

CENTRAL
BANK OF
KENYA



BANKI
KUU YA
KENYA

OVERSIGHT OF PAYMENT SYSTEMS IN KENYA

Policy Framework

JULY 2007

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1.0 OVERSIGHT OF PAYMENT SYSTEMS

1.10 General Provisions and acknowledgement

The purpose of this document is to define and disclose the objectives of the Payment System oversight policy performed by the Central Bank of Kenya. Although oversight of payment systems is a recent development, many countries now consider it a third core function of the Central Bank. In view of the more recent visibility of the subject, the Bank in developing this policy document has incorporated material from leading Central Banks such as the Bank of England, Central Bank of Bulgaria, Poland and Reserve Bank of South Africa among others as well as contributions from IMF consultancy reviews. The contributions of B.I.S, the World Bank, and the East African Monetary Affairs Committee (MAC) in the area of oversight have also been included.

1.11 Introduction

Payment systems are arrangements that facilitate funds transfers between parties in settlement of financial obligations. They consist of networks, which link participants, financial institutions the switches for routing financial messages together with appropriate rules and procedures that govern such systems. More specifically, a payment system requires:

- (a) Agreed technical standards for, and methods of transmitting, payment messages between members (ie agreement on the infrastructure to be used);
- (b) An agreed means of settling claims amongst members, normally a ‘settlement asset’, sometimes central bank money, a set of common operating procedures and rules describing participation, charging, etc.

Oversight, by definition refers to all activities aimed at ensuring the stability and efficiency of payment systems. The oversight function will regulate infra-structural components and the markets for the provision of payment services ensuring that they;

- Operate smoothly, efficiently and fairly in the interests of all participants and users;
- Minimize and control the risk of transmitting shocks through the economy arising from failures by individual participants to settle payment obligations;
- Pursue the level of technological and institutional development necessary to satisfy the payment needs of the economy.

In practice oversight serves to reflect and supervise changes in the pattern of payment flows through different payment systems and changes in the environment in which systems operate. For example, the increasing dependence of payment systems, on information technology and telecommunications networks gives rise to an increased exposure to hardware and software failure. Consequently, oversight places increased interest on this source of operational risk and

seeks to confirm that operators have taken reasonable steps to ensure the resilience of their systems. The Bank will therefore work with other authorities to ensure that Kenya's Payment Systems Service Providers and Operators make adequate plans to support continuity of operations and to respond effectively to actual or potential disruption. The Bank will not monitor day-to-day operational aspects of payment systems or seek to resolve day-to-day operational problems except where the Bank is itself operationally involved. Responsibility for the reliable functioning of payment systems lies with system operators and system members. The Bank's aim is to establish that operators have taken reasonable steps to ensure the robustness of their systems.

1.12 Importance of Payment Systems

Safe and efficient payment systems are essential to the working of financial markets and the economy. Specifically they:

- allow safe and timely completion of transactions. Companies use them when they buy or sell goods and services to facilitate exchange of payment obligations; individuals rely on them to receive salaries and for retail purchases; and Government depends on them to receive taxes and pay benefits.
- allow the customers of one bank to make payments to the customers of other banks. These interconnections mean that, in choosing a bank with which to hold their money balances, users can focus on the credit standing of the bank, the cost and quality of the services it offers and the terms of access. They need not worry about whether the people and institutions from whom they receive or to whom they make payments use the same bank.
- are used to settle transactions in money market instruments, bonds, equities, and foreign exchange. Financial market participants rely on them for timely funds transfer so that, they can settle subsequent, linked transactions.
- are used by Central banks in their Monetary Policy Operations.

1.13 Payment systems and public policy

Payment systems give rise to public policy issues in a number of areas. These include but are not limited to the structure of payment systems, their inter-connectivity and the implications for the stability of the financial systems as a whole. They also may raise concern about the efficiency and effectiveness of the Kenya's financial sector both domestically, in serving the needs of the economy and internationally, in terms of the attraction of Kenya as a place to undertake financial activities and attract Foreign Direct Investment. In working collectively with market participants, the Bank aims to promote improvements in the Kenyan payment and settlement infrastructure for the benefit of members and end-users. The Bank generally seeks to support market-led development but may, where necessary, take a more active part in

developing market initiatives or assume an operational role, as was the case in the Bank's proactive role in the automation of the Clearing House and the introduction of KEPSS, Kenya's Real-Time Gross Settlement System.

In the area of policy relating to competition, the Bank will continue to cooperate fully with the relevant authorities to ensure that a competitive environment is maintained and that any competitive abuses are curbed.

The autonomy of the oversight function, within this framework is fundamental and is premised on the principle that the oversight function calls for independence and objectivity on the part of the overseer and therefore requires adequate autonomy. It is envisaged that this oversight function will also cover entities that are not currently regulated by the CBK Banking Act as provided for in the Central Bank of Kenya Act.. An appropriate legal and institutional framework to facilitate this scope is critical and will require to be enacted. This will enable the Bank to undertake the oversight function effectively and independently in overseeing and regulating, systems within the Central Bank and in some cases outside the Bank's current mandate where such systems have direct impact on financial stability. It should be noted that the oversight function focuses on payment systems rather than institutions.

1.14 Payment systems and financial stability

Payment systems can expose their participants to financial and operational risks. Their interlinked nature implies that should one or more participants experience any form of system failure or malfunction it may induce direct and knock-on effects to other participants in a "domino-like" manner, extending perhaps beyond the system itself. This may also arise from operational failure or malfunction leading to unexpected financial exposures among participants. These disturbances are critical in large value payment systems that are used to settle wholesale financial market transactions in money, foreign exchange and securities markets. These transactions also tend to have time-critical settlement deadlines because they typically form part of a chain of transactions.

Even if the amounts transferred through a payment system are too small to give rise to systemic risk in the sense described above, the operational failure or malfunction of a system could still cause widespread disruption, especially if there are no ready alternative means of making payments. This **system-wide risk** could arise in relation to any System Wide Important Payment System (SWIPS). Oversight will seek to identify and designate such systems.

The mitigation of "Systemic Risk" is an important element of the CBK's undertaking oversight leading to the design and operation of an effective payment systems oversight framework. This

framework focuses on institutional foundations, operational objectives, and instruments and the organizational building blocks of an effective oversight function.

The Bank's role in this area was set out with the enactment of the CBK Amendment Act Section 4A(D) which empowers the Bank to *“formulate and implement such policies as best promote the establishment, regulation and supervision of efficient and effective payment, clearing and settlement systems”* This provided the Bank with the basis and authority/mandate to discharge its functions as a monetary authority and/or as overseer of payment systems thereby making oversight of payment systems an integral part of the wider responsibilities for monetary and financial stability. The focus of the Bank's oversight activities is to identify potential risks posed or introduced to the National Payments System, and to take necessary steps to eliminate or control them.

In developing an oversight framework care should be taken to ensure that the financial and technical integrity of the payment systems, their robustness against shocks, and overall efficiency are addressed through adherence to rules and standards, monitoring and enforcement. In this regard, the CPSS has laid out the core principles for Systemically Important Payments Systems (SIPS) that undertake high value / time critical payments which may contribute to systemic disturbances or risk. Such overarching principles will form the basis for Kenya's oversight function.

2.0 FOUNDATIONS OF OVERSIGHT FUNCTION.

Payment Systems Oversight is founded on the recognition that Payment Systems' technical and operational efficiencies determine the efficiency with which funds are circulated in the economy and the risks associated with its use. An efficient payment system serves to reduce the cost of exchanging goods and services and is critical to the robust and efficient functioning of the inter bank, money and capital markets. An inefficient payment system may stifle the stability and development capacity of an economy; its failures can result in inefficient use of financial resources, inequitable risk-sharing among agents, actual losses for participants and loss of confidence in the financial system.

2.10 The Bank's oversight role

Oversight of payment systems is a key element in the Bank's responsibilities for the stability of the financial system as a whole. As the values moving through payment systems keep increasing, their robustness and risk management have become issues of increasing importance. The Bank's oversight role relates closely to its operational role as the provider of the settlement asset (central bank money) to some payment systems and as the ultimate provider of liquidity to the banking system and to the economy. The Bank:

- is the settlement Bank for the ACH into which other sub-systems feed, and the KEPSS [RTGS] payment mechanisms;
- provides intra-day liquidity to members of KEPSS [RTGS] and ACH against eligible securities;
- Provides overnight liquidity as lender of last resort, to participants against eligible government securities;
- Is a member of a number of Kenyan payment systems, as banker to the government and other institutions as defined in the CBK Act.

2.11 The objectives of oversight

The Bank's main objective in overseeing payment systems is to promote their safety and efficiency. The system may be treated as safe if the risks incurred by the system are accepted as low; the system operator and its participants understand the consequences of, operational, credit, liquidity and systemic risk and are able to foresee, assess them, and apply appropriate risk management measures. The system is considered efficient if the services provided by it, meets user demands and its operations are performed quickly and at an effective cost to participants. Oversight thus seeks to ensure that sufficient weight is given to risk reduction and management in system design and operation.

2.12 The Bank's oversight in practice

The Bank's principal focus is on payment systems operating in, or with significant activity in Kenya together with cross border payment systems used by institutions operating in Kenya.

The Bank's oversight function will concentrate on systems that are likely to be exposed to systemic risk as they process payments that are individually or cumulatively of large value and can incur substantial involuntary exposures in carrying out their payment activities. Oversight will also focus on widely used systems even if the values involved generally may not give rise to major systemic disturbances or risks.

This function is spearheaded by the Banks' National Payment System Division in collaboration with Bank Supervision Department using all information available to the Bank directly, including through its provision of settlement services, and indirectly through exchanges with other relevant authorities such as the Capital Markets Authority (CMA), the Nairobi Stock Exchange (NSE) and utility service providers that include telecommunications and electricity firms. An enabling legal and institutional framework to support these converging functions and Institutions on payment systems shall be encouraged.

2.13 Risks in payment systems

Risks in payment systems take a variety of forms and are usually categorized as follows:

Credit risk -the risk that a counterparty will not meet an obligation for full value, either when due or at any time thereafter.

Liquidity risk -the risk that a counterparty will not settle an obligation for full value when due, but at some time thereafter.

Operational risk -the risk that hardware or software deficiencies, human error, internal controls, management failures or malicious attack will cause a system to break down or malfunction giving rise to credit, liquidity and operational risks.

Settlement Risk – The risk that settlement in a payment system will not take place as expected. This risk can involve both credit and liquidity risk. It can also arise as a result of operational risk..

Foreign Exchange Settlement Risk (Herstat Risk) – the risk that one party to a foreign exchange transaction does not receive the foreign currency it paid for.

Legal risk -the risk that unexpected application or interpretation of a law or regulation may lead to legal uncertainty that may leave the payment system or members with unforeseen financial exposures and possible losses because contracts cannot be enforced.

Oversight therefore is a public policy activity principally intended to promote the safety and efficiency of the National Payments System, and in particular to mitigate systemic risk while also reducing the overall risk profile of the National Payments System. All risks are required to be identified and, where possible, quantified and understood by payment system operators, participants, and the public. Oversight, may where appropriate propose changes to the rules, design or operation of a payments system, or to the environment in which such systems operates (e.g. the legal framework), in order to eliminate, reduce or better manage identified risks. A central aim is to achieve prompt final settlement in order to minimize the duration of financial exposure between participants, especially when the amounts involved are large. This was the motive, for example, for the introduction of the two clearing sessions of ACH and the implementation of Kenya Electronic Payment and Settlement System (KEPSS),

Before the introduction of KEPSS on July 29th 2005, settlement was undertaken on a deferred net basis under which banks exchanged payment messages during the day but settled the accumulated amounts at the end of the day. Until shortly before the introduction of KEPSS there were limited mechanisms to monitor or contain the risks that participants were exposed to. The introduction of the second clearing session enabled participants to settle large value

transactions in the course of the business day. Real-Time Gross Settlement (RTGS) allows payments among member banks to be made in real-time across their accounts held at the Central Bank of Kenya with participants receiving notification of payments if, and only if, final settlement has occurred.

A further pivotal aim of the Bank is to achieve Payment versus Payment (PvP) and Delivery versus Payment (DvP) in the settlement of wholesale foreign exchange transactions and securities transactions respectively. The implementation of KEPSS enhanced the capability to integrate with the CDS ultimately facilitate achievement of the Delivery versus Payment and Payment versus Payment objectives.

Reducing operational risk involves addressing technical reliability and redundancy, back-up facilities and contingency plans, security measures, risk concentration (such as over-reliance on a common technology supplied by third party) and internal controls. Oversight is intended to ensure that system operators recognize these issues and provide adequate measures that are acceptable to the CBK to address them.

The existence of “**Zero hour rule**” risk can also arise from legal uncertainty or expected legal decisions that may require recipient of a payment to return funds to the payer because a court decides that the payment is not final. Oversight will involve working with Government and other relevant authorities to identify and where possible, initiating changes to law in order to remove any legal ambiguities

3.0 THE BANK’S ROLE UNDER THE FINANCIAL MARKETS AND INSOLVENCY (SETTLEMENT FINALITY) MAC DIRECTIVES

One major objective of oversight is to enhance public confidence in the payment system. Settlement finality is key to this objective.

The bank’s oversight activity will therefore seek to highlight, inter alia, legal risks or the risk that a weak legal framework or unexpected interpretation of legislation could cause unforeseeable financial losses to the operator or participants of a payment or settlement system.

In doing this, the bank will be guided by international best practice and MAC directives that may be issued from time to time in the context of Payment Systems Harmonization within East Africa.

4.0. CO-OPERATION AND CO-ORDINATION WITH OTHER AUTHORITIES

4.10 Domestic Perspective

Various components of payment systems are inter-linked either directly or indirectly. Their individual operations are affected by the activities and risk management policies and practices of its participants together with those of participants customers. The Bank and the financial sector together with stakeholders are required to establish an information sharing, and reporting mechanism in order that all applicable information relevant to the discharge of their respective responsibilities will be shared fully and freely in order to ensure that actions taken neither cuts across, or contradicts the objectives of others.

4.20 International perspective

The three East African Central Banks¹ now oversee their National Payment Systems independently. Continuing co-operation among the three Central Banks is particularly important, in the development of uniform oversight procedures that will lead to joint oversight programs and information sharing relating to their oversight role. Future ongoing cooperation will lead to the development and publishing of a joint common statement, setting out the payment system oversight framework that will be followed by the East African Central Banks.

In addition, the Bank will be advised and guided by International Monetary Fund's (IMF) "Code of Good Practices on Transparency in Monetary and Financial Policies", that illustrates desirable transparency practices to be followed by Central Banks in their conduct of their financial policies, including the oversight of payment systems. This oversight policy document will thus be availed to the public in compliance with the IMF's disclosure recommendation.

5.0 THE BANK'S ROLE IN DESIGNATING SYSTEMICALLY IMPORTANT PAYMENT SYSTEMS

The Bank will maintain the responsibility to designate payment systems in accordance with the BIS Core Principles for Systemically Important Payment Systems. The Bank will have regard to systemic risk in all cases when determining whether or not to make a designation order.

Designated payment systems will be required to fulfill the following criteria but not be limited to;

- Provision of advance notice to the Bank of any significant changes
- Demonstrate to the Bank that the system maintains adequate risk-control and risk-sharing mechanisms together with any other risk mitigation measures considered appropriate, especially systemic risk, that may be associated with its operations.
- Be subject to directives and determinations issued by the Bank from time to time.

¹ Kenya, Tanzania and Uganda.

- Undergo Audits and inspections by the Bank regarding their internal controls and any other matters considered necessary by the Bank to carry out its oversight responsibilities.
- Prepare and forward rules that are legally enforceable and are protected from legal challenges based on the statutes or laws of Kenya.

6.0 GENERAL AND OPERATIONAL OBJECTIVES OF OVERSIGHT

The Bank's general and operational objectives as set out in the annexed table III may be discussed under the following sub-headings.

6.10 Framework for payment system oversight.

6.11 Safety and Efficiency

The Bank's oversight role stems from the realization that a safe and efficient payments system infrastructure in all domains that would include communications; information and financial transactions is essential to enhance the international competitiveness and efficiencies of Kenya's expanding economy.

6.12 Prevention of Market Abuse

Oversight activities will include the protection of participants and users from non equitable service provider contractual provisions that limit consumer choice and ensure that the payment services offered are in compliance with the law while promoting the free operation of market forces in the payments system to encourage competition and openness for the entry of new operators.

6.13 Fairness

Oversight will also aim at ensuring that payment systems are fair, in that, the rights and obligations of parties to the funds transfers are allocated in an equitable manner to ensure a common platform for all participants.

6.14 Extension of payment Services

Oversight will develop and encourage the geographic and regional extension of payment services to both rural and urban areas. The bank will encourage participants to cooperate in both the formal and informal financial sectors to broaden the availability of payment system services in a manner that is beneficial to the nation.

6.15 Protection from Criminal Abuse

Oversight seeks to protect payment system components that may include, electronic money instruments and the Internet, from criminal abuse such as their illegal use for purposes including money laundering and fraud. Oversight will undertake to extract, and manage

payment system statistics and other information that would be made available for crime detection purposes, while ensuring fundamental privacy principles.

6.16 Cooperation

The oversight role will emphasize mechanisms and frameworks that enhance cooperation between the Bank and participants, and among payment systems service providers. The NPS operations committee is an example of one such means of achieving cooperation among payments systems stakeholders in Kenya. Maintaining such cooperation guarantees the mutual exchange of information and subsequent action considered necessary for each appropriate entity to intervene promptly when necessary.

6.17.0 Legal Foundation of the Payment System

The Bank's oversight role recognizes that the legal framework affects efficiency, reliability, safety and stability of the payments system. Additionally, the legal framework also affords the protection of participants, and users from unfair rights allocation and criminal abuse.

Payments system oversight seeks to establish and encourage legal rules, regulations and procedures that govern the transfer of money, in a manner that serves the best interest of commercial parties who use the payment system, and the Bank to settle their financial obligations in a predictable, timely, safe and efficient manner.

Such a legal foundation should be built around the following principles, which help to achieve legal certainty and enforceability of settlement and settlement finality respectively;

6.17.1 Firm establishment of law

The payments system law governing funds transfers should take the form of a statute.

6.17.2 Accountability of the institutions involved in funds transfers

Institutions shall be held responsible for their own behavior, and actions. The rule of law shall override relationships among parties.

6.17.3 Integration with other bodies of law

The payments system law shall be part of the broad commercial and bankruptcy framework. Accordingly rules, concepts and incentives created by the different components of the overall legal framework must be mutually consistent.

6.17.4 Fraud Prevention

Appropriate safeguards must be implemented that create incentives for all payments system participants to exert reasonable care in managing, processing, and executing funds transfers.

Security procedures should be well designed based on negotiation among participant parties. Written account of these agreements shall be maintained.

6.17.5 Supporting the Financial Markets

The developed legal framework should anticipate, and address itself to the future needs of the financial community.

The CBK oversight role will include supporting and advising law-making authorities, in developing and strengthening payment system legal provisions that broadly incorporate the above principles

In general, the oversight function should itself be inscribed in the law clearly describing its purpose, prerogatives and powers in legal statutes, laws or parliamentary Acts.

7.0 INSTRUMENTS OF OVERSIGHT

In conducting the oversight function, the Bank will employ the following tools, but not be limited to:

7.11 System registration

The objective of system registration is to legalize the operation of the system and disclose information on these system participants, thus forming the conditions for assessment and monitoring of registered systems.

The Bank shall take a decision on the registration of a system or revocation. The Bank reserves the right to refuse system registration and communicate the circumstances under-pinning the decision.

7.12 System assessment

The objective of system assessment is to determine the system's compliance with the BIS Core Principles for Systemically Important Payment Systems, recommendations for Securities Settlement Systems, and standards, principles or recommendations established by the Bank, the MAC and other international financial organizations.

The system assessment methodology shall contain the desired system assessment process and parameters.

7.13 Regulations and Incentives

The overarching aim is to:

- Define organizational, functional and technical features of all payment systems.

- Establish infrastructural security standards e.g. information transfer, use of intraday liquidity and queues, cancellation of payments, account reconciliation, encryption, back-up etc.
- Apply set criteria for technical security that meets with internationally acceptable standards.
- Define access criteria, business conduct, and consequences for non-compliance by participants.
- Ensure arrangements are in place to cater for “failure to settle” circumstances by introducing loss sharing and liquidity sharing mechanisms in the event of illiquidity or insolvency by any participant.

7.14 Policy dialogue

Oversight will seek to promote dialogue and cooperation with all payments system stakeholders with a view to creating consensus for policy choices. This approach will provide the Bank with a mechanism to exert moral suasion and to develop the policy agenda by using feedback from the market to assess the efficiency, reliability and fairness of the payment services delivered by a payments system.

Through policy dialogue, the Bank will also seek to encourage self-regulation by Service Providers as this would complement the Bank’s oversight role especially with regard to determining access rules and sanctioning misconduct.

7.15 Monitoring

The oversight role will involve periodic examinations relating to the system integrity by the technical and risk-management infrastructure (including back-up facilities). This will also involve requisitioning for selected information from system participants.

Information may also be obtained through regular off-site data reporting by participants and system operators together with on-site inspections, on-line monitoring of real-time payment and settlement flows and of risk levels across the payments system.

7.16 Analysis

The Bank will analyze data and information to develop a greater knowledge and awareness of the weaknesses and developmental needs of the payments system across its various dimensions (i.e. legal, operational, financial, and technological). The Bank, will also analyze market developments in payment systems. The scope of the analysis embraces not only publicly accessible media but also specifically requested material together with complaints and court rulings in the field of payment systems.

7.17 Direct provision of Services

In undertaking the supervision of the Nairobi ACH and KEPSS, the Bank shall fulfill its oversight responsibilities in relation to Systemically Important Payment Systems.

7.18 Surveys

The Bank will conduct market surveys in order to obtain information considered complimentary to its oversight activities. This activity is of particular importance when compiling payment statistics.

7.19 Contact with Market players.

The Bank will hold meetings directly with market participants, and associations involved in the banking and financial industry at appropriate levels. It will also participate in events organized by the banking and financial industry and mount its own conferences, seminars and working meetings. Where necessary, Technical Working Groups (TWG) will be constituted to address specific payments system subjects.

The above activities are aimed at achieving the right mix of competition and cooperation of payment systems together with achieving the core objectives of safety, efficiency and reliability.

7.20 Targets of Oversight

The oversight function of the bank is aimed at achieving the following operational targets:

- Access and availability;
- Efficient and Reliable Technological platform;
- Risk management and control;
- Information Transparency;
- Pricing; and
- System viability

7.21 Access and Availability

Oversight ensures that access and availability is controlled in order to protect the systems and their stakeholders from participation by institutions that might expose them to excessive legal and operational risks. Defining minimum eligibility criteria will be necessary to ensure that participants possess the reputation, financial, governance, technical, risk mitigation and operational requisites as well as the business commitment to operate within the set standards.

The oversight function will also ensure that incumbents do not erect economic, technical and legal barriers to potential entrants or discriminate against themselves.

7.22 Efficient and Reliable Technological platform

Oversight ensures that the technological operating platform in terms of both hardware and software is in line with current international standards and that adequate support arrangements are in place to promote their efficiency and reliability.

7.23 Risk management and Control

Payment system risks which are financial, operational or legal in nature increase with the volume, value and composition of financial transactions made possible by the advance of technology. The speed with which funds settlement takes place may also increase incidence of the above risks.

Oversight will seek to ensure that participants adopt consistent methods to manage their risks and that systems have adequate incentives and safeguards against excessive risk exposures experienced by individual participants. Collective action by participants in this area which ties the risk profile of each participant to the behavior of others will be encouraged

7.24 Information Transparency

- This is important for both competition and stakeholders' protection. Oversight will therefore encourage participants to inform users of all relevant aspects concerning legal, operational, financial and cost profiles of their services by regularly disclosing updated information on their financial and technical status, performance together with their risk profile.
- Appropriate information channels will be established to collect service information and evaluate complaints from users that will be conveyed to the System Operator / Provider for corrective action.
- Information sharing with independent external expert payment system evaluation bodies is another dimension that oversight will employ to enhance transparency.

7.25 Pricing

Oversight will be directed at monitoring the evolution of pricing policies across payment systems to ensure that pricing practices are fair to operators, users and beneficiaries of payment system services.

7.26 Viability of the system

Oversight will confirm that Payment and Settlement Systems have adequate early warning procedures guarding against abnormalities across the payments system and have tested

emergency procedures in place that would allow them to operate smoothly at all times while ensuring resilience to operational disturbances.

8.0 OVERSIGHT ENFORCEMENT TOOLS

The Bank will employ oversight enforcement tools, that include but not be limited to participation in payment system meetings, moral suasion, publication of reports, disclosure of system assessment results, encouraging good governance/self regulation, requiring special external legal/ audit opinions, regulation, planned onsite inspections and cooperation with other authorities maintaining appropriate legal authority.

9.0 SCOPE OF PAYMENT SYSTEM OVERSIGHT IN KENYA

Oversight of Payment Systems, in Kenya, will encompass both high value (Wholesale) and low value (Retail) payment systems and services including the Bank's own internal systems, the Automated Clearing House, KEPSS, Securities Clearance and Settlement Systems and other payment systems that will be designated from time to time.

10.0 OVERSIGHT BENCHMARKS FOR KENYA

The function as described in this oversight document seeks to ensure that all payment systems optimize their provision of services to the economy as they develop over time. Specifically, it seeks to counteract undesirable activities and developments in the banking and financial services sector which may endanger the safety of the assets entrusted to institutions, impair the proper conduct of banking business or provision of financial services or involve serious disadvantages for the national economy.

The execution of the oversight functions, illustrated in this document are guided by the provisions of the BIS CPSS Core Principles for Systemically Important Payment Systems together with the responsibilities of the Central Bank, EMV standards and the IOSCO recommendations for the securities clearance and settlement system. Oversight activity aims at establishing compliance, by Kenya's payment systems, to these principles that requires payment system operators to take all reasonable measures to achieve full compliance. These principles are set out in <http://www.bis.org/publ/cpss43.htm> and <http://www.bis.org/publ/cpss42.htm> respectively. The brief role of the CBK oversight in relation to BIS CPSS core principles is described in annex tables I & II.

11.0 REPORTING OVERSIGHT ACTIVITIES OF THE BANK

The Bank will provide a summary of its payment systems oversight activities developments relating to Kenya's National Payment Systems in its Annual report. Technical oversight reports will be prepared regularly and presented to the NPS Operations Committee. Information that may enhance the effective functioning of the other departments of the Bank and other

institutions shall be handled with promptness. The Bank will, from time to time, also disseminate information of a general nature to promote public awareness on the developments in Kenya's National Payments Systems using appropriate media including; Bank Kuu Newsletter, the Print and Electronic media, professional journals, the Monthly Economic Review and the CBK website.

12.0 Principles for Effective Oversight Function.

In the conduct of the oversight function, the Bank will be guided by the following set of standards and assumptions, which foster oversight effectiveness:

- a) that the Bank is vested with the responsibility of overseeing domestic payment systems and cooperating with domestic and international regulatory/supervisory institutions involved in payment system matters and that the bank has clear legislative authority to carry out the oversight function.
- a) that the Bank shall commit adequate resources for the unit conducting oversight, staffing it with skilled professionals to deal with the composite dimensions of oversight and to carry out effective dialogue with the various parties involved in payment systems operations. Adequate intelligence resources will also be provided for effective system research and analysis. The Bank shall ensure the safe and efficient functioning of the Clearing and Settlement Systems that it operates. It shall also periodically review the design and functioning of such systems. The Bank shall make its National Payment Systems oversight strategy available to all participants and ensure that participants and service providers act transparently by publicly disclosing its objectives and policies. This principle forms the basis for this policy framework, and other policies that the Bank may publish from time to time.
- c) the Bank shall refrain from undertaking payment activities that the private sector can perform more efficiently. It will promote competition in the market for payment services by encouraging the private sector to take initiatives that enhance this objective.
- d) the Bank shall strive to ensure that all payment systems are both suitable and appropriate to serve the economy's needs and have capacity to operate safely even in conditions of exceptional contingencies and market distress.
- e) the Bank shall also ensure that domestic payment systems meet users' needs, both in terms of the range of payment instruments, services delivered, and territorial extension.

13.0 TABLES

Table: I Core Principles for Systemically Important Payment Systems: CBK Objectives & Actions		
No.	Principle Description	Central Bank Oversight objectives(s) and action(s)
1.	The System should have a well founded legal basis under all relevant jurisdictions	To ensure rules and procedures of system are enforceable predictable and clearly understood by all participants within the relevant jurisdiction such as law relating to contract, payments, securities, banking, debtor/creditor relationships and insolvency.
2.	The system's rules and procedures should enable participants to have a clear understanding of the system's impact on each of the financial risks they incur through participation in it.	To ensure that the rules and procedures define clearly the right and obligations of all the parties involved and all parties should be provided with up-to-date explanatory material. Key rules to financial risk should be publicly disclosed.
3.	The system should have clearly defined procedures for the management of credit risks and liquidity risks, which specify the respective responsibilities of the system operator and the participants and which provide appropriate incentives to manage and contain those risks.	To ensure the rules allocate responsibilities for risk management and containment and that limits are placed on the maximum level of credit exposure that can be produced by each participant especially in netting systems. Rules on pre-funding collateralizing obligations together with implementation of real-time processes will be of interest to the bank.
4.	The system should provide prompt final settlement on the day of value, preferably during the day and at minimum at the end of the day.	To ensure that appropriate mechanism (e.g. liquidity management, exposure limits, appropriate laws and real-time processes) exist to facilitate and support finality and irrevocability of settlement.
5.	A system in which multi-netting takes place should at a minimum be capable of ensuring the timely completion of daily settlement in the event of an inability to settle by the participant with the largest single settlement.	To ensure that the system has strong controls to address liquidity and credit risks that may arise from failure of the largest single net debtor to the system. Provisions for access to liquidity in adverse circumstances should be emphasized.
6.	Assets used for settlement should preferably be a claim on the central Bank; where other assets are used, they should carry little or no credit risk and little or no liquidity risk.	To ensure that settlement is effected using balances at the Central Bank since they lack credit or liquidity risk for the holder. Settlement in commercial bank claims should ensure that there is little or no financial risk. Legally off-setting of balances may be explored to minimize exposure.

7.	The system should ensure a high degree of security and operational reliability and should have contingency arrangements for timely completion of daily processing.	To ensure that the system has commercially reasonable standards of security and high degree of operational resilience. Reliable technology, adequate backup of hardware, software and network facilities as well as effective business procedures and well-trained and competent personnel are key ingredients that oversight will seek to establish.
8.	The system should provide a means of making payments, which is practical for its users and efficient for the economy.	To ensure that the system is cost effective and compatible or appropriate for the country's geography, population distribution and infrastructure such as telecommunications, transportation and banking structure. The system's technical, business and governance arrangements are flexible to respond to changing demands.
9.	The system should have objective and publicly disclosed criteria for participation, which permit fair and open access.	To ascertain that the access to the system encourages competition but protects systems and participants from exposure to excessive legal, financial and operational risks. System rules should clearly specify criteria and procedures for orderly entry and withdrawal of a participants form the them. Access criteria should thus be objective and publicly disclosed to interested parties.
10.	The system's governance arrangements should be effective, accountable and transparent.	To ascertain whether system participant's management have incentives to pursue objectives that are in the interest of the participants and their customers and that all interested parties have access to information about how decisions affecting system are made with due consideration accorded to the other BIS core principles.

Table II: Core Principles for Systemically Important Payment Systems/: CBK Responsibilities

	Description	CBK Action
A.	The Central Bank should define clearly its payment system objectives and should disclose publicly its role and major policies in respect to systemically important payment systems.	Through various instruments the Bank will define and publicly disclose clearly understood major policies that affect payment system operations and users to ensure safety and efficiency in payment systems. The Bank's role as owner, operator, overseer, settlement institution and liquidity provider should be disclosed publicly. Matters relating to charges system down times, the cut off times, costing methods and governance principles should also be disclosed.
B.	The Central Bank should ensure that the payment system it operates comply with the Core Principles.	The Bank will ensure that systems such as KEPSS and ACH comply with the core principles. Particularly on issues of risk information and control; settlement asset and preferably claim on central bank and governance arrangements.
C.	The Central Bank should oversee compliance with the Core Principles by systems that it does not operate and it should have the ability to carryout oversight.	The Bank will put in place the necessary resources to facilitate conduct of an impartial oversight role, particularly reviewing and evaluating the design and operations of SIPs and continuous basis. This role is founded
D.	The Central Bank, in promoting payment system safety and efficiency through core principles, will cooperate with other Central Banks and with any other relevant domestic or foreign authorities.	The Bank's oversight role will encompass cooperation with legislative authorities, Ministry of Finance, and other stakeholders in order to achieve public policy goals and ensure overall stability of the payment system. This complementary relationship among oversight agencies may be enhanced by regular exchange of views and information within a pre-agreed framework.

Table III: CBK Payment System Oversight Framework

The table below visualizes the framework for payment system oversight.

Role of the Bank as Payments System Overseer	<ul style="list-style-type: none"> • Develop principles and rules • Assess/enforce rule compliance • Promote/coordinate individual and collective action • Ensure system functioning • Promote system development 		
Operational Objectives	Development of efficient, reliable, safe and stable payment systems Prevention of market abuse Extension of payment services Prevention of criminal abuse		
Intermediate Objectives	<ul style="list-style-type: none"> • Promote competitive market conditions • Enhance Cooperation • Achieve Sound Legal foundations. 		
Instruments	Targets	Scope of Action	Types of Action
<ul style="list-style-type: none"> • Rules and incentives • Policy dialogue • Monitoring • Analysis • System governance • Direct service provision 	<ul style="list-style-type: none"> • Access • Risk control • Information transparency • Pricing • System viability • System development 	<ul style="list-style-type: none"> • Service providers, participants, and users • Instruments and services • Technical infrastructures 	<ul style="list-style-type: none"> • Structural • Routine • Crisis management • R & D • Resource mobilization

14.0 GLOSSARY OF TERMS AND ABBREVIATIONS

In this document, unless the context otherwise requires,

“**ACH**” (the Automated Clearing House). This is an electronic clearing system in which payment orders are exchanged among financial institutions, primarily via magnetic media or telecommunication networks and handled by a data processing center.

“**The Bank**” means the Central Bank of Kenya

“**BIS**” means the Bank for International Settlements

“**CBK**” means the Central Bank of Kenya

“**Clearing and Settlement System**” means a set of procedures whereby financial institutions present and exchange data and/or documents relating to funds or securities transfer to other financial institutions at a clearinghouse. The procedures often also include a mechanism for the calculation of participants’ bilateral and/or multilateral net positions with a view to facilitating the final settlement of their obligations.

“**CPSS**” (Committee on Payment and Settlement Systems). It is a forum for the central banks of the Group of Ten countries (G10) to monitor and analyze developments in domestic payment, settlement and clearing as well as in cross-border and multi-currency schemes.

“**CSDS**” (Central Securities Depository System). An institution for holding securities that enables securities transactions to be processed by means of book entries. Physical securities may be immobilized by the depository, or dematerialized so that they exist only as electronic records.

“**Designation of Payment System**” means the declaration of a payment and securities system as systematically important payment system based on defined minimum standards that designated systems will be expected to meet in order to adequately control systemic risk.

“**DVP**” (Delivery Versus Payment). It is a link between securities transfers and funds transfers that ensures that final transfer of securities or other financial instrument occurs if, and only if payment occurs.

“**EFT Act**” means the proposed Electronic Funds Transfer Act. **(This is not in place yet)**

“EMV” means Europay, Mastercard and Visa. These three companies merged to one entity; EMV Co, that sets standards and guidelines for card businesses.

“IOSCO means the International Organization of Securities Commissions”. The organization has the principles/recommendations to be adhered to in order to achieve safety, effectiveness and efficiency in securities training

“KEPSS” (Kenya Electronic Payment and Settlement System). This is a Real Time Gross Settlement System for Kenya Inter-bank exchanges that facilitate continuous settlement of large value transfers of funds instructions in central bank money on a gross basis.

“MAC” (Monetary Affairs Committee). This is a committee of the three East Africa Central Bank Governors.

“NPS Act” means the proposed National Payment System Act. **(This is none existent for now)**

“Payment Systems” means a set of instruments, banking procedures, telecommunication networks and typically inter-bank funds transfer systems that ensure the circulation of money.

“ Participant” means designated payment systems and institutions that participate in those systems.

“PVP” (Payment versus Payment). It is used to describe wholesale foreign exchange transactions market in which one side receives value if and only if the other side does.

“RTGS” Real Time Gross Settlement System. This is a transfer systems in which the settlement of funds or securities transfer instructions occur individually (on an instruction by instruction basis) without netting on a continuous basis throughout a business day.

“Securities Settlement System” means the full set of institutional arrangements for confirmation, clearance and settlement of securities trades and safekeeping of securities.

“SIPS” (Systemically Important Payment System). A System is likely to be of systemic importance if at least one of the following is true:

- It is the only payment system in the country or the principal system in terms of aggregate value of payment
- It handles mainly payments of high individual value or

- It is used for the settlement of financial market transactions or the settlement of other payment systems.

“System operator” means an Entity authorized by the Bank to operate a designated system.

“System Oversight” means all activities by the bank to influence the architecture, the rules and business conduct of payment system and securities settlement systems principally intended to promote the smooth functioning of payment systems and to protect the financial system from possible ‘domino effects which may occur when one or more members in that system incur credit or liquidity problems.

“Systemic risk” means the risk that the inability of one or more of the participants in a payment system to meet its obligations or a disruption in the system itself, could result in the inability of other system participants or financial institutions in other parts of the financial system to meet their obligations as they become due. Such a failure could cause widespread liquidity or credit problems and as a result could threaten the stability of the system or of financial markets.

“Zero Hour Rule” means provisions in the insolvency Act that gives retroactive effect to insolvency pronouncements by a court of competent jurisdiction. The effect of the zero hour is when an event is specified to have occurred on a particular day, that event takes place at the earliest point in time after midnight on that day. For instance, if a court orders the winding up of a company at 2pm on a particular day, the winding up is deemed to have commenced one second past midnight on the day that order is made. Therefore, any transactions entered into by the company before 2pm that day can be rendered void. This rule gives a liquidator ability to challenge the results of netting arrangements through which such payments were made with possible catastrophic results.