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THE KENYA FINANCIAL SECTOR STABILITY REPORT 2018

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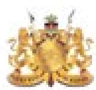

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LIST OF ACRONYMS AND ABBREVIATIONS

AML/ CFT	Anti-Money Laundering/Combating the Financing of Terrorism	MENA	Middle East and North Africa
ATM	Automated Teller Machine	MFI	Microfinance Institution
CAB	Current Account Balance	MSCIEM	Morgan Stanley Composite Index for Emerging Markets
CAR	Capital Adequacy Ratio	NASI	Nairobi Securities Exchange Index
CMA	Capital Markets Authority	NPLs	Non–Performing Loans
COMESA	Common Market for Eastern and Southern Africa	NSE	Nairobi Securities Exchange
EAC	East African Community	NSSF	National Social Securities Fund
EAPS	East African Payments System	OMO	Open Market Operations
EFTs	Electronic Funds Transfers	PMI	Purchasing Managers Index
EMDEs	Emerging Markets & Developing Economies	RBA	Retirement Benefits Authority
FTSE	Financial Times Stock Index	ROA	Return on Assets
FSD Kenya	Financial Sector Deepening Trust Kenya	ROE	Return on Equity
GDP	Gross Domestic Product	REPSS	Regional Payments & Settlement Systems
GEP	Global Economic Prospects	RTGS	Real Time Gross Settlement
GFSR	Global Financial Stability Report	Saccos	Savings and Credit Co-operatives
IADI	International Association of Deposits Insurance	SASRA	Sacco Societies Regulatory Authority
ICT	Information Communication and Technology	S&P	Standard & Poor's
IPO	Initial Public Offering	SWIFT	Society for Worldwide Interbank Financial Telecommunications
IRA	Insurance Regulatory Authority	TRWA	Total Risks Weighted Assets
KDIC	Kenya Deposits Insurance Corporation	UK	United Kingdom
KEPSS	Kenya Electronic Payments & Settlement System	USD	United States Dollar
KNBS	Kenya National Bureau of Statistics	WEO	World Economic Outlook
LCB	Local Currency Bond		

EXECUTIVE SUMMARY

This Financial Sector Stability Report for Kenya covers the period January to December 2018. Kenya's financial sector consists of deposit taking institutions (commercial banks and mortgage finance companies, microfinance banks and deposit taking Savings and Credit Co-operatives (Saccos)), nondeposit taking institutions (insurance, pensions, capital markets, and Development Finance Institutions (DFIs)) and financial markets infrastructure providers. The sector is regulated by; the Central Bank of Kenya (CBK); the Sacco Societies Regulatory Authority (SASRA); Insurance Regulatory Authority (IRA); Retirement Benefits Authority (RBA); Capital Markets Authority (CMA) and Government Ministries.

The global macro-financial conditions were tight in 2018, exacerbated by slow global output growth, trade tension between the advanced and emerging market economies, geopolitical tensions and uncertainty in major financial markets. Regional and domestic economies sustained the growth momentum in 2018 due to good weather and stable macroeconomic environment. The strong domestic growth enhanced the resilience of the Kenya's financial sector to vulnerabilities emanating from the trade tensions, weak demand in advanced economies, tight global financial conditions and operational risks.

The assets of the banking subsector, which amounted to 49.5 percent of the GDP, grew by 10.1 percent due to increase in loans and investment in government securities. The improved public confidence in the banking subsector, agency banking and integration of mobile phone platforms in the provision of banking services increased customer deposits by 12.4 percent, which funded the assets. Private sector credit grew by 3.1 percent, while investment in government securities slowed down from 24.6 percent to 19.03 percent in 2018. Profit before tax of the banking subsector increased by 14.6 percent in 2018, explained by 16 percent growth in interest on government securities and slow growth in expenses. The return on assets (ROA) increased by 0.2 percentage point, while return on equity (ROE) rose by 1.9 percentage point. Tier I banks (large banks) recorded the highest profitability, while Tier III banks (small banks) recorded negative ROA, ROE and profit before tax in 2018.

Credit risk was elevated as reflected by the increase in gross nonperforming loans (NPLs) by 19.69 percent to Ksh.316.7 billion in December 2018 from KSh. 264.6 billion in 2017. As a result, the ratio of gross NPLs to gross loans rose from 12.3 percent by end 2017 to 12.7 percent by end 2018. Banks tightened lending standards and increased investment in government securities to mitigate credit risks. Automation of operations and adoption of financial technologies elevated operational risks and increased the vulnerability of the banking sector to fraud and cyber-crime in 2018. Banks tightened internal control systems, sensitised customers on fraud and undertook ICT vulnerability assessments and penetration tests to mitigate operational risks. The CBK has also strengthened the AML/CFT risk assessment frameworks to address this risk. The banking subsector is expected to remain stable in 2019, on account of easing credit and liquidity risks as more banks consolidate and harness technology in processing customer data and automation of operations.

Foreign investment outflows on the equity market increased in 2018 due to trade tensions, slow global economic growth and poor performance of some companies listed on NSE. This led to a decline in share prices and market capitalisation. The stock market liquidity ratio declined to 6.81 percent, while market concentration risks increased in 2018. In particular, the top five (5) stocks accounted for 67.3 percent of market capitalization in 2018 compared to 64.8 percent in 2017, while foreign investors accounted for 63.3 percent of total equity turnover in 2018. There was no new listing through IPO at the bourse in 2018. Volatility in the stock market increased because of elevated risk and uncertainties reflecting developments in global financial markets and weak performance of some companies listed on the NSE. However, the CMA and NSE established futures

market to minimise fluctuations in share prices and deepen the financial market

The insurance and pension sub-sectors were resilient in 2018 despite a number of risks. The insurance subsector recorded declining performance metrix measured by Return on Assets (ROA) and Return on Equity (ROE) because of operational inefficiencies and unfavourable economic environment. The Pension sub-sector was relatively stable to register an asset growth rate of 8.0 percent as well as increase diversity of its portfolio.

Despite the sub-sector growing, the faster growth in pension liabilities relative to assets as well as increasing life expectancy has elevated funding risks. In the Defined Contribution schemes, unremitted contributions have increased due to poor economic performance and the insufficient funding of quasi government schemes. Cognizant of these risks, RBA has revised the risk toolkit to effectively measure risks and adopted measures to mitigate risks unique to pension funds. The Sacco sub-sector has grown significantly in terms of assets, products and membership. In 2018, the sub-sector's assets grew by 12.44 percent, slightly higher than 12.40 percent growth in 2017, driven by 7.5 percent loan book. Deposits/ savings declined in 2018 due to high cost of living affecting members. The sub-sector, however, had adequate capital buffers, with core capital of 14.6 percent compared to a statutory minimum requirement of 10 percent.

Overall, global and domestic economic recovery, robust regulatory frameworks and improving macroeconomic environment minimized risks to the financial sector, hence stability and resilience recorded in 2018. However, Kenya's financial sector is vulnerable to fragility in the global and domestic economies emanating from financial markets uncertainties; trade and geopolitical tensions; corruption, money laundering and financing of terrorism; and rapid adoption of financial technology and innovations. However, sustained recovery in global and domestic economies increased consolidation through mergers and acquisitions and leveraging on financial technology is expected to buttress the sector's stability and growth.

CHAPTER 1: GLOBAL ECONOMY AND FINANCIAL MARKETS DEVELOPMENTS

1.1. Global and Regional Developments

Global output recorded weaker growth in 2018, at 3.7 percent, below the 3.8 percent growth in 2017. The deceleration is attributed to the trade tensions resulting in tariff increases by the United States of America (USA) on Chinese commodities in the first half of 2018. The persistent trade tensions involving the United States of America, China, European Union, and in emerging and developing economies stiffled growth (**Table 1**). It is only in the United States where growth remained robust amid a tight labour market and strong consumption growth, but investment appeared to weaken in the second half of 2018.

Growth in the Euro area decelerated more than expected due to a combination of factors across countries. In particular:- (1) weakening consumer and business sentiment; (2) delays associated with the introduction of new fuel emission standards for diesel-powered vehicles in Germany; (3) fiscal policy uncertainty, elevated sovereign spreads, and softening investment in Italy; and (4) street protests that disrupted retail sales and weighed on consumption spending in France. In addition, concerns about a no-deal Brexit weighed on investment spending within the euro area. The region's exports declined considerably, partially because of weak intra-euro-area trade, which exacerbated poor sentiment across the currency area.

Table 1: Overview of the World Economic Outlook Projections (percent change)

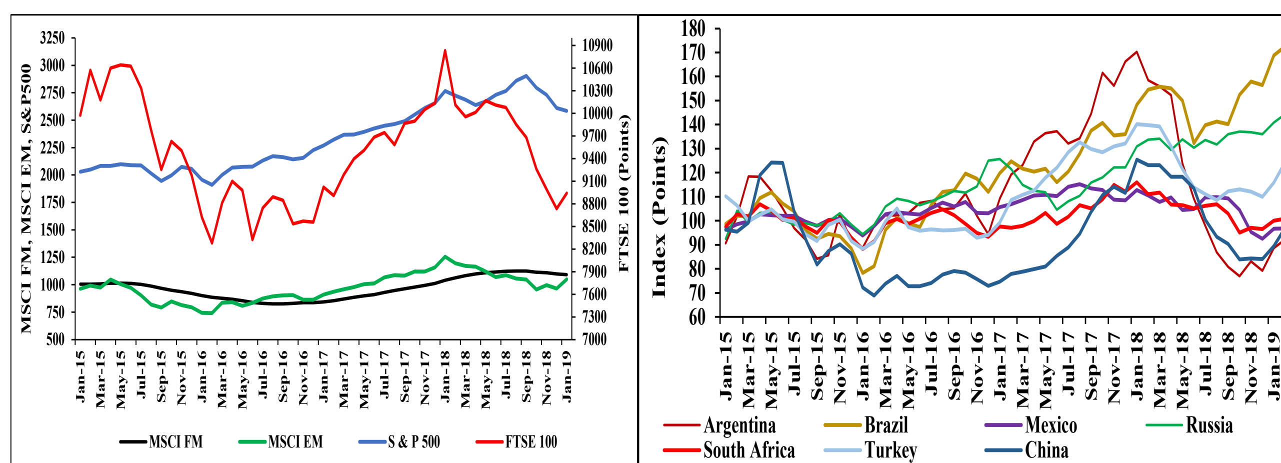
	Estimates		Projections		Difference from Oct. 2018 WEO Update	
	2017	2018	2019	2020	2019	2020
World output	**3.8**	**3.7**	**3.5**	**3.6**	**-0.2**	**-0.1**
Advanced economies	**2.4**	**2.3**	**2.0**	**1.7**	**-0.1**	**0.0**
United states	2.2	2.9	2.5	1.8	0.0	0.0
Euro area	2.4	1.8	1.6	1.7	-0.3	0.0
Emerging Market and Developing Economies	4.7	4.6	4.5	4.9	-0.2	0.1
China	6.9	6.6	6.2	6.2	0.0	0.0
Brazil	1.1	1.3	2.5	2.2	0.1	-0.1
Sub-Saharan Africa	2.7	2.9	3.5	3.6	-0.3	-0.3
Nigeria	0.8	1.9	2.0	2.2	-0.3	-0.3
South Africa	1.3	0.8	1.4	1.7	0.0	0.0
Low Income Countries	4.7	4.6	5.1	5.1	-0.1	-0.2
MENA Region, Afghanistan and Pakistan	2.2	2.4	2.4	3.0	-0.3	0.0
Consumer prices						
Advanced Economies	1.7	2.0	1.7	2.0	-0.2	0.0
Emerging Market and Developing Economies	4.3	4.9	5.1	4.6	-0.1	0.0
Interest rates: London Interbank Offered Rate (percent)						
On US Dollar Deposits (Six Month)	1.5	2.5	3.2	3.8	-0.2	-0.1
On Euro Deposit (Three Month)	-0.3	-0.3	-0.3	0.0	-0.1	-0.1

Source: WEO, April 2019

Among the EMDEs, necessary domestic regulatory tightening in China to address debt concerns, constrain shadow financial intermediation, and place growth on a sustainable footing led to slower domestic investment in infrastructure. Spending on consumer durables, especially automobiles declined in 2018. These developments contributed to slowing growth momentum over the year, with diminishing export orders attributed to the USA tariff actions. As a result, China's growth declined from 6.8 percent in the first half of 2018 to 6.0 percent in the second half of the year. The weakening import demand in instability and weaker economic activity.

Further, Trade tariffs by USA on steel, aluminium and on a wider range of Chinese products as well as threats by USA to impose tariffs on goods from the European Union in the first quarter of 2018 triggered more portfolio outflows. This led to a decline in share prices and volatility in the Frontier, EMDEs and the EU stock markets (**Figure 1**).

Figure 1: Equity prices in Frontier, Emerging Market and Advanced Capital Markets



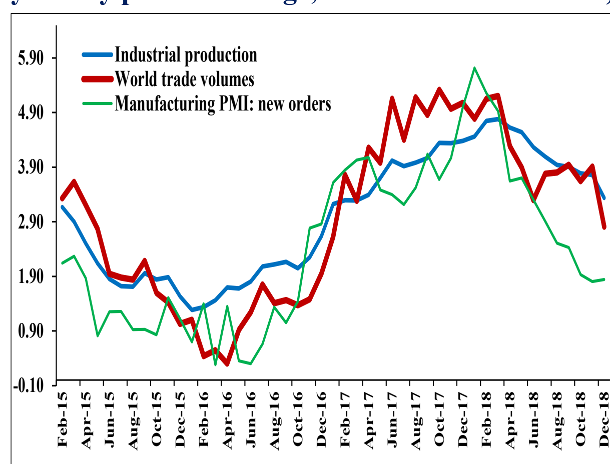
Source: Thompson Reuters

China appeared to have impacted exports among trading partners in Asia and Europe. Activity in other EMDEs moderated in the second half of 2018 due to country specific factors, which were compounded by worsening global financial conditions. In Argentina and Turkey, tight fiscal and monetary policy conditions to reduce financial and macroeconomic imbalances increased sovereign spreads and weakened consumer and investor sentiments. Cancellation of new airport construction in the capital and backtracking on energy and education reforms in Mexico and geopolitical tension in the Middle East and Northern Africa (MENA) region, contributed to financial market

Extended trade wars and geopolitical tensions poses uncertainties in global financial markets. This has implications on world trade, investment, and output. Trade restrictions and unresolved geopolitical tensions could trigger higher costs of imported intermediate, capital goods, and higher final goods prices for consumers. In addition, EMDEs face additional headwinds from the monetary policy normalization in advanced economies and other political developments, posing that policy uncertainties and higher risk aversion from advanced countries. These risks will exacerbate capital outflows, and will exert greater pressures among economies faced with higher vulnerabilities and weaker buffers (GFSR, October 2018).

Amid high policy uncertainty and weakening prospects for global demand, industrial production decelerated, particularly for capital and durable consumption goods. The slowdown was broad-based, notably across advanced economies, except for the United States of America (**Figure 2**).

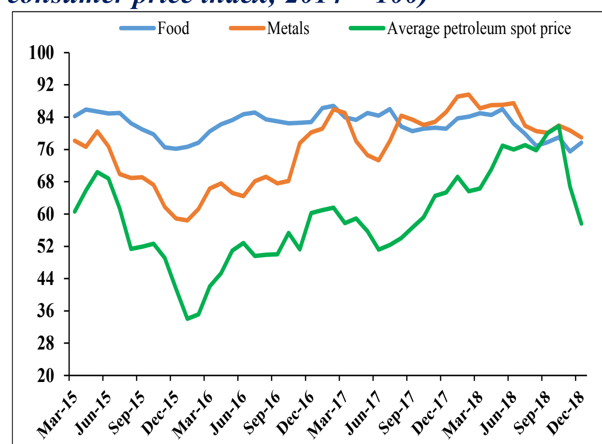
Figure 2: World Trade, Industrial Production, and Manufacturing PMI (Deviations from 50 for Manufacturing PMI) (3-month MA; y-over-y percent change, unless noted otherwise)



Source: WEO, April 2019

Commodity prices have been volatile in recent months, reflecting shifting supply influences against a backdrop of subdued demand (**Figure 3**).

Figure 3: Commodity Prices *(Deflated using US consumer price index; 2014 = 100)*

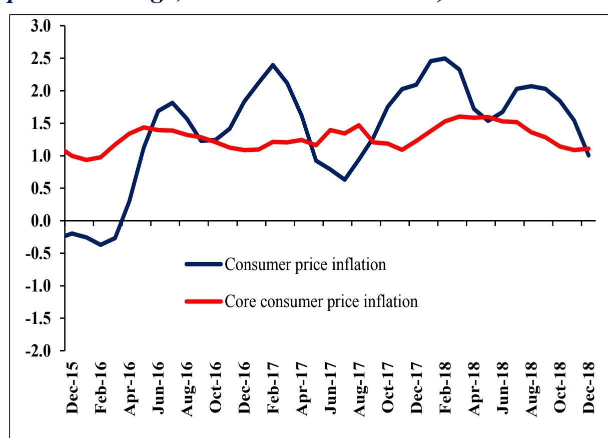


Source: WEO, April 2019

Global energy prices declined by 17 percent between October 2018 WEO and April 2019 WEO. Oil prices dropped from a four-year peak of USD 81 a barrel in October 2018 to USD 61 in February 2019 on weaker global growth that dampened prices by end of 2018. Prices of base metals increased by 7.6 percent since August 2018, due to supply disruption in some markets, more than offsetting depressed global demand.

Consumer price inflation remained muted across advanced economies, on the drop-in commodity prices, albeit marginal increases in both **Advanced Economies and in EMDEs**. The monetary authorities in advanced economies, however, raised interest rates to manage inflation expectations. This policy tightening triggered capital outflows from EMDEs in the third and fourth quarters of 2018 to advanced economies (**Figure 4**).

Figure 4: Global Inflation *(3-month MA; annualized percent change, unless noted otherwise)*



Source: WEO April 2019

Financial conditions in advanced economies have eased since the start of the year, after tightening sharply in the final months of 2018. Following a notable tightening of financial conditions in late 2018, market sentiment rebounded in early 2019 attributed to more accommodative monetary policy stances by central banks in advanced economies and the US–China trade negotiations. By March 2019, conditions were slightly tighter than in October 2018 (April 2019 *GFSR)*, but, still accommodative. In the US for instance, bond yields declined as investors reassessed the outlook for monetary policy normalization after the Fed announced a pause for further tightening. Better communications by major central banks has also eased financial conditions. The European Central Bank, which ended its net asset purchases in December 2018, announced in March a new round of targeted bank financing and further postponed a rise in policy rates to at least the end of 2019. The Bank of England and Bank of Japan have increasingly taken cautious views on the outlook.

Consistent with this shift in policy stance, yields on sovereign securities in advanced economies (10-year US Treasury Notes, German bunds[1], and UK gilts) have been declining in tandem with future policy rates and are generally 40–80 basis points below the peaks of early November 2018. (**Figure 5.a**). Italian spreads over German bunds, about 250 basis points in late March, have declined from their end October/ Early-November peaks, but remain elevated. Riskier asset classes have also benefited from improved sentiment at the start of 2019. The Equity markets in the United States and Europe have regained footing after the sharp sell-off at the end of 2018, while high-yield corporate spreads—which had decompressed significantly in December—have narrowed since, but remain wider than in October 2018 (**Figure 5.b**).

1 Refers to German bonds

Figure 5.a:10-year government bond yield (%)

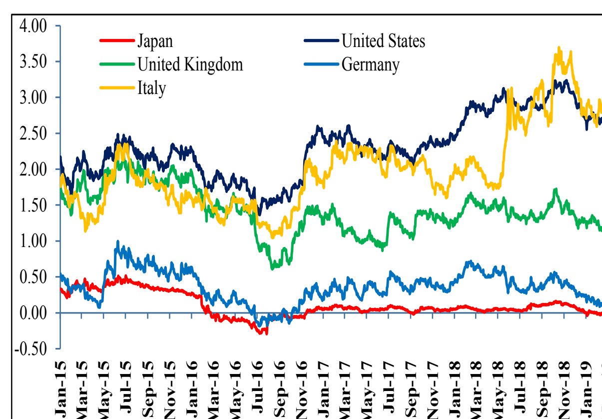
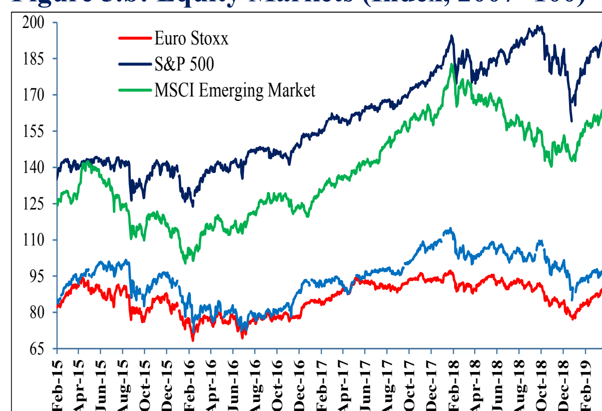


Figure 5.b: Equity Markets (Index, 2007=100)



Source: WEO, April 2019

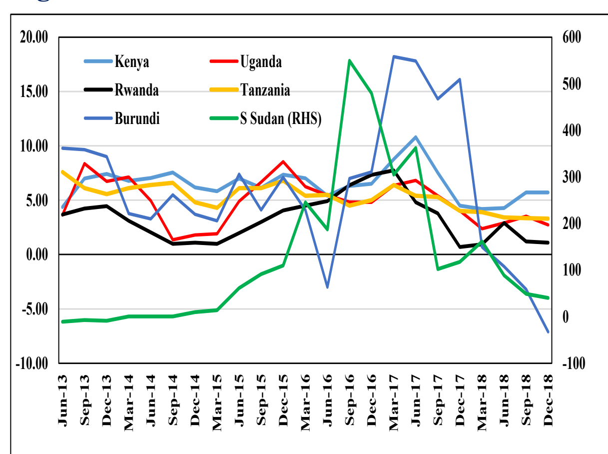
In Sub-Saharan Africa, the recovery in growth continued albeit at a slower pace compared to the recovery in commodity prices and conducive

weather in 2018. Growth in the region is estimated to have increased from 2.7 percent in 2017 to 2.9 percent in 2018, slower than expected, partly due to weaknesses in Nigeria, South Africa, and Angola. The region faced a tougher external environment on moderating global trade, tighter financial conditions, and a stronger U.S.D. (Global Economic Prospects (GEP), January 2019).

Balance of Payments financing faced challenges on the backdrop of rising external borrowing costs and weakening capital flows. Currencies in the region depreciated as the USD strengthened and investor sentiment toward emerging markets waned. Regional growth is projected to rebound at 3.5 percent in 2019, due to diminishing policy uncertainty, improved investment from Advanced Economies and robust growth in non-resource intensive countries.

In the East African Community region, growth recovered in 2018 on account of improved weather conditions for agricultural production, structural reforms and improved in political stability in Burundi and South Sudan. Inflation remained low and in single digit in 2018, except for South Sudan (**Figure 6**).

Figure 6: Inflation in EAC Partner States



Source: Respective Central Banks in the EAC

The growth momentum is projected to continue into 2019, backed by improving weather conditions and credit market supported by stability in the financial sector.

1.2. Risks to the Global and Regional Outlook

The global economic and financial conditions face a number of downside risks. **In particular, escalation of trade tensions, and heightened policy uncertainty could further weaken growth and cause volatility in financial markets**. The potential sharp deterioration in market sentiment, with ramifications on portfolio reallocations away from risk assets, wider spreads over safe haven securities, and overall tighter financial conditions, with vulnerable economies being most affected. Possible triggers include; global trade and geo-political tensions, a no-deal Brexit withdrawal of the UK from the European Union; persistently weak global growth; and prolonged fiscal uncertainty and elevated yields in Italy. A rapid reassessment by markets of the monetary policy stance in the US could also tighten global financial conditions. Over the medium term, climate change and political discord in the context of rising inequality are key risks that could lower global potential output, with severe implications for some vulnerable countries.

In the Sub-Saharan Africa (SSA), risks from external sources include; abrupt decline in commodity prices, rapid tightening of global financial conditions, and escalating trade tensions involving major economies. The SSA region faces risks associated with; political uncertainty in various countries, weakening aggregate demand, electioneering uncertainties, high and rising public debt levels on lack of commitment to address high fiscal deficits or implement structural reforms, increased reliance on foreign currency borrowing leading to refinancing and interest rate risks. There is also a risk of sudden capital outflows by increased foreign investors in the already shallow domestic capital markets in the region. In some countries, loans to state-owned enterprises and weak corporate sector performance, backed by commodity exports,

have increased the risk that a negative commodity price shock could trigger financial crises in debtor countries (GEP, January 2019, GFSR, October 2018 and WEO, April 2019).

The EAC region faces several downside risks. These include; rising public debt, declining trade and tightening global financial conditions. If global trade tensions persist and global financial conditions tighten abruptly, EAC Partner States would experience capital fight to advanced and emerging markets, and an increase in interest rates. This would increase funding costs, exacerbate exchange rate and cause increased volatility in domestic capital markets. The increasing level of government public debt coupled with elevated budget deficits, and reliance on foreign borrowing have reduced the ability of the governments to respond to adverse shocks. Regional conflicts and slow progress in implementing the Common Market protocol in the EAC Partner States are impacting the region negatively in terms of regional trade and growth prospects in 2019.

The regional banking sub-sector recorded 11.6 percent growth in assets by end December 2018. But, credit risk, however, remains elevated, with non-performing loans to total gross loans averaging 8.0 percent on account of varying factors including delayed government payments to suppliers, reduction in real estate occupancy rates and prices (uptake) and weak underwriting standards. While liquidity risk remained low, the increase in bank exposure to government securities raises concerns about sovereign debt risk and re-pricing risk on these securities, should interest rates rise more rapidly than currently expected. This has implications on financial stability.

1.3. Implications of Global Macro-Financial Developments to Kenya

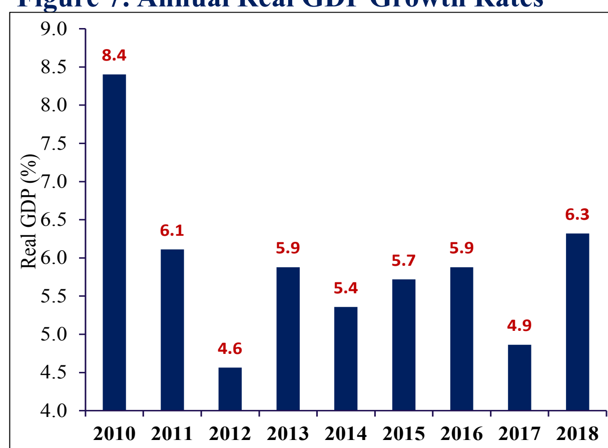
Recovery in global growth positively influences demand for Kenya's main exports of Tea, coffee, horticulture and travel services as well as increase in remittances. This will not only create jobs, but it enables suppliers of these goods and services to repay their loans and in turn lowers credit risks through declining NPLs among credit providers. The export earnings increase foreign reserves that ease balance of payment constraints, while tax revenue from secondary activities related to export increase government revenue.

Slowdown in global growth offers an opportunity for developing economies (DEs) to implement policies that enhance the resilience of their economies and support stability of the financial sectors. These policies include; fiscal consolidation to create room for fiscal stimulus during slowdown, strengthening the potential for higher and more inclusive growth, improving financial resilience to contain market risks leveraging on technology for sustained growth, and fostering international and regional cooperation to enhance trade.

CHAPTER 2: DOMESTIC MACROFINANCIAL CONDITIONS

Kenya's economy recovered from drought and extended electioneering period in 2017 to register a robust growth of 6.3 percent in 2018 compared to 4.9 percent in 2017 (Figure 7). Strong rebound in agricultural sector on favourable weather, government efforts to revive manufacturing sector and strong recovery in tourism sector following improved security, political stability and marketing of the country's tourist attractions supported the growth. However, continued global and regional trade tensions, a no-deal Brexit, geopolitical tensions and climate-related shocks might dampen future growth momentum. In addition, reducing fiscal space because of maturing public debt obligations could reduce public spending on priority projects, which have partly supported growth. However, expanded public investment in projects under the 'Big 4' development agenda may balance out these downside risks.

Figure 7: Annual Real GDP Growth Rates

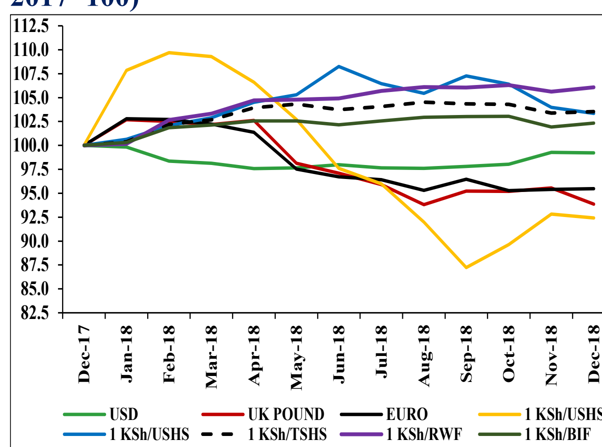


Source: Kenya National Bureau of Statistics (KNBS)

The Kenya Shilling was stable albeit slight appreciation against both the regional and international currencies in 2018 (Figure 8)[2]. Stability of exchange rate follows a narrow Current Account Balance (CAB) of 4.9 percent of GDP on increased diaspora remittances, reduced imports bill and expanded exports in to new markets. Remittances increased from US$ 450.41 million in the fourth quarter of 2017 to US$504.75 million in fourth quarter of 2018.

The Kenya Shilling is projected to remain stable in 2019 due to strong foreign exchange reserves, increase in remittances flows, improving exports and stable import bill. Downside risks include; faster than projected increase in global oil prices; global trade wars, no-deal Brexit and geopolitical tensions, especially between the US and Iran.

Figure 8: Exchange Rate Performance (December 2017=100)

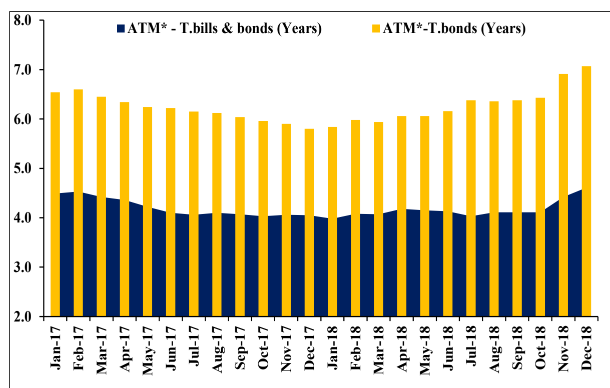


Source: Central Bank of Kenya

Domestic debt in form of total Government Securities (excluding Treasury bills stock held for Open Market Operations (OMO)), grew by 18.12 percent, to KSh.2,452.34 billion at the end of December 2018, from KSh.2,076.13 billion at end December 2017. Stock of domestic debt average maturity rose to 4.6 years in December 2018 from 4.1 years in December 2017, thus minimizing roll-over risks **(Figure 9).** The lengthening of the maturity profile could be due to increased uptake of long-term infrastructure financing bonds and repayment of maturing short-term debt.

2 Figure 8 Summarizes the performance of exchange rate from the base of December, 2017).

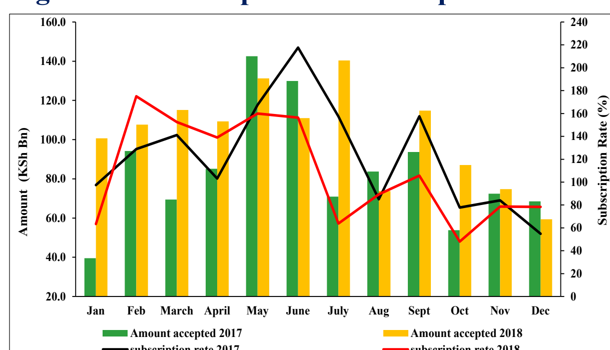
Figure 9: Average Maturity of Government Securities



Source: Central Bank of Kenya

Despite increased uptake of domestic debt, primary market for government securities performed well through 2018, reflecting adequate liquidity. The Treasury bill auction raised KSh. 1,225.19 billion in 2018 compared to KSh 1,003.98 billion in 2017 (**Figure 10**). Treasury bonds were subscribed at 76.22 percent in 2018 compared to subscription rate of 122.36 percent in 2017. The under subscription in 2018 may be explained by lower coupon rates offered on bonds to reduce cost of debt in line with the debt management strategy.

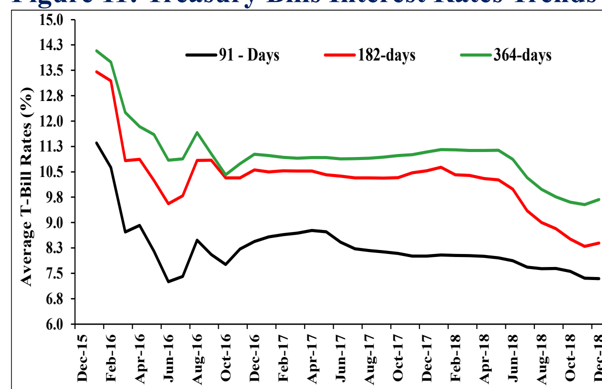
Figure 10: Subscriptions and Accepted Amount



Source: Central Bank of Kenya

Interest rates on treasury bills have been stable and declining since the fourth quarter of 2016, reflecting high demand by banks, improved market liquidity and overall market stability after the 2015–2016 crisis in the banking subsector (Figure 11). Implementation of the interest rates capping law in September 2016 influenced many banks to focus lending to government rather than the private sector. As a result, demand for Treasury bills and bonds increased, exerting downward pressure on interest rates. While this may signal a flight to safety by banks, it exposes banks to interest rates risks as well as asset concentration risk if interest rates reversal takes place on potential lifting of interest rates capping law.

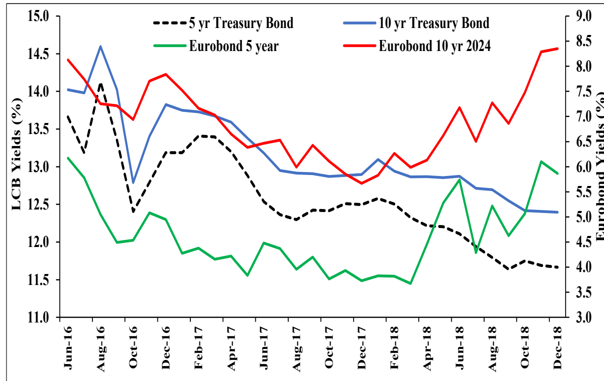
Figure 11: Treasury Bills Interest Rates Trends



Source: Central Bank of Kenya

Consistent with trends in Treasury bills yields, yields on Local Currency Bonds (LCBs) have declined steadily since 2016 (Figure 12). Most investors, mainly banks, purchased more government securities immediately after Interest Rates Capping Law became operational in September 2016, pushing down yields on the 5- and10- year LCBs significantly.

Figure 12: Declining Local Currency Bond Yields against rising Eurobond Yields

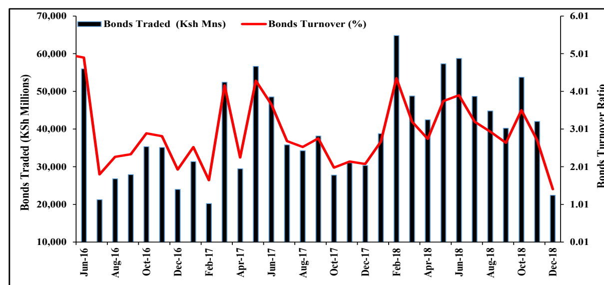


Source: Thomson Reuters and Central Bank of Kenya

The yields have since declined steadily through December 2018. On the flip-side, yields on similar maturities for Eurobonds have increased gradually since December 2017, reflecting tightening monetary conditions amid rising interest rates in advanced economies.

Trading in the secondary market for government bonds performed better in 2018 compared to activity in 2017, perhaps reflecting stable macroeconomic environment, improved political stability and adequate liquidity in the market (Figure 13). However, the steady decline in bonds turnover ratio in 2018 signifies a less liquid market in 2018, although relatively higher than in 2017 and 2016. It is essential to deepen the LCB market to build a strong base for potential shock absorption and create a long term financing market for the private sector.

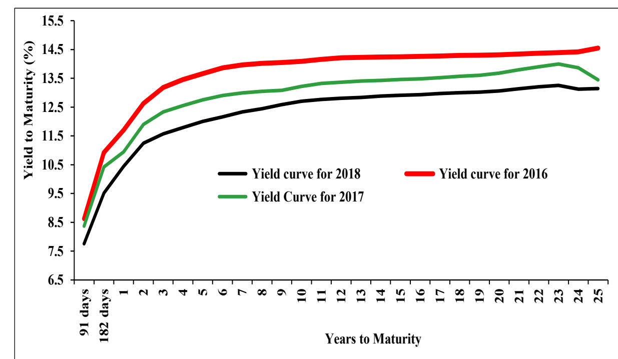
Figure 13: Secondary Market Trading Activity in Government Bonds



Source: Central Bank of Kenya

Stable macroeconomic conditions reflected by low and stable inflation and stable exchange rate supported by ample liquidity led to a downward parallel shift of the yield curve in 2018 (Figure 14). The steep slope of the 2016 yield curve reflects liquidity challenges in the market following placement of Imperial Bank and Chase Bank in receivership in October 2015 and April 2016, respectively, as well as banks' reaction to introduction of interest rates capping law in September 2016. However, shocks to the market affecting interest rates that causes a parallel upward shift of the yield curve back to the 2016 position, would lead to revaluation losses of existing mark-to-market bonds, thus impacting banks' balance sheet and other investors' portfolios.

Figure 14: Government of Kenya bonds Yield Curve



Source: NSE

Kenya's public and publicly guaranteed debt remains sustainable over the medium term. The rate of debt accumulation and terms of new borrowing are, however, areas of concern going forward (Table 2). Total public debt grew by 21.45 percent in December 2018 compared to its stock in December 2017, with external component was rising much faster than the domestic component.

Table 2: Public Debt, GDP and Tax Revenue

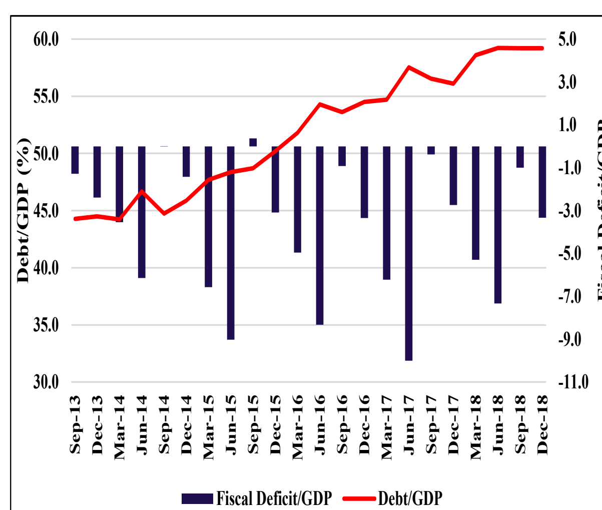
End Period	Public debt/ GDP	Public Debt/ Tax Revenue	Foreign debt service / Export	External debt service/ Export & Taxes	Domestic debt service/ Tax
Dec–15	50.4	52.22	75.4	1.85	3
Mar–16	51.89	53.65	23.11	0.56	3.08
Jun–16	54	55.75	123.94	2.7	2.36
Sep–16	52.78	56.32	32.82	0.69	3.47
Dec–16	53.47	57.05	111.33	2.25	3.72
Mar–17	53.97	57.37	66.16	1.39	3.61
Jun–17	56.77	59.25	99.66	1.96	3.38
Sep–17	57.29	61.51	66.77	1.3	4.13
Dec–17	50.4	61.66	91.65	1.81	3.51
Mar–18	58.33	62.81	174.44	5.7	3.86
Jun–18	59.55	61.56	98.12	4.22	4.27
Sep–18	59.67	61.01	216.75	1.63	4.07
Dec–18	59.21	60.61	72.52	1.43	4.24

Source: The National Treasury and Central Bank of Kenya

While the bulk of Kenya's external public debt has been on concessional terms, uptake of commercial loans, considered more expensive is increasing (syndicated loans and Eurobonds). The level of indebtedness as measured by the ratio of total debt to GDP has increased from 50.4 percent in December 2017 to 59.7 percent in 2018. The ratio of public debt to tax revenue has also increased from 52.2 percent in 2017 to 61.0 percent in 2018. The liquidity indicators; public debt service to tax revenue and exports, respectively have been increasing. Hence, overall narrowing room for further debt.

Despite fiscal space reducing, public debt is still sustainable over the medium term given the declining ratio of fiscal deficit to GDP **(Figure 15)**. The risk of external debt distress remains low due to increase foreign reserves and narrowing of the current account balance. In addition, the overall public debt has augmented productivity of the economy and increased output, generating adequate revenues to service the debt. The fiscal consolidation adopted by government in 2017 has buttressed public debt sustainability in line with the Government Medium-Term Debt Strategy.

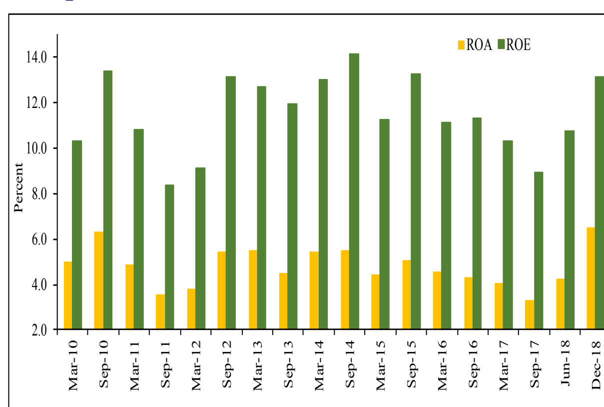
Figure 15: Narrowing Fiscal Space



Source: computed from The National Treasury data

The non-financial firms listed on the NSE reported improved profitability in the first half of 2018, compared to performance in 2016 and 2017 (Figure 16). This reflects better economic activity in 2018. Strong performance by non-financial firms enables them expand their businesses by ploughing back profits, service their debt and obtain favourable credit risk ratings. We have, however, noted increased accumulation of short-term debt, implying potential risks in the medium term.

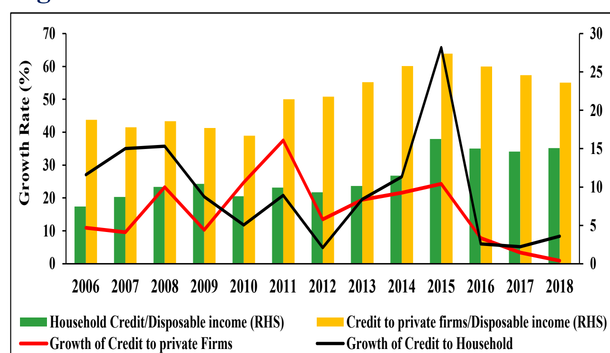
Figure 16: Profitability of Non-financial companies listed on the NSE



Source: Computation by CBK Staff

Overall, credit to the private sector recovered marginally in 2018 after the slump in 2016 and 2017 (Figure 17). Credit to households increased slightly but the proportion channelled to private firms declined, thus pulling down the overall credit to the private sector. The slow growth in disposable income relative to accumulation of credit reduces the ability of households to repay loans. The decline in credit to private firms amid low level of indebtedness implies that the firms received inadequate funding and therefore slow pace of expansion as they relied more on their reserves.

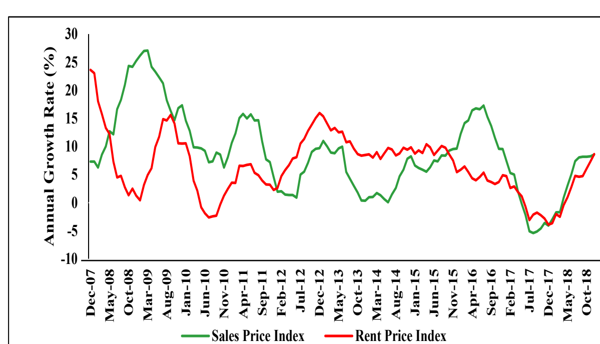
Figure 17: Private sector credit and indebtedness



Source: Central Bank of Kenya

Property prices recovered in 2018 as indicated by the Hass Consult and Cytonn latest published reports. The Hass Consult All Types Property Index showed that property prices gained 1.91 percent and 1.57 percent for selling and rental price in 2018 compared to 1.03 and 0.76 percent decline in 2017, respectively (**Figure 18**). The recovery in rental property prices comes from apartments, whose overall rental prices increased by 15.9 per cent on improved demand for the apartments. This drove their rental prices upwards sharply in the fourth quarter of 2018. The recovery in the overall sales price was driven by the detached and semi-detached houses with an annual increase of 9.7 percent and 9.5 percent, respectively.

Figure 18: Selling Price and Rental Price Indices



Source: Hass Consult

Financing of real estate by insurance and pension industry has increased faster compared to commercial banks. Credit from banks to the real estate grew by 2.49 percent in 2018 compared to 3.18 percent growth rate for pension funds and 8.61 percent in insurance companies **(Table 4)**. Other financing sources include; mortgage finance companies, Savings and Credit Cooperatives (Saccos), capital markets (Real Estate Investment Trusts), off-plan purchases, and private sources.

Table 3: Funding Options in Real Estate (KSh Billions)

Year	Insurance	Pension	Commercial Banks
2012	39.32	1.6	130.92
2013	54.26	119.84	162.33
2014	62.55	130.39	218.68
2015	68.62	50.78	262.48
2016	73.24	178.42	284.09
2017	76.04	226.72	371.65
2018	82.59	229.9	380.91

Source: Various reports of Real Estate Firms and Regulators

Approved actual buildings plans declined by 14.6 percent in 2018 compared to actual approvals in 2017 **(Table 4).** The property market is, however, expected to recover in 2019 on increased housing by Government, improved demand and recovery of commercial bank credit.

Table 4: Value of Building Plans Approved (KSh Millions)

Month	Actual Value of Buildings			Real Actual Value of Buildings			
	Residential	Non-Residential	TOTAL	Residential	Non-residential	2018 Total	2017 Total
Jan	13,122.47	6,824.92	19,947.39	154.20	78.25	232.45	236.83
Feb	10,917.29	9,822.84	20,740.13	128.29	112.62	240.91	230.14
Mar	12,810.54	6,607.25	19,417.78	150.53	75.75	226.28	252.06
April	-	-	-	-	-	-	254.48
May	12,917.29	7,122.58	20,039.87	151.79	81.66	233.45	257.99
June	13,409.58	7,207.25	20,616.83	157.57	82.63	240.20	267.76
July	10,624.92	7,201.69	17,826.61	124.85	82.57	207.42	242.8
Aug	10,735.63	4,880.78	15,616.41	126.15	55.96	182.11	-
Sept	11,132.49	6,147.54	17,280.03	130.82	70.48	201.30	279.94
Oct	9,696.37	8,082.13	17,778.50	113.94	92.66	206.60	372.92
Nov	15,319.80	9,354.40	2,4674.20	180.02	107.25	287.27	191.13
Dec	11,152.41	5,206.55	16,358.96	131.05	59.69	190.74	219.16
Total	**31,838.80**	**78,457.93**	**21,0296.70**	**1,549.21**	**899.52**	**2,448.73**	**2,805.21**

Source: KNBS actuals deflated by recent construction cost indices (Dec 1972 = 100), - No Building plans approved

CHAPTER 3: FINANCIAL SYSTEM VULNERABILITIES AND RISKS

Overall, Kenya's financial sector was stable and resilient in 2018, growing by 6.6 percent by assets. The insurance, capital markets, pensions, Saccos and banking sub-sectors' assets grew by 18.2 percent, 12.6 percent, 10.6 percent, 9.6 percent and 10.1percent, respectively. The Banking, SACCOs and pension sub-sectors recorded increase in profitability due to the recovery of the economy and improved regulatory framework. The insurance sub-sector, however, recorded a decline in profitability attributed to weak private sector businesses. The deposits insurance by the Kenya Deposit Insurance Corporation (KDIC) had Effective Cover of 33.3 percent in 2018 up from 29.6 percent in 2017. The capital markets recorded mixed performance in both primary and secondary markets activities for bonds.

The banking sub-sector assets accounted for 49.51 percent of nominal GDP in 2018, with pensions second at 13.10 percent (Table 5). The rest accounted for less than 10 percent of nominal GDP each.

Table 5: Share of Financial Sector Assets to GDP

YEAR	2017		2018	
Nominal GDP (millions)	8,144,373		8,904,984*	
Indicator/ Industry	Total Assets (KSh Bns)	Share of GDP (%)	Total Assets (KSh Bns)	Share of GDP (%)
Banks (excludes MFBs)	4,002.74	49.15	4,408.59	49.51
MFB	67.60	0.83	70.75	0.79
Insurance	590.95	7.26	637.41	7.14
Pensions	1,081.10	13.27	1,166.34	13.10
Saccos	442.90	5.44	493.82	5.55
TOTAL	**6,627.04**	**81.37**	**6,776.91**	**76.09**
Market Capitalization	2,521.77	30.96	2,102.00	23.60

Source:KNBS and Regulators' reports
**Provisional*

The banking industry's assets as a share of nominal GDP has declined over the last six years, from a high of 59.3 percent in 2014 to 49.5 percent in 2018 (**Table 6**).

Table 6: Trends in Share of Financial Sector Assets to GDP

Indicator/ Industry	2013	2014	2015	2016	2017	2018
Banks (excludes MFBs)	56.97	59.27	56.11	52.30	49.15	49.51
MFB	0.87	1.05	1.12	1.01	0.83	0.79
Insurance	7.72	7.90	7.69	7.35	7.18	7.14
Pensions	14.68	14.60	13.08	12.69	13.27	13.10
Saccos	5.42	5.59	5.27	5.47	5.44	5.58
Market Capitaliza-tion	40.48	42.61	32.93	26.85	30.96	23.60

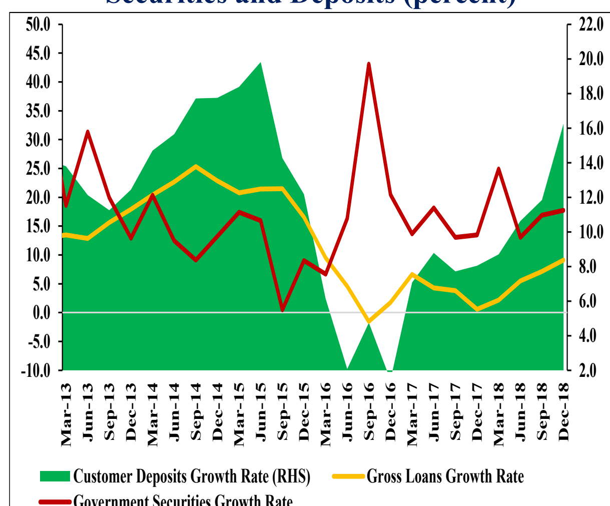
Source: Regulators' reports

3.1 Banking Sub-sector

As at December 2018, there were 42 commercial banks, 1 mortgage finance company, 13 microfinance banks, 9 representative offices of foreign banks, 70 foreign exchange bureaus, 19 money remittance providers and 3 Credit Reference Bureaus (CRBs).

Total net assets grew by 10.14 percent from KSh 4,002.74 billion in December 2017 to KSh 4,408.59 billion in December 2018. Loans and advances accounted for 52.6 percent of total assets in December 2018. Investment in government securities rose by 19.03 percent compared with just 3.07 percent growth in loans and advances in 2018. The collapse of Imperial Bank in October 2015 and Chase Bank in April 2016 and introduction of Interest Rates Capping Law in September 2016 had significant negative impact on the growth of deposits and loans and advances. However customer deposits recovered in the first half of 2017 to grow by 12.4 percent from KSh. 2,899.99 billion in December 2017 to KSh. 3,259.5 billion in December 2018 supported by deposits mobilization through agency banking and mobile phone platforms. Despite increase in customer deposits, most banks diverted their funds from lending to the private sector to investing in government securities (**Figure 19**). As a result, growth in gross loans and advances was low albeit gradual recovery.

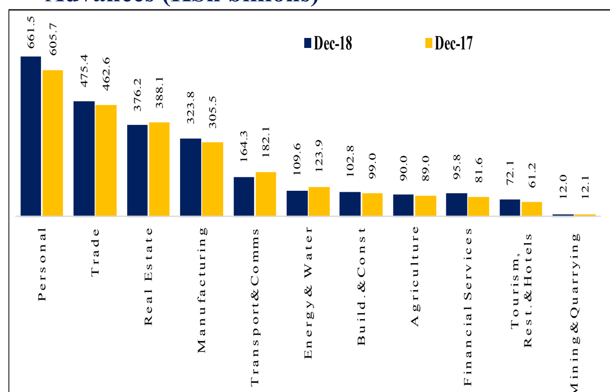
Figure 19: Growth in Loans, Government Securities and Deposits (percent)



Source: Central Bank of Kenya

The sectoral distribution of loans and advances as at December 31, 2018 indicates that personal/ household, trade, real estate and manufacturing sectors accounted for the largest growth in the banks' loan portfolio. (**Figure 20**).

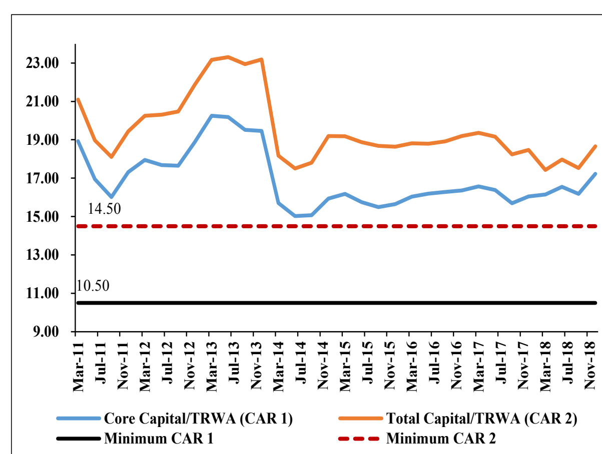
Figure 20: Sectoral Distribution of Loans and Advances (KSh billions)



Source: Central Bank of Kenya

Overall, banks were more resilient and solvent following build-up of strong capital buffers way above the minimum regulatory requirements **(Figure 21).** The ratio of Core to Total Risk Weighted Assets averaged about 16.5 percent in 2017 and 2018, while Total Capital to Total Risk Weighted Assets (TRWA) ratio averaged 19.5 percent in 2018 up from 18.8 percent in December 2017 . The two ratios were way above the minimum statutory requirements of 10.5 percent and 14.5 percent , respectively. Significant decline in CARs in the first half of 2014 is partially explained by increase in total risk weighted assets.

Figure 21: Quarterly Capital Adequacy Ratios (percent)



Source: Central Bank of Kenya

The banks' assets quality reflected by non-performing loans deteriorated in 2018 compared to 2017. The gross non-performing loans (NPLs) rose by 19.69 percent to Ksh.316.7 billion in December 2018 from KSh 264.6 billion in 2017. Similarly, gross NPLs to gross loans rose from 12.3 percent by end 2017 to 12.7 percent by end 2018 **(Table 7)**.

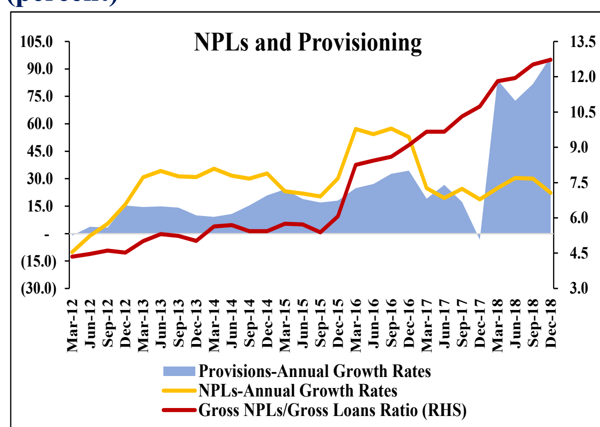
Table 7: Banks' Asset Quality

	Measure	Dec. 2017	Dec. 2018	Change (%)
1	Net Assets (KSh Millions)	4,002,741	4,408,593	10.14
2	Gross Loans and Advances (KSh Millions)	2,413,851	2,488,117	3.08
3	Total Loans (KSh Millions)	2,114,804	2,433,670	15.08
4	Net Loans (KSh Millions)	2,013,610	2,318,071	15.12
5	Gross Non-Performing Loans (KSh Millions)	264,617	316,712	19.69
6	Interest in Suspense (KSh Millions)	43,726	54,447	24.52
7	Total Non-Performing Loans (KSh Millions)	220,891	262,265	18.73
8	Total Provisions (KSh Millions)	101,193	115,599	14.24
9	Net Non- Performing Loans (KSh Millions)	119,698	146,666	22.53
10	Net NPLs to Gross Loans (%)	5.5	5.9	0.04
11	Gross Loans /Net Assets (%)	53.9	56.4	2.50
12	Gross NPLs to Gross Loans (%)	12.3	12.7	0.40

Source: Central Bank of Kenya

The rapid NPLs growth rates recorded in 2016 dissipated in second half of 2017 through 2018. However, the ratio of gross NPLs to gross loans has maintained a steady upward trend, signifying elevated credit risk in the banking industry. Banks have responded to this risk by increasing provisions for bad debts, to the highest level in 2018 after the introduction of IFRS 9 that became operational in January 2018 (**Figure 22**).

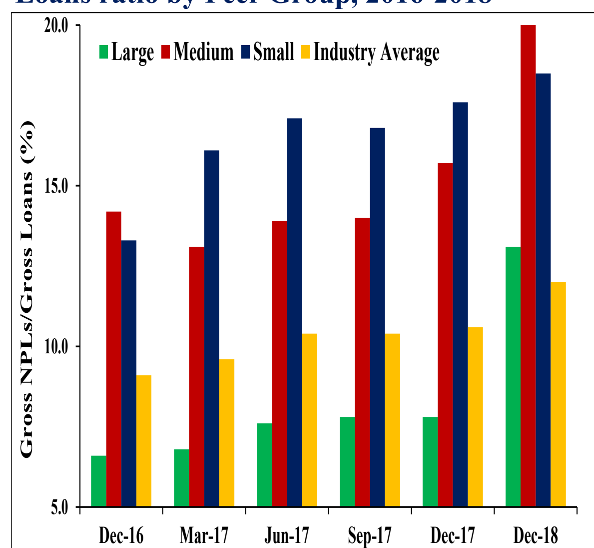
Figure 22: NPLs Trends and Provisioning (percent)



Source: Central Bank of Kenya

Different business models and bank management influences propensity to accumulate risky assets, thus impacting quality of assets. Banks in the medium peer group category were the main drivers of increase in the growth of Gross NPLs to Gross Loans ratio in the fourth quarter of 2018 compared to banks in the Small and Large Peer Group categories. In the period December 2016 – December 2018, banks in the small peer group recorded the highest average NPLs ratio of 16.6 percent compared to 15.3 percent for medium and 8.28 percent for large peer group banks (**Figure 23**).

Figure 23: Quarterly Gross NPLs to Gross Loans ratio by Peer Group, 2016-2018



Source: Central Bank of Kenya

The deteriorating asset quality amid decline in private sector lending elevates credit and liquidity risks to the banking sub-sector. To mitigate the risks, banks increased provisioning for non-performing assets, thereby increasing loan coverage ratio (percentage of specific provisions to total NPLs) to 44.7 percent in December 2018 from 34.5 percent in December 2017. Banks also tightened credit standards as well as enhanced credit recovery efforts.

Profitability of the banking industry increased in 2018 compared to 2017. Profit before tax increased by 14.6 percent from KSh133.2billion in 2017 to Ksh.152.7 billion in 2018, explained by 16 percent growth in interest on government securities, which rose from KSh102.8billion in 2017 to KSh119.2billion in 2018. In addition, increase in profitability is attributed to a higher increase in income of KSh 27.1billion compared to increase in expenses of KSh7.6billion. Interest on loans and advances accounted for 51.5 percent of total income for banks. On the expenditure side, interest on deposits, salaries and wages, and other expenses accounted for 33.1 percent, 25.0 percent and 24.6 percent of total expenses, respectively.

The Return on Assets (ROA) rose by 0.2 percentage point to 2.8 percent in December 2018. The Return on Equity (ROE) however, increased from 20.6 percent in December 2017 to 22.5 percent in December 2018, driven by increased in profitability (12.4 percent) as compared to 4.1 percent increase in Shareholders' funds during the period under review. Given the heterogeneous nature of Kenya's banking industry, banks in the small peer group category recorded negative ROA, ROE and Profits Before Tax in 2018 while banks in the large peer group accounted for 85 percent of Profits Before Tax of the total industry (**Table 8**).

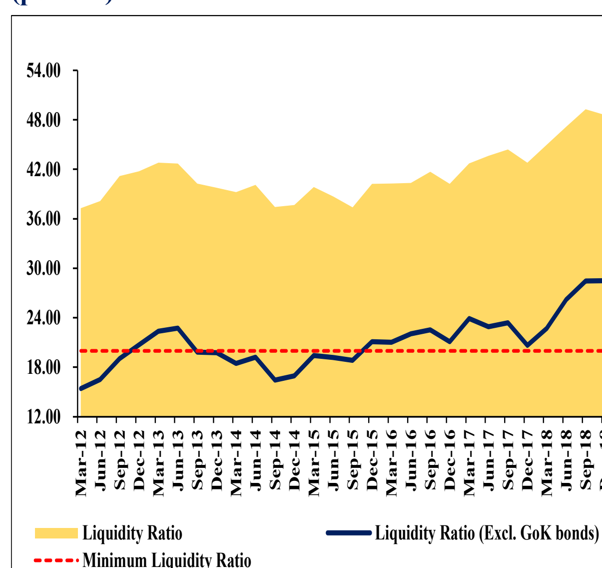
Table 8: Banks' Profitability Indicators by Peer Group[3] in 2018

MEASURE	Small Peer Group	Medium Peer Group	Large Peer Group	Industry Overall
Profit Before Tax (KSh Billions)	-0.31	23.23	129.78	152.70
ROA (percent)	-0.08	2.04	3.26	2.80
ROE (percent)	-0.58	15.01	27.62	22.50

Source: Central Bank of Kenya

Liquidity is key to banking industry stability, signifying the ability to fund assets and meet obligations as they fall due. A liquidity problem in one bank can disrupt liquidity distribution in the banking industry due to the interconnected operations. In addition, a liquidity problem can degenerate into a solvency problem for a bank if not handled well. The average liquidity ratio for all banks increased to 48.6 percent in December 2018 from 43.7 percent in December 2017. This was way above the minimum regulatory requirement of 20 percent. If we exclude government bonds, liquidity ratio for the industry reduces to 28.5 percent in 2018 (**Figure 24**).

Figure 24: Banking Industry Liquidity Ratios (percent)



The increase in the liquidity ratio is attributed to a higher growth in total liquid assets compared to the growth in total short-term liabilities. Liquid assets include all tradable government bonds and bills. Total liquid assets grew by 24.1 percent while total short-term liabilities grew by 11.5 percent. Over the same period, the ratio of gross advances to gross deposits declined to 73.0 percent in December 2018 from 83.2 percent in December 2017 due to a higher growth in deposits of 13.1 percent as compared to growth in advances of 4.7 percent.

3 As at December 2018, there were 20 banks in Small Peer Group, 11 banks in Medium Peer Group and 9 banks in the Large Peer Group.

The banking industry managed to cope with several risks, signifying resilience in 2018. The most persistent risk in the year was high level of NPLs and low credit to private sector, reflecting elevated credit risks. Delayed payments by governments to contractors and suppliers as well unfavourable business environment explain the elevated credit risk. Banks tightened lending standards and CBK enhanced surveillance to mitigate the situation. High exposure to government bonds by banks poses both sovereign and liquidity risks. As at December 2018, government bonds accounted for 20.1 percent of total liquidity of the banking industry, 24.36 percent of total assets held by banks and 16 percent of total income. Any shock to interest rates or rapid implementation of fiscal consolidation would negatively affect banks. Adoption of financial technologies by banks brought with it heightened operational risks reflected in increased fraud (cybercrime) in 2018. Banks have tightened internal systems, customer sensitization, and undertaken ICT vulnerability assessments and penetration tests to mitigate in the operation risks. The industry was also exposed to reputational risks in 2018 following incidences some banks were penalized and others placed under investigations for processing money for persons linked to corruption, money laundering and terrorism financing. CBK has strengthened the AML/CFT risk assessment frameworks to address this risk.

It is projected that banking industry will remain stable in 2019, with easing Credit risks and strong liquidity positions. More consolidation in the industry is expected following increased mergers and acquisitions that started in 2018.

3.2 Capital Market

The Capital Markets Authority (CMA) licensed entities as at December 2018 included; Securities Exchange (1), Central Depositories (1), Investment Banks (14), Stockbrokers (10), Investment advisers (14), Fund Managers (26), Collective Investment Schemes (23), Authorized Depositories/Custodians (14), Credit Rating Agencies (3), REIT Managers (8), REIT Trustees (3), Employee Share Ownership Plans (14) and Authorized Real Estate Investment Trusts (1).

The industry licensees 'assets' decreased to KSh 23.74 billion in 2018 from KSh 26.50 billion in 2017 (**Table 9**). CMA continuously monitors asset levels of its licensees to ensure accurate reporting of assets and liabilities, and sufficiency of liquid capital to identify potential bankruptcies.

Table 9: Performance of Capital Market Licensees in 2018[4] (KSh Millions)

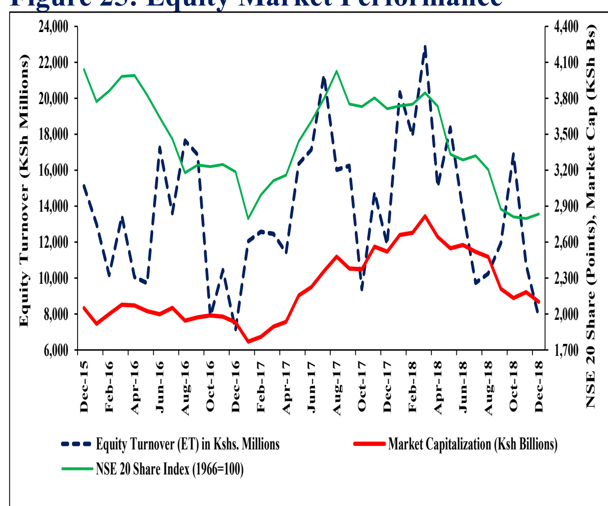
Licensee	Total Assets	Total Liability	Net Assets
Fund Managers	7,853.96	1,532.09	6,321.86
Stockbrokers	2,330.41	692.06	1,638.36
Investment Banks	11,885.78	2,995.46	8,890.32
Investment Advisors	1,464.78	161.95	1,302.82
Online Forex Broker (Non-dealing)	202.58	200.21	2.40
Total	**23,737.51**	**5,581.77**	**18,155.76**

Source: Capital Markets Authority

The equities market was generally on downward trend in 2018 as reflected in the performance of three key aggregate market indicators - NSE 20 Share Index, Equity Turnover and Market Capitalization largely influenced by foreign equity outflows in search for higher yields, profit taking and a number of adverse domestic and global policy pronouncements **(Figure 25)**. The NSE 20 Share Index however recorded a slight increase at end of 2018**.**

[4] Figures as at October 2018

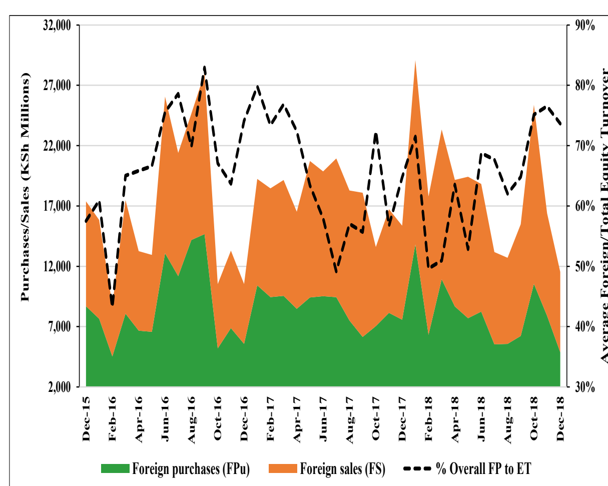
Figure 25: Equity Market Performance



Source: Nairobi Securities Exchange, 2018

Foreign investors' trading activity on the NSE as indicated by ratio of foreign participation to total equity turnover declined slightly to 63.2 percent in 2018 from 63.3 percent in 2017. (Figure 26). Transactions were more on the sell side (outflow), at KSh 29.7billion compared to KSh 11.6billion in 2017. Aggregate Equities holdings by foreign investors was 20.2 percent in December 2018, down from 21.1 percent in December 2017.

Figure 26: Foreign Participation Exposure (Equity) in KSh Millions



Source: Staff Computation

Liquidity of the equity market improved in 2018 as reflected by increase in the turnover ratio to 8.36 percent in 2018 from 6.81 percent in 2017. Launch of Derivatives market in July 2019 and operationalization of Securities Lending and Borrowing Regulations in 2017 will spur overall market liquidity and flexibility of financing. In addition, the launch of the NSE's Rapid Mass Visibilities Strategy (RMVS) will increase the visibility of a wider pool of Kenyan companies through an incubation and accelerator board, ultimately attracting more listings at the bourse **(Table 10).**

Table 10: Market Liquidity Ratios

Year	Equity Turnover (KSh Bins)	Market Cap (KSh Bns)	Liquidity Ratio (%)
2013	155.75	1,920.72	8.11
2014	215.73	2,300.05	9.38
2015	209.38	2,049.54	10.22
2016	147.18	1,931.61	7.62
2017	171.61	2,521.77	6.81
2018	175.65	2102.00	8.36

Source: Capital Markets Authority

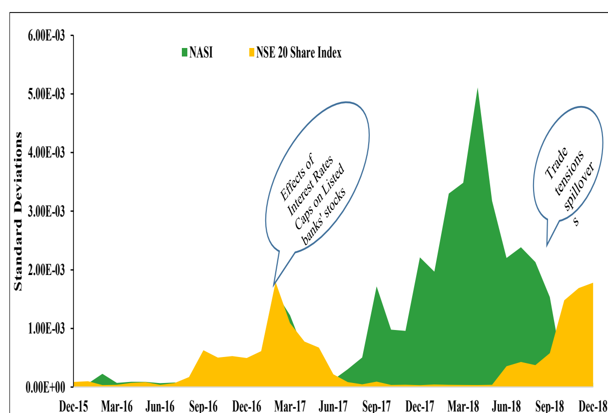
The capital market faced a number of risks in 2018. The market was vulnerable to three types of concentration risks: first, as at December 2018, top five companies by market capitalization accounted for 65.82 percent market capitalization from 64.83 percent in 2017, of which, Safaricom accounted for 42.31 percent. New listings of State Owned Enterprises and CMA's plans to roll out a product uptake and market deepening strategy targeting 'large cap' private companies to list on the NSE will rejuvenate capital markets activity. Secondly, foreign investors accounted for 63.28 percent of total equity turnover in 2018 compared to 63.23 percent in 2017. While this positive news, abrupt sell-offs, by this investor category can lead to excess volatility as noted in the first half of 2018 following interest rates hike in the advanced economies and emerging markets and the consequent search for yield. The CMA is committed to working towards attracting domestic investors at the NSE, through

aggressive investor education and awareness programmes. Thirdly, government bonds trading accounting for more than 99 percent of fixed income market segment.

The bourse also faced low liquidity in the equity market; limited issuance of corporate bonds; low uptake of new and existing products and services (Exchange Traded Funds, Real Estate Investment Trusts and Asset Backed Securities), crypto-assets related risks and regulatory challenges; market infrastructure failures as well as cyber risks, political and economic risks.

Volatility was high in 2018 compared to 2017, with NASI share price index averaging 0.55 percent in 2018 compared to 0.48 percent in 2017 (**Figure 27**).

Figure 27: Volatility in the Stock Market



Source: Staff computations

Excessive volatility in the equities market negatively affects investment. The CMA has taken initiatives to enhance the securities market and reduce volatility. These include market making, derivatives, securities lending and borrowing and direct market access.

The bond market was more active, recording a 27.95 percent increase in turnover, to KSh 557.72billion in 2018, form KSh 435.89billion traded in 2017, reflecting investors' flight to quality, following poor run in equities market. The corporate bond market was however inactive following insolvency issues with some of the bond issuers. CMA engaged some of its key strategic partners towards resolving issues around insolvency, revitalizing the bond market by approving issuance of green bonds, and fast-tracking implementation of the hybrid bond project.

To reinvigorate the market, CMA has introduced a raft of measures to incentivize potential issuers and investors. To spur new listings, CMA is developing the Growth Enterprise Market (GEMs) to attract Small and Medium Sized Companies to list. GEMs market offers; tax incentives, low listing fee, easier admission criteria and a reduction in free float requirement of 15 percent of issued share capital. CMA also adopted Business Incubator and Accelerator programme (Ibuka) on the Listing Experience initiative that has so far exposed over 45 potential issuers to requisite information on raising capital. The Programme enables local firms to enhance the financial, technical, operational, commercial and strategic aspects of their businesses, key requirements in raising capital through debt and equity markets. CMA continues with its robust investor education and public awareness initiatives, to promote investment in capital markets products and services.

Given the proliferation of FinTechs, products such as crypto-assets including cryptocurrency have found their way into the financial sector. This has introduced regulatory challenges in dealing with associated risks that have implications on financial stability. These instruments not only have the potential to destabilize the market, but they also present a new scope of market conduct concerns. Consequently, regulation of crypto-assets is of growing importance for financial markets and investors given that this asset class has experienced accelerated boom and bust cycles, which may expose investors to substantial losses. To address the risk, CMA issued a Cautionary Statement to the Public in its mandate of investor protection. Further, the CMA operationalized the Regulatory Sandbox framework, a formal regulatory program that allows innovative firms to test financial services or business models with live customers, subject to certain safeguards and oversight anchored in the

CMA Regulatory Sandbox Policy Guidance Note. The Authority stands to gain in its admission to the Global Financial Innovation Network (GFIN), a network of regulators to collaborate and share experience of innovation in respective markets.

Market Infrastructure failures and Cyber risks also emerged strongly for **Capital Markets in 2018**. For instance, the NSE Automated Trading System experienced hitches from a dependent System on October 1, 2018, leading to extended delay in trading hours by more than four hours. This resulted into a 20 percent decline in the equity turnover for the day compared to turnover of the previous trading day. On April 1, 2019, the market-trading infrastructure experienced a delay in opening due to unavailability of the Central Depository System. This led to the market opening for trading at 2.55 pm instead of the usual opening time of 9.30am. As result, equity turnover declined by 44.4 percent from the previous trading day. These highlight risks to the market arising from market infrastructure failures.

Cyber Risk is also emerging as one the top threats to financial markets as evidenced by prevalence of Cyber Incidents from financial data breaches affecting not only large multinational public companies but also Central Banks and Government systems in the face of increased use of Financial Technology (FinTech). A study by the International Organization of Securities Commissions (IOSCO) research department and the World Federation of Exchanges (WFE) show that about 50 percent of the global securities exchanges experienced cyber-attacks in 2018. This quite significant and could potentially undermine the integrity of global financial markets.

Alive to these risks CMA in collaboration with key industry players and other regulators are working towards systems' upgrade of the primary infrastructure used in the trading and settlement of securities. In addition, CMA is fastracking measures towards increasing Cyber Resilience of the capital markets.

3.3 Insurance Industry

Penetration of insurance services in the economy as measured by the ratio of insurance premium to GDP reduced in 2018 to 2.68 percent from 2.71 percent in 2017, falling below the global average of 6.1 percent **(Table 11).** Gross direct premiums have been growing at a decreasing rate over the past five years with the growth rates falling year-on-year. The highest growth rate of 17 percent was recorded over 2013/2014 whereas the lowest was 3 percent, recorded over 2016/2017 period.

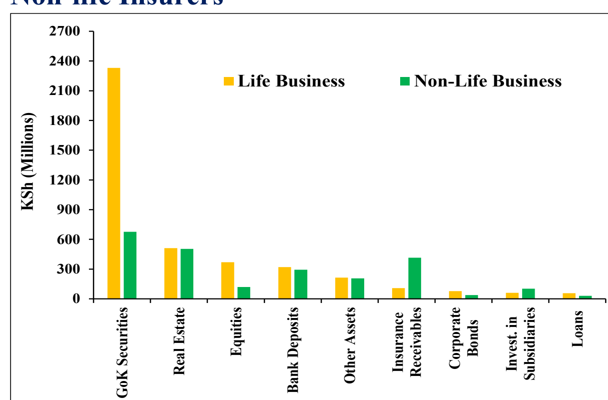
Table 11: Summary of industry performance during 2013-2018 (KSh Millions)

Indicator	2014	2015	2016	2017	2018*
Gross Premium Income	157.78	173.26	196.64	209.00	216.37
Net Premium Written	126.64	139.20	158.36	165.85	172.99
Claims Incurred (Gen. business)	41.89	49.05	54.86	56.15	56.78
Commissions	9.26	10.90	12.58	12.50	11.86
Expenses of Management	30.42	36.26	39.98	41.20	42.64
Investment Income (P&L)	9.54	6.74	6.02	6.60	5.40
Profit/Loss after Taxation	24.62	13.64	18.25	13.64	10.01
ROA	5.9	3.3	3.9	3.2	1.78
ROE	17.7	10.7	10.7	9.7	4.91
Investments	352.37	390.23	403.26	483.80	524.21
Assets	426.31	478.75	528.75	590.95	637.41
Shareholder's Funds	122.54	125.83	134.46	147.26	154.65

Source: Insurance Regulatory Authority
**Unaudited Data*

Despite the drop-in insurance penetration, there was a marked improvement in insurance coverage from 6.7 percent in 2017 to 8.99 percent in 2018 with number of policies (both life and general) increasing by 9.2 percent, from 3,139,984 policies in 2017 to 3,429,307 policies in 2018. The growth in insurance coverage was due to increased uptake of insurance by county governments and corporate organizations. Life and Non-Life Insurers have similar business models and similar liabilities structure. To match their liability maturities, insurers tend to have similar asset allocations with small variations depending on size and diversification objectives (**Figure 28**).

Figure 28: Portfolio composition of Life and Non-life Insurers



Source: Insurance Regulatory Authority

As a result, the variation in the portfolio of life and non-life insurers is highly correlated, exposing the industry to risks. The industry however remains stable with a number of measures being taken to enhance the regulatory framework through amendments to the Insurance Act and accompanying various legal notices. Some of the amendments include; group-wide supervision, harmonization of provisions on capital requirements, risk-based capital and investment guidelines and capital adequacy guidelines. Overall, the industry is expected to perform better in 2019 as the impact of these regulations take effect and the economy improves.

3.4 Pensions Industry

The pensions industry assets have grown from 696 billion in 2013 to KSh 1,166.34 billion in December 2018, because of prudent management and investment of scheme funds, and the reform initiatives targeting growing pension savings for workers in the informal and formal sectors. Pension coverage however, remained at 20.01 percent in 2018, although better than 18.6 percent in 2017. The industry assets were mainly in government securities and state-owned enterprises, property and equities (**Table 12**).

The pension industry has been relatively stable with the overall risk score at 3.07 against the baseline of 3.22 in 2018. The risk index was computed from a revised risk assessment toolkit. It is below the target for the year set at 2.89, mainly because governance parameters have not been included in the toolkit due to delayed gazettment of the governance guidelines in October 2018. The overall risk score is therefore, expected to improve. However, the industry continues to face Investment Risks given high exposure to government securities and quoted equities, which are vulnerable to interest rate and market risks. Similarly, schemes, which have invested in corporate bonds and fixed deposit, face interest rate risks and solvency risks.

Table 12: Pension Industry Assets

ASSET CLASS	2015		2016		2017		2018	
	Value	%	Value	%	Value	%	Value	%
Guaranteed Fund	99.4	12.21	129.58	14.20	142.97	13.24	167.31	14.34
Cash & demand deposits	11.26	1.38	12.93	1.42	12.95	1.20	12.72	1.09
Corporate Bonds	48.09	5.91	46.95	5.14	41.99	3.89	40.28	3.45
Quoted Equities	186.81	22.95	159.07	17.43	210.17	19.46	201.51	17.28
Fixed Term Deposits	55.61	6.83	24.57	2.69	32.88	3.04	36.39	3.12
Immovable property	150.78	18.52	178.42	19.55	226.72	20.99	229.91	19.71
Offshore investments	7.16	0.88	6.96	0.76	12.77	1.18	13.13	1.13
Other Assets*	12.57	1.54	5.03	0.55	5.474	0.51	5.42	0.46
Government Securities	242.43	29.78	349.15	38.26	394.19	36.50	459.68	39.41
Total	**814.11**	**100**	**912.66**	**100**	**1080.1**	**100**	**1166.35**	**100**
Risk Index	0.804		0.524		0.5087		2.895**	

Source: RBA

**the risk-rating toolkit was revised in 2018

** Unquoted Equities, private equity, REITS, CPs (1), Non-listed bonds by private firms (2), unclassified asset classes (investments in Collective Investment Vehicles)*

Schemes, which have invested in immovable property mainly buildings and land, face liquidity risks especially in cases where the retirees' pensions are paid out from the scheme. Schemes also face inflation risk, currency (exchange rate) risk, and credit or counter party risk. The industry has also noted emerging governance risks due to conflict of interest by either service providers, the trustees or the sponsor. The RBA has developed guidelines on the scope of investment, governance and treating customer fairly. Funding risks have also emerged due to increasing liabilities with inadequate assets. This is compounded by the increasing life expectancy. In the Defined Contribution schemes, unremitted contributions have increased due to poor economic performance and the insufficient funding of quasi government schemes.

To address the identified risks, RBA has initiated policy measures consistent with each risk type and prevalence. To mitigate investment risks, RBA amended investment guidelines to broaden the asset classes for schemes, brining on board; private equity, real estate investment trusts and derivatives. Schemes will also be allowed to invest in infrastructure projects under the PPP framework with dual goal of achieving the government developmental agenda and also ensuring members achieve a reasonable rate of return. To deal with funding risks arising from unremitted contributions, RBA Act was amended to enable RBA intervene directly against Sponsors who fail to remit employee deductions and contributions to schemes as and when they become due. To manage conflicts of interest and improve scheme governance, regulation 8 of the principal Regulations was amended to bar Board of Trustees from providing professional services to the schemes but seek independent professional services in the management of the scheme. Similarly, fund managers and administrators amended section 34 of the RBA Act to penalize late submission of audited accounts, investment returns and contribution returns. The pension industry is expected to perform better in 2019 on favourable economic growth that would support better return on stocks and properties.

3.5 SACCOs Industry

The Sacco industry has grown significantly in terms of assets, products and membership. The industry registered 12.44 percent growth in assets in 2018 compared with 12.40 percent in 2017 (**Table 13**). There were also five (5) new applications from Sacco's to conduct DT-Sacco business. Savings deposits remain the single largest source of deposit-taking Sacco's finance for their loans reinforcing the Sacco model of deposit mobilization for lending. Loans accounted for 75 percent of total assets of DT-Saccos. Deposits savings growth slowed due to high cost of living affecting members, thus leading to reduced ability to save. Sustained regulatory interventions have led to growth in core capital by 16.95 percent, which has in turn enabled of DTSs to adopt technology in delivery of new products and services.

Table 13: Saccos Performance Indicators (KSh Millions)

Indicator	Amount in KSh Millions			Changes in (2018-17)	Changes in (2017-16)
	2018	2017	2016		
Assets	497,278	442,277	393,499	12.44	12.40
Loans	373,195	331,212	297,604	12.68	11.29
Deposits	342,296	305,305	272,579	12.12	12.01
Capital and Reserves	92,406	72,328	61,261	20.14	21.76
Core Capital	78,267	64,254	54,943	21.81	16.95
Total Income	69,305	63,045	55,258	9.93	14.09

Source: *SASRA*

Key stability indicators show that Sacco Societies have adequate buffers to absorb business risks as measured by capital adequacy, liquidity, capacity to generate earnings and members' confidence (Table 14). Credit risk increased slightly in 2018, however, sustained regulatory interventions for DT-Sacco's increased capital by 13.1 percent, which is a sufficient buffer against credit risks and risks associated with adoption of technology to delivery new products and services.

Table 14: SACCO Sector Stability Indicators

Stability Indicator	Prudential standards	2016	2017	2018
Capital Adequacy				
Core Capital (KSh Millions)		54,943	64,254	78,267
Core Capital/Total Assets (%)	10 Percent)	13.96	14.53	14.46
Core Capital/Total Deposits (%)		20.16	21.05	21.01
Institutional Capital/ Total Assets (%)	8 Percent	7.71	8.18	8.03
Asset Quality				
Non-Performing Loans to Gross Loans	< 5 Percent	5.23	6.14	6.13
NPLs (Net of provisions)/ Core capital		7.63	9.90	10.94
Earning Assets to Total Assets		80.71	78.50	81.20
Earning Rating				
Return on Assets (ROA)		2.45	2.69	2.72
Non-Interest Expenses/ Gross Income		41.35	43.99	42.64
Operating Expenses/ Total Assets		5.44	5.29	4.90
Liquidity Ratio				
Liquidity Ratio+	> 15 Percent	49.95	54.10	54.82
Liquid Assets to Total Deposits		18.05	17.17	16.13
External Borrowings/ Total Assets	< 25 Percent	5.04	4.83	4.46
Liquid Assets/ Total Assets		12.49	11.85	11.10
Total Loans / Total Deposits		108.39	108.49	109.03

Source: SASRA, +Liquid Assets/ Savings Deposits +STLs

Saccos however faced a number of risks in 2018, mainly; credit, operational and governance. Credit risks associated with new areas of financing such as housing, manufacturing and even trade are emerging. SASRA is working to amend regulatory framework to enable DT-Saccos' provide detailed information on the specific sectors they finance and accompanying risk exposures. Operational risk associated with rapid adoption of technology in delivery of services are emerging. In particular, cybercrime risk is emerging among Saccos, which have limited capacity to hire and retain professionals with necessary ICT skills and experience to keep abreast with modern technological trends in the financial services sector.

The Industry also lacks the framework to effectively deal with third party service providers who collaborate with DT-Saccos' to provide management information system, Agency and mobile banking platforms among others. To address the risk, SASRA has developed Cyber security guidelines for issuance to DT-Saccos expected to form minimum standards for their operations and implementation. Consequently, SASRA has commissioned a feasibility study on shared services and ICT infrastructure to inform policy and capacity gaps. Lastly, Management or governance challenges affect the industry. The stability of DT- Saccos have experienced poor management controls and lack of skilled managers, leading to misappropriation of members deposits by Sacco managers by accumulating risky assets and flout prudential guidelines.

3.6 Deposit Insurance

Deepening financial inclusion has contributed to increased number of deposit accounts and total deposits. Kenya Deposit Insurance Corporation (KDIC) provides a deposit insurance scheme for customers of member institutions licensed by the Central Bank of Kenya as deposit taking Institutions. As at December 31, 2018, there were 55 member institutions comprising of 41 commercial Banks, 1 Mortgage Finance Company and 13 Deposit-taking microfinance banks. The total number of deposit accounts with member institutions rose to 57.32 million in 2018 from 49.88 million in 2017 (**Table 15**).

The level of exposure reduced from 70.45 percent in 2017 to 66.72 percent in 2018, while share of protected accounts increased to 97.43 percent, which are the fully protected accounts as per International Association of Deposit Insurance (IADI) principle 8.

Table 15: Growth of the Fund, Insurance Cover and Deposits

Row	Year	2014	2015	2016	2017	2018	Change(%)*
1	Total Deposits (KSh Bns)	2,384.72	2,673.95	2,783.72	3,075.82	3,385.20	10.06
2	Total Insured (KSh Bns)	224.87	244.65	255.54	272.08	269.74	-0.86
3	Protection Level (Row2/Row1)	9.43%	9.15%	9.18%	8.85%	7.97%	-9.92
4	Fund Balance (KSh Million)	52.17	61.66	73.25	86.08	100.15	16.35
5	Effective Cover (Row4/Row2)	21.80%	22.25%	25.85%	29.55%	33.28%	3.73
6	Total no. of accounts (‘000s)	30.70	37.35	43.25	49.94	57.32	14.76
7	Accounts fully covered (KSh. M)	29.55	36.10	41.83	48.37	55.85	15.46
8	Protected accounts (Row7/Row6)	96.27%	96.63%	96.73%	96.85%	97.43%	0.59
9	Exposure Level (100% - Row 5)	78.20%	77.75%	74.15%	70.45%	66.72%	-3.73

*Source: KDIC. *growth between 2018 and 2017*

Of the total deposits of KSh 3.38 trillion in 2018, KSh 269.7billion was fully protected in 2018, accounting for 7.97 percent of deposit value. This was way below the recommended proportion of 20 percent by IADI. The deposit protection fund increased from KSh 86.08 billion in 2017 to KSh 100.15billion in 2018, to cover 33 percent of total exposure.

Despite the fund’s capability of covering only 7.97 of total liability deposits, it continues to instil confidence among depositors, hence the increase deposits and accounts. The increase in deposits enhances stability and liquidity of financial institutions. KDIC expect to increase protection level to the IADI recommended ratio of 20 percent.

3.7 Financial Markets Infrastructure

Payment systems in Kenya have undergone changes, including innovations in financial technologies (FinTechs) that support electronic-based payment systems. These innovations have accelerated financial inclusion, reduced cost of transaction and handling of cash in the economy. The CBK has actively supported these innovations, thus promoting efficiency in business operations, cost reductions, enhanced security, and wider payment channels. However, these have come with cybersecurity threats given their interconnectedness and heavy reliance on information technology. The Bank has intensified its surveillance and monitoring role in collaboration with Communications Authority of Kenya to identify and take action to mitigate cybersecurity threats to enhance financial system stability.

The RTGS activities increased slightly in 2018 compared to 2017 in terms of volume and value of transactions. KEPSS processed 4.59 million transaction messages worth KSh 29.57 trillion in 2018 compared to 4.38 million transaction messages worth KSh 29.18 trillion in 2017 **(Table 16).**

Table 16: KEPSS System Flows

Year	Amount (KSh Bn)	Growth (%)	Messages Moved	Growth (%)
2012	19,880	-9.2	1,568,125	26.31
2013	22,669	14.03	1,977,885	26.13
2014	25,561	12.76	2,525,337	27.68
2015	29,703	16.2	3,124,960	23.74
2016	26,851	-9.6	3,988,168	27.62
2017	29,178	8.67	4,377,204	9.75
2018	29,566	1.33	4,589,256	4.84

Source: Central Bank of Kenya

EAPS and REPSS processed 18,307 and 620 transactions respectively, while the value of transactions in USD grew by 35 percent and 220.84 percent, respectively in 2018 compared to 2017. The increase in value and volume of transactions reflects increased trade in the EAC and COMESA regions as well as confidence in the payment system (**Table 17**).

Table 17: EAPS and REPSS transactions

YEAR	EAPS		REPSS		
	Volumes	Value in USD (Mns)	Volumes	Value in USD (Mns)	Value (EUR) ‘000s’
2014	4,977	223.79	10	0.35	-
2015	9,263	371.88	257	6.95	119.79
2016	10,933	826.24	161	7.24	-
2017	15,303	504.85	262	13.38	10.5
2018	18,307	681.48	620	42.92	5.71

Source: Central Bank of Kenya

The ability of an RTGS system to provide certainty of settlement without or minimal payment risk is an essential component of the financial infrastructure of an economy. In 2018, RTGS was available 99.92 percent compared to an optimum 99.99 per cent availability in 2017. Ongoing upgrade of RTGS will bolster efficiency and safety of payment systems. Liquidity management through the KEPSS by banks reduced to KSh 50.2 million in 2018 compared to KSh 2.6billion borrowed in 2017. The 98 percent decline in the banks' overnight loans through the KEPSS in 2018 reflects strong liquidity in the banking sector.

The CBK has developed a framework for identifying and mitigating internal and external threats to KEPSS in order to enhance the ability of the payment system to effectively withstand and respond to threats such as natural disasters or data breaches. The rapid recovery and resumption of systemically important payment systems (SIPS) is a key prerequisite if the financial system is to be resilient to adverse shocks. CBK has established a set of business continuity plans for KEPSS, and EAPS to ensure a high level of resilience.

Cybersecurity Risk remains a major threat to all payment systems given that Payment Service Providers operate in an interconnected and interdependent environment where the consequences of a cyber-attack on one can cascade to numerous others. To combat this growing risk, the Bank issued a Guidance Note on Cybersecurity in 2017. Further, the Bank in liaison with all RTGS participants launched the SWIFT Customer Security Programme to reinforce and safeguard the security of the wider ecosystem. FinTechs are also evolving rapidly to make digital payments accessible and affordable. To mitigate emerging risks, innovation such as leveraging on sound recognition technology to authentic payment play a key role in improving the safety in the payment systems. However, persistent cyber threats call for concerted efforts to mitigate them at national, regional and global level.

The ACH activity increased in terms of value and volume, by 0.84 percent and 3.34 per cent respectively **in 2018 compared to 2017.** The increase in value and volume of cheques and EFTs through the Clearing House can be attributed to preference for cheques to settle retail payments due to reduced clearing cycle from T+3 to T+1. Banks and merchants dominate electronic payment card market. There were 17.9 million active cards in 2018; processing 191 million payments valued KSh 1.39 trillion in 2018 up from KSh 1.35 trillion in 2017. POS terminals rose from 35,466 units in 2017 to 44,874 units while ATMs usage grew by 8 in 2018, signalling more uptake of plastic money. (**Table 18**).

Table 18: Payment Cards Usage

End December	No. of Cards (Mn)	No. of ATMs	No. of POS Terminals	Transactions	
				Volume (Mn)	Value (KSh Mn)
2015	13.2	2,718	22,230	20.1	121,821
2016	14.8	2,658	30,133	21.6	121,423
2017	15.4	2,825	35,466	19.1	124,844
2018	17.9	2,833	44,874	19.1	125,877
Change (%)*	**13.97**	**0.28**	**20.97**	**0.08**	**0.82**

*Source: Central Bank of Kenya *Growth between 2018 and 2017*

Mobile money services continue to deepen financial inclusion. The number of agents increased from 182,472 to 201,745 while value transacted grew by 12.75 percent in 2018 compared to 8 percent in 2017 **(Table 19)**. Upward growth trends also recorded in the number of active subscribers to mobile money services and the number of mobile money accounts, thus signifying higher intensity of utilising mobile money services in 2018. Central Bank also supported Mobile Network Operators (MNOs) by facilitating introduction of interoperability within the Mobile Payment Service in April 2018, thus enabling money transfers across MNOs customers, hence reducing the need for multiple mobile money subscriptions.

Table 19 Mobile Money Transfers

Period (January – December) / Year	2014	2015	2016	2017	2018
Number of agents	123,703	143,946	165,908	182,472	223,9310
No. of Active Mobile money accounts (millions)	24.02	26.75	31.99	30.68	31.63
No. of Mobile money transfer accounts (million)	25.8	28.6	34.9	37.4	47.70
No. of mobile money transactions (million)	911.3	1,114.20	1,331.00	1,543.50	1,740.00
Total transactions value (KSh. billion)	2,371.80	2,816.10	3,355.10	3,638.50	3,984.38
Average value per transaction (KSh)	2,602.66	2,527.46	2,520.74	2,357.30	2,290.00

Source: Central Bank of Kenya and Communications Authority of Kenya

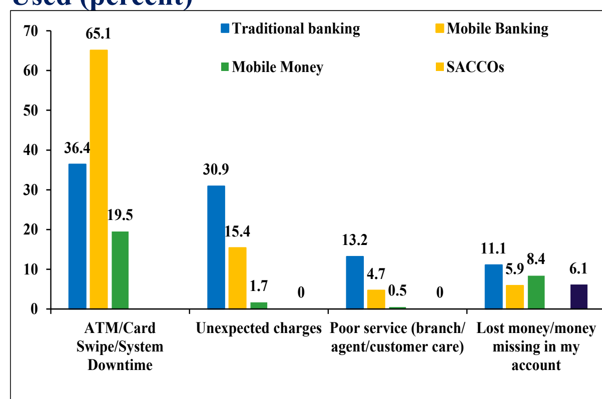
CHAPTER 4: KENYA'S FINANCIAL INCLUSION LANDSCAPE

Overall access to any form of financial services in Kenya has increased to 89 percent in 2018 compared to 82.5 percent in 2016 and 73.4 percent in 2006, (CBK, FSD, KNBS, 2019). Access to formal financial services was however at 82.9 percent, 75.3 percent and 26.7 percent in 2018, 2016 and 2006 respectively. In addition, usage of digital loans apps and mobile money have grown significantly, reflecting the important role technology is playing in shaping the financial sector development in Kenya. Adoption of financial technology is driving rapid uptake of innovations such as mobile banking, agency banking, internet banking, mobile apps and digital finance.

While we celebrate the high level of financial inclusion, risks are emerging, and more so, at household level - debt distress and defaults. In addition, there are also consumer protection concerns emerging as risky consumers enter the financial sector. Financial services that compromise household welfare also reduce the ability of users to either save, invest, borrow and service their loans. This in turn exposes financial institutions holding large proportion of risky assets to potential failures, thus limiting their growth prospects. Therefore, consumer protection in the face of FinTechs revolution is critical to the financial system stability. Perhaps this informs the decline in financial health of consumers from average of 39.4 percent in 2016 to an average of 21.7 percent in 2019.

Among the emerging consumer protection concerns are; frauds, cybersecurity risks, unfair practices including lack of transparency in pricing financial products, systems downtimes and unfair charges. The 2019 FinAccess Household Survey identified ATM/Card Swipe/system as the main challenge experienced in the use of financial services followed by unexpected charges on deposit accounts. Regulators need to look at the emerging challenges and ensure that service providers avail sufficient information to enable consumers make informed financial decisions **(Figure 29)**.

Figure 29: Challenges Experienced by Providers Used (percent)

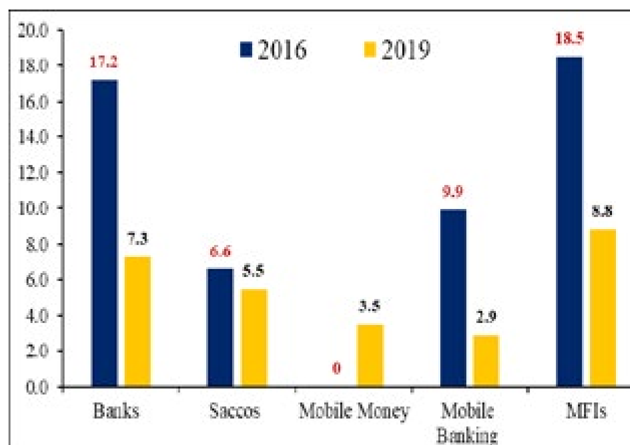


Source: FinAccess Household Survey Report, 2019

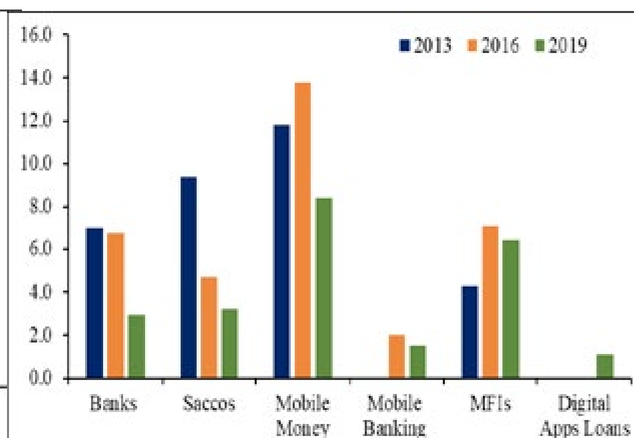
The 2019 FinAccess Survey shows declining proportion of respondents who reported to have incurred unexpected charges on accounts across banks and MFBs. Digital financial services providers are more transparent in pricing their products than traditional service providers. Cases of money lost from either traditional accounts or mobile wallets were also reducing for all institutions, except for Saccos. Although available data indicate a decline in the incidents of money lost since 2016, mobile money accounted for the highest incidences of loss in aggregate terms. This could be attributed to the identification of recipients prior to transfer from the mobile wallet, as well as improved mechanisms of reversal of erroneously transfers (**Figure 30**).

Figure 30: Challenges by Providers Overtime (percent)

a) Unexpected Charges on Accounts



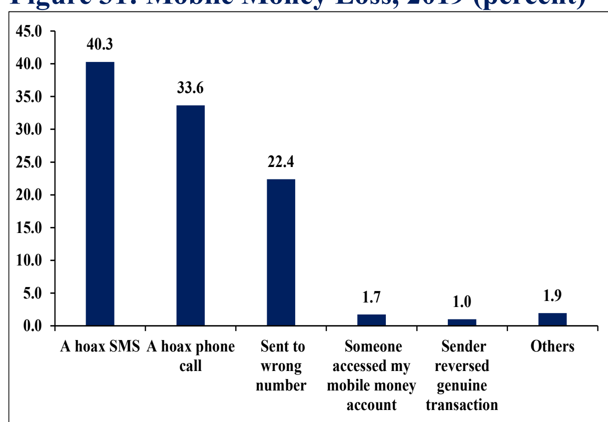
b) Money loss by Provider, 2016-2019



Source: FinAccess Household Survey Report 2019

Fraud remains the leading cause of mobile money losses, at 73.9 percent, through either a hoax message or call. Sending money to a wrong number mace at 22.4 percent of the incidences (**Figure 31**).

Figure 31: Mobile Money Loss, 2019 (percent)

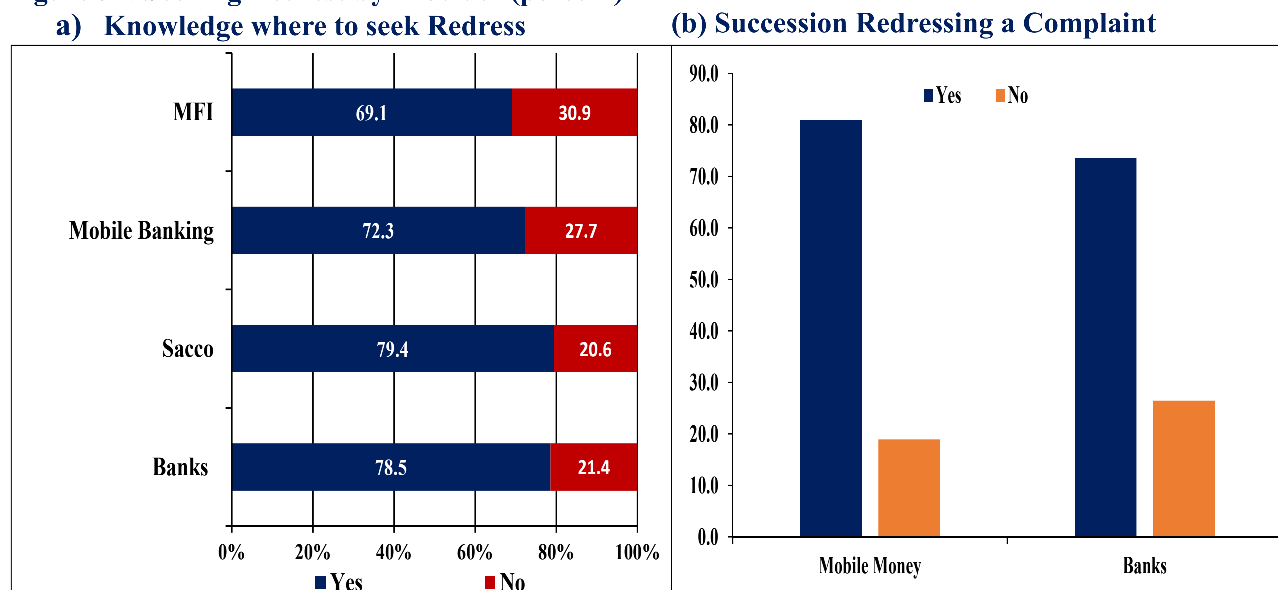


Source: FinAccess Household Survey Report 2019

Resolving consumer protection concerns promptly and efficiently, is key to enhancing confidence in the financial system. Mobile phone financial service providers need to establish robust mechanisms and channels through which consumers can seek redress and clarification at the least cost possible to solve conflicts that arise in the provision of financial services. The survey established that 78.5 percent and 79.4 percent of respondents, who use banking and SACCO services, respectively know where to seek redress. Mobile bank and MFI account holders constitute 69.1 percent and 72.3 percent of respondents who know where to seek redress **(Figure 32)**.

Figure 32: Seeking Redress by Provider (percent)

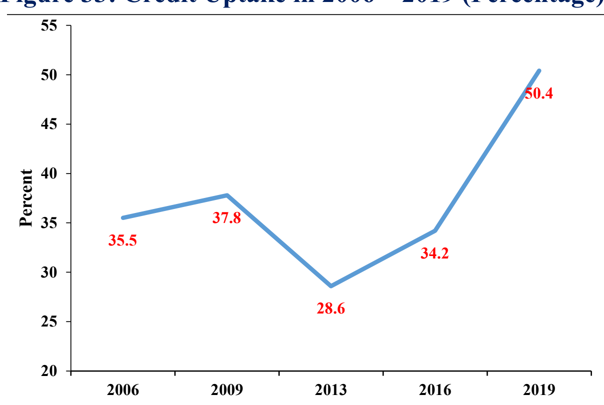
a) Knowledge where to seek Redress **(b) Succession Redressing a Complaint**



Source: FinAccess Household Survey Report, 2019

Access to credit enables households to invest beyond their resources as well as mitigating household shocks. Access to credit increased substantially between 2016 and 2019, despite a slight decline to in 2013 **(Figure 33)**. Loans from the shopkeeper constitute the largest proportion of credit followed by loans from family and friends and mobile banks.

Figure 33: Credit Uptake in 2006 – 2019 (Percentage)



Source: FinAccess Household Survey Report, 2019

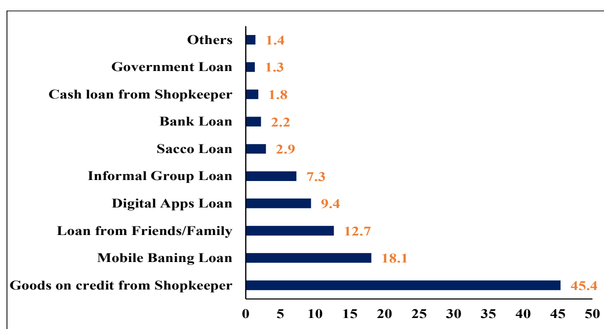
Most of the households used bank loans to buy vehicles and land or house, while SACCO loans were mainly used to undertake long-term investment such as buy land or house invest in education by paying school fees. Mobile banking loan mainly used to meet short-term household needs and emergencies, important in ameliorating liquidity problems and meeting unexpected expenditures of households. (**Table 20**).

Table 20: Reasons for Borrowing

Reason/Provider	Bank	Mobile Bank	Saccos	Informal Groups
Pay-off Debt	21.2	28.4	14.3	28.8
Vehicle	42.1	0.3	20.2	16.7
Buy Land/House	34.2	3.2	45.9	11.5
Emergency	6.7	40.9	10.5	40.1
Education Fee	14.5	8.1	36.5	34.1
Farming	10.7	10.5	21.5	51.5
Business	18.9	11.8	17.1	37.0
Meet daily needs	5.9	46.2	8.2	36.0

Access to credit enhances household well being if expenditures financed using credit increase household assets as well as income. This enables households to meet their loan obligations. However, terms of credit, mechanisms to monitor borrowers, returns from investment financed using credit as well as economic growth influence the likelihood of household defaulting. . Default rate for shopkeeper's credit in the form of goods and services was 45.6 percent but shopkeeper's credit in form of cash had default rate of just 1.8 percent (**Figure 34).**

Figure 34:Defaulters by Loan Type, 2019 (Percent)



Source: FinAccess Household Survey Report, 2019

Despite shopkeepers not directly linked to the financial sector, an increase in household default, raises credit risk to the financial sector because shopkeepers borrow from the financial sector to finance their merchandise. Hence, inability of households to repay goods purchased on credit reduces the capacity of shopkeepers to repay their loans, which reduces asset quality of financial institutions. Default on loans is mainly attributed to the borrowers using the loan to meet other expenditures other than the intended and perhaps productive investment, lack of financial planning and unexpected changes in income. The main expenditures on which borrowers diverted their loans included; food items, utility bills, unexpected emergencies and paying-off other loans. These expenditures do not generate income to service the loans.

Lack of planning occurs when borrowers divert money, have no money or forget to repay their loans when they fall due. This attracts penalties, which raises the cost of loans and therefore compounding default rate. This is more common among the Digital Application loans users. Defaults arising from loss of income by a household and poor business performance are more common among borrowers from informal sources (friends/family and Chamas) and those taken from Mobile banking providers. Lack of transparency on the side of the loan provider affects borrowers' probability of default. This is more common for mobile banking loans, and those from informal providers, where terms of the loan in terms of repayment and interest were not well understood (**Figure 35**).

Figure 35: Reasons for Default on Loans, by Provider 2019

Loan/Credit Provider/Source	Money went to basic needs e.g. food, utility bills	Did not plan well enough	Poor business performance	Unexpected emergency expenditure	Forgot to re-pay on time	Had to pay off other loans	Partner/someone else in household lost job/source of income	Payment was more than I expected	Did not understand the loan terms	Interest/ repayment rates increased
Commercial Bank Loan	7.1	2.2	0.0	0.0	0.0	.6	6.6	4.1	0.0	2.1
Mobile banking Loan	20.6	18.1	32.9	4.4	0.0	7.5	8.6	28.8	26.0	28.0
Digital App loans	4.8	9.4	19.8	0.0	50.0	6.6	21.6	8.3	7.3	12.2
Goods on credit from shopkeeper	37.6	45.4	15.1	95.6	41.6	63.0	23.3	26.0	0.0	34.4
Loan from friends and family	13.9	12.7	0.0	0.0	8.4	9.9	27.8	11.5	0.0	17.2
Loan from Groups *(Chamas)*	10.2	7.3	32.2	0.0	0.0	10.3	2.8	6.5	7.5	4.8

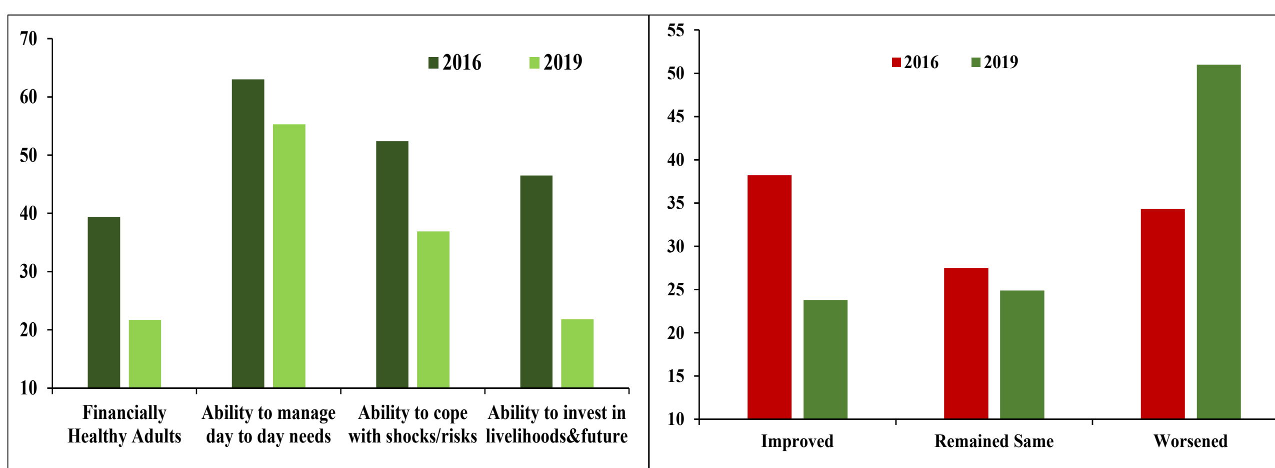
Source: FinAccess Household Survey Report, 2019

Colour Codes Key

Rating Colour	Rating	Risk Level
	1	Very Low risk
	2	Low Risk
	3	Moderate risk
	4	High Risk
	5	Very High Risk

Deterioration of the financial health of households also contributed to default. Despite a robust GDP growth in 2018 and 83 percent access to formal financial services by Kenyans, the proportion of household who felt that their financial health status worsened in 2018 survey increased to 51 percent from 34.3 percent in the 2015 survey (**Figure 36**). The deterioration in financial health undermines the ability of individuals to meet their financial obligation, with spillovers into the financial institutions.

Figure 36: Financial Health of Households and its dimensions



Source: FinAccess Household Survey Report, 2019

Therefore, gains in access and usage of financial services present risk to the financial sector through vulnerabilities by households. Whereas, household have become more informed about financial services they consume, prevalent of losses in mobile money transactions and rising debt distress indicate that consumers need more information to use financial services that meet their financial needs. Similarly, financial service providers need to improve services to meet needs of the consumer without undermining financial stability and welfare of households. Lastly, financial services provider needs to have a customer-centric approach for a win-win outcome.

CHAPTER 5: RISKS OUTLOOK AND PROSPECTS IN 2019

Kenya's financial sector remains stable and resilient albeit emerging risks and vulnerabilities associated with both domestic and external uncertainties, adoption of technology and innovations. For instance, the banking industry, which dominates the financial sector by assets' and profitability, has sufficient capital buffers to withstand shocks. In addition, the industry is adopting new business models including financial technologies and innovations to drive growth and manage risks. In particular, risks to the outlook have reduced in the near term due to recovery of global economy. However, risks persist with respect to the global front:

- Tightening global financial market conditions from current level into the medium-term;
- Trade tensions including those between USA and China, USA and Europe, and Britain and European Union (Brexit), could affect Kenya's economy and the financial sector; and
- Geopolitical tensions both within and across countries, including USA and Iran as well as North Korea that could heighten risks.

Downside risks in Sub-Saharan Africa are either domestic or originate from advanced economies, and relate to trade and geo-political tensions. These include:

- **Higher external market premium for sovereign bonds** due to changing investor sentiment, tightening of global monetary conditions, and a further drop in commodity prices;
- **Sovereign downgrade risks could further weigh on the investment** climate and adversely affect growth, particularly in South Africa, with potential regional spill-over effects to COMESA, SADC and EAC regions. In the medium term, risks are skewed to the downside; and
- **Delays in implementing policy adjustments would reduce fiscal space and delays in addressing structural constraints,** thus adversely affecting the economies through crowding out of the private sector and elevating vulnerabilities.

On the Domestic front, the downside risks relate to:

- Potentially below average bank credit to the private sector on weak corporate and household balance sheets, delayed payments of pending bills by both private and public sectors and delays in reversing the interest rates capping law;
- Elevated credit risks, slowing down the rate of credit growth necessary for accelerated investments;
- Weakness in governance of financial institutions including compliance to AML/CFT, cybersecurity concerns, operational risks, and consumer protection concerns;
- Rapid accumulation of debt that may reach unsustainable levels by both government and corporates; and
- The increasing households' indebtedness, mainly driven by increasing use of shopkeeper and digital apps loans, which may introduce household risks with implication on lowering aggregate demand.

Despite emerging risks and vulnerabilities, opportunities exist, which include:

- Continued infrastructure development to support growth, with positive effects on the financial sector development;
- Enhanced efforts and surveillance to address emerging risks associated with adoption of technology and innovations, AML/CFT and economic crimes concerns;
- Increased trade surveillance to stem dumping of cheap imports, and adherence to quality standards to strength domestic production;
- Improving environment to promote exploration and exploitation of natural resources, and the growing middle class; and
- Adoption of appropriate technologies and innovations to address the missing links for increased partnerships, efficiency gains and trade.

Overall, the financial sector is expected to remain stable and resilient in 2019 despite elevated risks and vulnerabilities arising from both the domestic and global perspectives muted by adequate buffers.

CHAPTER 6: SPECIAL TOPIC ON MERGERS AND ACQUISITIONS IN THE FINANCIAL SECTOR

Kenya's financial sector has undergone reforms during the period 2000-2018, making it more resilient and stable. In the process, the banking structure has been transformed through; restructuring of banks that faced liquidity and corporate governance problems; mergers and acquisition; conversion of non-banking institutions to banking institutions and; emergence of mobile money network. More banks are now profitable, liquid and stable as indicated by increased profits, strong capital buffers, and improved intermediation efficiency. However, some of the acquired banks are experiencing a decline in profitability and capital buffers.

In the aftermath of the global financial crisis, policy makers' attention has shifted to enhancing the stability of the financial sector and the economy, to avert the recurrent of a financial crisis. Policy makers have advocated for an increase in capital requirements, a change in business models, management of financial institutions, to increase the resilience of the financial sector to fragility emanating from interconnectedness, increased competition, financial innovation and cross-border operations. This has led to extensive reforms in the financial sector and in particular, the banking industry.

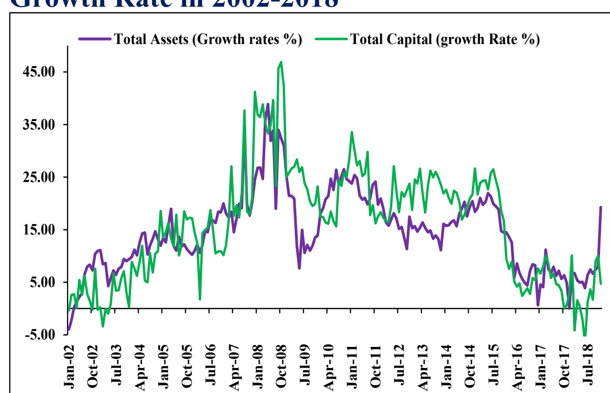
One of the effects of reforms include voluntary or non-voluntary consolidation in the banking sector to bolster profitability, capitalization and efficiency due to economies of scale and exploitation of niche market segment. Whereas merges and acquisitions are strategies bank managers adopt to increase profitability, the regulatory perspective is that it enhances stability of the resultant entity and the entire banking sector. The benefits of banks consolidating include; improved resilience to shocks given higher capital buffers, lower supervisory and compliant costs[5]. The stability benefits of consolidation in the banking sector have informed mergers and acquisition, especially after the liberalisation of the financial sector since 1990-2018. For example, Kenya had twenty-eight (28) mergers in 1990's, ten (10) in 2000's and three (3) in 2010's. In addition, there were two (2) acquisitions in 2000's and six (6) completed 2010-2018. This consolidation has occurred across all the peer groups[6]. It is therefore important to asses how the sector has been impacted in terms of assets liquidity profitability and efficiency by type of consolidation

Prior to the year 2008, Kenya's banking sector grew rapidly in terms of assets and capital base reaching its peak in 2008 following reforms, strengthening regulatory frameworks and improved economic environment undertaken in 1990s. In post 2008-09 however, banking sector growth decelerated, perhaps reflecting portfolio outflows, de-risking by global banking corporations from emerging and developing countries and tighter regulatory environment (**Figure 37**).

[5] Cerasi and Daltung (2000) large banks are easier to supervise and incur lower cost when complying with prudential regulations that small banks

[6] Tier 1 (large peer group), tier 2 (medium peer group) and tier 3 (small peer group)

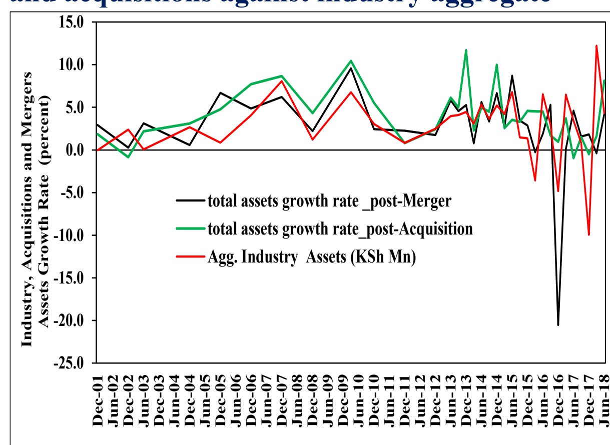
Figure 37: Banks Total Assets & Capital Growth Rate in 2002-2018



Source: Central Bank of Kenya

The slow growth at industry level after 2008 is also reflected among banks that were acquired or merged. However, the rate of growth in assets of acquired bank was higher than institutions that merged. In addition, acquired entities had a stable growth in assets compared to merged banks[7]. **(Figure 38)**.

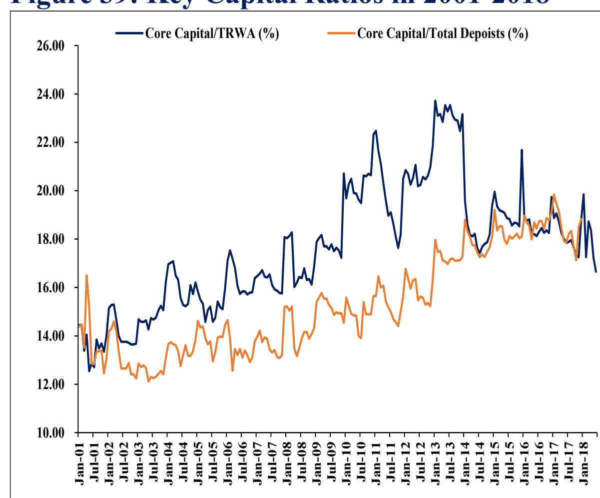
Figure 38: Growth in total assets in post mergers and acquisitions against industry aggregate



Source: CBK Staff Computations

The ratio of core capital to Total risk weighted assets and Core capital to deposits increased from 2000's to 2013, enabling banks to increase lending. However, growth rate decelerated significantly in 2014-2018, negatively affecting mobilization of deposits and growth of loans (**Figure 39**).

Figure 39: Key Capital Ratios in 2001-2018

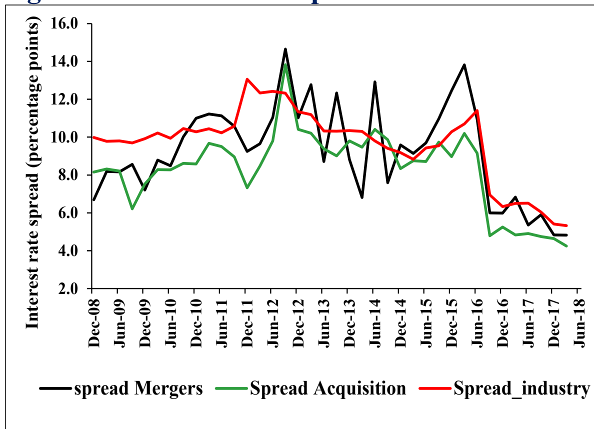


Source: Central Bank of Kenya

Intermediation efficiency as indicated by interest rate spreads increased steadily until 2012 before gradual decline **(Figure 40).** Introduction of interest rate control in September 2016, further reduced the spreads. What is notable is that banks that consolidated through mergers have higher interest rate spread compared to those that consolidated through acquisitions. Since most of the acquired institutions were either microfinance institutions or Tier 3 banks, which had lower spreads, it is probable that the acquirer wanted to leverage on efficiency of acquired institution to enhance intermediation efficiency, hence overall decline in the interest rate spread.

7 The placement of Chase bank under statutory management and liquidation of Imperial bank limited and Dubai bank in 2016, affected the growth in assets of banks

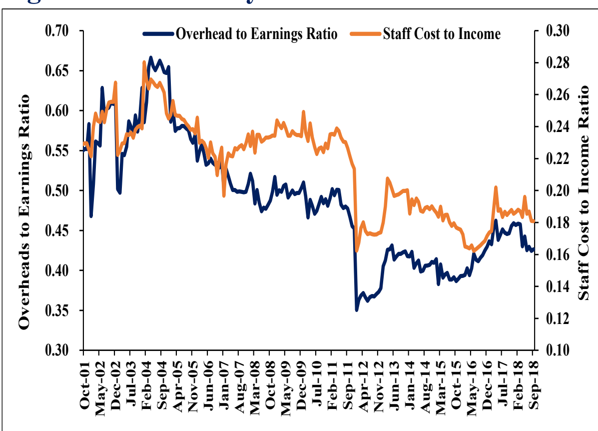
Figure 40: Interest rate spread



Source: Central Bank of Kenya

Operationally, banks have become more efficient as reflected in **figure 41**. The ratio of overheads to total earnings and ratio of staff costs (including Directors' emoluments) to total earnings have declined considerably since their peak in 2002. Improved efficiency among banks may be due to reforms undertaken including consolidation, strong regulatory framework and adoption of technology and innovations by banks in providing banking services.

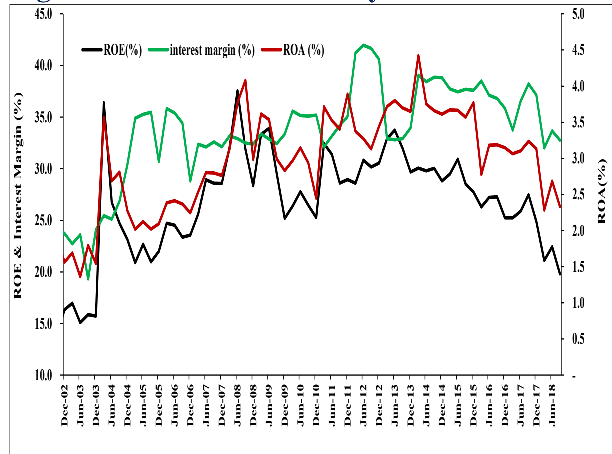
Figure 41: Efficiency of Banks



Source: CBK Staff Computations

Improved efficiency partially explains strong profitability in 2003-2012. However, slow growth in assets and reduced interest rate spread has lowered profitability since 2014 **(Figure 42).** The decline in ROA and ROE reflects declining interest margin and narrowing spreads. Decline in interest rates income reflects increase in interest expenses, relative to interest income.

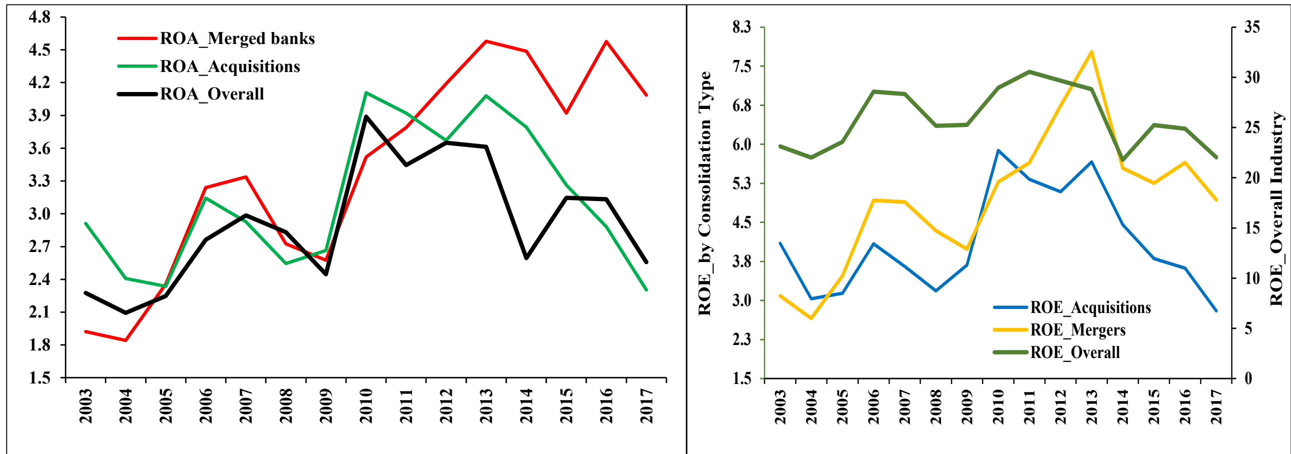
Figure 42: Banks Profitability Overtime



Source: CBK Staff Computations

Despite the decline in profitability in 2014 - 2018, banks that merged are more profitable than those that consolidated through acquisition (Figure 43). While mergers impact organizational culture and business models, leading to more efficiency and profitability, acquisition may not necessarily be motivated by integration of business model and organizational values. The new entity after acquisition may experience organizational frictions, thus undermining profitability.

Figure 43: Profitability of banks by Consolidation Type



Source: CBK Staff Computations

Banks liquidity remains high, consolidated banks via acquisitions have higher liquidity ratios compared to banks that consolidated through mergers (**Figure 44**). This implies that consolidated banks through acquisitions have better liquidity management practices.

Fig. 44(a): Liquid asset to total assets Ratio

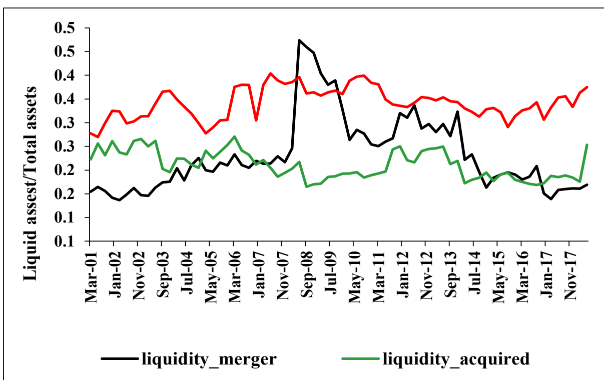
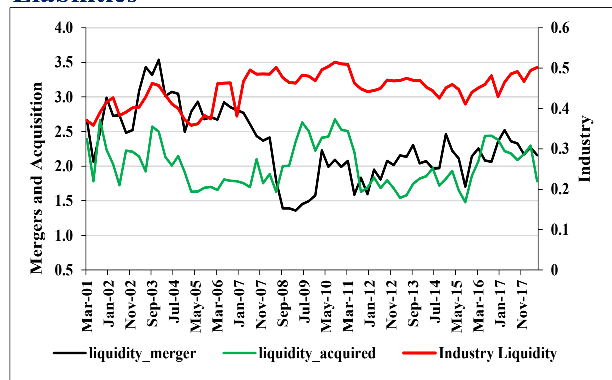


Fig. 44(b): Liquid asset to Short term Liabilities



Source: CBK Staff Computations

Overall, reforms and consolidation have supported stability of banking sector in Kenya. Structural changes because of mergers and acquisition have enhanced efficiency capital and assets base of consolidated institutions. Institutions that merged are more profitable due to higher efficiency and larger interest rate spread compared to institutions that consolidated through acquisition. However, liquidity of acquired institutions is more stable compared to institutions that merged. Profitability increases viability of banks through build-up of adequate capital buffers from retained earnings, which increases the resilience of banks to shocks. Therefore, consolidation in the banking sector has contributed to improved stability, but profitability and liquidity management depends on the type of consolidation.

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Table 21: Banks' Consolidation by Mergers

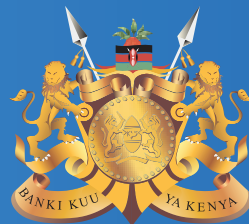
1	9 Financial Institutions	9 Financial Institutions Merged	Consolidated Bank of Kenya Ltd	1989
2	Indosuez Merchant Finance	Banque Indosuez	Credit Agricole Indosuez	10.11.1994
3	Transnational Finance Ltd	Transnational Bank Ltd	Transnational Bank Ltd	28.11.1994
4	Ken Baroda Finance Ltd	Bank of Baroda (K) Ltd	Bank of Baroda (K) Ltd	02.12.1994
5	First American Finance Ltd	First American Bank Ltd	First American Bank (K) Ltd	05.09.1995
6	Bank of India	Bank of India Finance Ltd	Bank of India (Africa) Ltd	15.11.1995
7	Stanbic Bank (K) Ltd	Stanbic Finance (K) Ltd	Stanbic Bank Kenya Ltd	05.01.1996
8	Mercantile Finance Ltd	AmBank Ltd	AmBank Ltd	15.01.1996
9	Delphis Finance Ltd	Delphis Bank Ltd	Delphis Bank Ltd	17.01.1996
10	CBA Financial Services	Commercial Bank of Africa ltd	Commercial Bank of Africa ltd	26.01.1996
11	Trust Finance Ltd	Trust Bank (K) Ltd	Trust Bank (K) Ltd	07.01.1997
12	National Industrial Credit	African Mercantile Banking Corp	NIC Bank Ltd	14.06.1997
13	Giro Bank Ltd	Commerce Bank Ltd	Giro Commercial Bank Ltd	24.11.1998
14	Guardian Bank Ltd	First National Finance Bank Ltd	Guardian Bank Ltd	24.11.1998
15	Diamond Trust Bank (K) Ltd	Premier Savings & Finance Ltd	Diamond Trust Bank (K) Ltd	12.02.1999
16	National Bank of Kenya Ltd	Kenya National Capital Corp	National Bank of Kenya Ltd	24.05.1999
17	Standard Chartered Bank (K)	StanChartered Financial Service	Standard Chartered Bank (K)	17.11.1999
18	Barclays Bank of Kenya Ltd	Barclays Merchant Finance Ltd	Barclays Bank of Kenya Ltd	22.11.1999
19	Habib A.G. Zurich	Habib Africa Bank Ltd	Habib Bank A.G. Zurich	30.11.1999
20	Guilders Inter. Bank Ltd	Guardian Bank Ltd	Guardian Bank Ltd	03.12.1999
21	Universal Bank Ltd	Paramount Bank Ltd	Paramount Universal Bank	11.01.2000
22	Kenya Commercial Bank	Kenya Commercial Finance Co	Kenya Commercial Bank Ltd	21.03.2001
23	Citibank NA	ABN Amro Bank Ltd	Citibank NA	16.10.2001
24	Bullion Bank Ltd	Southern Credit Banking Corp.	Southern Credit Banking Corp.	07.12.2001
25	Co-operative Merchant Bank	Co-operative Bank Ltd	Co-operative Bank of Kenya ltd	28.05.2002
26	Biashara Bank Ltd	Investment & Mortgage Bank Ltd	Investment & Mortgage Bank	01.12.2002
27	First American Bank ltd	Commercial Bank of Africa ltd	Commercial Bank of Africa ltd	01.07.2005
28	East African Building Society	Akiba Bank Ltd	EABS Bank ltd	31.10.2005
29	Prime Capital & Credit Ltd	Prime Bank Ltd	Prime Bank Ltd	01.01.2008
30	CFC Bank Ltd	Stanbic Bank Ltd	CFC Stanbic Bank Ltd	01.06.2008
31	Savings and Loan (K) Limited	Kenya Commercial Bank Limited	Kenya Commercial Bank Ltd	01.02.2010
32	City Finance Bank Ltd	Jamii Bora Kenya Ltd	Jamii Bora Bank Ltd	11.02.2010
33	Equatorial Commercial Bank Ltd	Southern Credit Banking Corporation Ltd	Equatorial Commercial Bank	01.06.2010

Table 22: Banks’ Consolidation by Acquisitions

Credit Agricole Indosuez (K)	Bank of Africa Kenya Ltd	Bank of Africa Kenya Ltd	30.04.2004
K-Rep Bank Ltd	Centum Ltd	K-Rep Bank Ltd	29.10.2014
Habib Bank Kenya Ltd	Diamond Trust Bank Kenya Ltd	Diamond Trust Bank Kenya	01.08.2017
Equatorial Commercial Bank	Mwalimu Sacco Society Ltd	Equatorial Commercial Bank	31.12.2014
Fidelity Commercial Bank Ltd	SBM Bank Kenya Ltd	SBM Bank Kenya Ltd	10.05.2017
Mashreq Bank Ltd	Dubai Kenya Ltd	Dubai Kenya Ltd	01.04.2000
Fina Bank Ltd	Guaranty Trust Bank Plc	Guaranty Trust Bank Plc	08.11.2013
Giro Commercial Bank Ltd	I&M Bank Ltd	I&M Bank Ltd	13.02.2017

(Footnotes)

1 GDP revised from KSh 7,749.43 billion in the FSR 2017 to KSh 8,144.37 billion for 2017 in the FSR 2018.



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