## **SOLUTION**

1. **CASE FOR and a CASE AGAINST financial sector regulation (16 marks)**

**CASE FOR:**

*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.*

*Related to the above (Protecting consumers), another argument for government regulation is based on the existence of* ***destructive, ruinous, or cutthroat competition****. This may drive out firms from the industry leading to monopolies that may exploit consumers.*

*In the financial sector, an additional motivation for regulation is* ***maintaining financial stability****, which is a clear public good. Asymmetric information can lead to widespread collapse of financial intermediaries, referred to as a financial panic. Because providers of funds to financial intermediaries may not be able to assess whether the institutions holding their funds are sound, if they have doubts about the overall health of financial intermediaries, they may want to pull their funds out of both sound and unsound institutions. The possible outcome is a financial panic that produces large losses for the public and causes serious damage to the economy.*

***Asymmetric information*** *in financial markets means that investors may be subject to adverse selection and moral hazard problems that may hinder the efficient operation of financial markets. Risky firms or outright crooks/ criminals may be the most eager to sell bad securities to unwary investors, and the resulting adverse selection problem may keep*

**CASE AGAINST**

*Regulation may* ***depress the returns (Profits)*** *earned by financial institutions by increasing costs needed for compliance with the regulations. An example is the minimum capital requirements of Ksh. 1 billion for commercial banks.*

*Regulation may lead to an* ***increase in prices*** *i.e. the commissions, accounts ledger fees charged to consumers. Alternatively, the financial institutions may resort to cost cutting measures that* ***lower the quality of service****. All this will be in a bid to meet the costs of regulation.*

*It has been found that with tighter regulations, financial institutions tend to engage in* ***riskier behavior****. For example, they issue riskier loans in order to make an adequate return on capital for the investor.*

*The* ***cost of the regulatory process (to the government)*** *must be emphasized. If regulation is truly to serve the public interest, it must increase the efficiency of the entire social system. That is, its benefits must exceed its costs. Too often the net benefits of regulation are overestimated because of a failure to consider its costs.*

*Regulations may make members of the public (Consumers) develop a* ***false sense of safety****. Experience shows that regulations are not an absolute insurance against failure of institutions. The fact is those financial crises occur even when regulations and regulators are present. Regulators often react to crisis by packaging new regulations- which raises the question of whether they have the moral authority to do so.*

1. **Discuss the FOUR laws/ acts and guidelines/ regulations from which the financial sector regulators in Kenya draw their powers (8 mks)**

* ***The Microfinance Act, 2006*** *and the Microfinance Regulations issued there under sets out the legal, regulatory and supervisory framework for the microfinance industry in Kenya. The Microfinance Act became operational with effect from 2nd May 2008.*
* *The Central Bank of Kenya was established in 1966 through an Act of Parliament - the* ***Central Bank of Kenya Act of 1966****. The establishment of the Bank was a direct result of the desire among the three East African states to have independent monetary and financial policies. This led to the collapse of the East Africa Currency Board (EACB) in mid 1960s.*
* *The Sacco Societies Regulatory Authority (SASRA) is established under the* ***Sacco Societies Act of 2008*** *with the mandate to license Sacco Societies to carry out deposit taking business; Regulate and supervise deposit taking Sacco Societies; Manage the Deposit Guarantee Fund under the trustees appointed under the Act; Advise the minister on national policy on deposit taking Sacco Societies in Kenya.*
* *Commercial Banks and Mortgage Finance Institutions are licensed and regulated pursuant to the provisions of the* ***Banking Act (CAP 488) and the Regulations and Prudential Guidelines*** *issued there under.*
* ***Banking (Credit reference bureau) regulations*** *setting up the credit reference bureaus.*
* ***The capital markets act****- Setting up the CMA that regulates the capital markets and listed firms.*
* ***The Finance act of 2009*** *that among others allowed for agent banking.*
* ***The Proceeds of Crime and Anti-Money Laundering Act, 2009.***

1. **Discuss the principle of agent banking. What are the aims of agent banking? (6 mks)**

*“Agent” means an entity that has been contracted by an institution and approved by the Central*

*Bank to provide the services of the institution on behalf of the institution in the manner specified in the Guideline issued by the CBK.*

*“Agent banking business” means the business carried out by an agent on behalf of an institution as permitted under the guideline. The purpose of agent banking is to:*

1. *increase financial services outreach and to promote financial inclusion to the un-banked and under-banked population without risking the safety and soundness of the banking system; and,*
2. *Encourage institutions to use agents in the provision of banking services so as to reduce the cost of financial services and to foster financial inclusion, reach and depth.*