



# BASEL II IMPLEMENTATION SURVEY RESULTS

CENTRAL BANK OF KENYA

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## 1.0 EXECUTIVE SUMMARY

The Basel Committee on Banking Supervision formulated and issued a revised capital framework referred to as **Basel II** in June 2004 which became available for implementation among its' 13 member countries<sup>1</sup>(mostly G 10 countries) from end-2006 and from end 2007 for the most advanced approaches.

Basel II consists of three pillars:-

1. **Pillar I-Minimum Capital Requirements**-Banks are required to set aside adequate capital to cover the credit, market and operational risks they face.
2. **Pillar II-Supervisory Review**-Under this pillar, banks are required to set aside adequate capital to cover all the business risks they face including those outside credit, market and operational risks. Supervisors on the other hand are required to assess the internal capital adequacy process that banking institutions have put in place.
3. **Pillar III Market Discipline**-Under this pillar, banks are required to disclose to the public, their risk management frameworks i.e. how they identify, measure and mitigate the risks they face.

CBK has been keenly following developments leading up to the adoption of the new capital framework through participation in regional and international supervisory fora.

Basel II became available for implementation in Basel member countries from the end of 2006 and from end 2007 for the most advanced approaches. The Basel Committee however recognises that moving towards Basel II may not be a priority for non-members (like Kenya) in terms of what is needed to strengthen supervision. The Committee recommends that countries decision to move towards implementing Basel II be based on their national priorities. This approach will ensure that emerging countries in particular put in place the prerequisite supervisory infrastructure for Basel II. This is indeed consistent with the position adopted by CBK.

CBK began a process in 2007 that will lead to the preparation of a comprehensive roadmap for implementation of Basel II. This process involves:

- Implementation of Basel II prerequisites:-

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<sup>1</sup> The Basel Committee Member Countries are Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States

- Full adoption of Basel I in particular the market risk amendment that requires banks to set aside capital for market risk in addition to credit risk.
- Implementation of Risk Based Supervision.
- Full compliance with the Basel Core Principles for Effective Banking Supervision through the comprehensive review of the Banking Act that is under consideration by the Attorney General.
- A survey conducted by CBK, to assess the status of Kenyan banks vis a vis the requirements of Basel II.
- Based on the findings of the survey, formulation of CBK's policy position with regard to Basel II that will broadly spell out:-
  - Elements of Basel II that be adopted.
  - Applicability of Basel II to domestic and internationally active banks.
  - Broad regulatory guidance on the approaches to be adopted.
  - Timelines for Basel II implementation.
- Jointly with industry players, development of a detailed roadmap towards implementation of Basel II.

This report sets out the findings of a Basel II Implementation readiness survey that was carried out among the Kenyan Banking Sector in the first quarter of 2008. Responses were received from 31 out of 43 banks (72% response). The key findings are as follows:-

1. Majority of the institutions rated the level of awareness of Basel II as medium (on scale of high, medium and low). There is therefore need to enhance Basel II awareness in institutions.
2. The key reasons for low awareness of Basel II in some institutions were cited as:-
  - a. Lack of prerequisite human resource competences.
  - b. Basel II is not considered a competitive tool.
  - c. It is not a regulatory requirement.
3. All the home regulators of international banks represented in Kenya allow for overseas operations to follow the approaches adopted by host supervisors. This leads to dual reporting to the home (who have adopted Basel II) and host regulators (who have not adopted Basel II).
4. Local subsidiaries/affiliates of international banks have had to upgrade their data systems, risk management policies and strategies to meet Basel II reporting requirements of their head office.

5. For all international bank respondents, a budget has been set aside at the group level. However only one institution has a specific allocation for the Kenya operations of USD 5 million (Approx Kshs. 350m).
6. Most of the local affiliates of international banks (72%) are ready to implement Basel II.
7. Majority of the local institutions (76%) will be ready to implement Basel II from 2010. This is in contrast to international banks, a majority (72%) of whom have indicated that they are ready to implement Basel II.
8. Only 3 out of the 24 local institutions surveyed have set aside specific budgets for Basel II implementation. 2 other institutions are actively considering a Basel II budget, while in one other institution investments in I.T. systems and training incorporate Basel II requirements.

The survey results indicate a mixed level of preparedness of the Kenyan banking sector as far as Basel II is concerned. The international banks drawing on the support of their parent groups are in a better state of preparedness compared to local institutions. However, there are also challenges in meeting requirements of Basel II that would impact on all banks. These are principally:-

1. The standardized approach to assessing the credit risk charge under Pillar II relies on ratings by External Credit Rating Agencies. The survey indicates that banks in Kenya do not rely on External Ratings save for their international counterparties and large corporate counterparties. This finding is consistent with the limited credit rating penetration in the country. Unrated exposures under the standardized approach would attract higher risk weights and thus more capital would be required to be set aside for such exposures.
2. Basel II allows for the use of internal models by banks to determine their capital charges pursuant to supervisory approval. However, these models require the use of up to five years data. Kenyan banks are by and large yet to adopt model based approaches to assessing their capital adequacy needs. Some international banks are however using models developed at their international headquarters. A transition period will therefore be required for Kenyan banks to collect the requisite data for the models.
3. Human resources competences have been identified as a cross cutting challenge. Basel II will require banks to upscale their human resource base and a "talent war" in the banking sector can be anticipated going forward.

4. Upgrades and overhauls of existing I.T. systems for most banks will be required. Robust, scalable systems will be required to ensure banks can meet the rigorous Basel II information requirements.

The challenges notwithstanding, it is noteworthy that most Kenyan banks are ready to embrace the enhanced risk and capital management practices that come with Basel II. In this regard, the Central Bank of Kenya is in the process of formulating a policy position on Basel II implementation in Kenya. This position will be informed by implementation of the Basel II prerequisites, the survey results and input from market players. It is anticipated that the policy position will be shared with market players before its' adoption.

## 2.0 BACKGROUND

### Introduction

The Basel Committee on Banking Supervision formulated and issued a revised capital framework referred to as **Basel II** in June 2004 which became available for implementation among its' 13 member countries<sup>2</sup>(mostly G 10 countries) from end-2006 and from end 2007 for the most advanced approaches.

Basel II consists of three pillars:-

1. **Pillar I-Minimum Capital Requirements**-Banks are required to set aside adequate capital to cover the credit, market and operational risks they face. A menu of options is available for calculating the capital charge ranging from simplified to advanced methods for each of these risks, but the required 8% total capital adequacy ratio (12% in Kenya) remains the same. Operational risk referring to the risk of loss arising from failure in people, processes and systems which was not included in Basel I was added.
2. **Pillar II-Supervisory Review**-Under this pillar, banks are required to set aside adequate capital to cover all the business risks they face including those outside credit, market and operational risks. Supervisors on the other hand are required to assess the internal capital adequacy process that banking institutions have put in place.
3. **Pillar III Market Discipline**-Under this pillar, banks are required to disclose to the public, their risk management frameworks i.e. how they identify, measure and mitigate the risks they face.

### Central Bank of Kenya (CBK) Position on Basel II

The CBK has been keenly following developments leading up to the adoption of the new capital framework through participation in regional and international supervisory fora. More specifically, Basel II has been a key agenda of the Monetary Affairs Committee (MAC) of the East African Community. MAC, which was formed in 1997 consists of the Central Banks of Kenya, Tanzania and Uganda and from 2007 also incorporated the Central Banks of Rwanda and Burundi. The primary objective of MAC is the formation of an East African Monetary Union, one of whose prerequisites is a harmonised legal and regulatory framework for banking institutions.

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<sup>2</sup> The Basel Committee Member Countries are Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States

The MAC considered the question of what position the region should adopt regarding implementation of Basel II. In May 2005, MAC adopted a position which states that the Central Banks of Kenya, Uganda and Tanzania will implement Basel II only after fulfilling some key prerequisites to strengthen baseline supervision, which are:-

1. Full implementation of the Basel I Accord, particularly the Market Risk Amendment;
2. Full Compliance with the Basel Core Principles for Effective Banking Supervision (BCPS); and
3. Adoption of Risk Based Supervision (RBS).

### **Basel II Implementation in Kenya**

As alluded to in the foregoing sections of this report, Basel II became available for implementation in Basel member countries from end 2006/end 2007. The Basel Committee however recognises that moving towards Basel II may not be a priority for non-members (like Kenya) in terms of what is needed to strengthen supervision. The Committee recommends that countries decision to move towards implementing Basel II be based on their national priorities. This approach will ensure that emerging countries in particular put in place the prerequisite supervisory infrastructure for Basel II. This is indeed consistent with the position adopted by the East African Central Banks.

It is noteworthy that CBK has made considerable progress in fulfilling the prerequisites of Basel II and it is now appropriate to begin engaging the banking sector on the new capital framework. Further, a strong banking sector is essential to fulfil the national development aspirations encapsulated in Kenya's current development blueprint, **Vision 2030**.

Under the Vision, the banking sector is expected to play a catalytic role in mobilising the substantial resources required to push Kenya to "new frontiers" of development. The Vision also seeks to transform Kenya into a "financial services hub" for the Eastern Africa Region. This will in turn require the formulation of a "*world class*" enabling legal and regulatory framework. In the current supervisory context, "*world class*" is set by the Basel Committee and it is anticipated that Basel II will in the near term become the global supervisory standard in the same way that Basel I was accepted and adopted by more than 100 countries in the world.

In this connection, the CBK began a process in 2007 that will lead to the preparation of a comprehensive roadmap for implementation of Basel II. This process involves:

- Implementation of Basel II prerequisites:-
  - Full adoption of Basel I in particular the market risk amendment that requires banks to set aside capital for market risk in addition to credit risk.
  - Implementation of Risk Based Supervision.
  - Full compliance with the Basel Core Principles for Effective Banking Supervision through the comprehensive review of the Banking Act that is under consideration by the Attorney General.
- A survey conducted by CBK, to assess the status of Kenyan banks vis a vis the requirements of Basel II.
- Based on the findings of the survey, formulation of CBK's policy position with regard to Basel II that will broadly spell out:-
  - Elements of Basel II that be adopted.
  - Applicability of Basel II to domestic and internationally active banks.
  - Broad regulatory guidance on the approaches to be adopted.
  - Timelines for Basel II implementation.
- Jointly with industry players, development of a detailed roadmap towards implementation of Basel II.

### **BASEL II Implementation Survey**

This report sets out the findings of a Basel II Implementation readiness survey that was carried out among the Kenyan Banking Sector in the first quarter of 2008. Responses were received from 31 out of 43 banks (72% response). The list of respondents is attached as Annex I.

### 3.0 SUMMARY OF SURVEY RESULTS

#### GENERAL

##### 1. Respondents

**Table I: Survey Respondents**

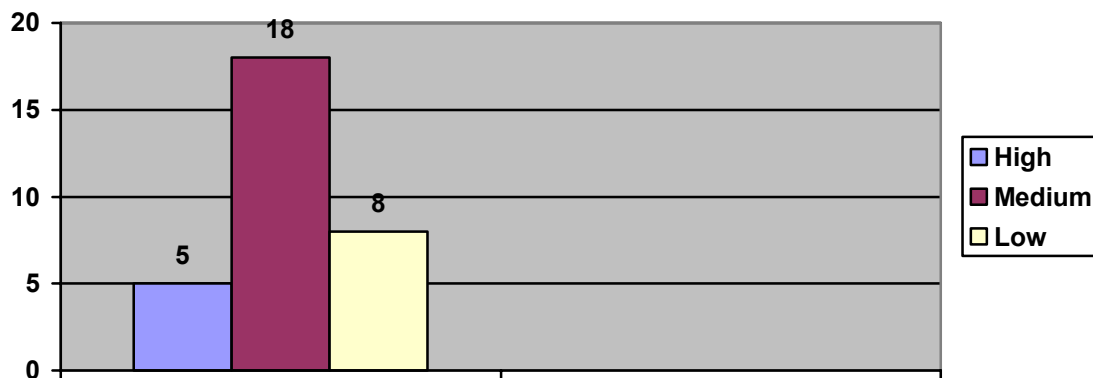
	<b>Title</b>	<b>Number</b>	<b>Percentage (%)</b>
1.	Head of Risk	14	45
2.	Head of Finance	4	13
3.	Managing Director	6	19
4.	General Manager	4	13
5.	Compliance Manager	1	3
6.	Assistant Manager	2	7
	<b>Total</b>	<b>31</b>	<b>100</b>

A majority of the respondents (45%) were Heads of the Risk function, an indicator of the growing prominence of this role. This follows the issuance of Risk Management Guidelines by CBK in 2005 requiring establishment of risk management functions in banks.

##### 2. What is your rating of the level of awareness of Basel II within your bank/financial institution?

The assessment of the level of awareness by the respondents on a range of low, medium and high is summarised in Chart I below:-

**Chart I: Basel II Awareness**



A majority of the institutions (18) rated the level of awareness of Basel II as medium. There is therefore need to enhance Basel II awareness in institutions.

3. If the rating of your institutions' awareness is high or medium, please indicate the source of that awareness in the table below:-

Table II: Sources of Basel II Awareness

	Source of Awareness	Number of institutions
1.	Basel II Training and Seminars	17
2.	International and Regional Banking Groups Headquarters Support	7
3.	Board and Senior Management Direction	17
4.	External consultants	8
5.	<b>Others(please specify)</b>	
	Internet	3
	Information sharing with peers	2
	Development Partners	1
	News Articles	1
	Basel II Awareness Campaigns	1
	Basel II competitions	1

Most institutions derive their Basel II awareness from attending training and seminars and Board and Senior Management direction.

4. If the rating of your institutions' awareness of Basel II is low, please indicate briefly the key reasons for this lack of awareness.

The key reasons for low awareness of Basel II in eight institutions were cited as:-

- Lack of prerequisite human resource competences.
- Basel II is not considered a competitive tool.
- It is not a regulatory requirement.

International/Regional Banking Groups {Subsidiaries and branches of international and regional banking groups (excluding regional banking groups which have the Central Bank of Kenya as their "Home Country Supervisor")}

1. Please indicate your home supervisor

7 institutions out of the 31 respondents are subsidiaries or branches of international banking groups with the Home Supervisors as indicated in Table III below:-

**Table III: Home Supervisors of International Banks**

	<b>Home Supervisor</b>	<b>Number of institutions</b>
1.	Reserve Bank of India	1
2.	Financial Services Authority-United Kingdom	2
3.	U.S. Office of the Comptroller of Currency and Federal Reserve Board	1
4.	Swiss Banking Commission	1
5.	State Bank of Pakistan	1
6.	South Africa Reserve Bank	1
	<b>Total</b>	<b>7</b>

**2. Has your home supervisor prescribed an approach to Basel II implementation?**

All the home supervisors listed above have prescribed an approach to Basel II.

**If the answer to 2 is yes, what is your home supervisor's prescribed approach to Basel II and its implementation timeline:-**

A summary of the approaches of the home supervisors is indicated herebelow:-

**Reserve Bank of India**

The standardized approaches for credit, market and operational risk became available for implementation with effect from 31<sup>st</sup> March 2008.

**Financial Services Authority (FSA)-United Kingdom**

All Basel II approaches became available for implementation from 1<sup>st</sup> January 2007 save for the Advanced IRB and Operational Risk AMA which were to be implemented from 1<sup>st</sup> January 2008.

**U.S. Office of the Comptroller of Currency and Federal Reserve Board**

Rules to operationalize Basel II were effective from 1<sup>st</sup> April 2008. However the Advanced Internal Rating Based Model and operational risk Advanced Measurement Approach will be implemented from 2011.

**Swiss Banking Commission**

The standardized approaches for credit and market risks and the basic indicator approach for operational risk became effective from March 2008.

## State Bank of Pakistan

The standardized approaches for credit and market risks and the basic indicator approach for operational risk became effective from January 2008. The foundation IRB approach will be available from January 2010.

## South Africa Reserve Bank

All approaches under Basel II became available from 1<sup>st</sup> January 2008.

3. If your Home Supervisor has prescribed an approach to Basel II Implementation, has any provision been made in the policy for adoption of Basel II for the international operations of banking groups with regard to:-
  - + Minimum size of the balance sheet.
  - + Flexibility in selecting the approaches to Basel II implementation i.e. whether they can follow a different approach than the one adopted by their Head Office if allowed by the regulators in their country of operations.

All the home regulators allow for overseas operations to follow the approaches adopted by host supervisors. This leads to dual reporting to the home and host regulators. Three of the home regulators also allow flexibility in selecting the approaches to Basel II by the subsidiaries based on their materiality to group operations. In this regard, two of the international banks represented in Kenya are following standardized approaches adopted for African/emerging markets operations within their respective groups.

**Please indicate the significance of local banking operations in relation to the banking group**

All the seven institutions local banking operations constitute less than 3% in relation to the international banking group. They may therefore not be considered material/significant from a balance sheet perspective of their respective international banking group operations.

4. **Is the local banking operation subject to consolidation? If yes to which regional group or business line.**

Six of the seven institutions are consolidated to their international group operations while one is consolidated into the emerging markets group.

5. How is the local bank affected by the group's Basel II approach and implementation? Please specify changes needed with regard to:-

**(a) Information requirements**

Four institutions have had to upgrade their data systems to meet Basel II reporting requirements of their head office.

**(b) Risk strategies and policies.**

Two institutions had to upgrade their risk management policies and strategies to adhere to Basel II requirements.

**(c) Internal capital**

There has been no impact on the seven respondents though Internal Capital Adequacy Assessment Programmes (ICAAPs) have been implemented at Group Level. The ICAAPs are yet to be cascaded to the local subsidiaries/branches.

**(d) Disclosure requirement**

Disclosures of the seven respondents are currently being driven by Kenyan regulatory requirements and international financial reporting standards.

**(e) Others (specify)**

None specified.

6. Has a budget been set aside for Basel II implementation?

For all the seven respondents, a budget has been set aside at the group level. However only one institution has a specific allocation for the Kenya operations of USD 5 million (Approx Kshs. 350m)

7. If the answer to 6 is yes, what is the amount and does it cover the components indicated in the table below (Please tick as appropriate):-

Table IV: International Banks-Budget Components

	Component	Number of Institutions
1.	Capacity Building/Training	4

	Component	Number of Institutions
2.	I.T. Systems	5
3.	Others(please Specify)	
	External Consultants	1

The focus of Basel II budgets as indicated in Table IV above is on capacity building and I.T. systems.

8. What support is the local bank receiving from the group regarding Basel II implementation viz a viz the components mentioned in Question 7 above?

Table V: Group Support for International Banks

	Nature of Support	Number of Institutions
1.	Advise/Direction	5
2.	Global/regional Project Management Office	2
3.	Capacity Building/Training	3
4.	I.T. support	1

Local international banks subsidiaries and branches are mainly receiving advise, direction and capacity building support from their respective groups.

9. When will your bank be ready to implement Basel II?

Table VI: Basel II Implementation Readiness-International Banks

Year	Number of Institutions	Percentage (%)
2008	5	72
2009	1	14
2010		
2011		
2012		
After 2012		
As per Parent Bank/CBK Roadmap	1	14
<b>Total</b>	<b>7</b>	<b>100</b>

Most of the local affiliates of international banks (72%) are ready to implement Basel II.

Local Banking Groups { Banks that are not subsidiaries or branches of international and regional banking groups(This section also applied to regional banking groups whose Home Supervisor is the Central Bank of Kenya)}

24 out of the 31 respondents are local banking groups or regional banking groups whose Home Supervisor is the Central Bank of Kenya.

1. When will your bank be ready to implement Basel II

Table VII: Basel II Implementation Readiness-Local Banks

Year	Number of Institutions	Percentage (%)
2008	1	4
2009	3	12
2010	9	38
2011	4	17
2012	1	4
After 2012	4	17
As per CBK Policy	1	4
Undecided	1	4
<b>Total</b>	<b>24</b>	<b>100</b>

Majority of the local institutions (76%) will be ready to implement Basel II from 2010. This is in contrast to international banks, a majority (72%) of whom have indicated that they are ready to implement Basel II.

2. Have you conducted a self assessment to determine your readiness to implement Basel II? If yes, please briefly list the benefits and costs.

11 out of the 24 local institutions have conducted a self assessment to determine their readiness to implement Basel II.

**Benefits**

The key benefits of Basel II implementation were cited as follows:-

- Enhanced risk management (9 institutions).
- Optimal utilisation of capital (8 institutions).
- Compliance with international best practice. (5 institutions).
- Enhanced investor protection through adequate/appropriate controls and enhanced disclosures. (1 institution).

## Costs

The key costs of Basel II implementation were cited as:-

- Investment in I.T. software and hardware.(10 institutions)
- Training and acquisition of prerequisite human resources. (8 institutions).
- Consultancy services. (4 institutions).

### 3. Has a budget been set aside for Basel II implementation?

Only 3 out of the 24 local institutions have set aside specific budgets for Basel II implementation. 2 other institutions are actively considering a Basel II budget, while in one other institution investments in I.T. systems and training incorporate Basel II requirements.

### 4. If the answer to 3 is yes, what is the amount and does it cover the components indicated in the table below (Please Tick as appropriate):-

Two of the institutions have indicated their Basel II budgets to be Kshs. 9 million and 25 million respectively.

Table VIII: Local Banks-Budget Components

Component	Yes	No
Capacity Building/Training	3 institutions	
I.T. Systems	2 institutions	1 institution
Others(please Specify)		
Consultancy	1 institution	

The budget allocations are focused on capacity building/training and I.T. systems.

### 5. What do you think are the major constraints for your bank/financial institution in implementing Basel II?

The major constraints were indicated as:-

- Human Resource competences (16 institutions).
- Information Technology capabilities (14 institutions).
- Data availability, reliability and adequacy (7 institutions).

- Lack of external credit rating agencies (5 institutions).
  - Lack of regulatory guidance (5 institutions).
  - Low/limited capital (4 institutions).
  - Past legacy of institution (2 institutions).
6. Do you consider your bank/institution to have adequate resources (systems, skills, expertise, money and time) to deploy towards adoption of Basel II?

Table IX: Local Banks-Basel II Deployment Resources

	Number of institutions	Percentage (%)
Yes	10	42
No	14	58
<b>Total</b>	<b>24</b>	<b>100</b>

58% of the local institutions do not consider themselves to have adequate resources to deploy towards adoption of Basel II.

Local Institutions noted as follows:-

- A phased approach to implementing Basel II in Kenya would be recommended so that costs are spread out.
- Time will be needed for some institutions to raise additional capital to implement Basel II.
- There is need to assess critically what is needed for Basel II implementation and set funds towards this end.
- Some institutions will leverage on existing relationships to enhance capability to implement Basel II while others will seek to bring on board new strategic partners with the prerequisite resources.

**Basel II Project Management-For those banks that have commenced the Basel II implementation process**

This section was completed by all the 31 institutions and sought to establish the implementation structure particularly for banks that have commenced the Basel II implementation process.

**1. Has a steering committee been set up?**

5 out of the 31 institutions have set up Basel II Steering Committees. For 1 institution the Committee has been set up at the Group level while for another institution, the Risk Management Committee also doubles up as the Basel II Steering Committee. A number of institutions expressed their willingness and

readiness to form such a Committee upon issuance of a policy position on Basel II by CBK.

**2. Have Basel II implementation Sub-Committees been set-up?**

3 of the 5 institutions with Steering Committees have already set up Basel II implementation Sub-Committees.

**3. Have you acquired the services of any external consultant for Basel II implementation? If yes, what has been their role?**

4 of the 31 institutions have already acquired the services of external consultants for Basel II Implementation. Their role has been:-

- Capacity Building and Training.
- Development of Models.
- Sourcing of new I.T. systems.
- Diagnostic review.
- Advising on implementation planning.
- Review of Risk Management policies.

**4. International banking groups and regional banking groups (Whose home supervisor is not the Central Bank of Kenya) should briefly indicate the progress made in Basel II implementation at the regional/head office level.**

All the regional/head offices of the 7 international banks are already implementing the Basel II approaches based on the respective Home Supervisors' timetable. For some of the institutions, Basel II preparations started as far back as 2002.

**5. Is Internal Audit represented on the organization's Basel II Steering Committee?**

Internal Audit is represented in the Basel II Steering Committee of the five institutions that have already set up this committee.

**6. Has a formal Basel II training plan been developed for each business unit to ensure that staff have an understanding of the appropriate methodology?**

Only 3 out of the 31 institutions have developed formal Basel II training plans.

7. If the answer to 6 is no, when do you intend to develop the training plan?

Table X: Basel II Training Plans

	Year when training plan will be developed	Number of institutions	Percentage (%)
1.	2008	4	14
2.	2009	2	7
3.	Once CBK Basel II Policy is issued	3	11
4.	Not Decided	19	68
	<b>TOTAL</b>	<b>28</b>	<b>100</b>

Most institutions have yet to develop Basel II Training Plans but some (21%) are in the process of developing them in the course of 2008 to 2009.

## Pillar I-Minimum Capital Requirements

Pillar I requires banks to set aside capital for credit, market and operational risks.

This section was completed by all the 31 institutions.

### Credit Risk Charge

Banks are permitted a choice between two broad methodologies for calculating their capital requirements for credit risk. One alternative, the Standardised Approach is used to measure credit risk in a standardized manner, supported by external credit assessments. The other alternative, the Internal Ratings Based (IRB) Approach is subject to explicit supervisory approval. The IRB Approach allows banks to use their internal rating systems to determine the capital to be set aside for credit risk.

#### 1. What tools does your bank use to measure, assess, monitor & control/mitigate credit risk?

The tools cited are as per Table XI below:-

Table XI: Credit Risk Management Tools

	Tool	Number of Institutions
1.	Credit appraisal and monitoring	21
2.	Credit risk rating	12
3.	Credit policies, processes and procedures	10
4.	Credit scoring	2
5.	Models	2
6.	Stress testing	1

Most institutions have put in place credit appraisal and monitoring tools to measure, assess, monitor and control/mitigate credit risk.

#### 2. Does your bank use ratings from External Credit Rating Institutions in the credit assessment of borrowers? (including counter-party credit risk for treasury) If yes please indicate the name(s) of External Credit Rating Agency used.

The Standardized approach bases capital requirements for credit risk on ratings of borrowers by External Credit Rating Agencies.

All the institutions do not use external credit ratings other than for international banks, investment in debt instruments and large corporate counterparties. The Agencies whose ratings are used in this regard include:-

- Fitch.
- Moody's.
- Standard and Poor.
- Dun and Bradstreet.
- CRB Africa.
- Global Credit Rating.

3. Does your bank segregate its' loan portfolio into the following categories:-

- ✚ Sovereigns.
- ✚ Non Central Government.
- ✚ Public Sector Entities.
- ✚ Multilateral Development Banks.
- ✚ Residential and Commercial Real Estate.

The Standardized Approach requires segregation of loan portfolios into categories principally the ones listed above.

21 out of the 31(68%) banks categorise their loan portfolios into the categories cited above.

4. Does your bank require a charge for credit risk? If yes, is an internal model used in assessing the capital charge for credit risk?

Basel II allows institutions to use internal models for the determination of the capital requirements for credit risk. However the models have to be approved by the supervisor.

All the 31 banks set aside a charge for credit risk based on CBK Prudential Capital Adequacy requirements. However, only four banks also have internal models to determine the capital charge for credit risk.

5. If the answer to 4 is yes, please provide a brief description of the model indicating the number of years of loss data used and any challenges faced in use of the model.

Three institutions use models developed by their international parent banks. Two of the models are economic capital models, while one institution uses a model based on International Accounting Standard (IAS) 39. Two of the three

models require seven year data but one of the institutions can only access three years data. The key challenge noted was obtaining past data.

**6. If the answer to 4 is no, would your bank consider adopting such models in future?**

25 out of the 27(93%) institutions that do not use internal models would consider adopting such models in future.

**7. If your answer to 6 is yes, when would you be ready to adopt the model?**

The 25 banks would be ready to adopt an internal model as indicated in Table XXII below:-

**Table XXII: Credit Risk Internal Models**

	Year	Number of Institutions	Percentage (%)
1.	2008	1	4
2.	2009	5	20
3.	2010	11	44
4.	2011	Nil	-
5.	2012	4	16
6.	On development of model by parent bank	1	4
7.	Upon guidance by CBK	2	8
8.	Undecided	1	4
	<b>Total</b>	<b>25</b>	<b>100</b>

Majority of the institutions that do not currently use internal models would be ready to adopt them from 2010 (60%).

**8. If your answer to 6. is no, please indicate briefly your reasons for not adopting an internal model.**

Two institutions would not adopt an internal model for the following reasons:-

- Inadequate data.
- Inadequate core banking system.

9. Does your bank identify, measure, assess portfolio concentration risk per;
- Single group obligor?
  - Industry type?
  - Security type?
  - Internal/ External ratings, per type?
  - Geographical status?
  - 50 largest exposure concentration?
  - Credit product type?
  - Business lines?

The summary of institutions that measure portfolio concentration risk as per the indicators above is summarised in Table XIII below:-

**Table XIII: Portfolio Concentration Indicators**

	Portfolio Concentration Indicator	Number of institutions
1.	Single group obligor	31
2.	Industry type	30
3.	Security type	19
4.	Internal/ External ratings, per type	18
5.	Geographical status?	17
6.	50 largest exposure concentration	31
7.	Credit product type	24
8.	Business lines	24

Most institutions are already measuring portfolio concentration risk along the indicators in the table above. The indicator that appears to be least used to assess portfolio concentration risk is geographical status/location which is used by seventeen institutions.

10. If yes to 9, please indicate briefly how the data/information is obtained and utilised in response to concentration risk.

27 out of the 31 institutions obtain portfolio concentration risk information from their core banking systems. Another 4 obtain the information during credit appraisal and monitoring. Institutions utilise portfolio concentration information to:-

- Diversify the loan portfolio.
- Diversify exposure to different types of collateral.
- Ascertain credit portfolio quality.
- Diversify credit portfolio by geography.

- Analyse skew of portfolio to various borrowers.
- Limit exposures to risky product types e.g. overdrafts, unsecured loans.
- Monitor exposure to business lines.

11. If no please indicate if you would consider adopting a system to identify, measure and assess portfolio concentration risk.

All institutions in the survey have systems to identify, measure and assess portfolio concentration risk.

12. If yes when would you be ready to adopt this?

As per 11. above.

13. If no briefly state reasons for not adopting the portfolio concentration risk system.

As per 11. above.

14. Does your bank keep the following data warehoused electronically(in a central database) for purposes of use in measuring historical credit risk trends of;

- a) Probability of default (PD).
- b) Loss given default (LGD).
- c) Exposure at default (EAD).
- d) Portfolio at Risk (PAR).

Banks that have received supervisory approval to use the IRB approach under Basel II may rely on their own internal estimates of risk components in determining the capital requirements for a given exposure. The risk components include measures of the probability of default (PD), loss given default (LGD), the exposure at default (EAD), and effective maturity (M).

The summary of institutions that keep the data warehoused electronically is as indicated below in Table XIV:-

**Table XIV: Centralised Data Warehousing**

	Data Indicator	Number of institutions
1.	Probability of Default(PD)	3
2.	Loss Given Default(LGD)	3
3.	Exposure at Default(EAD)	6
4.	Portfolio at Risk(PAR)	9

Also is the said information used to forecast future expected losses i.e. EL

Only 2 out of the 31 institutions use the information to forecast future expected losses (EL) based on models developed at a group level.

15. If the answer to 14 is yes, please give a brief description of what duration this historical data is available.

Under the IRB approach, generally historical data for the past five years is required for estimation of PD, LGD and EAD.

One of the institutions forecasting EL based on an internal model has seven year data while the other has three year data.

16. If the answer to 14. is no, would your bank consider implementing such electronic centralised systems?

28 out of the 29 institutions who do not store all the indicators centrally would consider implementing such a system.

17. If yes, when will your bank be ready to adopt such a system?

The 28 banks would be ready to adopt an electronic centralised system as indicated in Table XV below:-

**Table XV: Adoption of Centralised Data Warehousing**

	Year	Number of Institutions	Percentage (%)
1.	2008	4	14
2.	2009	7	25
3.	2010	5	17
4.	2011	1	4
5.	2012	1	4
6.	On development of model by parent bank	1	4
7.	Upon guidance by CBK	3	11
8.	Undecided	6	21
	<b>Total</b>	<b>28</b>	<b>100</b>

50% of the institutions would be ready to adopt an electronic centralised system from 2009 to 2012.

**18. If no briefly give reasons for not adopting the system.**

One bank would not adopt the system as Loss Given Default (LGD) is very difficult to compute. Its' home regulator has discouraged all but the largest two banks in its' jurisdiction to go for an Internal Ratings Based Approach.

**19. Does your bank assess credit risk exposures for counter party treasury deals? And if yes, what methodology is used to assess these risks before accepting the exposures.**

27 out of the 31 banks assess credit risk exposures for counter party treasury deals using the methodologies set out below:-

- Credit Risk Appraisal-9 institutions.
- Analysis of financial statements-9 institutions.
- Internal Grading System-6 institutions.
- External Credit Agency Ratings-4 institutions.
- Market information/sentiments-4 institutions.
- Risk Ratings-2 institutions.
- Past Relationships-2 institutions.
- Judgement-1 institution.

**20. If the answer to 19 is no, would the bank consider adopting a model for assessing counter party treasury deals?**

All 4 banks not using models for assessing counter party treasury deals would consider adopting them.

**21. If the answer to 19 is no please give reasons why the bank would not implement such a model.**

See response to 20. above.

## Market Risk Charge

1. Please indicate the types of market risk that your bank is exposed to in the table below (Tick where applicable)

The Basel II framework defines market risk as the risk of losses in on and off-balance sheet positions arising from movements in market prices. The risks subject to this requirement are:-

- The risks relating to interest rate related instruments and equities in the trading book;
- Foreign exchange and commodities risk.

**Table XVI: Types of Market Risk Exposures**

	Type*	Number of Institutions
1.	Interest rate risk	31
2.	Foreign exchange risk	31
3.	Equity Position risk	8
4.	Commodities Risk	2
5.	Others ( Please specify)	
	Liquidity Risk	5
	Concentration Risk	2
	Credit Risk	1
	Collateral Risk	1
	Country Risk	1

All institutions are exposed to interest rate and foreign exchange risks.

2. Please indicate the types of reports used for the management of Market Risk in Table XVII below:-

**Table XVII: Market Risk Management Reports**

	Report	Number of Institutions
1.	Foreign Currency	23

	Report	Number of Institutions
	Exposure Report	
2.	Maturity Profile(Gap) Analysis	12
3.	Liquidity Analysis Reports	13
4.	Interest Rate Sensitivity	7
5.	Exposure Limits	5
6.	Value at Risk	3
7.	Stress Test	2
8.	Mismatch	1
9.	Deposit Maturity Analysis	1
10.	Investment portfolio report	1

Most institutions use foreign currency exposure and maturity profile/gap analysis (mainly used to monitor interest rate risk) reports to manage market risk.

**3. Does the bank have an established policy for allocating financial instruments to the trading (See glossary for definition of trading book) or non trading (banking book) as well as procedures to ensure compliance with such policy? If yes please give a brief description.**

Basel II requires institutions to put in place clearly defined policies and procedures for determining exposures to include in, and to exclude from, the trading book for purposes of calculating their regulatory capital. Compliance with these policies and procedures must be fully documented and subject to periodic internal audit.

17 out of 31 institutions have policies for allocating financial instruments to the trading and the banking book. The salient features of the policies include:-

- Stipulate procedures for investing, trading and the respective limits.

- Allocation to the trading or banking book is done at inception based on management intention based on three types of portfolios:-
  - Held to maturity.
  - Available for Sale.
  - Trading Portfolio.
- One international institution is required to have a policy on allocation to banking and trading books by its' Home Regulator.

It is noteworthy that 4 banks do not currently hold any trading books.

**4. How often does the bank mark-to-market its trading Portfolio?  
Briefly describe the valuation methods used.**

The frequency of marking to market is as per Table XVIII below:-

**Table XVIII: Frequency of Marking to Market**

	Frequency of mark-to-market	Number of Institutions
1.	Daily	8
2.	Monthly	10
3.	Quarterly	1
4.	Annually	1
5.	Periodically(Period Not Specified)	5

Most institutions mark-to-market their trading portfolios on a monthly basis.

The valuation methods commonly used are as per Table XIX below:-

**Table XIX: Mark to Market Valuation Methods**

	Valuation Method	Number of Institutions
1.	Yield Curve	4
2.	Comparison of Current Market Rate Against Coupon Rate	3
3.	Net Present Valuation	3
4.	Internal Models	2
5.	Gap Analysis	1
6.	Use of Stock Prices	1

	Valuation Method	Number of Institutions
7.	Accrual	1

5. Please indicate the types of debt securities and other financial instruments that your bank has in its' trading book in the table below:-

Table XX: Trading Book Financial Instruments

	Type	Number of Institutions
1.	Treasury bills	16
2.	Treasury bonds	20
3.	Preferred Stocks non convertible	Nil
4.	Swaps	5
5.	Futures	Nil
6.	Forwards	5
7.	Options	1
8.	<b>Others(Please Specify)</b>	
	Commercial Paper	2
	Corporate Bond	2

Most institutions hold treasury bills and bonds in their trading books.

6. Please indicate the types of foreign exchange transactions that your bank engages in the table below(please tick where applicable)

Table XXI: Foreign Exchange Transactions

	Type of Foreign Exchange Transaction	Number of Institutions
1.	Spots	27
2.	Forwards	15
3.	Swaps	12
4.	Options	5
5.	Futures	Nil
6.	Others(please specify)	
	Foreign Exchange Investments	1

Most institutions engage in foreign exchange spots and forwards.

**7. What tools does your bank use to measure, assess, monitor and control/mitigate market risks?**

Tools used to measure, assess, monitor and control/mitigate market risks are set out in Table XXII below

**Table XXII: Market Risk Management Tools**

	<b>Tools</b>	<b>Number of Institutions</b>
1.	Limits	27
2.	Maturity Profile(Gap) Analysis	7
3.	Liquidity Analysis Reports	13
4.	Interest Rate Sensitivity	10
5.	Value at Risk	3
6.	Stress Test	5

Most institutions use limits to manage market risk.

**8. Does your bank set aside a capital charge for market risk?**

Basel II requires banks to set aside a capital charge for market risk. This is similar to Basel I which incorporated market risk in 1996. It is noteworthy that this aspect of Basel I is yet to be adopted in Kenya. Market risk was not significant in the Kenyan banking sector in the 1990's but has grown in prominence in the recent past.

Only 5 out of the 31 banks set aside a capital charge for market risk. However one of the five institutions only sets aside capital on the interest rate risk of the trading book.

**9. If the answer to 8 is yes, is an internal model used in assessing the capital charge for market risk? If yes, please provide a brief description of the model.**

Banks can use internal models to determine their market risk capital charge subject to supervisory approval. All five banks use internal models. 4 of the models are Value at Risk based and are developed at the global head office of the banks.

10. If your bank is not currently using an Internal Model, would you consider adopting such a model in future?

24 out of the 26 banks not using internal models would consider adopting them in future.

11. If your answer to 10 is yes, when would you be ready to adopt the model?

The 24 banks would be ready to adopt internal models as indicated in Table XXIII below:-

**Table XXIII: Adoption of Market Risk Internal Models**

	Year	Number of Institutions	Percentage (%)
1.	2008	1	4
2.	2009	7	30
3.	2010	8	34
4.	2011	1	4
5.	2012	2	8
6.	On development of model by parent bank	1	4
7.	Upon guidance by CBK	2	8
8.	Undecided	2	8
	<b>Total</b>	<b>24</b>	

Most institutions (76%) would be ready to adopt internal models from 2009 onwards

12. If your answer to 10 is no, please indicate briefly your reasons for not adopting an internal model.

2 banks would not consider adopting the models for the following reasons:-

- One bank faces an insignificant market risk as it has no trading book.
- The other banks' core banking system cannot support such a model.

## Operational Risk Charge

1. What tools does your bank use to measure, assess, monitor and control/mitigate operational risk?

Operational risk can be defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events.

Table XXIV: Operational Risk Management Tools

	Tool	Number of Institutions
1.	Internal Controls(Segregation of duties, reconciliations, snap checks, policies and procedures)	28
2.	Internal Audit	11
3.	Risks and Control Self Assessment	7
4.	Business Continuity Plans	5
5.	Key Risk Indicators	5
6.	Incident/Risk Event Reporting	4
7.	Specialised I.T. Tool/Package	1

Most institutions use internal controls to manage operational risk.

2. Does your bank set aside a capital charge for operational risk?

Basel II requires institutions to set aside a capital charge for operational risk. There are three methods of computing the charge for operational risk: - (a) **Basic Indicator Approach**-The operational risk charge is computed as a percentage of gross income. (b) **Standardized Approach**-Banks' activities are divided into eight business lines and the capital charge is arrived at by multiplying the gross income for each line with an assigned factor (denoted beta). (c) **Advanced Measurement Approach (AMA)**-This is an internal model based approach.

In Kenya, there is no statutory requirement yet for an operational risk capital charge. However, seven of the surveyed institutions set aside a capital charge for operational risk.

3. If the answer to 2 is yes, is an internal model used in assessing the capital charge for operational risk? If yes, please provide a brief description of the model.

Basel II allows banks to use internal models to assess capital requirements for operational risk subject to regulatory approval.

Three banks use internal models to set aside a capital charge for operational risk. All three models are based on frequency and impact of loss events. Two of the models are developed at the global head office of the institutions.

4. If your bank is not currently using an Internal Model, would you consider adopting such a model in future?

26 of the 28 banks not using models would consider adopting such models in future.

5. If your answer to 4 is yes, when would you be ready to adopt the model?

The 26 banks would be ready to adopt internal models as indicated in Table XXV below:-

**Table XXV: Adoption of Operational Risk Internal Models**

	Year	Number of Institutions	Percentage (%)
1.	2008	Nil	Nil
2.	2009	3	11
3.	2010	11	42
4.	2011	1	4
5.	2012	1	4
	After 2012	1	4
6.	On development of model by parent bank	1	4
7.	Upon guidance by CBK	3	12
8.	Undecided	5	19
	<b>Total</b>	<b>26</b>	<b>100</b>

Most institutions (42%) would be ready to adopt operational risk internal models in 2010.

6. If your answer to 4 is no, please indicate briefly your reasons for not adopting an internal model.

The reasons for not adopting an internal model are:-

- Lack of data on operational losses.
- Cost of adopting an internal model.
- Inadequacy of the current core banking software.

7. Does your bank segment its' income along business lines? If yes please indicate the business lines applicable from the table below?

The standardized approach requires institutions to segment their activities into eight business lines: corporate finance, trading and sales, retail banking, commercial banking, payment and settlement, agency services, asset management and retail brokerage.

23 of the 31 institutions segment their income along business lines. Further details of the segmentation are given in Table XXVI below:-

**Table XXVI: Business Line Income Segmentation**

	<b>Business Line</b>	<b>Number of Institutions</b>
1.	Corporate Finance	12
2.	Trading and Sales	15
3.	Retail Banking	20
4.	Commercial Banking	17
5.	Payment and Settlement	15
6.	Agency Services	9
7.	Asset Management	8
8.	Retail Brokerage	5
9.	<b>Others(please specify)</b>	
	Asset Finance	2
	Business Banking	1
	Corporate Banking	2
	Treasury	2
	Microfinance	1
	Trade Finance	1

From Table XXVI above, it is indicative that whereas institutions are segmenting their income along business lines, their definitions vary from the ones stipulated by Basel II. The most common segmentations for surveyed banks are retail banking, commercial banking and payment and settlement.

8. If the response to question 7 is "yes" please indicate how far back (years) the information on income along business lines goes

The total capital charge under the standardized approach is calculated as the three-year average of the simple summation of the regulatory capital charges across each of the business lines in each year.

**Table XXVII: Segmented Business Line Income Data**

	Number of Years	Number of Institutions	Percentage (%)
1.	One	3	13
2.	Two	2	8
3.	Three	3	13
4.	Four	1	4
5.	Five	4	18
6.	Six	Nil	-
7.	Seven	1	4
8.	Over Seven	4	18
9.	Not Specified	5	22
	<b>Total</b>	<b>23</b>	<b>100</b>

57% of the surveyed institutions have income data segmented along business lines that goes back three years and more.

## Pillar II-Supervisory Review

This pillar of Basel II is intended to ensure that banks maintain capital holdings that are commensurate with their risk profile. There are four key principles of supervisory review:-

- **Principle 1:** Banks should have a process for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital levels.
- **Principle 2:** Supervisors should review and evaluate banks' internal capital assessments and strategies, as well as their ability to monitor and ensure their compliance with regulatory capital ratios. Supervisors should take appropriate supervisory action if they are not satisfied with the result of this process.
- **Principle 3:** Supervisors should expect banks to operate above the minimum regulatory capital ratios and should have the ability to require banks to hold capital in excess of the minimum.
- **Principle 4:** Supervisors should seek to intervene at an early stage to prevent capital from falling below the minimum levels required to support the risk characteristics of a particular bank and should require rapid remedial action if capital is not maintained or restored.

Principle 2, 3, and 4 relate to Supervisors and the survey focused on Principle 1 which relates to banks' Internal Capital Adequacy Assessment Process (ICAAP).

**Does the bank have an Internal Capital Adequacy Assessment Process (ICAAP)? If yes, does it have the features indicated in the table below:-**

9 out of the 31 surveyed (29%) institutions have ICAAPs. The other institutions are largely guided by CBK Capital Adequacy Prudential Guidelines.

**Table XXVIII: Internal Capital Adequacy Assessment Process (ICAAP)**

Feature	Number of Institutions
Targets future capital levels commensurate with risk appetite of bank	8
Integrated with performance management processes	7
Includes stress testing of earnings	8

Feature	Number of Institutions
(potential loss scenarios)	
Includes stress testing of asset growth	7
Includes peer group analysis	7
Focuses on Economic Capital requirements: <ul style="list-style-type: none"> <li>- Calculated by individual business units</li> </ul>	3
Capital buffer requirements and anticipated volatility	7
Analyses regulatory and economic capital volatility	5

### Pillar III-Market Discipline

Pillar III complements Pillar I (Minimum Capital Requirements) and Pillar II (Supervisory Review). It aims to encourage market discipline through disclosures that will enable market participants to assess the capital adequacy of institutions.

1. Does your bank have a formal disclosure policy approved by the board of directors that addresses the bank’s approach for determining what disclosures it will make and the internal controls over the disclosure process? If yes please give a brief description of the policy

Basel II requires banks to have a formal disclosure policy approved by the Board of Directors that addresses the bank’s approach for determining what disclosures it will make and the internal controls over the disclosure process.

Disclosure of all surveyed institutions is guided by regulatory, International Financial Reporting Standards and Capital Market Regulations for listed banks. Only 1 bank has a formal disclosure policy that is aligned to International Financial Reporting Standards.

2. Do your bank’s disclosures in the print media, at your premises and in the annual report incorporate the following:-

Basel II stipulates disclosures relating to the following key themes:-

- Capital Structure.
- Capital Adequacy.
- Risk exposure and assessment.

**Table XXIX: Market Discipline Disclosures**

	Description	Number of institutions
1.	<b>Capital</b> -A detailed description of the capital structure and the bank’s approach to assessing the adequacy of its’ capital to support current and future activities.	18
2.	<b>Risk exposure and assessment</b> -A detailed description of each separate risk area e.g. credit, liquidity and operational, banks,	

	Description	Number of institutions
	<p>risk management objectives and policies including:</p> <ul style="list-style-type: none"> <li>❖ Strategies and processes for risk assessment, measurement and mitigation.</li> <li>❖ The structure and organisation of the relevant risk management function.</li> <li>❖ The scope and nature of risk measurement systems and/or reporting.</li> <li>❖ Policies for hedging and/or mitigating risk and strategies and processes for monitoring the continuing effectiveness of hedges.</li> </ul>	<p>18</p> <p>18</p> <p>18</p> <p>17</p>

Well over half of the surveyed institutions are already disclosing some of the information under Pillar III pursuant to CBK, IFRS and Capital Markets Regulations.

#### 4.0 CONCLUSIONS AND WAY FORWARD

The survey results indicate a mixed level of preparedness of the Kenyan banking sector as far as Basel II implementation is concerned. The international banks, drawing on the support of their parent groups, are in a better state of preparedness compared to local institutions. However, there are also challenges in meeting requirements of Basel II that would impact on all banks. These are principally:-

1. The standardized approach to assessing the credit risk charge under Pillar I relies on ratings by External Credit Rating Agencies. The survey indicates that banks in Kenya do not rely on External Ratings save for their international counterparties and large corporate counterparties. This finding is consistent with the limited credit rating penetration in the country. Unrated exposures under the standardized approach would attract higher risk weights and thus more capital would be required to be set aside for such exposures.
2. Basel II allows for the use of internal models by banks to determine their capital charges pursuant to supervisory approval. However, these models require the use of up to five years data. Kenyan banks are by and large yet to adopt model based approaches to assessing their capital adequacy needs. Some international banks are however using models developed at their international headquarters. A transition period will therefore be required for Kenyan banks to collect the requisite data for the models.
3. Human resources competences have been identified as a cross cutting challenge. Basel II will require banks to upscale their human resource base and a "talent war" in the banking sector can be anticipated going forward.
4. Upgrades and overhauls of existing I.T. systems for most banks will be required. Robust, scalable systems will be required to ensure banks can meet the rigorous Basel II information requirements.

The challenges notwithstanding, it is noteworthy that most Kenyan banks are ready to embrace the enhanced risk and capital management practices that come with Basel II. In this regard, the Central Bank of Kenya is in the process of formulating a policy position on Basel II implementation in Kenya. This position will be informed by implementation of Basel II prerequisites, the survey results and input from market players. It is anticipated that the policy position will be shared with market players before its' adoption.

## Glossary

1. **Commodities risk** is the risk of holding or taking positions in commodities, including precious metals, but excluding gold (which is treated as foreign currency under foreign exchange risk).
2. **Concentration risk** is the risk of loss due to an overexposure to a specific debtor or group of related debtors in the same industry or country.
3. A **debt security** is a financial instrument usually issued in the form of a certificate, or alternatively in bearer form, which evidences a contractual obligation to make coupon (interest) payments and to pay a stated principal (redemption amount) on a stated future date or dates (the maturity date(s)).
4. **Equity position risk** is the risk of holding or taking positions in equities in the trading book.
5. **Expected Loss (EL)** is the loss that a bank expects to suffer in respect of a particular asset.
6. **Exposure at Default (EAD)** is the expected amount of exposure to a particular borrower at the point of default.
7. **Foreign Exchange Risk** is the risk of holding or taking positions in foreign currencies.
8. **Home Supervisor** is the regulatory or supervisory authority of the jurisdiction in which the "parent" of a subsidiary or branch of an international or regional banking group is based.
9. **Interest Rate risk** is the risk of holding or taking positions in debt securities and other interest related instruments in the trading book.
10. **Internal Capital Adequacy Assessment Program (ICAAP)**-Processes put in place by a banking institution to ensure that:-
  - ✚ Target levels of capital chosen are comprehensive and relevant to the current operating environment.
  - ✚ Target capital levels are properly monitored and reviewed by Senior Management; and
  - ✚ The composition of capital is appropriate for the nature and scale of the bank'

11. The **Internal Models Approach** enables a bank to use its proprietary in-house method to compute the credit, market and operational risks it faces. These models are however subject to the explicit approval of a bank's supervisory authority before they can be used in capital adequacy assessment.
12. The **Internal Ratings Based Approach (IRB)** is a credit risk measurement technique permitted under Basel II. IRB allows banks to use their own internal ratings of counterparties and exposures, subject to supervisory approval and review and strict disclosure requirements.
13. **Loss Given Default (LGD)** is the percentage of an exposure that a lender expects to lose in the event of obligor default.
14. **Mark-to-market** refers to the process of revaluing the price of a financial holding/instrument at current market prices.
15. **Portfolio at Risk (PAR)**-Proportion of a bank's loan assets that may not be repaid by borrowers.
16. **Preferred Stocks-Non Convertible**- Preferred stock is a class of share capital that carries a fixed return and ranks ahead of common stock in the order of priority for the distribution of earnings and assets. Preferred non convertible stocks cannot be converted to common stock.
17. **Probability of default (PD)** is the likelihood that an obligor will default on an obligation within a certain time horizon.
18. **Trading Book/portfolio** consists of positions in financial instruments which are held with trading intent and are free of any restrictive covenants in their tradability, frequently, and accurately valued and are actively managed.

## Annex I-List of Banks that Responded to the Questionnaire

1. African Banking Corporation Ltd.
2. Bank of Africa (Kenya) Ltd.
3. Bank of Baroda (K) Ltd.
4. Barclays Bank of Kenya Ltd.
5. CfC-Stanbic Bank Ltd,
6. Chase Bank Ltd.
7. Citibank N.A.
8. City Finance Bank Ltd.
9. Commercial Bank of Africa Ltd.
10. Consolidated Bank of Kenya Ltd.
11. Co-operative Bank of Kenya Ltd.
12. Credit Bank Ltd.
13. Diamond Trust Bank Ltd.
14. Dubai Bank Ltd.
15. Ecobank Bank Ltd.
16. Equatorial Commercial Bank Ltd.
17. Equity Bank Ltd.
18. Fidelity Commercial Bank Ltd.
19. Fina Bank Ltd.
20. Habib AG. Zurich.
21. Habib Bank Ltd.
22. Investment and Mortgages Bank Ltd.
23. Kenya Commercial Bank Ltd.
24. K-Rep Bank Ltd.
25. Middle East Bank Ltd.
26. National Bank of Kenya Ltd.
27. National Industrial Credit Ltd.
28. Oriental Commercial Bank Ltd.
29. Paramount Universal Bank Ltd.
30. Southern Credit Banking Corporation Ltd.
31. Standard Chartered Bank Ltd.

## **ENQUIRIES**

Comments and queries on this survey report can be addressed to:-

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