# THE KENYA FINANCIAL STABILITY REPORT 2019

Theme: Lending in liberalised interest rate regime.

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## List of Acronyms

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

## Executive Summary

This 8th edition of Financial Stability Report 2019 covers the period January to December 2019. It encompasses deposits-taking institutions (commercial banks and mortgage finance companies, microfinance banks and deposit-taking Savings and Credit Co-operatives (Saccos)), non-deposit taking institutions (insurance, pensions, capital markets, and Development Finance Institutions) and financial markets infrastructure providers. The sector is regulated by; Capital Markets Authority (CMA); Central Bank of Kenya (CBK); Insurance Regulatory Authority (IRA); Retirement Benefits Authority (RBA); and the Sacco Societies Regulatory Authority (SASRA).

**Global output growth decelerated to 2.9 percent in 2019, from 3.7 percent in 2018 and 3.8 percent growth in 2017,** due to trade tensions involving the USA, China, European Union, and in emerging and developing economies. Trade restriction in the form of non-tariff barriers among world economies also impeded investment and production of goods and services. The Euro area growth was affected by a number of factors: (i) weaker consumer and business sentiment due to weak intra-euro-area trade; (ii) fiscal policy constraints, due to high level of debt, amid weak private sector investment; and (iv) street protests that disrupted retail sales and in turn consumption spending in France.

Growth in EMDEs declined from 4.6 percent in 2018 to 3.7 percent 2019 due to elevated trade restrictions from developed and emerging economies and unfavourable global financial market sentiments towards EMDEs. Geopolitical tensions in the Middle East and Far East difficulties in financing balance of payment deficits discouraged investment, while country-specific factors such as high public debt, constraint the use of fiscal policy to stimulate growth. In China, economy slowed to 6.1 percent in 2019 compared to 6.6 percent 2018 following effects of regulatory tightening to address debt concerns and constrain shadow financial intermediation as well as slow global growth. Growth in Sub-Saharan Africa increased to 3.3 percent in 2019 from 3.2 percent in 2018, partly due to recovery in Nigeria, South Africa, and Angola as a result of higher metal and oil prices. Conducive weather supported agriculture and hydroelectricity production in Eastern and Southern Africa. Risks to growth in EMDEs and SSA are corona virus disease pandemic, trade restrictions, high public and corporate debt, reliance on rain fed agriculture amid climate change, policy uncertainty and structural rigidities that stifle investment. Therefore, growth potential can be unlocked by containing and managing Corona Virus Disease, increasing multilateral engagement to reduce tariffs and non-tariff barriers to trade. The Corona Virus Disease has exacerbated debt distress especially in SSA. Hence, economies unable to undertake fiscal consolidation and repay debt should negotiate rescheduling of debt repayment, while they undertaking structural reforms to increase efficiency and production capacity of the economies.

**Kenya's economic growth slowdown to 5.2 percent in 2019 from 6.3 percent in 2018 due to slow global growth, geopolitical tension in the middle East and North Africa, which are the main market for Kenya's exports.** The decline in commodity prices on the world market reduced exports earnings, while manufacturing sector contracted because of competition from cheaper imports. The downside risk to this robust growth include; the Corona Virus Disease pandemic is likely to accentuate global recession, narrowing fiscal space because of maturing public debt obligations amid decline public revenue and nominal exchange rate depreciation, extreme weather patterns affecting Agriculture and non-tariff barriers to Kenya's exports. Fiscal stimulus and expansionary monetary policy may mitigate these downside risks.

Kenya's financial sector recorded 9.93 percent growth in terms of assets, financial sector's assets as a share of GDP increased to 25.8 percent in 2019. The banking industry accounts for 49.2 percent of the sector as at December 2019. Capital markets recorded increased domestic and foreign investment, despite poor performance of some listed companies in 2019. This saw the NASI and market capitalization increase by 18.5 percent and 20.8 percent respectively. However, market liquidity declined to 6.10 percent in 2019 from 6.81 percent in 2018 and market concentration risks increased. In particular, top five (5) stocks accounted for 70.5 percent of market capitalization in 2019 compared 67.3 percent in 2018, while foreign investors accounted for 68.5 percent of total equity turnover in 2019. Volatility in the stock market declined because of the derivatives market, which provided opportunity for investors to hedge against risks emanating from global and domestic financial markets. The insurance and pension industries were resilient in 2018 albeit a number of risks. The performance of the insurance industry improved as reflected in the increase in premiums and profitability as measured by Return on Assets (ROA) and Return on Equity (ROE) because of operational efficiencies and favorable economic environment. The Pension industry was relatively stable despite risk index rising to 3.095 in 2019 from 3.070 2018. The industry is also facing funding risks due to increasing liabilities against limited assets as well as increasing life expectancy. In the Defined Contribution schemes, unremitted contributions have increased due to poor economic performance and the insufficient funding of quasi government schemes. Cognizant of these risks, RBA has taken various policy measures consistent with each risk type and prevalence. The assets of the Sacco industry increased by 11.79 percent in 2019 compared 12.55 percent and in 2018. Large Saccos with asset base of more that KSh 5 billion account for 70.1 percent of the total asset. Total deposit increased by 11.33 percent in 2019 compared to 11.50 percent in 2018. The growth of deposits slowed due to high cost of living and decline in Tea and coffee prices which reduced ability of members to save. The quality of assets also deteriorated with NPLs to gross loans ratio increasing from 6.13 percent to 6.16 percent The industry however had adequate capital buffers, with core capital to total asset ratio of 15.5 percent.

The growth rate of private sector credit increased to 7.8 percent in 2019 from 3.8 in 2018, while the ratio of NPLs to gross loans for banks declined from 12.7 percent to 12.0 in December 2019., indicating that credit risk eased in 2019. However, profit before tax decelerated from 12.1 percent in December 2018 to 5.0 percent in December 2019. Interest on loans and advances accounted for 49.2 percent of total income. The ROA and ROE declined to 2.5 percent 21.3 percent. Banks in the small peer group category recorded profits before tax and positive ROA, ROE in 2019 compared to losses in 2018, due to tightening of lending standards, efficiency and enhanced surveillance by the CBK. Adoption of financial technologies by banks has increased fraud (cybercrime) in 2019. Banks have tightened internal systems, customer sensitization, and undertaken ICT vulnerability assessments and penetration tests to mitigate in the operation risks. The industry was also resilience to reputational risks in 2019 as a result of processing payments for customer while complying with Anti Money Laundering and Financing terrorism regulations (AM/CFT) and customers misusing custodial services. We expect the industry to be resilient to Corona Virus pandemic in 2020 due to high capital buffers and liquidity.

The global recession and slow domestic economic growth as a result of the Corona Virus pandemic will worsen household, corporate and government financial health. This will accentuate financial fragility of financial institutions, which can prolong the recovery of the economy during and after the Corona Virus Disease pandemic. Therefore, regulators have to invoke macroprudential policy actions as well as prompt corrective actions to mitigate the severity of the Corona Virus Disease pandemic.

# CHAPTER 1: GLOBAL ECONOMY AND FINANCIAL DEVELOPMENTS

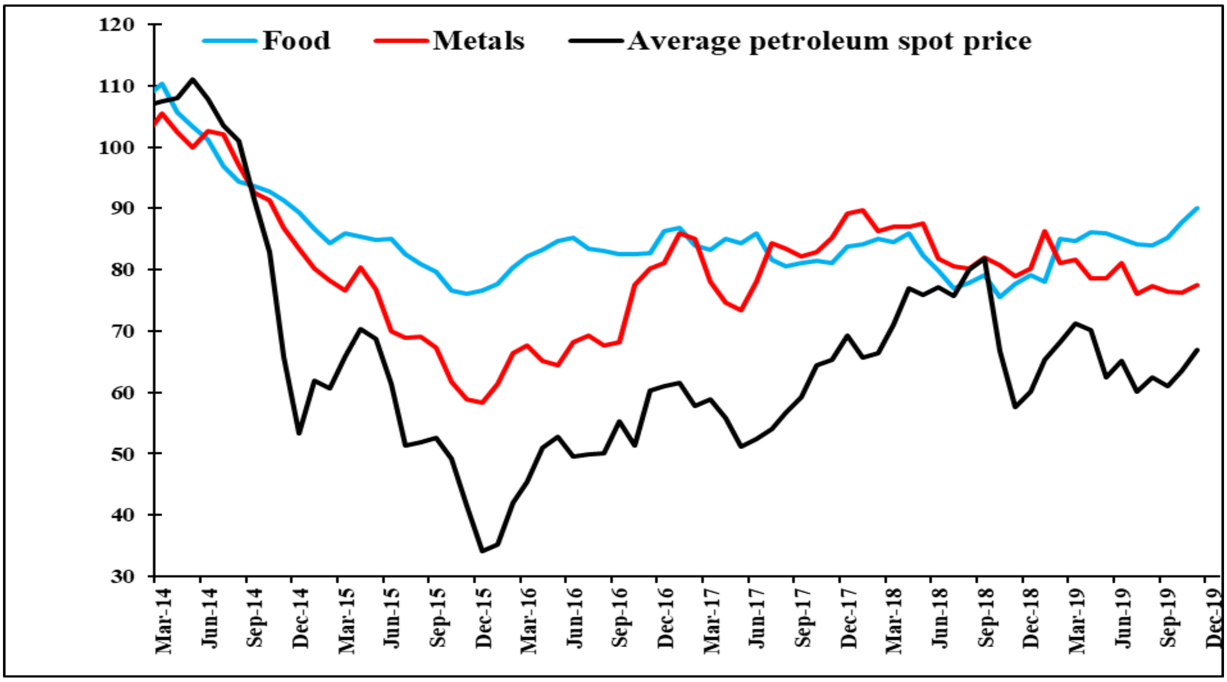
## 1.1. Global and Regional Developments

**Global output recorded a weaker growth of 2.9 percent in 2019 compared to 3.6 percent growth in 2018.** Trade tensions between USA, China, European Union and emerging economies stifled trade and investment in global economies. Emerging Market and Developing Economies such as Brazil, India, Mexico, Russia and Turkey recorded slow growth in 2019 due to geopolitical tensions, lack of fiscal space to stimulate economies and decline in international trade due to increase in trade restrictions.

**The Corona Virus Diseases (COVID-19) pandemic pose unprecedented health, economic and financial stability risks across the world with saving lives being first priority. As a result of the pandemic, the global economy is projected to contract sharply by –3 percent in 2020, much worse than during the 2008–09 financial crisis, however global economy is expected to rebound to 5.8 in 2021**. Growth in advanced economies is projected to fall to -6.1 percent in 2020 and rebound to 4.5 percent in 2021. Several economies in this group are experiencing widespread outbreaks and implementing COVID-19 containment measures. Growth in the United States is expected to contract sharply to -5.9 percent, while Japan United Kingdom and Germany will contract by -5.2 percent, -6.5 percent, and -7.0 percent, respectively. The contraction in output is attributed to the disruptions in the mobility of people and supply chains, which are projected to be concentrated in the second quarter of 2020. Growth in Emerging market and developing economies is expected to slow down to -0.2 percent in 2020 and 0.0 percent in 2021 due to a combination of COVID-19 health crisis, reduced public debt, slow growth in trade and stress in the economies.

**The slow global growth amid a decline demand has reduced prices of commodities.** Base metal prices has declined by about 15 percent, while energy prices have also plummeted, with natural gas and crude oil prices declining by 38 percent and 65 percent, respectively in comparison to mid-January prices **(Figure 1).** The decline in commodity prices will reduce Kenya’s earning from commodity export, which will not be compensated for the decline in energy prices. The decline in commodity earnings will also increase fiscal deficit due to decline in tax revenue and increase in public social spending on social safety nets and debt repayment.

**Figure 1: Commodity Prices (March, 2014=100)**

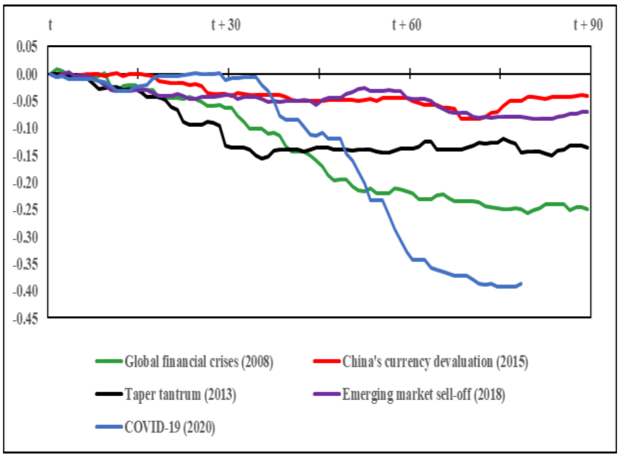



*Source: Illustration using FAO, Thomson Reuters Data*

**Global financial markets were volatile due to global trade and economic developments such as 'Phase One' agreement on trade between the United State and China, rising geopolitical tensions between in the Middle East between USA, Saudi Arabia and Iran which disrupted global oil supply.** The high trade tariffs especially among United States and its trading partners such as China as well protectionist policies among countries compounded the structural and cyclical economic slowdowns across many economies in 2019. The worsening of economic relations between United States and European Union undermined the recovery of global manufacturing and trade hence subdued global growth. Equity prices of firms most exposed to trade tensions such as automobile, metals, technology and telecommunications, and transportation performed below their peers (**Figure 2a**).

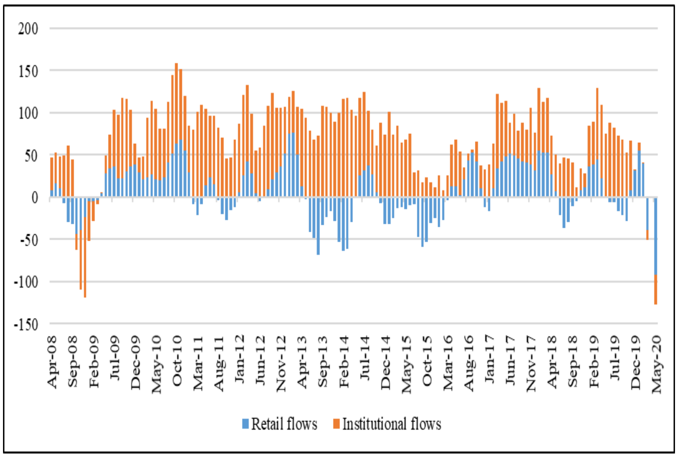
The public health crisis has accentuated flow of capital from emerging market to advance economies. Whereas institutional investors reduced investing in emerging market, capital outflow from retail investors increased **(Figure 2b)**.

**Figure 2(a): Portfolio Flows to Emerging Markets (% of GDP)**




*Source: April 2020, GFSR*

**Figure 2 (b): Portfolio Flow** (Billions of US Dollars)




*Source: Illustration using IMF data*

**The financial conditions have significantly tightened as concerns about the spread of COVID-19 and its disruptions to trade and livelihood persists.** Volatility in equity markets has increased, experiencing net sales of equities; yields on corporate and sovereign bonds have also increased while spreads have widened. As a result, financial conditions are tightening. It is no longer tenable for Government and corporates to borrow on the international financial market.

**Figure 3(a)Global Financial Conditions Indices (**Number of standard deviations from mean**)**

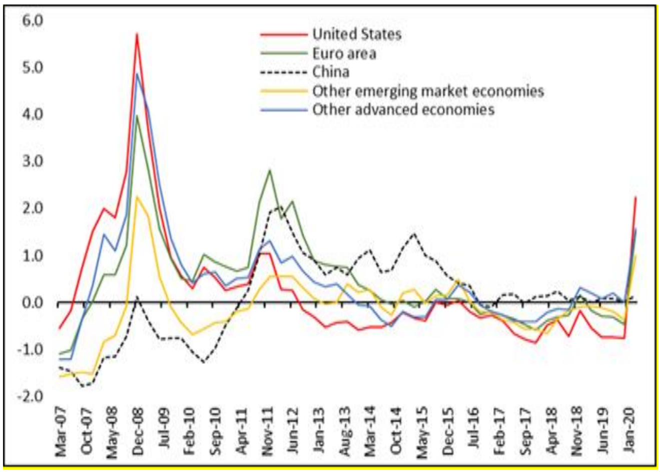
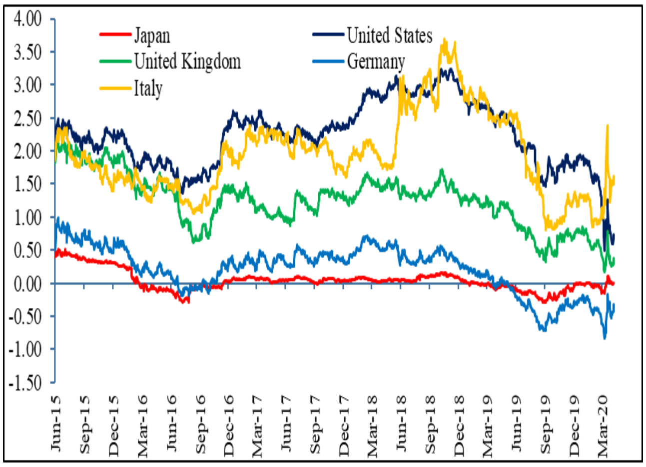



**Figure 3b. Ten-Year Government Bond Yields**




**The profitability of the corporate sector in advanced economies declined sharply in the last quarter of 2019 in tandem with slow growth and increase in trade restrictions. The fundamentals of the corporate sector in emerging market have also deteriorated since the last quarter of 2019.** Profitability of the corporate entities has further declined sharply in the advent of the COVID-19 health crisis, with price to earnings ratio decline by about 10 percent **(Figure 4(a))**. The indebtedness of the State-owned enterprise (SOE) has increased, thereby deteriorating their credit worthiness. This has been mainly driven by SOE debt, which accounts for a significant portion of total emerging market debt securities issued externally. Majority of these large nonfinancial SOEs tend to fall within a few important sectors—mostly oil and gas, utilities, telecommunications, and metals and mining. Leverage has risen most notably in oil and gas SOEs, with consistent increases since the global financial crisis. Despite the rise in leverage, many SOEs have experienced a sizable reduction in their profitability, with the median return on invested capital falling significantly since the financial crisis. As a result, equity prices in major stock marks have declined **(Figure 4(b))**.

**Figure 4 (a) Price-to-Earnings Ratios**

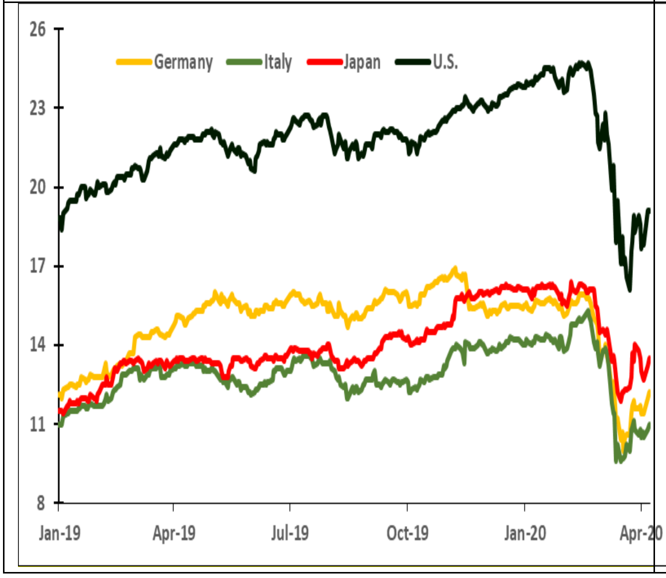
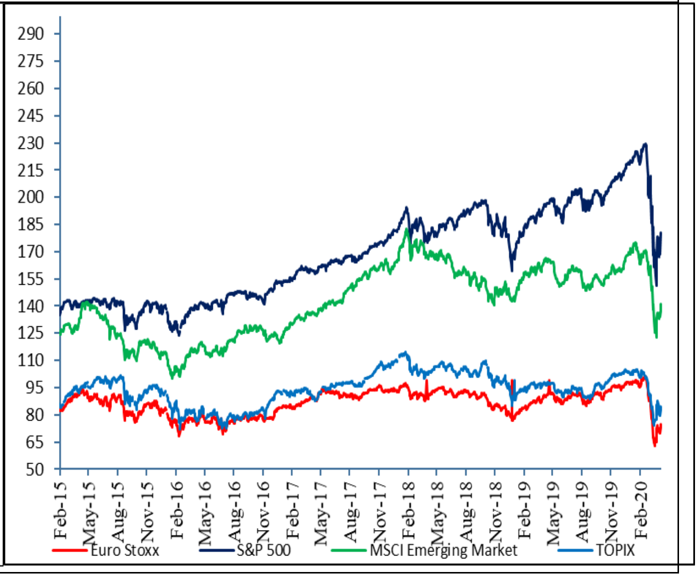



**Figure 4(b): Global Equity Prices (Points)**




**Weak growth has elevated likelihood of debt distress, especially in countries in frontier markets that relied on hard currency debt issuance in 2019 (Figure 5b).** The week global growth, COVID-19 pandemic as well as decline in commodity prices will elevate the risk of debt of debt distress.

**Figure 5a. Altman Z-Score for EM Corporations (Index)**

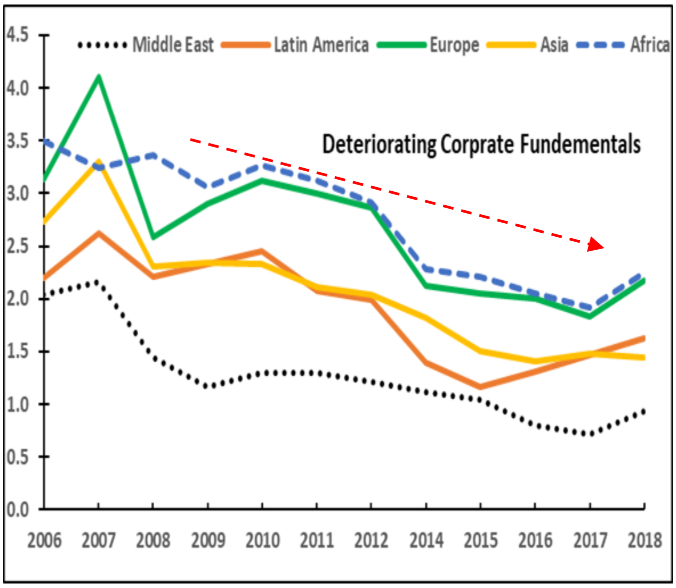
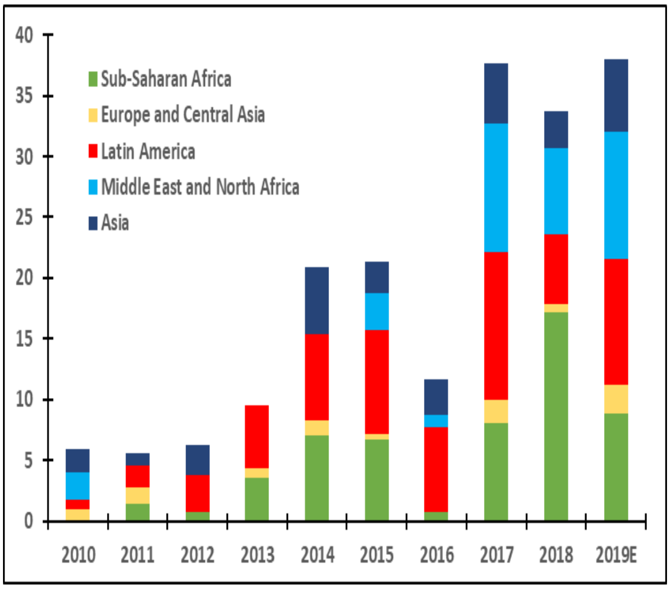



**Figure 5b. Hard Currency Debt Issuance for Frontiers (Billions of US dollars)**




*Source:* October 2019, GFSR

In Sub Saharan Africa (SSA) growth increased from 3.23 in 2018 to 3.3 percent in 2019, on account of stable commodity prices, easing political instability and conducive investment environment in most

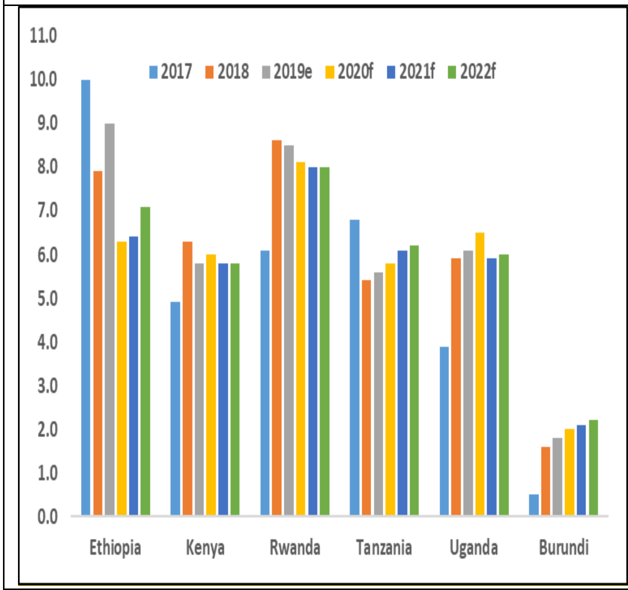
SSA. However, drought in Zimbabwe, Zambia, Kenya, Lesotho and Namibia as well as war in South Sudan stifled growth in 2019. In 2020 three largest economies Nigeria, South Africa Angola are projected to experience 6.9 to 8.0 percentage points reduction in GDP. Additionally, World Bank projects that in the absence of appropriate measures to mitigate effects of COVID-19 the outbreak will severely impact the livelihood and welfare of large numbers of individuals in the region. Countries with greater dependence on tourism revenues will be significantly affected (Botswana, Kenya, Mauritius, and South Africa, among others).

The decline in growth and increase in public spending to mitigate effects COVID-19 pandemic will increase fiscal deficits and alleviate debt distress. Financing Balance of Payments has also become more difficult against the backdrop of rising external borrowing costs and weakening capital flows. Currencies in the region depreciated as the U.S. dollar strengthened and investor sentiment toward emerging markets waned.

The slow economic growth has reduced tax revenue amid pressure to increase health care and social spending as well as service debt contracted prior to the COVID -19 pandemic has increased debt distress probability. Hence, debt distress can only be averted by granting temporary debt relief aimed at preserving macroeconomic stability in the region during and after the COVID-19 crisis. The World Bank estimates a debt moratorium granted by official creditors would be US$ 4.1 billion (4 percent of GDP) in Angola, US$ 675 million (0.8 percent of GDP) in Kenya, if the suspension of debt payments comes from official bilateral creditors.

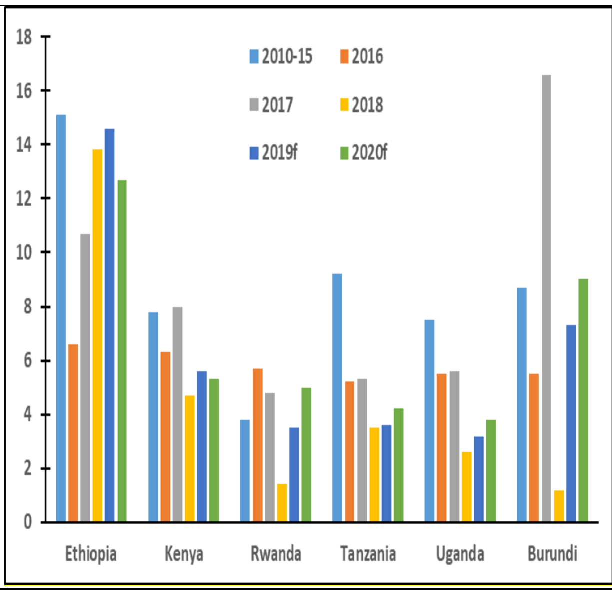
In the East Africa region growth in 2019 is estimated to average above 5.5 percent on account of public investment infrastructure, strong agricultural growth, accommodative monetary policy amid relatively subdued inflation. Ethiopia despite its double digit's inflation has the projected highest growth at 9.0 percent. Rwanda economy is projected to slightly slowdown in 2019 at 8.5 percent (Figure 3a). Rwanda and Ethiopia are part of the fastest growing economies in the world. Kenya, growth is expected to remain solid, but weaken somewhat as accommodative monetary policy does not fully offset the impact of a fiscal tightening and COVID-19 impact. Uganda's growth will be boosted by public and private infrastructure investments, as well as in energy projects in preparation for oil exports in 2023. For Tanzania, accommodative monetary policy stances amid relatively subdued inflation will further support activity (Figure 3b). According to REO, SSA October 2019, South Sudan is projected to recover from recession experienced in the last decade and report positive digit growth of 7.9 percent in 2019, decelerating to 4.2 percent in 2020. This is attributed to positive stride on reducing political instability in the country.

**Figure 6**a. Real GDP growth for Selected East Africa Countries (% )




***Source: GEP, January 2020***

**Figure 6b. Consumer Prices for Selected East Africa countries, Annual Average (%)**




***Source REO SSA, October 2019***

SSA and the EAC region need to diversify economic activities, undertake reforms to increase efficiency in production and distribution of goods and services leveraging on regional trade blocks and African Continental Free Trade Area (AfCFTA). Additionally, countries in this regions need to build resilience to weather-related, health, and security challenges, through mobilizing domestic revenue, streamlining inefficient subsidies, and improving public financial management all this aimed at enhancing domestic production and strengthening sovereign balance sheets and creating fiscal space for development needs

### 1.2. Risks at Global and Regional Outlook

The global economic and financial conditions face a number of downside risks. **In particular, public health crisis as a result of Coronavirus (COVID -19) pandemic, rising geopolitical tensions, notably between the United States and Iran, intensifying social unrest, further worsening of relations between the United States and its trading partners, and deepening economic frictions between other countries will slow global growth.** Additionally, the effect of climate change, the driver of the increased weather-related disasters such as tropical storms, desert locust invasion, floods, heatwaves, droughts and wildfires may impose severe humanitarian costs and significantly hampering economic

**In the Sub-Saharan Africa, risks from external sources include; abrupt decline in commodity prices, tightening of global financial conditions, and escalating trade tensions involving major economies**. Internally, the SSA region faces risks associated with; political uncertainty in various countries, weakening economies on subdued demand, high and rising public debt levels on lack of commitment to address high fiscal deficits or implement structural reforms, increased reliance on foreign currency borrowing leading to refinancing and interest rate risks. There is also a risk of sudden capital outflows by increased foreign investors in the already shallow domestic capital markets in the region. In some countries, sizable loans to state-owned enterprises, backed by commodity exports, have increased the risk that a negative commodity price shock occasioned by Covid-19 pandemic could trigger financial crises in debtor countries

**The EAC region faces several downside risks. These include; delayed rains in some parts, with implication on food prices, rising public debt, declining trade and tightening global financial conditions.** If global trade tensions persist and global financial conditions tighten abruptly, EAC partner states would experience capital fight to advanced and emerging market and an increase in interest rates. This would increase funding costs, exacerbate exchange rate depreciation and cause increased volatility in domestic capital markets. The increasing level of government public debt coupled with elevated budget deficits and reduced access to major financial markets due to Covid-19 pandemic reduced the ability of the governments to respond to adverse shocks. Regional conflicts and slow progress in implementing Common Market protocols in the EAC partner states are impacting the region negatively in terms of regional trade and growth prospects in 2020.

**The regional banking sector recorded 12.6 percent growth in assets by end December 2019. Banks were generally profitable and had adequate capital and liquidity buffers, with growth in credit to the private sector averaging 4.4 percent across the region.** Credit risk however remains elevated, with non-performing loans to total loans averaging 8.0 percent on account of delayed government payments to suppliers, reduction in real estate occupancy rates and prices, weak underwriting standards and drought. While liquidity risk remained low, the increase in bank exposure to government securities raises concerns about sovereign debt risk and re-pricing risk on these securities, should interest rates rise more rapidly than currently expected. This will reduce profits which are used to enhance capital buffers against shocks.

## 1.3. Implications of Global and regional Macrofinancial Developments to Kenya

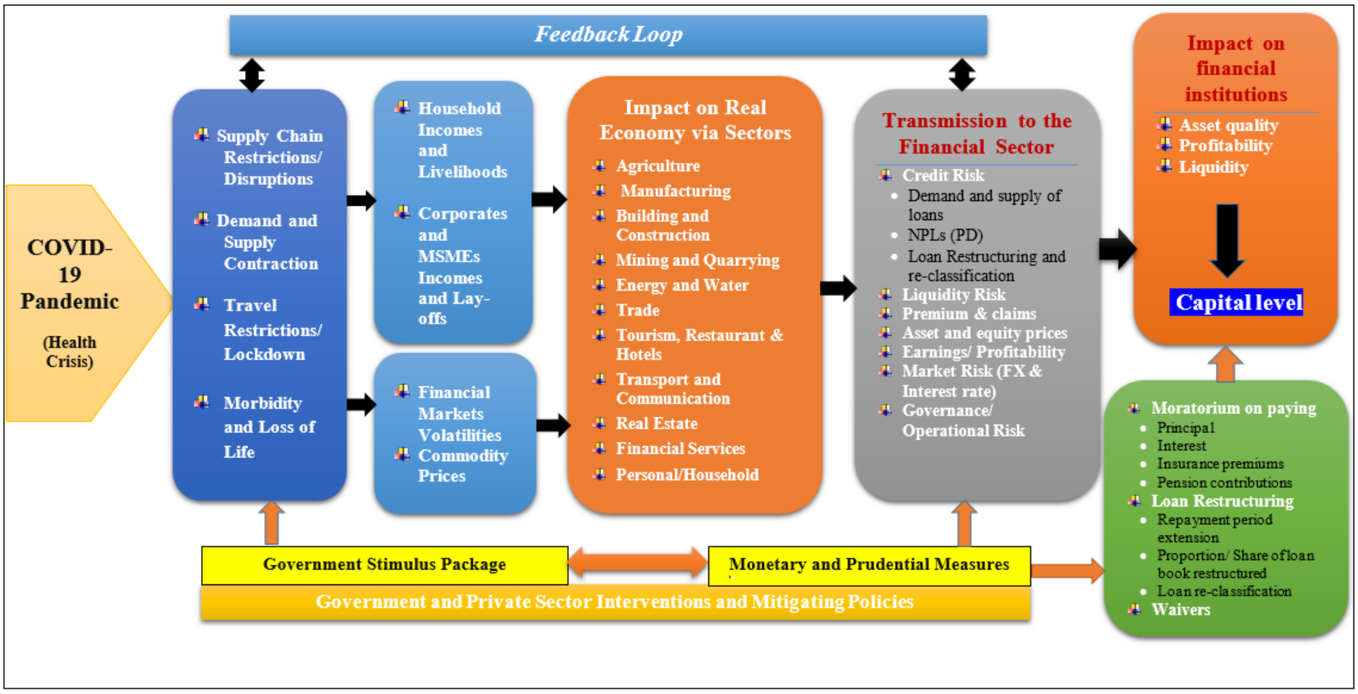
**The slow global growth has reduced demand for Kenya's main exports of Tea, coffee, horticulture and travel services. The resilience of remittances have not compensated for decline in commodity export earnings.** The decline in export earnings especially tea has reduced household and corporate income, SACCOs drawing a majority of members in the tea and tea related activities have experienced a decline in member contribution and increase in NPLs. Banks and insurance companies lending to the tea sector have also recorded an increase in defaults in the tea sector. Restriction on the mobility of people has reduced demand for touristic services and activity in the trade, manufacturing and transport sector has declined. As a results incomes have declined undermining the ability of borrower in this sectors to repay their loans.

**Slowdown in global growth and decline in oil prices offers an opportunity for developing economies (DEs) and Kenya to implement policies that enhance the resilience of their economies and support stability of the financial sectors**. The policies include; fiscal consolidation to create room for fiscal stimulus during slowdown, strengthening the potential for higher and more inclusive growth, improving financial resilience to contain market risks, and fostering international and regional cooperation to enhance trade and contain the spread of Covid-19.

**MACROFINANCIAL DEVELOPMENTS DURING CORONA VIRUS DISEASE PANDEMIC**

**The rapid spread of the Corona-virus disease (**COVID-19) **metamorphosed into a pandemic, prompting governments to restrict movement and quarantine people** to contain the spread of virus. These measures have disrupted supply chains, livelihoods and depressed aggregate demand in global economies. This has in turn triggered a global recession and macro financial fragility, with prices of assets in major global financial markets recording increase in volatility, capital flows from developing and emerging markets to developed countries and tightening of global liquidity conditions. In the domestic economy the Civid-19 pandemic shock has affected the real economy through supply chain disruptions, travel restrictions, morbidity and loss of life. This has disrupted livelihoods, reducing households' and firms' incomes, despite government and private sector deploying mitigation measures. The decline in incomes and slowdown in economic activity reduced profitability of financial institutions due to decline in the quality of assets (**Figure 1**).

**Figure i: Transmission Channels of the Macrofinancial Impact of the COVID-19 Pandemic**

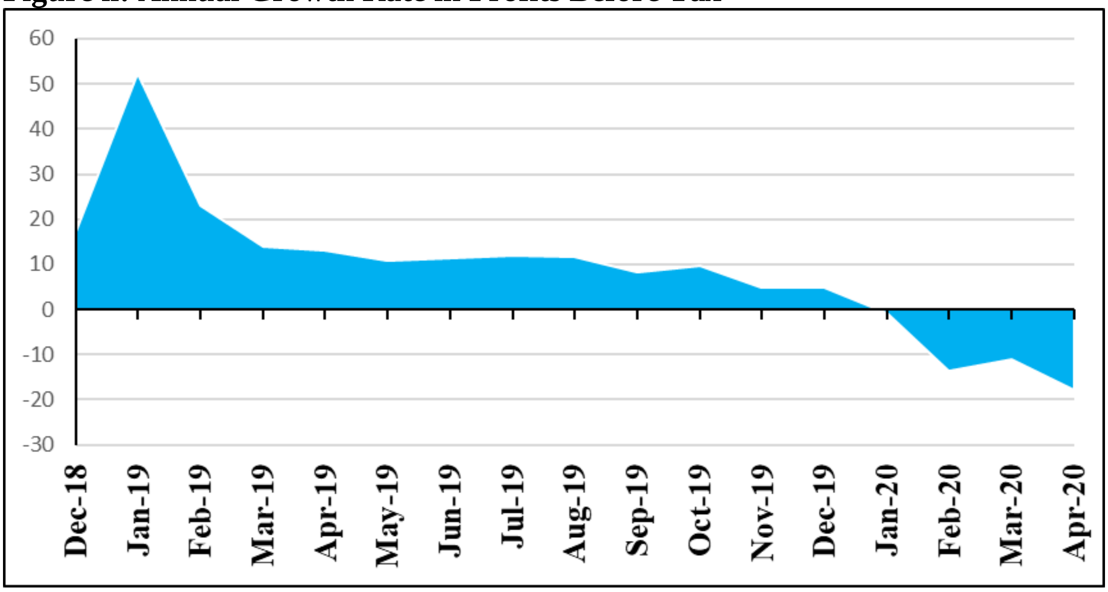



*Source: CBK*

The alternative working arrangement and suspension of annual general meetings may weaken corporate governance as well as reduce profitability due to increase in operational cost. The decline in profitability without enhanced corporate governance, especially with suspension of physical annual general meeting, may undermine stability of financial institution. In addition, the decline in profits curtail building up of capital buffers that enhance the resilience of financial institutions against shocks.

Some of the institutions that had low capital buffers and profits before the onset of the COVID-19 pandemic may be more vulnerable. Containment measures have been effective in limiting infections, thereby reducing medical and life claims for insurers. However, movements in equity prices and inability to pay premiums have increased losses to insurers. Further, some providers of credit insurance are vulnerable to a significant increase in unemployment.

**Figure ii: Annual Growth Rate in Profits Before Tax**



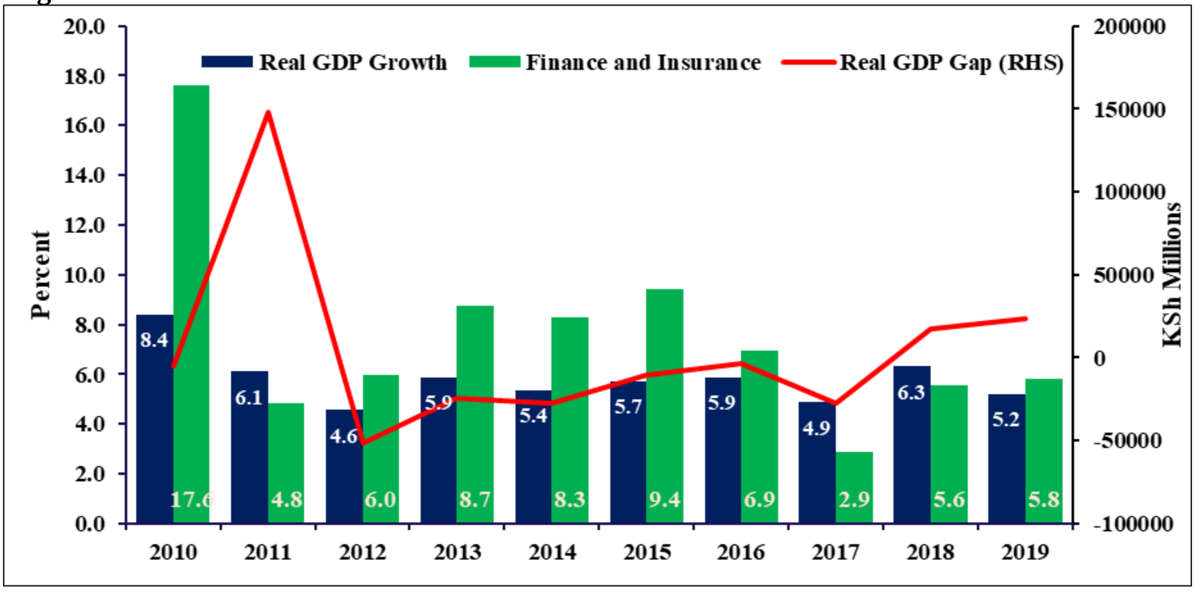

However, regulators have deployed measures to enhance the resilience of financial institutions against the COVID-19 pandemic. The CBK has allowed banks to restructure and granted flexibility in classification of loans whose repayment has been affected by the COVID-19. The CBK has also reduced cash reserve ratio and increased maturity of repurchase agreement bills to increase liquidity as well as enable banks to extend credit. The IRA has allowed insurers to provide life cover for a period of 3 months even without the insured paying premiums, while cover for travelers not able to travel to be suspended or the premiums to be refunded. The sponsors have been granted flexibility in filing returns, remitting sponsor and employee contributions depending on the employee compensation during the COVID-19 and not according to declaration filed before the onset COVID-19 pandemic. All the regulators have suspended physical annual general meeting and reactivated business continuity plans such as alternative working arrangements and sites as well as succession plans during the COVID-19 pandemic.

The waiver of compliance to prudential guidelines such as annual general meeting, penalties for failing to file returns and flexibility in restructuring of loans are temporary and targeted to financial institutions and borrowers affected by the pandemic. This engenders compliance after the COVID-19 pandemic ends.

## CHAPTER 2: DOMESTIC MACROFINANCIAL CONDITIONS

**Kenya's economy was resilient to drought to register a growth of 5.2 percent in 2019 compared to 6.3 percent in 2018 (Figure 7). The slow growth in 2019 was recorded in all the sectors of the economy.** Drought in the first quarter and excess rains in the second quarter of 2019 stifled agriculture production, while slow global economic growth due to protectionist policies among developed and emerging economies, macroeconomic instability in Kenya's main export destinations and geopolitical conflicts dragged growth in the services and mining sector. Competition from cheap imports and high cost of doing business undermined growth in manufacturing sector despite the sector receiving incentives under the "Big 4" Government initiatives. The finance and insurance services have recovered to grow faster than real GDP, while the output gap increased slightly (figure 7). Whereas, the financial sector may support economic recovery, faster growth in financial assets relative to the economy may elevate risk to the financial sector due to household and firms accumulating debts that cannot be sustained by their incomes. The incomes are expected to decline further in 2020 due to corona virus disease and the measure taken to contain the spread infections.

**Figure 7: Annual Real GDP Growth Rates**




*Source: KNBS*

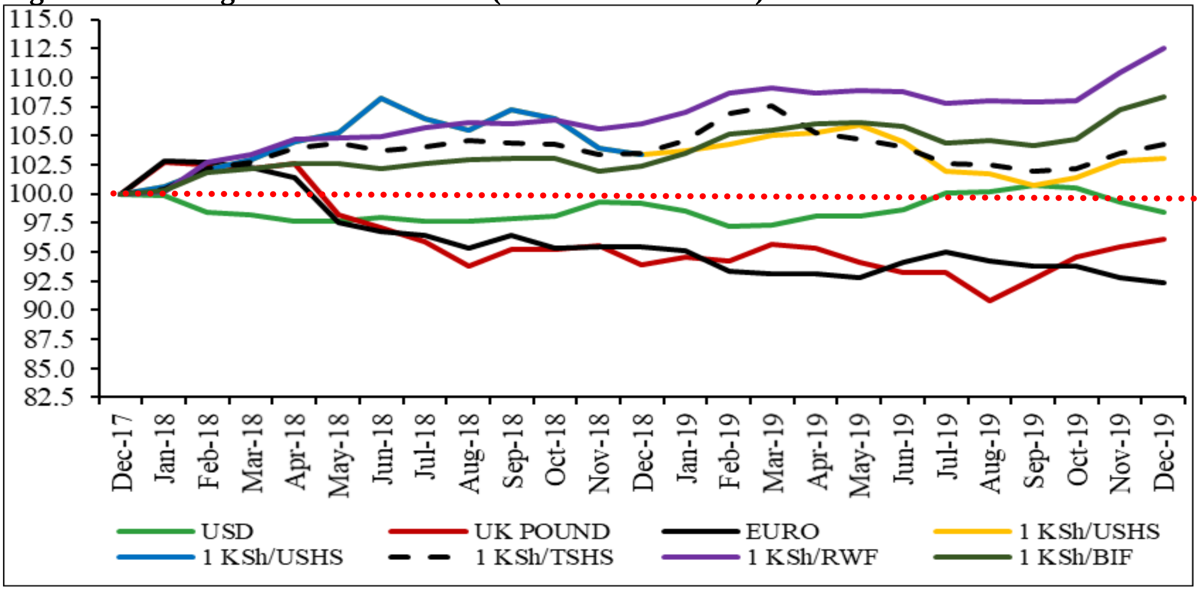
According to IMF, World Bank Group and Mckinsey, Kenya's GDP growth is projected could decline from to 5.2 percent to 2.4 percent and further to 1.9 percent after accounting for the 2020 locust invasion in the first second and third quarters of 2020, respectively. This is mainly due to reductions in household and business spending, disruption to supply chain, tourism and locust invasion. However, expansionary monetary policy may stimulate economic activity and reduce the risk of a recession.

**The Kenya Shilling was stable albeit slight appreciation against both the regional and international currencies in 2019** (**Figure 8**)[1]. Stability of exchange rate follows a narrowing Current Account Balance (CAB) from 4.9 percent of GDP on increased diaspora remittances, reduced imports bill and expanded exports in to new markets. Remittances increased from USD 5,054.1million in the fourth quarter of 2018 to USD 5,320.4 million in fourth quarter of 2019.

The Kenya Shilling is expected to be volatile in 2020 because of public health crisis caused by COVID-19, trade tension, geopolitical conflicts, slow growth in the global economy and especially in Kenya's main export destinations. However, increase in remittances flows, improving exports and stable import bill are to increase foreign exchange reserves that are expected to be used to mitigate volatility in exchange rate.

[1] Figure 13 Summarizes the performance of exchange rate from the base of December, 2017).

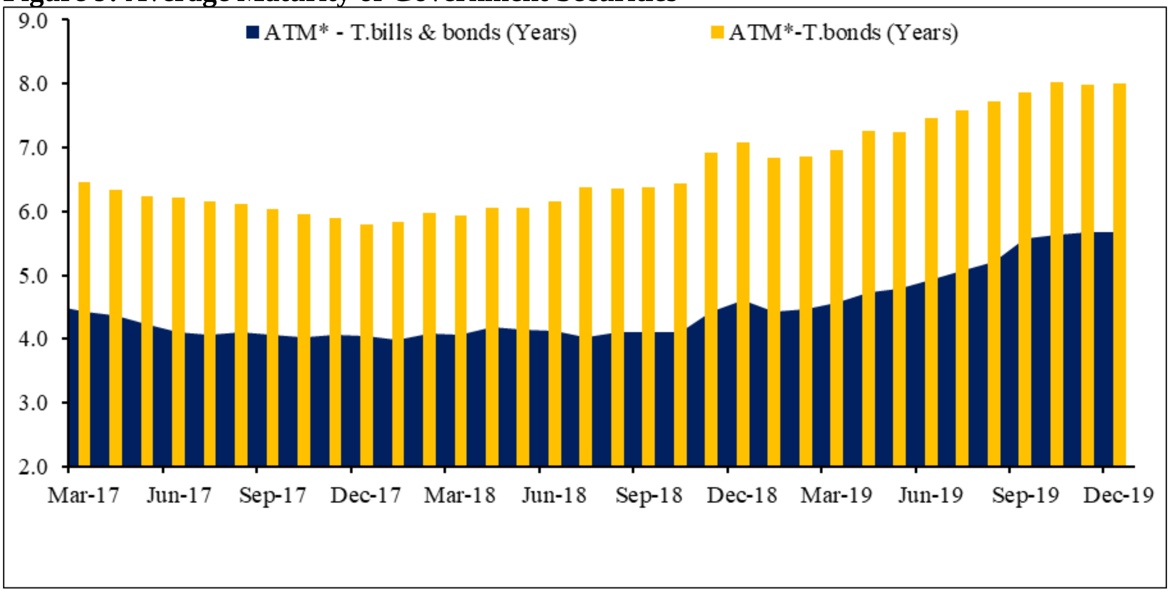
**Figure 8: Exchange Rate Performance (December 2017=100)**




*Source: Central Bank of Kenya*

Domestic debt in form of total Government Securities (excluding Treasury bills stock held for Open Market Operations (OMO)), grew by 16.15 percent, to KSh. 2,874.69 billion at the end of December 2019, from KSh. 2,475.065 billion in December 2018. However, liquidity of Government securities declined from 20.25 percent in 2018 to 19.88 percent 2019. The average maturity of the stock of domestic debt increased to 6.3 years in 2019 from 5.2 years 2018, thus minimizing rollover risks **(Figure 8).** The lengthening of maturity profile could be due to increased uptake of long-term infrastructure financing bonds and repayment of maturing short-term debt, which is consistent with The National Debt Strategy.

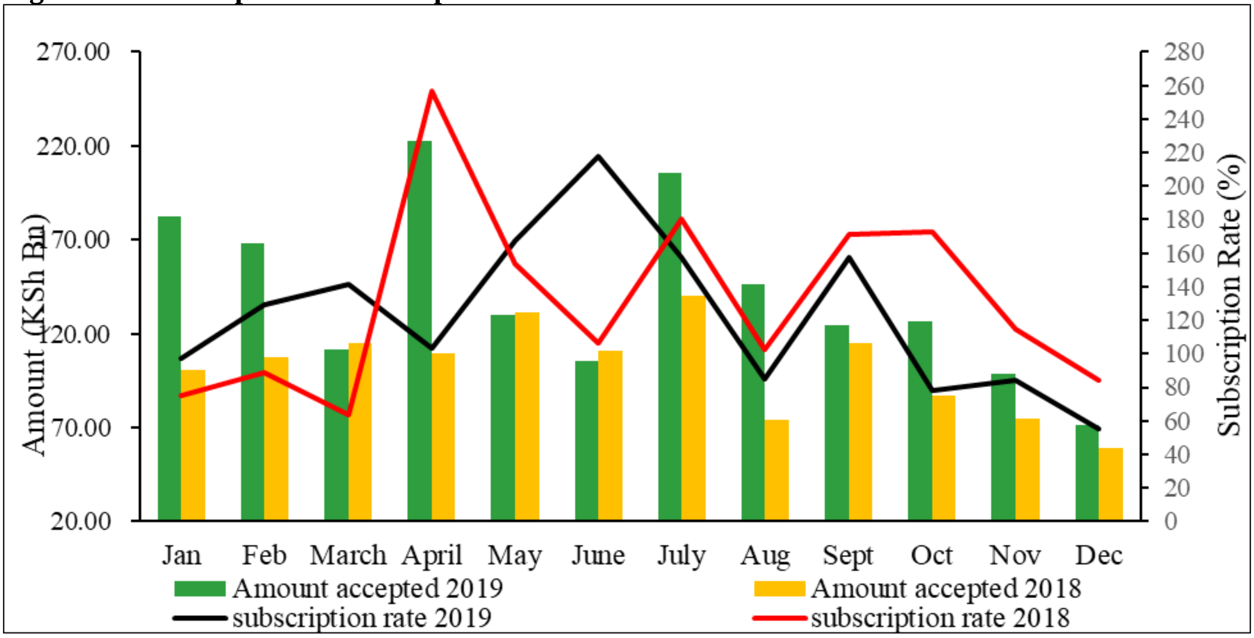
**Figure 9: Average Maturity of Government Securities**




*Source: Central Bank of Kenya*

**Despite increased uptake of domestic debt, primary market for government securities performed well through 2018, reflecting adequate liquidity**. The Treasury bill and bonds auction raised KSh 1,692.45 billion in 2019 compared to KSh 1,225.19 billion in 2018 (**Figure 9**). Treasury bills and bonds were subscribed at 133.55 percent in 2019 compared to subscription rate of 109.25 percent in 201 and 112.16. The increase in subscription in 2019 may be explained by higher coupon rates offered on bonds to finance fiscal deficit in the awake of declining tax revenue.

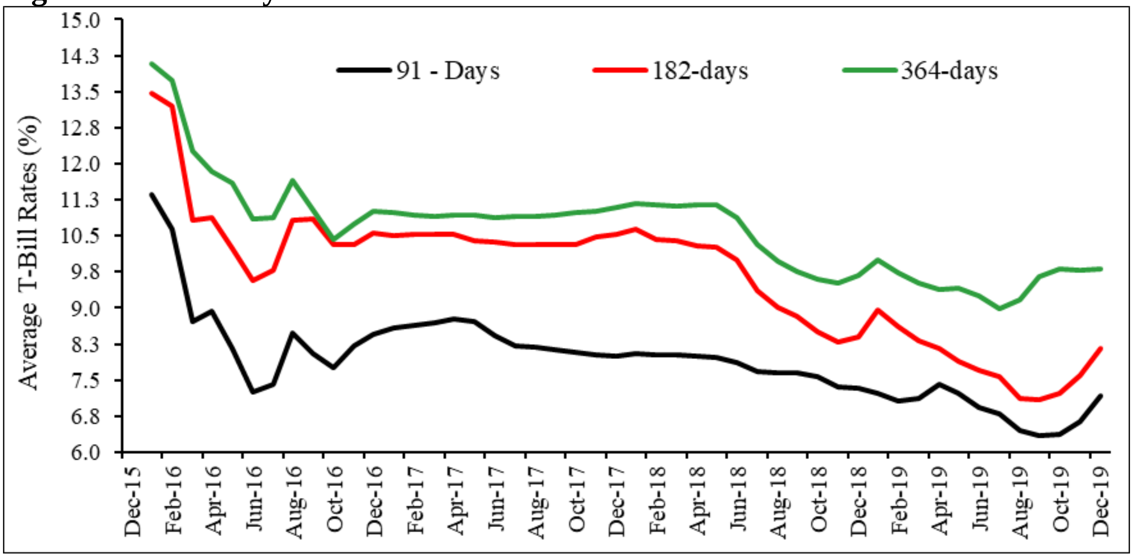
**Figure 10: Subscriptions and Accepted Amount**




*Source: Central Bank of Kenya*

**Interest rates on treasury bills have been stable and declining since the third quarter of 2018, reflecting fiscal consolidation, improved market liquidity and overall market stability after the 2015-2016 crisis in the banking sector (Figure 10).** Implementation of the interest rates capping law in September 2016 influenced many banks to focus lending to government rather than private sector. The removal of interest rate in the fourth quarter of 2019, has enhanced pricing of private sector loans according to risk. Resulting in increase in competition for loanable funds between the private sector and public sector. This led to the increase in interest rates on the treasury bills and bonds as well as yields on bonds in the secondary market..

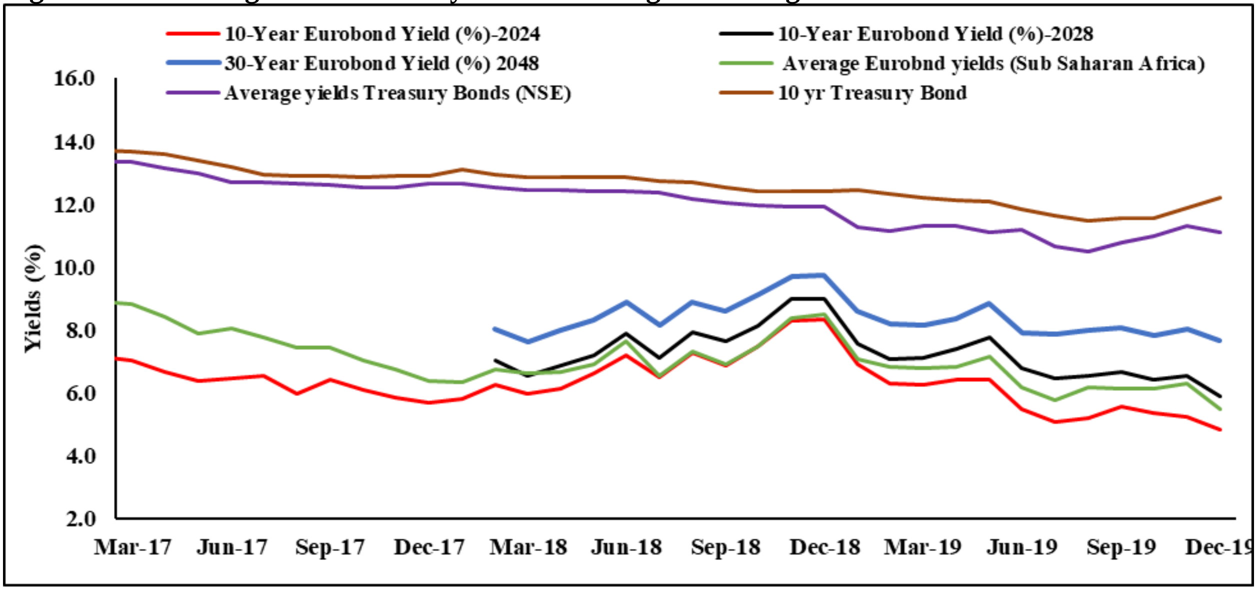
**Figure 11: Treasury Bills Interest Rates Trends**




*Source: Central Bank of Kenya*

**Consistent with trends in Treasury bills yields, yields on Local Currency Bonds (LCBs) increased in the second and the third quarters of 2019 (Figure 12).** This led to the decline in average bond prices from 99.87 to 99.48. Whereas, investment in government securities is safer than lending to the private sector, an increase in fiscal deficit financed by debt may increase yields, especially in liberalized interest rate regime, which may occasion losses to banks holding bonds for sale.

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

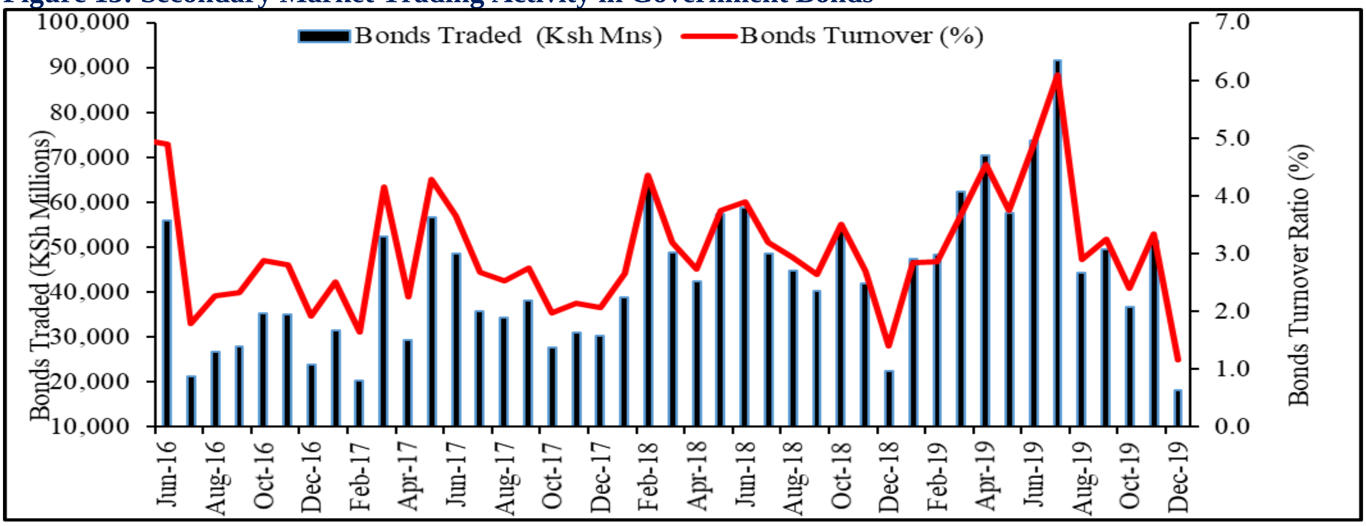



*Source: Illustration using Central Bank of Kenya and Thomson Reuters data*

In the international bond's market, Kenya's yields on Eurobonds declined in 2019, just like yields for Eurobonds of selected Sub Saharan African countries, reflecting easing monetary condition and sovereign risks. However, yields on the Treasury bonds traded on the NSE increased, due to the removal of interest rate controls and the increase in debt financed fiscal deficits.

**Trading in the secondary market for government bonds performed better in 2019 compared to activity in 2018, perhaps reflecting stable macroeconomic environment, improved political stability and adequate liquidity in the market (Figure 13).** However, the steady decline in bonds turnover ratio in 2019 signifies a less liquid market in 2019, although relatively higher 2018 and 2017. A decline in the liquidity of bonds discourage investment in bonds and development of the bonds. A deep bonds market enables the provide and public sector to mobilise savings for long term investment, which is vital for economic growth.

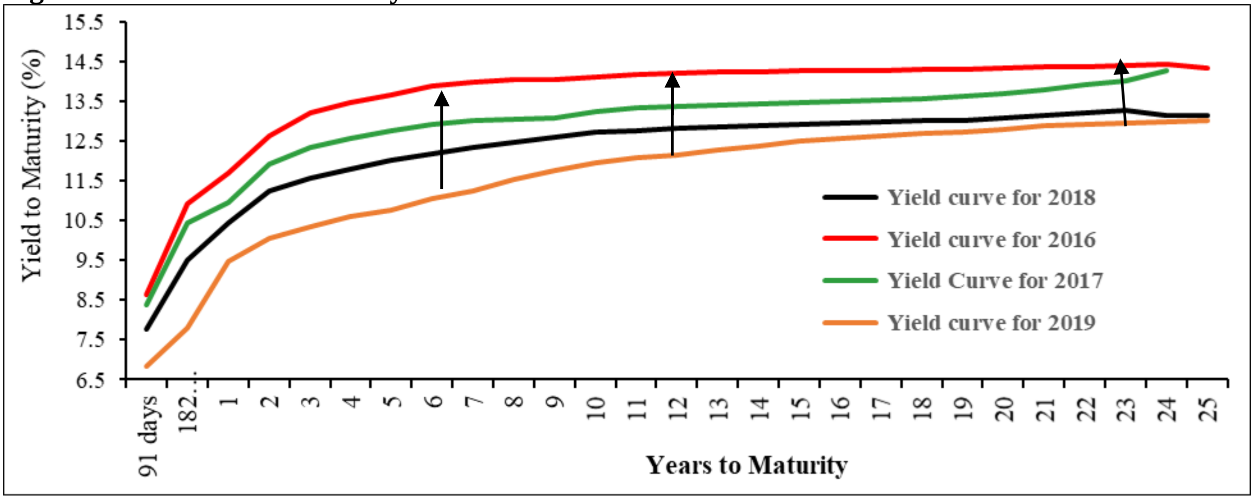
**Figure 13: Secondary Market Trading Activity in Government Bonds**




*Source: Illustration using NSE data*

**The stable macroeconomic conditions reflected in low and stable inflation and stable exchange rates supported by high liquidity conditions leading to a downward parallel shift of the yield curve in 2019 (Figure 13).** The 2019 yield curve is steeper at the long end than 2018 indicating that investors are effectively pricing risks associated with holding long term securities. This indicates that the steep slope of the 2016 yield curve reflects liquidity challenges in the market following placement of Imperial Bank and Chase Bank in receivership in October 2015 and April 2016, respectively as well as banks' reaction to introduction of interest rates capping law in September 2016. However, shocks to the market affecting interest rates that causes a parallel upward shift of the yield curve back to the 2016 position, would lead to revaluation losses of existing mark-to-market bonds, thus impacting banks' balance sheet and other investors' portfolios.

**Figure 14: Government of Kenya bonds Yield Curve**

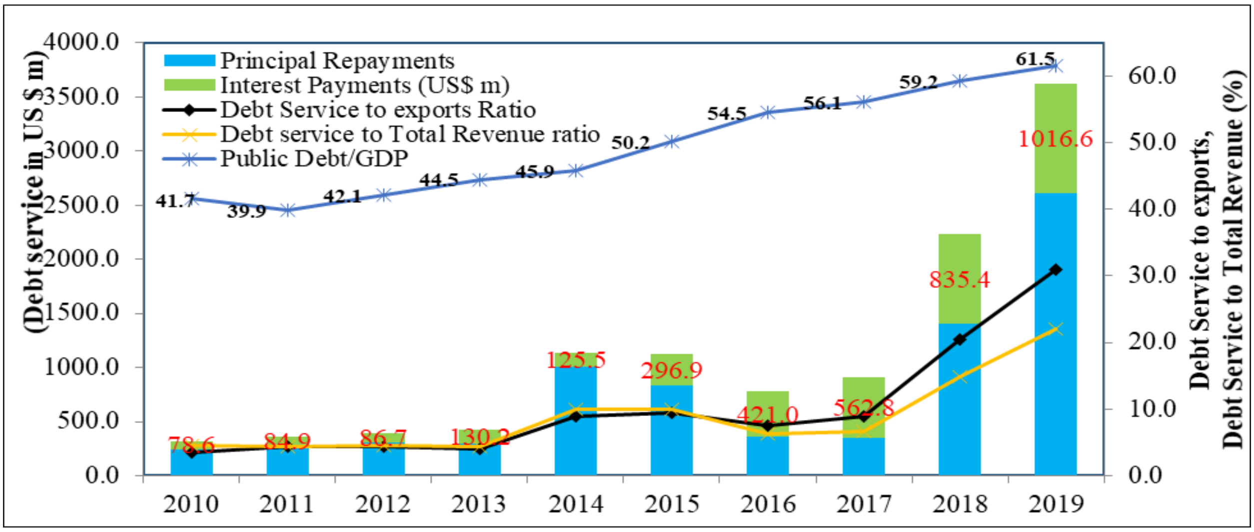



*Source: Illustration using NSE data*

**The removal of interest rate controls, may lead to increase in the lending rates and yields on corporate and Treasury bonds (figure 13).** This is because as banks evaluate between risks and return on lending to the private sector against lending to government, they may increase lending rates in order to maximise returns. Rising interest rates will lower the value of treasury bonds held under the Available For Sale due to repricing in line with mark-to-market principles. The impact on the balance sheet of banks is unrealized losses if these bonds are not sold or actual losses if banks offload them in order to obtain liquidity for lending to private sector.

**Kenya's public and publicly guaranteed debt remains sustainable over the medium term.** The ratio public debt increased from 59.2 percent in 2018 to 61.5 percent in 2019, while present value of public and public guaranteed debt to GDP ratio is estimated to be below 60 percent, which is less than 70 percent threshold for economies with similar characteristics as Kenya. However, the rate of debt accumulation of non-concessionary debt (syndicated loans and Eurobonds), which has higher interest rate compared to concessionary loans, is reducing Kenya's capability of servicing public debt (Figure 13). Interest rate repayment increased from USD 835.4 million to USD 1016.6 million, while principal repayment increased from USD 1400.6 million in 2018 to USD 2607.0 2019.

**Figure 15: Public debt, GDP and Tax revenue**

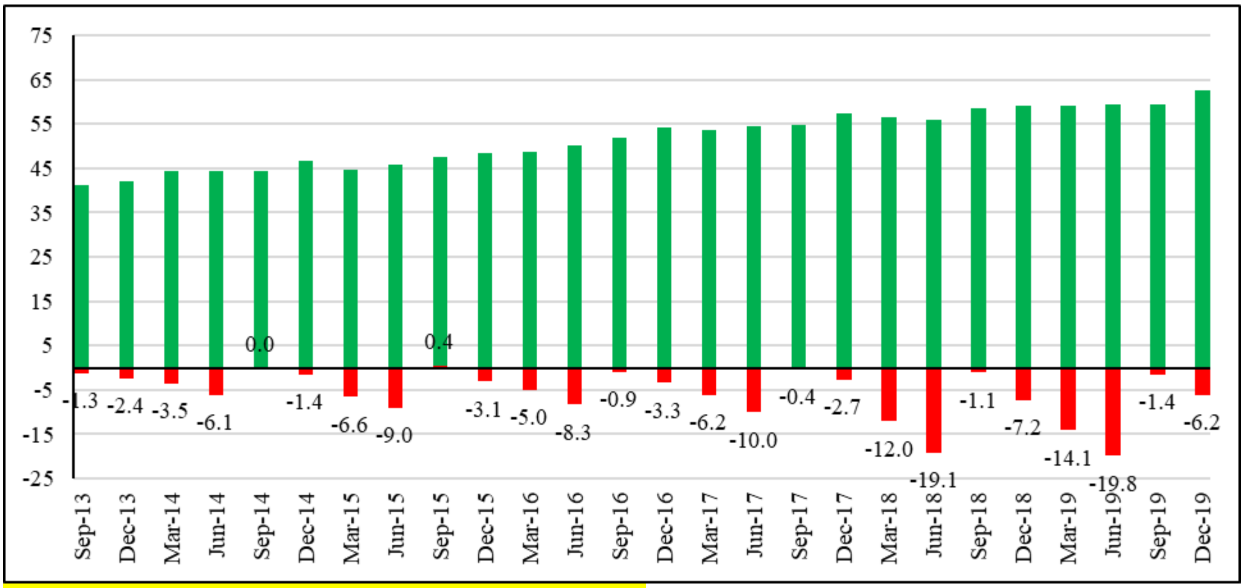



*Source: The National Treasury and Central Bank of Kenya*

However, exports and total revenue have not increased in tandem with principal and interest repayment. As a result, the ratio of debt service to exports and debt service to total revenue increased. This is indicates that Kenya's ability to service debt is declining. Hence, room for further debt accumulation is narrowing.

Despite fiscal space reducing, public debt is still sustainable over the medium term given the declining ratio of fiscal deficit to GDP **(Figure 15)**. The risk of external debt distress remains low due to increase in foreign reserves. In addition, the overall public debt has augmented productivity of the economy and increased output, generating income for households and firms to compensate for the reduction in public spending on goods and services to enable the Government to repay debt. The fiscal consolidation adopted by government in 2015 has buttressed public debt sustainability in line with Medium-Term Debt Strategy III.

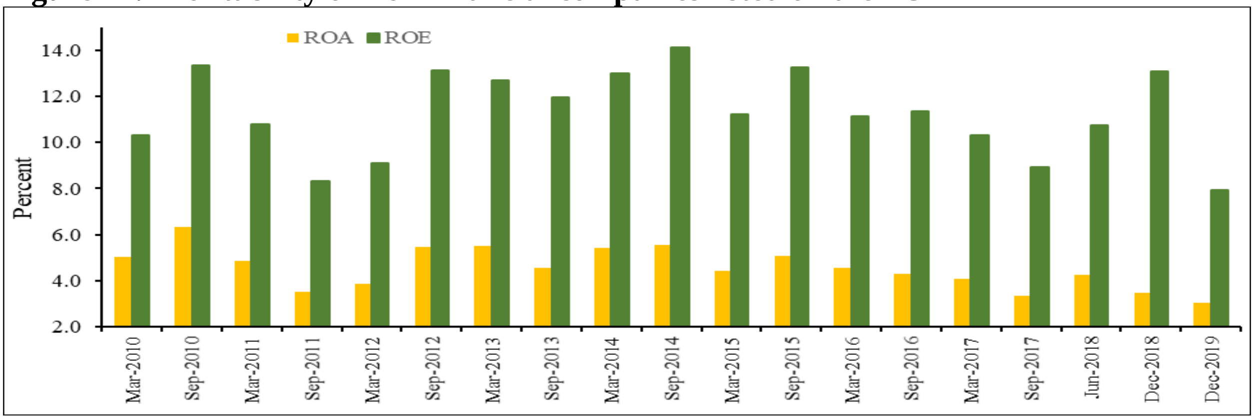
**Figure 16: Narrowing Fiscal Space**




*Source: Illustration using The National Treasury data*

**The non-financial firms listed on the NSE reported a decline in profitability in 2019 compared to 2018 and 2017 (Figure 17). This is due to slow domestic and global economic growth in 2019**. In addition, increasing number of corporates have declared profit warnings and started employee lay-off program due to rising staff costs, amidst depressed financial performance. Over 7,000 mass layoffs of workers have been declared in 2019 compared to 2876 in 2018 and 1870 in 2017. Depressed corporate sector performance may explain the rising non-performing loans in banks. A decline in profitability of these companies reduce their ability to service debts, while loss of employment reduces capacity of laid of employees to service their loans. The slow growth of short term and long term corporate debt as a result of weak performance has accelerated a decline in fixed capital formation form 3.7 percent in 2018 to 59.9 percent in 2019. This implies that first, there is a risk for the corporate to shrink in the medium and long term. Secondly, the corporate sector may not be able to meet debt obligations in the medium term and long term.

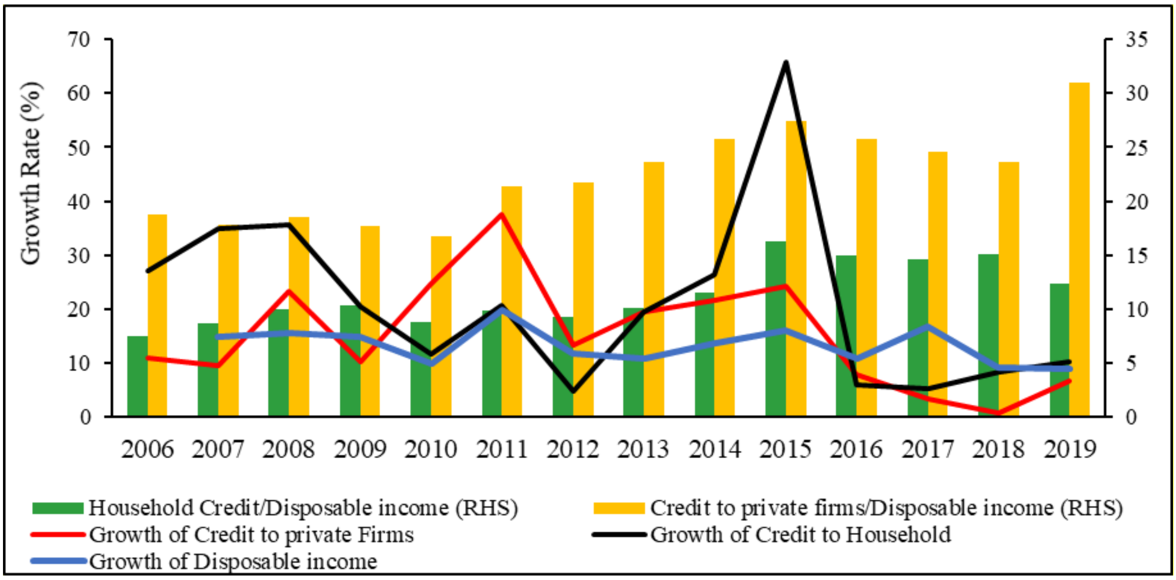
**Figure 17: Profitability of Non-financial companies listed on the NSE**




*Source: CBK Staff Computation*

**Overall, credit to private sector accelerated to 8.1 in 2019 from a slow growth of 3.7 in 2018.** Credit to households and firms grew 10.3 percent and 6.6 percent, respectively. However, the proportion of credit channeled to private firms declined from 61 percent in 2018 to 60 percent in 2019, while growth rate of disposable income decelerated from 9.2 percent to 9 percent. The faster growth in credit compared to disposable indicates that the ability to repay loans declined in 2019, but the level of indebtedness is low as indicated the ratio of credit to disposable income being less than 31 percent **(Figure 17)**.

## Figure 18: Private sector credit and indebtedness

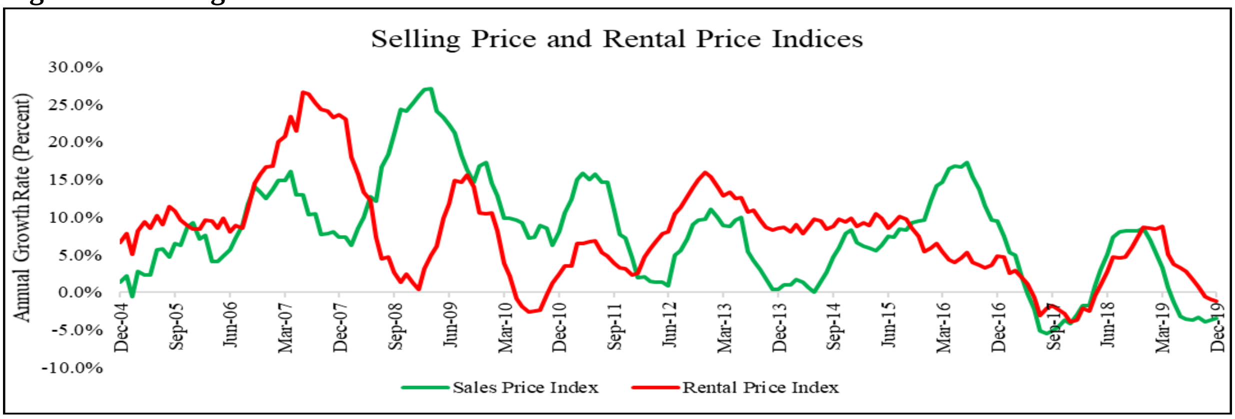



*Source: Illustration using CBK data*

**Property Markets Developments**

Property prices declined in 2019 as indicated by the Hass Consult and Kenya Bankers Association latest published reports. The Hass Consult All Types Property Index shows that property prices declined to 3.5 percent and 1.2 percent for selling and rental price in 2019 compared to 1.9 percent and 1.6 percent increase in 2018, respectively (Figure 18). The decline in the house prices is mainly from the satellite towns, where prices dropped by 0.5 percent in 2019, the first decline since 2008. The rental prices also declined in satellite towns by 2.1 per cent in 2019. This indicates that wealth and income of  home buyers in these areas has been declining due to slow economic growth **(Figure 18)**.

**Figure 18: Selling Price and Rental Price Indices**




Source: Hass Consult

Financing of real estate outside the banking sector has been increasing **(Table 2).** Credit from banks to the real estate grew by 3.8 percent in 2019 compared 1.8 percent growth rate for Insurance companies and 3.8 percent in pension funds. Other financing sources include; mortgage finance companies, Savings and Credit Cooperatives (Saccos), capital markets (Real Estate Investment Trusts), off-plan purchases, and private sources.

**Table 1: Funding Options in Real Estate (KSh. Billions)**

| Year | Insurance | Pension | Commercial Banks |
|---|---|---|---|
| 2012 | 39.32 | 1.6 | 130.92 |
| 2013 | 54.26 | 119.84 | 162.33 |
| 2014 | 62.55 | 130.39 | 218.68 |
| 2015 | 68.62 | 50.78 | 262.48 |
| 2016 | 73.24 | 178.42 | 284.09 |
| 2017 | 76.04 | 226.72 | 371.65 |
| 2018 | 82.59 | 229.9 | 380.91 |
| 2019 | 84.07 | 238.65 | 395.18 |

Source: Various reports of Real Estate Firms and Regulators

Approved actual buildings plans declined by 4.66 percent in 2019 compared to actual approvals in 2018 (Table 4). However, the property market is expected to marginally recover in 2020 on increased housing by Government under the affordable housing initiative and improved demand of commercial bank credit due to the removal of interest rate controls.

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

| | Actual Value of Buildings | | | Real Actual Value of Buildings | | | | |
|---|---|---|---|---|---|---|---|---|
| | Residential | Non-Residential | TOTAL | Residential | Non-Residential | 2019 Total | 2018 Total | 2017 Total |
| January | 10,435.29 | 7,064.94 | 17,500.23 | 114.03 | 75.22 | 189.25 | 232.45 | 236.83 |
| February | 10,357.13 | 7,435.42 | 17,792.55 | 113.18 | 79.16 | 192.34 | 240.91 | 230.14 |
| March | 12,256.40 | 8,991.05 | 21,247.45 | 133.94 | 95.73 | 229.67 | 226.28 | 252.06 |
| April | 11,544.20 | 7347.15 | 18,891.35 | 125.79 | 78.22 | 204.01 | - | 254.48 |
| May | 15,042.43 | 8,190.28 | 23,232.71 | 164.38 | 87.2 | 251.58 | 233.45 | 257.99 |
| June | 16,277.14 | 6,346.94 | 22,624.08 | 177.87 | 67.58 | 245.45 | 240.2 | 267.76 |
| July | 13,349.98 | 6,312.74 | 19,662.72 | 145.89 | 67.21 | 213.1 | 207.42 | 242.8 |
| August | 11,431.42 | 4,231.30 | 15,662.72 | 124.92 | 45.05 | 169.97 | 182.11 | - |
| September | 13,888.31 | 5,986.40 | 19,874.71 | 151.77 | 63.74 | 215.51 | 201.3 | 279.94 |
| October | 13,630.56 | 9,579.64 | 23,210.20 | 148.95 | 101.99 | 250.94 | 206.6 | 372.92 |
| November | - | - | - | - | - | - | 287.27 | 191.13 |
| December | 10,026.76 | 5,932.38 | 15,959.14 | 109.57 | 63.16 | 172.73 | 190.74 | 219.16 |
| **Total** | **138,239.62** | **77,418.24** | **215,657.86** | **1,510.29** | **824.26** | **2,334.55** | **2,448.73** | **2,805.21** |

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

**Impact of locust and floods on Kenya economy and the financial sector**

The invasion of the Desert Locusts may present a threat to food security and livelihoods in Kenya as the they destroy crops and pasture. Households who derive their livelihood from crops and livestock keeping may need food subsidy as well animal feeds to mitigate adverse loss of livestock and crops. This will reduce fiscal space to mitigate effects of COVID-19, to repay debt and public spending on investment. Households deriving their livelihood in crops, livestock, trade in livestock may not meet their financial obligation if locus invasion worsens.

However, the locust invasion in 22 counties invasion coincides with land preparation for planting and therefore, they are not expected to immediately be a threat to food security. In addition, the above average rainfall in January-March 2020 supports fast regeneration of vegetation in affected areas. The Locust movement has concentrated mainly in Northern counties, which are predominantly nomadic livestock rearing and crop growing counties are largely unaffected so far **(Figure 22).**

However, Government of Kenya in liaison with the Desert Locust Control Organization for Eastern Africa has intensified efforts to eradicate the locusts through aerial spraying and ground control operations. In addition, Food and Agriculture Organization (FAO) and European Union have allocated more than € 1 million in emergency funding to support efforts to tackle the spread of the desert locust.

**Figure 22: Locust Movement Path**

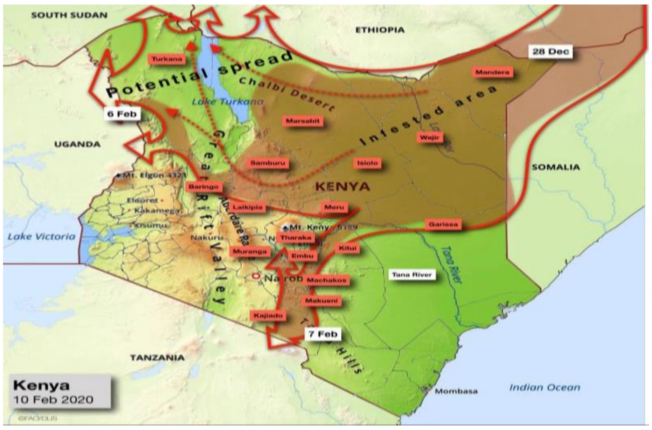
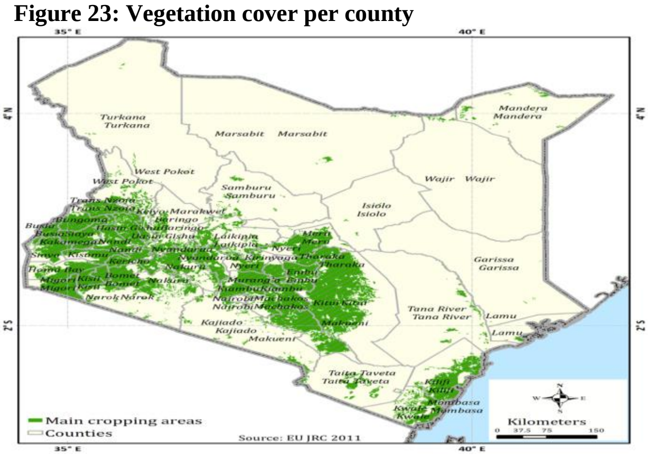



**Figure 23: Vegetation cover per county**




## CHAPTER 3: FINANCIAL SYSTEM VULNERABILITIES AND RISKS

**Kenya's financial sector was resilient in 2019, growing by 9.93 percent by assets.** The assets of insurance industry grew by 11.2 percent, capital markets by 18.2 percent, pensions by 10.6 percent, and Saccos by 11.8 percent and banking by 9.6 percent. The Banking, SACCOs and pension subsectors recorded increase in profitability due to the recovery of the economy and improved regulatory framework. The insurance subsector however recorded a decline in profitability attributed to weak private sector. The Kenya Deposit Insurance Corporation (KDIC) increased Effective Cover from 33.3 percent in 2018 to 40.35 percent in 2019. The liquidity of bonds increased form 3.09 percent to 3.49 percent, while liquidity of equity declined from 8.36 percent to 6.10 percent.

**The banking industry's assets accounted for 49.66 percent of nominal GDP in 2019 (Table 5).** This was followed by Pensions industry at 13.34 percent and the rest accounted for less than 10 percent of nominal GDP each.

**Table 2: Share of Financial Sector Assets to GDP**

| YEAR | 2017 | | 2018 | | 2019 | |
|---|---|---|---|---|---|---|
| Nominal GDP (millions) | 8,144,373 | | 8,904,984 | | 9,740,360 | |
| Indicator/ Industry | Total Assets (KSh Bns) | Share of GDP (%) | Total Assets (KSh Bns) | Share of GDP (%) | Total Assets (KSh Bns) | Share of GDP (%) |
| Banks (excludes MFBs) | 4,002.74 | 49.15 | 4,408.59 | 49.51 | 4832.35 | 49.61 |
| MFB | 67.60 | 0.83 | 70.75 | 0.79 | 77.17 | 0.79 |
| Insurance | 590.95 | 7.26 | 637.41 | 7.14 | 705.55 | 7.24 |
| Pensions | 1,081.10 | 13.27 | 1,166.34 | 13.10 | 1298.19 | 13.33 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Saccos | 442.90 | 5.44 | 493.82 | 5.55 | 555.92 | 5.71 |
| **TOTAL** | **6,627.04** | **81.37** | **6,776.91** | **76.09** | **7469.18** | **76.68** |
| Market Capitalization | 2,521.77 | 30.96 | 2,102.00 | 23.60 | 2,539.98 | 26.10 |

*Source: KNBS Economic Survey 2018 and regulators' reports*

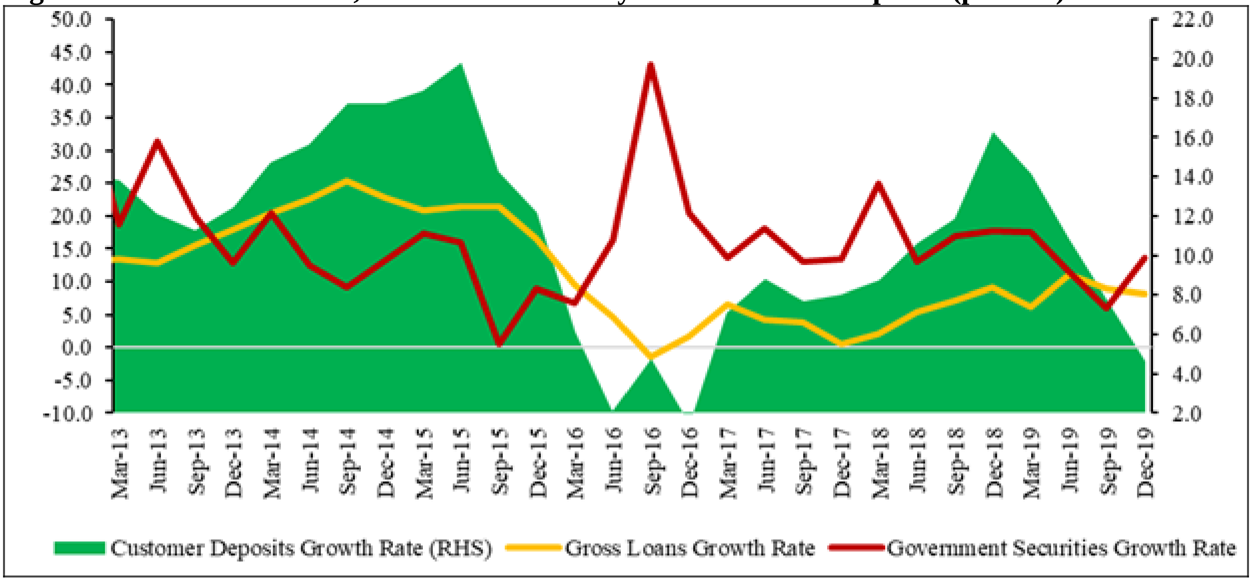
The depth of the financial sector in the Kenya's economy has been reducing since 2017. The ratio of total assets of banks, insurance and pension industry to GDP declined from 76.1 percent to 75.9, while the banking industry's assets as a share of nominal GDP declined from 49.5 percent in 2018 to 49.1 percent in 2019. This is partly attributed to slow growth in credit to private sector and fragility in the banking and insurance industry. However, recovery of equity prices in 2019 increased market capitalisation as a share of GDP to 25.8 percent (**Table 3**).

### 3.1. Banking Industry

As at December 2019, there were; 41 commercial banks, 1 mortgage finance company, 13 microfinance banks, 9 representative offices of foreign banks, 69 foreign exchange bureaus, 19 money remittance providers and 3 credit reference bureaus.

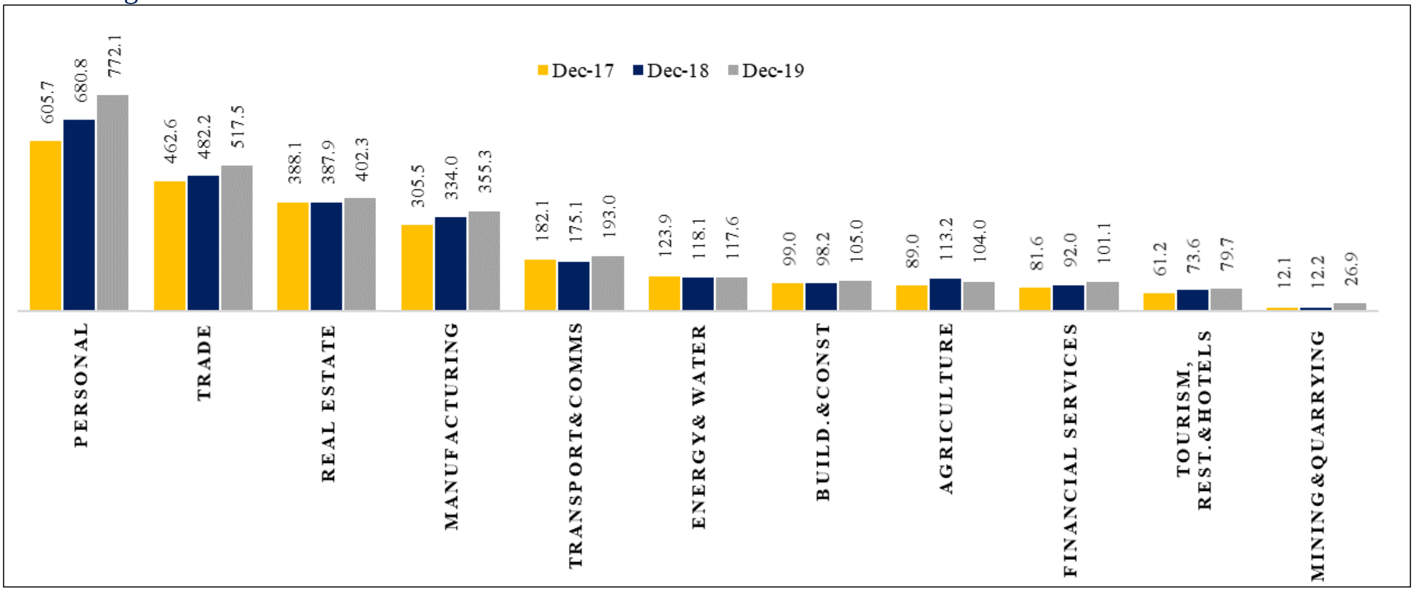
**Total net assets grew by 9.61 percent from KSh 4,408.59 billion in December 2018 to KSh 4,832.35 billion in December 2019**. Loans and advances accounted for 52.6 percent of total assets in December 2019 compared to 53.6 in December 2018. Share of government securities in total assets increased to 27.4 of total assets in 2019 from 26.2 percent in 2018. The growth in deposit recovered fully in the first quarter of 2019 from the collapse of Imperial Bank in October 2015, placement of Chase Bank in statutory management in April 2016. Customer deposits grew by 9.06 percent from KSh. 3,259.5 billion in December 2018 to KSh. 3,554.4 billion in December 2019, supported by deposits through agency banking and mobile phone platforms and demonetisation of 1000 notes between June and September 2019 (**Figure 19**). This enabled banks to increase loans. The removal of interest rate control in September 2019, also encourages banks to increase loans and advances instead of increasing investment in government securities

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




Mining and Quarrying; Personal/Household; Transport and Communication and Agriculture sectors received the highest amount of loans and advances between December 2018 and December 2019. These sectors recorded increases in credit of 120.1 percent, 13.4, percent, 10.3 percent and 9.9 percent, respectively. The growth rate of loans to mining and quarry, tourism restaurant & hotel, financial services and agriculture was the least (**Figure 20)**.

Figure 20: Sectoral Distribution of Loans

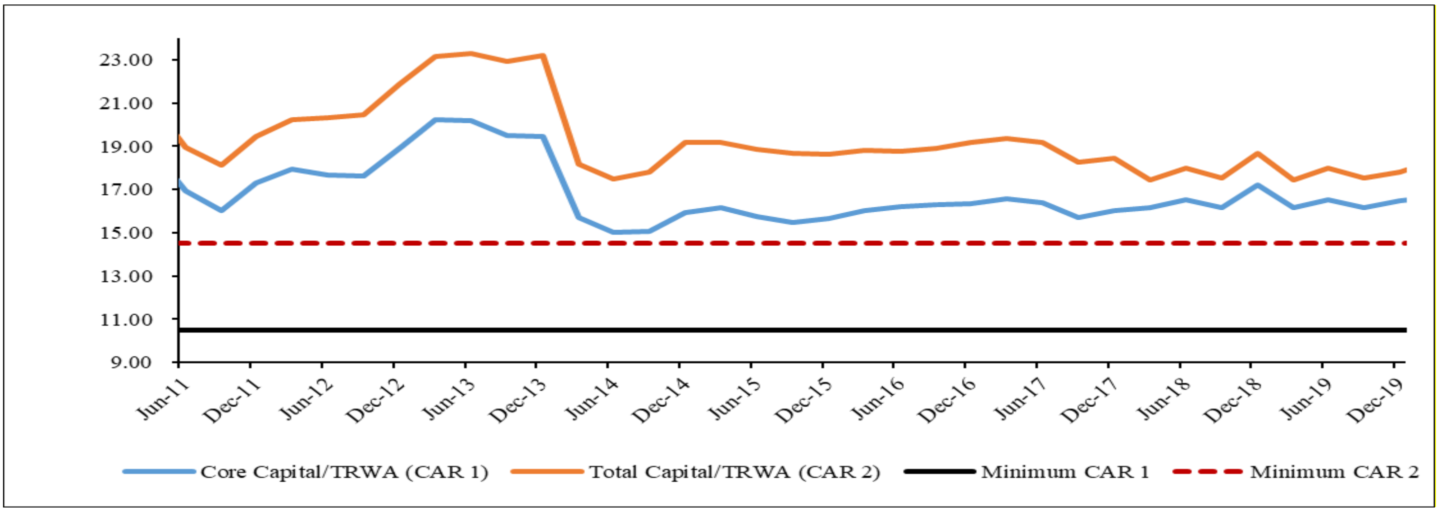



*Source: Central Bank of Kenya*

**The increase in loans to few sector increase concentration risks to banks, if the incident of slow economic growth affects severely sector that received a large proportion of total loans.**

**The banking sector remains resilient and adequately capitalized.** The with Core Capital and Total Capital to Total Risk Weighted Assets (TRWA) averaged 16.8 percent and 18.8 percent as at December 2019 from 16.6 percent and 19.5 percent respectively, this is above the regulatory requirements of 10.5 percent and 14.5 percent, respectively. However, growth rates of these ratios have been declining since June 2015, signalling either improved efficiency in the use of capital or overall capital erosion due to running down retained earnings and/ or reserves, slow build-up of reserves or increasing balance sheet risks manifested in increased provisioning amid increased losses among some banks. Tier II banks recorded the largest decline in capital in from November 2016. Tier II & III banks also recorded negative growth from April 2016 and to third quarter of 2017 (**Figure 21**).

**Figure 21: Quarterly Capital Adequacy Ratios (percent)**



**Assets quality of banks marginally improved in 2019 compared to 2018.** The ratio of gross NPLs to gross loans decreased to 12.01 percent in 2019 from 12.7 percent in 2018. However, the gross non-performing loans (NPLs) increased by 5.2 percent from KSh.316.7 billion in December 2018 to KSh.333.3 billion in December 2019 **(Table 7)**. Over the same period, coverage ratio, measured as a percentage of specific provisions to total NPLs, decreased from 44.7 percent in December 2018 to 43.7 percent in December 2019 meaning the banking industry is vulnerable in terms of withstanding future losses.

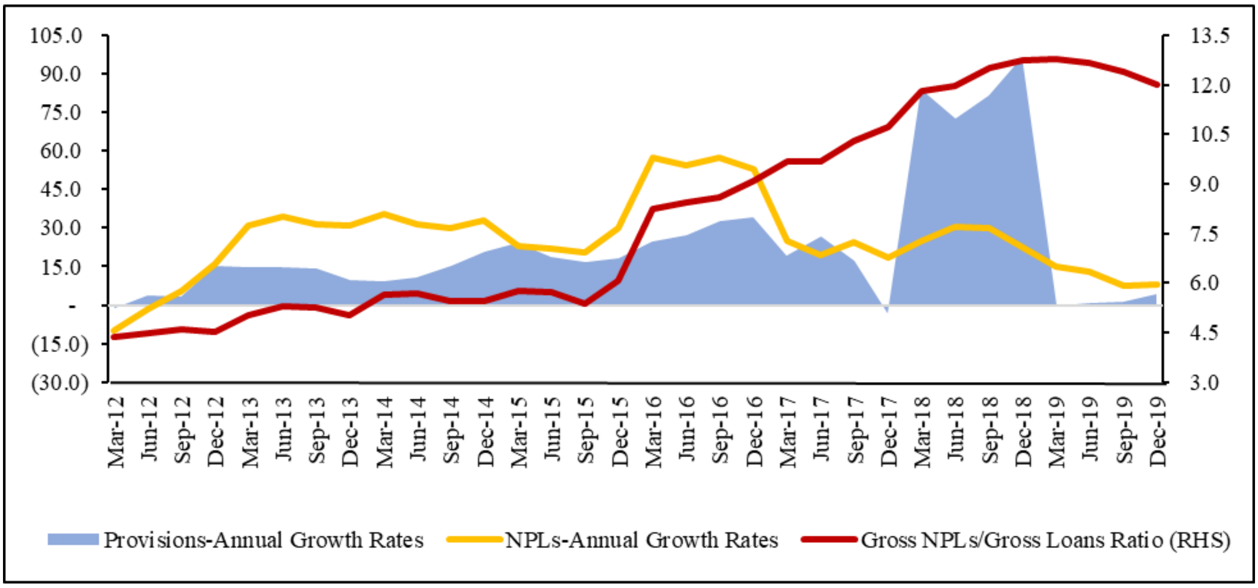
Table 3: Banks' Asset Quality

| | MEASURE | Dec. 2017 | Dec. 2018 | Dec.2019 | Change (%) |
|---|---|---|---|---|---|
| 1 | Net Assets (KSh Millions) | 4,002,741 | 4,408,593 | 4,832,348 | 9.61 |
| 2 | Gross Loans and Advances (KSh Millions) | 2,413,851 | 2,488,117 | 2,774,649 | 11.51 |
| 3 | Total Loans (KSh Millions) | 2,114,804 | 2,433,670 | 2,711,811 | 11.43 |
| 4 | Net Loans (KSh Millions) | 2,013,610 | 2,318,071 | 2,556.80 | 10.30 |
| 5 | Gross Non-Performing Loans (KSh Millions) | 264,617 | 316,712 | 333,393 | 5.24 |
| 6 | Interest in Suspense (KSh Millions) | 43,726 | 54,447 | 62,839 | 15.34 |
| 7 | Total Non-Performing Loans (KSh Millions) | 220,891 | 262,265 | 256,219 | 3.14 |
| 8 | Total Provisions (KSh Millions) | 101,193 | 115,599 | 154,966 | 34.08 |
| 9 | Net Non- Performing Loans (KSh Millions) | 119,698 | 146,666 | 152,423 | -0.21 |
| 10 | Net NPLs to Gross Loans (%) | 5.5 | 5.9 | 4.2 | -1.70 |
| 11 | Gross Loans /Net Assets (%) | 53.9 | 56.4 | 57.4 | 1.02 |
| 12 | Gross NPLs to Gross Loans (%) | 12.3 | 12.7 | 12.0 | -0.69 |

*Source: CBK*

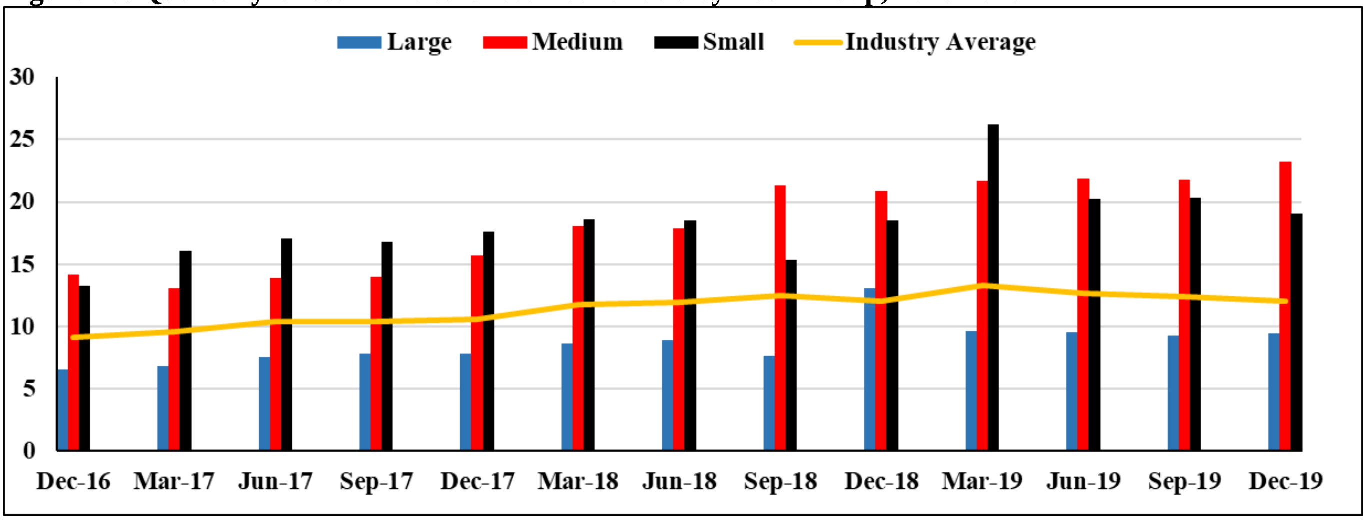
**The rapid growth rates in NPLs recorded in 2018 dissipated in second half of 2018 through 2019.** The ratio of gross NPLs to gross loans declined in 2019, indicating easing credit risk in the banking industry. Banks increased provisions for bad debts, to the highest level in 2018 after implementing IFRS 9 in January 2018. However, increase in provision for bad loans slowed in 2019 in tandem with declining credit risk (**Figure 22**).

**Figure 22: NPLs Trends against Provisioning Rates (percent)**




**Different business models and bank management influences propensity to accumulate risky assets, thus impacting quality of assets.** Banks in the medium peer group were the main drivers of Gross NPLs to Gross Loans ratio in the fourth quarter of 2019 compared to banks in Small and Large Peer Group categories (**Figure 23**).

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

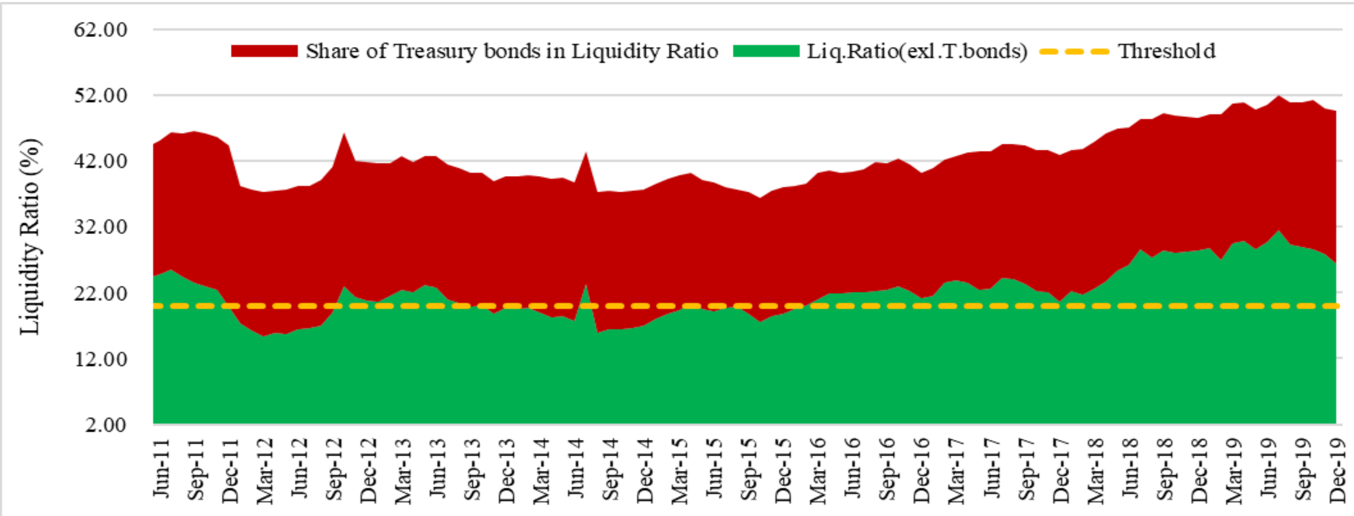


**NPLs developments reflected state of the overall economy between 2018 and 2019.** Trade recorded the highest increase of 60.2 percent (KSh. 38.4 billion) in NPLs between December 2019 due slowdown in global and domestic economic growth and delayed payment to suppliers of goods and services to Government. Real Estate sector with a 30.8 percent (KSh 25.37 million) due to slow uptake of housing units, while manufacturing NPLs amounted to KSh 23.03 billion due to increased competition from cheaper imports, slow growth and unconducive business environment. Personal/Household sector that recorded 15.4 percent (KSh 15.70 billion) increase in NPLs due to decline in personal disposable income.

The increase in NPLs amid slow growth in specific provisions has led to the decline the ratio of specific provisions to total NPLs to 46.11 percent in December 2019 from 48.6 percent in December 2018. This indicates that liquid assets meant to cover for NPLs have declined, thereby elevating liquidity risk emanating from deteriorating asset quality. Banks can ameliorate credit and liquidity risks by restructuring loan repayment and increasing the loan recovery efforts, while increasing specific provisioning and enhance resilience to NPLs shocks.

**Liquidity is key to banking industry stability,** signifying the ability to fund assets and meet obligations as they fall due. A liquidity problem in one bank can disrupt liquidity distribution in the banking industry due to the interconnected operations. In addition, a liquidity problem can degenerate into a solvency problem for a bank if not handled well. The average liquidity ratio for all banks increased to 49.7 percent in December 2019 from 48.6 percent in December 2018. This was way above the minimum regulatory requirement of 20 percent. If long term government bonds are excluded from liquid assets, liquidity ratio for the industry declines from 28.5 in December 2018 to 26.5 percent in 2019 (**Figure 24**).

**Figure 24: Banking Industry Liquidity Ratios (percent)**




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

**An efficient interbank market is effective in distributing liquidity in the banking sector. The interbank market enables banks with excess liquidity to lend to banks with short term liquidity shortages.** However, the intensity of transactions in the interbank market predisposes banks to contagion risk. The higher number of banks (5 to 6) that a bank will go through to secure liquidity indicates that distribution of liquidity in the interbank was constrained in June 2019, partly due to demonetization. The intensity of trading in the interbank market also reduced from 509 in December 2018 to 285 in June 2019. However, the distribution of liquidity in the interbank market improved in December 2019 compared to June 2019, as reflected by increase in the intensity of trading in the interbank (Table 6). The increase in the interconnectedness and intensity of transactions in the interbank market increases contagion risks if a dominant bank in the market is impaired to service its obligations when they fall due.

**Table 4: Interbank connectedness**

| | Nov. 2018 | Dec. 2018 | Jun. 2019 | Dec. 2019 |
|---|---|---|---|---|
| banks | 38 | 37 | 34 | 37 |
| Unique interbank transactions | 43 | 54 | 22 | 41 |
| Interbank transactions with Duplicates | 726 | 509 | 285 | 348 |
| Total transactions | 769 | 563 | 307 | 389 |
| Reciprocated Pair of transaction Ratio | 0.06 | 0.04 | 0.01 | 0.05 |
| Reciprocated interbank transactions Ratio | 0.12 | 0.08 | 0.03 | 0.10 |
| Connected Components | 1 | 1 | 1 | 1 |
| Single-Vertex Connected Components | 0 | 0 | 0 | 0 |
| Maximum transactions in a interbank network | 38 | 37 | 34 | 37 |
| Maximum of transactions in the network | 769 | 563 | 307 | 389 |
| Maximum transactions for isolated bank to get liquidity (Diameter) | 5 | 5 | 6 | 5 |
| Average Geodesic transactions | 2.13 | 1.95 | 2.41 | 2.27 |
| Density | 0.12 | 0.12 | 0.07 | 0.09 |
| Average degree | 8.16 | 8.22 | 4.59 | 6.05 |
| Betweenness centrality | 43.95 | 36.22 | 48.94 | 48.16 |
| Closeness | 0.01 | 0.01 | 0.01 | 0.012 |
| Eigen vector centrality | 0.17 | 0.27 | 0.03 | 0.03 |

*Source: Staff Computation*

**Profitability of the banking industry increased in 2019 compared to 2018.** Profit before tax increased by 5 percent from Ksh.152.7 billion in 2018 to 159.9 billion in 2019, explained by 50.7 percent, 3.8 percent and 10.8 percent growth in interest on placements, government securities and foreign exchange gains, respectively in 2019. In addition, increase in profitability is attributed to a higher increase in income of KSh. 22.9 billion compared to increase in expenses of KSh. 15.4 billion. Interest on loans and advances accounted for 49.2 percent of total income for banks. On the expenditure side, interest on deposits, salaries and wages, and other expenses accounted for 31.5,percent 25.4 percent 26.2 percent in 2019 compared to 33.1 percent, 25.0 percent and 24.6 percent of total expenses in 2018, respectively. This indicates that banks have increased investment in placements, government securities and foreign exchange at the expense of lending. Banks have also improved efficiency in their operations, which has reduced expenses.

The Return on Assets (ROA) by declined by 0.2 percentage point to 2.5 percent in December 2019, while The Return on Equity (ROE) declined to 21.2 from 22.5 percent in December 2018. The decline in profitability was recorded among all peer groups, especially the small banks, which had incurred losses in 2019 (**Table 8**).

Table 5: Banks' Profitability Indicators by Peer Group[2] in 2019

| MEASURE | Large Peer Group | Medium Peer Group | Small Peer Group | Industry Overall 2019 | Industry Overall 2018 |
|---|---|---|---|---|---|
| Profit Before Tax (KSh Millions) | 141982.87 | 17068.40 | 827.90 | 159879.17 | 152335.56 |
| Growth of profit before tax | 9.89 | -29.95 | -167.10 | 4.95 | 12.12 |
| ROA (percent) | 2.91 | 1.68 | 0.19 | 2.52 | 2.69 |
| ROE (percent) | 25.3 | 12.6 | 1.5 | 21.2 | 22.50 |

**Figure 25 a: Banks' Profitability ROA**

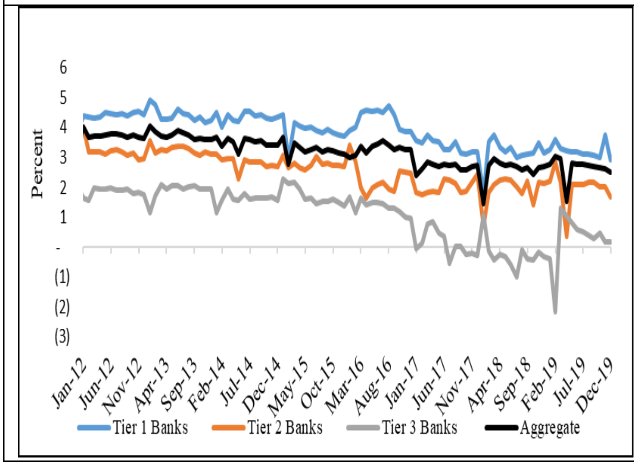
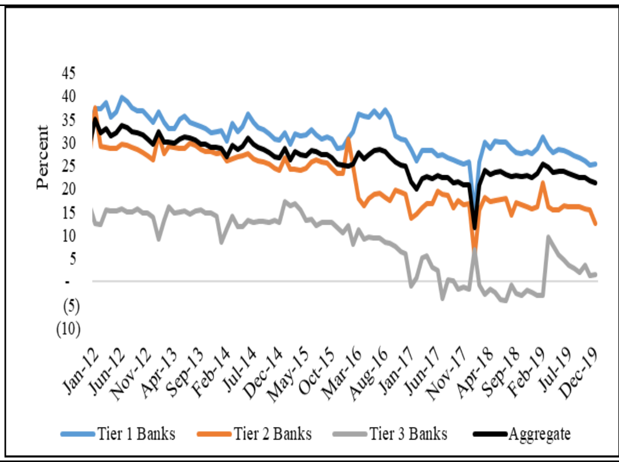


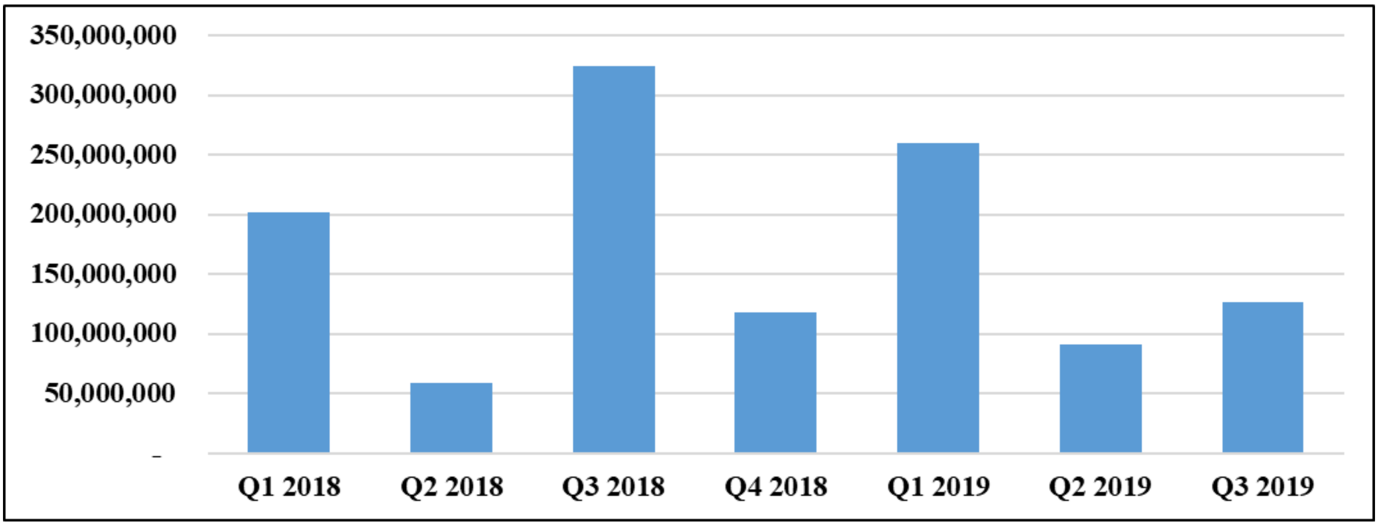

**Figure 25 b: Banks' Profitability ROA**




**Banking sector recorded decline in fraud and cyber-related attacks in the third quarter of 2019 (Figure 26).** Fraud incidences include; card fraud, cheque fraud, computer fraud, mobile banking fraud, online banking fraud, and identity theft. The third quarter of 2018 recorded the highest level of money lost through fraud in the banking sector followed by quarter 1 of 2019. A total of Ksh.126.5 million was lost in the third quarter of year 2019 down from Ksh.259.93 million lost in the first quarter of 2019. This decline is attributed aggressive measures by the banks and the law enforcement agencies as well as the banks improved fraud systems and processes.

### Figure 26: Losses due due to fraud

[2] As at December 2019, there were 20 banks in Small Peer Group, 10 banks in Medium Peer Group and 9 banks in the Large Peer Group.




*Source: CBK*

**The banking industry was resilient to credit, cyber and reputational risks, signifying resilience in 2019.** The most persistent risk in the year was persistent high NPLs, reflecting elevated credit risks. Delayed payments by governments to contractors and suppliers, unfavourable business environment as well as slow global economic growth especially among Kenya's major export destinations elevated credit risk. High exposure to government bonds by banks poses liquidity and bond repricing risks to banks. As at December 2019, government bonds accounted for 28.1 percent of total liquidity of the banking industry, 27.4 percent of total assets held by banks and 3.8 percent of total income. Increase interest rates or rapid implementation of fiscal consolidation would reduce profit and liquidity of banks.

Adoption of financial technologies by banks amid tightening of cyber security has reduce cyber risks. Banks have also tightened internal systems, customer sensitization, and undertaken ICT vulnerability assessments and penetration tests to mitigate operational risks. The industry was also exposed to reputational risks in 2019 as a result of not undertaking due diligence in effecting transactions linked to corruption, money laundering and terrorism financing. CBK has strengthened the AML/CFT risk assessment frameworks to address this risk.

The banking industry is expected to remain stable in 2020, due to large capital which will provide a sufficient buffer against asset impairment due to Corona Virus Pandemic. However, profitability and capital of some banks may not be resilient to the COVID-19 pandemic depending on the business models.

### 3.2. Capital Markets

The Capital Markets Authority (CMA) licensed entities as at December 31, 2019 included; Securities Exchange (1), Central Depositories (1), Investment Banks (16), Stockbrokers (10), Investment advisers (14), Fund Managers (25), Collective Investment Schemes (24), Authorized depositories/Custodians (19), Credit Rating Agencies (4), REIT Managers (9), REIT Trustees (3), Employee Share Ownership Plans (16) and Authorized Real Estate Investment Trusts (1).

**Table 6: Performance of Capital Market Licensees in 2018[3] (KSh Millions)**

[3] Figures as at October 2018

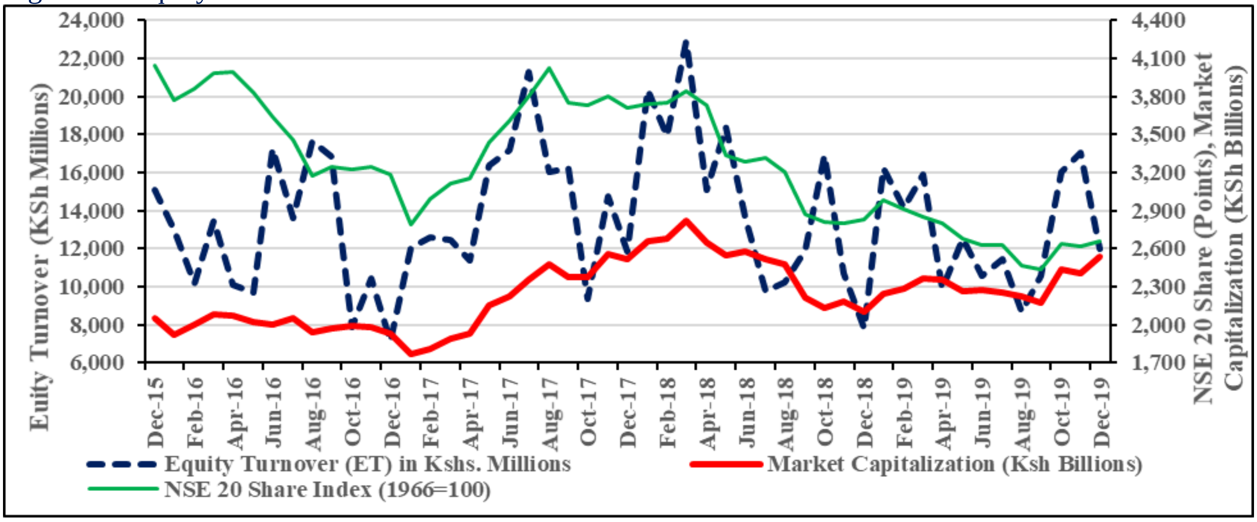
| Licensee | Total Assets | Total Liability | Net Assets |
|---|---|---|---|
| Fund Managers | 6,424.51 | 1,269.34 | 5,155.17 |
| Stockbrokers | 2,467.70 | 1,083.53 | 1,384.17 |
| Investment Banks | 16,529.67 | 5,779.76 | 10,749.91 |
| Investment Advisors | 1,805.09 | 199.96 | 1,605.13 |
| Online Forex Broker (Non-dealing) | 780.73 | 593.37 | 187.37 |
| Total 2019 | **28,007.70** | **8,925.96** | **19,081.75** |
| **Total 2018** | **23,697.77** | **5,527.84** | **18,169.92** |

*Source: CMA*

The industry licensees 'assets increased to KSh 28.00 billion in 2019 from KSh 23.70 billion in 2018, distributed as in **Table 9**. The CMA undertakes assessment of licensees to detect bankruptcy of as well as compliance with all reporting obligations.

**The slow economic growth in the global domestic economy due to trade tensions, geopolitical conflict and macroeconomic fragility in Kenya's main export destinations has stifled profitability of listed companies since 2018, leading to the decline in investing in equities.** The decline in the trading in equities that started in 2018 persisted in 2019. The equity turnover and declined from 175,657.35 to 154,857.53, while the NSE 20 Share Index declined by 179.45 points between December 2018 and December 2019. As a result, market capitalization declined from Ksh 29,551.57 KSh 27,831.25 (Figure 25).

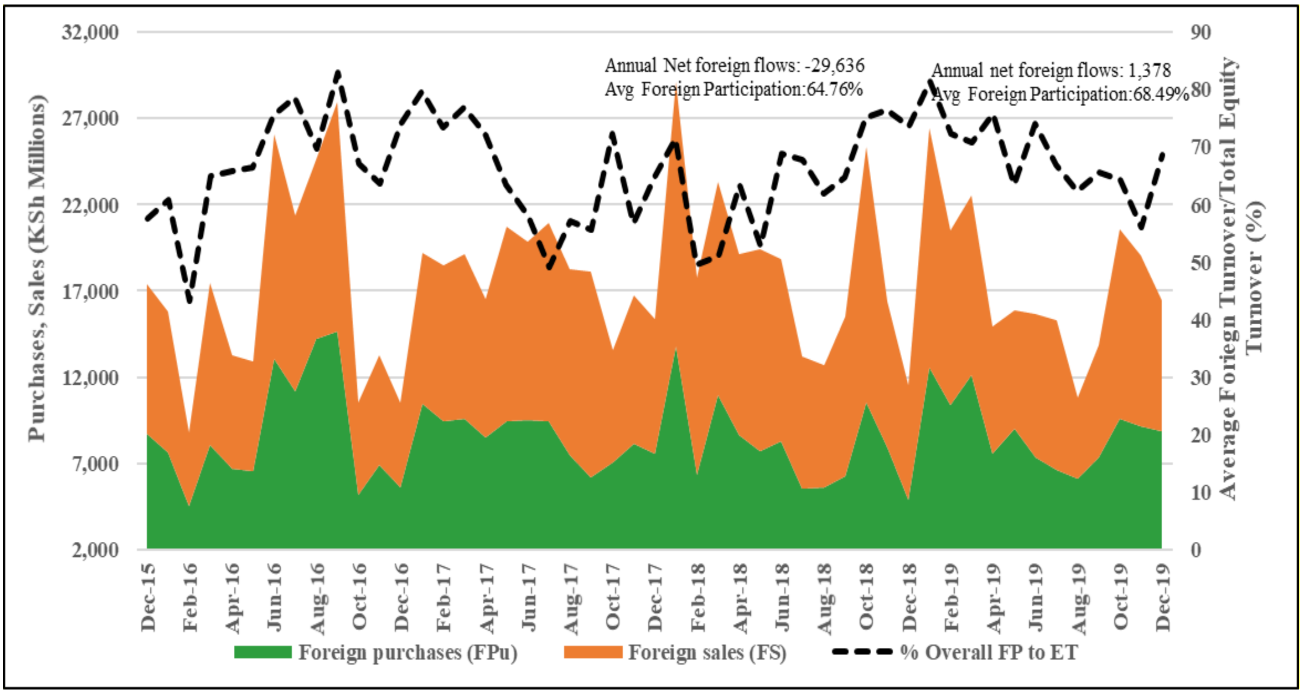
Figure 27: Equity Market Performance




*Source: Nairobi Securities Exchange, 2018*

**The foreign investors' trading activity on the NSE as indicated by total equity turnover increased to 68.5 percent in 2019 from 64.7 percent in 2018 (Figure 24). The foreign investors' trading** activity was more on the purchasing side (inflow). Equities held by foreign investors increased to 24.2 percent in December 2019, from 20.1 percent in December 2018.

**Figure 28: Foreign Participation Exposure (Equity) in KSh. Millions**




*Source: CMA*

**Liquidity of the equity market declined in 2019.** The liquidity ratio declined from 8.36 percent in 2018 to 6.10 percent in 2019 as a result of decline in equity prices as well as increase in volatility. The gazettement of the Securities Lending and Borrowing Regulations in 2017 to operationalize the lending and borrowing against securities and short selling have not improved trade in equities **(Table 10).**

Table 7: Market Liquidity Ratios

| Year | Equity Turnover (KSh Bins) | Market Cap (KSh Bns) | Liquidity Ratio (%) |
|---|---|---|---|
| 2013 | 155.75 | 1,920.72 | 8.11 |
| 2014 | 215.73 | 2,300.05 | 9.38 |
| 2015 | 209.38 | 2,049.54 | 10.22 |
| 2016 | 147.18 | 1,931.61 | 7.62 |
| 2017 | 171.61 | 2,521.77 | 6.81 |
| 2018 | 175.65 | 2102.00 | 8.36 |
| 2019 | 154.86 | 2,540.00 | 6.10 |

*Source: CMA*

**Risks in the capital markets include high concentration by top five companies and foreign investors, low liquidity, low products uptake, political and economic risks.** As at December 2019 the market concentration risk exposure of the top five companies by market capitalization increased to 70.89 percent compared to 65.82 percent in 2018. Safaricom accounted for 43.7 in 2019 percent of the total market capitalization compared to 42.31 percent in 2018. Foreign investors accounted for 68.49 percent of total equity turnover in 2019 compared to 63.28 percent in 2018**.** While it is beneficial to have significant presence of foreign investors in the local market, they can lead to excess volatility in case of abrupt sell-offs. The high level of foreign investor sell-offs in 2018 and 2019 was occasioned by trade tension among the advanced economies and emerging markets. The CMA has intensified domestic investor education to increase the share of domestic investors at the NSE.

The establishment of the derivative market has reduced volatility in the equity prices. Volatility in the NASI share price index averaged 0.55 percent in 2018 compared to 0.48 percent in 2019, while volatility in NSE 25 declined from 0.47 to 0.42. The derivatives market offers investors instruments to hedge against risk and uncertain income. As result, the derivatives market encourages investment in equity, which have variable income on the spot market.

The COVID-19 pandemic as well as containment measures are likely to impair the profitability of companies, due to disruption of supply chain, social distancing and human cost due to morbidity or death. This can distort pricing of securities on the capital markets and hence undermine the allocation of savings and hence investment. Corporate governance listed companies can also be impaired if the alternative work arrangement if the alternates are not competent. In addition, failure to hold Annual General meeting of Shareholders my weaken corporate governance.

However, the CMA has developed contingency plans to enhance business continuity of companies, NSE, and the Central Depository and Settlement Corporation (CDSC). The plans include, reactivating succession plans and enhancing the capacity of all staff to undertake allocated tasks at business premises and at home and allowing AGM and voting to be undertaking online or remotely. The CDSC is to ensure seamless settlement of securities traded at the exchange and the stakeholders have to deliver physical document by alternative channels to minimize physical contact.

### 2.3. Insurance Industry

**Penetration of insurance services in the economy as measured by the ratio of insurance premium to GDP reduced in 2019 to 2.39 percent from 2.43 percent in 2018, way below the global average of 6.1 percent (Table 11).** The industry however remains stable on enhanced regulatory framework by IRA (Amendment Act) No. 22 of 2017. This covers among others; group-wide supervision and harmonization of the Capital requirement provisions in the Insurance Act, Risk-based capital investment Guidelines, 2017 (L.N 37 of 2017), Capital Adequacy Guidelines, 2017 (L.N. 39 of 2017) and risk based supervision. The industry is expected to perform better in 2020 as the impact of these regulations take effect and the economy improves. Profitability of the insurance industry as indicated by ROA and ROE, increased in 2019 after decline for 4 consecutive years since 2014. The increase is profitability enables insurance companies to build buffers against shocks, thereby enhancing the resilience and viability of insurers.

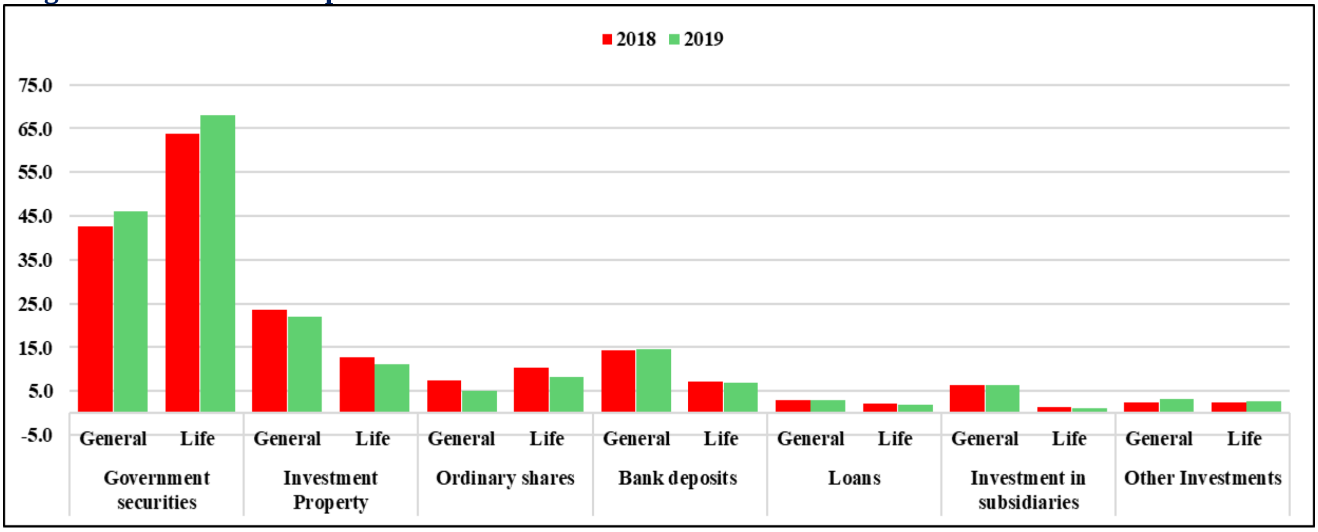
Table 8: Summary of industry performance during 2013-2018 (KSh Millions)

| Item | 2015 | 2016 | 2017 | 2018 | 2019* | Change |
|---|---|---|---|---|---|---|
| Gross Premium Income | 173,257,598 | 196,635,836 | 209,001,289 | 216,261,729 | 228,795,477 | 5.8 |
| Net Premium Written | 139,196,505 | 158,362,431 | 165,852,034 | 172,322,202 | 182,110,871 | 5.7 |
| Claims Incurred (General Business) | 49,051,411 | 54,857,495 | 56,151,961 | 56,928,003 | 57,600,528 | 1.2 |
| Commissions | 10,895,759 | 12,578,735 | 12,495,181 | 11,487,628 | 12,007,923 | 4.5 |
| Expenses of Management | 36,256,859 | 39,982,771 | 41,197,262 | 44,072,857 | 44,978,870 | 2.1 |
| Investment Income (P&L) | 6,737,813 | 6,017,766 | 51,675,571 | 44,514,367 | 62,293,534 | 39.9 |
| Operating Profit/Loss after Taxation | 13,635,096 | 18,249,270 | 13,642,971 | 7,269,263 | 9,089,345 | 25.0 |
| Investments | 390,225,358 | 403,261,887 | 483,799,656 | 524,237,249 | 592,763,691 | 13.1 |
| Assets | 478,752,457 | 528,748,193 | 590,953,337 | 635,035,110 | 705,546,218 | 11.1 |
| Shareholder's Funds | 125,830,031 | 134,455,222 | 147,255,007 | 149,134,602 | 163,764,340 | 9.8 |
| ROA | 3.8 | 3.6 | 3.2 | 1.8 | 2.4 | 0.6 |
| ROE | 11.4 | 9.9 | 9.7 | 4.9 | 7.0 | 2.1 |
| Combined ratio Gen Business) | 102.7 | 102.4 | 101.1 | 102.8 | 103.3 | 0.5 |
| Insurance Penetration Ratio | 2.75 | 2.71 | 2.68 | 2.43 | 2.44 | 0.0 |

*Source: IRA *Unaudited Data*

Life and Non-Life Insurers have similar business models and similar liabilities structure. To match their liability maturities, insurers tend to have similar asset allocations with small variations depending on size and diversification objectives (**Figure 28**).

**Figure 29: Portfolio composition of Life and Non-life Insurers**




As a result, the variation in the portfolio of life and non-life insurers is highly correlated, exposing the industry to risks. In addition, general insurance companies invest a larger proportion of their premiums in property compared to life insurance, yet general insurance claims are short term and hence investment in property may not be realized promptly when claims fall due. This predisposes general insurance companies to asset liability mismatch risks.

The COVID-19 pandemic presents the following risks to the insurance industry: attrition of talented and critical staff due to death arising from COVID-19 complication, non payment of premiums leading to cover lapsing cover, which can increase fragility of insurers due to erosion of capital. The insurers may not provide cover due to the event not occurring, and hence required to refund or suspend the cover. The insurance affected include travel insurance cover. This can expose insurers to reputational risk. The IRA has developed the following guidelines:

Insurers are to develop business continuity and contingency plans to ensure that services and operations are not impaired.

The insurers to grant life insurance policy holder a grace period of 3 months to pay premiums, without suspending the cover. The insurers are also to support brokers and agent by promptly paying fees and bonus. The measures deployed to ameliorate severity of COVID-19 increase expenses and can undermine the financial stability of insurers. The IRA has increased surveillance and directed insurers to undertake stress tests to assess the resilience of liquidity and capital to the impact of COVId-19.

## 2.4. Pensions Industry

The pensions industry assets recorded a growth of 11.29 per cent to reach a total of Kshs. 1,298.19 billion in December of 2019 as compared to KShs. 1,166.34 billion in December of 2018. This growth is attributable to consistent contributions to retirement benefits schemes and income realized from prudent investment of scheme funds. Equally, the pension industry has continued to develop and implement a number of policy and regulatory reform initiatives targeted at safeguarding retirement benefits funds through good governance and sound management of retirement benefits schemes. The industry assets were mainly concentrated in four asset classes; government securities, immovable property, quoted equities and guaranteed funds (Table 1). Fund managers and approved issuers held 90.42 per cent of the total pension assets. The remaining portion of the assets were internally managed by schemes including National Social

Security Fund (NSSF) that administered a total of Kshs. 57.16 billion internally[4]. Trustees of the various schemes also managed a total of Kshs. 67.18 billion of property investments internally[5].

Concerted efforts made to grow this industry have seen pension coverage rise to 22 per cent[6] of the total labor force in 2019 from 20 percent in 2018 with a majority of those covered being in the formal sector. Poor pension coverage of informal sector workers has shifted industry focus therein in order to boost pension savings among the informal sector workers with about four products already launched specifically targeting workers in the informal.

The pension industry has been relatively stable with the overall risk score at 3.09 in 2019 which is slight deviation from the score of 3.07 recorded in 2018 and below the desired overall risk score of 2.88 for the sector during the year. The below target achievement on the risk score was occasioned by absence of data on governance and market conduct parameters yet they had maximum score in the toolkit. Therefore, the overall risk score is expected to improve in the coming year once reliable data has been collected on the outstanding parameters.

**Table 9: Pension Industry Assets**

| ASSET CLASS | 2015 | | 2016 | | 2017 | | 2018 | | 2019 | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Value | % | Value | % | Value | % | Value | % | Value | % |
| Guaranteed Fund | 99.4 | 12.21 | 129.58 | 14.2 | 142.97 | 13.24 | 167.31 | 14.34 | 201.52 | 15.52 |
| Cash & Fixed deposits | 11.26 | 1.38 | 37.5 | 4.11 | 45.83 | 4.24 | 49.11 | 4.21 | 54.37 | 4.19 |
| Corporate Bonds | 48.09 | 5.91 | 46.95 | 5.14 | 41.99 | 3.89 | 40.28 | 3.45 | 17.8 | 1.37 |
| Quoted Equities | 186.81 | 22.95 | 159.07 | 17.43 | 210.17 | 19.46 | 201.51 | 17.28 | 228.12 | 17.57 |
| Fixed Term Deposits | 55.61 | 6.83 | 24.57 | 2.69 | 32.88 | 3.04 | 36.39 | 3.12 | 39.41 | 3.04 |
| Immovable property | 150.78 | 18.52 | 178.42 | 19.55 | 226.72 | 20.99 | 229.91 | 19.71 | 239.65 | 18.46 |
| Offshore investments | 7.16 | 0.88 | 6.96 | 0.76 | 12.77 | 1.18 | 13.13 | 1.13 | 6.32 | 0.49 |
| Other Assets* | 12.57 | 1.54 | 5.03 | 0.55 | 5.474 | 0.51 | 5.42 | 0.46 | 4.64 | 0.35 |
| Government Securities | 242.43 | 29.78 | 349.15 | 38.26 | 394.19 | 36.5 | 459.68 | 39.41 | 545.27 | 42 |
| **Total** | **814.11** | **100** | **912.66** | **100** | **1080.1** | **100** | **1166.35** | **100** | **1298.19** | **100** |
| **Risk Index** | 0.804 | | 0.524 | | 0.5087 | | 3.070** | | 3.095** | |

*Source: RBA* **risk-rating toolkit was revised in 2018 * Unquoted Equities, private equity, REITS, CPs (1), Non-listed bonds by private firms (2), unclassified asset classes (investments in Collective Investment Vehicles)

### 1.2 Developments in the Industry

The concentration of 94 per cent of pension assets in predominantly four investment asset classes; government securities, quoted equities, immovable property and guaranteed funds, exposes the industry to a number of risks. Investments in government securities and quoted equities are likely to suffer interest rate risks and market risks arising from fluctuations in the financial market caused by shocks in the economy. Likewise, investments in corporate bonds and fixed deposit are affected by interest rate risks and solvency risks. Scheme funds invested in immovable property, that is, buildings and land are likely to face liquidity risks occasioning untimely settlement of member benefits. In addition, scheme investments are also likely to face other market risks like inflation risk, currency (exchange rate) risk, and credit or counter party risk.

[4] This includes property amounting to Kshs. 43.73 billion, quoted equities Kshs. 9.15 billion; fixed deposits, Kshs. 768 million, Cash and demand deposits, Kshs. 3.18 billion, and unlisted shares, Kshs. 331 million.

[5] Internally managed property is investments in Property not reported by Fund Managers. The data of the internally managed property was extracted from the Schemes Financial Accounts for 2018. However, 2019 figures will be extracted once the audited accounts for 2019 are submitted.

[6] Provisional pending determination after from annual audited accounts for 2019.

Aside from investment risks, the industry also faces governance risks emanating from conflict of interest by either service providers, the trustees or the sponsor. To mitigate against such risks, a number of guidelines have been developed and some regulations reviewed from time to time by RBA. These guidelines are expected to regulate the conduct of trustees and service providers in the management of scheme funds.

During the year 2019, good governance guidelines and treating customers fairly guidelines were finalized and gazzetted thus allowing for commencement of their implementation. Equally, the Retirement Benefits Act was amended under section 37 to shorten the period allowed to exit from investment in a guaranteed fund to one year or less as provided in the exit clause of the deposit administration agreement. Section 45A of the Act was also repealed and replaced to provide for a procedure of transferring unclaimed retirement benefits to the Unclaimed Financial Assets Authority (UFAA) upon expiry of period of two years from the completion of winding up proceedings in respect of a scheme under the Act.

In addition, RBA also amended a number of regulations during the period under review including those which allowed members in Umbrella Retirement Benefits Schemes to make contributions for post-retirement medical funds and ensure preservation of benefits contributed by the employer for the member until attainment of retirement age, emigration, or on medical grounds. In addition, regulations relating to occupational and individual schemes were amended to provide for distribution of reserves to exiting members where a scheme has a reserve fund.

The outlook of pension industry in the year 2020 is expected to slowdown due the effects of COVID-19 pandemic that has ravaged global economies occasioning substantial loss of value assets hence affecting pension assets particularly those invested in stocks like equities, corporate bonds and offshore as well as those investments in the general economy. A number of employers have either closed operations or laid off employees hence impacting on contributions and may occasion withdrawals from schemes. The loss in contribution is estimate to be more than KSh 250 billion. Annual general meetings and training of trustees under the Trustee Development Training Program Kenya, which improve the quality of governance in the pension industry have been postponed due to the COVID-19. The RBA has also post postponed filling of annual report due march 30 for 60 days and granted a waiver of penalties accrued.

The mitigation measures will enhance the resilient of the pension industry during the pandemic, without encouraging noncompliance in the future. This is because, the waivers of penalty and compliance requirements are time bound and are also granted based on level of exposure, but not uniform across the industry.

## 2.5. SACCOs Industry

**The growth rate of Sacco industry in terms of assets and deposits decelerated in 2019 compared to 2018.** Total assets increased by 11.79 percent compared 12.55 percent and in 2018. Large Saccos with asset base of more than KSh 5 billion account for 70.1 percent of the total asset. Total deposit increased by 11.33 percent in 2019 compared to 11.50 percent in 2018The growth of deposits slowed due to high cost of living and decline in Tea and coffee prices which reduced ability of members to save. This reduced the ability of Saccos to increase loans because, 70.5 percent of assets are financed using deposits, while external financial and capital constitute 4.10 percent and 25.33 percent, respectively. The quality of assets also deteriorated with NPLs to gross loans ratio increasing from 6.13 percent to 6.16 percent.

**Table 10: Saccos Indicators (KSh. Million)**

| Stability Indicator | Prudential Standard | 2017 | 2018 | 2019 * |
|---|---|---|---|---|
| **Capital Adequacy** | | | | |
| Core Capital (KSh Millions) | | 64,254 | 78,267 | 86,323 |
| Core Capital/Total Assets (%) | 10 | 14.53 | 14.46 | 15.53 |

| | | | | |
|---|---|---|---|---|
| Core Capital/Total Deposits (%) | 8 | 21.05 | 21.01 | 22.65 |
| Institutional Capital/Total Assets (%) | 8 | 8.18 | 8.03 | 9.08 |
| **Asset Quality** | | | | |
| Non-Performing Loans to Gross Loans (%) | | 6.14 | 6.13 | 6.16 |
| NPLs (Net of Provisions)/Core Capital (%) | | 9.90 | 10.94 | 8.53 |
| Earning Assets to Total Assets (%) | | 78.50 | 81.20 | 81.96 |
| **Earning Rating** | | | | |
| Return on Assets (%) | | 2.69 | 2.72 | 3.71 |
| Non-Interest Expenses/Gross Income (%) | | 43.99 | 42.64 | 41.29 |
| Operating Expenses/ Total Assets (%) | | 5.29 | 4.90 | 4.89 |
| **Liquidity Rating** | | | | |
| Liquidity Ratio (%) | >15 Percent | 54.1 | 54.82 | 50.84 |
| Liquid Assets to Total Deposits (%) | | 17.17 | 16.13 | 17.77 |
| External Borrowings/Total Assets (%) | <25 Percent | 4.83 | 4.46 | 3.98 |
| Liquid Assets to Total Assets (%) | | 11.85 | 11.10 | 12.18 |
| Gross Loans/Total Deposits (%) | | 108.49 | 109.03 | 110.36 |

Source: *SASRA*

**The slow growth in deposit and increase in expenses slowed the growth in profitability of Saccos.** Net income of Saccos, decelerated from 15.31 percent in 2018 to 13.97 percent in 2019. Despite, asset quality and profitability reducing, Sacco's, retained earnings to build buffers against credit and market risks. As core capital to assets increased to 15.53 percent for 14.46 percent, between 2018 and 2019 (Table 13).

**Despite Saccos, enhancing capital buffers to absorb shocks, they face a number of risks.** The slow global economic growth and weakness in Tea and Coffee export destinations led to a reduction in prices by 25 percent and 35 percent in 2019. This reduced tea and coffee earnings, as a result agriculture based Saccos, experienced a decline in deposits and quality of assets. In bid to increase lending to members amid slow growth in deposits Saccos borrowed externally. This compressed Net interest margin.

**The advent of Management information systems (MIS) has enabled Saccos, to improve quality of services and reduce fraud, on the one hand.** However, MIS systems cannot be afforded by small saccos, especially those in rural areas. The small Saccos cannot afford audit services to enhance governance, which has stifled their growth. On the other hand, the adoption of MIS system without adequate controls and reliance on external vendors to provide MIS services has increased fraud in Saccos. The SASRA has encouraged Saccos to create a pool of deposits, from which Saccos with insufficient liquidity can obtain funds to finance loans to members to reduce external financing. small Deposit Taking Saccos facing technological risks due to inadequate infrastructure and capacity to mitigate cyber risks. The Authority has developed a framework for developing shared infrastructure and required Saccos to invest in building capacity of staff in information technology and cyber security. The authority has also discouraged Saccos from relying on vendors of MIS to provide basic ICT services.

## 2.6. Deposit Insurance

**Deepening financial inclusion has contributed to the increase in the number of deposit accounts and the volume of deposit. Kenya Deposit Insurance Corporation (**KDIC) provides a deposit insurance scheme for customers of member institutions licensed by the Central Bank of Kenya as deposit taking Institutions. As at 31st December, 2019 there were 55 member institutions comprising of 41 commercial Banks, 1 Mortgage Finance Company and 13 deposit taking microfinance banks.

The total number of deposit accounts with the member institutions increased to 63.37 million in 2018 from 45.140million in 2018. The level of exposure reduced from 66.71 percent in 2018 to 62.42 percent in 2019, while share of protected accounts increased to 97.55 percent, which are the fully protected accounts as per International Association of Deposit Insurance (IADI) principle 8. Of the total deposits of KSh.3.55 trillion in 2019, KSh. 281.337 billion was fully protected in 2019, accounting for 7.9 percent of deposit value, way below the recommended proportion of 20 percent by IADI. The deposit protection fund increased from KSh 86.08 billion in 2017 to KSh 100.15 billion in 2018, to cover 33 percent of total exposure (**Table 15**).

Despite the fund capable of covering only 7.97 of total liability deposits, it continues to instil confidence among depositors, hence the increase in the value of liability deposit and accounts. The increase in deposits as well as number of accounts is due to confidence instilled in depositors. The increase in deposits enhances stability and liquidity of financial institutions, which enables them to effectively undertake financial intermediation. KDIC expect to increase protection level to the IADI recommended ratio of 20 percent.

Table 11: Growth of the Fund, Insurance Cover and Deposits.

| Row | Year | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | % Change* |
|---|---|---|---|---|---|---|---|---|
| 1 | Total Deposits (KSh Bns) | 2,384.72 | 2,673.95 | 2,783.72 | 3,075.82 | 3,385.20 | 3,605.53 | 6.51 |
| 2 | Total Insured (KSh Bns) | 224.87 | 244.65 | 255.54 | 272.08 | 269.74 | 285 | 5.72 |
| 3 | Protection Level (Row2/Row1) % | 9.43 | 9.15 | 9.18 | 8.85 | 7.97 | 7.91 | -0.06 |
| 4 | Fund Balance (KSh Million) | 52.17 | 61.66 | 73.25 | 86.08 | 100.15 | 115 | 14.88 |
| 5 | Effective Cover (Row4/Row2) % | 21.80 | 22.25 | 25.85 | 29.55 | 33.28 | 40.35 | 7.07 |
| 6 | Total no. of accounts ('000s) | 30.7 | 37.35 | 43.25 | 49.94 | 57.32 | 65 | 12.89 |
| 7 | Accounts fully covered (KSh. M) | 29.55 | 36.1 | 41.83 | 48.37 | 55.85 | 63 | 13.05 |
| 8 | Protected accounts (Row7/Row6) % | 96.27 | 96.63 | 96.73 | 96.85 | 97.43 | 97.56 | 0.13 |
| 9 | Exposure Level (100% - Row 5) % | 78.20 | 77.75 | 74.15 | 70.45 | 66.72 | 59.65 | -7.07 |

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

## 2.7. Financial Markets Infrastructure

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

**The RTGS activities increased slightly in 2019 compared to 2018 in terms of volume and value of transactions**. KEPSS processed 4.97 million worth Ksh 32.52 billion in 2019 compared to a volume of 4.59 million transaction messages worth Ksh 29.57 billion in the year 2018 **(Table 16).**

Table 12: KEPSS System Flows

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

| | | | | |
|---|---|---|---|---|
| 2018 | 29,566 | 1.33 | 4,589,256 | 4.84 |
| 2019 | 32,520 | 9.99 | 49,701,43 | 8.30 |

*Source: Central Bank of Kenya*

EAPS and REPSS processed 9,949 and 646 transactions respectively, while the value of transactions in declined to USD 345.4 millions and increased to USD 43.9 millions, respectively in 2019. The increase in value and volume of transactions reflects increased trade in the EAC and COMESA regions as well as confidence in the payment system (**Table 17**).

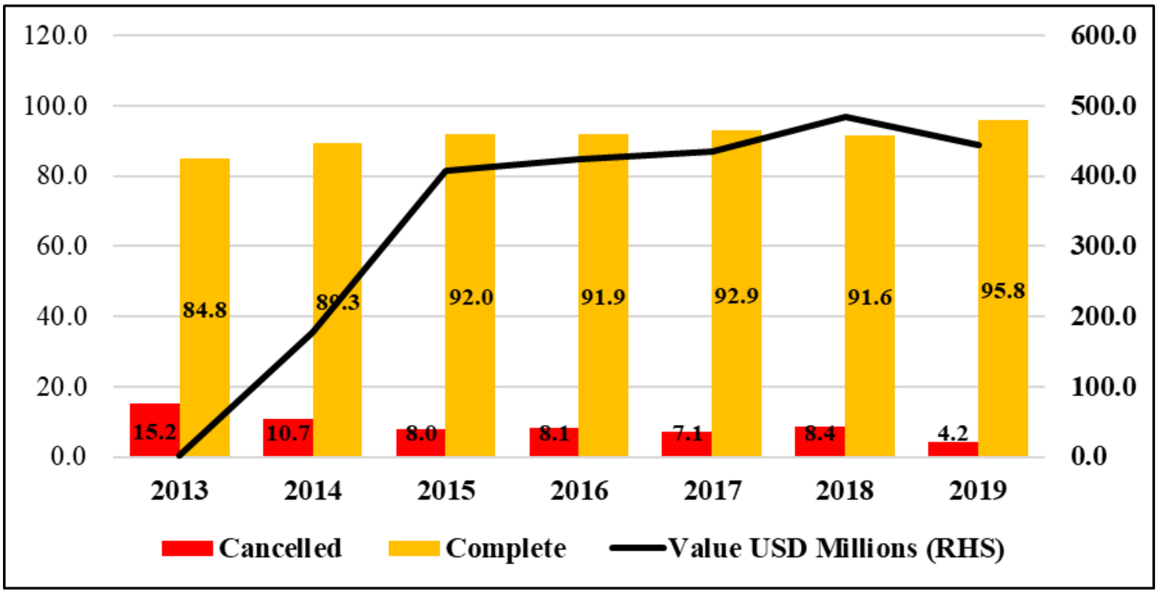
Table 13: EAPS and REPSS transactions

| | EAPS | | REPSS | | |
|---|---|---|---|---|---|
| YEAR | Volumes | Value in USD (Mns) | Volumes | Value in USD (Mns) | **Value (EUR) '000s'** |
| **2014** | 4,977 | 178.1 | 10 | 0.35 | - |
| **2015** | 9,263 | 407.1 | 257 | 6.95 | 119.79 |
| **2016** | 10,933 | 424.2 | 161 | 7.24 | - |
| **2017** | 15,303 | 434.6 | 262 | 13.38 | 10.5 |
| **2018** | 18,307 | 484.6 | 620 | 42.92 | 5.71 |
| **2019** | 28755 | 443.8 | 646 | 43.91 | |

The ability of an RTGS system to settle payment without or minimal payment risk is an essential component of the financial infrastructure of an economy. In 2019, RTGS was available 100 percent compared to an optimum of 99.99 per cent availability due to upgrade of RTGS in 2018.

The value of transaction cleared through the East A payment system declined in 2019. This could be partly attributed to transaction being undertaken through alternative platforms and the decline in trade in the region. However, efficiency of the system has been improving since 2013 as indicated by the number of transaction cancelled declining from 12.2 percent to 4.2 percent in 2019 (Figure 30).

**Figure 30:Efficiancy of EAPS**




*Source: Illustration using Payments data from CBK*

Banks did not manage liquidity through the KEPSS 2019. However, banks borrowed KSh 50.2 million in 2018 compared to KSh 2.6 billion in 2017. The decline in overnight loans by banks through the KEPSS in 2018 reflects an improvement in the liquidity of the banking sector.

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

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

**The ACH activity increased in terms of value and volume, by** 0.84 percent and 3.34 per cent respectively **in 2018 compared to 2017 (Table 16).** The increase in value and volume of cheques and EFTs through the Clearing House can be attributed to preference for cheques to settle retail payments due to reduced clearing cycle from T+3 to T+1. Banks and merchants dominate electronic payment card market. There were 17.9 million active cards in 2018; processing 191 million payments valued KSh 1.39 trillion in 2018 up from KSh 1.35 trillion in 2017. POS terminals rose from 35,466 units in 2017 to 44,874 units while ATMs usage grew by 8 in 2018, signalling more uptake of plastic money. (**Table 18**).

Table 14: Payment Cards Usage

| End December | No. of Cards | No. of ATMs | No. of POS Terminals | Transactions Volume | Transactions Value (KSh Million) |
|---|---|---|---|---|---|
| 2015 | 13.2 | 2,718 | 22,230 | 20.1 | 121,821 |
| 2016 | 14.8 | 2,658 | 30,133 | 21.6 | 121,423 |
| 2017 | 15.4 | 2,825 | 35,466 | 19.1 | 124,844 |
| 2018 | 17.9 | 2,833 | 44,874 | 19.1 | 125,877 |
| 2019 | 11.5 | 2,459 | 42,846 | 19.7 | 64,750 |
| **Change (%)*** | **-35.75** | **-13.20** | **-4.52** | **3.14** | **-48.56** |

*Source: Central Bank of Kenya *Growth between 2019 and 2018.*

Mobile money continues to deepen financial inclusion. The number of agents increased from 2,239,310 to 224,108 while value transacted grew by 9.1 percent in 2019 compared to 9.5 percent in 2018 **(Table 19)**. The number of active subscribers to mobile money services and the average value of mobile money per transaction increased, signifying higher intensity of utilising mobile money services in 2018. Central Bank also supported Mobile Network Operators (MNOs) by facilitating introduction of interoperability within the Mobile Payment Service, thus enabling money transfers across MNOs customers, hence reducing the need for multiple mobile money subscriptions.

Table 15 Mobile Money Transfers

| Period (January – December) / Year | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 |
|---|---|---|---|---|---|---|
| Number of agents | 123,703 | 143,946 | 165,908 | 182,472 | 2,239,310 | 224,108 |
| No. of Active Mobile money accounts (millions) | 24 | 27 | 32 | 31 | 32 | 23 |
| No. of Mobile money transfer accounts (million) | 26 | 29 | 35 | 37 | 48 | 58 |
| No. of mobile money transactions (million) | 911 | 1,114 | 1,331 | 1,544 | 1,740 | 1,839 |
| Total transactions value (KSh. billion) | 2,372 | 2,816 | 3,355 | 3,639 | 3,984 | 4,346 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Average value per transaction (KSh) | 2,603 | 2,527 | 2,521 | 2,357 | 2,290 | 2,363 |

*Source: Central Bank of Kenya and Communications Authority of Kenya*

# CHAPTER 4: SAFETY NETS IN FINANCIAL SECTOR

## 4.1 Background

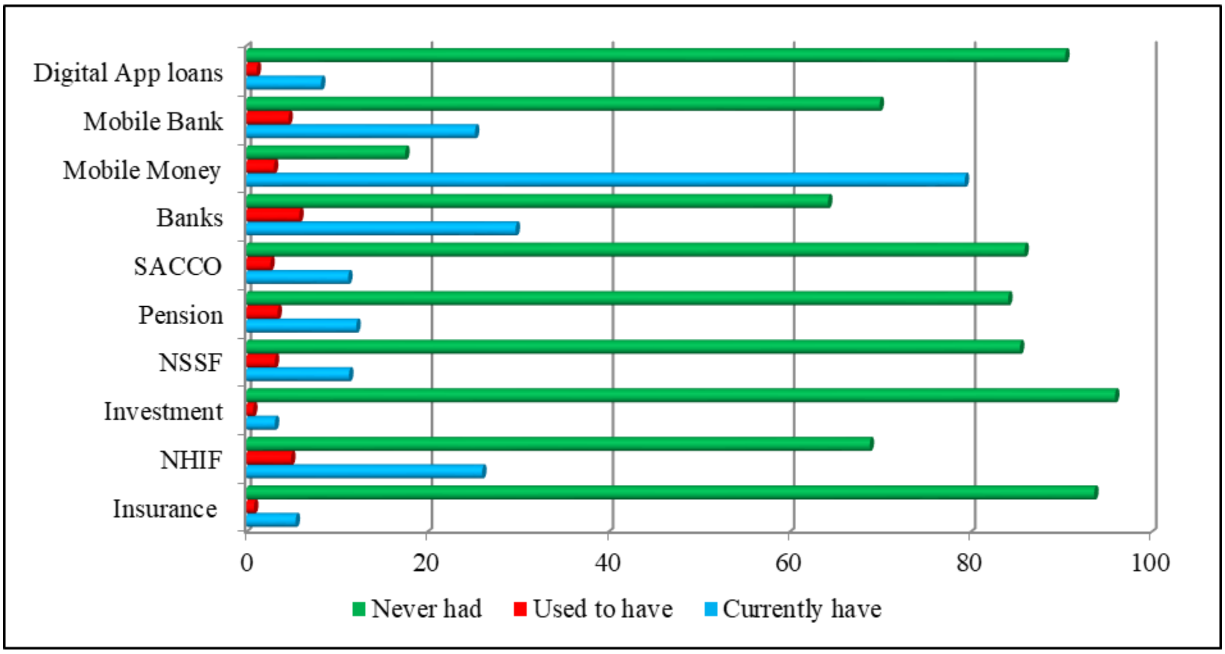
**The Vision 2030 recognizes the role of the financial sector in mobilising saving for investment to achieve and sustain a 10 percent annual economic growth target.** Therefore, fostering a vibrant, competitive and stable financial sector to increase access and utilisation of financial services is critical to achieving Vision 2030. Whereas financial inclusion increased rapidly between 2006 and 2019, fragility of the financial sector increased as reflected in placement of banks, insurance companies, Saccos and stock brokers under statutory management or in receivership. In addition, financial institution have not been sensitive to dynamic needs of financial services consumers as well as building a robust system for addressing grievances or losses that arise from consuming financial services. This reduces confidence of individuals and firms in using financial services and also viability of financial institutions. It is against this backdrop that the financial sector regulators are enhancing safety nets to mitigate the adverse effects arising from the financial sector.

**Safety nets are measures and institutions, which mitigate adverse and unintended outcomes from providing or consuming financial services. The safety nets reduce vulnerabilities and losses arising in consuming financial services, thus fostering improvement in income households and financial stability of institutions. However, strong safety nets can encourage excess risk taking, which is detrimental for the growth and development of the financial sector. Therefore, safety nets have to be complemented with better regulation and supervision to mitigate moral hazard problem.**

## 4.2 Utilisation of financial services and challenges

Access to formal financial services in Kenya has increased to 82.9 percent in 2019 compared to 75.3 percent in 2016 and 26.7 percent in 2006 thus, reducing the financially excluded population by over 30 percent since 2006 (CBK, FSD, KNBS, 2019). The increase in access to financial services has also increased utilization of financial services. In addition, the adoption of financial technology is driving rapid uptake of innovations such as mobile banking, agency banking, internet banking, mobile applications and digital finance (Figure 29).

**Figure 31: Usage of Financial Products in Kenya (%)**




*Source: 2019 FinAccess Household Survey*

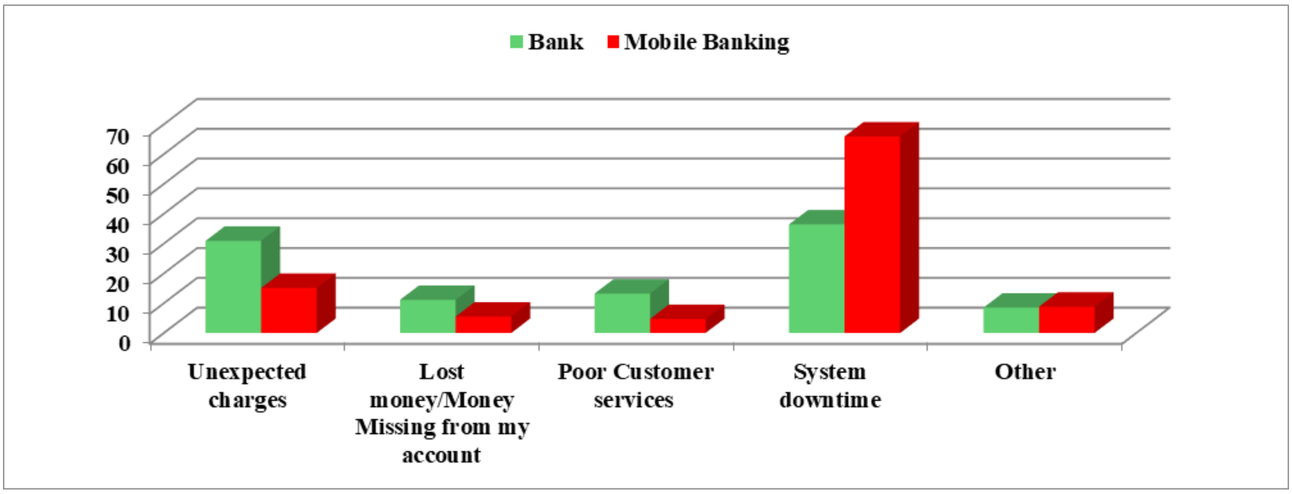
Financial institutions especially banks have leveraged on technology to provide banking services. As a results, utilization of conventional banking services declined marginally in 2019 to 29 percent from 31.7 percent in 2016, while a combination of conventional banking and mobile banking increased from 34.4 percent in 2016 to 40 percent in 2019. This is mainly due to convenience and low cost of utilizing digital banking services.

Despite gains in utilizing financial services, investment in stocks, shares and mutual funds declined from 10.3 percent in 2016 to 3.2 percent in 2019. Similarly, insurance, pension and SACCO usage declined from 6 percent, 12.2 percent and 12.9 percent in 2016 to 12.2 percent, 5.5 percent and 11.3 percent in 2019, respectively. This could be attributed to the failure to leverage on new technology and over reliance on the formally employed population. However, NHIF subscription increased from 21.2 percent in 2016 to 26.1 percent in 2019, due to Government campaigning for NHIF to provide universal health cover.

The increase in utilization of financial services has increased vulnerability of households and financial institutions. The likelihood of debt distress, losing deposits, and savings as well an unfair practices such as lack of transparency in pricing financial products, hidden charges and service down times have increased. The vulnerability of financial services consumers has also been accentuated by digital financial services, due to the ease of accessing digital credit (CBK, FSD, KNBS, 2019).

The biggest challenge reported by users of banking and mobile banking services is system downtime. This inhibits transactions occasioning losses to businesses and individuals. The regulators have issued guidelines on the establishing and enhancing system continuity infrastructure such as redundant backup systems to mitigate interruption of services. The persistence of the system downtime indicates that the back up systems to ensure business continuity have not been implemented.

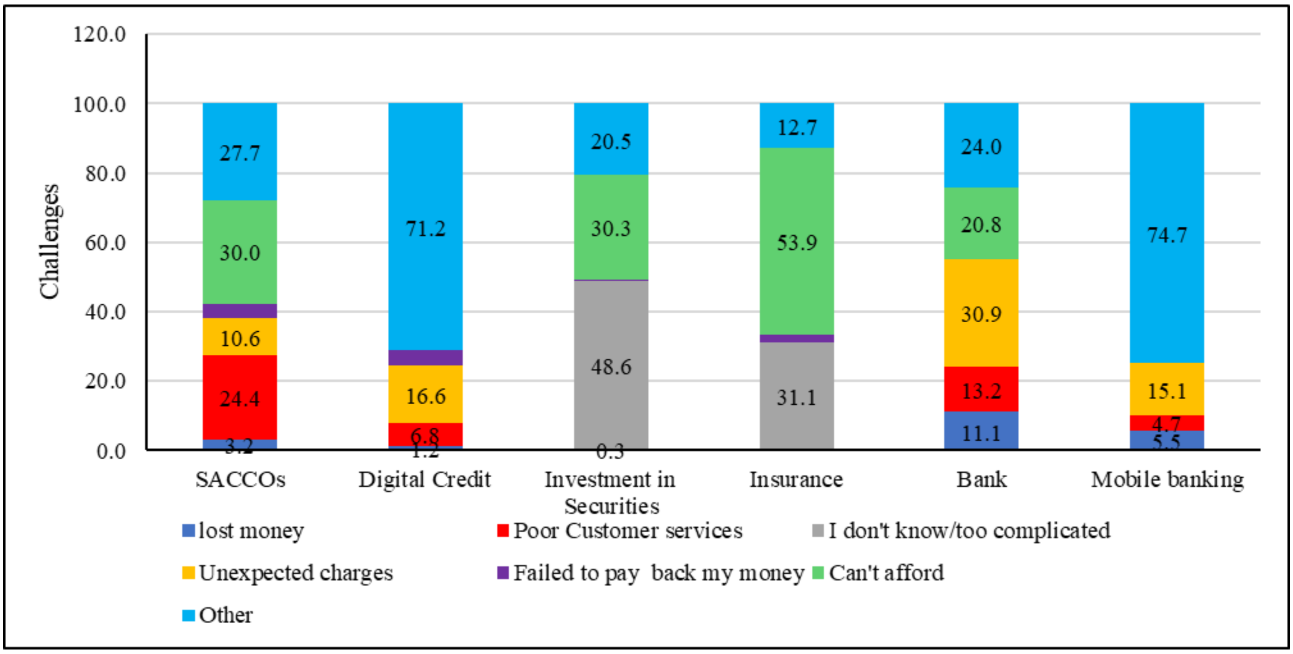
**Figure 32: Traditional and Mobile Banking (%)**




*Source: 2019 FinAccess Household Survey*

Banks have also not been transparent in pricing services. As a result, 30 percent and 15 percent of consumers of conventional and mobile banking services, respectively lost their money to banks due to unexpected charges. Transparency in pricing of financial services is one of the tenets of financial intermediary because they hold deposits instruct  and lend with due deligence. The weaknesses in adhering to integrity in pricing and providing information on financial services has prompted the development of banking charter on ethical banking. Failure to provide information on financial services, lack of transparency in pricing and poor services has reduced propensity to use banking services. For example, 21 percent of the respondent could not afford banking services and 15.7 percent did use banking services because they did not have regular income. Other bank related impediment to using banking services are preferences for other services to banks, lack of trust, minimum balance and long queues discourage people from using banking services.

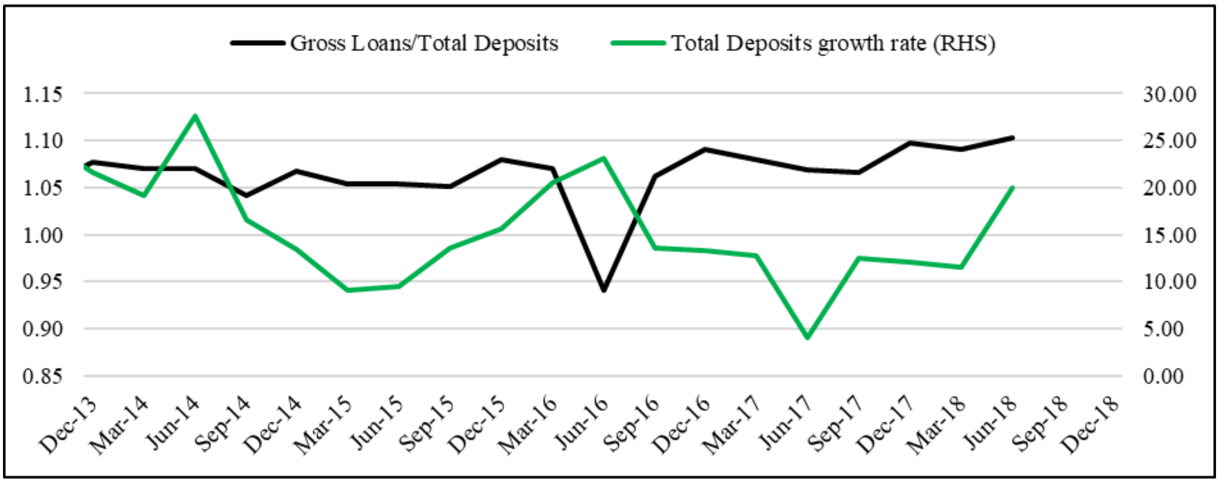
**Figure 33: Supply side constraint to utilization of financial services (%)**




*Source: 2019 FinAccess Household Survey*

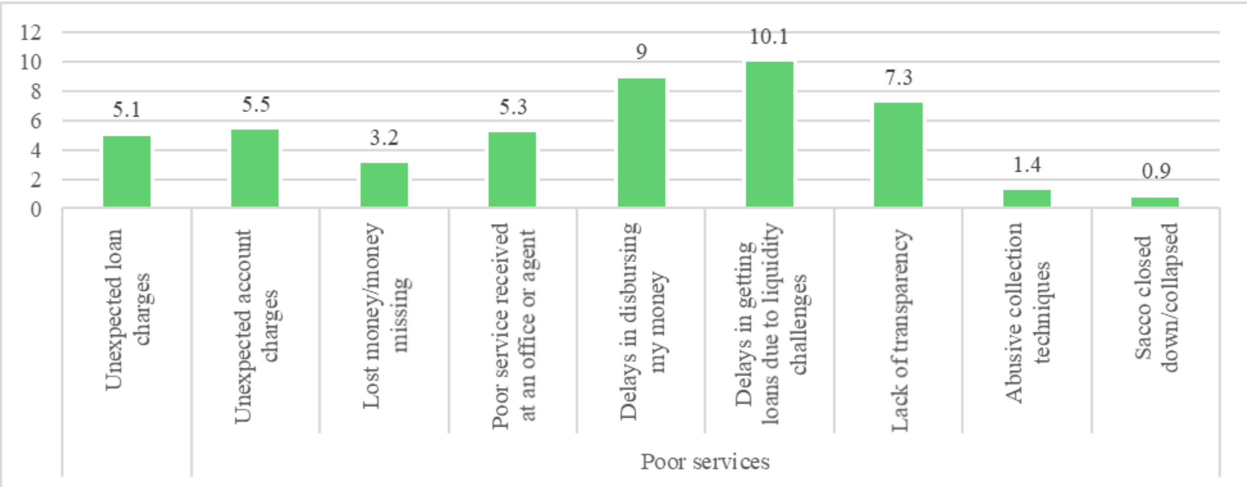
The Saccos subsector received an impetus after the establishment of SASRA. This is because the Authority provided a regulatory framework that safeguards deposits and refocuses intermediation activities to be in the best interest of members. This has increased confidence of the public to join the Sacco movements, thereby increasing deposits, which are then used to finance assets.

**Figure 34: Growth of deposits and assets of SACCOs**




However, delays in disbursing money and loans discouraged respondents from joining a Sacco. Transparency in pricing of services accounted for 10.6 cases, which is higher than failing to disburse deposit or loans within expected time. The complains are aggravated by poor services at the agent or offices

**Figure 35: Challenges for using SACCO services (%)**




*Source: 2019 FinAccess Household Survey*

The closure of Sacco accounted for one percent of the reason of not utilizing Sacco services. This indicates that the resolution mechanism was not sufficient to protect the deposits. Robust resolution regimes enable deposits to continue saving even after the Sacco is liquidated.

The uptake of insurance services in Kenya is not only low at 5 percent but also declining. The ratio of insurance premiums to GDP declined from 2.42 percent in 2018 to 2.41 percent in 2019. This is lower than 10 percent average of lower middle income countries. This indicates that the uptake of insurance services is lower compared to the risks that households and firms are predisposed to.

According to the 2019 FinAccess survey, approximately 80 percent of the adult population excluded from the insurance market cited either cost of insurance, limited knowledge on insurance and where to get it, as the greatest drawback to insurance uptake. This emphasizes the need to address the issue of affordability of insurance services which was mentioned by 53.9 percent of the respondents as a main barrier (Figure 30).

Lack of knowledge and high cost of participating in the stock market has also stifled investment in securities to remains low 3.2 percent. Similar to insurance, 73.83 percent of the non-investors cited limited income and limited financial knowledge about investment in securities. About 11 percent however never saw the need to invest in securities, which also could be associated with inadequate knowledge on securities (Figure 30).

One of the recent innovations that have elicited interest from the financial sector is the rapid increase in the uptake of digital app loans which averaged 8.3 percent up in 2019 up from 0.6 percent in 2016. This increase could be attributed to regulatory arbitrage from prudential lender to digital lending, where there is no regulation. Users cited unexpected charges related to the loan and listing in the credit reference bureau accounted for 13.52 and 13.26 percent, respectively. Unsolicited messages, fraud and explained deductions are also prevalent (Figure 30).

Finance services that deprive individuals their income, undermine improvement household welfare and growth in income. Financial services consumers in most cases cannot enforce their rights, because, the amount involved per capita is small, even though on aggregate the losses could be large, the cost of seeking redress could be higher than the financial loss and some consumers may not be aware of the loss. Therefore, there is need to regulations and financial safety nets to protect the vulnerable financial services consumers.

## 4.3 Financial Safety Nets

**Safety nets in the financial sector protect consumers of financial services against loss emanating from financial transactions, distressed institutions as well as enforcing rules to enhance financial stability.** Financial safety nets cushion financial service providers and consumers against losses, hence they provide insurance against risk taking behavior of the private sector. However, safety nets that exceed risks encourage excess risk taking, which could undermine stability of the financial sector and the economy[7]. Whereas, consumers have become more informed about financial services they consume, mobile money losses, rising debt distress, insolvent financial service providers raise the need for consumers to be more informed on the use of financial services and the need to strengthen social safety nets for financial services. The need for financial service providers to improve services to meet financial needs of consumer without undermining financial stability and welfare of households and the adequacy of the financial sector safety nets have become even more pertinent for a sustainable financial sector to enable realisation of the *Vision 2030.*

### 4.3.1 Deposit Insurance Fund

**Deposit insurance has become an increasingly used tool by governments in an effort to ensure the stability of banking systems and protect depositors from incurring large losses due to bank failures[8].** Although there are implicit or explicit deposit insurance regimes in most countries, the United States, OECD countries and European Union have adopted explicit deposit insurance due to its ability to protect all depositors in case of a crisis (Garcia, 2000). The United States was the first country to adopt an Explicit Deposit Insurance Scheme (EDIS) in 1934 following a banking crisis.

The EDIS is a rule based system which explains the main ingredients of the deposit insurance such as the beginning date, coverage limits, how (if any) they are going to be funded, and how bank failures will be resolved. On the other hand, an implicit protection system operates under an ambiguous protection system where conditions and limits are to be negotiated during the failure process (David, Michael and Ulrich, 2006). Emerging markets have also adopted the explicit deposit insurance following the development of a code of best practice by the IMF in 1997 and the establishment of the International Association of Deposit Insurers at the Bank of International Settlements (BIS).

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[7] https://elibrary.worldbank.org/doi/abs/10.1093/wbro/15.1.69

[8] http://documents.worldbank.org/curated/en/593131468330040612/text/wps36280rev.txt

One of the principal objectives of the Kenya Deposit Insurance Corporation (KDIC) is to provide a deposit insurance scheme for depositors of member institutions. Deposit insurance is considered to be beneficial in protecting consumers who are deemed incapable of adequately assessing the riskiness of depository corporations by reducing the uncertainty about the safety of deposits. The insurance of deposits is paid as a proportion of liability deposits to depositors of bank or deposit-taking institutions. The Kenya Deposit Insurance Act of 2012 require each deposit placed with an institution to be insured, provided that the maximum amount payable to a customer in respect of the aggregate credit balance of any deposit accounts maintained by the customer with the institution does not exceed one hundred thousand shillings or such higher amount as the Corporation may from time to time determine.

The KDIC has however increased the insurance coverage for depositors to KSh 500,000 up from KSh 100,000 to boost confidence in the banking sector. In Kenya, the number of insured deposit accounts increased to 97.56 percent in 2019 from 97.43 percent in 2018. The effective cover which is expressed as a ratio of the fund balance to the total insured improved from 33.28 percent in 2018 to 40.35 percent in 2019. This has reduced the exposure of deposits by 7.07 percent. Although banks currently pay premiums to KDIC at a flat rate of 0.15 per cent of their total deposits in a year, the KDIC is preparing to adopt a risk-based model which will see high risk and unstable lenders paying more.

**Table 16: Growth of the Fund, Insurance Cover and Deposits**

| Insurance premium | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | % Change* |
|---|---|---|---|---|---|---|---|---|---|
| Banks | 1,934.6 | 2,294.3 | 2,615.7 | 2,952.7 | 3,546.2 | 3,923.0 | 4,157.7 | | |
| Non-Bank FIs | 25.4 | 28.3 | 35.4 | 40.6 | 50.4 | 59.9 | 58.4 | | |
| DTMs | 12.9 | 16.5 | 24.8 | 39.2 | 55.5 | 60.8 | 60.1 | | |
| **Total Insurance Premium** | **1,972.9** | **2,339.1** | **2,675.9** | **3,032.5** | **3,601.7** | **4,042.6** | **4,276.1** | | |
| Total Deposits (KSh Bns) | | | 2,384.7 | 2,674.0 | 2,783.7 | 3,075.8 | 3,385.2 | 3,605.5 | |
| Total Insured (KSh Bns) | | | 224.9 | 244.7 | 255.5 | 272.1 | 269.7 | 285 | |
| Protection Level (Depsits/insurance) % | | | 9.4 | 9.2 | 9.2 | 8.9 | 8.0 | 7.9 | -6.00 |
| Fund Balance (KSh Million) | | | 52.2 | 61.7 | 73.3 | 86.1 | 100.2 | 115 | 14.88 |
| Accounts fully covered (KSh. M) | | | 29.6 | 36.1 | 41.8 | 48.4 | 55.9 | 63 | 13.05 |

*Source: KDIC, 2019*

**Where a depositor owns more than one deposit account with an institution, the aggregate of those deposits are insured in respect of the consolidated amount to the prevailing maximum amount.** Despite these efforts, the insurance premium and fund for compensating depositors very and declining compared to value of liability deposits in financial institutions. The value of deposits covered declined from 9.4 percent in 2014 to 7.9 in 2019, which lower than the 10 percent recommended by International Association of Deposit Insurers (IADI). The total liability deposit grew by 10.1 percent in 2018 and 2019, while the insurance cover for deposit decelerated by 1 percent. This indicates that the effective cover is not only but also declining, exposing deposits to losses. The insurance premiums are also low to augment the sufficiency of the compensation fund.

According to IADI effective deposit insurance should be governed by the following IAD principles: coverage, funding, powers, membership, transitioning from blanket to limited coverage and prompt reimbursement[9]. Hence, migration to risk based premiums on deposits an increasing deposit cover will enhance effective protection of deposit. However, mitigating excess risk taking by depository corporations who may invest the funds in risky assets knowing that there is sufficient insurance for deposit may be difficult.

A vibrant insurance sector can be a financial sector safety net by allowing consumers of financial services to insure against losses. However, the uptake of insurance services has been declining. As a result the capability of insurance sector to smoothen losses and benefits has been declining**.** This is partly because of

[9] https://www.iadi.org/en/core-principles-and-research/core-principles/

the slow pace of claim settlement by the insurer and insolvency of some insurance companies with customer premiums prior to the year 2005. This led to the establishment of the Policyholders Compensation Fund (PCF) in January 2005, now the Insurance Amendment Act 2019. The main objective of the Fund is to provide compensation to policyholders of an insurer that has been declared insolvent and boost public confidence in the insurance sector. The fund also plays a complementary role in the financial service sector; through consumer protection and promotion of market stability[10]. The Insurance Regulations, 2019 on Kenya's PCF allows for compensation of policyholders of any distressed insurance firm that has not been liquidated. Further to that, the law now removes insolvency of the insurer as a condition for compensation of claimants. Policy holders of collapsed or distressed insurers will now be paid KSh 250,000.

Despite the establishment of the fund, the insured are either poorly compensated or not compensated at all leaving them exposed when insurance firms collapse. Some of the issues affecting its success include; rigorous and lengthy compensation claim procedures as well as processes of winding up an insolvent insurer which often give rise to unending legal and administrative delays. The fund collects contributions for the sole purpose of compensation of policyholders. The beneficiaries of the fund are policyholders and not the insurance companies. By contributing to the fund, the policyholders are meeting their statutory obligation of ensuring that they will be compensated should their insurer be declared insolvent. In terms of the fund management, 10% of the total contributions received are allocated to the administration of the fund. The balance of 90% is invested in Government Securities like Treasury Bills to earn interest.

### 4.3.2 Savings/ Deposit Guarantee Fund (DGF)

**SACCOs have continued to make investment decisions on behalf on their members.** The risk of loss of member contribution can be more pronounced if the investment decision is not well thought out. The reliance on the SACCOs for savings and investment also result to loss of savings due to conflict of interest, weak governance and mismanagement by the directors. This calls for robust regulation of the SACCOs to minimize risks and ensure that investment decisions made by the SACCOs on behalf of their members are prudent as well as deposit insurance scheme to ameliorate loss of deposit. The Sacco Societies Regulatory Authority (SASRA) has already established a Deposit Guarantee Fund (DGF) to provide protection of SACCO deposits up to KSh 100,000.

Similarly, the savings guarantee fund in other jurisdictions like Belgium guarantee that consumers can recover their assets on the whole of current accounts, savings accounts and term accounts up to at least 100,000 euros per person and per institution[11]. A savers compensation fund is recommended for non-deposit taking SACCOs to ensure all financial investments for depositors are insured to ameliorate loss of savings. The Sacco Societies Act requires all deposit taking credit institution to contribute to the deposit guarantee fund from which depositors and policy holders will be compensated incase of collapse.

### 4.3.3 Investor Compensation Fund (ICF)

**The year 2007 and 2009 witnessed the collapse of a number of stock brokers including;** Francis Thuo and Partners Limited and Discount Securities Limited eroding investor confidence due to loss of millions of investor funds. The 2009 CMA Statistical Bulletin reveals a sharp drop in the shareholding of foreign investors from 33 percent in 2003 to 8 percent in 2008. The recent collapse of Chase bank, Imperial Bank, Uchumi,

[10] http://erepo.usiu.ac.ke/handle/11732/208;jsessionid=A185E116E11126AAC7FEE9C766F78392

[11] http://www.rkenneylaw.com/savings-insurance-is-protected-by-the-guarantee-fund/

among others in the last decade exposed investors to huge losses. In view of this, the establishment of an investor compensation fund is critical in ensuring the protection of investments in the stock market.

The Capital Markets Authority (CMA) have developed mechanisms for cushioning investors against unexpected losses. The Investor Compensation Fund (ICF) is established under the Capital Markets Amendment Act, 2018 Cap 18 Section 1. The ICF rules and regulations provides that every investor who suffers pecuniary losses from failure of a licensed stock broker or dealer to meet contractual obligations receives upto KSh 50,000 in compensation. The maximum compensation for claimants is based on international best practice and availability of funds. Other measures expected to protect investors include review of market intermediaries and phased implementation of risk-based supervision (RBS) of market intermediaries. Most countries rely on the member's contributions to replenish the fund although there are other sources which include; admission fees, risk based quarterly contributions and additional contributions incase of a deficit. The European Union compensation fund is governed by the 1997 Directive of the European Union.

### 4.3.4 Regulatory framework to enhance Safety Nets in the financial sector

Even though the KDIC provide insurance cover on deposit liabilities in banks and deposit taking SACCOs, their, depositors and borrowers are still susceptible to supply side constraint that undermine access to quality financial services. This has prompted the CBK and SASRA to develop regulations and Memoranda of understanding to emphasis the to provide customer centric services. For example The CBK **pursuant to Section 33(4) of the Banking Act and Section 48(2A) (6) of the Microfinance Act developed a Banking Sector Charter (BSC) in 2019,** which empowers the CBK to issue directions on responsible and disciplined banking sector cognizant of, and responsive to, the unique socioeconomic realities of the Kenyan populace. This is also in response to a perception that the high profitability of banks is associated with high cost of credit, and the need for banks to prioritise long term environmental, social and governance issues when conducting financial intermediation.

The charter[12] is founded on the following pillars:

i. Adoption of customer-centric business models by banks;
ii. Risk-based credit pricing;
iii. Enhanced transparency and information disclosure; and
iv. Entrenching an ethical culture in banks – doing the right thing.

**The Charter represents a commitment from lenders to be responsible and disciplined to enhance a market-driven transformation focused on providing services that benefit Kenyans.** The charter is also concerned with driving ethical banking by commercial and microfinance banks through provision of training for MSMEs on record-keeping, how to improve their risk profiles, build collateral and improve their credit scores, among other important lessons.

**The launch of the cost of credit web portal in June 2017 highlights the commitment by the Kenya Bankers Association (KBA) and the CBK to enhance transparency in pricing and reporting the cost of credit.** The web portal is to information all banks with respect to internal and external fees for all products to enable customers make rational financial decisions. The Credit Reference Bureaus (CRBs) are also in the forefront to ensure banks apply credit risk pricing models. Other measures taken to enhance fairness and transparency in pricing of bank products include; risk based credit scoring techniques in loan screening processes. This helps in differentiating potential borrowers by the risk they carry rather than lumping them together.

[12] https://www.centralbank.go.ke/wp-content/uploads/2018/08/Proposed-Kenya-Banking-Sector-Charter-2018.pdf

**The Consumer Protection Guideline and Consumer Protection Act, 2012, also require institutions to publish key fact** statements of all their products on their respective websites and places of business. These include:

i. Complaints handling and consumer recourse mechanisms - An institution, on receiving a complaint, shall provide the complainant with a prompt written acknowledgement within 48 hours and resolve the complaint in 7 working days.
ii. Terms and conditions of their products including, but not limited to, allowance of cooling off period, customer complaint processes, protection of consumer data and privacy.

## 4.4 conclusion

The gains financial inclusion has also elevated vulnerability of consumer of financial services to losses, poor quality services and unfair pricing. However, protection of consumer financial services enhances uptake of financial services and increases stability of financial institution. This enable financial institution to effectively intermediate funds, thereby accelerating growth and improving welfare. Kenya has enhanced financial sector safety nets and developed institutional framework to address unintended consequences of providing and consuming financial services. However, the financial sector safety nets are not sufficient and need to be reformed to effectively protect consumers of financial services in a dynamic financial sector.

Reforms in the financial safety nets should be informed by the structure of the financial sector such as private and public institution, propensity to take risk, and the pace at which the financial difficulties are resolved. The existing safety nets should be reformed to take into account of risks emanating from technological, global and financial sophistication and contagion risks. This is also important in lowering moral hazard which may emanate from increased risk taking behavior by the private sector and resource misallocation.

## CHAPTER 5: RISKS OUTLOOK AND PROSPECTS IN 2019

Kenya's financial sector will be resilient in 2020 albeit emerging risks and vulnerabilities associated with both domestic and global uncertainties and the COVID-19 Pandemic. In particular, these emerging risks and vulnerabilities will remain elevated in the near-term due to global recession, precipitated by COVID 19 pandemic and trade and geopolitical tensions. The decline in economic activity and commodity prices will spill-over to the domestic economy. The invasion of desert locust and excess will accentuate growth in agricultural output.

The global risks may persist with respect to:

- All countries currently face the unprecedented threat of a simultaneous global health crisis, economic recession and financial meltdown associated with COVID-19 pandemic, whose end and intensity is unknown.
- Global trade tensions between United States of America (USA) and China on one hand, USA and Europe and Britain and European Union, could affect Kenya's economy and the financial sector.
- Persistent geopolitical tensions including between USA and Iran as well as North Korea coupled with wars and unstable governments in major Kenya's export destination such as Pakistan and Sudan, could escalate risks to the economy and the financial sector.
- Tightening of global financing markets volatilities/ meltdown from their current conditions, either in the near term or medium term.

Downside risks in Sub-Saharan Africa (SSA) are real and emanate from global economy uncertainties, asset price volatility and trade and geopolitical tensions. These include:

- The COVID-19 pandemic will greatly reduce Africa's GDP growth in 2020 and calls for Governments, private sector, and development institutions need to double their efforts and resolve to safeguard economies and livelihoods across Africa. SSA and EAC growth outlook is expected to ….
- Delays in implementing policy adjustments would reduce fiscal space, adversely impacting the economies through crowding out of the private sector.
- Commodity dependent economies may be affected more.
- Higher external market premium for sovereign bonds due to changing investor sentiment, a tightening of global monetary conditions, and a further drop in commodity prices.
- Sovereign downgrade risks could further weigh on the investment climate and adversely affect growth, particularly in South Africa, with potential regional spillover effects, to SADC and EAC countries. In the medium term, risks are skewed to the downside.

In the domestic front, downside risks and vulnerabilities are associated with:

- Uncertainty in the domestic economy outlook due to the unpredictability of the intensity and duration of Covid-19 Pandemic.
- Desert locust invasion that may pose a threat to the food security and agricultural sector, which may worsen the agricultural sector bank asset quality.
- Diminishing fiscal policy space and accumulation of debt to unsustainable levels.
- Weakness in the financial sector governance, thus increasing operational, cyber security, fraud and anti-money laundering and combating the financing of terrorism (AML/CFT) risks.
- Potentially slow growth in private sector credit due to weak corporate and household balance sheets.

- Slow pace of credit risks easing, which may slow down the speed of credit growth to support accelerated investments.
- Increased use of informal and Digital App financial service providers may increase household risks with implication on financial stability.

Despite these downside risks and vulnerabilities; opportunities, however, exist that will mitigate any potential emerging threats, including:

- The policy responses to contain the effects of COVID-19 on the economy, firms balance sheets and peoples' livelihoods such as through both monetary and fiscal policies.
- In a dramatic post COVID-19 pandemic turn, the collapse agreement between OPEC and some non-OPEC oil exporters caused global demand-supply imbalances and depressed prices, which may dampen the trade effects on the domestic economy.
- Continued public infrastructure investment and completion of on-going projects may support growth, with positive effects on financial sector stability.
- Adoption of appropriate technologies and innovations supported by both private-public sector incentives, which may continue post COVID-19 pandemic.
- Enhanced efforts to deal with weak governance and economic crimes concerns.
- Increased surveillance to stem dumping of cheap and sub-standard imports, to strength domestic production and create employment.

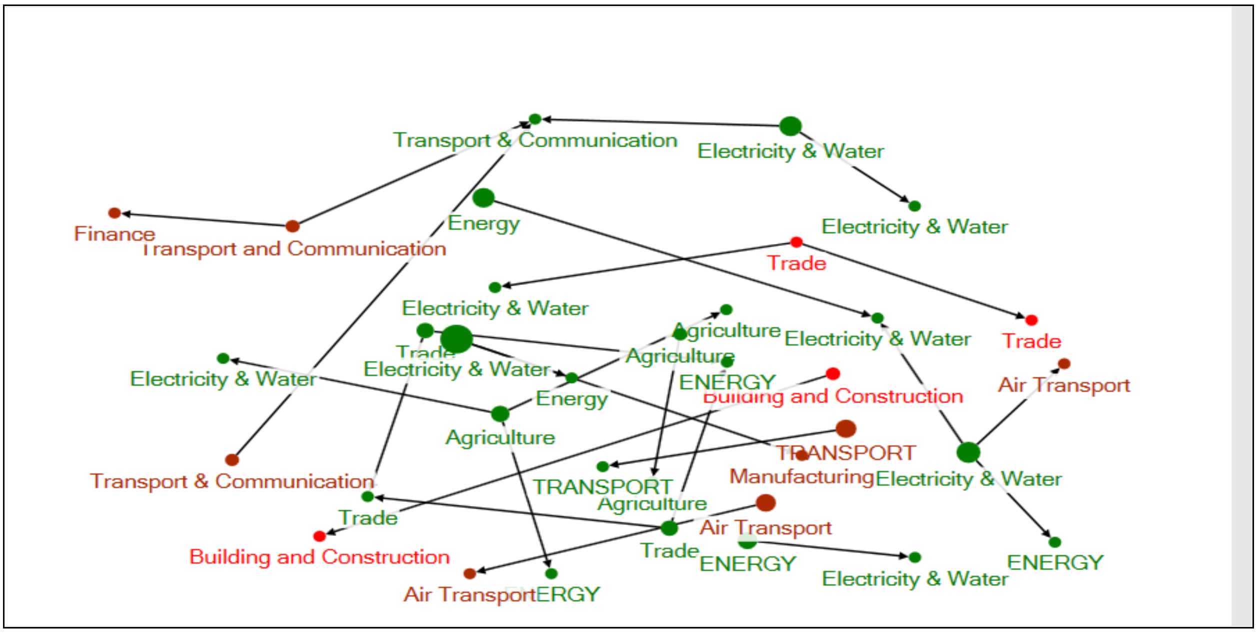
In a nutshell, the financial sector is expected to remain stable in 2020 despite elevated threats and risks that will wane in the fourth quarter as normalcy returns after the global health crisis (COVID-19 pandemic), normalisation in the financial markets.

**CHAPTER 6: CORPORATE PERFORMANCE AND FINANCIAL SECTOR STABILITY**

State Owned Enterprises (SOEs) provide goods and services the private sector may not provide efficiently due to externalities in the production and consumption of the goods and services. State corporations implement government policies and supplement private sector in providing goods and services, that are essential for enhancing productivity of the economy as well as mitigate volatility in prices of goods. The role of state owned enterprises has even become more pertinent in implementing government policies in the advent of increase in inequality amid faster growth and liberalisation of economic activities[13]. In this regard, SOEs are critical in achieving Vision 2030 in various sectors.

However, the effectiveness of State owned enterprises in implementing government polices depends on their financial viability, especially with liberalization in the economy. The Inspectorate of State Enterprises recognizes the importance of financial soundness of parastatals. Consequently, the inspectorate, Auditor General and the Public Service commission has developed guidelines to enhance corporate governance and prudent utilization of resources at the disposal of State Owned Enterprises. Financial viability of State enterprises also affects fragility of financial institutions and households, because their borrowing and spending decisions affects balance sheets in the economy. The SOEs are also among ten large borrowers in the banking sector, large payers of insurance premiums and Saccos draw a large proportion of their membership from state agencies.

**Figure 36: State Owned Enterprises loans from the banking sector**




*Source: Illustration using CBK data.*

Loans to state corporation from the banking sector amounted to about KSh 100 billion as at December 2019. The energy sector received the largest amount of loans, followed by transport and communication and then agriculture. Each parastatal borrowed at least from 2 bank, while other parastatals borrowed from 4 banks. A total of 35 banks extended loans to parastatals in December 2019. From figure 32, the loans from banks to parastatal coloured red and maroon are in the doubtful and watch categories, respectively, while green indicates that the parastatals were meeting their loan obligations. State Owned Enterprises in the agriculture sector are able to service their loans. However, banks are exposed to State Owned Enterprises is mainly in transport, trade

[13]According to *Mwongozo*, the objective of State corporation is to provide goods and services to meet the aspiration of Kenyans as envisaged in the Kenya's constitution

and manufacturing sector, because the enterprises have loans that fall in the watch and doubtful categories. Therefore, figure 30 indicates that the banking sector is affected by the financial performance and viability of parastatals.

The slowdown in economic activity coupled with competition from cheaper imports and weak governance have reduced viability of state owned enterprises, especially in the manufacturing, transport, trade and services sectors. On aggregate state owned enterprises a decline in the value of assets and increase in indebtedness. The value of assets decelerated from 8.7 percent in FY2017/2018 to 83.0 percent FY2018/2019 despite increase in long-term debt. The ratio of long term debt to assets increased from 108.1 in FY2017/2018 to 108.5 in FY2018/2019 (Figure 34). Despite slow growth in the economy and poor performance of private corporates, their accumulation of long term debt declined. The decline in long term debt as a propotion of equity of the private corporates indicates a decline in indebtedness (Figure 31 (b)).

**Figure 37 (a): Indebtedness of State-owned enterprises**

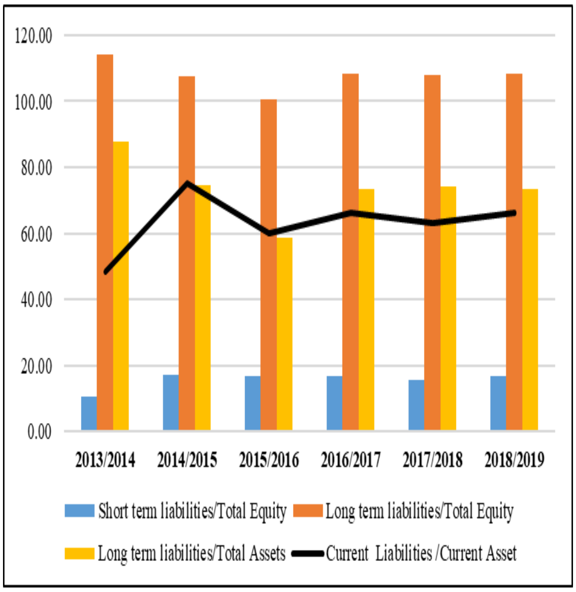
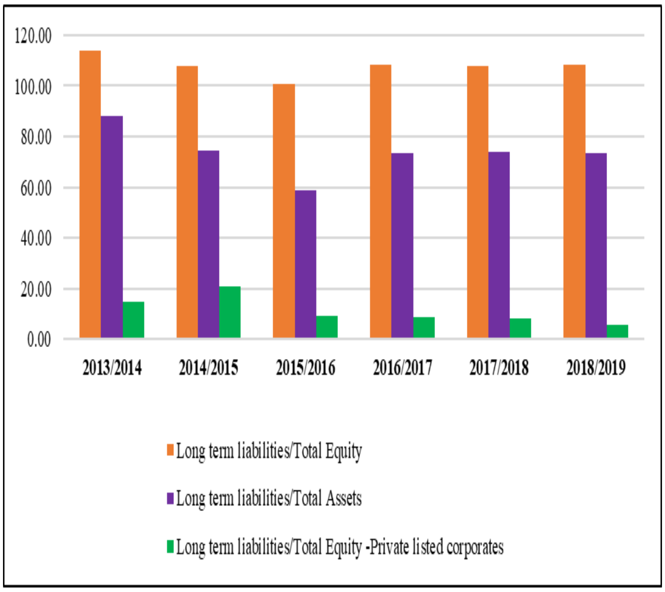



**Figure 37 (b): Indebtedness of State-owned enterprises compared to private corporates**

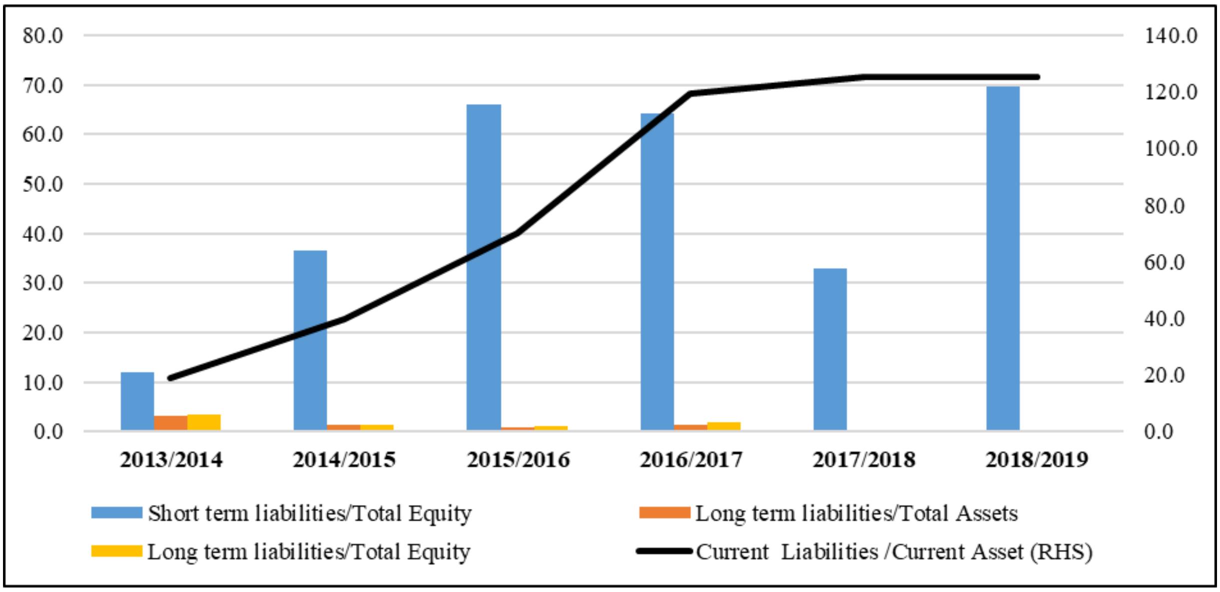



*Source: Illustration using data compiled from parastatals and listed companies.*

However, viability of firms depends on investment in fixed capital as well as replacement of wornout or obselete fixed assets, which can be financed by long term borrowing if profitability is declining. Hence a decline in long term liabilities of companies may suggest inability of companies to take on more debt due to decline in profitability. With regards to state owned enterprises, the high level of long term liability, a mid slow growth in assets suggest that the long term financing was not been used to finance assets. As a results, efficiency and production capacity declined. This compromised profitability and hence viability of parastals. Financial fragility of parastatals undermine their ability to fulfill their mandate.

The ratio of short liabilities to assets and ratio of short liabilty to total equity increased from 15.44 percent to 16.59 percent and 12.62 percent to 13.54 percent in 2018 and 2019, respectively. However, current liabilities as a ratio of current assets increased from 63.06 percent in 2018 to 66.28 percent in 2019. This indicates that SOEs are accumulating short term liabilities, which are not suitable for capital formation. The accumulation of short term liabilities is even faster for parastatals providing services such as public universities (Figure 32).

**Figure 38:Declining solvency and liquidity of service providing parastatals**



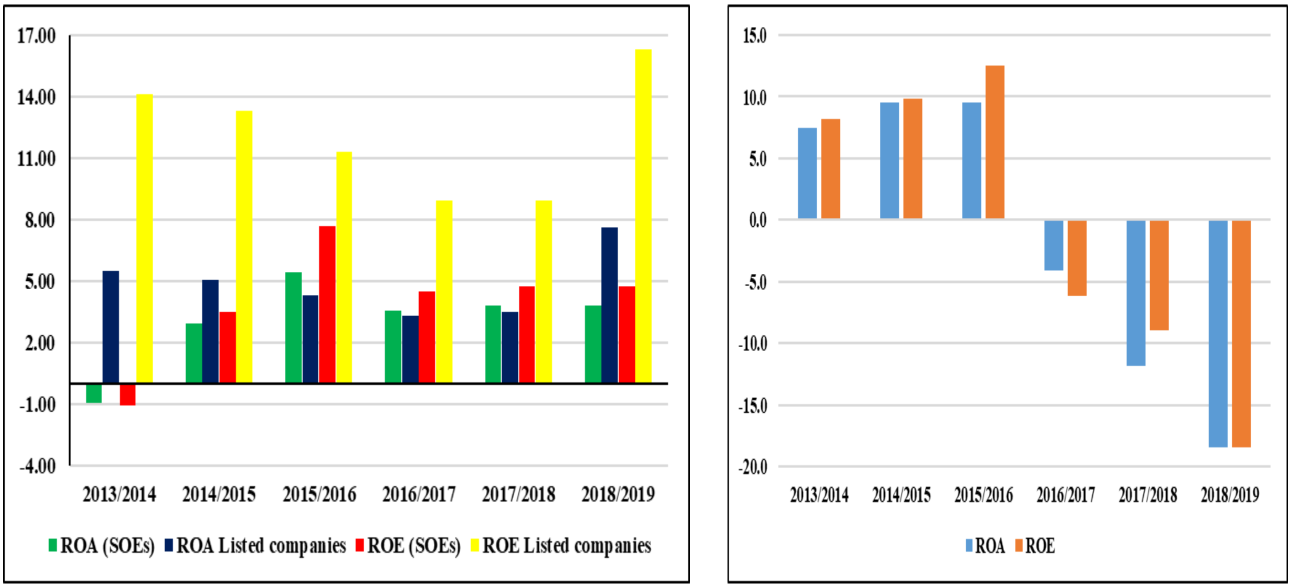

*Source: Illustration using data compiled from parastatals*

The ratio of current liabilities to current assets of service providing parastatal charging fees increased to 125.3 percent in 2019. This indicates that the fees and current assets cannot cover current liabilities. This indicates that the solvency of parastatals is not only low but also declining. The current liabilities include salaries and wages, consumables and short term loans, which are obtained from households, small firms and financial institutions. Hence, the increase in current laibilities suggests that parastatal are not settling their short term debt in time, this increases indebtendess of service providers who may have obtained loans in the financial sector to supply goods and services. This also reduces disposable income of workers whose salaries are not paid, thereby weakening balance sheet of households.

The ability of state corporation to fulfill their mandate depends on their financial viability. The policy framework on management of state corporation *Mongozo* emphasises good corporate governance and prudent management of state corporations, to enhance the effectiveness in fuilfiling their mandate. Mwongozo is underpinned by *The State Corporations Act 2015*, which specifies the qualification, the procedure of appointing the board and chief executive officers, their roles and responsibilities. The culpability of the board and the chief executive officer for routine and and strategic activities of has compeled boards to enhance their strategic leadership and provide oversight to seniour executives of state corporation. This has improved management of state corporation on aggregate. This is evident from the increase in profitability as indicated in figure 33. The ROA and ROE increased from -1.4 percent and 1.6 percent in the FY2013/2014 to 3.9 percent and 4.9 percent in the FY 2018/2019, respectively.

**Figure 39 (a): aggregate profitability of Parastatals**

**Figure 40 (a): Profitability of Service providing Parastatals**




*Source: Illustration using data compiled from parastatals and listed companies.*

However, profitability of SOEs is lower than listed companies. Listed companies have higher average return on equity of 12.2 percent compared to 4.0 percent of SOEs between 2013 and 2019. Parastatals providing services have been incurring losses since FY 2016/2017. The ROA and ROE declined from -4.1 percent to -6.1 percent to -18.4 percent. This indicates that revenues generated did not cover expenses. as a result, the parastatals are eroding equity and fixed assets. The decline profitability also undermines their ability to repay loans, to borrower and fulfill their mandates.

The erosion of equity and fixed assets, may compel the National Treasury to inject capital to ameliorate liquidity and debt distress for SOEs to continue discharging their mandate. This will increase public and public guaranteed debt, which is against commitment to fiscal consolidation strategy embedded in the Medium Term Debt Strategy. Hence, a viable and sustainable option for loss marking parastatals is to improve efficiency and quality of management to enhance profitability and viability. Indeed, about 30 percent of the of the 144 SOEs either do not have a full Board of Governors or substantive chief executive officer. This has stifled operation and design and implementation of strategic plans, that are critical to steering the parastatals to prosperity.

**Conclusion.**

State Owned Enterprises provide goods and services that are essential for achieving social economic objectives as well as stabilize prices, for efficient allocation of resources in the economy. Therefore, SOEs enable the government to achieve policy objectives and aspirations of Kenyan as outlined in Vision 2030 and in the Constitution. However, increase in indebtedness and decline in profitability has not only increased exposure of financial institution and household to SOEs, but also compromises their ability to fulfil their mandate. The indebtedness of SOEs is also increasing financial burden to the tax payer contrary to public policy of SOEs being self-sustaining, efficient and financially viable to discharge their mandates. Hence, management of SOEs needs to be re-hearted for boards to provide better leadership and strategical guidance, to enhance efficiency through innovation adoption of new technologies, prudent financial and non-financial resource management.

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