# INVESTIGATING THE EFFECTS OF DE-RISKING ON FINANCIAL SERVICES

## A CASE OF COMMERCIAL BANKS IN KENYA

**BY**

**CAROLINE ROSE MWANIKI**

**UNITED STATES INTERNATIONAL UNIVERSITY-AFRICA**

**SUMMER 2019**

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**A Research Project Submitted to the Chandaria School of Business in Partial Fulfillment of the Requirement for the Degree of Master in Business Administration (MBA)**

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**SUMMER 2019**

## STUDENT'S DECLARATION

I, the undersigned, declare that this is my original work and has not been submitted to any other college, institution or university other than the United States International University in Nairobi for academic credit.

**Signed: _____ Date: _____**

**Caroline Rose Mwaniki (ID 654997)**

This project has been presented for examination with my approval as the appointed supervisor

**Signed: _____ Date: _____**

**Prof. Amos Njuguna**

**Signed: _____ Date: _____**

**Dean, Chandaria School of Business**

## ABSTRACT

The purpose of this study was to investigate the effects of de-risking on the financial activities of Commercial Banks in Kenya. The research questions that guided the study were: What are the factors leading to de-risking in the banking sector in Kenya? What are the effects of de-risking in the banking sector in Kenya? What strategies and policies are directed towards managing de-risking in the banking sector in Kenya?

This research was conducted in Nairobi, Kenya and focused on a sample of twenty-one Commercial Banks. The respondents of the research comprised of senior banking officials from each of the Commercial Banks. Descriptive and inferential research designs were utilized. Data was collected by use of a questionnaire and analyzed using Statistical Package for Social Sciences (SPSS). This was conducted by using descriptive analysis and correlation analysis. The related results were presented in tables and reports to facilitate interpretation of data and drawing of conclusions and recommendations. The study established that factors leading to de-risking were mainly anchored on regulatory requirements which dictate the regulations for complying with Anti Money Laundering (AML) and Combating Financing of Terrorist (CFT) activities policies and given standards. The associated compliance costs and hefty AML fines experienced by the correspondent banks globally were also seen to be a major contributing factor to de-risking in the banking sector in Kenya. There was a positive relationship between de-risking, cross-border payments and financial inclusion but the study concluded an insignificant correlation between de-risking and Trade Finance Services. Banks maintained closely knitted relationships with their correspondent banks to minimize the risk of losing their accounts and credit limits. The study also concluded that harmonizing regulatory requirements with the aim of combating financial crime amongst the various regulators both at a local and global level is instrumental in facilitating compliance and ultimately reducing the pressures of de-risking. The study additionally showed that training and boosting of compliance departments were key strategies adopted by banks to reduce the impact. The study recommends that Banks revamp their Risk departments and training policies to ensure continued regulatory compliance. Further the impact of leveraging on Fintech (Financial Technology) and Regtech (Regulatory Technology) innovations and its effect on de-risking should also be considered for further exploration.

## COPYRIGHT

**ACKNOWLEDGEMENT**

I would like to extend my heartfelt appreciation to Professor Amos Njuguna for his relentless guidance and support throughout the project writing process.

## DEDICATION

I dedicate this project to God, the pillar of my entire being, my husband Timothy and gorgeous daughter Jessica for their love and support always.

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## ACRONYMS AND ABBREVIATIONS

AML-Anti-Money Laundering

ASBA-Association of Banking Supervisors of the Americas

BIS-Bank for International Settlements

CBs-Correspondent Banks

CBK-Central Bank of Kenya

CBRs-Correspondent Banking Relationships

CFT-Combatting/Countering the Financing of Terrorism

FATF-Financial Action Task Force

FCA-Financial Conduct Authority

FCY-Foreign Currency

FDIC-Federal Deposit Insurance Corporation

FFI-Foreign Financial Institutions

FRC-Financial Reporting Centre

GPFI-Global Partnership for Financial Inclusion

IFC-International Finance Corporation

IMF-International Monetary Fund

KYC-Know Your Customer

MENA-Middle East and North Africa

MSBs-Money Service Bureaus

NPO-Non-Profit Organization

OCC-Office of the Comptroller of the Currency

OFAC-Office of Foreign Assets Control

REG TECH-Regulatory Technology

REN21-Renewable Energy Policy Network for the 21st Century

SACCO-Savings and Credit Cooperative Organization

SPSS-Statistical Package for Social Sciences

SSA-Sub-Saharan Africa

SWIFT-Society for Worldwide Interbank Financial Telecommunications

TIER 2-Medium Segment Banks

TIER 3-Lower Segment Banks

UNDP- United Nations Development Programme

# CHAPTER ONE

## 1.0 INTRODUCTION

### 1.1 Background of the Study

De-risking in general terms can be defined as the process of shifting risk away or reducing risk exposure in events of uncertainty (Steckel & Jakob, 2018). De-risking can be applied across various industries in the business world today.

The concept of de-risking can be related to other sectors such as energy and agriculture other than the financial segment. In a report by Waissbein, Glemarec, Bayraktar, and Schmidt (2013) the United Nations Development Programme (UNDP) embarked on an initiative to de-risk renewable energy investment. The innovative framework developed by UNDP was aimed at assisting policy makers to come up with ways to reduce these costs or efficiency in public finance to promote accessibility to sustainable energy. Policy de-risking and financial de-risking instruments were developed to address this issue.

According to REN21 (2018) there has been a drive to increase the use of renewable energy for heating and cooling, transport and power generation. Developed economies such as Europe, North America, and some countries in Asia such as China and Singapore have developed comprehensive policies to de-risk renewable energy by reducing the use of bio mass for heating and coal for power generation. In transport Europe and North America continue to dominate in bio-methane production for vehicle fuel. For power generation Europe dominate in the implementing wind and solar systems.

In the agricultural space de-risking mainly revolves around providing loan guarantees to source funding and implementation of insurance schemes especially in crop disaster management. Farmers partner together to produce food and flowers using efficient sustainable methods (Holland Trade and Invest, 2018). Rabo bank in cooperation with the United Nations environment agency came up with an initiative to promote sustainable agriculture in developing nations through grants, structured development loans and de-risking instruments in the form of guarantees (Cobley, 2017).

According to Bouldoukian (2012) in the financial segment de-risking is experienced in financial services such as correspondent banking in the banking sector. A correspondent bank is an Institution that provides financial services on behalf of another Financial

Institution (Respondent Bank). Correspondent banking relationships (CBRs) are established between banks to facilitate cross-border payments and international trade, which results in the growth of global economies.

Starnes, Kurdyia, Prakash, Volk, and Wang (2017) in their report define de-risking as the phenomenon of restricting, withdrawing or terminating certain banking services from a client due to risk regulatory requirements or demands. The main driver to this phenomenon is to combat anti money laundering and terrorist financing activities as guided by the Financial Action Task Force (FATF). However this can create an opportunity for the use of un-regulated channels to transfer funds which reduces transparency and thereby increase the risk of money laundering and terrorist financing activities.

Arnold and Fleming (2014) in their report on global regulation stated that one of Europe's largest banks by assets, HSBC paid $1.9billion to regulatory authorities in the United States for dealing with drug-trafficking proceeds in Mexico and funds from Iran .This experience led to HSBC exiting from markets that it considered risky across the markets it had operations in. JP Morgan Chase at one point was fined about $20 billion in penalties that also triggered the withdrawal of correspondent relationships that they considered high risk especially in developing countries.JP Morgan's costs for enhancing their compliance systems and operations also went up. Westpac in Australia also withdrew its banking relationships in Somalia due to the same pressures of regulatory requirements. Some remittance companies in Minnesota have also experienced closures by some US local banks caused by their nature of business that is extremely prone to anti-money laundering risks.

Hassan and Liberatore (2016) in their article raised great concerns around the subject of financial inclusion and the risk of cutting off certain countries that are perceived as high risk from economic activities. The wholesale de-banking approach which has been brought about by the increase of regulatory requirements and compliance costs has also resulted in closures of several Money Service Bureaus (MSBs) in the UK such as Dahabshiil. In 2013 Barclays Bank UK shut down more than two hundred MSBs as a result of perceived risks and due-diligence costs that far outweighed profitability from this sector of business.

According to Bouldoukian (2012) increased stringent anti money laundering and terrorist financing compliance requirements and Basel III revised capital buffers for banks have forced several international banks to cut back on global expansion especially to emerging markets. The Basel Committee on Banking Supervision defined tougher capital and liquidity standards for strengthening capital requirements for banks. This was to aid in absorbing defaults in the banking industry. This specifically comprised of raising the capital ratio for Tier 1 capital to six percent of risk weighted assets. Global banks such as HSBC,BNP Paribas, Society Generale and Commonwealth Bank of Australia among others have either entirely exited their businesses or scaled down due to regulatory costs which have diluted profits in these banks leaving them with no other choice but to exit the markets they perceive as high risk (O'Neill, 2017).

According to U.S Department of the Treasury (2018) global regulatory bodies such as the Financial Action Task Force (FATF) and the Office of Foreign Assets Control (OFAC) are mostly behind the execution of this phenomenon. OFAC enforces economic and trade sanctions based on US foreign policy and national security against targeted foreign countries, narcotics traffickers or other threats of national security. Most sanctions are based on United Nations and other international mandates. FATF is a policy making inter-governmental body that set standards to promote effective implementation of regulatory measures for combating money laundering, terrorist financing or any other threats to the global financial system. FATF comprises of members from over thirty countries worldwide (Financial Action Task Force, 2018a).FATF in providing these guidelines or recommendations ensures transparency by enabling Financial Institutions globally to effectively combat with illicit financial activity (Financial Action Task Force, 2018b).

According to Artingstill, Dove, Howell, and Levi (2016) many global international banks have suffered hefty fines based on not observing certain sanctions or disregarding some of the money laundering and terrorist financing requirements.BNP Paribas was fined Ten Million Euros by the French regulator for not fully effecting anti-money laundering policies. The trend of such punitive fines coupled with other compliance costs and capital requirements causes many global banks to reduce activity abroad. Correspondent banks are becoming increasingly risk averse and the manner in which they run their relationships with other banks has drastically changed. This has seen a significant level of focus turned toward Risk and Compliance segments of Financial Institutions. To mitigate

the associated risks correspondent banks are recommended to conduct periodic due diligence, enhanced due diligence and continuous monitoring of the client. This type of due diligence is guided by Wolfsberg principles or standards which provide clarity into what kind of information should be provided by the Respondent bank (Wolfsberg Group, 2018). Sometimes costs associated with enhanced due diligence far exceeds the costs of maintaining such accounts. In some cases global banks mitigate this challenge by charging higher fees. Impact on compliance and reputational risk must be considered when dealing with high risk segments (Scott, 2015).

Starnes *et al.* (2017) in a recent survey conducted by International Finance Corporation (IFC), a member of World Bank Group, showed that more than a quarter of global banks that participated indicated a reduction of correspondent banks, experienced increased compliance related costs and demand for correspondent banking services. It was also concluded that some of the significant implications of de-risking were its threat on financial inclusion and economic stability.

In the recent past, de-risking has become a looming crisis in the financial segment of developing and emerging markets nations. The underlying concern this presents is that these countries could ultimately lose access to the global financial system. Eventually initiatives toward poverty alleviation and economic development will be undermined (Haley, 2017). Transactional activity in financial institutions has been greatly affected and sometimes even paralyzed in many countries in some European developing nations such as Latvia which has been suffered de-risking over high risk clients such as shell companies and foreign politicians (Couvee, 2018). Countries in Asia Pacific such as Cambodia and Myanmar have experienced de-risking in Trade Finance activities which has forced many of their banks to turn to innovative ways of facilitating their transactions. In overcoming the challenges presented by de-risking the Dominican Republic has incorporated a closed user group using SWIFT and central bank as the hub to transfer real time local payments. In Mexico, Banco de Mexico has also created a domestic electronic system to transfer USD payments (SWIFT, 2016)

Non-profit organizations in developing countries continue to face extensive challenges related to cross border payments as a result of de-risking and reduced access to the financial system in these nations. Payments can take up to several months to be executed forcing some firms to carry cash instead. On the other hand war torn countries such as

Libya; Yemen and Syria continue to experience reduced humanitarian assistance due to reduced correspondent banking relationships. Inaccessibility to income generating activities has subjected some of these countries to abject poverty (Justine, 2017).

In South Africa, Standard Bank of South Africa has also suffered the effects of de-risking in some of subsidiaries such as Angola where they replaced the USD clearing services with an innovative solution that reduced the high risk regulatory concerns. This initiative was as a result of a major European bank pulling out of some African nations where they have representation (FinTech Futures, 2017). Ecobank in West Africa has resorted to implementing technologically advanced products to mitigate the effects of de-risking. Through a mobile app, their clients can transfer funds from one African state to another. Their presence in 33 nations in Africa also gives them an advantage over their competitors (Holmey, 2018). On the other hand, banks in Nigeria have experienced limited de-risking compared to other African states. Local Nigerian banks have also been forced to cut off relationships with other African banks that they perceive as risky. Efforts by bodies such as the Committee of Chief Compliance Officers of banks have boosted collaboration between banks and regulators ultimately reducing the effects of de-risking (Smit, 2016). Banks in Eastern and Central Africa could face increased due diligence from financial institutions by engaging in activities that promote anti-money laundering activities. Kenya and Uganda could be at risk by merely engaging with South Sudan in what may be perceived as high risk activities (Brooks-Rubin, 2017).

In Kenya Banks in Tier 2 and3 have lost most of their correspondent banking relationships especially during the period when some banks went into receivership between 2015 and 2016 that dived the financial banking industry into a crisis. In a specific case, one of the mid- tier banks lost its relationship with an international bank in South Africa owing to money laundering accusations (Kamau, 2017).

### 1.2 Statement of the Problem

Previous studies conducted on the subject of de-risking have mainly focused on Financial Institutions on a global scale. IFC conducted research in 2017 based on information gathered from operations in 2016. This research focus was on Emerging markets in Europe, Latin America, Asia, Sub-Saharan Africa, among others. Their research was to determine the impact of de-risking by Correspondent Banks in the banking industries of these regions (Starnes et al., 2017).

The International Monetary Fund (IMF) conducted a similar study that included advanced economies, low income countries, fragile states, emerging markets as well as small states. The timeframe of their research covered the financial years between 2012 and 2015 in the banking industry. Their research was based on specific trends in CBRs, drivers affecting withdrawal of CBRs, the impact of these withdrawals and their role in addressing this phenomenon (IMF, 2017). As described in the above cases no research exists to the best of my knowledge in addressing the specific effects of de-risking affecting the banking industry in Kenya, hence the gap of limited literature on this subject.

According to Cheramboss (2017) the Proceeds of Crime and Anti-Money Laundering (Amendment) Act (POCAMLA) was enacted. Apart from dealing with money laundering violations in Financial Institutions (which the initial act in 2009 covered) this amendment was to deal with issues around corruption, tax evasion and sanction violations by non-financial businesses. It also empowered the Financial Reporting Centre (FRC) with the mandate to revoke licenses of Banks that were charged with money laundering and terrorist financing offences. Even with the legal frameworks in place, there exists a gap in studying the implementation of compliance policies and procedures as well as institutionalization of Know Your Customer (KYC) practices in conducting thorough due diligence for high risk individuals or entities in the local financial sector. This research will also seek to address these gaps.

Additionally a report by ASBA (2016) indicated that the Society for Worldwide Interbank Financial Telecommunications (SWIFT) in their paper addressing de-risking in Africa suggested that best practices such us policies around transparency and information sharing with the correspondent banks could mitigate the risk of being de-risked. Joining the SWIFT KYC Registry could also reduce the cost of due-diligence for the clearer and would be a step in the right direction to avoid de-risking. Implementation of compliance monitoring systems helped to filter doubtful transactions beforehand. Global banks in developed nations and emerging markets have developed comprehensive policies in overcoming some of the challenges presented by de-risking such as those mentioned in this paper. However there is little knowledge around affecting the same in banks in Kenya (Smit, 2016).

## 1.3 Purpose of the Study

The purpose of this study is to investigate the effects of de-risking in the financial activities of Commercial Banks in Kenya.

## 1.4 Research Questions

The study was guided by the following research questions:

1.4.1 What are the factors leading to de-risking in the banking sector in Kenya?

1.4.2 What are the effects of de-risking in the banking sector in Kenya?

1.4.3 What strategies and policies are directed towards managing de-risking in the banking sector in Kenya?

## 1.5 Significance of the Study

The intention of this research is to create awareness on the effects of de-risking in the banking sector in Kenya and to emphasize on the need for Banks to implement effective strategies to reduce the ramifications of de-risking and subsequently work toward lowering their risk profiles to prevent the same.

The findings of this research will be of importance to the following stakeholders:

### 1.5.1 Regulatory Bodies

Regulatory bodies in the banking sector such as Central Bank of Kenya and Kenya Bankers Association will benefit from the findings of this research as it will provide information on the impact de-risking has on the banking industry and form a basis for formulating solutions to cushion Banks from the same.

### 1.5.2 Correspondent Banks

The findings of this research will benefit Correspondent Banks that provide services to the banking industry in Kenya on gathering information of the degree to which de-risking has affected the banking industry and consequently come up with initiatives to assist banks manage the same.

### 1.5.3 Management of Commercial Banks

The top level management teams within the Banks in Kenya will benefit from this research by providing a basis on which they can formulate effective strategies to manage the risks leading to de-risking and solutions to prevent the same.

### 1.5.4 Researchers

Future researchers will benefit from this research by providing additional information on the effects of de-risking in the banking sector in Kenya as well as greater insights in providing recommendations for lasting solutions.

## 1.6 Scope of the Study

This research was conducted in Nairobi, Kenya and focused on a population of a total of twenty-one commercial banks governed by Central Bank of Kenya. The respondents of the research comprised of senior management banking officials in each of the commercial banks participating in the research. The research also targeted a minimum of at least two respondents in each of the commercial banks resulting in fifty-three respondents in total. This research was conducted in 2018.

## 1.7 Definition of Terms

### 1.7.1 Correspondent Bank

A correspondent bank provides a current or other liability account and other related services to another financial institution to facilitate third party payments and international trade transactions (Bank for International Settlements, 2016).

### 1.7.2 Respondent Bank

This refers to the bank that is recipient to the financial services offered by a correspondent bank which is often located in another jurisdiction from that of the correspondent bank (Bouldoukian, 2012).

### 1.7.3 De-risking

The act of Banks removing bank accounts or services from their clients (other banks) or relationships that are perceived to be associated with higher money laundering or terrorist financing risks (Artingstill et al., 2016).

### 1.7.4 Customer Due Diligence

This is the process by which a Correspondent Bank obtains periodic information on its Clients or Relationships to ascertain that they are comfortable with a particular client given their risk profile (Bouldoukian, 2012).

### 1.7.5 Enhanced Due Diligence

This is subjected to those Institutions that present greater risks especially in the products and services they provide or the environments in which they conduct their business (Bouldoukian, 2012).

### 1.7.6 Nesting or Downstream clearing

The act of nesting or downstream clearing is the process by which a Correspondent Banking Client (Respondent) provides correspondent banking services to other financial institutions in the same currency as the account it maintains with its Correspondent Bank (Bouldoukian, 2012).

## 1.8 Chapter Summary

Chapter one has presented the main outline of the research study based on the effects of de-risking on financial services in the banking sector in Kenya. It defines the concept of de-risking from other segments apart from financial. The impact of de-risking in banking is also discussed in a global context providing various examples. The statement of the problem speaks to past research on the same subject by various Institutions in other markets which indicates a research gap on the topic in the Kenyan banking sector exclusively. It also identified policy gaps and gaps in procedures where legal frameworks exist. The purpose of the research is to provide awareness on the effects of de-risking and the benefits it shall provide to banking industry in Kenya. Each of the research questions: What are the factors leading to de-risking in the banking sector in Kenya? What are the effects of de-risking in the banking sector in Kenya? What strategies and policies are directed towards managing de-risking in the banking sector in Kenya? Form the foundation of the study and act as a guideline in sourcing information from the different commercial banks. This chapter also elaborates on the significance of the study and provides detail to the scope of the study by giving specific information on the population.

Chapter two presents literature on past research and findings relating to the problem that this study brings out and will be centered on the three main research questions to provide better insight and clarity to the problem. Chapter three focuses on the methods and procedures that were used to facilitate the study as well as the research design and data analytical methods. It also describes the population and sampling design that was applied in conducting the study. Chapter four provides a comprehensive presentation of the results and findings of this study. Chapter five presents detailed discussion, conclusions and recommendations for the study in line with findings provided in chapter four.

# CHAPTER TWO

## 2.0 LITERATURE REVIEW

### 2.1 Introduction

This chapter presents the literature review based on the effects of de-risking on financial services in relation to the following research questions: What are the factors leading to de-risking in the banking sector in Kenya? What are the effects of de-risking in the banking sector in Kenya? What strategies and policies are directed towards managing de-risking in the banking sector in Kenya?

### 2.2 Factors Leading to De-risking in the Banking Sector

According to OCC (2018) and FATF (2018a) Regulators of Correspondent banks such the Office of the Comptroller of the Currency (OCC) and the Financial Conduct Authority (FCA) in the UK regulate and supervise banks in their specific jurisdictions to promote sound financial environments. Correspondent Banks are expected to comply with the statutes and regulations provided by their Regulators especially in deterring AML and CFT activities. The Financial Action Task Force (FATF) has provided extensive recommendations focusing on preventive measures of certain customer groups and the risk-based approach for implementation by correspondent banks. Some of the OCC supervised banks include Citibank N.A, Deutsche Bank Trust Company, JP Morgan Chase, HSBC Bank and Wells Fargo Bank. All of these banks provide USD clearing services for Foreign Financial Institutions (FFIs) in the developing and emerging markets economies globally. Drivers of de-risking affect countries of all sizes the difference is seen on the magnitude of the effects in each bank (Starnes et al., 2017).

#### 2.2.1 Regulatory Factors

OCC(2016a) explains that Institutions in the U.S that maintain correspondent accounts for FFIs are expected to formulate effective due diligence policies and procedures that are used to manage the risks inherent with these relationships. These Institutions are expected to continuously and consistently monitor and report suspicious activities that are identified in transactions. In doing so, strict adherence to AML and CFT requirements as guided by the Bank Secrecy Act (BSA) and the Office of Foreign Assets Control (OFAC) is expected. The Federal Banking Agencies (FBAs) are tasked with the mandate of ensuring that depository Institutions comply with the requirements raised by the BSA and

OFAC. Overall these agencies are responsible for implementing strong regulatory frameworks that promote a resilient and transparent financial system.

Kaufman and Scott (2003) in their research paper on systemic risk within banking industry indicated that tthe Federal Deposit Insurance Corporation (FDIC) required banks to implement a risk-based assessment for deposit insurance for mitigation purposes. Similarly, financial institutions that support correspondent banking activities can result in asset or liability concentrations that have to be appropriately managed according to the regulations in place (FDIC, 2014).

According to Mckendry (2015a) the FDIC place emphasis on Institutions taking a risk-based approach when assessing their Financial Institutions relationships rather than declining to provide financial services on a holistic basis. FDIC advises that they should be a compelling legitimate reason to terminate the Financial Institution's business relationship. The FCA suggest that they may pursue Institutions that cut off businesses if it causes consumer protection issues and advocate that they should be relatively few instances where a bank should de-risk a relationship on just the basis of anti-money laundering requirements. Strict global regulations have caused banks to end in some instances long- standing business relationships that have existed for many years. A research conducted by Duke University in North Carolina on the impact of AML/CFT regulations pointed out that it was clear that de-risking which has impacted society in terms of interuppting flow of remittances from especially migrants to their families in developing nations was a regulatory problem.It further recommended that reduction of the regulatory burden subjected to those financial institutions providing correspondent banking services would promote financial inclusion (McGough, 2016).

Starnes et al. (2017) in a recent survey conducted by the International Finance Corporation(IFC) noted that following the 2007-2008 global financial crisis and 2010-2011 Eurozone crisis, various regulatory requirements by governments and international bodies were implemented to promote transparency and stability of economies. Banks were required to revamp their capital and liquidity requirements which has resulted in most correspondent banks reducing or cutting off their confirming limits for Trade Finance and other financial services. Most respondent banks also expected little or no growth in correspondent bank relationships in the future. Most affected currencies were USD, GBP and EUR. The Dodd-Frank Act requires that U.S Financial Institutions to hold

additional capital to absorb loan losses in future downturns and boost liquidity by holding a larger proportion of their assets in cash and securities. Erturk (2016) in his report further stated that these post-crisis regulatory initiatives failed to address the risks associated with maximising shareholder value for the banks.

Additionally according to the Basel Committee on Banking Supervision, the Basel III framework requires that Banks maintain additional capital of higher quality (shares and retained earnings) to build up capital buffers. Minimum Tier 1 capital was increased to six percent. Global systematically important banks are subject to additional capital requirements. Banks were also required to increase their liquidity ratios and leverage ratios (Basel Commitee on Banking Supervision, 2018). The pressure brought about by these additional requirements have caused most global banks especially the larger ones to reduce their correspondent banking activities where the cost of maintaining the relationship was much higher than the income derived from volume of business generated (Financial Action Task Force,2018b).

### 2.2.2 Risk and Compliance Related Factors

OCC (2016b) provides guidance with regards to evaluating the risks associated with the management of correspondent accounts for foreign financial institutions. It discusses pertinent issues around recommending corporate governance best practices for banks at the point of conducting periodic reevaluations on the relationships that they hold accounts for. These provide guidance in making informed decisions when retaining or terminating relationships. Banks are also expected to have comprehensive policies and procedures for implementation of thorough risk assessments for their respective correspondent accounts. OCC does not give directives as to which relationships should be terminated or retained. A decision to de-risk a particular business line or to exit a relationship is left to correspondent bank to make on its own. Banks also decide which relationships to initiate based on the products and services offered type of customers, corporate governance practices, business potential and financial stability.

According to Haley (2017) risk management in banks involves market, credit and operational risks. However market and credit risks are allocated the highest capital allocation. Another study conducted by the World Bank on Caribbean banks identified risk related drivers such as insufficient information on due-diligence reports, AML/CFT deficiencies in the operations of the banks, high-risk customer base and lack of

compliance with sanctions regulations. In cases where certain risks are identified that cannot be adequately mitigated, a bank is left with no option but to terminate that relationship. For the FFI this can lead to reputational risk and financial loss. Surprisingly even with banks losing their CBRs they were still able to establish other relationships with banks in Europe and Asia (Boyce & Kendall, 2016). The OCC recommends that when a correspondent bank is terminating a business relationship it should communicate the same to the senior management of the FFI extending sufficient time to establish alternative banking relationships (Office of the Comptroller of the Currency, 2016b).

Additionally Starnes et al. (2017) in their findings from a survey conducted by IFC on some of the challenges of de-risking discussed that the Financial Action Task Force (FATF) proposes global standards for AML and CFT that is guided by a risk-based approach. This approach gives Financial Institutions the flexibility to determine appropriate effective measures to address the risks in question. FATF also requires that banks assess threat risks for countries, clients and products among others. They also identified a limiting constraint focusing on the lack of standardized and conflicting regulatory requirements from various regulatory bodies that caused a lot of confusion and the inability for banks to comply effectively. In cases where relationships had to be terminated respondent banks did not receive explanations for the same although in some cases compliance constraints was quoted. Risk-based approaches can also be misleading and inaccurate in decision making as was seen in the case of Belize banks whose relationships were terminated despite scoring highly in risk evaluations (Philippa, 2019).

### 2.2.3 Business-Related Factors

Correspondent banks can de-risk business relationships based on the type of customers or business segments they bank (Starnes et al., 2017). Money Service Businesses (MSBs) tend to pose higher risks in comparison with other conventional businesses. However not all MSBs are high risk and OCC expects the banks it regulates to treat each MSB on a case to case basis and thereby implement controls to manage each relationship according to the degree of risk it poses (Office of the Comptroller of the Currency, 2014).

According to Bank for International Settlements (2016b) some regional banks in various jurisdictions provide downstream clearing to third party financial institutions. These arrangements between banks mostly in the same jurisdiction can expose the correspondent bank to AML and CFT risks as it obscures financial transparency.

Correspondent banks assess the associated risks presented by the nested relationships on a case to case basis. Factors that determine whether or not the Correspondent bank will allow the Respondent bank to engage in nesting vary. Determinants such as the type of customers, size and geographical location of the FFI are evaluated when assessing the risks. The level at which the respondent bank is able to effectively monitor transactions also assists in decision making. Nesting requires high levels of approvals from the upstream or primary correspondent bank (Boyce & Kendall, 2016). Research has shown that the main drivers that lead to de-risking are the inability of correspondent banks to make profits due to low volumes of transactions and reduced risk appetite (The World Bank Group, 2018).

Starnes *et al.* (2017) in their research focusing on emerging markets such as Sub-Saharan Africa (SSA) and Middle East and North Africa (MENA) state that correspondent banks have to invest heavily on robust transaction monitoring systems that investigate suspicious activity on real time basis. Sometimes these initial costs cannot be recovered from the Respondent bank due to low volumes of business activity. Based on cost-benefit analyses most banks are forced to opt out when the business is not profitable and they are unable to recover their costs. In some instances low issuing bank and country credit ratings and insufficient information on ownership structures for the respondent banks were seen as some of the factors leading to de-risking. Lack of standardized regulatory requirements at a global and local level was also mentioned.

FIs also consider certain business segments riskier forcing them to de-risk relationships in such cases. These include Forex Bureaus, Money Trading Operators and Non Profit Organizations just to mention a few (The World Bank Group, 2018).

### 2.3 Effects of De-risking in the Banking Sector

Correspondent Banking Relationships (CBRs) support economic activity in enabling cross border payments and international trade (Bank for International Settlements, 2016a).

Miller (2017) on a separate article discussing the importance of correspondent banking noted that the Federal Reserve Board in the U.S had imposed hefty fines on some CBRs for failing to comply with the Bank Secrecy Act (BSA) and AML regulations. BNP Paribas for instance was fined close to nine billion dollars in 2014 for violating U.S economic sanctions with Iran, Sudan and Cuba. According to the International Chamber

of Commerce (ICC), compliance costs for maintaining a correspondent relationship ranges anywhere between $20,000 to $ 90,000. With such penalties and costs more and more CBRs are becoming increasingly risk averse. This has resulted in de-risking posing a threat to financial inclusion and adverse effects to developing economies. There is also the risk to exposure to financial crime by encouraging the use of informal and unregulated financial networks to transfer funds. According to the Financial Stability Board (FSB) the number of correspondents dropped by 6% between 2011 and 2016. Tougher AML rules on disclosure of beneficial ownership of banks has also been a direct effect of de-risking. Smaller banks are more affected by de-risking in serving their clients and larger banks expect compliance costs to continue increasing (Starnes et al., 2017).

### 2.3.1 Financial Inclusion

According to United Nations (2018) financial inclusion enables individuals and businesses to access financial products and services that meet their day to day needs in a sustainable manner. Transactional accounts allow individuals and businesses to receive and send money and without them financial inclusion would be greatly hindered. Transactional accounts also serve a minimum requirement to facilitate other financial activities. This is why ensuring that people have access to transactional accounts forms part of the World Bank Group's Universal Financial Access 2020 initiative. Financial inclusion is critical in effecting some of the key global sustainable development goals such as sustainable cities and communities, no poverty and economic growth. Imposing fines on some large banks has also had a chilling effect on financial inclusion (Mckendry, 2015b).

Additionally according to Global Partnership for Financial Inclusion (GPFI) Central Bank Governors committed to advance financial inclusion worldwide especially among vulnerable groups and Small to Medium Enterprises (SMEs). G-20 and non G-20 countries are encouraged to implement principles for digital financial inclusion as well as improve the environment for facilitating remittances effectively (GPFI, 2018). Similarly, the World Bank Group considers financial inclusion as an important component of reducing extreme poverty levels and boosting prosperity. Some countries have put in place policies and regulations to facilitate innovation in financial services. Digital financial technology (Fintech) has enabled financial activity to populations in remote places and small businesses at reduced costs through mobile banking. However these

innovations have to be regulated by relevant authorities and regulators to ensure transparency (World Bank Group, 2018).

Queralt and Fu (2017) state that financial inclusion improves the living conditions for poor communities by helping them develop the habit of building savings and increasing their assets. This leads to access of credit facilitates and growth of SMEs especially in developing economies. Female vendors in Kenya were able to increase investments in their businesses by 38 to 56 percent by having access to credit and savings .Some public sector banks in India do not charge poor clients for transfers to promote facilitation of remittance flows. The introduction of the microfinance industry and innovations in the digital space has improved the financial infrastructure of developing nations.

### 2.3.2 Cross Border Payments

According to Bank for International Settlements (2016a) the Committee on Payment and Market Infrastructures (CPMI) promotes financial stability by identifying risks for the safety and efficiency of payment, clearing and settlement systems. These recommendations are also shared with non-CPMI central banks present in other jurisdictions. Some of the BIS member central banks are the European Central Bank, Bank of England, South African Reserve Bank and the Federal Reserve Board of Governors in the United States.

The Society for Worldwide Interbank Financial Telecommunication (SWIFT) is a global member-owned cooperative that provides secure financial messaging services. According to SWIFT (2018) the cooperative enables its global community of users to communicate securely through the exchange of standardized financial messages which facilitate global and local financial flows including trade and commerce.

According to a report by Central Bank of Kenya (2017a) cross border payments and remittances are a major source of foreign exchange in developing countries. Remittance flows to these nations amounted to a total of $429 Billion in 2016.For many households especially in SSA these flows can be the only source of income. Innovations in the digital space have boosted the flow of remittances through mobile banking platforms such as MPESA in Kenya. The remittance industry faces some significant challenges especially around international regulatory requirements and high costs of remitting funds through the international banking ecosystem. Great emphasis has to be placed in implementing

effective policies and procedures to ensure compliance with global regulatory requirements to mitigate the impediment of remittance flows through de-risking. Cyber security can also pose a threat to effecting regulatory measures. This has caused many banks to invest heavily on compliance systems which have led to price hikes and in some cases loss of market share (Starnes et al., 2017).

Starnes et al. (2017) observed that a significant number of households rely on cross-border payments for their sustenance. According to the International Labor Organization (ILO) migrants depend on the money transfer operators to wire remittances which account for more than 90 percent of all international payments in most emerging markets. The value of remittances in developing countries is usually significantly higher than foreign aid to those nations and contributes an average of 10 percent in GDP. It was also observed that most banks in the emerging markets experienced an increase of demand in international business but did not have the requisite capacity to meet it. Some respondent banks have been forced to sever relationships with certain NPOs and MTOs whose business is centered on cross-border payments. Banks have also been affected by increased costs for upgrading compliance systems. A recent study done on Belize banks showed that the exit of one major correspondent bank affected the facilitation of cross-border payments for a month which formed the bulk of international operations (Philippa, 2019).

### 2.3.3 Trade Finance and Foreign Exchange Services

Sanusi (2011) noted that the global financial meltdown in 2008 which began in a developed nation affected the economies of the developing and under-developed countries. During that time Nigeria experienced a significant drop in trade finance transactions and for some banks credit lines were adversely affected. According to Dorsay, Saito, and Asmundson (2011) Trade Finance involves the use of trade instruments such as letters of credit where the payment risk is borne by the Financial Institution that issues the instrument on behalf of the importer. They further explained that the global financial crisis affected bank intermediated trade instruments by mainly increased product pricing for the counterparties. During this period the share of open account trade shifted to bank intermediated instruments to address the risks that were associated with the level of uncertainty. The larger banks could not all satisfy the trade finance demands of their customers due to the need for deleveraging. CBs increased

pricing margins mainly because of perceived default risk and higher capital requirements as guided by Basel II demands.

Ahn (2011) illustrates that during the financial crisis banks in the emerging markets reported a decline of an average of 6 percent in international trade finance transactions. It also became evident that international trade finance is more sensitive to economic downturns much more significantly than domestic trade finance. The volume of international trade transactions is also seen to decrease more in terms of volumes compared to domestic trade during any crisis. If there is an increase in a bank's default risk the pricing for the letter of credit would always increase.

Starnes et al. (2017) explain that forty-five percent of all global payments are settled in USD accounting for trillions of dollars on a daily basis arising from transactions based on international trade and foreign assets. In 2015 the U.S clearing system handled over $178 trillion in wire transfers and automated payments accounting to more the twice the value of global GDP. Increased AML/KYC and capital requirements, costs in software and system upgrades, hiked fees, reduced limits and low credit ratings for respondent banks and their respective countries were some factors that affected Trade Finance in terms of volumes and transaction size. To adapt banks have been forced to reduce limits for their clients and reduce their customer base.

### 2.4 Strategies and Policies directed towards Managing De-risking

According to IMF (2018) workshops are held to address the impact of Correspondent Banking Relationship (CBR) withdrawals and possible future feasible solutions. They have held several workshops in Central Asia, the Caribbean, the Pacific, Arab region and SSA. Across all the regions the urgent need for coordinated strategies to address this problem has been identified. Building trust and enhancing effective communication between the Correspondent and Respondent banks has been stressed upon in the effort of proposing solutions around the problem of de-risking. The pressures caused by the phenomenon of de-risking have continued to negatively impact both financial institutions and non-bank financial institutions such as Money Transfer Operators (MTOs) in SSA .The impact is higher in the smaller economies in this region which has imposed an eminent risk to economic growth by hindering trade and remittance operations.

### 2.4.1 Risk and Compliance Policies

Williams (2017) discussed that banks in the Caribbean have had most of their CBRs severed due to the high cost of managing risk and compliance.Compared to returns the cost of compliance is usually much higher leaving the correspondent bank with no choice but to let go of the relationships.The Caribbean has in the past been associated with money laundering activities which has complicated the situation.To mitigate this risk some banks have partnered with bodies such as FATF to reinforce compliance requirements. Blockchain technology was suggested to reduce the cost of compliance by enhancing surveillance of transactions.

IMF (2018) suggested that in improving communication channels with Correspondent banks (CBs); Respondent banks should strive to drive transparency by sharing their risk and compliance policies. This will build a culture of mutual trust with the correspondent banks. CBs are required to conduct periodic due diligence reevaluations on their business relationships as guided by the Risk-Based Approach requirements .These evaluations provide the Correspondent banks with the current position of the Respondent's bank risk policies and nature of business. Emphasis should thereby also be placed on providing timely responses to information requested by the CBs during the Risk and Compliance periodic reevaluations. To enhance the AML/CFT policy frameworks and capacity building of Respondent Banks continuous training must be conducted on a regular basis. These trainings should be affected by relevant subject matter stakeholders to keep the respondent banks aligned to the evolving international banking practices and environment. Harmonizing regulatory requirements from various regulators and regulatory bodies across the board would be instrumental in reducing de-risking as compliance would be simplified (Starnes et al., 2017).

Arnold (2016) pointed out that de-risking has been created largely by financial sanctions and compliance costs causing more banks to de-risk relationships. Banks in Russia have developed alternatives to the global financial system to avoid financial exclusion. China has made significant developments in making the renminbi a legitimate currency for international trade.The report continues to suggest increased collaboration by financial institutions to reduce risk aversion and the involvement of governments in providing guidance for financial monitoring.

### 2.4.2 Business and Technology Related Strategies

According to IMF (2017) some banks in developing economies have sought alternatives in managing the effects of de-risking by engaging established intermediary banks with robust risk and compliance frameworks to provide them with clearing services for their payments. This kind of arrangement is known as downstream clearing. This is a feasible strategy that can be adopted by affected banks to reduce the impact of de-risking especially where banks face customer attrition for not providing certain services. Most CBRs do not allow nesting arrangements between banks due to heightened risk implications. However there those banks that are satisfied with the compliance controls that certain Respondent banks have in place to allow them to provide downstream clearing to other banks. Technological solutions in KYC utilities such as the SWIFT registry can also be considered. The enactment of regional clearing and payment systems can help reduce the impact of de-risking in certain markets.

According to Central Bank of Kenya (2017b) the East Africa Community (EAC) and the Common Market for Eastern and Southern Africa (COMESA) have established regional clearing systems that enable member countries to effect payment transfers with each other. The East African Payment System (EAPS) allows member countries such as Kenya, Uganda, Tanzania and Uganda to remit funds in local currencies. The Regional Payment and Settlement System (REPSS) allow members of the COMESA region such as Mauritius, Malawi, Rwanda, Swaziland, Zambia and Kenya to effect payments in USD and Euro. These existing regional payment systems can also be enhanced to accommodate other countries within the related regions. Other countries within other affected markets can also borrow the initiative of adopting similar regional clearing services such as Ethiopia where the lack of a national payment system creates a barrier for economic growth (Mohapatra & Ratha, 2011).

In some countries supervisory authorities such as Central Banks have started to monitor the trends around de-risking and some MTOs have started adopting AML/CFT regulatory requirements such as those in Financial Institutions to reduce their high risk ratings. MTOs that adopt this strategy are seen to be accommodated better by Correspondent banks (The World Bank Group, 2018). The Central Bank of Belize in Central America got into partnership with credit card companies and put in place new arrangements to reduce the impact of the disruptions caused by extensive withdrawals of CBRs. The

Central bank has also being wiring payments through its own CBRs (Boyce & Kendall, 2016).

According to Woodsome and Ramachandran (2018) new technologies have also emerged to address the de-risking problem. These innovative technologies based on Fintech can improve information sharing capabilities, boost transparency and automation in the compliance activities of financial institutions. They also contribute in detecting criminal activity in transactions. Apart from financial institutions these technologies can assist regulators and other policy makers to come up with possible solutions to deal with the effects of de-risking. Big data allows extensive types of data to be stored centrally enabling compliance functions to collate information from extensive sources. They also increase the scope of information available for KYC and transaction screening.

According to the World Bank Group (2018) India has adopted electronic KYC (e-KYC) initiatives such as the Aadhar 12 digit identification number that captures biometric information of individuals up to and including demographic data. Such mechanisms seem to be attractive to correspondent banks because they demonstrate enhanced capabilities in regulatory frameworks. Machine learning is another form of e-KYC mechanism that leverages on automated detections pointing to suspicious activity reports. This mechanism is able to detect fraud that would otherwise not be picked by manual interventions. KYC utilities facilitate KYC information sharing for an array of Institutions. These utilities are usually provided by third parties such as SWIFT or statutory bodies. Mexico for instance have adopted a KYC utility that stores integral counterparty information of all outgoing cross border and local payments originating from all their financial institutions in foreign currencies.

Wass (2018) discusses other forms of regulatory technologies that can be exploited in reducing the impact of de-risking in the form of reducing compliance costs and elevating confidence levels of respondent banks in the eyes of the correspondent banks .These include Legal Entity Identifiers (LEI), Distributed Ledger Technology (DLT) and block chain. Additionally banks that adopt these technologies extensively improve the security of their KYC systems and processes as well as derive considerable savings on the same. However banks in emerging and developing economies still utilize very basic sanctions screening systems or none at all.

### 2.4.3 Industry Related Policies

According to World Bank Group (2018) banks all across developing economies and emerging markets have suffered the effects of de-risking for providing banking services to customers from certain industries that are perceived to be of a higher risk profile. Many of the affected banks have even gone to the extent of terminating banking services to certain customer segments to save their CBRs. Some of these sectors include Non Profit Organizations (NPOs) and Charities, Money Service Bureaus (MSBs), Forex Bureaus, Jewelers, General Trading Companies, Gambling Entities, Travel and Tour companies and entities dealing in arms and ammunition.

Eckert, Kay, and Andrea (2017) and Wang (2011) stated that NPOs in the U.S found were adversely affected by the de-risking problem due to either delayed payments on aid funds, extensive documentation requirements and high fees by banks or even sometimes account closures. These constraints adversely affect their humanitarian activities especially in developing economies. FIs consider these categories of customers to be susceptible to anti-money laundering and terrorist financing activities. A similar study focusing on other developed economies such as Sweden, UK and Germany MTOs pointed to similar challenges around regulatory requirements. These businesses drew a lot of attention following the 9/11 attacks in 2011 and the 2008 financial crisis. Two key approaches of registering and licensing the MTOs were implemented in these countries to comply with AML/CFT requirements. Registration was seen to be the most effective over licensing which was considered to be cost intensive and stricter in nature. Other policies to enhance transparency and knowledge acquisition were also implemented within the MTOs to safeguard their operations and reputation.

In Kenya, Foreign Exchange Bureaus and Money Remittance Providers (equivalent of MTOs) are regulated and licensed by the Central Bank of Kenya to ensure compliance of banking regulations in the sector. In comparison to other markets in Africa, Ethiopia, Ghana and Nigeria use both registration and licensing approaches to regulate MTOs. Outward remittances through MTOs are prohibited in Nigeria and Ghana. However regulatory frameworks for inward flows are considered weak in Nigeria (Mohapatra & Ratha, 2011; Central Bank Of Kenya, 2017b).

## 2.5 Chapter Summary

Chapter two has focused on the literature review relating to various studies, policy and research papers that have presented views and findings as relates to the effects of de-risking in Financial Institutions. Regulatory requirements and risk and compliance standards are seen as the main and significant drivers of de-risking in emerging markets. The impact of de-risking on cross-border payments carries the most weight in terms of disrupting economic activity and possible solutions are sought by focusing on collaborations with correspondent banks and fetch developments.

Chapter three presents the research methodology of the study which expounds on the research design, population and sampling design, data collection and analysis methods.

# CHAPTER THREE

## 3.0 RESEARCH METHODOLOGY

### 3.1 Introduction

This chapter presents the research methodology and design of the study. It covers the research design, population and sampling design including sampling technique, data collection methods, research procedures and data analysis methods.

### 3.2 Research Design

Rugg and Petre (2007) define research design as discovering things out in a systematic manner as opposed to treasure hunting. The findings from a well- planned out research design will always contribute to knowledge in whatever measure whether big or small. According to Saunders, Lewis and Thornhill (2016) research design is the ultimate plan derived to answer your research questions including the method of collecting and analyzing the related data. Research design simply put can be the blueprint for collection, measurement and analysis of data or summarized as the framework for defining the various relationships constituted in the variables of the study and the construct of the research problem (Cooper & Schindler, 2014). A good research design should be flexible and efficient. It should also reduce bias and optimize on accurate and detailed data collection (Sreejesh, Mohapatra, & Anusree, 2014).

This study has adopted both descriptive and inferential research designs where the research seeks out to find out the specifics on who, what, where, when or how then the study is descriptive (Cooper & Schindler, 2014). An explanatory research design tends to answer the why and how questions as well as attempt to explain the causes of the phenomenon or determining causal relationships between variables (Cooper & Schindler, 2014; Saunders et al., 2016). This study sought to find out the effects of de-risking on financial services in the commercial banking sector in Kenya including the factors leading to de-risking and the strategies adopted to manage the same. Descriptive research design also involves describing a phenomena or characteristics associated with a certain population as well as estimating the proportions of the characteristics (Cooper & Schindler, 2014). Since this study seeks out to describe a phenomenon and its related effects and whether there are any patterns or associations (correlations) between the

different variables of the study then adoption of descriptive and inferential research methods are justified.

This study adopted a quantitative research methodology. Cooper and Schindler (2014) illustrate the main focus of quantitative research to be within the description, explanation and prediction of data variables. The researchers' involvement is limited to prevent bias and factual information is clearly defined in quantitative approaches. It also seeks to measure knowledge and opinions. Quantitative research is utilized in various fields ranging from business to social studies (Adams & Raeside, 2014). A survey was conducted to collect data in this study in the form of a questionnaire. It involved a cross-sectional time series because the data was collected at one point in time. The data collected was statistically analyzed to achieve accuracy of the same.

## 3.3 Population and Sampling Design

### 3.3.1 Population

A population is the total collection of elements from which data is collected from. An element is defined as the unit of study (Cooper & Schindler, 2014).A population can also be defined as every person or entity that can be included in a research study (Quinlan, 2011).The population of this study comprised of the senior management of the departments relevant to this study located at the Head Office of the current operating Commercial Banks in Kenya. These banks are 40 in total (see Appendix I) and are located in Nairobi County. The targeted population comprised of the Head of Risk and Compliance and the Head of Treasury or Head of Financial Institutions in these banks giving a total of at least 80 respondents from all the current commercial banks.

### 3.3.2 Sampling Design

#### 3.3.2.1 Sampling Frame

A sampling frame is a list or chart of every member of the population from which the sample is drawn from. Each entity or item in a sample is randomly selected from the population for inclusion in the specific study or research (Quinlan, 2011).A sampling frame can also be a directory or index of listings from which a sample is selected (Mugenda & Mugenda, 1999). It is crucial that one ensures that the sample frame is from

a valid, updated and accurate source. Generalizing outside of the sample frame is not encouraged (Saunders et al., 2016).

The sample frame of the study as shown in appendix I lists the commercial banks currently operating in Kenya (Central Bank of Kenya, 2017c).

#### 3.3.2.2 Sampling Technique

According to Quinlan (2011) a sampling method or technique can be defined as the means by which a sample is selected from the population of the study and the extent to which it is representative of population. The inclusion and exclusion criteria are also considered in sampling techniques. The inclusion criteria stipulate the criteria prospective respondents must meet to be a part of the research and the exclusion criteria is the criteria which are employed to exclude candidates from the study. There are two types of sampling techniques: probability and non-probability.

This study employed the use of convenience and quota sampling techniques which are both non-probability methods. In convenience sampling selection of the candidates is based on accessibility and availability (Mugenda & Mugenda, 1999). Quota sampling further divides the sample into different quota criteria that adequately defines and represents the population (Quinlan, 2011).

Convenience sampling best suited this study because the topic of de-risking in the banking sector is extremely technical and participants have to be selected based on their knowledge and experience of the subject to ensure accuracy and precision of data collected. Secondly not all banks are affected by de-risking and hence a technique like random selection may not be appropriate. The sample banks are divided into three main quotas based on their size in the market. Selection will be made from the large, middle and small bank quotas or tiers (see Appendix I) based on convenience sampling.

#### 3.3.2.3 Sample Size

A sample or sample size can be defined as a portion or target of participants selected from a larger population to facilitate a survey or a granular part of a population used to makes estimates of the larger population (Singh, 2007).

The sample size of this study was calculated using the Yamane formula (Yamane, 1967).This is illustrated below:

$$n = \frac{N}{1+N(e)2}$$

where

n= sample size

N= size of target population

e = acceptable sampling error

Using a confidence level of 93% and significance level of 0.07 and population of 80 participants, the sample size will be calculated as follows:

n = 80/1+0.392

= 57 participants

The distribution of the sample size is given below:

**Table 3.1: Sample size**

| **Bank Tier** | **No. of Banks** | **Percentage %** | **Sample Banks** | **Participants per Bank** | **Sample size** |
|---|---|---|---|---|---|
| Large | 8 | 88 | 7 | 2 | 14 |
| Middle | 11 | 64 | 6 | 3 | 18 |
| Small | 21 | 33 | 8 | 3 | 24 |
| **Total** | **40** | | | | **56** |

Source: Central Bank of Kenya

### 3.4 Data Collection Methods

This study conducted a survey by using a questionnaire to collect primary data from its respondents. A survey is a process used to obtained information is a structured manner (Cooper & Schindler, 2014). A questionnaire is a data collection instrument that is constructed around the research objectives or questions of the study (Punch, 2003). The structured questions should be easily understood for reliability and relevant to the study for validity purposes (Bourke, Ann, & Doran, 2016). The main data collected in this study

was quantitative which is usually characterized by precision. Questionnaires as described by Quinlan (2011) ensure that respondents provide clear and concise answers which therefore made it the most appropriate tool to implement in this study together with the descriptive nature of the information required.

The structured questionnaire was divided into four main sections: the first one covered questions pertaining to general information, the second section entailed questions pertaining to the first research question which focuses on the factors leading to de-risking in the banking sector in Kenya, the third section addressed the effects of de-risking in the banking sector in Kenya and the final section covered the strategies and policies directed towards managing de-risking in the banking sector in Kenya.

The questionnaire adopted six-point likert rating scales in framing closed questions which measure not only the direction of attitudes but their forces too (Quinlan, 2011). Some open-ended questions were utilized to gain depth from different opinions.

### 3.5 Research Procedures

A pilot study was conducted to ensure validity and reliability of the data collecting instrument. The pilot study aims to test and enhance the rigor of the tool used to facilitate the survey research (Quinlan, 2011). The questionnaire was sent to four respondents for testing and critiquing. The findings uncovered by the pilot study included duplication of questions within the different objectives and suggestions of pertinent questions that were missing to achieve the objective of the study. The feedback obtained from the respondents was used to improve on the structure of the questionnaire for effectiveness and practicability by deleting duplicated questions and shortening some of the lengthy questions.

After the piloting stage, actual data was collected from the respondents by providing an e-copy of the questionnaire. The respondents given a period of not more than seven working days to complete and submit the same. Once the data was collected the researcher ensured that the instruments were numbered and copies for all the questionnaires obtained in case of loss or damage to the original documents. Due to the sensitive and confidential nature of the data, safe and secure storage of the same was administered to prevent access by unauthorized persons. Confidentiality of the respondents was achieved by concealing their identities from the public. To maintain integrity the researcher ensured that the data collected was handled in an ethical manner

and not for selfish gain. The data was then coded to facilitate analysis and eventual drawing of conclusions from the resultant findings.

### 3.6 Data Analysis Methods

Data analysis involves processing and analyzing data by describing, presenting and exploring trends within the data (Saunders et al., 2016). The data collected was summarized by coding the responses and assigning numeric labels to the same. The data was then inputted into the statistical analysis tool, Statistical Package for Social Sciences (SPSS) for analysis. Descriptive statistics presented data in form of frequency tables and charts while inferential statistics was used to determine whether there existed any associations between variables of the study. To infer these relationships, correlation analysis was utilized. This aided in enhancing the interpretation of the findings of the study.

The drawing of conclusions and recommendations of the study was facilitated by the interpretation of the data aided by SPSS.

### 3.7 Chapter Summary

This chapter has highlighted the research methodology adopted in the research study. The study assumed a descriptive research design. The sample of the study comprised of senior management participants in Risk and Compliance, Treasury and Financial Institutions selected from a total of 40 commercial banks in Nairobi. The techniques for sampling the sample involved both convenience and quota sampling. A sample size of 53 respondents was selected from 21 of the 40 commercial banks represented in Kenya. The data was collected by the facilitation of a survey questionnaire that was distributed to all the respondents and eventually summarized by using both descriptive and inferential statistics.

Chapter four presents the results and findings of this study.

# CHAPTER FOUR

## 4.0 RESULTS AND FINDINGS

### 4.1 Introduction

Chapter four is a presentation of the findings of the study as relates to the data collected and analyzed respectively. The findings were based on the following: General Information, Factors leading to de-risking in the banking sector, Effects of de-risking in the banking sector and strategies and policies towards managing de-risking in the banking sector. The findings were on the basis of 53 questionnaires out of a targeted sample size of 56 representing a response rate of 95% completed by employees of 21 banks in the banking sector. For purposes of interpretation findings are presented in form of tables, graphs and pie-charts

### 4.2 General Information

#### 4.2.1 Level of Management

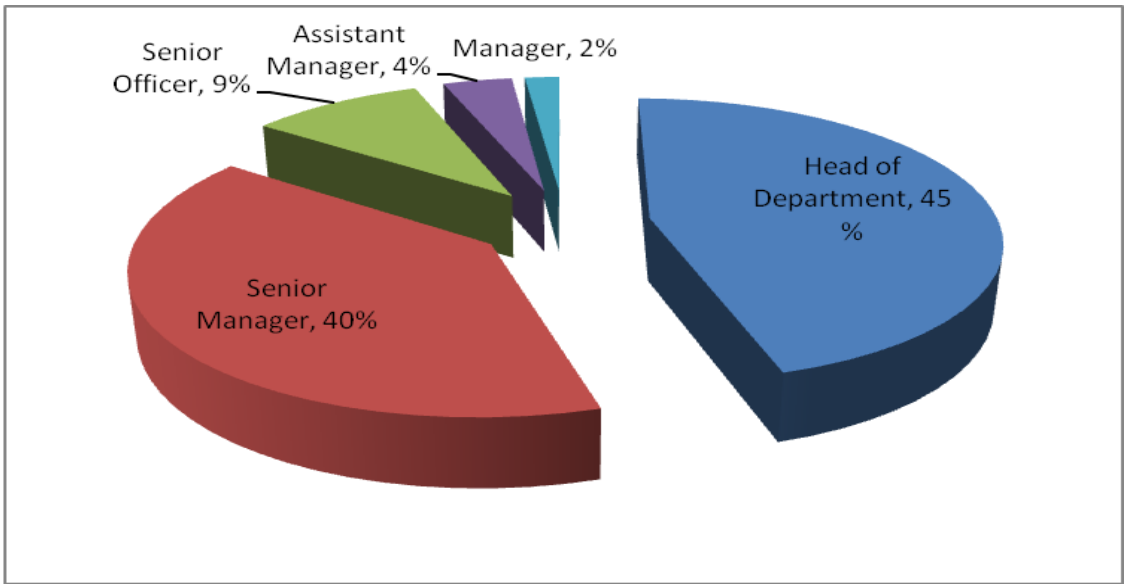


**Figure 4.1: Level of Management**

Forty-five percent of the respondents were heads of departments; forty percent were senior managers while nine percent were senior officers. The study results also show that four percent of the respondents were assistant managers and two percent of the respondents were managers. This shows that majority of respondents were in senior management.

### 4.2.2 Gender

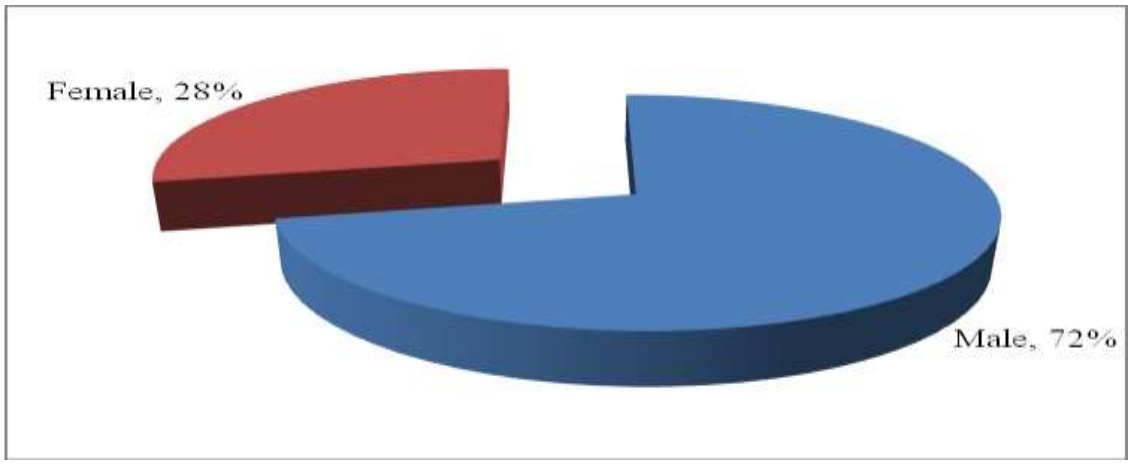


**Figure 4.2: Gender**

Seventy-two percent of the respondents in this study were male while twenty-eight percent were female. This data shows that the male gender had a higher proportion amongst the respondents in the various banks sampled.

### 4.2.3 Work Experience

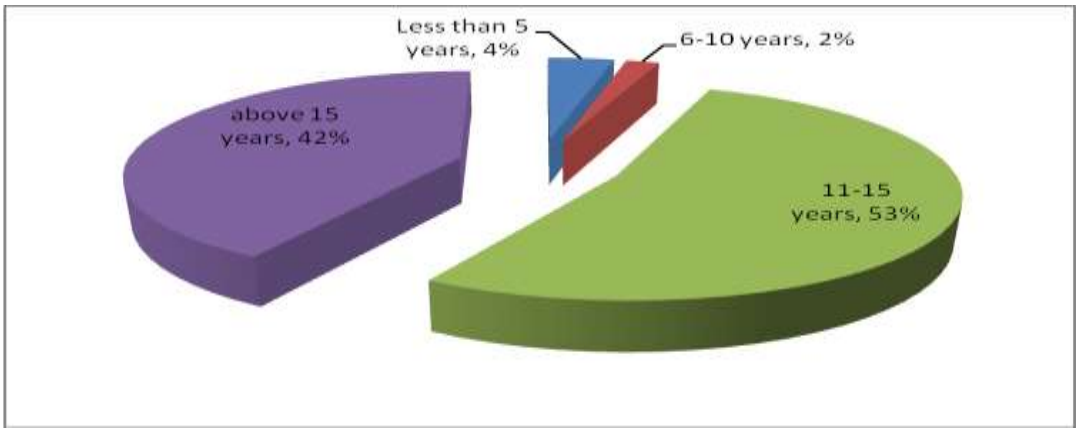


**Figure 4.3: Work Experience**

Fifty-three percent of respondents had between eleven and fifteen years of work experience, Forty-two percent had over fifteen years of work experience, two percent had a work experience of six to ten years and four percent of respondents had work experience of less than five years.

### 4.2.4 Highest Level of Education

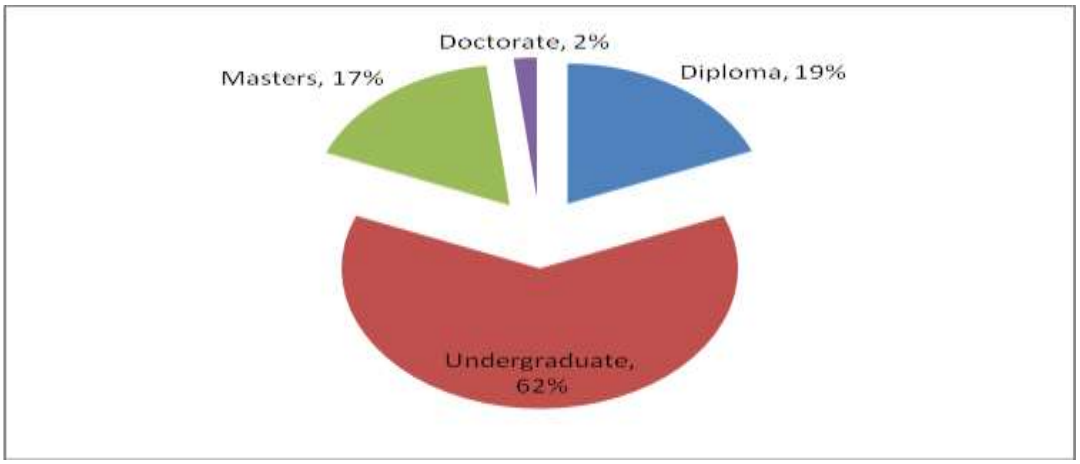


**Figure 4.4: Highest Level of Education**

Sixty-two percent of the respondents had an undergraduate degree, nineteen percent had a diploma, seventeen percent had a Masters degree, and two percent had a doctorate. This shows that majority of the respondents had attained an undergraduate degree as the highest level of education.

### 4.2.5 Function Unit

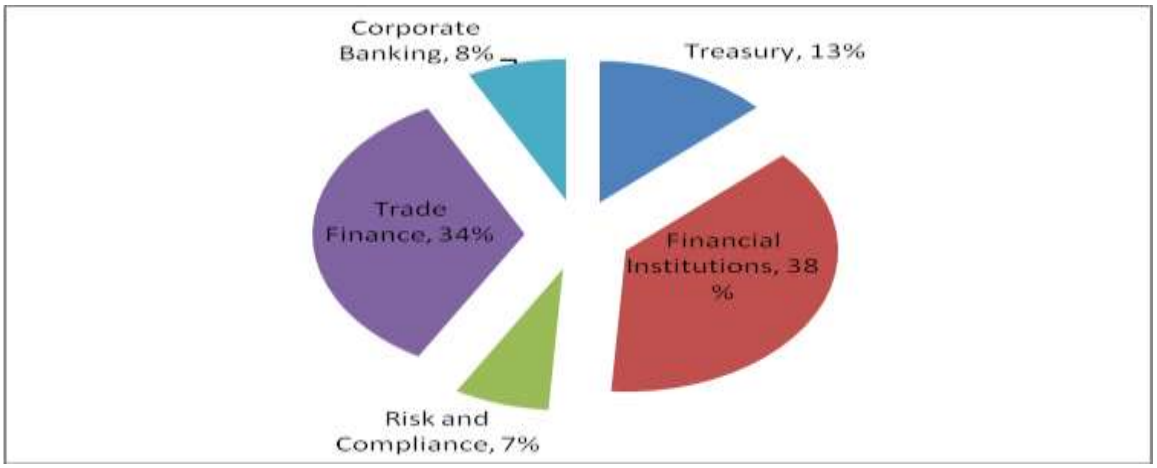


**Figure 4.5: Function Unit**

Thirty-eight percent of respondents were working in the Financial Institutions unit, thirty-four percent in the Trade Finance unit while thirteen percent were represented from Treasury and fifteen percent from other departmental units of the sample banks.

### 4.2.6 Industry Market Share

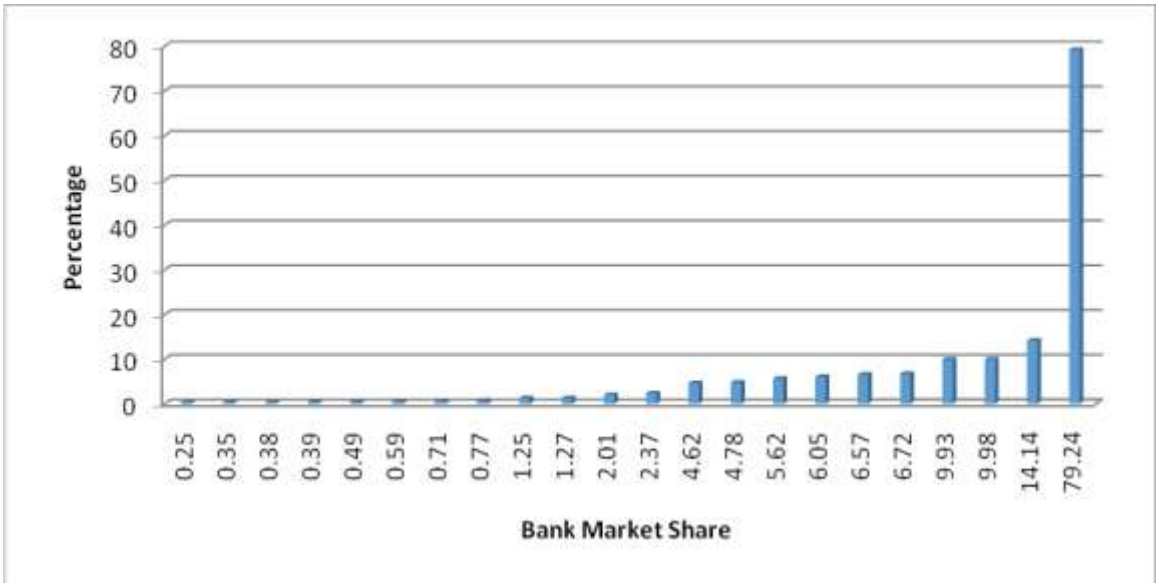


**Figure 4.6: Market Share**

Eight banks of the sample banks had a market share of less than one percent representing banks in Tier 3,six banks had a market share of between one and five percent representing banks in Tier 2 and seven banks had a market share of greater than five percent representing banks in Tier 1.

### 4.2.7 Bank Ownership

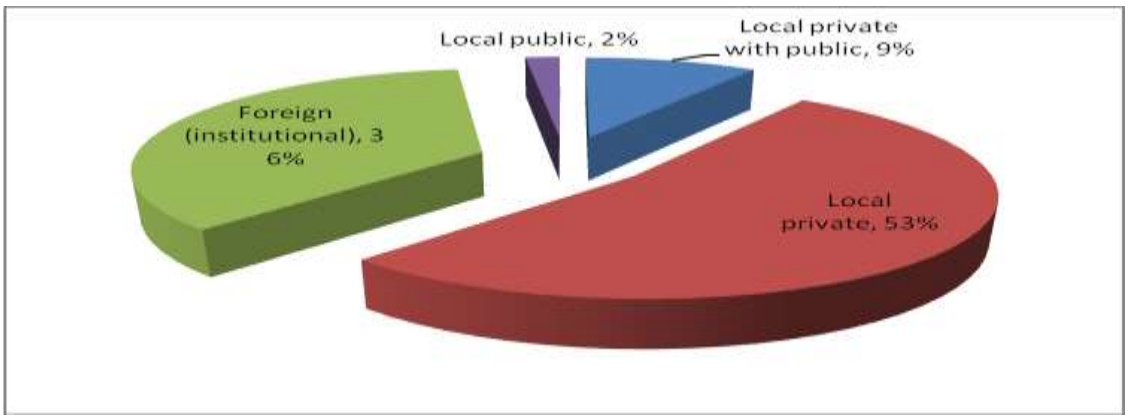


**Figure 4.7: Bank Ownership**

Fifty-three percent of the banks are privately locally owned, thirty-six percent are foreign owned and eleven percent are locally owned with public ownership .It was observed that majority of the sample banks were locally-privately owned.

### 4.3 Factors leading to De-risking in the Banking Sector

Research question one sought to evaluate the factors or reasons leading to de-risking of financial services in the banking sector in Kenya. The factors were subdivided into three segments: Regulatory factors, Risk and Compliance factors and Business related factors. Each segment was presented with various statements which respondents ranked using the likert scale.

#### 4.3.1 Regulatory related factors

**Table 4.1: AML /CFT Requirements**

| | Frequency | Percentage |
|---|---|---|
| Strongly Disagree | 1 | 2 |
| Disagree | 1 | 2 |
| Neutral | 4 | 7 |
| Agree | 10 | 19 |
| Strongly Agree | 37 | 70 |
| Total | 53 | 100 |

Eighty-nine percent of the respondents agreed AML and CFT requirements are the main reasons that lead to de-risking of financial services in the banking sector while four percent disagreed.

**Table 4.2: Regulatory Frameworks**

| | Frequency | Percentage |
|---|---|---|
| Disagree | 4 | 8 |
| Neutral | 4 | 8 |
| Agree | 15 | 28 |
| Strongly Agree | 30 | 56 |
| Total | 53 | 100 |

Eighty-four percent of the respondents agreed that regulatory bodies such as FATF are responsible for implementing regulatory frameworks that lead to de-risking while eight percent disagreed and eight percent remained neutral.

**Table 4.3: Global Financial Crisis / Eurozone Crisis**

| | Frequency | Percentage |
|---|---|---|
| Disagree | 3 | 6 |
| Neutral | 3 | 6 |
| Agree | 14 | 26 |
| Strongly Agree | 33 | 62 |
| Total | 53 | 100 |

Twenty-six percent and sixty-two percent of respondents agreed and strongly agreed that correspondent banking experienced many challenges following the global financial crisis and 2010-2011 Eurozone crises that led to the implementation of extensive regulatory frameworks.

**Table 4.4: Annual KYC reviews on Nostro Accounts**

| | Frequency | Percentage |
|---|---|---|
| Disagree | 2 | 4 |
| Neutral | 1 | 2 |
| Agree | 7 | 13 |
| Strongly Agree | 39 | 74 |
| N/A | 4 | 7 |
| Total | 53 | 100 |

Eighty-seven percent of the respondents agreed that their correspondent banks conducted annual KYC reviews on the various nostro accounts held with them.

### 4.3.2 Risk and Compliance factors

**Table 4.5: Insufficient Information on Due Diligence Reports**

| | Frequency | Percentage |
|---|---|---|
| Strongly Disagree | 1 | 2 |
| Neutral | 1 | 2 |
| Agree | 12 | 23 |
| Strongly Agree | 39 | 74 |
| Total | 53 | 100 |

Ninety-seven percent of respondents agreed that AML/CFT deficiencies in bank operations, compliance with sanctions and insufficient reporting during due-diligence reviews can lead to de-risking while three percent disagreed.

**Table 4.6: Lack of standardized Global Regulatory Requirements**

| | Frequency | Percentage |
|---|---|---|
| Strongly Disagree | 2 | 4 |
| Disagree | 3 | 6 |
| Neutral | 5 | 9 |
| Agree | 17 | 32 |
| Strongly Agree | 25 | 47 |
| N/A | 1 | 2 |
| Total | 53 | 100 |

Seventy-nine percent of respondents agreed that lack of standardized requirements within the regulatory bodies can lead to de-risking while twenty-one percent disagreed.

**Table 4.7: Hefty AML penalties/Compliance Costs**

| | Frequency | Percentage |
|---|---|---|
| Agree | 8 | 15 |
| Strongly Agree | 44 | 83 |
| N/A | 1 | 2 |
| Total | 53 | 100 |

Ninety-eight percent of respondents agreed that hefty AML penalties and compliance costs have caused correspondent banks to become risk averse and hence conservative in growing their business relationships while two percent disagreed.

### 4.3.3 Business related factors

**Table 4.8: Loss of Correspondent Accounts**

| | Frequency | Percentage |
|---|---|---|
| Strongly Disagree | 7 | 13 |
| Disagree | 10 | 19 |
| Neutral | 6 | 11 |
| Agree | 15 | 28 |
| Strongly Agree | 12 | 23 |
| N/A | 3 | 6 |
| Total | 53 | 100 |

Fifty-one percent of respondents agreed that they suffered loss of correspondent banking accounts due to low transaction volumes while thirty-two percent disagreed.

**Table 4.9: Growth in Correspondent Banking Relationships**

| | Frequency | Percentage |
|---|---|---|
| Strongly Disagree | 10 | 19 |
| Disagree | 15 | 28 |
| Neutral | 8 | 15 |
| Agree | 9 | 17 |
| Strongly Agree | 10 | 19 |
| N/A | 1 | 2 |
| Total | 53 | 100 |

Forty-seven percent of respondents disagreed that they expected little or no growth in their correspondent banking relationships going forward while thirty-six percent agreed that they expected minimal growth if at all.

**Table 4.10: Low Bank /Country Credit Ratings**

| | Frequency | Percentage |
|---|---|---|
| Disagree | 1 | 2 |
| Neutral | 5 | 9 |
| Agree | 17 | 32 |
| Strongly Agree | 30 | 57 |
| Total | 53 | 100 |

Eighty-nine percent of respondents agreed that low bank and country risk ratings can lead to de-risking of CBRs.

**Table 4.11: Downstream Clearing**

| | Frequency | Percentage |
|---|---|---|
| Strongly Disagree | 1 | 2 |
| Disagree | 1 | 2 |
| Neutral | 3 | 6 |
| Agree | 10 | 19 |
| Strongly Agree | 38 | 72 |
| Total | 53 | 100 |

Ninety-one percent of respondents agreed that downstream clearing can expose the correspondent bank to AML and CFT risks by obscuring transparency while nine percent disagreed.

### 4.3.4 Correlations between Bank Market Share and Ownership, and Factors Leading to De-Risking

Pearson correlation was used to determine whether there exists a relationship between bank market share and ownership, and factors leading to de-risking in the banking sector in Kenya. From the findings it is revealed that regulatory factors correlate with bank market share at $r$ (53) = 0.100, $p>0.05$, and ownership at $r$ (53) = -0.014, $p$>0.05. The results also shows that risk and compliance factors correlate with bank market share at $r$ (53) = -0.053, $p>0.05$, and ownership at $r$ (53) = -0.086, $p$>0.05. In addition, the results indicate that business factors correlate with bank market share at $r$ (53) = 0.104, $p>0.05$, and ownership at $r$ (53) = 0.076, $p$>0.05. The study findings reveal that there is no significant relationship between factors leading to de-risking and bank market share and ownership.

**Table 4.12: Correlations Factors Leading To De-Risking**

| | | Bank Market share | Bank Ownership |
|---|---|---|---|
| Regulatory Factors | Pearson Correlation | .100 | -.014 |
| | Sig. (2-tailed) | .476 | .919 |
| | N | 53 | 53 |
| Risk and Compliance Factors | Pearson Correlation | -.053 | -.086 |
| | Sig. (2-tailed) | .707 | .540 |
| | N | 53 | 53 |
| Business Factors | Pearson Correlation | .104 | .076 |
| | Sig. (2-tailed) | .459 | .590 |
| | N | 53 | 53 |

## 4.4 Effects of De-risking in the Banking Sector

Research question two analyzed the effects of de-risking on the financial services offered by banks in Kenya based on Correspondent Banking Relationships, Financial Inclusion, Cross-border payments, Trade finance and Foreign exchange settlements. The extent to which these services were affected by de-risking was measured by the various questions which specifically targeted these areas and the effects thereof. Respondents used the likert scale to rank the effects of de-risking on each product or service.

### 4.4.1 Correspondent Banking Relationships

**Table 4.13: Correspondent Banking Accounts lost in 2015**

| | Frequency | Percentage |
|---|---|---|
| 1-2 accounts | 14 | 26 |
| 3-4 accounts | 6 | 11 |
| None | 33 | 62 |
| Total | 53 | 100 |

Sixty-two percent of respondent Institutions did not lose correspondent banking accounts in 2015 while twenty-six percent lost between one and two accounts and eleven percent lost between three and four accounts.

**Table 4.14: Correspondent Banking Accounts lost in 2016**

| | Frequency | Percentage |
|---|---|---|
| 1-2 accounts | 20 | 38 |
| 5 and above accounts | 1 | 2 |
| None | 32 | 60 |
| Total | 53 | 100 |

Sixty percent of respondent banks did not lose any correspondent banking accounts in 2016 while thirty-eight percent lost between one and two accounts and two percent lost more than five accounts.

**Table 4.15: Correspondent Banking Accounts lost in 2017**

| | Frequency | Percentage |
|---|---|---|
| 1-2 accounts | 14 | 26 |
| 3-4 accounts | 1 | 2 |
| None | 38 | 72 |
| Total | 53 | 100 |

Seventy-two percent of respondent banks did not lose any correspondent banking accounts in 2017 while twenty-six percent lost one to two accounts and two percent lost between three and four accounts

**Table 4.16: Increase of Correspondent Accounts/Relationships**

| | Frequency | Percentage |
|---|---|---|
| Yes | 24 | 45 |
| No | 8 | 15 |
| Remain the same | 21 | 40 |
| Total | 53 | 100 |

Forty-five percent of respondent institutions expected their correspondent accounts and relationships to increase between 2018 and 2019 while forty percent expected the accounts to remain the same and fifteen percent did not expect any additional growth. Most banks that expected growth during this period attributed the same to business growth, reputable corporate governance and business appetite from banks in the Middle East and Asia

**Table 4.17: Compliance Costs between 2015 and 2017**

| | Frequency | Percentage |
|---|---|---|
| Yes | 49 | 92 |
| No | 4 | 8 |
| Total | 53 | 100 |

Ninety-two percent of respondents agreed that their risk and compliance costs increased between 2015 and 2017 while eight percent disagreed.

**Table 4.18: Extent of Increase**

| | Frequency | Percentage |
|---|---|---|
| High extent | 13 | 27 |
| Moderate Extent | 31 | 63 |
| Low Extent | 5 | 10 |
| Total | 49 | 100 |

Sixty-three percent agreed that their compliance costs increased by a moderate extent while twenty-seven percent agreed that the costs increased by a high extent and ten percent by a low extent.

### 4.4.2 Financial Inclusion

**Table 4.19: De-risking poses Challenge to Financial Inclusion**

| | Frequency | Percentage |
|---|---|---|
| Strongly Disagree | 1 | 2 |
| Disagree | 3 | 6 |
| Neutral | 5 | 9 |
| Agree | 13 | 25 |
| Strongly Agree | 31 | 58 |
| Total | 53 | 100 |

Eighty-three percent of respondents agreed that de-risking of financial services in the banking sector poses a substantial challenge in promoting financial inclusion in enhancing economic growth in the country while seventeen percent disagreed.

**Table 4.20: Costs of Remitting Funds**

| | Frequency | Percentage |
|---|---|---|
| Strongly Disagree | 7 | 13 |
| Disagree | 11 | 21 |
| Neutral | 9 | 17 |
| Agree | 14 | 26 |
| Strongly Agree | 11 | 21 |
| N/A | 1 | 2 |
| Total | 53 | 100 |

Forty-seven percent of respondents agreed that they experienced higher costs of remitting funds due to increased regulatory requirements while thirty-four percent disagreed and nineteen percent remained neutral.

**Table 4.21: Innovations in the Digital Space**

| | Frequency | Percentage |
|---|---|---|
| Neutral | 1 | 2 |
| Agree | 8 | 15 |
| Strongly Agree | 44 | 83 |
| Total | 53 | 100 |

Ninety-eight percent of respondents agreed that innovative mobile platforms in the digital space such as MPESA have boosted financial inclusion at reduced costs while two percent remained neutral.

### 4.4.3 Cross-Border Payments

**Table 4.22: Affected Transactional Currencies**

| | Frequency | Percentage |
|---|---|---|
| Strongly Disagree | 1 | 2 |
| Disagree | 8 | 15 |
| Neutral | 5 | 9 |
| Agree | 7 | 13 |
| Strongly Agree | 31 | 59 |
| N/A | 1 | 2 |
| Total | 53 | 100 |

Seventy-two percent of respondents agreed that de-risking affects transactions in USD, GBP and EUR while seventeen percent disagreed and eleven percent remained neutral.

**Table 4.23: High Risk Customer Types and Businesses**

| | Frequency | Percentage |
|---|---|---|
| Disagree | 4 | 8 |
| Neutral | 12 | 22 |
| Agree | 15 | 28 |
| Strongly Agree | 21 | 40 |
| N/A | 1 | 2 |
| Total | 53 | 100 |

Sixty-eight percent of respondents agreed that changes in the correspondent banking environment has resulted in exiting high risk customer types and businesses while twenty-four percent remained neutral and eight percent disagreed.

**Table 4.24: Opportunity for Financial Crime**

| | Frequency | Percentage |
|---|---|---|
| Strongly Disagree | 3 | 6 |
| Disagree | 3 | 6 |
| Neutral | 9 | 17 |
| Agree | 18 | 34 |
| Strongly Agree | 20 | 37 |
| Total | 53 | 100 |

Seventy-one percent of respondents agreed that de-risking has created an opportunity for financial crime by encouraging the use of informal channels to transfer funds while twelve percent disagreed and seventeen percent were neutral.

### 4.4.4 Trade Finance and Foreign Exchange Services

**Table 4.25: Trade Finance Challenges**

| | Frequency | Percentage |
|---|---|---|
| Strongly Disagree | 8 | 15 |
| Disagree | 6 | 11 |
| Neutral | 8 | 15 |
| Agree | 17 | 32 |
| Strongly Agree | 13 | 25 |
| N/A | 1 | 2 |
| Total | 53 | 100 |

Fifty-seven percent of respondents agreed that they have experienced challenges in effecting Trade Finance transactions due to increased pricing and reduced credit limits while twenty-six percent disagreed and seventeen percent remained neutral.

**Table 4.26: Increased demand in International Business**

| | Frequency | Percentage |
|---|---|---|
| Strongly Disagree | 14 | 27 |
| Disagree | 15 | 28 |
| Neutral | 8 | 15 |
| Agree | 6 | 11 |
| Strongly Agree | 9 | 17 |
| N/A | 1 | 2 |
| Total | 53 | 100 |

Twenty-eight percent of respondents agreed that they experienced increased demand in international business with no capacity to meet the same while fifty-five percent disagreed and seventeen percent remained neutral.

**Table 4.27: Challenges in FCY transactions**

| | Frequency | Percentage |
|---|---|---|
| Strongly Disagree | 18 | 34 |
| Disagree | 16 | 30 |
| Neutral | 5 | 10 |
| Agree | 7 | 13 |
| Strongly Agree | 6 | 11 |
| N/A | 1 | 2 |
| Total | 53 | 100 |

Twenty-four percent of respondents agreed that they were experiencing challenges in settling foreign exchange transactions due to decreased counterparties while sixty-four percent disagreed and twelve percent were neutral.

### 4.4.5 Correlations between Bank Market Share and Ownership, and Effects of De-Risking

Pearson's correlation analysis was conducted to investigate the relationship between bank market share and ownership, and effects of de-risking. The results of the analysis show that financial inclusion significantly correlates with bank market share at $r$ (53) = -0.307, $p<0.05$, and ownership at $r$ (53) = 0.162, $p>0.05$. The study also shows that cross border payments significantly correlate with bank market share at $r$ (53) = -0.430, $p<0.01$, and ownership at $r$ (53) = 0.299, $p<0.05$. Further the results from the study show that trade finance and foreign exchange services significantly correlate with bank market share at $r(53)$ = -0.563, $p<0.01$, and ownership at $r(53)$ = 0.315, $p<0.05$. The findings reveal that there is a significant relationship between bank market share and the effects of de-risking in financial services. There is also a significant relationship between bank ownership and cross-border payments, trade finance and foreign exchange services but not with financial inclusion.

**Table 4.28: Correlations Effects of De-Risking**

| | | Bank Market Share | Bank Ownership |
|---|---|---|---|
| Financial Inclusion | Pearson Correlation | -.307* | .162 |
| | Sig. (2-tailed) | .025 | .245 |
| | N | 53 | 53 |
| Cross Border Payments | Pearson Correlation | -.430** | .299* |
| | Sig. (2-tailed) | .001 | .030 |
| | N | 53 | 53 |
| Trade Finance and Foreign Exchange Services | Pearson Correlation | -.563** | .315* |
| | Sig. (2-tailed) | .000 | .022 |
| | N | 53 | 53 |
| **. Correlation is significant at the 0.01 level (2-tailed). | | | |
| *. Correlation is significant at the 0.05 level (2-tailed). | | | |

## 4.5 Strategies and Policies towards managing De-risking in the Banking Sector

Research question three sought to identify various strategies that banks and other financial institutions could implement to reduce the impact of de-risking on various financial services that are offered in the banking sector. Suggested strategies and policies

were classified into Risk and Compliance, Business and Technology and Industry related. Respondents applied the likert scale to rank their responses.

### 4.5.1 Risk and Compliance Strategies

**Table 4.29: Periodic Due Diligence Re-evaluations**

| | Frequency | Percentage |
|---|---|---|
| Neutral | 2 | 4 |
| Agree | 8 | 15 |
| Strongly Agree | 43 | 81 |
| Total | 53 | 100 |

Ninety-six percent of respondents agreed that their institutions provided timely responses to correspondent banks during Risk and Compliance periodic reviews while four percent remained neutral.

**Table 4.30: Document Sharing with Correspondent Banks**

| | Frequency | Percentage |
|---|---|---|
| Disagree | 2 | 4 |
| Neutral | 2 | 4 |
| Agree | 11 | 21 |
| Strongly Agree | 38 | 71 |
| Total | 53 | 100 |

Ninety-two percent of respondents agreed that their Institutions demonstrated KYC thoroughness in sharing their risk and compliance documents with Correspondent Banks while eight percent disagreed.

**Table 4.31: Knowledge and Capacity Building**

| | Frequency | Percentage |
|---|---|---|
| Disagree | 2 | 4 |
| Neutral | 2 | 4 |
| Agree | 14 | 26 |
| Strongly Agree | 35 | 66 |
| Total | 53 | 100 |

Ninety-two percent of respondents agreed that they conducted Risk and Compliance training to enhance capacity building and awareness while eight percent disagreed.

### 4.5.2 Business and Technology Strategies

**Table 4.32: Effective Communication with Correspondent banks**

| | Frequency | Percentage |
|---|---|---|
| Neutral | 1 | 2 |
| Agree | 5 | 9 |
| Strongly Agree | 47 | 89 |
| Total | 53 | 100 |

Ninety-eight percent of respondents agreed that their Institutions demonstrated effective communication with their correspondent banks as a strategy of building trusted relationships while two percent remained neutral.

**Table 4.33: Fintech Technology**

| | Frequency | Percentage |
|---|---|---|
| Strongly Disagree | 14 | 26 |
| Disagree | 13 | 25 |
| Neutral | 7 | 13 |
| Agree | 6 | 11 |
| Strongly Agree | 4 | 8 |
| N/A | 9 | 17 |
| Total | 53 | 100 |

Nineteen percent of respondent banks agreed that they use block-chain technology to enhance surveillance of transactions while fifty-one percent disagreed and thirty percent remained neutral.

**Table 4.34: Downstream Clearing**

| | Frequency | Percentage |
|---|---|---|
| Strongly Disagree | 20 | 38 |
| Disagree | 6 | 11 |
| Neutral | 7 | 13 |
| Agree | 8 | 15 |
| Strongly Agree | 9 | 17 |
| N/A | 3 | 6 |
| Total | 53 | 100 |

Thirty-two percent of respondent bank agreed that their banks had partnered with other banks that were not direct clearers to facilitate cross border payments while forty-nine percent disagreed and nineteen percent remained neutral.

**Table 4.35: Adoption of KYC Utilities**

| | Frequency | Percentage |
|---|---|---|
| Strongly Disagree | 2 | 4 |
| Disagree | 4 | 7 |
| Neutral | 2 | 4 |
| Agree | 17 | 32 |
| Strongly Agree | 27 | 51 |
| N/A | 1 | 2 |
| Total | 53 | 100 |

Eighty-four percent of respondent banks agreed that they had adopted automated KYC utilities in their correspondent banking activities while eleven percent disagreed and six percent remained neutral.

### 4.5.3 Industry Related Strategies

**Table 4.36: Harmonizing Regulatory Requirements**

| | Frequency | Percentage |
|---|---|---|
| Neutral | 2 | 4 |
| Agree | 13 | 24 |
| Strongly Agree | 38 | 72 |
| Total | 53 | 100 |

Ninety-eight percent of respondents agreed that regulatory bodies harmonizing regulatory requirements would help ease the impact of de-risking on financial services in the banking sector while two percent disagreed.

**Table 4.37:Involvement of Central Bank of Kenya**

| | Frequency | Percentage |
|---|---|---|
| Strongly Disagree | 2 | 4 |
| Neutral | 6 | 11 |
| Agree | 19 | 36 |
| Strongly Agree | 26 | 49 |
| Total | 53 | 100 |

Eighty-five percent of respondents agreed that the involvement of Central Bank of Kenya in monitoring the effects of de-risking in the banking sector could assist in reducing its impact while four percent disagreed and eleven percent remained neutral.

**Table 4.38: Money Transfer Operators**

| | Frequency | Percentage |
|---|---|---|
| Neutral | 2 | 4 |
| Agree | 17 | 32 |
| Strongly Agree | 32 | 60 |
| N/A | 2 | 4 |
| Total | 53 | 100 |

Ninety-two percent of respondents agreed that adoption of AML/CFT regulatory requirements by MTOs would reduce their high risk ratings while eight percent remained neutral.

**Table 4.39: Termination of Banking Relationships**

| | Frequency | Percentage |
|---|---|---|
| Strongly Disagree | 4 | 8 |
| Disagree | 5 | 9 |
| Neutral | 9 | 17 |
| Agree | 15 | 28 |
| Strongly Agree | 20 | 38 |
| Total | 53 | 100 |

Sixty-six percent of respondents have reduced their banking services to NPOs, MSBs and Forex Bureaus to retain relationships with correspondent banks while seventeen percent disagreed and seventeen percent were neutral.

### 4.5.4 Correlations between Bank Market Share and Ownership, and Strategies and Policies for Managing De-Risking

The intention of the analysis was to assess the relationship between bank market share and ownership, and strategies and policies directed towards managing de-risking in the banking sector in Kenya. The findings show that risk and compliance policies correlate with bank market share at $r$ (53) = -0.067, $p>0.05$, and ownership at $r$ (53) = -0.079, $p>0.05$. The results also show that business and technology policies correlate with bank market share at $r$ (53) = -0.244, $p>0.05$, and ownership at $r$ (53) = 0.212, $p>0.05$. In

addition, the findings of the study indicate that industry related policies correlate with bank market share at $r$ (53) = -0.101, $p>0.05$, and ownership at $r$ (53) = 0.086, $p$>0.05. The study findings reveal that there is no significant relationship between strategies and policies for managing de-risking and bank market share and ownership.

**Table 4.40: Correlations Strategies Directed Towards Managing De-risking**

| | | Bank Market share | Bank Ownership |
|---|---|---|---|
| Risk and Compliance Policies | Pearson Correlation | -.067 | -.079 |
| | Sig. (2-tailed) | .635 | .574 |
| | N | 53 | 53 |
| Business and Technology Policies | Pearson Correlation | -.244 | .212 |
| | Sig. (2-tailed) | .078 | .128 |
| | N | 53 | 53 |
| Industry Related Policies | Pearson Correlation | -.101 | .086 |
| | Sig. (2-tailed) | .472 | .540 |
| | N | 53 | 53 |

## 4.6 Chapter Summary

This chapter presented the analysis of data on the research of the effects of de-risking on financial services in the banking sector in commercial banks in Kenya. The findings showed that to a large extent de-risking was caused by regulatory and risk and compliance factors. De-risking largely affected financial services on cross-border payments and Trade Finance transactions. The findings also showed that of the banks that lost correspondent accounts between 2015 and 2017 lost between one and two accounts. Risk and compliance costs increased across all banks as a major impact of de-risking. A large proportion of respondents also agreed that de-risking presented an opportunity of financial crime. Findings also showed that banks sought to comply with KYC requirements of correspondent banks as a strategy to reduce de-risking of services. On the other hand most banks had not embraced innovations in the technology space to reduce the impact of de-risking. Majority of banks also had also terminated relationships with high risk business segments as a strategy to maintain their correspondent banking relationships in reducing the impact of de-risking. A correlation analysis conducted showed that there is a significant relationship between the effects of de-risking in financial inclusion, cross-border payments and trade finance services, and bank market share. Findings also revealed that there is no significant relationship between factors leading to de-risking and strategies utilized to manage de-risking with bank market share

and ownership. Chapter five presents discussions, conclusions and recommendations for the study.

# CHAPTER FIVE

## 5.0 DISCUSSIONS, CONCLUSIONS AND RECOMMENDATIONS

### 5.1 Introduction

This chapter presents a comprehensive summary of the findings of this study as elaborated in chapter four. It discusses the key findings that were projected from the objectives of the study that focused on investigating the impact of de-risking on financial services in the banking sector in Kenya. Additionally this chapter provides recommendations for further research and studies.

### 5.2 Summary of the Study

The purpose of the study was to investigate the impact of de-risking on financial services in the banking sector in Kenya. The research questions utilized for the study were summarized as factors leading to de-risking in the banking sector, effects of de-risking in the banking sector and strategies and policies directed towards managing de-risking in the banking sector.

The research design for this study was a descriptive research design that sampled 21 of the existing 40 commercial banks during the year of the study. Convenience sampling was utilized to generate the sample size that was adequately distributed amongst the three banking tiers of large, medium and small banks in the banking sector in Kenya. Data for the study was collected by use of a questionnaire as a collection tool that the researcher distributed to 53 respondents from the 21 sampled banks. The respondents were conveniently selected to capture senior management from mostly the Treasury, Financial Institutions, Risk and Compliance functions of the selected banks. Upon collection of data descriptive statistics analyses was performed to generate patterns of the findings as presented by the frequency distribution tables. Inferential statistics were also undertaken by use of Pearson's correlation coefficient to investigate the relationship between factors leading to de-risking, effects of de-risking, strategies employed to manage de-risking and bank market share and ownership.

The study found that out of the factors leading to de-risking regulatory and risk and compliance factors carried the most weight amongst the respondents especially AML and KYC requirements as well as compliance costs and AML fines for the correspondent banks. Additionally downstream clearing and country credit ratings were seen to

contribute largely to de-risking of relationships and financial activities in the banking sector.

The study also found that there is a significant relationship between the effects of de-risking in financial inclusion, cross-border payments and trade finance services with banks' market share. Analysis conducted also revealed that there is a significant relationship between cross-border payments and trade finance and foreign exchange services, and bank ownership but not with financial inclusion. Additionally findings also revealed that there is no significant relationship between factors leading to de-risking and strategies utilized to manage de-risking with bank market share and ownership. Banks that were affected by de-risking lost between one and two accounts each year between 2015 and 2017.

Majority of respondents also agreed that in crafting strategies towards managing de-risking conducting continuous training on AML/KYC requirements and building trust through effective communication with correspondent banks are the most effective.

## 5.3 Discussions of Results

### 5.3.1 Factors leading to de-risking in the Banking Sector

The basis of the first research question was to determine or investigate the factors that have led or caused the phenomenon of de-risking in the banking industry in Kenya. The study established that regulatory requirements were the main reasons behind de-risking of financial services in the banking industry especially brought about by the implementation of regulatory frameworks by supervisory bodies such as FATF and OCC as indicated by OCC (2018) and FATF (2018a). Financial Institutions were under immense pressure to comply with statutes to deter AML and CFT risks causing them to become risk averse and hence de-risk relationships. The same was observed in a similar study by researchers in Duke University (McGough, 2016). The study revealed that the effects of the global financial crisis and the Eurozone Crisis also resulted in many financial institutions curtailing their financial activities with respondent banks. The same was also observed as a catalyst of de-risking according to Starnes et al. (2017) in a study conducted by IFC. Additionally the study also indicated that local banks are subjected to annual KYC reviews by their correspondent banks as a regulatory requirement as enforced by global regulators according to OCC (2016b).

As part of risk and compliance factors the study established that it was very likely that a respondent bank would be at the risk of losing its correspondent banking relationships if it provided insufficient information in the annual KYC/AML reviews. According to Boyce and Kendall (2016) this was also observed in a related study conducted by the World Bank on Caribbean Banks which identified risk related drivers such as insufficient information on reporting and lack of compliance with sanctions requirements as a factors leading to de-risking. The study also indicated that the risk of incurring hefty AML fines caused correspondent banks to become risk averse as also observed by Boyce and Kendall (2016) in their study. The study also showed that the lack of standardized regulatory requirements also could lead to de-risking. Starnes et al. (2017) in their study also concluded that indeed the lack of standardization led to a lot of confusion that caused banks not to comply effectively to the regulatory requirements.

The study also acknowledged that despite the challenges around de-risking approximately local banks remained optimistic in establishing new correspondent banking relationships especially from Middle East and Asia which resonated with findings from a research by Boyce and Kendall (2016) who established that despite most CBRs losing their accounts they were still able to initiate new relationships with some banks in Europe and Asia .However according to Starnes et al. (2017) in a similar study by World Bank the reverse was noted in observing that most respondent banks from Central Asia, Latin America and the Caribbean expected little or no growth of correspondent banking relationships.

Risks associated with downstream clearing were also established as significant factors that could lead to de-risking if not properly managed. The same sentiments are also expressed in the guidelines by BIS (2016b) who state that such arrangements could subject the correspondent bank to serious AML and KYC associated risks due to decreased transparency. Boyce and Kendall (2016) similarly noted that when a correspondent bank allowed a respondent bank to perform downstream clearing it enforced stringent due diligence requirements to mitigate the risks associated with the same.

Respondents from the local banks also expressed that low transactional volumes and bank credit ratings have led to the de-risking of correspondent banking relationships. Starnes et al. (2017) also established that due to the punitive costs associated with compliance systems including low country and bank ratings most correspondent banks were unable to

recover the same from the business flows initiated by their respondent banks forcing them to cut off links with some of them.

The study revealed that there was no relationship between the banks' market share with the factors leading to de-risking. Starnes et al. (2017) also identified that the drivers of de-risking affect countries of all sizes and similarly banks showing that the size did not matter only the magnitude of the effect.

### 5.3.2 Effects of De-risking in the Banking Sector

The second research question sought to investigate the extent to which de-risking affected financial services in the banking sector in Kenya. The main focus areas were cross-border payments, Trade Finance and Financial Inclusion. Across the board and also in other jurisdictions in sub-Saharan Africa and Europe cross-border payments remain to be the most affected financial service affected by de-risking. Financial Inclusion is closely linked to cross-border payments and Trade Finance Services are affected by not by such a great extent compared to payments and settlements.

Most local commercial banks lost an average of between one and two correspondent banking accounts every year between 2015 and 2017 which greatly impacted their remittances business and access to financial services by their clients. According to United Nations (2018) it was observed that without transactional accounts financial inclusion was greatly hindered. According to Miller (2017) some international banks paid fines in the tune of one million dollars and above for violating AML and sanctions laws. This results in de-risking of relationships and curtailing of international payments. The study also showed that compliance costs for banks increased between 2015 and 2017 .A study by Starnes et al. (2017) also showed that banks expected their compliance costs to increase due to de-risking.

In addition to loss of accounts the study also established that majority of the banks in Kenya experienced increased costs for remitting funds abroad which in turn increased costs for their clients affecting their business. A research by Starnes et al. (2017) also determined that price hikes for bank services also led to reduction of market share for some. However according to a report by Queralt et al. (2017) some public banks in India chose not to charge under priviledged clients for transfer of funds to facilitate access of funds.

The study indicated that the introduction of fintech innovations such as MPESA facilitate the accessibility of funds by improving the financial services infrastructure and ultimately reducing the effect of de-risking on financial inclusion.World Bank Group(2018) similarly reported that innovations promote financial activity.

It was established that most local banks in Kenya are forced to exit business relationships with certain segments of clients such as NPOs and Forex Bureaus that are considered to be high risk by correspondent banks.Starnes et al. (2017) in their study also concluded that some respondent banks were forced to sever relationships with high risk customer segments to retain their correspondent banking relationships.

The study fund thatwith increased restrictions around cross- border payments the fall back to the use of informal avenues to remit funds was inevitable.The same risk was reported by Miller (2017) in a separate related study.The most affected currencies reported in the study are USD, GBP and EUR .This was also observed by Starnes et al. (2017) in their research on Caribbean and Latin American banks.

The study indicated that some local banks experienced challenges in effecting Trade Finance transactions due to reduced credit limits and increased pricing on related products. A study conducted by Sanusi (2011) in Nigeria also observed a drop in trade finance trasactions and credit limits as a result of the global financial crisis.However most local banks were still able to meet increased demand for international business.

The study revealed that there is a significant relationship decribed by a negative correlation between bank market share with financial services in Cross-Border Payments,Trade Finance including Foreign –Exchange services and Financial Inclusion. It was also revealed that there is a positive correlation between bank ownership ,and Cross-Border Payments and Trade Finance Services. Similarly Starnes et al. (2017) in their study also noted a relationship between the size of the bank and magnitude of the effects of de-riskingin the financial services they offered.

### 5.3.3 Strategies and Policies towards Managing De-risking

The intention of the third strategy question was to determine what different strategies and policies commercial banks had in place to reduce the impact of de-risking in their financial services offerings as well as navigates the effects of the same. The strategies

discussed had a main focus on risk and compliance, technology and industry related policies.

In this study majority of the banks drive significant emphasis on ensuring that their institutions focused on building a culture of trust with their correspondent banks. This is effected by providing timely and accurate responses to their periodic due-diligence re-evaluations and enhancing transparency through sharing of internal documents as requested by the correspondent bank. Investing on training programs to build capacity on AML requirements is also leveraged on by most banks. These practices are seen to greatly improve and enhance the business relationships and thus reduce the impact of de-risking altogether. The same notion was also confirmed by IMF (2018) who suggested that building trust and facilitating effective communication with correspondent banks was likely to deal with the problem of de-risking. They also mentioned that continuous training and capacity building on the latest trends of AML/CFT requirements assisted in easing off the pressures of de-risking.

The study showed that most banks have not embraced the use of block-chain technology compared to other banks in developed economies for transactional surveillance in their operations to reduce compliance costs but some were utilizing KYC utilities such as KYC registry to store compliance documentation. Technology as a tool can be leveraged upon to significantly reduce compliance costs, increase accuracy and delivery. The same was also reported by Williams (2017) and Woodsome Ramachandran (2018) who indicated that Fintech can boost automation and increase transparency in transactional monitoring as well as come up with possible solutions to reduce the impact of de-risking. A similar survey conducted by GTR (2018) also confirmed that banks in the developing economies were still using basic sanctions screening methods and use of block-chain technology and other fetch technologies had not quite penetrated the banking industry.

Some commercial banks especially in the lower tier indicated that they had partnered with third party established banks to provide them with currency clearing services to enable them to continue providing such services for their clients. This strategy encourages business continuity and reduces customer attrition. According to IMF (2018) the same policy was implemented by most banks in emerging markets and developing economies that were mostly affected by de-risking as an alternative for their business needs.

The study established that majority of the banks agreed that harmonizing regulatory requirements and expectations amongst the various regulatory bodies would simplify the process and boost compliance altogether. Starnes et al. (2017) in their study also concluded that indeed harmonization would be instrumental in reducing de-risking. The banks also indicated that the involvement of Central Banks would be crucial in reducing the effects of de-risking if they got more involved in monitoring the repercussions of the same in the local banking industry. According to a report by Boyce and Kendall (2016) they also noted that the Central Bank of Belize assisted local banks that were affected by de-risking to clear payments through their own correspondent banks.

Taking a look at business segments and customer types in the local industry in Kenya showed that banks have either been forced to exit certain high risk customer types or to bank only a selected few to maintain their relationships with correspondent banks. Some of these high risk business segments are Jewellers, MSBs and Forex Bureaus. This is validated by similar findings by Starnes et al. (2017) and World Bank Group (2018) who established that CBs avoided high risk customer segments to avoid non-compliance with regulatory requirements.

This study also established that there is no relationship with bank market share and ownership, and strategies adopted to manage the effects of de-risking. This is also supported by Starnes et al. (2017) who indicated that the pressures of CBRs affected all banks irrespective of their size and thus the strategies adopted would be similar in nature.

## 5.4 Conclusion

### 5.4.1 Factors Leading to De-risking

Following the global financial crisis in 2008 and the 9/11 attacks in 2011 a lot has changed in the financial services segment that has brought about many changes in the global financial infrastructure affecting how both financial institutions and non-financial institutions operate and drive their businesses. The shift to more stringent measures on how business is conducted has become the norm. De-risking is said to be caused by various factors but the most prominent one is regulatory requirements which has been the basis of correspondent banks becoming risk-averse in their business dealings leading to de-risking of any relationships that posed a threat to complying with the statutes that have been set by regulators in various jurisdictions. The focal point of these regulations are

centered on AML/CFT requirements which is the main risk that banks across the global network encounter when dealing with correspondent banking relationships. Apart from AML/CFT requirements, correspondent banks also de-risk relationships on the basis of low business volumes and associated high compliance costs. Commercial banks in Kenya depend on correspondent banks to facilitate international business whether in payments or Trade Finance transactions. Banks have to comply with all the regulatory requirements imposed by their Correspondents to provide such services to their clients and to avoid the risk of losing their relationships. The study has shown that banks whether big or small are keen to do just that to remain relevant in the banking industry.

### 5.4.2 Effects of De-risking

De-risking has had a substantial impact on the financial services provided by Financial Institutions. This relates both to the correspondent banks and their respondent banks. The pressures brought about by the regulatory requirements have led to huge investments in compliance related requirements such as updating monitoring systems and up skilling of staff. The impact is felt more by the correspondent banks whose compliance costs can range from $20,000 to $90,000 annually according to ICC for maintaining a correspondent bank relationship. These costs coupled with other reasons force the correspondent banks to de-risk.

For commercial banks in Kenya the most affected business is cross-border payments which many households and businesses depend on for sustenance and viability. For the banks that may have lost relationships with direct clearers their costs for remitting funds have increased significantly by engaging third party banks to clear on their behalf. Across the board banks have had to revamp their risk and compliance departments to ensure compliance with AML/CFT requirements and to avoid losing their accounts. Trade Finance services and foreign exchange settlements are not affected to a large extent compared to payments. Banks have also become very selective on who they bank as a client to avoid scrutiny from their Correspondent Banks.

The study also revealed that there is a significant relationship between Banks' market share, and Cross-Border Payments and Trade Finance Services.

### 5.4.3 Strategies and Policies towards Managing De-risking

The study established that commercial banks have deliberately adopted various strategies to reduce the impact of de-risking on their businesses. Banks have adopted the strategy of actively engaging and collaborating with their respective correspondent banks to maintain vibrant relationships and enhance transparency. Banks have taken the initiative to upgrade their compliance systems and train their staff on a regular basis to keep them well informed of current developments to ensure compliance with the regulations in place. Compared to developed economies fetch innovative technologies such as Distributed Ledger Technology (DLT) is yet to be embraced by majority of the Financial Institutions to improve data analytics and automation of compliance checks. On the other hand the use of KYC utilities has been adopted by most banks to facilitate document sharing and cut compliance costs. It was also noted that for banks to maintain relationships with their correspondent banks they had reduce business relationships with high risk clientele or cut them off altogether. Additionally harmonizing regulatory requirements at a local and international level is also considered as a game changer in combating with AML /CFT risks and thus reducing de-risking levels.

## 5.5 Recommendations

### 5.5.1 Recommendations for Improvement

#### 5.5.1.1 Factors Leading to De-risking

This study recommends that the local banking sector continues to focus in risk and compliance initiatives to ensure compliance with regulatory requirements of CBs given that regulatory factors contribute largely to de-risking. The study also recommends that banks strive to provide comprehensive information on their due diligence reports to maintain strong relationships with their CBs. To reduce compliance costs for CBs which also contributes to de-risking this study recommends that banks embrace innovative developments such as centralized KYC registries to provide due-diligence data for correspondent partner banks. Additionally it is also recommended that banks boost business volumes through enhanced customer experience and innovation to grow their transactional volumes to avoid de-risking.

#### 5.5.1.2 Effects of De-risking

The researcher recommends that banks strive to grow their transactional volumes to maintain competitive pricing from CBs which will ultimately sustain access to financial

services to boost both financial and economic growth for the country. The study also recommends that banks continue to embrace innovations such as MPESA and regional payment platforms such as EAPS and REPSS to support access of funds. The study additionally recommends that banks should avoid dealing with high risk customers that pose a threat to their correspondent banking relationships. Further the study recommends that if these customer types cannot be avoided the banks put in place the necessary structures to ensure that compliance to all regulatory requirements are adhered to. The study also recommends collaboration between the larger banks and the smaller banks in the banking sector in Kenya by providing support of transactions where possible.

#### 5.5.1.3 Strategies and Policies Directed Towards Managing De-risking

The researcher recommends that the local regulators look into ways of supporting the local banking industry more to reduce the impact of de-risking in support of financial inclusion and economic growth. The study also recommends that local banks should invest more in training initiatives to enhance capacity building and knowledge on combating AML and KYC associated risks. In the same strength banks should improve on information sharing with each other to reduce AML risks in the banking industry in Kenya. Additionally apart from training their own staff banks should also extend the same service to particular segments of their clientele to strengthen their compliance with regulatory requirements. The study also recommends constant collaboration of local banks with CBs by participating in events such as conferences to strengthen their business partnerships.

### 5.5.2 Recommendations for Further Studies

The researcher suggests that further research should be conducted to incorporate the adoption of Fintech and Regtech innovations to reduce the impact of de-risking on the financial services provided by banks in Kenya. Further research should also be undertaken to analyze the effect of CBK collaborating more with Commercial Banks and other foreign financial regulatory bodies to reduce the effects of de-risking in the banking sector in Kenya.

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## APPENDIX I: SAMPLING FRAME

## BANKING SECTOR COMMERCIAL BANKS- DECEMBER 2017(CBK)

| | **List of Banks** |
|---|---|
| | |
| | **Large Peer Group (Tier 1)** |
| 1 | KCB Bank Kenya Ltd |
| 2 | Co - operative Bank of Kenya Ltd |
| 3 | Equity Bank Ltd. |
| 4 | Standard Chartered Bank (K) Ltd |
| 5 | Diamond Trust Bank (K) Ltd |
| 6 | Barclays Bank of Kenya Ltd |
| 7 | Commercial Bank of Africa Ltd |
| 8 | Stanbic Bank (K) Ltd |
| | **Medium Peer (Tier 2)** |
| 9 | I&M Bank Ltd |
| 10 | NIC Bank Ltd |
| 11 | Bank of Baroda (K) Ltd |
| 12 | Citibank N.A. Kenya |
| 13 | National Bank of Kenya Ltd |
| 14 | Prime Bank Ltd. |
| 15 | Family Bank Ltd |
| 16 | Bank of India |
| 17 | HFC Ltd |
| 18 | Ecobank Kenya Ltd |
| 19 | Bank of Africa (K) Ltd |
| | **Small Peer Group (Tier 3)** |
| 20 | Guaranty Trust Bank Ltd |
| 21 | Gulf African Bank Ltd |
| 22 | African Banking Corporation Ltd |
| 23 | Victoria Commercial Bank Ltd |
| 24 | Sidian Bank Ltd |
| 25 | Habib Bank A.G. Zurich |

| | |
|---|---|
| 26 | Guardian Bank Ltd |
| 27 | First Community Bank Ltd |
| 28 | Credit Bank Ltd |
| 29 | Development Bank of Kenya Ltd |
| 30 | Jamii Bora Bank Ltd |
| 31 | M Oriental Commercial Bank Ltd |
| 32 | Trans - national Bank Ltd |
| 33 | Consolidated Bank of Kenya |
| 34 | SBM Bank(Kenya) Ltd |
| 35 | Paramount Bank Ltd |
| 36 | Spire Bank Ltd |
| 37 | UBA Kenya Ltd |
| 38 | Middle East Bank (K) Ltd |
| 39 | Mayfair Bank Ltd |
| 40 | DIB Bank Kenya Ltd |
| 41 | Chase Bank Ltd** |
| 42 | Charterhouse bank * |
| 43 | Imperial Bank Ltd** |

Source: CBK Annual Survey Report (Central Bank of Kenya,2017c).

** Banks under receivership

* Banks under statutory management

## APPENDIX II: COVER LETTER

United States International University-Africa
P.O BOX 14634-00800
Nairobi

Dear Respondent,

**RE: RESEARCH QUESTIONNAIRE**

I am graduate student studying at United States International University, currently conducting a research on investigating the effects of de-risking on financial services in the banking sector in Kenya.

This research is purely for academic purposes and the information collected will be treated with utmost confidentiality. Kindly spare about 20 minutes of your time to complete the attached questionnaire.

Your assistance in this is highly appreciated

Yours faithfully,

Caroline Rose Mwaniki

## APPENDIX III: QUESTIONNAIRE

The purpose of this questionnaire is to investigate the effects of de-risking on financial services in the banking sector in Kenya. Kindly respond by selecting the choice that best represents your view or Institution.

**SECTION A: GENERAL INFORMATION**

1. **Level of Management:**

Head of Department ☐ Senior Manager ☐ Senior Officer ☐ Other (specify)……..

2. **Gender:**

Male ☐ Female ☐

3. **Work Experience**

Less than 5 years ☐ 11-15 years ☐

6-10 years ☐ above 15 years ☐

4. **Highest Level of Education:**

Certificate ☐ Diploma ☐ Undergraduate ☐ Masters ☐ Doctorate ☐ Other(Specify)

5. **Function Unit**

Treasury ☐ Financial Institutions ☐ Risk and Compliance ☐ Trade Finance ☐

Other (specify)……..

6. **Market Share (Percent)**……..

7. **Bank Ownership**

Local Private ☐ Local Private with Public ☐ Foreign Institutional ☐ Local Public

**SECTION B: FACTORS LEADING TO DE-RISKING IN THE BANKING SECTOR**

| | **On a scale of 1-6 rate to what extent the following statements apply with respect to factors leading to de-risking in the banking sector**<br>**(1-Strongly Disagree,2-Disagree,3-Neutral,4-Agree,5-Strongly Agree,6- N/A )** | **1** | **2** | **3** | **4** | **5** | **6** |
|---|---|---|---|---|---|---|---|
| **8** | Anti-money laundering(AML) and Countering Financing of Terrorist activities(CFT) requirements are the main reasons behind regulatory restrictions that lead to de-risking | | | | | | |
| **9** | Agencies such as the Financial Action Task Force(FAFT) are responsible for implementing strong regulatory frameworks that lead to de-risking | | | | | | |
| **10** | Correspondent banking experienced many challenges following the global financial crisis and 2010-2011 Eurozone crisis | | | | | | |
| **11** | Our correspondent banks conduct annual KYC reviews on the various Nostro accounts held | | | | | | |
| **12** | Our Institution has suffered loss of correspondent accounts due to low volumes of transaction flows | | | | | | |
| **13** | Our Institution expects little or no growth in correspondent bank relationships in the future due to AML restrictions | | | | | | |
| **14** | Low bank and country credit ratings can lead to de-risking | | | | | | |
| **15** | Insufficient information on due-diligence reports, | | | | | | |

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|---|---|---|---|---|---|---|---|
| | AML/CFT deficiencies in the operations of banks and lack of compliance with sanctions regulations leads to de-risking | | | | | | |
| **16** | Downstream clearing can expose the correspondent bank to AML and terrorist financing risks by obscuring financial transparency | | | | | | |
| **17** | The lack of standardized global regulatory requirements promotes de-risking | | | | | | |
| **18** | The threat of hefty AML penalties and compliance costs have forced correspondent banks to become risk averse and conservative in their banking activities | | | | | | |

Any other additional comments

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**SECTION C: EFFECTS OF DE-RISKING IN THE BANKING SECTOR**

**19. How many correspondent banking accounts/relationships did you lose in 2015?**

1-2 accounts ☐ 3-4 accounts ☐

5 and above accounts ☐ None ☐

**20. How many correspondent banking accounts/relationships did you lose in 2016?**

1-2 accounts ☐ 3-4 accounts ☐

5 and above accounts ☐ None ☐

**21. How many correspondent banking accounts/relationships did you lose in 2017?**

1-2 accounts ☐ 3-4 accounts ☐

5 and above accounts ☐ None ☐

**22. Do you expect your correspondent accounts/relationships to increase in 2018?**

**Yes ☐ No ☐ remain the same ☐**

If Yes, Why?

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**23. Did your risk and compliance costs increase between 2015 and 2017?**

**Yes ☐ No ☐**

**If Yes, to what extent?**

High extent ☐ Moderate Extent ☐ Low Extent

| | **On a scale of 1-6 rate to what extent the following statements apply with respect to the effects de-risking in the banking sector in Kenya**<br>**(1-StronglyDisagree,2-Disagree,3-Neutral,4-Agree,5-Strongly Agree, 6- N/A )** | **1** | **2** | **3** | **4** | **5** | **6** |
|---|---|---|---|---|---|---|---|
| **24** | De-risking poses a great challenge to financial inclusion in economic development in Kenya | | | | | | |
| **25** | De-risking has affected transactions mainly in USD,EUR and GBP in my Institution | | | | | | |
| **26** | My Institution has experienced a decline in remittance flows due to de-risking | | | | | | |
| **27** | My Institution experiences higher costs of remitting funds due to heightened regulatory requirements in the international banking ecosystem | | | | | | |

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|---|---|---|---|---|---|---|---|
| **28** | Innovations in the digital space has boosted the flow of remittances through mobile banking platforms such as MPESA in Kenya | | | | | | |
| **29** | My Institution has experienced challenges in effecting Trade Finance transactions due to reduced credit limits and increased pricing margins from correspondent banks | | | | | | |
| **30** | My Institution has experienced an increase of demand in international business but does not have the requisite capacity to meet it | | | | | | |
| **31** | My Institution has experienced challenges in settling foreign currency with foreign counterparts due to decreased correspondent banking relationships | | | | | | |
| **32** | My Institution has been forced to exit certain high risk customer types and businesses to adapt to the changes within correspondent banking relationships | | | | | | |
| **33** | De-risking creates an opportunity for financial crime by encouraging the use of informal and unregulated financial networks to transfer funds | | | | | | |

Any additional comments

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**SECTION D: STRATEGIES AND POLICIES TOWARDS MANAGING DE-RISKING IN THE BANKING SECTOR**

| | **On a scale of 1-6 rate to what extent the following statements apply with respect to strategies and policies towards managing de-risking in the banking sector**<br><br>**(1-StronglyDisagree,2-Disagree,3-Neutral,4-Agree,5-Strongly Agree, 6- N/A** | **1** | **2** | **3** | **4** | **5** | **6** |
|---|---|---|---|---|---|---|---|
| **34** | My Institution builds trust and demonstrates effective communication with all its Correspondent banks | | | | | | |
| **35** | My Institution uses blockchain technology to enhance surveillance of transactions. | | | | | | |
| **36** | My Institution provides timely responses to information requested by Correspondent Banks during the Risk and Compliance periodic due diligence reevaluations. | | | | | | |
| **37** | My Institutiondemonstrates KYC thoroughness by sharing internal documents such risk and compliance policies among others with Correspondent banks | | | | | | |
| **38** | My Institution conducts training on a regular basis to enhance AML/CFT knowledge and capacity building | | | | | | |
| **39** | Harmonizing regulatory requirements from various regulatory bodies would be instrumental in reducing de-risking as compliance would be simplified | | | | | | |
| **40** | My Institution has partnered with international banks that are not direct currency clearers(downstream clearers) to facilitate cross border payments | | | | | | |

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|---|---|---|---|---|---|---|---|
| **41** | My Institution has adopted automated technology solutions in KYC utilities such as the SWIFT registry | | | | | | |
| **42** | Involvement of Central Bank of Kenya in monitoring the trends of de-risking within the banking sector can prompt the institution of strategies to reduce its impact | | | | | | |
| **43** | Adoption of AML/CFT regulatory requirements such as those in Financial Institutions can be replicated by Money Transfer Operators to reduce high risk ratings | | | | | | |
| **44** | My Institution has terminated/curtailed banking services to Non-Profit Organizations, Money Service Bureaus and Forex Bureaus to retain relationships with correspondent banks | | | | | | |

**Any additional comments**

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***Thank you for your responses***