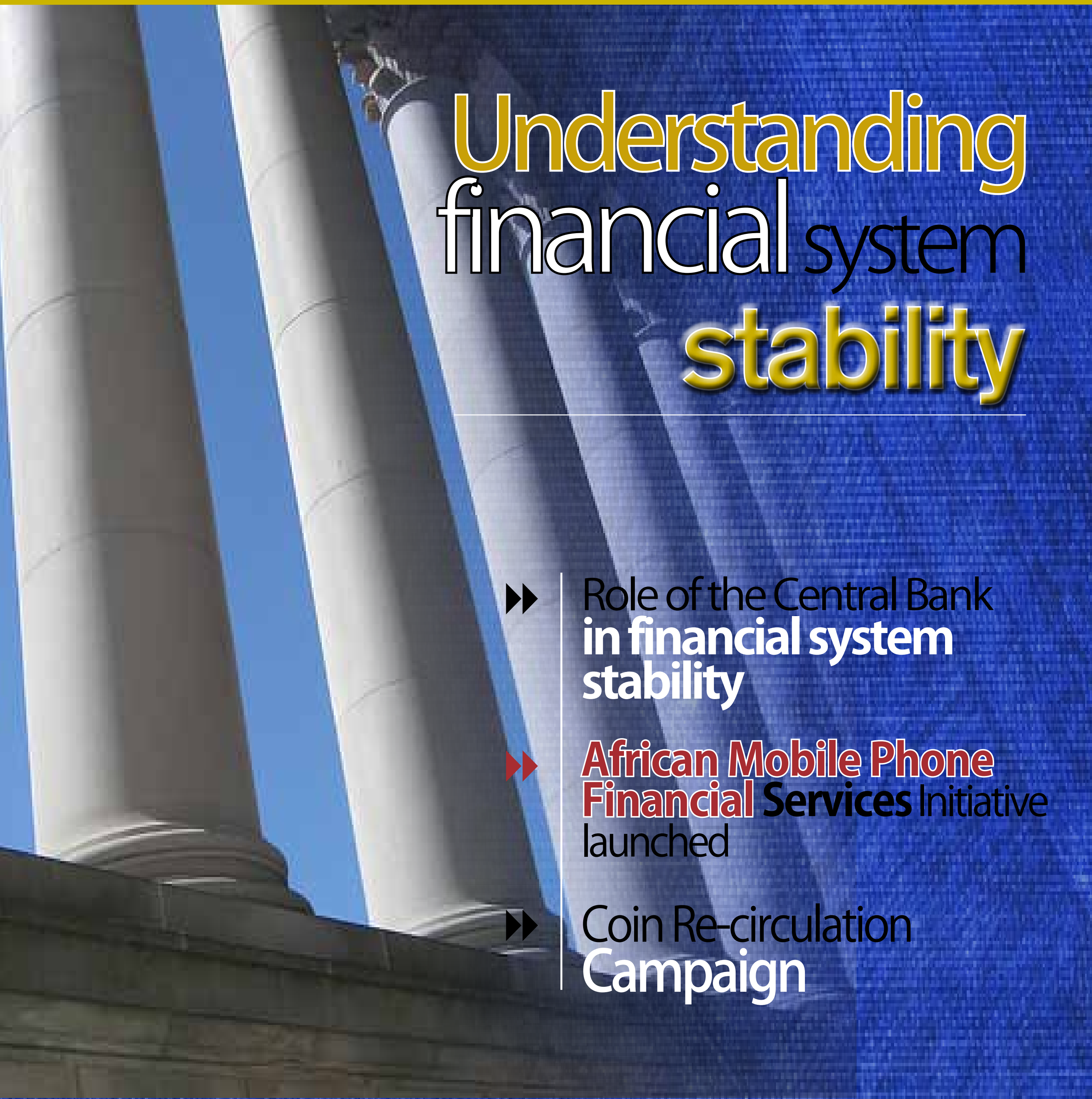
CBK Newsletter

Keeping you Informed

No. 5 | *A Central Bank of Kenya Publication* | *Issue 1/ March 2013*



Understanding financial system stability

- Role of the Central Bank in financial system stability
- African Mobile Phone Financial Services Initiative launched
- Coin Re-circulation Campaign

CENTRAL BANK OF KENYA

VISION

A World Class Modern Central Bank

PRINCIPAL OBJECTIVES

The Principal objectives of the Central Bank of Kenya (CBK) are:

1. To formulate and implement monetary policy directed to achieving and maintaining stability in the general level of prices;
2. To foster the liquidity, solvency and proper functioning of a stable, market- based, financial system;
3. Subject to (1) and (2) above, to support the economic policy of the Government, including its objectives for growth, and employment.

Without prejudice to the generality of the above, the Bank shall:

- Formulate and implement foreign exchange policy;
- Hold and manage its foreign exchange reserves;
- License and supervise authorized foreign exchange dealers;
- Formulate and implement such policies as best to promote the establishment, regulation and supervision of efficient and effective payment, clearing and settlement systems;
- Act as banker and adviser to, and as fiscal agent of, the Government; and
- Issue currency notes and coins.

CBK NEWS 1

The Editor welcomes comments and articles from readers and stakeholders. Contact us through: Comms@centralbank.go.ke

The CBK Newsletter is published by the Communications Office, Central Bank of Kenya, Haile Selassie Ave., Nairobi.
www.centralbank.go.ke

In this Issue

The Central Bank and financial stability

Financial stability is a critical function of central banks the world over. A stable financial system is one that is predictable and efficient in performing its role and gives confidence to savers and investors. A stable financial system is strong and capable of withstanding shocks and other disruptions that may interfere with the financial intermediation process, which might impair allocation of savings to investment opportunities in the economy. A stable financial system should have strong institutions that ensure public confidence and trust in the institutional framework.

Safeguarding financial system stability is an important policy objective for the Central Bank of Kenya and indeed other financial sector regulators. An unstable financial system can disrupt economic activity and undermine public confidence. At the peak of 2008 financial crisis, authorities around the world devised specific strategies to mitigate adverse effects to the financial system, with mixed results. In the U.S for instance, the strategies largely helped restore stability in the banking system and secondary credit Markets and prevented further foreclosures of homes and collapse of several institutions, all of which would otherwise have had far reaching ramifications on the global economy. Regular assessment of financial system

stability, both at micro (institutional) and macro (system-wide) level therefore helps to facilitate early identification of sources of risks and potential vulnerabilities. The assessment should allow systematic and periodic processes of monitoring and evaluation of each of the sources of risks, incorporating intra-regulator, cross-sector and cross-border linkages to identify the most material risks (fault lines) to the financial system.

Kenya has a multi-regulatory regime where the financial system comprising of financial institutions, financial markets and financial infrastructure fall under different regulators, namely; Central Bank of Kenya (CBK) for deposit taking institutions as well as the payments, clearing and settlement system; Capital Markets Authority (CMA) for the capital markets intermediaries such as the stock exchange and investment banks; Retirement Benefits Authority (RBA) for the pensions industry; Insurance Regulatory Authority (IRA) for the insurance industry; Sacco Societies Regulatory Authority (SASRA) for the deposit taking Sacco societies; and other regulated entities falling under several government ministries. Cognizance of this, the Central Bank, jointly with other regulators established the Financial Sector Regulators Forum in 2009 under a Memorandum of Understanding (MOU), to enhance policy coordination and information sharing in order to achieve and maintain stability of the financial system.

At the institutional level, the Central Bank has an elaborate framework for discharging the financial stability mandate as provided in the law. The Bank's direct financial stability function includes regulation and supervision of the commercial banks, deposit taking microfinance institutions and forex bureaus, credit reference bureaus, lender of last resort facility; system-wide national payment and settlement system; deposit protection (safety net), resolution of failed institutions and macroeconomic management through formulation and implementation of monetary policy. In addition, the Bank has a fiduciary role to maintain public confidence in the financial sector by addressing all factors that lead to long-term stability. The Bank works together with other regulators on assessment of financial system, whose results are published in the annual Financial Stability Report (FSR). There is move to publish these reports on a bi-annual basis.

At the regional and international level, the Bank is part of global initiatives spearheaded by the East African Community (EAC), the Common Market for Easter and Southern Africa (COMESA), the Financial Stability Board (FSB) and the International Monetary Fund (IMF) to develop and promote implementation of effective regulatory, supervisory and other financial sector policies. The FSB initiative brings together national authorities responsible for financial stability, international financial institutions, sector-specific international groupings of regulators and supervisors, and committees of central bank experts.

Looking ahead, the Central Bank will invest in capacity building in its financial system stability function as part of its core strategic objectives to ensure that appropriate structures and systems are in place to steer the sector towards a world class status as envisioned under the Bank's Vision. Additionally, the envisaged capacity development should support the Bank's financial inclusion goals, with emphasis on financial inclusion for financial stability. Building highly skilled capacity, ensuring robust legal and institutional framework and leveraging on international experience will be crucial in the detection, analysis and prevention of emerging threats to financial stability.

Prof. Njuguna Ndung'u CBS

New Mobile Banking Platform Launched

L-R: CBA Chairman, Desterio Oyatsi; CBK Governor, Prof. Njuguna Ndung'u; Minister for Information & Communication, Hon. Samuel Poghisio; Minister for Finance, Hon. Njeru Githae and Chairman, Safaricom Limited, Nicholas Ng'ang'a toast to the new mobile banking product, 'M-Shwari'.

A new mobile banking product known as M-Shwari was launched in November 2012, targeting existing M-PESA users. M-Shwari is a suite of banking products developed by Commercial Bank of Africa in partnership with Safaricom, and allows prospective customers to use M-PESA as the delivery channel to the "M-Shwari" bank products. The product enables subscribers to build up savings and earn interest on the money. Apart from attracting savings, the innovation offers an opportunity to access credit services through the mobile phone.

The new platform adds to other successful initiatives that have enhanced financial inclusion and reach of banking and financial services to the unbanked and under-banked population. Mobile based financial services have been a phenomenal success in Kenya, thanks to a supportive policy and regulatory environment that allows integration between mobile phone services providers and commercial banks to leverage on mobile phone technology to provide financial services at a lower costs for their customers without compromising quality of service.

The product was launched by Hon. Njeru Githae, Minister for Finance.

Collaboration with other Central Banks

Between August and November, 2012, the Central Bank of Kenya hosted officers from the Central Banks of Burundi, Uganda and Tanzania for for joint onsite inspection of a regional banking groups. Joint inspections of banks with regional presence are part of the EAC central banks ongoing efforts towards harmonized supervisory rules and practices.

During the same period, the Central Bank also hosted officials from the Ministry of Finance, Malawi on 21st November, 2012 for knowledge exchange on financial sector reforms in Kenya. The Malawi delegation was taken through the recent banking sector reforms towards enhanced financial inclusion. These include licensing of deposit taking microfinance institutions, introduction of agency banking for banks and deposit taking microfinance institutions, introduction of credit information sharing and roll-out of mobile financial services by banks.

CBK Pension Fund feted

The CBK Pension Fund won a trophy for being the Best Retirement Benefit Scheme during the 3rd annual Institute of Certified Public Secretaries of Kenya (ICPSK) Champions of Governance (COG) Award Ceremony held in November 2012, at Panari Hotel.

Moses Barboi, Pensions Administrator (second right) and Stephen Thuo, Asst. Director, Finance & IMS Department (extreme right) receiving Best Retirement Benefit Scheme trophy from Seno Nyakenyanya, PS Min. of Cooperative Dev. and the ICPSK Chairperson, Catherine Musakali.

The Fund was participating for the first time in the COG Award competition organized by ICPSK. The Award fetes organizations that entrench good governance practices and whose business transactions are above board.

The CBK Pension Fund was feted under the Retirement Benefits Schemes category in recognition of its strong earnings record, adequate funding level, adherence to laws and regulations, high quality service to members, transparency and disclosure, among others.

Supervisory College launched

The Central Bank of Kenya (CBK) hosted the inaugural meeting of the Kenya Commercial Bank Group Supervisory College on 3rd – 4th October 2012 at the Kenya School of Monetary Studies. The CBK Governor, Prof. Njuguna Ndung'u said during his opening remarks that the model was made possible through the technical assistance and capacity building support of the IMF's East African Regional Technical Assistance Centre (East AFRITAC).

The concept of the supervisory college is informed by the need to enhance information sharing and collaboration among financial sector supervisors owing to continued cross-border expansion of financial sector players as well as the convergence of their cross-sector operations.

Some 10 Kenyan banks had a total of 240 branches outside Kenya as at 30th June 2012, up from 204 in December 2011.

This therefore made it neccessary for CBK as the home supervisor to design a framework for a supervisory college to bring together supervisors of these banks i.e the KCB Group, in all countries where they operate, as an avenue to share supervision information.

The Supervisory College also serves as a forum for the supervisors to collaborate in strengthening their supervisory practices to enhance regional financial stability. The pioneering college had representatives from the five East African Community central banks as well as from the Bank of South Sudan.

CBK plans to rollout supervisory colleges for all Kenyan banks that have significant business presence outside Kenya.

Assessment for Deposit Protection Fund Board

The International Association of Deposit Insurers (IADI) held its 5th Regional Training Workshop at the Kenya School of Monetary Studies (KSMS) from 5th to 9th November, last year.

The purpose of the workshop was to assess the Deposit Protection Fund Board's (DPFB) level of Compliance with IADI Core Principles for Effective Deposit Insurance Systems. Prof. Njuguna Ndung'u, Chairman DPFB, who is also the Governor of the Central Bank of Kenya officially opened the workshop.

The one-week workshop provided the IADI assessors and participants with an opportunity to critically evaluate DPFB's compliance with the eighteen (18) Core Principles set by IADI.

The Core Principles are a set of internationally accepted standards, rolled-out in 2009, that are used to benchmark an effective design of a deposit insurance system that promotes financial stability.

The Core Principles are a set of internationally accepted standards, rolled-out in 2009, that are used to benchmark an effective design of a deposit insurance system that promotes financial stability. The assessment includes identification of the strengths of the deposit insurance system, and the nature and extent of weaknesses, if any. This should help deposit insurers and policymakers to benchmark their deposit insurance system against best practice and align them with broader public policy objectives.

L-R: David Walker, Canadian Deposit Insurance Corporation, Rose Detho, Director, DPFB – Kenya, Vijay Deshpande (Standing), Federal Deposit Insurance Corporation, Vilma Rosa Leon-York , US Dept. of the Treasury, Int. Affairs, Prof. Neil Murphy, US Dept. of the Treasury and also Advisor to KSMS and Dr Jacob Ade Afolabi, NDIC during a wrap-up meeting after the 5th Regional Training on IADI Core Principles Assessment workshop held in Nairobi.

The lead assessor from the Federal Deposit Insurance Corporation (FDIC) led a team of six others drawn from the World Bank, Deposit Protection of Swiss Banks and Security Dealers, Nigeria Deposit Insurance Corporation (NDIC), Philippines Deposit Insurance Corporation (PDIC) and Office of Technical Assistance, US Treasury.

After the assessment, the assessors prepared a report, which was shared with the DPFB's Senior Management on Friday, 9th November, 2012 . The assessors are expected to prepare a more comprehensive report and submit the same to DPFB management in due course.

The workshop was held at an opportune moment when DPFB is in transition following the enactment of the Kenya Deposit Insurance Corporation (KDIC) Act (2012) that was assented to by the President of the Republic of Kenya in May 2012. The Act has broadened the mandate of DPFB to a risk minimizer and promoter of financial stability.

A total of 45 participants from 14 countries attended the workshop.

African Mobile Phone Financial Services **Initiative (AMPI) launched**

African policymakers and regulators from Alliance for Financial Inclusion *(AFI) network member institutions gathered to launch the first African Mobile Phone Financial Services Policy Initiative (AMPI) on 14th and 15th February, 2013 in Zanzibar, Tanzania. Hosted by Bank of Tanzania (BoT), Central Bank of Kenya (CBK) and AFI, participants included high level financial sector policy makers and regulators from 18 African regulatory institutions. Other stakeholders included representatives from financial services providers, telecommunications companies and international development agencies.

The discussions centered around effective ways to share knowledge and experiences on Mobile Phone Financial Services (MFS). It was noted that the development of mobile phone financial services was not even across Africa despite its latent potential as a critical tool for enhancing financial inclusion. AMPI was therefore proposed as a framework through which African AFI Network members will seek to determine effective solutions for advancing MFS across the African continent. The work of AMPI will be coordinated through two key mechanisms:

a) AMPI African Leaders Roundtable meeting, which will provide a platform for high level African AFI members to meet annually to coordinate and take a lead role in the overall development of MPFS policy and regulatory frameworks in their countries.

b) AMPI Help Desk tasked with providing a virtual help desk to facilitate all technical coordination.

AMPI is expected to become the primary platform for AFI's African members to provide high-level leadership in broadening knowledge and promoting MFS policy development in Africa and

A group photo of participants during the launch of the African Mobile Phone Financial Services Policy Initiative (AMPI) in Zanzibar.

*AFI, is a global network of over 80 member countries representing financial policymakers from developing and emerging countries working together to increase access to appropriate financial services for the poor.

throughout the whole of the AFI Network.

Following discussions at the Inaugural African Leaders' Roundtable meeting, strategic objectives, governance and institutional structures to implement the new regional initiative, AMPI, were agreed upon. These were then formulated into the 'Zanzibar Declaration', which was endorsed by participating policymakers at the conclusion of the meeting. The CBK Governor, Professor Njuguna Ndung'u, was elected for a one-year tenure as Chair of AMPI, and Banque Centrale des Etats de l'Afrique de l'Ouest (BCEAO) Governor Tiémoko Meyliet Kone was appointed as the vice-chair.

The Help Desk would have six regional focal points across the African regional whose participation would be coordinated by the AFI Management Unit. The initiative is expected to go a long way in reducing the unbanked populace in the African continent. "The benefit of expanding mobile financial services to Africa's unbanked is undeniable," said Professor Ndung'u. "Together we have the experience, the knowledge and now a common regional commitment to make Africa the world leader in this field, through smart, secure and practical policies as well as cost-effective financial services delivery channels."

FIRST ANNUAL AMPI MEETING

The Zanzibar Declaration 15 February 2013

We, African policymakers and regulators, as members of the Alliance for Financial Inclusion (AFI), met in Zanzibar, Tanzania to launch the first African Mobile Phone Financial Services Policy Initiative (AMPI). During our meetings we heard from each other, and from stakeholders, including high-level representatives from financial services providers, telecommunications companies, and international development agencies.

Together we reflected on effective ways to support policy reforms for mobile financial services in Africa within a regional framework. Following these discussions we agreed on the strategic objectives, governance structure, and logistical arrangements for this landmark initiative – the AMPI.

We believe that AMPI will be the firm platform for AFI members in Africa to provide high-level leadership in the overall development of mobile financial services policy and regulatory frameworks, and to coordinate efforts of regional peer learning. This in turn will broaden knowledge and promote MFS policy development throughout the entire AFI Network.

Our initiative is a framework through which our members will determine effective policy solutions for advancing MFS across the African continent through cooperation among policymakers and regulators, private sector players, development partners as well as research institutions.

We are confident that AMPI will serve as a mechanism to drive responsible uptake of the use of Mobile Financial Services (MFS) in Africa and contribute to mutual learning and best practices.

FRC Hosts AML/CFT **National Stakeholders Forum**

Kenya has made significant steps towards combating money laundering and the financing of terrorism. The enactment of the Proceeds of Crime and Anti-Money Laundering (Amendment) Act is an important step towards the eradication of money laundering.

To further enhance the AML/CFT initiatives, the newly established Financial Reporting Centre (FRC) and in partnership with the Kenya School of Monetary Studies (KSMS) and the United Nations Organization on Drugs and Crime (UNODC) held a National Stakeholders Forum on Thursday, 4th October, 2012. The forum aimed at creating sufficient AML/CFT awareness within the financial sector in Kenya.

The National Stakeholders Forum is the inaugural awareness initiative in which the FRC, with support of the Danish Government will run an extensive AML/CFT programme spanning over 24 months. The programme is intended to raise awareness on money laundering vices as well as train reporting entities, law enforcement authorities and the Financial Intelligence Units personnel on Anti Money Laundering initiatives. The extensive training programme will significantly contribute to the curbing of money laundering and financing of terrorism in Kenya.

The Assistant Minister for Finance, Hon. Dr. Oburu Odinga, in his opening remarks expressed gratitude to the development partners who have supported Kenya to develop the necessary laws to combat money laundering and financing of terrorism. He said the government was seeking to establish Kenya as a leading financial services hub in the world. “For this objective to be realized, a strategic partnership between the Government and the financial sector is very important. The success of the sector will therefore depend on the effectiveness of this partnership”, he added.

On his part, CBK Governor, Prof. Njuguna Ndung’u, noted that in the last two years, the Central Bank has issued regular AML/CFT guidelines to financial institutions to further support and enhance the implementation of the law. The guidance has covered the operationalization of the AML law, suspicious transaction reporting and measures to be adopted by financial institutions to combat the financing of terrorism. He added that the Central Bank has revised the Forex Bureau Guidelines so as to align them with the anti money laundering law, while requiring Deposit Taking Microfinance institutions and their agents to implement AML/CFT measures. "As far as Kenya and other developing economies are concerned, significant efforts have been directed toward a safer financial system through the establishment of an International

AML training center, the Financial Reporting Centres (FRC) and other structures," said the Governor.

Mr. Thomas Konigsfeldt, Political Counselor, Danish Embassy said there was need to counter regional links to terrorism. "Denmark aims at supporting the CBK and KSMS initiative by providing training on subjects like the establishment of effective asset recovery units in banks", he said.

Speaking during the forum, Prof. Kinandu Muragu, Executive Director of KSMS, said the forum marked the beginning of an important journey in counteracting money laundering in Kenya. "The safety of Kenya's financial system has been a concern for the Central Bank of Kenya which is committed to contribute in every way to making Kenya a leader in financial sector integrity," he said.

Hon. Dr. Oburu Odinga, Asst. Minister, Ministry of Finance and John Wanyela, Chairman, Financial Reporting Centre (FRC) share a light moment during the National Stakeholders Forum held in Nairobi.

"For this objective to be realized, a strategic development partnership between the Government and the financial sector is very important. The success of the sector will therefore depend on the effectiveness of this partnership"

Going forward, the forum agreed that legislation should be adapted to each country's culture and that reporting of suspicious transactions should be handled with care , informed by intelligence to avoid trampling on individual liberties. The forum however noted that banks were protected legally if their actions were done in good faith. The forum further noted the need for banks to cooperate with FRC and to expand awareness about FRC so that all stakeholders get to know its functions.

The half-day forum attracted key decision makers in the financial sector and international community including CEOs and compliance chiefs of commercial banks, forex bureaus, deposit taking microfinance institutions, embassies and senior intelligence officers.

Role of the Central Bank of Kenya in financial system stability

Introduction

A financial system, at the very basic level, is the structure or arrangement that allows the transfer of money between savers (investors) and borrowers. A financial system can operate on a global, regional or country level. Financial systems play an important role in the resource allocation process by enabling the channelling of savings or funds from households to the corporate or production sectors. It comprises the totality of financial institutions, markets, instruments, services and so on. Its stability is therefore of fundamental importance to governments in general and financial sector regulators in particular.

What is Financial System Stability

The International Monetary Fund (IMF) defines financial system stability as a range of conditions in which the financial system, comprising of financial institutions, financial markets and financial infrastructure:

- Fulfils its key economic functions without significant failures or adverse systemic impact on the real and/or financial sectors;
- Is resilient to current or potential internal or external shocks;
- Facilitates effective assessment, pricing and management of risks and
- Promotes public confidence and credibility.

This definition, which has been adopted globally, outlines a number of necessary conditions that must hold for a given financial system to be described as stable. In particular, a stable financial system must instil public confidence and trust in the institutional framework. The financial system must also be predictable and efficient; and should be run by competent financial authorities.

Kenya's Financial System

Kenya's financial system is dualistic in nature, made up of both the formal and informal sectors. The formal financial system comprises the banking industry, mortgage finance companies, foreign exchange bureaus, credit reference bureaus, microfinance industry, capital markets industry, insurance industry, pensions industry, payments system subsector, the Savings and Credit Cooperative (SACCO) societies; the hire purchase companies (HPCs) and Development Finance Institutions (DFIs). The informal financial service providers include Rotating and Accumulating Savings and Credit Associations (ROSCAs and ASCAs), Chamas or merry go rounds, shopkeepers and moneylenders, among others.

The financial system in Kenya comprises financial institutions, financial markets and financial

market infrastructures that fall under different regulatory authorities, namely; Central Bank of Kenya (CBK), Capital Markets Authority (CMA), Retirement Benefits Authority (RBA), Insurance Regulatory Authority (IRA), and Saccos Societies Regulatory Authority (SASRA). This article focuses on the role of Central Bank of Kenya in achieving and maintaining financial system stability.

Central Bank of Kenya

The Central Bank regulates the largest segment of the financial system in terms of value, namely, the banking sector, foreign exchange markets, deposit-taking microfinance institutions, and mortgage markets. It is also responsible for domestic securities markets operations and the national payments and settlement system. In addition, the Bank through the Deposit Protection Fund, not only plays a crucial role in crisis resolutions, but the very existence of the DPFB signals stability to the financial system. The Bank is also the custodian of monetary policy, a key pillar for macroeconomic and financial system stability.

Mandate

The Financial Stability objective of the Central Bank is drawn from the Central Bank of Kenya Act (Cap.491, Laws of Kenya). Specifically, Section 4(2) states that, `the Bank shall 'foster the liquidity, solvency and proper functioning of a stable market-based financial system'. Section 4A(1)(d) also states that, `Without prejudice to the generality of Section 4, the Bank shall formulate and implement such policies as best promote the establishment, regulation and supervision of efficient and effective payment, clearing and settlement systems'. These provisions clearly indicate that the focus of financial stability mandate is the entire financial system.

Implementation of the Financial Stability function

Within CBK, the financial stability function is a shared responsibility among various Departments of the Bank, namely, Bank Supervision; Research and Policy Analysis; Banking Services & Risk Management; Financial Markets; and the Deposit Protection Fund Board (DPFB). The Bank's direct financial stability function entails the regulation and supervision of the banking industry, provision of short term loans to banks as the lender of last resort, oversight of the system-wide national payment and settlement system, management of

Continued on page 14

Picture Speak

1. L-R: Benedict Ssekabira, Director, Commercial Banking, Bank of Uganda; Agapiti Kobello, Director, Bank Supervision Department, Bank of Tanzania; Joy Ntare, Executive Director, Financial Stability Directorate, National Bank of Rwanda. The officials were in Kenya to attend a supervisory college for a regional banking group.

2. L-R: Florian Werner, Kevin Mellyn, Mike Angus and Charlton Goredema, all consultants from MasterCard, with Mark Lesiit, CBK Director for Banking and Risk Management (extreme right) and Stephen Mwaura, Asst Director, NPS. MasterCard presented the findings of a consultancy to identify and analyse policy options to encourage inter-operability of the payment system infrastructure in Kenya.

3. His Excellency the President, Hon Mwai Kibaki being taken around the Central Bank Stand by the Governor, Prof. Njuguna Ndung'u during last year's Nairobi International Trade Fair. Hon Dr. Sally Kosgei, Min. for Agriculture is on the extreme right.

4. L-R: Molly Dingani, Southern Africa Chairperson CBZ Bank, Zimbabwe; Marie-José Ilunga, Rep., Central Africa Sub Région, Director, Banque Centrale du Congo ; Idrissa Nasa, Afraca Vice Chairman, Directeur General/CEO Coris Bank International, Burkina

Faso; Anthony Olufidipe, West Africa I Chairperson & Deputy General Manager Union Bank of Nigeria; Saleh U. Gashua, AFRACA Secretary General and Millison Narh, Afraca Chairman & Deputy Governor, BOG cheer as Prof. Njuguna Ndungu, Governor, CBK cuts the commemorative cake to mark the inauguration of the new AFRACA Executive Committee.

5. Jared Getenga, Project Manager, Kenya Credit Information Sharing Initiative (KCISI) gives his remarks during a recent Credit Information Sharing workshop in Nairobi.

6. Kornelio Koriom Mayik, Governor, Bank of South Sudan shake hands with CBK Governor, Njuguna Ndung'u after signing the MoU. Looking on are Gabriel Buoc, Board secretary, BSS and Kennedy Abuga, Bank Secretary CBK.

Continued from page 11

the deposit protection (safety net) and resolution of failed institutions through the Deposit protection Fund Board and macroeconomic management through formulation and implementation of appropriate monetary policy to achieve price stability. As a regulator therefore, CBK has a fiduciary role to maintain public confidence in the financial sector by addressing all factors that would undermine the sector's long-term stability.

In view of this, the Central Bank has made financial stability one of its core strategic functions in its 2012-2015 Strategic Plan. In addition, the Board of Directors of the Bank has stablished the Financial Stability and Investment Committee (FSIC) with clear terms of reference focussing on financial system stability.

How does CBK conduct financial system stability assessment?

The Central Bank of Kenya conducts financial system stability assessment at macro (system-wide) and micro (institutional) prudential levels.

At the macro level, the Bank uses the assessment frameworks based on the International Monetary Fund (IMF) Financial Soundness Indicators (FSI) and COMESA frameworks. It conducts macroprudential (system-wide) analysis to establish the stability of the overall financial system. This involves use of quantitative and qualitative tools to carry out diagnostic tests based on data and information obtained from the banking, financial, insurance, pension, and cooperatives sectors on an aggregate level.

In conducting stability assessment, the Central Bank collaborates with the Capital Markets Authority (CMA), Retirement Benefits Authority (RBA), Insurance Regulatory Authority (IRA) and SACCO Societies Regulatory Authority (SASRA). Through its various departments, it collates useful data and information on key indicators and developments necessary for carrying out the assessment. The output of this exercise is published in the annual Financial Stability Report (FSR) while the analytical report on Macro-financial conditions are presented to the Financial Stability & Investment Committee (FSIC) of the CBK Board. The Bank also obtains data from all sectors of the financial system and generates Financial Soundness Indicators (FSIs). These indicators (FSIs) are published on the IMF websites and helps other countries to compare financial system conditions of their countries.

At micro-prudential level, the Bank focuses on the risks and potential vulnerabilities at the industry (banking sector) level, especially the individual institutions. Micro prudential supervision is critical at this stage and linkages between the parent company and subsidiaries at cross-sector/cross border levels. This is becoming increasingly important given the emergence of Systemically Important Financial Institutions (SIFIs) that pose systemic risks - a problematic institution from one country can severely affect its subsidiaries in other countries. Quantitative tools such as; Stress testing, Distance to Default (DtD) analysis, and Value at Risk (VaR) are therefore used in to assess the soundness of institutions . Financial Soundness Indicators such as Capital Adequacy Ratios, Return on assets, non-performing loan ratios, exposures, and liquidity ratios are also useful tools in this assessment. In addition Qualitative information such as corporate governance, compliance to prudential guidelines and regulatory framework, management

As mentioned, the financial stability mandate at the Bank can be viewed in terms of micro-prudential, macro-prudential and crisis management components

quality as well as institutional arrangement is assessed.

The Bank therefore looks at factors that could affect the stability of the financial system as a whole, at a system-wide and industry level, and analyses how they could impact on the entire economy. With more local institutions expanding to the EAC region, the Bank is now paying greater attention to cross-border operations that may pose systemic threats, by examining common exposures and counterparty linkages.

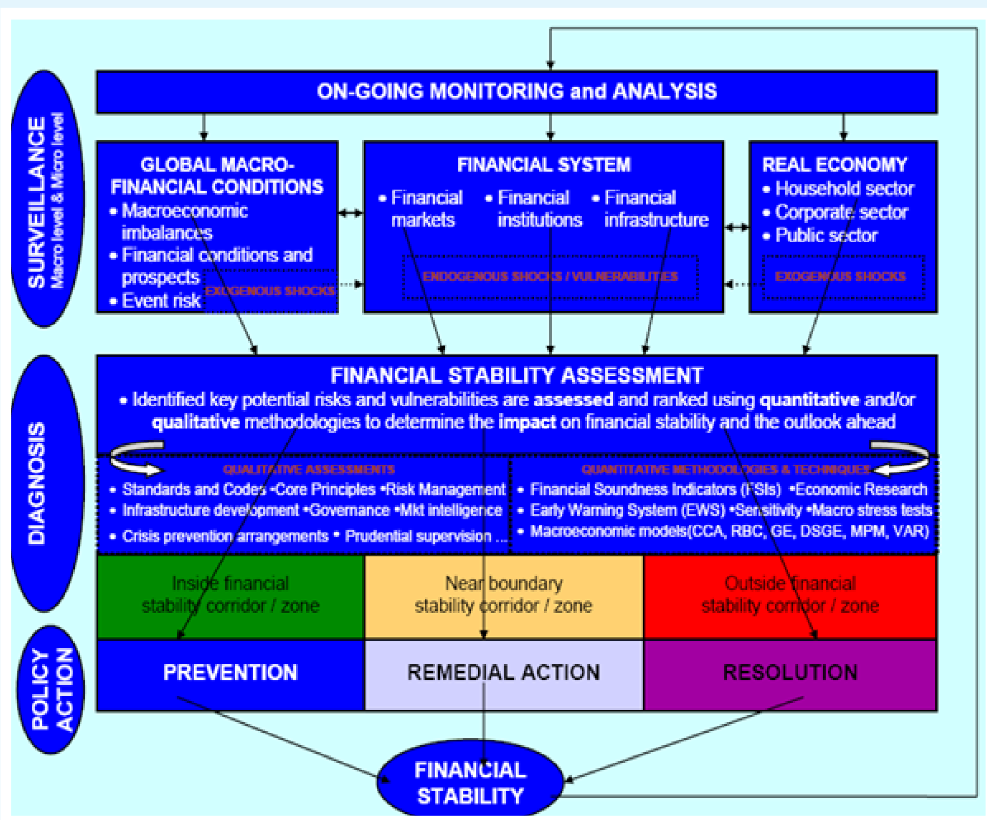
Institutional Arrangement in Financial System Assessment

As mentioned, the financial stability mandate at the Bank can be viewed in terms of micro-prudential, macro-prudential and crisis management components. This mandate is operationalised as follows;–

Research Department

Research and Policy Analysis Department is responsible for macro prudential (systemwide) stability assesment function. It is responsible for ensuring that the Bank works towards achieving and maintaining general price stability. Its critical role in monetary policy decisions helps in informing appropriate policy formulation that enhances rather than destabilizes stability of the financial system. It also coordinates the financial system stability objective in the Bank with other financial regulators and other stakeholders (EAC, COMESA, AACB, IMF and AfDB). It coordinates activities of the Financial Sector Stability Technical Committee (FSSTC), whose membership include all financial sector regulators. It ensures data

COMESA Framework for Maintaining Financial System Stability



information sharing critical in monitoring financial system stability and facilitates publication of Financial Stability Reports. Jointly with the Ministry of Finance, the Department participates in the regular Debt Sustainability Analysis exercises as unsustainable debt level have destabilising effect to the financial system, as is the current case in European financial and economic crisis.

Bank Supervision Department

Bank Supervision Department is responsible for executing the financial system stability function at the micro prudential level. It undertakes the regulation and supervision of the banking industry – commercial banks, mortgage finance companies, deposit taking microfinance institutions, foreign exchange bureaus (forex bureaus) and credit reference bureaus (micro-prudential analysis and remedial action).

Banking Services & Risk Management Department

Banking Services & Risk Management Department promotes the development as well as oversight of the system-wide stability of the national payment and settlement infrastructure, regulates and supervises payment services providers. It also plays the role of Lender of Last Resort for short term liquidity support for banks facing liquidity problems.

Financial Markets Department

Financial Markets Department implement the Monetary Policy Commitee's monetary policy decisions through open markets operations, operates rediscount window to provide liquidity and undertakes investment of the country's foreign exchange reserves. It also partially implements the fiscal agency function of the Bank through sale of government securities and facilitates secondary trading securities and Horizontal Repos window operations.

Deposit protection Fund Board

The Deposit Protection Fund Board (DPFB) provides a deposit insurance scheme (safety net) for customers and also handles resolutions to member institutions facing insolvency. This is covered in the next article.

The Financial Stability & Investment Commitee

The Financial Stability & Investment Committee of CBK Board provides oversight policy role on activities of the above Departments in achieving and maintaining stability of the financial system.

The Central Bank therefore continues to entrench financial system stability function in its core strategic objectives to ensure that appropriate policies are formulated and implemented to drive the sector to a world class status as envisioned in Vision 2030. It is against this background that amendments to the CBK Act are ongoing to entrench and incorporate financial stability as a direct mandate of the Bank and also align it to the New Constitution, which is in line with best practice in other modern central banks.

In summary, the emergence of the financial crisis in 2009 that progressed into an economic crisis has yet to be resolved . This has provided new impetus to custodians of global financial system to place the stability of the sector at the forefront. The Bank therefore seeks to build on the experience of this development in strengthening domestic cooperation among various regulators in the sector to ensure that Kenya's financial system remains stable so that it plays its crucial role in achieving the country's long term development goals.

Collaboration between Financial Sector Regulators in Kenya

Kenya's financial system in made up of different types of institutions and service providers offering a wide range of financial services, whose functions are supervised and regulated by different regulatory bodies, government ministries and agencies. In an effort to better coordinate the supervision of these various financial sector players, the Financial Sector Regulators have established collaborative arrangements which are intended to facilitate their effective performance and promote safe and stable financial institutions in Kenya. The regulators will collaborate in the areas such as joint onsite supervision of institutions, public education and awareness campaigns, information sharing, and joint capacity building among others.

The partnership between the regulators was formalised through a Memorandum of Understanding (MOU) signed in August 2009 between the Capital Markets Authority (CMA), the Central Bank of Kenya (CBK), Insurance Regulatory Authority (IRA) and the Retirement Benefits Authority (RBA). The Sacco Societies Regulatory Authority (SASRA) was enjoined later. The broad mandates of these regulators are:

- CMA is charged with the responsibility of supervising, licensing and monitoring the activities of market intermediaries, including the stock exchange and the central depository and settlement system and all the other persons licensed under the Capital Markets Act. It regulates and supervises the capital markets that include the Nairobi Stock Exchange (NSE), investment banks, stockbrokers and collective investment schemes.
- IRA is an agency established under the Insurance Act to regulate, supervise and develop the insurance industry. Its regulatory objectives include ensuring compliance by insurance/reinsurance companies and intermediaries with legal requirements, promoting compliance; protecting consumers and promoting efficient, fair, safe and stable markets.
- RBA regulates and supervises the pensions industry that includes the retirement benefits schemes, fund managers and custodians. The Authority is mandated to protect the interest of members and sponsors of retirement Benefits schemes, and to advise the Government on the national policy with regard to the retirement benefits industry, among other objectives.
- SASRA is a Semi-Autonomous Government agency under the Ministry of Co-operatives with the responsibility to licence and supervise Deposit Taking Sacco Societies in Kenya. It has the dual objectives of protecting the interests of Sacco members and ensuring that there is confidence in the public towards the Sacco sector savings.
- The Attorney General's Chambers regulates the hire purchase companies and different types of institution involved in financial services business.

Since signing the MOU, the regulators have enhanced their areas of collaboration to include knowledge exchange and capacity building; amendment of the respective legal frameworks to support the collaboration; harmonization of financial sector licensing circles and joint participation at the Agricultural Society of Kenya (ASK) Shows.

Deposit Protection and Financial Stability

The Deposit Protection Fund Board (DPFB) was established in 1985 as a body corporate pursuant to Section 36 of the Banking Act. The public policy objective behind the creation of DPFB was the restoration of public confidence in the banking system following a number of bank failures in the 1980s.

In establishing the DPFB, the Government sought to achieve the objective of providing an effective deposit insurance scheme to foster financial stability. The DPFB was therefore established with a threefold mandate, namely;

- to provide a viable deposit insurance scheme for customers of member institutions;
- to levy contributions from member institutions and to prudently hold and manage the Fund;
- to liquidate and wind up operations of any institution in respect of which DPFB is appointed by CBK as liquidator, pursuant to Section 35 of the Banking Act.

Over the years, the Fund has continued to execute its mandate within the established law, providing insurance coverage to customers of member institutions and winding up of failed institutions in the banking sector. However, a review of the operations and structure of the DPFB was deemed necessary after it emerged that deposit insurance systems around the world had evolved in response to emerging challenges and complexities of the financial systems.

A Task Force was then set up in 2006 to study model deposit insurance systems in other countries, review existing legislation and a draft legislation that would align with best practice in deposit insurance, provide DPFB with more autonomy, enhanced corporate governance and expand its mandate appropriately . The assignment culminated in the publication of the Kenya Deposit Insurance Bill in September 2011.

Kenya Deposit Insurance Act 2012

On 14th May 2012, the President of the Republic of Kenya, H.E. Hon. Mwai Kibaki, assented to the Kenya Deposit Insurance Act (KDIA) 2012 and signed it into Law. The Law provides for the establishment of a deposit insurance scheme and a corporation to manage the scheme and to wind up failed deposit taking institutions, among other things. It also establishes a Deposit Insurance Fund to replace the Deposit Protection Fund, and the Kenya Deposit Insurance Corporation (KDIC) to replace the Deposit Protection Fund Board (DPFB). The KDIC's responsibilities will include providing a deposit insurance scheme for customers of member institutions; administering the deposit insurance scheme; collecting contributions for the Fund from member institutions; and holding, managing, and applying the Fund. The KDIC will also receive, liquidate, and wind up institutions for which it is the designated receiver or liquidator. The KDIC will also work towards creating an environment for sound risk management and a stable financial system.

There is a transition period of one year during which to migrate from DPFB to KDIC, and put in place the new institutional structures.

The main objects of the Law are as follows:-

Alignment to international best practice

The provisions of the Law will facilitate compliance with international best practice, which have been codified by the International Association of Deposit Insurance in the form of "Eighteen Core Principles for an Effective Deposit Insurance System."

Autonomy

Though DPFB is a body corporate in its own right, it currently operates as a functional department of Central Bank of Kenya (CBK). The Law establishes the Kenya Deposit Insurance Corporation ("KDIC") as an operationally independent entity from CBK with its own management and staff who are answerable to the KDIC Board.

Enhanced Corporate Governance

Under the current set-up, the CBK Governor chairs the Board and simultaneously oversees the day to day management of DPFB through the CBK administrative structures. Section 7(1) of KDIA provides for an independent Board comprising of a non-executive chairperson appointed by the President; the Permanent Secretary in the Ministry of Finance; the Governor of the Central Bank of Kenya or his representative; five members (who are not public officers) appointed by the Minister for Finance and the Chief Executive Officer who shall be an ex-officio member.

Expanded Mandate

Due to the narrow scope of its mandate, the DPFB is currently classified as a ''paybox'' deposit insurance system with the added responsibility of liquidating failed institutions. Currently, DPFB's role is restricted to payment of the insured deposit of Kshs.100,000/= and the liquidation of failed institutions. Though DPFB carries the responsibility of failed member institutions, it has no role in mitigating industry and institutional risks. The new law therefore allows for a framework that empowers KDIC to proactively manage the risks of providing deposit insurance by expanding the mandate of KDIC to include risk minimization and resolution of problem banks.

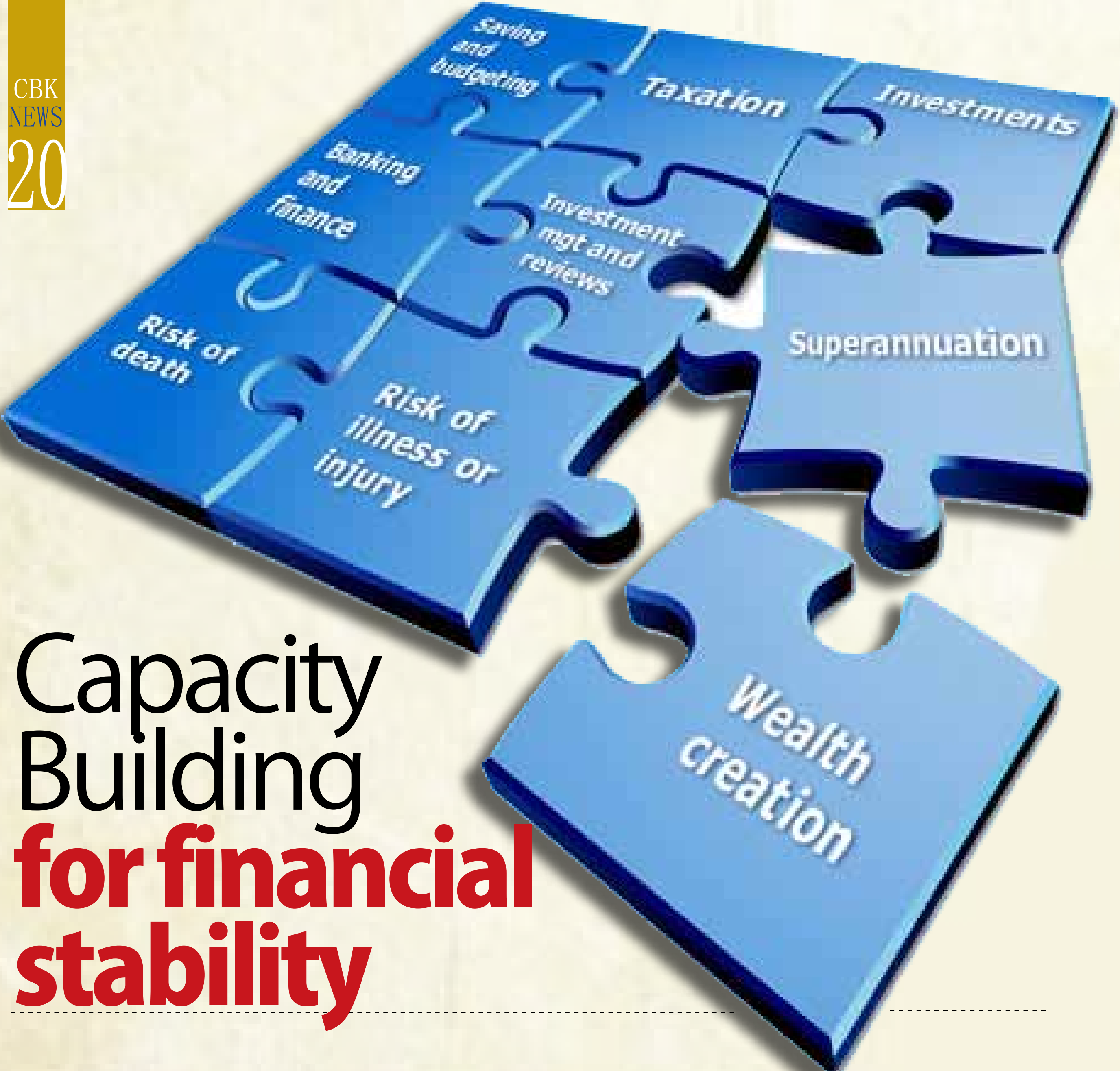
Effective Resolution Mechanism

The expanded mandate will also allow KDIC to contribute to the stability of the financial system as a financial safety net through early detection, timely intervention and resolution of troubled banks. In this regard, KDIC will participate, jointly with CBK, in the inspection/examination of member institutions and in problem bank resolutions.

Rules, Regulations and Guidelines

In order to enable KDIC to execute its expanded mandate, the law provides for the publication of Rules, Regulations and Guidelines. These will cover such areas as scope of deposit coverage; determination of contributions by member institutions; the nature of records to be held by institutions; recovery of penalties imposed on institutions; and prescribe for anything which under the Law ought to be prescribed.

In essence, the new law will empower KDIC to play a more effective role, in collaboration with other safety net participants, in fostering financial stability.



Capacity Building for financial stability

case of Kenya School of Monetary Studies

The topic of capacity building as a driver of financial market stability in Kenya and the wider African region has continued to generate a lot of debate. The debate has largely revolved around the relevance of various programmes offered by institutions, their length, and whether our financial institutions attach as much value to building the capacity of their human resource as they do in pursuit of the bottom line. Yet it is clear that both the financial market crisis and the special role of central banks across the world in resolving the crisis and containing its effects are justification enough for institutions to deliberately pursue a prudent capacity building agenda with the common goal of creating an enlightened competitive environment where sound decisions are made from a reasoned input.

Capacity building continues to be an integral part of how financial institutions can achieve the cutting edge in services design

Investment opportunities in this area have continued to expand, thanks to the restlessness of the human resource factor in these institutions and few education institutions have seized the initiative.

and delivery and strengthen their competitive edge. In the developed world, focus has been on a fair mix of both short term and long term programs including research. On the other hand, the approach in developing countries has been overwhelmingly on the short term training side. The latter group of countries have not fully embraced capacity building as a critical component of stability and hence enhancement of financial gains. Investment opportunities in this area have continued to expand, thanks to the restlessness of the human resource factor in these institutions and few education institutions have seized the initiative. It is in this area that the Kenya School of Monetary Studies has been trying to be the leader in the wider Anglophone Africa since 2008.

In this region, KSMS is the ideal place for capacity building geared towards financial stability– and not just because of its geographic location in this gateway to other African countries. As a training institution, the impetus behind its formation was in response to financial sector instability in Kenya which had the potential to spread to other Eastern and Southern African countries.

The School began by offering short management development courses and professional courses then considered appropriate at the time. However, with time, demand became increasingly sophisticated hence creating the need to offer further education. KSMS in collaboration with Moi University, took a deliberate move and rolled out the first ever African Capacity Building Foundation (ACBF) funded Masters in Banking and Finance (MBF) targeting financial sector institutions in Kenya and the Wider Eastern and Southern African Countries. The Success of this programme both locally and regionally motivated the School to explore other higher education training gaps, still with the objective of strengthening sectoral stability. Amongst these are Masters level programmes in Finance, Financial Economics, Economic Policy and Analysis and Public Policy Analysis , offered in collaboration with Jomo Kenyatta University of Agriculture and Technology (JKUAT)

At the KSMS, on-the-job training is essential and remains the most important engine of growth of the sector. This is why the school continues to explore areas including Masters level programmes in Financial Journalism, Financial Computing and eBanking, Programme Monitoring and Evaluation and Agricultural Finance. From these many programmes, the School hopes to develop its own signature programme which will only be offered by the School.

the School seeks to develop a pool of expertize in the region to support the financial sector's need for highly skilled manpower, in line with its long-term objective of a regional Centre of Excellence for capacity building in Kenya and the rergion.

The Central Bank launches a coin re-circulation campaign

You are in your favourite supermarket purchasing your weekly groceries. To your surprise, you are short-changed by the cashier. Reason - they don't have coins. The same story is repeated in the Matatu- you cannot receive your proper change as there are no coins available. This is a familiar story to many Kenyans especially, those who reside in the urban centres.

In the recent past, numerous concerns have been raised by the public and media over unavailability of adequate coins in the market. The Central Bank has however indicated that there are adequate numbers of coins in the country going by the circulation figures and trends in the last few years.

In response to the public outcry, the Central Bank of Kenya together with the Kenya Bankers Association and major Supermarkets in Kenya represented by their umbrella body Retail Traders Association of Kenya (RETRAK) , came together to launch the National Coin re-circulation Campaign dubbed "Chomoa Coins" campaign. This campaign was officially launched on 26th November 2012 by the Governor of the Central Bank of Kenya, Prof. Njuguna Ndung'u. The campaign was necessitated by concerns raised from retailers and general public regarding shortages of loose change at points of sale outlets.

Besides educating the public on importance of coins, the campaign aimed at:

- Encouraging the general public to utilize coins in making low value payments
- Calling upon the public to circulate coins by dropping them at designated change points in supermarkets and banks.
- Informing the general public and traders in particular that

The bulk of coins are held by the members of the public either in their homes, offices or car pouches. The tendency is such that when shoppers receive their change in the form of coins, they most likely deposit them at home, in car pouches or piggy banks.

they have a responsibility towards their currency and should accept all legal tender coins that are in circulation.

To ensure adequate supply of coins, the Central Bank issues coins through its network of Branches, Currency Centres and over 1200 commercial bank branches countrywide. The Bank has issued more than 1.3 Billion pieces of coins into circulation in various denomination. During the month of October 2012 alone, 9 Million pieces of coins were issued to the commercial banking sector for use across the country. The figure grew to 12 million pieces in the month of November 2012. So where does the problem lie? Where are the 1.3 billion coins hidding?

The bulk of coins are held by the members of the public either in their homes, offices or car pouches. The tendency is such that when shoppers receive their change in the form of coins, they most likely deposit them at home, in car pouches or piggy banks. The practice inadvertently leads to coins shortage. Whereas a saving culture is beneficial to every investor, the habit of keeping coins without releasing them for re-circulation can also be injurious to the economy. If for example 2 million shoppers piled up an average of 100 coins in their homes, then we are looking at an excess of 200 million pieces that are not available for circulation as they should, causeing an artificial shortage.
A typical shopper withdraws notes from the ATM, shops at the suppermarket, receives mixed change, puts the notes in the wallet, then shoves the coins into a jar somewhere at home. The result is an artificial shortage. The coin campaigns carried out by the Central Bank together with other stakeholders therefore aim at changing the coin hoarding culture and encouraging re-circulation and acceptance of all coins in business transactions. The campaigns have mobilized the public to exchange for notes, the coins in their possession. Shops and kiosks owners are being encouraged to accept all denominations of coins as they are legal tender.
It is therefore clear that the problem of coins inadequacy in circulation cannot be addressed by adding new coins but by ensuring that there is an efficient mechanism for re-circulating existing coins within the economy. Let us get the coins moving!

Scenes during the launch of 'chomoa' coin campaign.

The negative impact of money laundering

It's a Monday morning and you are on the road battling the jam in your trademark jalopy. Suddenly, you grind to a complete halt in Uhuru Highway of all the places. Your attempts to seek help from fellow motorists are unsuccessful. Just as you are about to dispair, Benson, your childhood friend pulls aside in a sleek, top of the range Toyota and offers to help. You take note of the suave suit, high end cell phone and of course the bling. As the conversation progresses, Benson reveals he is a motor vehicle dealer and offers to trade-in your "jalopy" for a new improved model at a price that you cannot afford to let go. You accept the offer but at the back of your mind, however, there is the small issue of how he made all the money. later, you hear of Benson's rumoured connections with a suspected drug dealer. The car dealership, you learn, is just a small piece of Benson's empire that now includes hotels and a chain of supermarkets. You wrestle with the fact that your own brother-in-law, who closed his motor vehicle dealership a while ago, would wonder why you are dealing with an unscrupulous competitor who drove him out of business. Anyhow, you decide to take Benson's offer because its too good to let go. This unfortunately is the reality of the negative social and economic effects of money laundering on the society.

Money laundering poses a seriious challenge to the stability of any financila system. Recent studies or typologies on the trends in money laundering show that launderers often tend to place their ill-gotten gains in what are commonly referred to as "sterile" investments. These are investments that do not generate additional productivity to the economy. Examples of sterile investments include high value assets such as luxury motor vehicles, real estate and art. There have been instances where entire sectors of an economy are driven by the interests of money launderers, as opposed to actual demand. When such businesses no longer suit the purposes of the launderers, the projects are abandoned leading to the collapse of entire business sectors and damaging the economies that rely on the funds generated from such businesses.

One of the most serious effects of money laundering is its impact on the private sector. Launderers often use front companies; business entities controlled by criminals to combine illicit funds with legitimate funds in order to disguise their true origin. This enables front companies to offer products and services, at below-market prices. As a consequence, legitimate business enterprises are often "crowded out" by front companies as they are unable to compete. This in turn increases the potential for monetary and economic instability due to misallocation of resources and artificial distortions in the prices of goods and services.

Financial institutions may also face liquidity challenges if their clients decide to withdraw funds, due to percieved association with money laundering. Foreign financial institutions that offer correspondent banking services may decide to limit their transactions with institutions located in money laundering havens and subject these transactions to extra scrutiny, driving up the cost of doing business.

Beyond the economic and financial costs posed by money laundering, there are the social costs to the society as well. Money laundering tends to have a corrupting influence on the fabric of society, resulting in increased criminality. It corrupts the judiciary, law enforcement, and financial institutions. Money laundering transfers economic power from the market, government, and citizens to criminals . In some instances, it could even lead to the control of legitimate governments by money launderers.

Vision 2030, Kenya's economic blueprint aims to transform the country into a regional economic and financial hub. This is in recognition of the fact that the globalization of financial markets offers opportunities for increased economic growth and prosperity. It should be noted therefore, that as emerging markets begin to open their economies and financial sectors, they become increasingly viable targets for money laundering activity. This, coupled with advances in communications and technology, present criminals with additional opportunities to launder their ill-gotten gains. In such instances, a negative reputation arising from money laundering may diminish legitimate global opportunities and sustainable economic growth. It is for this reason that one of the pre-requisites for transforming into global international financial centers be it New York, London, Singapore or Hong Kong has been to adopt a robust anti –money laundering legal and regulatory regime.

OPPORTUNITY TO INVEST IN GOVERNMENT BONDS AND BILLS

Did you know you could save and invest in secure high return Kenya Government Bonds and Treasury Bills?

WHO CAN INVEST?

Any individual,corporate body,groups and non-Kenyans can invest in Government securities by opening a Central Depository System (CDS) Account (for Free) with the Central Bank of Kenya directly or through your commercial bank.

STEPS IN OPENING A CDS ACCOUNT

1. Visit the nearest office of the Central Bank of Kenya (Nairobi,Mombasa, Eldoret, Kisumu, Nakuru, Nyeri or Meru) or Kenya Commercial Bank, Equity Bank, National Bank, Cooperative Bank and Kenya Post Office Savings Bank and obtain a CDS opening /mandate card and fill out your details. Note: CDS account application cards for individual and corporate applicants are different.
2. Attach a recently taken coloured passport size photograph and a copy of your National Identity Card(ID) or Passport.
3. Take the filled CDS mandate card to your commercial bank for certification.
4. Your bank will certify your particulars in the completed CDS mandate card by way of appending the bank's stamp and signature of two of their authorized signatories on the space provided.
5. Corporates are required to affix a company seal on the mandate card.
6. Send the filled up mandate card and attachments to the issuing office.
7. Once the CDS account is opened in your name,you will be notified of the CDS account number via the address you have provided on the CDS mandate card. A formal notification letter will also follow.
8. Once you have been allocated and notified of your CDS account number,you can apply(bid)for the Amount of Treasury Bond or Treasury bills you wish to invest in.

GUIDELINES FOR APPLICATION(BID)FOR BONDS AND BILLS

1. Obtain application forms for bonds/bills from any of the Central Bank of Kenya's office in Nairobi, Mombasa, Eldoret, Kisumu, Nakuru, Nyeri or Meru or Download the form from the CBK website:http://www.centralbank.go.ke/securities/ApplicationForms.aspx
2. Fill out the following
   - Bond/Bill Issue Number.
   - Duration/Tenure as provided for in the respective prospectus/advert.
   - Value date .
   - Total face value-Amount you wish to invest(Kenya Shillings).
   - Interest Rate-This is the investor's desired yield.
   - Your details-as per the CDS mandate card.
3. The minimum investible amount in Treasury Bills is Ksh.100,000.00 and 50,000.00 for Treasury bonds.
4. Sign the application form and submit to any CBK office or financial institution specified in 1 above
5. NB.Do not make payments for the Treasury bills and bonds until you confirm with the central Bank of Kenya of the exact amount you will need to pay.

For further information call Central Bank of Kenya (National Debt Office)on:
2863600 or email ndo@centralbank.go.ke

CBKNewsletter

Keeping you Informed

www.centralbank.go.ke