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Executive Summary: State of Kenya's Financial Sector Stability in 2016

A vibrant and well-functioning sound, efficient and stable financial system is a catalyst for broad based sustainable economic growth and development. It mobilizes savings and channels them to investors facing shortage of investible funds to support Kenya's development aspirations outlined in the Kenya Vision 2030. It also facilitates settlement of claims and provides a platform for risk sharing. Increased investment in productive sectors, not only contributes to growth, but also enhances welfare through wealth and employment creation. Kenya's financial sector comprises of deposits-taking institutions (commercial banks and mortgage finance companies, microfinance banks and deposit taking Savings and Credit Co-operatives (Saccos)), non-deposits taking institutions (insurance industry, pensions industry, capital markets industry, Development Finance Institutions and several other entities) and financial markets infrastructure providers. The sector is regulated and supervised by five main regulators responsible for different segments in this sector, namely the Capital Markets Authority (CMA); Central Bank of Kenya (CBK); Insurance Regulatory Authority (IRA); Retirement Benefits Authority (RBA); and the Sacco Societies Regulatory Authority (SASRA). The banking sub-sector, which comprises of commercial banks, mortgage finance companies and microfinance banks accounted for more than 60 percent of total assets in the sector.

This report covers the period, January 2016 to March 2017, which was characterized by a resilient financial system albeit the shocks and vulnerabilities emanating from both domestic and external sources. As the system was recovering from vulnerabilities following placement of one bank and two banks in liquidation and receivership respectively in the second half of 2015 and first quarter of 2016 (placement of Dubai Bank under liquidation in August 2015 and placement of Imperial Bank and Chase Bank under receivership in October 2015 and April 2016), coupled with the implementation of the 'new normal' (based on three pillars - enhanced transparency, governance and business models), three key events occurred in 2016. These events, both from domestic and external sources are thought to have impacted Kenya's financial sector in one way or another. These are: United Kingdom (UK) Referendum (Brexit) outcome on June 24, 2016, US president Trump election and the Kenya's Banking (Amendment) Act, 2016 on interest rates control assented to in August 24, 2016 that came into force on September 14, 2016. Reactions to these shocks varied across the sector, sub-sectors and institutions, but there was overall decline in leading indicators depending on their level of exposures.

Globally, the main source of risk with implications on Kenya's financial sector was increased protectionism culminating into the Brexit referendum and United States of America (US) Presidential election of Donald Trump. Kenya's stock market reacted to the outcome negatively, with leading counters especially in financial sector recording significant sell-offs at highly discounted prices. In addition, proposals to increase deregulation of the financial system in the US, although not actualized, and more pursuit of inward-looking policies by the West, posed risks to Kenya's financial sector. Some African economies and financial markets experienced a pull-out of international banks or termination of correspondence banking operations (de-risking) due to increased litigations on global banking corporations. This has repercussions on trade between Africa and the rest of the world.

On the domestic front, bank credit to the private sector decelerated rapidly from 15.57 percent in the year to March 2016 to 3.28 percent in the year to March 2017 and 1.55 percent in the year to June 2017. This deceleration is attributed to both supply – and demand – side factors. On the demand side, lower households demand for credit and weak corporate sector balance sheets as well as cash flow problems facing many companies impacted on credit uptake. On the supply side, banks took precautionary measures and tightened their lending standards to minimize further exposures, by increasing their holding of government securities considered to be risk-free. They

also shortened loan maturities to less than five (5) years to reflect unstable funding dominated by demand deposits, and increased loan sizes amid reduced number of loan approvals.

Another area of focus is liquidity challenges that faced and continue to face the entire financial sector, albeit showing signs of easing in the second quarter of 2017. The interbank market had liquidity constraints in the first quarter of 2016, characterized by low volumes and large and volatile spreads. This, however, smoothened out in the year as liquidity management among banks improved and central bank window offered support and reassurance. In the corporate sector, viability (profitability) and liquidity problems were reported in several companies, including those listed on the Nairobi Securities Exchange (NSE). This was reflected in their inability to meet their cash obligations resulting into court cases and issuance of profit warnings. The stock market experienced reduced liquidity, with top 10 counters reporting 8.67 percent liquidity ratio of their stocks in 2016, down from 10.98 percent in 2015. Thin liquidity in the market saw increased concentration risks, whereby top five (5) stocks accounted for 64 percent of market capitalization in 2016 and volatility of stock prices was very high. Drought that started in 2016 spilling over to 2017, saw the counters linked to agricultural sector experience drop in prices and attract less demand due to low output that impact profitability and in turn stock prices. In addition, there were no Initial Public Offerings (IPOs) listings or new corporate bonds issuances in 2016 compared to six (6) corporate bond listings and one (1) IPO in 2015.

The banking sub-sector recorded elevated credit risks, reflected in deterioration of their asset quality following increased Non–Performing Loans (NPLs) and provisions. The gross NPLs increased by 106 percent in the year to December 2016 compared to 30.14 percent in the year to December 2015. The gross NPLs, however, rose by 65. 1 percent in the year to March 2017 compared to 57.2 percent in the year to March 2016. The ratio of gross NPLs to gross loans rose from 6.1 percent in December 2015 to 11.8 percent in December 2016, and from 8.3 percent in March 2016 to 12.3 percent in March 2017, which is partially due to the decline in gross loans. The sub-sector also recorded a 10.9 percent increase in profits in the year to December 2016 but 11.7 percent decline in profitability in the year to March 2017. The top five banks by assets recorded 14.25 percent growth in profits in the year to December 2016, while the lowest performing five banks recorded 8.8 percent losses during the period. In the year to March 2017, top five banks recorded 10 percent losses, while the bottom five banks recorded 80.1 percent increase in losses. This trend shows heterogeneity in performance of the banking sub-sector, with majority of the middle and lower peer group incurring the largest loss. This has implications on capital buffers used to absorb shocks, since banks use retained earnings to build capital buffers or enhance efficiency in capital utilization. In response to reduced buffers, there has been increased consolidation, with a total of four (4) mergers and acquisitions between 2016 and first quarter of 2017 being announced or actualized compared to three (3) announced in three years to March 2015. On average, the sub-sector remain well capitalized and resilient, but tending towards the minimum capital requirements.

The insurance and pension sub-sectors also experienced a number of risks in 2016. In particular, the insurance industry recorded declining margins and falling performance metrics measured by Return on Assets (ROA) and Return on Equity (ROE). This was attributed to challenges in operational efficiency and challenging economic environment. The Pension sub-sector on the other hand, recorded marginal growth in assets in 2016 compared to 2015 due to exposure of its assets to excessive stock market volatility and instability in the banking sector and off-shore investments.

The regulators and policy makers have instituted measures to mitigate current and emerging vulnerabilities that threaten the soundness and stability of a vibrant financial sector. Key among these is the improved regulatory and supervisory environment and better coordination among various regulators. The enhanced regulatory regime, improved coordination and cooperation among both the domestic and other cooperating regulators, and positive economic growth prospects are likely to support a more robust financial sector. The on-going modernization of infrastructure in Kenya and the region at large, will further support a vibrant financial sector, both directly and indirectly. However, uncertainty surrounding the interest rates capping law may undermine the very purpose of increasing transparency in pricing and uptake of credit at affordable costs. So long as the law exists, and government continues to increase borrowing, banks may want to continue lending to the government instead of the private sector, making it difficult to extend credit to wider customer base.

Global macro–financial conditions, growth prospects and normalization of monetary policy in developed economies will increasingly play a significant role in shaping the Kenyan financial sector. This likely to spillover to EAC region given the increased cross-border operations and interconnectedness of Kenya's financial sector with the rest of the world. Kenya's financial sector therefore remains resilient despite recent vulnerabilities, but the ongoing reforms and innovations are meant to strengthen it further in order to rightfully play its role in supporting full realization of aspirations of Kenya Vision 2030.

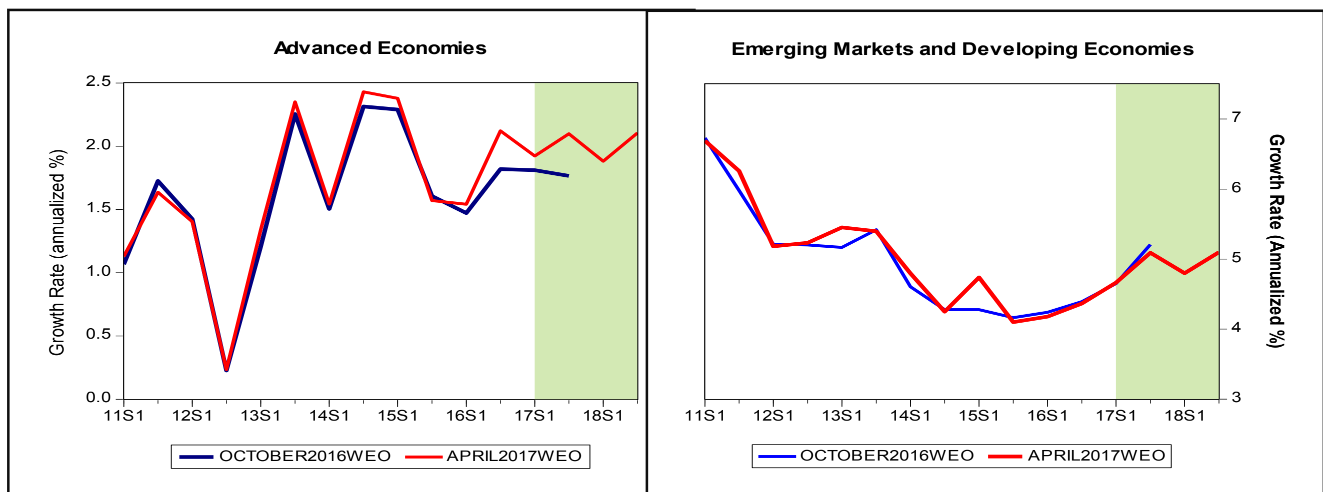
Chapter 1: Global and Domestic Macro-financial Developments

1.1 Global Macrofinancial Developments

The World economic growth is expected to rise from 3.1 percent in 2016 to 3.5 percent in 2017 and 3.6 percent in 2018, mainly driven by advanced economies, according to World Economic Outlook (WEO) April 2017, (figure 1). This has implications on global macro-financial conditions, particularly for emerging markets and developing economies including Kenya.

The World economic growth is expected to rise from 3.1 percent in 2016 to 3.5 percent in 2017 and 3.6 percent in 2018, mainly driven by advanced economies according to the World Economic Outlook (WEO), April 2017 (figure 1). This global growth is however not uniform given that Emerging and developing economies are generally forecast to have slower growth in 2017-2018 on fears of rising inflation, higher commodity prices (oil) and financial market recovery in advanced countries.. Weak growth in India and deep recession in Brail cancelled out strong growth in China (WEO, April 2017). The MENA region also recorded lower growth, which may affect Kenya's exports of tea and in turn affect Balance of Payments. Strong recovery in financial markets of advanced economies can induce capital flight from emerging markets and developing economies, thus destabilizing macrofinancial conditions in these countries.

Figure 1: Global GDP Growth (Annualized semi-annual percent change)



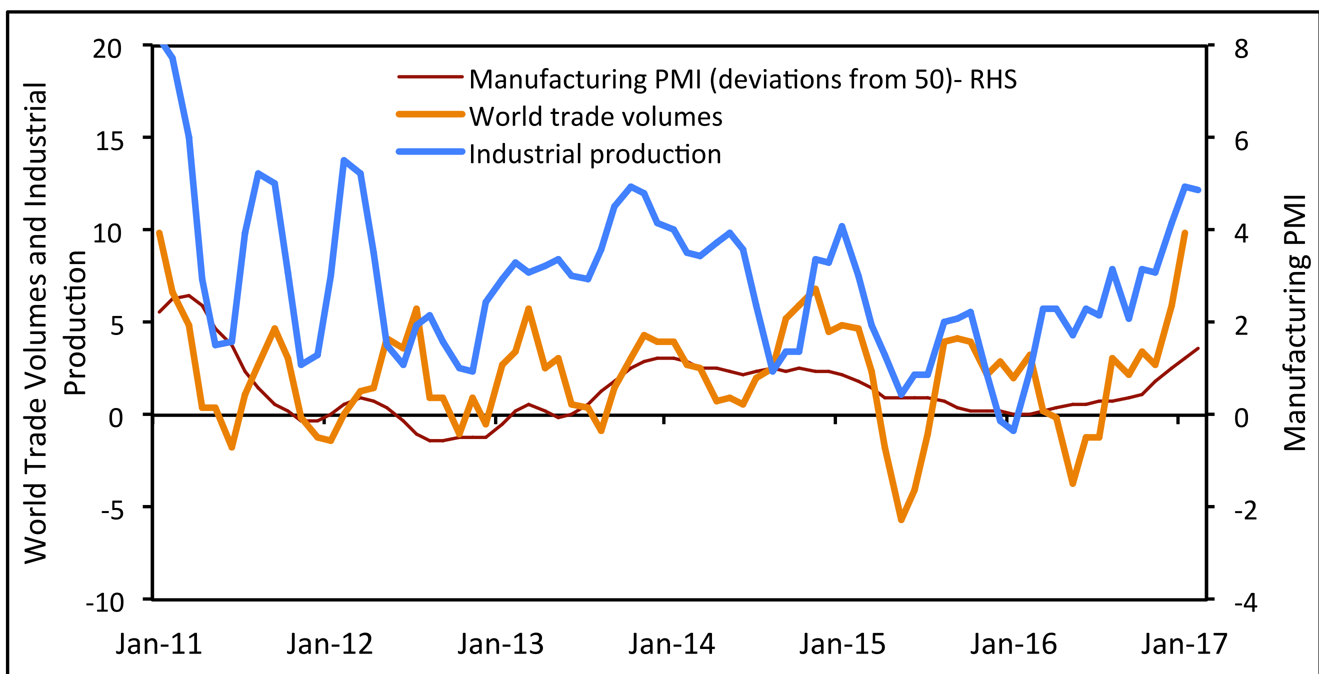
Source: WEO, April 2017

The recovery in global growth was driven by improvement in investment, manufacturing, and trade as well as improved expectations about global demand (figure 2). This has led to recovery in commodity prices, which may benefit major commodity exporters. Kenya as a major exporter of tea, coffee and horticulture and stands to gain from global price improvements.

Global financial markets have also continued to rebound as a result of policy support in China and the expected fiscal expansion and deregulation in the U.S (WEO, April 2017). However, if the proposed tax reforms and deregulation in the U.S could lead to growth and debt reduction that are less benign than expected, risk premiums and volatility could rise sharply, undermining financial stability with spill-overs to emerging and frontier markets. In addition,

a faster-than-expected pace of interest rate hikes in the U.S. could tighten financial conditions elsewhere. Further, appreciation of the U.S. Dollar could potentially strain emerging market economies that have either exchange rate pegs to the dollar or material balance sheet mismatches. More generally, a reversal in market sentiment and confidence could increase capital flight and volatility in exchange rate, which exacerbates existing vulnerabilities in emerging market and developing economies. A dilution of financial regulation, may lead to stronger near-term growth but may imperil global financial stability and elevate the risk of costly financial crises and resolution. A shift towards protectionism in advanced economies could reduce global growth and trade, impede capital flows, and dampen market sentiment and confidence. All these have significant direct and indirect as well as second and third round effects on developing economies including Kenya's macro-financial linkages through trade, foreign direct investments and/or portfolio flows.

Figure 2: World Trade, Industrial Production, and Manufacturing PMI*



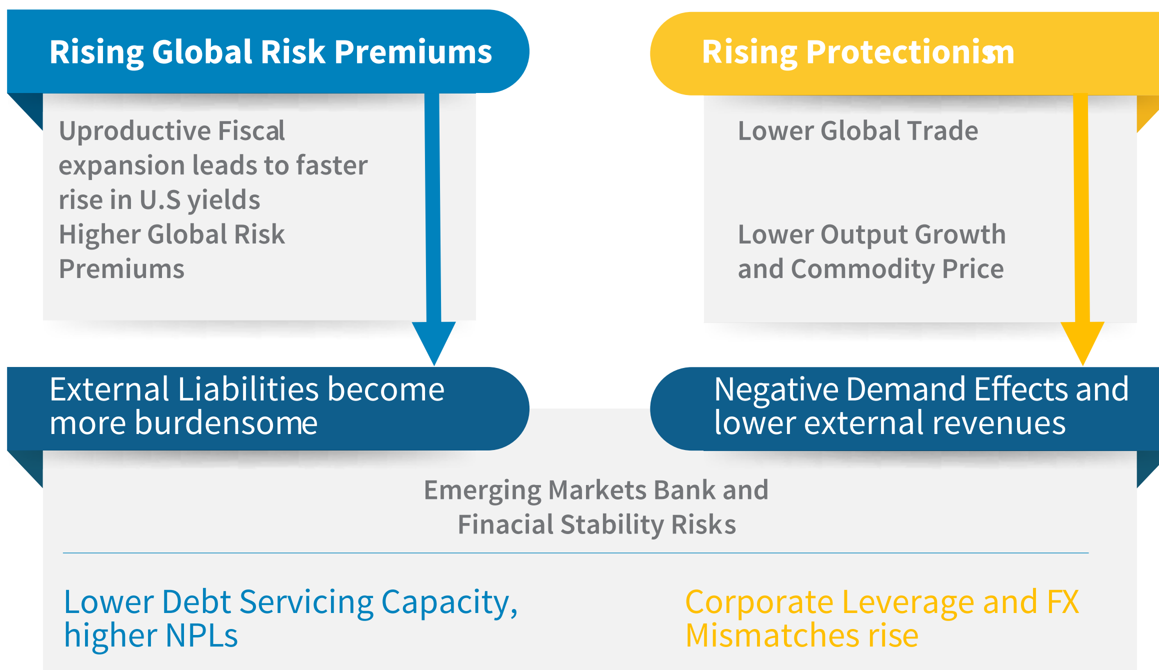
**Three-month moving average; annualized percent change*

Source: WEO, April 2017

The persistent decline in Total Factor Productivity (TFP) growth reflects the legacies of the global financial crisis. In advanced economies, notably in Europe, high levels of corporate debt and non-performing loans have constrained investment in capital goods and intangible assets, slowing the pace of capital-embodied technological change. Subdued TFP growth prospects also reflect unfavourable trends that started before the crisis - waning effects of the earlier boom in the adoption of information and communications technologies, aging population, decelerating global trade integration, slowing human capital accumulation, and taxation policies. In emerging market economies, the muted TFP growth stems from the fading effects of earlier structural reforms and transformation. In Europe, lack of progress on structural challenges in banking system and high debt levels could reignite financial stability concerns. Emerging market risks remain elevated but unchanged, as recovering commodity prices and modest deleveraging in some corporate sectors are offset by higher external financing risks and rising financial vulnerabilities in China (figure 3).

The likelihood of negative spillovers from political and policy uncertainty in advanced economies means that a sudden re-pricing of risk or a rise in protectionism could trigger capital outflows and hurt demand, with ramifications on existing vulnerabilities in household and corporate sectors and increased risks in the weakest banking systems.

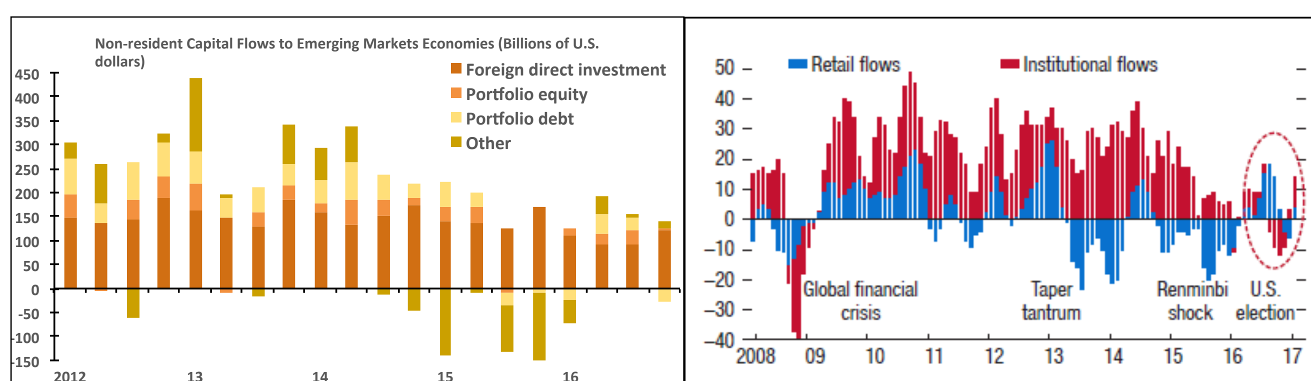
Figure 3: Transmission of External Risks to Emerging Market Economies



Source: GFSR, April 2017

Capital flows to emerging market economies have been subdued in recent years (**figure 4).** Although emerging market economies have enhanced their resilience, higher inflation and exchange rates volatility in some countries and rising financial vulnerabilities in China have left emerging market risks unchanged.

Figure 4: Non-resident Capital and Portfolio Flows to Emerging Markets (USD Billions)



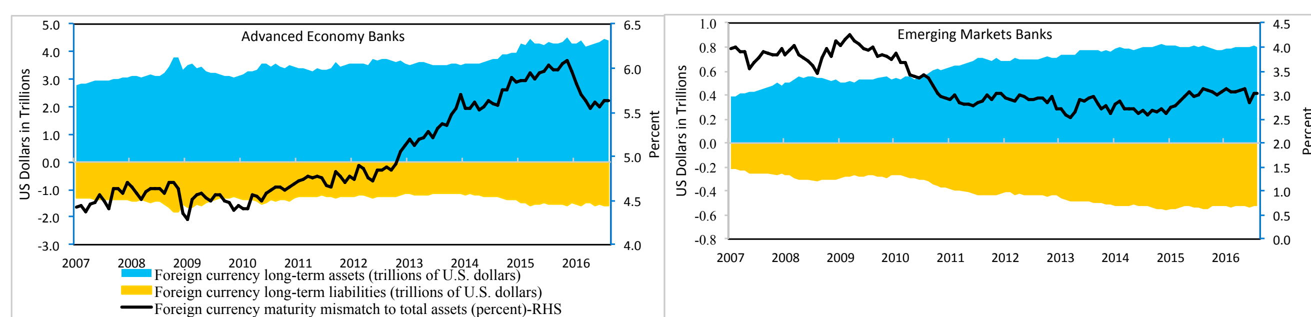
Source: GFSR, April 2017

In emerging market economies, liquidity and credit risks are sizable due to these countries' increased reliance on bond issuance and elevated redemption needs. Low interest rates, a relaxation of bond issuance requirements, and expectations of a stronger U.S. Dollar triggered a surge in issuance beginning early in 2015. China now accounts for more than two-thirds of total emerging market bond issuance and a third of U.S. Dollar issuance, and maturities are shortening. Retail investors are the largest drivers of outflows. Banks continue to be the largest bond holders, but wealth management products and securities firms also have significant exposure. In some cases, these firms are highly leveraged to boost returns, often through informal markets with limited documentation and transparency.

Global liquidity risks could be amplified by the currency mismatch between non-U.S. banks' assets and liabilities, especially if U.S. interest rates were to increase sharply and the dollar were to appreciate. Risks would be greatest for those banking systems that are highly dependent on short-term dollar funding for long-term assets.

Banks in advanced economies have become reliant on cheap short-term foreign-currency funding for their long-term foreign-currency assets. Since 2007, their maturity gap (difference between long-term foreign-currency assets and long-term foreign-currency liabilities), has nearly doubled to USD 2.9 trillion (figure 5). As a percentage of total assets, the maturity gap reduced from a high of 6.1 percent in November 2015 to 5.6 percent in June 2016. When local-currency assets come under funding stress, the local central bank can provide almost limitless liquidity to banks via temporary funding transactions. But when funding strains arise for foreign-currency-denominated assets, local central banks can provide liquidity only from their finite foreign-currency reserves or by tapping foreign exchange swap facilities and credit lines with other official institutions. If offshore dollars were to become a scarce resource, then banks will reduce their global footprint or to increase their reliance on central banks to provider dollars as a lender of last resort. Emerging market banks have a smaller and more stable maturity gap.

Figure 5: Foreign-Currency Maturity Mismatches



Source: GFSR, April 2017

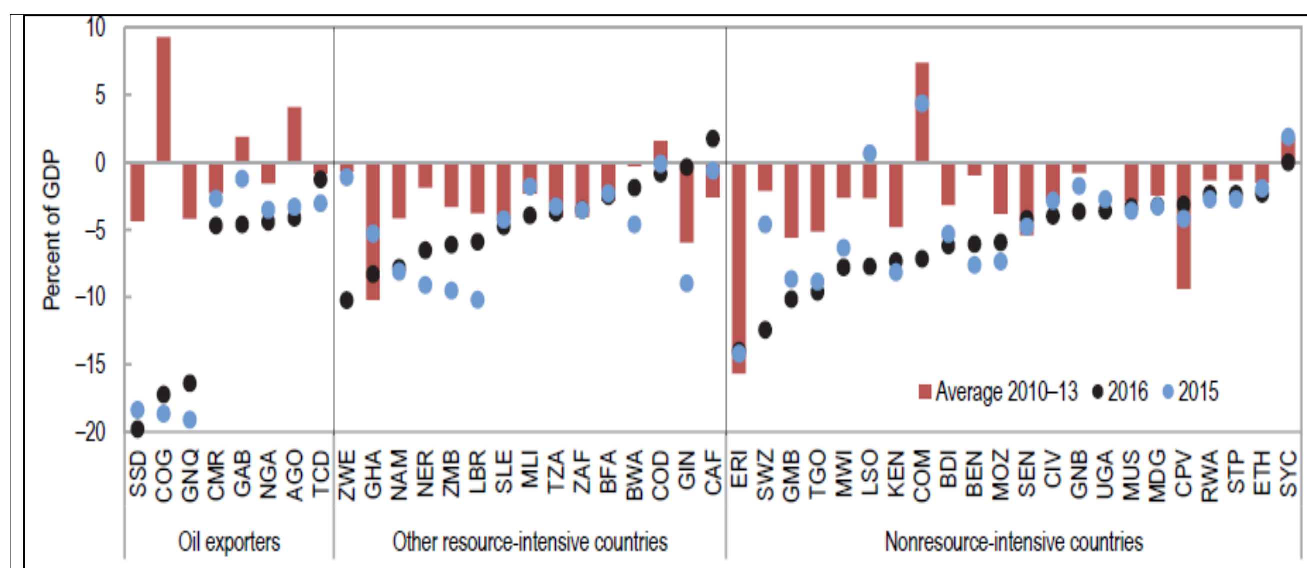
1.2 Macrofinancial conditions in Sub-Saharan Africa

Sub-Saharan Africa (SSA) output growth is projected at 2.6 percent in 2017 and 3.5 percent in 2018. This slower growth in 2016 is explained by: disruptions in the oil sector, shortages in foreign exchange, power, and fuel as well as insufficient policy adjustments to external and internal vulnerabilities. The most affected countries include; Angola, Nigeria, and the Central African Economic and Monetary Community (CEMAC). This is due to low oil prices that led to revenue losses and balance of payments pressures. The non-resource-rich countries like Côte d'Ivoire, Kenya, and Senegal, face high fiscal deficits arising from financing social and infrastructure gaps.

South Africa is forecasted to grow at 0.8 percent in 2017 as commodity prices rebound, drought conditions ease, and electricity capacity expands. Angola is expected to grow by 1.3 percent in 2017, driven by an expansion in the non-oil sector because of higher public spending and better terms of trade. The outlook for the region remains less optimistic with output growth expected to just exceed population growth, having fallen short in 2016.

Vulnerabilities are emerging or still exist in SSA countries – rising public debt is attracting higher borrowing costs, arrears are rising, and nonperforming loans in the banking sector are increasing (REO-Sub-Saharan Africa April 2017), **figure 6.**

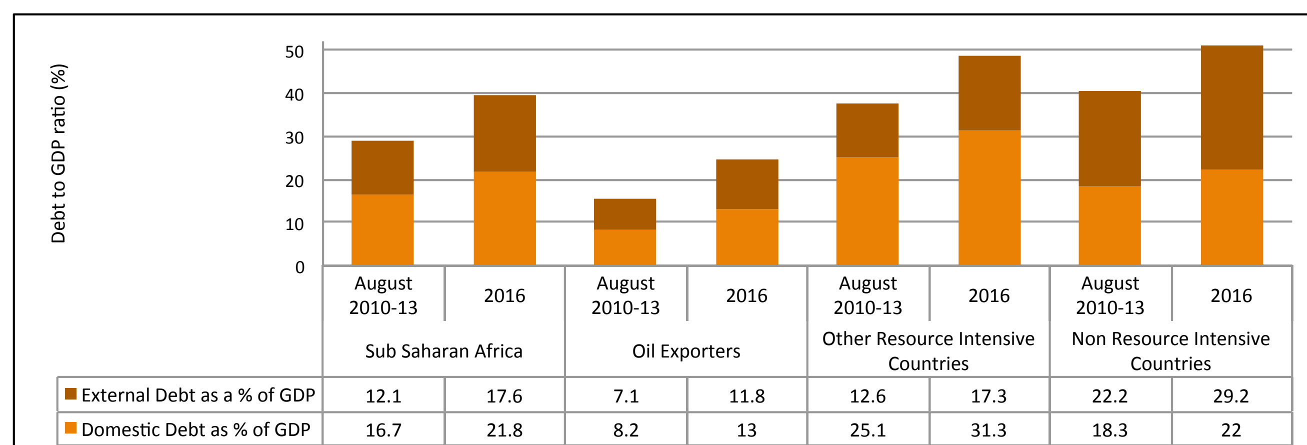
Figure 6: Overall Fiscal Balance in SSA, 2010-16



Source: REO-SSA April, 2017

The rapid increase in public debt in SSA is explained by both delayed fiscal adjustments in hard-hit countries and expansionary fiscal stances elsewhere. On average, the ratio of public debt to GDP has increased by about 10 percentage points since 2014 to average of 42 percent of GDP in 2016, the highest since the debt relief initiative in the 2000s under the Heavily Indebted Poor Countries/Multilateral Debt Relief Initiative (**figure 7**).

Figure 7: Public Sector Debt in SSA, 2010-13 and 2016



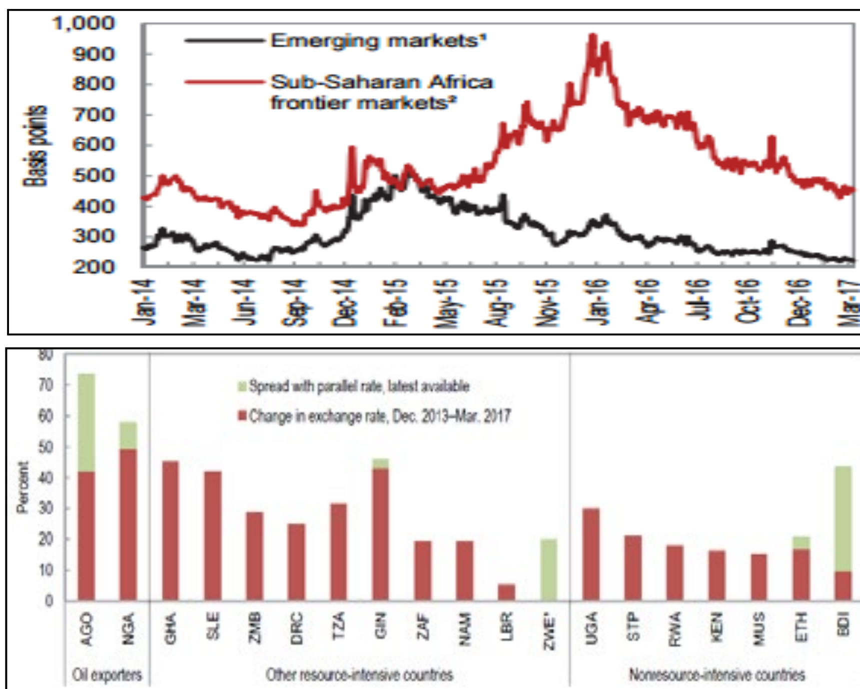
	Sub Saharan Africa		Oil Exporters		Other Resource Intensive Countries		Non Resource Intensive Countries	
	August 2010-13	2016	August 2010-13	2016	August 2010-13	2016	August 2010-13	2016
External Debt as a % of GDP	12.1	17.6	7.1	11.8	12.6	17.3	22.2	29.2
Domestic Debt as % of GDP	16.7	21.8	8.2	13	25.1	31.3	18.3	22

Source: REO-SSA April, 2017

Besides reduced revenues streams, rapid debt accumulation especially for non-resource rich countries could be explained by heavy spending to address huge infrastructure gaps in these countries.

The SSA countries also faced external pressures arising from large terms-of-trade shocks and tighter external financing conditions in 2016. In reaction, a number of countries left currencies to depreciate or devalue. However, some of the hardest-hit countries also resorted to harmful exchange rate restrictions to stem the depletion of reserves (Angola, Nigeria). These have added to growing policy uncertainties, generated economic distortions, and led to a widening of spreads in parallel markets (**figures 8**).

Figure 8: Exchange Rates in SSA and Emerging Markets Spreads and Depreciation of SSA Currencies against U.S dollars in 2013 - 2017



Source: Bloomberg, March 2017 and REO-SSA April, 2017

In terms of outlook for SSA region, aggregate fiscal deficit is expected to remain elevated at 4.5 percent of GDP and growth expected to be uneven. In the East African Community (EAC), the fiscal deficit reached 5.1 percent of GDP in 2016, while in WAEMU countries it was 4.1 percent of GDP. The fiscal deficits have been rising in EAC and WAEMU countries since 2012. In the EAC, Kenya, Rwanda, Tanzania, and Uganda are expected to maintain 5 percent growth, supported by public spending. However, the extended drought, affecting agriculture and energy, are likely to dent the growth trajectory.

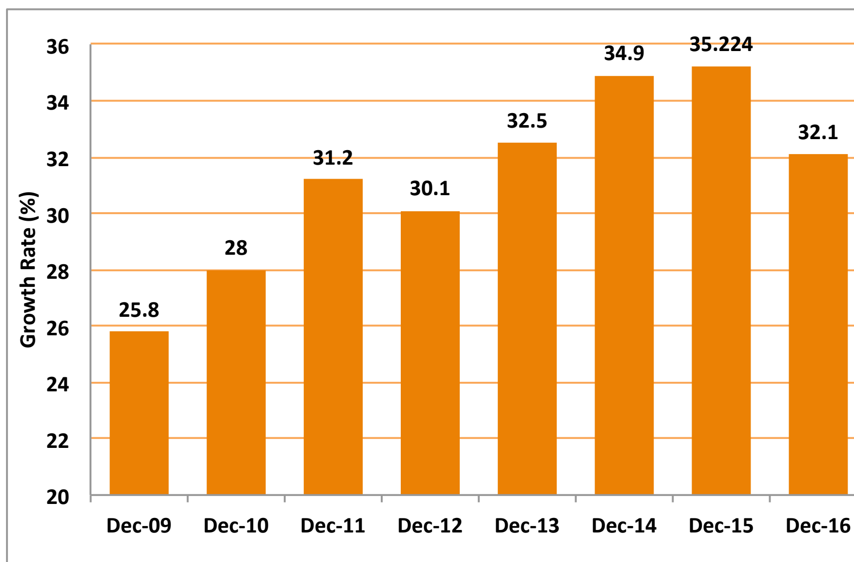
There are headwinds to regional outlook - interest rates reversals, which are likely to impact negatively financial markets. Rapid reversals could induce excess volatility, affecting these markets through portfolio outflows. Geopolitical tensions in the MENA region also pose a risk to global growth and Kenya in particular, thus affecting macro-financial stability. Other challenges from global sources are protectionism, derisking by global banking corporations from Africa and interest rates reversals.

1.3 Domestic Macrofinancial Developments

Kenya's Gross Domestic Product (GDP) expanded by 5.8 percent in 2016 up from 5.7 percent in 2015, supported by 13.3 percent growth in accommodation and food services in 2016 compared with a 1.3 percent contraction in 2015. Other sectors that boosted growth include; information and communication, real estate and transport and storage sectors. The headwinds to stronger growth in 2017 include the 2017 general elections drag, drought conditions, and continued private sector credit squeeze, weak corporate sector balance sheet, and external developments.

Overall domestic credit growth decelerated from 20.8 percent in 2015 to 6.4 percent in 2016. This is explained by steep decline in the growth of credit to the private sector, from 18.0 percent in 2015 to 4.3 percent in 2016. This trend is explained by both demand and supply side factors. These are; weak corporate and household balance sheets, banks reallocating their money to purchase of government debt and hard economic conditions affecting SMEs ability to borrow.

Figure 9: Private Sector Credit as a Percentage of GDP

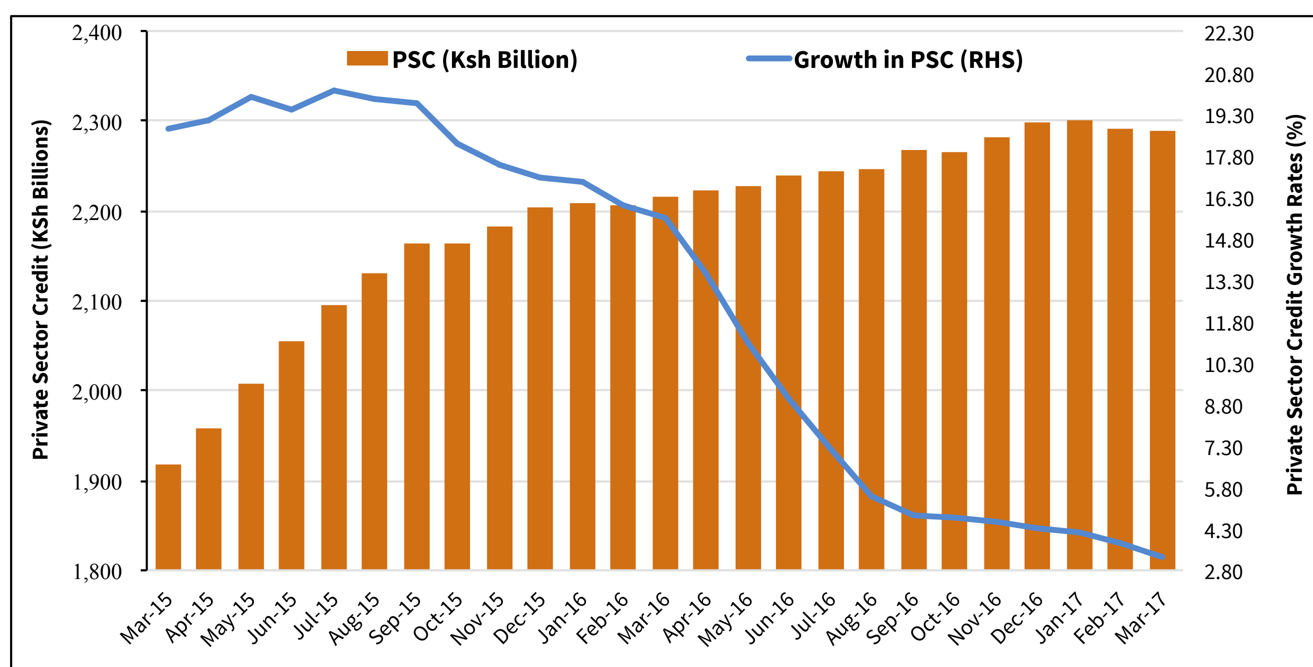


Source: Central Bank of Kenya

1.1.1. Trends in Private Sector Credit Flows

The banking sector credit to the private sector grew steadily from 2012 reaching a historical high in 2015 before decelerating in 2016. As noted in figure 9, annual private sector credit growth rate as a share of GDP peaked at 35.22 percent in 2015 from 25.8 percent by the end of 2009. The trend however reversed, decelerating to 32.1 percent in 2016 and to about 25.8 percent by June 2017.

Figure 10: Private Sector Credit Stocks and Growth Rates



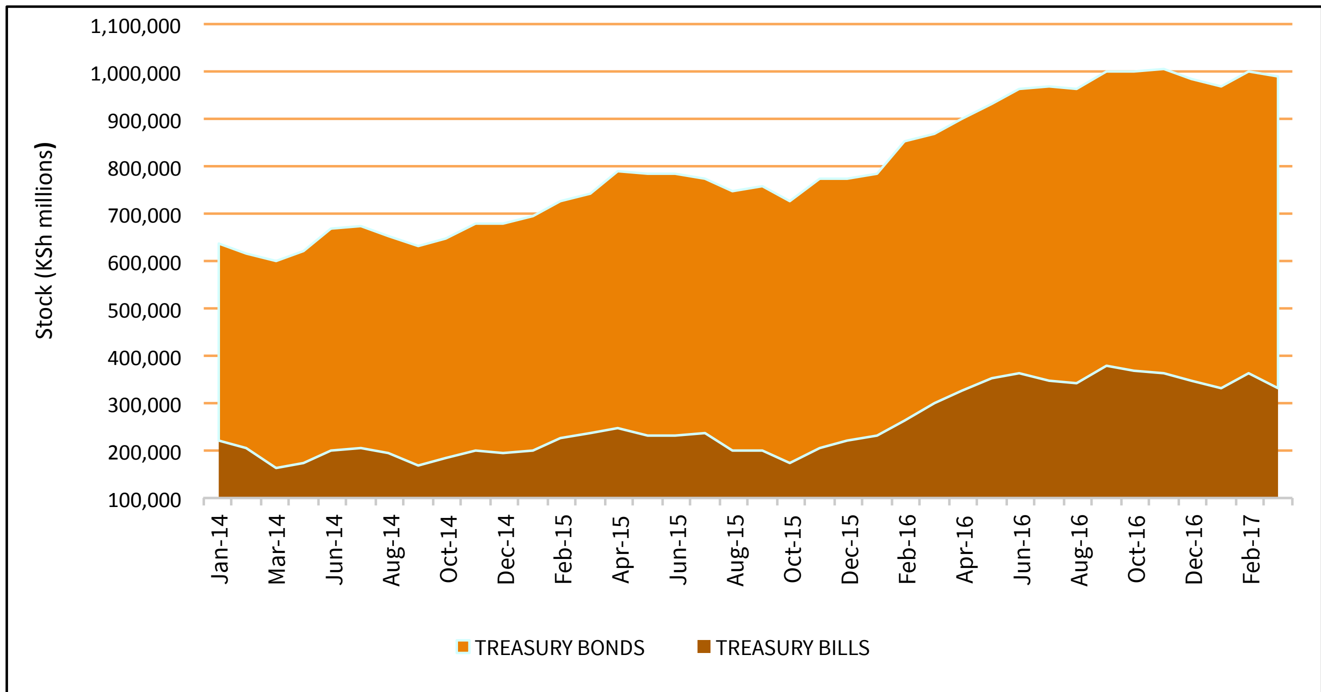
Source: Central Bank of Kenya

The growth rate of Credit to Private Sector (PSC) declined rapidly following placement of two banks (Imperial Bank and Chase Bank) under receivership, among other factors (**figure 10**).

The slowdown in credit since mid-2015 is attributed to both supply side and demand side factors. On the supply side, banks changed their business models to limit their exposure to credit risks, and liquidity challenges. In addition, some banks faces weak corporate governance, culminating into 3 banks being placed in receivership, one of which was placed under liquidation. Placement of two banks in receivership in the third quarter of 2015 and first quarter of 2016, created jitters in the market, causing liquidity stress especially for the small tier banks, depressed lending and overall instability. The situation was compounded by interest rates capping law in the third quarter of 2016.

Banks responded to the risks by changing the composition of their balance sheets whereby they reallocated their money to purchase of government securities, considered to be risk-free. In particular, banks increased their lending to government significantly, reaching a high of KSh 950.8 billion in September 2016 before closing the first quarter of 2017 at KSh 907.8 billion. On average, the banks' holding of government securities rose to KSh 879.5 billion in 2016 compared to an average of KSh 710.6 billion in 2015. Their stock in the first quarter of 2017 averaged KSh 898.6 billion (**figure 11)**. On the liabilities side, the banks shifted their deposits into demand deposits and therefore shorten their loans maturities to less than 5 years owing to instability in the banking sector combined with interest rates capping. There was also reduced market funding for banks, both from local and external sources, perhaps highlighting elevated risks perception.

Figure 11: Holding of Government securities by banks (KSh

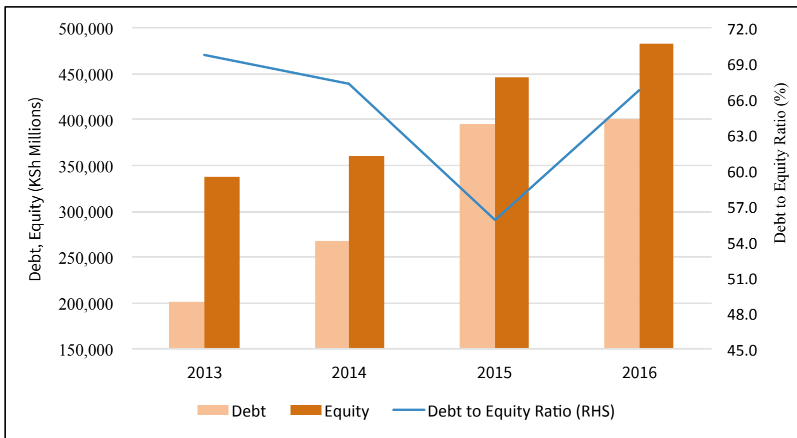


Source: Central Bank of Kenya

Overall, there has been a rapid increase in corporates leveraging their balance sheet, which seem to have constrained corporates borrowing space thus reducing the volume of credit uptake. Corporates seem to have taken up more debt as reflected in the balance sheet financing for non-financial listed companies at the Nairobi Securities Exchange (NSE). Leverage measured by debt to equity ratio has been rising since 2015 thus reducing the borrowing space of these companies1 **(figure 12).** Majority of these firms are the top large borrowers. Therefore, corporate sector weaknesses across a majority of economic sectors largely restricted their ability to borrow and expand the asset side of banks.

[1] *Bamburi Cement, ARM Cement, KenGen, KPLC, EABL, Kenol Kobil, KQ , Nation, Sasini, Scan group, Mumias, Safaricom. (NSE 20 non-financial companies).*

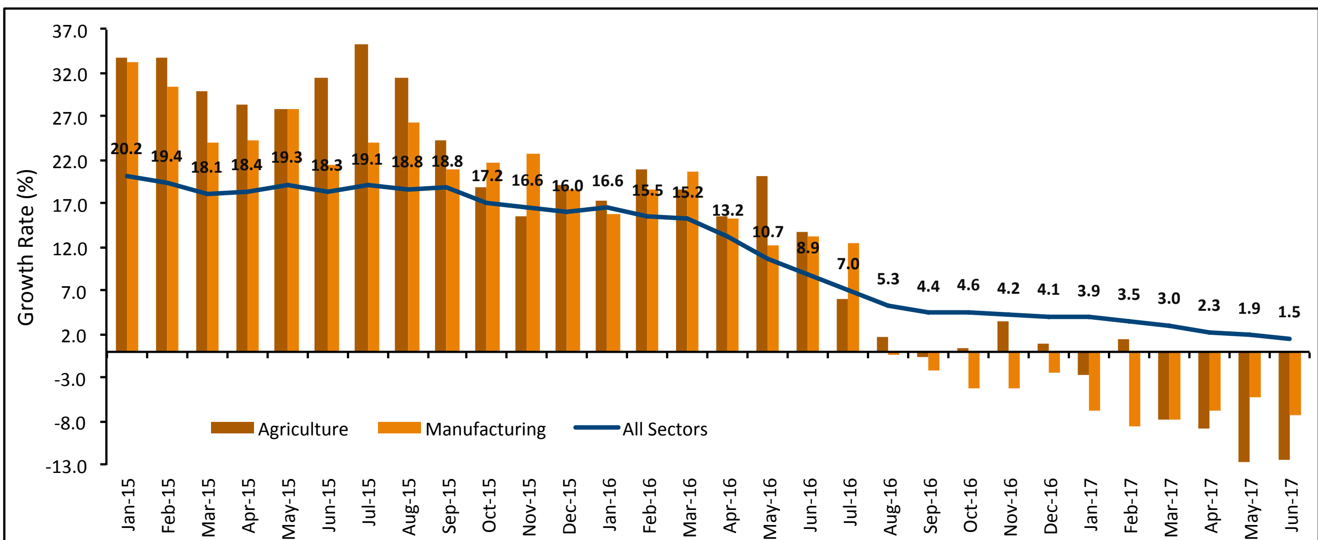
Figure 12: Leverage of the NSE-20 listed Non-Financial Companies



Source: Computed from Nairobi Securities Exchange

Growth in credit slowed down continuously, reaching 1.5 percent by June 2017. The slowdown has been recorded across all sectors of the economy. Some sectors however recorded faster decline, specifically agriculture and manufacturing, which had net repayments **(figure 13).**

Figure 13: Annual Credit Growth Rate for Select Economic Sectors (%)

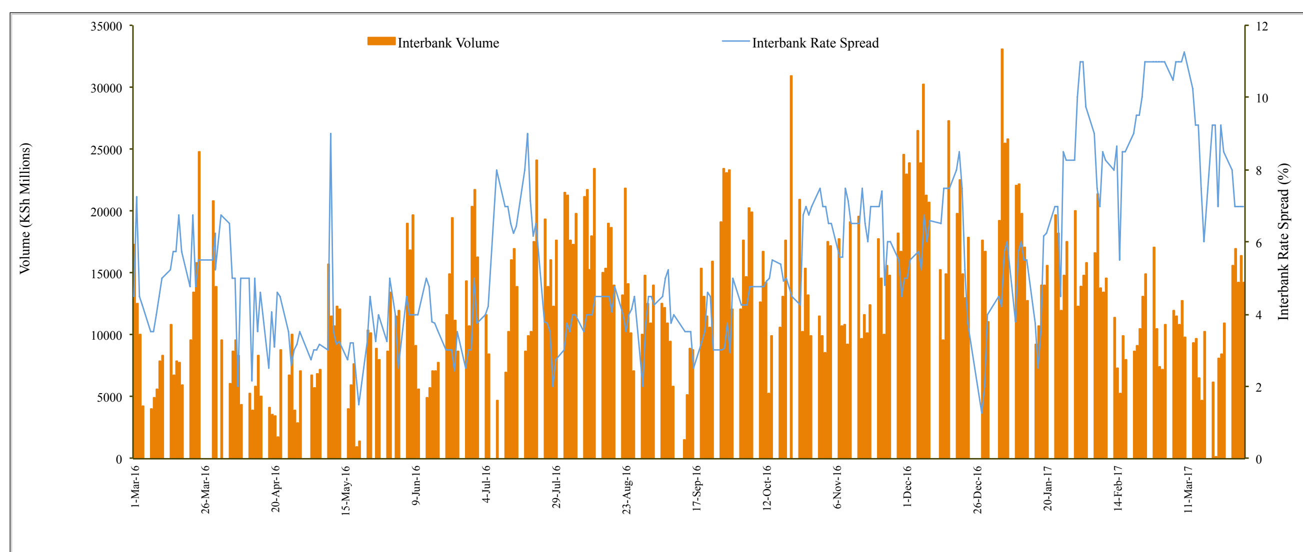


Source: Central Bank of Kenya

Other sectors that have recorded significant decline in credit uptake leading to a net repayments in the recent past include mining and quarrying, building and construction, business services and other services. There are signs of the trend bottoming out, with upticks recorded in trade, transport and communications, real estate, private households and consumer durables sectors. This should however be supported by slowdown in lending to government, which currently offer better returns given the risk-free perception.

Liquidity in the interbank market was on average adequate throughout 2016 and first quarter of 2017, **(figure 14).** Central bank window played an important stabilizing role in the market, creating confidence and improved liquidity distribution, especially for small tiered banks.

Figure 14: Interbank volume and interbank rate spread



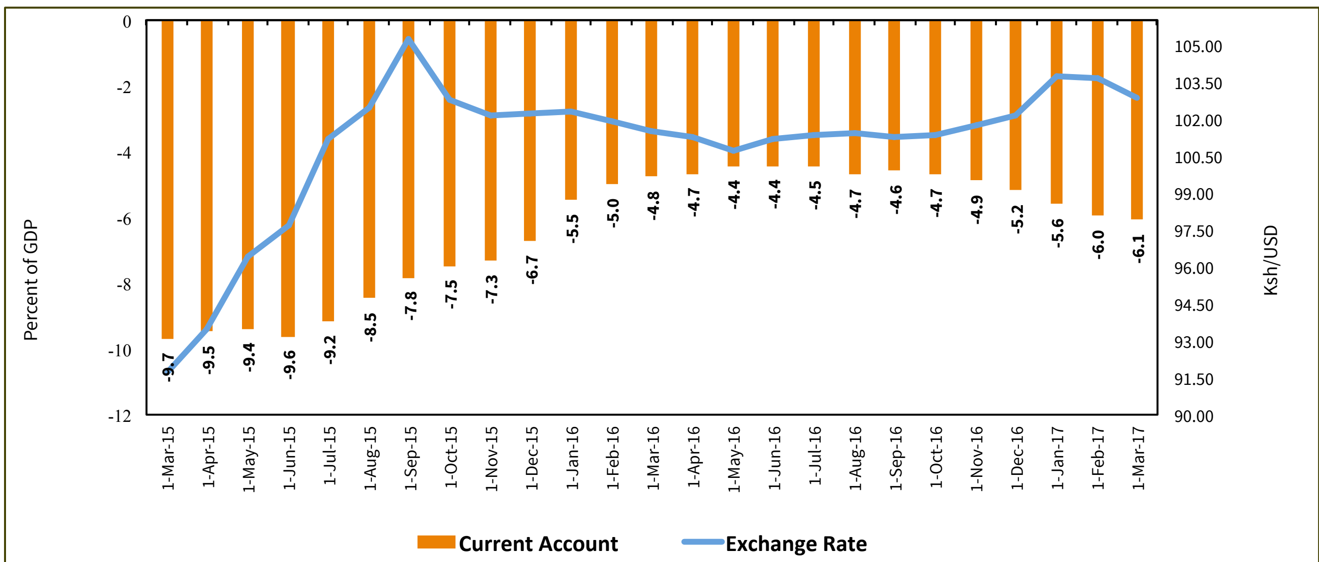
Source: Central Bank of Kenya

1.1.2. Inflation, Exchange Rate and Current Account Balance

The Kenya Shilling was generally stable against the USD since the third quarter of 2015, despite a slight depreciation from the second quarter of 2016. In the fourth quarter of 2016, the Kenya Shilling appreciated steeply against the Pound Sterling, the Euro and the Japanese Yen. In the EAC region, Kenya Shilling strengthened in the fourth quarter of 2016 against the Uganda Shilling and the Rwanda and Burundi Francs, but weakened slightly against Tanzania Shilling. Stability of the Kenya Shilling against the USD between the third quarter of 2015 and fourth quarter of 2016 was due to a narrower Current Account Balance (CAB) of below 5.2 percent, supported by diaspora remittances.

The current account deficit however worsened to 6.1 percent of real GDP in the year to March 2017, compared to 4.8 percent of real GDP in the year to March 2016. This could be explained by transitory demand pressure arising from high import bill occasioned by food, oil and transport and office equipment as well as wagons and locomotives related to the Standard Gauge Railway (SGR) project phase 1. Importation of Cereals and Sugar were meant to mitigate the effects of prolonged drought that begun in late 2016 spilling over into 2017. This led to slight depreciation of exchange rate towards the end of the first quarter of 2017 (**Figure 15**).

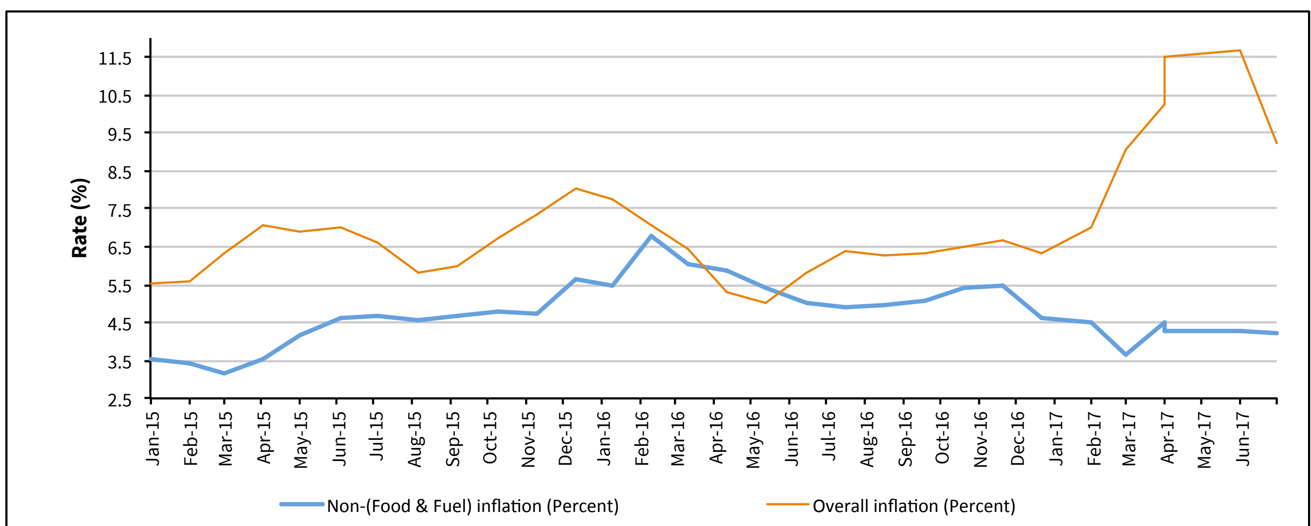
Figure 15: Current Account Balance (Year-on-Year Change) and KSh-USD



Source: Central Bank of Kenya

Overall inflation eased to 5 percent in the first quarter of 2016 from 8 percent the fourth quarter 2015, on lower prices of transport, housing and utilities, and communication on account of lower international oil prices. However, overall inflation rose in the first quarter of 2017 due to drought in many parts of the country from late 2016 to the first quarter of 2017 (**Figure 16).**

Figure 16: Average Annual overall Inflation and Non-food Nonfuel inflation



Source: Central Bank of Kenya

1.1.3. Public Debt and Domestic Debt Markets

Kenya's public debt has risen in recent years, growing by 19.3 percent in the year to December 2016, but remains sustainable in the medium term. The increase is explained by 25.4 percent growth in domestic debt and 13.5 percent increase in external debt, **Table 1**. Average composition of debt ended the year to March 2017 at 52 percent in favour of external debt and 48 percent for domestic debt. Most of the new debt targets infrastructure financing, including the Standard Gauge Railway and roads. The bulk of Kenya's external public debt carries concessional terms, but recent commercial borrowing entails significant repayment needs in 2017 (2015 syndicated loan), in 2019 and, especially in 2024 (2014 sovereign bond issuance). Implementation of the proposed reduction in the fiscal deficit over the medium term is essential to limit and eventually reverse the rise in public debt ratios. In addition, the composition of fiscal financing between domestic and foreign sources should seek to contain risks of public external debt from export shocks while avoiding a crowding out of domestic bank credit to the private sector.

Kenya's public debt is within sustainable levels over the medium term and well within the 50 per cent limit of GDP in Net Present Value (NPV) terms in line with Public Finance Management Act (PFMA) regulations and the requirements of the East Africa Community (EAC) convergence criteria. Kenya's risk of external debt distress remains low, while overall public sector debt dynamics continue to be sustainable. However, standardized stress tests signal rising vulnerabilities of debt to exports shocks.

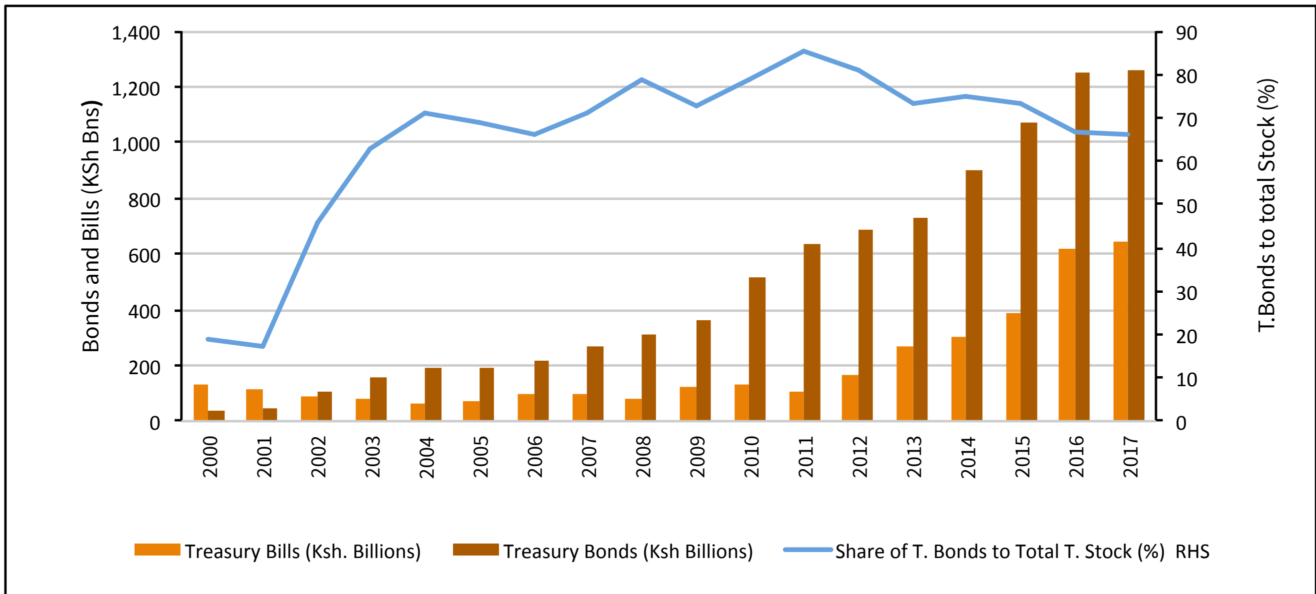
Table 1: Kenya's Public Debt Stock in KSh Billions

DEBT TYPE/QUARTER	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17
EXTERNAL	1,615.18	1,665.58	1,803.20	1,838.42	1,832.45	2,101.39
Share of Total (%)	**51.19**	**50.29**	**49.84**	**49.78**	**48.69**	**51.93**
DOMESTIC	1,540.02	1,646.53	1,815.13	1,854.55	1,930.98	1,944.95
Share of Total (%)	48.81	49.71	50.16	50.22	51.31	48.07
GRAND TOTAL	**3,155.20**	**3,312.11**	**3,618.34**	**3,692.97**	**3,763.43**	**4,046.35**

Source: Central Bank and The National Treasury

Overall, domestic debt is less exposed to rollover risks given that by end of March 2017, Treasury bonds (long term) accounted for 66.24 percent of outstanding debt, while Treasury bills accounted for 33.7 percent, but lower than ratio of 73:27 treasury bonds to bills recorded in 2015.

Figure 17: Stock and Composition of Government Securities, 2000 - March 2017



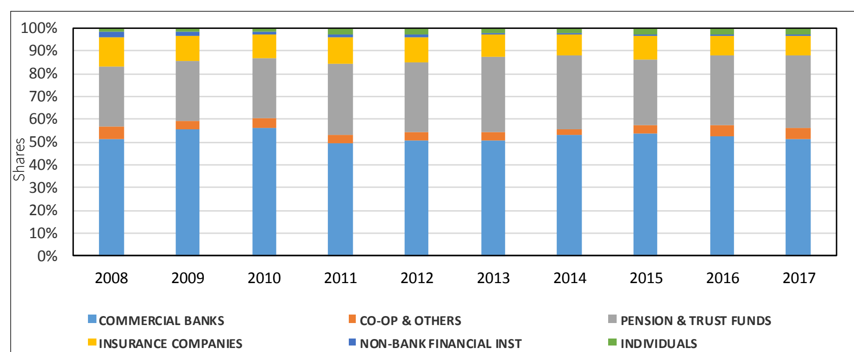
Source: Central Bank of Kenya

The decline in the ratio of long term debt is explained by issuance of more short term securities to minimize the cost of domestic following increase in interest rates recorded in late 2016 and early 2017 **(figure 17).** Interest rates rose sharply on liquidity concerns following interest rates capping law and seasonal factors. The issuance strategy was however consistent with the Government's Medium Term Debt Strategy (MTDS) that targets to raise adequate funds taking into account the cost-risk objectives.

1.1.4. Holders of Government Securities

Commercial banks remained the largest holders of Government securities, accounting for 55.41 percent of all stock of Government securities as at March 2017. Pensions sector reduced their share, perhaps reflecting lower uptake of short term securities, mostly issued in the second half of 2016 to minimize interest rates risk. Cooperatives and Others have increased their share in 2016 and 2017 **(Figure 18).**

Figure 18: Holders of Government Securities, 2008 - March 2017

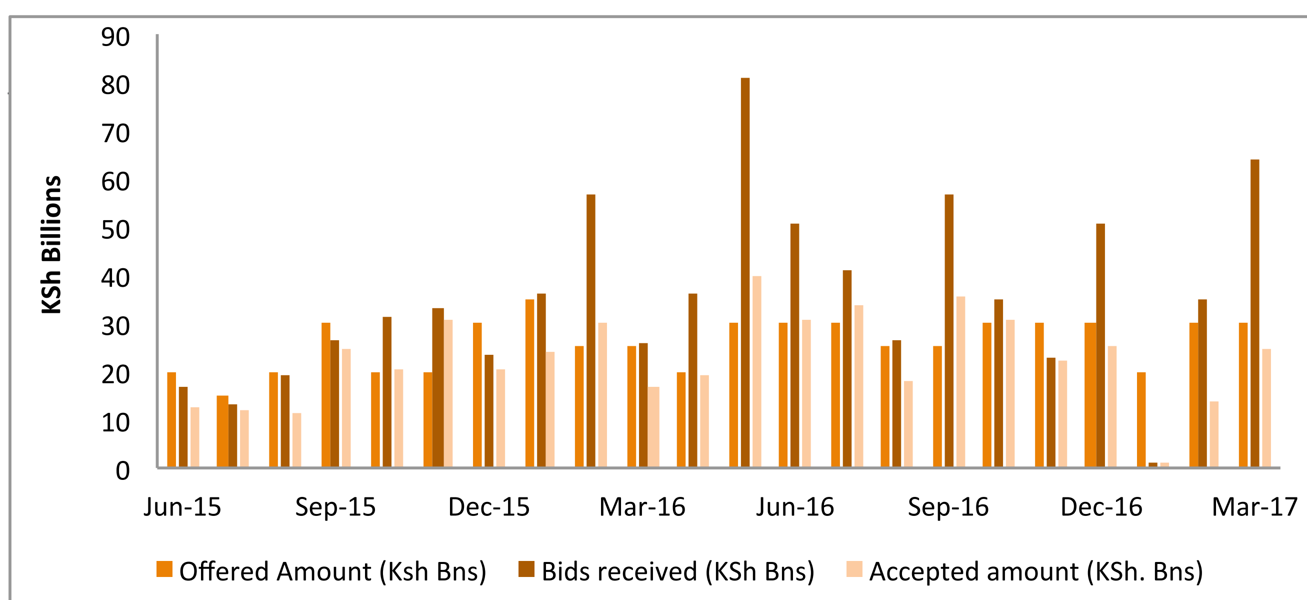


Source: Central Bank of Kenya

1.1.5. Primary and Secondary Markets Activity

The subscription rate for the twelve Treasury bond auctions held in 2016 averaged 155 percent, compared to 130 percent in 2015 (**figure 19**). A total of bids worth KSh 519.28 billion were received against a target of KSh 335 billion. This ensured that the Government achieved its borrowing objectives of budgetary financing and domestic debt market development.

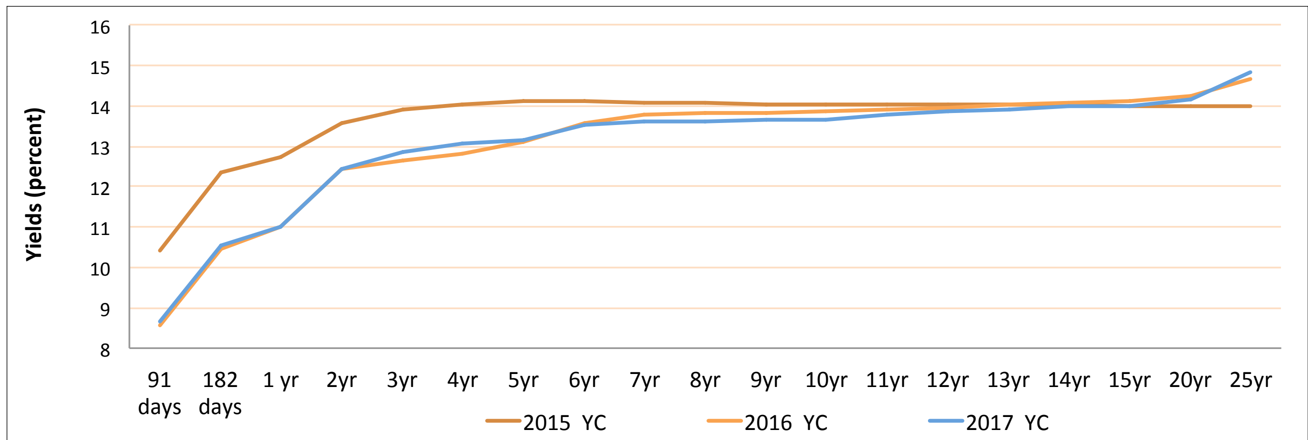
Figure 19: Treasury Bonds Primary Market Performance 2012-2017



Source: Central Bank of Kenya, Financial Markets database

performance in the primary market saw the volume of bonds traded increase by 41.72 percent, from KSh 305.10 billion in 2015 to KSh 432.38 billion in 2016. However, the volume of bonds traded was 14.56 percent lower than that in 2014. Between 2016 and 2017, the yield curve shifted upwards, reflecting tight liquidity conditions and an overall increase in long-term yields **(figure 20).**

Figure 20: Position and Shape of the Yield Curve, 2015 – 2017



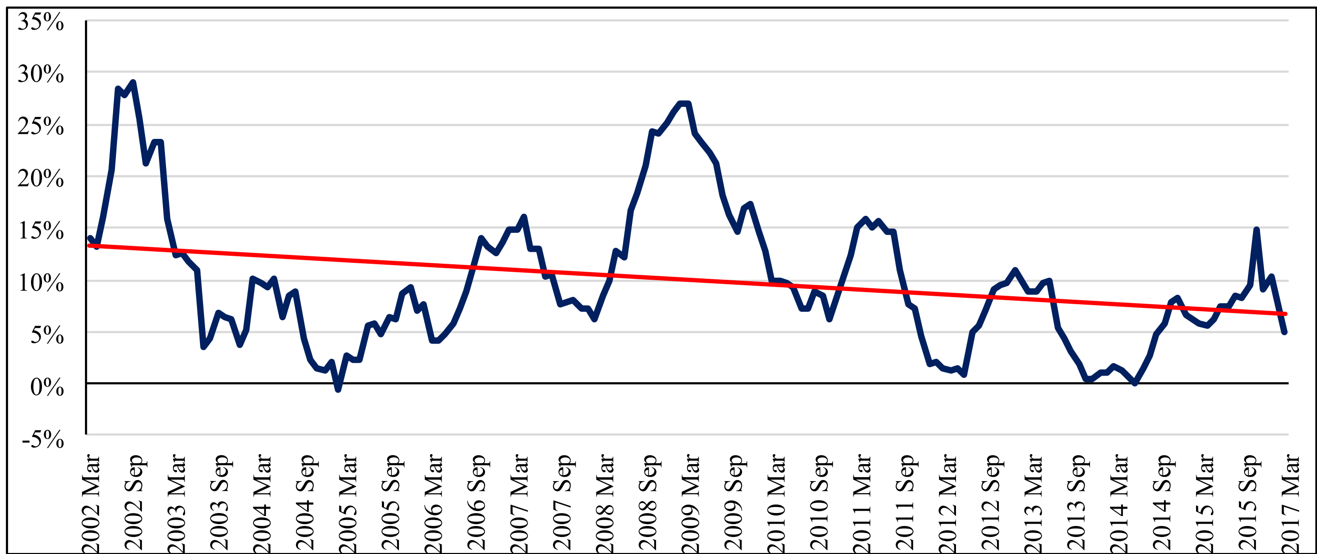
Source: Central Bank of Kenya

1.1.6. Developments in the Real Estate Market

The private sector plays a critical role in real estate sector development in Kenya. It accounted for the largest share of investment in both residential and commercial developments. The value of private sector investment in real estate in Nairobi grew by 74.97 percent between 2015 and 2016, pushing the real estate sector to account for 9.6 percent of real GDP in the first quarter of 2017, an increase from an average of about 5 percent between 2010 and 2014. This was however a decrease from 9.68 percent in the fourth quarter of 2016.

The leading real estate indices and reports by Hass Consult, Cytonn Investment, Kenya Bankers' Association (KBA), Knight Frank and the World Bank show a slowdown in the growth rate of property market prices (figure 21). The Hass Consult All Types Property Index and the KBA Housing Price Index (KBA–HPI) show that property prices remained positive albeit declining, despite low units sold in the market. House prices increased by about 1.1 percent in the first quarter of 2017, compared to 1.6 percent in the fourth quarter of 2016, reflecting to low demand for housing and commercial office space.

Figure 21: Hass Consult Annual Changes Sales Price Index, 2002 (Q1)-2017 (Q1)



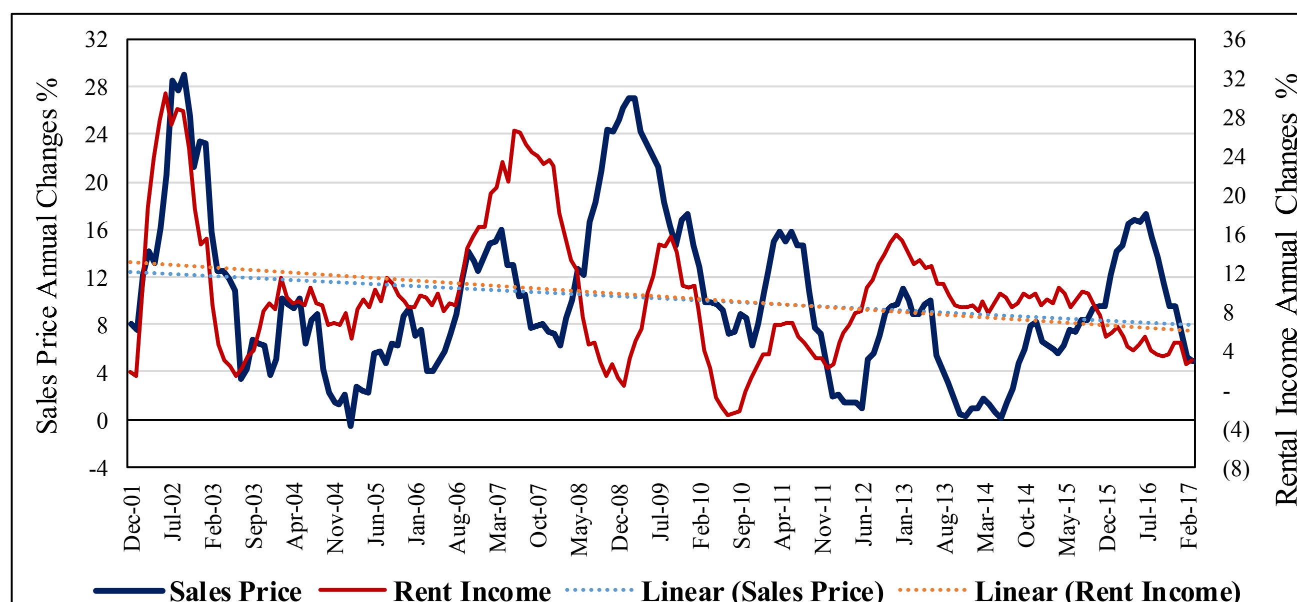
Source: Staff Calculations from Hass Consult data

The cooling off in effective demand for real estate properties is also captured in the rate of growth rates of asking price and rental income per month in Nairobi and its satellite towns. From 2011 the rate of growth of rental income was higher than the rate of growth of property sales asking price. However, correction seem to have occurred from July 2016, reflecting depressed rental income market that may be attributed to oversupply of property (**figure 22**). This is mainly affecting the apartments in middle to high end market and class B commercial properties market.

Annual growth of commercial bank credit to the real estate sector, averaged 11.04 percent in 2016 from 15.66 percent in 2015, but effects were muted by emerging alternative financing options. These include joint ventures with alternative financiers rather than bank credit, Private Equity and other sources (Table 2). Developers favour these sources to bank loans at initial stage of property development, due to high cost of credit, delays in loans disbursements, inefficiencies and taxation. These alternatives financiers include non-bank financial institutions, mortgage finance companies, Savings and Credit Cooperatives (Saccos), capital markets (Real Estate Investment Trusts), private equity funds, off-plan purchases, and private sources.

Saccos have remained crucial in funding purchase of land and construction of residential houses for their members in urban areas. Majority of Saccos have established investment units, mostly dedicated to real estate development. Local institutional funds like National Social Security Fund (NSSF), Insurance companies (Old Mutual Towers), and Pension Funds, have also invested substantial amounts in real estate, without resorting to bank loans.

Figure 22: Property Sales Price and Rental Income annual Growth Rate (%)



Source: Staff Calculations from Hass Consult data

There has been also increased inflow of foreign funds through Private Equity Funds, Pension Funds and other Institutional investors. Examples of the known alternative financing reported recently include; Actis that concluded the Actis Africa Real Estate Fund 3 (AAREF3) with commitments totaling US$500 million, China Africa Development Fund (CADFund) and Government of Kenya entered into an agreement to develop Ngara City, Dubai-based investors - Hass Petroleum and White Lotus signed a KSh 22 billion deal with China State Construction Engineering Corporation to build the Pinnacle Towers, a 67-storey (300 metres) tower in Nairobi, and Cytonn Investments Limited has about KSh 75 billion projects funded through Private Equity funds, debt, mezzanine and Off-Plan options. In addition, capital markets facilitated raising of capital through rollout of Kenya Real Estate Investment Trusts (REITS) issued by Fusion Capital in 2015 and 2016.

Table 2: Funding Options in Real Estate (KSh Billions)

Year	Insurance	Pension	Private Equity	TOTAL	Bank Credit
2010	-	80.01	-	**80.01**	78.93
2011	-	87.80	-	**87.80**	111.63
2012	-	101.60	-	**101.60**	130.92
2013	-	119.84	0.12	**119.96**	162.33
2014	61.24	130.39	0.32	**191.95**	218.68
2015	66.97	150.78	18.72	**236.47**	262.48
2016	71.19	178.42	95.94	**345.55**	284.09

Source: compiled by CBK team from various reports of Real Estate Firms

The real estate market outlook for 2017 remains mixed for both rental and sale markets, on account of August 2017 elections, interest rates capping law and subdued demand side. There are no foreseeable property bubble due to large housing deficit, especially in low income segment of the population (supply-side) and tight lending conditions (demand side).

Chapter 2: Vulnerabilities and Risks Assessment in the Financial System

2.0. Overview of Financial system

Kenya's financial system is multi-regulated and comprises of Banking, Insurance, Pensions, Financial Markets Infrastructure, Capital Markets and pensions industry. Banking industry is the largest, with about 60 percent of total assets excluding market capitalization. The system has grown significantly, becoming more complex and highly integrated. It has developed more cross-sector linkages and cross-border operations. Interactions in the system are therefore potential sources of risks spillovers. So far, the financial system remains stable and robust, albeit instances of vulnerabilities that have been managed well through enhanced supervision, improved regulatory frameworks, and better coordination in policy making and implementation.

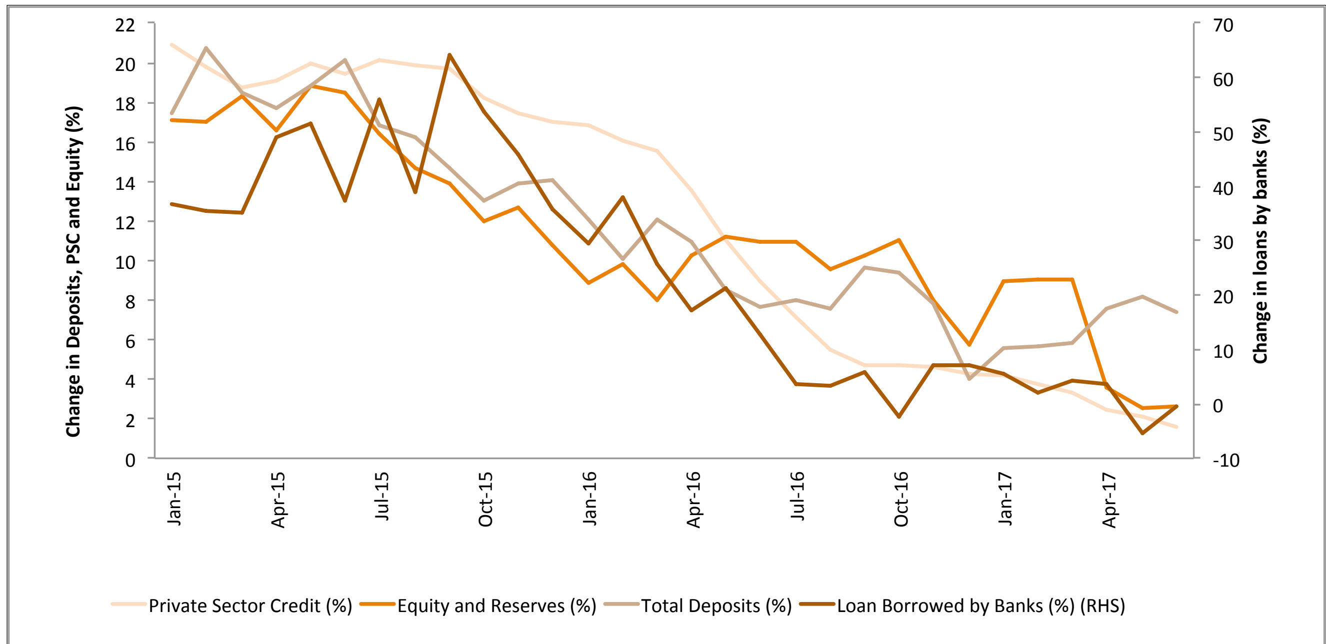
2.1. The Banking Industry

The banking industry comprised 42 banks, one mortgage finance company, 13 microfinance banks, and 8 representative offices of foreign banks. In addition, the CBK has oversight for 76 foreign exchange bureaus, 17 money remittance providers and three credit reference bureaus. The industry remains resilient, despite recent episodes of instability that culminated into three (3) banks being placed in receivership, one of which was placed in liquidation.

Overall, the industry has faced three main risks that contributed to gradual contraction of the key components of banks' balance sheet (figure 15). These risks were; elevated credit risk, liquidity risks (particularly market funding) and declining profitability. Some of these risks are uniform across all the banks, but others were more specific to the lower tiered banks. Credit risks and reducing profitability cuts across the industry, but liquidity risk has eased and was concentrated in tier III banks. Falling profitability and/or extended losses inhibits banks' ability to build up sufficient reserves and capital buffers through retained earnings.

Supply side constraints in the banking industry as reflected in contraction of banks' balance sheet seem to largely explain the slowdown in lending to the decline in credit to the private sector. Key sources of banking sub-sector assets funding base comprise of deposits, borrowed funds and shareholders' funds. Total capital comprising of shareholders equity, shareholders' loans and reserves form a critical buffer against assets deterioration. The continued decline in the funding base of banks since 2015 appear to have constrained the lending ability of banks resulting in overall decline of credit to the private sector. Borrowed funds from both local and foreign banks and other non-bank lenders including Private Equity Funds form a critical components of funding banks assets. This source also declined significantly in the period under review; thus limiting the banks' ability to intermediate deposits and expand credit to potential borrowers. Continued decline in total equity signals erosion of buffers; making banks to cut down their risk exposures and appetite by limiting lending **(Figure 23).**

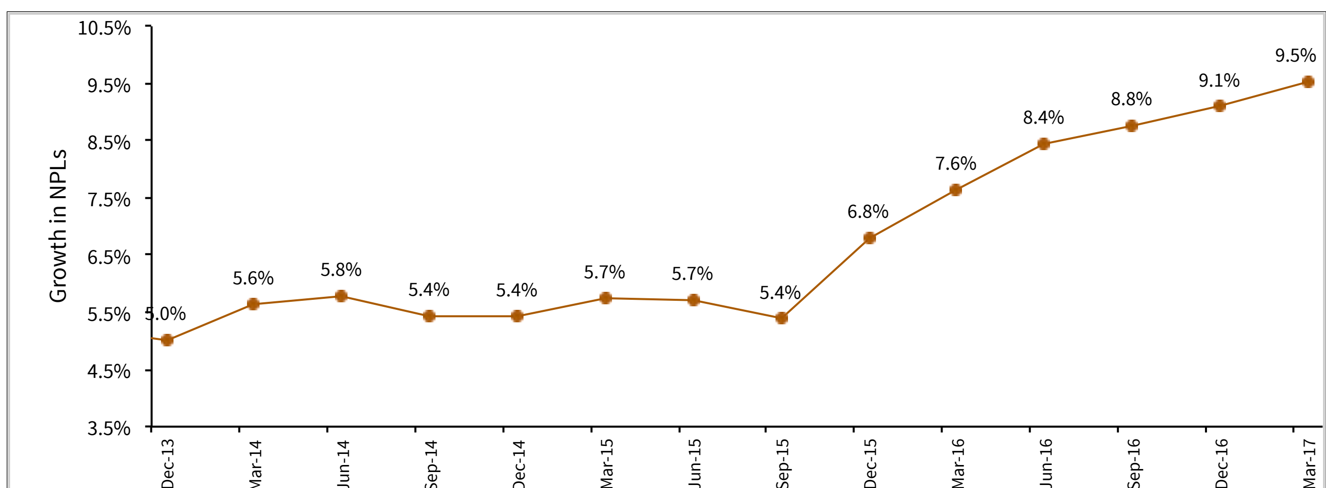
Figure 23: Annual Changes in Key Components of Banks Balance Sheet



Source: Central Bank of Kenya

On the Asset side of the balance sheet, the period under review saw deterioration in banking sector assets quality, reflected in rapid growth in gross non-performing loans. Indeed Credit survey of March 2017 show that credit risk was the single largest factor affecting the soundness of financial institutions and the financial system as a whole. The ratio of gross non-performing loans (NPLs) to gross loans, from 8.3 percent in March 2016 to 9.5 percent in March 2017 (**figure 24**). The significant increase in NPLs could be attributed to a number of factors.

Figure 24: Non Performing Loan (NPL) Ratio Trend, March 2010 - March 2017



Source: Central Bank of Kenya

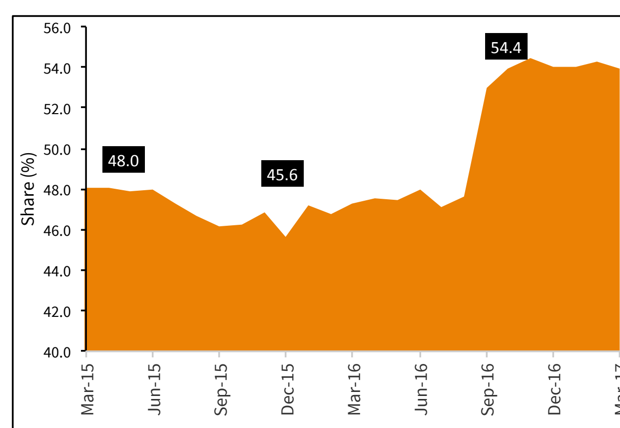
First, following the placement of two banks in receivership in 2015 and one bank in 2016, the regulator enhanced regulatory and supervisory compliance measures under the 'new normal' that strengthened reporting, transparency and governance. This prompted banks to not only start reporting their financial positions correctly, but also provisioning for non-performing loans correctly, hence increased NPLs. The second issue arises from the delayed remittances by employers, slow uptake of housing units following real estate market slump and delayed payments to contractors by government agencies. This led to trade, personal/household, real estate, manufacturing, and building and construction sectors account for the majority of NPLs, with 82.3 percent of gross NPLs. The trade sector recorded the greatest increase in NPLs in 2016, perhaps reflecting the challenges facing Small and Medium Enterprises (SMEs) and commercial and retail sectors. Many companies, including the listed ones faced cash flow problems due to low business environment, making it difficult to service their loans.

As a copping mechanism, banks changed the composition of their balance sheets in response to the elevated credit risks by increasing their purchases of government securities, considered as risk-free and liquid assets and reducing lending. In particular, banks' lending to government peaked at KSh 950.8 billion in September 2016 before closing the first quarter of 2017 at KSh 907.8 billion. On average, banks increased their holding of government debt to KSh 879.5 billion in 2016 compared to KSh 710.6 billion in 2015. Holdings in the first quarter of 2017 was KSh 898.6 billion. Net loans and advances grew by 5.4 percent compared to 13.69 percent growth in Government securities in the year to March 2017.

The liabilities side of banks was also affected during the period under review in response to shocks in the sector. Overall, customer deposits increased by 7.1 percent to KSh 2,741.2 billion in the year to March 2017 from KSh 2,559.8 billion in the year to March 2016, driven by agency banking and mobile phones. The distribution was however in favour of the top tier banks and maturity structure was short term or demand deposits to avoid high interest cost after the interest rates capping law. This explains the reduced average loan maturity to below 5 years.

The recovery in total deposits in the first half of 2017 was not accompanied by commensurate impact on private sector credit (PSC); partly because a large proportion of total deposits are demand deposits, usually not considered suitable to fund long term assets. Banks increased the share of demand deposits to total deposits from an average of 46.4 percent in September 2015 to July 2016 to average 53.7 percent over the period August 2016 to June 2017 (**figure 25**). This limits the banks' ability to expand lending, hence the slowdown in private sector credit in the period under review.

Figure 25: Share of Demand Deposits in Total Deposits (%)



Source: Central Bank of Kenya

The industry remains well capitalized, with capital adequacy ratios above the required regulatory ratios. The Total Capital to Total Risk Weighted Assets ratio was 19.4 percent in March 2017, above the minimum of 14.5 percent. Similarly, the ratio of Core Capital to Total Risk Weighted Assets was 16.6 percent as at March 2017, against the 10.5 percent minimum. The Core Capital to Total Deposits ratio was 19.2 percent by end March 2017 against a minimum requirement of 8 percent. These strong ratios signal the robustness of the sector and ability to absorb shocks. New capital injections following increased consolidation through mergers and acquisitions and increased retained earnings among the medium and top tier banks also explains these robust capital adequacy levels.

A total of seven banks have been or are in the process of being acquired or merged with others in the past four years, four of which were announced in 2016 and 2017. This signals a shift to a strong banking sector, well-capitalized competitive and liquid (**Table 3**). Consolidation may increase as banks seek to shore up capital, re-engineer their business and develop systems to absorb adverse shocks.

Table 3: Banks Mergers and Acquisitions

	Acquirer	Bank Acquired	Announcement Date
1.	Diamond Trust Bank-Kenya	Habib Bank Ltd.	Mar-17
2.	SBM Holdings (Mauritius Firm)	Fidelity Commercial Bank	Nov-16
3.	M Bank	Oriental Commercial Bank	June-16
4.	I&M Holdings	Giro Commercial Bank	June-16
5.	Mwalimu SACCO	Equatorial Commercial Bank	Mar-15
6.	Centum	K-Rep Bank	Jul-14
7.	GT Bank	Fina Bank Group	Nov-13

Source: Central Bank of Kenya

Liquidity is one of the important financial stability indicators in the banking sector. A liquidity problem in one bank can quickly evolve into a systemic crisis whether there is direct or indirect interconnectedness. Liquidity held by a bank signifies its ability to fund increases in assets and meet obligations as they fall due. As of March 2017, average liquidity was 43.8 percent against a minimum ratio of 20 percent. Liquid assets include all tradable government bonds and treasury bills. The role of central bank was very important in ensuring timely and adequate liquidity distribution among all banks in the first half of 2016 following instability witnessed in the last quarter of 2015 and first quarter of 2016.

With the net foreign exchange exposure position to Core Capital ratio of 3.5 percent in March 2017, against maximum statutory requirement of 10 percent, there no foreign exchange risks to the banking industry balance sheet despite the fact this was lower than 2.9 percent average in the year to March 2016. Banks therefore maintained optimum mix of local and foreign currency denominated assets and liabilities, thus limiting exposure to foreign exchange exposure. The slight decline is explained by a 1.7 percent decrease in foreign currency loans as compared to 8.3 percent increase in net local currency loans. But foreign currency deposits to total deposits ratio increased to 18.1 percent in March 2017 from 17.9 percent in March 2016, following faster increase in foreign currency deposits compared to the rate of growth of local currency deposits.

Another important indicator this report focused on was profitability of the banking industry in the year to December 2016 and in the year to March 2017. Profitability is core to the viability of a bank or any institution as it affects growth of the institution in terms of valuation and further build-up of capital and reserves through retained earnings. A bank that consistently makes losses over an extended period of time is likely to require external capital injection and even change its business model in order to remain viable going forward. The report has analyzed profits before tax, return on assets (ROA) and return on equity (ROE) for all banks at aggregate level, and also for the top five (5) banks and bottom (5) banks.

Profitability of the banking sector was hard hit in the year to March 2017 compared to performance in the year to December 2016, perhaps a reflection of the effects of interest rates capping law and elevated credit risks, table 4. At industry level, aggregate profits before tax rose by 10.9 percent in the year to December 2016, with ROA and ROE closing the year 2016, at 4 percent and 24.7 percent better than 3.7 percent and 24.1 percent in 2015 respectively. This performance was however not uniform across the industry. While the top five (5) banks recorded a 14.25 percent growth in profits in 2016 compared to 2015, the bottom five (5) banks recorded higher losses of 8.8 percent, with similar trends noted in both ROA and ROE.

Table 4: Annual Profitability of the Banking Industry

Profits Before Tax (Ksh. 000)						
	Dec-15	Dec-16	Change (%)	Mar-16	Mar-17	Change (%)
Industry	132,915,108	147,445,451	10.93%	38,913,631	34,375,294	-11.66%
Top five (5) banks	80,953,490	92,488,150	14.25%	24,147,248	21,733,257	-10.00%
Bottom five (5) banks	(5,180,019)	(4,724,999)	-8.78%	(357,851)	(644,619)	80.14%
Return on Asset (%)						
	Dec-15	Dec-16	Change (pps)	Mar-16	Mar-17	Change (pps)
Industry	3.66	3.99	0.33	4.39	3.63	(0.76)
Top five (5) banks	4.99	5.30	0.32	5.84	4.76	(1.07)
Bottom five (5) banks	(1.44)	(4.93)	(3.49)	(1.21)	(1.57)	(0.36)
Return on Equity (%)						
	Dec-15	Dec-16	Change (pps)	Mar-16	Mar-17	Change (pps)
Industry	24.09	24.68	0.58	28.43	22.83	(5.60)
Top five (5) banks	31.34	33.11	1.76	37.41	30.49	(6.92)
Bottom five (5) banks	(15.38)	(30.86)	(15.48)	(8.76)	(9.01)	(0.25)

Source: Central Bank of Kenya

In the year to March 2017, the interest rates capping law and elevated credit risks may have affected profitability of the banking industry. At aggregate level, the industry profits before tax declined by 11.7 percent with ROA and ROE closing March 2017 at 3.6 percent and 22.8 percent respectively. While the top five banks were affected, the losses in the bottom five banks increased significantly, by 80.1 percent in the year to March 2017 compared to the year to March 2016. This raises concerns about business models and business environment for this group of banks. It is however assumed that they are not systemic and therefore poses no risks to the entire industry.

The banking industry looks resilient in 2017, despite elevated credit risk. This positive outlook is hinged on expectation of improved corporate sector balance sheet, continued business models reengineering, better liquidity management, improved corporate governance, and robust regulatory framework.

2.2. Capital Markets Performance and Risks

The capital markets subsector membership and products largely remained unchanged by March 2017 compared to composition reflected in the 2015 FSR. The only new development was the launch of Barclays NewGold Exchange Traded Funds (ETFs) in March 2017. This is a security, whose underlying asset is cold and offers investors indirect access to the gold market in Kenyan currency. It is originally listed in South Africa as 400,000 gold bullion debentures on the Nairobi Securities Exchange (NSE). Kenya is the seventh market within the Barclays Africa Group to launch this product which is valued at USD 1.4 billion, making it the largest Gold ETF in Africa and the seventh globally.

The capital markets remained resilient despite the liquidity squeeze. This was characterized by inactive corporate debt segment where only one corporate bond was issued, absence of new Initial Public Offerings (IPOs), high concentration risk, and reduced profitability among listed firms leading to fewer companies declaring dividends in 2016 compared to 2015. The leading equities market indicators - equity turnover, volume of shares traded, NSE 20 Share Index, Nairobi All Share Index and Market Capitalization, closed lower in 2016 compared to 2015 (**table 5**). Companies could also not raise capital either through debt or equities listing, thus limiting growth and expansion of corporate sector. The decline in profitability of listed firms not only denies the companies' liquidity to reinvest and expand, but also reduces share premia and valuation, which impacts on their ability to borrow or attract capital injection for growth.

Table 5: Equity Market Performance

Month/Year	Equity Turnover (KSh Billions)	Share Volume (Millions)	NSE 20 Share Index (Points)	NASI Share Index (Points)	Market Capitalization (KSh Billions)
April-2016	10.07	426.65	4,009.26	146.93	2,054.73
May-2016	9.72	384.80	3,867.50	145.54	1,996.65
June-2016	17.25	601.40	3,640.61	140.60	1,998.75
July-2016	13.61	543.56	3,488.67	142.40	2,052.13
Aug-2016	17.66	708.07	3,178.83	134.90	1,945.21
Sept-2016	16.87	746.89	3,243.21	136.80	1,971.83
Oct-2016	7.85	351.71	3,251.46	141.50	1,987.65
Nov-2016	10.44	461.71	3,247.19	136.61	1,979.26
Dec-2016	7.11	289.00	3,186.21	133.34	1,961.92
Jan -2017	13.00	422.74	2,794.27	122.23	1,770.30
Feb-2017	10.16	341.03	2,962.00	124.89	1,810.39
Mar-2017	13.45	535.92	3,112.52	130.50	1,894.34
Total (Apr 2016-Mar 2017)	**147.19**	**5,813.48**	**3,112.52**	**130.50**	**1,894.34**
Total (Apr 2015-Mar 2016)	**199.65**	**6,490.12**	**3,982.09**	**147.44**	**2,078.28**
% Change	-26.28%	-10.43%	-21.84%	-11.49%	-8.85%

Source: Nairobi Securities Exchange, 2017

The low market activity saw the market intermediaries, which rely on transactions and advisory fees and commissions realize reduced profits and/or even turn into losses. In particular, the NSE, fund managers, investment banks and brokers recorded huge losses in 2016 compared to their performance in 2015 (**Table 6**).

Table 6: Performance of Capital Market Licensees as at Dec. 2015/16 in KSh Millions

Name	Year	Total Assets	Total Liabilities	Net Assets	Total Income*	Profit Before Tax	Net Profit/ Loss After Tax
Fund Managers**	2016	5,243.3	2,957.9	2,285.4	4,449.8	(323.3)	(189.4)
	2015	*4,875.7*	*1,940.6*	*2,935.1*	*4,420.8*	*1,368.2*	*935.0*
Investment Banks	2016	9,122.4	2,053.2	7,069.2	1,972.7	35.9	(26.0)
	2015	*10,133.6*	*3,317.1*	*6,816.5*	*1,178.8*	*634.7*	*419.2*
Stock Brokers	2016	4,170.4	1,416.8	2,753.7	641.2	(235.9)	(249.1)
	2015	*8,386.2*	*2,595.8*	*5,790.4*	*1,402.8*	*222.6*	*172.0*
Industry Total	(2016)	19,949.4	7,804.9	12,864.4	7,556.9	(285.5)	(345.3)

**excludes unrealized gains; **Fund manager assets are own Assets;*

Source: CMA, 2016

The market also increased concentration risk during the period under review. As at March 2017, the capital market had high market concentration exposure where top five (5) listed and actively trading stocks by market capitalization out of the total 64, accounted 64.23 percent of market capitalization. Of this, Safaricom accounted for 38.07 percent of the total market capitalization, an increase from 32.58 percent as at March 2016. This is a major risk to the market in terms of liquidity and even stability in the event of shocks to such companies. The main mitigating measure is increased menu of products that assure investors of good yield and safety.

On the positive side however, the market recorded lower volatility, bullish government bonds market segment and robust foreign investors' participation. Capital markets remained stable with less volatility in the third quarter of 2016 and March 2017. This pocket of volatility that dissipated quickly could be attributed to banks stocks' reaction to the interest rates capping law that became effective on September 24, 2016 and half year profit announcements made in the first quarter of 2017.

Table 7: Foreign Participation Exposure (Equity) in KSh Millions

Year	Foreign purchases (FP)	Foreign sales (FS)	Net Foreign Portfolio Flow	Overall Foreign Investor participation (%)
March-2016	8,077	9,411	-1,334	65.02
April-2016	6,669	6,589	80	65.86
May-2016	6,571	6,375	196	66.59
June-2016	13,082	12,982	100	75.56
July-2016	11,186	10,212	974	78.59
Aug-2016	14,183	10,480	3,703	69.85
Sept-2016	14,669	13,326	1,343	83.18
Oct-2016	5,200	5,325	-125	67.07
Nov-2016	6,878	6,419	459	63.69
Dec-2016	5,574	4,959	615	74.10
Jan -2017	10,424	8,816	1,608	79.81
Feb – 2017	9,447	9,012	435	73.37
Mar-2017	9,550	9,605	-55	76.87
Total (Apr 2016-Mar 2017)	**113,433**	**104,100**	**9,333**	
Total (Apr 2015-Mar 2016)	**131,808**	**129,321**	**2,487**	

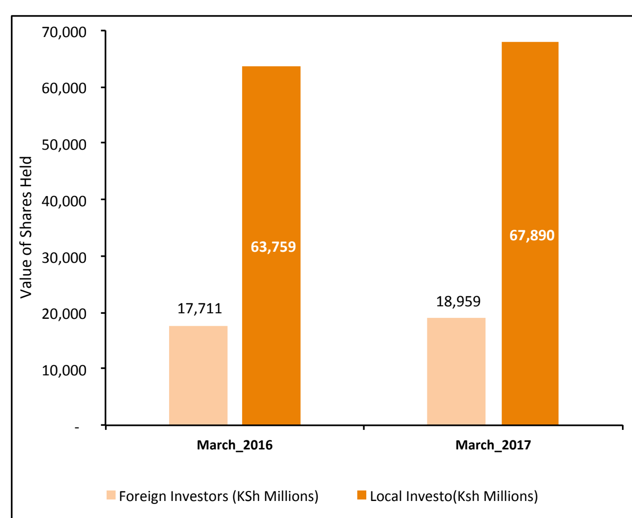
Source: Nairobi Securities Exchange, 2017

Overall, the market has remained resilient, signifying its maturity with capability to withstand shocks. Foreign investors have been active at the NSE, providing liquidity to the market. The net foreign portfolio flows to NSE improved significantly as at March 2017 compared to the year-to March 2016. The portfolio inflows rose to KSh 9.3 billion, from KSh 2.5 billion in the year to March 2016. The average foreign participation, which is average foreign participation to equity market turnover ratio, stood at 76.9 percent, compared to 65 percent in March 2016 (**Table 7**). The increased appetite could be due to profit-taking and cheap stocks given depreciated local currency and less appetite by local investors.

Normally, foreign portfolio investors can be destabilizing to the domestic market if their funds are very short term and pullout of the market very quickly. Our market has however recorded more net inflows (purchases) than out flows (sales), signaling confidence and long term investor view. As a result, actual equities held by foreign investors rose to 21.83 percent in the year to March 2017, up from 21.74 percent in March 2016.

Intuitively, the local market faces lower foreign exposure risks, given that long-term foreign equity holdings have remained relatively low as compared to domestic equity holdings and those who come into the market, are more on the buy side (**figure 26**).

Figure 26: Foreign Versus Local Shareholding in KSh Millions



Source: Capital Markets Authority, 2017

The NSE recorded lower liquidity of its top ten listed stocks in 2016 compared to 2015. The average annual liquidity ratio for 2016 was 8.67 percent, down from 10.98 percent in 2015. Only two counters recorded liquidity ratio exceeding 20 percent each for two years in a row. Eight (8) counters had liquidity ratio of below 10 percent in 2016 compared to six (6) counters in 2015, reinforcing reduced liquidity. Innovations such as short-selling securities and lending aim to address this problem (**Table 8**).

Table 8: Equity Turnover, Market Capitalization and Liquidity Ratio of Top 10 listed firms

2015 (KSh Billions)			2015	2016 (KSh Billions)			2016
Company	Turnover	Market Capitalization	Liquidity Ratio (%)	Company	Turnover	Market Capitalization	Liquidity Ratio (%)
Equity	50.33	150.95	33.34	KCB	21.65	88.15	24.57
KCB	31.56	132.35	23.84	Equity	25.20	113.21	22.26
BAT	10.14	78.50	12.92	EABL	19.08	192.95	9.89
EABL	25.42	215.88	11.78	Safaricom	43.41	767.25	5.66
DTB	2.76	41.16	6.71	Coop	3.52	64.54	5.46
Safaricom	39.02	653.07	5.98	BAT	4.36	90.90	4.80
Coop	5.10	88.01	5.79	Bamburi	2.76	58.07	4.75
Bamburi	2.44	63.52	3.84	Barclays	1.85	49.43	3.74
Barclays	2.42	73.87	3.28	KenGen	1.32	36.21	3.64
StanChart	1.38	60.29	2.29	StanChart	1.26	64.92	1.94

Source: NSE/CMA

2.2.1. Recent Market Developments and Plans Underway

- **Recent Market Developments and Innovations**
    - ***M-Akiba, a retail mobile***-based savings product/ bond launched in April 2017.
    - ***Exchange Traded Funds*** - launched in March 2017 to provide investors an opportunity to invest in gold-backed assets as one of the ways of diversifying the choice set for capital markets investors.
    - ***Support for FinTech innovations*** - CMA and the Australian Securities and Investments Commission (ASIC) signed a cooperation agreement in October 2016 to promote innovation in financial services in the respective markets and the Regulatory Sandbox.
    - ***Islamic Financial Services Board Membership*** - The CMA was admitted by the Council of the Islamic Financial Services Board (IFSB) as an associate member in December 2016. This is a key step towards the development of Islamic finance hub in the East African region.
    - ***Increase the number of listings*** – CMA initiated business incubator, accelerator and listing experience initiative to help small and medium enterprises to list on the NSE.

- **Market Developments and Innovations in the pipeline**
    - ***Project Financing for County Governments*** – CMA is undertaking a diagnostics study to establish capital market products suitable for raising capital by county governments, the national government and other state owned enterprises.
    - ***Global Depositary Notes (GDNs) and Global Depositary Receipts (GDRs) Guidance Notes*** – CMA subjected draft Policy Guidance Notes on Global Depository Receipts and Notes (GDR/ GDN) to public exposure third quarter of 2016 for comments on the guidelines.
    - Asset Backed Securities – CMA developed a Policy Guidance Note (PGN) to facilitate issuance of Asset Backed Securities (ABS). The PGN provides for a Special Purpose Vehicle (SPV) as a corporate structure/company and is expected to be operational in the first quarter of 2017 after the CMA Board's approval.
    - Derivatives Markets - CMA working closely with NSE to operationalize a Derivatives Exchange, with the launch designed in two phases before fully "going live". This "Soft Launches" approach is aimed at ensuring that all critical pre-conditions for the effective and efficient functioning of a derivatives market are met before going live.

2.2.2. Risks Outlook in the Capital Markets

Despite the resilience of capital markets in Kenya in 2017, the following concerns exist:

- ***Policy Uncertainty*** - Recent political events both in the United States and Europe have ushered in policy uncertainty that could impact of foreign capital flows to emerging and frontier markets, in addition to affecting diaspora remittances.
- ***Low Commodity Prices***- global commodity prices remain low amid continued weak demand, with implications on fiscal deficits and the capacity of capital markets to effectively play their role in capital mobilization.

- ***Drought -*** The country has experienced prolonged periods of drought from 2016 into 2017. Kenya's agricultural sector is rain-fed and therefore prolonged drought affects output for domestic consumption and exports. This affects foreign exchange. In addition, agriculture-based listed companies that have been adversely affected.
- ***Political Risk -*** Market sentiments on elections has led to investors to hold-back new investments until after the elections, thus affecting the market activity.

2.3. Insurance Industry

The non-life insurance business accounted for 63 percent of total insurance premiums, with motor and medical insurance comprising of over two thirds of the non-life premiums. The industry premiums grew by 13.5 percent, the life business growing faster by 20 percent compared to the non-life segment growth rate of 9.9 percent between years 2015 and 2016 (**table 9**).

Table 9: Summary of Industry performance for years 2011-2016 in KSh (Millions)

Item	2012	2013	2014	2015	2016
Gross Premium Income	108,610	131,002	157,779	173,258	196,636
Net Premium Written	87,840	104,948	126,636	139,197	158,362
Claims Incurred (General Business)	29,433	33,442	41,895	49,051	54,857
Commissions	7,034	7,204	9,257	10,896	12,579
Expenses of Management	19,552	24,808	30,418	36,257	39,983
Investment Income (P&L)	7,594	9,429	9,544	6,738	6,018
Operating Profit/Loss after Taxation	13,350	20,236	24,619	13,635	18,249
Investments	235,565	296,337	352,370	390,225	403,262
Assets	302,233	366,252	426,310	478,752	528,748
Shareholder's Funds	74,812	100,958	122,544	125,830	134,455

Source: Insurance Regulatory Authority

The insurance industry experienced operational changes in response to declining growth characterized by shrinking margins and falling performance metrics like return on assets and return on equity. Solutions to enhancing performance in this phase include implementing cost efficiency strategies as well as seeking premiums supplements through active investment strategies. As a result, Insurance Regulatory Authority (IRA) introduced a risk-based supervisory regime to enhance oversight and therefore foster financial stability and benchmarking with the best internationally accepted insurance practices. The IRA has also introduced a risk-based capital model to enhance prudence in the entities' capital management strategies as well as adoption of International Financial Reporting Standards (IFRS) framework. Other changes to the regulatory framework include:

a) Change in the Insurance Act to capture legal backing for both the risk-based supervision and risk-based capital approach;

b) Issuance and gazetting of the risk-based capital model guidelines, coming into effect in 2020;

c) Alignment of Guidelines to the Statutory Instruments Act.

The regulatory changes are likely to pose inefficiencies in the investment strategies for insurance companies in Kenya. As a result of the stringent investment requirements, the much required premiums supplements (investment income) will be significantly reduced. We therefore expect a decline in ROA and ROE following the implementation of the Risk-Based Capital regime. To cope with new changes, the insurance market has recorded increased mergers and acquisitions involving both local corporations as well as

multinationals. This is expected increase going forward following full liberalization of the industry as well as the increased capital requirements and improvement of operational efficiency.

2.4. Pensions Industry

In 2016, pension assets grew minimally due to challenges including market volatility and the recent banking crisis. Retirement benefit assets grew from KSh 814 billion in December 2015 to KSh 830 billion in June 2016. The assets and membership of the Individual Retirement Benefits Schemes grew considerably, from 147,154 members in June 2015 to 165,480 members in June 2016. The assets grew from KSh 26.36 billion to KSh 31.28 billion in the same period, reflecting efforts by RBA through public campaigns. RBA worked with other bodies and employer-based organizations to sensitize employers on the need to save for retirement. Retirement benefits products targeting the self-employed and individuals working in the informal sector have also been on the rise. Emergent pension products leverage mobile technology to expand access to a larger population, such as the M-pension and MBAO pension plans.To develop and spur growth in the pension sector, RBA undertook various initiatives and communications programmes to enhance growth, expand coverage adequacy and foster stability of the pension sector. RBA developed and commenced implementation of a communication strategy to encourage Kenyans into thinking about the consequences of not saving for retirement. RBA also, in collaboration with various stakeholders, initiated the process of developing a National Retirement Policy which is expected to streamline the retirement benefits sector. Other policy changes made in 2016 include:

- **Perpetual licensing of service providers:** Effective 2017, service providers (fund managers, custodians and administrators) will not be required to apply for annual licenses but will still file with the Authority various returns such as audited accounts and any material changes such as shareholding, directorship and top management in their companies;
- **Protection of the trustees against victimization or discrimination while performing their duties:** Regulation 8 of the Occupational Retirement Benefits Schemes regulations and Regulation 9 of the Individual Retirement Benefits Schemes Regulations were amended to ensure that trustees shall not be victimized, removed from office or discriminated against for having performed the function of office in accordance with the Trust Deed and Rules of a scheme or any law without due process of the law;
- **Post-retirement medical scheme:** Regulation 14 was amended to provide for the schedule of rates of contributions to allow for additional voluntary contributions by a member in respect of funding of a medical fund to be accessed at retirement. Regulation 19 was amended to ensure that the scheme rules provide for a member who may wish to transfer a portion of the member's benefits to medical-cover provider where the member has been unable to build a post-retirement medical fund from additional contributions; and,
- **Review of the investment guidelines:** Table G of the investment guidelines was amended to explicitly include REITS, exchange traded derivatives and the separation of listed and unlisted corporate bonds and commercial paper approved by the Capital Markets Authority. The investment assets classes were increased from 10 to 14 asset classes.

RBA continued to implement risk-based supervision and, in December 2016, the overall risk score was 0.855, implying medium risk ("amber"), or that the sector is relatively stable. However, the growth and stability of the sector may be hampered by various risks:

- **Investment/Market Risks:** In 2016, the stock market prices were volatile, especially the bank shares which schemes have heavily invested in. The schemes also are faced with concentration risk due to the shallow market. The adverse movement of interest rates and market prices which may lead to underfunding in

defined benefit (DB) schemes and low balances in defined contribution (DC) schemes. To address this, RBA expanded the investment asset classes to allow investment in alternative asset classes such as private equity and derivatives.

- **Funding and Solvency Risks:** although the average funding level for DB schemes in the sector is 101 percent, some schemes, mainly public institutions are highly underfunded. This arises from unremitted contributions.
- **Liquidity Risk:** due to the shallow markets and the appetite for investment in property and immovable assets, some schemes are faced with liquidity challenges, hence unable to meet their obligations.
- **Actuarial Risks:** arises in the DB schemes where poor actuarial valuation methods and assumptions have been applied. Retirees have contested the computation of their benefits, ending up in court cases.

The sector expects a slowdown if the stock market remains down, but the reverse is true.

2.5. The SACCOs Industry

As at March 2017, there were 177 licensed DTSs in Kenya, who are required to comply with capital adequacy ratios: core capital to total assets at 10 percent; core capital to total deposits at 8 percent and institutional capital to total assets at 8 percent. **Table 10** provides Financial Soundness Indicators of SACCOs. There has been significant growth in core capital due to retentions, which grew by 17.80 percent. Loans constitute the single largest assets in the DTS' balance sheets, at 73.4 percent of total assets. Loan issuance grew by 15.3 percent in 2016. Lending accounted for 85.1 percent of DTSs' gross total income.

Income from loans rose from KSh 39.23 billion to KSh 46.86 billion. Income from front-office, banking-like services accounted for 11 percent of total earnings. Management efficiency in generating earnings improved over the period as reflected by return on assets. This is supplemented by the reduction in cost to income ratio over the period. Ultimately, members in licensed DTSs had their return on investments improve due to improved performance.

Table 10: Financial Soundness Indicators of Deposit Taking SACCOs

INDICATOR/YEAR	2015	2016
Capital Adequacy		
Core Capital (Millions)	41,697	54,943
Core Capital/Total Assets (%)	12.17	13.96
Core Capital/Total Deposits (%)	17.57	20.16
Institutional Capital/Total Assets (%)	8.75	7.71
Asset Quality		
Non-Performing Loans (NPLs) to Gross Loans (%)	5.12	5.23
NPLs Net of Provisions to Core Capital (%)	14.77	7.63
Earning Assets to Total Assets (%)	80.67	80.71
Earnings Rating		
Return on Assets (ROA) (%)	1.89	2.45
Interest Margin to Gross Income (%)	43.01	42.15
Cost Income Ratio (%)	66.72	62.80
Non-Interest Expense to Gross Income (%)	41.58	41.35
Operating Expense to Total Assets Ratio (%)	5.13	5.44
Liquidity Ratio		
Liquid Assets/Savings Deposits +STLs (Liquidity Ratio) (%)	55.90	49.95
Liquid Assets/Total Deposits (%)	17.21	18.05
External Borrowings/Total Assets (%)	5.21	5.04
Liquid Assets/Total Assets (%)	11.93	12.49
Total Loans/ Total Deposits (%)	108.8	108.39

Source: SASRA, 2017

For the period under review, DTSs satisfied the minimum liquidity ratio of 15 percent, enabling them to cater for continued withdrawal of deposits and to settle other short term liabilities. Other liquidity measures as computed by level of external borrowings to total assets indicate that DTSs relied on their savings deposits to finance their assets. Savings deposits grew to KSh 272.6 billion in 2016 or 14.9 percent increase. External borrowing rose from KSh 17.82 billion to KSh 20.1 billion, or 12.9 percent growth rate. Reliance on savings to finance assets reinforces the Sacco model of deposits mobilization for on-lending.

To mitigate potential credit risks following increased borrowing, provisioning rose from KSh 7.05 billion to KSh 8.63 billion over the same period. Earnings to assets ratio grew by 0.04 percent while quality of loans measured by non-performing loans (NPL) deteriorated from 5.12 percent to 5.22 percent. The marginal increase mainly came from DTSs exposed to the agricultural sector, which was severely affected by drought, low prices and low bonus payout **(Table 11).**

Table 11: Risk classification of loans over the two year period.

		2016		2015	
Classification	**Provision Rate (%)**	**Gross Loans (Ksh. Mns)**	**Ratio to Total Loans (%)**	**Gross Loans (Ksh. Mns)**	**Ratio to Total Loans (%)**
Performing (As per Contract)	1	263,505	88.50	226,434	87.7
Watch (1-30 days)	5	18,525	6.20	18,612	7.2
Substandard (31-180 days)	25	8,050	2.70	6,813	2.6
Doubtful (181-360 days)	50	3,288	1.11	2,804	1.1
Loss (Over 360 days)	100	4,236	1.48	3,601	1.4
Total Amounts		279,297		258,264	
Portfolio at Risk (NPL/Gross Loans)		5.22		5.12	

Source: SASRA, 2017

2.6. Deposits Insurance

Kenya Deposit Insurance Corporation (KDIC) provides a deposit insurance scheme for all customers of member institutions' licensed by the Central Bank of Kenya as deposit takers. KDIC has resolution powers and prudential oversight responsibilities, instilling confidence and enhancing stability in the financial system. Membership is mandatory for all deposit-taking institutions licensed by CBK.

As at 31 December, 2016, there were 55 member institutions comprising of 41 Commercial Banks, one Mortgage Finance Company and 13 deposit-taking microfinance banks. Two members were placed in receivership while one member institution was put under liquidation (**Table 12**).

Table 12: Deposit Accounts Have Grown Over Time

		Dec 2014	June 2015	Dec 2015	Dec-16
Growth	Total Number of Accounts	30,697,704	33,936,072	37,353,419	43,247,522
	Percent change	11.94	10.55	10.07	15.80
Growth Of The Fund, Insurance Cover & Deposits.	Total Deposits (Sh'000')	2,384,722,828	2,630,907,822	2,673,953,860	2,783,718,808
	Insurance Cover (Sh'000')	224,867,756	246,771,544	244,646,706	255,534,863
	Fund Growth (Sh'000')	52,165,034	54,914,117	61,726,669	72,184,024

Source: KDIC, March 2017

Deposit accounts with member institutions increased by 15.8 percent in 2016. Of the total deposits of KSh 2.78 trillion in 2016, those fully protected were KSh 255.54 billion, or just 9.2 percent. The Fund balance was KSh 72.184 billion and only 28.3 percent of total exposure was fully covered (**Table 13**).

Table 13: Summary of Protection and Exposure Indicators

	Banking Sector Deposits	Dec-15	Dec-16	Change in Percent
1	Total Deposits (KSh M)	2,673,956	2,783,719	4.10
2	Total Protected Deposits (KSh M.)	244,647	255,535	4.00
3	Protection Level (2/1)	9.20%	9.20%	0
4	Funds Balance (KSh M)	61,730	72,184	17
5	Effective Cover (4/2)	23.20%	28.30%	22
	Deposit Accounts			
6	Number of Deposits ('000')	37,353	43,247	15.80
7	Number of accounts fully protected ('000')	36,096	41,833	15.90
8	Share of Protected accounts (7/6)	96.70%	96.80%	
9	Exposure Level	74.80%	71.80%	-2.64

Source: KDIC, March 2017

2.7. Financial Markets Infrastructure

In 2016, payment systems operated smoothly, recording increases in value and volume. Large-value payment systems are typically the most significant component of the market infrastructure since their stability contribute to overall stability of the financial system. KEPSS recorded 4.01 million transaction messages worth KSh 26,851 billion, compared to 3.13 million transaction messages worth KSh 29,703 billion in 2015, representing a 28.1 percent increase in volume and 9.6 percent increase in value. Direct settlements through KEPSS by commercial banks accounted for 99 percent of total activity while the Net Settlement Instruction (NSI) or activity through ACH to KEPSS accounted for about 1.0 percent of total activity (**Table 13**). No major risks reported in the domestic payments and settlement system in 2016.

Table 14: KEPSS System Flows

Year End	Transfer (KSh Billion	Growth (%)	Messages Moved	Growth (%)
2010	17,101	22.8	904,717	131.5
2011	21,894	28.0	1,241,531	37.2
2012	19,880	-9.2	1,568,125	26.3
2013	22,669	14.1	1,977,885	26.1
2014	25,561	12.8	2,525,337	27.7
2015	29,703	23.3	3,124,960	15.7
2016	26,851	-9.6	3,988,168	28.1

Source: Central Bank of Kenya

The automated Clearing House (ACH) and Payments Cards also played an important role facilitating transactions. The ACH processed 31 million transactions valued at KSh 3.2 trillion in 2016. The increase is attributed to the use of cheques for retail payments due to the short clearing cycle of T+1.

Usage of payment cards has grown following efforts by the Central Bank of Kenya and the Kenya Credit and Debit Card Association to sensitize the public on plastic money. As a result, in 2016 there were 14.8 million active cards in use, moving KSh 1.39 trillion in 216 million transactions. The increase reflects usage of cards for settling some large value transactions, given that mobile phone payments are capped. The number of ATMS declined from 2,718 to 2,656 during the same period, reflecting closure of some branches (**Table 15**).

Table 15: Number of Cards, ATMSs, POS Terminals and ACH Transactions

December	No. of Cards	No. of ATMs	No. of POS Terminals	Transaction Volume (Mns)	Transaction Value (KSh Mns)
2012	10.7	2381	18478	28.9	101,939
2013	11.5	2487	21089	28.3	120,670
2014	13.9	2613	17511	18.6	110,660
2014	13.2	2718	22230	20.1	121,821
2015	14.8	2656	30133	21.6	121,489

Source: Central Bank of Kenya

KEPSS and ACH operations were stable in 2016, with monthly average KEPSS system availability level was 99.35 percent while ACH system availability averaged 99.98 percent. KEPSS participants borrowed a total of KSh 16.9 billion in 2016, compared to KSh 112.9 billion in 2015, implying an 85.1 percent decline in overnight loans in 2016. This signals reduced interbank activity as an indication of high liquidity levels in 2016. In addition, there were fewer incidences of commercial banks requesting for extension of operating windows, confirming less liquidity pressure.

Mobile Phone Money Transfer services continued to grow in 2016, with the number of agents up by 15.3 percent in December 2016. Mobile money transfer accounts increased by 10.4 percent while the volume and value of transfers increased from 1,114 million transactions worth KSh 2,816.1 million in 2015 to 1,526 million transactions worth KSh 3,355.6 million in 2016 (**Table 16**).

Table 16: Mobile Money Transfers

INDICATOR/YEAR	2012	2013	2014	2015	2016
Number of Agents	76,912	113,130	123,703	143,946	165,908
Mobile Money Accounts	21.1	25.3	25.2	31.6	34.9
No. of Transactions (Millions)	575	733	911	1,114	1,526
Value of Transactions (KSh Billions)	1,537.5	1,901.6	2,371.8	2,816.1a	3,355.6
Average Transaction Value (KSh)	2,672	2,594	2,604	2,528	2,199

Source: Central Bank of Kenya

2.7.1. Outlook

Payment systems are maturing and transitioning from narrow channels of Person to Person (P2P) transfers to integrated networks for transfer of value. In Kenya, innovations in the retail payments space has contributed to increased financial inclusion. The dynamic nature of emerging financial technologies (Fintech) create challenges but also opens up opportunities for innovation and growth.

While traditional payment methods (internet banking, credit and debit cards) remain the main channels for online transactions, the share of alternative payment methods is expected to rise globally with business-to-consumer e-commerce sales. Along with online payments, contactless payment systems through mobile devices are also expected to gain momentum and disrupt existing arrangements but security concerns are key to further innovations in a safe and secure payments systems.

Going forward, Kenya expects to see even faster changes in the payments landscape, building on rapid growth in electronic payments and the advent of new and disruptive market players. The legal and regulatory regime is also changing to provide effective oversight for both existing and planned systems, and the changes in payment technology are increasingly requiring joint oversight and cooperation among regulators including the Central Bank of Kenya (CBK), Capital Markets Authority (CMA), Communications Authority of Kenya (CA) and Competition Authority (CAK) among others. The payments system is expected to transform and become more innovative has the National Payments System Act becomes fully operational.

Chapter Three: Risks Outlook and Prospects in 2017

Kenya's financial sector stable resilient albeit the continuing vulnerabilities associated with both domestic and external uncertainties. There are however innovations and risk mitigation measures being instituted to create opportunities for growth and resilience of the sector. In summary;

1. Global risks are easing but remain uncertain;

i. The ongoing debate on the U.S financial sector deregulation, is likely to spillover to emerging and developing countries if it materializes. In addition, increased derisking of global financial corporations from Africa presents challenges of correspondence banking in the continent. Finally, the increasing protectionist policy tendencies in the U.S and Europe including Brexit negotiations may pose risks to macro-financial conditions.

ii. Commodity dependent countries in emerging markets and developing countries including SSA region are likely to face growth and fiscal challenges if subdued demand and low prices persist.

iii. Cybercrimes and cybersecurity concerns may introduce new rounds of regulatory requirements, bringing along regulatory burden to consumers.

2. Domestically;

i. Continued slowdown in bank credit to the private sector coupled with several corporates facing unfavourable business environment may pose bank balance sheets and liquidity risks.

ii. Rising credit risks in the financial sector may stifle further expansion in credit to private sector, thus slowing down investments.

iii. Consumer protection concerns leading to interest rates capping law continue to affect efficient intermediation and monetary policy transmission mechanism.

iv. Sluggish property markets may hamper further investments, thus impacting the rest of financial sector and overall economy.

v. Rapid public debt accumulation need to match with accelerated GDP for it to remain sustainable.

3. Despite the challenges and risks ahead, opportunities do exist;

i. Continued public infrastructure development key to supporting growth, with positive effects on financial sector.

ii. The banking reforms under the 'new normal' covering improved transparency, enhanced governance and change in business models coupled with consolidation is expected to generate a more stable and efficient financial sector to withstand any emerging risks.

iii. Increasing technological enabled financial services innovations and delivery channels is key to an efficient and stable financial sector.

iv. Future positive growth prospects hinged on discovery of natural resources and growing middle class.

Special Features

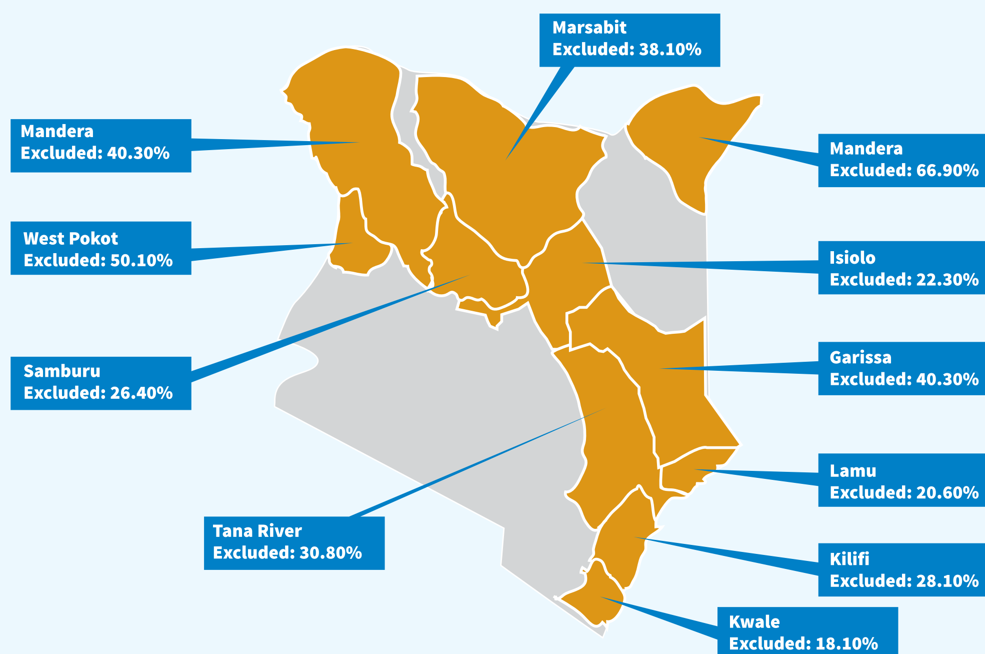
Box I: Using Financial Access to Mitigate Drought Effects

In late 2016, severe drought affected 23 of the 47 counties in Kenya, leading the Government declare a National Disaster in February 2017. More than 2.7 million people in arid and semi-arid lands (ASALs) and about 300,000 in non-ASAL counties faced food insecurity given that about 30 percent of Kenya's population live in ASAL areas. While financial institutions and the Kenyan Government have played an important role in responding to the drought, continuing to improve access and usage of financial services in these areas will ensure that affected populations can invest in productive ventures and mitigate the severe impacts of drought.

The 2016 FinAccess Household Survey results show that more than 4.6 million adults consider drought as the largest risk to their household income, and more than 5.9 million reported drought as having had the biggest impact on their income in the past two years. However, of those who mentioned drought or famine as the largest risk facing their household, only 14 percent used insurance products, as compared to the national average of 23.2 percent. Moreover, though agricultural insurance was introduced as a product in 2010, only five of Kenya's 55 regulated insurance providers currently offer agricultural insurance products.

Among the 11 counties mostly affected by the drought conditions, access to formal financial services remains below the national average in all except one county. Mandera, West Pokot and Turkana counties have the highest levels of financial exclusion. These people only use financial services through social networks or keep their finances in secret places. The exclusion rates for the counties stand at 66.9 percent, 50.1 percent and 47.2 percent for Mandera, West Pokot and Turkana counties respectively, as compared to the national exclusion average of 17.4 percent (**Figure 27**).

Figure 27 Financial Access in Severely Drought Affected Counties (2016)



Usage of insurance, credit and savings products, is significantly lower than the national average in the counties most severely affected by the drought. Mandera County is particularly under-served, with only 5.2 percent usage of insurance, 16.7 percent usage of credit and 8.1 percent usage of savings. Without adequate access to formal financial services in order to enable productive investment and protect against shocks, many of the pastoralists and agriculturalists in these counties are highly vulnerable to droughts and other weather-related risks.

Table 17: Financial Services Usage in Drought-Affected Areas

County	Formally Included	Insurance Usage (Including. NHIF)	Insurance Usage (Excluding NHIF)	Credit Usage	Savings Usage
Garissa	38.20	5.80	1.20	29.70	16.90
Marsabit	57.00	9.40	6.30	15.70	35.90
Isiolo	76.60	28.50	8.80	20.90	42.50
Samburu	68.10	23.00	7.40	23.00	40.70
Kilifi	60.00	16.20	0.50	33.00	53.30
Tana River	54.00	10.30	4.10	28.50	45.70
Lamu	71.70	14.50	1.90	37.90	53.40
Turkana	42.90	14.80	3.40	29.20	46.90
Mandera	15.20	5.20	1.50	24.90	8.10
West Pokot	35.90	5.70	1.70	16.70	34.20
Kwale	67.70	15.20	3.90	39.50	52.20
National Average	**75.30**	**23.20**	**5.30**	**34.20%**	**66.40%**

Source: KNBS Kenya Economic Survey 2016, National Drought Management Authority

Government and Financial Sector Drought Risk Mitigation Initiatives

Government and financial sector have played an important role in mitigating the effects of drought, limiting effects of the shocks to the agricultural sector. The Government in partnerships with financial sector stakeholders, launched the Kenya Agriculture Insurance and Risk Management Program (KAIRMP) in 2015 that covers livestock and crop sub-sectors. The program has two approaches - livestock insurance, and the crop (maize and wheat) insurance.

The livestock insurance program, named the Kenya Livestock Insurance Project (KLIP), was introduced in October 2015. It leverages on satellite imagery to monitor forage conditions, triggering payouts for feed, veterinary supplies and water to pastoralists when vegetation moves beyond critical levels Through KLIP, the Government purchases drought insurance from a consortium of private insurance companies on behalf of pastoralists. Payouts are disbursed directly to pastoralists via their mobile phone bank accounts or using Cheques. About 14,000 individuals in six counties have benefited. The Government made KSh 215 million in livestock insurance payouts to 12,000 pastoralists by March 2017, helping livestock owners to cope with the impact of drought.

On the crop insurance product, the KAIRMP introduced insurance program in Bungoma, Embu and Nakuru Counties in 2016. It uses an "area yield" index approach to reduce the risks faced by farmers. Farming areas are divided into insurance units, and if average production

in one of the units falls below a designated threshold, all insured farmers in the unit receive a payout.

Innovations and Opportunities

New financial innovations may further assist in addressing the financial access gap in drought-affected areas and ensuring that these populations are able to effectively withstand the impact of weather-related production shocks. Insurance providers, for example, should explore the use of index-based insurance products to reach into high-risk, under-served areas. Insurers can more accurately price insurance products and thus reduce the risk of cover in drought-prone regions. These products include weather-index, area-yield index and satellite-based rainfall index insurance, among others. To reduce the costs of offering financial services in rural areas, mostly affected by weather-related shocks, providers are also increasingly leveraging mobile technology. Service providers could distribute their products among rural populations can deploy mobile-based products to enable users to open accounts, save money and pay for healthcare services, all via their mobile devices.

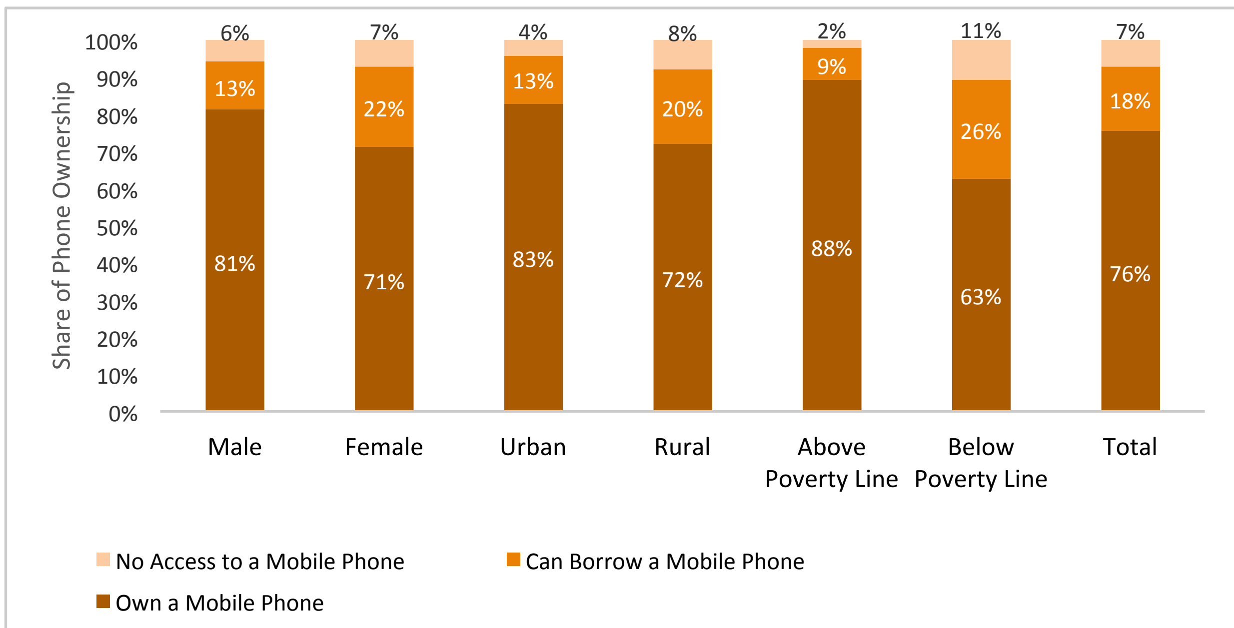
Box II: Digital Channels Enhances Risk Assessment, Investment, Savings and Consumer Protection

Financial Innovations Leveraging on Digital Channels generates data to enhance credit risk assessment. This can enable the population excluded from formal financial system to build their financial track records. Users can now accumulate data that can be used to assess their creditworthiness, and thereby open access to additional financial opportunities. Since the introduction of mobile-based lending products in 2012, the number of unique records at Credit Reference Bureaus (CRBs) has grown from 300,000 to more than 6.5 million. Many non-bank lenders are leveraging alternative sources of data, such as mobile phone usage data or social media usage data, to assess creditworthiness for those excluded, especially farmers. These lenders often have proprietary algorithms that transform vast streams of data into credit scores that can be used to assess risk of default and set rates or lending limits accordingly. CRBs are also integrating data from third party sources, like SACCOs or non-bank credit providers, into credit reports, expanding credit assessment among those who might not be in the formal financial system.

A mobile-based Government bond, M-Akiba, was launched in April 2017 to enhance the savings and investment culture in Kenya, besides raising money for the Government. Through M-Akiba, investors can buy bonds from as low as KSh 3,000, compared to the earlier minimum of KSh 50,000 required to buy Government bonds. Investors can now easily buy and sell the bonds via their mobile phones to earn a fixed 10-percent, tax-free interest rate. High retail investors' appetite for the M-Akiba bond shows that leveraging digital channels can open new financial opportunities for consumers. At the time that the bond sale closed, 5,692 investors had invested in the bond worth KSh 150 million. The average investment was KSh 26,359, with the majority investing between KSh 3,000 and KSh 3,500.

Digital platforms have transformed from simple mobile money transfers to unlocking savings, loans, investment and insurance opportunities. However, challenges remain as the financial sector continues to undergo technological innovations. A large proportion of the population, 17.4 percent still remain excluded from both formal and informal financial services. In addition, adoption rate of mobile financial services (MFS) in the under-served groups like women, rural residents, farmers and the youth is relatively low (Figure 28). Furthermore, whereas approximately 88 percent of the population has mobile phones, only 71.4 percent are users of MFS, highlighting an untapped opportunity to expand MFS among mobile users.

Figure 28: Mobile phone ownership, 2015 (%)



Source: Financial Inclusion Insights (FII), 2016

Enhancing consumer protection through data privacy laws and regulations. As more and more people use their mobile phones for financial services and a wealth of financial data is generated about specific consumers, it has become increasingly important that their financial data is protected and secure. The legal and regulatory framework that governs the Kenyan financial system includes a number of important protections for customers that aim to ensure confidence and trust in the financial sector. However, further trust will require implementation of data protection laws and regulations specific to electronic transactions, as well as cyber-crime and computer crime laws and regulations. Kenya is currently developing a Data Protection Legislation that will provide additional safeguards to end users. The legislation will be anchored in data protection principles, such as: i) information is collected and stored for a lawful and explicitly-defined purpose, ii) information is collected directly and with the consent of the subject, iii) data subjects are allowed right of access to their personal information.

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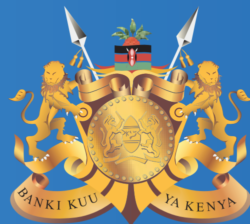

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