CENTRAL BANK OF KENYA

RISK MANAGEMENT SURVEY FOR THE BANKING SECTOR

JANUARY 2011

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1.0 FOREWORD

In the year ended 31st December 2010, the Banking Sector experienced impressive growth. Highlights of the sector's performance are as follows:

- Total assets grew from KShs 1.35 trillion in December 2009 to approximately KShs 1.69 trillion in December 2010.
- Deposits increased from KShs 1.0 trillion in December 2009 to approximately KShs 1.26 trillion in December 2010.
- Total loans and total liabilities stood at approximately KShs 915 billion and KShs 1.43 trillion in December 2010.
- Overall unaudited pre-tax profits stood at KShs 72.4 billion for the year ending 31st December 2010 compared to KShs 48.3 billion for the year ending 31st December 2009, a 69% increase.

In its endeavour to raise financial inclusion and enhance financial stability, the Central Bank of Kenya (CBK) undertook such initiatives as the rollout of the agent banking model in May 2010, rollout of the banking sector credit information sharing (CIS) mechanism in July 2010 and licensing of deposit taking microfinance institutions.

As the banking sector continues to embrace innovations, the intensity and variety of risks that the players are exposed also continue to increase in tandem. To ensure that the growth in the banking sector does not jeopardise its stability, risk management is crucial. In view of this, the CBK carried out a risk management survey on the Kenyan banking sector in September 2004. The survey's objective was to determine the needs of the local banking sector with regard to risk management. The survey was necessitated by the drive to fully adopt *Risk Based Supervision* and to incorporate the international risk management best practices envisioned in the 25 Basel Core Principles for Effective Banking Supervision. The survey culminated in the issuance of the Risk Management Guidelines (RMGs) in 2005 and the adoption of the *Risk Based Supervision* approach of supervising financial institutions in 2005.

In order to assess the adequacy and impact of the Risk Management Guidelines, 2005 on Kenyan banking institutions, CBK issued risk management survey (2010) questionnaires to 42 Commercial Banks and one Mortgage Finance Institution in November 2010. Charterhouse Bank Ltd which is currently under statutory management was excluded from the survey. The questionnaire is attached to this report as **Annex I**. The goal of the survey was to determine whether the RMGs issued in 2005 have had any impact on the institutions and as to whether the RMGs are adequate, as well as establishing the necessary amendments and/or additions that needed to be introduced to ensure that the RMGs remained relevant, current and reflective of circumstances in the operating environment.

Out of the forty three questionnaires sent out, CBK received responses from all institutions. The list of the respondents is attached to this report as **Annex II**. CBK expresses its gratitude to the forty three institutions that responded.

Central Bank of Kenya
January 2011

2.0 EXECUTIVE SUMMARY

The CBK is currently in the process of reviewing its Prudential and Risk Management Guidelines in order to align them with the contemporary operating environment and international best practices. In this regard, the Risk Management Survey (2010)('the survey') was administered with a view to ascertaining the impact that the existing risk management guidelines have had on the industry since their issuance in 2005, as well as identify what changes would be necessary to ensure the guidelines remain relevant to the current operating environment.

The survey comprised of twelve questions focusing on the following aspects:

1. Existence, management and reporting lines in the risk management function in institutions.
2. Risks faced by institutions.
3. Development of Risk Management Manuals and Programmes by the institutions.
4. Challenges faced during the establishment and roll-out stages of the risk management function and the strategies adopted to address those challenges.
5. Structure and staffing of the risk management function.
6. Efforts undertaken by institutions to create risk management awareness.
7. Usage of Management Information Systems (MIS) in risk monitoring, measurement and reporting.
8. Changes experienced as a result of the introduction of the risk management framework.
9. Budgetary allocation to the risk management function.
10. Review of the effectiveness of the risk management function.
11. Measures put in place by institutions to enhance the risk management function.
12. Recommendations by institutions on changes required in the current risk management guidelines.

The survey questionnaire was issued to a total of 43 institutions, comprising 42 commercial banks and 1 mortgage finance institution. All the institutions responded to the survey, for a response rate of 100%. In summary, the overall feedback from the survey was as follows:

a. All surveyed institutions had a risk management function. 95% of the respondents indicated having an *independent* risk management function, while 5% did not, as per the responses obtained. Of the total respondents, 70% ran *centralised* risk management functions, 21% ran *decentralised* functions while 9% have *hybrid* functions that are partially centralised and decentralised.
b. Market, operational and credit risks are the risks of greatest concern to most respondents (being identified by 100%, 95% and 93% of the respondents respectively).
c. 84% of the respondents reported having developed Risk Management Manuals and Programmes. 56% of respondents reported that their Risk Management Manuals and Programmes are reviewed annually. 60% of respondent institutions indicated that the responsibility of reviewing these manuals and programmes rested with the full Board or Board Committees.
d. Key challenges faced by the institutions during formulation and implementation of the risk management function were the lack of the appropriate risk management policies, lack of adequate, skilled manpower, lack of appreciation by the rest of the organisation, of the role

played by the Risk Management function, and inadequate management information systems. The majority of institutions addressed these challenges mainly through staff training (67% of the respondents), the installation of new (computerised) management information systems (21% of the respondents), and by enhancing communication within the institutions (14% of the respondents).

e. The mechanisms most commonly applied by institutions to ensure that risk management culture penetrates to all levels of staff were staff training (91%), enhanced application of risk management tools and techniques across the organisation (44%), formulation of manuals and programmes for internal guidance on risk management procedures (40%) and inclusion of risk management as a key staff performance indicator (10%).

f. 81% of the respondents indicated that they had in place a risk-dedicated management information system (MIS). These systems generated a wide range of reports on such risks as operational, liquidity, credit, market and regulatory risk, among others.

g. *Stress testing* was the technique most widely used by respondents to measure risk (93%), followed by *Contingency Planning* (74%) and *Value at Risk* (51%) among other techniques.

h. Since its introduction, the Risk Management Framework had impacted the respondent institutions in various ways, notably by raising organisational risk-awareness (95%) and through improved operating procedures aimed at better management of risk (90%).

i. Budgetary allocation by 63% of respondent institutions to their risk management functions, as a proportion of the total annual institutional budget, ranged from 0% to 20%. 37% of the respondents, however, indicated that they could not estimate this proportion with accuracy owing to the nature of their organisational budgeting approach, which prevented the isolation of the risk management element from the overall budget.

j. All respondents indicated they had an independent function that reviews the effectiveness of their Risk Management framework. In most cases, this was either the internal audit function (60%), a board committee (23%) or an executive risk management committee (7%).

k. Additional risks and emergent issues facing institutions and that need to be addressed in the Risk Management Guidelines include(as recommended by the respondents):
   - the need to enhance guidelines on operational risk to include risks surrounding outsourcing, fraud, corporate governance, leasing and online banking;
   - introduction of provisions governing country risk, sustainability risk, expansion and project management risks and Sharia Compliance risk;
   - introduction of risk management and performance returns in the risk management guidelines;
   - publication of sectoral performance and industry benchmarks addressing emerging risk exposures to enhance the risk management practices of financial institutions;
   - adoption of international best practices such as the recommendations by the Basel Committee on Banking Supervision and Committee of Sponsoring Organisations (COSO) on Enterprise Risk Management Framework;
   - introduction of standardized tools/models of identifying, assessing and reporting the risks covered by the Risk Management Guidelines;
   - incorporation of explicit provisions, in the RMGs (and the relevant legislation), governing the increased risk of fraud in the financial sector, and
   - provision of practical guidance on the application of risk measurement techniques to assist institutions in better management of their risk exposures.

The detailed description of the above findings which now follows gives an itemised analysis of all responses to facilitate a closer view.

3.0 DETAILED SURVEY FINDINGS

3.1 Background

In the Risk Management Survey of 2004 many banks reported that they heavily relied on Central Bank of Kenya's prudential returns to monitor risks, due to the absence of internal risk management information systems. In response, the Central Bank introduced the Risk Management Guidelines (RMGs) in 2005 to assist institutions under its purview in formulating and implementing internal risk management policies and procedures with a view to better monitor, measure and report risks. Since the introduction of the RMGs in 2005, subsequent developments and occurrences in the global economy such as the recent global financial crisis and Basel Committee pronouncements have necessitated review, by the Central Bank, of both its Prudential and the Risk Management Guidelines to ensure that they remain relevant to circumstances in the operating environment. The Risk Management Survey (2010) aimed at evaluating what effect the RMGs (2005) have had on institutions' risk management functions, in order to determine the impact and adequacy of the RMGs.

3.2 Findings

3.2.1 Existence and Management of the Risk Management Function

3.2.1.1 Existence of the Risk Management Function

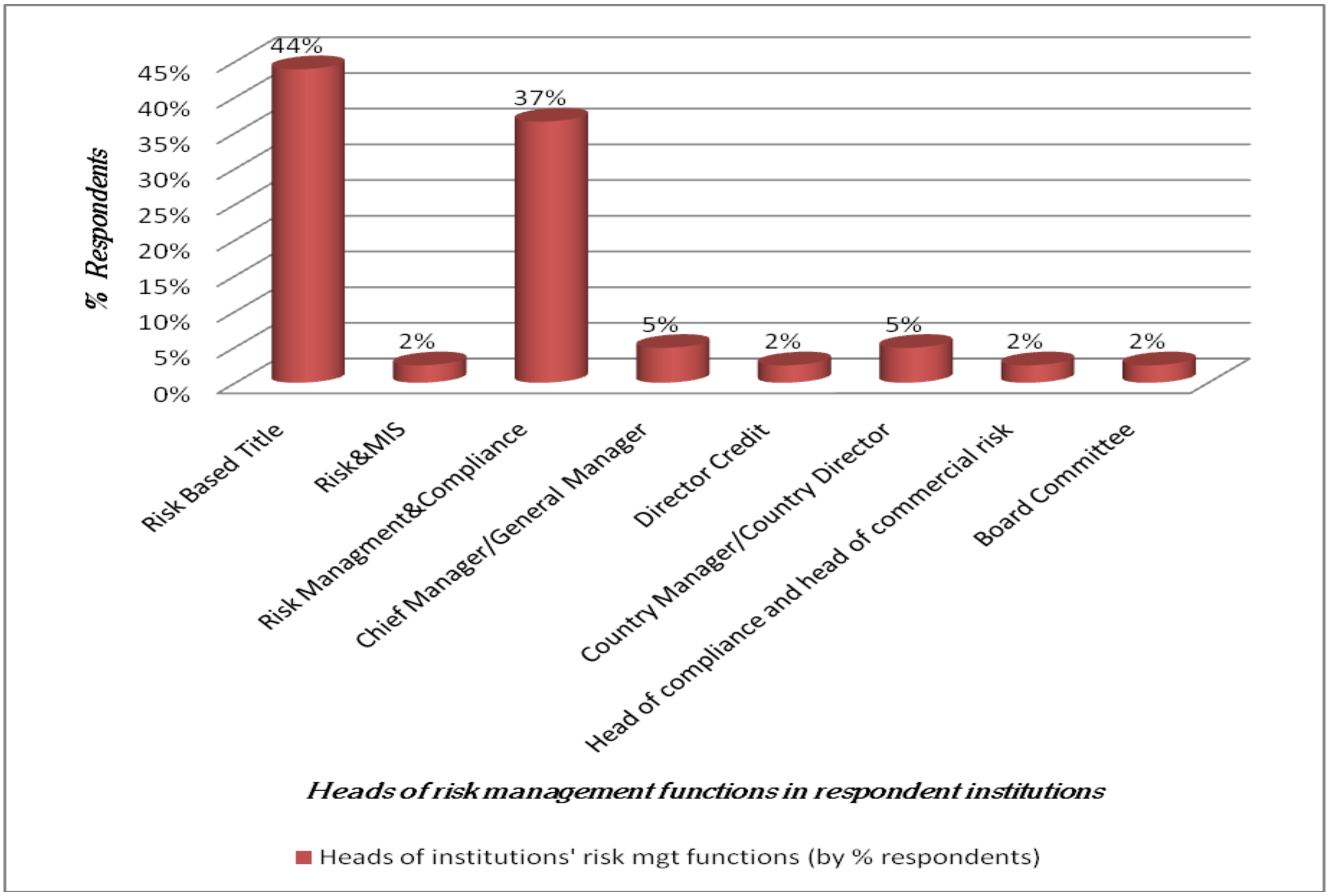
95% of the respondents indicated that their institutions had an independent risk management function, while the remaining 5% indicated not having one in place. In the 2004 survey, institutions had been asked whether or not they had *(internal)* risk management *guidelines,* rather than a *dedicated function.* 94% had then indicated having those guidelines. However, with particular respect to existence of risk management *functions*, the 2004 survey is not directly comparable to the current survey.

3.2.1.2 Management of the Risk Management Function

The leadership of the risk management determines and directs an institution's overall risk management strategy: its selection, implementation, and ultimate success or failure.

In the survey, 42% of the respondents indicated that they had a functional head for their Risk Management Function with a risk-related title such as *Risk Manager, Chief Risk Officer* or *Director, Risk.* In 37% of the respondent institutions, the head of the risk department doubled up as the head of compliance or management information systems (MIS). It is noteworthy that majority of the institutions (81%) had dedicated risk management functions, showing the level of importance to which they assign the likely impact of inadequate risk management. Chart 1 below shows the various titles of the heads of risk management functions in respondent institutions.

Chart 1: Heads of Risk Management Functions



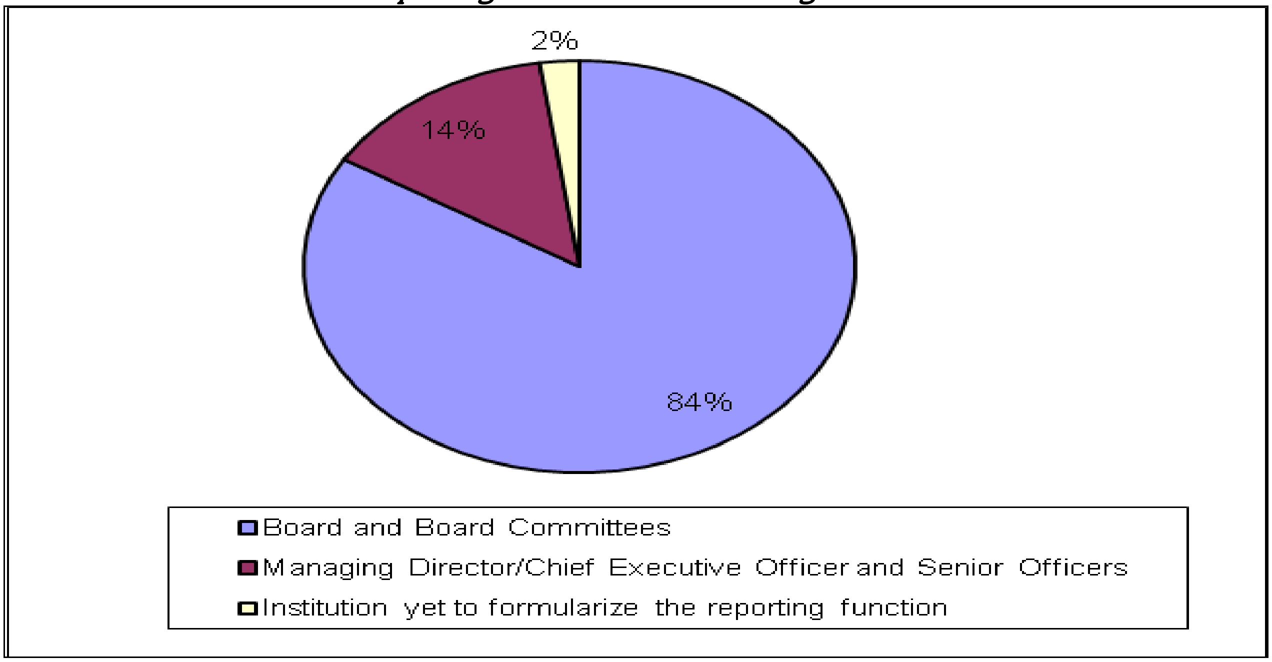
3.2.1.3 Reporting lines in the Risk Management Function

The concept of independence is a vital element because it ensures that the risk management function performs its duty without undue influence from the management. For the independence of the function to be felt the institution's reporting line should be to the Board of Directors.

The results of the survey showed that risk management functions reported to:
- the Board and Board Committees in 84% of the respondents
- the Managing Director/ Chief Executive Officers and Senior management in 14% of the respondents
- 2% of the respondents (1 institution) indicated that it was still in the process of formalizing its reporting lines and structure through formulation of its Risk Management Manuals and Programmes.

Chart 2 below depicts these findings.

Chart 2: Reporting lines in the Risk Management Function



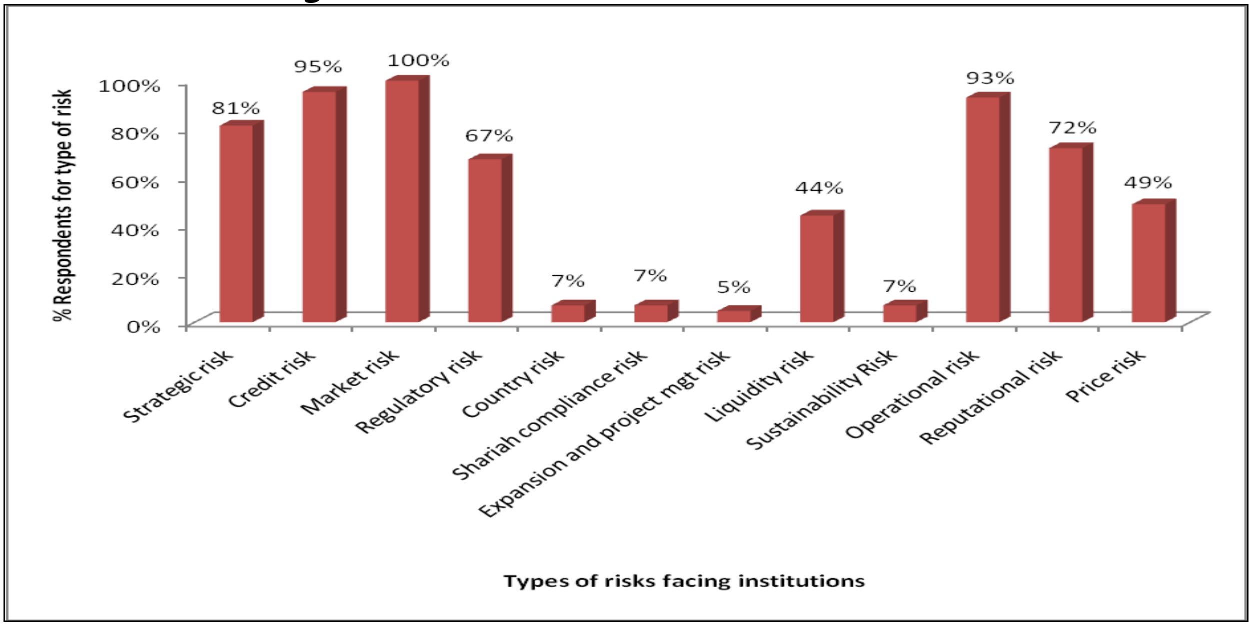
3.2.2 Risks Facing Institutions

3.2.2.1 Overall Risks Faced by Institutions

The survey results show that market risk (in this context, comprising of equity risk, interest rate risk, currency risk and commodity risk) was the risk facing most institutions, having been identified as a principal risk by all forty three respondents (100%), followed by credit and operational risks which were identified by 95% and 93% of respondents respectively. In the 2004 survey, credit risk was the most widely identified risk (97% of respondents). The current survey's results show that credit risk is still essentially as significant as it was in the earlier survey, which may be attributed to the large proportion of banks' asset portfolio made up of loans and advances to customers.

From the survey, respondent institutions have notably demonstrated greater knowledge of the risks facing their businesses than was the case before. This is evident from the introduction of dedicated risk-management functions by most of the institutions (95%). This reflects a higher level of institutional risk awareness, a possible result of the issuance of risk management guidelines and continuous monitoring to ensure implementation. Chart 3 below shows the response rates for the risks cited by the institutions as facing them.

Chart 3: Risks facing Financial Institutions



3.2.2.2 New Risks Facing Institutions – Not Covered in Current RMGs

CBK has undertaken many initiatives since the issuance of the Risk Management Guidelines in 2005. These initiatives were either market driven or geared towards enhancing greater access, stability and efficiency of the sector. Some of the initiatives undertaken after 2005 are:

1. **Introduction of Sharia Compliant Banking**

This initiative was necessitated by the need to bring on board members of the public who, due to religious or cultural beliefs were excluded from conventional banking services. CBK has since licensed two institutions, First Community Bank Ltd (May 2007) and Gulf African Bank Ltd (September 2007) to offer purely Sharia compliant financial services besides eight other conventional commercial banks that have opened windows to offer Sharia compliant banking products. The introduction of Islamic Banking resulted in enhanced compliance risk.

5% of the respondents cited operational risks arising from the introduction of Islamic banking products.

2. **Expansion programmes**

In their pursuit of greater market share, institutions have been undertaking large expansion programmes through opening more branches, contracting agents or even opening subsidiaries in neighbouring countries.

The Agent Banking Model was operationalised in May 2010. The model allows institutions licensed under the Banking Act to use third party agents to provide certain banking services in areas with business opportunities which may not necessarily merit their physical presence. This innovation changed the traditional use of brick and mortar branches, reduced both fixed and operational costs and provided for low cost delivery channels.

5% of the respondents cited operational risks emanating from agent banking and other models of expansion whereas 12% of the respondents cited country risk emanating from their regional expansion programmes as being of concern.

3. **Increased focus on corporate social responsibility**

An institution's operating environment is a significant determinant of that institution's long-term sustainability. Risks emanating from the operating environment such as political instability, disruption or termination of customers' businesses would adversely affect institutions. An institution's business activities also have positive or negative effects on its operating environment and society in general.

In recognition of this mutual relationship, institutions are obliged to exercise corporate social responsibility in their activities in order to ensure their business remains sustainable and viable in their social and environmental context.

In the survey, 14% of respondents identified *sustainability risk* as an additional risk facing financial institutions, and which should be catered for in the risk management guidelines.

Table I below summarises the above findings.(*NB: Out of the 43 respondents in the survey, only 15 institutions cited new risks as being of concern, i.e. risks not covered by the current RMGs)*

Table 1: New risks faced by institutions

	New risk cited	Number of Respondents	%age of Respondents
1.	Country Risks	5	12%
2.	Sustainability-Environmental Risks and Social Responsibility	6	14%
3.	Expansion and Project Management Risk	2	5%
4.	Risks from Islamic banking products	2	5%
5.	No new risks cited	28	64%
	Total Respondents	**43**	**100%**

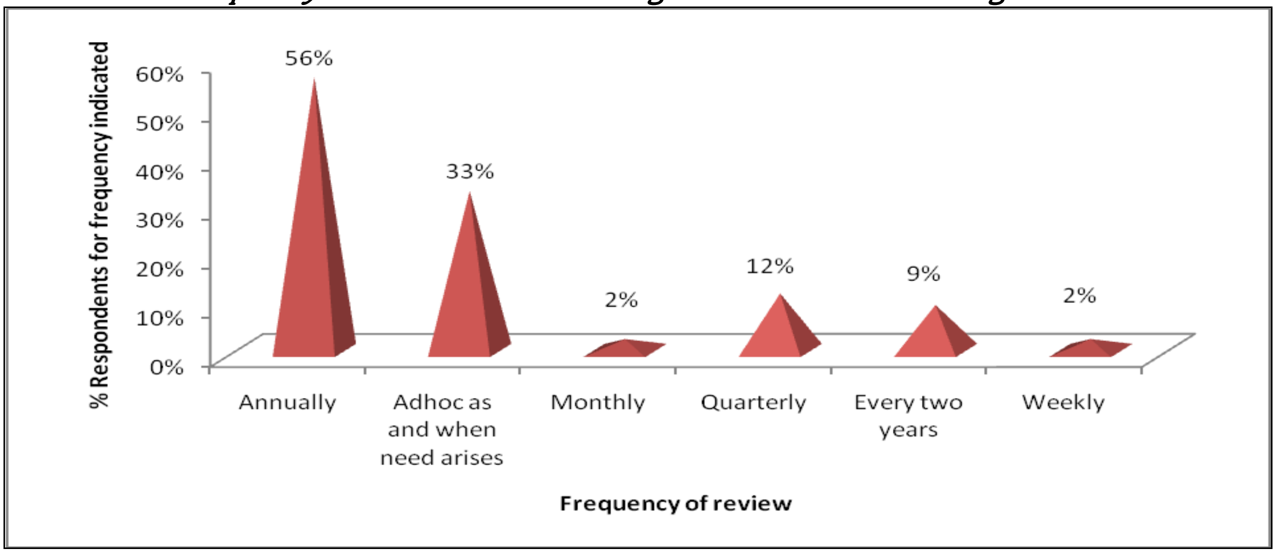
3.2.3 Existence and Review of Risk Management Manuals and Programmes

3.2.3.1 Existence and frequency of review of the Risk Management Manuals and Programmes

84% of the respondents reported having developed Risk Management Manuals and Programmes. On the frequency and regularity at which institutions reviewed their risk management manuals and programmes, Chart 4 below shows that 24 institutions (56% of the respondents) indicated that they review theirs annually (with 6 of these respondents indicating that they conduct their reviews *both annually and on an ad hoc basis*), 14 institutions (33% of the respondents) indicated that they review theirs purely on an ad hoc basis, 5 institutions (12 % of the respondents) indicated that they carried out their review on a quarterly basis. 4 institutions (9% of respondents) stated that they review theirs every two years, while one institution indicated weekly review. 6 institutions indicated that they conduct their reviews *both annually and on an ad hoc basis* while 2 institutions (5% of respondents) indicated that they were in the process of developing the Risk Management Manuals and Programmes. These responses show that majority of institutions indeed appreciate the dynamic nature of the risks facing them and hence the regular review of their risk management manuals and programmes.

In the 2004 survey, 94% of the respondents reported having clearly defined risk management *guidelines*. This progression from risk management guidelines to developing risk management manuals and programmes is a notable positive influence of the RMGs on the industry.

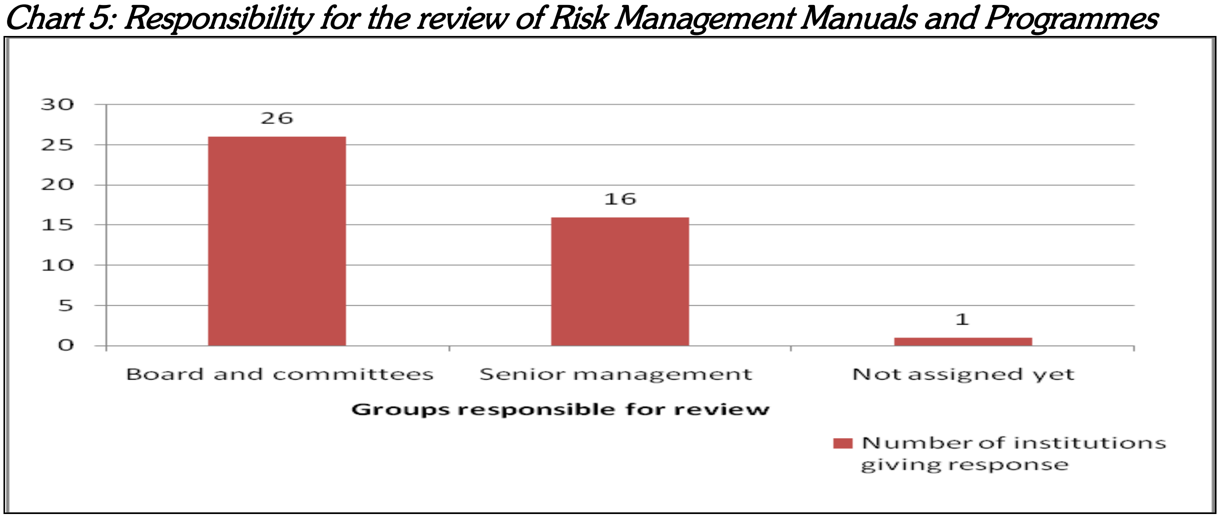
Chart 4: Frequency of Review of Risk Management Manuals and Programmes



3.2.3.2 Responsibility for the Review of the Risk Management Manuals and Programmes

The survey indicated that the responsibility of reviewing the Risk Management Manuals and Programmes rested with the Board or Board Committees upon recommendations from the management in 26 institutions (60%); sixteen institutions (38%) indicated that this responsibility rested with senior management while one institution indicated that it was in the process of formulating the risk management manuals and programmes. Chart 5 shows these responses in diagrammatic form.

Chart 5: Responsibility for the review of Risk Management Manuals and Programmes



3.2.4 Challenges experienced during formulation and implementation of the risk management function and responsive strategies

3.2.4.1 Challenges experienced by institutions during the formulation and implementation of their risk management functions.

The survey showed that the challenges experienced by institutions during the formulation and implementation stages of the risk management function include the following:

- **Inadequate technical expertise:** 32 of the respondents indicated not having sufficient technical staff during the process and for this reason, they had to recruit additional, suitably skilled staff
- **Inadequate management information systems:** 13 institutions indicated that their management information systems were inadequate in generating suitable reports for the identification, monitoring and mitigation of risks. Owing to this, the affected institutions lacked adequate historical data for use as input during the implementation stage of their risk management framework.
- **Lack of support, from the rest of the organisation, for failure to appreciate the role of the risk management function:** 4 institutions indicated that risk management was duplicating the roles of either the internal audit or compliance departments, and for that reason, support for the establishment of the risk management function was not easy to obtain.
- 7 institutions cited the **lack of a well-defined departmental structure and inadequate resourcing** as a challenge in setting up their risk management function.
- 4 institutions affiliated to international financial institutions experienced **difficulties in aligning their local risk management practices to the international group practices.** One particular respondent reported experiencing difficulty in harmonizing local regulatory requirements on risk with those of the international group which it was part of; one other institution, which faced a similar dilemma, stated that it followed the head office's risk policies, which presented a compliance challenge to the local operation as some risks are specific to the local environment and may not be addressed by parent office.
- 14 institutions reported lacking appropriate policies to continuously adapt to changing emergent risks. As a result, they recommended more frequent review of the RMGs some proposing an interval of two years.

Table 2 below summarises the challenges faced by institutions during the formulation and implementation of their risk management functions. *(NB: Some institutions gave two or more of the responses indicated and hence the total responses exceed the total number of responses).*

Table 2: Challenges faced by institutions during the formulation and implementation of the risk management function

	Challenges	Number of institutions giving response
1.	Inadequate technical expertise	32
2.	Inadequate management information systems	13
3.	Lack of support, from the rest of the organisation, for the Risk Management Function	4
4.	Difficulty in aligning their local risk management practices to international group practices	4

	Challenges	Number of institutions giving response
5.	Lack of appropriate (adaptive) policies	14
6.	Lack of appropriate departmental structure and resourcing	7

3.2.4.2 Strategies implemented by institutions to overcome the challenges faced during the formulation and implementation of the risk management function

Respondents adopted the following strategies to overcome the challenges identified in S. 3.2.4.1 above:

- 67% of the respondents trained their existing staff on risk management practices and recruited additional staff with the relevant skills and expertise to resource their functions.
- 9% of the respondents used the CBK's Risk Management Guidelines, 2005 to set up the risk management departments.
- 21% of the respondents reported that they installed new management information systems to assist in the identification, monitoring and mitigation of risk.
- 17% of the respondents indicated that they formulated and implemented risk and anti money laundering policies and manuals.
- 5% of the respondents reported having implemented compliance testing and self assessments on risks.
- 12% of the respondents were guided by their boards in establishing the risk-management department; branch staff were also attached to the head office (for training purposes).
- 14% of the respondents indicated that they enhanced communication on risk internally through meetings at all levels within the organisational hierarchy.
- 7% of the respondents either developed an institutional risk and compliance charter or terms of reference for the Risk Management Committee, Board Audit and Risk Committees.
- 5% of the respondents engaged external risk consultants to improve competence, build technical capacity and enhance the independence of the department.
- 2% of the respondents included risk management performance targets in Staff Performance Management Systems.

3.2.5 Operationalisation of the Risk Management Function in Institutions

3.2.5.1 Nature of the Risk Management Function in Institutions

The survey's results showed that 70% of the respondents ran centralised risk management functions (as compared to 37% in 2004) while 21% ran decentralised functions (as compared to 34% in 2004). 9% ran hybrid functions that were both partially centralised and decentralised. The tremendous increase in centralised risk management functions over the period is a testimony to institutions' realisation of the need to manage risks at group level to ensure completeness. Purely decentralised systems expose institutions to group wide risks which may not be managed at unit/branch level. Table 3 below presents these findings.

Table 3: *Nature of the Risk Management Function in institutions*

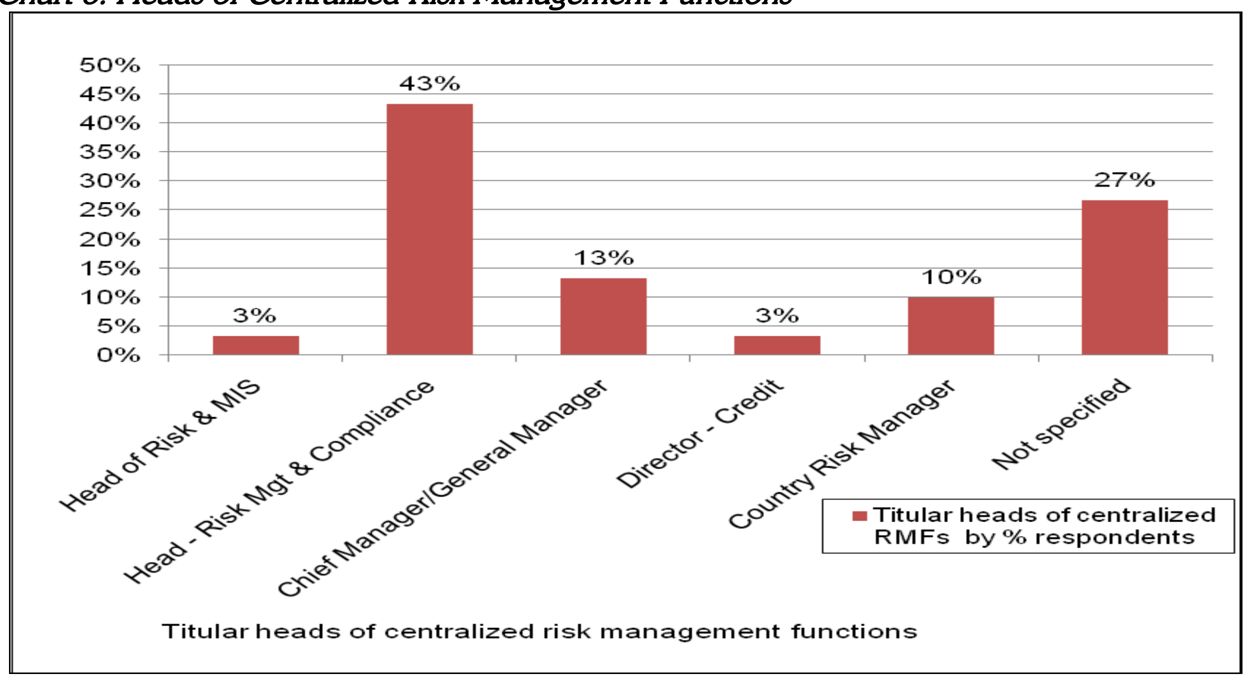
	Nature of risk management function	Number of institutions	Percentage of institutions
1.	Centralised	30	70%
2.	Decentralised	9	21%
3.	A combination of centralised and decentralised	4	9%

3.2.5.2 Heads of Centralised Risk Management Functions

Titular heads of centralized risk management functions in the respondent institutions were:

- the Head Of Risk *and* Management Information Systems(MIS) in 3% of institutions in this category;
- the Head of Risk Management and Compliance in 43% of the institutions in this category;
- the Chief Risk Manager/General Manager - Risk in 13% of institutions in this category;
- the Director or Head of Credit in 3% of the institutions in this category;
- the Country Risk Manager in 10% of the institutions in this category;

Chart 6: Heads of Centralized Risk Management Functions



3.2.5.3 Level of staffing in risk management functions

77% of the respondents running centralized risk management functions employed between 1 and 5 persons in their risk management functions. 3% employed between 6 to 10 persons. The number of staff in 20% of respondents in this category ranged widely from 11 to 99. This is a reflection of the differences in size and complexity among the respective risk management functions of the surveyed institutions.

The modal number of staff employed in centralized risk management functions was four (4); the highest number of staff employed in a single institution was ninety nine (99) while the lowest number of staff was one (1).

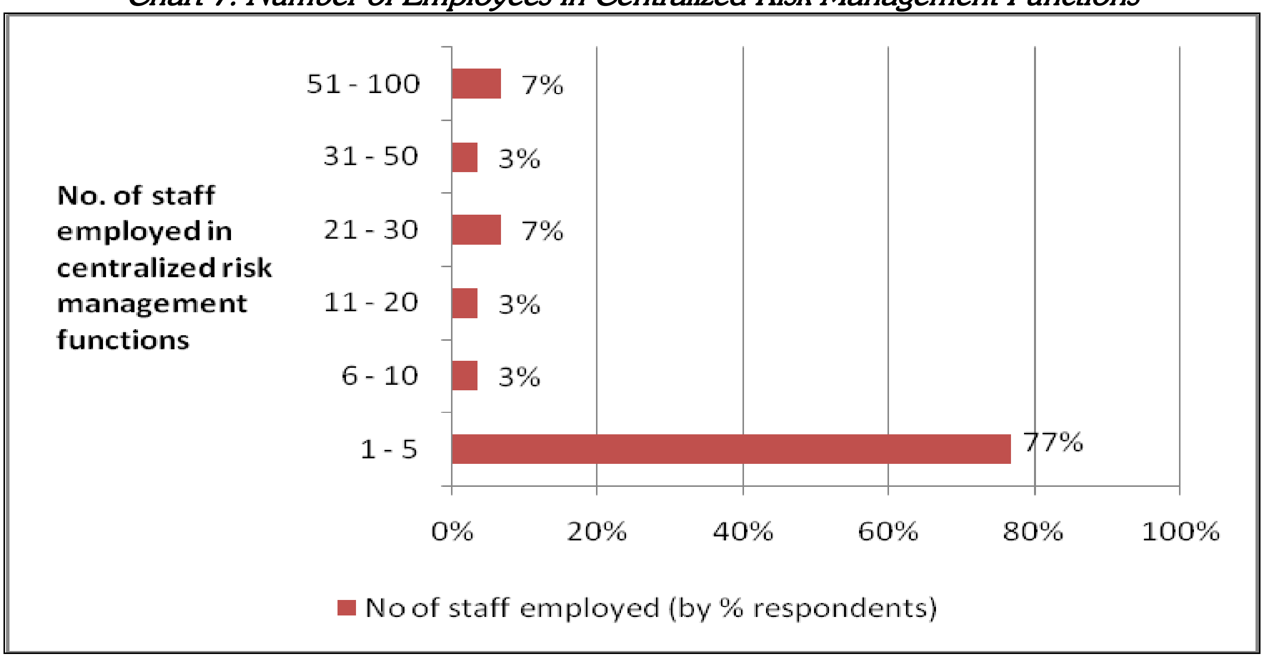
13% of the respondents indicated that their risk management functions were ran by one person. This raises concern over the adequacy of staffing and the extent to which duties are segregated in the risk management departments of the institutions in question. Staff adequacy, in terms of both numbers and skills is vital, if any risk management function is to effectively serve its intended role.

Table 4 and Chart 7 below depict these results.

Table 4: Staff Employed in Centralised Risk Management Functions

	Number of Staff	Number of institutions	% Institutions
1.	1	4	13%
2.	2	4	13%
3.	3	5	17%
4.	4	6	20%
5.	5	4	13%
6.	8	1	3%
7.	11	1	3%
8.	29	1	3%
9.	30	1	3%
10.	45	1	3%
11.	97	1	3%
12.	99	1	3%

Chart 7: Number of Employees in Centralized Risk Management Functions



3.2.5.4 Responsibilities of Staff in Centralised Risk Management Functions

38% of those working in centralised risk management functions were involved in enterprise risk management and compliance. 11% were deployed in the formulation and communication of their institutions' risk management objectives and directives. A similar proportion handled staff training. Table 5 below summarizes these responsibilities of staff across the respondent institutions.
(NB: All institutions indicated more than one of the responsibilities shown, hence the sum of percentage responses exceed 100%).

Table 5: Responsibilities of employees in Centralised Risk Management Functions

	Function	% Respondents
1.	Enterprise Risk Management and Compliance	38%
2.	Establishment and communication of the organizations Enterprise Risk Management objectives and direction	11%
3.	Managing, training, developing and coaching staff	11%
4.	Monitoring KYC/AML status	8%
5.	Ensuring that the bank adheres to its policies, procedures and overseeing Business Process Reengineering	8%
6.	Designing and reviewing of risk management toolkits	5%
7.	Develop risk tolerance limits for senior management and Board	3%
8.	Formulation of the corporate risk matrix	3%
9.	Formulation of the corporate risk register	3%
10.	Formulation of the treasury risk report	3%
11.	Compilation of the operational risk management report	3%
12.	Compilation of the BCP/DRP Reports	3%
13.	Integrating risk management with the organisation's central strategy.	3%

3.2.5.5 Operations of Decentralized Risk Management Functions in Institutions

26% of respondents who ran decentralized risk management functions described their mode of operation as follows:

- 14% indicated that line managers together with operational and other risk champions monitor and manage risks within their departments and report either to the top executive management, the CEO or Board Committees on their risk assessment and management activities.

- 5% indicated that each department handled its own risks and that the departmental heads were responsible for having proper risk management mechanisms in place.

- 5% of respondents indicated that, in their institutions, quarterly risk committee meetings were held, in which staff discussed and reassessed risk management activity during the quarter under review. At these meetings, branch representatives were invited to report on their risk compliance status.

- 2% of the respondents (one institution) indicated that each of its departments is mandated to manage its own risk, and to carry out periodic self-assessments on the same. The internal auditor oversees self assessments on risk by each department and advises them on risk mitigation. The auditor later reviews each department's progress in implementing the risk-mitigation measures recommended, and reports to the Board Risk Committee which carries out an overall review.

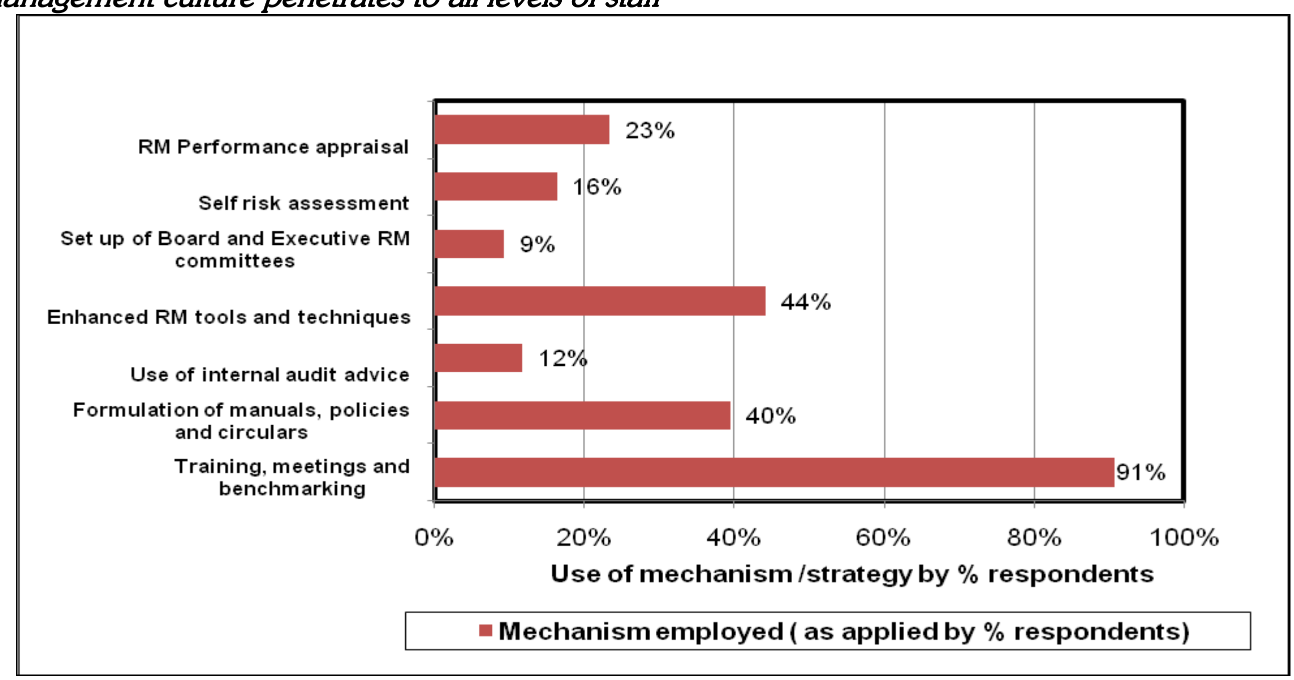
3.2.6 Mechanisms employed by institutions to ensure the penetration of the risk management culture to all levels of staff

The results of the survey showed staff training to be the most widely used strategy by institutions (accounting for 91% of total responses) in ensuring the penetration of the risk management culture to all levels of staff. Institutions further reported that staff training took a variety of forms which included e-learning courses, information dissemination via intranet portals, circulars and quarterly bulletins among others. In addition:

- 44% of the respondents indicated that they developed enhanced (internal) tools and techniques to inculcate the risk management culture in all staff;
- 40% of respondents formulated risk management policies, manuals and circulars and disseminated these to staff;
- 23% included risk management as an additional deliverable in staff performance management and appraisal systems as measured through performance contracting and balanced scorecards;
- 16% initiated continuous self-assessments on risk management;
- 12% indicated that they took advice on risk management from their internal audit functions, and
- 9% established risk-dedicated board and executive level committees to oversee staff sensitization on risk management.

The above responses are presented in Chart 8 below.

Chart 8: Mechanisms employed by the management of the institutions to ensure that the risk management culture penetrates to all levels of staff



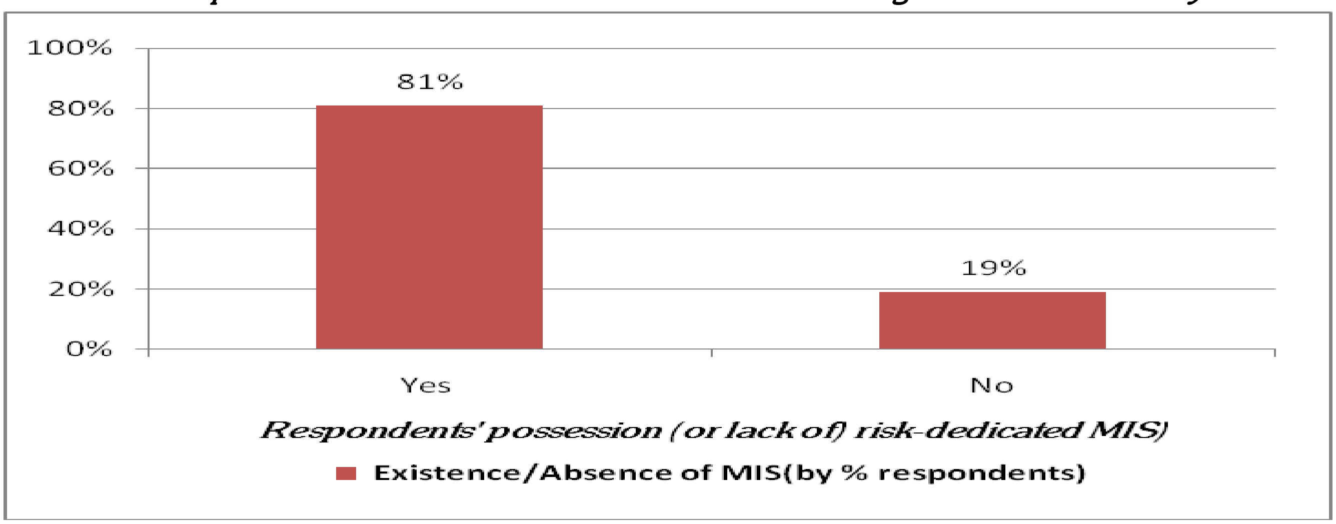
3.2.7 Existence of Risk-Dedicated Management Information Systems, Generation and Frequency of Reports

3.2.7.1 Existence of a management information system that facilitates effective risk identification, measurement, control, reporting and monitoring

81% of the respondents indicated that they had in place a management information system (MIS) that facilitates effective risk identification, measurement, control, reporting and monitoring. As shown in Chart 9, 19% of the respondents indicated they had no such MIS in place. Of the 19% respondents who indicated not having an MIS, 2% (one respondent institution) reported having an MIS for general business information but not specifically dedicated to risk management. Another 2% (one other institution) reported being in the process of installing an MIS. The responses are presented in Chart 9 below.

On this aspect, the current survey's findings show a significant improvement in comparison to the 2004 survey, in which 21% of the respondents indicated the existence of a risk-dedicated MIS. This represents a 60% increase in institutions running risk-dedicated MIS, and possibly points to growing appreciation, across the banking sector, of the vital role played by risk-dedicated MIS in managing risks effectively. At the very least, it is an improvement in the level of regulatory compliance which may be attributed to the issuance of the Risk Management Guidelines in 2005.

Chart 9: % Respondents with and without a Risk-dedicated Management Information System



3.2.7.2 Type of risk monitoring reports generated, frequency of such reports and ultimate recipients.

On the types of risk reports generated:

- 42% of the respondents indicated that they generated operational risk reports;
- 51% of the respondents indicated generation of liquidity risk reports;
- 53% of the respondents indicated that they generated credit risk reports;
- 30% indicated that they generated market risk reports, and
- 42% of the respondents indicated that they generated regulatory compliance reports.

Table 6 below presents a summary of the above responses. It is noteworthy that market risk, despite its prevalence, ranks lower in reporting than credit and operational risk. This point to the need for more regulatory guidance on the measurement and reporting of market risk by institutions with a view to obtaining an objective picture.

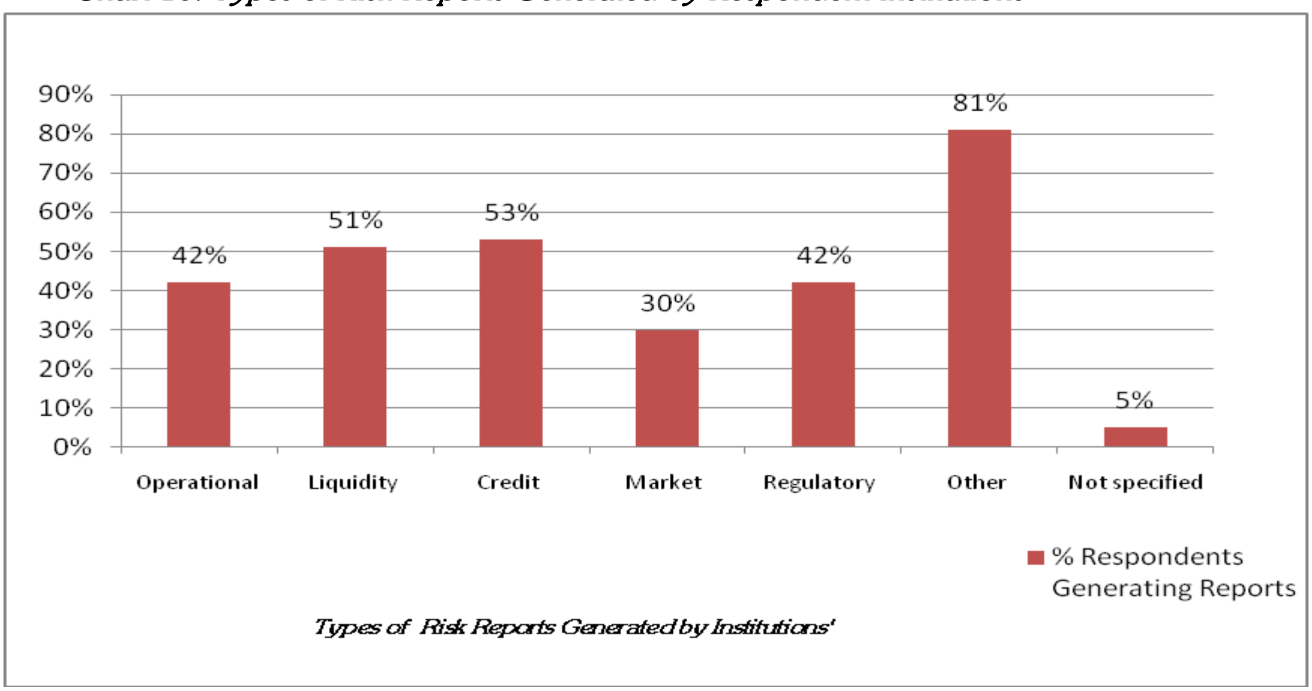
Majority of the respondents (81%) also indicated that they generated a multiplicity of other risk reports of a diverse nature. These 'other' reports have various titles, some of which are listed in Chart 10 below.

Responses on the types of risk reports generated are shown in Table 6 and Chart 10 respectively, below.

Table 6: Types of Risk Reports Generated by Respondent Institutions

	Type of Reports	No. of Respondents Generating Reports	% Respondents Generating Reports
1.	Operational Risk Reports	18	42%
2.	Liquidity Risk Reports	22	51%
3.	Credit Risk Reports	23	53%
4.	Market Risk Reports	13	30%
5.	Regulatory Compliance Reports	18	42%
6.	Other Reports	35	81%
7.	Did not specify	2	5%

Chart 10: Types of Risk Reports Generated by Respondent Institutions



Some of the 'other' risk reports generated by the institutions include the following:

(i) Key Risk Indicators reports
(ii) Information Security risk reports
(iii) Risk management reports
(iv) Daily Statistics Reports
(v) Excess over limit reports
(vi) Temporary overdraft reports
(vii) Large transaction reports
(viii) Account opened reports
(ix) Risk mgt and compliance limit/threshold report
(x) Consolidated trial balance
(xi) System Exception reports
(xii) Treasury reports
(xiii) Environmental and motivational issues
(xiv) Overdrafts by age – ageing schedule
(xv) Daily vital parameters reports
(xvi) P& L , Balance Sheet
(xvii) Debit balances in P& L a/c
(xviii) Daily transactions reports
(xix) Reports on transactions above (a specified amount)
(xx) Monthly Managers Report – Large debit and credit balances
(xxi) High value reports
(xxii) Corporate risk matrix
(xxiii) Corporate risk register

3.2.7.3 Frequency of risk report generation

95% of the respondents reported that periodic risk reports in their institutions are generated at various intervals, ranging from daily reports to annual reports. Other reports are also produced on an ad hoc basis, as and when necessary. In summary:

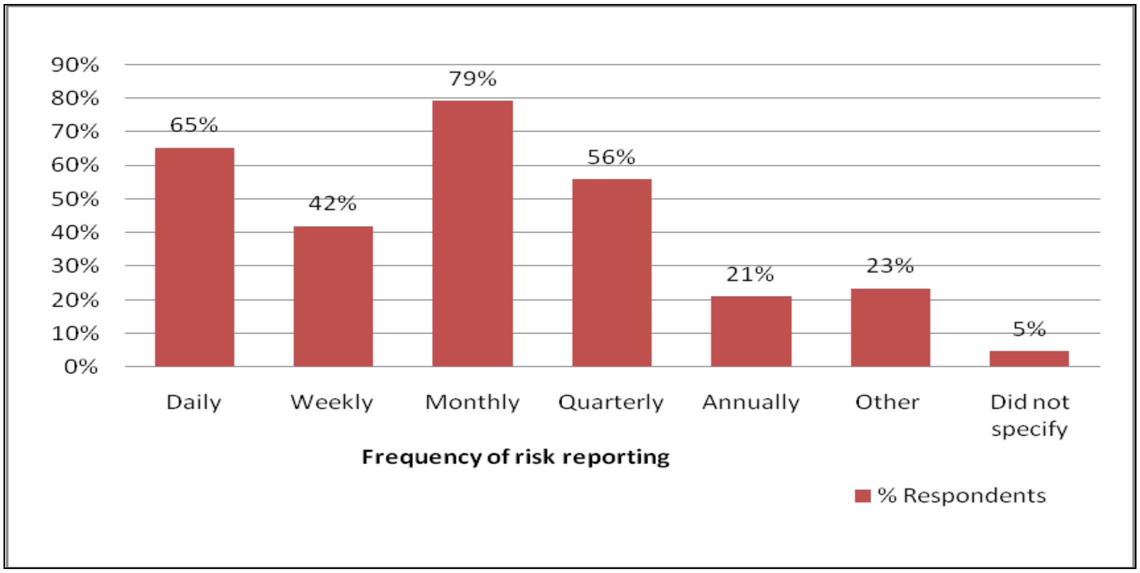
- 65% of the respondents reported that they produced daily risk reports;
- 42% indicated they produced weekly risk reports;
- 79% indicated they generated monthly risk reports;
- 21% stated that they produced annual risk reports, and
- 24% indicated they generated risk reports at 'other' time intervals as and when necessary.

Table 7 and Chart 11 below show the frequencies of risk report generation among the respondent institutions.

Table 7: Frequency of Risk Reporting

	Frequency of Reports	No. of Respondents Generating Reports at Shown Frequency	% Respondents Generating Reports at Shown Frequency
1.	Daily	28	65%
2.	Weekly	18	42%
3.	Monthly	34	79%
4.	Quarterly	24	55%
5.	Annually	9	21%
6.	Other	10	24%
7.	Did not specify	2	5%

Chart 11: Frequency of Risk Reporting



3.2.7.4 Recipients of risk reports

Respondents indicated that risk reports were issued to managers at all levels of the organisational hierarchy, operational, tactical and strategic. Risk reports were therefore not restricted to top management but were shared across the institution. Specifically:

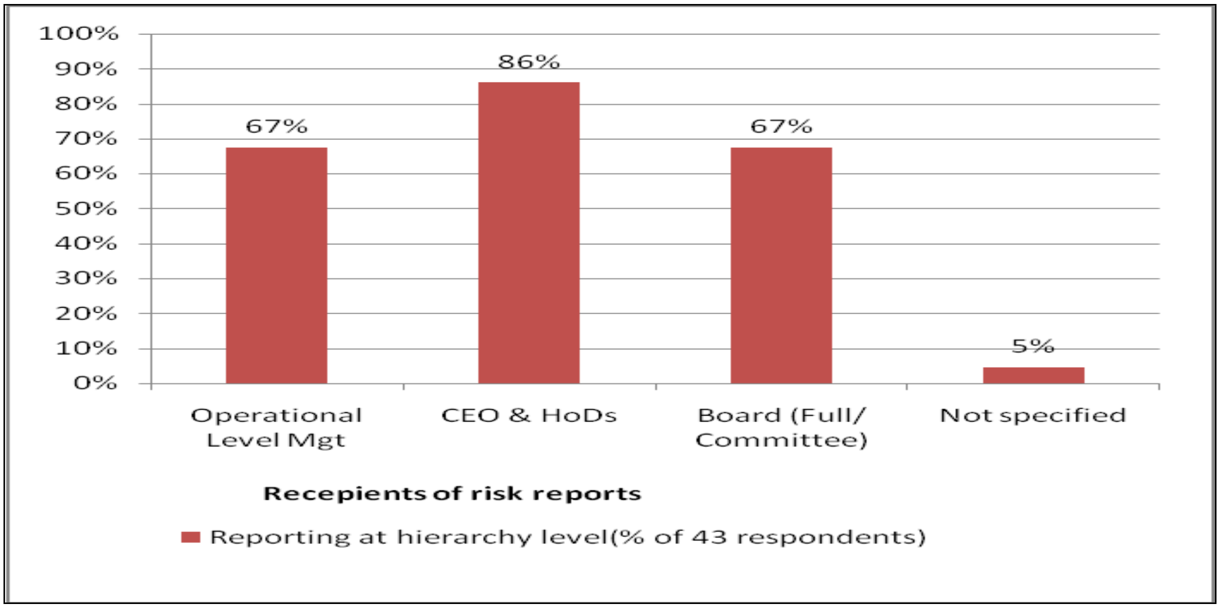
- In 67% of the respondent institutions, periodic risk reports were issued to operational level management.
- In 86% of the respondent institutions, periodic risk reports were issued to the CEOs and heads of departments.
- Risk reports were issued either to the full Board or to Board committees in 67% of the respondent institutions.

Table 8 and Chart 12 below show the recipients of risk reports by hierarchical level in the respondent institutions.

Table 8: Recipients of Risk Reports by Hierarchical Level

	Recipients of Risk Reports (Level in Organisational Hierarchy)	No. of Respondents Reporting to Hierarchical Level	% Respondents Reporting at Hierarchical Level (Out of 43 respondents)
1.	Operational Level Mgt	29	67%
2.	CEO and Heads of Dept	37	86%
3.	Board (Full board/ Committee)	29	67%
4.	Did not specify	2	5%

Chart 12: Recipients of Risk Reports by Hierarchical Level



The diversity of sharing risk reports across respondent institutions reflect the degree of importance respondents attach to the roles each of the parties play in managing risks.

3.2.7.5 Risk measurement techniques used by institutions

The tools and techniques used by institutions to measure and monitor the risks they faced were given as follows:

- Stress testing is currently used by 93% of the respondents, up from 23% in 2004; stress-testing therefore had the widest usage in the survey.
- Back-testing is used by 35% of the respondents, up from 29% in 2004; among the techniques identified in the survey, back-testing had the second lowest number of users (Gap-testing being the least applied with no users at all).
- Contingency planning was applied by 74% of respondents, up from 59% in 2004;
- Value-at-risk was used by 51% of the respondents, up from 34% in 2004;
- 17 institutions (or 40%) indicated that they applied other models besides the four listed in the questionnaire. These other models included the following:
  - Internally customized risk measurement models.
  - Risk control assessment models.
  - Self-assessments on Business Continuity Planning.
  - Scenario planning and sensitivity analysis.
  - Trend analysis on risk variables.
  - Dashboard reporting.
  - Internal rating programs (quantitative and qualitative).
  - Probability of default models for counterparty risk.
  - Pricing Engine models.

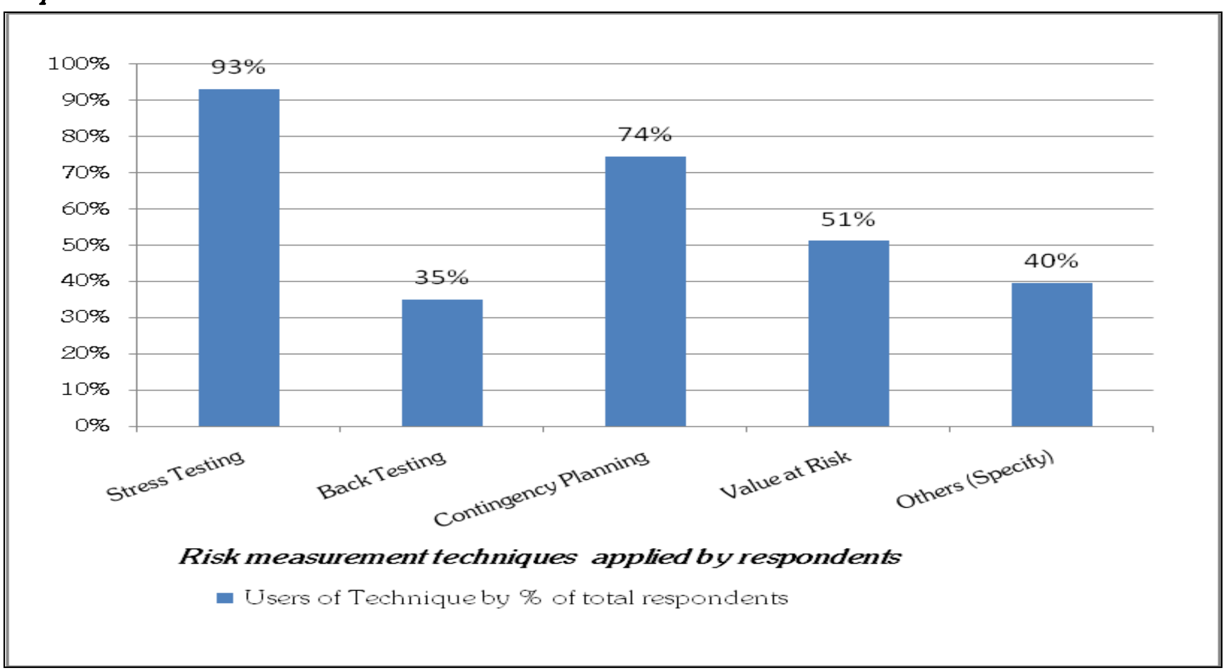
- **Gap analysis** was not in use by any of the respondents, unlike in 2004 when 5% of respondents used this technique.
- It is noteworthy that most respondents applied two or more risk-measurement models simultaneously; 14 or 33% of total respondents currently applied all the four listed models as specified in the questionnaire, in their efforts towards exhaustive identification of risks.

The responses obtained on the risk measurement models in use by institutions are presented in Table 9 and Chart 13 below.

Table 9: Risk Measurement Models applied by Respondent Institutions

	Respondents	Stress Testing	Back Testing	Contingency Planning	Value at Risk	Others (see above)
1	Use model	40	15	32	22	17
2	Do not use model	3	28	11	21	26
	Total Responses	**43**	**43**	**43**	**43**	**43**
1	% Users	93%	35%	74%	51%	40%
2	% Non - Users	7%	65%	26%	49%	60%
	Total Responses	**100%**	**100%**	**100%**	**100%**	**100%**

Chart 13: Application of Risk Measurement Models by Percentage Number of Respondents



3.2.8 Impact of the Risk Management Framework on Institutions

Changes experienced by the respondent institutions as a result of the introduction of the risk management framework were given as follows:

- 95% of total respondents indicated that there had been increased awareness on risk management across their institutions.
- 14% of the respondents indicated that there had been personnel changes in their institutions, mainly through recruitment of additional staff with the required skills, or organisational restructuring to create and activate a dedicated risk management function.
- 90% of the respondents indicated that there had been improvement in operating procedures aimed at better management of risks. Change in procedures here entails review of internal operational processes in order to better manage risk by minimizing the degrees of respective exposures.
- 5% reported having improved their information systems, which they achieved through acquisition and installation of new management information systems with a view to improving risk management.
- Notably, 5% of the respondents indicated that they had experienced no changes at all from the introduction of the risk management framework, a similar proportion to those who indicated improved information systems.

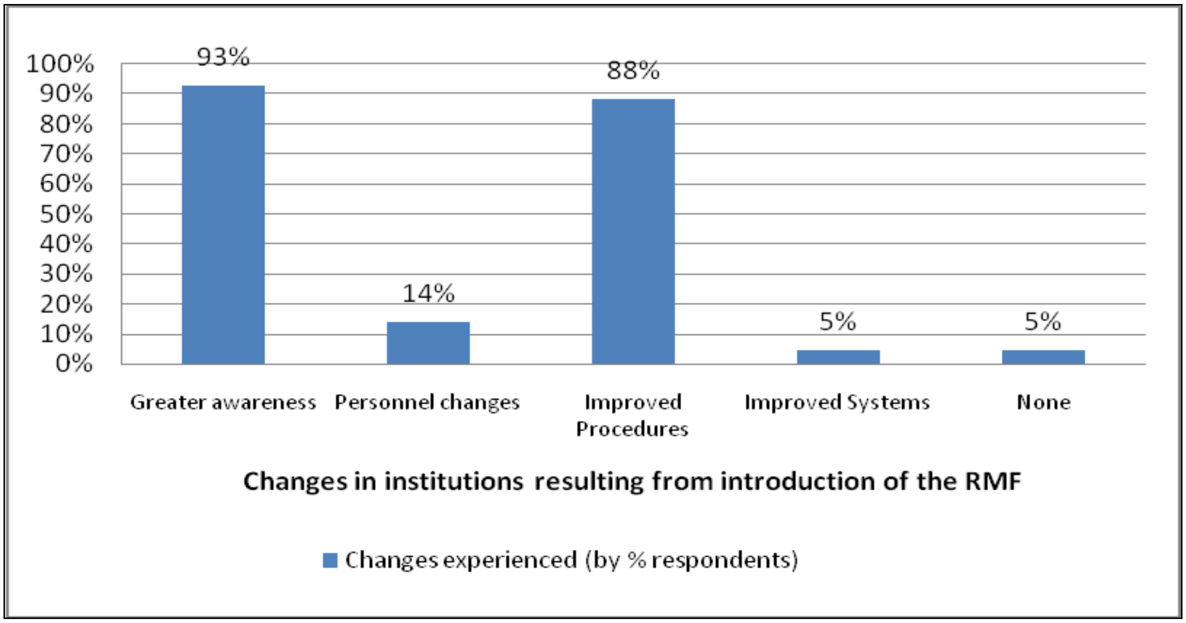
Table 10 and Chart 14 below show the responses obtained on the impact of the risk management framework in the respondent institutions.

Table 10: Impact of the Risk Management Framework on Respondent Institutions

Changes experienced by respondents as a result of the introduction of the risk management framework						
	Respondents who:	Greater awareness	Personnel changes	Improved Procedures	Improved Systems	None
1	Experienced change	40	6	38	2	2
2	Did not experience change	3	37	5	41	41
	Total responses	43	43	43	43	43

	% Respondents who:	Greater awareness	Personnel changes	Improved Procedures	Improved Systems	None
1	Experienced change	93%	14%	88%	5%	5%
2	Did not experience change	7%	86%	12%	95%	95%
	Total responses	100%	100%	100%	100%	100%

Chart 14: Impact of the Risk Management Framework on Respondent Institutions



The results of the survey indicate that institutions have applied considerable effort in sensitizing staff at all levels on risk issues and in enhancing their operating procedures for better risk management. This positive trend is an additional consequence that may be directly attributed to the issue of the Risk Management Guidelines in 2005.

3.2.9 Budgetary allocation to the Risk Management Function

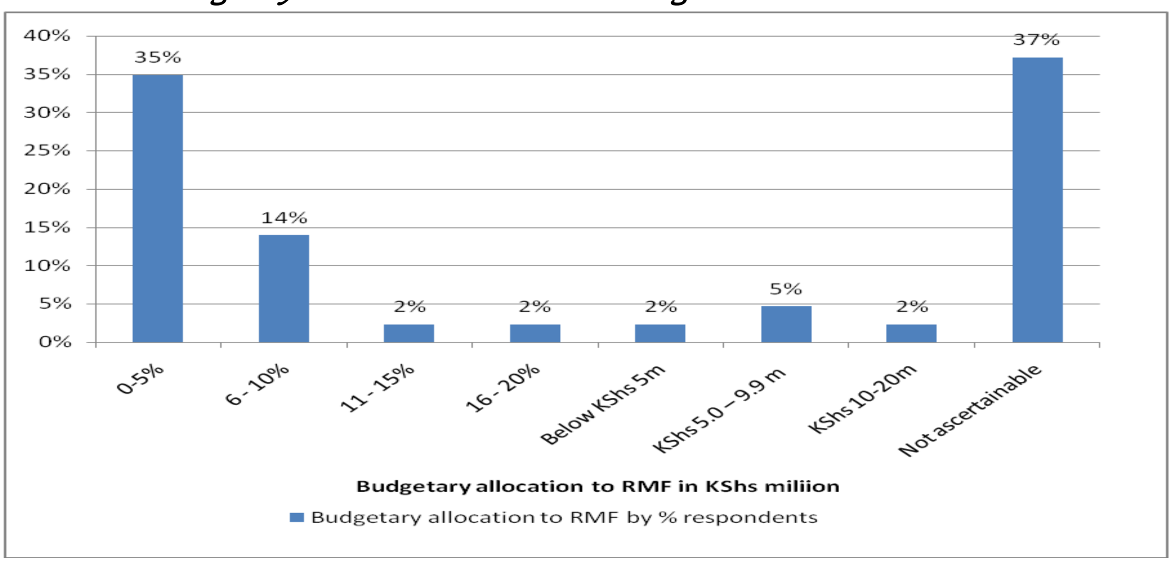
At least 60% of respondent institutions have set aside specific budgetary allocations for their risk management functions, up from 17% in 2004. This supports the high level of institutions that have set up risk management functions i.e. 93% of respondents. The results of the survey show that, in proportion to their total annual budget:

- 35% of respondents spent between 0-5% on their risk management function;
- 14% spent between 5-10%;
- 2% spent between 10.1-15%;
- 2% spent between 15.1 – 20%
- 9% estimated their institutions' budgetary allocation in absolute amounts; 2% estimated theirs at below KShs 5.0m, 5% at between KShs 5.0 – 10.0m and 2% at between KShs 10.1 – 20m.
- Overall, 63% of institutions allocate funds to their risk management function, a clear demonstration that these institutions recognize the role of proper risk management in minimising losses and boosting productivity.
- 37% of respondents indicated that they could not estimate their budgetary allocation with reasonable certainty owing to the nature of the budgeting systems.
- As shown in Table 11 and Chart 15, the modal and average percentage expenditure on risk management as a proportion of the total (annual) institutional budget was 5%, as given by 12% of the respondents.

Table 11: Budgetary allocation to the Risk Management Function

	Expenditure given as (as Percentage of Institution's Total (Annual) Budget	No. of respondents within range	% respondents
1.	0-5.0%	15	35%
2.	5.1 – 10.0%	6	14%
3.	10.1 – 15.0%	1	2%
4.	15.1 – 20.0%	1	2%
	Expenditure given as absolute amount (Kshs'm)		
1.	Below 5.0	1	2%
2.	5.1 – 10.0	2	5%
3.	10.1 - 20	1	2%
4.	Unascertainable/ Not indicated	16	37%
	Total	**43**	**100%**
	Modal response* (5.0%)	**15**	**35%**
	****Refers to the budgetary allocation percentage indicated by the highest number of respondents.*		

Chart 15: Budgetary allocation to the Risk Management Function



3.2.10 Independent review of the Risk Management Function.

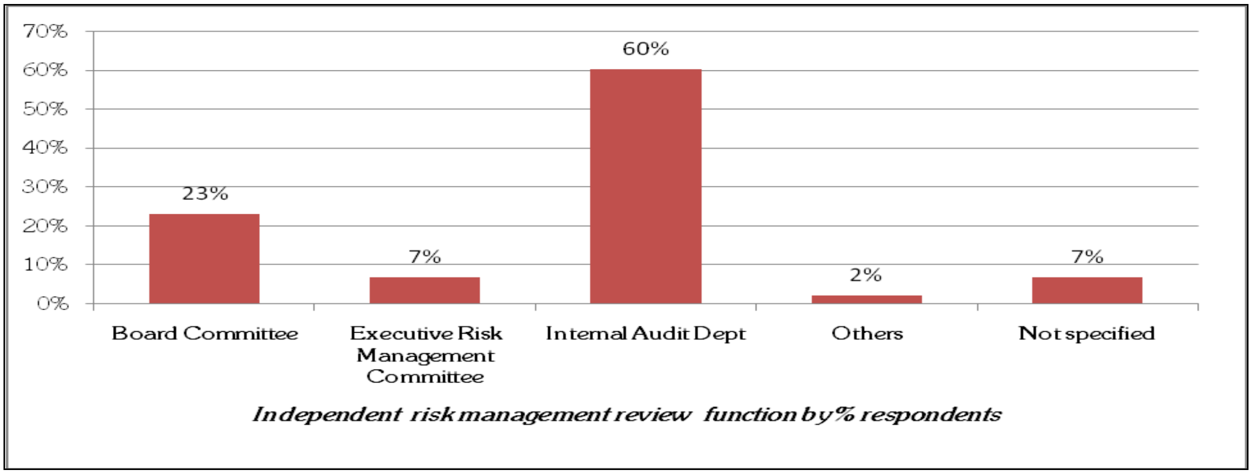
41 respondents with an RMF (95% of total respondents) indicated they had an independent function that reviews the effectiveness of their risk management function, up from 60% in 2004. Specifically:

- 60% of the respondents indicated that their internal audit department carried out the risk management review function.
- 16% of respondents indicated that the Board Risk Committee carried out this review function.

- 12% of respondents indicated that the review function was done by the Executive Risk Management Committee(overall);
- 7% of respondents indicated that the review function was done by the *Board* Risk Management Committee.

These results are depicted in Chart 16 below.

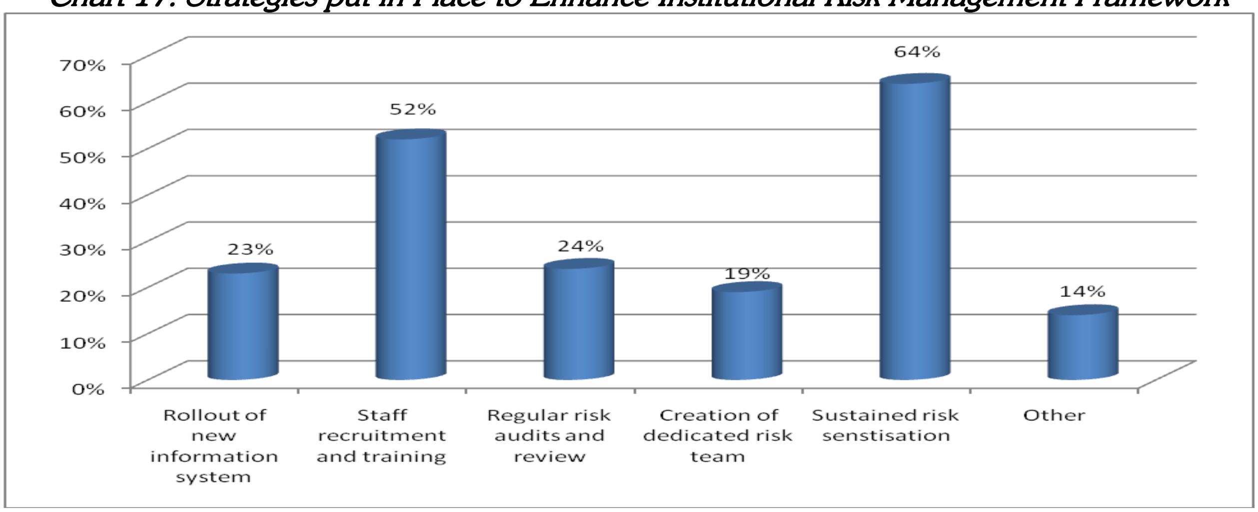
Chart 16: Responsibility for Independent Review of the Risk Management Function



3.2.11 Plans and Strategies put in place by institutions to change or enhance the Risk-Management Function

Majority of the respondent institutions (64%) have undertaken sustained sensitization initiatives to raise awareness at all institutional levels, operational, tactical and strategic, on risk-related matters. Other plans and strategies put in place, in order of prevalence are staff recruitment and training (52%), regular risk audits and review (24%), rollout of new information systems (21%) and creation of dedicated risk management teams (19%). 14% of the respondents indicated other measures of a general nature such as continuous risk monitoring and the inclusion of risk management in the list of key performance indicators for their staff. Chart 17 below illustrates these results.

Chart 17: Strategies put in Place to Enhance Institutional Risk Management Framework



3.2.12 Respondents' Recommendations on Changes to the Risk Management Guidelines

Some of the changes recommended by the respondents to the current risk management guidelines include the following:

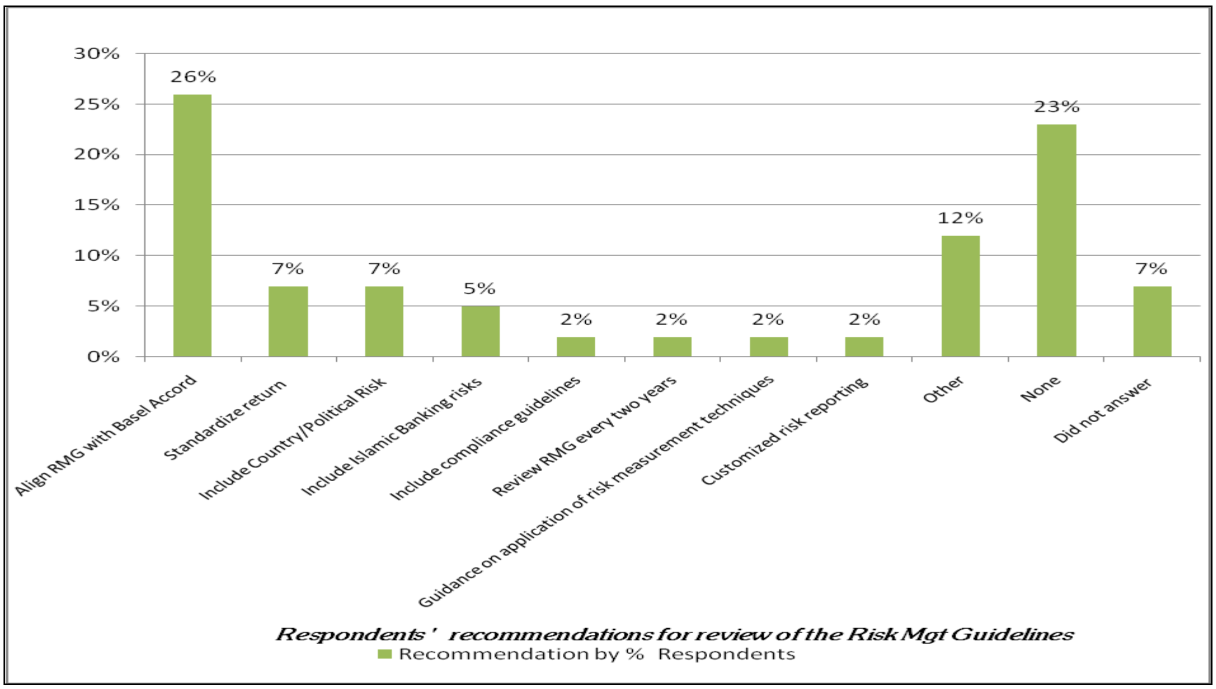
- 26% of the respondents called for the alignment of the RMGs with the latest Basel Accords so as to ensure institutions in Kenya adhere to international best practices.
- 7% of the respondents suggested the introduction of a standardized return on risk for regulatory purposes; a similar number of the respondents proposed that the RMGs should explicitly recognize country/political risk, to which Kenyan banks operating in other countries are increasingly exposed to.
- Respondents offering purely Islamic banking services (5% of total respondents) proposed the introduction of guidelines on risks relating to *Sharia* banking, since these are not addressed by the current guidelines.
- 2% of respondents proposed the inclusion of rules governing general compliance (aligned with international best practice) to guide institutions in meeting both national and global compliance requirements.
- 2% of the respondents recommended that the RMGs should be reviewed every two years to keep up with the rapid rate of change in the operating environment.
- 2% of the respondents recommended the RMGs should contain further guidance on how institutions should apply the prescribed of risk measurement and reporting techniques.
- 2% of the respondents recommended that the RMGs should provide for customised risk measurement and reporting by institutions since every institution faced unique business circumstances and risk exposures.
- 12% of the respondents proposed the recognition of sustainability risk in the risk management guidelines.
- 5% of respondents proposed the recognition of risks relating to expansion and project management.
- Other proposals from the institutions surveyed include the following:
    - recognition of **sustainability risk** in the risk management guidelines (proposed by 12% of the respondents).
    - the recognition of **risks relating to expansion and project management** (proposed by 5% of the respondents)
    - **On Operational risk**: The RMGs should include measurable rregulatory assessment criteria for a well functioning operational risk management regime, that is, the RMGs should be more specific as to what constitutes acceptable operational risk management for an institution.
    - The RMGs should provide further guidance on the reporting, within institutions, of risk occurrences likely to occasion losses, both on a real time and periodic basis.
    - **On reputational risk**: RMGs should contain explicit guidance on reputational risk monitoring and reporting both within and outside institutions.

- **Staff training (on risk management):** The RMGs should specify minimum staff training requirements on risk management, which should be met by all institutions as a regulatory obligation.
- **ICT Risk:** There should be an explicit requirement for all institutions to put in place an IT security risk management framework outlining an institution's approach to managing IT security and embodied in a hierarchy of policies, standards, guidelines and procedures.
- **Outsourcing (& BCM):** The RMGs should be expanded to cater for all institutional risks emanating from outsourcing arrangements made by regulated institutions.
- **Risk Transfer**: Guidelines covering permissible insurance activity, mandatory insurance requirements, use of captive internal insurance carriers, reinsurance, etc should be incorporated in the RMGs.

- 23% of respondents stated that the guidelines are adequate as they currently stand and that they saw no need for any changes at present.

Chart 18 shows the main proposals made by the respondents on changes required in the current risk management guidelines.

Chart 18: Respondents' Proposals on Changes to the Risk Management Guidelines



4.0 SUMMARY AND CONCLUSION

Generally the institutions revealed that the Risk Management Guidelines issued in 2005 had, for the majority of them:

- enhanced risk-awareness and risk-management at the institutions;
- increased the efficiency and effectiveness of risk management;
- helped reduce financial losses;
- led to the establishment of effective and better-resourced risk management functions, and
- enhanced the overall decision making processes in their institutions.

However, they emphasised the need for continuous review of the Risk Management Guidelines to accommodate changes taking place in the financial sector subsequent to issuance of the guidelines, thereby ensuring their continued relevance.

5.0 WAY FORWARD

The survey identified the Kenyan banking industry's need for enhanced RMGs. Both the information gathered in the survey and respondents' recommendations will be taken into account by the Central Bank during the on-going review of the current RMGs which is expected to be completed in the course of 2011.

CENTRAL BANK OF KENYA
JANUARY 2011

Annex 1(Survey Questionnaire)

RISK MANAGEMENT SURVEY- NOVEMBER 2010

Introduction

Following the operationalisation of the Risk Management Guidelines in 2005, the Central Bank of Kenya is in the process of assessing the adequacy and impact of the Risk Management Guidelines on the Kenyan institutions. The assessment is aimed to inform the necessary amendments and or additions that need to be introduced to ensure that the Guidelines remain relevant, current and reflective of circumstances in the operating environment. To enable the Central Bank to carry out this assessment, we kindly request that you complete the questionnaire below.

QUESTIONNAIRE[1]

Name of Institution:	
Type of Institution:	
Contact Person:	
Address:	
Telephone Number:	
Email:	

1. (a). Does your institution have an independent risk management function?

YES ☐ NO ☐

(b). If yes, (i).Who heads the risk management function? (Job Title)………………………

(ii).Who does s/he report to?.......……………………………………………………

2. (a) List the risks faced by your institution:

- ……………………………………………………………………………………..……..
- ……………………………………………………………………………………..……

(b) Which new/additional risks, other than those covered in the Risk Management Guidelines, does your institution face?

…………………………………………………………………………………………………
…………………………………………………………………………………………………

[1] Please note *that the definition of terms contained in this questionnaire are as per the Risk Management Guidelines, 2005 which can be downloaded from Central Bank of Kenya website, under the link:* *http://www.centralbank.go.ke/downloads/acts_regulations/RiskManagementGuideline2005.pdf*

3 (a). Has your institution developed Risk Management Manuals and Programmes for all the risks listed in 2(a) and (b) above?

YES ☐ NO ☐

(b). If yes, how often are the risk assessment procedures in the manuals and programmes reviewed by your institution?

……
……

(c). Who reviews the procedures?

……
……

4 (a) Which challenges did your institution experience during the formulation and implementation stages of the risk management function?

……
……

(b) Which strategies did your institution put in place to overcome the challenges stated in 4 (a) above?

……
……

5 (a). Is your institution's risk management function centralised or decentralised?

Centralised ☐ Centralised means it falls under a department/section with staff involved full-time in risk management.

Decentralised ☐ Decentralised means respective business units handle risk management.

(b). If centralised, indicate the person responsible for the overall risk management of your institution, number of staff involved in the function, and the corresponding responsibilities for each of the staff involved.

Name	Title	Responsibility	Number of staff

(c). If decentralised, describe how your institution is undertaking overall risk management.

……
……

6. What mechanisms have been employed by the management of your institution to ensure that the risk management culture penetrates to all levels of staff?

……………………………………………………………………………………………………
……………………………………………………………………………………………………

7. Does your institution have a management information system that facilitates effective risk identification, measurement, control, reporting and monitoring?

YES

NO

If yes,

a) What risk monitoring reports are available within your institution; what is the frequency of such reports and who are they issued to?

Risk Monitoring Reports	Frequency of issue	Who are the reports issued to?

b) How does your institution measure the risks it faces?

Stress Testing

Back Testing

Contingency Planning

Value at Risk

Others (Specify)

8. Which changes have been experienced by your institution arising from the introduction of the risk management framework?

……………………………………………………………………………………………………
……………………………………………………………………………………………………

9. What proportion of your institution's budget is spent purely in the risk management function?

……………………………………………………………………………………………………
……………………………………………………………………………………………………

10. Does your institution have in place an independent function that reviews the effectiveness of the Risk Management function?

YES

NO

If yes, indicate the department/function responsible...

11. Which plans and strategies has your institution put in place to change or enhance the risk management function?

…………………………………………………………………………………………………
…………………………………………………………………………………………………

12. What changes would you propose to the Risk Management Guidelines?

…………………………………………………………………………………………………
……………………………………………………………………………………………........

Name of Chief Executive:……………………………………........
Signature:…………………………………….....
Date:……………………………..............

Complete this questionnaire and return it to:

Director,
Bank Supervision Department,
P.O Box 60000-00200
Nairobi.

Thank you for participating in the survey.

Annex II (List of Respondents)

LIST OF THE RESPONDENTS

1. African Banking Corporation Ltd.
2. Bank of Africa Kenya Ltd.
3. Bank of Baroda (K) Ltd.
4. Bank of India
5. Barclays Bank of Kenya Ltd.
6. CfC Stanbic Bank Ltd.
7. Chase Bank (K) Ltd.
8. Citibank N.A Kenya
9. Commercial Bank of Africa Ltd.
10. Consolidated Bank of Kenya Ltd.
11. Co-operative Bank of Kenya Ltd.
12. Credit Bank Ltd.
13. Development Bank of Kenya Ltd.
14. Diamond Trust Bank (K) Ltd.
15. Dubai Bank Kenya Ltd.
16. Ecobank Kenya Ltd
17. Equatorial Commercial Bank Ltd.
18. Equity Bank Ltd.
19. Family Bank Ltd
20. Fidelity Commercial Bank Ltd
21. Fina Bank Ltd
22. First community Bank Limited
23. Giro Commercial Bank Ltd.
24. Guardian Bank Ltd
25. Gulf African Bank Limited
26. Habib Bank A.G Zurich
27. Habib Bank Ltd.
28. I & M Bank Ltd
29. Imperial Bank Ltd.
30. Jamii Bora Bank Ltd.
31. Kenya Commercial Bank Ltd
32. K-Rep Bank Ltd
33. Middle East Bank (K) Ltd
34. National Bank of Kenya Ltd
35. NIC Bank Ltd
36. Oriental Commercial Bank Ltd
37. Paramount Universal Bank Ltd
38. Prime Bank Ltd
39. Standard Chartered Bank (K) Ltd
40. Trans-National Bank Ltd
41. Victoria Commercial Bank Ltd
42. UBA Kenya Bank Ltd.
43. Housing Finance Ltd