A REVIEW OF FINANCIAL STABILITY AND CRISIS MANAGEMENT ARRANGEMENTS

CENTRAL BANK OF KENYA

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INTRODUCTION

This report presents an assessment of existing arrangements for financial stability and crisis management within the Central Bank of Kenya (CBK) and makes recommendations for improvement. The assessment was conducted following a CBK request to USAID Kenya for technical support in to help strengthen ongoing monitoring of the financial system and preparedness to manage emerging problems within individual institutions and threats of a more systemic nature.

This report was prepared by Alice Carr (Crisis Management Analytics). It draws on discussions held with CBK staff at initial fact-finding meetings in May 2010 and a subsequent seminar in June 2010 and comments received from CBK staff on a first draft of the report.

EXECUTIVE SUMMARY

1. Recent events have illustrated vividly the importance of robust arrangements for both financial stability and crisis management. In the absence of the former, there is a risk that serious threats to the financial system are not identified and mitigated in a timely manner. And without the latter, and following a severe shock to financial stability that involves or imperils systemically important financial institutions, the Kenyan authorities would be forced to improvise solutions. Experience suggests that such solutions are likely to prove costly, either because they fail to contain financial instability (directly impacting on the real economy) or because they entail substantial public expenditure to bail out financial intermediaries.

2. Existing arrangements for financial stability and crisis management – with a focus on those that fall under the remit of CBK – were assessed during a visit to Kenya in May 2010. The headline findings of this assessment are as follows (also summarised in Box A):

   a. Although CBK apparently has a broad legal mandate for financial stability, and various areas of the bank already make contributions in this area, a formal internal framework to support discharge of this policy objective is not in place and needs to be developed;
   b. There are currently no formal arrangements to coordinate the response within CBK, nor between CBK and other key partners (such as the Finance Ministry), to emerging problems within an individual institution or following a broader shock to financial stability;
   c. Although CBK has at its disposal a set of policy tools to manage shocks impacting deposit-taking institutions, there are uncertainties about how they would be used – and a number of critical weaknesses and gaps – to deal with systemic cases;
   d. In particular, in the context of a systemic threat, CBK has inadequate powers to resolve problem banking institutions (and the existing regime for statutory management could not be used safely in such circumstances);
   e. The box below summarises the main findings of the assessment. The basis for the findings is explained in the remainder of the report.

Box A: Overall Findings

	Extent to which in place… **Not**			**Fully**
Financial stability framework		X		
Crisis Management framework	X			
- Information-sharing		X		
- Systemic assessment	X			
- Decision-making	X			
- External communication	X			
Policy tools:				
- Regulatory measures			X	
- Liquidity insurance		X		
- Bank resolution	X			
- Deposit insurance			X	

3. The main recommendations that follow from these findings are that CBK should:

   a. Develop an *internal* framework for delivering on its financial stability objective (by agreeing the nature of CBK's the policy objective, establishing an internal governance structure, organising and scaling up supporting CBK functions, agreeing an approach to risk identification and mitigation);
   b. Draw up an *internal* crisis management plan (setting out policy objectives, responsible CBK departments, arrangements for systemic assessment (and related information sharing), the menu of available policy tools and providing for mechanisms for coordination on policy decisions);
   c. Consider replacing the existing statutory management regime with more extensive bank resolution powers (first answering key questions on policy design, then drafting the necessary legislation) and review the policy framework for provision of liquidity insurance following a severe shock to financial stability and take steps to make operational (including revisions to CBK Act as needed).

4. The investment needed to establish robust arrangements is considerable. Having agreed an internal framework, CBK will also need to formalise arrangements to ensure coordination with key domestic and foreign counterparts. And once arrangements are in place, continued investment is needed to keep them current. But the work can and should be broken down into a number of distinct stages (as outlined in Part Three).
5. The remainder of this report is divided into three parts. Part One describes the context and approach taken for the assessment of existing arrangements. Part Two presents the assessment whilst Part Three sets out recommendations and proposals for their implementation.

PART ONE

Context for the Assessment

6. The financial system in Kenya has grown rapidly during the last decade. Banking assets more than doubled between 1999 and 2009 (with the ratio to GDP reaching 56%). And in recent years, innovation led by the non-banking sector and a sub-set of banks, has helped support improved access to finance from a low base (and to intensify competition). Complexity in the system has also increased (including as cross-sector and cross-border inter linkages have grown). These trends, which look set to continue, have resulted in the financial system playing a more central role in the real economy.

7. The public authorities in Kenya have helped to support and guide development of the financial sector, by strengthening relevant policy frameworks (including for CBK in relation to monetary policy, banking supervision and for payment and settlement infrastructure). But as the financial system becomes ever more significant (as its systemic importance rises), it is increasingly important that the relevant public authorities strengthen their policy functions to deliver financial stability and ensure that on a contingent basis they are able to manage problem financial institutions and systemic crises effectively.

8. In Kenya, CBK has a critical role to play as, uniquely amongst the Kenyan authorities, it has a legal mandate for financial stability and is responsible for many of the policy tools that would be needed to address a systemic crisis. And whilst CBK has begun to develop its financial stability capabilities this initiative is at an early stage and a comprehensive program of investment in crisis management arrangements has not been initiated (although efforts to address some known weaknesses in policy tools have been made).

9. Therefore CBK requested technical support from US Aid to review financial stability and crisis management arrangements in Kenya to identify gaps and to make proposals on their strengthening. The assessment was carried out by Crisis Management Analytics Ltd on the basis of meetings with staff at CBK between 24 and 27 May 2010, a seminar held at CBK on 15 June 2010 and examination of supporting materials (laws, regulations, and policy documents).

10. It is important to note, that there are currently no formal best practice standards for financial stability and crisis management akin to the Basel Core Principles. The assessment in the report is based on a comparison of the arrangements in Kenya with emerging good practice internationally in the wake of the financial crisis of the last two years. The assessment was thus based on the following principles:

    a. A framework for financial stability is needed to coordinate work to identify systemic risk;
    b. Risks identified should then be mitigated, including via adjustments to policy design;
    c. A framework for crisis management is needed to coordinate the actions of the authorities with responsibility for system stability in response to a future financial crisis;
    d. The framework should be flexible, broadly defined and forward-looking to ensure that it is applicable, whatever the exact source or scale of the shock;
    e. In all types of crises the assumption is that the owners (and managers) of financial institutions will bear primary responsibility for resolving any problems, and will be the first to bear any losses or to meet resolution costs;
    f. In situations where shareholder resources prove insufficient and there is a significant risk to the financial system as a whole, the authorities will use the tools at their disposal to resolve the problem in a way that preserves financial stability at least cost in a timely, consistent and accountable manner;
    g. Decision-making should be based on a broad definition of costs, taking account not only of fiscal costs (direct and contingent) but also of systemic costs and distortions caused by public intervention (moral hazard, impact of system efficiency). In the case of idiosyncratic bank failure with minimal systemic impact, in order to minimise moral hazard and avoid any fiscal cost, intervention by the authorities will be restricted to liquidating the bank and paying out deposits as quickly as possible. In systemic banking crises, the authorities will also seek least cost solutions, but the potential for significant systemic costs may justify resolution measures that involve fiscal costs;
    h. While drawing on good practice internationally, any framework should be tailored to the specific national context. Relevant features of the financial system and institutional framework are considered in Box B below.

Box B: The Kenyan Context

The following features are relevant in considering the development of the crisis management framework in Kenya:

- **Bank-dominated system**: a clear priority should be the capacity to manage a problem in the banking system including resolving one or more troubled banks (both because CBK has a clear responsibility for effective regulation and supervision of the sector, but also because banks continues to dominate the formal financial system);
- **Concentration:** the moderate degree of concentration (where the four largest banks account for just over 40% of banking system assets) presents a number of challenges. It is highly likely that, should problems emerge in any of the larger institutions, the risk of contagion will be significant, yet at the same time their size presents challenges for rescue or resolution by the authorities;
- **Non-bank sectors**: but the growing importance of some non-bank sectors means crisis management arrangements need to be flexible and comprehensive enough to manage a shock which may be transmitted via or impact on other potentially systemic sectors (e.g. SACCOs, MFIs);
- **Cross-border banking:** the presence of foreign-owned banks in Kenya (operating as both subsidiaries and branches) and the trend for expansion by Kenyan banks into other countries in the region undoubtedly present additional challenges. The Kenyan authorities need to review in advance of any crisis how their crisis management arrangements (and particularly their policy tools) might be used in all relevant cross-border contexts.

PART TWO

Arrangements for Financial Stability

11. In this section, existing arrangements to support delivery of CBK's financial stability responsibilities are considered. As context, recent global financial instability has shown that efforts by public authorities at a micro prudential level – to identify and mitigate risks to individual institutions, markets and infrastructure – may not be sufficient to contain systemic risk and deliver financial stability at the aggregate level. It is increasingly accepted that a macro prudential approach that targets risk reduction across the system as a whole is needed. At the same time, there is a lower degree of consensus about the optimal structure for financial stability frameworks (than for say monetary policy). Despite this, and in part because CBK has only just embarked on this particular journey, the initial steps that would move the CBK towards having a more effective operational framework are relatively clear.

The Policy Function

12. The Central Bank of Kenya Act identifies the formulation and implementation of monetary policy as a principal policy objective[1]. But the Act gives almost equal weight to a second objective that "the Bank shall foster the liquidity, solvency and proper functioning of a stable market-based financial system" (Article 4(2)). Until recently, CBK had mainly interpreted this objective micro-prudentially, and sought to meet it by

[1] Article 4(1): "The principal objective of the Bank shall be to formulate monetary policy directed to achieving and maintaining stability in the general level of prices".

identifying and mitigating risks to individual institutions regulated by CBK (setting prudential regulations and supervising compliance with those). But the wording of the Act suggests that CBK's responsibilities could be interpreted as extending to the stability of the banking and wider financial system as a whole.

13. Although the Central Bank has initiated some work in this area, it is not clear that the implications for CBK of the apparent legal mandate have been fully examined and agreed (often work done to date on financial stability has been to support outward looking initiatives in collaboration with other domestic regulators and COMESA partners). As a priority, further work is needed to define the nature of CBK's *own* policy objective (and how it will go about meeting it). An important issue for discussion is whether domestically CBK has some sort of overarching responsibility for financial stability (rather than simply one shared with regulators of other parts of the system and with the Finance Ministry). A quick review of the Insurance, Capital Markets, Retirement Benefits and SACCOs Societies Acts suggest that the other regulators in Kenya do not have explicit financial stability mandates. And historically it has been rare for non-bank regulators to have any specific legal mandate in this area; whilst an arrangement – where a central bank has primary responsibility for delivering financial stability system wide – is found elsewhere (regulatory central banks are often seen as being uniquely placed to deliver financial stability).[2]

14. So whilst close coordination with domestic and other counterparts[3] remains critical, the scope of CBK's responsibility for delivering financial stability in Kenya needs to be considered further within CBK and agreed at Board level (and with key domestic partners). And as a priority CBK should then invest in its own internal arrangements to ensure that it is able to deliver on this objective (as described below).

CBK Supporting Functions and Responsibilities

15. A Financial Sector Stability Assessment Division has been given responsibility for financial stability analysis (housed within the Research Department). This has provided a useful focal point (and some resources) for financial stability analysis. But to ensure delivery on this important mandate, it may be necessary to clarify and strengthen their responsibilities (and to provide any additional resources needed). Currently the Division is responsible for both financial access issues and financial stability analysis, although there may be few synergies between these topics and a Division that focused solely on financial stability issues could help to ensure that this important policy area is given adequate attention. Furthermore, the Division would benefit from formal articulation of its role, with important components being: to build CBK's capacity to deliver on this its financial stability objective; for ongoing identification and mitigation of risks to financial stability; and for managing coordination with other relevant functions within CBK and with domestic and international counterparts[4]. The department could also house CBK's

[2] Although prior to the recent crisis there was some shared responsibility (and much ambiguity), both the UK and US have moved to formalise the statutory responsibilities of the Federal Reserve and Bank of England for financial stability.

[3] Whilst coordination with foreign counterparts is important, they clearly have no legal mandate for delivering financial stability in Kenya itself.

[4] In the future CBK could consider whether it is appropriate to elevate the existing division to a department: a model implemented in a number of countries (this would have the added benefit of placing the function on an equal footing with the departments it was seeking to work with).

crisis preparedness work. I In order to build and run both the financial stability and crisis management functions, it would be necessary to provide necessary additional resources (the work involved is considerable and will require appropriately skilled and dedicated staff).

16. In relation to internal coordination, a number of other CBK departments perform relevant functions and their input needs to be harnessed (during the fact-finding meetings, staff from across the bank pointed to ways that they were already contributing to financial stability). As a starting point there is a need for clearer articulation of the responsibilities each area currently has and should have going forwards (an initial attempt is made to identify the existing and future contributions of relevant departments to the financial stability policy function in Box C below, but further work should be done within CBK to develop this and formally extend responsibilities where necessary). Following such a review, it may make sense to consolidate some additional functions with the financial stability division. But it is important to note that this would not negate the need for internal coordination within CBK (it would not be appropriate to subsume all areas contributing to financial stability into the financial stability area given other functions also serve monetary stability and other objectives).

Box C: Departments with Financial Stability Responsibilities

Department	Current Responsibilities	Additional FS Responsibilities?
Bank Supervision	Develop regulatory framework to support *micro prudential* objectives. Supervision of individual entities, detection of threats to their viability. Regulatory action to address identified threats.	Adapt regulatory framework to support *macro prudential* objectives. Input to risk identification (particularly on risks to banking system).
Banking & National Payment System	Develop market operations framework to support monetary policy objective. Develop and oversee payment and settlement systems (to support stability and efficiency objectives).	Develop market operations framework and payment and settlement systems to support financial stability objective. Input to risk identification and mitigation via market intelligence.
FS Division within Research	Undertake macro prudential monitoring, analysis and reporting. Act as focal point for domestic and external coordination on FS.	Design and develop CBK's financial stability capabilities. Identify key risks to financial stability (drawing on input from across CBK, other domestic and external sources).
Deposit Protection Fund Board	Develop, run robust deposit insurance scheme.	Identify, mitigate key threats to depositor confidence.

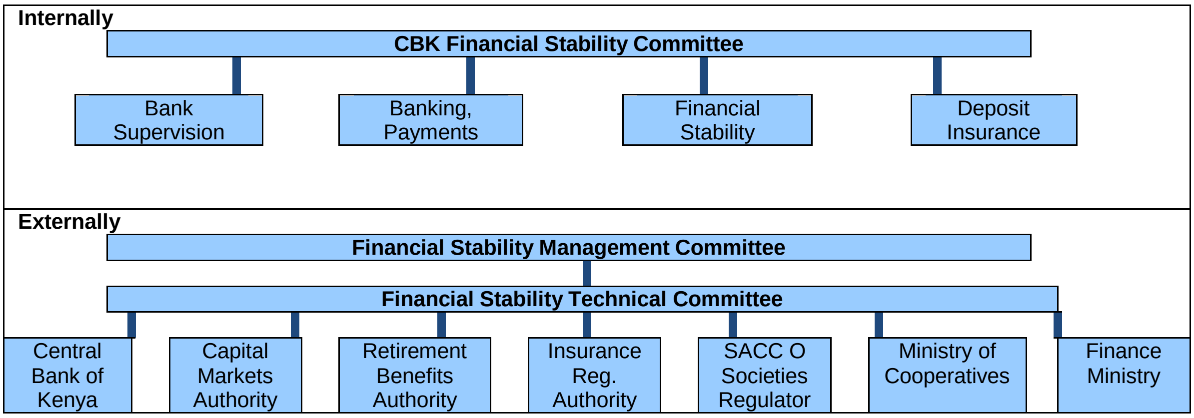
Internal Governance

17. Some work has been done to outline mechanisms for coordination on financial stability issues externally (an internal policy document[5] notes that CBK has recommended to other domestic counterparts that a cross-authority Financial Stability Committee be established to function at technical, management and oversight levels). However, the nature of

[5] See CBK's "Financial System Stability Assessment Framework" dated April 2010.

CBK's financial stability mandate and the range of relevant functions mean that it is as (if not more) important as a first step to establish an *internal* governance structure to support coordinated assessments of key risks to financial stability and decision-making on related risk reduction measures. It is important to note, that some countries have chosen to make a single committee responsible for both monetary and financial stability (and others to separate governance for these functions). The applicability of the two models for Kenya needs further consideration. Whatever structure was chosen, an internal committee with formal FS responsibilities would be charged with ensuring that CBK discharged its mandate by identifying and mitigating risks to financial stability. Membership of the committee would need to be at the most senior levels (and could include the Governor, a relevant Deputy-Governor, and the heads of relevant departments). The two sets of coordination arrangements – internal and external – are outlined in Box D below.

Box D: Coordination Mechanisms



Supporting Analytical Framework and Processes

18. As noted, CBK has already established an FS Division with a remit to conduct the necessary macro prudential analysis. Its success will likely depend on several factors. Firstly, a clear strategy should be outlined – and agreed at Board level and/or by the newly designated committee within CBK – on what analytical work the Division is being asked to do. A good starting point would be to develop an up-to-date picture of the various constituent parts of the financial system and the inter linkages between them (something that is being attempted with the first draft Financial Stability Report[6]). But the Division will also have overall responsibility for identifying and quantifying risks to financial stability systematically. Once a strategy has been set, work can be done to identify which analytical tools will support delivery on these objectives[7].

19. Secondly, it is clear the FS Division cannot fulfil its remit without seeking input to its risk identification work from other relevant CBK departments. As such, a regular assessment of systemic risk – produced by the FS Division – but drawing on inputs from across CBK is needed (a quarterly cycle for this may be appropriate). After initial review at working level, analysis supported by suggestions for risk mitigation should be presented to the

[6] Produced as a collaborative effort between CBK and the other key regulators.

[7] There is a risk that otherwise, the development of an array of ever more sophisticated analytical tools (financial stability indicators, stress tests) drives the work done (rather than being called into action to answer important questions).

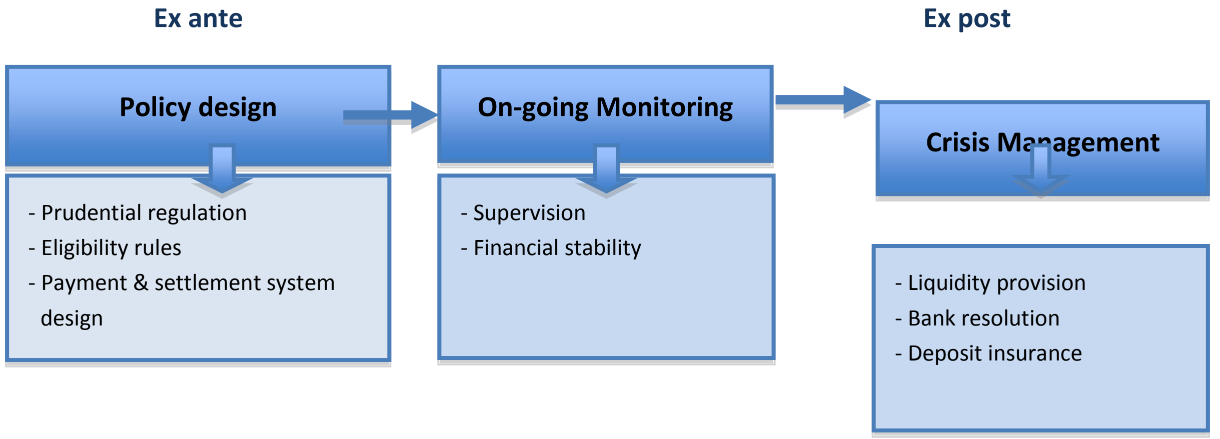
senior decision-making committee internally. This process should help CBK to reach a well-informed and internally consistent assessment of threats, to act as a base for its contributions to cross-authority work (including via the planned bi-annual Financial Stability Report) and on policy decisions to mitigate identified risks.

Policy Tools Clarified

20. Whilst identification of key systemic risks is important, it is critical that equal weight is placed on designing policy responses to mitigate these risks[8]. As context, and as illustrated in Box E below, CBK's interventions in relation to the financial system come at three critical points. The first is in relation to policy design (e.g. setting appropriate prudential requirements), the second to on-going monitoring (split between micro prudential supervision and macro prudential or financial stability work) and the third to crisis management (both ex ante investment in arrangements, and the in-crisis response). Financial stability analysis helps to identify sources of systemic risk, but ultimately achieves little unless it acts to influence policy design (and investment in crisis management arrangements).

21. Going forward, in relation to policy design CBK work to identify risks to financial stability *could* reveal a need to adjust prudential regulations to mitigate these risks (and serve macro-prudential objectives[9]). As an example, there is growing consensus that prudential requirements that result in banks building buffers (via provisioning and capital) in the good times, which can be drawn on in a crisis (and are therefore countercyclical) would better support a financial stability objective. As such, CBK's financial stability arrangements should facilitate this feedback loop, between financial stability work and prudential policy design, in order to reduce the probability (and severity) of future crises. And financial stability work should inform the design of crisis management arrangements (for example their scope should encompass all identified sources of systemic risk). The FS Division could also take the lead on implementing the systemic assessment framework needed (discussed further in section 2.2 below).

Box E: CBK Intervention



[8] Arguably, during the 2000s many public authorities (central banks, supervisory agencies) invested heavily in identifying and articulating systemic risks (including via Financial Stability Reports), but underinvested in devising macro-prudential policy tools to mitigate them.

[9] A full assessment of the extent to which the existing regulatory framework in Kenya supports macro prudential principals was outside of the scope of this work.

External Communication

22. As for monetary policy, a comprehensive framework for financial stability would need to be supported by an appropriate communication strategy: both to educate key groups about financial stability risks (which should help also to mitigate them) and for accountability. An important part of external communication would likely be the planned Financial Stability Report.

Recommendations

23. In the light of this assessment, the following recommendations are made for strengthening the financial stability policy function in Kenya:

R1**:** Develop an internal framework for delivering on the CBK financial stability remit by working up a comprehensive strategy paper for discussion and agreement by CBK Board setting out the key policy design issues including: defining nature of CBK mandate; establishing an internal governance structure; ensuring an adequately empowered and resourced centralised financial stability capacity; defining contributions required from other areas of CBK; setting of an analytical strategy (and supporting processes); identification of policy tools available; initial outline of an external communications strategy;

R2**:** Meanwhile prioritise the establishment of:

a. A process for cross-departmental identification, quantification and discussion of key risks to financial stability, and of policy tools available to mitigate such risks; and
b. A senior decision-making body, to receive regular briefing on key risks identified and recommendations for their mitigation, and responsible for taking relevant policy actions.

R3**:** **C**onduct a quick review of the planned cross-authority Financial Stability Report to ensure planned approach and content fits with likely outcomes for R1 above.

Crisis Management Process

24. In this section, existing processes to support a coordinated response to problem institutions and wider systemic crises within CBK (and between CBK and key domestic partners such as the Finance Ministry) are considered.

25. As already seen, responsibilities for financial stability are shared by various CBK functions. And if risks were to crystallise resulting in problems at one or more institutions these same departments would – to a greater or lesser extent – have a role to play in managing them. Whilst the Bank Supervision department may be first to identify problems at individual institutions and would lead efforts to address them (calling on the available regulatory measures and other powers reviewed in section 2.3 below), coordination with other areas of CBK will be critical in ensuring an effective response to

idiosyncratic failure and systemic cases (as outlined in Box F below). And in the latter case, CBK would also likely need to coordinate with the Ministry of Finance[10].

Box F: In-Crisis Coordination Within CBK

Case A: Problems in small institution, likely not systemic
Information-sharing • Problems *likely* identified by Bank Supervision, but where liquidity under pressure, Banking or National Payments may be first to spot them; • Without a mechanism in place, there is no certainty these departments will share concerns on emerging problems in a timely manner. *Assessment* • Assessment likely led by Bank Supervision although, focus potentially on severity of threat to individual institution rather than systemic implications (as no framework for systemic assessment exists); • And there is no mechanism to incorporate views from other departments (including Banking and National Payments on liquidity, FS Division on systemic risk, DPFB on deposit insurance issues). *Decision-making on measures* • Bank Supervision in lead to determine response (in non-systemic case likely path is from Article 33 to Article 34 and on to liquidation) but no mechanism to keep others informed of progress. • But Banking and National Payments need to take decisions to cut access to CBK liquidity (both have legal requirements to exclude banks entering statutory management from accessing central bank money but there no guarantee that they would be given advance warning of banking supervision's intention to use such measures[11]). • And to ensure effective response, DPFB needs advance warning of potential deposit payout (but there is no guarantee it would receive this at present).
Case B: Problems in larger institution, viewed as potentially systemic
Information-sharing • As above. *Assessment* • As above, but in this case the failure to identify a systemic case (and potential application of inappropriate policy tools as a consequence) would pose high systemic costs. *Decision-making on measures* • Bank Supervision in lead to determine response, but a systemic case may justify provision of lender of last resort (Banking and National Payments in lead on this but efforts may be impeded by a lack of clarity on policy tools and decision-making process for agreeing their use); • And will likely require resolution (or bail out) of problem bank rather than use of statutory management and liquidation; • CBK may not wish to extend liquidity in such a case, and does not have the necessary powers for resolution nor ability to fund rescue and would need to coordinate with the Finance Ministry .

26. However, despite the need for the various departments to work together, no arrangements to support a coordinated response within CBK or with key domestic counterparts (such as the Finance Ministry) currently exist. Rather any coordination would need to be

[10] In a crisis, the range of external counterparts that CBK needs to interact with includes other domestic and foreign regulators, and any contingency plan should set out how processes to support those interactions (in the meantime the report focuses on internal CBK coordination, and makes reference to the key external counterpart – the Ministry of Finance).

[11] In a worst case scenario Banking or National Payments could learn about use of Article 34 with a delay and may have extended CBK liquidity to the institution during that period and/or allowed payment and settlement transactions to enter the system (potentially facilitating fraudulent flows of funds out of the institution and complicating settlement finality).

improvised increasing the changes of coordination failures. Drawing on the cases outlined in Box E such failures could include:

a. Information-sharing: as information is fragmented across CBK, no one department would have a clear picture of the scale of emerging problems and so the central bank may be slow to identify emerging problems;
b. Assessment: without an agreed framework for reaching an institutional assessment of the severity of a problem (with inputs drawn from all relevant areas), CBK could be slow to recognise the potential systemic impact of a problem;
c. Decision-making: with no internal mechanism to coordinate decision-making, individual departments may act without fully consulting one another, and the process is likely to be impeded by a lack of clarity over some policy tools (and a total absence of others);
d. External communication: if several CBK departments have an external interface but lack a common understanding on the nature of the shock, its likely severity and intended policy measures, external communication is likely to be poorly coordinated. And without a clear overall strategy for addressing all key constituencies (other public authorities, the public, the market, and/or media), external CBK communication may be confused or incomplete.

27. To avoid or minimise the risk of failures, many countries have put in place some form of framework for intra- and/or inter-agency coordination. Typical elements of these crisis frameworks are listed in Box G.

Box G: Components of a Crisis Management Framework

Overall Framework

- Public authorities with responsibility for financial stability adopt an internal and/or national crisis management framework (documented in a crisis handbook), and update and test this framework on a regular basis;
- Respective responsibilities within and across the authorities under the framework are defined (with reference to the existing mandates and functions);
- The framework sets out clear public policy objectives for crisis management;
- Mechanisms for coordination are described, usually based around a committee to support the processes outlined below.

Related Processes

Arrangements are established to support coordination in the following areas:

- Information-sharing: covering ex ante information-sharing on potential threats to financial stability and in-crisis information-sharing on the likely systemic implications of the problem and the appropriate policy response;
- Assessment: a common analytical framework is developed to support assessment of the likely systemic implications of a crisis to help identify the appropriate policy response;
- Decision-making: a process is established for making decisions on measures (particularly those implying a public cost);
- External communication: a strategy for coordinated communication with agreed stakeholders and to maintain public confidence is put in place.

28. The following points on the list are worth noting:

a. *Responsibilities:* The respective roles and responsibilities within and across the authorities are typically documented in the framework with reference to existing mandates and functions. The most relevant CBK departments were identified above. But it is important to note, that whilst on a day-to-day basis, the Ministry of Finance plays a limited role in relation to financial stability, it is likely to play a central role in any crisis as the agency with overall responsibility for economic and financial sector policy, and as the only authority that can (or should) finance public sector support to secure financial stability if that were to become necessary.
b. *Objectives:* The framework usually sets out agreed public policy objectives for management of a crisis. This helps to achieve a coherent response to a crisis and the best possible decisions on measures. Objectives might include: to minimise systemic risk (to minimise the impact on the real economy of a potentially severe disruption in the financial system); to do so while minimising the cost of public intervention (measured not only in terms of fiscal costs but also of contingent liabilities, moral hazard and any distortion to competition within the system).
c. *Coordination mechanisms:* There are typically coordination committees within and across the relevant authorities that would meet frequently during a crisis at working and senior levels (the format is similar to those suggested to support financial stability work, raising the possibility that these could serve a dual purpose (in normal times having a financial stability focus, and following a shock a focus on crisis management)). In a crisis, the forum operating at the senior level would need to involve at a minimum the Governor and the Finance Minister (with the Minister usually in the Chair).
d. *Information sharing:* A common feature of these frameworks are arrangements for information-sharing to ensure that the information needed to support ex ante contingency planning and in-crisis assessment is available in a timely manner, and shared freely within and between the relevant authorities.
e. *Systemic assessment:* Crisis management arrangements often include some form of framework for systemic assessment to enable relevant authorities to make an effective assessment of the impact of a shock (whatever their source), the scope for onward transmission through the system (via financial institutions, markets and/or infrastructure) and the overall effect on the real economy. The systemic assessment is central to the whole crisis framework: judgment of whether a case is systemic or not will determine whether the coordination arrangements need to be activated. For example, where problems in an individual bank are judged under the assessment framework to be idiosyncratic and non-systemic, a CBK bank supervisor can apply its problem bank procedures without reference to other authorities. However if the problem in the bank is judged to be potentially systemic, then the authorities should consider together the risks to the system and the optimal policy response.
f. *Decision-making:* Crisis frameworks typically set out processes for decision-making in a crisis. The need for coordination arises because of the interdependencies that exist between the policy functions within and across the authorities, but also because of the potential need to decide on use of measures, justified on systemic risk grounds that involve implicit or explicit public costs. Areas of interdependence where coordination may be needed in a crisis include: taking regulatory measures against systemic banks; the provision of liquidity or solvency support to individual banks; the provision of liquidity support market-wide and managing the impact on monetary policy; foreign exchange intervention and managing the impact on exchange rate

policy; and debt issuance and managing the impact on government finances. In documenting the framework, all the measures that may be needed in a crisis should be listed, identifying in each case the risks and potential costs associated with the measures, the legal powers that would be used and how and by whom the measure would be implemented.

g. *External communication:* Crisis frameworks often incorporate a strategy for communication in-crisis setting out how responsibilities for external communication would be split (and coordination achieved) between authorities and identifying key constituencies (depositors, press, market participants), and appropriate strategies for addressing them.

Recommendations

29. In the light of this assessment, the following recommendations are made for strengthening coordination within CBK and between CBK and key counterparts such as the Finance Ministry in Kenya:

R4: Draw up an internal CBK crisis management plan to provide a framework for coordination between the relevant departments (but also identifying where coordination is needed with external counterparts), and setting out policy objectives, responsibilities, arrangements for information-sharing and systemic assessment, the menu of policy tools available and mechanism for coordination on policy decisions;

R5: Establish a more formal process for assessment of the potential impact of problem institutions or more widespread instability on the financial system (systemic assessment framework) to support decision-making on measures.

Crisis Management Policy

30. This section assesses whether the set of policy tools available to CBK are adequate to support effective management of a crisis, particularly in a scenario where problems in one or more institutions pose a systemic threat. The focus is on the parts of the policy framework that fall under the remit of CBK directly: (i) regulatory (or "corrective") measures; (ii) bank resolution; (iii) liquidity provision; and, (iv) deposit insurance. Additionally, the extent to which these measures are robust in a cross-border context is considered briefly. It is important to note that in a systemic crisis, the authorities would likely need to call on all of these tools and is essential that each is robust and consistent with the authorities identified objectives for crisis management. The key components of the policy framework are summarised in Box H below.

Box H: The Policy Framework

Overall Framework
A broad, flexible and complementary set of tools that support public policy objectives for crisis management are needed, and in particular:

- *Regulatory measures:* Powers and policy tools to support proactive measures to address emerging threats (including at problem financial institutions), with costs borne by shareholders (and possibly other liability holders).
- *Liquidity insurance:* A robust policy framework for liquidity insurance that supports market-wide liquidity provision and where necessary lender-of-last-resort to individual institutions (including to support resolution) in relevant currencies (a provision would ideally support monetary policy and be structured such that it provided appropriate incentives for banks to manage their liquidity in normal times).
- *Bank resolution:* Powers and a full set of policy tools which permit public authorities to take control of failing institutions ahead of the point of bankruptcy to resolve them decisively (as part of a special resolution regime).
- *Deposit insurance:* A deposit insurance scheme that is adequately resourced and operational;
- *Non-banks and Cross-border:* The policy toolkit should support resolution of potentially systemic problems emerging the non-bank sector, markets and infrastructure and should be robust in a cross-border context.

Regulatory Measures

31. Regulatory measures available to CBK to address potentially serious[12] problems in a bank are an important part of the crisis management toolkit, providing a window of opportunity where management (and owners) can be directed to take pre-emptive or remedial steps to address threats to the viability of their institution. From a micro-prudential perspective, such regulatory actions serve to protect depositors (and other counterparties) of the bank, and from a macro-prudential perspective to reduce the likelihood that the problem bank becomes a source of risk to the wider financial system. For both, a graduated approach, where the types of measures used and time allowed for their implementation reflects the severity of the threat to the institution but also to the wider financial system, is required. And ultimately there should be credible sanction in cases where a bank's management and owners prove unwilling or unable to address identified weaknesses in a timely manner.

32. The Banking Act offers CBK useful flexibility to take regulatory action in response to both identified threats to a bank's viability and/or an actual breach of regulatory requirements[13]. At the same time, as for supervisors everywhere, there is a risk such flexibility is not used and results in *delayed* rather than *pre-emptive* action on the part of supervisors. To help address this, CBK has proposed a revision to the Banking Act to add a quantitative trigger tied to capital adequacy (along US lines), allowing CBK to take measures when a bank becomes "undercapitalised" (with this interpreted as meaning below the minimum capital requirement). This revision should strengthen CBK's hand (by acting as a threshold beyond which action *must* be taken), but it is important to note

[12] Routine supervisory interventions are not considered here.

[13] Under Article 33(1)(a) CBK may act where "an institution conducts its business in a manner contrary to the provisions of this Act or of any regulations made there under or in a manner detrimental to or not in the best interests of its depositors or members of the public".

that similar quantitative triggers elsewhere have not been sufficient on their own to ensure timely action by supervisors[14]. Indeed action is often needed before any quantitative trigger is breached (and on the basis of supervisory judgements about risks to a bank, rather than lagging indicators that trigger action when risks have already crystallised). As such, there may be a need to further develop internal procedures that map deterioration in an institution's soundness (across a series of indicators including forward-looking ones) and an assessment of systemic risk posed to appropriately proactive supervisory responses. It should be noted however, that there was no opportunity during the fact-finding phase of the project to review the extent to which the existing internal supervisory manual meets this objective.

33. The Banking Act establishes that CBK may tailor the forcefulness of its response to the problem identified by allowing it to provide advice and recommendations in the first instance, followed by directions and finally orders to cease particular activities. But the Law currently offers CBK *few* specific tools (limited to blocking distribution of profits, changes to management and directors, withholding future corporate approvals). So the changes proposed for inclusion in the Finance Bill, 2010, including those allowing CBK to order a bank to submit a capital or other type of recovery plan, are important additions[15]. But, despite these powers and the work done to make them operational, several aspects of the current framework are likely to lead to regulatory measures being applied more cautiously and over a longer timeframe than is optimal from a financial stability and crisis management perspective.

34. The graduated response set out in the operational manual may result in action against institutions being taken on too protracted a timetable (both because the quantitative elements of CAMEL ratings are backwards looking, and because it creates a sense that regulatory measures should be applied in a linear fashion). And there is a need to recognise that in some cases rapid escalation to severe measures on a more compressed timetable – motivated by macro-prudential concerns – may be necessary and so thought should be given as to how this would be done in practice. There would be benefit in working through challenging scenarios to agree the corrective measures that would be deployed, a process for escalation and timeframe for remedial action appropriate for situations where deterioration in an institution is rapid (or has gone unnoticed for some time), where the bank is unable and/or unwilling to respond in an effective and timely manner, and where the likely systemic implications are severe. The challenge in this case would be to move through the corrective action process in a rapid (as short as a few weeks) and decisive manner.

35. Finally, the sanctions available to CBK to ensure compliance with regulatory measures are currently rather limited[16]. In particular statutory management – the ultimate sanction for non-compliance with corrective measures – provides a bank's managers and owners

[14] See for example, G. Garcia, "Failing Prompt Corrective Action" (2010) which finds a tendency in the US for failing banks to avoid PCA triggers by artificially maintaining capital, sometimes with support from supervisors, until close to the point of failure.

[15] Proposed additions include: increased frequency of inspections; prohibitions imposed on salary and bonus payments; insisting on the appointment of an advisor to help oversee implementation of any recovery plan; imposing restrictions on growth of assets/liabilities.

[16] Non-compliance with CBK directions can result in fines or short prison sentences for individual officials in the problem institution.

with yet a further opportunity to rescue their institution (at least in theory). And the existence of statutory management likely reduces the sense of purpose and urgency for both the bank's managers and shareholders and for CBK supervisors in applying regulatory measures. The problems associated with statutory management are discussed in more detail in the section below on bank resolution.

Bank Resolution

36. The policy framework also needs to be robust to cases where regulatory measures taken against a problem institution are judged likely to fail or have failed already. In such cases, the specific nature of bank failure, which can have serious implications for the wider financial system and real economy, means that banks should not be allowed to fail over an extended period nor wound-up under normal corporate insolvency law. Rather it is increasingly accepted that a special resolution regime is justified to take into account such factors as the need for pre-emptive intervention, speed of resolution and ensuring the continuity of systemically important functions. More specifically, such a regime would afford the authorities, once certain triggers had been met, powers to take full control of troubled institution(s) and to apply one or more techniques to fundamentally restructure and/or dissolve the entity (with the exact nature of the response varying depending on the assessed risk posed by problems within the entity to the financial system).

37. CBK – and the Kenyan authorities more generally – currently lack comprehensive powers to undertake bank resolution. As a result, the time taken and costs associated with problem institutions may be higher than would otherwise be the case. In cases where a problem institution poses minimal systemic risk it is likely to mean that having exhausted the options under Article 33 of the Banking Act, a problem institution would enter statutory management (Article 34) rather than moving straight to liquidation (when moving to wind-up the institution as quickly as possible, as set out below, would arguably result in a more equitable and less costly outcome). In a case where the difficulties faced by an institution posed a potentially systemic threat, CBK would currently face an impossible choice between trying to use statutory management then liquidation (when both would have serious systemic consequences) or effecting a rescue of the institution (likely at significant public cost). In short, as currently specified, statutory management is not fit-for-purpose. Some its weaknesses are examined in more detail below.

Objectives of the Regime

38. Statutory management currently offers a final opportunity to turn a troubled institution around. But such an objective – given an institution is within touching distance of insolvency at this point – delivers a poor outcome from a public policy point of view. Indeed the process is likely to transfer value from all types of depositors and other creditors to a bank's shareholders. Whilst depositors and creditors would likely see access to their funds frozen for an undefined period of time under a moratorium, shareholders – whose equity stake is likely to be worth close to zero – are offered a final opportunity for restitution. During the period of statutory management it is likely that the net asset value of the institution will deteriorate rapidly resulting in poor recoveries on any future liquidation (raising the possibility DPFB will not be made whole on any payout of insured deposits). A more appropriate objective for intervention by CBK – given the associated risks and costs – would be to effect resolution of problem institutions whilst minimising systemic externalities and doing so at least cost.

Triggers

39. As for regulatory measures, trigger events for bank resolution should be carefully set to strike an appropriate balance between supporting premature and belated intervention by the public authorities[17]. For systemic cases the triggers should permit the authorities to act in a pre-emptive manner where a firm looks likely to fall below minimum regulatory requirements (and a judgement is made that the firm will be unlikely to be able address this effectively over an acceptable timetable and that meanwhile its problems pose an unacceptable threat to system stability) and obliged to act when the firm actually breaches these requirements.

40. In Kenya, the current triggers are generally set at the point of insolvency and so too late. One trigger appears to afford CBK the power to intervene pre-emptively although it is not clear whether there would be appetite for acting in this way (Article 34(1)(d) states CBK may act when "the exercise of the relevant power [is] in the interests of the institution or its depositors or other creditors"). Adjustments proposed to triggers (again put forward for inclusion in the Finance Bill 2010) would also permit action where a bank was judged "significantly under-capitalised" (defined as meaning capital has fallen at least 50% below prudential levels) or had failed to act in compliance with orders issued under Article 33 (for example had not submitted or implemented a recapitalisation or recovery plan). As with triggers for regulatory measures, it is important that the capital trigger does not preclude action where necessary against a bank ahead of the bank becoming undercapitalised.

Stages of Resolution

41. In any resolution process, the authorities need to move quickly to conduct initial diagnosis of a problem bank, and to identify and implement the most appropriate policy tools. But at the same time, and regardless of the time elapsed between diagnosis and final resolution, it is essential that at all times the approach used is (a) equitable and (b) acts to contain systemic risk. Achieving (a) implies that in seeking to resolve an institution the interests of small retail depositors are protected and the resolution approach adopted does not otherwise facilitate any transfer of value that impacts negatively on normal creditor priorities. And (b) implies that there no more than a very short interval (preferably outside normal business hours) where the systemically important functions become unavailable.

42. However, it is clear that statutory management (as currently defined) cannot meet either of these important objectives. One approach to statutory management, a problem bank could be kept open for business to allow depositors ongoing access their funds and other systemically important functions to continue. However, there would then be a high probability that depositors (both insured and uninsured) and other counterparties would withdraw their funds (and otherwise reduce exposure to the problem bank), adding to the institution's problems and with potential for contagion to other banks.

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[17] Premature intervention could increase the cost of capital for banks, whilst belated intervention is likely to mean that the authorities act too slowly to preserve value in resolution and/or liquidation or to contain systemic externalities.

43. Under an alternative approach, statutory management would trigger a moratorium on the bank's activities (likely to last months, if not longer). In fact although not required by law this approach is likely unavoidable because use of statutory management results in a bank's access to central bank money and payment and settlement systems being curtailed. But a moratorium is not equitable: small retail depositors would see access to their funds blocked; and in offering a final opportunity to rehabilitate the bank at the point of insolvency, statutory management likely has an expected return greater than zero for shareholders and therefore represents a transfer of value to them[18]. And this approach clearly fails to protect any of the systemic functions performed by the institution. So whichever approach is taken, at best use of statutory management leads to an inequitable outcome, and at worst becomes a source of significant systemic risk.

Resolution Powers

44. In order to contain the potential externalities of bank failure, and once an institution has reached specified trigger points or thresholds, the public authorities should be empowered to resolve the institution decisively drawing on one, or more, policy tools from a broad set. This should include the power to: bring about the sale of part or all of a financial institution to a private sector purchaser; take control of all or part of a failing bank's business through a bridge bank; transfer a bank into public ownership ("nationalisation") on a temporary basis; and a modified insolvency procedure to close part or all of the bank and facilitate either a transfer of insured deposits to a healthy bank or to effect a rapid payout. Furthermore, the application of these tools requires that the rights of shareholders (but not their beneficial ownership) should be suspended[19]. Finally, during resolution, as noted below there may be an ongoing need for liquidity support, without which the resolution process may be compromised.

45. Given the objective of statutory management is to restore a failing bank to health, the policy tools outlined above (for private sector solutions, bridge banks, public ownership, modified liquidation) are not available to the manager appointed by CBK. Furthermore, the tools that are available to support restructuring appear to have a low probability of success – particularly in systemic cases[20]. Fundamentally, the manager continues to rely on shareholder cooperation to raise new capital or effect fundamental reorganisation of the entity (something shareholders had the opportunity but failed to do whilst under Article 33).

46. CBK has considered how to address some of the weaknesses in existing powers for resolving problem banks. In suggested amendments to the Banking Act, Bank Supervision has attempted to ensure that the period of statutory management does not extend beyond three months, but even such a short period of use may result in a

[18] Insured depositors would be better served by immediate liquidation and payout of their deposits.

[19] Thus the responsible authority should be able to apply any of the available tools as appropriate without having to seek shareholder approval. Once the bank has been resolved (and all depositors and other creditors paid-off in line with creditor preference), and to the extent that there is any net asset value, this is distributed to shareholders.

[20] In discussion, CBK could point to one or two cases where they judged that statutory management had succeeded, in the sense that banks had exited the process other than via liquidation. However, if the objectives of bank resolution were adapted to better capture optimal public policy outcomes simply turning a bank around would no longer necessarily constitute success.

destabilising and sub-optimal outcome (and it's not clear what could be achieved to turn around a bank during that time). And in discussion, DPFB noted they had considered recommending an amendment where upon entering statutory management, payout of insured deposits would occur (although payout would leave the bank with a significant funding gap likely sealing its fate). The Kenya Deposit Insurance Corporation (KDIC) Bill that exists in draft form would see the deposit insurance and liquidation functions transferred to an independent public agency, with this new agency also taking on powers to act as a receiver (with this process likely to replace but being otherwise similar in form to statutory management). But whilst this would likely address some of the challenges faced under the existing liquidation process, it does not provide for the kind of bank resolution regime enjoyed by, for example, the FDIC in the US.

Box I: Important Features of a Bank Resolution Regime

Institutional framework: clear designation to an appropriate public agency of responsibility/powers for: triggering use of regime; identifying and deciding on measures applied under regime; managing implementation (these responsibilities could be concentrated in one entity, or shared as appropriate).

Objectives: appropriately determined public policy objectives to create a framework for decision-making on measures to produce optimal outcomes (e.g. to resolve problem entities in a manner that preserves system stability at least cost).

Thresholds: appropriately determined thresholds or "triggers" beyond which the designated authority takes full control of a problem entity and imposes resolution (including liquidation) in a manner that best serves the identified public policy objectives.

Resolution measures: power to impose one or more policy tools from a suitably wide menu of options to include private sector solutions (including subsidised where necessary); good bank, bad bank structures, bridge banks, temporary public ownership, modified liquidation processes (allowing for transfer of insured deposits).

Treatment of counterparties: application of regime triggers full transfer of control to designated authority away from existing shareholders (who become claimants on resolved, liquidated entity).

Provision of Liquidity Insurance

47. In recent years the Kenyan banking system has tended to be liquid although CBK has acted to respond to temporary liquidity shortages[21]. Following a severe shock to financial stability liquidity pressures are likely to be more extreme and prolonged. In such a case, it would fall to CBK to respond by making additional liquidity available and so the policy tools available to the Central Bank to support this lender of last resort function are important. As work continues within CBK to strengthen the operational framework for monetary policy, it is important to also consider how far the same framework can be used to support its financial stability (and related crisis management) objective.

48. In normal times, a robust framework would create appropriate incentives for banks to manage their liquidity effectively[22]. At the same time, the framework should offer

[21] In particular, to minimise the impact of the 2008 Safaricom IPO.

[22] This implies a need to minimise time inconsistency: if banks are clear that CBK stands ready to meet individual or collective liquidity shortages on favourable terms, incentives to manage liquidity

mechanisms for CBK to respond to a number of "crisis" scenarios including: (i) a shock that necessitates liquidity provision to a segment or all of the banking system; (ii) a temporary liquidity gap at an individual institution that is otherwise structurally sound; (iii) a liquidity need at an institution no longer a going concern but is undergoing resolution. The existing arrangements are considered against these scenarios in turn.

Provision of Liquidity to a Segment or the Whole Market

49. Under the existing operational framework, CBK can mop-up excess liquidity or inject funds via almost daily auctions of repo and reverse repo (against government securities). Since early 2009, CBK has responded to liquidity shortages by injecting funds via reverse repo (whose maturity were standardised to 7-days), and made further cuts to reserve requirements (from 6% to the current 4.5% in 2008-09).

50. But a strategy to respond to future market wide liquidity shocks has not been articulated. As such, a review of how the current policy framework – which was designed to support the monetary policy function – could be flexed or adapted to support a financial stability objective would be timely. Such a review could consider the extent to which CBK could lend more funds, at longer maturities to segments of, or the whole, system and whether this should be done by adjusting regular operations or via a new special purpose facility. Careful consideration would need to be given to the terms and conditions.

51. The review should also identify any impediment to CBK's ability to respond to such a severe shock. One clear obstacle is that although the law affords CBK considerable flexibility to shape its market operations, it is not able to accept collateral other than government securities. However, following a severe shock this could act as a binding constraint.

Provision of Institution-Specific Liquidity to Meet Short-Term Liquidity Needs

52. Where an apparently sound institution faces a temporary liquidity shortage, it can access overnight liquidity via the existing CBK discount window, against government securities (at an interest rate tied to that last seen in CBK's regular operations). But banks may have hesitated to avail themselves of the funds due both to stigma effects[23] but also because the interest rate applied is the CBK policy rate (and this *normally* exceeds the auction-determined reverse repo rates by some margin).

53. Therefore on three occasions CBK has improvised a response and has, on its own initiative, supplied liquidity to institutions via covert bilateral reverse repo operations (with the rate tied to that seen in recent reverse repo operations, but at an unlimited size and with the option to roll the funds if needed after 7 days have elapsed). CBK has not publicised the existence of this facility on concerns it would act as a disincentive to banks

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conservatively (with its associated costs) are reduced. In turn this increases the likelihood that banks will not act prudently and that central bank will have to act as lender of last resort.

[23] Staff reported that data on aggregate use of the discount window is published and this could deter some banks – particularly larger banks – from accessing funds in this way as where usage passed a certain threshold it would likely stimulate market debate over which institution had needed to draw down. Similar stigma problems in relation to standing lending facilities were observed in the US and UK during the recent crisis (as covered in a 2008 paper by the Committee on the Global Financial System entitled "Central bank operations in response to the financial turmoil").

to manage their liquidity effectively in normal times (although of course the more this facility is used, the harder it becomes to maintain the constructive ambiguity targeted). The overall effect is that an institution facing a liquidity shortage would first seek funds via CBK's regular operations, would then consider use of the discount window and ultimately may need a bilateral repo. However whilst escalation through these facilities is tied to varying degrees of distress the terms and conditions attached to all three do not get progressively more penal (in fact a bank that was lucky enough to take funds via a bilateral repo rather than the standing facility would do so at no penalty to other banks that had managed their funding appropriately). Overall this has the effect of blurring incentives for banks to manage their liquidity effectively in normal times.

54. It is also important to note that the criteria against which a decision to lend to an individual institution would be made are unclear. Staff mentioned that such funds would be extended where the bank was considered a going concern but there was some uncertainty about how this would be established (although likely BSD would be asked to provide views). However, it remains unclear how CBK intends to deal with potentially systemic cases where a problem institution faces an immediate liquidity need but where there is a likelihood that the shortage is structural and/or the institution is short of the government securities eligible for use with CBK. In discussion, CBK personnel were clear that it could not lend in such cases. But it was not clear that the potential consequences for financial stability of any decision not to lend had been internalised.

Provision of Institution-Specific Liquidity during Resolution

55. Where there are doubts about a bank's viability (and specifically solvency), it rightly becomes ineligible for central bank liquidity insurance (and therefore cannot continue to operate in its current form). Ahead of this critical point, measures to resolve the institution should be employed. But in cases where resolution of the whole bank via liquidation is excluded on systemic grounds, it is likely that public provision of liquidity to all or part of the institution (or to an acquirer) will be needed[24].
56. There is currently no provision for such lending under the existing framework and a mechanism needs to be found alongside any work done to develop powers for bank resolution. It is important to note, in making provision for any such lending, that in some countries a central bank will only lend after prior agreement with the Finance Ministry that this is necessary (and after seeking an indemnity against potential losses).

Deposit Insurance

57. Deposit insurance for institutions regulated by the Central Bank[25] is provided by a well-established scheme under the Deposit Protection Fund Board (DPFB), which runs the scheme, pays out when member institutions are liquidated and in the majority of cases is appointed as liquidator. The scheme has a number of strengths, but also some weaknesses outlined below (some of these weaknesses have been addressed in a *draft* Bill, drawn up in 2009, and submitted to the Ministry of Finance).

[24] And it is important to recognise that there may be timing issues where liquidity problems present and the case is judged likely systemic but there has been insufficient time to outline and start to implement resolution.

[25] Given the focus of this report, the adequacy of deposit insurance arrangements for other types of financial institutions – in particular SACCOs – is not considered.

Objectives, Governance, Mandates and Powers

58. Under the Banking Act (Articles 36-42), DPFB's principal objective is described as being "to provide a deposit insurance scheme for customers of member institutions and liquidate and wind up operations of any institution in respect of which the Board is appointed as a liquidator" but is silent on the broader policy objectives DPFB is being asked to discharge (some combination of protecting retail depositors and financial stability, whilst doing so at least cost subject to minimising systemic risk). The draft Bill makes welcome reference to both financial stability and least cost objectives although arguably they could be given greater emphasis[26].

59. However the draft, seeks to extend the fund's remit to include receivership (and related powers for inspection and corrective action). It remains unclear exactly what objectives the proposed receivership process is designed to meet however (and this may need further consideration). The Bill makes reference to receivership offering a final opportunity to turn a failing bank around – but as for statutory management it is not clear that this objective is consistent with that of fairness for key counterparts (the same issues around access to insured deposits would exist) and minimising systemic externalities. Overall, the risk that devoting time to efforts to revive an institution and thereby delaying liquidation (negatively impacting recoveries) would continue to exist.

60. However to the extent that the intention was to provide for an administrative version of liquidation (granting the deposit insurer additional powers to manage the process more effectively with likely higher recoveries than has been possible under the liquidation process described in the Banking Act) the Bill should act to strengthen the current framework.

61. Currently, DPFB is established as a legal entity in its own right (although in practice it operates as a department of CBK). The Governor heads the Board and other members are the Permanent Secretary to the Treasury and five industry representatives. Ensuring the right balance of relevant experience and independence for Board members is of course a challenge, and DPFB staff noted concerns around the current structure in relation to ex officio members. However, the presence of industry representatives is also of some concern and may present serious conflicts of interest (a quick review suggests it's rare to have Board members who are also employed by an insured entity as shown in Box J below). Arguably this risk is not dealt with adequately in the draft Bill (which focuses instead on moving the deposit insurance function out of the Central Bank)[27]. Further work may be needed therefore to review the governance structure (and supporting criteria for directors) to ensure such conflicts of interest are minimised.

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[26] Although, the exact wording states that the "Corporation shall act in such manner as to minimise costs to the financial system" and so does not recognise that in a severe crisis minimising costs incurred by the public sector may be even more important.

[27] The relevant core principal states **"**The deposit insurer should be operationally independent, transparent, and accountable and insulated from undue political and industry influence."

Box J: Board Structure in Selected Countries

Scheme Country	CDIC Canada	FDIC US	KDIC Republic of Korea
Overview	Board consist of 11 members which five are private sector (but none are currently employed by scheme members).	Five-member board (two seats ex officio). No Board members are currently employed by scheme members.	Board consists of seven members, some with banking experience but none currently employed by scheme members.

Membership and Coverage

62. In line with recommended practice, all deposit-taking institutions licensed by the Central Bank are required to be members of the scheme (excluding the foreign operations of Kenyan banks, but including the local branches and subsidiaries of foreign banks). Ideally the scheme would extend protection to retail depositors only, and although all types of deposits are covered (except interbank) coverage is set so low that it likely has little impact on incentives for corporate and financial entity depositors[28]. Deposits are covered to an appropriate level of Kshs100,000 (around US$1,300, against GDP per capita of less than US$1,000 in 2009). DPFB staff noted that they had considered increasing coverage. But on balance, this does not appear to be warranted because, whilst it is important to keep coverage under review, some 91% (by volume) of deposits are already captured by the scheme and so the current level of cover captures the targeted small retail depositor adequately[29].

Funding and Resources

63. Compared to deposit insurance schemes elsewhere, DPFB appears to have adequate financial and other resources (given its existing remit). Indeed, premiums levied plus other sources of funds (particularly returns on investment assets) have resulted in DPFB assets of some Kshs20.7bn at June-2009 against total insured deposits of Kshs129.2bn (resulting in a reserve ratio of 16.0%[30]). In order to ensure, going forwards, that the DPFB continues to strike the right balance between building up too small or large a fund it may be appropriate to set a target reserve ratio (to provide a reference point for decision-making on appropriate premiums).

64. Despite the funds accumulated to date, it is important to recognise that in the event of the failure of multiple institutions or one large institution, the resources of the DPFB both to

[28] In a case where coverage limits were increased substantially it may be appropriate to exclude from the scheme the deposits of those entities that can reasonably be expected to have assessed the associated risk (which would definitely include deposits placed by other financial institutions, and arguably large corporates).

[29] And in is in line with international best practice suggesting schemes target coverage of 90% of accounts by volume. The power to adjust coverage currently resides solely with the Minister of Finance, which may not be appropriate. The amendment included in the draft Bill – whereby the Minister remains responsible but must first seek council from the deposit insurance agency – appears appropriate.

[30] Based on data to end-June 2009 just one bank and one deposit-taking MFI had total insured deposits that exceeded the DPRB resources.

handle payout (and liquidation) may prove inadequate. DPFB could face liquidity constraints (as it seeks to dispose of assets) and/or require recapitalisation. Currently no mechanisms exist to support DPFB in these eventualities so their inclusion in the draft Bill is welcome (the Bill allows for DPFB to borrow from CBK and for recapitalisation drawing on resources in the general purpose Consolidated Fund).

Relationship with Other Safety-Net Partners

65. The current structure – including the Board – ensures some degree of coordination with the Central Bank and Finance Ministry. However, Board meetings take place only quarterly and no mechanism exists to increase their frequency in times of crisis. And whilst data sharing does take place, DPFB does not receive adequate information from Bank Supervision to allow it to assess potential likely calls on its resources[31], or the quality of depositor data (and related IT systems) within individual banks (something that has a significant bearing on the speed with which there could be prepared and payout started once a bank went into liquidation).

66. As noted the draft Bill attempts to address this by granting the new KDIC inspection powers and the right to request a broader range of information from Bank Supervision and by building in a legal requirement for Bank Supervision to notify it of any material changes to the condition of a bank. It may be that legislative action is needed to ensure that important information-sharing and coordination takes place between the supervisory area and the deposit insurer[32]. However, the existence of dual powers – within Bank Supervision and the deposit insurer – for corrective action will need to be managed carefully.

Payout

67. Under the Banking Act, DPFB has a binding legal requirement to ensure it is ready to start payment two weeks after a bank is first placed into liquidation. DPFB has not set a shorter operational target (and some concern was expressed that it might struggle to meet even the two-week target in some cases). It is important to note, that even a two-week delay could be sufficient – in the midst of a systemic crisis – to damage depositor confidence and so every effort should be made to identify and address obstacles to more rapid payout.

Cross-Border Issues

68. The challenges of crisis management are magnified in a cross-border context given differing national interests, institutional and legal frameworks, and reaction functions. So in addition to ensuring domestic arrangements are adequate – the first step towards effective cross-border crisis management – consideration should be given to mechanisms for coordination with foreign counterparts and the application of each of the main policy

[31] DPFB receives CAMEL rating data only once per year from which it attempts to discern likely calls on its resources to support the annual budgeting process. Otherwise the Fund is left trying to identify problem banks from other types of monthly prudential data reports.

[32] Although once this is initiated the presence of industry representatives of the Board of the deposit insurer becomes even more problematic.

tools (regulatory measures, provision of liquidity and bank resolution (including liquidation)) in all potential cross-border contexts[33].

69. A quick review of CBK's policy tools suggests that the law provides for the application of the regulatory actions set out under Article 33 to all foreign banking institutions operating in Kenya (whether as branches or subsidiaries) and in relation to the foreign operations of Kenyan banks[34]. The Banking Act is not explicit in relation to statutory management (and so further work is needed to clarify this). In addition to legal considerations, the effectiveness of any regulatory measures taken would likely depend on the cooperation of foreign parent banks or regulators, and so work would be needed on appropriate strategies for coordination with them[35].

70. CBK lacks bank resolution powers presently, but an important policy design question would be their application in a cross-border context (and how that mapped to the approach taken by the home and host countries for cross-border banks). In countries with such powers, their application is often in line with the approach taken to general corporate or bank insolvency[36].

Recommendations

71. In the light of the assessment, the following recommendations are made for strengthening CBK's policy framework:

R6: Review replacement of "statutory management" with full powers for bank resolution: first answering key questions on policy design (including on policy objectives, governance, triggers, desirable tools, application in cross-border contexts), then drafting the necessary legislation;

R7: Undertake desk-top exercise to review application of regulatory measures ("corrective action regime") in fast-moving systemic cases to test robustness of steps set out in existing operational manual;

R8: Review provision of liquidity to individual institutions and market as a whole in stressed conditions – across all of CBK functions. Formalise policy objectives, and basis for policy choices (especially in systemic cases). Consider revisions to CBK Act to allow use of wider collateral in such systemic cases;

R9: Address additional issues identified for DPFB by adjusting draft KDIC Bill (clarify policy objective for scheme and the nature of receivership, address governance issues).

[33] To include: the foreign operations of local banks, and local operations (via both subsidiaries and branches) of foreign banks.

[34] Article 33(4)(a) states "The Central Bank may issue directions to institutions…with respect to…the standards to be adhered to by an institution in the conduct of its business in Kenya or in any country where a branch or subsidiary of the institution is located".

[35] It is positive that CBK works closely with key counterparts within East Africa (and in other regional forums) and has signed a Memorandum of Understanding with regulators in four other East African countries.

[36] It was not possible to confirm the approach taken in Kenya: but for comparative purposes in the UK bank resolution and/or liquidation powers can be used against UK-based banks and their foreign branches (but not their overseas subsidiaries), plus the local subsidiaries of foreign banks.

Additionally consider operational steps needed to make scheme robust to systemic situations (faster payout, mechanisms for raising liquidity).

PART THREE

Recommendations and Next Steps

72. The recommendations identified throughout the assessment are listed in Box K. Taken together they represent a significant programme of work and so there is a clear need to prioritise next steps (and to ensure that adequate resources are devoted to this investment programme). Furthermore some recommendations – and in particular putting in place a credible bank resolution regime – have a long lead-time and would ultimately require legislative change.

73. In terms of taking forward these recommendations, it is proposed that work is initially undertaken in two phases. The first phase would, as detailed below, focus on developing a framework for financial stability, outlining a CBK crisis plan and initiating steps to address identified weaknesses in arrangements for dealing with failing banks. In the second phase, the enhanced framework would be tested with a crisis simulation exercise.

Phase 1

74. In the first phase, work should focus on the following areas (and could take between three and six months to complete):

    a. After agreeing the nature of the CBK mandate, develop an internal framework for financial stability to include: identification of supporting CBK functions; an analytical strategy; and co-ordination mechanisms at working and decision-making levels;
    b. Draw up an internal CBK crisis management plan to provide a framework for coordination between the relevant departments (also identifying where coordination is needed with external counterparts), and setting out policy objectives, responsibilities, arrangements for information-sharing and assessment, the menu of policy tools available, and mechanisms for coordination on policy decisions;
    c. Establish a more formal process for assessment of the potential impact of problem institutions or more widespread instability on the financial system (systemic assessment framework) to support decision-making on measures;
    d. Move to replace “statutory management” with full powers for bank resolution (first answering key questions on policy design, then drafting the necessary legislation).

Box K: Timetable for Implementation of Recommendations

No.	Recommendations	Legislative Change?
R1	Develop an internal framework for delivering on the CBK financial stability remit by working up a comprehensive strategy paper for discussion and agreement by CBK Board, setting out the key policy design issues including: defining nature of CBK mandate; establishing an internal governance structure; ensuring an adequately empowered and resourced centralised financial stability capacity; defining contributions required from other areas of CBK; setting of an analytical strategy (and supporting processes); identification of policy tools available; initial outline of an external communications strategy;	**No**
R2	Meanwhile prioritise the establishment of: (i) a process for cross-departmental identification, quantification and discussion of key risks to financial stability, and of policy tools available to mitigate such risks; and (ii) a senior decision-making body, to receive regular briefing on key risks identified and recommendations for their mitigation, and responsible for taking relevant policy actions;	**No**
R3	Conduct a quick review of the planned cross-authority Financial Stability Report to ensure planned approach and content fits with likely outcomes for (R1) above.	**No**
R4	Draw up an internal CBK crisis management plan to provide a framework for coordination between the relevant departments (but also identifying where coordination is needed with external counterparts), and setting out policy objectives, responsibilities, arrangements for information-sharing and assessment, menu of policy tools available, and a mechanism for coordination on policy decisions;	**No**
R5	Establish a more formal process for assessment of the potential impact of problem institutions or more widespread instability on the financial system (systemic assessment framework) to support decision-making on measures;	**No**
R6	Review replacement of "statutory management" with full powers for bank resolution: first answering key questions on policy design (including on policy objectives, governance, triggers, desirable tools, application in cross-border contexts), then drafting the necessary legislation;	**Yes**
R7	Undertake desk-top exercise to review application of regulatory measures ("corrective action regime") in fast-moving systemic cases to test robustness of steps set out in existing operational manual;	**No**
R8	Review provision of liquidity to individual institutions and market as a whole in stressed conditions – across all of CBK functions. Formalise policy objectives, and basis for policy choices (especially in systemic cases). Consider revisions to CBK Act to allow use of wider collateral in such systemic cases;	**Yes?**
R9	Address additional issues identified for DPFB by adjusting draft KDIC Bill (clarify policy objective for scheme and the nature of receivership, address governance issues). Additionally consider operational steps needed to make scheme robust to systemic situations (faster payout, mechanisms for raising liquidity).	**Yes**

Phase 2

75. In the second phase, the enhanced arrangements – and in particular the newly developed CBK crisis management plan – would be tested with a simulation exercise. In addition to testing any improvements made, the exercise would act as a dynamic diagnostic for policy makers on further reforms needed and provide experience of scenario and exercise-based testing. Box L below provides an overview of how such an exercise might work.

Box L: Introduction to Simulation Exercises

Crisis simulation exercises provide an opportunity for authorities – such as central banks and finance ministries – to test their level of readiness to manage a financial stability event in a controlled environment. Such testing – which has long been used in other sectors – is increasingly being called on by public authorities to help strengthen the policy framework for dealing with infrequent but potentially costly systemic banking crises.

A typical exercise would be played out over the course of a day, and would involve senior staff working in teams to respond to a tailor-made scenario describing the evolution of a shock through the financial system. The participants would need to assess the severity of the crisis, decide how to coordinate with key counterparts and manage the crisis drawing on available policy tools.
Crisis exercises have been used in single-authority, national and cross-border contexts. And learning points have including those relating to coordination, assessment frameworks, and the robustness of policy tools and on appropriate strategies for external communication.

76. As for this review of existing arrangements, CBK should also consider external resources that may be available to support this work program. This would provide additional capacity until a time when capabilities in relation to financial stability and crisis management have been scaled up and also technical experience (and some context to allow CBK to draw on lessons from other countries).