THE KENYA FINANCIAL STABILITY REPORT

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ABOUT THE FINANCIAL STABILITY REPORT

The Financial Stability Report is published once a year and contains the Regulators' assessment of the financial system stability in compliance with the Central Bank of Kenya Act, Section 4(2) and the Financial Sector Regulators Memorandum of Understanding (MOU). Financial stability fosters the development of a vibrant and inclusive financial system that enable Kenya to meet the national development aspirations .

The MOU establishes a Forum comprising of the Capital Markets Authority (CMA), Central Bank of Kenya (CBK), Insurance Regulatory Authority (IRA), Retirement Benefits Authority (RBA) and Sacco Societies Regulatory Authority (SASRA). The National Treasury and Planning, Ministry of Trade, Industry and Cooperatives, and the Kenya Deposit Insurance Corporation (KDIC) have observer or associate membership status. The MOU provides a framework for collaboration and cooperation in information sharing, prudential supervision, financial stability and other areas of mutual interest. This report is published in uncertain conditions as a result of the evolving Coronavirus disease (Covid-19) pandemic.

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www.cma.or.ke	www.centralbank.go.ke	www.ira.go.ke	www.rba.go.ke	www.sasra.go.ke
The Director, Regulatory Policy Strategy, Capital Markets Authority Embankment Plaza, Longonot Road, off Kilimanjaro Avenue, Upper hill P.O Box 74800 - 00200 NAIROBI, KENYA	The Director, Research Department, Central Bank of Kenya Haile Selassie Avenue P.O Box 60000 – 00200 NAIROBI, KENYA	Chief Manager, Policy Research & Development, Insurance Regulatory Authority Zep-Re Place, Longonot Road P.O. Box 43505-0100 NAIROBI, KENYA	Chief Manager, Research and Strategy Department, Retirement Benefits Authority Rahimtulla Tower, Upper Hill Road P.O. Box 57733 - 00200 NAIROBI, KENYA	Chief Manager, Research & Policy Department, Sacco Societies Regulatory Authority UAP Old Mutual Tower, Upper Hill Road, Upper Hill. P.O. Box 25089-00100, NAIROBI, KENYA
Tel: +254 20 2264000/ 2264900 / 2221869 Cell: +254 722 207767 E-mail: corporate@cma.or.ke	Tel: +254 20 286 1000, +254 20 286 3000, +254 709 081 000, +254 709 083 000 E-mail: researchstat@centralbank.go.ke	Tel: +254 20-4996000/ Toll Free No: 0800724499 E-mail: commins@ira.go.ke	Tel: +254 20 2809000 Toll Free No: 0800720300 E-mail: info@rba.go.ke	Tel: +254 20 2935101 E-mail: info@sasra.go.ke

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EXECUTIVE SUMMARY

This 11th Edition of the Financial Stability Report (FSR) provides an assessment of vulnerabilities and resilience of the financial system during the period January 2019 to June 2020. The report is being released at a time when economies and financial systems are facing negative shocks, especially due to the Coronavirus Disease (COVID-19) pandemic. The report also highlights measures deployed by the Government and the financial sector regulators, in collaboration with key stakeholders to contain the spread of the disease, ameliorate the households livelihoods and firms incomes and foster financial system stability.

The global output growth decelerated to 2.9 percent in 2019 from 3.7 percent and 3.8 percent in 2018 and 2017 due to trade tensions, geopolitical conflicts and decline in commodity prices. In 2020, the global economy is projected to contract by 4.9 percent as a result of COVID-19 pandemic that tightened financial conditions and disrupted global supply chains. The global economy is expected to recover in 2021, to grow at 5.4 percent. However, the narrowing of the fiscal space and resurgence of COVID-19 infections, is expected to drag economic recovery.

Kenya's economy grew by 5.4 percent in 2019 and was projected to grow by 6.2 percent in 2020. However, the COVID-19 pandemic has weakened Kenya's economic growth outlook in 2020. This is mainly attributed to the COVID-19 containment measures by the Government. These measures disrupted supply chains and impacted negatively on household livelihoods, resulting in subdued aggregate demand. In response, the Government deployed monetary, fiscal and financial measures to mitigate the impact of COVID-19 on the financial sector and the economy.

Kenya's financial sector was stable and resilient in 2019. The sector's total assets grew by 9.9 percent, liquidity measured as current assets to current liabilities, increased to 53.3 percent and profits increased by 8.5 percent in 2019. However, in the first half of 2020, total assets grew by 8.3 percent, profitability declined by 25.4 percent, but liquidity increased to 56.5 percent as the effects of COVID-19 permeated the economy.

The banking industry was resilient in the period under review, as reflected by high capital and liquidity buffers of 18.5 percent and 53.1 percent against the statutory minimum requirements of 14.5 percent and 20 percent, respectively. However, profit declined by 30.0 percent in the year to June 2020 and assets quality deteriorated, with the ratio of non-performing loans to gross loans increasing from 12 percent in December 2019 to 13.1 percent in June 2020. Similarly, the SACCOs industry was resilient in 2019, with enhanced capital and liquidity buffers. However, the industry's high interest expenses to income ratio and disruptions in members' livelihoods elevated funding and credit risks, respectively.

The capital market recorded subdued performance, with equity market capitalization declining by 17.2 percent in June 2020 compared to 20.8 percent increase in the year to December 2019. Significant exit by foreign investors from the equity market heightened market volatility in the first half of 2020. The corporate bonds market was inactive with no new issuances. Instead, some corporates retired their listed bonds. The insurance and pension industries were resilient in 2019, despite elevated risks. The advent of COVID-19 pandemic impacted negatively on insurance premiums and profitability due to loss of livelihoods and restrictions on travel. Whereas the assets of the pension industry increased in 2019 compared to 2018, the decline in equity prices in the first half of 2020, has reduced the schemes assets' base and loss of jobs is expected to reduce pension contributions.

To mitigate the adverse socio-economic and financial impact of COVID-19 pandemic, the Government instituted fiscal, monetary and financial measures. The fiscal policy measures included; reducing income tax rates for individuals and corporates, lowering turnover tax and Value Added Tax, immediate payment of suppliers and tax refunds, increase in tax relief, and increase in financial transfers to vulnerable groups. In addition, the Central Bank instituted accommodative monetary policy and financial measures, such as; reducing the policy rate, lowering the Cash Reserves Requirements and extended the maximum tenor of Repurchase Agreements from 28 to 91 days, worked with banks and payment services providers to waive charges on mobile money and mobile banking transactions, suspended the listing of defaulting borrowers with Credit Reference Bureaus and asked banks to renegotiate terms and restructure loans for borrowers, who face difficulties in servicing their loans as a result of the pandemic.

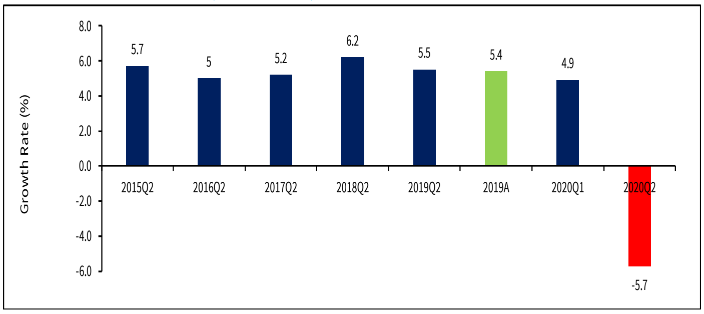
The SASRA allowed SACCOs to restructure and renegotiate loans to ease pressure on their members facing difficulties in repaying loans due to the pandemic. To cushion policyholders and insurers against the negative impact of the pandemic, the IRA allowed insurers to grant a three (3) months grace period to policyholders who are not able to pay premiums for life insurance business, and directed insurers to pay commissions to agents and brokers immediately the business is transacted. The RBA allowed pension schemes to either accept delayed or suspended member contributions to reduce the financial burden to contributors. These measures have played a central role in fostering resilience and stability of the financial sector, while mitigating the impact of the pandemic on household livelihoods and firms' incomes.

Overall, Kenya's financial system is expected to remain stable and resilient in 2020, underpinned by adequate capital and liquidity buffers to weather the negative impact of COVID-19. These are complemented by a robust regulatory oversight, and reliable and efficient financial market infrastructure. However, economic slowdown due to COVID-19, rising credit risks, declining profitability, concentration risk in the capital market, weak balance sheets for listed corporates and State-Owned Enterprises (SOEs), and corporate governance challenges may undermine financial sector stability. The Regulators in collaboration with the other stakeholders remain vigilant to take appropriate measures to mitigate risks and safeguard stability.

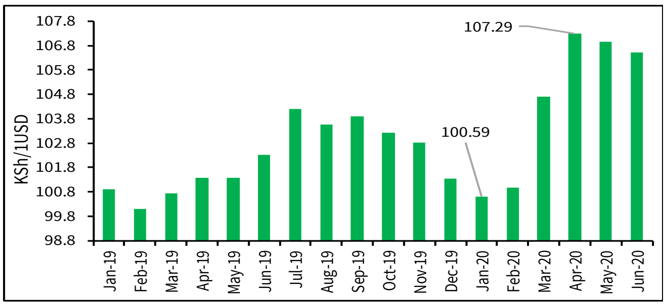
IMPACT OF COVID-19 PANDEMIC ON MACROFINANCIAL CONDITIONS

The following indicators show the impact of COVID-19. Growth is projected to decelerate in 2020 while fiscal deficit widened due to increase in public spending amid decline in revenues. The deficits have been financed by public borrowing, which has increased the ratio of pubic debt to GDP. The stock prices declined as a result of decline in profits and foreign investment outflows. The occupancy rate of property declined depressing selling and rental prices. The slowdown in economic activity reduced uptake of insurance services, while disruption of livelihoods has impaired capability of borrowers to repay loans. As a result, the quality of assets deteriorated and profitability of financial institutions declined.

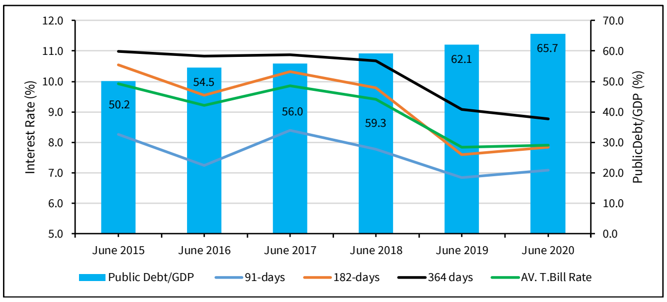
Real GDP Growth (Percent)



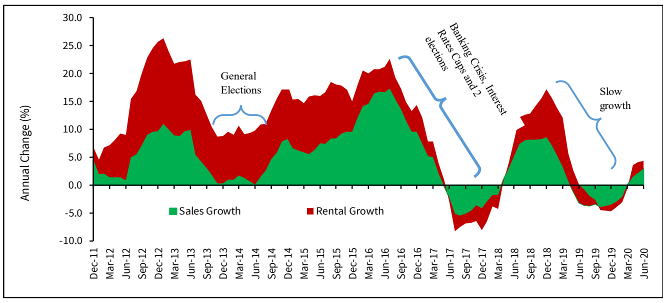
Exchange Rate



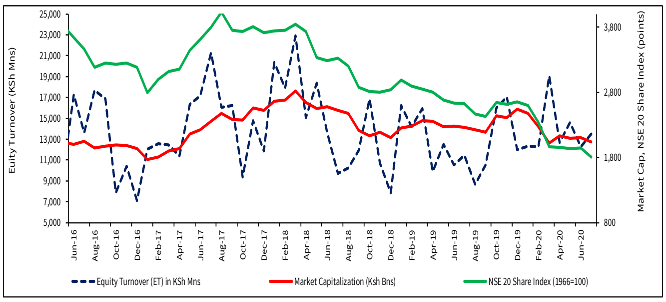
Low interest rate despite rising Public Debt (% of GDP)



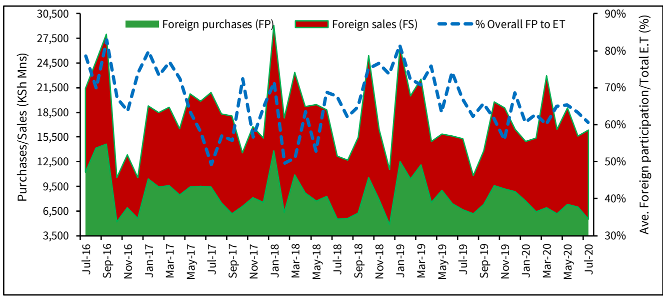
Annual Change in Selling and Rental Price Indices



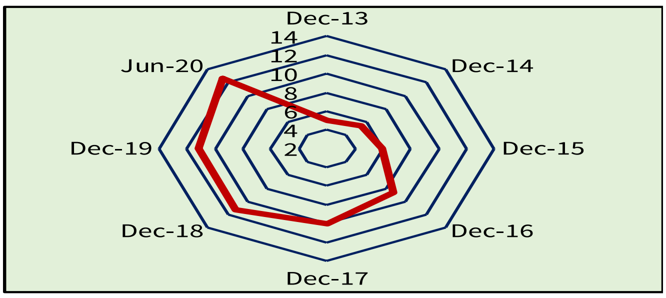
Stock Market Losses with Investor Exits



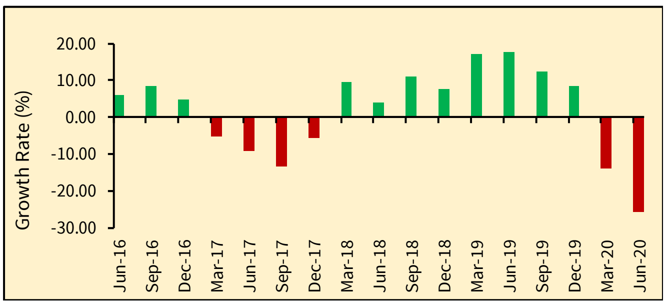
Foreign Investor Sell-Off (Net Outflow)



Rising Banks and Saccos NPLs Ratio



Profits Before Tax for Banks, Saccos and Insurance

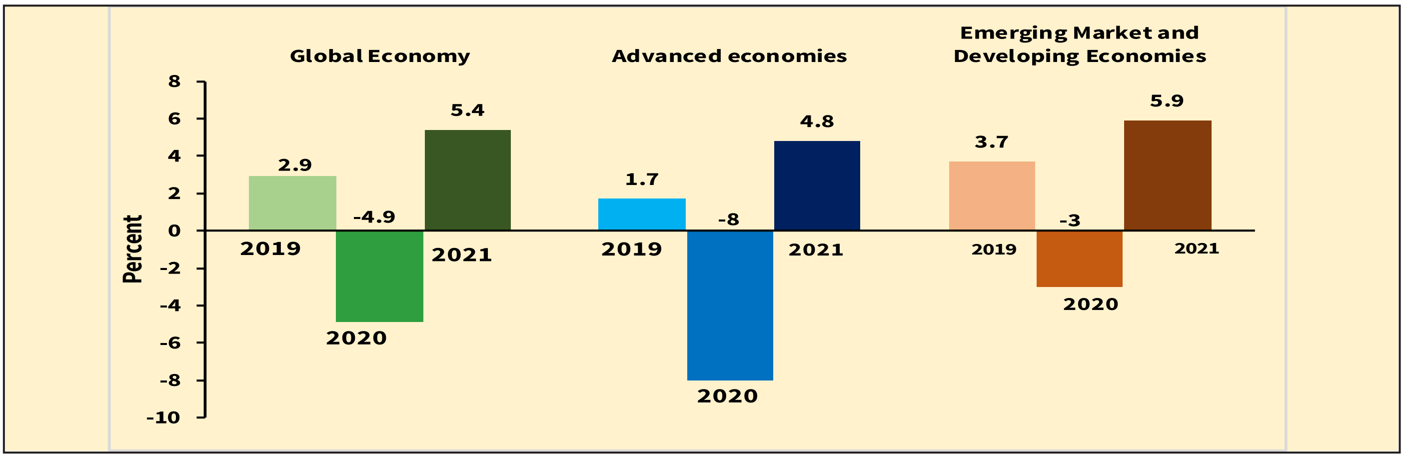


1. MACROECONOMIC CONDITIONS AND RISKS

1.1. Global Growth and Outlook

The global economy recorded weaker growth of 2.9 percent in 2019 compared to 3.6 percent growth in 2018. Trade tensions between USA, China, European Union and emerging economies coupled with geopolitical conflicts contributed to the global economic slowdown. Growth is projected at -4.9 percent in 2020 due to the evolving COVID-19 pandemic before rebounding to 5.4 percent in 2021 on expected pick-up of economic activities as normalcy returns (International Monetary Fund (IMF), June 2020). The outbreak of COVID-19 pandemic in December 2019 negatively affected the global economy, leading to a projected recession in 2020 **(Figure 1).** The narrowing fiscal space in emerging markets is also expected to drag economic recovery.

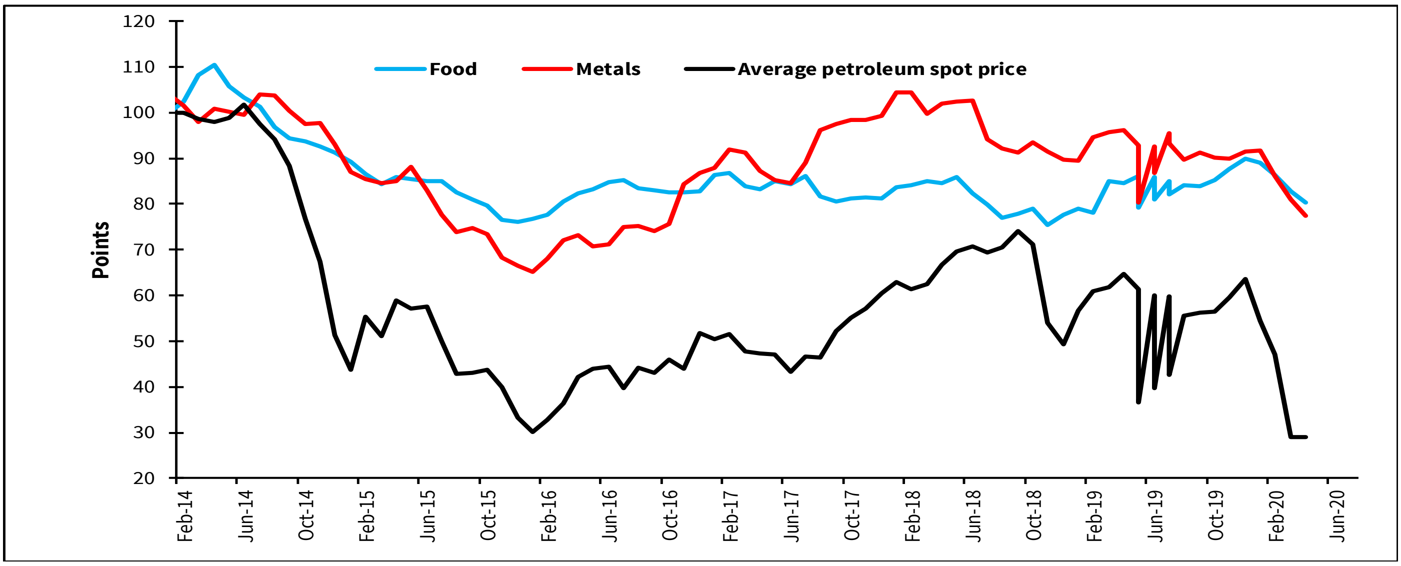
Figure 1: Global economic growth and projections(%)



Source: IMF World Economic Outlook (WEO) Update, June 2020

The slow growth has impacted commodity prices, with base metal, natural gas and oil prices, declining significantly due to the Governments restrictions to contain the spread of COVID-19 **(Figure 2).**

Figure 2: Commodity Prices (March, 2014=100)



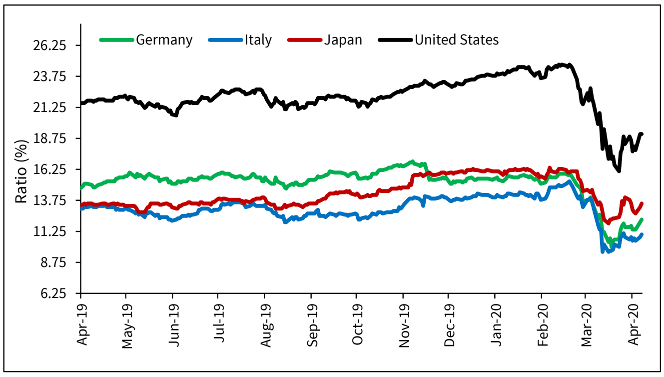
Source: FAO and Thomson Reuters

Whereas the decline in oil prices has reduced the import bill for oil importers, most of these countries are exporters of primary commodities, such as tea, coffee and horticulture, whose decline in prices is not compensated by the savings in oil prices. The decline in export earnings has reduced household and firms' incomes, raising stability concerns on financial institutions exposed to the sectors affected. The outbreak of COVID-19 has further accentuated stability concerns, with travel restrictions affecting the insurance industry and employee furloughs affecting the banking and pensions sectors.

Volatility in the global financial markets increased sharply in the first quarter of 2020, driven by the spread of COVID-19 pandemic. The financial markets were recovering from the effects of trade wars, geopolitical tensions and fragilities in emerging and developing economies in the fourth quarter of 2019. However, the COVID-19 pandemic exacerbated volatility in the first half of 2020, with most investors selling their stocks **(Figures 3 & 4).**

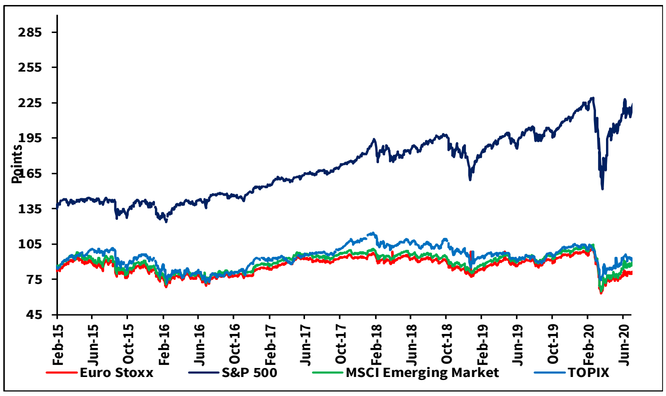
Portfolio flows to advanced economies increased as investors exited emerging markets and developing economies on elevated risks. Institutional investors reduced their exposure to emerging markets, while capital outflows from retail investors increased **(Figures 5 & 6).**

Figure 3: Price-to-Earnings Ratios



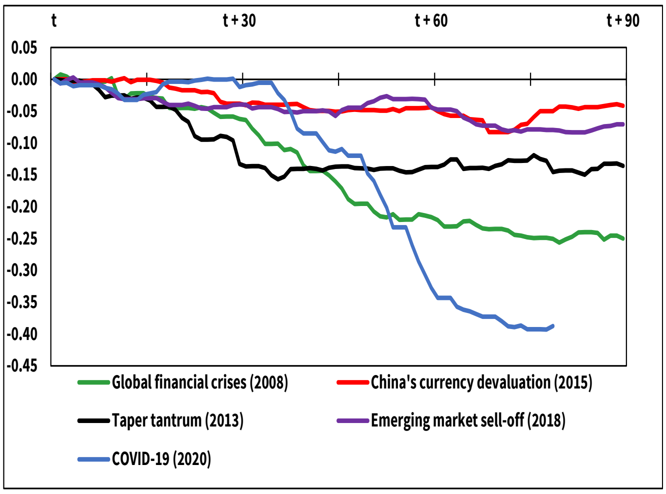
Source: International Monetary Fund

Figure 4: Global Equity Prices Indices (Points)



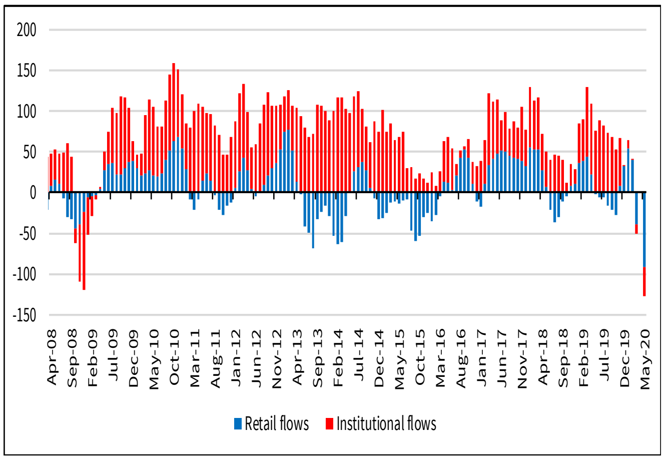
Source: Thomson Reuters

Figure 5: Emerging Markets Portfolio Flows (% of GDP)



Source: Global Financial Stability Report, April 2020

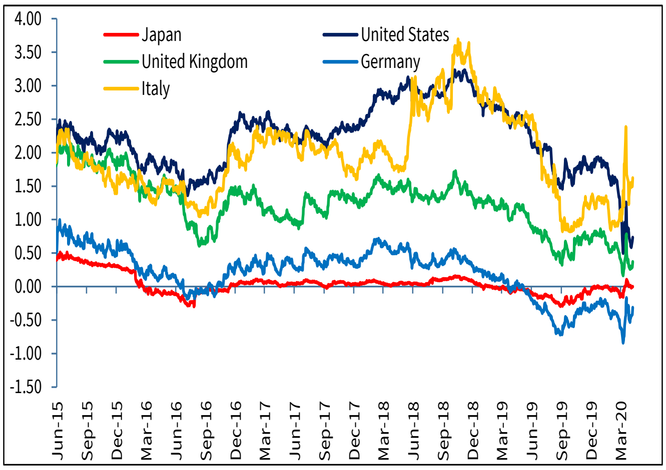
Figure 6: Portfolio Flows (USD Billions)



Source: International Monetary Fund

The elevated risks in the global economy tightened financial conditions in 2019 compared to 2018, reflected by increased yields on corporate and sovereign bonds **(Figure 7).**

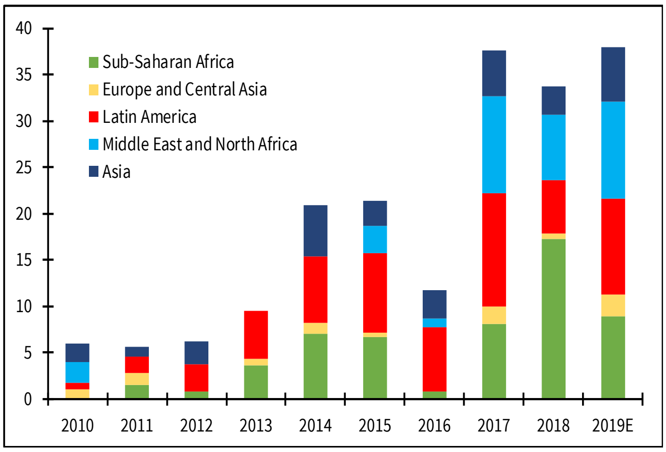
Figure 7: Ten-Year Government Bond Yields



Source: Thomson Reuters

Sub-Saharan Africa (SSA) countries reduced Eurobond issuance in 2019 due to tight market conditions and elevated public debt risks **(Figure 8).**

Figure 8: Eurobonds by Frontiers markets (USD Bns)



Source: Thomson Reuters

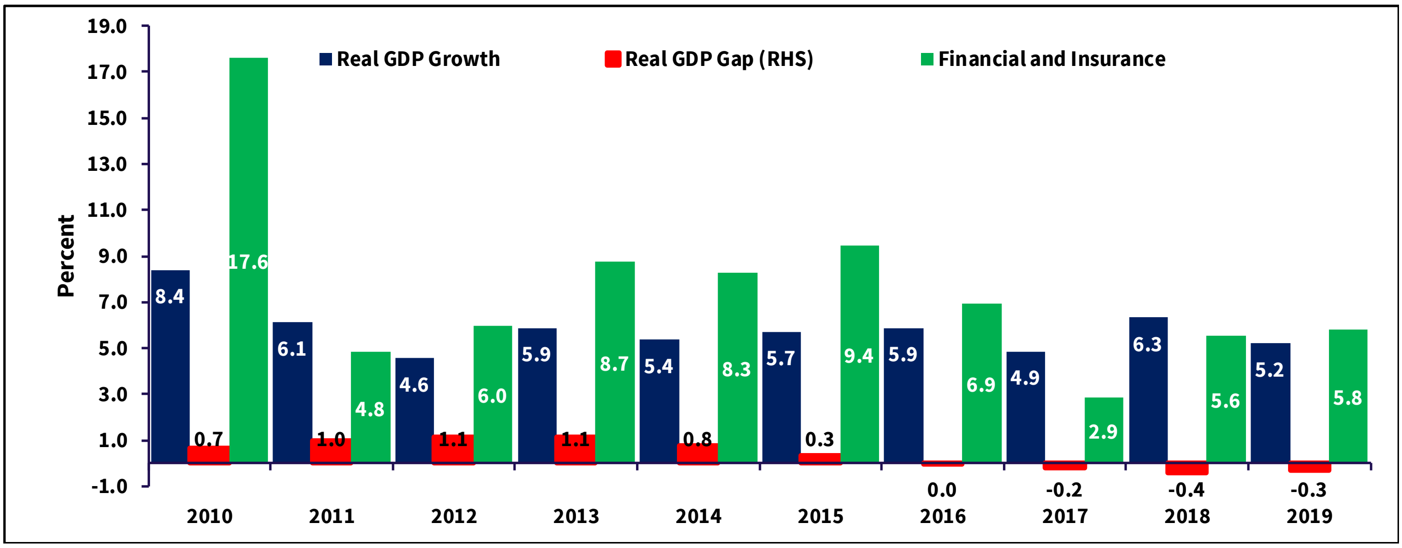
The East African region's growth in 2019 is estimated above 5.5 percent on account of public investment in infrastructure, strong agricultural growth, and accommodative monetary policy given low and stable inflation. The East African Community (EAC) banking industry's assets grew by 12.6 percent, with strong capital and liquidity buffers. Credit risk, however, remained elevated, with Non-Performing Loans (NPLs) to gross loans ratio increasing to average about 9.2 percent in June 2020 compared to 8.9 percent in 2019 and 7.2 percent in 2018. Assets Quality was affected inter- alia by delayed government payments to suppliers, low real estate occupancy rates and prices, weak credit underwriting standards and drought. The increase in financial institutions exposure to government securities poses sovereign debt and re-pricing risks in the face of diminishing fiscal policy space.

1.2. Domestic Macroeconomic Conditions

On the domestic front, Kenya's economy remained resilient to drought and floods, to grow at 5.4 percent in 2019 compared to 6.3 percent in 2018 (Figure 9). Delayed rains in the first half of 2019 hampered agricultural production. In addition, competition from cheap imports and challenging business environment slowed growth of the manufacturing sector. As a result, the output gap as a ratio of potential output increased to 0.3 percent.

Prior to COVID-19 outbreak, the economy had been projected to grow by 6.2 percent in 2020. The confirmation of the first COVID-19 case in Kenya on March 13, 2020, triggered measures by the Government to contain the spread of the disease and mitigate the impact on households, firms and the economy. The pandemic affected all sectors of the economy negatively, except Information and Communications sector. Disruption of supply chains, furloughs, closure of businesses and restrictions of movements contributed to subdued aggregate demand and overall economic slowdown. Consequently, the has Government projected GDP growth to decline from 5.4 percent in 2019 to about 1.3 percent in 2020, widening the output gap and further loss of income, which accentuates fragility in the financial sector. Fiscal, monetary and financial sector policy measures put in place are expected to resuscitate the economy to grow at 6.2 percent in 2021.

Figure 9: Annual Real GDP Growth Rates



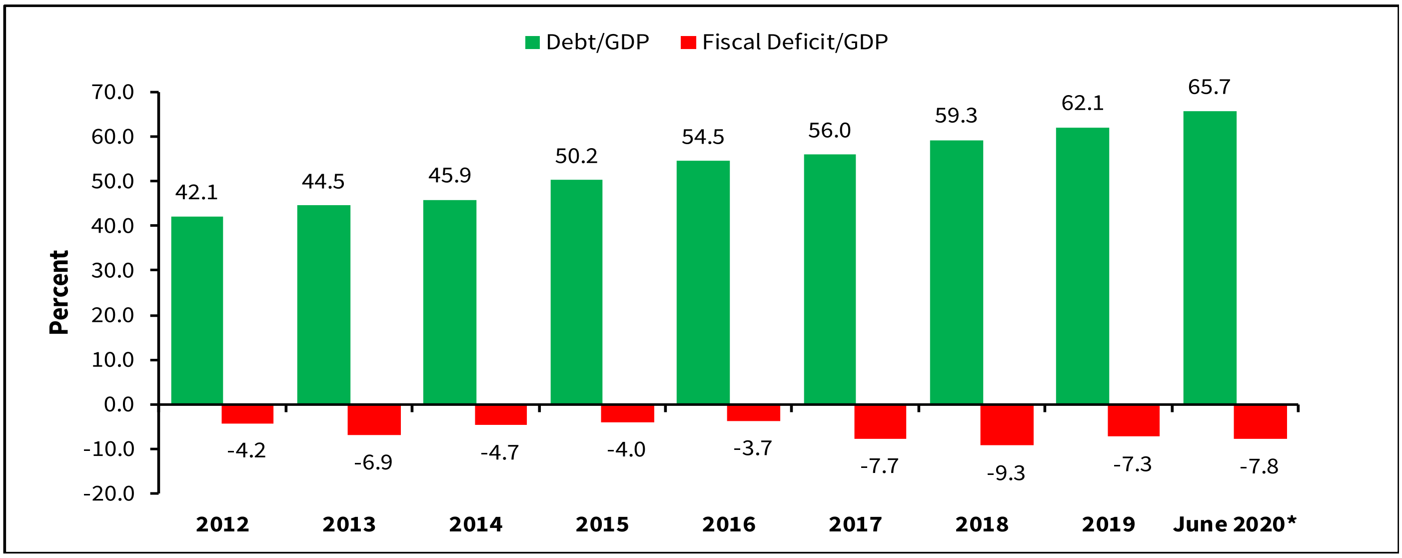
Source: Kenya National Bureau of Statistics (KNBS)

The current account balance improved despite slow global growth and fragility in Kenya's main export markets. The current account deficit to GDP ratio improved to 5.8 percent in 2019 and 4.8 percent in June 2020 compared to 6.2 percent in 2018, on increased diaspora remittances, reduced imports bill and increased exports to new markets.

The Kenya Shilling remained stable against both the regional and international currencies in 2019 and in the first quarter of 2020. However, the Kenya Shilling depreciated in the second quarter of 2020 as the effects of COVID-19 pandemic filtered into the economy. International travel restrictions, closure of air airspace and reduced demand for main exports, accentuated depreciation of Kenya Shilling. However, increase in remittances, resumption of exports, prudent monetary policy and stable import bill have stemmed exchange rate volatility.

The Government's increased spending and reduction in taxes to mitigate spread and impact of COVID-19 pandemic on households and firms in the first half of 2020, narrowed the fiscal space (Figure 10). With already low tax yield given the

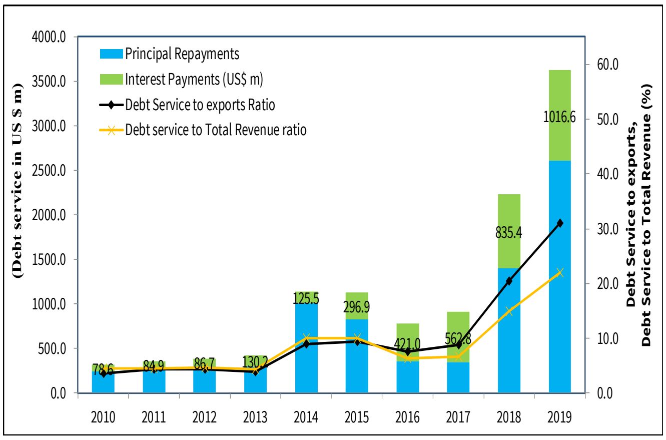
Figure 10: Fiscal Deficit and Public debt as a percent of GDP



*Source: The National Treasury and Planning. *Budget estimates* large informal sector, fiscal deficit as ratio of GDP increased from 7.4 percent in the FY 2017/2018 to 7.7 percent in FY 2018/2019 and 7.8 percent in the FY 2019/2020. This has slowed the pace of the National Treasury's fiscal consolidation programme that targeted reducing fiscal deficit from 9.2 percent of GDP to less than 3.5 percent by FY 2021/2022.

Kenya's overall public and publicly guaranteed debt has increased in recent years but remains sustainable. Gross public debt increased from 50.2 percent of GDP at the end of 2015 to 65.7 percent of GDP at end of June 2020, reflecting, among other factors, high deficits and large public infrastructure spending. The risk of debt distress has increased to high from moderate due to the impact of COVID-19 pandemic, which exacerbated the existing vulnerabilities. The rapid pace of debt accumulation has resulted in increased interest and principal repayments in the last six years. However, Government revenues and export earnings have not increased in tandem with debt service. As a result, the ratio of debt service to exports and debt service to total revenue increased, signalling potential debt distress **(Figure 11).**

Figure 11: Public Debt Service

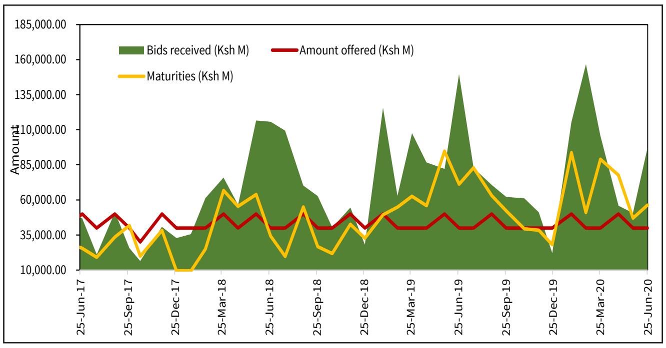


Source: The National Treasury and CBK

The auctions of government securities on the primary market recorded strong performance in 2019 and first half of 2020, reflecting increased demand from investors. Treasury bills auctions were fully subscribed throughout the year except in December 2019 **(Figure 12 a).** The increased appetite for Treasury bills despite declining interest rates, may explain the risk aversion by banks, who consider them less risky compared to private lending during interest rate control period. The Law, which capped the lending rate to the Central Bank Policy Rate plus a margin of 4 percent, distorted pricing of credit, resulting to decline in intermediation and lending to risky borrowers. Other metrics for this high demand are subscription rates and bid to cover ratio **(Figure 12 b)**.

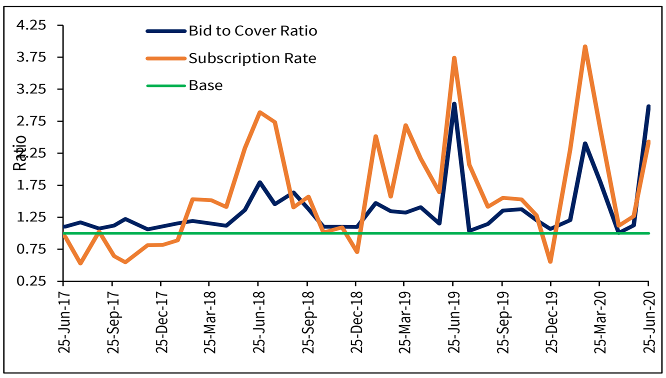
Despite the faster increase in the stock of domestic debt by the end of 2019 and in the first half of 2020, refinancing risk has reduced significantly. This is depicted by increase in the average time to maturity from 4.5 years in December 2018 to 5.7 years in December 2019 and 5.6 years in June 2020. In addition, interest rates on short term debt and yields on long term debt have fallen to their lowest levels, consistent with the implementation of The National Treasury Medium Term Debt Management Strategy (MTDS).

Figure 12 (a): Treasury bills Performance in Primary Issuance



Source: CBK

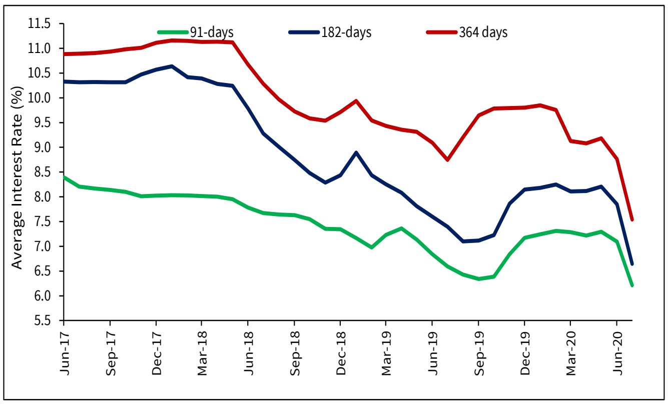
Figure 12 (b): Subscription rate and bid cover ratio for Treasury bills



Source: CBK

The Interest Rates Capping Law amid ample liquidity and elevated credit risk has driven down Treasury bill rate and increased propensity to invest in Government securities. Seasonal liquidity cycles typical in the last quarter of every year underpinned fluctuations in the Treasury bill rates **(Figure 13).** The decline in the Treasury bill rates reduces the cost of Government debt and eases fiscal burden.

Figure 13: Treasury bills Average Interest Rates

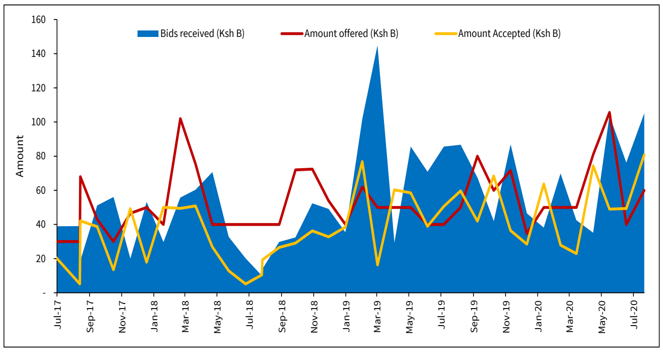


Source: CBK

The demand for Treasury bonds was also high as reflected by the subscriptions and bids against amounts offered and amounts accepted, respectively **(Figures 14 a & b).** A combination of reopening and issuance of long term bonds, such as infrastructure bonds, increased average time to maturity of outstanding bonds from 6.9 years in December 2018 to 8 years in December 2019 and 7.7 years in June 2020. This has lowered the refinancing risk of domestic debt.

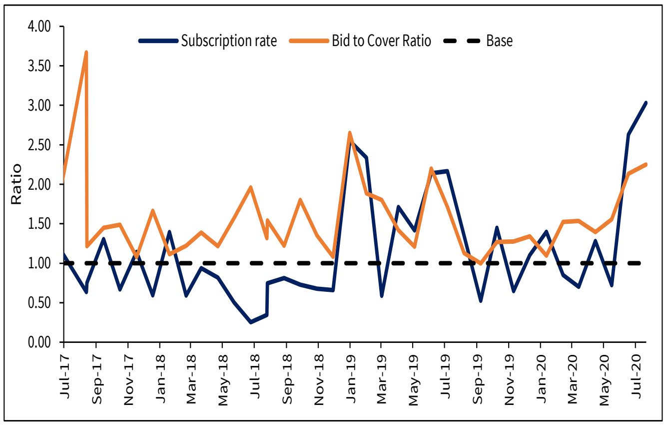
Strong demand for Treasury bonds in the primary market was also reflected in the increased trading activity in the secondary market for government bonds in 2019 compared to 2018 (Figure 15). However, the bonds turnover ratio, though very low, at 2.7 percent in June 2020, was better than 0.93 percent in December 2019, signifying improved liquidity in secondary bonds market. The low turn over ratio discourages issuance by other private and public corporates as well as investment in fixed income securities. Therefore, efforts to deepen the domestic bonds

Figure 14 (a): Treasury bonds Performance in Primary Issuance



Source: CBK

Figure 14 (b): Subscription rate and bid cover ratio for Treasury bonds

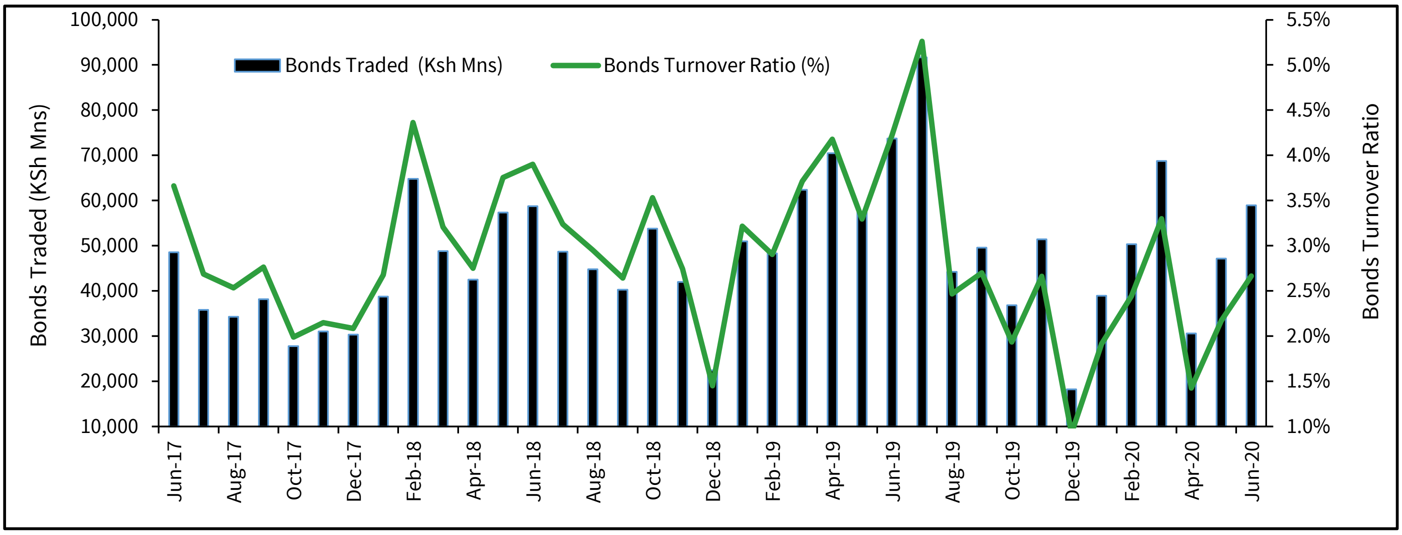


Source: CBK

market that entails improving liquidity of bonds will alleviate liquidity risks for holding bonds. This will also enhance the role of bonds as collateral in the money market.

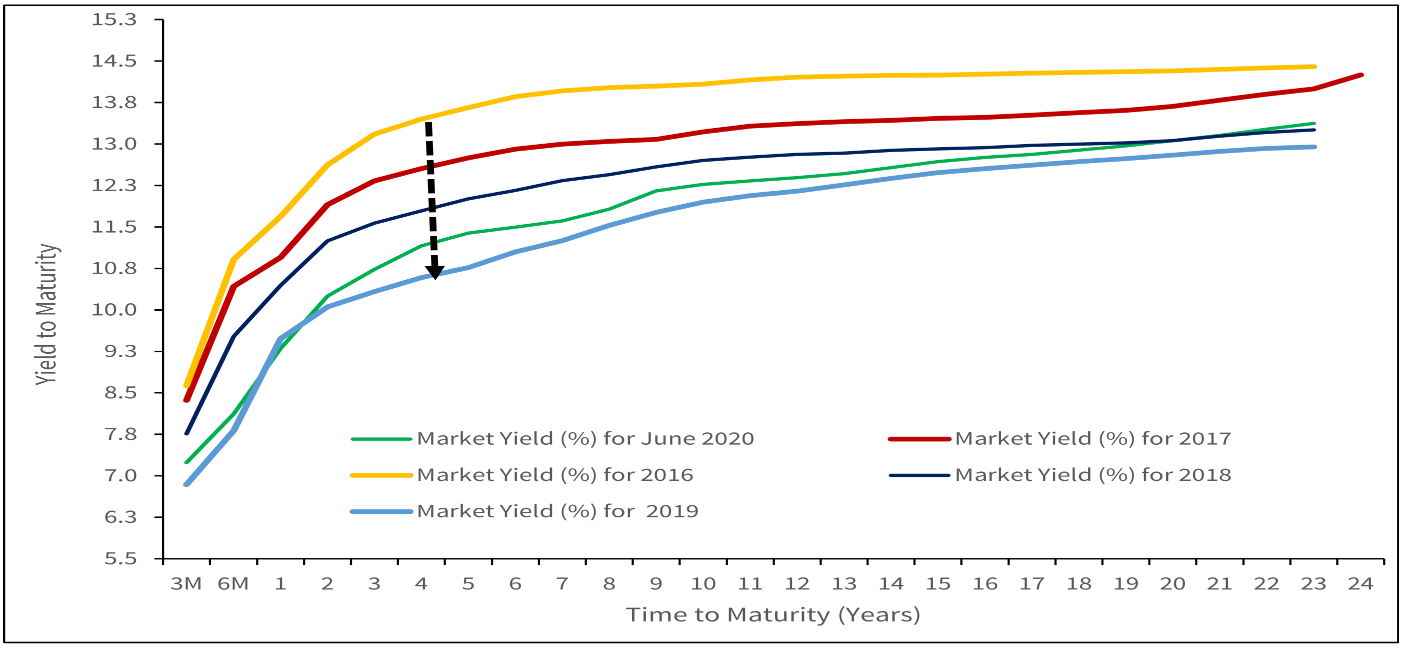
The decline in interest rates on Government bills and Bonds in the primary market and stable inflation have reduced yields in the secondary market as reflected by downward shift in the yield curve (Figure 16). The short end of the curve was lowest and less steep in June 2020, reflecting ample market liquidity. The concern however is the repricing risks in the event of interest rates reversal that would lead to upward shift in the yield curve. This would lead to revaluation losses, impacting negatively on the balance sheet of the bondholders, who are mainly, financial institutions.

Figure 15: Secondary Market for Government Bonds



Source: Nairobi Securities Exchange (NSE)

Figure 16: Government of Kenya bonds Yield Curve



Source: Nairobi Securities Exchange (NSE)

Lending to the private sector increased following repeal of the Interest Rates Capping Law in November 2019 (Table 1). The annual growth rate of credit to the private sector rose to 7.8 percent in December 2019 and June 2020 from a low of 2.5 percent and 2.4 percent in December 2017 and 2018, respectively. The growth rate of private sector credit slowed because of fragility in the banking sector in 2015 and 2016 (collapse of Dubai bank, Imperial bank Limited and Chase Bank Limited) and introduction of the Interest rates controls in September 2016.

The growth in the private sector credit (PSC) in the first half of 2020 despite the COVID-19 pandemic, indicates the positive impact of removal of interest rates controls and monetary policy easing. The sectors driving this growth in terms of share to total credit are; Trade, Households, Manufacturing and Real Estate, which are key to the overall economy and stability of the financial sector. The microfinance banks (MFBs) have been most affected by the COVID-19 pandemic in terms of their ability to provide credit to the private sector as it has recorded negative growth in the second quarter of 2020 compared to banks and Sacco societies.

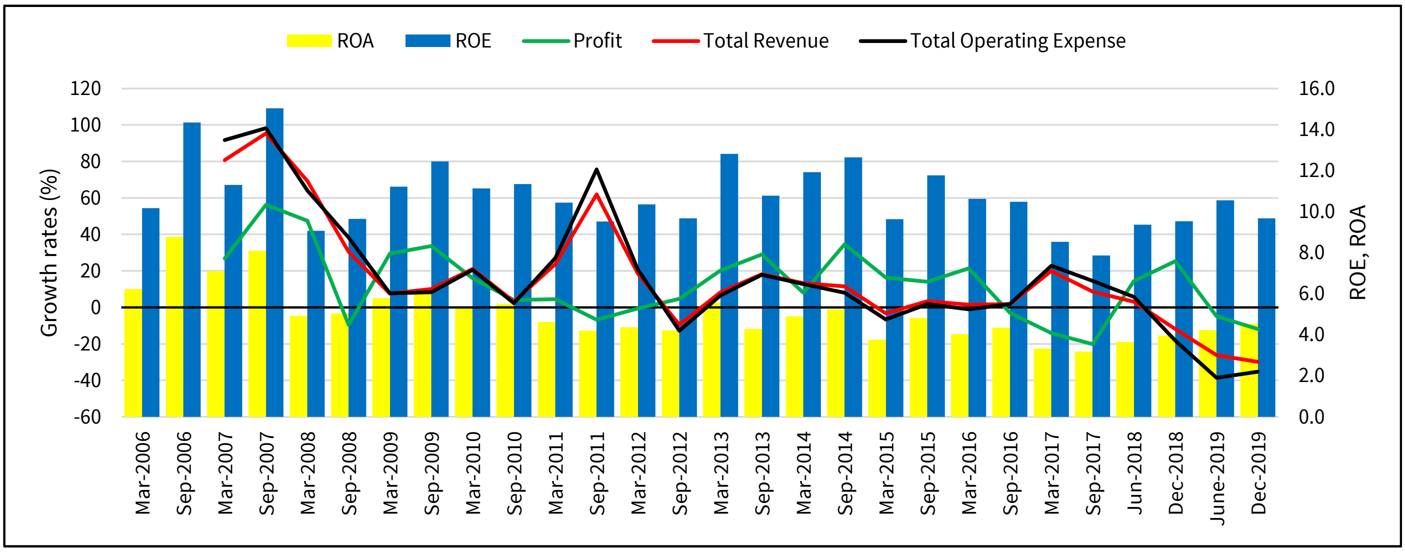
Table 1: Annual Growth in Credit to Private Sector

	12-month growth in private sector credit by acitivity (%)																	
ECONOMIC SECTOR	**Sep-15**	**Dec-15**	**Sep-16**	**Dec-16**	**Mar-17**	**Jun-17**	**Sep-17**	**Dec-17**	**Mar-18**	**Jun-18**	**Sep-18**	**Dec-18**	**Mar-19**	**Jun-19**	**Sep-19**	**Dec-19**	**Mar-20**	**Jun-20**
Agriculture	24.2	20.6	0.7	1.2	(7.2)	(11.7)	(1.4)	(7.5)	(6.2)	(4.7)	(6.0)	(2.0)	0.2	3.9	5.5	(2.4)	1.4	2.2
Manufacturing	21.0	19.7	(1.2)	(2.2)	(7.5)	(6.8)	6.4	12.9	11.2	12.2	11.9	6.5	7.2	11.4	7.5	9.2	15.3	11.1
Trade	13.0	7.6	15.7	16.0	11.7	10.9	7.1	9.0	5.4	8.5	3.2	2.9	8.7	5.5	7.6	8.9	9.4	9.4
o/w domestic trade	*6.5*	*0.0*	*14.0*	*14.1*	*11.2*	*8.9*	*7.7*	*10.5*	*4.5*	*8.8*	*4.6*	*4.6*	*13.0*	*9.1*	*9.9*	*10.5*	*9.2*	*10.0*
Building & construction	31.3	35.9	2.7	(2.4)	1.1	(0.1)	2.4	5.0	12.6	13.3	11.1	1.8	(7.0)	(6.3)	(5.3)	1.6	9.5	4.6
Transport & communication	40.6	36.4	15.2	15.1	9.9	3.8	(4.2)	(6.9)	(18.4)	(12.7)	(9.1)	(9.4)	5.7	5.8	5.0	8.1	7.1	14.9
Finance and insurance	111.2	45.6	3.1	16.8	(9.1)	(4.3)	(1.2)	(4.2)	11.6	3.8	6.6	17.5	10.2	4.7	14.5	0.4	6.6	3.2
Real estate	22.0	16.8	9.9	11.2	12.6	10.4	9.2	8.7	4.5	3.8	1.7	(0.5)	(0.1)	1.0	2.2	1.5	2.2	4.9
Mining & quarrying	1.0	(9.5)	(32.0)	(18.2)	(32.8)	(36.5)	0.3	(5.0)	(2.7)	(9.1)	(15.5)	(10.7)	(11.4)	(4.3)	(5.1)	(5.8)	3.9	10.0
Private households	19.4	3.0	10.8	19.7	13.3	11.0	2.0	(1.5)	(0.7)	2.9	5.1	6.8	8.0	7.6	8.8	5.6	3.4	3.6
Consumer durables	50.1	40.1	5.7	11.3	10.1	7.5	(0.4)	0.6	4.7	7.8	7.8	11.0	13.9	21.3	28.4	26.0	24.1	15.2
Business services	(6.6)	35.4	(7.9)	(33.8)	(14.5)	(14.5)	(5.1)	(8.4)	(0.5)	6.7	4.3	8.0	(0.4)	(3.2)	3.2	2.4	3.3	5.3
Other activities	(27.1)	(13.6)	(18.2)	(23.8)	(19.0)	(20.6)	(23.2)	(5.6)	(6.3)	(7.9)	2.7	(34.8)	(31.7)	(22.6)	(13.6)	16.0	36.8	(3.7)
Overall Growth Banks credit	**19.99**	**18.60**	**5.64**	**5.17**	**3.36**	**1.9**	**2.2**	**2.5**	**2.1**	**4.3**	**3.8**	**2.4**	**4.3**	**5.2**	**7.0**	**7.1**	**8.9**	**7.7**
Growth of SACCO credit					**11.57**	**14.6**	**14.4**	**13.6**	**18.1**	**12.8**	**12.7**	**12.5**	**11.0**	**12.4**	**11.7**	**12.6**	**13.8**	**9.9**
Growth of MFB's Credit					**-2.39**	**-4.2**	**-6.5**	**-7.2**	**-3.0**	**-1.1**	**2.6**	**8.9**	**7.8**	**8.7**	**6.4**	**3.3**	**2.7**	**-1.5**
Overall Financial Institution					**5.03**	**2.8**	**2.9**	**3.6**	**3.7**	**5.2**	**4.9**	**3.8**	**5.2**	**6.1**	**7.6**	**7.8**	**9.4**	**7.8**

Source: CBK

The Corporate balance sheets reflect resilience of the NSE listed non-financial companies to the sluggish economy as well as competition from cheaper imports in 2019. The short-term and long-term debt accumulation by corporates declined by 2.1 percent and 3.2 percent in 2019, respectively, implying low solvency risks. However, the ratio of current assets to current liabilities declined from 4.7 percent in 2018 to 3.2 percent in 2019, indicating reduced capacity from these firms to meet short term debt obligations and thus raising stability concerns in the financial sector **(Figure 17).**

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



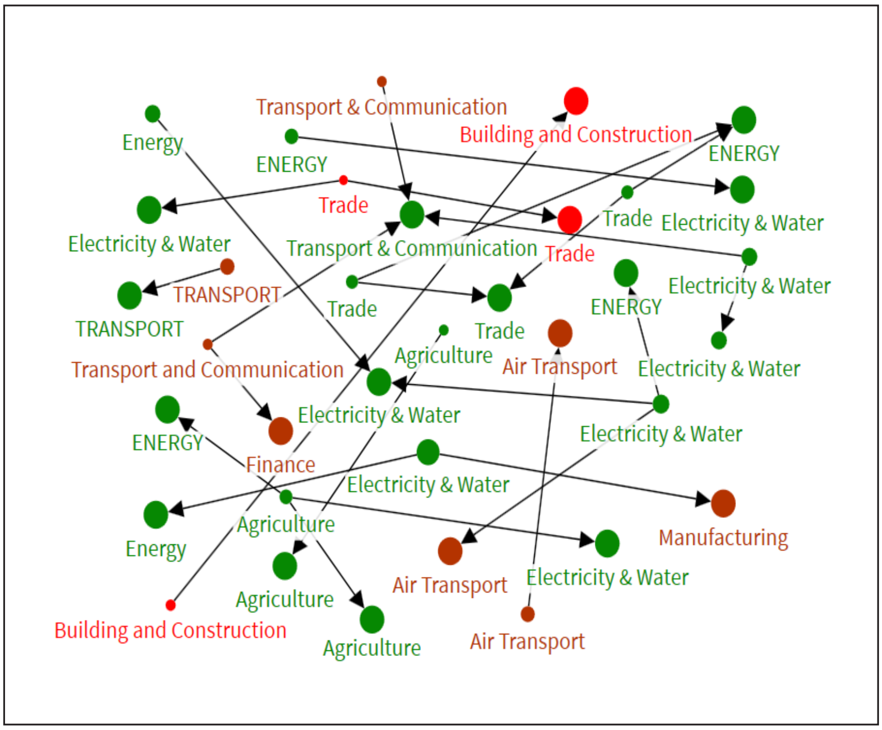
Source: CBK

Declining profitability combined with falling revenues in 2019, saw a number of these firms resort to downsizing staff, with over 7,000 staff laid off in 2019 compared to 2876 in 2018 and 1870 in 2017. Other companies issued profit warnings (17 listed firms in 2019 compared with 11 firms in 2016) and initiated employee lay-offs to manage expenditures. As a result, average earnings per share for select listed firms declined from KSh 7.2 in 2018 to KSh 2.1 in 2019, hence further decline in equity prices. Declining revenues and profitability for firms and furloughs of employees increases credit risks as those with outstanding debt will be unable to service them, hence a financial stability concern.

The State Owned Enterprises (SOEs) are key players in the financial services sector and overall economy. They are among the ten (10) largest borrowers and depositors in the banking industry and large payers of insurance premiums, while Sacco Societies, largely draw their membership from SOEs. Their stability is therefore, critical to the economy and financial stability. Financial viability of SOEs affects financial institutions, households and private businesses through their interconnectedness and value chain, since their borrowing and spending decisions affects balance sheets in the economy. The banking industry's loans to SOEs amounted to about KSh 100 billion as at December 2019, with the energy sector accounting for the largest share. A total of 35 banks extended loans to SOEs/ parastatals in December 2019, thus comprising some of the large single borrower exposures **(Figure 18).**

Loans from banks to SOEs (parastatal corporations) coloured in red and maroon are in the doubtful and watch categories, respectively; while loans coloured in green indicates that the SOEs were servicing their loans (performing category). The SOEs in the agriculture sector were able to service their loans, while SOEs in the transport, trade and manufacturing sectors, have their loans mostly in watch and doubtful categories. This may be explained by slowdown in economic activity, competition from cheaper imports and weak governance that have reduced their viability. This exposes the banking industry to vulnerabilities in the SOEs.

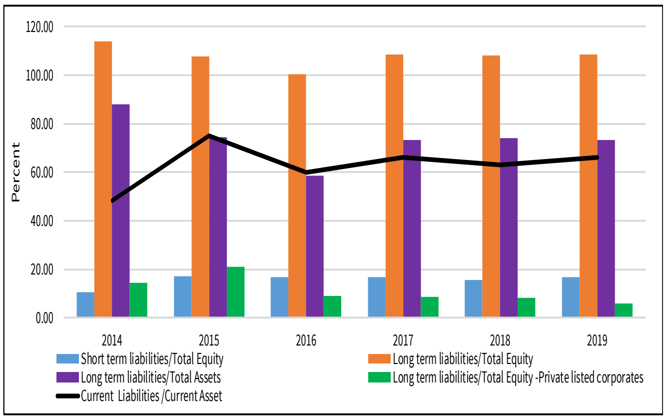
Figure 18: State Owned Enterprises Loans from Banking Industry



Source: CBK Staff Computation of Lending Network for SOEs

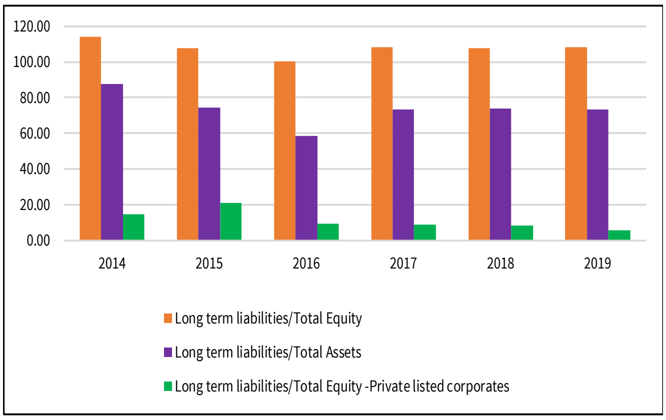
The long term debt to assets ratio for SOEs increased marginally, from 108.1 in 2018 to 108.5 in 2019 **(Figure 19),** while accumulation of long term debt relative to equity by private corporates declined **(Figure 20).** SOEs have accumulated debt faster than private corporates. The high level of long term liabilities against slow growth in assets suggest that the long term debt was not used to fund SOEs assets. This limits productivity, expansion capacity and profitability of SOEs. This

Figure 19: Indebtedness of SOEs



Source: Selected SOEs and NSE Listed Private Companies.

Figure 20: Indebtedness of Private Corporates



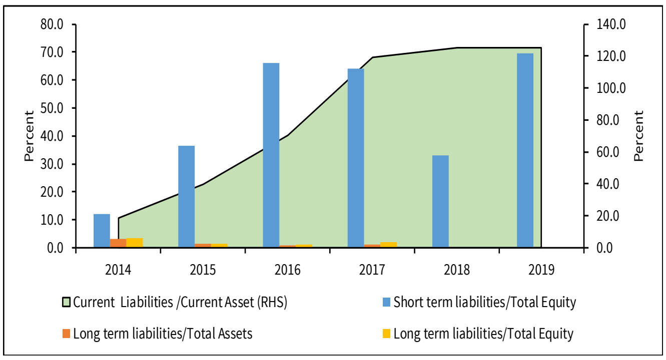
Source: Selected SOEs and NSE Listed Private Companies.

in turn raises both fiscal concerns and financial stability issues through their exposure to financial institutions by borrowing and the government by ownership.

The short term liabilities to assets and to total equity ratios of SOEs increased from 15.4 percent and 12.6 percent in 2018 to 16.6 percent and and 13.5 percent in 2019, respectively. However, current liabilities to current assets ratio, increased from 63.1 percent in 2018 to 66.3 percent in 2019, indicating that SOEs, especially, in the services sector, are accumulating short term liabilities much faster, which is not good for capital formation **(Figure 21)**.

The increase in current laibilities suggests that SOEs are not settling their short-term debt in time, thus raising indebtendess of service providers/suppliers, which has a contagion effect

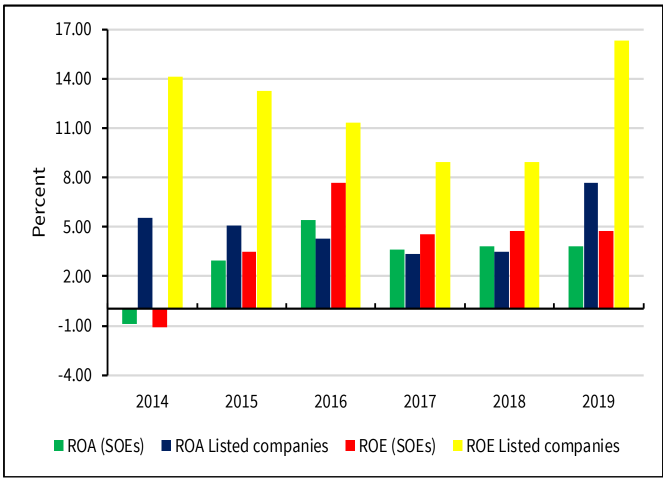
Figure 21:Declining Solvency and Liquidity of Service Providing SOEs



Source: Selected SOEs

to the financial sector through non-performing loans. To address weaknesses in SOEs balance sheets, the government published a policy framework on management of state corporations, *Mwongozo*[1]. Its implementation aims to enhance sound and prudent corporate governance and management of state corporations, thus ensuring their effectiveness in fuilfiling their mandates. Implementation of Mwongozo has led to improved profitability of SOEs, with their ROA and ROE, rising from -1.4 percent and 1.6 percent in the 2014 to 3.9 percent and 4.9 percent in 2019, respectively **(Figure 22)**.

Figure 22: Total Profitability of SOEs

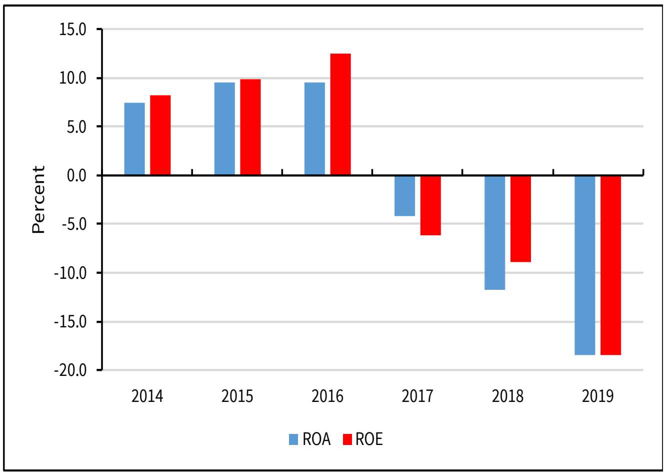


Source: Select SOEs and NSE Listed Companies.

[1] *Mwongozo is policy guide for managing State Owned Enterprises.*

However, SOEs providing services have been making losses since the 2017, with their ROA and ROE declining from -4.1 percent in 2017 to -6.1 percent in 2018 and -18.4 percent in 2019 **(Figure 23).**

Figure 23: Profitability of SOEs Providing Services



Source: Select SOEs and NSE Listed Companies.

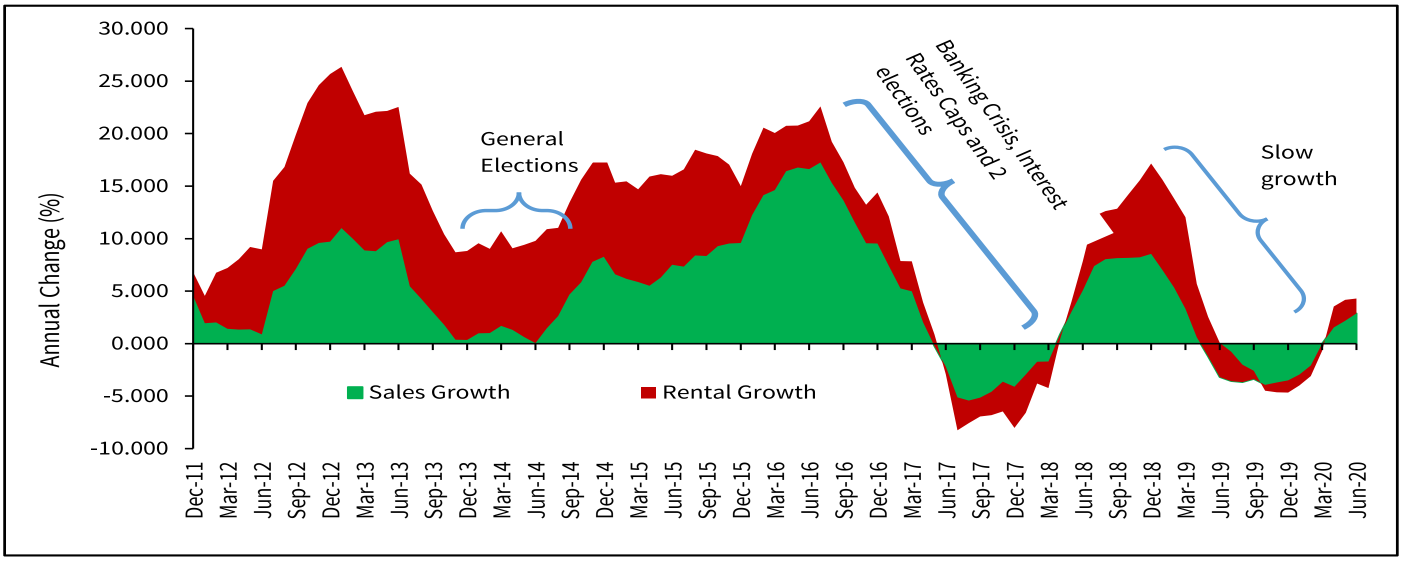
This makes it difficult for them to meet their maturing obligations, including debt repayments without government financial support, hence posing a potential fiscal burden in ensuring such SOEs remain operational.

The activity in the real Estate sector declined in 2019. The demand for property was subdued due to slow economic growth, especially for middle and high income earners. The Hass Consult Limited All Types Property Index shows that property prices declined by 3.5 percent and 1.2 percent for selling and rental prices in 2019 compared to 1.9 percent and 1.6 percent increase in 2018, respectively **(Figure 24).** The supply and uptake of property have been affected in the past by slow economic growth, general elections uncertainties, banking industry instability and interest rate controls that constrained lending to real estate sector.

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

Approved actual buildings plans declined to the lowest level in the last three years to KSh 2.33 billion in 2019 compared with KSh 2.45 billion in 2018 and KSh 2.81 billion in 2017. However, Government initiative to build affordable houses and increase in commercial bank lending to the real estate sector after removal of interest rate control in November 2019, saw the value of approved plans increase to KSh 1 billion in the first two months of 2020.

Figure 24: Annual Change in Selling Price and Rental Price Indices



Source: Hass Consult Limited

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

Year	Insurance	Pension	Commercial Banks
2012	39.32	1.60	130.92
2013	54.26	119.84	162.33
2014	62.55	130.39	218.68
2015	68.62	50.78	262.48
2016	73.24	178.42	284.09
2017	76.04	226.72	371.65
2018	82.59	229.90	380.91
2019	84.07	238.65	395.18

Source: Various reports of Real Estate Firms and Regulators

To grow the mortgage market, the Kenya Mortgage Refinance Company (KMRC) was established in 2018 to support the Affordable Housing, one of the Government's Big 4 Agenda. KMRC's mandate is to provide long-term funds to primary mortgage lenders (Banks, Microfinance Banks (MFBs) and Saccos) in order to increase the availability and affordability of mortgage loans to Kenyans. The entry of KMRC in the market is expected to improve mortgage affordability, increase the number of qualifying borrowers and result in the expansion of the primary mortgage market and home ownership in Kenya. The company will offer fixed rate long term loans initially at concessional rates to financial institutions.

Overall, macroeconomic risks have increased significantly as a result of the COVID-19 pandemic, with significant impact on financial stability. The economic growth is projected to decelerate way below the pre-COVID pandemic expectations. This has negative impact on household livelihoods and businesses incomes and employment, which in turn affects credit uptake, loans repayments, investment in stock markets, insurance uptake, property market activity and pension contributions. The rising public debt has also raised concerns about its sustainability in the medium term, especially with the COVID-19 pandemic and its impact on government finances. In addition, interest rates reversal resulting from liquidity squeeze, will not only raise the cost of borrowing, but may also lead to revaluation losses for financial institutions holding Government bonds, further exacerbating decline in profitability. It is essential to monitor macrofinancial risks for potential spillovers to the system.

2. FINANCIAL SECTOR DEVELOPMENTS AND RISKS

Kenya's financial system comprises of the banking, insurance, capital markets, pensions, and Sacco societies industry and unregulated financial services providers. It is supported by a robust financial markets infrastructure that facilitates payments, settlement and custodial services.

The financial system is highly interconnected, diversified and segmented with increased cross border operations. Adoption of FinTechs has transformed the sector in terms of products and services through innovations. Complexity of the financial sector has resulted to the establishment of non-operating holding companies to manage operations of these complex entities. While this transformation and growth in complexity has brought efficiency and synergies in resource use and profit maximization, it has also become a growing source of potential risks, including episodes of fraud and cyber security attacks. However, the financial system was generally stable in 2019, and is able to withstand macrofinancial shock due to COVID-19 pandemic.

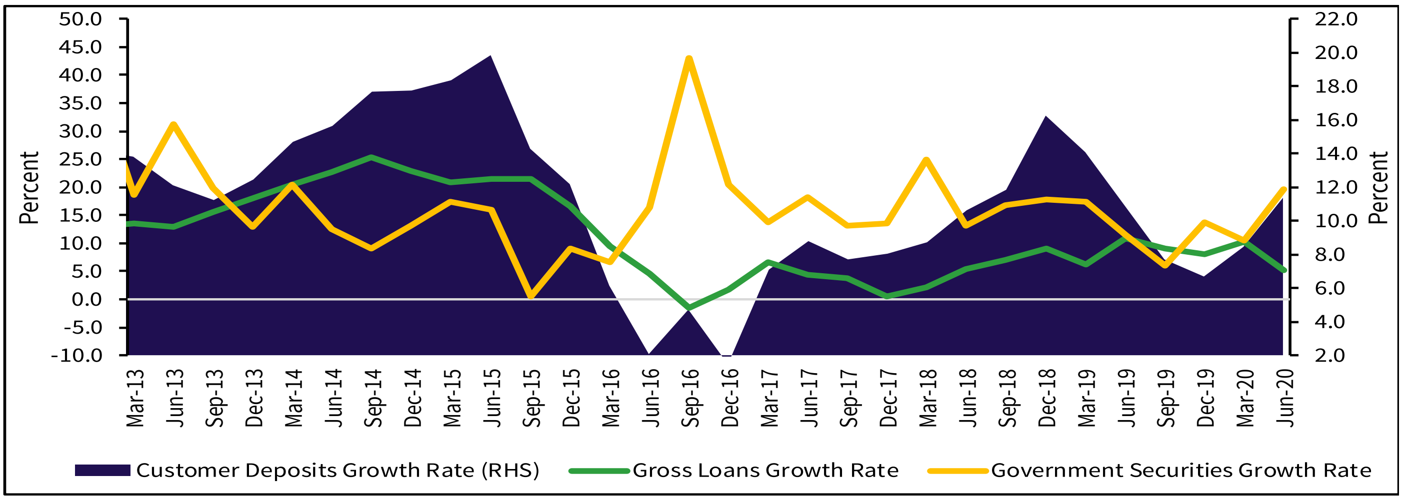
2.1 Resilient Banking Industry

As at June 2020, the banking industry comprised; 38 commercial banks, 1 mortgage finance company, 14 MFBs, 9 representative offices of foreign banks, 68 foreign exchange bureaus, 19 money remittance providers and 3 credit reference bureaus.

The banking industry was resilient in 2019 despite interest rates controls and sluggish economy, registering a 9.6 percent growth in assets and 9.1 percent growth in deposits. The total net assets of the industry amounted to KSh 4,832.4 billion in December 2019 and KSh 5,207.82 billion in June 2020, of which about 53 percent were in loans and advances and 13.6 percent in government securities. Customer deposits were KSh 3,554.4 billion in December 2019 and KSh 3,903.6 billion in June 2020. The increase in deposits is attributed to more usage of digital finance including mobile money, agency banking, and demonetisation of KSh 1,000 notes in 2019 **(Figure 25)**.

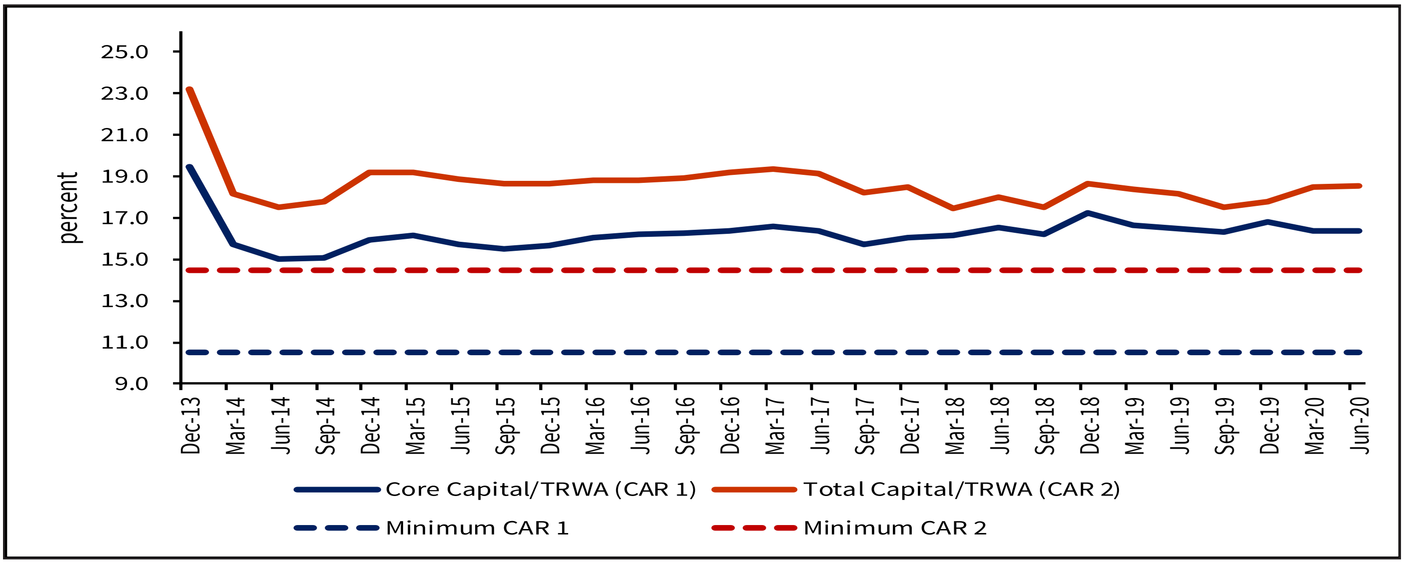
The resilience of the industry is also reflected in the high capital levels in relation to assets. As at end June of 2020, the Core Capital to Total Risk Weighted Assets (TRWA) and Total Capital to TRWA ratios were 16.4 percent and 18.5 percent, compared to 16.8 percent and 18.8 percent, respectively as at end of December 2019. The Core Capital to TRWA and Total Capital to TRWA ratios are above the minimum regulatory requirements of 10.5 percent and 14.5 percent, respectively **(Figure 26)**.

Figure 25: Growth in Loans, Government Securities and Deposits (percent)



Source: CBK

Figure 26: Capital Adequacy Ratios (CARs)



Source: CBK

The stability of the Core Capital to TRWA and Total Capital to TRWA ratios at a lower level compared to a higher level in 2013, indicates increase in the efficiency utilising capital.

The COVID-19 pandemic eroded the banks' assets quality gains made in 2019 as shown by the increased Non-Performing Loans (NPLs). The ratio of gross NPLs to gross loans deteriorated to 13.1 percent in June 2020 from 12.0 percent in 2019, reflecting worsening households' livelihoods and business closures, staff lay-offs due to disruptions in supply chains, restrictions of movements and lockdowns. The gross NPLs increased by 14.6 percent in the first half of 2020 to KSh 381.98 billion in June 2020, indicating elevated credit risk **(Table 3).**

The banks' assets quality deterioration was not uniform across banks due to differences in business models and management's attitude towards risk. Banks in the medium peer group were the main drivers of high Gross NPLs ratio from June 2019 compared to banks in small and large groups **(Figure 27).**

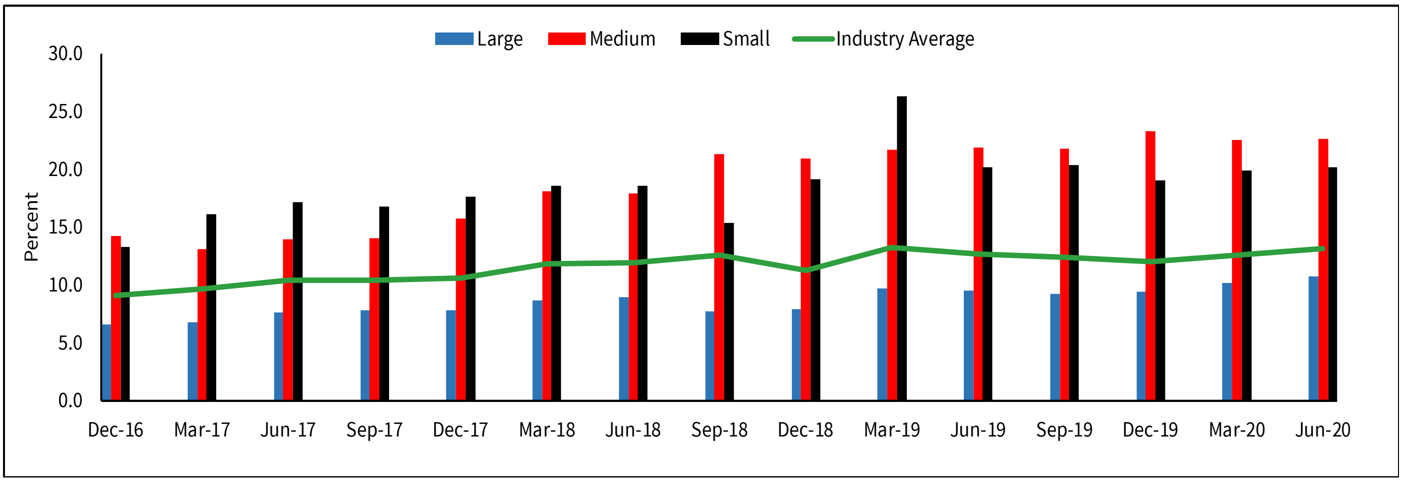
Table 3: Banks' Asset Quality (KSh Millions)

MEASURE	Dec. 2017	Dec. 2018	Dec.2019	Jun-20	Change (%) (2019-2018)
Net Assets	4,002,741	4,408,593	4,832,348	5,207,815	9.61
Gross Loans	2,413,851	2,488,117	2,774,649	2,908,702	11.51
Net Loans	2,013,610	2,318,071	2,556.80	2,837,834	10.3
Gross NPLs	264,617	316,712	333,393	381,981	5.24
Interest in Suspense	43,726	54,447	62,839	70,869	15.34
Total NPLs	220,891	262,265	256,219	311,112	3.14
Total Provisions	101,193	115,599	154,966	186,331	34.08
Net NPLs to Gross Loans (%)	5.5	5.9	4.2	5.9	-1.7
Gross Loans /Net Assets (%)	53.9	56.4	57.4	55.9	1.02
Gross NPLs to Gross Loans (%)	12.3	12.7	12	13.1	-0.69

Source: CBK

Liquidity conditions and distribution is key to the banking industry stability, signifying the bank's ability to fund assets and meet obligations as they fall due. A liquidity problem in one bank can disrupt liquidity distribution in the entire banking industry due to the interconnected operations. Liquidity problem may also metamorphose into a solvency problem for a bank if not handled well.

Figure 27: Quarterly Gross NPLs ratio by Peer Group, 2016- June 2020

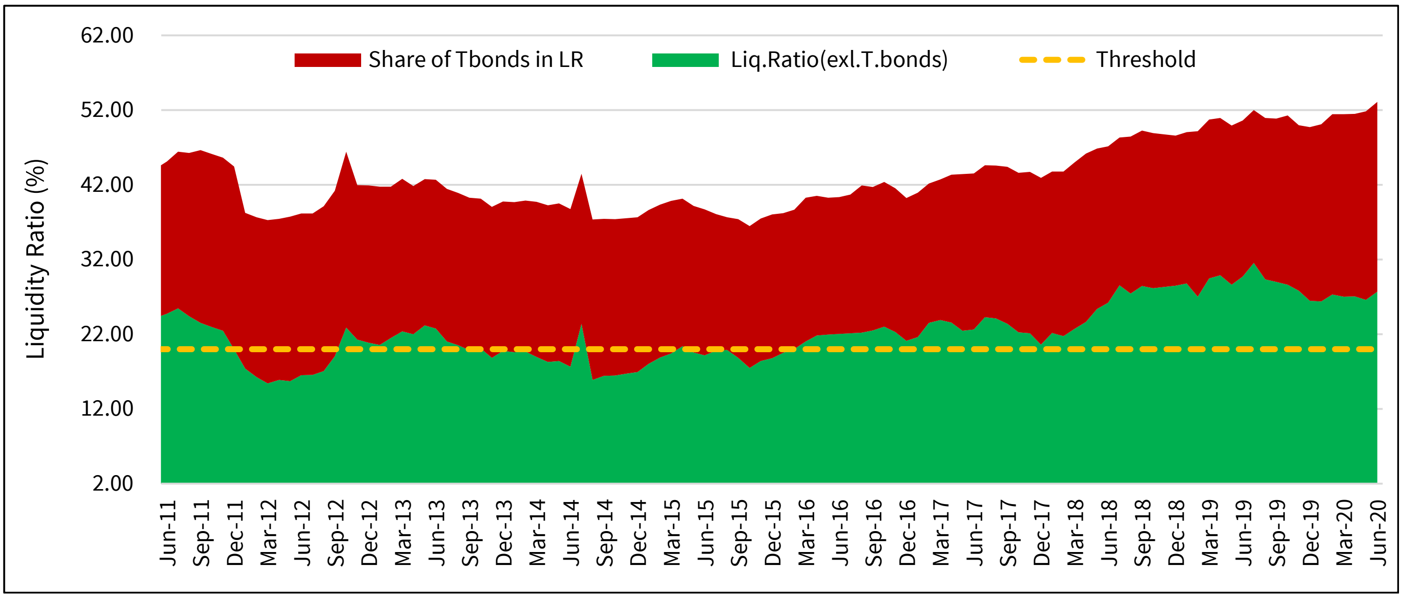


Source: CBK

The banking industry has enjoyed ample liquidity overtime, averaging way above the minimum regulatory requirement of 20 percent. However, if long term government bonds are excluded from liquid assets, the liquidity ratio shrinks to 26.5 percent in December 2019 and 27.1 percent in June 2020 **(Figure 28)**.

Government securities are therefore significant component of banks liquidity and therefore a change in their treatment, in computing liquidity ratios, will significantly affect banks' liquidity buffers. Deposits remain a key funding source for banks, with the ratio of gross advances

Figure 28: Banking Industry Liquidity Ratios (percent)

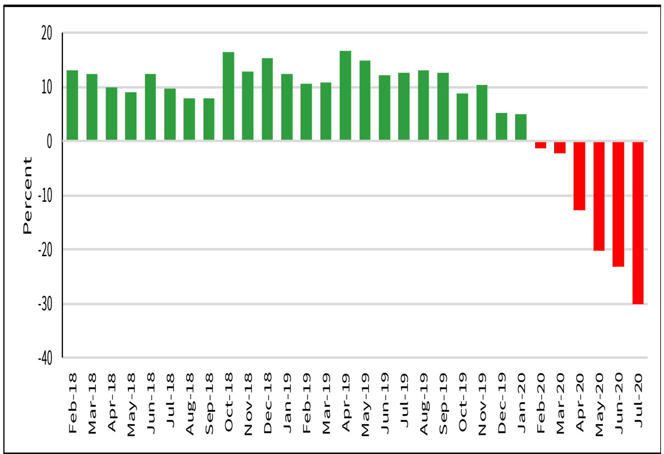


Source: CBK

to gross deposits increasing to 79.6 percent in December 2019 from 76.8 percent in December 2018.

A increase in bad debts charge and a decline in fees due to waiving of charges on bank- mobile money transaction reduced profit before tax (PBT). The PBT declined by 30 percent in the first half of 2020 compared to 5 percent increase in 2019 **(Figure 29).**

Figure 29: Profit Before Tax (Annual Change)



Source: CBK

In tandem with PBT, both the ROA and ROE declined in 2019 through the first half of 2020 compared to 2018. Banks in the medium and small peer groups incurred losses. The decline in profits reduces reserves to build capital and liquidity buffers as well as viability of banks **(Table 4).**

Nevertheless, the banking industry's outlook is expected to remain stable and resilient in 2020 albeit potential negative effects of COVID-19 pandemic on assets quality and overall performance metrics. This however, depends on the intensity and duration of the pandemic, which remains uncertain. Overall, the banking industry has sufficient capital buffers to withstand the COVID-19 pandemic shock, supported by the mitigation measures put in place by the Government and financial institutions. Other

Table 4: Banks' Profitability Indicators by Peer Group in 2019

MEASURE	Large Peer Group	Medium Peer Group	Small Peer Group	Industry Overall (2019)	Industry Overall (2018)
Profit Before Tax (KSh Mns)	141,982.9	17,068.4	827.9	159,879.2	152,335.6
Growth of profit before tax	9.89	-29.95	-167.1	4.95	12.12
ROA (percent)	2.91	1.68	0.19	2.52	2.69
ROE (percent)	25.3	12.6	1.5	21.2	22.5

Source: CBK

regulatory measures that enabled the banking sector to be resilient include the Kenya Banking Sector Charter of 2019 which entrenches a responsibility and discipline in the banking industry. The Banking Sector Charter is anchored on adoption of customer-centric business models, risk-based credit-pricing, transparency and ethical banking. The repeal of the Interest Rates Capping Law in November 2019 to allow market-determined credit pricing; market-driven bank consolidation; publication of revised Credit Information Sharing System (CIS) Regulations in April 2020 will strengthen consumer protection and improve business environment for banks. The Guidance Note on COVID-19 Pandemic Planning in March 2020 to prepare banks to deal with the crisis, mitigation measures taken by banks to ease pressure on borrowers reduced credit risks **(Annex I).**

2.2 Capital Markets Industry

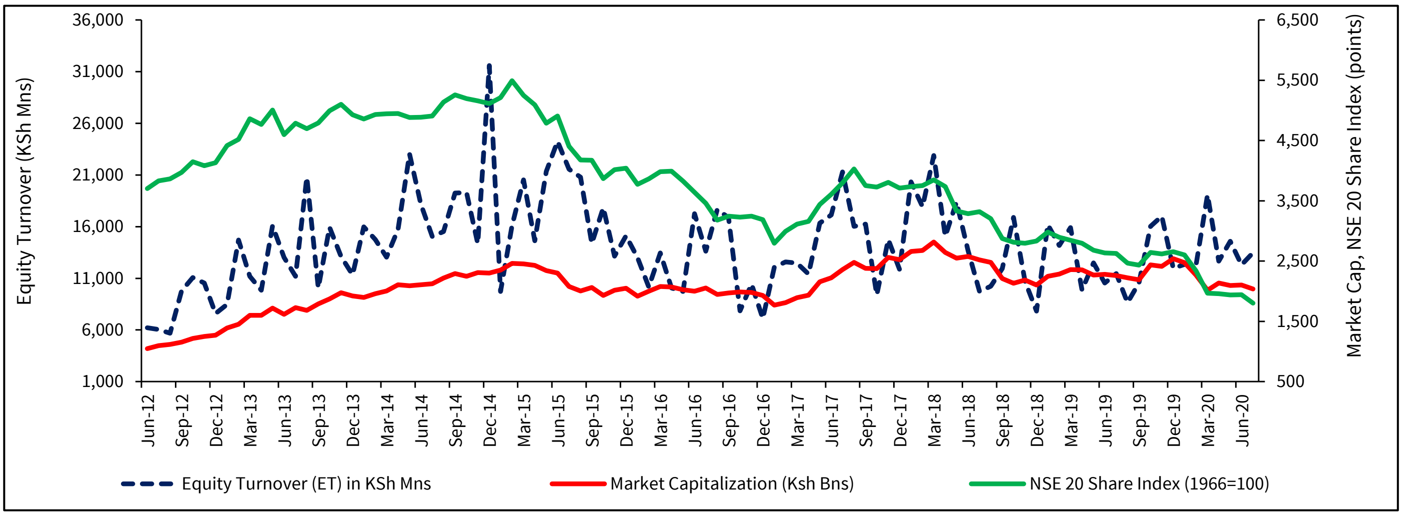
The Capital Markets Authority (CMA) licensed intermediaries as at June 30, 2020 included; Securities Exchange (1), Central Depositories (1), Investment Banks (16), Stockbrokers (10), Investment advisers (14), Fund Managers (25), Collective Investment Schemes (24), Authorized depositories/Custodians (19), Credit Rating Agencies (5), Real Estate Investment Trust (REIT) Managers (9), REIT Trustees (3), Employee Share Ownership Plans (16) and Authorized Real Estate Investment Trusts (1). The industry licensees' assets increased to KSh 28 billion in 2019 from KSh 23.70 billion in 2018.

The capital markets industry remains vulnerable as indicated by the leading equities market indicators that were already declining in 2019, but have worsened in the first half of 2020 due to the COVID-19 pandemic (Figure 30). The fragility in the equities markets could be explained by difficult businesses conditions facing listed companies and corporates in general. In addition, the interest rates capping law affected banks, whose stocks form a significant portion of the equities market. The emergence of COVID-19 has complicated an already fragile market. The market leading indicators, closed June 2020 at the lowest level in the last eight years.

The subdued equities market performance could be explained by declining participation by foreign investors at the NSE **(Figure 31).** The average foreign investor participation to total equity turnover declined from 73.7 percent in December 2018 to 68.6 percent in December 2019 before further decline to 60.6 percent be end July 2020. Most of the foreign investors sold more shares than they purchased, resulting to net outflow from the local bourse.

The poor performance could also be attributed to weak corporate governance in some listed

Figure 30: Equities Market Performance



Source: Nairobi Securities Exchange

companies that have been making losses, which were then delisted and/or placed under receivership. The COVID-19 pandemic further weakened the firms, which led to overall net outflows by foreign investors to cut losses. Whereas sell-offs by foreign investors may reduce liquidity of stocks in the equity market, it also creates opportunity for local investors to buy undervalued blue-chip stocks. Introduction of alternative investment segments such as the ABSA Gold Exchange Trade Fund (ETF) and derivatives market provides investors opportunities to diversify their portfolio and hedge against risks.

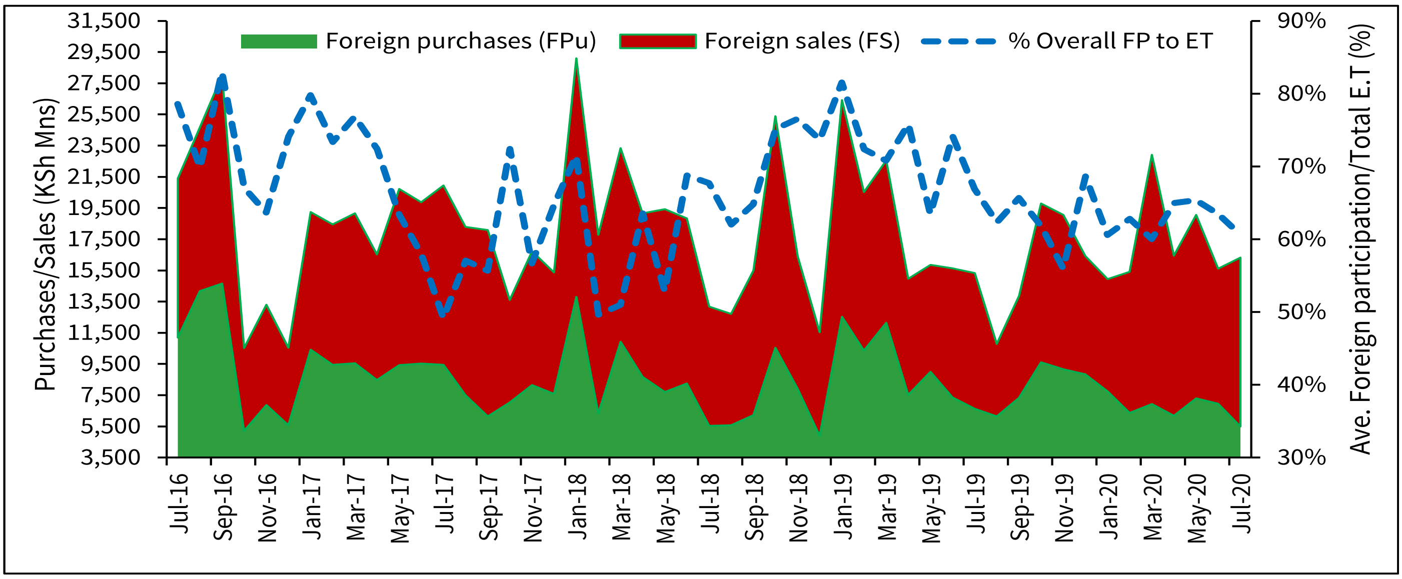
The liquidity ratio of equity market declined from 8.4 percent in 2018 to 6.1 percent in 2019, contributing to decline in prices and increase in volatility **(Table 5).** The top 5 companies accounted for over 90 percent of the equity turnover during the period, reflecting concentration risk and illiquidity of

Table 5: Select Market Liquidity Indicators (KSh Billions)

Year	Equity Turnover	Market Capitalization	Liquidity Ratio (Percent)
2013	155.75	1,920.72	8.11
2014	215.73	2,300.05	9.38
2015	209.38	2,049.54	10.22
2016	147.18	1,931.61	7.62
2017	171.61	2,521.77	6.81
2018	175.65	2102	8.36
2019	154.86	2,540.00	6.1
2020(June)	83.23	2,104.33	3.96

Source: CMA

Figure 31: Foreign Participation Exposure (Equity) in KSh. Millions



Source: CMA

other companies' shares. The gazettement of Securities Lending and Borrowing Regulations in 2017 to operationalize lending and borrowing against securities and short selling are expected to improve liquidity going forward.

The main risks in the last two years to June 2020 include; high concentration by top five companies and foreign investors, low liquidity, low products uptake, political and economic risks. As at December 2019, top five companies by market capitalization accounted for 70.9 percent compared to 65.8 percent in 2018. Foreign investors accounted for 68.6 percent of total equity turnover in 2019 compared to 63.3 percent in 2018. Establishment of the derivative market has reduced volatility in the equity prices, with volatility of the Nairobi All Share Index (NASI), averaging 0.48 in 2019 compared to 0.55 in 2018. Corporate bonds component of the Fixed Income Securities segment has dried up, both for primary issuances and secondary trading. Since 2015, the only new issuance was the first Green Bond by the British real estate developer, Acorn Holdings and private equity fund Helios in October 2019. The value of outstanding bonds on the secondary market declined from KSh 86.8 billion for 17 issues in 2016 to KSh 23.2 billion for 6 issues in June 2020 **(Table 6).** Governance issues that led to the collapse of Chase Bank and Imperial Bank as well as weak balance sheets, have made it unattractive to issue or invest in corporate bonds. Some companies decided to buy their existing corporate

Table 6: Outstanding Corporate Bonds

End Period	Number of Issuers	Amounts in KSh.Billions
Dec-16	17	86.8
Dec-17	17	73.1
Dec-18	18	61.9
Dec-19	12	38.1
Jun-20	6	23.2

Source: Nairobi Securities Exchange

bonds, thus reducing outstanding stocks.

In response to the negative impact of COVID-19, CMA introduced Policy and Regulatory measures to Promote Fintech Utilization to ensure minimal business disruptions and protect market players. Market players were allowed to use information technology for virtual Annual General Meetings and auto account opening options. The launch of Regulatory Sandbox in March 2019 has already attracted six FinTech companies to test their innovations, with one company preparing to roll out its innovative product to the market.

In addition, the Capital Markets (Commodities Market) Regulations 2020, gazetted in March 2020 are expected to facilitate the establishment of structured commodities trading in Kenya aimed at enhancing a transparent, efficient and structured trading system, quality assurance for commodities, efficient price discovery and in the long-term, facilitate improved export competitiveness for Kenyan commodities. This is critical for value addition and improved food security.

2.3 Soundness of the Insurance Industry

The insurance industry comprises; 56 insurers, 5 re-insurers, 220 insurance brokers, 10, 471 insurance agents (including 26 bancassurance agents), 35 medical health insurance providers, 138 motor assessors, 144 insurance investigators, 33 insurance surveyors, 31 loss adjusters and 8 claims settling agents. There are two types of insurance business namely; long-term and general insurance. The general insurance business accounts for 63 percent of the total insurance premiums. Overall, the industry performed better in the first quarter of 2020 compared to the first quarter of 2019 in terms of gross premium income.

However, the insurers incurred a loss of KSh 1.1. billion in the first quarter of 2020 on account of increased expenses. In addition, there was significant reduction in investment income due to volatility at the NSE **(Table 7).**

Table 7: Key Performance Indicators for the Insurers (KSh Millions)

INDICATOR	2017Q1	2018Q1	2019Q1	2020Q1	% Change in 2019-	% Change in 2020-
Gross Premium Income	63,213.06	65,239.91	67,219.27	70,250.21	3.03	4.51
Net Premium Written	49,467.94	50,549.12	51,596.88	53,692.59	2.07	4.06
Claims Incurred (Gen. Business)	14,596.76	13,968.14	14,796.97	15,312.42	5.93	3.48
Benefits Payment (Long Term)	11,988.87	12,682.99	12,851.31	11,802.73	1.33	-8.16
Commissions	2,919.11	2,898.19	2,342.43	2,609.04	-19.18	11.38
Management Expenses	9,708.80	10,625.29	10,611.15	10,690.98	-0.13	0.75
Underwriting Profits/Loss (GB)	(453.74)	(1,148.61)	(378.30)	(1,879.69)	-67.06	396.88
Investment Income	8,548.66	18,936.90	16,096.61	1,406.49	-15.00	-91.26
Profit/(Loss) After Taxation	2,196.43	1,640.08	3,078.85	(1,058.34)	87.73	-134.37
Combined Ratio Gen.Business(%)	102.00	105.30	101.70	108.70	-3.60	7.00

Source: IRA

The premium income increased by 3.0 percent as at June 2020. However, the highest monthly decline in the premium income was 12.1 percent in May 2020, reflecting impact of COVID-19 **(Table 8).**

Table 8: Premium Income (KSh Millions)

Month	2018	2019	2020	% Change in 2019-2018	% Change in 2020-2019
January	29,042.38	30,599.84	32,177.00	5.36	5.15
February	13,480.58	13,099.37	14,631.16	(2.83)	11.69
March	13,969.90	14,100.07	14,203.63	0.93	0.73
April	13,920.58	14,633.34	15,329.31	5.12	4.76
May	12,155.44	12,739.15	11,198.15	4.80	(12.10)
June	11,255.22	12,356.41	12,877.11	9.78	4.21
TOTAL	**93,824.10**	**97,528.17**	**100,416.35**	**3.95**	**2.96**

Source: IRA

Insurance penetration ratio, measured by premiums paid to GDP, remained very low, at 2.4 percent in 2019 similar to 2018 and below global average of 7.2 percent **(Annex II).** While a number of measures have been taken to strengthen oversight and promote uptake of insurance products, there are a lot of headwinds. The rapid adoption of information technology and innovations has increased cyber security risks. In addition, the challenging business environment and the COVID-19 pandemic have negatively affected the industry, with likely effects of stifling growth and penetration.

There has been recent reforms and measures to refocus and grow the industry, which include:

- Adoption and implementation of risk-based capital regime effective June 2020 to ensure that insurers maintain sufficient capital adequacy levels commensurate to their risk profile at all times for achieving and maintaining financial stability. This has become even more important with emerging insurance groups and increased interconnectedness which may present systemic risks in case of failure that can spill over to the rest of the sector.
- Regulations on investment management to ensure prudent investment of policyholder funds by matching maturing liabilities with assets allocations to avoid default once their obligations fall due.

- Operationalization of the regulatory sandbox framework to enable innovators test their insurance services and business models under a controlled environment.
- Adoption of consumer centric policies and practices to enhance consumer protection and rights and Treating Customer Fairly framework and enhance financial literacy. This requires that products and services are designed to meet the identified customer groups, provision of clear product information and prompt handling of customer claims and complaints.
- Amendment to the Insurance Act to empower the Commissioner of Insurance to settle disputes in finality to all parties involved in the dispute, and thus strengthening alternative disputes resolution mechanism.

Despite these reform measures, the industry continued to face various risks that may pose a threat to its stability, including:

- Elevated market risk arising from changes in interest rates, exchange rates, stock prices and real estate prices resulting to decline in assets valuation.
- Increase in interest rates for instance will affect the value of government securities held by insurance companies, which amounted to KSh 387.9 billion or 65 percent of total assets as at March 2020. A decline in interest rates on the other hand reduces interest earnings **(Annex III).**
- Credit exposure arising from a counterparty failure to meet its obligations as they fall due.
- The credit exposure from outstanding premiums and reinsurance recoveries increased by 10.3 percent in the first quarter of 2020 to KSh 39.4 billion.
- Increased fraud involving fictitious claims, insurance application process and premium processing recorded 37 cases in the first quarter of 2020, up from 31 cases reported in the last quarter of 2019 **(Annex IV).**

The outbreak of COVID-19 will have negative effects and has elevated vulnerabilities in the industry. As a result, the IRA has taken mitigation measures to cushion policyholders and insurers against the negative impact of the pandemic. These include: recommending for insurers to consider granting a three (3) month grace period, to policy holders who default in premium payment for life business; supporting insurance agents and brokers through prompt payment of commissions by insurers immediately the business is transacted and in accorance with provisions of the Isurance Act: and expeditious processing and settlement of all claims and payments related to the pandemic illnesses by the insurers to contain the impact on households' livelihoods.

In the outlook, we expect most of the key indicators for the industry to deteriorate in 2020 owing to the effects of the COVID-19 pandemic and subsequent Government measures undertaken to contain its spread. In particular; travel restrictions and movement restrictions have a significant impact on aviation, marine and travel insurance businesses. The rising cases of COVID-19 cases may lead to increased hospitalisations in which is likely to put heavy financial strain on insurance companies offering medical cover. Lastly, the pandemic has resulted either in job redundancies and salary cuts, thus negatively impacting the pension and life assurance businesses. Overall, the resilience of the insurance industry will be tested by the COVID-19 pandemic but the regulator and stakeholders stand ready to take appropriate measures to limit the effects.

2.4 Pensions Industry

The pensions industry recorded a strong growth of 11.3 percent in total assets in 2019 compared to 2018, supported by improved monthly contributions **(Table 9).** The government securities, immovable property, quoted equities and guaranteed funds formed the core of assets portfolio. Fund managers and approved issuers held 90.4 percent of the total pension assets, with remainder being internally managed by schemes including National Social Security Fund (NSSF), which administered a total of KSh. 57.16 billion. The pension coverage, however, still remains low at 22 percent of the total labour force in 2019, a slight improvement from 20 percent in 2018 with a majority of those covered being in the formal sector. The low level of the pension penetration in the informal sector has necessitated a shift in industry focus to boost pension savings among the informal sector workers.

The industry has been relatively stable with the overall risk score at 3.09 in 2019, but below the desired overall risk score of 2.88. This is partly explained by the absence of data on governance and market conduct parameters, which account for a maximum score in the toolkit. The overall risk score has also been worsened by the outbreak of the COVID-19 pandemic.

Among the main risks facing the industry is the market risk given that about 94 percent of pension assets are held in just four asset classes. For instance, an increase in interest rates will lead to valuation losses for government securities and corporate bonds. There is also loss of corporate bonds and fixed deposits in case of insolvency . In the equities market, a decline in prices as in the first half of 2020, reduces the value of quoted equities held by the schemes. The pension schemes and fund managers who have invested in buildings and land face liquidity risks occasioning delays in settling member benefits. In addition, schemes' investments also face inflation, currency (exchange rate), and credit or counter party risks. The service providers (trustees or the sponsors), also expose the industry to governance and reputational risks emanating from conflict of interest. To address these risks, RBA has issued guidelines on good governance and treating customers fairly.

Table 9: Pension Industry Assets (KSh Billions and Percentages)

Assets Category	2016		2017		2018		2019	
	Amount	%	Amount	%	Amount	%	Amount	%
Government Securities	349.15	38.3	394.19	36.5	459.68	39.4	545.27	42
Quoted Equities	159.07	17.4	210.17	19.5	201.51	17.3	228.12	17.6
Immovable Property	178.42	19.6	226.72	21	229.91	19.7	239.65	18.5
Guaranteed Funds	129.58	14.2	142.97	13.2	167.45	14.4	201.52	15.5
Listed Corporate Bonds	46.95	5.1	41.99	3.9	40.28	3.5	17.8	1.4
Fixed Deposits	24.57	2.7	32.88	3	36.39	3.1	39.41	3
Offshore	6.96	0.8	12.77	1.2	13.13	1.1	6.32	0.5
Cash	12.93	1.4	12.95	1.2	12.72	1.1	14.96	1.2
Unquoted Equities	3.95	0.4	4.06	0.4	3.79	0.3	3.61	0.3
Private Equity	0.22	0	0.32	0	0.86	0.1	0.97	0.1
REITs	0.84	0.1	1.03	0.1	0.71	0.1	0.5	0
Commercial paper and non-listed bonds	-	-	0.1	0	0.06	0	0.16	0
TOTAL	**912.66**	**100**	**1,080.11**	**100**	**1,166.49**	**100**	**1,298.19**	**100**
Overall Risk Score	**0.524**		**0.509**		**3.070****		**3.095**	

*Source: RBA **The risk tool was revised*

The RBA has initiated a number of reforms to address potential vulnerabilities and strengthen the industry. Gazettement of sound governance practices guidelines and guidelines on fair treatment of customers in 2019 has now moved to implementation by industry players. Secondly, the regulations shortened the period allowed to exit from investment in a guaranteed fund to one year or less. Also, for the occupational and individual schemes there will be distribution of reserves to exiting members where a scheme has a reserve fund. Finally, the members of retirement benefits schemes can now access a portion of their accrued benefits to purchase a residential house.

The COVID-19 pandemic is expected to stifle growth of the pension industry due to decline in contributions, value of assets and profits from investments. The decline in equity and bond prices on the financial market as a result of slowdown in economic activity is further expected tocurtail growth of the pension industry, especially for schemes that invest a large proportion of liability contribution in the stock market. A total of 83 employers participating in 43 retirement benefits schemes had applied for suspension of contributions owing to the effects of the pandemic. Pensions industry is therefore projected to lose about KSh. 1.78 billion in contributions, eroding pensions assets considering the foregone investment income realizable from the contributions.

2.5 Developments in the Sacco Societies Industry

Kenya's Sacco industry is among the biggest in Africa with 5.7 percent of total assets to GDP ratio, followed by Rwanda and Ethiopia, with 3.0 percent and 0.7 percent, respectively **(Table 10)**. Growth of the Saccos industry has leveraged on rapid adoption of technology and innovations in the provision of financial services and products coupled with the opening up of the common membership bond. In addition, enhanced legal and regulatory environment have helped Saccos industry to grow and be accessed by 28.4 percent of the adult population as at December 2019, the highest in Africa.

Table 10: Sacco Assest to GDP Ratio of Selected African Countries

Country	Assets in 2019 (USD)	Nominal GDP (USD), 000s	Total Assets/GDP Ratio
Kenya	5,567,147,218	97,403,600	5.72%
Rwanda	308,481,890	10,209,000	3.02%
Ethiopia	635,000,000	91,166,000	0.70%
Ghana	297,683,637	67,077,000	0.44%
South Africa	22,039,604	358,839,000	0.01%

Source: World Council of Credit Unions

Total assets for all Deposits Taking Saccos grew by 11.8 percent, to KSh 555.9 billion in 2019 and by 3.2 percent in the first half of 2020. The gross loans accounted for 73.9 percent of the total industry total assets, mainly funded from members' contributions and deposits, which grew by 11.3 percent in 2019 **(Table 11).**

Table 11: Key Performance Indicators (KSh Million)

INDICATOR	2017	2018	2019	2020(June)	%age change
Assets	442,277	497,278	555,917	577,110	11.79
Loans	331,212	373,195	420,549	426,435	12.69
Deposits	305,305	342,296	381,081	406,123	11.33
Core Capital	64,254	78,267	95,128	93,036	21.54
Total	63,045	69,305	80,154	39,824	15.65

Source: SASRA

The Sacco industry has continued to build and maintain strong capital adequacy levels with sufficient liquidity and earning capacity to withstand shocks and vulnerabilities **(Table 12).** However, the industry continued to maintain high cost to income ratios. In addition, credit risk remains elevated with NPLs increasing from 5.2 percent in 2016 to 9.1 percent in June 2020. Agriculture and Micro and Small Enterprises (SMEs) sectors have been affected most by COVID-19 pandemic, making it difficult for members to service their loans. Saccos societies restructured loans totalling KSh 4.7 billion in 3 months to June 2020, reflecting the difficulties members were facing in loan repayment.

Table 12: Financial Soundness Indicators

Stability Indicator	Prescribed Minimum	2016	2017	2018	2019	2020 (June)
Capital Adequacy						
Core Capital	KSh 10 Millions	54,943.00	64,254.00	74,375.00	79,204.00	93,036.00
Core Capital/Total Assets Ratio	10%	13.96	14.53	15.02	14.23	16.12
Core Capital/Total Deposits Ratio	8%	20.16	21.05	21.75	20.82	22.91
Institutional Capital/Total Assets Ratio	8%	7.71	8.18	8.50	10.63	9.43
Asset Quality						
Non-Performing Loans/Gross Loans (%)	< 5 %	5.23	6.14	6.30	6.15	9.12
NPLs (Net of provisions)/ Core capital (%)		7.63	9.90	9.27	8.50	18.24
Earning Assets/Total Assets (%)		80.71	78.50	77.68	76.90	80.71
Earning Rating						
Return on Assets (ROA) in (%age)		2.45	2.69	2.40	2.60	1.86
Non-Interest Expenses/Gross Income (%)		41.35	43.99	62.10	57.67	49.41
Operating Expenses/Total Assets (%)		5.44	5.29	4.62	4.75	2.45
Liquidity Ratio						
Liquidity Ratio (%)	>=15 %	49.95	54.10	52.68	50.92	81.11
Liquid Assets/Total Deposits (%)		18.05	17.17	17.05	17.00	20.59
External Borrowings/Total Assets (%)	<=25 %	5.04	4.83	4.11	3.88	3.85
Liquid Assets/ Total Assets (%)		12.49	11.85	11.77	11.60	14.49
Total Loans / Total Deposits (%)		108.39	108.49	109.47	110.28	105.00

Source: SASRA

SASRA in collaboration with other stakeholders, has initiated reforms to address potential vulnerabilities and strengthen the Sacco industry. These reforms include:

- Regulations requiring all deposit-taking Saccos to report sectoral loans for improved risk assessment.
- Amendment to the Sacco Societies Act to expand the SASRA mandates to include regulation and supervision of non-deposit taking Saccos and operationalize the Sacco industry safety net, the Deposits Guarantee Fund, by appointing the Fund board of trustees in the FY 2020/21.
- Based on the assessment of key performance matrices, the industry remains resilient and stable to withstand shocks and vulnerabilities.

2.6 Robustness of the Financial Markets Infrastructure

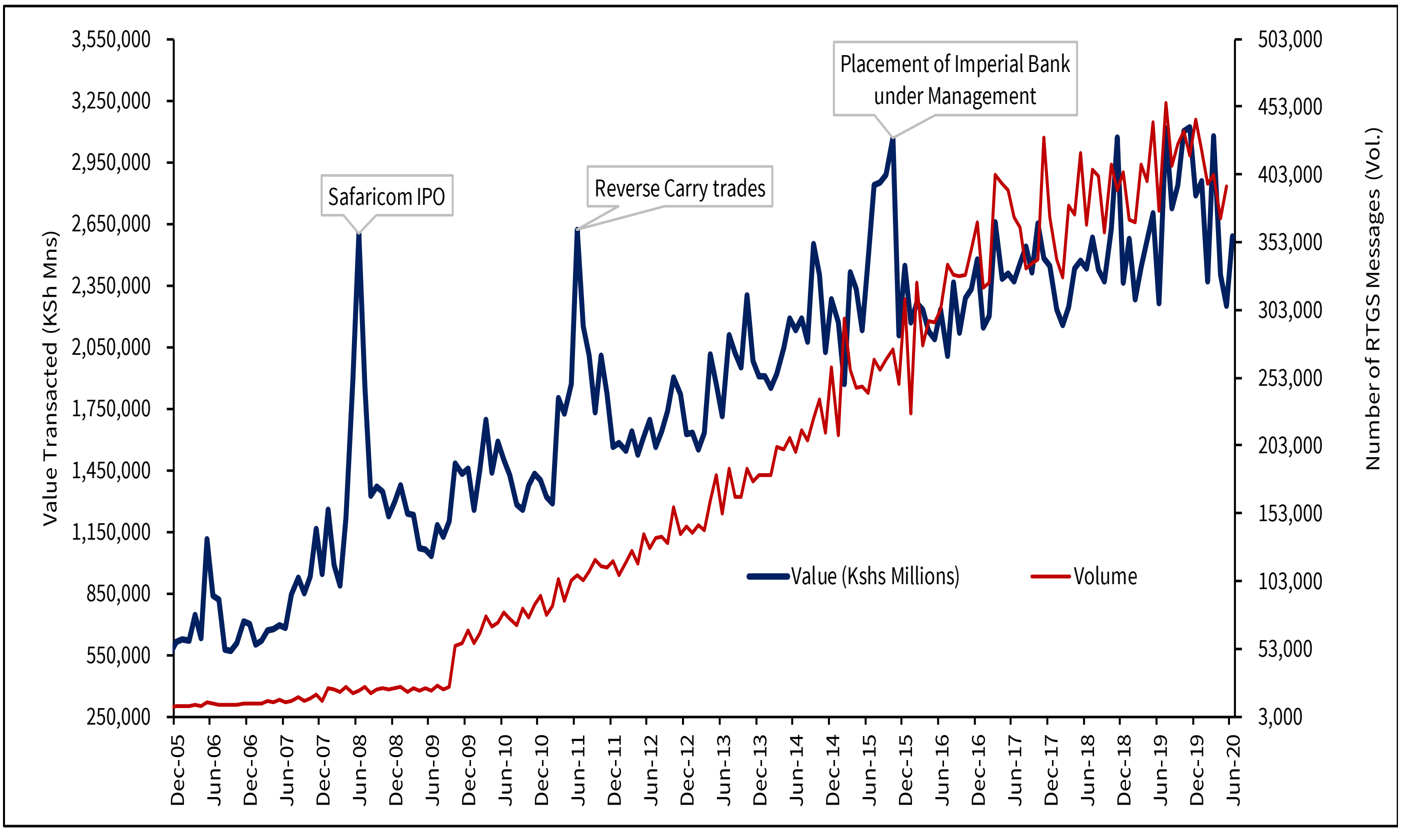
A well-functioning financial market infrastructure (FMI) plays a critical role in ensuring effective, efficient, safe and reliable financial transactions and transfer of value by households, firms, public entities and the Government within and across borders. These transactions include transfers of value/ payments, trading, settlements and custody through retail, wholesale, trading and custodial payments systems. The FMI is therefore, the nerve centre of the financial system, which connects financial markets and financial institutions to the economy. This close interconnectedness and partnership arrangements means that FMIs can easily propagate shocks and risks quickly across the financial system, and ultimately the rest of the economy. Parties in the financial market infrastructure operations and the regulatory authorities must institute measures to mitigate disruptions and manage risks, for efficiency, effectiveness, safety, reliability and availability. Regulators, on the other hand, ensures that there is a sound and enabling legal and regulatory framework that supports availability and proper functioning of FMI ecosystems at all times, even in periods of high in financial markets stress. Availability and proper functioning of the FMI is thus key to financial system development and stability.

Kenya's payments ecosystem comprises both retail and wholesale platforms that serve individuals, firms and Government. Retail payments and settlement systems include: mobile money service platforms, automated cheque clearing houses, Automated Teller Machines (ATMs) and point of sale (POS) devices. Other systems include wholesale and trading platforms such as the Real Time Gross Settlement (RTGS) system, also known as the Kenya Electronic Payment and Settlement System (KEPSS) and Nairobi Securities Exchange Trading System. Systemically Important Payment System (SIPS) are assessed by the number of users or the value of transactions. The retail platforms services are used by many consumers but value of transactions is small. The RTGS system facilitates the country's high value transactions such as interbank transactions and therefore, the system is important for effecting transactions that affect financial stability.

Transactions through KEPSS have increased since the launch in August 2005, reflecting growth in the economy and overall financial system development. In 2019, KEPSS moved KSh 32.5 trillion transaction (or USD 303.9 billion) at the current exchange rate of KSh 107 per USD, making it a Systemically Important Payment System (SIPS), hence its crucial role in financial stability **(Figure 32).**

A reliable and safe payment system instils confidence and trust among users in terms of smooth execution of transactions and finality even during stress periods. The ability of a payments system especially, RTGS system to provide certainty of settlement in an efficient manner without or with minimal risks such as liquidity, counterparty and system availability is an essential component of the financial markets infrastructure of any economy. We assessed the payments systems resilience based on the KEPSS availability, number and value of transactions. KEPSS has also been effective in facilitating liquidity distribution in the banking system.

Figure 32: KEPSS Transactions (Value and Volume)

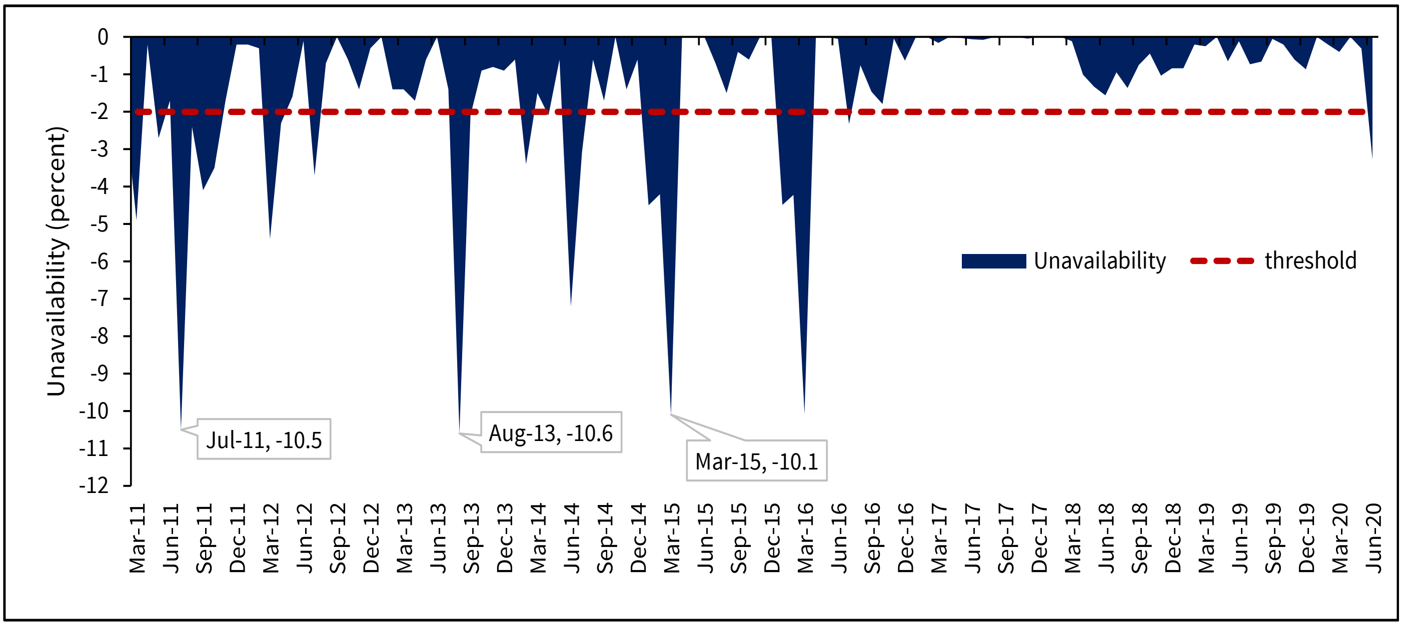


Source: CBK

In 2019, RTGS was available 100 percent compared to an optimum of 99.99 per cent availability due to upgrade of RTGS in 2018, thus bolstering efficiency, reliability and safety of the system. The average month-on-month KEPSS availability has increased significantly since mid-2016, compared to earlier years, indicating improved resilience and stability of the system **(Figure 33).** This reflects stability in the SWIFT, enhanced telecommunication connectivity and minimal power outages that used to disrupt delivery of the system availability and its associated inefficiencies in the past.

KEPSS has also been critical in ensuring effective liquidity management by facilitating overnight loans transactions for commercial banks, an important aspect of financial stability. The system was very effective in 2011 and 2015, periods characterized by exchange rate crisis and instability in the banking industry, respectively **(Table 13).** The interbank market has been liquid through 2016–2019.

Figure 33: KEPSS Availability (Percent)



Source: CBK

Table 13: Overnight Loans to Banks (KSh Million)

Month	2011	2012	2013	2014	2015	2016	2017	2018	2019
January	750	7,950	-	2,500	1,350	-	610	-	-
February	425	12,827	-	-	-	-	40	-	-
March	17,046	71,288	8,088	480	13340	12560	-	-	-
April	60,563	4,770	-	6,510	17,800	-	-	-	-
May	31,403	-	200	15,172	17,340	-	-	-	-
June	353,623	10,745	2,010	-	1980	-	-	-	-
July	199,049	-	2,800	19,656	25,655	-	-	-	-
August	67,257	-	-	22,400	-	1820	-	44	-
September	5,034	-	15,210	-	2,960	0.2	290	-	-
October	180,313	-	16,911	-	27,806.50	-	265	-	-
November	134,250	-	5,448	-	1,396	2500	-	6.2	-
December	20,680	-	25,936	3,400	3,000	-	-	-	-
TOTAL	**1,070,393**	**107,580**	**76,603**	**70,118**	**112,628**	**16,880**	**1,205**	**50**	**0**

Source: CBK

Another indicator of stress in the interbank market is the number of operating window extensions requested by banks. Extension of ‘operating window’ is granted by CBK on request by a bank to enable it settle its obligation in KEPSS beyond the official transaction hours. The number of KEPSS window extensions have been high since 2017, highlighting delays in settlement of interbank activity during official hours **(Figure 34).** The high number of window extensions requests noted in the last three years despite very low overnight loans could be partially explained by the possibility of a number of banks facing challenges in obtaining liquidity in time to settle their end of day obligations.

The KEPSS has been expanded to cover regional payments to facilitate trade. The transactions cleared through the KEPSS have increased in terms of transactions and value. The East African Payment System (EAPS) established under the auspices of the EAC processed 28,755 transactions valued at USD 443.8 million in 2019 compared to higher transactions in the period 2016 – 2018, reflecting reduced trade within the region. On the other hand, transactions within the Common Market for Eastern and Southern Africa region (COMESA) Regional Payments and Settlement System (REPSS) has increased significantly in the last two years as indicated by the volume and value transacted **(Table 14).** Increased uptake of the payments and settlement services through EAPS and REPSS not only supports trade, but also enhances confidence in the regional payment systems.

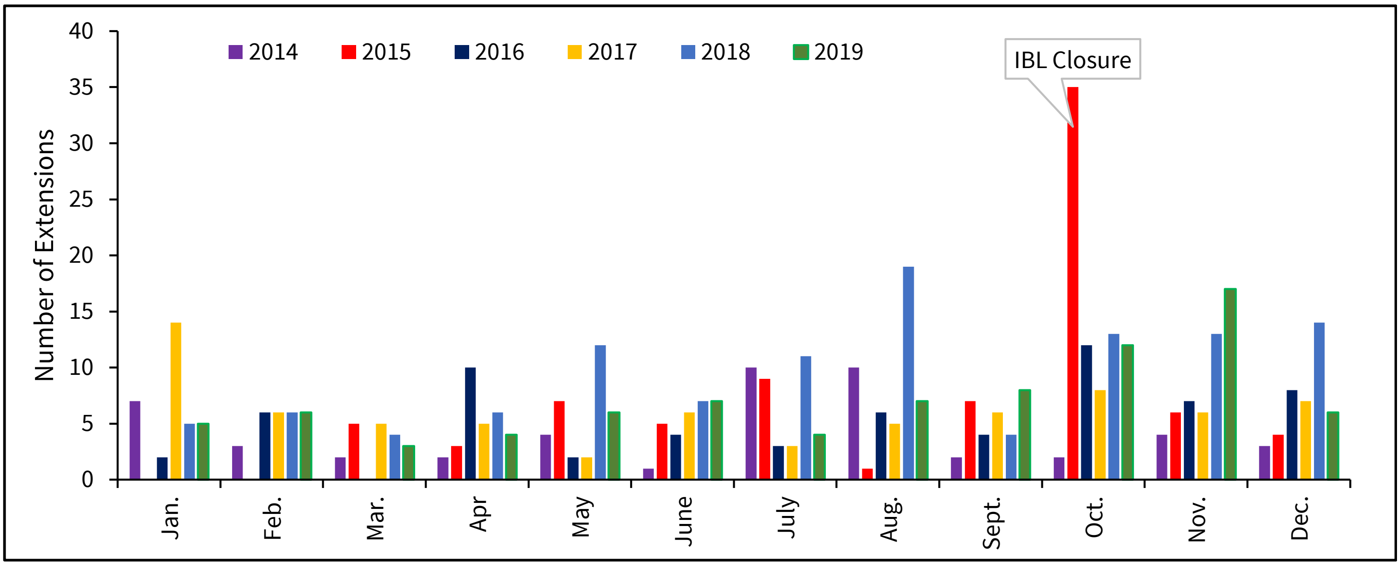
Despite the decline in the value of transactions cleared through EAPS in 2019, partly due to use of alternative platforms and the decline in regional trade, efficiency of the system has improved since 2013 **(Figure 35).** This is reflected by the significant decline in the number of transactions cancelled from 15.2 percent in 2013 to 4.2 percent in 2019, a strong indicator of EAPS stability.

Table 14: EAPS and REPSS Transactions

	EAPS		REPSS		
YEAR	Volumes	USD in Millions	Volumes	USD in Millions	Euros in '000s
2014	4,977	223.79	10	0.35	-
2015	9,263	371.88	257	6.95	119.79
2016	10,933	826.24	161	7.24	-
2017	15,303	504.85	262	13.38	10.5
2018	18,307	681.48	620	42.92	5.71
2019	28,755	443.8	646	43.91	

Source: CBK

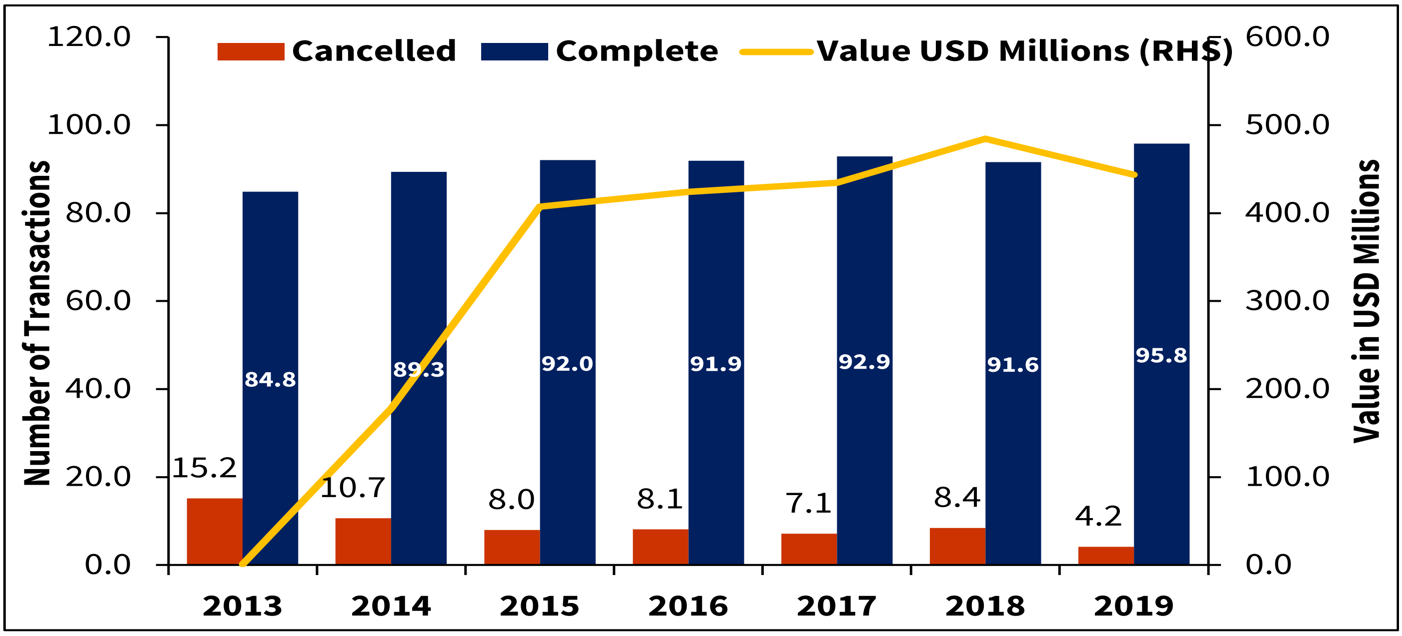
Figure 34: KEPSS Window Extensions



Source: CBK

The retail payment ecosystem in Kenya has undergone significant transformation on account of adoption of technology and innovations, which has enhanced the digitization of the economy. At the core of the retail payment systems is the rapid development of mobile money and mobile banking transactions supported by improved partnership arrangements, for example, between Telcos or Mobile Network Operators (MNOs), financial service providers, merchants and Government. Usage of the mobile money transfers services has significantly increased overtime, both in terms of value and volume **(Table 15).**

Figure 35: Efficiency of EAPS



Source: Illustration using CBK EAPS Payments data

Table 15: Mobile Money Transactions

Year	Number of Agents	Customers In (Millions)	Transactions in Number (Millions)	Transactions in Value (KSh. Billions)	Value Per Transaction (KSh)
2007	1,582	1.3	5.5	16.3	2,983
2008	6,104	3.1	62.7	166.6	2,655
2009	23,012	8.9	193.5	473.4	2,447
2010	39,449	16.4	311	732.2	2,354
2011	50,471	19.2	433	1,169.20	2,700
2012	76,912	21.1	575	1,537.50	2,672
2013	113,130	25.3	733	1,901.60	2,594
2014	123,703	25.2	911	2,371.80	2,604
2015	143,946	31.6	1,114	2,816.10	2,528
2016	165,908	34.9	1,331	3,355.10	2,199
2017	182,472	37.4	1,543	3,638.50	2,357
2018	223,931	47.7	1,740	3,984.40	2,290
2019	224,108	58	1,839	4,346.00	2,363

Source: CBK

Mobile money transfer services have become critical in facilitating person-to-person (P2P), customer-to-business (C2B) and Person or Business to Government transactions, thus digitizing transaction inthe economy. Mobile money has also contributed significantly to deepening financial inclusion. The introduction of interoperability within the mobile money payment Service in April 2018 among the MNOs has enabled money transfers across platforms, hence reducing the need for multiple subscriptions.

While the mobile money payment system may not be considered has a systemically important, its outreach and impact to households, businesses and government operations has made it very important to the economy and the entire financial system. Any mobile money services outages and reliability concerns affect transactions in the economy, hence they are it is systemically important.

Other retail payments infrastructure includes the Automated Clearing House (ACH) and Pesalink that facilitates the electronic funds transfers (EFTs) and Point of Sales (POS) devices. Suffice to note that the number and value of card transactions declined, due to increased use of mobile money services **(Table 16)**.

Other notable Financial Markets Infrastructure (FMI) includes the CBK Central Depository System (CDS) for Government Securities, the Central Depository and Settlement Corporation (CDSC) system for equities, corporate bonds and M-Akiba retail bond and the Nairobi Securities Exchange trading platforms. Developments in the FMI include:

- The rollout of the Government Retail Bond dubbed M-Akiba by The National Treasury (TNT) in conjunction with CDSC in March, May and September 2019. The platform leverages on mobile money and banking to enable retail investors invest in government securities. By end of 2019, the bond had been Issued five times raising a total KSh 1.05 billion and in April 2020, CDSC paid out the Principal amount and the final interest of KSh 157. 6 million to 5,609 M-Akiba I investors.
- In 2019, CDSC commissioned a new depository system developed by Perago Financial Systems Enablers Limited of South Africa. The new system has enabled removal of pre-validation by decoupling the trading and the depository systems, enabling multiple settlement cycles, enhanced risk mitigation measures, supported multiple markets, currencies and high availability cluster. This has increased CDSC's compliance level with CPMI-IOSCO Principles for Payments and Financial Market Infrastructures (PFMIs) as per the assessment by the Thomas Murray (TM), which upgraded the CDSCs Risk Assessment from A- to A, which denotes a 'Low' Overall Risk.
- The upgrade of NSE Trading System (ATS) in October 2019 after 13 years since its launch, offers a more robust platform that supports diversification of trading securities with improved business and technical capabilities. The new system enables Day Trading and facilitates Securities Lending and Borrowing (Short Selling). Further upgrade is expected to enhance product offering and mitigate system downtime and malfunctions. In addition, enhancement of NSE bond trading system in February 2019 has also reduced the trading and settlement period of Government bonds as it enables immediate upload of executed positions for settlement at CBK. This ensured multiple trading and settlement of Government bonds within the same trading session since March 2019, thus boosting liquidity and stability of the Fixed Securities' Segment of the Exchange.

Table 16: Payment Cards Usage

End of December	Number of Cards	Number of ATMs	Number of POS Terminals	Transactions Voume	Value in KSh Millions
2015	13.2	2,718	22,230	20.1	121,821
2016	14.8	2,658	30,133	21.6	121,423
2017	15.4	2,825	35,466	19.1	124,844
2018	17.9	2,833	44,874	19.1	125,877
2019	11.5	2,459	42,846	19.7	64,750
Change (%) *	**-35.75**	**-13.2**	**-4.52**	**3.14**	**-48.56**

Source: CBK

- The NSE also launched the NEXT, Africa's second Exchange Derivatives Market on July 11, 2019, enabling the offering of Single Stock and Index Futures to its investors. The launch of Derivatives Market is expected to develop and deepen capital markets in Kenya, thus providing new opportunities to investors and ensuring better portfolio diversification. Investors are now able to form expectations about underlying assets in order to manage price risks.

The Government in partnership with the regulatory authorities and stakeholders have continued to strengthen the legal, regulatory and supervisory framework and oversight procedures by adopting risk–based approaches and enhancing their processes overtime to promote stability. Specifically:

- The NSE launched revised listing rules and requirements for Green Bonds in February 2019 under the Green Bond Regulatory Framework in recognition of the growing need and demand for sustainable financing. Consequently, a British real estate developer, Acorn Holdings and private equity fund Helios successfully issued the first green bond in Kenya in October 2019, raising KSh 4.3 billion of the targeted KSh 5 billion. The proceeds targeted construction of up to 3,800 student hostel units in Nairobi under the Qwetu brand that are climate-friendly.
- CBK developed a framework to strengthen the payments systems and for identifying internal and external threats to KEPSS in order to bolster the robustness of the payments system, thus enhancing its ability to effectively withstand and respond to threats such as natural disasters, data breaches, consumer protection concerns and AML/CFT issues. The rapid recovery and resumption of systemically important payment systems (SIPS) is a key prerequisite for resilience and stability of the financial system.
- CBK has also enhanced business continuity plans (BCPs) for KEPSS, EAPS and mobile money systems to ensure a high level of resilience. In recognition of the growing cybersecurity threats in the payment systems given the interconnectedness and interdependence of Payment Service Providers. In this regard, CBK in collaboration with all RTGS participants launched the SWIFT Customer Security Programme to reinforce and safeguard the security of the wider ecosystem. Persistent cyber threats and fraud call for concerted efforts among all players to mitigate them at national, regional and global level. This covers both retail payment systems and SIPs, given their reliance on technology. CBK works closely with the Government, and stakeholders to meet this objective.

Payments and FMIs in Kenya have played pivotal role in containing the spread of COVID-19 pandemic mainly in reducing the use of cash transactions and mitigating the impact of COVID-19 pandemic to households, firms and investors through use of e-commerce and access to markets. In particular, mobile money platforms have facilitated most of the e-commerce transactions and information flows, thus limiting person to person contacts that minimized spread of the disease through handling of cash or personal contact.

The FMI is expected to remain stable and resilient going forward supported by enhanced legal and regulatory reforms, systems upgrade by regulators and service providers, deployment of modern technology as well as improved risk management and business continuity plans. The regulators stand ready to deal with emerging threats especially fraud, cyber security and consumer protection concerns, among others.

3. FINANCIAL SECTOR SAFETY NETS

3.1. Background

The Vision 2030 recognizes the role of the financial sector in mobilising saving to meet the investment needs to achieve and sustain a 10 percent annual economic growth target. Therefore, fostering a vibrant, competitive and stable financial sector is vital in achieving our national development aspirations. The financial system has undergone major transformation in the last decade, with Access to formal financial services increasing to 82.9 percent in 2019 compared to 75.3 percent in 2016 and 26.7 percent in 2006 thus, reducing the financially excluded population by over 30 percent since 2006 (CBK, FSD, KNBS, 2019). The increase in access and usage of financial services and products has been due to rapid adoption of financial technology and innovations coupled with emerging new risks and vulnerabilities. The financial sector has experienced increased fragilities in the recent past as reflected in placement of banks, insurance companies, Saccos and stock brokers under receivership. Increased use of financial services and products has also increased vulnerabilities to households, firms and financial intermediaries. The emergence of non-regulated financial intermediaries especially the digital financial services have worsened the situation due to the ease of accessing digital credit (CBK, FSD, KNBS, 2019).

In addition, financial institutions have not been sensitive to dynamic needs of financial services consumers as well as building a robust system to enhance financial services safety nets and consumer protection and rights concerns such as transparency in pricing and marketing practices, hidden charges, alternative dispute resolution mechanism, complaints grievances handling arrangements, protection against over indebtedness and fair debt collection practices, and fostering financial literacy, among others. These fragilities and weaknesses reduce confidence and trust of individuals and firms in using financial services and products but also raises financial institutions viability concerns. It is against this backdrop that the the Government in collaboration with the financial sector regulators and stakeholders are enhancing financial sector safety nets and resolution frameworks.

Financial sector's safety nets are frameworks including legal, regulatory and institutional arrangements put in place to mitigate adverse and unintended outcomes from providing or consuming financial services and products. They reduce vulnerabilities and losses arising in consuming financial services, thus fostering improvement in consumer welfare, trust, use and foster financial stability. However, strong safety nets can encourage excess risk taking and moral hazards, which is detrimental for the growth and development of the financial sector. Safety nets must be complemented with better and proportionate regulation and supervision of financial intermediaries.

3.2. Financial Sector Safety Nets

Safety nets in the financial sector protect consumers of financial services and products against loss emanating from financial transactions, distressed institutions as well as enforcing rules to enhance financial stability. Financial safety nets cushion financial service providers and consumers against losses, hence they provide insurance against risk taking behaviour of players. However, safety nets that exceed risks encourage excessive risk taking and moral hazards, which could undermine stability of the financial sector and the economy . Whereas consumers have lost money, experienced rising debt distress and exposed to insolvent financial service providers, financial safety nets and resolution framework are not only insufficient, but also ineffective in ameliorating financial losses and adverse outcomes of consuming financial services. Hence, there is need to strengthen safety nets and resolution regimes for the financial services providers including in the banking, insurance, Sacco, capital markets and pensions sub-sectors.

The banking industry's safety nets and resolution regime is domiciled with the Kenya Deposits Insurance Corporation (KDIC). The Kenya Deposits Insurance (KDI) Act of 2012 established the legal framework for KDIC has the resolution authority of banks and to provide deposit insurance scheme for member institutions (banks licensed by CBK). Deposit insurance has been used by governments to protect depositors from incurring large losses due to bank failures and ensure the stability of banking system. KDIC provides a deposit insurance scheme for depositors of member institutions. The scheme protects depositors by reducing the uncertainty about the safety of their deposits. The Act require each deposit placed with an institution to be insured, provided that the maximum amount payable to a customer in respect of the aggregate net deposit balance of any individual depositor with the institution does not exceed one hundred thousand shillings or such higher amount as the Corporation may from time to time determine. This insurance coverage limit has been increased to KSh 500,000 from KSh 100,000 to boost confidence and deposit mobilization in the banking industry.

In 2019, the number of insured deposit accounts increased to 97.6 percent from 97.4 percent in 2018. The effective cover, a ratio of the fund balance to the total insured, improved from 33.3 percent in 2018 to 40.4 percent in 2019, thus reducing exposure of deposits by 7.1 percent. KDIC is expected to rollout a risk-based model for insurance premiums, which will increase deposit premiums paid by banks to reflect high risk profiles.

The value of deposits covered declined from 9.4 percent in 2014 to 7.9 in 2019, which is lower than the 10 percent recommended by the International Association of Deposit Insurers (IADI). The total liability deposits grew by 10.1 percent in 2018 and 2019, while the insurance cover for deposit decelerated by 1 percent. This indicates that the effective cover is low and declining, exposing depositors to risks. IADI recommends that an effective deposit insurance should be governed by the following principles: coverage, funding, powers, membership, transitioning from blanket to limited coverage and prompt reimbursement. Hence, migration to risk based premiums on deposits and increasing deposit cover will enhance effective protection of deposit.

A vibrant and stable insurance industry can be a financial sector safety net by allowing consumers of financial services to insure against losses. The delays in settling claims by insurers and insolvency of some insurers led to the establishment of the Policyholders Compensation Fund (PCF) in January 2005, under the Insurance Act. It aims to provide compensation to policyholders of an insurer that has been declared insolvent and placed under receivership in order to boost public confidence in the insurance industry. It also plays a complementary role of consumer protection and promotion of market stability. In 2019, Insurance Act reviewed the trigger for payment by the PCF to be when an insureer is placed under statutory management or its license is cancelled. Previsiosly , the trigger for payment was when an Insurer is liquidated. Currently, policyholders of collapsed or distressed insurers are entitled to payment of up to KSh 250,000.

Some of the issues affecting success of PCF include; rigorous and lengthy compensation claim procedures as well as processes of winding up an insolvent insurer which often give rise to unending legal and administrative delays. In terms of the fund management, 10 percent of the total contributions received are allocated to the administration of the fund. The balance of 90 percent is invested in Government Securities to preserve value, earn interest and ensure liquidity.

Sacco Societies have continued to make investment decisions on behalf of their members. The risk of loss of member contribution can be more pronounced if the investment decision is not well thought out and supported by sound governance practices. Conflict of interest, weak governance and mismanagement by the directors also lead to loss of members' savings and investments. This calls for robust regulation of the Saccos to minimize risks and ensure that investment decisions by the SACCOs are prudent. The Saccos Societies Act has established the Deposits Guarantee Fund to provide protection of members' funds up to a maximum cover of KSh 100,000. A savers' compensation fund is recommended for non-deposit taking Saccos to ensure all financial investments for depositors are insured to ameliorate loss of savings. The Sacco Societies Act requires all deposit taking credit institution to contribute to the DGF from which depositors will be compensated in case of a failure of a Sacco.

Capital Markets Investors Compensation Fund (ICF). During the period 2007-2009, a number of stock brokers including; Francis Thuo and Partners Limited and Discount Securities Limited collapsed, leading to huge losses in investor funds and eroding investor confidence. In addition, collapse of Chase bank, Imperial Bank, and Uchumi, among others in the last decade exposed investors to huge losses. Therefore, establishment of ICF is to ensure protection of investors in the capital market. The ICF provides that every investor who suffers pecuniary losses from failure of a licensed stock broker or dealer to meet contractual obligations receives up to a maximum of KSh 50,000 in compensation. This is based on international best practice and availability of funds. Other investor protection measures include review of market intermediaries and phased implementation of risk-based supervision (RBS) of market intermediaries.

Legal reforms involving changes in various laws including the Competition Act, Companies Act and Insolvency Act have strengthened Safety Nets for the financial sector. In particular, the Competition Act has strengthened consumer welfare through sustained provision of services by a firm and likely impact on competition by merged entity when considering an application for mergers and acquisitions. The Act makes it easier to merge or acquire a weak financial institution to safeguard deposits and reduce contagion risks associated with putting an institution under liquidation. The merged entity is stronger and capable of providing financial services that enhance consumer welfare. Changes in the Companies Act to allow for establishment of a holding company as separate legal entity from the subsidiaries makes it now possible for financial institutions providing diverse financial services to leverage from leadership, capital and synergies from the holding company. For example, recent mergers and consolidations in the banking industry leveraged on the Companies Act and Competition Act to consolidate business, thereby improving services to consumers, enhancing stability, without stifling competition in the financial sector. However, resolution of undercapitalized and fragile institution through merger or acquisition may not always enhance viability and stability of the merged entity due to different business models.

The insolvency Act provides a legal framework for resolving problem institutions to be managed as a going concern to achieve a more favourable outcome compared to receivership or liquidation. The insolvency Act applies to weak as well as insolvent institution, thus enabling managers and owners of weak institutions to file for voluntary arrangement management to trigger operation of the Insolvency Act. This protects the institution from creditors enforcing outstanding claims. Insolvency Act also protects collateral from being disposed by the creditor and instead, the receiver manager determines the disposal of such assets. The orderly resolution of weak institution protects investors and depositors.

Looking ahead, the country continues to make strides in enhancing financial sector safety nets and resolution regimes through strengthening legal, regulatory and institutional frameworks. The Competition Act and Companies Act provide a framework for market-based merger of financial institutions at different level of fragility, while Insolvency Act stipulates an orderly resolution mechanism. Hence, the recovery and resolution framework in Kenya elevates the interest of consumers and shareholders, by prioritizing managing an institution as a going concern. Therefore, Reforms in the financial safety nets and resolution should be customer centric, protecting private investment and enhancing the stability of financial institutions.

4. SUMMARY OF THE FINANCIAL STABILITY ASSESSMENT

The outbreak of the COVID-19 in Wuhan Province in China in December 2019 and subsequent declaration as a global pandemic by the World Health Organization (WHO) in January 2020, changed the course of global economy and financial system. In Kenya, confirmation of the first COVID-19 case on March 13, 2020, led to immediate imposition of containment measures, which affected both the economy and financial sector significantly. Travel restrictions and lockdowns led to supply chain disruptions, business closures and staff furloughs, with negative implications on households' livelihoods and firms' incomes. This had spiral effects not only to the economy, but also to all facets of the financial sector.

Kenya's pre-COVID real GDP growth projection of 6.2 percent in 2020 was revised to 1.3 percent growth as a result of the impact of the pandemic, which affected all sectors of the economy, except Information and Telecommunications sector. The 1.3 percent projected growth in 2020 against -4.9 percent global growth projection, is underpinned by the recovery in Agriculture, Services and Manufacturing sectors. The government and private sector deployed mitigation measures to reduce the impact of COVID-19 on firms and households. Government measures included reduction in taxes, payments of pending bills to suppliers, payments of tax refunds, and disbursements of funds to vulnerable members of the society. There was also a stimulus package to release funds to the public. Further, the CBK also took measures to cushion households, Micro Small and Medium Size Enterprises (MSMEs), and banks. Measures included; reduction in key policy rate (CBR), reduction in the Cash Reserves Requirements by 100 basis points, releasing KSh 35 billion for lending to businesses, disbursements of KSh 7.4 billion to Government as proceeds of demonetization of the KSh 1,000 note, lengthening the repurchase agreements (Repos) maturity to provide liquidity for banks, and asking the Telecommunications Companies and banks to waive charges on the mobile money transactions of below KSh 1,000. Other measures included requirement for banks to renegotiate terms and restructure outstanding loans for customers that were previously performing as at March 2, 2020, suspension of blacklisting defaulters in the Credit Information Sharing (CIS), suspension of loans classification, among other measures. Other regulators in the financial sector and private sector players have taken measures to mitigate the impact of COVID-19 to the financial sector. The impact has been positive.

Overall assessment indicates that Kenya's financial system is stable and resilient to shocks emanating from COVID-19 pandemic. Banks and Saccos have adequate capital and liquidity buffers to absorb shocks. Ample liquidity and robust regulatory oversight have supported a stable, efficient and well-functioning financial markets infrastructure. Insurance companies, capital markets and pension funds have taken measures to mitigate the likely impact and stands ready to use their regulatory powers to ensure stability.

In the outlook, we expect the regulators and sector players to remain vigilant on the rising credit risk for Saccos and banks; decline in profitability and therefore jeopardising viability of insurers and pensions schemes; and concentration and liquidity risks for capital markets. The regulators are also dealing with corporate governance challenges among the regulatees, increase in cyber crime due to increasing role of information technology in undertaking operations, Money Laundering Financing of Terrorism issues and consumer protection concerns to ensure a stable, sound and customer-centric financial services sector that supports the national development aspirations.

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ANNEXES

Annex I: Restructured Loans by Banks

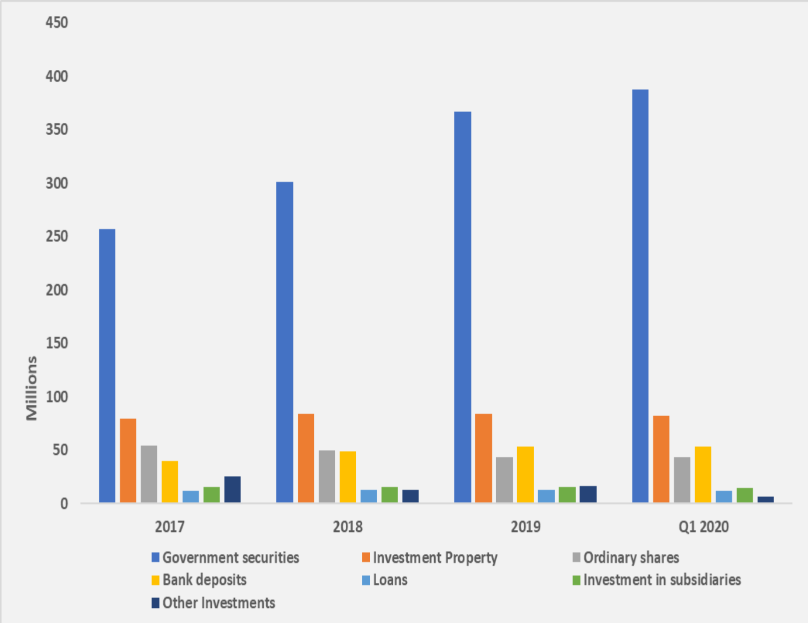
	Number of restructured loans					Amount Outstanding (Ksh.'000)						
Sectors	Mar-20	Apr-20	May-20	Jun-20	Total	Mar-20	Apr-20	May-20	Jun-20	Total	Outstanding Loans by Sector	Rest.Loans to Sectoral
Agriculture	151	3407	5633	1572	10763	4,580,961	11,868,481	13,947,964	10,910,145	41,307,551	100,491,635	41.11
Manufacturing	250	804	1054	1000	3108	6,727,550	23,116,070	21,466,027	17,378,776	68,688,424	403,613,394	17.02
Building & Construction	74	411	615	515	1615	13,853,350	9,116,652	9,057,541	3,869,783	35,897,326	118,872,282	30.20
Mining & Quarrying	1	58	95	80	234	47,056	529,688	13,534,960	243,034	14,354,738	24,474,480	58.65
Energy and water	61	105	157	118	441	888,773	2,802,235	7,203,138	4,432,241	15,326,387	103,464,251	14.81
Trade	801	36854	45679	10380	93714	10,100,961	44,890,165	58,727,233	28,348,264	142,066,624	532,741,310	26.67
Tourism,Restaurant & Hotels	165	348	513	469	1495	25,291,247	23,121,742	11,998,155	7,109,225	67,520,369	94,708,728	71.29
Transport & Communication	139	1823	3401	2561	7924	6,056,045	20,882,896	27,420,750	20,247,603	74,607,294	211,389,516	35.29
Real Estate	180	1515	2800	1291	5786	14,028,804	31,674,448	53,940,981	24,126,858	123,771,091	429,599,581	28.81
Financial Services	19	212	243	167	641	109,665	2,561,128	11,027,305	7,162,211	20,860,309	92,366,890	22.58
Subtotal - Other Sectors	**1841**	**45537**	**60190**	**18153**	**1E+05**	**81,684,414**	**170,563,505**	**228,324,053**	**123,828,140**	**604,400,112**	**2,111,722,067.00**	28.62
Personal/Household	6430	39725	46393	42407	92548	9,852,207	102,516,738	86,702,298	40,950,858	240,022,101	796,980,402	30.12
Grand Total	**8271**	**85262**	**106583**	**60560**	**2E+05**	**91,536,621**	**273,080,243**	**315,026,351**	**164,778,998**	**844,422,213**	**2,908,702,469**	**29.03**
total loans						2,793,792,446	2,827,684,074	2,821,489,767	2,908,702,469	2,908,702,469		
Share of Total Loans (%)						**3.28**	**9.66**	**11.17**	**5.67**	**29.03**		

Annex II: Insurance Industry Balance Sheet Key Indicators

Indicator	2017	2018	2019	2020	Annual Change 2018/2019 (%)	Annual Change 2019/2020 (%)
	KSH '000'	KSH '000'	KSH '000'	KSH '000'		
Land Buildings	8,718,281	8,976,774	8,773,089	8,654,609	-6.7	-1.4
Other Fixed Assets	3,484,086	3,558,046	3,329,461	3,172,514	-2.5	-4.7
Cash and Cash Balances	9,955,858	11,082,068	14,350,313	13,022,661	17.9	-9.3
Outstanding Premiums	39,168,734	41,772,165	35,729,849	39,354,190	11.5	10.1
Other Receivables	7,421,542	9,620,174	12,180,961	10,648,244	-5.4	12.6
Other Assets	29,494,058	26,652,175	29,171,440	33,417,632	1.4	14.6
Intangible Assets	8,911,122	9,136,459	9,345,064	10,204,072	7.6	9.2
Investments	483,799,656	524,237,249	592,763,691	600,592,379	4.6	1.3
Total Investments	590,953,337	635,035,110	705,546,218	719,066,301	4.8	1.9
Shareholders' Funds	147,255,007	149,134,602	163,764,340	157,363,170	2.4	3.9
Insurance Penetration Ratio (%)	2.68	2.43	2.35			

*Source: IRA * Unaudited data*

Annex III: Insurance Industry Investments



Annex IV: Insurance Fraud

Nature of Cases	2019Q4	2020Q1
Theft by Agents	5	7
Motor Insurance Fraud (Damage/Theft) Claim	4	6
Motor Accident (Injury) Claim Fraud	0	5
Forgery of Company Documents	0	5
Medical Claims Fraud	4	3
Funeral Claim Fraud	4	2
Impersonating IRA Officials/Fraud Payments	1	2
Theft by Insurer Employees	0	1
Fraudulent Life Claim	6	1
Operating Without License	0	1
Motor Theft Claim Fraud	0	1
Others	7	3
TOTAL	**31**	**37**

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www.centralbank.go.ke

www.ira.go.ke

www.rba.go.ke

www.sasra.go.ke

CAPITAL MARKETS AUTHORITY

Embankment Plaza, Longonot Road, off Kilimanjaro
Avenue, Upper hill
P.O Box 74800 - 00200
NAIROBI, KENYA

Tel: +254 20 2264000/ 2264900 / 2221869
Cell: +254 722 207767

E-mail: corporate@cma.or.ke

CENTRAL BANK OF KENYA

Haile Selassie Avenue
P.O Box 60000 – 00200
NAIROBI, KENYA

Tel: +254 20 286 1000,
+254 20 286 3000, +254 709 081 000, +254 709 083 000

E-mail: researchstat@centralbank.go.ke

INSURANCE REGULATORY AUTHORITY

Insurance Regulatory Authority
Zep-Re Place, Longonot Road
P.O. Box 43505-0100,
NAIROBI, KENYA

Tel: 020-4996000/
Toll Free No: 0800724499

E-mail: commins@ira.go.ke

RETIREMENTS BENEFITS AUTHORITY

Retirement Benefits Authority
Rahimtulla Tower, Upper Hill Road
P.O. Box 57733 - 00200
NAIROBI, KENYA

Tel: +254 (20) 2809000
Toll Free No: 0800720300

E-mail: info@rba.go.ke

THE SACCO SOCIETIES REGULATORY AUTHORITY

Sacco Societies Regulatory Authority
UAP Old Mutual Tower,
Upper Hill Road, Upper Hill.
P.O. Box 25089-00100,
NAIROBI, KENYA

Tel: +254 (20) 2935101

E-mail: info@sasra.go.ke