The Kenya Financial Sector Stability Report, 2015

August 2016, Issue No. 7

The Kenya Financial Sector Stability Report, 2015 was prepared by the Financial Sector Regulators Forum, which brings together the Central Bank of Kenya, Capital Markets Authority, Insurance Regulatory Authority, Retirement Benefits authority and Sacco Societies Regulatory Authority under a Memorandum of Understanding (MOU) for collaboration in several areas of mutual interests. The National Treasury, Ministry of Industrialisation and Enterprise Development Kenya Deposit Insurance Corporation and the Insurance Policy Holders Compensation Fund have observer status under the MOU.

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This Financial Stability Report (FSR), 2015 provides an assessment of key developments in Kenya's macro-financial conditions. It highlights key developments, risks and vulnerabilities, and growth opportunities resulting from global, regional and domestic factors in 2015 and first half of 2016.

The FSR, 2015 is a joint report of the five financial sector regulators in Kenya, namely: the Capital Markets Authority (CMA); Central Bank of Kenya (CBK); Insurance Regulatory Authority (IRA); Retirement Benefits Authority (RBA); and SACCOs Societies Regulatory Authority (SASRA) as well as Kenya Deposit Insurance Corporation (KDIC). The five regulators coalesce under Financial Sector Regulators Forum through a Memorandum of Understanding (MOU).

The regulators have worked jointly under the Forum since 2009 in a collaborative manner to address issues of mutual interest on Kenya's financial system development and stability as well as facilitating regular information sharing. This report is coordinated and compiled by the Financial Stability Unit at the Research Department, CBK. The Unit is responsible for providing day-to-day operational and technical support on financial stability assessment and analysis to ensure that the FSRs are prepared and published in good time. The Unit's oversight is provided by the Director, Research Department at the CBK.

The financial sector regulators Chief Executive Officers played a key role in providing leadership in the preparation and finalization of this report. The team benefited greatly from the expertise of Bank typesetters and design of the layout of the report. We also take this opportunity to recognize all those who, in one way or another, made this report publication possible.

Executive Summary

This 7th Issue of Financial Stability Report (FSR), 2015 is being published at a time when Kenya's financial sector is increasingly playing a pivotal role in facilitating economic expansion domestically and in the East African region. The sector, has however weathered shocks that have in the process made it stronger through key reforms implemented on three pillars: transparency, enhanced governance and re-engineering the business models. The report covers developments in the real economy, financial institutions and markets, financial institutions, financial markets infrastructure, and changes in legal and policy issues during the period January 2015 through June 2016. It also incorporates a new chapter on financial inclusion that discusses the extent of financial inclusion access in Kenya. The last chapter summarizes risks outlook for the rest of 2016 with mitigation measures in place.

Kenya's financial sector has grown significantly in terms of its contribution to overall Gross Domestic Product (GDP). By end December 2015, financial sector's assets as a share of nominal GDP was 83.27 per cent compared to 88.41 per cent in 2014, with a decline attributed to exclusion of assets for three banks placed under receivership. Market Capitalization for all listed and actively trading equities at the Nairobi Securities Exchange (NSE) accounted for 32.27 per cent as at the end December 2015 compared to 42.61 per cent at the end December 2014, reflecting a decline in shareholders' wealth due fall in share prices. In terms of the proportions by each sub-sector, the total banking sub-sector including Microfinance banks' assets accounted for 56.11 per cent; the Pension subsector accounted for 13.08 per cent; Insurance industry accounted for 7.90 per cent; and Saccos subsector accounted for 5.59 per cent, respectively of nominal GDP by end December 2015.

Overall, Kenya's financial sector remained stable and resilient, supported by macroeconomic stability in 2015. The prospects for 2016 remain positive driven by heavy investments in infrastructure, rebound in accommodation and food services, low global oil prices and overall stable macroeconomic environment. Indeed, Kenya is among few Sub-Saharan African countries that are forecast to register strong economic performance in 2016, thus supporting a stable and vibrant financial sector.

However, there are downside risks to Kenya's macro-financial conditions. Domestically, the banking subsector faced liquidity risks coupled with skewed distribution and corporate governance issues that resulted in two banks being placed under receivership in 2015; and a third bank in the first half of 2016, for the first time in over a decade. One bank is currently undergoing liquidation process, while another one was re-opened. The subsector also recorded increased credit risks, with Non-Performing Loans (NPLs) rising faster than historical trends and credit to private sector slowdown to about 14 per cent of GDP. The year 2015 also experienced exchange rates and interest rates volatility in Q1 through Q3 that impacted credit markets negatively. CBK policy interventions and other policy reforms as well as coordinated communication with other financial sector players restored stability. CBK successfully restored stability through policy interventions, reforms and initiatives such as establishment of Liquidity Support Framework for commercial banks and microfinance banks, enhanced governance and transparency in reporting, appropriate monetary policy actions, and improved coordination with other regulators.

The instability did not just affect the banking subsector, but was also experienced in other financial sub-sectors. In particular, the Deposit Taking Sacco societies reported elevated credit risks that manifested in faster growth of NPLs. Capital markets, on other hand, grappled with concentration risks, legislative risks associated with market-unfriendly laws like Capital Gains Tax and liquidity stress. The capital market also recorded decline in foreign investors' participation, which was skewed to the sale-side of the market. Insurance industry experienced declining premiums, increased fraud cases and governance issues that affected their growth.

From the regional perspective, the Sub-Saharan Africa recorded the slowest growth in 15 years, with further slowdown expected in 2016. The downside risks include increased fiscal strains, declining reserves in an effort to stabilize local currencies, de-risking by major international financial institutions, terrorism threats, political instability and conflicts, and low commodity prices. The geo-political conflicts in South Sudan and Burundi, increased terror activities in the northern Africa region, the Middle East and Europe, are likely to impact trade flows in the region. The prolonged decline in global oil and commodity prices continue to wear down oil exporting and commodity-reliant countries, thus offsetting gains on oil importers. Tighter global macro-financial conditions in the U.S may also result in the outflow of private capital and increase currency volatility. Weather shocks manifested in drought in some Eastern and Southern African countries would weigh on agricultural productivity and electricity generation, thus affecting growth.

Global developments such as raising the U.S federal funds rate from the zero lower bound to 0.25 per cent in December 2015 resulted in tightening of external financial conditions that impacted capital flows and currencies volatility of emerging markets, including Kenya. The slowdown in China arising from rebalancing of the economy from raw material-intensive sectors to service sectors has impacted Sub-Saharan African countries as it is the biggest market for the continent's raw materials. The effects of Brexit are also expected to affect Kenya and Africa in general, if the process of disengaging is not smooth and takes longer than expected.

To mitigate potential threats, CBK in collaboration with other domestic financial sector regulators and the East African Community (EAC) Central Banks stand ready to intervene and initiate necessary reforms to achieve and maintain stability. In addition, EAC central banks are implementing a more robust Stress Testing framework for conducting regular stress tests for early identification of vulnerabilities and take appropriate mitigation measures. These would enable policy makers and financial sector players to better evaluate and monitor the degree of financial stability, anticipate sources and causes of financial stress, and address any emerging weaknesses and vulnerabilities effectively and timely. High interest rates debate in Kenya is a key policy agenda with likely spillovers the rest of EAC countries. CBK and other stakeholders are exploring ways to address the issue sustainably.

DR. PATRICK NJOROGE
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Forward

Publication of this 7th Issue of the Financial Stability Report (FSR), 2015 emphasizes the commitment by Kenya's Financial Sector Regulators in collaboration with other stakeholders to foster the development of a liquid, efficient, sound and stable inclusive financial system in Kenya that support economic development. The report provides recent developments on macro-financial conditions globally, regionally and domestically with emphasis on implication to the financial system functioning and stability.

Effective financial system surveillance, assessment and analysis of potential vulnerabilities and risks, are key to timely policy interventions including mitigation measures by both the regulators and policymakers. Enhanced information sharing among regulators, policy makers and players will ensure effective policy implementation and create awareness to the public on new developments. The report also reflects Kenya's efforts towards EAC regional integration process in achieving the monetary union and fostering a well-integrated financial sector.

This report consolidates assessment and analysis undertaken by the five financial sector regulators, namely: CMA, CBK, IRA, RBA, and SASRA, KDIC also contributed to the report. The financial sector stability assessment and analysis is one avenue through which the Regulators monitor and evaluate developments and performance of the financial sector for timely risks and vulnerabilities mitigation measures. This publication, therefore, highlights developments, policy actions and macro-financial conditions in 2015 and first half of 2016 and provides the outlook on risks in 2016.

Finally, I wish to thank the Financial Sector Regulators Forum Technical Committee and its Financial Stability and Research Subcommittee that worked diligently in preparing this report. I also thank the Chief Executive Officers of the five regulators for providing staff, technical support and other resources to facilitate preparation of this report and its dissemination. We continue to invite the public for feedback on this publication in order to improve future editions of FSRs.

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Chapter I: GLOBAL AND DOMESTIC DEVELOPMENTS

1.1. Global Developments

The World Economic Outlook (WEO) April 2016 reported a gradual global economic recovery but increasingly becoming very fragile following a 3.1 per cent growth in 2015. This sluggish recovery pace is attributed to global assets markets volatility, loss of growth momentum in advanced economies and persistent headwinds for emerging market economies and lower-income countries (Table 1).

Table 1: World Economic Outlook Update

OUTPUT INDICATORS					Difference from Jan 2016 WEO		Difference from October 2015 WEO	
Real GDP Growth (%)/Year	**2014**	**2015**	**2016e**	**2017f**	**2016e**	**2017f**	**2016e**	**2017f**
World	3.4	3.1	3.2	3.5	-0.2	-0.1	-0.4	-0.3
Advanced Economies	1.8	1.9	1.9	2.0	-0.2	-0.1	-0.3	-0.2
Euro Area	0.9	1.6	1.5	1.6	-0.2	-0.1	-0.1	-0.1
Japan	-0.1	0.5	0.5	-0.1	-0.5	-0.4	-0.5	-0.5
United States of America	2.4	2.4	2.4	2.5	-0.2	-0.1	-0.4	-0.3
Emerging & Developing Econ.	4.6	4.0	4.1	4.6	-0.2	-0.1	-0.4	-0.3
China	7.3	6.9	6.5	6.2	0.2	0.2	0.2	0.2
Russia	0.6	-3.7	-1.8	0.8	-0.8	-0.2	-1.2	-0.2
Brazil	0.1	-3.8	-3.8	0.0	-0.3	0.0	-2.8	-2.3
MENA, Afghanistan, Pakistan	2.7	2.5	3.1	3.5	-0.5	-0.1	-0.8	-0.6
Sub-Saharan Africa	5.0	3.4	3.0	4.0	-1.0	-0.7	-1.3	-0.9

Source: WEO April 2016, and Regional Economic Outlook for SSA, April 2016

The already weak and fragile global growth has been further affected by “Brexit”. Prior to this key downside risk, the fast pace of global economic recovery was undermined by unfavourable pre-crisis productivity trends, the legacy of high private and sovereign debt, and hysteresis problems (G20 Report of July, 2016). With current increases in economic and geo-political uncertainties, and the attendant financial market repercussions that impact market confidence, the outlook remains uncertain, but strong global growth will depend on decisive policy action. The global outlook, set for a small upward revision prior to the U.K.’s referendum (Brexit), has been revised downward modestly for 2016-2017, reflecting the expected macroeconomic consequences of a sizable increase in economic, political, and institutional uncertainty.

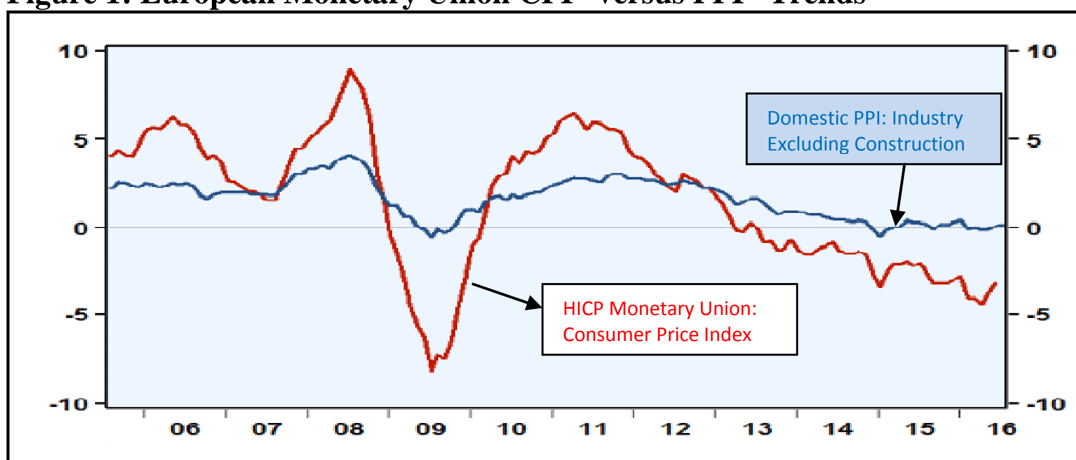
Financial conditions in the U.S, Europe, and Japan have been tightening since mid-2014, and even more outside advanced economies. Further increase in net capital outflows from emerging markets would worsen currencies depreciation triggering adverse balance sheet effects. China’s transitioning from export-led economy to a more sustainable broad-based growth based on consumption and services may encounter bumps in the process, which could have substantial spillovers effects, especially on emerging market and developing economies given its important role in global trade. In particular, if not managed well, China’s transition could further raise volatility around the baseline path of the global economy. Therefore, insufficient rebuilding of policy buffers and tackling of corporate and financial weaknesses in emerging economies would leave them highly vulnerable to shocks.

There are also non-economic pressures related to political, geopolitical, and/or natural developments. In both the U.S and Europe, the political discussion is turning increasingly inward. Compounded by fear of terrorism, countries are now advocating for more nationalistic policies, including protectionism. In the UK, the June 2016 referendum on exit from the European Union created uncertainty for investors; causing excess volatility in the financial markets and the Sterling Pound plummeting to historical lows. Strains in Europe are the tragedy of large-scale refugee inflows, especially from the Middle East. There are also natural causes of population displacement; some linked to climate change, such as; diseases (Zika Virus in Americas), extreme flooding and drought from the worsening poverty and displacement in several emerging markets and low-income developing countries.

While monetary policy must remain accommodative to address deflationary pressures, it must be supported by other policies to boost supply and demand. These should include; investment in infrastructure, structural reforms in the labour markets and financial reforms to enhance financial stability as well as strengthening monetary and fiscal policy transmission. Cooperation to enhance the global financial safety nets and regulatory regime is central to a resilient international monetary and financial system.

The Euro Area started the 2016 with stronger-than-expected momentum, helped by higher investment. However, the level of underlying growth remained weak, and inflation—now projected at just 0.2 percent in 2016 was still uncomfortably low (Figure 1).

Figure 1: European Monetary Union CPI* versus PPI* Trends



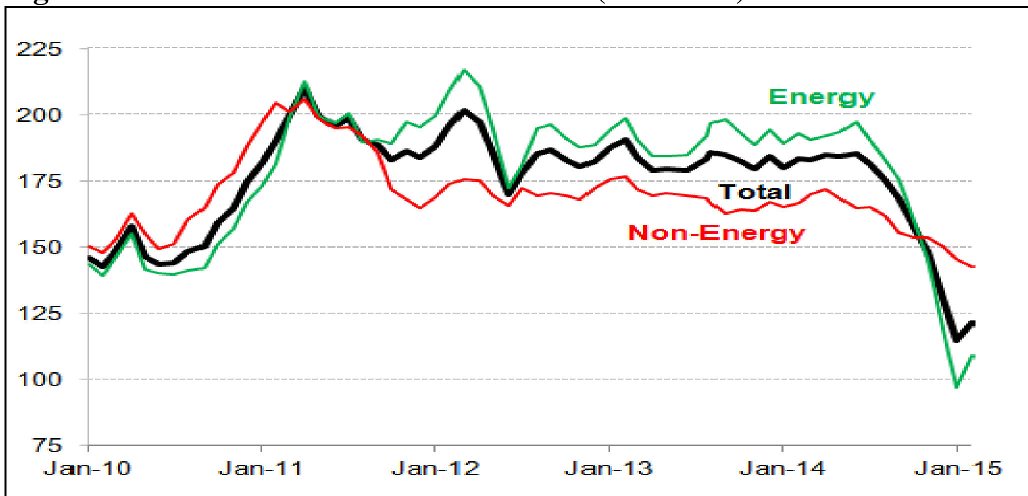
Source: Haver Analytics

*CPI – Consumer Price Index *PPI – Producer Price Index

In the U.S, the first quarter GDP growth was 1.1 percent, about half of what had been predicted in the WEO, October 2015 (Table 1). In Japan, the first quarter growth remained very weak and headline inflation turned negative again. And, while emerging economies data
pointed to somewhat better outcomes in the first part of the year, much of it was driven by renewed policy support in China—support that comes with further credit expansion and even higher corporate debt. Commodity prices have risen recently but remain low overall

and continue to strain large economies such as Brazil, Russia, and Saudi Arabia. This affects both energy and non-energy commodities (Figure 2).

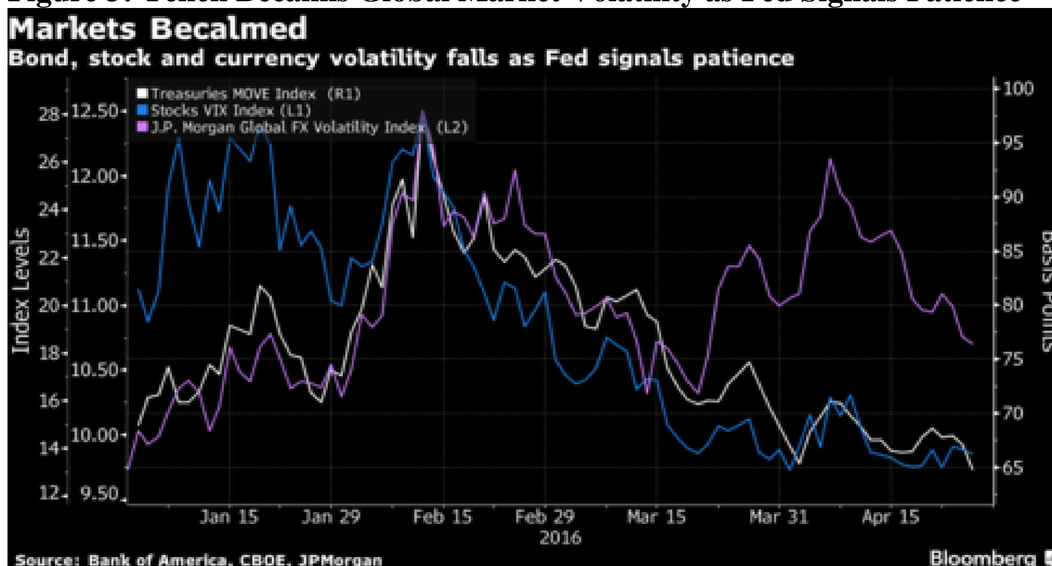
Figure 2: IMF Commodities Prices Indices (2005=100)



Source: IMF Statistics, July 2016

Financial conditions in advanced economies remained very accommodative following lifting of the federal funds rate from zero lower bound to 0.25 per cent in December 2015. By mid-February 2016, financial and oil markets had started recovering accompanied by a modest recovery in capital flows to emerging markets in the first quarter of 2016, partly attributed to the U.S Federal Reserves to calm the market (Figure 3).

Figure 3: Yellen Becalms Global Market Volatility as Fed Signals Patience



Before global markets consolidated the gains, the UK referendum unsettled financial markets, reacting with a strong global flight from risk, reflected in sharp price fall in equities across the world, especially for European banks, and declining yields on safe assets. The pound plummeted while the yen and the U.S. dollar strengthened on safe haven flows. These adjustments reflected a downgrade to the growth outlook and

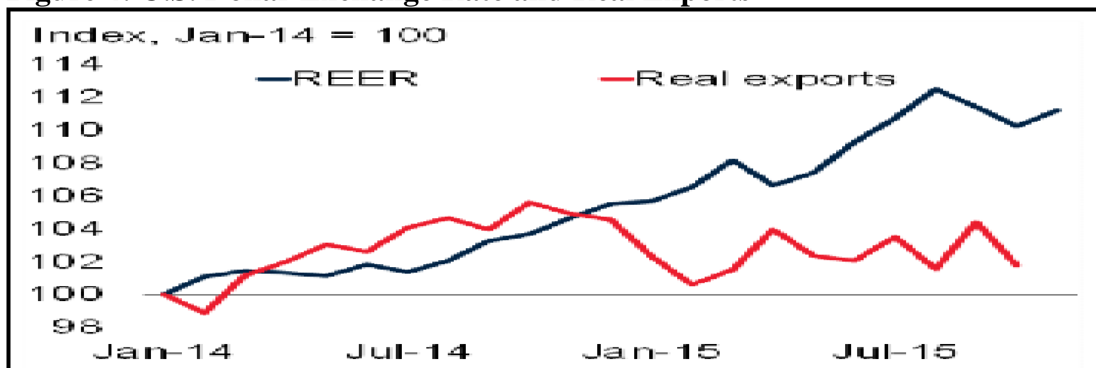
uncertainty about the terms of the U.K.'s exit from the European Union. While the initial financial market reaction was severe, it was generally orderly, and since then, markets have stabilized and broad equity measures have recovered. However, financial sector stocks remain significantly lower than before the "Brexit" referendum, especially in Europe, and currency shifts continue.

Advanced economies are expected to record modest recovery, reflecting the continuing weakness in underlying growth and persistent uncertainty in the global financial markets and related to the outcome of the U.K referendum (Brexit). The U.S. growth is forecast was revised down by 0.2 per cent to 2.2 percent in 2016 and 2.5 percent in 2017 relative to the April WEO as a result of further dollar appreciation and weaker global demand, and subdued non-residential investment. In the Euro Area, economy is expected to grow at 1.6 percent and 1.4 percent respectively in 2016 and 2017 supported by low oil prices, the ECB policies and a broadly neutral fiscal stance, which partly offset the immediate impact of uncertainty and weak confidence related to spillovers from "Brexit." Delays in tackling legacy issues in the banking system pose downside risks to the forecast. In the U.K., the large negative demand shock and heightened uncertainty will lead to a significant slowdown. Growth in Japan is expected to remain weak at 0.3 per cent this year and 0.1 percent in 2017, reflecting anaemic consumption growth, lacklustre investment, and the effects of the appreciating yen on net exports. However, upside risk to this forecast is from fiscal support, expected in a supplementary budget for 2017.

Emerging economies' growth prospects remain muted on account of slowdown and rebalancing in China, low commodity prices, and distress in some large emerging market economies. In China, the government resorted to boosting credit and infrastructure spending, supporting near-term growth but further raising vulnerabilities. As a result, the economy is expected to grow at 6.6 percent in 2016, exceeding the IMF's forecast range of 6–6½ percent, before slowing to 6.2 percent in 2017. India's economy is expected to grow by 7.4 per cent in 2016 helped by lower oil prices, positive policy actions and improved confidence. However, headwinds from weaknesses in India's corporate and bank balance sheets, a decelerating pace of reforms and sluggish exports will weigh on growth. Finally, conditions in Brazil and Russia are starting to improve gradually, with a return to positive growth expected for 2017.

Inflation in many major economies declined further reflecting low commodity prices and weaker currencies in the Euro Area and Japan. In the U.S., inflation is expected to rise gradually towards the Federal Reserve's 2 per cent long term target while the emerging market and developing economies' inflation is expected to decline from 4.5 per cent in 2014 to 4.2 per cent in 2016. Oil importing and exporting countries with fixed exchange rates risk deflation from falling inflation expectations where inflation is already low. Oil exporting countries with flexible exchange rates, however, exhibited uptick in inflation due to the pass-through of exchange rate depreciation. Persistently low inflation combined with low growth is a threat to financial stability.

Figure 4: U.S. Dollar Exchange Rate and Real Exports

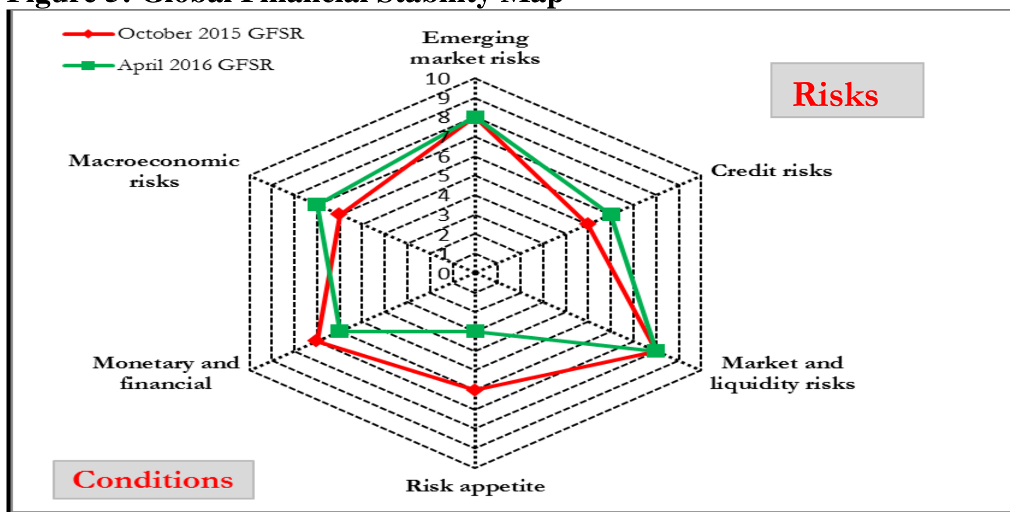


Source: World Bank, Global Economic Prospects January 2016

Monetary expansions by major central banks and expected monetary conditions tightening by the U.S., has contributed to the U.S. dollar appreciation (13 per cent from Jan to Dec 2015, Figure 4). This has reduced capital flows to developing countries, thus weakening their currencies, raising concerns about their balance sheet exposures in terms of substantial dollar-dominated liabilities impacting their financial stability. Macro-financial conditions could become unstable and uncertain as developed economies tighten monetary policy in phases.

The Global Financial Stability Report (GFSR), April 2016 show that overall stability risks have increased since GFSR, October 2015 due to disruptions to global asset markets reflecting setbacks to growth, greater uncertainty, and weaker confidence. While the emerging market risks, and markets and liquidity risks remained elevated, credit and macroeconomic risks increased globally, increasing financial stability risks (Figure 5).

Figure 5: Global Financial Stability Map



Source: Global Financial Stability Report, April 2016

Note: Away from centre signifies higher risks, easier monetary and financial conditions, or higher risk appetite.

Higher macroeconomic risks, as a combination of weaker data, deteriorating sentiment, and policy surprises roiled markets. More uncertain global growth prospects and declines

in inflation expectations have increased downside risks to the baseline growth forecast. Concerns about slower growth, weaker commodity prices, and tighter credit conditions are reducing many emerging market economies' buffers, keeping emerging market risks elevated at level 8. Consequently, this has led to a decrease in risk appetite to level 3 as is evident from the pullback of capital flows by foreign investors. In advanced economies, credit risks have increased for the first time since 2011 following pressures from equity price declines and rising credit spreads that eroded bank valuations sharply, especially those with the weakest business models and capital buffers.

Despite significant policy efforts to support aggregate demand and strengthen the financial system, the risks from slowing growth, remaining balance sheet vulnerabilities, and tighter and more volatile financial conditions have become more apparent. Monetary and financial conditions have become less accommodative as risk premiums spiked alongside tighter financial conditions, keeping market and liquidity risks elevated. Financial markets appear to be questioning the ability of policymakers to fully offset recurring bouts of market disruption and deliver a stronger path for growth and financial stability.

Increased political uncertainty related to geopolitical conflicts, political discord, terrorism, refugee flows, or global epidemics loom over some countries and regions. If unchecked, they could impact financial markets significantly. In addition, uncertainties arising from Brexit could weigh heavily on global stability outlook. This may be compounded by perceptions of limited policy space to respond to adverse shocks.

1.2. Global Economic and Financial Outlook and Risks

Downside risks to the global growth outlook have increased significantly following the "Brexit" referendum, especially an unnecessarily long period of political and economic uncertainty surrounding the U.K.'s exit from the European Union and the deterioration of financial conditions in several countries. This outcome could have severe macroeconomic repercussions, with advanced economies (particularly Europe) likely to be hit harder through intensification of bank distress in vulnerable economies. Heightened uncertainty also makes it more likely that unforeseen negative shocks translate into global disruptions. In particular:

- Policymakers may not do enough to prop up growth in the short-to long-term, thus extending the already protracted period of stubbornly weak growth in advanced economies, which might be reinforced by negative feedback loops, including a surge in inward-looking policies.
- The continuing China's economic transition could add volatility around the baseline because of an abrupt adjustment if unsustainable policies are maintained for too long, or owing to financial market uncertainties surrounding policy intentions.
- There is also a risk that emerging economies do not reduce vulnerabilities and rebuild buffers sufficiently before capital flow reversals materialize. Corporate leverage has increased significantly in emerging economies (e.g., Brazil, India, and Turkey), in domestic and foreign currency, due to ample global liquidity. A strong pullback of capital flows to emerging economies could tighten financial conditions and weaken their currencies, with the possibility of significant adverse corporate

balance sheet effects and funding challenges, and significant repercussions for banking systems.

- Risks of noneconomic origin also remain salient. Political divisions within advanced economies may hamper efforts to tackle important challenges, such as the long-standing structural problems and the refugee problem; and a shift towards protectionism is a distinct threat. Other on-going concerns include geopolitical tensions, domestic armed strife, terrorism, climate related factors (e.g. drought in East and Southern Africa), and diseases such as the Zika virus afflicting the Latin America and Caribbean region.

- In advanced economies, unfavourable demographic trends, low productivity growth, and legacies from the global financial crisis continue to hamper a more robust pickup in economic growth beyond 2016. While accommodative monetary policy and lower oil prices will support domestic demand, weak external demand, further exchange rate appreciation (especially in the United States) and relatively tighter financial conditions will weigh on the recovery. In the Euro Area, the risk of a de-anchoring of inflation expectations is a concern amid large debt overhangs in several countries.

A pick-up in global recovery will depend on rising growth in emerging market and developing economies given the projected modest growth in advanced economies. This however assumes:

- A gradual normalization of conditions in several economies now under stress
- A successful rebalancing of China's economy with growth rates that remain high
- Improved performance of commodities markets to support exporting countries

Among measures identified to support global growth and financial stability include;

- Reducing uncertainty around "Brexit" and its repercussions - A smooth and predictable transition to a new relationship between the U.K. and E.U. that preserves gains from trade is essential. Policymakers should stand ready to act decisively should financial market turbulence threaten the global outlook.
- Implementing effective macroeconomic support - Where demand is still falling short, this requires a broad-based approach that exploits policy synergies by combining structural and balance sheet reforms with continued monetary support and growth-friendly fiscal policies to reduce external imbalances.
- Addressing debt overhangs - In many advanced economies, balance sheet repair remains critical to lift investment, contain vulnerabilities, and improve monetary transmission. Addressing corporate debt and other financial risks is also important in emerging economies, and a key ingredient of China's transition to a new growth model.
- Lifting long-term growth and making it more inclusive - The G-20 can lead by encouraging strong implementation of the G-20 growth strategies, and prioritizing structural reforms that have a high short-term growth impact.
- Strengthening multilateral action - Reinvigorating trade integration remains crucial to boost global growth, while making sure that gains from trade are shared widely and

equitably. And it remains important to strengthen global safety nets, including by monitoring geopolitical spillovers that could threaten the global recovery.

1.3. The Sub-Saharan Africa (SSA)

Economic activity in SSA has weakened markedly, with varying degree across countries. Growth for the region as a whole fell to 3.4 per cent in 2015, the lowest level in 15 years, and is set to decelerate further in 2016 to 3 percent—below the 5-7 percent range recorded over the past decade (IMF- SSAEO, 2015).

The sharp decline in commodity prices has put severe strains in many of the largest SSA economies. Oil exporters, which include; Angola and Nigeria, continue to face difficult economic conditions (with growth for oil exporters as a whole forecast to slow further to 2¼ percent in 2015 from 6 percent in 2014), but so do non-energy-commodity exporters, such as Ghana, South Africa and Zambia. Guinea, Liberia, and Sierra Leone are only gradually recovering from Ebola epidemic, and several southern and eastern African countries including; Ethiopia, Malawi, and Zimbabwe, are suffering from a severe drought.

The oil importers are, however, faring better, with growth rates above 5 percent in countries such as Côte d'Ivoire, Kenya, and Senegal. In most of these countries, growth is being supported by ongoing increased infrastructure investment and strong private consumption. The decline in oil prices has also helped these countries, though the windfall has tended to be smaller than expected, as exposure to the decline in other commodity prices and currency depreciations have partly offset gains in many of them.

The SSA region is projected to grow at 3.4 per cent in 2015 from 4.6 per cent in 2014 (Table 2). External factors affecting SSA growth include lower commodity prices, tight borrowing conditions and a slowdown in major trading partners, in particular; China. Internal factors include; political instability and conflict in countries like Burkina Faso, Burundi, South Sudan and infrastructure constraints. Côte d'Ivoire, Rwanda and Tanzania maintained a robust economic growth due to their limited exposure to commodity prices, and tailwind risks from large-scale infrastructure investment.

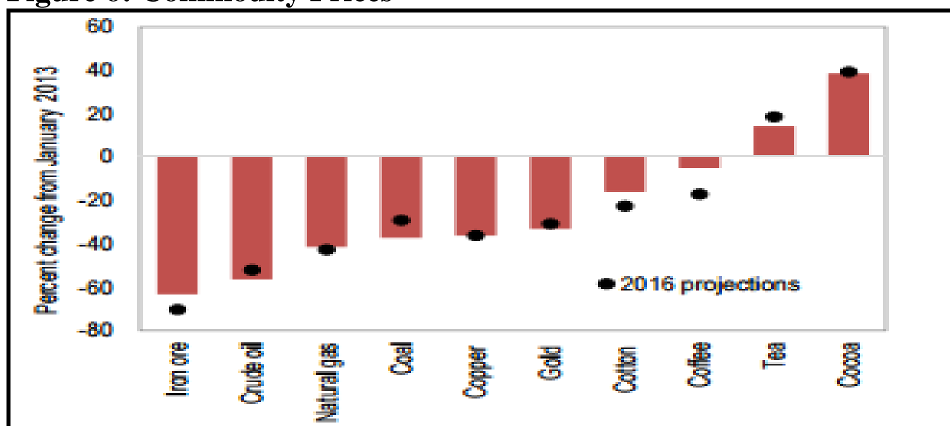
Table 2: Sub-Saharan Africa's Real GDP Growth

CATEGORY	2004-08	2009	2010	2011	2012	2013	2014	2015	2016	2017
SSA Region	6.8	4.0	6.6	5.0	4.3	5.2	5.1	3.4	3.0	4.0
Oil Exporters:	9.2	70	8.5	4.6	3.8	5.7	5.9	2.6	2.2	3.4
Nigeria	8.6	9.0	10.0	4.9	4.3	5.4	6.3	2.7	2.3	3.5
Middle-Income States:	6.9	3.8	6.5	4.5	4.2	4.6	4.6	2.6	2.5	3.4
South Africa	4.8	-1.5	3.0	3.2	2.2	2.2	1.5	1.3	0.6	1.2
Low-Income Countries	7.7	6.3	7.6	7.6	6.2	7.0	7.2	7.2	5.6	6.5
Fragile States	3.5	3.3	5.6	3.1	3.4	7.2	6.1	3.9	4.2	5.2
World Economy	4.9	0.0	5.4	4.2	3.5	3.3	3.4	3.1	3.2	3.5
SSA Resource-Rich	7.0	3.9	6.7	4.9	3.9	5.0	4.7	2.6	2.4	3.4
SSA Frontier & EMEs	7.1	4.4	6.8	5.0	4.5	5.1	5.0	3.5	3.0	3.9

Source: IMF Sub-Saharan Africa Economic Outlook, April 2016

Commodity prices continued to decline through 2015 reflecting a weak global demand for raw materials. Fuels, ores and metals, which account for more than 60 per cent of SSA region's exports in 2010-14 declined compared to prices of cocoa and tea that gained marginally (Figure 6). The slowdown in China, which is the largest external trading partner with SSA region and a growing source of foreign direct investment, has left SSA countries facing major risks.

Figure 6: Commodity Prices

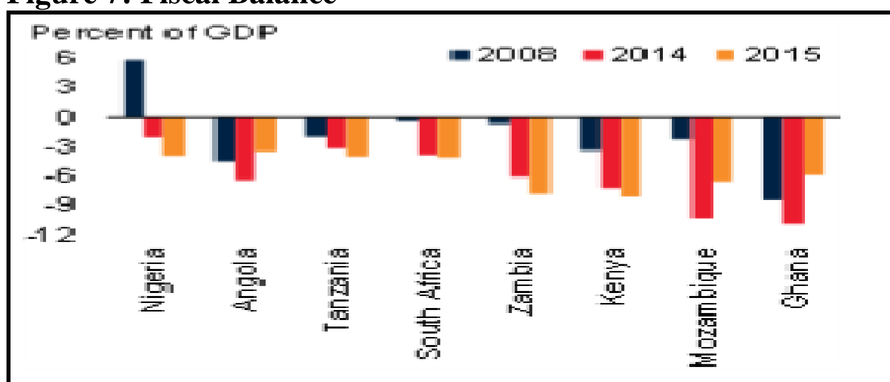


Source: IMF, SSA Region Economic Outlook October 2015

Several SSA countries tapped international capital markets to raise long-term funds. Côte d'Ivoire, Gabon, Zambia, Ghana, Angola, Kenya, and Cameroon issued Eurobonds to finance their investment. This was to take advantage of low interest rates and investors' search for yields coupled with decline in capital flows into the region in 2015 (Figure 7). These countries, however, faced challenges when sovereign spreads rose in late 2015 on expectation of a rate hike by the U.S Federal Reserve that materialized in December 2015.

Domestically, a number of SSA countries faced infrastructure limitations, especially power supply that impacted negatively on productivity and growth. Nigeria and South Africa, the largest economies in the region were most affected with power cuts. Fiscal deficits in Gabon, Republic of Congo and Nigeria widened on account of either falling revenues or increased government spending in countries like Zambia, Kenya and Malawi. Angola and Ghana implemented expenditure measures including removal of fuel subsidies and freezing public sector hiring (Figure 7).

Figure 7: Fiscal Balance

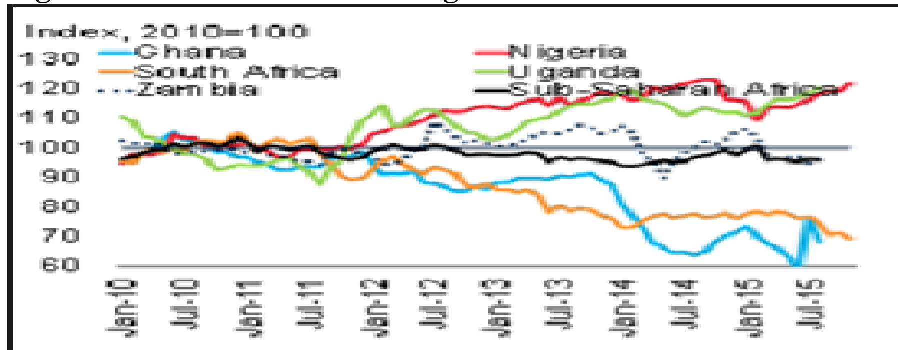


Source: World Bank, Global Economic prospects 2016

Current account positions across the SSA region widened in oil exporting countries and remained large in oil importing countries on low commodity prices and increased non-oil imports. As a result,

currencies in SSA region were under pressure in 2015. Even though currencies of commodity exporters and frontier markets sharply depreciated, the average movement in real effective exchange rate was small due to high inflation (Figure 8). The Ghanaian Cedi depreciated 30 per cent largely due to loose monetary and expansionary fiscal policies; and South African rand depreciated by 19 per cent to the U.S Dollar. Conversely, the Naira appreciated by 5 per cent compared to 2014 largely due to the Central Bank of Nigeria interventions that included administrative measures like reduction of the cash reserve ratio in the second quarter to foster liquidity.

Figure 8: Real Effective Exchange Rates



Source: World Bank, Global Economic prospects 2016

Outlook and Risks

The GDP growth for SSA region is projected at 3.0 per cent in 2016, below 3.4 per cent growth recorded in 2015. The less than optimistic growth forecast is explained by unfavourable external conditions led by persistent uncertainties on the path and implications of the Chinese rebalancing, U.S. monetary tightening, and weak growth in advanced markets. The situation could be complicated further with additional difficulties in Europe owing to financial or geopolitical developments including Brexit and refugees problems that could further weaken the external demand for African exports and the supply of capital and development aid.

The heightened volatility in global financial markets in the first half of 2016 underscores severity of these concerns because it has significantly affected the region's frontier economies' spreads. On the domestic and regional side, the key risk is that necessary policy adjustments are not implemented in a timely manner, creating the risk of financing difficulties and an even more abrupt adjustment.

Sub-Saharan growth prospects and financial stability going forward, are therefore threatened by:

- Rising fiscal deficits and more costly external and domestic financing conditions, elevating macroeconomic vulnerabilities and, in some cases, impeding central banks' pursuit of their primary objectives, such as price stability. These conditions are adding to exchange rate pressures, and many central banks have responded by raising interest rates. This, in combination with large government borrowing, has increased private sector borrowing costs, thus undermining growth.
- Countries experiencing these pressures with lower buffers than at the onset of the global financial crisis have drawn down their available foreign exchange reserves significantly to mitigate the shocks, severely limiting room for additional countercyclical policy.
- Sovereign risks associated with large commercial bank exposures to government debt and related governments' rollover risks have increased in some cases, posing risks to financial stability.

- Growth in Nigeria, South Africa and Angola, may be subdued due to continuing power shortages, depressed oil prices, weakened consumer spending, and difficult labour conditions. Ghana, Zambia and Kenya, are expected to record stronger growth given reduced fiscal and current account balances complemented by large infrastructure projects underway. Persistent power shortages and low copper prices, may, however dampen Zambia's growth rates.
- Oil exporting SSA countries are expected have a weak private consumption, low FDI flows and government expenditure cuts due to low revenues, currency depreciation pressure on consumers purchasing power and deteriorating growth prospects. Oil importing SSA countries could however, experience improved consumer spending due to low inflation and low oil prices. This may however be countered by currency depreciation and interest rate increase. Low income, non-oil exporting countries are expected to continue investing in infrastructure and energy to enhance efficiency for improved productivity and growth.
- Risks in SSA remain tilted to the downside, both domestic and external. External risks include declining foreign capital flows, persistent low commodity prices, and high debt repayments thus increasing currency depreciation if U.S dollar strengthens further.
- Domestic risks include political conflicts, security concerns (for Nigeria, Kenya, Chad, Niger and Cameroon), power shortages, high inflation, and currency pressures.

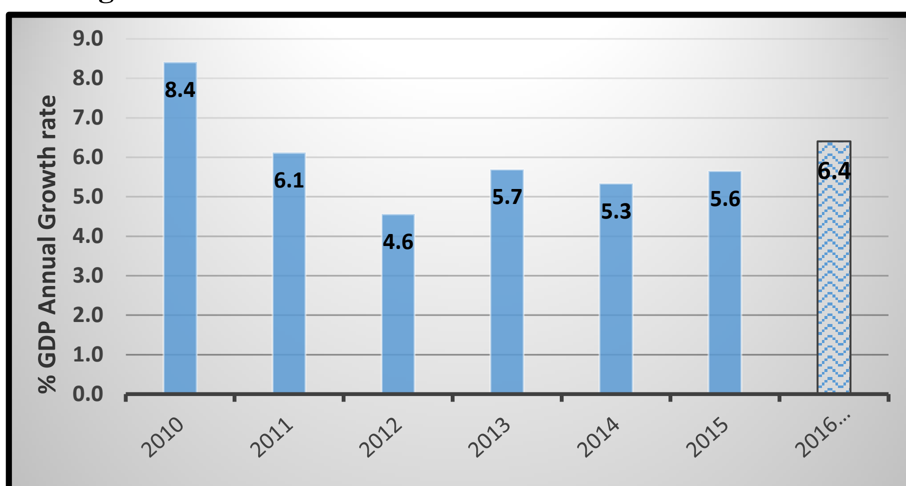
Chapter II: DOMESTIC ECONOMY

2.1. Output, Inflation and Exchange Rates Trends

Kenya's economy grew by 5.6 per cent in 2015, supported by expansion in mining and quarrying, tourism, financial services, real estate and construction. The economy is expected to continue with the growth momentum in 2016 that started in the second quarter of 2015. All sectors of the economy posted positive growth resulting to an expansion of 5.9 per cent in real GDP during the first quarter of 2016 compared to 5.0 per cent in a similar quarter of 2015 (Figure 9).

The impressive growth in 2015 and first quarter of 2016 can be explained by increased spending on infrastructure, improved agriculture output, rebound accommodation and food, and enhanced investor confidence following stable sovereign credit rating outlook of B+/B and B1 by S&P and Moodys, respectively that has in addition allowed Kenya access international financial markets.

Figure 9: GDP Growth Rates



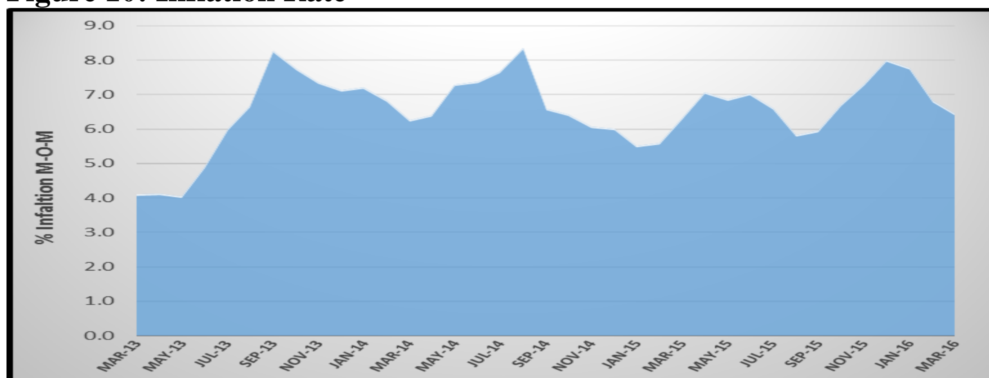
Source: Central Bank of Kenya

The downside risks to growth include; effects of global dynamics such as Brexit that may affect Kenya's trading partners, stress among corporate sector that may affect jobs and taxes, and uncertainties that normally follow general elections in Kenya (the next election is scheduled in August 2017). Weaker than expected economic growth, has negative implications on the macro-financial stability, through credit channel.

The overall inflation rate remained within the government medium term target of 5 per cent (+/- 250 basis points) from January 2015 to June 2016. However, towards the end of the period, inflation risks emerged temporarily, breaching the upper medium target, to 8.01 per cent by end December 2015. This was due to increase in food prices triggered by unfavourable weather conditions, and the effect of excise tax on select products, notably beer and cigarettes that became effective December 1, 2015. Inflation pressures eased in

2016Q1 following improved weather conditions (Figure 10). Inflation also remained within the target band through 2016Q2.

Figure 10: Inflation Rate

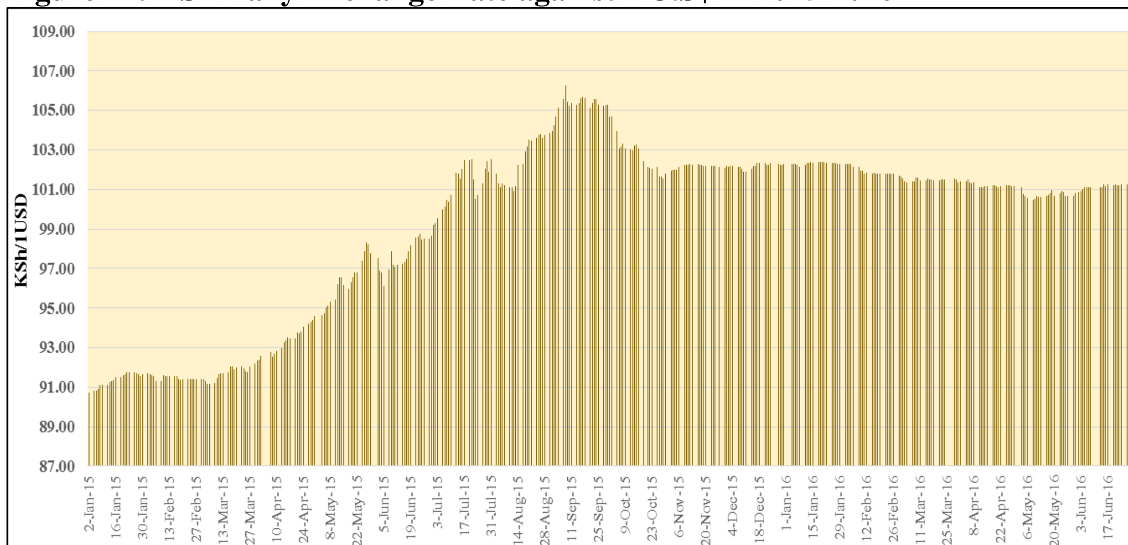


Source: Central Bank of Kenya

Foreign Exchange Markets

The Kenya Shilling depreciated against the USD in nominal terms during the period 2015Q1-Q3, hitting KSh 106.245 peak on September 8, 2015. It, however, strengthened in 2015Q4. The 2015Q3 to early 2015Q4 also experienced elevated volatility as the local currency reacted to both global and domestic developments (Figure 11 and 12).

Figure 11: KSh Daily Exchange Rate against 1 U.S$ in 2015-2016



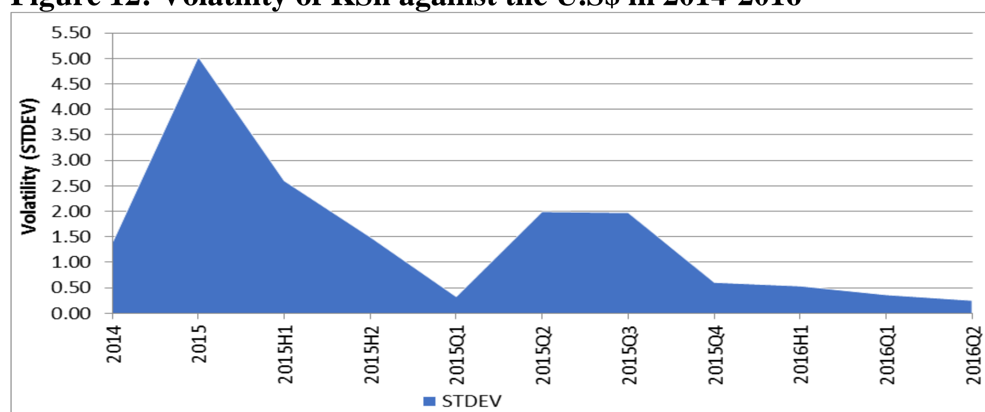
Source: Central Bank of Kenya

Globally, uncertainties surrounding the timing of the first interest rate increase in the U.S following the tapering of Quantitative Easing led to a stronger dollar, undermining stability of emerging markets' and developing economies' financial markets. This caused volatility among most currencies of emerging markets economies as well as currencies of

frontier markets, including the Kenya Shilling (KSh) in the second and third quarters of 2015.

The volatility and depreciation was caused by portfolio investors divesting from these markets for safe havens in developed economies markets, where returns were poised to rise with expected increase in interest rates. On the domestic front, the local currency faced depreciation pressures from strengthening U.S dollar in international markets and high current account deficits reflecting the peak of capital equipment imports in 2014, weak exports receipts, and increased foreign investors' outflows from the Nairobi Securities Exchange (NSE) in the first half of 2015.

Figure 12: Volatility of KSh against the U.S$ in 2014-2016



Source: Estimated Standard Deviations from CBK data

Note: H - refers to half of a year and Q-refers to a quarter of a year

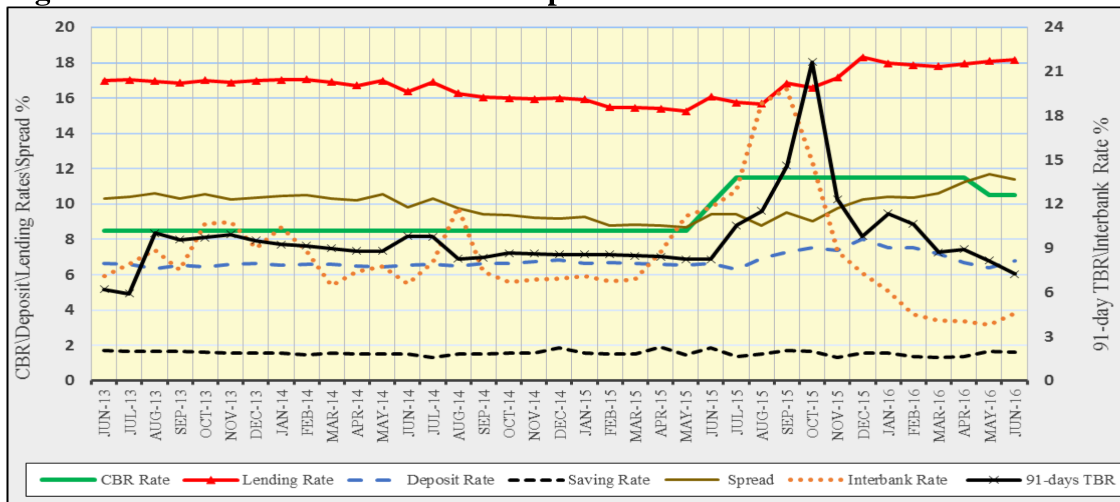
The CBK policy support through Open Market Operations (OMO) and existence of US$ 7.2 billion (equivalent to 4.5 months of import cover) at the end of June 2015 together with the Precautionary Arrangements with the International Monetary Fund (IMF) of US$ 1.5 billion continued to provide adequate buffers against short-term shocks, restoring stability of the exchange rate, through to 2016Q2 (Figures 12).

2.2. Interest Rates and Credit to Private Sector

The first half of 2015 experienced a build-up of inflationary expectations emanating from exchange rate depreciation, demand pressures and persistent global foreign exchange volatility. To moderate these pressures, CBK raised its policy rate (Central Bank Rate) by 150 basis points in June 2015 to anchor rising inflation expectations after holding it unchanged for two years at 8.5 per cent. The CBR was further raised by 150 basis points in July 2015 to consolidate gains made from tightening policy bias that raised CBR to 11.5 percent. This increase however, brought with it volatility in the Treasury bill and interbank interest markets, spilling over into the lending and deposits rates as well as spreads (Figure 13).

The policy actions undertaken led to tight liquidity conditions in 2015, leading to interest rates spikes in the second half of 2015 that later dissipated in 2016Q1. Treasury bill rate increased from an average of 8 per cent that prevailed in close to two years to a peak of 21.65 per cent in October 2015. Commercial banks' average lending rate rose by 188 basis points in 2015 compared with a decrease of 104 basis points in 2014. Similarly, average deposit rate rose by 133 basis points relative to a marginal increase of 26 basis points in 2014, as banks sought to retain their depositors.

Figure 13: Trends of Interest Rates & Spread

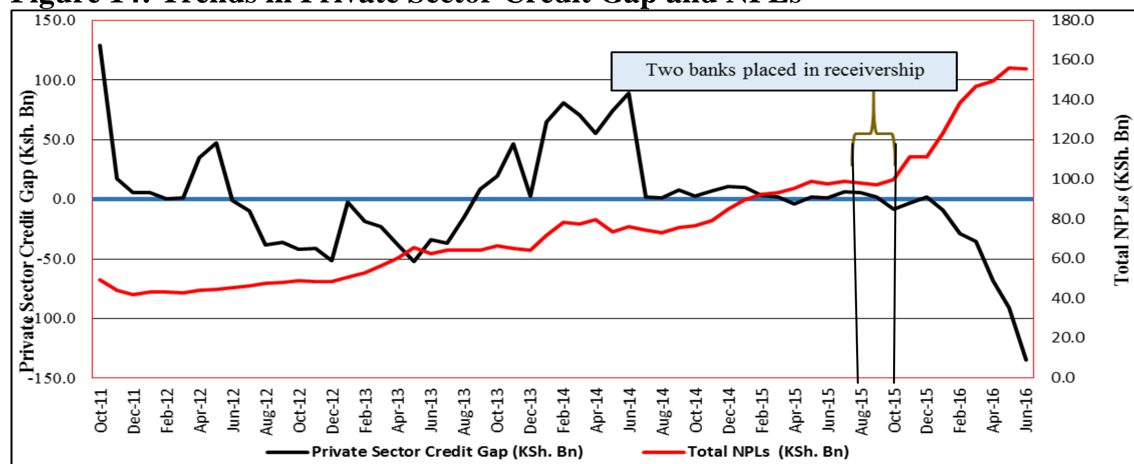


Source: Central Bank of Kenya

The CBK downward adjustment of CBR by 100 basis points in May 2016 and reforms taken to restore stability in the banking sector following placement of three banks under receivership in 2015 and early 2016, contributed stability in the interest rates markets.

Besides interest rates spikes, private sector credit shrank as banks became more cautious on lending. While it can be observed from the general trend that banks began reducing credit to the private sector from June 2012, except in early 2014, the steepest slowdown occurred in the fourth quarter of 2015 onwards. The private sector credit gap (actual credit advanced to private sector minus the targeted credit allocation) widened rapidly from December 2015, implying that actual credit disbursed was much lower than the set target to supported projected economic growth (Figure 14).

Figure 14: Trends in Private Sector Credit Gap and NPLs



Source: Generated from CBK data

The significant fall in credit was accompanied by sharp increase in non-performing loans. A number of factors explain the tight liquidity conditions. First, the placement of two commercial banks under receivership in the second half of 2015 and a third bank in 2016Q2, created liquidity freeze among the lenders keen to minimize further exposures, and to enhance recovery of existing loans. In addition, reforms undertaken by CBK to restore stability of the financial sector including requirement for proper data reporting, provisioning for loan losses, enhanced transparency in reporting and corporate governance as well as liquidity challenges facing small and medium tier banks due to skewed interbank market, all contributed to the credit squeeze.

The tight liquidity conditions in the domestic interbank market heightened activity in the Horizontal Repurchase Agreements (Horizontal Repos) market, where lending/borrowing among commercial banks was collateralized to minimize interbank exposures and facilitate liquidity distribution. The amount transacted under this window improved in 2015 after a two-year lull (Table 3). A similar heightened activity was recorded in 2010-2011 when the interbank market also experienced tight liquidity conditions, high interest rates regime and depreciating local currency. In such circumstances, banks borrow mainly on collateralized basis in order to meet their increased liquidity demands as depositors seek to get their cash amid reduced deposits flows.

Furthermore, activity in the government securities rediscount window at CBK increased as holders of debt securities sought to mitigate potential liquidity risks. At the time, secondary market for the Treasuries was almost non-existent due to fear among investors for making huge losses associated with high interest rates. Of the total KSh 52.24 billion T-Bills rediscounted (early retirement of debt securities) in 2015, commercial banks redeemed a total of KSh 52 billion (or 99.55 per cent). Banks also rediscounted Treasury bonds worth KSh 12.18 billion (99.95 per cent) at CBK in the year to ease their liquidity pressures. Therefore, in both rediscount window and Horizontal Repos market, activities were very high in 2015, signaling liquidity risks in the market.

Table 3: **Government Securities Rediscounts and Horizontal Repos Deals (KSh Mns)**

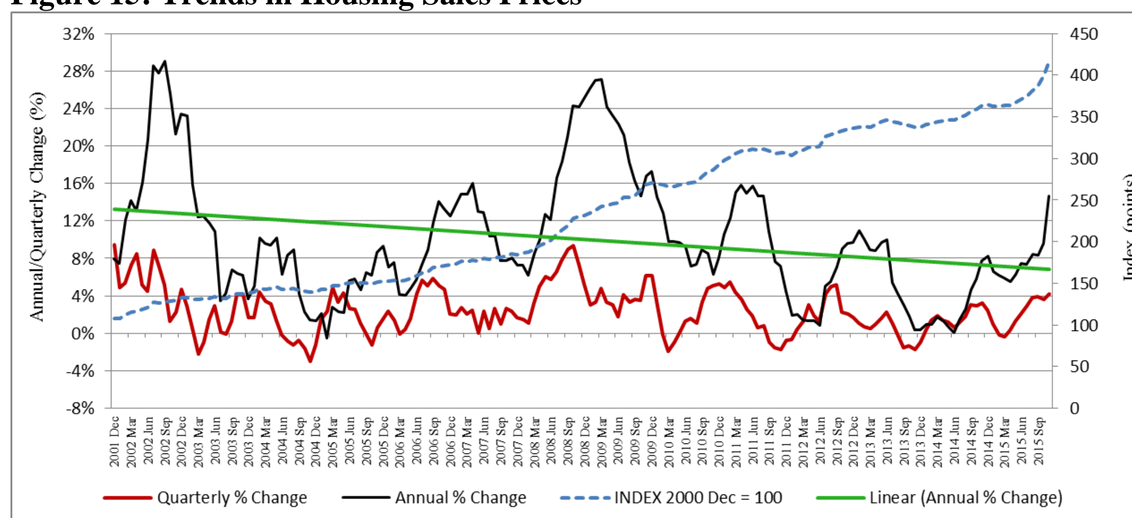
Year	All Bonds Rediscounted	Rediscounted by Banks	All Bills Rediscounted	Bill Rediscounted by Banks	Horizontal Repos Market Deals
2010	10.05	-	4,100.00	28,100.00	75,025.42
2011	3,975.15	3,945.30	7,100.00	5,400.00	90,114.52
2012	510.55	500.00	1,317.60	1,250.00	53,140.11
2013	12.15	-	6,612.70	6,500.00	34,170.49
2014	6.75	-	17,446.55	17,250.00	16,650.41
2015	12,186.50	12,180.00	52,236.45	52,000.00	39,186.79

Source: Central Bank of Kenya

2.3. Developments in the Real Estate and Property Market

The annual housing price index has generally trended downward since 2009, albeit with some degree of seasonality. Annual house prices over 2015 rose by 11.9 per cent in Nairobi's satellite towns and by 9.59 per cent for all properties. The rents rose 9 per cent to reflect real estate rental income tax and increased demand for rent given high house prices. The fourth quarter of 2015 saw a 3.6 per cent increase in prices, a much slower pace, compared to increase in 2014 especially within Nairobi's suburbs. The sluggish rent increase in Nairobi's suburbs in 2015 was attributed to apartments oversupply leading to a rent price correction in the segment. Asking rent prices also increased more than two-fold since 2007 in Kiserian, Juja, Kiambu and Mlolongo as rental prices in Nairobi's suburbs got out of reach for a majority of tenants (Figure 15).

Figure 15: Trends in Housing Sales Prices



Source: Generated from Hass Consult data

Reducing demand for housing sector including low demand for renting on account of high prices can cause risks to the financial sector stability, if financing mainly originates from loans. It is, therefore important to monitor changes in this market to avoid negative

impact in case slowdown and buildup of imbalances with downside macroeconomic vulnerabilities.

2.4. External Sector Environment

The Current Account Deficit (CAD) narrowed by 36 per cent in 2015, supported by decline in the import bill, which more than offset the fall in exports of goods and services (Table 4).

Table 4: Balance of Payments (USD Millions)

ITEM	Year to December 2014	Year to December 2015*				Year to December 2015*	Change	% Change
		Jan-March	April-June	July-Sep	Oct-Dec			
1. OVERALL BALANCE	1378	-164	-482	-500	853	-294	-1673	-121.3
2. CURRENT ACCOUNT	-6087	-969	-1341	-754	-832	-3896	2191	-36.0
2.1 Goods	-12719	-2449	-2806	-2370	-2563	-10189	2530	-19.9
Exports (fob)	6174	1437	1390	1599	1482	5908	-266	-4.3
Imports (cif)	18893	3886	4196	3970	4045	16096	-2796	-14.8
2.2 Services	6632	1480	1465	1617	1731	6293	-339	-5.1
Non-factor services (net)	3373	804	958	933	962	3658	285	8.4
Income (net)	-518	-100	-244	-56	-60	-461	58	-11.2
Current Transfers (net)	3777	777	750	740	829	3096	-681	-18.0
3. CAPITAL & FINANCIAL ACCOUNT	7465	805	859	253	1685	3602	-3864	-51.8
3.1 Capital Tranfers (net)	24	28	40	25	26	118	94	394.8
3.2 Financial Account	7441	777	818	229	1659	3483	-3958	-53.2
memo:								
Gross Reserves	9738	9834	9473	8899	9794	9794	56	0.6
Official	7895	7723	7212	6711	7534	7534	-360	-4.6
*import cover***	*4.6*	*4.6*	*4.4*	*4.4*	*5.2*	*5.2*	*0.5*	*11.6*
*import cover****	*5.0*	*4.9*	*4.6*	*4.3*	*4.8*	*4.8*	*-0.2*	*-3.8*
Commercial Banks	1843	2111	2262	2188	2259	2259	416	22.6

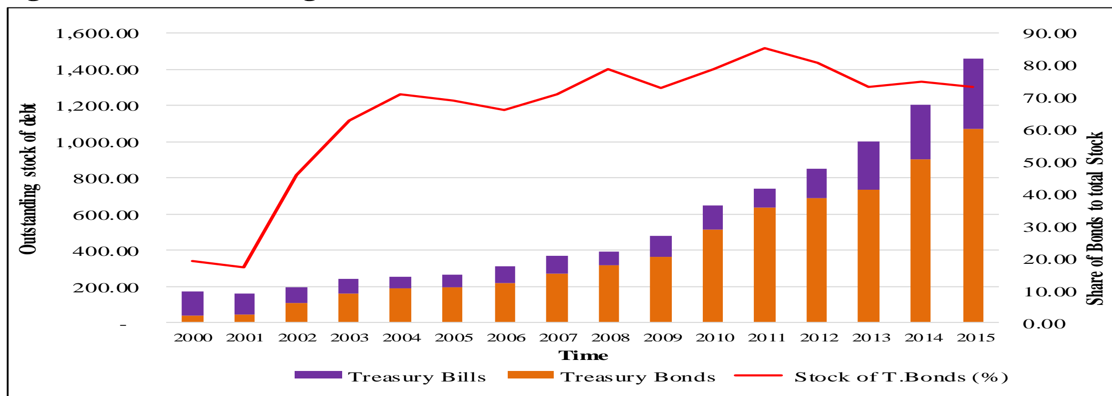
Source: Central Bank of Kenya

The Balance of Payments (BOP) position improved on account of CAD narrowing between 2014 and 2015. This improvement in the CAD was offset by a decline in the Financial Account due to a one off reduction in portfolio flows. BOP is envisaged to improve with the narrowing of Current Account Balance (CAB) on account of reduction in import bill and recovery in merchandise exports of tea and horticulture, hence no immediate risks to financial stability stemming from the external sector.

2.5. Public Debt and Debt Markets

In 2015, stock of outstanding debt increased by 21.61 per cent following increased domestic borrowing by the Government to finance targeted infrastructure and budget support. The spike in short term interest rates in second half of 2015, saw investors reduce appetite for long term securities (Treasury bonds) in favour of short term securities (Treasury bills), hence issuance of more short term debt in line with investor appetite to meet government borrowing requirements. Consequently, the ratio of long term to short term debt declined to 73:27 in 2015 down from 75:25 in 2014 (Figure 16).

Figure 16: Outstanding Government Securities

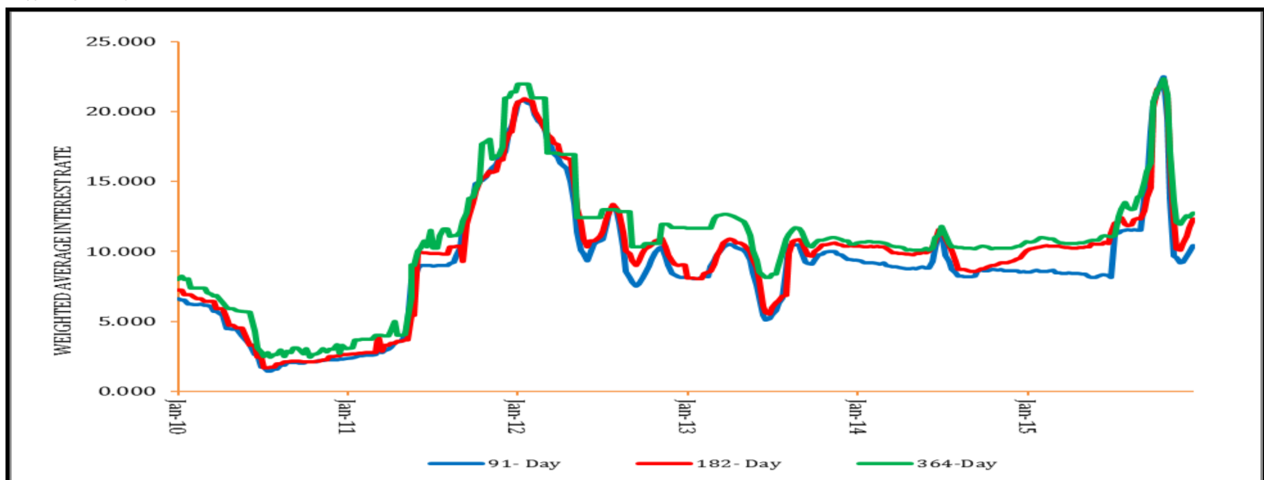


Source: Central Bank of Kenya

Demand for government securities in the primary market remained high in 2015 with average subscription rate of 130 per cent for all securities offered but below 156 per cent realized in 2014. The Offers were mostly oversubscribed in 2015Q4, due to flight to safety tendencies by banks. About half of all Treasury bonds issued in 2015 were oversubscribed reflecting good investors uptake following CBK policy actions that improved liquidity.

The short term securities' markets defined by Treasury bills experienced higher volatility (Figure 17) in second half of 2015 following tight liquidity conditions associated with exchange rate volatility, increased government borrowing and placement of two banks in receivership.

Figure 17: Tight liquidity market conditions led to volatile interest rates in second half of 2015

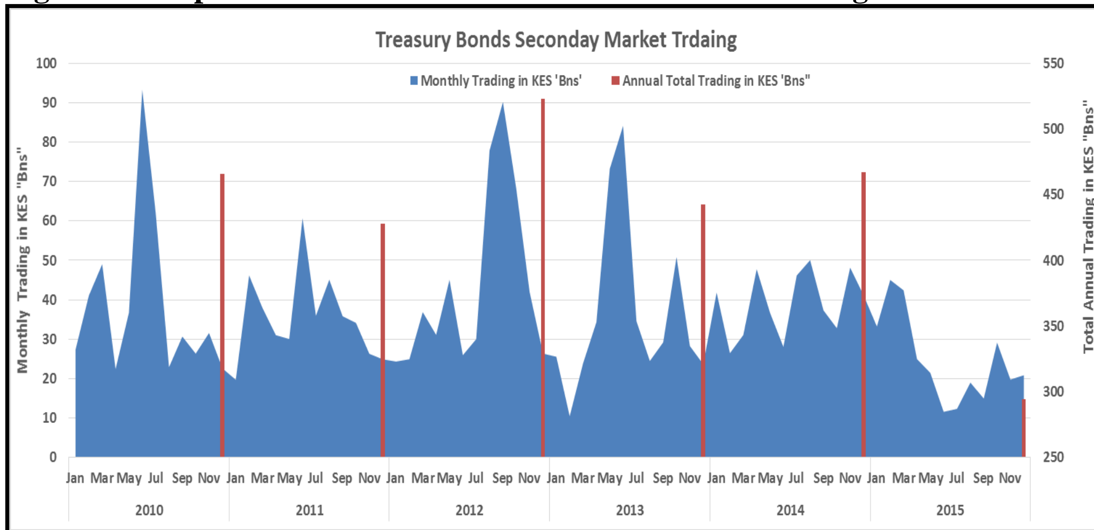


Source: Central Bank of Kenya

2.6. Secondary Market for Fixed Income Securities

High interest rates impacted negatively on the bond market as holders reduced trading to avoid losses. The volume of bonds traded declined by 37 per cent in 2015 compared to 2014, reaching KSh 294 billion in 2015 down from KSh 467 billion in 2014 (Figure 18). Trading of bonds in a high and volatile interest rates environment creates losses to banks; hence preference to hold the securities until maturity.

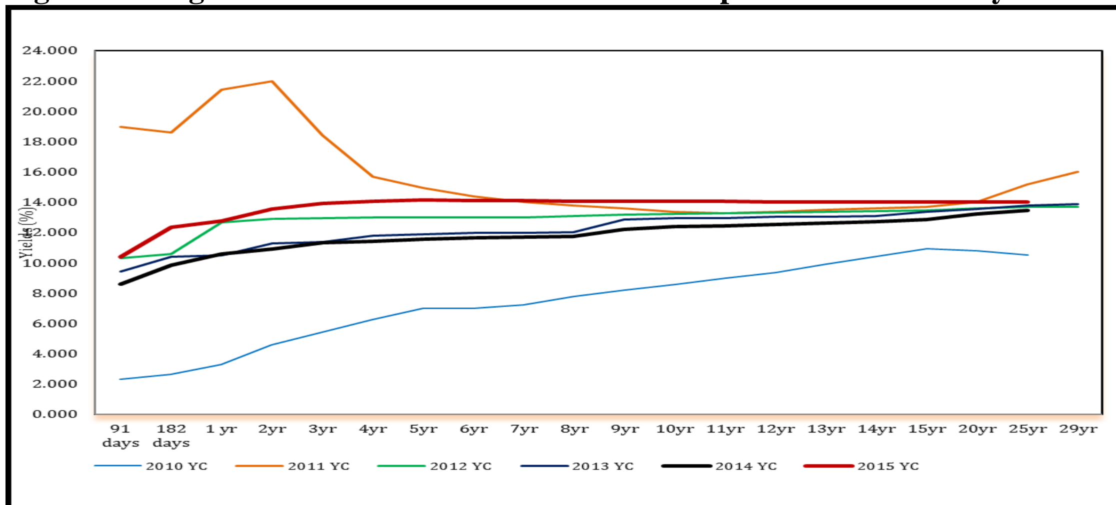
Figure 18: Impact of short term interest rates on bonds trading at the NSE



Source: Central Bank of Kenya and Nairobi Securities Exchange

Conditions which affected the market in 2015 mirror the market instability experienced in 2011 as reflected in the shape and position of the yield curves (Figure 19).

Figure 19: Higher interest rates in 2015 influenced upward shift of 2015 yield curve

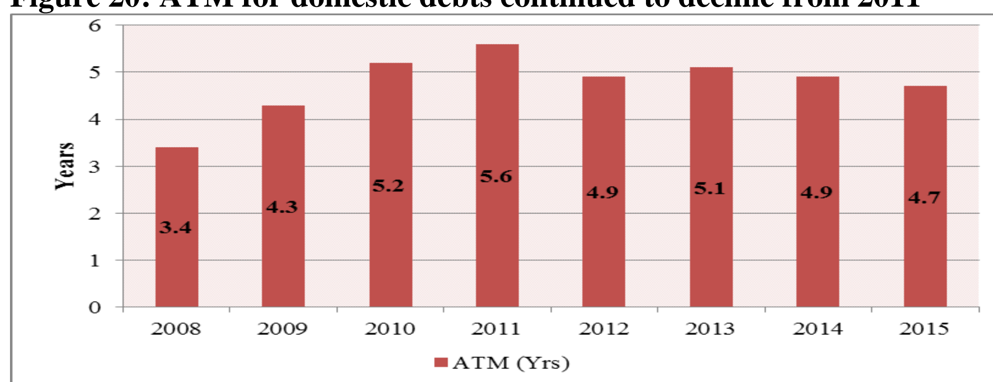


Source: Central Bank of Kenya

2.7. Risks in the Domestic Debt Markets and Outlook

Refinancing Risk arises when the debt issuer (government) is unable to successfully take-in new debt at sustainable market rates to offset maturing debt. This occurs when the market perceives a certain level of risks on the issuer or there are competing instruments that offer better return, hence need for higher rates to compensate for any potential losses. During this period, interest rates rose sharply and auctions were just-subscribed. To mitigate the pressure Government issued more short term debt to minimize high interest cost bonds and also ensure full uptake of new debt. The net effect was reduction in Average Time to Maturity (ATM) of outstanding domestic debt to 4.7 years in 2015 from 4.9 years in 2014 (Figure 20).

Figure 20: ATM for domestic debts continued to decline from 2011



Source: Central Bank of Kenya

The government securities worth KSh 539.84 billion will mature and KSh 119.97 billion will be paid out in interest as indicated in the maturity calendar of 2016. Total borrowing from domestic markets will therefore; cater for all maturities and new borrowing for budget support. The issuance calendar should be managed well to ensure less upward pressure on interest rates.

Interest Rate Risks were elevated in second half of 2015, with Treasury bills average rates ranging between 8 per cent and 23 per cent, while Treasury bond yield curve had yield spreads of 600bps between the lowest and the highest maturity. This volatility was in response to increased government borrowing as well as monetary policy tightening amid liquidity distribution challenges facing the banks.

2.8. Public Debt Sustainability

A Debt Sustainability Analysis (DSA) update by the International Monetary Fund (IMF) and the World Bank in September 2015, showed a low risk debt distress for Kenya for both domestic and external debt. However, fiscal policy discipline remains crucial to maintain sustainable debt paths. Exchange rate shocks as witnessed in 2015 and less favourable terms on new public sector loans represent the largest upside risks to external

debt in 2016. Overall public debt would increase most in the event of significantly lower than anticipated economic growth following lower than anticipated growth of tax revenues, unfavourable weather conditions that require additional financing and unfavourable terms and direction of trade that impact export revenues.

Public debt accumulation has grown faster as government borrows to finance infrastructure and growing expenditures. Examples include Standard Gauge Railway loan from China's Exim Bank and the sovereign bond issuance. The DSA projects that overall public debt is set to increase to 56 per cent of GDP in 2015/16. Kenya has strong market foundations and sound macroeconomic policies to absorb any shocks associated with debt vulnerabilities that may emerge.

Chapter III: FINANCIAL SECTOR DEVELOPMENTS AND OUTLOOK

Kenya's financial sector has grown significantly in size and complexity as it continues to support the overall economy. The sector comprises of the banking, capital markets, insurance, pensions, and savings credit cooperatives. Other players include microfinance institutions, money remittances companies, foreign exchange bureaus and development finance institutions. There are also safety nets and resolution institutions such as the Kenya Deposits Insurance Corporation for commercial and microfinance banks; Investor Compensation Fund for Capital Markets subsector; and the Insurance Policyholders' Compensation Fund for the insurance subsector. These are supported by Credit Information Sharing (CIS) platforms through the Credit Reference Bureau and a vibrant Financial Markets Infrastructure (FMI) system comprising of trading, payments and settlements, and custodial services platforms.

As a proportion of nominal GDP, the financial sector's total assets excluding capital markets accounted for 83.27 per cent in 2015 while equities' market capitalization was 32.93 per cent. The sector's share of GDP, however declined compared to 2014, with the largest fall coming from banking industry (Table 5). The decline could be explained by exclusion of assets of three banks placed under receivership.

Table 5: Share of the Financial Sector to GDP

INDUSTRY INDICATOR	*2013*		*2014*		*2015*	
	KSh Mn	*% of GDP*	*KSh Mn*	*% of GDP*	*KSh Mn*	*% of GDP*
Nominal GDP	**4,745,439**	**-**	**5,398,020**	**-**	**6,224,369**	**-**
Banking Net Assets	2,703,394	56.97	3,199,396	59.27	3,492,643	56.11
Microfinance Assets	41,400	0.87	56,900	1.05	69,465	1.12
Pension Industry Assets	696,680	14.68	788,150	14.60	814,100	13.08
Insurance Assets	366,252	7.72	426,310	7.90	478,752	7.69
Saccos Industry Assets	257,368	5.42	301,537	5.59	328,244	5.27
TOTAL ASSETS	**4,065,094**	**85.66**	**4,772,293**	**88.41**	**5,183,204**	**83.27**
Equities Market Cap.	1,920,718	40.48	2,300,054	42.61	2,049,539	32.93

Source: Compiled from sectoral data and KNBS

3.1. Banking System Developments

As at December 31, 2015, Kenya's banking system comprised of the Central Bank of Kenya as the regulator, 42 commercial banks, 1-mortgage finance company, 8 representative offices of foreign banks, 12 microfinance banks, 3 Credit Reference Bureaus (CRBs), 14 money remittance companies and 80 foreign exchange bureaus. The banking industry however comprises of all the above except the CBK.

The banking industry's overall capital adequacy ratio averaged 19 per cent against a statutory minimum of 14.5 per cent with average liquidity ratio of 38.3 per cent as at end December 2015. Liquidity was, however, skewed in favour of large tier banks.

In 2015, two banks were placed under receivership in August and October 2015, of which one was subsequently placed under liquidation. The two banks were not systemic, hence limited spillovers to the rest of the industry. A third bank was briefly placed in receivership in the first half of 2016, but reopened again under new management. CBK, working closely with the KDIC, contained the impact of the three banks and smoothened operations in the industry. However, placement of the three banks in receivership, created panic among depositors in small banks, causing liquidity glitch but spillovers were limited due to uniqueness of reasons for closure of the three banks.

Total net assets of the industry grew by 9.2 per cent in 2015 supported by the growth in loans and advances and investment in Government Securities, which grew by 4.8 per cent to KSh. 696.6 billion in December 2015. Cumulative audited pre-tax profits, however, declined by 5 per cent during the same period. Customer deposits, the main source of funding to the banks, increased by 10.6 per cent to KSh. 2,615.5 billion in December 2015 driven by branch expansion, exports receipts and use of innovative delivery channels like agency and mobile banking platforms.

Unfavourable business environment in 2015 characterised by high interest rates, low growth opportunities due to, among other factors, insecurity and poor weather conditions, and enhanced reclassification and provisioning of bad debts contributed negatively to the quality of loans and advances. As a result, non-performing loans (NPLs) increased by 36.04 per cent to KSh. 147.3 billion in December 2015, with the ratio of gross NPLs to gross loans at 6.8 per cent in December 2015 from 5.4 per cent in December 2014. These signalled elevated credit risks in 2015, but expected to ease in 2016 (Table 6).

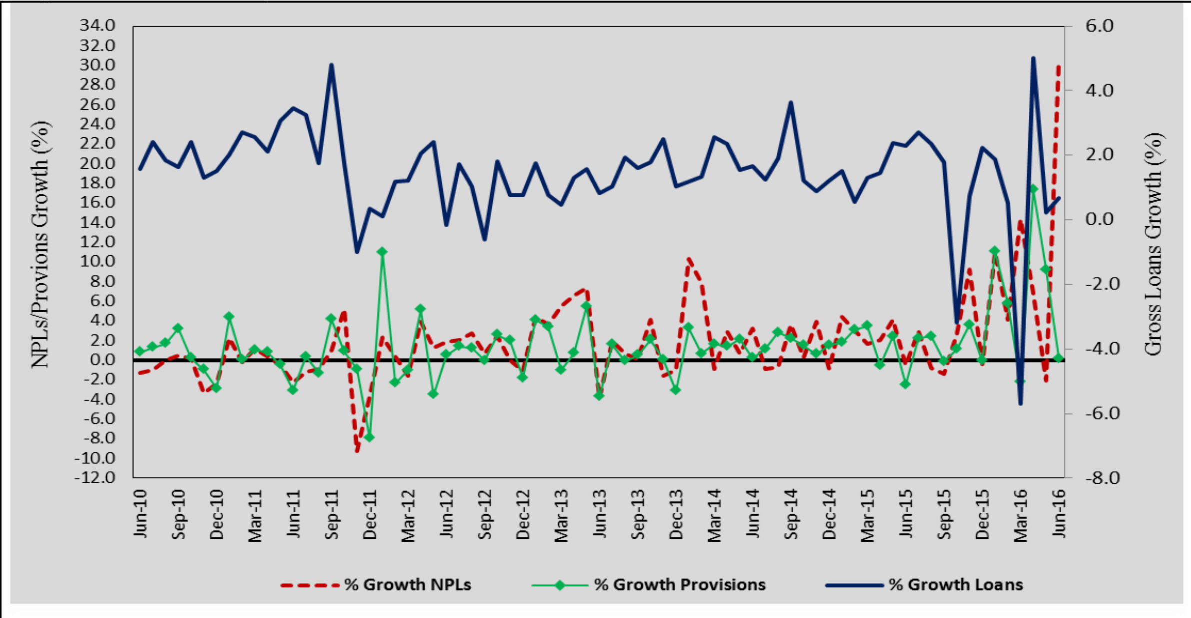
Table 6: Asset Quality Indicators in December 2014 and 2015

Indicator	Dec. 2014, KSh	Dec. 2015, KSh M	% Change
Net Assets	3,199,396	3,492,643	9.20
Gross Loans	1,940,781	2,165,329	11.60
Total Loans	1,922,857	2,142,150	11.40
Net Loans	1,881,024	2,091,361	11.20
Gross Non-Performing Loans	108,300	147,331	36.00
Interest in Suspense	17,923	23,179	29.30
Total Non-Performing Loans	90,377	124,152	37.40
Specific Provisions	41,833	50,789	21.40
Net Non-Performing Loans	48,544	73,363	51.10
Gross Loans/Net Assets (%)	60.70	62.00	1.30
Gross NPLs/Gross Loans (%)	5.60	6.80	1.20
Net NPLs/Net Loans (%)	2.50	3.39	0.89

Source: Central Bank of Kenya

In the period June 2010 - June 2016, trends in assets quality have reflected challenges besetting macro-financial conditions. The periods; September–December 2011 and September–December 2015, and first quarter of 2016 were characterised by fluctuations in loans advanced, NPLs and provisions growth rates (Figure 21). These were periods with sharp rise in interest rates, exchange rate depreciation, and liquidity squeeze in the markets.

Figure 21: Monthly Trends in Loans, NPLs and Provisions



Source: Estimated from CBK data

Fluctuations in growth rates in the last quarter of 2015 and first half of 2016 is attributed to placement of three banks under receivership by CBK, and subsequent reopening of one the banks.

In the period, CBK also introduced reforms and enhanced enforcement measures in the banking industry that led to improved data reporting, transparency and corporate governance and review of business models of banks. The key observation in the period is increased credit risks since the third quarter of 2015 as reflected in growth rates of NPLs.

Four economic sectors, namely; Personal/Households, Trade, Real Estate, and Manufacturing sectors accounted for 70.89 per cent of total gross loans and advances in December 2015 (Table 7).

Table 7: Distribution of Loan accounts, Gross Loans and Gross NPLs

ECONOMIC SECTOR	No. Loan Accounts	% Share of Total	Gross Loans(Ksh Mn)	% Share of Total	Gross NPLs (Ksh Mn)	% Share of Total
Agriculture	180,533	2.12	87,456	**4.04**	8,384	**5.69**
Manufacturing	15,393	0.18	266,389	12.30	16,773	11.38
Building & Construction	10,552	0.12	100,200	**4.63**	16,243	**11.02**
Mining & Quarrying	1,003	0.01	21,860	**1.01**	2,471	**1.68**
Energy and water	2,507	0.03	100,144	4.62	3,666	2.49
Trade	394,822	4.64	423,626	**19.56**	44,294	**30.06**
Tourism, Restaurant, Hotels	5,563	0.07	54,529	2.52	2,562	1.74
Transport& Communication	40,113	0.47	185,167	8.55	12,143	8.24
Real Estate	20,093	0.24	293,989	13.58	12,426	8.43
Financial Services	20,772	0.24	80,905	3.74	2,273	1.54
Personal/Household	7,815,764	91.87	551,063	25.45	26,096	17.71
Total	**8,507,116**	**100.00**	**2,165,329**	**100.00**	**147,331**	**100.00**

Source: Central Bank of Kenya

Trade and Building & Construction sectors had the fastest deterioration of loan book into NPLs. Trade sector was affected by difficult business conditions including high interest rates that saw many small and medium enterprises as well as established corporate enterprises face difficulties in servicing their loans. Building & Construction sector was mostly affected by delays in government payments to contractors and suppliers.

Capital Adequacy and Liquidity in the Banking Industry

In 2013, CBK introduced a capital conservation buffer of 2.5 per cent above the minimum stipulated capital adequacy ratios that became effective on January 1, 2015, raising the minimum core capital and total capital to total risk weighted assets to 10.5 per cent and 14.5 per cent, respectively. In 2015, the industry's average Core Capital to Total Risk Weighted Assets ratio was 16 per cent while Total Capital to Total Risk Weighted Assets ratio was 19 per cent. The decline total below the 20 per cent recorded in 2014 was due to higher growth in risk weighted assets compared to increase in capital.

During the year, the ratio of Core Capital to Total Deposits averaged 19 per cent in 2015 against a required minimum of 8 per cent. All banks met minimum capital adequacy ratios in December 2015 except one bank, which failed on the minimum total capital to total risk weighted assets ratio as well as core capital to total risk weighted assets ratio. The bank has agreed CBK on a time bound capital restoration plan to ensure full compliance.

Banking Industry Profitability

The banking industry had a 5.03 per cent decline in pre-tax profits in 2015 compared to profitability in 2014 (Table 8). The decline could be explained by exclusion of three banks (Dubai, Imperial and Chase) placed under receivership at the time of preparing this report. Performance of these banks was included in the 2014 FSR.

Table 8: Banking Industry Profitability, 2013 - 2015

Measurement/Year	2013	2014	2015
Profitability in KSh Millions			
Profit/(loss) before tax and exceptional items	125.8	141.1	134.0
Profit/(loss) after exceptional items	124.9	140.9	134.3
Profit/(loss) after tax and exceptional items	88.8	101.4	95.3
Annual Growth Rates			
Profit/(loss) before tax and exceptional items	16.6%	12.0%	-5.0%
Profit/(loss) after exceptional items	15.8%	12.4%	-4.7%
Profit/(loss) after tax and exceptional items	18.4%	10.6%	-6.0%

Source: Central Bank of Kenya

The banks' income grew by 9.1 per cent compared to 16.3 per cent increase in expenses over the period, following increased loan loss provisions and interest cost on deposits. Six (6) banks reported cumulative losses of KSh. 4.5 billion in 2015 up from KSh. 1.0 billion cumulative losses reported by three (3) banks in 2014, signaling difficult credit markets coupled with high interest rates reflected in faster growth in NPLs.

Table 9: Top and Bottom Five (5) Banks Performance (KSh. Millions)

INDICATOR	INDUSTRY		Top five (5) Banks		Bottom five (5) Banks	
	Dec -14	Dec -15	Dec -14	Dec -15	Dec -14	Dec -15
Net Assets (KSh Mn)	3,199,396	3,492,643	1,418,115	1,623,904	31,343	42,768
Shareholders' Equity	529,115	551,662	221,024	258,267	6,193	7,551
Profits Before Tax	141.1	134.0	80,213	69,473	-171	-229
Return on Assets (%)	3.40	3.80	4.60	4.28	-0.86	-0.54
Return on Equity (%)	26.60	24.30	30.82	26.90	-3.94	-3.03

Source: Central Bank of Kenya - Based on Commercial banks unaudited results

Profitability was however uneven, with top five (5) banks recording stronger profits, while bottom five (5) banks recording more losses (Table 9).

Impact of Interest Rates Changes on Banks Treasury Bonds' Holdings

Sharp increase in interest rates in the 2015H2 impacted negatively on the balance sheets of commercial banks. A total of fourteen (14) commercial banks who held 55 per cent of

all tradable bonds by end of 2015 recorded actual revaluation losses of KSh 6.86 billion, the first loss in four years (Table 10). Note that all tradable bonds held are categorized; Available For Sale (AFS)1 or Held For Trading (HFT)2 portfolios, which are subject to Mark-to-Market valuation rules under the IFRS Principles.

Table 10: Impact of High interest rates on banks' bond portfolio

Year End	Tradable Bonds Held by All Banks (KSh Bn)	Tradable Bonds Held by top 14 banks (KSh Bn)	% of Total Bonds Held	Net Loss (-)/ Gain (+) (KSh Bn)
2012	328.52	189.38	57.65	+8.31
2013	359.49	227.43	63.26	+0.04
2014	445.52	243.52	54.66	+0.75
2015	504.79	278.97	55.26	-6.86

Source: Central Bank of Kenya

Outlook for the Banking Industry in 2016

The banking industry is expected to remain stable and resilient 2016 supported by positive economic sentiments, improving regulatory measures by CBK and deepening risks management practices. CBK stands ready to support the sector in case of downside risks related to liquidity and credit risks in 2015, and shocks related to de-risking by foreign banks. CBK has enhanced has enhanced regulatory and supervisory compliance measures especially with regard to reporting, transparency and governance, and reengineer their business models.

3.2. Kenya Deposit Insurance Corporation (KDIC)

The role of deposit insurance is to protect depositors, particularly small, vulnerable and less financially sophisticated, against potential losses they may face as a result of failure of banks, hence, creating public confidence in the financial system. Availability of deposit insurance serves to engender confidence in the banking system and thus contribute to financial stability. KDIC, established through an Act of Parliament, provides a deposit insurance scheme for customers of member institutions' licensed by the CBK to receive, liquidate and wind up any institution of which it is appointed a receiver or liquidator by CBK.

Membership is mandatory for all deposits taking institutions licensed by the CBK. As at the end of December 2015, there were 55 member institutions comprising of 42 commercial banks, 1 mortgage finance company and 12 deposit taking microfinance institutions. Two commercial banks were placed in receivership, while one was put in liquidation in the first half of 2016.

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1 Available-For-Sale security is a debt/equity security bought with intention of selling it before maturity, or selling prior to a lengthy time period in the event the security does not have a maturity.
2 Held-For-Trading securities are purchased and held primarily for sale in the short-term. The purpose is to make a profit from the quick trade rather than the long-term investment. On the other, end of the spectrum are Held-To-Maturity securities.

The number of deposit accounts with KDIC member institutions increased by 21.7 per cent in 2015 attributable to financial inclusion initiatives by CBK, and more usage of Mobile and Agency Banking channels by banks (Table 11). Total deposits were KSh. 2.674 trillion in 2015, with total deposits fully protected at KSh. 244.65 billion or 9.15 per cent. Of the total deposit accounts, those fully covered stand at 96.63 per cent, implying low exposure. Given the Fund Balance of KSh 61.73 billion against the protected deposits of KSh 244.647 billion, there was a high exposure level of 74.77 per cent since only 25.23 per cent of total value was fully covered. This is way below the 40 per cent international benchmark (Table 11).

Table 11: Summary of Protection & Exposure Indicators

No.	MEASURE	Dec. - 2014	Dec - 2015	Change (%)
1	Total Deposits (KSh Mns)	2,384,723	2,673,954	12.13
2	Protected Deposits (KSh Mns)	224,868	244,647	8.80
3	**Protection Level (2/1)**	**9.43%**	**9.15%**	**-2.97**
4	KDIC Balance (KSh Mns)	52,165	61,727	18.33
5	Effective Cover (4/2)	23.20%	25.23%	8.75
DEPOSITS ACCOUNTS				
6	No. of Deposit A/Cs (‘000s)	30,698	37,353	21.70
7	No. of A/Cs fully covered (‘000s)	29,552	36,096	22.14
8	Share of protected accounts (7/6)	96.26%	96.40%	0.15
9	**Exposure (row 2 – row 4/row 2)**	**76.80%**	**74.77%**	**-2.64**

Source: Kenya Deposits Insurance Corporation

3.3. Financial Markets Infrastructure (FMI)

Payment systems in Kenya have grown rapidly overtime largely supported by faster growth in internet and mobile phones, e-commerce, technological developments and Near Field Communication (NFC). Cross-border payments can now be made in exactly the same way as national payments, allowing the most innovative payments firms to compete in the retail payments.

Factors supporting these initiatives, include: innovative technology-enabled business products and services; broadening the range of payment instruments and services; Improved cost efficiency measured by operating, access and usage costs; Enhanced interoperability and resilience of banking, payment and securities infrastructures; Improved oversight and regulatory regimes for the national payment system; and Enhanced efficiency and stability of payment systems and service providers.

For smooth functioning of payment, clearing and securities settlement systems, CBK cooperates closely with other regulators like CMA, Communications Authority of Kenya (CA) and Competition Authority of Kenya (CAK), among others to ensure stability and

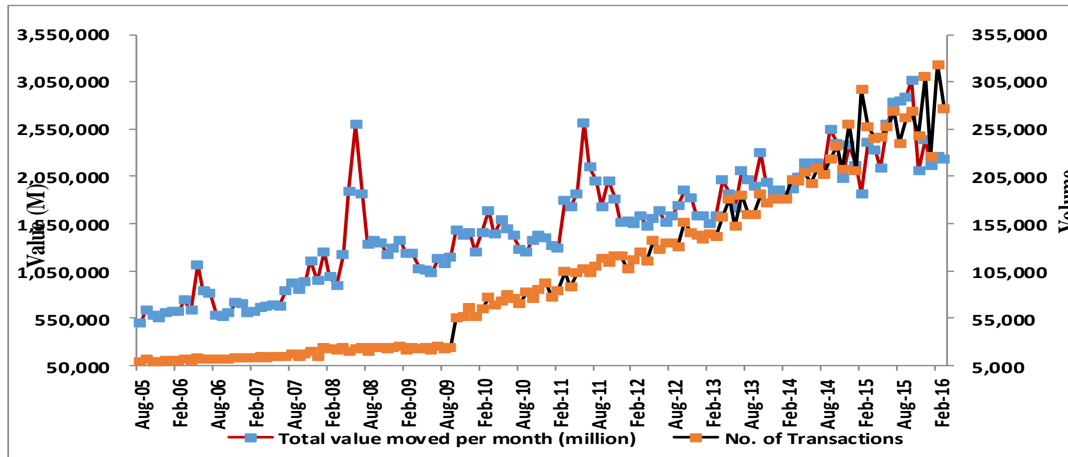
resilience of the systems. Generally, the payment systems operated smoothly in 2015, recording increased values and volumes transacted.

Real Time Gross Settlement (RTGS) System: Kenya Electronic Payment and Settlement System (KEPSS)

KEPSS recorded 3.13 million transaction messages worth KSh. 29,703 billion in 2015 compared to 2.53 million transaction messages worth KSh. 25,561 billion in 2014 (Figure 22), reflecting more usage by the public given its security and speedy mode of payment. The first quarter of 2016 saw KEPSS process 826,050 messages valued at KSh. 6,667 billion.

Direct settlements through KEPSS by commercial banks accounted for 99 per cent of the total activity, while the Net Settlement Instruction (NSI) or payment instructions through Automated Clearing House (ACH) to KEPSS accounted for an average 1.0 per cent.

Figure 22: KEPSS Usage from 2007

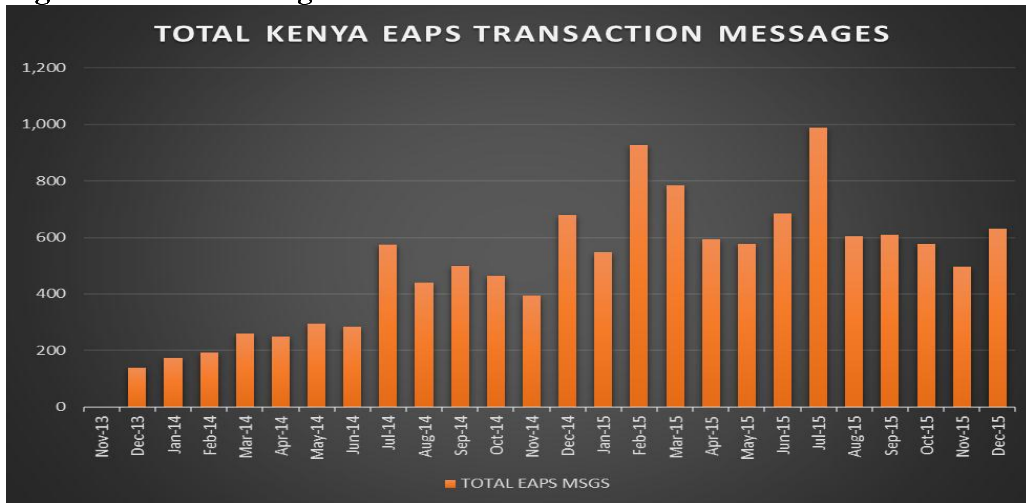


Source: Central Bank of Kenya

Regional Payments and Settlement Systems

The East African Payment System (EAPS) was established via an East African Community (EAC) Monetary Affairs Committee (MAC) of Central Bank Governors to facilitate trade in EAC region. The system involves integration of the respective country RTGS. Currently, Kenya, Uganda, Tanzania and Rwanda are using EAPS since its going live on November 25, 2013, which has significantly grown overtime (Figure 23).

Figure 23: EAPS Usage since 2013



Source: Central Bank of Kenya

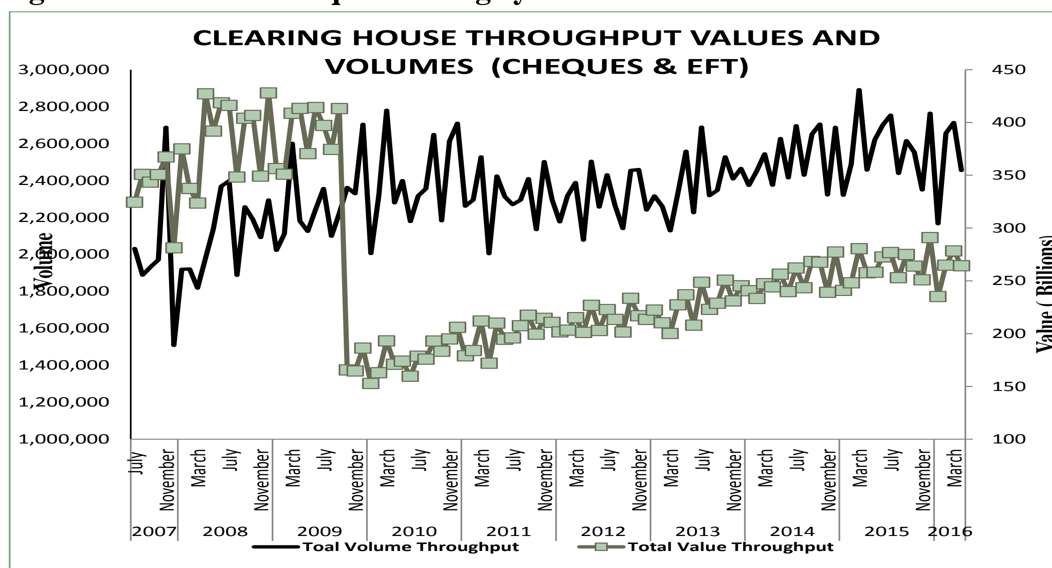
The other regional payment system is the Regional Settlement and Payment System (REPSS), which is a multilateral netting system managed by the Common Market for Eastern and Southern Africa (COMESA) Clearing House based in Zimbabwe with backup operations in Mauritius. Bank of Mauritius is the settlement bank for REPSS, whose objective is to facilitate settlement of payments instructions among the 19 COMESA member countries in either USD or the EURO. Currently, 7 out of the 19 countries are live on the system, namely; Rwanda, Mauritius, Kenya, Uganda, Democratic Republic of Congo, Zambia and Swaziland. CBK has signed agreements with the COMESA Clearing House and the Settlement Bank (Bank of Mauritius) and prefunded its accounts at the Bank of Mauritius. REPSS went live in Kenya on November 14, 2014.

The Automated Clearing House (ACH)

The ACH processed 31 million transactions valued at KSh 3.2 Trillion in 2015. Compared to the same period in 2014, the volume increased by 0.73 million instructions with a value of KSh 131 billion.

The increase in value and volume of cheques and Electronic Funds Transfers (EFTs) through the ACH can be attributed to a preference of cheques for payment due to reduced clearing cycle from T+3 to T+1 and the capping to above KSh 1 million (Figure 24).

Figure 24: Reduced cheque clearing cycle from T+3 to T+1



Source: Central Bank of Kenya

Cards Transactions

Payment cards, including debit, credit and charge cards usage has grown significantly as users now embrace initiatives by CBK and the Kenya Credit and Debit Card Association to adopt plastic money as well as the move to cash-lite.

There were 13.2 million active cards that facilitated transactions worth KSh 1.35 trillion in 2015 compared to 13.9 million cards that facilitated KSh 1.3 billion in 2014. The number of ATMs increased from 2,613 to 2,718, thus raising access to touch points for card users (Table 12).

Table 12: Increased usage of Cards

End Year	No. of Cards	No. of ATMs	No. of POS Terminals	Transactions Volume (Mns)	Transactions Volume (Mns)
2011	10.1	2,205	16,604	12.1	57,290
2012	10.7	2,381	18,478	28.9	101,939
2013	11.5	2,487	21,089	28.3	120,670
2014	13.9	2,613	17,511	18.6	110,660
2015	13.2	2,718	22,230	20.1	121,821
Change	**-5.04%**	**4.02%**	**26.95%**	**8.06%**	**10.09%**

Source: Central bank of Kenya

The Point of Sale (POS) terminals have also experienced significant growth since 2011 from 16,604 to 22,230 in 2015 as the public move towards reducing cash transactions.

Mobile Phone Money Transfers

Mobile Phone Money Transfer services continued to grow in 2015, with the number of agents up by 16.4 per cent, mobile money transfer accounts up by 25.4 per cent, the volume of transactions up by 22.3 per cent and transactions value up by 18.7 per cent. These increases is attributed to adoption of mobile money transfer services by different institutions comprising of both financial and non-financial including banks, pensions, Saccos, merchants, like microfinance institutions (MFI), NGOs, insurance, government agencies, among others for cash disbursement and repayment of loans and salary payments as well as purchases of goods and services (Table 13).

Table 13: Mobile Phone Money Transfer Services

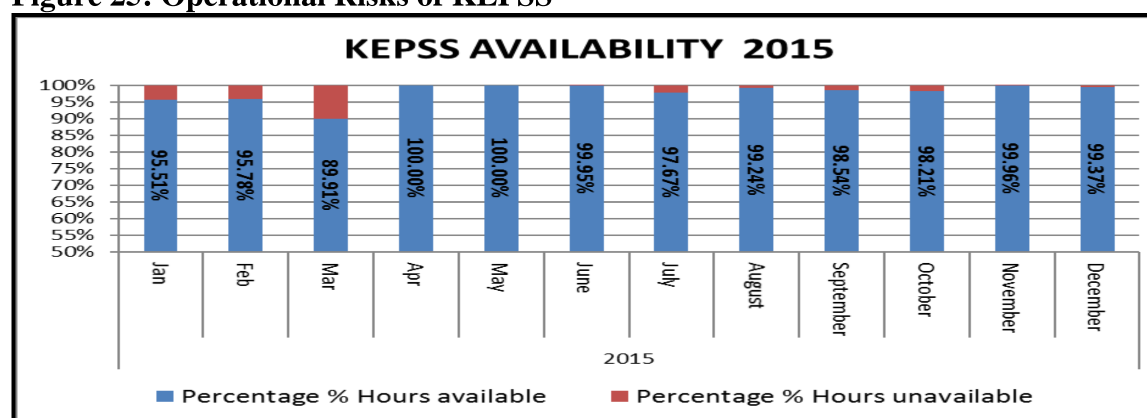
Indicator	2010	2011	2012	2013	2014	2015
No. of Agents	39,449	50,471	76,912	113,130	123,703	143,946
Mobile Money Ac/s (mns)	16.4	19.2	21.1	25.3	25.2	31.6
No.of Transactions (mns)	311	433	575	733	911	1,114
Transactions Value (KSh bn)	732.2	1,169	1,538	1,902	2,372	2,816
Average Transaction Value (KSh)	2,354	2,700	2,672	2,594	2,604	2,528

Source: Central Bank of Kenya

KEPSS Availability

The 2015Q1 recorded the lowest downtime of KEPSS availability due to power outages and interruptions by service providers following a cut on fibre optic cable (Figure 25).

Figure 25: Operational Risks of KEPSS

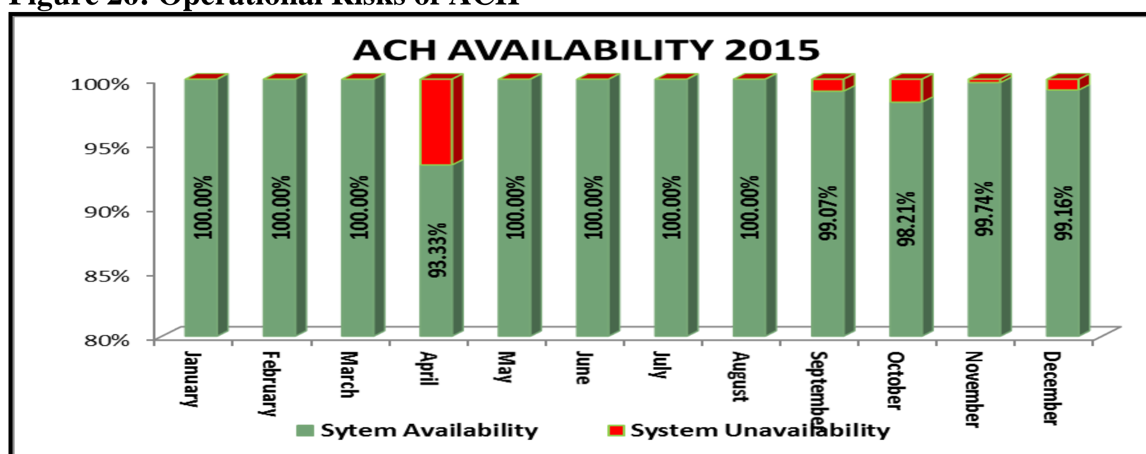


Source: Central Bank of Kenya

ACH Availability

The ACH system experienced highest downtime in April 2015, though it was not systemic to affect the entire financial system (Figure 26).

Figure 26: Operational Risks of ACH



Source: Central Bank of Kenya

Liquidity Management by KEPSS Participants

KEPSS users borrowed overnight loans totalling KSh. 112.9 billion up from KSh. 70.1 billion in 2014, reflecting elevated liquidity risks that banks sought to mitigate (Table 14).

Table 14: Overnight loans to commercial loans via KEPSS (KSh Millions)

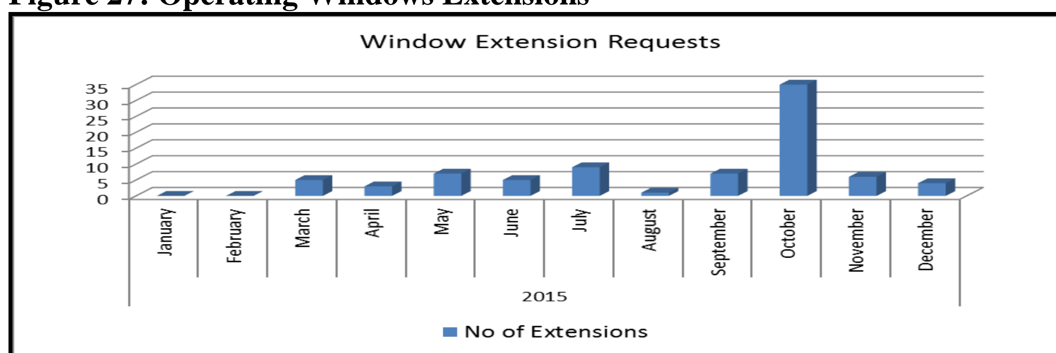
MONTH	2014		2015	
	Loans	Cum. Loans	Loans	Cum. Loans
January	2,500	2,500	1,350	1,350
February	-	2,500	-	1,350
March	480	2,980	13,340	14,690
April	6,510	9,490	17,800	32,490
May	15,172	24,662	17,430	49,920
June	-	24,662	1,980	51,900
July	19,656	44,318	25,655	77,555
August	22,400	66,718	-	77,555
September	-	66,718	2,960	80,515
October	-	66,718	27,806	108,321
November	-	66,718	1,396	109,917
December	3,400	70,118	3,000	112,917

Source: Central Bank of Kenya

Window Extensions

To enable commercial banks meet their obligations in KEPSS, extension of 'operating windows' is granted upon request (Figure 27). The liquidity strain experienced in 2015H2 saw October record the highest operating windows extensions.

Figure 27: Operating Windows Extensions



Source: Central bank of Kenya

Financial Markets Infrastructure outlook in 2016

The financial system stability relies on a stable and robust payment and settlement system since a default by one participant can easily cause systemic risks. The FMI is therefore, being upgraded to benefit from technological developments with CBK rolling out a robust legal and regulatory framework (National Payments System Act) to support this transformation upon full implementation.

3.4. Savings and Credit Cooperative Societies (SACCOs)

The Saccos movement comprises of Deposit-Taking SACCOs (DTS) regulated by the Saccos Societies Regulatory Authority (SASRA) and non-deposit taking Saccos supervised by the Ministry of Industry, Trade and Cooperatives.

Table 15: Financial Soundness Indicators (FSIs) for DTS

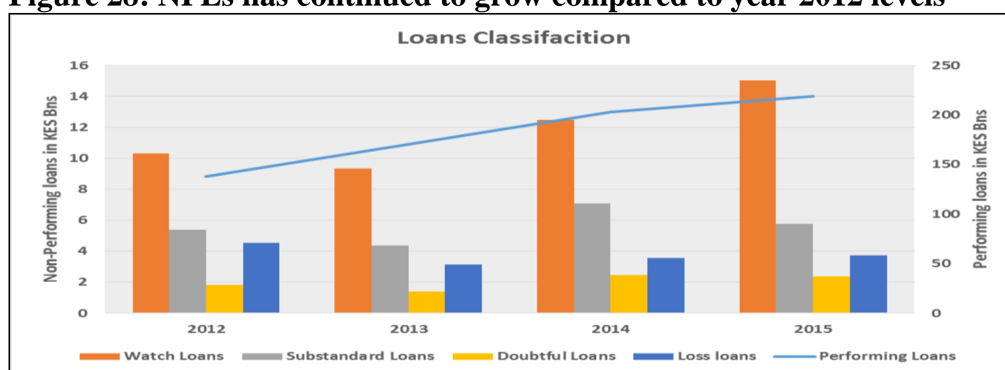
FINANCIAL SOUNDNESS INDICATORS	2013	2014	2015
CAPITAL ADEQUACY			
Core Capital/Total Assets ***(Minimum 10%)***	7.74	11.20	12.17
Core Capital/Total Deposits ***(Minimum 8%)***	10.90	16.40	17.57
Institutional Capital/Total Assets ***(Minimum 8%)***	2.84	5.42	8.75
ASSET QUALITY			
NPLs to Total Gross Loans (%)	4.72	5.73	5.12
NPLs Net of Provisions to Capital (%)	14.50	17.06	14.65
Earning Assets to Total Assets (%)	82.62	79.45	80.54
EARNINGS			
Return on Assets (ROA) %	2.32	2.56	1.87
Returns on Equity (ROE) %	19.03	18.78	13.65
Interest Margin to Gross Income %	46.86	45.70	42.97
Non-Interest Expenses to Gross Income %	43.76	38.40	41.69
LIQUIDITY RATING (%)			
Liquid Assets to Short-term liab.***(Liquidity ratio)***	7.76	47.32	55.99
Liquid Assets to Total Deposit	36.40	14.57	17.18
Liquid Assets to Total Assets	10.93	9.99	11.90
Total Loans to Total Deposit	108.06	110.95	108.74

Source: Saccos Societies Regulatory Authority

The Saccos' industry comprising of DTS, had total assets growth of 12.17 per cent in 2015, with loans as the single largest asset of the balance sheet. SASRA renewed licenses for 181 deposit taking SACCOs to operate in 2015 whose performance is in Table 15.

There was improved capital ratios for the 181 licensed Saccos in 2015 compared to 2014. However, some Saccos faced loan repayment challenges, forcing them to increase provisioning, which negatively impacted their core capital. Sacco's in the Agricultural sector experienced high NPLs due to erratic weather patterns that negatively affected their farm output (tea and coffee). Loans disbursed rose by 7.8 per cent, but NPLs declined from 5.73 per cent in 2014 to 5.12 per cent in 2015, indicating tightening of credit administration procedures to mitigate credit risks. In addition, Saccos increased their loan losses provision by 29.44 per cent, from KSh. 1,471 Million in 2014 to KSh 1,904 Million in 2015 to cushion against loan defaults and write-offs (Figure 28).

Figure 28: NPLs has continued to grow compared to year 2012 levels



Source: Saccos Societies Regulatory Authority

Profitability of SACCO Industry

Saccos rely on loan interest income as their main source of earnings, accounting for over 85 per cent of total income. Where Saccos borrow from commercial banks to on-lend to members, this should not exceed 25 per cent of total assets since the main funding source come from members' contribution (Table 16).

Table 16: Statement of Comprehensive Income

MEASURE	END 2014		END 2015		Y-on-Y Change (%)
	KSh. Mns	Share (%)	KSh. Mns	Share (%)	
Income from Loans	33,075	84.03	40,405	86.6	26.4
Investments Income	1,092	2.78	2,293	3.5	53.7
Other Incomes	5,190	13.19	4,702	9.9	-8.4
Total Income	**39,339**	**100.00**	**47,400**	**100.00**	**22.6**
Financial Expenses	17,021		21,727,		27.6
Net Financial Income	**22,318**		**28,977**		**30.00**
Bad Loans Provision	1,471		1,904	3.7	29.00
Operating Expenses	13,777	35.02	16,707	35.0	31.5
Net Surplus before Tax	**7,071**		**7,674**		**8.5%**

Source: Saccos Societies Regulatory Authority

The rapid credit growth in 2015 is attributed technological innovations adoption in the delivery channels and payments platforms like mobile phone platforms and agency banking that has expanded financial inclusion in Saccos' industry. The industry recorded 110 per cent increase in income from investment in Treasury bills and bonds, offering high returns in the second half of 2015 (Table 16)

Policy Developments

In 2015, SASRA championed amendments to the Sacco Societies Act to strengthen the legal framework and improve governance in DTS. These include:

i. ***Central Finance Facility* -** The Sacco Societies Act requires the DTSs to hold and maintain minimum liquidity, develop and implement contingency liquidity plans so as to effectively serve their members. This has led to situations where the Sacco Societies borrow expensively from commercial banks to bridge temporary liquidity needs and this has evidently threatened financial soundness of DTS and hence, safety of member deposits. SASRA proposes establishment of a Sacco system driven Central Finance Facility (CFF) to aid in liquidity management for Saccos. The CFF will facilitate:

    - Effective monitoring of system and individual Saccos liquidity compliance hence provide early signal on liquidity risks.
    - Pooling of liquidity since Saccos will hold minimum amounts with the CFF
    - Inter-lending within the Sacco system
    - Efficient access to funds in case of illiquidity issues, outside banking system
    - Prudent business practices and hence self-regulation in the Sacco industry;
    - Lower cost of credit as Saccos can effectively manage costs of funds
    - Competitiveness of DTS as alternative financial service providers in line with Vision 2030 and the Medium Term Plan for the Financial Sector.

ii. ***Credit Information Sharing (CIS)*** – The current CIS legal framework is limited to inter-Sacco sharing of negative information only and, with SASRA alone. It excludes sharing of positive information or sharing with other financial institutions, thus hindering access to credit. SASRA has proposed amendments to the Sacco Societies Act (Cap 490B) to address this challenge as indicated in Budget Speech by the Cabinet Secretary, National Treasury.

iii. ***Criteria for determining the suitability of officers for DTSs* -** The Saccos Societies Act (Cap 490B) envisages that SASRA shall vet key officers of Sacco societies, through the "Fit & Proper Test" form provided in the Regulations. To ensure probity and fitness of persons elected as directors, SASRA has proposed a provision to stipulate the minimum criteria for assessing the fitness and propriety of senior officers of DTS, which includes Directors and senior management.

The Saccos Industry Outlook

DTS continue to grow above 12 per cent in all key performance indicators, accounting for 75 per cent of the total assets and deposits (Table 17). DTS with net assets exceeding

KSh 5 billion accounted for 54 per cent of the net assets and deposits, while those with assets under KSh 1 billion held on average 8 per cent of the assets base and deposits in 2015. The increasing demands for prudential regulatory compliance coupled with the fact that majority of the small Saccos are financially and technically constrained, remain a challenge. The growth momentum for the large and medium sized DTS is expected to exert competitive pressure, with small DTS opting out of the business and concentrate in non-DTS or merge with large and financially sound DTS.

Table 17: Asset based categorization of deposit taking SACCOs

RANGE in bns	No. of SACCOs	ASSETS				DEPOSITS			
		Amount in 2014	% Share	Amount in 2015	% Share	Amount in 2014	% Share	Amount in 2015	% Share
>Ksh 5	15	152.3	50.4	177.9	54	78. 9	51	94.6	53
Ksh 1-5	58	111.7	37.0	36.0	25	90.2	22	105.2	24
<Ksh 1	104	37.6	12.6	128.9	8	36.8	12	37.6	10
TOTAL	**177**	**301.6**	**100**	**342.8**	**100**	**205.9**	**100**	**237.4**	**100**

Source: Saccos Societies Regulatory Authority

3.5. Capital Markets Developments

Capital markets broaden the choice of financing corporates and government. Development of efficient debt, equity and derivative markets create an enabling environment for successful financing. Capital markets industry comprises of; equities market and fixed income market segments. The equities market segment experienced low investors' appetite, and especially for risk assets like the Stanlib Fahari Real Estate Investment Trust (REIT[3]), whose IPO in October 2015 received KSh 3.6 billion subscriptions against KSh 12.5 billion target

Table 18: Monthly Leading Equities Market Indicators in 2015

Month	Equity Turnover (KSh Billions)	Share Volume (Millions)	NSE 20 Share Index (Points)	Market Capitalization (KSh Billions)
January	9.72	414.28	5212	2,342.60
February	16.11	593.24	5491	2,460.80
March	20.52	614.20	5346	2,452.50
April	14.64	487.84	5091	2,422.98
May	21.33	683.76	4788	2,267.71
June	24.25	680.71	4906	2,301.88
July	21.55	714.88	4405	2,079.77
August	20.79	733.96	4176	2,005.60
September	14.38	433.96	4173	2,063.64
October	17.84	540.04	3869	1,930.81
November	13.15	440.59	4016	2,018.13
December	15.12	6,812	4040	2,053.52
Total	209.38	8,134	4040*	2,053.52*
Total (for 2014)	215.73		5112*	2,312.10*

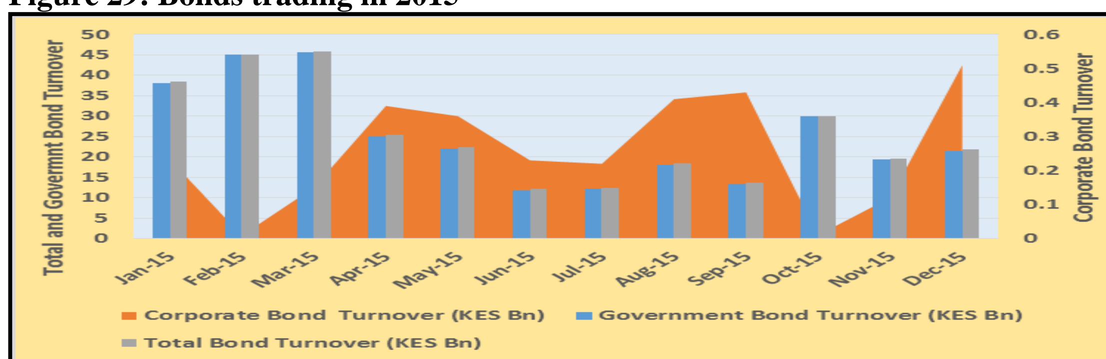
Source: Nairobi Securities Exchange, 2015 **End Period data*

3 REIT is a collective investment vehicle that allows investors to pool capital, which is then invested in a portfolio of selected properties for a return. Investors gain through capital appreciation and rental income, with the latter being distributed to unit-holders annually.

The equity markets activity was less in 2015 compared to performance in 2014, with NSE 20-share index down 29 per cent by end December 2015 compared to similar period in 2014. Shareholders wealth measured by market capitalization lost a total of KSh 258.58 billion between December 2015 and December 2014, reflecting a depressed market (Table 18).

The bonds market had mixed performance in 2015, with primary market recording 128.32 per cent subscription rate against Government's offer of KSh 270 billion. Secondary market activity was down 40.19 per cent in bonds traded in 2015 compared to trading in 2014 (Figure 29).

Figure 29: Bonds trading in 2015



Source: Nairobi Securities Exchange

High interest rates regime saw the amount of bonds accepted fall to KSh 256.72 billion against the targeted amount of KSh 270 billion, which translated to a bid-to-cover ratio of 0.95. Corporate Bonds market had five (5) firms; East African Breweries, Centum Investment Company Limited, Chase Bank, Real People and Family Bank bonds that raised a total of KSh 19.45 billion.

Market Concentration risks

Concentration risks measured by the holding structure of equities remained high through 2015, with local institutional and retail investors accounting for 78.15 per cent of all listed and trading equities at the NSE in 2015 marginally up from 77 per cent in 2014. Foreign institutional investors held 21.72 per cent in 2015, up from 21.5 per cent in 2014. The EAC institutional investors continued to divest from the NSE for the eighth year in a row but foreign investors' interest has more than tripled **(Table 19).**

Table 19: East African Institutional Investor Holdings at the NSE

Investor Group/Year	EAC Institutions (%)	EAC Individuals (%)	Foreign Investors (%)
2010	73.60	13.80	12.60
2011	68.33	12.23	19.44
2012	66.70	12.01	21.29
2013	47.58	23.70	27.89
2014	65.41	13.00	21.64
2015	46.87	18.85	26.42

Source: Capital Market Authority

Foreign investors accounted for more than 55 per cent of total equity market flows through 2015, with a bias on the sale side than purchases, with seven (7) months in 2015 recorded net outflow (Table 20). 2015 recorded the second lowest net inflow of KSh 916 million in Kenya's stock market by foreign investors since 2011, which traded only KSh 220 million.

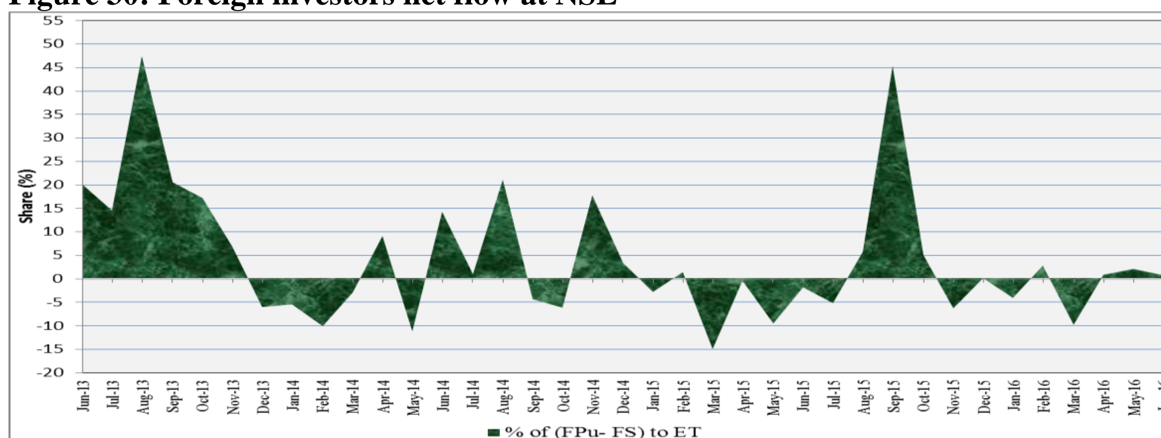
Table 20: Foreign Investors Net Equity Portfolio Inflow (KSh Millions)

Month/Year	2011	2012	2013	2014	2015
January	1,987	-812	2,133	-876	-273
February	622	795	-3,927	-1,505	201
March	1,552	2,651	1,810	-399	-3,085
April	-3,024	1,771	3,026	1,409	-67
May	-3,334	1,099	3,475	-2,578	-2,030
June	-1,597	1,639	2,602	2,586	-447
July	1,173	828	1,625	142	-1,127
August	621	1,048	9,839	3,253	1,183
September	535	3,286	2,063	-850	6,500
October	719	2,965	2,723	1,208	889
November	31	4,335	884	2,535	-829
December	935	2,129	-690	1,021	1
Net Cash Flow	**220**	**21,734**	**25,563**	**3,530**	**916**

Source: Nairobi Securities Exchange

Except for August to October 2015, the year recorded notable foreign investors sell-offs at the NSE compared to the purchases, which extended the trend in 2016 (Figure 30)

Figure 30: Foreign investors net flow at NSE



Source: Generated from NSE data

A market concentration risk measured by total market capitalization of top 10 traded stocks at the NSE is still high, at 76 per cent of total listed and trading shares in 2015. In terms of market infrastructure efficiency, Automated Trading System (ATS) experienced

a downtime of 95 minutes[4]. The top 5 out of the 22 operating Brokers and Investment Banks accounted for 65 per cent of all trading volumes at NSE. This was however, a 6 per cent decline from 2014, implying less probability of firm's falling into distress.

Capital Markets Industry risk factors

As the market grows, there are several risks that would need to be mitigated to achieve both short -and long-term strategic goals. These include but not limited to:

Elections fears – The 2017 general elections is likely to make investors adopt a 'wait and see' attitude towards any new or expansion of new investments. As a result, the stock market is likely to record further depressed activity.

Government borrowing – high domestic borrowing by government could impact negatively on secondary market activity and corporate debt market growth if it is associated with interest rates volatility and/or tight liquidity in both primary and secondary markets.

Challenging business environment that affected profitability in 2015 saw a total of twenty (20)[5] listed companies issue profit warnings, implying that their earnings declined by at least 25 per cent compared to earnings in 2014, thus impacting the market negatively through loss of investor confidence. In 2014, eleven (11) listed companies issued profit warnings up from eight (8) in 2013.

Liquidity risks - Six (6)6 listed companies experienced liquidity problems in 2015, making difficult for them to meet their obligations falling due, hence decline in their share prices.

Corporate Governance - Some market licensees experienced corporate governance issues including conflicts of interest and fraudulent activity.

Digital disruption- Financial Technology (FinTec) and other Information and Communications Technology (ICT) Innovations in the capital markets sector such as Block Chain Technology, Peer to Peer (P2P) lending, crypto-currencies and Robo-advice may be a source of risks given that potential customers may not have clear understanding.

Capital Markets Industry Outlook for 2016

Challenging business environment in 2015 was reflected in a total of 20 NSE listed companies issue profit warnings, implying that their profits fell by at least 25 per cent below the 2014 earnings. Indeed some of these firms together with others that did not issuing profit warnings but posted huge losses, had to seek government bailouts or

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4 The ATS had 95 minutes of downtime recorded within the review period= 0.002% of total trading time. The opportunity cost is approximately KSh 225 million.

5 Twenty (20) companies listed at Nairobi Securities Exchange issued profit warning in 2015 as required by law. These companies include: Standard Chartered, Britam, ARM Cement, East African Portland Cement, Liberty Kenya, Pan African Insurance, East African Cables, UAP Insurance, Mumias Sugar, Car and Generals, Express Kenya, Sameer African, BOC Kenya, TPS Eastern Africa, Standard Group, CFC Stanbic Bank, Home Africa, Uchumi Supermarkets, Crown Paints and Atlas Development.

6 Centum Investments, Mumias Sugar, Express Kenya, Home Africa, Uchumi Supermarkets, and Kenya Airways

shareholders' capital injection to meet their financial obligations. In 2014, eleven (11) listed firms issued profit warnings up from eight (8) in 2013.

The 2015 was characterized by slack market performance attributed to increase in domestic borrowing, uncertainty of CGT, global markets volatility, corporate governance issues in some listed companies, higher and volatile interest rates, weakening Shilling and a general drop in earnings by listed companies causing unprecedented profit warnings and liquidity problems of some listed companies. The year 2016 through 2017 is likely to extend underperformance by the NSE, given the 2017 General Elections jitters. On a positive note, full implementation of the Capital Markets Master Plan (CMMP) and scrapping of 5 per cent CGT on securities is expected to spur trading.

Derivatives Market

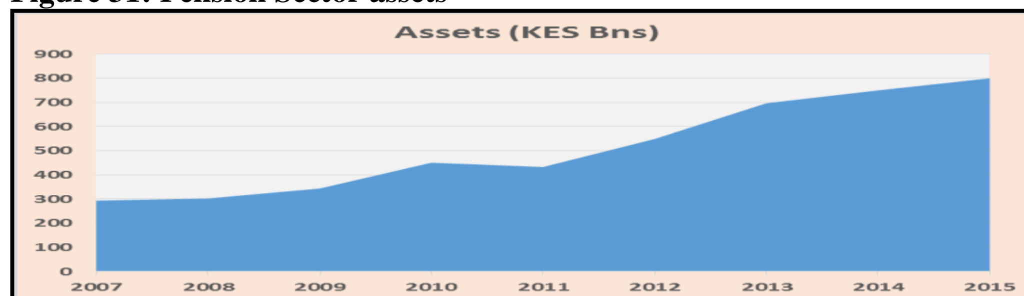
CMA approved the NSE to operate a derivatives exchange business in Kenya in October 2015 after fulfilling Licensing Requirements. Besides any capacity issues related to Futures Oversight Unit at CMA, the Authority is also working with the National Treasury and the Office of the Attorney General to fully address any regulatory issues that govern market intermediaries in the derivatives market as well as regulate the formulation of derivatives contracts.

Companies listing on a securities exchange in Kenya by way of introduction now pay 25 per cent tax for a period of five years commencing immediately after the year of income following the date of such listing. This benefit was initially only applicable to companies listing through Initial Public Offering (IPO). In addition, stamp duty shall not be levied on real estate transfer into a special purpose vehicle dealing with a Real Estate Investment Trust (REIT) under the Capital Markets Act, hence taxation and transaction charges neutrality. Stamp Duty is also exempted on transactions involving asset backed securities (ABS) approved by CMA.

3.6. Pension Industry Policy and Development

Pension industry total assets grew by 3 percent, to KSh 814.1 billion in 2015 from KSh 788.15 billion in 2014, mainly due to subdued stock market activity. The industry was supported by 20 fund managers, 29 administrators and 11 custodians registered by Retirement Benefits Authority (RBA) in 2015 (Figure 31).

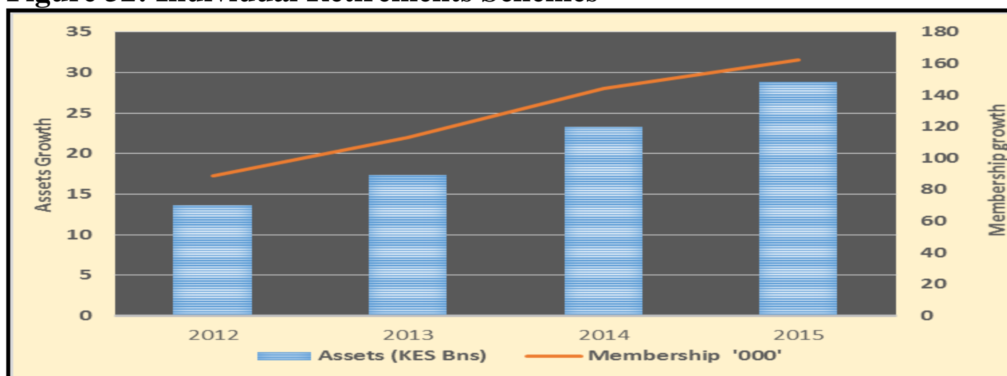
Figure 31: Pension Sector assets



Source: Retirement Benefits Authority

Membership of Individual Retirement Benefits Schemes grew from 144,000 members in 2014 to 162,000 members in 2015, while total assets grew from KSh. 23.3 billion to KSh. 28.8 billion (Figure 32). Enhanced public awareness and education initiatives by RBA contributed to this growth.

Figure 32: Individual Retirements Schemes



Source: Retirement Benefits Authority

Policy Developments in the Pension Industry

RBA in collaboration with the National Treasury has set up a Working Committee to spearhead the development of the National Pension Policy aimed at redesigning the architecture of Kenya's pension system. Once adopted and implemented, it would enhance harmony and coordination; coverage and adequacy; and address issues of portability of benefits across pension schemes and regions as well as mutual recognition and information sharing with other pension industry regulators. RBA also established a Market Conduct Department to enhance consumer protection and member education; and handle member complaints and dispute resolution.

Stability of the Pension Industry

Overall Risk Score – The industry scored 0.64 (medium risk) in 2015 better than 0.759 ("amber") in 2014 reflecting improved stability following enhanced enforcement by RBA on schemes with high risk score. A number of risks, however, still exist: - market risks due to the stock market volatility and counter party risks; collapse of Imperial Bank exposed pension assets worthy KSh. 2.88 billion arising from KSh. 2.2 billion invested in fixed deposits and KSh 719 million invested in the Imperial Bank corporate bond.

Pension Coverage: Pension coverage in 2015 rose to 18.2 per cent from 15 per cent in 2014 on increased education and awareness programmes undertaken by RBA.

Efficiency measured by Administrative Costs: Although the administrative expenses to total assets ratio has reduced overtime, some schemes like NSSF, still have high administrative costs compared to the members' contributions. In 2014, the ratio of administrative costs to total assets for occupational schemes, individual pension plans and NSSF was 1.02 per cent, 0.77 per cent and 2.87 per cent respectively; while the ratio of administrative expenses to contributions for these schemes were 12.49 per cent, 3.72 per

cent and 53.41 per cent, respectively. This reduces pension payouts due to escalated management costs.

Outlook for the Pension Sector

Although the pension industry is relatively stable and has witnessed tremendous growth in the recent past, multiple challenges ranging from low pension coverage, inadequate savings and low diversification of the pension fund investments still exist. The pension coverage has remained below 20 per cent of the recorded employment due to the ever growing informal sector and the voluntary nature of Kenya's pension system. Similarly, pension assets have mainly invested in; government securities and quoted equities, hence limited opportunities for higher returns from alternative asset classes like private equity and venture capital.

The pension industry also faces the challenge of pension adequacy because majority of the members contribute only to the mandatory scheme (NSSF). Enactment of the NSSF Act, 2013, aimed at converting NSSF into a pension scheme from a provident fund in order to enhance contributions from the current KSh. 400 per month to 12 per cent of pensionable pay was meant to address this challenge. Implementation stalled due to several court cases. Implementation of online submission of returns has not taken off due to some fund managers still facing challenges in the integration of the systems to the Risk Based Supervision System. This has made the RBA fail to compile and publish investment returns report on a timely basis as envisaged.

Despite the challenges, the industry has witnessed various innovations and introduction of new products, including; post-retirement medical schemes. However, such products are currently unregulated given that it is not clear whether the product is a pension or an insurance product, thus becoming a likely source of risk to members due to regulatory arbitrage. New asset class like REITs, private equity and venture capital is likely to make the industry grow in future. This may, however, be affected by low stock market activity.

3.7. Insurance Industry Developments

Kenya's insurance industry is moving towards saturation point where underwriting margins are shrinking and industry players are seeking growth through mergers and acquisitions. The industry's turnover grew by 9.8 per cent in 2015 compared to 17.3 per cent on average in the last decade. Growth opportunities however still exist for underwriters, especially in the uninsured life segment (Table 21).

Table 21: Industry Performance for years 2006-2015 in KSh. Millions

Item	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Gross Premium Income	41,475	48,013	55,246	65,013	76,909	93,632	108,609	131,002	157,779	173,258
Net Premium Written	33,520	39,628	45,593	45,593	64,123	77,344	87,839	104,948	126,636	139,197
Claims Incurred (General Business)	12,359	14,235	15,884	19,768	21,629	25,053	29,433	33,442	41,895	49,051
Commissions	4,858	5,504	7,252	8,714	10,269	9,407	7,034	7,204	9,257	10,896
Expenses of Management	9,854	12,902	12,602	14,641	16,758	18,889	19,552	24,808	30,418	36,257
Investment Income P&L	11,228	11,412	8,191	12,112	23,369	5,626	7,594	9,429	9,544	6,738
Operating Profit/Loss after Taxation	3,837	3,549	3,349	3,421	7,634	6,781	13,350	20,236	24,619	13,635
Investments	95,836	114,589	123,621	113,453	177,521	181,179	235,565	296,337	352,370	390,225
Assets	124,738	146,541	154,453	178,404	223,491	233,172	302,233	366,252	426,309	478,752
Shareholder's Funds	34,575	38,349	38,161	41,469	58,649	57,828	74,812	100,958	122,544	125,830

Source: Insurance Regulatory Authority

The Non-Life business accounts for 65 per cent of insurance premiums, with motor and medical insurance contributing more than half of the non-life business turnover.

Key drivers of Growth and Risks

New Products - Many insurers are focusing on the largely uninsured population through developing products and services that meet their diverse needs, with micro insurance product that target the low income earners as most popular. Insurers employ very cost-effective strategies given that margins in micro insurance business are low due to high loss ratios. Insurers globally are appreciating the important role of parametric (index based) insurance in reaching the masses especially farmers. Kenya has followed suit with the government partnering with other stakeholders to provide agricultural insurance with prospects for deepening insurance penetration.

Distribution Channels - Low demand for insurance services and products is attributed to limited effective and efficient distribution channels. Adoption of networks like Bancassurance by major banks partnering with insurers to act as outlets for various insurance products is to address this problem. In 2015, a total of nineteen (19) commercial banks had registered as insurance sales outlets. In addition, Insurers are reviewing their digital strategies to anchor insurance distribution on technology to include online sales and mobile phone platforms. Insurers are also investing in robust underwriting systems to improve controls and efficiency in both underwriting and claims processing that would enhance their returns.

Underwriting risks (products and pricing) - A "good" product or service is easy to price, which is important in a competitive environment. To meet varying customer needs, insurers have to come up with unique products that provide consumers with unique experience.

Information Technology risks - IT related risks, especially on data security, are emerging, hence need for tight regulation and compliance.

Insurance fraud risk - Amongst the emerging risks in insurance industry is insurance fraud, mainly at the pre-insurance level where potential policyholders provide false

information or at the claim level for personal gain. Insurers need robust fraud risk management strategies within the overall risk management framework if the underwriters are to remain profitable and viable.

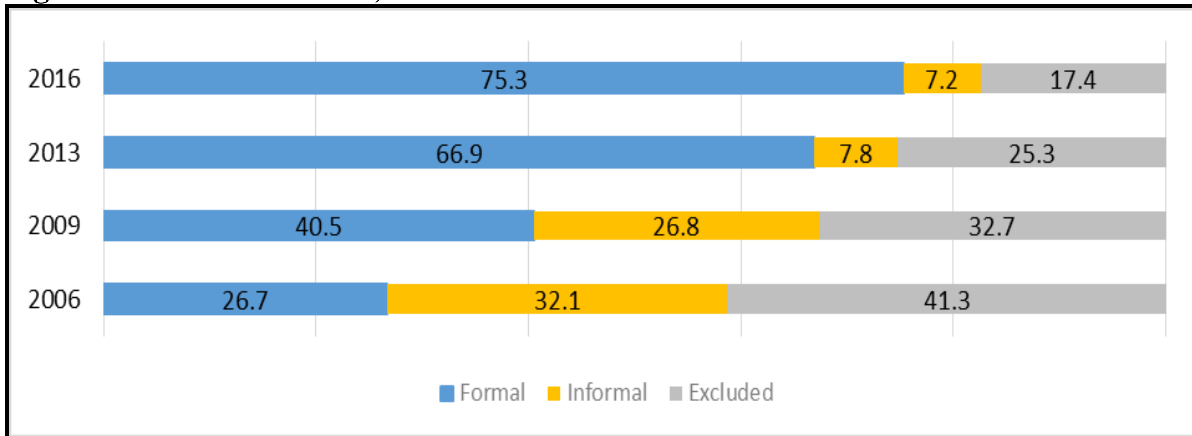
Insurance Industry Outlook

Following increased capital requirements introduced by IRA in line with best practices coupled with introduction of risk based capital (RBC), more consolidation and restructuring is likely to occur in the medium-term. This will improve capacity, stability and investment return within the industry due to accrued synergies. Kenya being the market leader in the East Africa region, realization of regional integration agenda provides opportunities for further growth among Kenyan insurers and even entry of international brands into the market.

Chapter IV: FINANCIAL INCLUSION

The Government in collaboration with key stakeholders has played a key role in measuring and expanding financial inclusion in Kenya. Progress made in expanding financial inclusion in Kenya to average about 75.3 per cent of adult population is attributed to rapid innovation by the private sector in collaboration with public sector. In 2006, only 26.7 per cent of the adult population accessed formal financial services, while those excluded from any formal financial services stood at 17.4 per cent in 2016 from 41.3 per cent in 2006 (Figure 33).

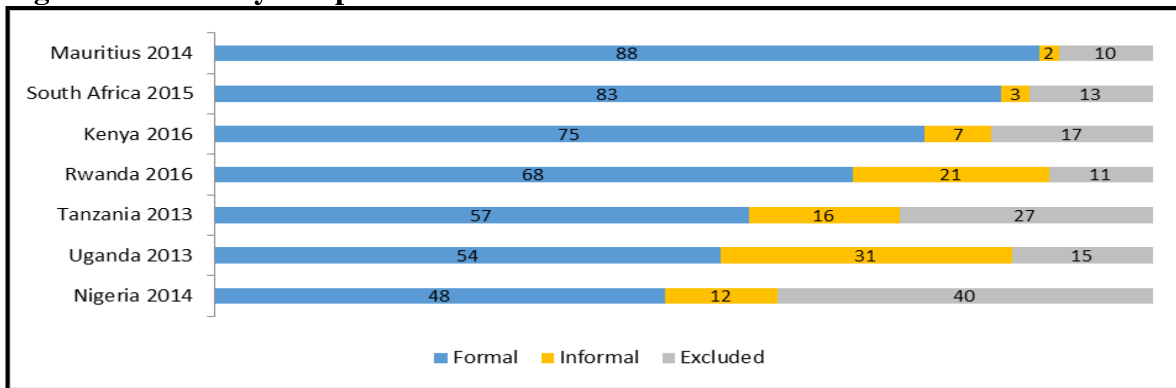
Figure 33: Financial access, 2006 - 2016



Source: FinAccess Household Survey 2006, 2009, 2013 and 2016

In terms of regional comparison, Kenya is now among the top countries in Africa with high formal financial inclusion among her adult population (Figure 34).

Figure 34: Country comparison of financial inclusion in select African countries



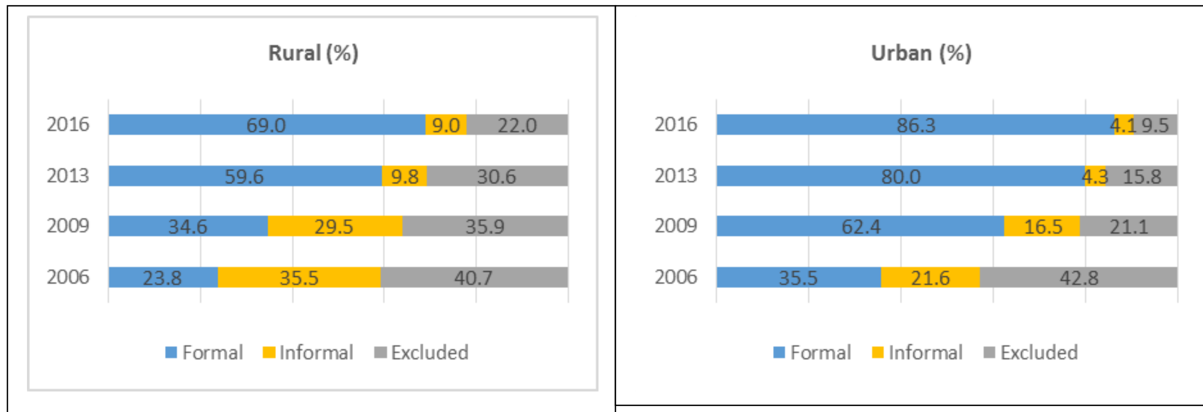
Source: Centre for Financial Regulation and Inclusion

4.1. Gaps in Financial Inclusion by Region, Gender, Age and Education

Despite the achievements made so far, a number of gaps in attaining full financial inclusion still exist. These include: rural-urban gap, gender gap, income level, age, and education level.

Rural-Urban Gap - In 2016, formal financial inclusion in the rural areas stood at 69 per cent compared with 86 percent for urban areas. The rural-urban gap in financial inclusion has persisted over time due to poor infrastructure, especially electricity connectivity and Information Technology (Figure 35).

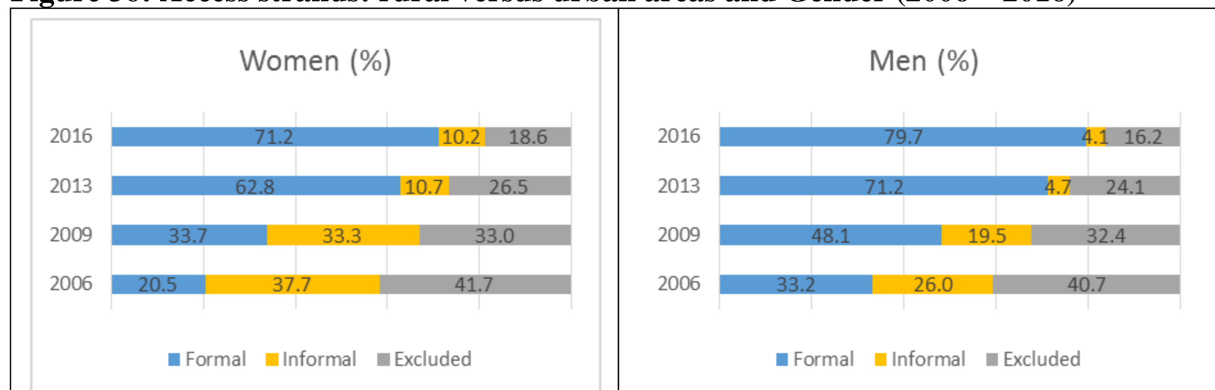
Figure 35: Access strands: rural versus urban areas and Gender (2006 – 2016)



Source: FinAccess Household Surveys

Gender Gap - Women lag behind men in accessing and using formal financial services. This gender gap has been narrowing to reach 8.5 per cent in 2016, mainly due to the use of mobile phone financial services by women (Figure 36).

Figure 36: Access strands: rural versus urban areas and Gender (2006 – 2016)



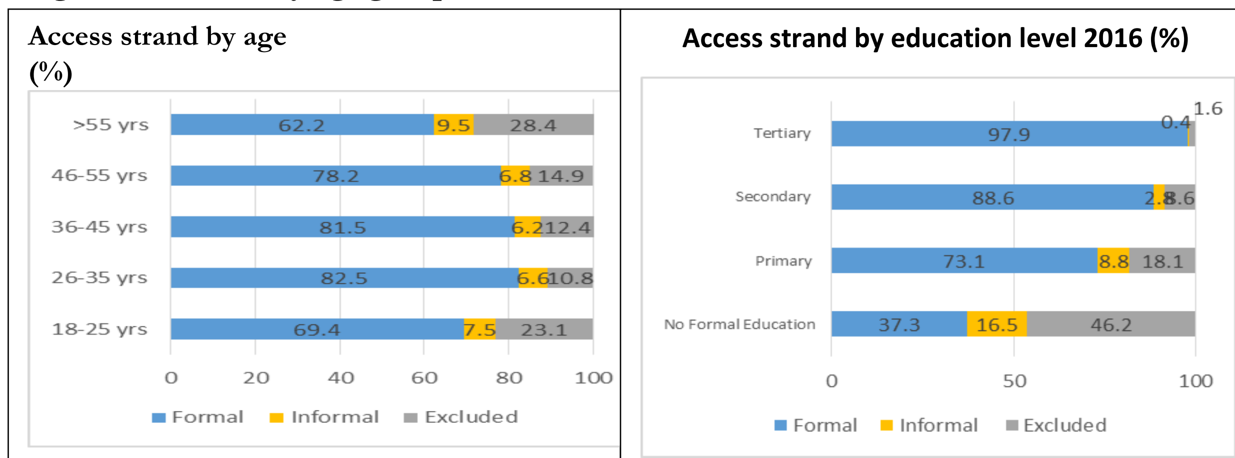
Source: FinAccess Household Surveys

Gaps in Financial Inclusion by Age – Age impacts access to formal financial services. The oldest (above 55) and youngest (below 26) age groups are more likely to be excluded and less likely to have access to formal financial service providers than the middle age groups. Over 23 per cent of young adults aged 18 - 25 years are excluded compared to the national exclusion average of 17.4 per cent (Figure 37).

Level of Education influences access to formal financial services as shown in Figure 37. Only 37.3 per cent of those with no education had access to formal financial services

compared to 73.1 per cent of those who had primary level of education, 88.6 per cent of those with secondary education and 97.9 per cent of those with post-secondary or tertiary education. Exclusion for Kenyans without formal schooling is noticeably high, at 46.2 per cent; implying illiteracy is a barrier to financial inclusion (Figure 37).

Figure 37: Access by age group and education level in 2016

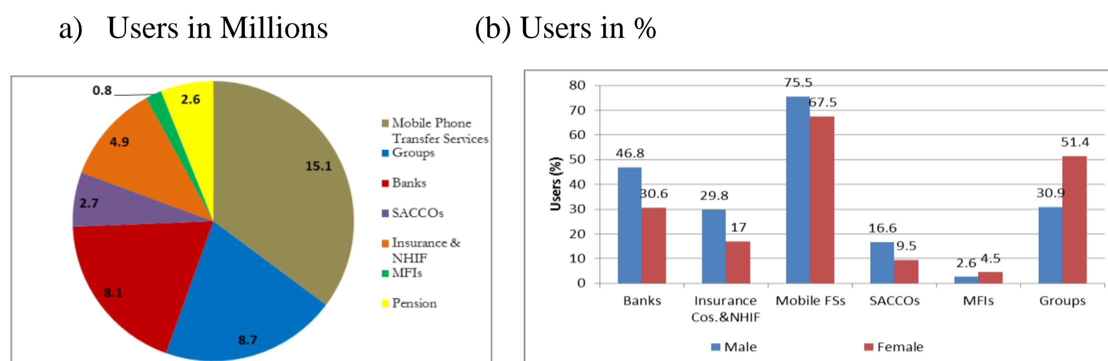


Source: FinAccess Household Surveys

Accesses to Formal versus Informal financial service providers - Men have higher access to formal financial services including banks, insurance companies and SACCOs, while more women than men use informal sources. Mobile phone financial services has reduced share of women using informal services, despite groups still remaining most common among women at 51.4 per cent compared to 30.9 percent for men (Figure 38).

Figure 38: Usage of formal and informal service providers in 2016

a) Users in Millions (b) Users in %



Source: FinAccess Household Surveys

Banks' penetration has grown in the last 10 years, driven by branch expansion, bank agent services and mobile bank solutions[7]. About 71.4 per cent of Kenya's population access financial services from mobile phone financial service providers while 38.4 per cent access banks directly.

7 Mobile bank accounts include services such as KCB M-Pesa, M-Co-op Cash and M-Shwari. Equitel had not been launched at the time of the 2016 FinAccess Household Survey kick off.

Chapter V: SUMMARY OF RISKS AND OUTLOOK FOR 2016

i. Global Outlook

- Global macro-financial risks remain elevated as reflected in increased credit, financial and macroeconomic risks. The impact of unwinding of unconventional monetary policy and macroeconomic rebalancing including the Brexit may further worsen the economic outlook downwards and increase financial markets vulnerabilities.
- Emerging economies market and liquidity risks remained high in April 2016. This has eroded investor confidence and increased financial markets volatility as reflected in elevated risk appetite. These economies have also experienced macroeconomic shocks coupled with geo-political instabilities slowing down economic growth prospects with increased unemployment levels.
- Middle East and North Africa (MENA) region economies have been significantly affected by the geo-political unrest and effects of the Islamic States war coupled with the slump in commodity prices. This situation has spread to several parts of Europe and western Africa region.
- Sub-Saharan Africa (SSA) continues to face challenges at varying degrees with negative impact on growth prospects and stability of her macro-financial conditions going into 2016-17.

ii. Domestic Outlook

- Kenya's Macro-financial conditions remain stable with a positive outlook through 2016, characterized by low and stable inflation, stable exchange and interest rates. The downside risks, however, are shocks emanating from global developments such as Brexit, moderation in China, U.S monetary policy tightening and policy change under new government. Impact of such risks includes: reduced trade, higher cost of servicing external debt, currency volatility and low growth.

- Domestically, the election cycles generally impacts negatively on financial stability and growth prospects, especially if results are contested. This coupled with geo-political and macroeconomic instability in some East African regional countries where Kenya's financial institutions operate in and the trade links are strong is more likely to be a source of vulnerabilities going forward.

- The banking system is expected to remain sound and resilient through 2016 anchored on reforms being implemented by the Government and the CBK as well as industry players. However, there are on-going downside risks that include interest rates, credit and liquidity risks as well as concentration risks. In addition, the interest rate charges court issue and the interest rate capping debate is likely to pose additional risks if these materialize. Among the reforms to address these risks are based on three pillars: greater transparency, strong governance and adoption of effective business models.

- The capital markets activity is expected to remain sluggish in 2016 on account of high interest rates if domestic borrowing remains high, corporate liquidity stress, global dynamics, challenging economic prospects that led to a general drop in earnings by listed companies, hence low share prices. Investor jitters associated with 2017 general elections is also a factor to impact on capital markets. CMA continues with investor education and widening the products range to usher in risk-neutral assets like derivatives in order to expand and deepen the markets.

- The insurance industry faces shrinking underwriting margins and increased fraud cases. However, the increase in capitalization requirements is expected to encourage mergers and acquisitions thus enhancing industry soundness going forward. IRA in collaboration with key stakeholders have initiated reforms, while the insurance industry players have introduced new products and innovations that are expected to deepen the industry and enhance public confidence, thus fostering a positive performance outlook in 2016.

- The expanding financial inclusion is great for inclusive and sustained economic growth. However, it brings with it consumer protection challenges, especially if the new entrants into the financial system are exposed to more sophisticated financial products and services that would leave them worse. It is, therefore, important for regulators, policy makers and industry players to come up with strong consumer protection framework incorporating education and awareness for the wider population in order to reap the dividends of wider access.

Appendix: ABBREVIATIONS

ACH	Automated Clearing House
ATMs	Automated Teller Machines
BIS	Bank for International Settlements
BOP	Balance of Payments
CBK	Central Bank of Kenya
CBR	Central Bank Rate
CMA	Capital Markets Authority
DSA	Debt Sustainability Analysis
DTS	Deposits Taking Saccos
EAC	East African Community
FDI	Foreign Direct Investment
FOSAs	Front Office Savings Activities
FSI	Financial Soundness Indicators
FSR	Financial Stability Report
FSSTC	Financial Sector Stability Technical Committee
GDP	Growth Domestic Product
IAIS	International Association of Insurance Supervisors
IADI	International Association of Deposits Insurance
IOSCO	International Organization of Securities Commission
IMF	International Monetary Fund
IRA	Insurance Regulatory Authority
IT	Information Technology
KEPSS	Kenya Electronic Payment & Settlement
MENA	Middle East and North Africa
MTDS	Medium Term Debt Strategy
NPLs	Non-Performing Loans
NSSF	National Social Security Fund
RBA	Retirement Benefits Authority
REITs	Real Estate Investment Trust
SASRA	Saccos Societies Regulatory Authority
SIPS	Systemically Important Payment System
SMEs	Small and Medium Enterprises
SSA	Sub-Saharan Africa
TRWA	Total Risk Weighted Assets
USA	United Sates of America
USD	United States Dollar
WEO	World Economic Outlook