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CASE FOR CONSOLIDATED FINANCIAL SECTOR REGULATION IN KENYA

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1.0 INTRODUCTION

Australia, Austria, Canada, Colombia, Denmark, Estonia, Finland, Germany, Hungary, Iceland, Ireland, Japan, Latvia, Malta, Netherlands, Nicaragua, Norway, Peru, Singapore, South Africa, South Korea, Sweden, Switzerland, and the United Kingdom among other countries have all established consolidated regulators[1] in the financial sector within the last thirty years. On the other hand, many other countries, including Kenya, have different regulatory institutions to govern different sub-sectors of the financial sector. Even within those countries with consolidated financial sector regulators, there are a myriad of combinations in which of the sub-sectors – insurance, securities, banking, pensions– are incorporated in the integrated regulator and which are left out. For example in South Africa, insurance, pensions and securities are in the consolidated regulator but banking is excluded and remains under the Central Bank. Conversely in the United Kingdom banking, insurance and securities are integrated but pensions are excluded and fall under the independent Pensions Regulator.

Is there an optimal regulatory structure? Which sub-sectors are most suited for integration? In Kenya, where there are a multiplicity of regulators, what is the case for and against adopting a consolidated regulatory framework for the financial sector. Section 2 of this paper looks at the theoretical rationale for financial regulations and at the critical elements for effective regulation. The paper thus looks at the situation currently obtaining in Kenya in Section 3 and Internationally in Section 4, before looking at the case for and against consolidation in sections 5 and 6 respectively. Section 7 and 8 conclude and draw recommendations.

2.0 PURPOSE OF FINANCIAL SECTOR REGULATION

Governments primarily regulate industries with a view to protecting consumers. This, for example, is why Governments regulate public utilities which may use monopoly positions to exploit consumers. In the financial sector, an additional motivation for regulation is maintaining financial stability, which is a clear public good. Financial sector supervision thus requires a more elaborate framework and tends to be more rigorous and intensive than is the case in other sectors. Regulation of the financial sector should achieve the following seven key principles[2]:

[1] Even though a regulator is strictly defined as an entity with power to gazette regulations to govern sector players, this paper uses the term regulator loosely so as to include entities with power to supervise sector players even if they lack power to issue regulations.
[2] Abrahms & Taylor (2000)

Clear Objectives – The regulator should have a clear mandate set out in its enabling legislation. Regulation should ideally be only limited to correction of market failures and should not be a burden to the regulated institutions. Any developmental objectives requiring, for example, research and public education, should be clearly provided in the statutes.

Independence and Accountability - Decisions by the regulator within its sub-sector should not be subject to undue influence from the Minister or any other parties. The principal officer and top management should have an element of security of tenure or at least clear rules governing their removal. Similarly, their recruitment should be done transparently and competitively and their remuneration should not be significantly discordant with that of senior officials in the regulated entities. Historical evidence shows that lack of independence of financial sector regulators worsens financial crises. For example, the lack of independence of financial supervisors in Japan's Ministry of Finance weakened the financial sector and contributed to prolonged banking sector problems prompting the creation of a n independent Financial Services Agency in the late nineties[3].

At the same time the regulator must be accountable and must report to the legislature through periodic reports including audited financial statements. In addition, there must be a mechanism for the regulator to be held accountable by the regulated industry while avoiding regulatory capture by the industry.

Adequate Resources - The regulator must have adequate funding, preferably through industry levy, so as to enable the industry have a role in checking the regulator's spending. Adequate resources are a prerequisite to enable the regulator recruit, train and retain a cadre of experienced professional staff. In addition, the regulator requires resources for timely and effective data collection and processing.

Effective Enforcement Powers – The regulator must be able to take enforcement measures against all the players that it is required to regulate. These powers should include, inter allia, powers to:

- Require information to be provided;
- Assess probity of owners and managers of regulated entities;
- Inspect the operations of regulated entities;
- Intervene in operations of regulated entities including removal of managers;
- Revoke licenses or registration; and,
- Sanction entities or individuals.

[3] Quintyn & Taylor (2004)

Enforcement powers are best only set out broadly in legislation with regulations having powers to issue guidelines and directives. This allows flexibility and reduces the need for frequent cumbersome and time consuming legislative amendments. Staff of regulators should be protected from legal actions arising from their enforcement actions.

Comprehensiveness of Regulation – Regulation should clearly be comprehensive and not leave any unregulated areas, so called regulatory gaps. Activities should not be left unregulated due to lack of clarity as to which regulator is responsible. Also, this requires regulators to have some flexibility to respond to innovations which may result in new products which were not envisaged at the time of establishment of the regulatory structure.

Cost-Efficient Regulation – The direct cost of regulation in terms of levies and fees should clearly be reasonable and not an undue burden on the regulated institutions. This is clearly more important where, as is usually the case, these costs are ultimately passed on to the consumers. As indicated above, it is important for the amounts raised and how they are utilized to be transparently disclosed and accounted for to the industry and the legislature.

In addition, there are indirect costs of compliance which must also be controlled to avoid undue burden on the industry. Indirect costs include costs of appointing service providers and experts, costs of having "compliance officers" within the organizations – including the now popular Head of Regulatory Affairs – as well as costs of installing systems to provide required reports and data to the regulator.

Market Developments and Industry Structure - Regulatory structure should mirror the sectors being regulated. Different countries have different industry structures and each country should seek to have a regulatory structure tailored to this other than attempting a one-size-fits-all structure or borrowing those in other countries. Presence of financial conglomerates, universal banking, bancassurance and other unified products lends the industry to a more unified regulatory framework than in the case of disaggregated sectors. When one financial institution is in several sectors facing different risks, there is a need for some mechanism to assess the overall risk facing the institution.

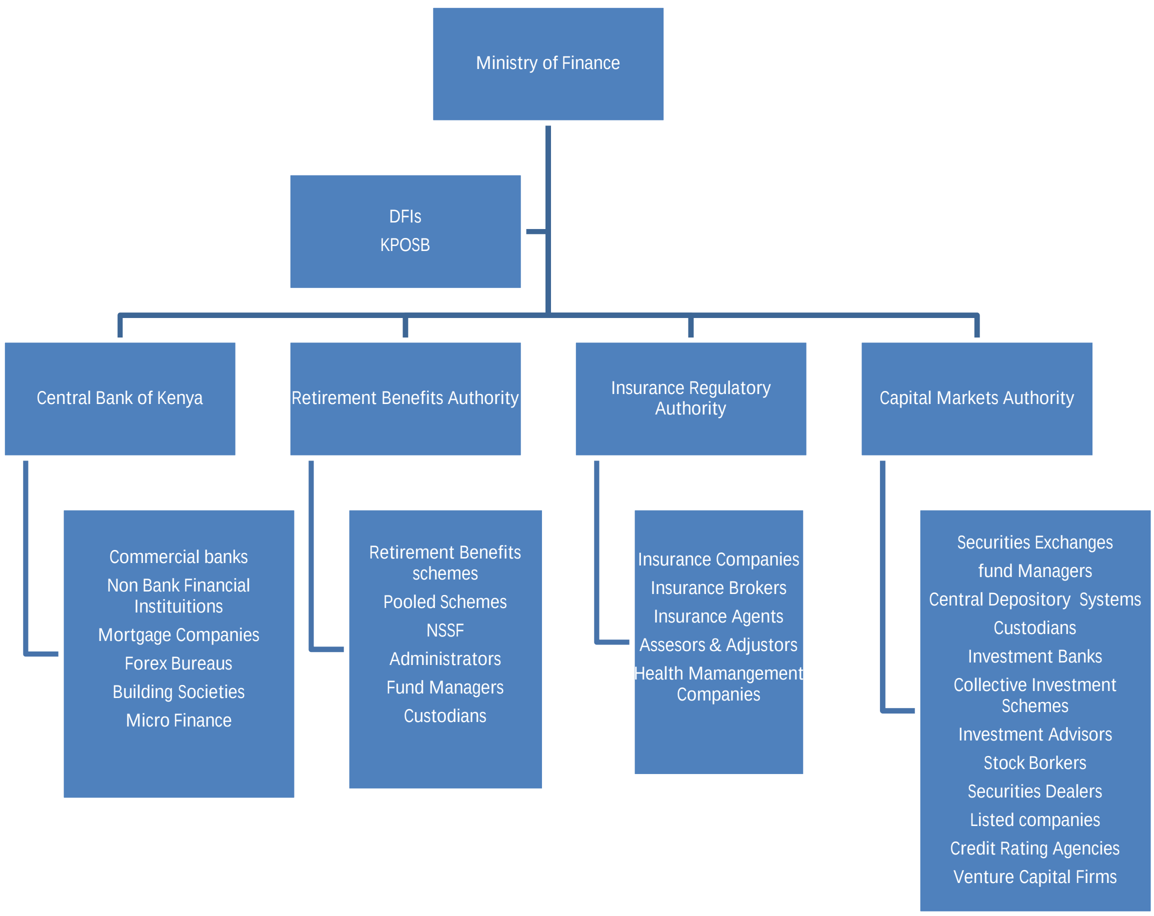
3.0 EXISTING FINANCIAL SECTOR REGULATORY FRAMEWORK IN KENYA

3.1 FRAMEWORK

The existing regulatory framework for the financial sector in Kenya consists of a number of independent regulators each charged with the supervision of their particular sub sectors. The recent creation of the Insurance Regulatory Authority has completed the shift from having departments under the Ministry of Finance to having independent regulators for each sub-sector.

The current regulatory structure is characterized by regulatory gaps, regulatory overlaps, multiplicity of regulators, inconsistency of regulations and differences in operational standards. For example, some of the regulators have at least partial exemption from the State Corporations Act while others do not, some have tax exemption, others do not. Some regulators have powers to issue regulations while in other cases the power is retained by the Minister for Finance.

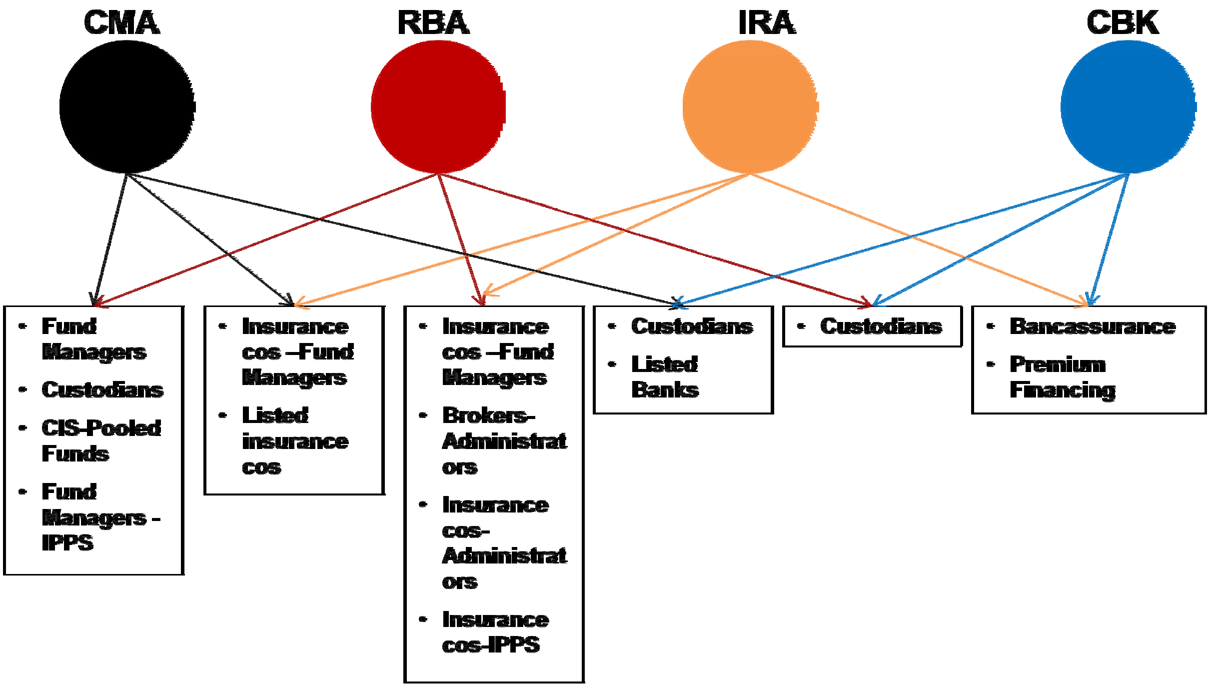
CHART 1: STRUCTURE OF FINANCIAL SECTOR REGULATION IN KENYA



3.2 OVERLAPS

This structure has resulted in some overlaps in regulation as some institutions are regulated by more one than one regulator as summarized below.

CHART 2: OVERLAPS IN FINANCIAL SECTOR REGULATION IN KENYA



3.3 REGULATORY GAPS

Some, but by no means all, of the regulatory gaps in the financial sector include:

3.3.1 The Savings and Credit Cooperative Societies

The SACCO system is a mutual membership organisation. It involves pooling voluntary savings from members in the form of shares and on lending the same to members. In Kenya, like in many other countries, shares cannot be withdrawn and are used as security for loans to members. Credit is usually based on three times the level of savings/shares. A number of rural SACCOs have fully operating retail banking services commonly referred to as front office services (FOSAs). Others run back office operations. SACCOs operate under the Co-operatives Societies Act. The Act has given the Commissioner of Co-operatives and the Registrar of Co-operative Societies regulatory and supervisory powers over SACCOs. The

Cooperative Societies Act 1997 has been considered inadequate for SACCOs. Official supervision is also considered weak due to lack of adequate capacity.

3.3.2 The Kenya Post Office Savings Bank (KPOSB)

The Kenya Post Office Savings Bank (KPOSB) was incorporated in 1978 under the KPOSB Act (Cap 493B). The mission of the bank is "to sustainably provide savings and other financial services to our customers, through a countrywide branch network, by use of modern technology in delivery of efficient and effective customer service, and to the satisfaction of all stakeholders."

Section 8(1) KPOSB Act that provided for the Government guarantee over the deposits placed with the savings bank was repealed via the Finance Bill 2001. The repeal of the section implies that new avenues should be found for deposit protection. It also implies that the bank should be adequately capitalised as a first step to protect deposits against possible losses.

3.3.3 Companies Act (CAP 486)

The Companies Act, which is a holdover of pre-colonial British Law, is creating problems for private sector activities in Kenya and indeed the financial services sector. Old-fashioned UK companies' law, currently in use, is complicated, cumbersome, inconsistent and at odds with modern "enabling" regulation of corporations. Another layer of complexity and compliance is added to an already burdensome structure, leading to multiple disclosure requirements, overlap and expensive duplication.

The regulation of companies is currently under the Registrar of Companies in the Office of the Attorney General but could be brought under the financial sector regulatory framework for more responsiveness to market dynamism.

3.3.4 Development Finance Institutions (DFIs)

DFIs have always provided the impetus for economic development be it in the developed or developing countries. In Kenya, DFIs were specifically established to spearhead the development process by:

- Availing credit funds to those venturing into commerce, tourism and industry.
- Assisting those wishing to venture into small-scale manufacturing enterprises.
- Assisting in the initiation and expansion of small, medium and large-scale industrial and tourist undertakings.
- Provide long-term lending (Project financing) to sustain economic development
- Provide Technical Assistance/Co-operation extension services
- Provision of special Financing and Support services to stimulate Private Sector to live up to its potential and create jobs and wealth, develop and expand indigenous skills

The existing framework has potential for disharmony as they fall under different regulators. For example ICDC/KIE are under the Ministry of Trade and Industry, IDB is under the Central Bank of Kenya and AFC the Ministry of Agriculture.

3.3.5 Premium and Other Financing

A number of premium finance companies have evolved in the Kenyan market. These companies offer financing to companies and individuals to meet insurance premium payments. This is clearly a financial service but is currently not regulated by any of the existing regulatory institutions.

Similarly, there are other money lenders and financers who are totally unregulated. There is also need for regulation of leasing which is a developing financial service.

4.0 INTERNATIONAL EXPERIENCE

4.1 LEVEL OF CONSOLIDATION WORLDWIDE

There is by no means unanimity on the need for consolidated financial sector regulations with different countries adopting differing approaches as indicated in Table 1 below. No clear pattern can be discerned by region or even financial system.

TABLE 1: LEVEL OF CONSOLIDATION IN REGULATION OF BANKING INSURANCE AND CAPITAL MARKETS SELECTED COUNTRIES

NO CONSOLIDATION		PARTIAL CONSOLIDATION			FULL CONSOLIDATION	
Separate Regulators for each sub-sector		Capital Markets + Insurance	Banking + Insurance	Banking + Capital Markets	Banking + Capital Markets + Insurance	
Argentina	Jordan	Bolivia	Australia	Dominican	Austria	Maldives
Bahamas	Kenya	Chile	Belgium	Republic	Belgium	Malta
Botswana	Lithuania	Mauritius	Canada	Finland	Bermuda	Nicaragua
Brazil	New Zealand	Slovakia	Columbia	Luxembourg	Cayman I.	Norway
Bulgaria	Panama	South Africa	Ecuador	Mexico	Denmark	Singapore
China	Philippines	Ukraine	El Salvador	Switzerland	Estonia	South Korea
Cyprus	Poland	Netherlands	Guatemala	Uruguay	Germany	Sweden
Egypt	Portugal		Kazakhstan		Gibraltar	UAE
France	Russia		Malaysia		Hungary	UK
Greece	Slovenia		Peru		Iceland	
Hong Kong	Sri Lanka		Venezuela		Japan	
India	Spain				Latvia	
Indonesia	Thailand					
Israel	Turkey					
Italy	USA					
38%		9%	135	8%	29%	

Source: Martinez and Rose (2003)

Pensions is often the last sector to be included in consolidated financial regulation after banking, capital markets and insurance. Again no clear pattern can be discerned in terms of consolidation of pension regulation as shown in Table 2.

TABLE 2: LEVEL OF CONSOLIDATION IN REGULATION OF PENSIONS IN SELECTED COUNTRIES

NO CONSOLIDATION		PARTIAL CONSOLIDATION	FULL CONSOLIDATION	
Separate Regulator for Pensions		At least Pensions + Insurance	Pensions + Capital Markets + Insurance + Possibly Banking	
Chile	Japan	Belgium	Australia	Kazakhstan
Costa rica	Kenya	Finland	Austria	Kosovo
Hong Kong	Mexico	France	Bulgaria	Korea
India	Nigeria	Jordan	Canada	Mauritius
Ireland	UK	Luxembourg	Croatia	Namibia
Indonesia	USA	Portugal	Czech	Netherlands
Israel		Spain	Republic	Norway
Italy		Turkey	Denmark	Pakistan
		Zambia	Germany	Poland
			Hungary	Slovak Republic
			Iceland	South Africa
			Israel	Thailand
			Jamaica	Trinidad + Tobago

Source: Madero & Lumpkin (2007)

4.2 COUNTRY SUMMARIES

There is no one single optimal model for the organisational structure of financial regulation. The prevailing circumstances, historical factors and comparative advantages in any given country determine the structure of the integration. It follows therefore, that even if countries have much to learn from each other, different countries adopt different integration approaches.

4.2.1 United Kingdom[4]

Financial Services Authority (FSA) in the UK evolved after an intense debate by the Bank of England and London financial market. The former had a developed supervisory capacity and the latter a well governed market. This led to the creation of the FSA on the basis of conduct of business rather than on prudential aspects. The FSA objectives include reducing financial crime: money laundering; fraud and dishonesty; and criminal market misconduct such as insider dealing, securing the right degree of protection for consumers, and vetting at entry aims to allow only those firms and individuals satisfying the necessary criteria (including honesty, competence and financial soundness) to engage in regulated activity. Once authorized, firms and individuals are expected to maintain particular standards set by FSA and promote public understanding of the financial sector. FSA helps people gain the knowledge, aptitude and skills they need to become informed consumers, so that they can manage their financial affairs more effectively. Despite the creation of the FSA, pension regulation remained under a separate entity The Occupational Pensions Regulatory Authority, which in 2006 was reformed into The Pensions Regulator.

Mortgage advisors and insurance brokers were included in the scope of the FSA at a later stage. Currently, the FSA has been under criticism as being too unwieldy and unresponsive to needs of particular sectors.

4.2.2 Australia[5]

Australia established a prudential regulatory agency – Australian Prudential Regulatory Authority (APRA) and a separate market integrity and consumer protection agency, the Australia Securities and Investment Commission (ASIC). APRA regulates all deposit taking institutions (banks), life and general insurance companies, superannuation funds other than self managed superannuation funds (which are regulated by the Australian Taxation Office) and retirement savings. APRA is accountable to an independent board. APRA operates under a charter that ensures financial safety objectives of prudential regulation are balanced with efficiency, competition and contestability considerations.

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[4] See Briault (2002) for a exposition of the FSA

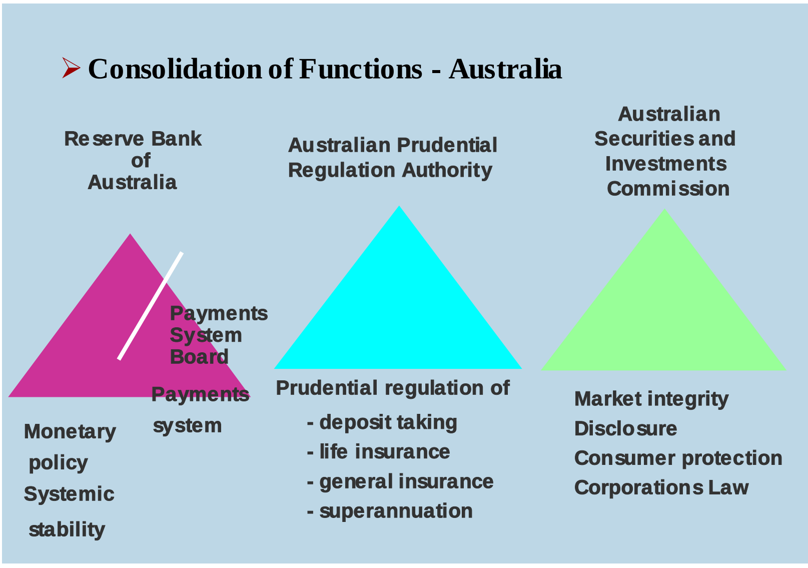
[5] See Carmichael (2002) for details on the operations of APRA

APRA is enthroned with power to legislate all the above institutions in a manner that will meet the set objectives, to make standards of prudential matters in relation to all the above institutions, initiate wind up or appoint administrators to troubled institutions in order to prevent further losses from accruing.

A bulk of the staff of APRA was drawn from the Insurance, superannuation commission and the bank supervision of the Reserve Bank.

APRA is funded by levies paid by the regulated institutions and charges for certain services. The levies are based on a percentage of assets held by the entity, subject to minimum and maximum levy amounts.

CHART 3: AUSTRALIAN FINANCIAL SYSTEM REGULATORY STRUCTURE



Source: Harper (2001)

4.2.3 Mauritius

The establishment Financial Service Commission – the integrated financial services regulator – was established based on the recommendations of the Committee on Financial Services Regulation in 2001. Integration of the financial services was to be done in two phases. The First phase set up a new Financial Services Commission (FSC) to regulate and supervise the entire financial activities environment save for the banking sector, which was under the supervision of the Bank of Mauritius. The second phase entailed the integration of the FSC and the banking sector to finally achieve a fully integrated supervisory structure.

The underlying objective to be achieved through integration in Mauritius was consumer protection. The Financial Services Commission, which was established under the Financial Services Development Act, strongly set out to suppress dishonourable and improper practices, market abuses, set guidelines on conduct of business, promote public understanding of the financial sector and set up of a recourse mechanism for channeling and investigating public complaints.

5.0 CASE FOR CONSOLIDATED FINANCIAL SECTOR REGULATION

5.1 MARKET DEVELOPMENTS

The need for the structure of regulation to mirror the structure of the industry is one of the most compelling arguments for consolidation. If the regulators entities are conglomerates covering banking, insurance, securities and pension then it is difficult for a regulator for a particular sub-sector to draw a view of the overall risks facing the entity. A consolidated regulator on the other hand would be able to understand and monitor risks across the sub sectors and develop policies to address the risks facing the entire conglomerate.

Even if the institutions are not in themselves conglomerates, the products they are offering may defy conventional categorization. For example, In Kenya many insurance products carry investment components which are larger than the risk components. It can be argued that these products are closer to deposit taking or collective investment schemes than they are to insurance. In the developed world many traditional debt products such as mortgages, credit cards and loans have been securitized and are traded in the capital market. Indeed, the global financial crisis in 2007 and 2008 arose from securitized mortgages known as Collateralised Debt Obligations (CDOs). Even though the underlying instrument is a mortgage issued by a mortgage lender, the resulting CDO that bundles mortgages, often with different risks, is a security primarily held by players in the capital markets. As a result when the housing bubble in the United States burst, it did not only affect the mortgage issuers but also investment banks, fund managers, pensions schemes and other financial players that were holding CDOs. In such cases a consolidated financial sector regulation would be in a better position to supervise such non-categorised products.

5.2 ECONOMIES OF SCALE AND COST REDUCTION

Another popular argument for consolidation arises from the cost efficiency gains that can be obtained by consolidating multiple regulators into a single body. Clearly a consolidated regulator will only have one set of service departments such as administration, finance and human resources hence reducing on staff and other overhead costs. Indeed, even core departments like legal, research, and public awareness can be unified into a single department in the new consolidated regulator leading to significant cost savings.

Where there are overlaps in registration and licensing then consolidation will also bring cost reductions and efficiency gains by allowing regulated entities to have a one-stop licensing procedure as opposed to multiple registrations. These gains are maximised where regulation is consolidated by function as in the case of Australia as opposed to consolidation by institutions as in South Africa.

The cost reduction gains to the industry may be minimal if the direct compliance costs are much less then the indirect compliance costs. Indirect compliance costs are unlikely to change much in the face of consolidation unless such consolidation is also accompanied by changes in compliance requirements.

5.3 REDUCE REGULATORY ARBITRAGE

Where there are regulatory overlaps, as is the case in Kenya, then having multiple regulators can allow regulated entities to engage in regulatory arbitrage. This is where entities opt to register products in those sub-sectors where regulations are weakest or most cost efficient. Again this is more feasible where products are not be easily categorised into conventional sub-sectors. With a consolidated regulator, uniform standards can be applied to all sub-sectors hence eliminating the motivation for arbitrage. Even where the consolidated regulator has different departments regulating different sub-sectors, the scope for information flow between the departments is much higher in terms of both quality and quantity.

In addition, a large consolidated regulator is less likely to suffer from regulatory capture by the industry. This can happen when industry groups and regulated entities are so large they are able to dominate a small regulator especially, one with limited internal capacity and resources.

5.4 STRENGTHEN ACCOUNTABILITY

Regulatory gaps often lead to regulators "washing their hands" of certain sub-sectors especially when things go wrong. Blame may be passed from one regulator to another when supervisory failure occurs. In Kenya, we have seen different regulators disavowing blame for an instrument that never came to market with no one ready to accept that they were the ones who had refused to approve the instrument. A consolidated financial regulator would be responsible for supervising all entities and products in the financial sector and would be duly held accountable. It is, in this regard, argued that CDOs in the United States would not have been unregulated if there was a single consolidated regulator in that country.

A problem, however, still arises where products are encompassing more than just the financial sector. For example, is money transfer through mobile phones a financial sector product or a communications sector product? Would one argue for consolidation of all regulatory institutions in the country so as to address such products?

6.0 CASE AGAINST CONSOLIDATED FINANCIAL SECTOR REGULATION

6.1 REDUCED EFFECTIVENESS

Large consolidated regulators are often criticised for becoming "Bureaucratic Leviathans."[6] That is, the regulator becomes so big and powerful that it is divorced from the industry it is supposed to be regulating. A consolidated regulator is likely to have a diversity of objectives and striking the appropriate balance between these may be difficult. Indeed, the different objectives may clash forcing the regulator to have to choose between policies many of which may favour one sub-sector over the others.

6.2 LOSS OF FOCUS

Consolidation may undermine overall effectiveness of supervision if the unique characteristics of the sub sectors are not recognized. Operations may become so broad based that they deny managers a chance to understand specific sub-sectors. In developing countries where some sub-sectors are less developed than others then there is a danger of regulation of the dominant sector - usually banking - overriding the others resulting in the smaller sub-sectors, which may require more flexibility, not getting the attention they require to develop. Indeed where multiple regulators are merged but one pre-merger regulator dominates in terms of size and staffing it may subsume the other regulators at the expense of focus paid to those sub-sectors.

6.3 DISECONOMIES OF SCALE

A consolidated regulator is effectively a regulatory monopoly[7] which may give rise to inefficiencies and sub-optimal resource allocation associated with monopolies. There may be merit in having a degree of competition between regulators as this enables learning from each other and striving to out-perform the others. In Kenya we have seen ideas from one

[6] Madero & Lumpkin (2007)
[7] Abrams & Taylor (2000)

financial sector regulator adopted by others in a modified form hence benefiting all the sub-sectors.

6.4 MORAL HAZARD

There is a compelling argument that a consolidated regulated framework gives consumers a false impression that all financial instruments have similar risks. When banks and securities are regulated by the same regulator consumers may fail to differentiate the very different risks in these two markets. Similarly, all institutions licensed by the regulator may be assumed by the public to be receiving equal protection. Yet, whereas bank depositors may be protected by the Deposit Protection Fund, this is not the case for the other sub-sectors.

6.5 COMPLEXITY OF INTEGRATION

Where multiple financial sector regulators are in existence, consolidation into a single regulator may not be as straightforward as commonly believed. Some of the challenges of integrating the bodies include:

6.5.1 Legal Issues

Consolidation requires reviewing all the existing statutes pertaining to each sub-sector to provide for the new consolidated framework or replacing all the sub-sector legislations with a new comprehensive framework. Legal difficulties encountered in those countries that have consolidated financial regulation in the past include sources of funding, ownership of assets, powers to sign foreign treaties, powers to enforce sanctions and powers to issue and amend prudential legislation[8]. Further, opening up legislation to changes or replacement opens an opportunity for vested interests to reopen issues that may already have been settled within the sub sector. These could be issues pertaining, for example, to exemptions from regulation. Whichever route to consolidation is adopted, the required legal changes are likely to prove very involving, cumbersome and expensive.

6.5.2 Staffing Issues

The uncertainty of the merger process inevitably results in the departure of key personnel from the regulatory agencies. Once information is made available that the existing regulators will be merged, talented staff may opt to move to the private sector or retire to avoid the uncertainty and difficulty of the change. Often, it is the best staff , critical to the

[8] Martinez and Rose (2003

success of the consolidated regulator, who leave for more secure pastures. Where, for example, bank supervision is being removed from the Central Bank to a new financial sector regulator, bank supervisors may opt to remain in the Central Bank which they may consider to be more prestigious. After the merger, even those who opt to stay may be demoralised especially if there difficulties implementing a new unified organisation structure.

6.5.3 Culture Issues

Each independent regulator will have its own culture and means of doing business. Regulators will have differing procedures and tools. Some may have international standards accreditation while others may not. Bringing these divergent cultures under a unified structure is a major challenge which requires a well conceived and effectively monitored change management program.

6.5.4 Systems Issues

Each regulator will have its own Information Technology and other infrastructure for doing its core business. Regulated entities may have invested heavily in having systems that can provide data in the format required by the regulator's system. Bringing the different platforms into a unified one may not be possible without major upheavals within and without the regulators.

6.6 CONTAGION EFFECTS

In the event of a problem in one of the sub-sectors, the consolidated regulator stands accused of poor supervision, This is likely to damage confidence in the whole financial system whereas such effects would have been limited to one sub sector and one regulator if the regulatory regime had remained diversified.

7.0 CONCLUSIONS

The most commonly cited reasons given for adopting consolidated financial sector regulation are market developments and cost efficiency. A survey of 15 countries[9] that have consolidated found these reasons cited in 93 percent and 80 percent of the countries respectively compared to less than 30 percent for other reasons. Of the two, the efficacy of reducing compliance cost will lie in the relativity of indirect compliance costs to direct compliance costs and to how much reduction can be achieved in direct compliance costs.

[9] Martinez and Rose (2003)

The market developments argument relating to conglomerates and non-categorised financial products appears to be stronger. In this regard, the case for consolidation appears to be strongest between banking and capital markets as opposed to insurance or pensions.

On the other hand, there are convincing arguments against consolidation including risks of reduced effectiveness, loss of focus and moral hazard. In addition, the actual process of integration is likely to be disruptive and expensive and this must be viewed against the expected benefits.

In Kenya, the case for consolidation appears weaker as market developments have not seen the rise of truly universal conglomerates[10]. Nevertheless the expected development of new securitized instruments including asset backed securities, special purpose vehicles and derivatives will no doubt eventually see the blurring of boundaries between financial products. Recent Initial Public Offerings (IPO) such as that for Safaricom have seen heavy demand for shares impact on liquidity in the banking sector. However, this is more a question of better managing of the IPO process and cooperation between regulators than an argument for consolidation

8.0 POLICY RECOMMENDATIONS

The seven principles of effective financial sector can still be achieved in a diversified regulatory framework through enhanced co-operation between the financial sector regulators. Implementation of the following recommendations can bring about an effective financial sector regulatory framework without undergoing the upheaval of consolidation.

1. Independence and Uniform Operating Standards

   All the four financial sector regulators should have similar operational powers and independence including the following:
   - Power to issue regulations or guidelines and practice notes to the industry
   - Exemptions from state corporations Act
   - Exemption from Income Tax.
   - Power to set adequate remuneration levels.

[10] The CFC Heritage group is the exception as it has interests in all four sub-sectors

2. Joint Board Representation

   To ensure effective co-ordination the Chief Executives of the Insurance Regulatory Authority, Retirement Benefits Authority, Capital Markets Authority and Central Bank of Kenya Bank Supervision should be members of the boards of all the other financial sector regulators.

3. Signing of Memorandum of Understanding between regulators

   The four financial sector regulators should sign Memorandum of Understanding for cooperation in the following areas.
   - One-Stop Registration and Licensing to remove overlaps
   - Joint Inspections of Service Providers
   - Sharing of Risk Scoring and Stress Tests
   - Joint Financial Literacy Campaigns
   - Coordinated Public Education
   - Collaboration in Research

4. Oversight Board

   An oversight Financial Sector Regulators Forum chaired by the Ministry of finance and having high level representation from all the regulators should be created to harmonise broad regulatory policies and agree on how to address regulatory gaps.

5. Creation of a Single Financial Sector Appeals Tribunal for all sub-sectors

   This will address unnecessary duplication and allow regulated entities to appeal on cross cutting issues.

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