9

Kenya

'Dubai' in the Savannah

Radha Upadhyaya

Introduction

Two words reoccur when people describe the Kenyan financial and banking sector in recent years: ambitious and innovative. Kenya's banking system made huge strides between 2003 and 2015, both in terms of overall financial depth and financial inclusion. However, efficiency, measured in terms of interest rate spreads, remains a major concern (Upadhyaya and Johnson, 2015). The rise of mobile banking (MPesa) and local banks following an agency banking model have led to the transformation of both the payments and credit landscapes (Heyer and King, 2015).

Kenya was an early adopter of Basel II and III relative to other cases in this book. It has taken a selective approach, implementing some elements of Basel II and III, in a manner broadly consistent with selective adoption in other peripheral developing countries (Jones and Zeitz, 2017). This chapter sets out the level of adoption of Basel standards in Kenya in detail, and then traces the drivers of this adoption. It argues that Kenya's high level of adoption of Basel standards is due to the alignment of government (politicians and regulators), banking sector, and donor interests. These groups share the view that financial growth, stability, and financial inclusion are priorities for economic development, and essential to the achievement of the country's Vision 2030 goals—and the implementation of Basel standards is perceived to be critical to meeting these objectives. Unlike its neighbours Tanzania and Ethiopia, which take a more interventionist approach to the financial sector and have been cautious about implementing Basel standards, Kenya has always followed a capitalist path and there is little commitment to government-led industrial policy.

In this chapter, we show how Kenya's adoption of Basel standards has been driven by the regulator and supported by both politicians and banks. The regulator, the Central Bank of Kenya (CBK), has a high level of independence in both theory and practice. It has strong links to the international policy community and is very receptive to international policy ideas. Since 2003, the incumbent politicians have also been internationally oriented and keen to adopt the latest

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international standards. Meanwhile, as the banking sector is relatively well capitalized, there has been little opposition to Basel Adoption from banks, with some international and large local banks being mildly in favour of it. There is evidence to suggest that enforcement of regulations may have been lax before 2015, but this may be due to capacity issues and not a form of mock compliance. While more stringent application of the rules since 2015 has met with some resistance from banks and politicians, the commencement of other international regulations like IFRS9 reporting standards means that banks see increased compliance with international standards as a fait accompli. In terms of our analytical framework, Kenya is an example of regulator-driven convergence.

The analysis draws chiefly on primary sources: a systematic review of regulatory texts, central bank publications, newspapers, and policy documents; and sixteen interviews conducted between April and December 2017 with CBK employees, ex-central bank regulators, ex-Treasury officials, policy experts on the financial sector, ex-Monetary Policy Committee officials, compliance professionals at banks, representatives of the Kenya Bankers' Association, and experts from the World Bank. Interview data is cited in ways that preserve the anonymity of interviewees.

Political economy context: the evolution of Kenya's banking sector

Kenya is one of the largest economies in Sub-Saharan Africa and a regional hub in East Africa, and is known for its vibrant but fragile democracy. In 2013, Kenya was classified as a lower-middle-income country, after rebasing its GDP (Handjiski et al., 2016).

The economy is still largely dependent on agriculture, which contributed to 30 per cent of GDP in 2015 (KIPPRA, 2016). While manufacturing growth is sluggish, the services sector has been performing well, and the depth of the financial sector and stock market capitalization are very high compared to other countries with the same level of GDP, both in the region and across the world (see Table 9.1).

At the time of independence, Kenya was one of the few African countries to already have a diversified banking sector with both foreign and local banks and an established stock market (Upadhyaya, 2011). Unlike many developing countries, in Kenya there was no wholesale nationalization of banks after independence. International and local private banks continued to operate, though state-owned banks and development finance institutions were established (Upadhyaya and Johnson, 2015). This reflects the international orientation of the Kenyan government that has persisted since independence. The banking sector has gone through a series of reforms, which began with the liberalization of interest rates and exchange rates in the 1990s (Ndung'u and Ngugi, 1999). However, by 2000, the sector remained extremely fragile: the ratio of non-performing loans (NPLs)

Table 9.1 Kenya: key indicators

Kenya	
GDP per capita (current US$, 2017)	1508
Bank assets (current US$)	31 bn
Bank assets (% of GDP)	43.8
Stock market capitalization (% of GDP, 2014)	50
Credit allocation to private sector (% of GDP)	32.7
Credit allocation to government (% of GDP)	13.7
Polity IV score (2017)	9

Note: All data is from 2016 unless otherwise indicated.
Source: FSI Database, IMF (2018); GDI Database, World Bank (2017); Central Bank of Kenya, (2015); Handjiski et al. (2016); Polity IV (2014)

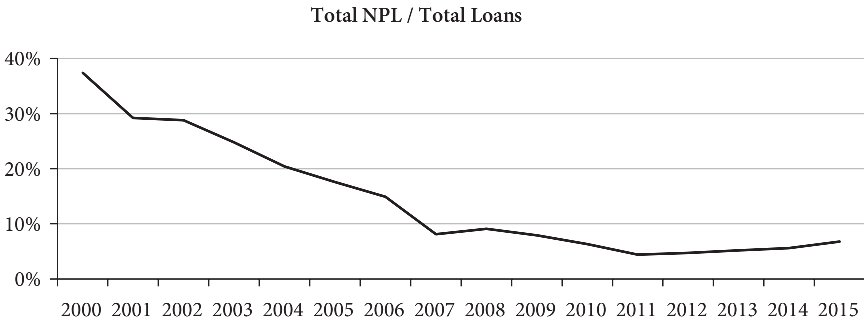

Figure 9.1 Kenya: non-performing loans (NPLs) (% total loans).
Source: Central Bank of Kenya (2015, 2014, 2014, 2002)

for three government-owned banks ranged from 42 per cent to 72 per cent (Upadhyaya and Johnson, 2015). Since then, banking regulations and guidelines have been continuously amended to strengthen supervision and regulation (Dafe, 2014). The main changes have been the introduction of guidelines requiring banks to conform to the various capital stipulations in line with the Basel Capital Accord, and restricting lending to insiders to 20 per cent of core capital (Central Bank of Kenya, 2000).[1]

The most significant impact of strengthening regulation and supervision has been on the quality of banking assets. The overall NPL ratio has reduced significantly from 2000 to 2012 from a high of 37 per cent to 5 per cent, though there has been a slight increase thereafter to 6.8 per cent by 2015 (Figure 9.1). This can partly be attributed to weaker macroeconomic conditions, but also to more stringent application of regulations.[2] Between 2007 and 2014, the banking sector in

[1] This is discussed in more detail in the next section.
[2] This is discussed in more detail in the next section.

Kenya was relatively stable with only one bank failure. However, in 2015, three banks were put under CBK statutory management, testing the reputation of other private banks (Ngugi, 2016).

There has also been an improvement in banks' capital adequacy ratios (see Figure 9.2). The ratio of total capital to total risk-weighted assets increased from 17 per cent (in 2000) to 23 per cent (in 2012) and then reduced to 19 per cent (in 2015), still staying above the required minimum ratio of 14.5 per cent (Central Bank of Kenya, 2015). Interest rate spreads decreased from 14.24 per cent in 2000 to 7.8 per cent in 2005, but have remained steady since then—economists and policymakers generally agree that the interest rate spread in Kenya is high.[3] The banking sector in Kenya has a low concentration by regional standards, with an HH index of 0.05 in 2012 (see Figure 9.3), and a spread of ownership between foreign-, local-, and government-owned banks (Upadhyaya and Johnson, 2015). However, profitability of the banking sector has been steadily increasing and the return on assets has risen from 0.8 per cent in 2000 to 3.5 per cent in 2011, with a slight drop to 2.9 per cent in 2015. This shows that sustained interest rate margins and spreads have allowed banks to maintain high profit margins. The other key challenges relate to the high level of bank assets in government securities,

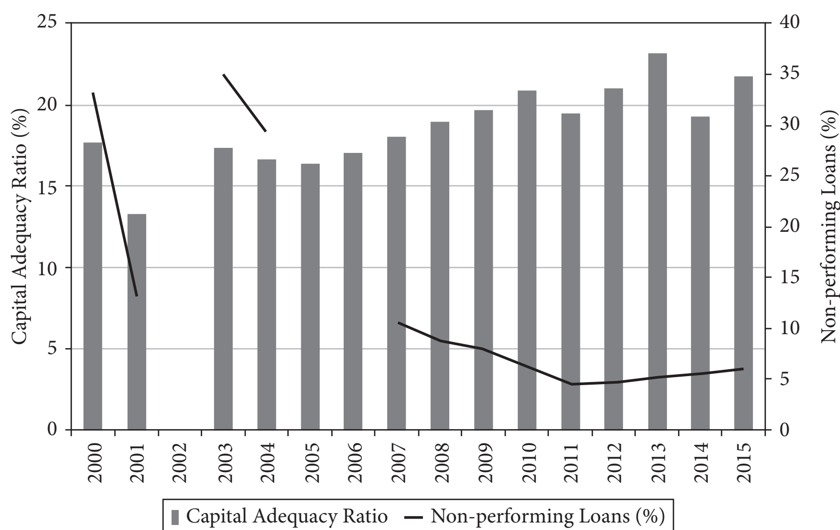

Figure 9.2 Kenya: capital adequacy ratios (CAR) and non-performing loans (NPLs).
Source: Financial Soundness Indicators Database, IMF (2018)

[3] In September 2016, MPs passed a law capping the interest rate spread. Thereafter there has been a drying-up of credit to the private sector which can be attributed to both the rate cap and general economic and political uncertainty. It is still unclear whether this cap will be lifted by Parliament.

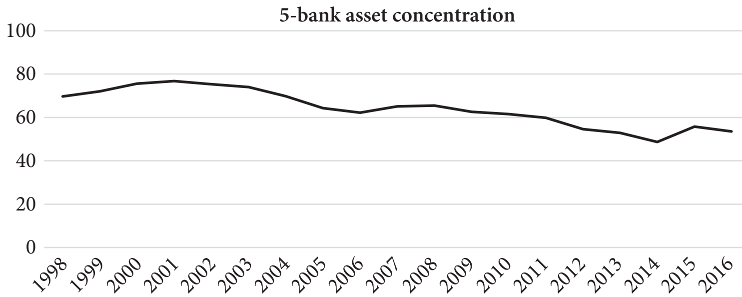

Figure 9.3 Kenya: banking sector concentration (asset share of the five biggest banks).
Source: Global Financial Development Database, World Bank (2018)

a low level of credit to key sectors including agriculture and infrastructure, and low overall savings (Upadhyaya and Johnson, 2015).

Kenya has become an inspiration globally because of the huge strides it has made in financial inclusion. The population that is included in formal finance has jumped from 26.7 per cent in 2006 to 75.3 per cent in 2016 (Central Bank of Kenya, Kenya National Bureau of Statistics, and FSD Kenya, 2016). This can largely be attributed to the rise of mobile money, and Equity Bank and other local banks following the agency banking model (Johnson and Arnold, 2012).

Basel adoption, implementation, and enforcement

While Kenya was a relatively late adopter of Basel I, it has made significant efforts to adopt and implement Basel II and Basel III and to comply with the Basel Core Principles. This section explains that while the level of adoption and implementation is high, the international standards have been adapted to suit the particular needs of the Kenyan banking sector.

Basel I adoption

Kenya began implementing Basel I in the early 1990s. Some of these requirements were included in the Banking (Amendment) Act of 1994, including the reduction of the ratio of single borrower limit to core capital from 100 per cent to 25 per cent (Central Bank of Kenya, 1996, 1995). In response to a spate of bank failures by 1998, several changes were brought into force in 1999, including detailed guidelines on provisioning and regulatory ratios based on Basel I (Central Bank of Kenya, 1999). Thus, while Kenya started the process of adopting some of the Basel requirements as early as 1994, the main requirements regarding ratios were only adopted in 1999.

Basel II adoption

In 2006, the CBK issued new prudential guidelines. While these guidelines do not mention Basel regulations explicitly, the changes were designed to strengthen Kenyan regulations in line with Basel I in preparation for Basel II. The main changes included highlighting differences between core capital (Tier 1) and supplementary capital; defining four risk weights for classifying balance sheet assets (the standardized approach to credit risk); and the definition of conversion factors for interest rate and exchange rate contracts based on residual maturity periods for market risk (Central Bank of Kenya, 2006).

The Basel Committee had noted that the implementation of Basel II may not be a priority for non-members like Kenya (Mwega, 2014). However, CBK documents revealed that in 2007 and 2008, it was developing a framework and preparing the prerequisite supervisory infrastructure to implement Basel II. In 2008, the CBK carried out a Basel II implementation survey that highlighted that the key challenges to implementation were the lack of both human resources and sufficiently advanced IT systems. The CBK noted that many of the relevant institutions did not have requisite five-year data to use for their internal models (Central Bank of Kenya, 2008). This survey was probably a major factor in the CBK's decision to not make internal models compulsory, but to instead recommend that banks use the standardized approach to credit risk; however, with Kenya, government securities were given a zero rating even though they are not AAA risk rated.[4]

New prudential guidelines were issued in 2013, and included many elements of Basel II and some of Basel III (see Table 9.2). The main additions to the credit risk regulations were rules on operational and market risk. In both cases the standardized approach was implemented.[5] The 2013 prudential guidelines also specify liquidity requirements, but Kenya has not adopted the liquidity coverage ratio that is part of Basel III. In 2013 the CBK also issued risk management guidelines and developed a risk-based framework for supervision. While banks were required to report their financial statements on a quarterly basis since 2006, stress testing of banks for supervision has been done since 2015. However, the ICAAP reporting which was in the 2013 guidelines was only enforced in 2017.

Basel III adoption

The CBK, while continuing to implement Basel II, made a series of changes to ensure that Kenya was also moving towards adopting elements of Basel III, with the most significant modifications being implemented in 2013.

[4] Interview 7—Senior Manager, accounting firm, Nairobi, 16 May 2017.

[5] Operational risk-weighted assets equivalent is calculated as 15 per cent of average gross income for three years multiplied by 12.5 (inverse of 8 per cent). Interview 7—Senior Manager, accounting firm, Nairobi, 16 May 2017.

Table 9.2 Kenya: adoption of Basel standards

Basel component	Adoption	Implementation
Basel I	Credit risk-weighted ratios—1994 onwards	1999
Basel II (5 out of 10 components)	2013 onwards - Risk management guidelines - Standardized approach to credit, operational, and market risk	1 January 2014 (1-year adjustment period built into guidelines). CBK 2013 pg. 124
Basel III (2 out of 8 components)	- Capital conservation buffer—2013 - Stringent definition of capital	- 1 January 2015

Source: Authors' summary from Central Bank reports and interviews

The main change in relation to Basel III was the inclusion of a capital conservation buffer of 2.5 per cent applicable to all banks (Central Bank of Kenya, 2013), which they were given twenty-four months to comply with (Central Bank of Kenya, 2013, p. 88). The CBK has decided not to implement several elements of Basel III, including contingency capital ratios, the Basel III liquidity ratios, and countercyclical macroprudential regulations,[6] all of which were perceived by the regulator as less relevant to the Kenyan banking system.[7] Unlike some countries, the Kenyan central bank decided not to make exceptions for small banks or development finance institutions.

Compliance with Basel Core Principles

In 2002, a regulation self-assessment revealed that Kenya had fully complied with twelve of the twenty-five Basel Core Principles. The CBK's report notes that it had not fully implemented twelve other core principles, while one was seen as irrelevant to the Kenyan context (Central Bank of Kenya, 2002).[8] In the FSAP 2009 Update conducted by the World Bank, the BCP Detailed Assessment Report stated that the CBK had 'made substantial progress in addressing the deficiencies highlighted in the 2003 FSAP' (World Bank, 2013).[9]

[6] Interview 6—Former Treasury official, Nairobi, 9 May 2017; Interview 11—Senior Banker, pan-African Bank, Nairobi, 19 May 2017.

[7] Interview 14—Senior Official, Central Bank of Kenya, Nairobi, 14 August 2017.

[8] In 2002, the requirement of the CBK to ensure that banks adequately control market risks was considered not to be applicable in the Kenyan environment, but by 2007 it was included in the CBK's roadmap to implement Basel II.

[9] The WB's 2005 Financial Sector Assessment report which is based on 2003 FSAP of Kenya mentions that an assessment of compliance with Basel Core Principles was done, but the result is not

Overall, Kenya has made significant progress in adopting and implementing the Basel principles, especially compared to other African countries (Marchettini et al., 2015). In particular, the CBK has stood out for its high level of operational independence, substantial powers, and engagement in consolidated supervision (Central Bank of Kenya, 1997).[10] Continuous improvements have meant that the number of principles that were assessed as Compliant or Largely Compliant increased from sixteen in 2003 to eighteen in March 2013 (World Bank, 2013).

All this means that Kenya is a relatively high adopter of Basel II and Basel III, and exhibits a high level of compliance with the Basel Core Principles. Furthermore, it has the legal authority to ensure its regulations are enforced.[11] This said, there is evidence that despite good adoption of the regulations, enforcement did not happen in full, particularly before 2015, which interviewees suggest was the result of a lack of resources rather than lack of intent and therefore not a form of mock compliance.

The political economy of Basel adoption, implementation, and compliance

This section discusses the specific contextual factors that resulted in the international orientation of politicians, regulators, and banks, and allowed their interests to align in support of Basel implementation.

Politicians

In 2003, Mwai Kibaki succeeded Daniel arap Moi to become the third president of Kenya, as head of the NARC—the National Rainbow Coalition. In the early years, the government had a broad mandate and there was a lot of optimism. This sense of hopefulness was captured in the chants of 'Yote yawezena bila Moi (everything is possible without Moi)' (Murunga and Nasong'o, 2006), and provided the impetus for a drive to change both the structures of government and the relationship between the government and private sector.

Under Kibaki's government, Kenya embarked on an ambitious programme of reform. Financial sector reform constituted a key part of the government's commitment to growth, which included the Economic Recovery Strategy for Wealth

discussed in the report that is available online. We have not found a copy of any report based on the 2009 FSAP on the WB web page.

[10] Interview 14—Senior Official, Central Bank of Kenya, Nairobi, 14 August 2017.

[11] Interview 1—KBA official, Nairobi, 4 April 2017; Interview 2—former Senior Banker, foreign-owned bank, Nairobi, 5 April 2017.

and Employment Creation (ERS) (Republic of Kenya, 2003) and the Kenya Vision 2030 (Republic of Kenya, 2007). The ERS explicitly acknowledged that a vibrant financial sector was necessary in order to mobilize the domestic resources necessary for investment, but equally recognized that the performance of the financial sector was constrained by the high level of NPLs prevalent in 2002 (Republic of Kenya, 2003, p. 15). Furthermore, both Treasury and central bank officials had internalized some of the messages coming from IFIs that the two goals of financial stability and financial inclusion were intertwined and crucial for development and growth.[12,13] In this context, the goals of international standards like Basel, which seek to improve the regulation, supervision, and risk management of banks, matched those of the government in its attempt to clean up the banking sector.

Unlike many developing countries, in Kenya successive governments have not pursued an industrial policy that includes directed lending to specific industries. Instead, bank lending in Kenya has remained market-driven, and Basel regulations are seen to be supporting banks' own efforts rather than in conflict with government policy.[14] Recent government documents, including the Sector Plan for Financial Services 2013–17, are explicit in saying that the rationale for following international standards is to increase stability within the banking sector: 'The CBK used the BIS and IMF defined financial soundness indicators to monitor and evaluate the soundness of financial institutions' (Republic of Kenya, 2003, p. 7).

The international orientation of government policy is also highlighted by the close involvement of international consulting firms in the development of the national economic strategy, and the policy intention to turn Nairobi into a financial services hub.[15] While there was broad consultation with Kenyan citizens when developing Vision 2030, it was openly acknowledged that international consulting firms like McKinsey were strongly involved in its development, as well as the roadmaps to achieving its goals (Wakiaga, 2015).

The plan to turn Nairobi into a regional finance hub lay at the heart of Vision 2030, in plans to establish the Nairobi International Financial Centre. The Kenyan government views the Nairobi International Financial Centre as a key development tool to increase investment and create employment (Republic of Kenya, 2013). While academics have highlighted that the impact could be negative for development (Waris, 2014), the government's commitment to this project has been steadfast. In July 2017, President Uhuru Kenyatta signed the Nairobi International Financial Centre Act, providing the legal framework to facilitate its development (Mwaniki, 2017).

[12] Interview 6—former Treasury official, Nairobi, 9 May 2017.
[13] Treasury and ministry of finance are used interchangeably.
[14] Interview 14—senior official, Central Bank of Kenya, Nairobi, 14 August 2017.
[15] Interview 1—KBA official, Nairobi, 4 April 2017; Interview 13—senior banker, large privately owned local bank, Nairobi, 14 September 2017.

Interviews and newspaper articles revealed that this policy goal was a key driver of recent moves to implement Basel II and III standards. As an interviewee noted, 'If we want Nairobi as a financial hub, players must a have a certain status'.[16] When launching the draft bill for the NFIC, the Cabinet Secretary to the National Treasury, Henry Rotich, reiterated that a key source of competitive advantage for the NFIC is that 'Kenya has a robust *legal and regulatory framework based on international best practices*' (Rotich, 2016). Speaking at the launch of the Capital Markets Authority Strategic plan in July 2018, Rotich again reiterated the government's commitment to establish the Nairobi International Financial Centre before the end of 2018 (Amadala, 2018). Thus, while the early impetus for Basel adoption came from the desire to clean up the banking sector, more recent moves have been motivated by the desire to create an internationally recognized financial hub.

Regulator: the Central Bank of Kenya

While the international orientation of the government provided a favourable policy context for adoption, it was the regulator—the Central Bank of Kenya—that was the driving force behind the implementation of Basel and other international banking standards. Crucially, and in contrast to many other case studies in this book, the CBK has enjoyed a high level of autonomy in setting regulations, which has given it the leeway needed to adopt and implement Basel standards.

This trend was entrenched under Kibaki, a very hands-off president who respected independent offices including that of the Central Bank Governor, and gave Treasury and central bank officials the space to drive regulatory reforms.[17] One interviewee stressed that President Kibaki 'gave a free hand which ensured reforms took off'.[18] Still, there was definitely some pushback from the politicians, particularly to the independence of the central bank. This quote from Cheserem's autobiography highlights some of the tensions:

> At the time of my appointment as Governor in July 1993, the office of Governor did not have safety of tenure…I faced a lot of resistance in my quest for CBK independence. A number of people, especially those in government, questioned the wisdom of granting independence to the bank. (Cheserem, 2006, p. 93)

The length of time it took to entrench the independence of the governor, between 1997 and 2006, shows the process was not easy, but nevertheless it did happen.

[16] Interview 1—KBA official, Nairobi, 4 April 2017.
[17] Interview 10—senior manager, financial sector donor, Nairobi, 18 May 2017.
[18] Interview 13—senior banker, large privately owned local bank, Nairobi, 14 September 2017.

Furthermore, the independence of all government institutions was strengthened under the very progressive Constitution that was passed in Kenya in 2010.[19]

Compared to many of the case studies in this book, the Kenyan regulator has substantial autonomy over the country's banks. Although several politicians do own banks, these are smaller organizations often referred to as 'Tier 3' banks within Kenya, and they do not have the level of political clout required to push back against regulatory changes.

That said, regulators are not completely unencumbered by politics. There is evidence of regulatory forbearance before 2015, as stricter enforcement of regulations only after Dr Patrick Njoroge took office in June 2015 led to the closure of three banks in late 2015 and early 2016. There is also evidence that politicians are trying to push through changes in the CBK Act in order to reduce the powers of the governor—but so far these efforts have not been successful (Some and Ngirachu, 2017).

International orientation of the central bank

The CBK viewed the implementation of international standards as integral to the broader goals of economic development. A regulator notes, the 'Adoption of BCPs or global standards will enable Kenya [to] achieve aspirations of Vision 2030 which include: improving financial stability; enhancing efficiency in delivery of credit and other financial services; promoting East African Community financial services integration to facilitate trade, enable cross-border operations and movement of capital; and achieving a well-functioning financial system safeguarding the economy from external shocks, and establishing Kenya as a leading financial centre in Eastern and Southern Africa'.[20]

Three specific factors help to account for the CBK's determination to implement Basel standards. First is the extreme fragility of the banking sector in the early 2000s; second, the view that improved regulation is essential to fostering growth within the financial sector; and third, the internationally oriented nature of CBK governors, who have been influenced both by the IFIs and their peers.

The fragility of the banking sector, reflected in very high levels of NPLs and several bank failures in 2004/5, provided the initial impetus for Basel implementation. There was widespread agreement among regulators that an inclusive and stable financial system was needed to support economic growth (Republic of Kenya, 2003). Reformist technocrats within the CBK viewed international standards as an aspiration worth achieving, and they perceived adherence to these standards as a basis for ensuring financial stability and inclusion.[21] This perspective is captured in a speech by the CBK governor Ndung'u, who in a speech to banks

[19] Interview 3—former senior official, CBK, Nairobi, 27 April 2017.
[20] Interview 14—senior official, Central Bank of Kenya, Nairobi, 14 August 2017.
[21] Interview 4—former CBK MPC member, Nairobi, 4 May 2017.

in 2013 noted: 'As you expand and innovate, it behoves you to ensure that adequate risk management is employed. It is with this in mind that the central banks have continuously adapted international best practices to ensure that financial stability is maintained' (Ndung'u, 2017). In the Kenyan context, international standard setting bodies were a source of ideas, rather than a source of pressure.[22]

To understand why successive central bank governors have been keen to implement international standards, it is instructive to examine their career trajectories and the extent to which they are connected to international policy debates throughout their careers, their engagement in transnational professional networks, and their participation in international training programmes. Examining the careers of central bank governors reveals that nearly all of them have a high level of embeddedness in international networks and close ties with IFIs (Table 9.3). Prior to his appointment as governor, Micah Cheserem worked for a multinational corporation outside Kenya. He notes in his autobiography that he agreed with many of the ideas promoted by the IMF and World Bank. 'Some people in government accused me of being too close to the IMF. I readily agreed with them. I do not deny that I was close but I must say that I accepted their conditionalities only if they made economic sense' (Cheserem, 2006, pp. 123, 124).

Dr Andrew Mullei worked for the IMF between 1974 and 1981, with a short stint at the UNECA in 1978. Dr Njuguna Ndung'u, while not working directly for the IMF or World Bank, worked for many years for the African Economic Research Consortium, which was funded by the World Bank but was also a forum for researchers across the world to come together to exchange ideas on economic development issues. Dr Patrick Njoroge, who began his term in 2015, had also worked for the IMF since 1995. The one exception was Nahashon Nyagah, who grew through the ranks of the CBK. During his short tenure he did not carry out many changes in regulation, but he was instrumental in developing the bond market.[23]

Table 9.3 Kenya: level of embeddedness of central bank governors

Name	Tenure	Level of embeddedness in international networks
Mr Micah Cheserem	1993–2001	High
Nahashon Nyagah	2001–3	Low
Andrew Mullei	2003–7	High
Njuguna Ndung'u	2007–15	High
Patrick Ngugi Njoroge	2015–Incumbent	High

[22] Interview 3—former senior official, CBK, Nairobi, 27 April 2017.
[23] Interview 13—senior banker, large privately owned local bank, Nairobi, 14 September 2017.

The central bank governors and senior staff have further been engaged in transnational professional networks, particularly since the start of Governor Ndung'u's tenure. There were several cross-border visits between the central bank governors of East Africa, which led to an exchange of ideas and declarations of intent to adopt international best practices.[24] The CBK is also involved in several international networks, including the Financial Stability Board (FSB) through the FSB's Regional Consultative Group for Sub-Saharan Africa, the Financial Action Task Force (FATF) through the Eastern and Southern Africa Anti-Money Laundering Group (ESMAALG), and the Association of African Central Banks.[25]

The CBK staff have also been exposed to high levels of international training on regulatory issues.[26] The role of the IMF's East Africa Technical Assistance Centre (East AFRITAC) should be highlighted here. East AFRITAC has been recognized in several of the CBK reports as providing training, particularly on regional supervision (Central Bank of Kenya, 2014). Membership of these transnational professional networks and participation in international training courses provide fertile ground for the exchange of ideas and emulation of international best practices.

Government engagement with IFIs

Although not in the driving seat, the IMF, the World Bank, and DFID have played an instrumental role in Kenya's implementation of Basel standards. Since the Kibaki government took office in 2003, the government has worked closely with the IMF and World Bank. Alongside Vision 2030 and other government economic blueprints, the two institutions developed the Financial and Legal Sector Technical Assistance Programme (FLSTAP), a broad-based lending programme to assist the Kenyan government in identifying weaknesses in the financial sector. The FLSTAP was agreed between the World Bank and the government in 2004,[27] and was based on the Financial Sector Assessment Programmes (FSAPs) that were conducted by the WB and IMF in 2003 and again in 2009. The broad agenda of the World Bank, which is captured in the publication 'Making Finance Work for Africa', centres on its view that stability, certainty, and transparency are cornerstones for an efficient financial system (Honohan and Beck, 2007). Interviews support the idea that politicians and regulators in Kenya took on the World Bank's

[24] Interview 2—former senior banker, foreign-owned bank, Nairobi, 5 April 2017.

[25] Interview 14—senior official, Central Bank of Kenya, Nairobi, 14 August 2017.

[26] Interview 13—senior banker, large privately owned local bank, Nairobi, 14 September 2017.

[27] FLSTAP stands for Financial and Legal Sector Technical Assistance Project, which was a lending programme of the World Bank.

position, which helps to explain their desire to incorporate financial growth, financial stability, and financial inclusion in broader economic goals.[28]

Interviews also revealed that in 2003, there was a willingness on the part of the Kenyan government to work with IFIs in a way that had not been the case for a long time.[29,30] There was an explicit recognition that the high level of NPLs in government-owned banks was not sustainable (Republic of Kenya, 2003).

It is clear that the World Bank, the IMF, and other donors like DFID played an instrumental role in the adoption of international banking standards in Kenya.[31] Many of the changes made to ensure compliance with the Basel Core Principles and implement Basel standards were brought in by the Government of Kenya and funded through the FLSTAP.[32] DFID co-funded this programme as part of its support to private sector development, and because it was seen as integral to attaining financial inclusion. This reflected a wider emphasis placed by the UK government on the implementation of international financial standards, as the Prime Minister of the UK at that time, Gordon Brown, was at the forefront of the global move towards Reporting on Standards and Codes.[33]

Although there was some disagreement between the government and World Bank on the privatization of government-owned banks, there was genuine enthusiasm among government officials for the regulatory agenda of the FLSTAP.[34] Some interviewees explained that the IFIs initially tried to push through regulatory reforms via consultants, but after they changed tactics and developed the capacity of Kenyans within the Treasury and central bank, the project took off.[35] While the World Bank and IMF did not drive adoption of the standards, the CBK took their recommendations seriously, and 'implementation of the 2003 recommendations resulted in ceding of operational supervisory powers from the Ministry of Finance to CBK. And the 2009 FSAP recommendations led to the development of a legal and regulatory framework for consolidated supervision'.[36]

[28] Interview 6—former Treasury official, Nairobi, 9 May 2017; Interview 14—senior official, Central Bank of Kenya, Nairobi, 14 August 2017.

[29] Interview 10—senior manager, financial sector donor, Nairobi, 18 May 2017.

[30] There was a recognition that at a very low level of inclusion, higher inclusion can lead to increased stability as banks have a larger depositors base. But, in turn, inclusion needs stability as increased stability allows depositors to trust banks (Interview 6—former Treasury official, Nairobi, 9 May 2017).

[31] Interview 10—senior manager, financial sector donor, Nairobi, 18 May 2017; Interview 5—senior World Bank official, Nairobi, 9 May 2017.

[32] Interview 6—former Treasury official, Nairobi, 9 May 2017; Interview 3—former senior official, CBK, Nairobi, 27 April 2017; Interview 5—senior World Bank official, Nairobi, 9 May 2017; Interview 4—former CBK MPC member, Nairobi, 4 May 2017.

[33] Interview 10—senior manager, financial sector donor, Nairobi, 18 May 2017.

[34] Interview 10—senior manager, financial sector donor, Nairobi, 18 May 2017; Interview 12—former senior official, World Bank, Oxford, 8 June 2017.

[35] Interview 10—senior manager, financial sector donor, Nairobi, 18 May 2017.

[36] Interview 14—senior official, Central Bank of Kenya, Nairobi, 14 August 2017.

Adopting Basel capital standards was seen by the IFIs as one part of the broader institutional architecture needed to improve the financial system.[37] Other important tools included the building of a credit registry, regulations for microfinance institutions, and Savings and Credit Cooperatives, which were also enacted during this period.[38] The development of the credit registry was seen as key to helping reduce NPLs in the system.[39] A project implementation report dated 2013 stated that fifteen Kenyan laws had been drafted and passed with the support of this project (World Bank, 2013). The World Bank and IMF were also key to providing training on Basel, discussed below. Other institutions such as DFID and FSD Kenya were important in providing support for other regulations related to the financial sector.

Therefore, while the CBK was the driving force as a regulator in ensuring adoption of Basel standards, IFIs played an important role alongside it. They were keen to support the broader reform of the financial sector, and their recommendations were crucial to providing information and capacity-building on these issues.

Role of the East African Community

In some countries, including Rwanda, regional integration dynamics have provided impetus for the implementation of international standards. Although Kenya has played a leading role in the development of the East African Community, this does not appear to have been a motivator for Basel implementation.

Central banks from three East African countries have been cooperating with each other to ensure joint supervision of banks. The East African Community web page states: 'With this regard, moving towards legal and regulatory harmonization against the international standards known as the Basel Core Principles (BCPs) is critical to achieve an effective functioning of a single market in banking services' (East African Community, n.d.). In practice, however, interviews indicated that there was little evidence that the EAC was a driving force in adopting Basel. One interviewee reflected that 'Kenya is the driver of standards and there are so many trade conflicts between the East African Community members that issues like Basel are not pushed at EAC level'.[40] There is a lot of positive goodwill at the very top level with governors of the different East African countries meeting in different forums, but lower down and at the EAC secretariat there doesn't seem to be any movement.[41]

[37] Interview 3—former senior official, CBK, Nairobi, 27 April 2017.
[38] Interview 3—former senior official, CBK, Nairobi, 27 April 2017.
[39] Interview 5—senior World Bank official, Nairobi, 9 May 2017.
[40] Interview 15—financial sector consultant and former senior banker, foreign-owned bank, Nairobi, 13 December 2017.
[41] Interview 1—KBA official, Nairobi, 4 April 2017.

Market factors

The evidence gathered from interviews suggests that while international or private banks did not lobby for Basel standards to be adopted—because complying with these standards would be resource-intensive—they were not averse to it either. To understand the reaction of banks in Kenya, it is helpful to examine the composition of the banking sector when each set of Basel standards was introduced (Table 9.4). When Basel I and II were introduced, the largest banks by asset share were foreign- and government-owned (FOB and GOB, respectively). International banks were already at different stages of adopting Basel II and III, because of their head office reporting requirements, so the introduction of these standards in Kenya did not pose problems for them.[42] KCB, a GOB, reflects the broad improvement in NPLs reflected in the Kenyan banking sector between 2005 and 2012 and the introduction of a risk management framework in line with international best practices was a key reason for this reduction.[43] The government partially privatized the bank and hired two CEOs with experience from foreign-owned banks—Gareth Terry Davidson and Martin Oduor-Otieno—to head a turnaround and expansion strategy. A reading of Martin Oduor-Otieno's biography shows that the government and board viewed a reduction in NPLs as essential to KCB's expansion strategy (Muluka et al., 2012). While there is no specific reference to Basel, it is highlighted that one of the key reasons why Martin Oduor-Otieno was selected to join KCB was because 'He had the special advantages that he was overseeing projects in Barclays which revolved around getting the multinational operations in Africa to adopt higher governance standards, brought about by Sarbanes-Oxley Act. This, as well as the introduction of International Financial Reporting Standards, meant that his recruitment into KCB would raise the bank's operations to *international best practices*. That international exposure was also important to a bank that wanted to *branch across borders*' (Muluka et al., 2012, p. 148).

By 2010, when Basel III started to be introduced, there had been a major shift in ownership due to the rise of local privately owned banks (LPOBs), including Equity Bank. Crucially, large local banks like Equity Bank were expanding regionally and they viewed adopting international standards as aligned with their interests.[44] As of the end of 2014, eleven Kenyan banks had subsidiaries across branches within the EAC region and South Sudan. The key banks were: KCB, Equity Bank, Cooperative Bank, Imperial Bank, Diamond Trust Bank, CBA, NIC, and I&M (Central Bank of Kenya, 2014; Irungu, 2015).

[42] Interview 2—former senior banker, foreign-owned bank, Nairobi, 5 April 2017; Interview 8—senior banker, foreign-owned bank, Nairobi, 16 May 2017.

[43] Interview 16—former senior banker, government-owned bank, Nairobi, 5 April 2018.

[44] Interview 1—KBA official, Nairobi, 4 April 2017; Interview 3—former senior official, CBK, Nairobi, 27 April 2017.

Table 9.4 Kenya: top three banks at different stages of Basel adoption

	Introduction by Basel Committee	Adoption and implementation in Kenya	Top three banks in Kenya (at beginning of implementation)
Basel I	1988	1994 onwards but mainly 1999	Barclays Bank (FOB) Standard Chartered (FOB) KCB (GOB)
Basel II	2004	2006–13	Barclays Bank (FOB) Standard Chartered (FOB) KCB (GOB)
Basel III	2010	2013 onwards	KCB (GOB) Equity (LPOB) Cooperative (LPOB)

Banks expanding across the region viewed a domestic regulatory architecture based on international standards as a 'defence mechanism' that allowed them to expand into other jurisdictions without suspicion.[45] As articulated by the CEO of one private bank, 'One fear we have as we expand is that regulation will be different in different jurisdictions. One therefore wonders if we will be treated differently and we therefore prefer to work within the international best practice regulation'.[46] These newly emerging banks also expected the implementation of Basel standards to make it easier to develop and retain correspondent relationships with foreign banks.[47] As Kenyan banks have expanded regionally, the CBK has set up supervisory colleges to strengthen cross-border banking supervision. These colleges manage the risks posed by Kenyan banks' presence abroad and base their work on the Basel Core Principles (Republic of Kenya, 2012).

A recent study on the credit risk approaches in Basel II and on the enhancement of capital quality and the introduction of capital buffers in Basel III found that the implementation of these requirements in 2013 led to a drop in bank capital ratios, particularly due to the inclusion of market risk and operational risk in calculating capital requirements. However, since the majority of banks in Kenya were above the minimum 14.5 per cent ratio, the impact of the increase in capital due to these requirements was not significant (Ambasana, 2015). The fact that Kenyan banks were well capitalized because of steady increases in capital requirements from 1998 onwards helps explain why banks in Kenya have not opposed some of the more complicated Basel II requirements.

[45] Interview 3—former senior official, CBK, Nairobi, 27 April 2017.
[46] Remarks by Mr John Gachora, CEO of NIC Bank at KBA/SOAS/UoN conference, Nairobi, 8 December 2017.
[47] Interview 1—KBA official, Nairobi, 4 April 2017; Interview 2—former senior banker, foreign-owned bank, Nairobi, 5 April 2017; Interview 4—former CBK MPC member, Nairobi, 4 May 2017.

Interviews showed that smaller banks were generally well capitalized, but struggled with adopting the risk-based guidelines mainly because of human resource constraints.[48] As one respondent remarked, in 2006 when it became mandatory for all banks to have a risk manager, there were only three qualified risk managers in Kenya and over forty banks.[49] Some regulations like the Internal Capital Adequacy Process (ICAAP) have been requirements since 2013, but the CBK only began enforcing them in 2017. There is some evidence that smaller banks found it harder to develop these reports than larger banks because of their systems' inability to generate client-specific data.[50] However these smaller banks were not strong enough to push back on these regulations. Overall, then, the CBK was not constrained by the banks in its push for adoption of Basel.

Conclusion

Kenya is a selective adopter of Basel standards. It has not adopted the standards fully but selected those parts of Basel II and Basel III that are relevant to its circumstances.[51] In terms of our analytical framework, the dynamics in Kenya illustrate how regulator-driven convergence can lead to implementation when supported by politicians and banks. Perhaps because the regulator has greater institutional capacity than in countries like WAEMU and Rwanda, so understands the challenges posed by Basel standards, it has taken a more selective approach to implementation.

The regulator received strong support from the politicians and wider government. Politicians from the main parties, as well as senior government officials, are strongly steeped in a market-led view of economic development, and they staunchly support the internationalization of the financial sector, which they believe is at the heart of the development process. As a result, even when governments have changed, key projects like the creation of the Nairobi International Financial Centre have been carried through. This has led them to support the CBK's implementation of international standards, including Basel. The international orientation of successive central bank governors and their embeddedness in international networks highlights the role of ideas in driving Basel adoption and implementation. IFIs, particularly the IMF and World Bank, have been instrumental, providing information and training about the adoption of

[48] Interview 2—former senior banker, foreign-owned bank, Nairobi, 5 April 2017.

[49] Interview 2—former senior banker, foreign-owned bank, Nairobi, 5 April 2017.

[50] Interview 8—senior banker, foreign-owned bank, Nairobi, 16 May 2017; Interview 9—senior banker, small privately owned local bank, Nairobi, 17 May 2017; Interview 13—senior banker, large privately owned local bank, Nairobi, 14 September 2017.

[51] This is in contrast to Pakistan, another high adopter where many regulations were brought in word for word.

standards to receptive regulators. Meanwhile, the banks are well capitalized, and their ambition to become regional players has meant that they have not opposed the introduction of international banking standards.

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