Njuguna Ndung'u: IFRS, Basel II and the challenges ahead in Kenya

Keynote address by Prof Njuguna Ndung'u, Governor of the Central Bank of Kenya, during the Official Opening of Financial Reporting Workshop for the Banking Sector, Nairobi, 27 March 2008.

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Distinguished Participants,
Distinguished Resource Persons,
Ladies and Gentlemen

Let me first thank Ernst and Young for the invitation to give today's keynote address, on the Financial Reporting Workshop for the Banking Sector. Looking at the agenda, this meeting in the next two days will dwell on a number of important accounting and regulatory issues. Therefore, to help set the stage for the discussion to follow, I would like to take this opportunity to expound on the Central Bank of Kenya's perspective on compliance with International Financial Reporting Standards (IFRS), and specifically at the benefits from such compliance, the progress we have made, the link between IFRS and Basel II and the challenges ahead.

Acceptance and use of IFRS has become virtually universal, with many countries that hitherto operated their own national standards having phased them out for IFRS despite the associated challenges. International flows of investment capital and capital instruments across geographical boundaries have added a new impetus to the adoption of international standards globally.

It is no wonder that in 1998, the Institute of Certified Public Accountants of Kenya (ICPAK), moved from Kenya Accounting Standards in favour of International Accounting Standards. The Central Bank as the principal regulator of banks and non-bank financial institutions, formulates prudential guidelines that are in harmony with IFRS in order to minimize conflict and enhance compliance with international standards.

The Central Bank of Kenya recognises that financial reporting standards play a crucial role in enhancing financial stability. On one hand, Reporting Standards provide the foundation for the production of credible financial statements and other disclosures that communicate the performance of the industry and at the firm level.

On the other hand, disclosure of reliable information facilitates market discipline, cultivates confidence and reduces the possibility of adverse instability. The credibility of information allows market participants to process the right information and make appropriate decisions, thus a good signalling mechanism. Disclosure of information, however, should not compromise proprietary data, but must be flexible enough to accommodate future advancement in risk management. Such outcomes therefore, have obvious implications for the supervisor's ability to oversee the safety and soundness of financial institutions.

It is necessary for banks and non-bank financial institutions to prepare quality financial statements so that shareholders and other stakeholders are well-informed and a sound judgement on their financial status can be made by the market. Quality and reliable information depends in turn, on the reporting standards being applied. In this respect, IFRS ensures that financial reporting is prepared under accepted principles that convey a true and fair view of the financial position of an institution.

The foregoing notwithstanding, the Central Bank has made significant progress in strengthening the supervisory approaches and risk management guidance for banks and non-bank financial institutions. This is aimed at encouraging the banks and non-bank financial institutions to implement sound risk management practices at all levels and in all market segments.

It is for this reason that the Central Bank will continue to attach great importance to risk management and reporting standards so that financial statements produced by banks and non-bank financial institutions convey adequate information about their risk management activities to key stakeholders, such as shareholders, creditors, depositors and any other interested parties. It is hoped that with adequate and timely information potential investors can make correct judgement/assessment of this market.

The choice of Basel II as a topic for discussion during the workshop is indeed timely. Basel II represents a crossroad, a watershed and a turning point for the future of global supervisory practices. Basel II presents us with an opportunity to enhance risk management systems in our banks, upgrade our supervisory approaches and inculcate market discipline. This can only serve to enhance financial stability. Central Bank recently issued an information memorandum to banks and non-bank financial institutions thereby setting the stage for the implementation of Basel II.

Unlike Basel I which focused on a single risk measure, Basel II puts more emphasis on the banks' own internal methodologies, supervisory review, and market discipline. The Accord is based on three mutually reinforcing pillars that allow banks and supervisors to evaluate properly the various risks that banks face. All of the reinforcing pillars will contribute to safety and soundness in the financial system.

Market discipline reinforces the incentives for the management of banking enterprises to manage them along sound lines. It operates on the basis of disclosures and other information available in the market and defines the reward system for the management. Periodic and meaningful disclosures by banks relating to their capital, risk exposures and risk management techniques enable market participants to make an assessment of a bank's risk profile. The information is also appropriate for supervision in that it generates advice and /or strengthens partnership.

Enhanced, high-quality disclosures are mandated in IFRS from an accounting perspective and in Basel II from a prudential perspective. While IFRS disclosures focus on assessing the current financial position of an enterprise, Basel II disclosures are more forward-looking. Given the different focus of accounting and prudential standard setters, it is to be expected that the disclosure requirements under the two standards differ in some respects. IFRS disclosures are made in the financial statements by all enterprises that prepare and submit financial statements. On the other hand, disclosures under Pillar 3 are required to be made only by banks that are implementing Basel II. Moreover, Pillar 3 disclosures need not necessarily be made in the financial statements.

IFRS and Basel II disclosures do, however, complement as well as supplement each other in several ways. Both require corporates to provide information on their capital, the risks exposed to, and how these risks are managed. Disclosures are required to be made "through the eyes of the management". This enables the user of information to view and assess a firm in the same way its management would. Disclosures under both IFRS and Basel II include a good mix of quantitative and qualitative aspects.

Consistent, comprehensive and comparable disclosures contribute to effective market discipline. IFRS and Basel II disclosures try to ensure that this goal is met. There is potential for achieving synergies in disclosures under IFRS and Basel II by defining risk parameters in a common way, and developing common processes and data collection methodologies. This could lead to a consistent basis for internal reporting to the management of the enterprise and external reporting to the supervisors or regulators and other stakeholders.

Challenges with IFRS and Basel II

Compliance with IFRS will assist banks to comply with certain aspects of Basel II. Both IFRS and Basel II intend to leverage on market discipline by requiring the disclosure of certain information. Basel II encourages development of more refined approaches to the measurement of risks and greater transparency while IFRS strives to support broader and more sensitive recognition and disclosure of risks.

Through financial reporting, the management of banks and non-bank financial institutions provide their shareholders, potential investors and other stakeholders with the past results of the business being managed and supervised. These reports give more in-depth insight into the income statement, balance sheet and cashflow and therefore, help the users of these reports better understand and assess the financial performance of the business. The market participants base their investment decisions mainly on the financial reports, thus reinforcing the importance of providing adequate and accurate information. Although financial reports are a crucial management tool, they at the same time provide the management with an opportunity to explain to stakeholders the institution's performance, achievements and future plans.

Basel Committee on Banking Supervision recognises the importance of IFRS in Basel Core Principle (BCP) 22 by requiring regulators to ensure that banks maintain adequate records which are prepared in accordance with consistent accounting policies and practices.

Compliance with IFRS and Basel II will however, pose certain challenges to banks and non bank financial institutions. For accounting standards, the most recent challenge is the accounting methods for sophisticated financial products, such as bonds, in which differences in financial assets' classifications can result in different financial impacts. For example, held-to-maturity classification conceals profit or loss until maturity, while trading classification charges profit or loss to financial statements in every accounting period. The interpretation for a suitable classification relies significantly on the intention of bank management as well as on the judgment of external auditors.

Another practical challenge is the use of complex financial models to measure risks in banks' portfolio. These models are important as they provide adequate predictive power. But there must be sufficient data, appropriate risk measurement techniques, and a rigorous validation process for the benefits of the predictive power of the models to be analysed. At present, the most important concern is the lack of consistent data points over time. For example, for credit risk measurement, a certain amount of data on default is required. Such data is typically not readily available.

Banks may need to rethink their operations and strategies on account of the expected greater involvement of third parties. The point here is that new regulations allow banks to use financial models to estimate required capital and fair values of assets and liabilities. This means that banks can take advantage of the lower capital requirements by offering cheaper or more cost efficient products to their customers. But these aspects in the market place are driven by the market niche the bank is serving. The combination of market niche, requisite information and efficiency will be the core of operating strategies in the banks.

Banks must increase their knowledge base regarding risk management techniques, especially on risk modelling. Going forward, a good internal rating system is key to business expansion and growth. To do so, banks can initially seek support from external consultants to transfer the know-how on risk management. But, in the longer term, it will be necessary for banks to train their own staff and build expertise to work as specialists on internal rating system and risk modelling. But we all do know that at the end of it all, these requirements and their derivative innovations are driven more not by the regulator like CBK, but the market niche the bank or any other firm in business is operating in. The more we understand our market niches, the more we perform better and above all adhere to the rules of the game. Market niches provide a drive to innovativeness.

I should now end my talk. It has been a pleasure to share with you a regulator's view on compliance with IFRS. I hope my remarks and observations have been useful. We are travelling on an important and challenging path towards achieving a robust and resilient financial system, and steady progress is being made. Indeed, this progress is usually noticeable in times of economic vibrancy. You, as a key stakeholder, are also an important part of this journey.

It is a great honour and privilege for me to declare the Financial Reporting Workshop for the Banking Sector officially opened and to thank Ernst and Young for organizing such a workshop.

Thank you very much.