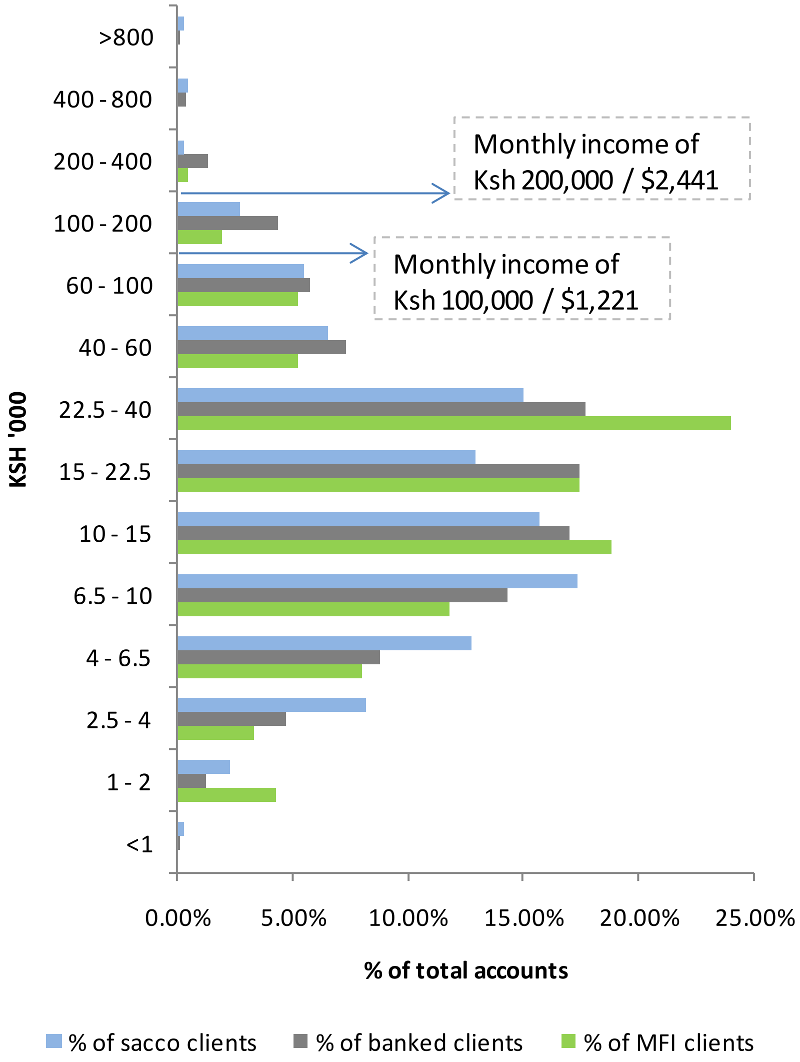

Figure 5: Income distribution of MFI, Banks and SACCO users

Source: FinAccess data 2009/06

Figure 5 also allows quite precise quantification of the number of current clients of financial institutions who fall below certain income thresholds. If we use monthly income as a proxy indicator for maximum transaction sizes (and thus erring on the high side), we observe that a Ksh

200,000 transaction threshold will include 99.5% of MFI users, 98% of Bank users and 99% of SACCO users. A Ksh 100,000 transaction threshold will include 97.7% of MFI users, 93.9% of Bank users and 96.3% of SACCO users.

Increased Bank Penetration in the Low-Income Market

Banks have made significant in-roads into the very low-income market with 6% of all bank accounts reaching below the PPP$2 a poverty line (Ksh 0 – 4000). Similarly, SACCOs (10.67%) and MFIs (8%) provide financial services to individuals earning between Ksh 0 – 4000.

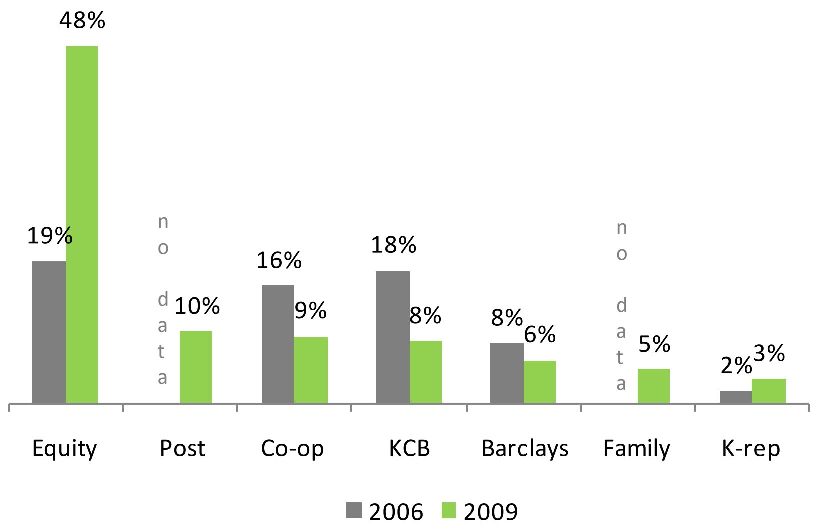

Figure 6: Largest banks by number of clients (as % of total bank accounts)

Source: FinAccess data 2009

Highest Growth and Account Base for Banks with Low-Income Focus and Reduced KYC Requirements

The largest bank by number of users, as depicted in Figure 6, is Equity Bank with 48% of all bank accounts, followed by Post Bank[9] (10%) and Co-operative Bank (9%). Equity Bank has seen significant increases in its share of bank accounts, increasing from 19% in 2006 to 48% in 2009. This is partly due to their low-income client acquisition model with decreased KYC requirements[10].

The largest MFI's, by percentage of total accounts, are Kenya Woman's Finance Trust (46%) and Faulu Kenya (23%). Both these institutes have been granted a deposit taking license, and fall under the supervision of the CBK.

[9] Post Bank is not regulated under the Bank Act. However, Post Bank implements KYC requirements, on its own customer, in –line with that of the prudential guidelines set out for banks. Post Bank has already indicated that it would adopt any new KYC requirements issued by the CBK or other relevant authority.
[10] During an interview with Equity, they indicated that proof of residential address is relaxed for those individuals who are not able to comply.

PREVAILING AML PRACTICES

Consultations with financial institutions either subject to or observing AML controls, revealed the following practices.

Risk

Banks and other financial institutions seem to have a limited appreciation of the nature and extent of the money laundering risk to which they are exposed. Besides an assumption that lower value transactions imply lower risk, they are not able to identify other lower risk customers or categories of transactions.

Current KYC Practices

Banks subject to the CBK prudential guidelines all acknowledge that it is either very difficult or impossible for them to comply with the current 3 component client identification and verification requirement laid down in the guidelines: verifying (1) identity, (2) residential address, and (3) employment/source of income. They experience particular difficult with the verification of residential address. Whereas some institutions admitted either dispensing with this requirement when opening accounts or accepting other means of verification such as a declaration from an authority within the area, others turn clients away if they cannot comply. Generally financial institutions consider the Kenya national identity document as having sufficient integrity to verify client identify. The incidence of fraudulent national identification documents was estimated as somewhere between less than 1% and 5%. It is also estimated that 95% of Kenya adults are in possession of a valid national identification document. Banks accept only ID documents and passports for verification purposes.

Transaction Monitoring

Financial institutions follow diverse practices for monitoring transactions, depending on their systems capability and internal policies. Most common is a form of manual monitoring that requires authorization from more senior managers for transactions above a certain threshold amount which varies between KSH50 000 and KSH1 million. Alternatively, transactions above this amount are investigated after the event. Some of the institutions acknowledge that their current monitoring practices are inadequate. A number of institutions are currently upgrading their core banking systems. The new systems would be better equipped to monitor for suspicious transactions. Very few institutions have fully automated monitoring systems, especially not systems that apply artificial intelligence to monitor transaction patterns.

Reporting Institutions Banking with Banks

There is concern amongst banks that they will be held accountable for AML control breaches committed by reporting institutions (notably forex bureaus, microfinance institutions and cooperatives providing front office service activities - FOSAS) that bank with them. Should this happen they will at a minimum suffer reputational risk, but may also be held accountable for the AML breaches of their clients. Banks are therefore seriously considering whether they should close the accounts of reporting institutions banking with them[11].

[11] This is in fact what happened in the US. See Bester, H., Chamberlain, D., de Koker, L., Hougaard, C., Short, R., Smith, A. & Walker, R. (2008), *Implementing FATF Standards in Developing Countries and Financial Inclusion:*

CDD on Existing Customers

Not one of the institutions interviewed had considered how they would comply with s.45(2) of the Act that requires reporting institutions, upon the coming into force of the Act, to undertake CDD on existing customers.

CONCLUSIONS

From the above market analysis the following conclusions can be drawn:

- The largest client base of any reporting institution under the Act will be that of M-Pesa. M-Pesa is therefore potentially vulnerable to the imposition of AML controls that do not take account of the circumstances of both Kenyans currently using M-Pesa as well as those excluded from the financial system.
- Up to 18.49 million adult Kenyans will have difficulty to provide proof of income if this is required for the verification of identity, as is currently the case for banks.
- Address verification, especially when primarily done through the presentation of a utility bill, will be very difficult for the currently unbanked. Most of the unbanked live in rural areas and are women.
- 98% of current bank clients have monthly incomes below KSH200 000 and 93% have monthly incomes below KSH100 000. However, the mean income is much lower – somewhere below KSH30 000 per month. The mean value of transactions is even lower than that (the mean value of M-Pesa transactions is currently below KSH3 000). Creating a single transaction or even a balance threshold for enhanced CDD of KSH200 000 is therefore likely to leave 98% of bank clients unaffected by client identification and verification requirements that they cannot comply with.
- The financial institutions that have grown the fastest amongst the low income population over the past few years have been those who do not insist on client verification beyond the presentation of a Kenya national ID card.
- If the value of transactions is a proxy for money laundering risk, potentially high risk transactions are spread across all the institutions supervised by the CBK and no single institution can be classified as consistently lower risk.

STRATEGY GOING FORWARD

During the consultations in Nairobi from 25 to 27 May 2010, a number of strategic issues emerged. We deal with them below and also make recommendations for the way forward.

Jurisdiction of CBK and Status of Existing Guidelines

The first and paramount issue is whether the CBK has, following the coming into operation of the Act, any legal power or authority to issue guidelines pertaining to AML controls.

Status of Existing CBK Guidelines

Prior to the coming into operation of the Act, the CBK issued general regulations and guidelines regarding AML controls in terms of the Banking Act (for banks and other financial institutions being regulated under that Act), the Microfinance Act (for deposit-taking microfinance

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Findings and Guidelines, FIRST Initiative, Washington, DC, for a case study on the closing of the bank accounts of money services business in the US.

institutions) and the CBK Act (for forex bureaus). However, section 131 of the Act now provides that "where there is a conflict between the provisions of this Act and the provisions of any written law with regards to any matter, the provisions of this Act shall prevail". The term "any written law" should be wide enough to include any regulation or guideline issued by the CBK. Moreover, the brief analysis of the correspondence or conflict between the compliance obligations of reporting institutions under the Act and the compliance obligations of financial institutions under current CBK guidelines contained in Table 2 above would suggest that there are a number of conflicts. It is therefore safe to assume that substantial portions of current AML guidelines issued by the CBK will cease to be binding on the relevant financial institutions on 1 July 2010 when the Act comes into operation. Financial institutions will then only be bound by the Act.

Future Jurisdiction of the CBK to Issue AML Guidelines and Exercise Supervision under the Act

The Act does not confer any regulatory or supervisory authority in relation to the Act to the CBK or any other supervisory authority. Although the supervisory authorities relevant for the reporting institutions under the Act is listed in the First Schedule (and this list is incomplete since, for example, SASRA is not included), none of the supervisory authorities nor the supervisory authorities collectively, is designated to perform any supervisory or regulatory function under the Act. On the contrary, the Act is quite explicit in allocating the regulatory function to the Minister of Finance (s.134) and the supervisory functions to the Financial Reporting Centre (see sections 24 and 33 – 39). The Centre is tasked to prepare the regulations to be issued by the Minister (s.24(m)), to set anti-money laundering policies (s.24(n)) and even to issue guidelines to reporting institutions (s.24(f)). All the oversight and supervision functions and powers, with which a financial sector supervisor is normally imbued, are given to the Centre (see especially sections 33 to 39).

The only mention in the Act of guidance provided by a supervisory authority is in section 11(2). The context here is the prosecution of a reporting institution or person for failure to comply with the AML compliance duties for reporting institutions. S11(2) permits the court to have regard to "such custom and practice as may, from time to time, be current in the relevant trade, business, profession or employment, and may take account of any relevant guidance adopted or approved by a public authority exercising supervisory functions in relation to that person …". From the context here it would seem clear that the reference is not to guidance relating to AML controls and issued in terms of the Act, but guidance relating to general custom and practice in the sector concerned.

The conclusion must therefore be that, under the Act as it is phrased, neither the CBK nor any other supervisory body has any legal power to issue regulations or guidelines regarding AML controls and other related matters falling within the purview of the Act. Neither do they have supervisory powers under the Act.

Regulations under the Act can be issued by the Minister of Finance only. And they can be issued only after the appointment of the Director of the FRC by the National Assembly (section 25), for the regulations must be prepared by the FRC before submission to the Minister. In the absence of regulations issued under the Act, the provisions contained in the Act itself will obviously be binding on reporting institutions as from 1 July 2010.

Way Forward for the CBK

The coming into operation of the Act will therefore trigger a period of uncertainty regarding the exact nature of the AML controls to be applied by the institutions supervised by the CBK. In the absence of an operational FRC, financial institutions are likely to turn to the CBK as their "supervisor-in-chief" for guidance as to how to manage the situation.

At this point, we have to note that the duty to undertake customer due diligence (CDD) measures is not solely an AML/CFT function. Banks that do not submit their clients to CDD measures are at risk of being defrauded. They are also exposed to transaction failure if they are not able to identify and distinguish correctly between clients. CDD measures therefore mitigate general operational risks. As a consequence banks have an obligation to implement appropriate CDD measures and bank supervisors have a duty to satisfy themselves that banks are taking the correct steps in this regard.

The Central Bank of Kenya Act entrusts the CBK with the duty to "foster the liquidity, solvency and proper functioning of a stable market-based financial system" (section 4(2)). The Basel Committee on Banking Supervision's Core Principles for Effective Banking Supervision (as revised in 2006) provide a framework of minimum standards for sound supervisory practices and are considered universally applicable. Two of the 25 Core Principles are particularly relevant to the CDD obligation:

- *Principle 15 – Operational risk: Supervisors must be satisfied that banks have in place risk management policies and processes to identify, assess, monitor and control/mitigate operational risk. These policies and processes should be commensurate with the size and complexity of the bank.*
- *Principle 18 – 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.*

It is clear that the Basel Core Principles envisage that the bank supervisor will have a duty to ensure that banks take the required measures. In many cases bank supervisors may rely on regulations issued by the AML/CFT regulator. In fact, in most countries these regulations would have been issued after consultation with the bank supervisor. In a number of jurisdictions the bank supervisor may clarify aspects of AML/CFT duties by means of guidance. In the case of the CBK where a legal lacuna is envisaged after July 1, it is submitted that the Basel Committee will expect of the CBK to take a more active role to ensure that banks know what is expected of them. This could be done by issuing revised Prudential Guidelines that reflect the requirements of the Act. By taking appropriate action the CBK will ensure that it meets its statutory duty to "foster the … proper functioning of a stable market-based financial system."

Recommendation

In the circumstances, and pending the promulgation of regulations under the Act, it is recommended that the CBK issue revised Prudential Guidelines (with the same approach being followed for deposit-taking microfinance institutions and forex bureaus) elaborating AML controls that are consistent with the requirements of the Act. The risk in this course of conduct is that supervised institutions may be resistant to implement any AML practices and systems different from their current practices and systems pending confirmation by the FRC and regulations issued by the Minister that these practices and systems will indeed be binding. All new systems require costs to implement and institutions will not be keen to implement systems required by the CBK if these are likely to be changed by the FRC or ministerial regulations. One of the options to deal with this situation is to involve the Minister of Finance closely in the endorsement of any revisions of the Prudential Guidelines.

Risk Assessment

All regulation, including AML regulation should be proportionate to the risks involved. FATF encourages countries to follow a risk-sensitive approach in the design of AML controls. A risk-sensitive approach will also ensure that financial access is maximized. However, a risk-sensitive approach presupposes an understanding of risk and therefore some form of risk assessment. In 2008 FATF published a report titled *Money Laundering and Terrorist Financing Risk Assessment Strategies* (FATF 2008). The purpose of the report was to provide information and guidance on the development of a national money laundering and financing of terrorism risk assessment. It describes such an assessment as follows:

> *"A national ML/TF risk assessment is an organised and systematic effort to identify and evaluate the sources and methods of money laundering and terrorist financing and weakness in the AML/CFT systems and other vulnerabilities that have an impact, either direct or indirect, on the country conducting the assessment. Such an assessment may involve multiple public sector offices working together with or without the private sector, or it may involve one or more individual agencies working independently to assess specific aspects of the country's ML/TF situation." (p.5)*

It continues:

> *"Assessing the nature and scale of ML/TF and related predicate crimes involves identifying and quantifying the predicate crimes and methods supporting money laundering and terrorist financing, using law enforcement investigations, prosecutions, and convictions, as well as financial institution currency and transaction reporting, and other relevant data." (p.6)*

At least two methodologies for undertaking such a risk assessment have subsequently been developed. One of these was developed by the Asia/Pacific Group on Money Laundering (APG) in cooperation with the World Bank. It is described as a Strategic Implementation Planning Framework (see Appendix 1) and is recommended to be undertaken as part of the implementation of the recommendations of a mutual evaluation report. The World Bank has advised that delegates from ESAAMLG countries were recently trained to use this methodology. Implementing such an assessment will require some preparatory work as well as a 2 – 3 day workshop with key stakeholders during which the risks will be mapped and discussed.

Kenya has just undergone an ESAAMLG mutual evaluation. At the same time it has to develop regulations and guidance to implement the new Act. It would seem to be a highly opportune moment to implement such a ML risk assessment.

Recommendation

We recommend that a FATF-compliant national money laundering risk assessment be undertaken as a primary input into the preparation of the regulations under the Act as well as any revised guidelines issued by the CBK. The methodology developed by the APG would be appropriate for such a process and an expert from the World Bank could be included in the process. We also note that such an assessment can be undertaken in anticipation of the creation of the FRC.

KYC – Customer Identification and Verification

The only area where the current Prudential Guideline is more stringent than the provisions of the new Act relates to client identification and verification. Whereas the Act requires verification of identity only through a national identity card or other official record, the Prudential Guideline applicable to banks require verification of (1) identity (via an official record such as a national identity card, (2) current address "verified by a referee or a utility bill" and (3) employment and/or source of income. The other existing guidelines require no more than verification of identity. Given the integrity and comprehensiveness of Kenya's national ID system, it is submitted that a person's identity has been verified once the personal particulars were compared to those in the national identity card. Thereafter, whereas there is a need to record the person's address, it need not be verified. It does not serve any identifying purposes in the Kenyan scheme. Neither does employment verification.

The current reality is that financial institutions that insist on some form of address verification struggle to make headway in the low income market.

Recommendation

It is therefore recommended that the identification and concomitant verification standard set out in the Act become the standard for all client identification and verification. Requirements may be set in regulations for this minimum level of identification to be amplified by minimum prescribed levels of customer profiling. In addition, a risk-based approach also implies the identification of higher risk customers and the imposition of enhanced control on their accounts and transactions (s.134(1)(d) of the Act). It is important that the country employs enhanced CDD in cases indicated by the FATF, the Basel Committee (especially in its guidance on customer due diligence) and the Wolfsberg Group (referring to, amongst others, PEPs).

Recommendation Regarding CDD on Existing Clients

The Act in s.45(2) requires reporting institutions "upon the coming into force of this Act (to) undertake customer due diligence on the existing customers or clients". The re-identification of existing clients has proven a pitfall and costly for many countries who enacted new AML regimes. To ensure that this obligation is met in the most efficient and effective manner possible, it is recommended that each supervised institution should assess current client records and identification procedures followed against the new requirements of the Act and guidelines and submit a proposal to the CBK on how to undertake CDD on existing clients and the timeframe within which it will be done. Note that FATF allows financial institutions to do CDD on existing clients on a basis of risk and materiality and as and when the opportunity presents itself (appropriate times, for instance when the customers ask for an increase in or extension of his credit line).

Recommendation Regarding Generally Applicable Guidance

Transactions with similar risk profiles should be subject to the same guidelines. The current 3 sets of guidelines were issued under different pieces of enabling legislation before the Act came into force. The presence of one piece of enabling legislation now facilitates the creation of unified rules that distinguish only on the basis of the risk profile of clients and transactions, not by financial institutions. Unfortunately, however, unified regulations are likely to be issued only once the FRC is in place. In the interim, the separate regimes will have to continue.

Monitoring

Financial institutions currently employ diverse systems to monitor for suspicious transactions. Most of the systems are manual or rely on very simple transaction thresholds to trigger reporting or investigation. In the absence of good information of money-laundering risks, all systems of monitoring are likely to be “tick-box” and mechanical.

Recommendation

Do not prescribe particular systems (eg electronic or automated) for monitoring of suspicious transactions. Rather prescribe the desired outcome, leaving it to individual institutions to determine the most appropriate systems to achieve that outcome. Institutions must ensure that they can justify the system that they implement. It is also advisable to provide guidelines on what is acceptable. For instance, if you cannot afford a USD 10 million operating system for your 2000 clients, what would be adequate as a manual system? Is it sufficient to audit 10% of the client files every year, and all files of clients with account balances higher than a threshold amount? (If guidance is not provided, risk managers will go for the gold-plated standard for fear of getting it wrong). Also specify how reporting institutions must check PEP status.

Banking Reporting Institutions

The consultations revealed concern on the part of banks about the levels of AML compliance of institutions that bank with them, all of which will be reporting institutions once the Act comes into force (SACCOS, forex bureaus, and MFIs) A special category is likely to be mobile network operators that operate money transfer services such as M-Pesa and Zap. These institutions also bank with licensed banks – with whom they keep their e-money floats – whilst having to comply with minimum AML requirements in respect of their money transfer operations. The risk is that banks, fearing reputational risk for AML control failures on the side of these institutions, will refuse to maintain bank accounts for them.

Recommendation

The CBK should deal proactively with this emerging issue. If need be, they should consider explicitly demarcating the liability for AML controls between reporting institutions dealing with each other.

Coordination with Other Regulatory Authorities

The Communications Commission of Kenya (CCK) was tasked by a Presidential Directive in July 2009 to compile a central data base with all mobile phone users’ data, including national ID number. Telecommunication providers have complied with this directive and collected customer details on a voluntary basis, despite there being no legal basis to compel them to do so. They are in the process of collecting outstanding customers’ identity numbers, birthdates and physical addresses.

Recommendation

At this point insufficient information is available on how this process is progressing. However, it would be reasonable for the CBK to coordinate with the CCK on whether there is room for reporting institutions to leverage off these multiple client identification processes.

PROCESS RECOMMENDATIONS

It is therefore recommended that the CBK proceed as follows:

- In the first instance it should clarify its mandate to proceed with the issuance of revised Prudential Guidelines dealing with AML controls. The basis for such a mandate is set out above.
- Undertake a FATF-compliant risk assessment to determine the main money laundering risks facing the jurisdiction as well as deficiencies in current systems and controls.
- In parallel with the risk assessment, and due to the urgency of the legal vacuum created by the coming into operation of the Act, the CBK (provided it is satisfied with its mandate) should proceed with the preparation of revised prudential guidelines and regulations (for MFIs and forex bureaus) prescribing AML controls that are consistent with the Act.
- As part of the process of preparing these revised guidelines the CBK should consult with financial institutions on the proposed changes and the various parameters to be included in the guidelines – especially systems requirements. Consultations should be individual rather than collective, to ensure maximum sharing of information and current weaknesses by financial institutions.

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APPENDIX

Institutions and Persons Consulted

Name of institution	Individuals
Association of Microfinance Institutions (AMFI)	Benjamin F. Nkungi (Chief Executive Officer)
Central Bank of Kenya (CBK)	James Manyonge (Manager, Bank supervision) Matu Mugo (Assistant Director, Bank Supervision)
Co-operative Bank of Kenya	Mercy W. Buku (Senior Manager, Compliance Department)
Equity Bank	Charles M. Ireri (Head of Enforcement & Operational Risk Silas Gachanja Macharia (Head of Compliance)
Faulu Kenya Limited	Josephat Kimanzi (Project Manager Operational Excellence) Pauline Githugu (Company Secretary) Raphael Lekolool (Head of Internal Audit)
Financial Sector Deepening Trust	David Ferrand (Director) James Kashangaki (Head, GrowthFin)
Kenya Bankers Association	J. K. Wanyela (Executive Director)
Kenya Posts Office Savings Bank	Anne W. Karanja (Director, Operations & Business Development) Simon Njoroge (Money Transfer Services)
Kenya Women's Finance Trust	Rose M. Muyanga (Risk Compliance Manager) Anthony Chege (Operations Director) Bernice W. Ng'ang'a-Muya (Legal Manager)
Kenya Commercial Bank (KCB)	Rose W. Kinuthia (Chief Risk Officer) John Ndegwa (Head of Compliance, KCB Group) Charles M. Ringera (Head, Group Operational Risk)
Bay Forex Bureau NBI. LTD. Bureau De Change	Anwar Ahmed