

# KENYA FINANCIAL SECTOR STABILITY REPORT 2010

**Prepared Jointly By:**



*Under the Financial Sector Regulators Forum in collaboration with the Ministry of Finance and the Ministry of Co-operative Development and Marketing, October 2011*

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## ABBREVIATIONS

ATS	Automated Trading System
BCPS	Bank Claims on Public Sector
BL	Bank Leverage,
BRICs	Brazil, Russia, India and China
CBK	Central Bank of Kenya
CBR	Central Bank Rate
CMA	Capital Markets Authority
CMBS	Commercial Mortgage Backed Securities
EAC	East African Community
ECB	European Central Bank
FDI	Foreign Direct Investment
FIGD	Financial Institutions Gross Debt
FSSTC	Financial Sector Stability Technical Committee
FSR	Financial Stability Report
GDHA	Government Debt Held Abroad
GDP	Gross Domestic Product
GFSR	Global Financial Stability Report
GGD	Government Gross Debt
GND	Government Net Debt
HHGD	Household Gross Debt
HHND	Household Net Debt
IMF	International Monetary Fund
IRA	Insurance Regulatory Authority
KNBS	Kenya National Bureau of Statistics
LICs	Least Industrialized Countries
MENA	Middle East and North Africa
MTDS	Medium Term Debt Strategy
NDA	Net Domestic Assets
NCDE	Non-financial Corporates' Debt over Equity (%)
NCGD	Non-financial Corporates' Gross Debt
NFA	Net Foreign Assets
RBA	Retirement Benefits Authority
RMBS	Residential Mortgage Backed Securities
SASRA	Saccos Societies Regulatory Authority
SSA	Sub-Saharan Africa
TEGEL	Total Economy Gross External Liabilities,
TENEL	Total Economy Net External Liabilities,
USD	United States Dollar
VAT	Value Added Tax
WEO	World Economic Outlook

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## **FOREWORD**

This issue of Financial Stability Report 2010 (FSR, 2010) was prepared jointly by the five financial system regulators: Capital Markets Authority (CMA), Central Bank of Kenya (CBK); Insurance Regulatory Authority (IRA), Retirement Benefits Authority (RBA), and Sacco Societies Regulatory Authority (SASRA), in collaboration with the Ministry of Finance and the Ministry of Co-operative Development and Marketing.

The primary objective of the FSR 2010 is to provide the public and key stakeholders an assessment and analysis of developments and performance of the economy and the financial sector in Kenya in 2010. The report highlights major risks and vulnerabilities the economy faced; and outlines policy actions taken to mitigate those risks and vulnerabilities by the regulators, government and other domestic and international agencies. Besides sensitizing the public on the need to maintain financial stability, the Report offers a platform for informed public discussion on all aspects of the financial sector development.

The financial system is a nerve centre of economic development. It provides the important service of financial intermediation that largely entails enabling surplus spending units to save and deficit spending units to raise fund for investment and consumption. The financial system comprises of four segments that provide distinct service including banking, insurance, pensions and equity and long term bonds. Each segment is regulated by a statutory body with a mandate to promote orderly growth and development of financial markets. The oversight function of each of the regulator is also focused on identifying and taking measures to mitigate potential weaknesses and downside risks in the relevant financial market segment. Each of the five financial sector regulators collects data and other relevant information to monitor and evaluate performance, soundness and stability of their respective licensees and market segments as well as the overall stability of the system.

The aftermath of the 2008 global financial and economic crises was a wakeup call for financial sector regulators and governments worldwide to enhance transparency and accountability of financial intermediation and ensure financial soundness and stability. The Kenya's financial system has previously experienced risks emanating from poor corporate governance; weak risk-management frameworks; competition and globalization, including cross border trade risks; rapid technological innovations, mainly product development, delivery channels and methodologies; and from socio-economic shocks. Besides addressing these risks, the joint financial sector regulators platform seeks to accelerate the process of deepening the financial system by promoting financial access and inclusion.

The Financial Stability Report 2010 comes at a time when global and domestic financial and economic recovery has gained momentum. However, a number of threats and vulnerabilities linger. The report highlights policy initiatives each regulator is undertaking to

mitigate potential sources of vulnerabilities. As we work towards semi-annual publication of this report, the public will find the document invaluable in terms of enhancing knowledge on financial sector developments and performance.



**PROF. NJUGUNA NDUNG’U**  
**GOVERNOR, CENTRAL BANK OF KENYA, AND**  
**THE CHAIRPERSON, THE JOINT REGULATORS BOARD**

## **ACKNOWLEDGEMENT**

The production and publication of the Financial Stability Report, FSR 2010 is combined effort of the Joint Regulators Board. The Report brings together the five regulators of the financial system, namely: the Capital Markets Authority (CMA), Central Bank of Kenya (CBK); Insurance Regulatory Authority (IRA), Retirement Benefits Authority (RBA), and the Sacco Societies Regulatory Authority (SASRA). The Ministry of Finance and Ministry of Co-operative Development and Marketing participated as observers. The joint financial sector stability assessment and analysis enables the Joint Regulators Board Forum to monitor and evaluate developments and performance of the financial sector in order to mitigate risks and vulnerabilities and thereby engender orderly development. This publication highlights financial market developments in 2010 and policy responses taken to manage emerging risks.

I take this opportunity to thank the senior management of regulators in the sector, and their chief executive officers for providing staff, technical support and approval of this Report. I wish to thank in particular members of Financial Sector Stability Technical Committee (FSSTC) who undertook the analysis and production of this Report. FSSTC membership include: Ministry of Finance; Ministry of Co-operative Development and Marketing; CMA; CBK; Deposit Protection Fund Board; IRA; RBA; and SASRA. I wish to encourage the team of the FSSTC to consider reducing the publication period to 6 months to provide more regular update consistent with best international practice evident in Europe, United Kingdom, South Africa, the IMF and neighbouring country and EAC Partner State Uganda.



**CHARLES G. KOORI**  
**DIRECTOR, RESEARCH AND POLICY ANALYSIS DEPARTMENT,**  
**CENTRAL BANK OF KENYA AND CHAIR OF THE FSSTC**



## 1.0. OVERVIEW

The FSR 2010 provides a comprehensive assessment of Kenya's financial system performance in the year 2010, identifying the main sources of risks and vulnerabilities to the system. It also highlights regulators' capacity to deal with noted adverse shocks.

Kenya depicted strong macroeconomic environment in 2010 with GDP growth rate accelerating to 5.6% up from 2.6% in 2009. Both Inflation and short term money market interest rates were low and stable within single digits, and broad monetary and fiscal aggregates were within respective targets. Overall public and publicly guaranteed debt was sustainable under the standard thresholds, with government borrowing costs relatively low due to low interest rates regime. The remittances inflows from Kenyans in Diaspora maintained an upward trend, increasing by 5.1% to USD 641,943 million in 2010 from USD 609,156 million in 2009. At the global level, the economy expanded rapidly in the first 10 months of 2010, reaching a high of 5% from a contraction of 0.5% in 2009, mainly driven by strong performance in global consumption. The financial landscape also improved in 2010, with strong capital flows into emerging & developing economies and risk appetite in developed economies observed, implying investors' interest in taking more risky assets that offer better return.

The financial system registered strong performance perhaps, reflecting better economic performance in 2010. Banking sector profitability increased by 51.9%, NPLs declined and stress testing results were robust thereby indicating little threat to stability. The value of money transfers via mobile phones rose by 55%, and the number of users (number of subscribers who used mobile phone to transfer money) almost doubled to 16.4 million from 8.9 million in 2009. Similarly, both primary and secondary markets for bonds and equities were vibrant as measured by all market indicators. The Pension industry and insurance sector recorded 31.2% and 25% growth in assets, with schemes return for the former averaging 27.8% up from 11% in 2009.

Despite strong recovery at global scale and robust growth of domestic economy, downside risks remained elevated, particularly in developed economies which might weigh heavily on the 2011 global growth projections, with negative spillovers felt in the domestic economy. The specific vulnerabilities include the fiscal problems in the euro area leading to renewed stress, slowdown in recovery in advanced economies, overheating in emerging & developing economies, and stubbornly high unemployment in developed economies. In addition, the political instability in the MENA region, impacting negatively on imported inflation, escalated drought in SSA and higher commodities prices, are a cause of further vulnerability. Reflecting the combined effect of these weaknesses the downward trend of inflation reversed from October 2010, both in Kenya and in other EAC member countries, indicating vulnerability generated from rising oil prices.

The FSR 2010 allows the oversight function of each of the financial system regulator to focus on identifying and mitigating potential weaknesses and downside risks in their respective industries. As a result, the regulators are better prepared to:-

Contain and deal with any imbalances and risks in the economy before they become a threat to the overall financial system stability.

Create a well-functioning, sound and stable financial system, based on prudent risk management and business continuity strategies and market-disciplining mechanisms that achieve resilience and prevent financial crises.

Promote a financial system that fulfil its role of effectively and efficiently allocating resources among economic agents, while managing and mitigating risks, mobilizing savings and facilitating wealth creation for wider economic development.

Pursue policies that would improve access to finance for a majority of the population, thus, raising the level of monetization in the economy for economic development and effective implementation of monetary policy.

This Report provides a perspective of financial system risks and threats and an early warning system for strengthening financial system stability.

## 2.0. GLOBAL ECONOMIC AND FINANCIAL SECTOR DEVELOPMENTS

Developments in the global macroeconomic environment impact on Kenya's overall economy and financial sector performance through the trade balance, net capital inflows and foreign exchange market. This in turn has implications on the financial system stability.

### 2.1 Global Economic and Financial Developments in 2010

The world real output averaged 5% in 2010, compared with 4.5% growth forecast in 2011 and 0.5% contraction in 2009 (Table 1 and Chart 1). This 'two-speed recovery' - modest in advanced economies and robust in emerging market economies, reflected 5.25% expansion in the second quarter of 2010 and modest a 3.75% growth in the third quarter of 2010. The strong performance was due to better than expected consumption in the United States and Japan, partially emanating from the stimulus measures. Overall, the 2010 performed well across all economic groups (Table 1).

**Table 1: World Economic Outlook Projections (Percentage Change)**

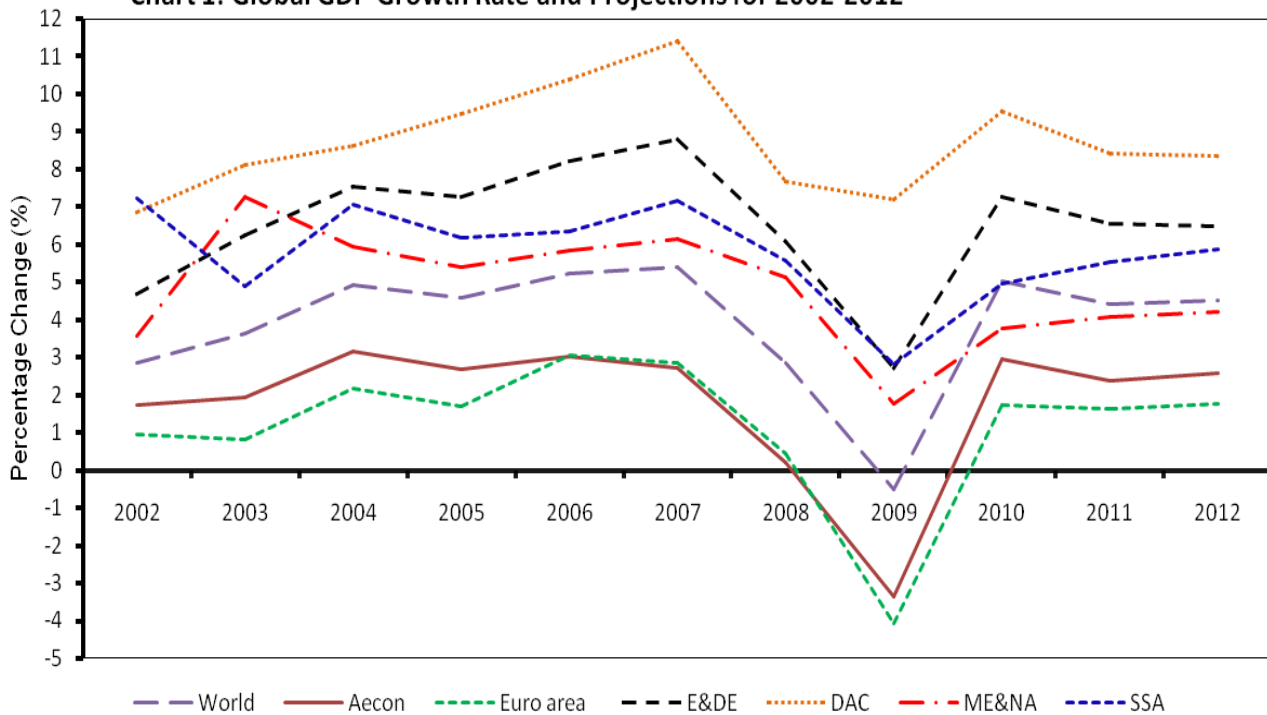
<b>GROUP</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>
World Economy	2.8	-0.5	5.0	4.5
Advanced Economies	0.2	-3.4	3.0	2.4
Emerging & Developing Economies (E&DEs)	6.0	2.7	7.3	6.5
Sub-Saharan Africa (SSA)	5.5	2.8	5.0	5.5
BRICs (Brazil, Russia, India, and China)	6.6	1.9	8.0	6.8

*Source: World Economic Outlook, April 2011*

Growth in emerging and developing economies remained robust in the third quarter, more than doubling real GDP to 7.3% in 2010 from 2.7% in 2009. This was buoyed by vibrant private demand, accommodative policy stances, and resurgent capital inflows. Most of the developing countries, particularly in sub-Saharan Africa (SSA), also grew strongly, but below E&DEs.

Global output in 2011 is projected to expand by 4.5% (World Economic Outlook (WEO) of April 2011) which is about 25 basis points above the previous forecast (WEO October 2010). But despite the forecast strong global recovery, downside risks remain elevated. Activity in advanced economies has moderated less than expected, unemployment is still high and there are renewed stresses in the Euro Area periphery.

Chart 1: Global GDP Growth Rate and Projections for 2002-2012

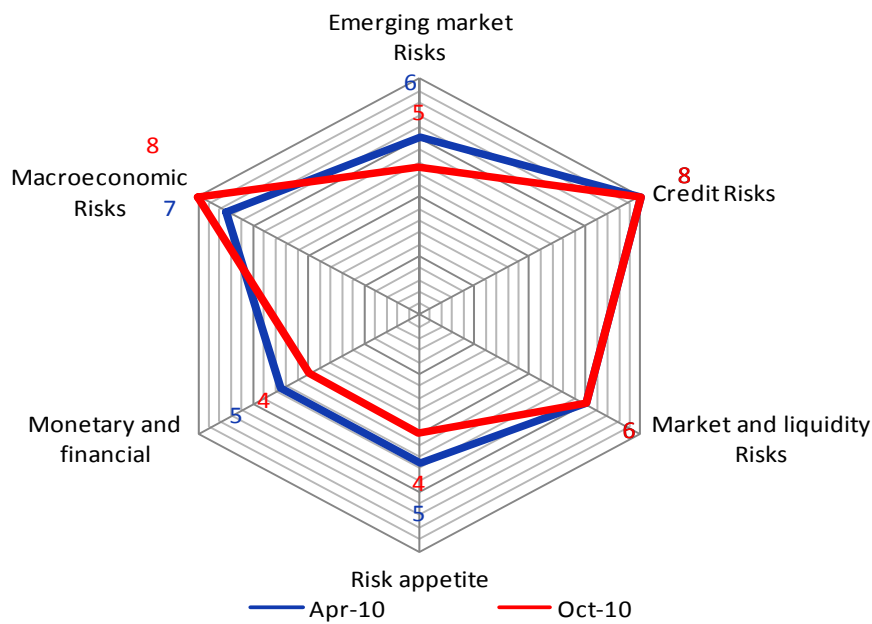


Source: Estimated from World Economic Outlook Database April 2011

Despite enhanced activity in Emerging economies, inflation pressures are emerging and there are signs of overheating, partly driven by strong capital inflows. This calls for comprehensive and swift actions to overcome sovereign and financial troubles in the Euro Area. More generally, policies should be implemented to redress fiscal imbalances and reform financial systems in advanced economies (in order to achieve robust recovery) and check overheating pressures in key emerging economies (in order to facilitate external rebalancing).

The *Global Financial Stability Report 2010* shows that structural weaknesses and vulnerabilities remained in some important financial systems despite improvement in global financial conditions during the second half of 2010. Assessed on a scale of *Global Financial Stability Map, October 2010 (Chart 2)*, macroeconomic risks increased from level **7** in the April 2010 FSR to **8** in October 2010 FSR as sovereign debt and deflation undertones rose amid economic activity uncertainty. Credit risks were however unchanged at level **8** between April and October 2010, as stronger corporate sector with stronger balance sheets attributed to the recovery dampened strains in the banking system. Similarly market and liquidity risks had stabilised at level 6. The global risk appetite among investors, and conditions of monetary and financial institutions tightened to level **4** in October 2010 FSR from level **5** in April 2010 FSR.

**Chart 2: Global Financial Stability Map**



Swift global policy response to arrest sovereign and banking strains bore fruits, with overall market and liquidity strains totally contained. This left monetary and financial conditions still tight, slowing efforts for countries to pullout out of support programs such as the Stimulus packages established during the global credit crisis. Risk appetite contracted during the period, except for retail capital inflows into emerging markets which experienced low risk profile, supported by strong fundamentals and positive economic growth outlook.

Equity markets rose, risk spreads continued to tighten, and bank lending conditions in major advanced economies became less tight, even for small and medium-sized firms. Nonetheless, pockets of vulnerability persisted with real estate markets and household income still weak in some major advanced economies (like the US), and securitization was subdued. Using the Markets Heat Map<sup>1</sup>, both subprime residential Mortgage-Backed Securities (RMBS) and commercial Mortgage-Backed Securities (CMBS) show elevated vulnerabilities in the real estate. Only money markets and emerging markets asset classes had the lowest volatility reported of below 4 standard deviations.

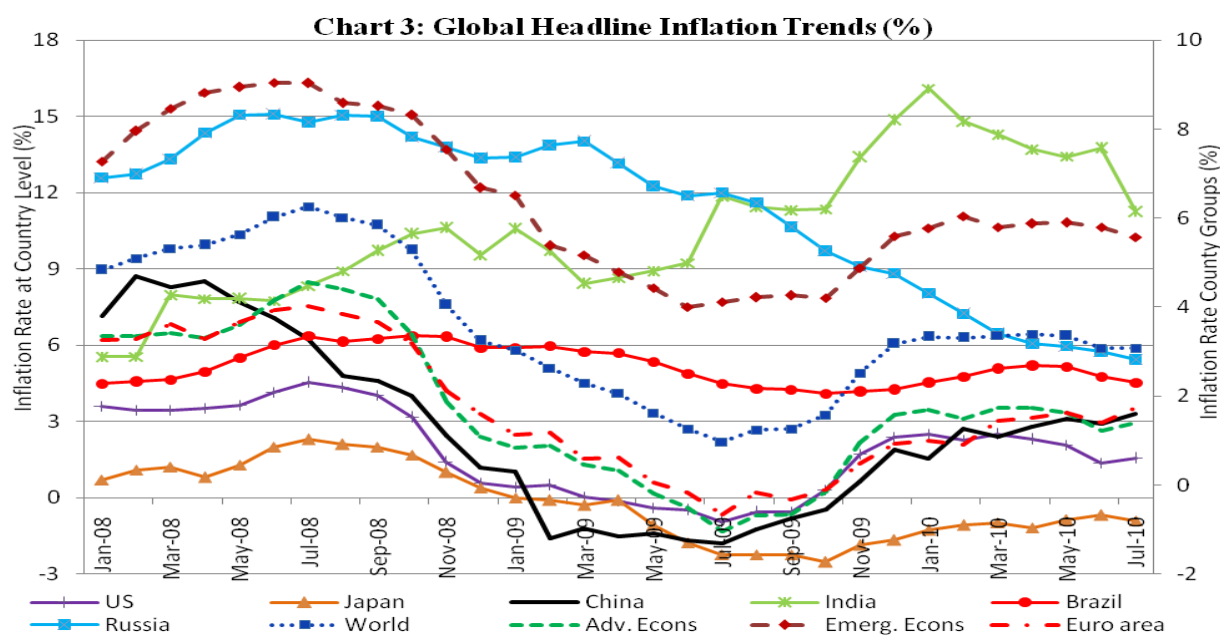
Overall, turmoil in mid-2010 led to a spike in global risk aversion and a scaling back of exposures in other regions, including emerging markets. Financial markets have been more discriminating: measures of risk aversion have not increased, equity markets in most regions

<sup>1</sup> The heat map measures both the level and one-month volatility of the spreads, prices, and total returns of each asset class relative to the average during 2003–06 (i.e., wider spreads lower prices and total returns, and higher volatility). The deviation is expressed in terms of standard deviations. Light green signi.es a standard deviation under 1, yellow signi.es 1 to 4 standard deviations, orange signi.es 4 to 9 standard deviations, and red signi.es greater than 9. MBS = mortgage-backed security; RMBS = residential mortgage-backed security.

have posted significant gains with financial stresses limited mostly to the periphery of the Euro Area.

Monetary and financial conditions eased further in the third quarter of 2010, helping to remove deflation-related tail risks. Continued accommodative policies, including quantitative easing, coupled with the improved macroeconomic outlook, boosted risk appetite and encouraged a rally in risk assets, helped by a search for yield and a shift from fixed-income securities to equities. Equities—especially in advanced economies—benefited from continued positive economic data, though geopolitical tensions and higher and more volatile oil prices have erased some of the recent gains. High-yield and investment-grade credit spreads in the United States, Europe, and Asia have continued to tighten, while investors are moving toward weaker-quality credit in search of yield. As a result, market and liquidity risks remain contained, despite renewed episodes of market turmoil in the Euro Area.

Sovereign balance sheets remain under strain in many advanced economies, as illustrated by increased sovereign bond market volatility in some Euro Area countries over the past six months. Sovereign bond yields were higher across advanced economies, partly due to improved economic data, and mainly due to certain countries in the Euro Area, response to concerns about weakening public sector balance sheets.



Source: IMF, World Economic Outlook Database, October 2010

Revived fear among investors about credit risk has put a spotlight on high debt levels in many parts of the global economy, including households with negative equity in their homes, banks with thin capital buffers and uncertain asset quality, and sovereigns facing market concerns about debt sustainability. Stronger-than-anticipated global demand for commodities has reduced inventories and led to a strong sustained and broad-based

increase in prices. The overall IMF commodity price index rose 32% from mid 2010, slashing about three quarters of the 55% fall after cyclical highs of 2008 through 2009. Although food prices hovered within reach of their 2008 peaks, good harvest in Sub-Saharan Africa cushioned some of the world's poor.

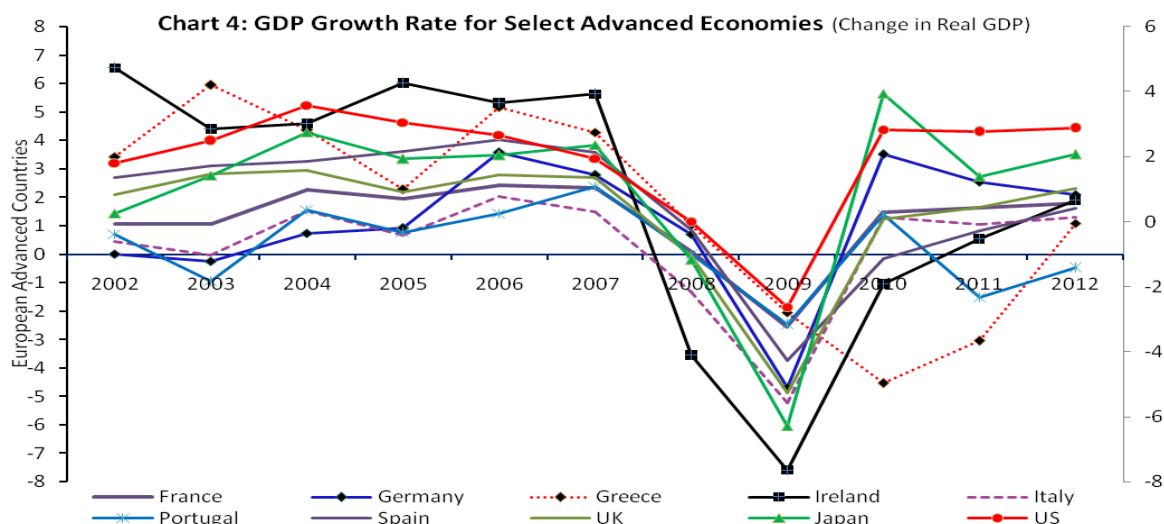
As indicated in Chart 3, inflation was not a threat during the year 2010 as countries pursued appropriate monetary policy and good harvest in Sub Saharan Africa dampened food prices. Except for India and overall emerging economies, global inflation trend was stable and remained within single digit in 2010. Only Japan had negative inflation in 2010, while the rest of other select countries had inflation levels of below 5% by end July 2010.

## **2.2 Developments in Advanced Economies**

Advanced economies recorded a 3% expansion in 2010 after a 3.4% contraction in 2009. Of the 10 selected advanced economies plotted in Chart 4, the US, Germany and Japan recorded economic expansion averaging 3% while Ireland, Greece and Spain recorded a contraction, although better than the 2009 level. The recovery has strengthened corporate balance sheets and stabilized some indicators of household leverage.

Despite notable growth of advanced economies, governments and households remain heavily indebted, and the health of financial institutions has not recovered in tandem with overall economy. Financial turbulence re-emerged in the periphery of the Euro Area in the last quarter of 2010 arising from concerns about banking sector losses and fiscal sustainability. These were triggered by the situation in Ireland, which led to widening spreads in these countries, in some cases reaching highs not seen since the launch of the European Economic and Monetary Union.

Funding pressures also reappeared, but there were limited financial market spillovers to other countries due to the intervening policy actions that managed to keep the financial turmoil and its real effects contained in the periphery of the Euro Area, resulting in only a modest drag on the global recovery. The limited financial spillovers observed across the financial markets and regional economies, as well as the appropriate policy responses by ECB, European Leaders and IMF to limit contagion and financial turmoil to the Greek crisis, mitigated negative impact on the global recovery in the second half of 2010. The first round of crisis response policy measures in May 2010, focused on financial assistance to Greece from the Eurozone leaders and the IMF, paired with austerity measures and reforms implemented by the Greek government. Central banks also played a role in providing liquidity in the region. The policy measures were aimed to prevent a disorderly Greek default, to restore debt sustainability in Greece, and to prevent the spread of the crisis to other Eurozone countries and the global economy. To date, they have succeeded in the first objective, but generally failed in the second two.



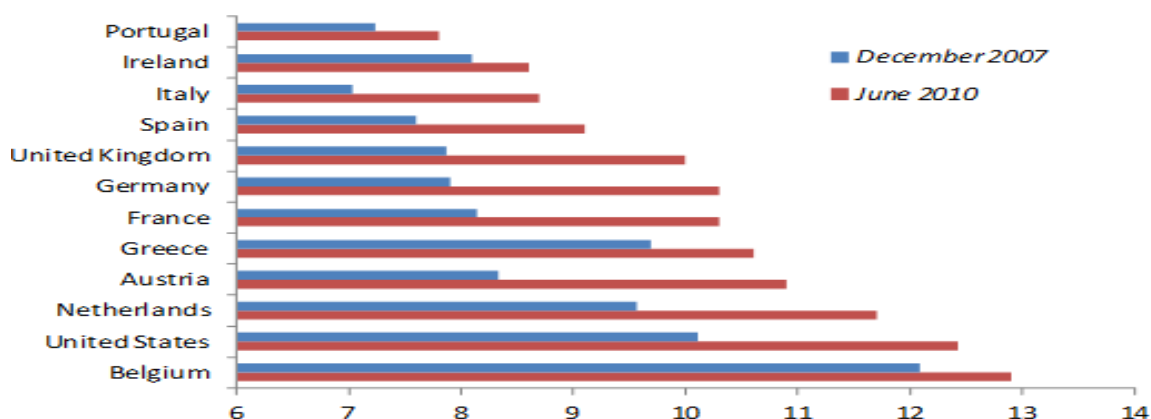
Source: The IMF Statistics Database, 2010

Against the backdrop of heightened economic uncertainty, continuing deleveraging, and sovereign spillovers, core banking systems remain vulnerable to confidence shocks and are heavily reliant on government support. Risks remain in the Euro Area from the negative interactions between sovereign and banking risks. Challenges also remain for banking systems in the United States and Japan. Uncertainties surrounding the US housing market and the risks of a “double dip” in real estate markets remain high. Overall, bank balance sheets need further bolstering to ensure financial stability against funding shocks and to prevent adverse feedback loops with the real economy. This is because fiscal challenges and heightened economic uncertainty has exposed banking systems’ vulnerabilities to sovereign risks and funding shocks. In part, this reflects crisis legacy problems and incomplete reforms, as well as highly leveraged balance sheets reliant on wholesale funding.

The estimated crisis-related total bank writedowns and loan provisions between 2007 and 2010 fell from \$2.3 trillion in the April 2010 GFSR to \$2.2 trillion in October 2010 GFSR, driven mainly by a fall in securities losses. In addition, banks have made further progress in realizing those writedowns, with more than three quarters already reported, leaving a residual amount of approximately \$550 billion. The average Tier 1 capital ratio (Chart 5) in the global banking system rose to over 10% at end-2010, although much of this is due to government recapitalization. Consequently, banks have sought to raise both the quantity and quality of capital (Chart 5), but progress has been uneven, with European banks generally lagging US banks.



**Chart 5: Banking System Tier 1 Capital Ratios (in percent)**



Sources: EU Consolidated Banking Data; and Federal Deposit Insurance Corporation.

European banks also made less progress in lengthening the maturity of their funding, and remain highly dependent on wholesale funding, with second-tier banks increasingly reliant on covered bond markets and the European Central Bank (ECB) for funding. Banks are also facing pressures on the asset side of their balance sheet, reflecting concerns about exposures to troubled sovereigns and to property markets in Ireland, Spain, the United Kingdom, and the United States.

Underlying credit measures show further deterioration in residential and commercial mortgage loans. Although credit growth has been steadily recovering in most advanced economies, it remains sluggish and well below pre-crisis levels, due to persistent weak bank balance sheets. These weaknesses include excessive leverage, uncertainties about the quality of bank assets, insufficient capitalization in some banks, and generally higher bank funding costs. In the United States, the weak housing market is likely to extend the household deleveraging process, slowing the economic recovery and weighing on bank balance sheets.

As indicated in Table 2, Government debt is generally high and on a worrying upward path in a number of advanced economies. Except for Italy, all other advanced economies had negative Primary balance in 2010, signifying persistent fiscal deficits and therefore potential high public debt accumulation. Many advanced economies face high public debt funding needs, as primary balances remain in deficit and shorter-term debt issued during the financial crisis matures over the next year and a half, posing rollover risks. Notably, of the eleven countries selected, all, but Spain's gross public debt exceeded 70% of GDP in 2010, and five countries exceeded 100%.

Households remain highly indebted on net basis in the United States, Japan and all other advanced economies.

High mortgage debt and sharp fall in house prices left many U.S households with negative equity and raised risks to banks from mortgage defaults.

**Table 2: Indebtedness and Leverage in Selected Advanced Economies (Percent of 2010 GDP)**

Measure	US	Japan	UK	Canada	Euro Area	Germany	Greece	Italy	Ireland	Spain	Portugal
GGD	100	229	83	84	87	80	152	120	114	64	91
GND	72	128	75	35	67	55	n.a	101	95	53	86
PB	-9	-8.6	-5.5	-4.1	-1.7	-0.3	-0.9	0.2	-7.5	-4.6	-1.6
HHGD	91	74	107	98	72	62	6.8	50	129	90	103
HHND	-230	-231	-184	n.a	-129	-130	-56	-178	-60	-74	-126
NFCGD	76	138	128	n.a	142	69	71	119	278	205	154
NCDE (%)	105	176	89	72	106	105	218	135	113	152	145
FIGD	97	188	735	n.a	148	95	21	99	664	113	65
BL	13	23	24	18	26	32	17	20	18	19	17
BCPS	8	76	7	20	n.a	25	27	32	28	22	16
TEGEL	144	64	696	91	174	181	194	153	1598	215	293
TENEL	19	-52	14	7	13	-39	99	20	102	90	106
GD Abroad	32	7	27	20	29	53	61	47	59	50	57

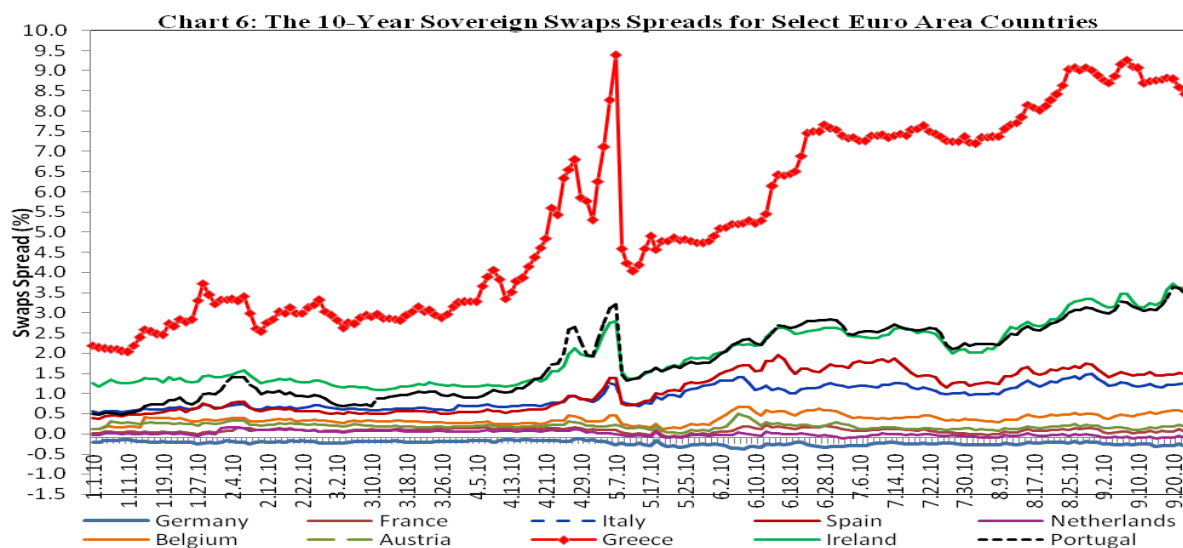
Source: *Global Financial Stability Report, 2011*

There is need for additional policy efforts to secure a comprehensive solution to the fiscal problems and prevent further contagion. Ireland and Spain face similar vulnerabilities due to bursting of housing bubbles. Portugal, Italy, Germany, Euro Area and the United Kingdom also face high household debt. Germany, Greece, Republic of Ireland, Spain and Portugal were indebted to foreign lenders to the tune exceeding 50% of their respective GDPs in 2010.

In the Euro Area, prospects for the financial sector remain closely tied to sovereign stress. Although their capital ratios have been bolstered since the onset of the crisis, many banks still face investor doubts about their financial future. Problems are most acute in those Euro Area countries where the very adverse situation in the real estate markets heralds further write-downs, and where strained public balance sheets weigh on the creditworthiness of banks. More generally, still-high bank leverage means that many financial institutions find it difficult to secure market funding on adequate terms in the absence of some form of public support. In countries perceived as most vulnerable by markets, an adverse feedback loop developed, with widening sovereign spreads raising concerns about bank exposures. This drove up counterparty risk and led to higher funding costs, at times in an indiscriminate manner (**Chart 6**).

Interbank markets also began differentiating between types of Euro government collateral and the borrowing institution's country of origin. With each cycle, the affected sovereign's

ability to backstop the financial system came into further doubt, as rising funding costs heightened the magnitude and likelihood of bank interventions.



Source: IMF Statistics Database, October 2010

Substantial market uncertainties persist and tail risks are elevated as can be observed by markets reaction to the EU-ECB-IMF rescue package in May – July 2010 to Greece and Ireland and release of the results of the Committee of European Banking supervision for the Euro Area around September 2010. Markets still expect volatility to remain high as reflected in the 10-year sovereign swaps spreads in **Chart 6**. Greece still poses greatest vulnerability to the Euro Area through cross-border exposures and foreign holders of Greek debt (**Table 2**).

### 2.3 Emerging Markets and Developing Economies (EM&DEs)

EM&DEs had robust growth, surpassing 7.3% in 2010, up from 2.6% in 2009. This two-speed recovery - large output gaps in advanced economies and narrowing gaps in the later economies, shows notable differences among each set of countries. China led the pack with a 10.3% economic growth in 2010, making it the world's fastest-expanding major economy. This growth is however expected to fall to annual growth target of 7% in 2011 in order to "raise the quality and efficiency of economic growth"<sup>2</sup> to safeguard environmental exploitation. As indicated in Table 3, EM&DEs recorded strong capital inflows, reflecting accommodative policies and slow recovery in mature economies. It also shows low risk and higher return in emerging and developing economies.

<sup>2</sup> Mr Wen, China's Prime Minister told BBC Business News

**Table 3. Global Financial Flows (In U.S Dollars Billions)**

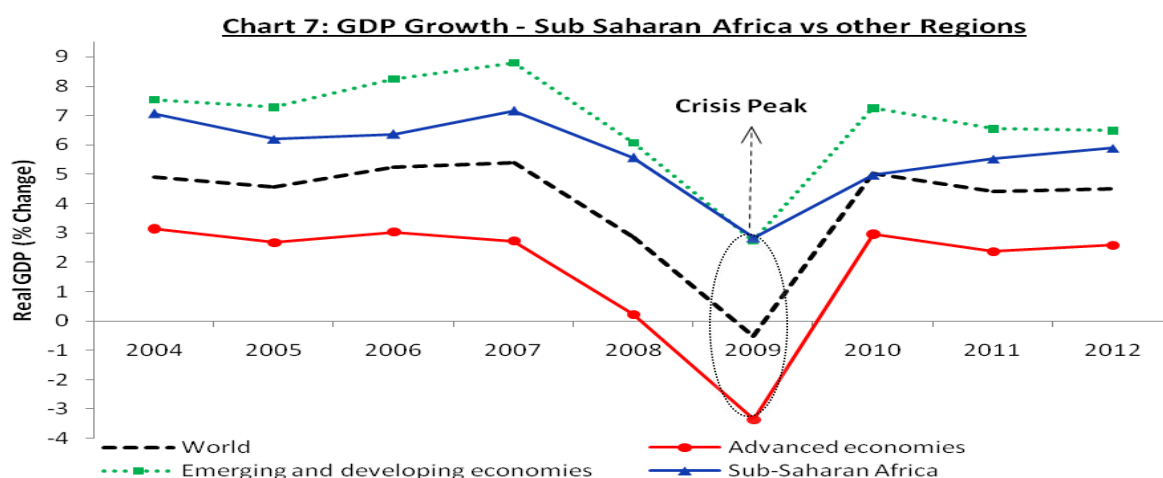
Country/Region	Capital Inflows			Capital Outflows		
	2007	2008	2009	2007	2008	2009
United States	2,107.7	454.7	305.6	-1,475.7	156.1	-140.4
Canada	145.1	99.2	136.1	-162.1	-107.9	-93.0
Japan	267.7	-16.4	-108.6	-494.2	-211.9	-59.0
United Kingdom	2,088.7	-757.9	-231.7	-1,984.8	1,021.2	205.6
Euro Area	2,628.6	1,001.4	-105.2	-2,564.3	-677.8	102.3
EM & DEs	1,730.6	856.2	670.6	-2,346.3	-1,506.1	-850.1

Sources: IMF, International Financial Statistics and World Economic Outlook databases, September 24, 2010.

Latin America and Asia received the bulk of capital inflows. Capital flows to some larger emerging economies such as Brazil, China, India, Indonesia, Mexico, Poland and Turkey ranged slightly above the pre-crisis levels. The recovery was influenced by portfolio and bank flows, with declining proportion of foreign direct investment (FDI) flows. This may raise the risk of future instability, including capital outflows within the region. Overall, *emerging market risks* have declined further since the October 2010 GFSR, with limited spillovers from renewed stress in the Euro Area and increased political uncertainty in the Middle East. However, the increase in corporate and financial leverage, rising asset valuations, and growing inflationary pressures in emerging markets raise concerns about the gradual buildup of imbalances, hence need for increased vigilance by policymakers.

## 2.5 Sub-Saharan Africa and East African Economies

Growth in Sub-Saharan Africa was 5% in 2010 from 2.8% in 2009. It is projected by expand further to 5.5% in 2011 as indicated in the Chart 7.



Source: IMF, World Economic Outlook database, April 2011

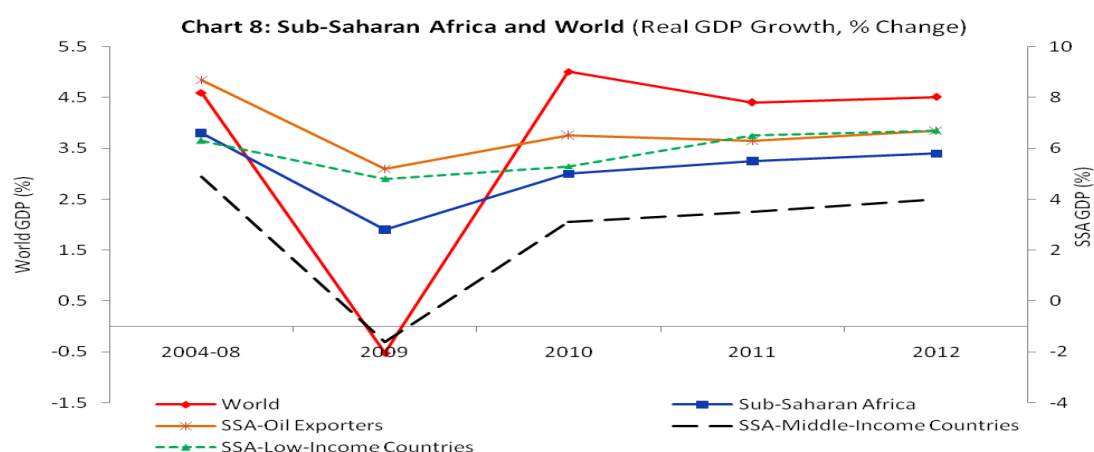
The output growth in most oil exporters and low-income countries (LICs) of the SSA region were close to pre-crisis highs in 2010 as shown in Table 4. The region's 29 LICs' growth averaged above 6% during 2004–08, second only to developing Asia. The Middle Income countries of SSA like Botswana, Swaziland and Lesotho, performed dismally compared to the rest of the countries.

**Table 4: Sub-Saharan Africa - Growth by Country Groups**

Regions within Sub-Saharan Africa	2004-08	2009	2010	2011	2012
	<i>Latest Projections</i>				
Sub-Saharan Africa	6.6	2.8	5.0	5.5	5.8
Oil Exporters	8.7	5.2	6.5	6.3	6.7
Middle-Income Countries	4.9	-1.6	3.1	3.5	4.0
Low-Income Countries	6.3	4.8	5.3	6.5	6.7
World	4.6	-0.5	5.0	4.4	4.5

Source: IMF, World Economic Outlook database, January 2011

South Africa and its neighbors however had muted recovery due to severe impact of the collapse in world commodities trade and elevated unemployment levels that proved difficult to reduce. In 2011, LICs are projected to grow above 6.5% due to rising domestic demand arising from automatic stabilizers, expansion in public investment and social support programs, and continued monetary accommodation (**Chart 8**). Growing trade ties with Asia are also playing a role in the region's recovery, primarily through commodity markets.



Source: IMF, World Economic Outlook database, January 2011

Output growth has rebounded in South Africa, but high unemployment and subdued confidence are expected to continue to dampen the pace of recovery, restricting growth to about 3.5% in 2011 (Table 5). Despite the robust recovery, downside risks weigh on SSA. The region's dominant trade partner, Europe, face modest uncertain recovery.

**Table 5: Actual and Projected Output for EAC Region and South Africa**

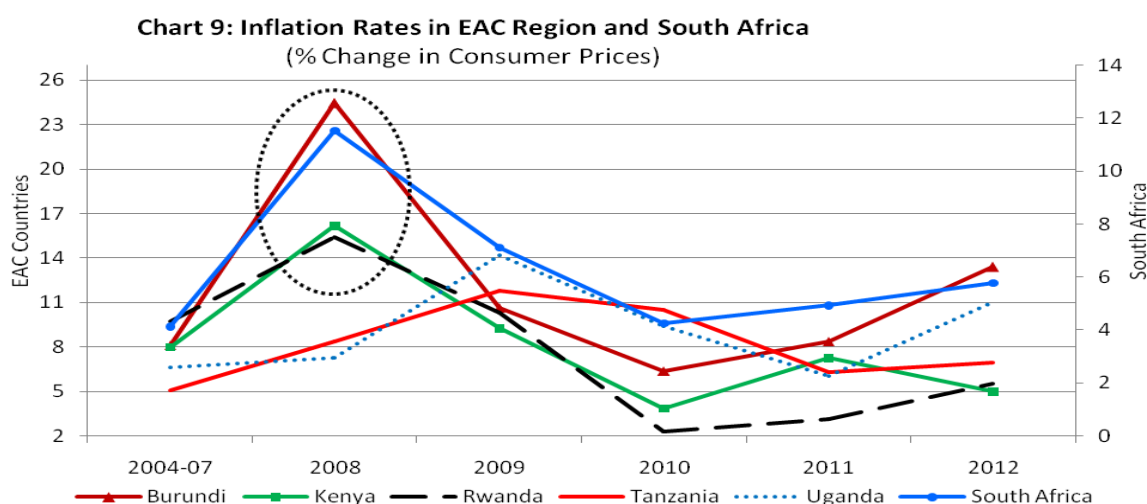
Country/Region	2004-07	2008	2009	2010	2011*	2012*
SSA	6.69	5.5	2.80	5.00	5.50	5.80
South Africa	5.25	3.58	-1.68	2.78	3.52	3.85
Kenya	5.80	1.55	2.59	5.60	5.72	6.53
Tanzania	7.29	7.73	6.70	6.50	6.44	6.61
Uganda	8.08	8.71	7.25	5.18	6.00	6.50
Rwanda	7.89	11.19	4.14	6.50	6.50	7.00
Burundi	3.61	4.53	3.48	3.85	4.46	4.78

Source: IMF World Economic Outlook Database, April 2011 and October 2010

\* Projections

This is likely to pull back recovery momentum especially in non-oil commodities market, thus slowing down growth in trade. More immediately, the sharp pickup in fuel and food prices stands to make a significant impact on many non-oil-exporting countries. Governments should consider targeted social safety nets to protect the hard hit urban poor, a potential source of public unrest. However, the elevated fiscal deficits and narrowing output gaps, in the midst of busy political calendar with 17 national elections scheduled in 2011, makes this path difficult. Other policy areas to target are; closer monitoring and sounder regulation of the financial sector, policy improvements targeted at the business environment, and robust public financing mechanisms to cut on government spending.

Inflation was under control in most countries, and the monetary stance appropriate. However, policymakers should remain alert to potential pressure from rising commodity prices—particularly with growth approaching potential levels. The EAC region maintained single digit inflation in 2010 as indicated in Chart 9, with Rwanda having the lowest and Tanzania had the highest.



Source: IMF World Economic Outlook Database, April, 2011

## **2.5 Impact of Global Macrofinancial Developments to Kenya's Financial Sector Stability**

Kenya is an open economy with fully liberalized financial markets and no capital accounts controls. There is free movement of capital into and outside the economy. The country has fairly diversified export and import of goods and services. Export commodities include; tea, coffee, horticulture, industrial goods, and limited minerals. Services are mainly hospitality industry, with tourism being key and financial services. The main trading partners include EAC, COMESA, Europe, United Kingdom, and the US.

Economic recovery in the Kenya's main trading partners such as the US, Europe, and EAC has positive impact on Kenya's macroeconomic environment and in turn overall financial system stability. Besides improved Balance of Payments to Kenya, stability of these countries' currencies will ensure stability of Kenya Shilling, thus ensuring foreign exchange stability. In addition, the country will benefit from improved capital flows both in terms of foreign direct investment (FDI), capital transfers and Diaspora remittances. Improved equities markets abroad reflecting, higher risky assets appetite means foreign investors look for higher yields/return in emerging markets like Kenya, thus leading to stability of domestic financial markets. The stronger than anticipated global commodities demand in 2010 was good for Sub-Saharan Africa which had rich harvest, thus boosting their exports.

Despite positive performance and outlook from global and regional economies, Kenya's economy and financial system stability face vulnerabilities associated with global risks. For instance, there were downside risks emanating from sharp increase in commodity and fuel prices, especially in non-oil producing countries. This led to imported inflation and impacted negatively on the stability of exchange rate. This is compounded by social and political tensions in the MENA region a key source market for oil and consumers of Kenya's tea exports. Rising unemployment, fiscal imbalances, households' debt problems amid weak disposable incomes, deflation signs in some countries and vulnerabilities in real estate markets in advanced economies pose significant risks to Kenya's macroeconomic indicators. These compounded with signs of overheating, inflationary pressures, and cautious global capital and credit markets can considerably impact negatively on Kenya's financial sector stability. This is through unstable exchange rate, imported inflation, foreign reserves erosion thus affecting BoPs, reduced exports markets, and strained foreign capital inflows. Foreign investors may resort to net sell-off in domestic financial markets, thus aggravating instability.

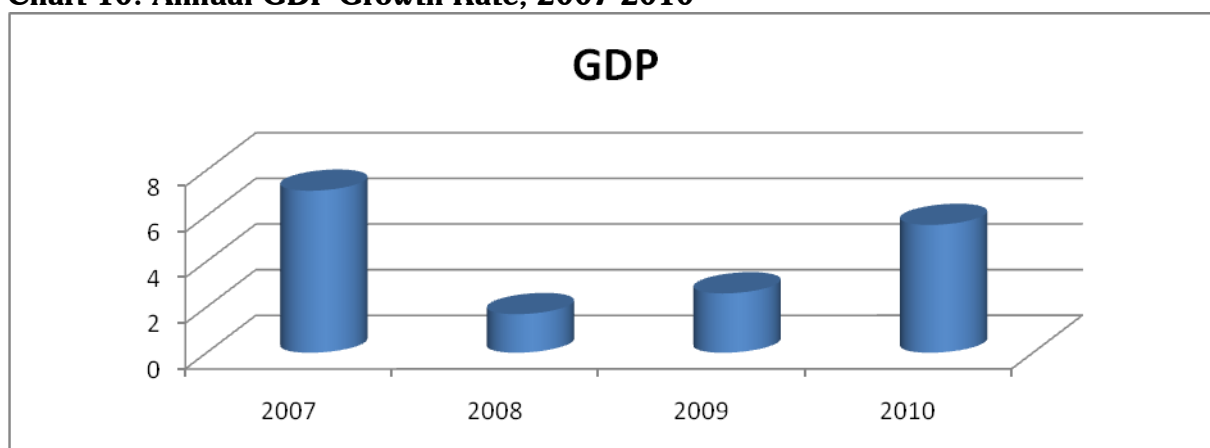
### 3.0. DOMESTIC ECONOMIC ENVIRONMENT

#### 3.1. Macroeconomic Developments in Kenya in 2010

Analysis of the relationships between the financial sector and real sector of the economy is pertinent in understanding threats to financial stability. This section provides a background for such an understanding by reviewing developments in key macroeconomic indicators of the Kenyan economy in the year 2010. GDP growth, interest rates, inflation, exchange rate, capital flows, public debt and balance of payment trends are the major variables of focus in this section.

Overall, GDP growth rose to 5.6% in 2010 from 2.6% in 2009 (Chart 10). This was due to better performance in agricultural, manufacturing and financial sectors, which grew by 6.3%, 4.4% and 8.8% from a contraction of 2.6% and a growth of 1.3% and 4.6%, respectively, in 2009. Fiscal policy stimulus and monetary policy easing also supported consumer and business confidence.

**Chart 10: Annual GDP Growth Rate, 2007-2010**



Source: Central Bank of Kenya and KNBS Database

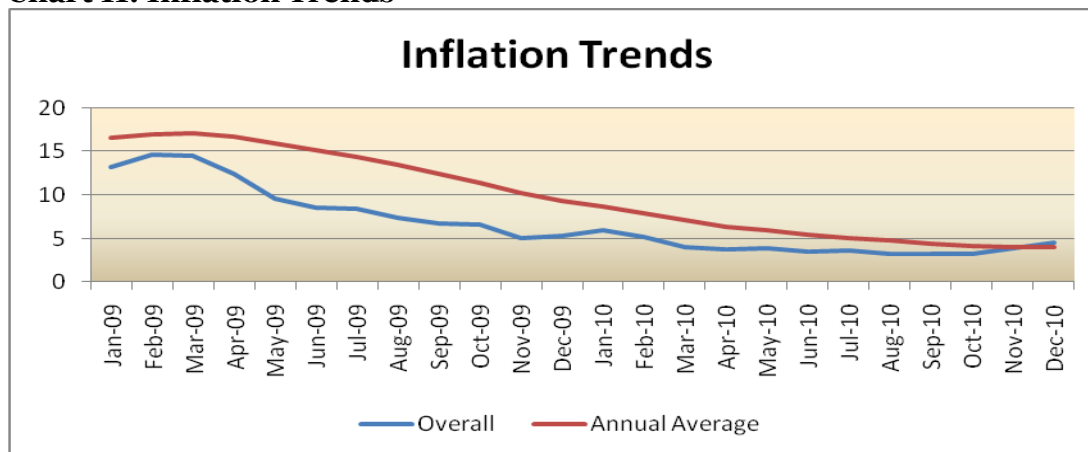
Efforts to accelerate economic activity further and particularly to increase and sustain agricultural growth are pertinent in ensuring financial stability. Sustained growth of the key sectors to GDP performance would boost incomes with positive implications for banking institutions and financial stability. To ensure sustainable food security, irrigation schemes be intensified to achieve food self sufficiency to reduce imports costs. This would free resources used for emergency relief with possibility of reallocation to more productive areas, and lower household debt burdens.



### 3.1.1. Inflation Developments

Kenya recorded declining inflation in 2010 experienced compared to the year 2009, with annual and overall inflation averaging 5.6% and 3.9%, respectively in 2010, compared to 14.1% and 9.4%, respectively, in 2009 as indicated in Chart 11.

**Chart 11: Inflation Trends**



Source: Kenya National Bureau of Statistics Central Bank of Kenya database

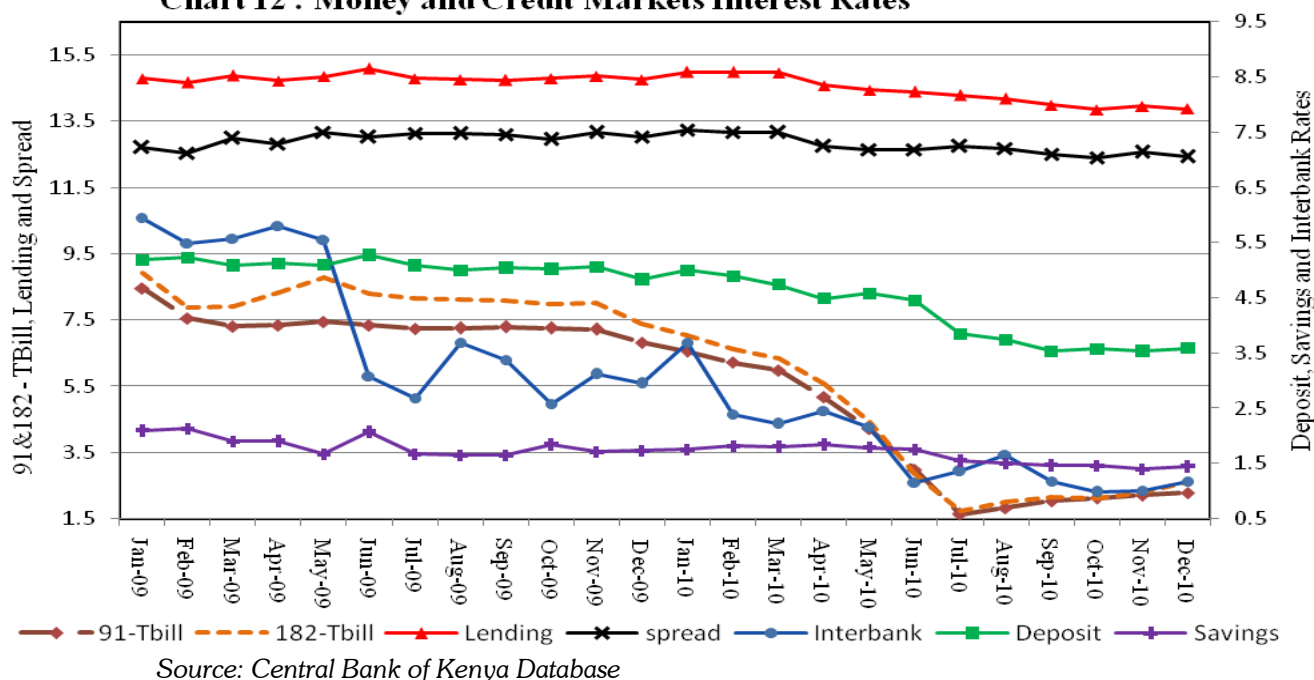
The economy maintained an expansionary monetary policy complementary to the stimulus program to strengthen the recovery, following the 2008 post-election violence and the global financial crisis. However, potential risks arising from political instability in the Middle East and North Africa (MENA) region and drought in quarter one of 2011 is likely to increase the energy and food prices, which is likely to put pressure on inflation. The arising inflation differential between Kenya and her trading partners has led to exchange volatility in 2011 which may adversely impact the pace of economic recovery in 2011.

### 3.1.2. Money and Credit Markets Interest Rates

As indicated in Chart 12, while short-term money market interest rates declined due to sustained reduction of the policy rate, the Central Bank Rate (CBR), credit markets remained sticky upward. The second half of 2010 saw reversal of downward trend for interest rates. Neither lending nor savings rates adequately responded to the CBR signal, following a 300 basis points slash of the later to 6% in December, 2010 from 9% in December 2008 by CBK.

The average lending rates in 2010 were 14.36% compared to 14.8% in 2009, a paltry 0.44% decline. The average saving rate however declined from 1.83% in 2009 to 1.63% in 2010 implying an even smaller net gain in cost of credit to borrowers.

**Chart 12 : Money and Credit Markets Interest Rates**

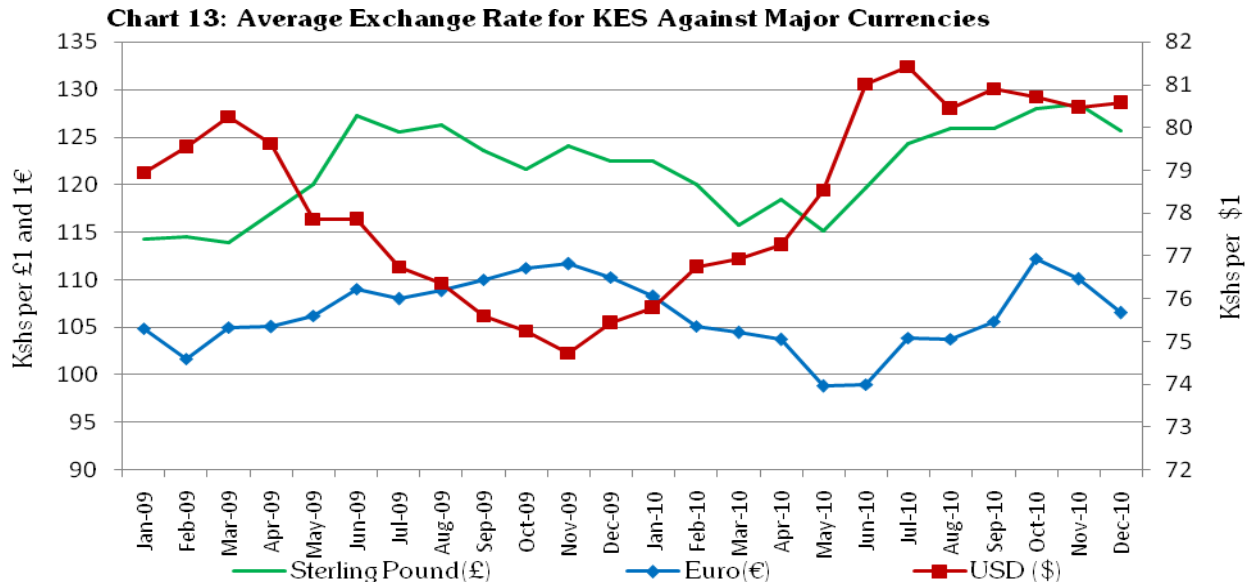


Interest rates spread remained wide, narrowing only by 0.49% between 2009 and 2010. The spread averaged 10.20% in 2010 from 9.71% in 2009, reflecting rising lending rates against depressed deposit rates in the commercial banks. Rising interest rate implies more current borrowers are likely to have difficulties in servicing their running loans amid stagnant incomes. In addition demand for new loans to private sector and household that mainly supported economic expansion in 2010 is likely to be suppressed in 2011 as borrowers such as private consumption and SMEs reduce demand for new loans. Note that in 2010, Credit growth rate to private consumption and real estate averaged 29% and 73% respectively compared to 14.5%, 14.4% and 9.2% allocations to Agriculture, Manufacturing and Businesses & Services respectively. With 54% credit growth rate in Mining & Quarrying, 26% growth in Consumer durables and 15% growth rate of credit to Building & Construction, the economy is likely to experience overheating in 2011, largely driven by rapid credit expansion Private Consumption and Real Estate. This has negative implications on household, business incomes, growth and loan repayment capacities.

### 3.1.3. Exchange Rates Movement

The exchange rate weakened mainly due to the strengthening of the US dollar in the international currency markets. The Kenya Shilling against the USD depreciated by 2.7% in 2010, averaging Ksh 79.23/ 1 USD compared to an average of Ksh 77.35/ 1 USD in 2009. It crossed the Ksh 80 mark per dollar in June, 2010 and thereafter stabilised in the Ksh 80-81 range for the rest of 2010. Against the UK sterling pound, local currency averaged Ksh 122.5 to the pound compared to Ksh. 120.9 to the pound in 2009; and strengthened to Ksh 105.1 per Euro compared to Ksh. 107.6 in 2009.

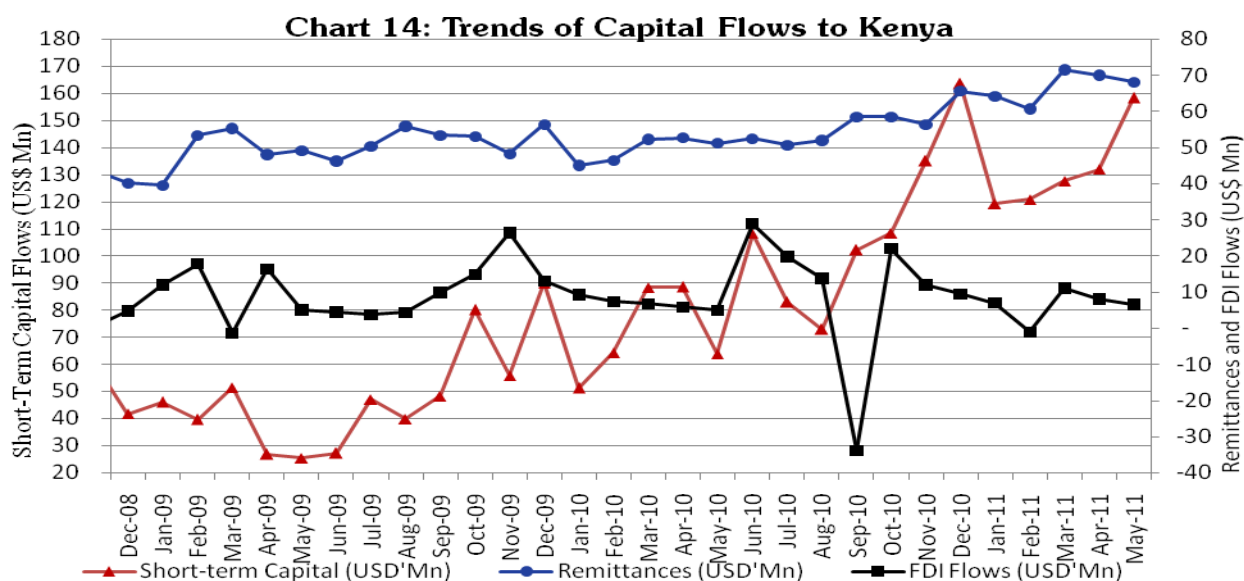
A weakening local currency can trigger instability in the financial sector through negative impact on trade balance, higher external debt service, and foreign reserves. It can also lead to flight by foreign investors from domestic financial markets and heighten inflationary pressures due to excess supply of local currency amid constrained supply of hard currency.



Source: Central Bank of Kenya Database

### 3.1.4. Capital Flows

The remittances inflows were largely oscillating within the USD 50mn - 65mn band during the year 2010. The peaked at the USD 70 mn level in December 2010 and have stabilised above USD 70 mn, reflecting economic recovery in traditional sources of North America and Europe. The flow of remittances closely tracked the monthly average of US \$ 53.5 million in 2010 up from US\$ 50.8 million in 2009 (Chart 14). The Short-term capital inflows including portfolio flows were volatile and trended upward, surpassing the USD 160 mn in December 2010. The Foreign Direct Investment (FDI) inflows in both equity and capital flows in the country have remained below USD 30 mn. The steepest outflow of USD 30 mn was recorded in September 2010. Stability of capital flows is important in balancing the capital account (Chart 14). Usually a disproportionately large inflow of short term capital is vulnerable to reversal which becomes a source of instability to the balance of payments and domestic prices via the exchange rate channel. Caution must therefore be taken when there are observed large inflows that are speculative in nature. Speculative capital flows triggered by interest rate differentials across countries and expectations on currency movements can be detrimental to financial stability, particularly in the event of capital reversals.



Source: Central Bank of Kenya Database

### 3.2. Macro-economic Risks to Financial Stability

A stable financial system requires adequate macroeconomic stability, characterised by stable employment, stable prices and high growth prospects. High unemployment and economic stagnation have negative effects on financial stability through accelerated credit risk perceptions and constrained debt servicing capacity by borrowers. Macro-economic indicators in the year 2010 show a robust GDP growth of 5.6 percent up from the 2.6 percent in 2009. Other macroeconomic indicators were fairly stable. There are however threats emanating from inflation and foreign exchange rates as well as slowdown in economic recovery of Kenya’s major trading partners. In addition, rising international crude oil prices is likely to dampen economic recovery.

Volatile consumer prices affect disposable incomes and fixed income markets, thus escalating real debt burdens. Volatile exchange rate impacts negatively on potential foreign investors, worsens external debt service and increases import bill, making a country uncompetitive as an investment destination. Increasing domestic prices of food caused by delayed and insufficient rain in the last quarter of 2010 may also pose a threat to growth prospects with possible negative effects on stability. Some parts of the country are already facing shortages of food in 2011 and this has been aggravated by influx of refugees from Somali (another drought afflicted country in the Horn of Africa region). Growth prospects may also be dampened by domestic power rationing, currently targeting manufacturing firms.

Risk factors from the external sector include political strain in the MENA region, nuclear plant threats in Japan, fiscal problems in Europe, and slow recovery in the advanced economies. Prolonged political unrest in the MENA region, spreading to other African

countries, is likely to create supply shortages and uncertainty in the macro-economic environment. Already, it has impacted negatively on Kenya's tea exports to Egypt, and transport of crude oil through the Suez Canal from MENA region. Consequently, there are fears of continued imported inflationary pressures triggered by rising oil prices, which in turn will erode consumer's purchasing power, depress demand for manufactured goods and other consumer products and feed into food inflation. There is also fear of perceived higher risks in African markets by international investors, which may lead to possible capital reversals as potential investors scale down their portfolio. This is detrimental to the stock market, the economy and financial stability. Second, the developments in Japan, which is Kenya's major trading partner, following the failure of the nuclear power facilities after experiencing an Earthquake and Tsunami may disrupt aid and trade flows to Kenya. All these risks impact negatively on the country's foreign exchange rate stability and thus require close monitoring to mitigate potential risks.

### **3.3. Monetary Developments and Implications on Financial System Stability**

The monetary policy stance of a country has implications on the financial system stability through inflation, interest rates markets and foreign exchange markets. During the fiscal year 2010/11, Kenya focused on achieving and maintaining a stable overall inflation rate (at 5%) to attain price stability, support economic growth through credit expansion to the private sector and ensure stable short-term interest rates.

Through its monetary policy operational framework, CBK targeted reserve money (RM) as the operating target and broad money supply (M3) growth as intermediate target. The M3 rose by 21.6% by end December 2010 compared with 16.9% in a corresponding period in 2009, but was within the 22.6% target (Table 6). The NDA of the banking system increased by 24.9% in 2010, which, reflects overall domestic credit expansion. Similarly, the NFA of the banking system grew by 10.7% in 2010 compared with a decline of 2.3% in a corresponding period in 2009. This accumulation of NFA reflected purchases from of foreign exchange from the interbank market to build foreign reserves. Domestic credit growth accelerated to 24.3% in 2010 from 17.2% in 2009, credit to Government expansion rose by 35.5% from 32%, while credit to private sector was accelerated to 21.3% from 13.7% in 2009.

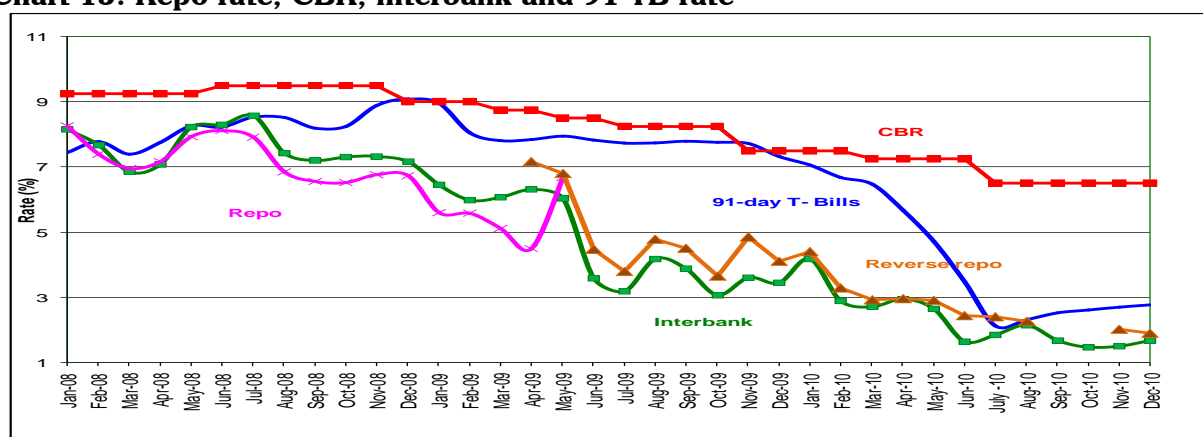
**Table 6: Money supply and its sources (KSh. billion)**

	2008 Dec	2009 Dec	2010 Dec	Annual % Change	
				2009/10	2010/11
<b>1. Money supply, M3 (2+3) 2/</b>	<b>901.1</b>	<b>1045.7</b>	<b>1271.6</b>	<b>16.0</b>	<b>21.6</b>
1.1 Money supply, M2 3/	766.4	898.1	1099.2	17.2	22.4
1.2 Money supply, M1	392.8	442.2	577.2	12.6	30.5
1.3 Currency outside banks	93.7	100.9	122.9	7.6	21.9
<b>2. Net foreign assets 4/</b>	<b>249.5</b>	<b>243.8</b>	<b>269.8</b>	<b>-2.3</b>	<b>10.7</b>
Central Bank	199.1	222.9	252.4	11.9	13.2
Banking Institutions	50.4	21.0	17.4	-58.3	-16.9
<b>3. Net domestic assets (3.1+3.2)</b>	<b>651.6</b>	<b>801.9</b>	<b>1001.8</b>	<b>23.1</b>	<b>24.9</b>
<b>3.1 Domestic credit (3.1.1+3.1.2)</b>	<b>815.5</b>	<b>955.8</b>	<b>1188.4</b>	<b>17.2</b>	<b>24.3</b>
3.1.1 Government (net)	155.3	205.1	277.8	32.0	35.5
3.1.2 Private sector and other public sector	660.2	750.7	910.6	13.7	21.3
<b>3.2 Other assets net (3-3.1)</b>	<b>-164.0</b>	<b>-153.9</b>	<b>-186.6</b>	<b>-6.1</b>	<b>21.2</b>
<b>Memorandum items</b>					
1. Overall liquidity, L 1/	<b>1091.9</b>	<b>1280.5</b>	<b>1569.6</b>	<b>17.3</b>	<b>22.6</b>
2. Reserve money	<b>163.6</b>	<b>182.0</b>	<b>222.6</b>	<b>11.2</b>	<b>22.4</b>
Currency outside banks	93.7	100.9	122.9	7.6	21.9
Bank reserves	69.9	81.1	99.7	16.1	22.9

Source: Central Bank of Kenya

Through policy instruments such as CBR, Repo and Reserve Money, CBK can regulate the quantity money in the economy at any one point in time to achieve price stability which is one of its main objectives. However in the conduct of monetary policy the CBK cannot wholly ignore price movements and usually applies open market operations to stabilise short term interest rate movements. For instance, very low short term interest rates might lead to very low yields on fixed income securities, making them unattractive to both foreign and domestic investors. If they dispose off their holdings, it will weaken the exchange rate besides being inflationary. Flight from the equities market creates a potential threat to financial sector instability as the corporate sector weakens and the households' net worth is eroded. This way the conduct of monetary policy is pertinent to financial stability.

**Chart 15: Repo rate, CBR, interbank and 91-TB rate**



Source: Central Bank of Kenya

### 3.4. Balance of Payments

Kenya's balance of payments surplus narrowed from US\$ 781 million in 2009 to US\$ 163 million in 2010 reflecting a wider current account deficit due to increased imports bill in 2010 (Table 7). Imports expanded to US\$ 12,395 million over the same period, due to higher purchase of capital goods for infrastructure development and oil. The rising international crude oil prices and weakening Kenya Shilling in 2010 translated into higher inflation rate at home, thus filtering into macroeconomic vulnerabilities and overall financial sector instability.

**Table 7: Balance of Payments (US \$ M)**

	2009 Total	2010 Total	2010 Quarterly Changes			
			Q1	Q2	Q3	Q4
<b>1. OVERALL BALANCE</b>	781	163	-101	54	264	-54
<b>2. CURRENT ACCOUNT</b>	-1,671	-2,512	-451	-602	-631	-828
<b>3. MERCHANDISE ACCOUNT</b>	-5,768	-7,169	-1,474	1,750	-1,815	2,130
3.1 Exports (fob)	4,528	5,225	1,306	1,253	1,256	1,411
3.2 Imports (cif)	10,296	12,395	2,780	3,002	3,071	3,541
<b>4. SERVICES</b>	4,097	4,657	1,023	1,147	1,184	1,302
4.1 Non-factor services	1,876	2,527	556	620	620	732
4.2 Income account	-38	-158	-40	-53	1	-67
4.3 Current Transfers account	2,259	2,288	507	581	563	637
<b>5. CAPITAL &amp; FINANCIAL ACCOUNT</b>	2,451	2,675	350	656	895	774
<b>6. OVERALL BALANCE</b>	781	163	-101	54	264	-54
Gross Reserves	5,064	5,123	5,188	5,009	5,141	5,123
Official	3,847	4,002	3,74	3,799	4,063	4,002
Commercial Banks	1,217	1,121	1,443	1,211	1,078	1,121
Import cover (36 months imports)	4.1	3.9	3.9	3.9	4.0	3.9

Source: Central Bank of Kenya

Rising imports against declining exports in value terms, constrains foreign exchange earnings thus exerting upward pressure on the exchange rate. Persistent weakening of the local currency amid declining foreign reserves expressed in months of import cover from 4.1 months in 2009 to 3.9 months in 2010 has destabilizing effect not only on the foreign exchange market, but also on the entire financial stability and overall economy. The outlook for 2011 therefore remains less robust due to spillover effects of BoPs developments in 2010. We are likely to see a weaker local currency, rising inflation and reduced activity of foreign participation in the domestic financial markets.

## 4.0. PUBLIC DEBT AND DEBT SUSTAINABILITY ASSESSMENT

### 4.1. Government Borrowing from the Central Bank

Government indebtedness to the CBK was Ksh 55 billion in 2010 from Ksh 45 billion in 2009 due to higher use of Government overdraft by Ksh 11.5 billion. While the overdraft utilisation was within ceiling, the stock of Government debt to CBK was dominated by previously securitized past lending which Government amortizes at Ksh 0.5 billion semi-annually. Accelerated borrowing from CBK can be inflationary thereby engendering macroeconomic instability.

**Table 8: Government Indebtedness to the Central Bank (Ksh billion)**

	Dec-09	Dec-10	Change
<b>Total Credit</b>	<b>45.0</b>	<b>55.0</b>	<b>10.0</b>
1. Overdraft	11.1	22.7	11.5
2. Rediscounted Securities	0.0	0.0	0.0
Treasury Bills	0.0	0.0	0.0
Treasury Bonds	0.0	0.0	0.0
3. Pre-1997 Government Overdraft at CBK	33.3	32.2	-1.1
4. IMF funds on-lent to Government	0.5	0.0	-0.5
5. Cleared items	0.0	0.1	0.0
<b>Memorandum</b>	<b>16.9</b>	<b>22.9</b>	<b>11.6</b>
Authorised Overdraft limit	9.8	22.7	22.6
Amount utilized to date	7.1	0.3	-11.0

Source: Central Bank Database

### 4.2. Government Revenue Performance

Government revenue (including grants) amounted to KSh.560.8 billion in the fiscal year 2009/10 compared with KSh.506 billion in a similar period in the fiscal year 2008/09. However, as a percentage of GDP, the revenue and grants increased by 1 basis point to 22.7% during the period. Despite this better performance, the set targets were missed by 9.5% due to decline in corporate taxes, VAT and other taxes as a result of slower-than- envisaged expansion in economy. Short falls in revenues through taxes implies the government has to borrow more from domestic markets to finance its budget. This could hike interest rates, and can distort the yield curve and create instability in credit markets. The government raised its domestic borrowing target from Ksh 105.9 billion to Ksh 124.9 billion for FY 2010-11 partially as a result of short-falls in tax revenues. Interest rates however remained low due to higher liquidity created by an accommodative monetary policy through the monetary stimulus strategy to nurture economic recovery.



### 4.3. Public Debt and Debt Sustainability

Kenya's public and publicly guaranteed debt increased by 16% by end June 2010 to Ksh 1,229.4 billion (51% of GDP) from KSh.1, 059.4 billion by end June 2009 (45.9% of GDP). By end December 2010, the debt stock had risen to Kshs 1,320.14 billion or 51.8% of GDP.

**Table 9: Stock of Public Debt**

Measure	Ksh (Bn)	% of GDP	Share of Total Debt (%)	Weighted Average Interest Rate (%)
<b>June 2009</b>				
Domestic	518.5	22.5	48.9	10.3
External	540.9	23.4	51.1	1.7
<b>Total</b>	<b>1,059.4</b>	<b>45.9</b>	<b>100.0</b>	<b>5.9</b>
<b>June 2010</b>				
External	569.2	23.6	46.3	1.3
Domestic	660.3	27.4	53.7	10.4
<b>Total</b>	<b>1,225.7</b>	<b>51.0</b>	<b>100.0</b>	<b>6.2</b>
<b>Dec. 2010</b>				
External	599.9	23.5	45.4	0.8
Domestic	720.2	28.3	54.6	7.8
<b>Total</b>	<b>1,320.1</b>	<b>51.8</b>	<b>100.0</b>	<b>4.9</b>

Source: Annual Public Debt Management Report May 2011, December 2010 Monthly Debt Bulletin, and June 2011 MTDS

The level of domestic debt was below the target and the average interest cost declined from 6.2% to 4.9% due to low domestic interest rates during the FY 2010/11. There was low uptake of domestic borrowing and underperformance of revenues while expenditures increased due to unforeseen contingencies to mitigate effects of drought and higher fuel prices. The level of refinancing risk in the domestic debt improved significantly, with average time to maturity lengthening to 5.9 years from 4.6 years. The proportion of domestic debt falling due within 12 months fell from 28% as of end June 2010 to 18% as of end June 2011.

**Table 10: Characteristics of the Public Debt Portfolio by End of 2010/11**

Measure	June 2010	June 2011
<b>Portfolio Composition</b>		
Domestic	54	57
External	46	43
<b>Refining Risk</b>		
Average maturity of entire debt (years)	8.9	8.4
Average maturity life of domestic debt (years)	4.6	5.9
% of domestic debt maturing in 12 months	28	18
<b>Cost</b>		
Average Interest Rate (%)	6.2	4.9

Source: June 2011 MTDS

#### 4.4. Developments in the Debt markets in 2010 and Potential Risks

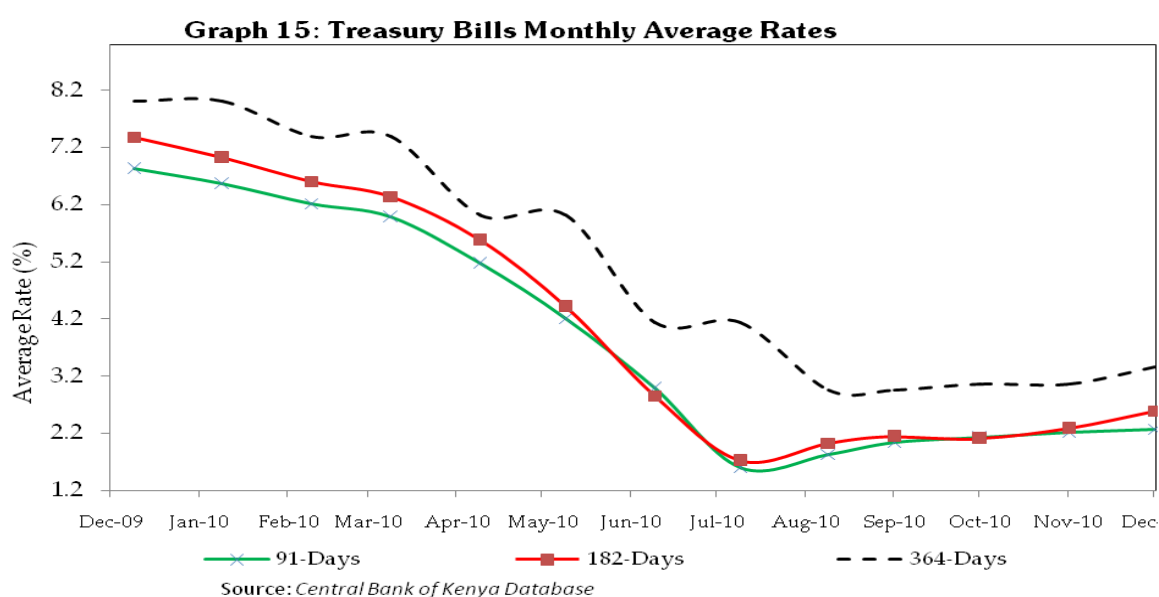
Primary market for Treasury bills and bonds recorded full subscriptions in all the 2010 tender offers. Performance rate exceeded 110% per issue since 2007, with 2010 recording the highest offer of Ksh 176 billion against 163% subscription (Table 11).

**Table 11: Government Bonds Primary Market Performance (Ksh Millions)**

YEAR	Offer	Bids	Allotment	Performance (%)
2007	87,000	143,744	84,980	165.22
2008	85,000	94,385	61,532	111.04
2009	42,500	214,032	40,384	150.20
2010	176,100	287,027	179,855	162.99

Source: Central Bank of Kenya, Financial Markets database

Similarly, about 95% of all Treasury bills primary auctions were fully subscribed for all the 91,182-and 364-days tenors. Interest rates on the benchmark 91-days Treasury bill declined significantly, from monthly average of above 6.5% in December 2009 to below 2.5% in June 2010 before assuming upward direction in September 2010 (Chart 15).



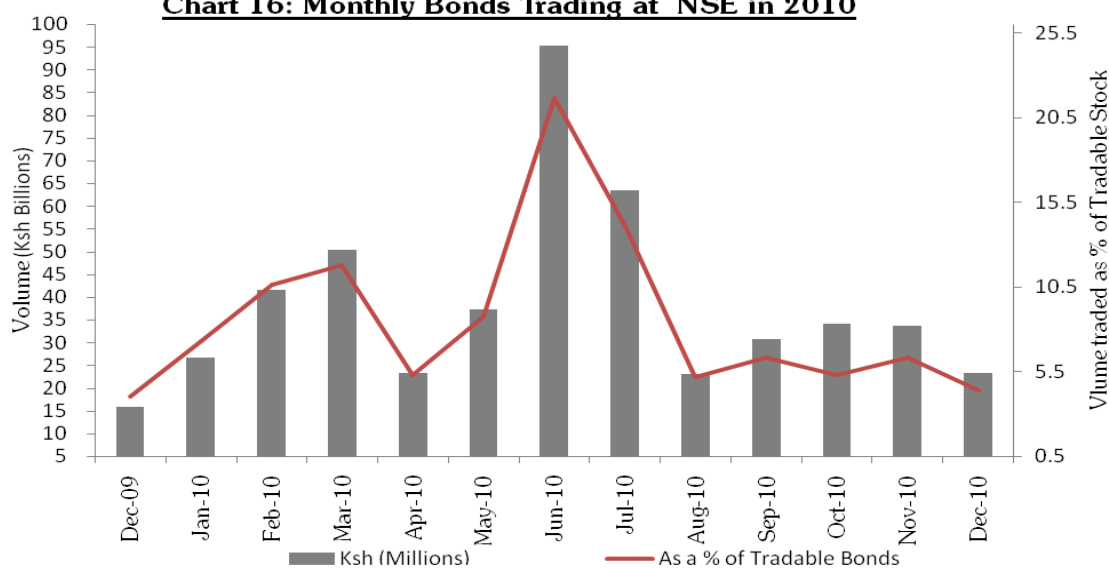
The significant fall in rates was due to high liquidity associated with less tight monetary policy taken by CBK to support the Stimulus programme of the government. The declining money market yields increased appetite for bonds, in both primary and secondary markets as investors looked for better yields that bonds promised. As a result, the debt (bonds) market rose to the highest level in 2010, surpassing all other years combined. A total of bonds worth Ksh 466.1 billion were transacted in 2010, 432% higher than the volume traded in 2009.

**Table 12: Treasury Bonds Secondary Market Trading (Kshs. M)**

MONTH	2007	2008	2009	2010
January	1,653.90	4,870.95	5,647.80	27,282.10
February	4,449.75	3,177.55	6,861.80	41,058.50
March	5,732.90	14,291.35	8,449.60	49,048.60
April	8,511.00	3,073.10	4,533.42	22,376.90
May	9,899.00	3,037.20	10,477.35	36,733.40
June	10,320.60	2,446.70	11,099.35	93,377.45
July	10,137.70	1,893.93	7,542.80	62,231.55
August	9,778.95	8,416.85	6,138.80	22,865.65
September	9,498.75	10,988.71	10,672.60	30,650.65
October	4,216.80	4,320.85	11,713.15	26,314.50
November	3,464.45	3,118.60	9,434.70	31,557.90
December	6,472.05	3,577.00	15,280.00	22,570.65
<b>TOTAL</b>	<b>84,135.85</b>	<b>63,212.79</b>	<b>107,851.37</b>	<b>466,067.85</b>

Source: Financial Markets database, CBK

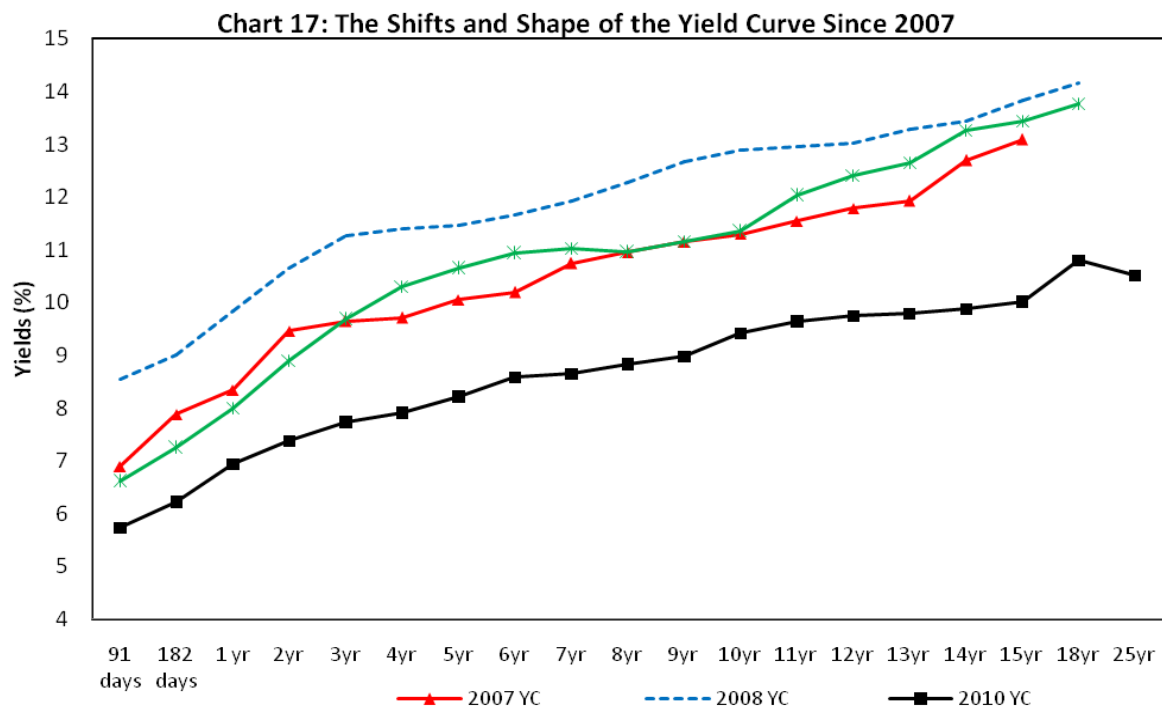
This was due to higher amounts issued in primary market both by government and Corporates, low interest rates regime by CBK that led to low yields, implying higher capital gains for traders, low inflation hence higher real returns, automation of trading platform (ATS) guaranteeing market confidence and government policy for pensions to invest all new contributions into government paper. June and July 2010, were the most active months for the secondary market at the NSE, with more than 15 percent of tradable bonds transacting at the Exchange. This vibrancy however cooled off towards end of 2010 and therefore a potential source of risks and instability.

**Chart 16: Monthly Bonds Trading at NSE in 2010**

Source: Central Bank of Kenya and Nairobi Stock Exchange

Instability in the bond markets has enormous potential risks to financial markets stability. First, rapidly rising inflation erodes returns on long term paper, making real yields economically insignificant or negative and therefore disincentive to potential buyers. Higher inflation expectations cut-back uptake of long term instruments or leads to demand for higher rates for long term securities, which is unsuitable for financial markets growth and stability. Third, rapidly rising money market interest rates shifts investors' appetite to short term instruments and in turn affects stability of yields and volumes in both primary and secondary markets for debt instruments. Low returns on bonds affects investment thresholds for pension schemes and if combined with undesirable policy measures like early access to pension contributions by beneficiaries can lead to increased withdrawal of pension contributions to registered Schemes by members before retirement age. This later factor is critical as pension funds may no longer invest in more long term papers in anticipation of meeting liabilities falling due in short to medium term.

The rapidly rising short term interest rates and falling demand for long term securities will lead to upward shift of the yield curve, and if it surpasses the 2008 position, holders of longer-dated papers with low nominal yields, especially commercial banks, might dump them to CBK via rediscounts or sell at very low prices to cut down on losses. This will in turn negatively affect on future investor confidence in long term papers, thus stifling prospects for long term capital formation.



Source: Central Bank of Kenya

#### 4.5. Public Debt Sustainability Analysis

The most recent Debt Sustainability Analysis for 2010 (DSA, January 2011) by the joint World Bank-IMF Debt Sustainability Framework (DSF) concluded debt sustainability indicators have deteriorated somewhat, reflecting a projected faster debt accumulation over the medium term. However, Kenya remains at low risk of external debt distress.

Under stress tests using different scenarios which consider significant fall in real GDP, rise in primary balance, 30% depreciation in the Kenya shilling and 10% of GDP increase in borrowing (borrowing shock) in the FY 2011-12, Kenya's level of debt remain within sustainable levels. The results indicate that in the medium term (by FY2013/14), the debt burden indicators will breach one debt sustainability benchmark, the NPV of Debt/GDP.

**Table 13: Sensitivity Analysis for Key Indicators of Public Debt**

<b>Measure</b>	<b>Benchmark under CPIA)</b>	<b>June 2011</b>	<b>Impact of a 10% of GDP rise in 2011 borrowing on debt indicators in 2014</b>
<b>NPV of Debt as a % of</b>			
GDP	40	40	52
Revenues	250	161	181
<b>Debt Service as a % of</b>			
Revenues	30	23	26

Source: June 2011 MTDS, [www.treasury.go.ke](http://www.treasury.go.ke)

## 5.0. FINANCIAL SECTOR DEVELOPMENTS

Financial system in Kenya is segmented and dualistic (formal and informal) in structure. It comprises of the banking, pension, insurance, capital markets, and SACCOs, and Development Finance Institutions (Kenya Post Office Savings Bank (KPOSB or Postbank) and the Agricultural Finance Corporation). As at 31st December 2010, the banking industry, the largest of the financial sector, comprised of the Central Bank of Kenya, as the regulator, **44** banking institutions (**43** commercial banks and **1** mortgage finance company), **2** representative offices of foreign banks, **5** Deposit-Taking Microfinance Institutions (DTMs) and **126** Forex Bureaus.

### 5.1. Banking Industry

The banking sector recorded strong performance in 2010, with capital adequacy ratios surpassing the minimum prudential requirements of 8% and 12% respectively. The average liquidity ratio for the industry was 44.5%, way above the statutory minimum requirement of 20% and higher than the 39.8% registered in 2009, with all institutions meeting the liquidity threshold in 2010. Gross Loans and Advances grew by 20.7% from Ksh. 757.8 billion in December 2009 to Ksh. 914.9 billion in December 2010, mainly supported by expansion in personal, trade and real estate subsectors. Gross non-performing loans (NPLs) declined by 5.1 percent from Ksh. 60.7 billion in December 2009 to Ksh. 57.6 billion in December 2010, hence improved ratio of gross NPLs to gross loans from 7.9% in December 2009 to 6.3% as at December 2010. This decline was partly due to recoveries, continued deployment of sound credit appraisal and monitoring standards and robust domestic economic growth witnessed in the year.

Profit before tax rose markedly, by 51.9%, from Ksh. 48.9 billion in December 2009 to Ksh. 74.3 billion in December 2010. This was driven by higher revenues from the growth in credit portfolio and investment in Government securities.

Five sectors registered increased proportion of their loans to gross loans with two sectors accounting for over 47% of gross loans is indicated in Table **14**. The largest sector was Personal or Household followed by trade and Manufacturing. Given that household sector is more for consumption purposes, this largest proportion point to possibility of inflationary pressures as productive sectors like Agriculture and Manufacturing had less access to capital for expansion. In addition, given that household sector had largest share of NPLs, this has implications of potentials risks of defaults. Rising NPLs poses credit risks to the entire financial sector stability.

**Table 14: Share of Gross Loans and NPLs**

<b>Sectors</b>	<b>Share of Gross Loans</b>		<b>Share of NPLs</b>	
	<b>2009</b>	<b>2010</b>	<b>2009</b>	<b>2010</b>
Personal/Household	29.3%	28.8%	28.1%	31.5%
Trade	17.9%	18.5%	22.0%	21.6%
Manufacturing	14.0%	13.7%	13.9%	12.1%
Real Estate	10.1%	11.7%	11.9%	11.2%
Transport & Communication	8.3%	7.8%	4.9%	6.1%
Agriculture	5.8%	5.4%	9.0%	8.0%
Financial Services	5.8%	5.0%	4.7%	2.9%
Energy and Water	3.5%	2.9%	0.5%	0.4%
Building and Construction	2.1%	2.8%	2.0%	2.4%
Tourism, Restaurant & Hotels	2.0%	2.2%	2.9%	3.6%
Mining and Quarrying	1.2%	1.3%	0.2%	0.1%
<b>Grand Total</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>

Source: Bank Supervision Report, 2010

### 5.1.1. Stress Testing

Stress testing as defined by Bank for International Settlements (BIS), is a risk management technique that is used to evaluate the potential effects of a specific event and/or movement in a set of financial variables on an institution's financial condition. Central Bank on a regular basis conducts stress tests to determine the sector's stability against certain risk factor shocks. As at the end of December 2010, there were no major threats anticipated in the banking sector in view of improved GDP growth in 2010. However, plausible scenarios were used to stress the banking sector resilience as follows:

**Overall Risk** – Stress testing results indicated that the banking sector was in good health and can cope with substantial negative shocks. The sector met all the statutory ratios, namely; capital adequacy, liquidity and sensitivity to market risk (net open position in FX to Capital) ratios as indicated in Table 15.

**Credit Risk** – a 10-year month on month analysis of non-performing loans (NPLs) was undertaken and the highest growth registered was 9.1%. However, there has been an upsurge in loans to trade, real estate personal/household and manufacturing sectors which are susceptible to both global and domestic economic developments. Similarly, credit to agricultural sector is subject to unpredictable weather conditions. Consequently, 10%-15% of the performing loans with respect to each of the 11 sectors were assumed to migrate to NPLs.

**Table 15: Financial Soundness Indicators**

<b>INDICATOR (FSI)</b>	<b>Dec' 2009</b>	<b>March' 2010</b>	<b>June' 2010</b>	<b>Sept' 2010</b>	<b>Dec' 2010</b>
<b>Capital Adequacy</b>					
Capital to Risk-Weighted Assets ( <b>Min 12%</b> )	19.6%	20.5%	19.6%	20.6%	20.8%
Tier 1 Capital to Risk-Weighted Assets ( <b>Min 8%</b> )	17.4%	18.3%	17.5%	18.6%	18.7%
Total Capital to Total Assets	12.7%	13.1%	12.3%	12.8%	13.2%
<b>Asset Quality</b>					
NPLs to Total Gross Loans	7.9%	7.9%	7.4%	7.0%	6.3%
NPLs Net of Provisions to Capital	11.8%	10.6%	10.0%	8.0%	6.4%
Earning Assets to Total Assets	87.9%	89.6%	87.9%	88.7%	88.8%
<b>Earnings &amp; Profitability</b>					
Return on Assets (ROA)	2.8%	3.7%	3.5%	3.4%	3.7%
Return on Equity (ROE)	25.4%	32.4%	32.6%	31.3%	30.7%
Interest Margin to Gross Income	35.6%	32.0%	32.9%	33.7%	34.7%
Non Interest Expenses to Gross Income	50.8%	46.6%	47.1%	49.2%	48.2%
<b>Liquidity</b>					
Liquid Assets to Total Assets	36.0%	38.9%	39.7%	39.9%	38.4%
Liquid Assets to Short-term liabilities (Liquidity ratio – <b>Min 20%</b> )	39.8%	43.8%	45.1%	46.7%	44.5%
Liquid Assets to Total Deposits	46.3%	49.6%	50.4%	51.5%	51.0%
Total Loans to Total Deposits	72.4%	69.6%	68.0%	69.2%	72.5%
<b>Sensitivity to Market Risk</b>					
Net open position in FX to Capital ( <b>Max. 20</b> )	4.9%	5.1%	4.9%	4.8%	4.3%
Interest Bearing Assets to Interest Bearing Liabilities	113.2%	114.3%	111.6%	114.4%	117.8%
FX Currency Denominated Assets to Total Assets	8.1%	9.4%	10.2%	9.7%	10.6%
FX Currency Denominated Liabilities to Total Liabilities	18.1%	16.5%	16.3%	17.1%	17.1%
Spread between lending and deposit rate	8.7%	9.0%	9.4%	9.3%	9.3%

Source: Banking Supervision, CBK

**Liquidity Risk** – a 10-year month on month analysis in deposits was undertaken and the highest decline registered was 4.8%. However, a larger portion of liquid assets are in form of government securities which are mainly held to maturity thus making secondary trading illiquid. As a result, a 15% drop in deposits was assumed.

**Market Risk** – Lending interest rates movement on month to month basis has registered minimum change. However, interest income constitutes about 50% of banks total income and interest rates are easily adjustable hence mitigating the impact of interest rate shock. However, a 7.5% shock has been applied on the interest yield (interest income to total loans ratio). Foreign assets and liabilities including both on and off balance sheet items are reasonably matched, with assets in foreign currency being slightly higher. Further, banks are able to review their exposures to ensure compliance with prescribed limits. In addition,



banks use smaller share of their foreign currency denominated deposits to extend credit. As a result, a 15% depreciation of the shilling was applied on net foreign assets.

## 5.2. Deposit Protection Fund Board (DPFB)

At the end of December 2010, total number of member institutions was 47, of which 43 were commercial banks, 1 was a mortgage finance company and 2 deposit-taking microfinance institutions. Charterhouse Bank Limited still remains under statutory management and a member of the Fund.

### 5.2.1. Growth of Deposit Accounts

The total number of deposit accounts with the member institutions increased by 4,146,071 from 8,657,490 in December 2009 to 12,803,561 in December 2010, reflecting a 47.9% growth in the banking sector. The growth in the number of accounts during the year could be explained by: licensing of Deposit Taking Microfinance Institutions; agency banking; aggressive marketing by commercial banks to capture lower-end market, and stable macroeconomic environment. However growth rate of new deposits accounts declined during the third quarter of 2010, at only 6.7% compared to 12.4% in the second quarter of 2010, implying reduced expansion banking services.

**Table 16: Growth of Deposit Accounts**

ITEM	Dec.2009	Mar.2010	June 2010	Sept.2010	Dec.2010
Total No. of A/Cs	8,657,490	8,857,802	10,676,455	12,000,450	12,803,561
Quarterly Increase	656,335	200,312	1,818,653	1,323,995	803,111
Deposits a/c change (%)	8.20	2.31	20.53	12.4	6.7

Source: Deposit Protection Fund Board database

### 5.2.2. Growth of the Fund

The Fund grew by Kshs 3.9 billion or 17% in 2010, buoyed by prudent investment policies adopted by the Board. The funds are in a mixed portfolio of both short and long term government securities as required by the Law and the Board aims to achieve the optimum yielding mix in its portfolio.

**Table 17: Growth of DP Fund, Insurance Cover & Deposits (in Kshs)**

ITEM	Dec .2009	March 2010	June 2010	Sept 2010	Dec 2010
Total A/Cs	8,657,490	8,857,802	10,676,455	12,000,450	12,803,561
Total Deposits	1,062,511,543	1,130,167,933	1,222,160,340	1,273,581,637	1,279,954,382
Insurance Cover	129,018,195	137,612,724	136,291,394	153,202,286	157,173,795
Fund Level	23,051,867	23,604,111	24,101,216	26,461,400	26,943,600

### 5.2.3. Deposit Protection

The total deposits in DPF member institutions by end December 2010 was Kshs 1,280 billion while total protected deposits amounted to Kshs 157,174 million. Total deposits accounts in the sector were 12,803,561; while those accounts fully protected were 12,026,566 representing 94% of total accounts in the sector. This is only 17% of total value of deposits in the sector.

### 5.2.4 Risk Exposure

The current Fund Balance stands at Kshs 26,944 million compared to protected deposits of Kshs. 157,174 million, a considerably high exposure level of 83%. The number of deposit accounts fully covered as at 31st December 2010 is 12.027 million out of a total number of 12.804 million accounts, representing 94% coverage and 17% in terms of value covered which is low compared to 40% international benchmark. This is however mitigated by a stable financial sector as a result of sustained economic growth and sound prudential supervision. A notable large exposure to the Fund is one large bank, which currently stands at Kshs 38.92 billion, against total value of the fund at Ksh 26.94 billion. The bank however, has a substantial liquid asset base and does not pose any major risk to the Fund presently. Table 19 shows summary of protection and exposure indicators.

**Chart 18: Protection & Exposure Indicators as at end December 2010**

	<b>Banking Sector Deposits</b>	<b>Dec. 2009</b>	<b>Dec. 2010</b>	<b>Change (%)</b>
1	Total Deposits (Ksh Mn)	1,052,282	1,279,954	22
2	Total Protected Deposits (Ksh Mn)	124,403	157,174	26.3
3	Protection Level (%)	11.82	12.3	0.46
4	Funds Balance (Ksh Mn)	23,052	26,944	17
5	Effective Cover (4/2) in %	18.53	17.14	-1.39
6	Deposit Accounts ('000)	8,083	12,804	58.41
7	Accounts fully Protected ('000)	7,445	12,027	61.54
8	% of Protected Accounts (7/6)	92	94	2
9	Exposure Level (2-4/2) in %	81	83	2

Source: Deposit Protection Fund Board Database

## 5.3. National Payment Infrastructure

### 5.3.1. Real Time Gross Settlement (RTGS) System

Kenya's RTGS system, acronymed, Kenya Electronic Payment and Settlement System (KEPSS) is a Systemically Important Payment System (SIPS) and is hence the Bank's main concern for the purposes of mitigating systemic payment risks in the financial system. Cumulatively, KEPSS cleared KSh.17.1 trillion in 2010, up from KSh.13.9 trillion in 2009.

The number of corresponding messages was 904,717 up from 390,737, signaling increased public usage due to continued awareness.

**Table 19: KEPSS System Flows**

Year End	Amount (KSh. Billion)	Number of Messages
2006	2,936.9	142,445
2007	9,599.4	180,312
2008	17,269.3	273,941
2009	13,925.4	390,737
2010	17,100.7	904,717

Source: [www.centralbank.go.ke](http://www.centralbank.go.ke)

### 5.3.2. Cards Transactions

Transactions using Credit cards surpassed 50,000 per month in 2010 while those involving Debit cards exceeded 5 million per month. Cumulatively, there were 521,761 credit cards and 60,906,940 debit cards transactions during the year. The POS Machines grew by 6.4 percent from 17,092 Machines in January 2010 to 18,179 Machines in December 2010. There were 5,507,320 ATM cards transactions in 2010 while transactions via POS were 5,496,360. These reflect a shift away from the cash-based transactions to plastic money transactions.

**Table 20: Monthly Number of Transactions by Cards**

Year 2010	ATMs	Credit	Debit	POS Machines
January	413,581	60,202	6,442,266	427,920
February	431,045	58,541	8,773,391	419,043
March	496,879	61,801	5,187,042	479,303
April	467,331	59,095	7,240,815	466,463
May	417,234	62,549	6,843,646	451,366
June	410,487	54,665	6,647,688	395,891
July	435,765	51,888	6,867,328	431,833
August	433,565	58,667	7,241,399	496,450
September	445,459	54,353	5,663,365	443,633
October	518,131	55,235	7,107,838	466,523
November	504,688	56,244	8,098,233	459,430
December	533,155	56,804	10,068,430	558,505

Source: <http://www.centralbank.go.ke>

In Table 22, Ksh 117.63 billion transacted via ATMs, Ksh 3.7 billion passed through Credit cards while transactions involving debit cards were valued Ksh 395.1 billion. Transactions involving Point of Sale (POS) Machines were Ksh 43.6 billion in 2010.

**Table 21: Value of Cards Transactions (Ksh Millions)**

Year – 2010	ATMs	Credit	Debit	POS Machines
January	8,719	341	29,221	3,340
February	8,246	281	27,054	3,174
March	9,414	377	28,179	3,689
April	9,150	285	35,877	3,238
May	9,435	292	34,353	3,302
June	9,481	279	31,983	3,198
July	9,871	294	33,700	3,599
August	10,243	318	36,305	3,984
September	9,866	323	32,725	3,679
October	10,403	314	26,289	3,871
November	10,432	310	36,164	3,866
December	12,367	333	43,291	4,675

Source: <http://www.centralbank.go.ke>

Total Automated Teller Machines (ATMs) increased from 1,827 in 2009 to 2,091 in 2010, implying a 14.4% growth. This has further deepened access to financial products and services by wider public. The Government targets to reduce the current ratio of 1 ATM for 20,000 people. The number of ATM Cards held had reached 1,348,236, credit cards were 113,236, debit cards were 6,191,792 while the POS were 18,179 by end of December 2010.

**Table 22: Number of ATMS, ATM Cards, Cards and POS Machines**

Year – 2010	ATMS	ATM Cards	Credit	Debit	POS Machines
January	1,840	1,073,052	107,682	3,659,965	17,092
February	1,865	1,069,050	107,927	3,768,154	17,587
March	1,887	1,090,092	108,345	3,894,580	18,582
April	1,904	1,126,793	112,203	3,955,160	19,753
May	1,940	1,165,574	110,147	4,067,088	19,399
June	1,943	1,252,893	111,383	4,156,187	19,608
July	1,973	1,271,823	110,788	4,256,198	21,934
August	1,995	1,316,350	112,675	4,353,272	21,805
September	2,025	1,339,649	114,204	4,539,792	20,309
October	2,037	1,306,185	114,058	4,617,459	19,279
November	2,052	1,321,933	113,789	5,746,510	18,243
December	2,091	1,348,236	113,192	6,191,792	18,179

Source: <http://www.centralbank.go.ke>

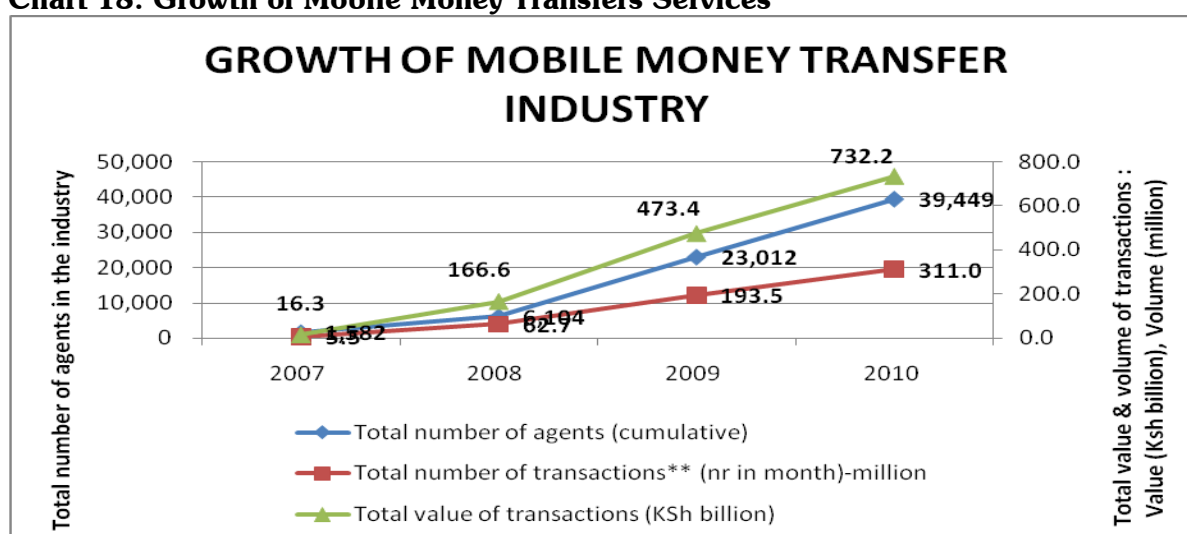
### 5.3.3. Mobile Phone Money Transfers

The Mobile money transfers service recorded a total of Ksh 732 billion transacted in 2010, compared with Ksh 473 billion in 2009, translating into 155% rise in usage. The corresponding number of transfer messages increased to 311 million in 2010 from 194 million in 2009. The number of customers nearly doubled, rising from 8.9 million in 2009 to 16.4 million in 2010.

**Table 24: Mobile Money Transfers By end December 31<sup>st</sup>**

	2007	2008	2009	2010
Total number of agents	1,582	6,104	23,012	39,449
Total customers (million)	1.3	5.1	8.9	16.4
Total number of transactions (million)	5.5	62.7	193.5	311.0
Total value of transactions (Ksh billion)	16.3	166.6	473.4	732.2
Average value per transaction (Ksh)	2,983	2,655	2,447	2,354

Thus, for retail payment systems, mobile money transfers are today the most widely used mode of payment in Kenya followed by the use of plastic cards.

**Chart 18: Growth of Mobile Money Transfers Services**

Source: National Payments System Database, 2010

#### 5.4. Savings and Credit Cooperatives Societies (Saccos) Industry

The Saccos represent a considerable part of the Kenya financial sector especially with respect to access, savings mobilization and wealth creation. Sacco societies are member-based organizations that are focused on meeting financial needs of their members for personal and enterprise development. They have membership across different economic activities in both rural and urban areas and are engaged in Back Office Savings Activities (BOSAs), Front Office Savings Activities (FOSAs), or both. The Sacco societies operating FOSAs undertake near retail banking business operations.

There were 6,007 registered Saccos as at December 2010 out of which 3280 were active. Of the active Saccos, 215 operated FOSAs, accounting for 6.6%, with a combined total asset base of Kshs. 171 billion. The total assets of all deposit-taking and non-deposit taking Saccos were Kshs. 216 billion; implying FOSAs controlled 79.2% of the industry. The

industry continued to experience accounting challenges; lack of a uniform chart of accounts, unrealistic or lack of provisioning and poor compliance with International Financial Reporting Standards (IFRS).

#### 5.4.1 Overall performance of FOSA Operating Sacco Societies

The industry had 215 Sacco societies operating FOSAs by end 2010. Its total assets grew by 10.9% and member deposits expanded by 10.4%. The turnover was up 53%, but loans to members rose by Ksh 3.7 billion or 2.6%. These were driven by FOSA savings.

**Table 24: Performance of the Sacco Industry in 2010**

YEAR	DEPOSITS	TURNOVER	LOANS	ASSETS
2010	140,554,849,435	34,872,162,876	143,187,856,772	216,144,677,262
2009	127,339,725,060	22,801,091,056	139,502,963,908	194,943,235,177
Change	13,215,124,375	12,071,071,820	3,684,892,864	21,201,442,085
% Change	10.4 ↑	52.9 ↑	2.6 ↑	10.9 ↑

*Source: SASRA database*

Sacco societies are not subject to prudential regulation and supervision like commercial banks and deposit-taking microfinance institutions. This makes it difficult to objectively analyse their financial statements for asset quality, capital adequacy, earnings, liquidity, efficiency, productivity and profitability, which are key indicators of financial soundness and stability. The Sacco Societies Act, 2008 and Sacco Societies (Deposit-Taking Sacco Business) Regulations, 2010 provide legal, regulatory and supervisory framework commensurate to the risks in deposit taking business conducted by Sacco Societies. Sacco societies' serve largely the personal loans market lending on a guarantee system, with credit risk perceived to remain high and hence posing the greatest risk to the Sacco movement. This is largely manifested in high borrowing from commercial banks, which has resulted in low liquidity and solvency margins in many Sacco Societies.

#### 5.4.2 Licensing of FOSA Operating Saccos

FOSA operating Saccos had up to June 2011 to apply for a license to conduct deposit taking Sacco Business. A total of 200 Saccos applied for licensing, of which 66 were licensed and 56 issued with letters of intent.

#### 5.4.3 Policy Developments

The Sacco Societies Regulatory Authority (SASRA) is mandated under an Act of Parliament, to licence, regulate and supervise Sacco societies. It seeks to enhance the

regulatory and supervisory requirements such as corporate governance, transparency and accountability, liquidity, loan classification and provisioning, capital adequacy requirements, investment, risk management frameworks and financial reporting.

**Table 25: Sacco Societies Financial Soundness Indicators (FSIs)**

<b>FINANCIAL SOUNDNESS INDICATORS</b>	<b>31 Dec 09</b>	<b>31 Dec 10</b>
<b>Capital Adequacy</b>		
Core capital to Total Assets (10%)	7%	16%
Core Capital to Total deposit liabilities (8%)	9%	21%
Institutional Capital to Total Assets (8%)	1%	3%
<b>Asset Quality</b>		
NPLSs to Total Gross Loans	N/A	N/A
NPLs Net of Provisions to Capital	N/A	N/A
Earning Assets to Total Assets	N/A	N/A
<b>Earnings &amp; Profitability</b>		
Return on Assets (ROA)	N/A	N/A
Return on Equity (ROE)	N/A	N/A
Interest Margin to Gross Income	N/A	N/A
Non Interest Expenses to Gross Income	N/A	N/A
<b>Liquidity</b>		
Liquid Assets to Total Assets	N/A	N/A
Liquid Assets to Short-term liabilities(Liquidity ratio)	N/A	N/A
Liquid Assets to Total Deposit	N/A	N/A
Total Loans to Total Deposit	97	99

Source: SASRA                      N/A – Not available

The Act establishes a deposit guarantee fund (DGF) which shall provide protection to members' deposits up to Ksh.100, 000 per member (the same protection accorded depositors with banking institutions licensed under the Banking Act). This process has commenced. The priority of SASRA is on the 219 deposit taking Sacco societies (FOSAs), which control more than 67% of deposits and total assets in the Sacco industry. While Core capital to total assets and core capital to total deposit liabilities were way above required ratios, institutional capital to total assets fell way below. However, performance in 2010 shows significant improvement to 2009. Other financial soundness indicators are yet to be compiled by the industry as shown in Table 25.

## **5.5. Capital Markets**

Capital Markets Industry comprises the Capital Markets Authority as the regulatory agency mandated to supervise approved institutions like Nairobi Stock Exchange, Central Depository and Settlement Corporation; Credit Rating Agencies; and licensed market intermediaries. The Authority is also charged with developing the capital markets industry.

A total of 11 categories of capital market intermediaries comprising 100 players were licensed to operate in 2010 compared to 10 categories and 92 licensees in 2009.

### **5.5.1. Equities Market**

Equities market recorded marked improvement in activity in both primary and secondary markets. Market capitalization rose by 40% in 2010, exceeding the Kshs 1 trillion, with average annual return of 36% based on the NSE 20 Share Index. As a result, NSE was among the best performing equity markets in Africa after the Uganda Securities Exchange, which recorded an index return of 53%. Equity turnover and share volume recorded 190% and 127% respectively, as market capitalization rose by 40% compared to 2009.

The impressive performance is attributed to improved business confidence in the market on account of economic recovery, adoption of best practice within capital markets resumed participation by foreign and institutional investors. Turnover attributed to foreign investors reached a historical high of Kshs 50 billion or 46% of total annual turnover, with a Kshs 15 billion net foreign portfolio inflow. This could however create instability in the event of loss of confidence and the attendant capital outflow from the market which could also destabilise other segments of the financial system. This, therefore, underscores the need to ensure macroeconomic stability.

### **5.5.2. Bonds Market**

The primary debt market had fifteen (15) Treasury (Government) bonds issued, including two re-openings and two Infrastructure bonds raising Kshs 176 billion. In addition, three corporate bonds were issued raising Kshs 14 billion. The secondary bond market recorded Kshs 479 billion worth of bonds traded during the period under review, a 332% rise over 2009 turnover of Kshs. 111 billion. The increase in turnover can be greatly attributed to the implementation of bond market reforms, the automation of bond trading and settlement and the issuing of Infrastructure Bonds by the Government which greatly increased supply of debt securities at the NSE Exchange.

The tightening of monetary policy by CBK from April 2011 will directly impact on interest rates. This will lower bond prices, translating into capital losses in bond valuations. As a result, investors could hold back trading at NSE, in order to cut down losses, which in turn would reduce activity in the bond market. Volatility in yields in both primary and secondary markets, occasioned by rising inflation premiums all along the curve could impact negatively on the 2011 performance.



**Table 26: Gross Secondary Market statistics (Equities and Bonds)**

Year End	Equity Turnover (Kshs Bn)	Share Volume (Mn)	NSE Index	Market Cap (Kshs Bn)	Bond Turnover (Kshs Bn)
2006	95	1,455	5,646	792	49
2007	89	1,938	5,445	851	85
2008	98	5,857	3,521	854	95
2009	38	3,169	3,247	834	111
2010	110	7,181	4,432	1,167	479.09

Source: Nairobi Stock Exchange

### 5.5.3. Risks in the Capital Markets

**Stock Market Volatility:** Stock market volatility and associated risks can impair the allocation of credit in the financial system and create funding constraints with potential instability undertones. Kenya's stock market volatility began in 2008 and persisted through 2010, due to uncertainty in global markets that filtered into the local market. CMA is working on hedging products such as derivatives to mitigate for volatility risk.

**Net Foreign Equity Flow:** Net foreign equity flow measures the value of outflows from the sale of shares by foreign shareholders against value of inflows from the purchase of shares by foreign shareholders. A high net outflow is a sign of foreign investors leaving the stock market as happened in 2008 when net foreign equity outflow was Kshs 8.3 billion. As at December 2010 net foreign equity annual inflow was Kshs 15 billion, implying more purchases than sales, leading to a recovery in stock prices.

**Market Liquidity:** Liquidity ratio is used to measure total traded shares turnover as a percentage of total value of listed shares at the Nairobi Stock Exchange - the higher the ratio, the higher the level of liquidity. By the end of 2010, equity turnover ratio was 1.5%, implying a decline in equity market activity, and more illiquid market. The turnover ratio in the bond market was 6% by end of 2010, implying more activity than in the secondary equity market. To enhance liquidity, CMA is working on products such as commodity futures and a hybrid bond market as well as alternative market for SMEs. There are also plans to introduce internet trading, provide for securities borrowing arrangements for short selling and market making, introduce margin trading and shorten transaction cycle.

**Table 27: Capital Markets Stability Indicators**

INDICATOR	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10
<b>Market Stability</b>					
Stock Market Index ( <i>End of Period</i> )	3,247.44	4,072.93	4,339.28	4,629.80	4,432.60
Volatility of Stock Market Index	56.93	150.16	67.84	99.73	60.91
Net foreign equity flow (Kshs Million) (Quarterly Aggregate Total)	4,253	5,004	1,427	2,836	5,859
Domestic Shareholders (%)	90.07	79.14	80.00	88.18	87.4
Foreign Shareholders (%)	9.93	20.86	20.0	11.8	12.6
<b>Market Concentration</b>					
Contribution of the biggest three firms to total Market Capitalisation (%)	43.01	42.66	41.84	36.27	38.22
<b>Market Size</b>					
Total Number of Listed Domestic Firms	55	55	55	55	55
Market Capitalization - (Ksh Billion) ( <i>End of Period</i> )	834.17	983.12	1,090	1,740	1,670
Equity Turnover (Kshs Billion) (Quarterly Aggregate Total)	11.76	18.89	23.9	35.4	25.48
Equity Turnover as a % of GDP	0.5	0.8	1.04	1.3	0.9
<b>Market liquidity</b>					
Equity Turnover Ratio (Quarterly Aggregate) (%)	1.4	1.9	2.2	2.0	1.5
Free float (%)	-	36	36	36	36
<b>Market Size</b>					
Turnover of Bonds (Kshs Billion)(Quarterly Aggregate Total)	53.26	118.80	155.64	120.58	83.98
Bond Turnover as a % of GDP	0.68	2.21	4.17	5.24	3.65
Bond Turnover Ratio (Government Bonds) (%)	3.96	11.52	20.83	6.12	6.08

Source: CMA Statistical Database and NSE

**Market Concentration:** Concentration of market value by a few listed companies poses risks to entire market if any of such firms fail. Market concentration measures the level of dominance of large listed companies in terms of market value. Three listed companies dominated the stock market with a concentration of 38% in 2010, compared with 43% in 2009. The decrease in market concentration was occasioned by a slight fall in share prices of these companies. To mitigate associated risks, CMA is providing incentives to encourage more listings at the NSE, proposed new segment within the NSE that targets small and Medium Enterprises (SMEs), and increased public awareness on advantages of diversifying investment across listed companies.

**Systemic risks:** This refers to the risk of collapse of the entire market, as opposed to risk associated with any one individual entity, group or component of the capital markets. This may be caused by weak corporate governance within the capital markets institutions and market intermediaries, poor internal controls in the conduct of licensed businesses, low

capitalization of market intermediaries, weak trading and settlements systems, weaknesses in enforcement capacity, as well as gaps and weaknesses in the regulatory framework.

#### **5.5.4. Policy Developments**

To ensure well developed and robust capital markets that can withstand sizeable risks, CMA is steering the following reforms:

**Demutualization of the NSE:** NSE demutualization to allow public ownership of the exchange is the key in addressing the corporate governance problems that face the NSE and as a result significantly bolster the global competitiveness and integration of the Nairobi Stock Exchange as a modern and transparently run exchange. Key amendments to the Capital Markets Act to remove perceived legal barriers on demutualization of the securities exchange were introduced by way of the Finance Act 2010. Since then, detailed framework with guidelines were developed to facilitate completion of demutualization process.

**Corporate Governance and Conduct of Business Regulations:** To refine the legal and regulatory framework for enhanced accountability of both CMA and intermediary clients, the proposed Capital Markets Regulations 2011 and Capital Markets (Conduct of Business) (Market Intermediaries) Regulations 2010 received Ministerial assent and approval by the Attorney General for gazette into law. As at December 2010, there was 96% compliance rate amongst affected licensees to these regulations.

**Low capitalization of capital market intermediaries:** As at December 2010, the compliance rate amongst affected licensed entities of the regulations on new capitalization for stockbrokers and investment banks was 80%. The Authority, in January 2010, introduced requirements for key intermediaries to secure professional indemnity insurance relative to their market operation exposures.

**Risk-Based Supervision (RBS):** To implement RBS, a Quantitative Impact Assessment study was conducted by International Securities Consultants (ISC). A stakeholders' sensitization workshop was held in November 2010 to discuss the findings.

### **5.6. Retirement Benefits/ Pension Industry**

#### **5.6.1. Industry Growth**

The retirement benefits sector comprises of the Retirement Benefits Authority as the regulator, the retirement benefits schemes, fund managers, custodians and administrators.

In 2010, there were 1,288 registered retirement benefits schemes, 17 fund managers, 10 custodians, and 25 registered administrators as shown in Table 28.

**Table 28: The Industry Licensees' by end 2010**

Number of	Dec '07	June '08	Dec '08	June '09	Dec '09	Dec '10
Retirement Benefit Schemes	1,205	1,225	1,246	1,266	1,284	1,288
Registered Fund Managers	13	16	16	17	17	17
Registered Custodians	5	6	6	10	10	10
Registered Administrators	13	23	23	24	22	25

Source: RBA database, July 20<sup>th</sup> 2011

### 5.6.2. Risk Based Supervision

RBA implemented risk based supervision on all registered schemes, and scored schemes based on a comprehensive matrix of risk parameters ranging from **0** to **4**. A higher score indicates a higher risk while a lower average score reflects a more secure industry, better able to grow and deliver benefits to scheme members. As at 31<sup>st</sup> December, 2010, over 500 schemes scored averaged score of **1.68**, which indicates that the industry face a lower risk of failure.

### 5.6.3. Asset Growth and Composition

The pension industry assets grew by 31.2% from Ksh. 343.8 billion in 2009 to Ksh. 450.69 billion in 2010 as shown in Table 29. The sector is diversified in terms of ownership and composition of assets. Of the total assets held by the industry in 2010, Ksh. 104.2 billion or 23.1% was held by the National Social Security Fund, while the balance belonged to occupational and individual retirement benefits schemes and managed by the various fund managers.

**Table 29: Industry Performance Indicators**

Measure	Dec '07	June '08	Dec '08	June '09	Dec '09	Dec '10
Assets (Ksh. Billion)	293.7	321.2	302.8	317.7	343.8	450.69
Annual increment (%)	-		3.1%	-	13.5%	31.2%
Schemes Average return (%)	8.7	14.6	-2.8	-4.2	11.0	27.8%

Source: RBA database, July 2011

A total of Ksh 143.6 billion or 31.9% of total pension assets were held in government securities as Treasury Bills and Bonds; a total of Ksh 130.4 billion or 28.9% was in the form of quoted equities; Ksh. 80.01 billion or 17.8% worth of assets were in immovable property, while Ksh. 33.3 billion or 7.4% was in form of guaranteed funds investment.

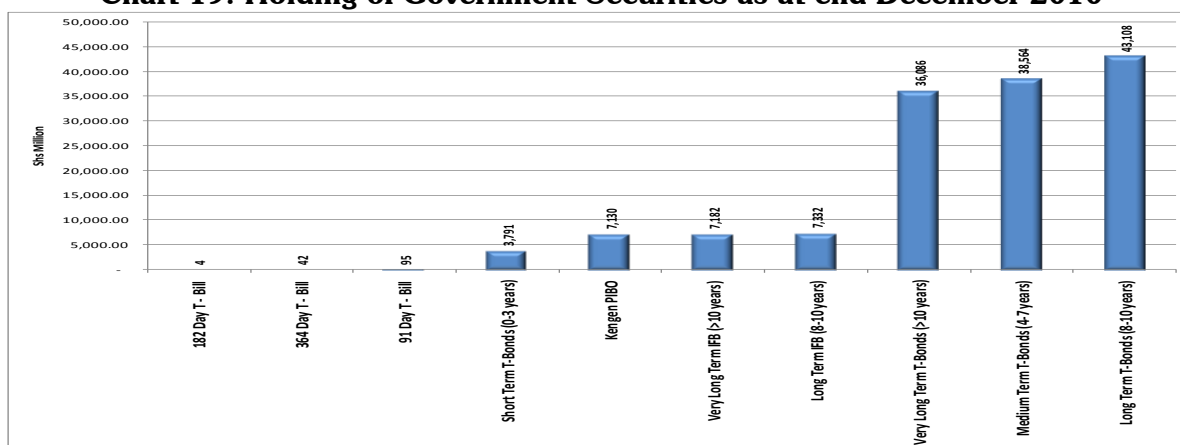
**Table 30: Pension Industry Investment Portfolio as at December, 2010**

	<b>Asset Classes</b>	<b>Assets Value (Kshs. Billion)</b>	<b>Percent</b>	<b>Statutory Maximum%</b>
1	Government Securities	143.63	31.9	90
2	Quoted Equities	130.36	28.9	70
3	Immovable property	80.01	17.8	30
4	Guaranteed Funds	33.26	7.4	100
5	Fixed Income	21.11	4.7	30
6	Fixed Deposits	17.17	3.8	30
7	Offshore Investments	15.35	3.4	15
8	Cash	7.30	1.6	5
9	Unquoted Equities	2.50	0.6	5
	<b>Total</b>	<b>450.69</b>	<b>100</b>	

Source: RBA Database

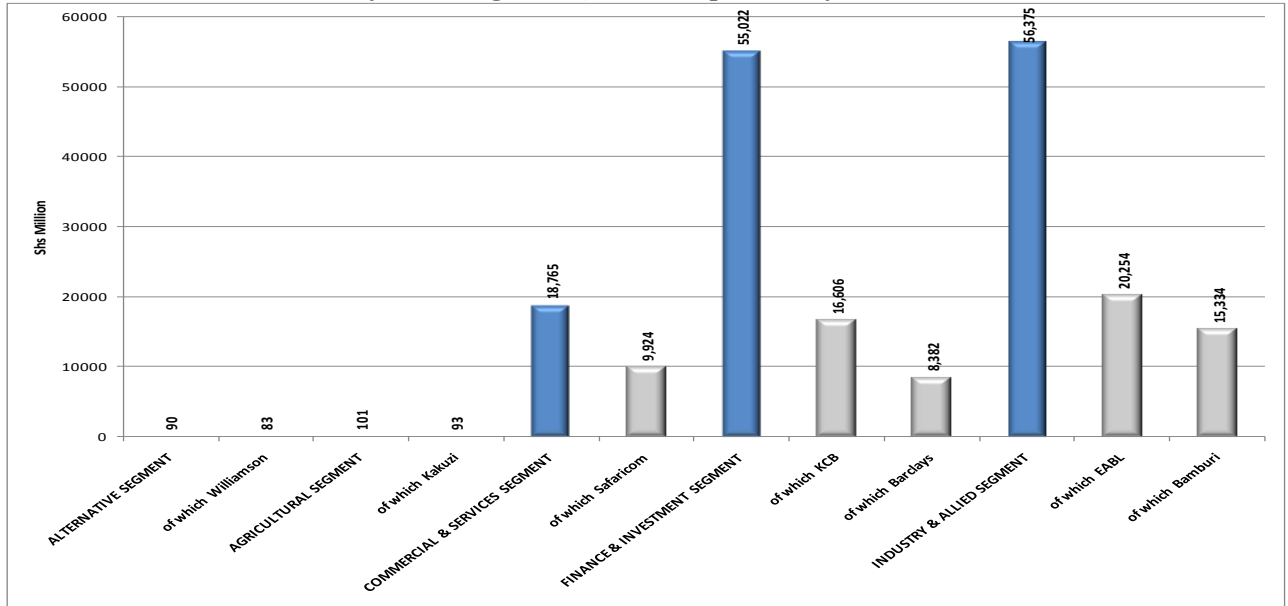
The balance of 14% was held as fixed income, fixed deposits, offshore investments, cash and unquoted equities in proportions of 4.7%, 3.8%, 3.4%, 1.6% and 0.6%, respectively. Overall, all the categories of investment were within the statutory maximum guidelines as provided for in the Retirement Benefits regulations shown in Table 30.

Composition of the assets shows dominance of investments in government securities and quoted equities which both constitute around 60.8% of the total pension industry assets. Total assets held by the NSSF grew to Kshs.104.2 billion in December 2010 compared to Kshs 96.5 billion in June 2010. The NSSF assets in Immovable Property declined to 32%, but remained 200 basis points above the statutory maximum of 30%. Assets perceived to have higher risk, that is, real estate, quoted and unquoted equity, offshore investments and “other assets”, accounted for 50% of the total industry investment portfolio as at December 2010 up from 45% at end of 2009. Of total assets held in Government Securities, only Ksh 141 million were held in Treasury bills of up to 1 year to maturity, while the balance of Kshs 143.46 billion were in Treasury bonds and KenGen PIBO. Retirement Schemes have been critical source of Government long term debt, thus lengthening maturity structure of its debt via longer dated bonds.

**Chart 19: Holding of Government Securities as at end December 2010**

The industry's investment in stock markets in the East African Community was Kshs 130.4 billion, with bulk of the portfolio at the Nairobi Stock Exchange. The portfolio was well diversified across the Industrial & Allied, Commercial & Services and Finance & Investment sectors of the MIMS as well as in AIM Segments of the Exchange.

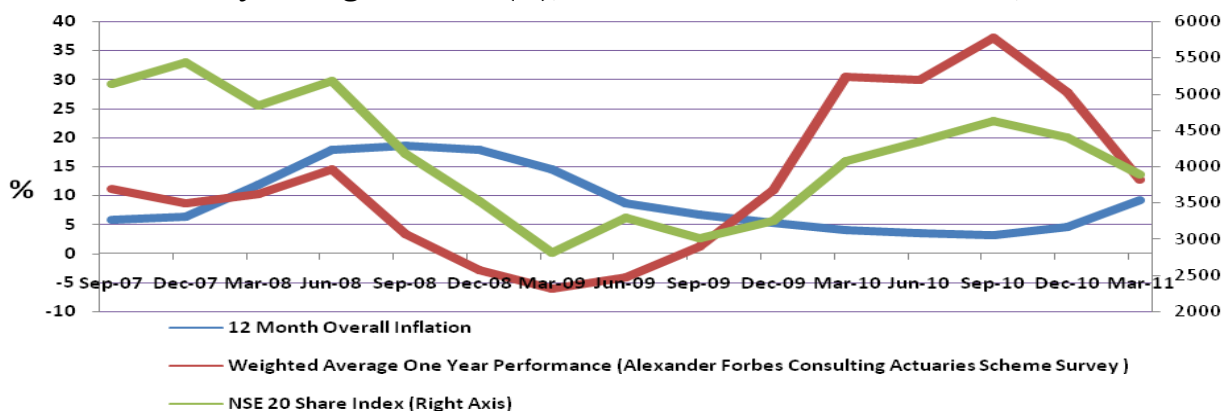
**Chart 20: Industry Holdings of Quoted Equities by end December 2010**



#### 5.6.4. Rates of Return

The industry average return on investment recorded negative rates of return in both real and nominal terms at the end of 2008 to first half of 2009 due to shocks in the market. Third quarter of 2009 saw a reversal to positive territory in both real and nominal terms. Schemes enjoyed exceptionally high rates of return in 2010 peaking at 37.2% in the third quarter and remaining at an extraordinary 27.8% by December 2010 (see chart below). With overall inflation at 3.8% to December 2010 scheme members enjoyed significantly positive real rates of return, particularly those in segregated investments.

**Chart 21: Industry Average Returns (%), Annual Inflation and NSE Index,**



Source: Retirement Benefits Authority Database

### **5.6.5. Pension Sector Outlook**

Asset values are likely to be subdued in the first half of 2011 due to emerging risks from:

- Amendment of Regulation 19(5) of Occupational Regulations by the Minister of Finance that allowed members to access up to 50% of the employers' locked-in benefits. The amendment came into force on 30th September, 2010. These withdrawals will impact negatively on the asset base of the industry, and a large extent, stability of the industry;
- Declining stock valuations at the Nairobi stock; and
- Increasing bond yields as a result of rising interest rates in the primary market issuance, leads to low bond valuations due to capital losses.

### **5.7. Insurance Sector**

The insurance sector covers re-insurance companies, insurance companies, insurance brokers, medical insurance providers, insurance agents, loss assessors, insurance investigators, loss adjusters, surveyors and claims settlement agents. As at 31<sup>st</sup> December 2010, the industry had **47** insurance companies, **2** reinsurance companies, **158** insurance brokers, **23** medical insurance providers, **3,788** insurance agents amongst other service providers.

#### **5.7.1. Financial Performance**

The total industry assets stood at Ksh.223 billion as at December 2010, representing 25% growth in asset base (Table **31**). Growth in premiums over the last five year period has stabilized at an annualized rate of 18%. Gross direct premiums for 2010 totalled KSh.76.5 billion, with KSh.27.2 billion in long term business and KSh.49.3 billion in general insurance business. Access to insurance services by the low income earners still remains a challenge for the insurance sector.

#### **5.7.2. Policy Developments**

In line with the broader government policy to transform Kenya into a globally competitive and prosperous nation by the year 2030, the Insurance Regulatory Authority has strived to keep pace with emerging economic realities, national policy changes and priorities. Challenges such as low insurance penetration, new distribution channels for insurance, insurance fraud, poor performance of motor insurance subsector, micro insurance, regulation of Takaful, corporate governance are noted and we are developing strategies that will ensure efficiency, fair play and stability in the insurance sector.

**Table 31: Industry Performance (Ksh '000s)**

ITEM/YEAR	2006	2007	2008	2009	2010	Average Growth (%)
Shareholder's funds	34,574,575	38,348,735	38,161,222	41,468,967	60,620,423	46
Assets	124,737,706	146,541,007	154,452,739	178,403,820	222,762,366	25
Investments	95,836,181	114,589,974	123,621,370	113,452,503	174,138,819	54
Investment income	11,227,800	11,141,669	8,191,112	12,112,000	16,452,131	33
Gross Direct Premium	41,475,358	48,012,987	55,245,838	65,012,837	76,442,384	18
Net premium written	33,520,388	39,628,480	45,593,023	45,592,656	53,104,611	16.5
Claims (General Business)	12,359,561	14,235,405	15,883,565	19,768,322	21,205,754	7.3
Commissions	4,858,458	5,504,342	7,252,116	8,714,712	10,012,339	15
Expenses of management	9,853,675	12,902,101	12,602,253	14,640,675	16,610,293	13.5
Underwriting(Gen. business)	715,860	236,011	872,496	401,806	1,625,478	300
Profit/loss after taxation	3,836,587	3,549,898	3,349,997	3,420,972	7,752,465	126.6
Commission ratio (%)	14.4	13.9	15.9	19.1	13.1	-31.4
Mgt. expense ratio (%)	29.4	32.6	27.6	32.1	25.3	-21

Source: Insurance Regulatory Authority database, July 2011

Over the review period, the following reform initiatives were put in place;

- i. Promoting fair and efficient market so as to enhance stability in the insurance industry through; off-site and on-site surveillance of industry players; limiting individual ownership of share capital of an insurance company; introduction of medical insurance class of business; and implementing guidelines for bancassurance
- ii. Establishment of a Consumer Protection Department at IRA to deal with complaints from policyholders and general public
- iii. Creating a consumer education department at IRA to improve public image and perception of the insurance industry
- iv. Promoting understanding of Insurance Contracts through standardization and simplification of Policy Document Wordings and improving market conduct and disclosure requirements
- v. Allowing insurance agents from EAC member states to operate as Kenyan agents
- vi. Embracing ICT for Effective Service Delivery



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