Njuguna Ndung'u: Implementation of Basel II, risk management framework within banks and the prevention of financial crime

Address by Prof Njuguna Ndung'u, Governor of the Central Bank of Kenya, at the opening of the 7th East African Banking School, Nairobi, 20 August 2007.

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The Chairperson, Kenya Institute of Bankers;
Representatives of Financial Institutions;
Distinguished Participants;
Distinguished Guests;
Ladies and Gentlemen;

It gives me great pleasure to be with you today and to address the participants at the **7th East African Banking School**. Before I make some remarks, let me take this opportunity to thank the organisers of this workshop and the facilitators for inviting me to preside over the opening of this important workshop and to give a keynote address. On behalf of the Central Bank of Kenya, and on my own behalf, please allow me to warmly welcome each and every one of you to Nairobi, Kenya.

Ladies and Gentlemen,

The financial sector is growing in dynamism and complexity to become very competitive. These developments require highly trained expertise and substantial resources to support such capacity building. The banking sector and our respective central banks must therefore invest heavily in capacity building. I would appeal to banks from partner states to continue supporting their respective Institutes of Bankers with adequate resources to enable them offer more courses that meet the growing demand in training. In Kenya, we are pleased with the efforts the Kenya Institute of Bankers (KIB) is making to meet the growing demands of the financial sector in professional training. The Central Bank of Kenya has continued to complement KIB's efforts in these endeavours through the Kenya School of Monetary Studies.

Ladies and Gentlemen,

It is worth noting that the theme, "**Banking in a Globalised and Complex Environment**", is very appropriate in this era of globalisation of banking business. However, before delving into this topic allow me, ladies and gentlemen, to recognise the important role KIB has been playing in capacity building in Kenya. Currently, KIB has 40 banks out of 42 banks as corporate members. I have also been informed that KIB has approximately 7,000 individual members, with 2,300 actively pursuing courses leading to professional examinations. Successful candidates at the lower level examination are offered a Certificate in Banking & Financial Services, whereas at a higher level, a Diploma in Banking and Financial Services is offered by the Institute. Therefore, KIB provides examinations that enable successful candidates to be professionally qualified bankers. This underlines the significant contribution that KIB has been making in improving management of financial institutions in Kenya. I urge you to continue this good work. With the rapid expansion and the ever increasing sophistication and dynamism of the banking sector, the demand for well trained bank professionals will definitely be on the increase.

Ladies and Gentlemen,

I have reviewed the contents of the 7th School's workshop programme and noted that it has been well designed around ten topics to reflect the central theme of the workshop, namely, **Implementation of Basel II, Risk Management Framework within banks and the Prevention of Financial Crime**. In my remarks, I will briefly touch on these issues and make an attempt to clarify our position on some of them. However, during the training sessions, you will be required to delve into greater details on these subjects.

Ladies and Gentlemen,

One of the best known schemes for financial crimes involves money laundering. This is the method of hiding, mixing and disguising the proceeds of criminal activities through legally operating institutions for the purpose of disguising the origins of the proceeds. In other words, money laundering is a tool that is used by people involved in illegal activities, such as drug trafficking, organised crime, tax-evasion, political bribery, and above all, corruption. In addition, the events of September 11th have added another dimension to the problem of money laundering and brought to light the synonymy between money laundering and terrorism. Reliable estimates by the IMF put money laundering to be in the ranges of USD 590 billion to USD 1.5 trillion, about 2% to 5% of the world's economic output.

Due to banks' confidentiality principle and their capability to handle huge cashless transactions and transmit funds efficiently, they are normally the targets of money laundering activities. In doing so, banks also suffer serious consequences from money laundering, which include reputation and legal risks. Money launderers are now able to quickly move illicit money between national jurisdictions, therefore complicating the task of tracing and confiscating these assets. It is in this regard that there is a concerted international and regional effort to combat the vice.

In the area of Anti–Money Laundering (AML), Kenya has set out seven key strategic objectives for the proceeds of crime and anti-money laundering prevention. As you may remember, Kenya has signed and ratified all the United Nations Conventions on combating Money Laundering and the Financing of Terrorism. Kenya has also criminalised money laundering under the Narcotics Drugs and Psychotropic Substances (Control) Act No. 4 of 1994.

To date a draft Proceeds of Crime and Money Laundering (Prevention) Bill, 2007 is now being debated by Parliament. The proposed legislation will be the focal point of Kenya's AML regulatory regime. The legislation will, amongst others, require financial institutions to:

- Establish appropriate Know Your Customer (KYC) requirements;
- Maintain records;
- Establish suspicious transaction reporting mechanisms; and
- Provide training to staff on anti-money laundering techniques.

The Central Bank expects financial institutions to be committed to ensure that the integrity of the Kenyan financial system is not in any way compromised by these criminal activities. In this connection, I would like to urge the respective Institutes of Bankers to develop and implement relevant course materials to support institutions in their efforts to train staff on anti-money laundering techniques.

Ladies and Gentlemen,

On the topic of risk management framework within banks, I am pleased to report that over the last two years, the Central Bank has been involved in initiatives aimed at transforming the approach used for conducting its core mandate of supervision and regulation of banks to make it more risk-focused. During the year, significant steps were made towards implementation of Risk Based Supervision. Inspection procedures and report formats were modified, and the Central Bank received Risk Management Programs (RMPs) from all institutions as required of them.

The exercise has substantially raised the level of awareness among banks on the importance of strong risk management systems. Most banks have now hired risk management personnel and introduced procedures for reporting and reviewing the critical risks facing their operations. This process will continue to improve bank operations and contribute to the soundness of Kenya's banking system.

In addition to this, risk management and strategic management are both aimed at enhancing corporate governance in the banking sector. The Central Bank has continued to lay emphasis on corporate governance in the banking sector as one of the key tenets of its legal and regulatory framework. In this regard, the Central Bank has revised provisions in the prudential guidelines to require institutions to separate ownership from management, restrict ownership of shares to reduce shareholder dominance, introduce board independence and periodic disclosure of financial statements.

During our deliberation under the auspices of the Monetary Affairs Committee of the East African Community last May, we were pleased to learn that majority of our partners have equally made notable progress in these areas. I am therefore pleased that this Workshop will cover these topics adequately. However, we expect that having followed keenly the developments in the banking sector, our respective Institutes of Bankers will strive to offer more relevant courses and training opportunities to its membership to meet the growing training needs on risk management in banks.

Ladies and Gentlemen,

Since 1999, banking institutions in Kenya have been regulated under Basel I Capital Adequacy Accord which was issued by the Basel Committee in 1988 to guide in assessing banks' capital adequacy requirements. Under this framework, the focus has been largely placed on the credit risk faced by banks. The 1988 Accord was later amended in 1996 to incorporate a capital charge for the market risk, which we in Kenya and other Central Banks in the region have not adopted.

In 2004, the Basel Committee issued the Basel II Capital Accord which, in addition to credit and market risk, introduces a capital charge for operational risks that banks face. The Accord took effect from the beginning of 2007 in G10 countries. However, the committee recognises that emerging countries such as Kenya will not be able to implement this accord in 2007 as they are yet to fulfill the prerequisites of the new Accord. The Central Banks of Kenya, Uganda and Tanzania have indeed agreed that they will only implement the Basel II accord upon implementation of key prerequisites. These preconditions include:

- The full implementation of the Basel I Accord;
- Adoption of Risk Based Supervision; and
- Adherence to the Basel Core Principles for Effective Banking Supervision.

The move to Basel II will ensure that the solvency of the banking sector is determined in more precise terms, taking into account most of the critical risks that banks are exposed to. Through the revised approach, we will overcome the simplistic methods of measuring capital adequacy currently in use, which do not reflect the increasing sophistication of activities that many banks are beginning to engage in. As a result of the improved techniques brought about by the new Accord, we hope to achieve increased stability of the sector.

The Central Bank is currently undertaking various initiatives within its' current 2006-9 strategic plan to ensure full compliance with the aforementioned prerequisites of Basel II implementation. Of critical importance has been the shift to **Risk Based Supervision (RBS)** which began in 2004. RBS focuses on assessing the adequacy of banks' risk management frameworks in identifying, measuring and mitigating inherent business risks.

Ladies and Gentlemen,

Risk Management does indeed lie at the heart of Basel II and it is imperative that a "risk management culture" be inculcated in banks as a precursor for implementation of the new Accord. Towards this end, the Central Bank conducted a survey in 2004 that indicated gaps in Risk Management Practices in Kenyan Banks. This led to the issuance of Risk

Management Guidelines by the Central Bank to guide banks in the development of Risk Management Frameworks.

The Central Bank, since May 2006, has been reviewing the Risk Management Frameworks of all institutions. These frameworks will form the basis of future "supervisory relationships" between the Central Bank and each institution. More fundamentally, the **Risk Based Supervision** approach will inculcate the requisite "risk management culture" in banks before Basel II implementation can be considered.

The Central Bank recognises that the structure of banking institutions is increasingly evolving and becoming more complex due to business linkages with the non-bank financial associates, affiliates and subsidiaries. These linkages obviously affect the soundness of the banks in the conglomerate group. The Central Bank supervisory approach has traditionally viewed banks as "stand-alone" entities. In response to this, the Central Bank is developing a consolidated supervision framework, which will address the risks arising from the activities of the conglomerate.

Ladies and Gentlemen,

To achieve all these, the Central Bank has proposed comprehensive amendments to the Banking Act with a view to bringing it in line with international best practices and to meet the dynamic needs of the banking industry. In particular, some of the objectives of the review exercise include:

- Enhancing the independence of the Central Bank;
- Expanding the "Permissible Activities" of banking institutions;
- Introducing consolidated supervision; and
- Establishing provisions for Prompt Corrective Action.

A robust legal and regulatory framework for the banking sector in Kenya is part of the reform package that is intended to ensure a suitable environment for safe and sound banking.

Ladies and Gentlemen,

Before I conclude, please allow me to pose a few challenges for the regional Institutes of Bankers.

First, as you are well aware, microfinance is the provision of financial services to low income people and enterprises. The microfinance industry in our region has experienced major transformations over the past twenty years, growing from a fledgling concern dominated by a few donor and church-based NGOs to a vibrant industry increasingly driven by commercial viability and sustainability. We challenge the institutes to tailor a curriculum that meets the requirements of this sector, which plays an important part in the financial market.

Second, regional central banks are currently enhancing their technical capacity to handle the challenges posed by the implementation of Basel II. Basel II implementation requires various skills like IT experts, legal expertise, actuaries and banking experts. Thus the training efforts of the institutes will be a key ingredient in the development of the three pillars of Basel II. The inclusion of the stakeholders in this consultative process and capacity building is crucial.

Ladies and Gentlemen,

I would like to encourage you all to participate actively during this important forum so as to get maximum benefits from this workshop. As I conclude, may I welcome the presence of delegates from Rwanda and Burundi to this workshop. I wish the participants a happy stay in Nairobi and fruitful deliberations.

With these few remarks, it is now my humble duty to declare the **7th East African Banking School** officially open.

Thank you for your kind attention.