CENTRAL BANK OF KENYA

Supervision of Development Finance Institutions

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Outline

1. Structure of the Kenyan Financial Sector
2. Vision 2030 and DFIs
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4. Tenets of Effective Legal & Regulatory Systems
5. Overview of AADFI Prudential Standards
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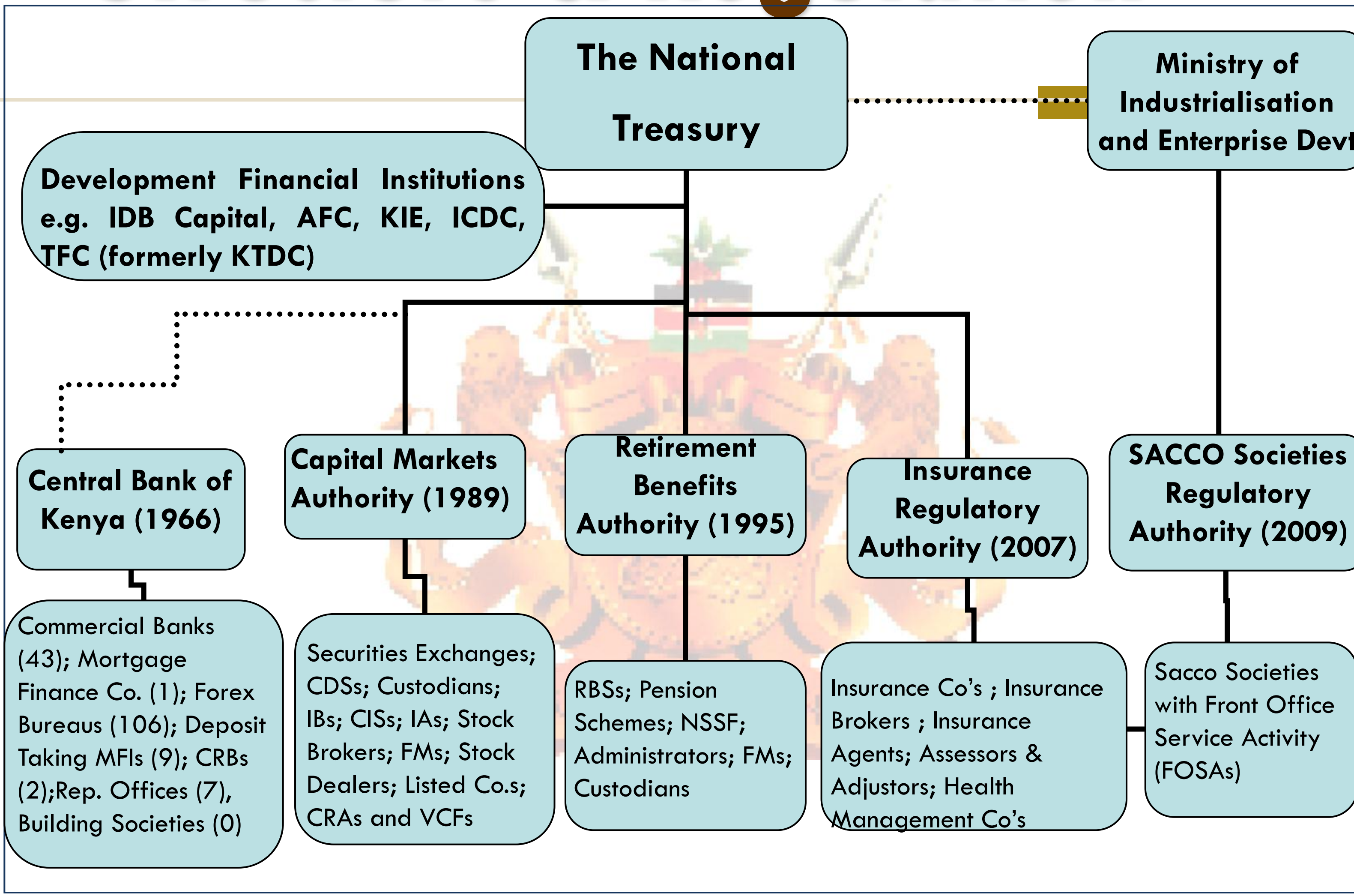
1. The Kenyan Financial Sector: Structure & Regulation



The DFIs are not under a direct regulator

2. Vision 2030 & DFIs

- Government of Kenya **long term development blueprint** aimed at:
  - ✓ ***Transforming Kenya into "a newly industrialising, middle income country providing a high quality of life to all its citizens in a clean and secure environment" by 2030***
- Vision for Financial Sector in Vision 2030: "***Create a vibrant and globally competitive financial sector***:"
  - ✓ Promoting high level of savings
  - ✓ Financing Kenya's investment needs
- It is only through concerted efforts of **all financial sector players** that a ***vibrant and globally competitive financial sector*** can be created
- DFIs are key players in the financial sector – They should provide long-term finance; provide SMEs with development finance
- A market for long-term finance with initiatives of credit information sharing will deepen and develop the financial sector

2. Vision 2030 & DFIs…

- Under Vision 2030, DFIs are expected to contribute towards enhanced **financial access** and **investment goals** (especially improving investors' access to long term finance)
- DFIs require capacity to grow and a regulator to grow the market
- DFIs expected to mobilise resources for long term lending to productive sectors of the economy
- For DFIs to play this role and fulfill market expectations, some ground rules should be set and finance allocated
- Targeted intervention for specific sectors or groups like SMEs, Youth, Women, etc will work even better with DFIs in control

3. History of DFIs in Kenya

- Some Kenyan DFIs converted to commercial banks in the1990s
- But the journey was not smooth. They had to re-convert back to DFI status in the early 2000s due to their inability to comply with the prudential requirements such as:
  - Undercapitalization - Minimum core capital requirement of Ksh.250 million not met
  - Violating lending limits – More than 25% of core capital limit lent to several borrowers
  - Excess foreign exposure limit – More than 20% of core capital limit exceeded due to large foreign funding for onward lending
  - High Non-Performing Loans level – 50% of loans not performing
  - High concentration risk – 95% of loans with top 50 borrowers
- The DFIs non-compliance with the prudential requirements could have mainly been driven by:
  - **Non-conformity** of DFIs primary mandate (long term lending) and the banking regulatory framework - Banking regulatory framework uniformly applicable to all banks with no exception
  - DFIs inability to mobilise long term local deposits to match profile of assets – Reliance on foreign credit lines to support mainly long term assets
  - Failure of DFIs to customise their policies & practices towards commercial bank orientation
  - Weak corporate governance structures – From years of lack of prudential guidelines
- Mandate of DFIs (Economic Development) and Commercial Banks (profit motive) at variance => there is therefore need to customise the regulatory frameworks
- There is a market for long-term finance to support firms in all sectors of the economy

4. Tenets of Effective Legal & Regulatory Systems

- An effective legal & regulatory framework should be commensurate with the risks posed to the financial system by the targeted players
- Such a legal framework should provide for:
  - minimum entry/prudential requirements, which are the basis for ongoing supervision, including core capital levels;
  - powers to address non-compliance; and
  - legal protection for supervisors
- Clear responsibilities and objectives for the supervisor(s)
- The supervisor(s) should possess operational independence and adequate resources
- Effective market discipline - financial transparency and effective corporate governance
- Procedures for the efficient resolution of problems in financial institutions - Supervisors should have sufficient and flexible range of procedures for efficient resolution of problems

4. Tenets of Effective Legal & Regulatory Systems…

- The most critical challenge - Overbearing regulation stifling innovations => Need for **Better Regulation**
- Better regulation is characterised by a regulatory framework with ability to:
  - ✓ readily identify weaknesses and emerging vulnerabilities;
  - ✓ analyse and price risks appropriately;
  - ✓ provide appropriate incentives (and penalties) to induce prudent behaviour in the market place; and
  - ✓ encourage innovations and develop strong institutions of the regulators and the regulated – strong institutions define appropriate rules and the appropriate incentives

- Regulators have a role to:
  - Guide markets to develop with safety, credibility and stability
  - Promote a hands-on approach to innovation. Being on the forefront to encourage innovation
  - Promote a dynamic collaborative relationship with market players

5. Overview of AADFI Prudential Standards

- The AADFIs standards will not only create a level playing field for DFIs but will also act as benchmarks towards the desired mandates
- The three pronged AADFI standards, has to a large extent incorporated a mix of an effective regulatory framework:
  - **Governance and Management Standards:**
    - Sufficient independence from Government
    - Management independence and commensurate incentives
    - Operating in accord with reasonable commercial principles
    - Proper accounting and auditing principles embraced
    - Appropriate Management Information Systems and procedures

5. Overview of AADFI Prudential Standards…

- **Financial Prudential Standards:**
  - Capital Adequacy – well capitalised DFIs better placed to withstand shocks
  - Profitability and efficiency – Profitable DFIs attractive to financiers and limited demand for additional public resources
  - Asset quality, diversify and safety – Contributes to stable financial sector
  - Liquidity and funding – Promotes a match of assets and liabilities
- **Operational Standards:**
  - Risk Management Policies – identification, monitoring and mitigation of all potential risks
  - Lending policies – Lending is the core business of DFIs. Appropriate lending policies (approval, disbursement, monitoring/supervision & collection) ensures sustainability of the business
  - Operations Strategy Policies – Ensures that DFIs operate within permissible boundaries as defined in the enabling legislations

6. The Way Forward for Kenyan DFIs

- DFIs role in financial intermediation (resource mobilisation & allocation) cannot be overemphasized:
  - ✓ The 5 DFIs (IDB Capital, ICDC, KIE, AFC and KTDC had lent a total of **Ksh.6.8 billion** (approximately **USD80.73 million**) as at June 2012
  - ✓ The targeted sectors include: Small & Medium Enterprises, Trade, Manufacturing, Tourism and Agriculture
- DFIs use public funds - targeted intervention case
- This role can only be effectively discharged by having some form of regulation & supervision
- A combination of prudential and market conduct regulation may be necessary
- Several countries including Tanzania, Nigeria, China, Swaziland and Korea already regulate and supervise DFIs. As a result, countries such as Kenya, need not reinvent the wheel
- It is a matter of customising the regulatory & supervisory frameworks to local circumstances

6. The Way Forward for Kenyan DFIs…

- An effective regulatory and supervisory framework should adequately address all potential risks
- The DFIs regulatory and supervisory framework should be tailored to suit their unique features, especially:
  - Economic development orientation
  - Long term structure of assets
- **Better regulation** as opposed to **more regulation** is key in building strong institutions, encouraging prudent market behaviour and incentivising the market
- Regulation and supervision must continuously evolve to keep pace with innovation

THANK YOU FOR LISTENING