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THE KENYA FINANCIAL SECTOR STABILITY REPORT 2017

Published by the Financial Sector Regulators Forum, September 2018

Central Bank of Kenya

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Executive Summary: State of Kenya's Financial Sector Stability in 2017

This report on the state of financial sector stability in Kenya covers the period January 2017 to December 2017. Kenya's financial sector comprises of deposits-taking institutions (commercial banks and mortgage finance companies, microfinance banks and deposit-taking Savings and Credit Co-operatives (Saccos)), non-deposit taking institutions (insurance industry, pensions industry, capital markets industry, and Development Finance Institutions) and financial markets infrastructure providers. The sector is regulated and supervised by; Capital Markets Authority (CMA); Central Bank of Kenya (CBK); Insurance Regulatory Authority (IRA); Retirement Benefits Authority (RBA); and the Sacco Societies Regulatory Authority (SASRA) and Government Ministries for DFIs. The banking subsector, which comprises of commercial banks, mortgage finance companies and microfinance banks accounted for more than 60 percent of total assets in the sector as at December 2017.

In 2017, banking sub-sector was resilient to domestic and external shocks and vulnerabilities. The recovery of the global economy as well as increased competitiveness of Kenya's exports strengthened the financial sector, outweighing headwinds to growth emanating from protectionism in the USA and UK. In the domestic economy front, the sector sustained a recovery despite placement of Dubai Bank Limited under liquidation in August 2015 and placement of Imperial Bank Limited and Chase Bank (K) Limited in receivership in October 2015 and April 2016 respectively, implementation of the 'new normal' (based on three pillars - enhanced transparency, governance and business models) and interest rate capping law. The banking sector was also resilient to political risks emanating from the 2017 general elections.

Banking sector assets grew by 8.1 percent, despite credit extended to the private sector decelerating from 5.5 percent in the year to December 2016 to 2.2 percent in the year to December 2017. Decline in credit growth is attributed to both supply and demand side factors. Demand side factors include; low household demand for credit and weak corporate sector balance sheets as well as cash flow problems that faced many companies. On the supply side, banks took precautionary measures and tightened their lending standards to minimize further exposures to private sector. Assets growth were therefore driven by increased lending to the government, considered to be less risky. The banks also shortened loan maturities to less than five (5) years to reflect short-term funding dominated by demand deposits, and increased loan sizes amid reduced number of loan approvals.

Credit risk was also evident as reflected in growth of Non–Performing Loans (NPLs). The gross NPLs as a ratio of gross loans increased from 9.3 percent in December 2016 to 11.0 percent in December 2017. In terms of growth rate however, NPLs decelerated from 43 percent in the year to 2016 to 25 percent in year December 2017, an indication of easing pressure. Banking subsector's profitability declined in the year, limiting banks' ability to build strong capital buffers through retained earnings. In particular, return on Assets (ROA) declined from 3.2 percent in December 2016 to 2.6 percent in December 2017, while Return on Equity (ROE) also decreased from 24.4 percent to 20.6 percent. This decline could be attributed to less lending to the private sector given unfavourable business climate in the electioneering period and increase in the cost of deposits. To shore up capital, the industry witnessed increased consolidation, with a total of four (4) mergers and acquisitions being announced or actualized between 2016 and first quarter of 2017 compared to three (3) announced in three years to March 2015. The liquidity challenges that the entire banking sub-sector experienced in 2016, eased in 2017, with improved interbank volumes, less volatility, narrow spreads and low average interbank rates. This stability is

explained by improved liquidity management by banks, with support and reassurances from the CBK. Overall, the industry remains resilient to shocks given adequate level of capital.

Kenya's stock market was less vibrant on account of economic moderation in the face general elections in 2017 and effects of interest rates capping law on financial sector profitability and in turn their respective stock prices. The stock market recorded reduced liquidity ratio at 6.81 percent of their stocks in 2017 from 7.62 percent in 2016. Thin liquidity in the market increased concentration risks, whereby top five (5) stocks accounted for 64.8 percent of market capitalization in 2017 compared 63.8 percent in 2016. Volatility in the stock market rose on account of prevailing risks and uncertainties, especially in the period towards the general elections. The liquidity problems facing listed firms in 2016 spilled over to 2017, limiting firms' ability to borrow and even pay existing debts. This impacted their business expansion plans leading to low leverage ratio and in turn squeezed any room for increased profitability in 2017.

The insurance and pension sub-sectors also experienced a number of risks in 2017 but were generally stable. The insurance industry recorded declining margins and falling performance metrics measured by Return on Assets (ROA) and Return on Equity (ROE) as a result of operational inefficiencies and unfavorable economic environment. The Pension sub-sector on the other hand, recorded a 5.5 percent growth in assets in 2017 on account of stable banking sub-sector and higher returns from off-shore investments as a result of the recovery of the global economy.

Overall, recovery in global economy, robust regulatory frameworks and certainty in macroeconomic environment balanced out any fragilities and potential risks to the financial sector. This culminated into a stable and resilient financial sector in 2017. With general elections behind us, global growth trajectory strong and global financial markets calm, we expect domestic financial sector to perform better in 2018 with positive medium term outlook.

Chapter 1: Global Economy and Financial Developments

The global economy grew fastest in 2017 since 2011 with this growth momentum expected into 2018-2019 on account of higher growth in both advanced economies and emerging markets economies (Table 1). Key drivers of this growth include; strong aggregate demand by consumers on account of lower inflation **(Figure 1)** and better wages, lower cost of energy, and supportive financial conditions.

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

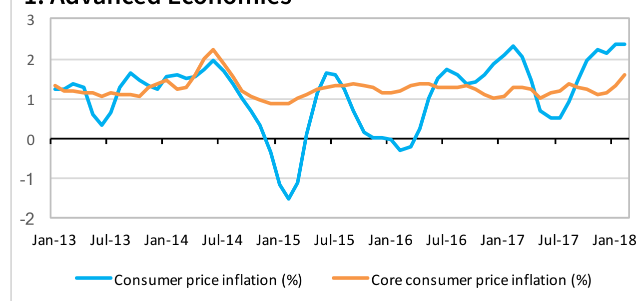
		Projections		Difference from January 2018 WEO Update		Difference from October 2017 WEO	
	2017	2018	2019	2018	2019	2018	2019
Global output	3.8	3.9	3.9	0.0	0.0	0.20	0.2
Advanced economies	2.3	2.5	2.2	0.2	0	0.5	0.4
United states	2.3	2.9	2.7	0.2	0.2	0.6	0.8
Euro area	2.3	2.4	2	0.2	0	0.5	0.3
Emerging Market and Developing Economies	4.8	4.9	5.1	0	0.1	0.0	0.1
China	6.9	6.6	6.4	0.0	0.0	0.8	0.4
Brazil	1.0	2.3	2.5	0.4	0.4	0.1	0.0
Sub-Saharan Africa	2.8	3.4	3.7	0.1	0.2	0.0	0.3
Nigeria	0.8	2.1	1.9	0	0	0.2	0.2
South Africa	1.3	1.5	1.7	0.6	0.8	0.4	0.1
Low income countries	4.7	5.2	5.3	0.0	0.1	-0.2	0.1
MENA Region, Afghanistan and Pakistan	2.6	3.4	3.7	-0.2	0.2	-0.1	0.2

Source: WEO, April 2018

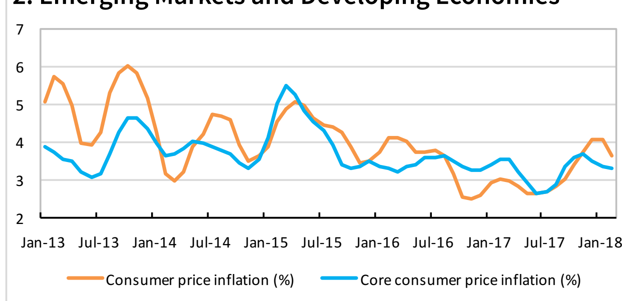
Inflation in advanced economies remains below target but rising on account of stronger demand and bottomed out in emerging market and developing economies (Chart 1). Inflation in emerging market and developing economies is expected to increase to 4.6 percent in 2018, from 4.0 percent in 2017, with Venezuela's inflation expected to exceed 10,000 percent in 2018 through 2019. In 2019 and beyond, inflation is expected to moderate to about 4.0 percent on stabilizing energy prices and closing output gaps. Inflation rates among emerging market and developing economies is quite diverse, reflecting heterogeneity in cyclical positions, central bank credibility, and inflation targets.

Chart 1: Global Headline Inflation

1. Advanced Economies



2. Emerging Markets and Developing Economies

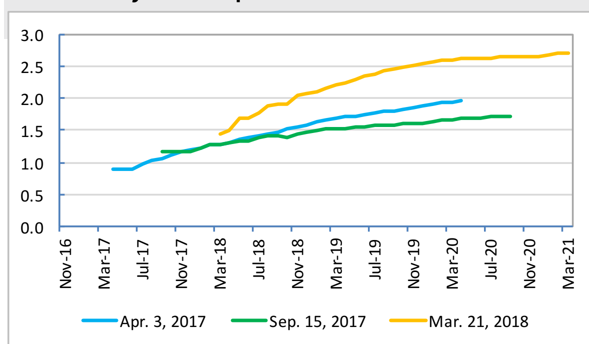


Source: The IMF World Economic Outlook, April 2018

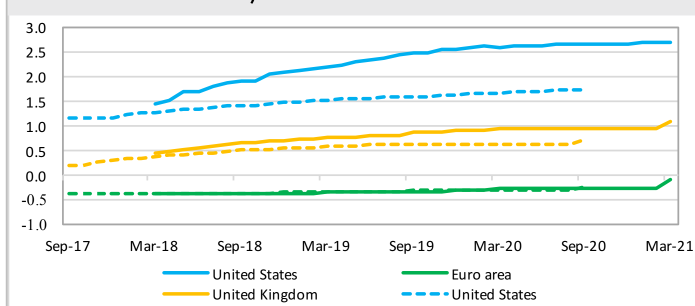
Financial conditions remain accommodative and supportive of the global economy, Global Financial Stability Report April 2018 (GFSR April 2018). Markets are therefore pricing in two additional interest rate increases in 2018—a more rapid pace of normalization than expected a few months ago **(Chart 2).**

Chart 2: Monetary and Financial Market Conditions in Advanced Economies

1. U.S Policy Rate Expectations



2. Policy Rate Expectations (Percent;Dashed lines are from October 2017 WEO)



Source: World Economic Outlook, April 2018

The balance of risks to the near-term forecasts remains two-sided and balanced. On the upside are positive growth surprises due to strong business and consumer confidence through February 2018 and a rebound in productivity, implying higher potential growth in the near term, fueling accelerated demand and eventually, inflation pressures.

There are however headwinds to growth momentum beyond 2019 too; aging populations and lackluster productivity in advanced economies coupled with the reverse effects of expansionary fiscal policy in the US. Substantial fiscal consolidation amid less vibrant commodities markets remain biggest cause of subpar growth in several emerging market and developing economies. Overall, downside risks include; a possible tightening of financial conditions, waning popular support for global economic integration, growing trade tensions and risks of protectionist policies, and geopolitical strains.

The early February 2018 was marked by turbulence and the equity market correction in March 2018 following the US tariff announcement on steel, aluminum and a range of Chinese products. In retaliation, China imposed tariffs on imports from the US. This can lead to sharp correction in asset prices, triggering possible disruptive portfolio adjustments. Therefore a worsening of trade tensions and the imposition of broader barriers to cross-border trade would impact economic activity and weaken confidence, with further adverse repercussions.

The current recovery offers a window of opportunity to advance policies and reforms that secure the current upswing and raise medium-term growth to the benefit of all. Such policies should focus on strengthening the potential for higher and more inclusive growth, improving financial resilience to contain market risks and stability concerns, and fostering international cooperation (WEO, April 2018).

1.1 Slow Recovery amid growing challenges in Sub-Saharan Africa

The Sub-Saharan Africa (SSA) economic growth is expected to double from 1.4 percent in 2016 to 2.8 percent in 2017 and level at 3.7 percent in 2019 **(Chart 3)**, underpinned by stronger global growth, higher commodity prices, and improved market access (REO-SSA, April 2018). Many countries continue to rely on public-investment-driven growth. External position for the region has strengthened, reflecting both global developments and in some cases improved policy frameworks. As a result, many countries have projected rising growth in GDP **(Chart 4).**

Chart 3. Sub-Saharan Africa: Real GDP Growth, 2013–19

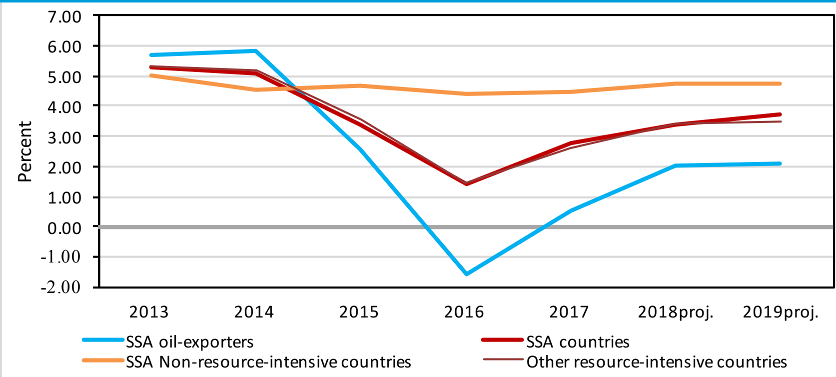
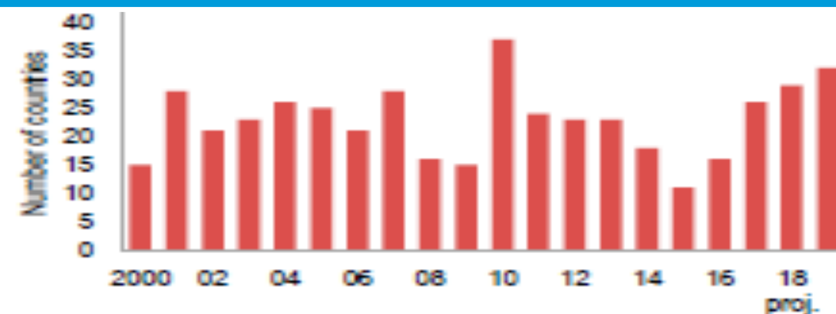


Chart 4: Sub-Saharan Africa: Countries with rising Real GDP growth, 2000–19



Source: Sub-Saharan Africa Regional Economic Outlook, April 2018

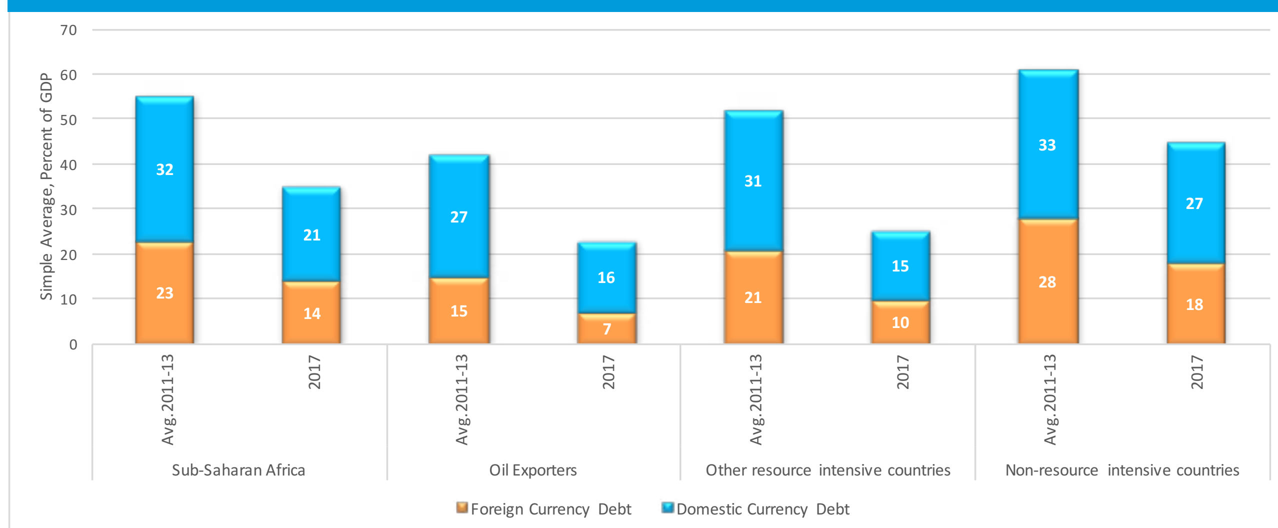
Better terms of trade contributed to narrowing of current account deficit in most resource-intensive countries, but demand compression also played important role in some countries. Record-low spreads prompted a surge in Eurobond issuances by the region's frontier markets while stock markets, fueled by portfolio inflows were buoyant in the region's economic hubs. Exchange rate pressure subsided in some countries seeing increased foreign exchange rate flexibility (Angola) and new foreign exchange measures (Nigeria).

There are however headwinds to this bullish outlook. Many SSA countries rely heavily on debt to finance their public-funded investment growth. Public debt has therefore risen rapidly, with potential threats of limited fiscal space, balance sheet weaknesses due to sovereign risks and declining private sector credit compounded by increasing nonperforming loans **(Chart 5).**

Tail risks from external environment include tapering off of current growth in advanced economies and the borrowing terms for the region's frontier markets become harder, in the wake of the normalization of US monetary policy as global asset price volatility sets in. This could coincide with higher refinancing needs for

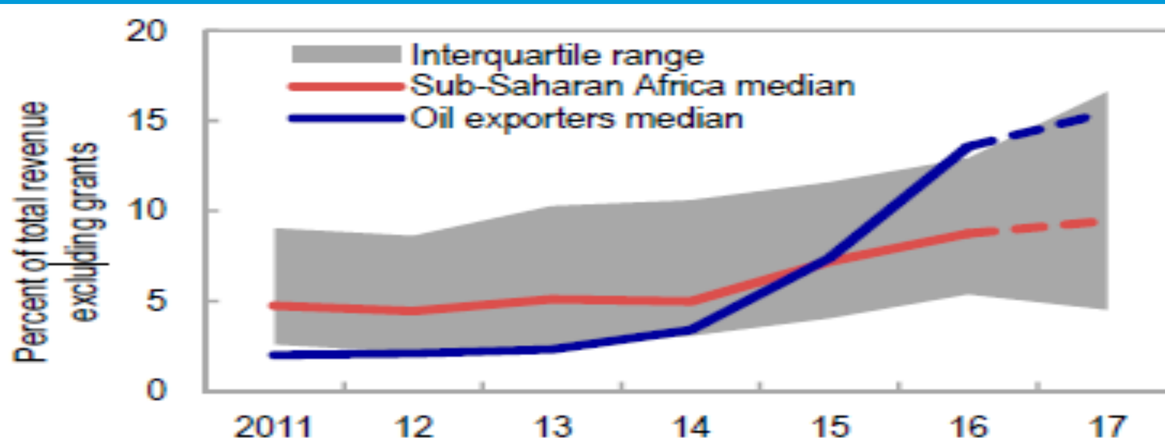
many countries across the region. Fiscal consolidation efforts in the SSA region have yielded mixed results, with about 40 percent of low income countries in SSA region facing debt distress or assessed as being high risk of debt distress. The median level of public debt in sub-Saharan Africa at the end of 2017 exceeded 50 percent of GDP, on account of large primary deficits and interest bills. With rising debt stocks, interest payments have also been increasing, eating up a growing share of revenues. The median interest-payments-to-revenue ratio nearly doubled from 5 to close to 10 percent between 2013 and 2017, and for oil-exporting countries, it increased from 2 to more than 12 percent **(Chart 6).**

Chart 5: SSA Public Sector Debt Currency Decomposition, 2011–17



Source: SSA Regional Economic Outlook, April 2018

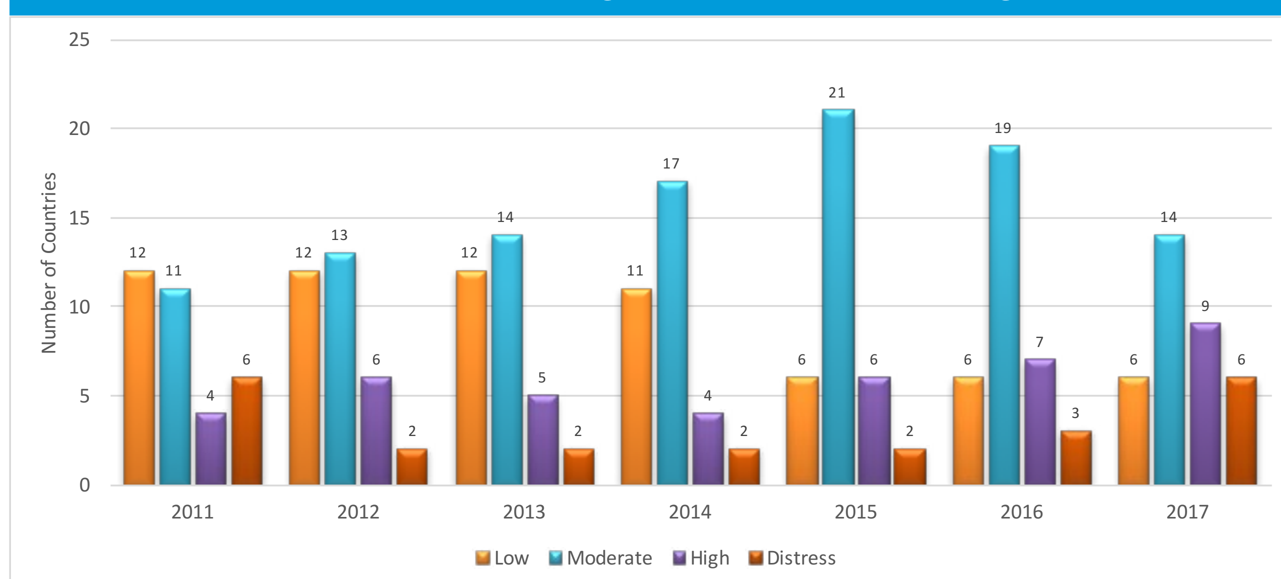
Chart 6: SSA Interest Payments, 2011-2017



Source: SSA Regional Economic Outlook, April 2018

Debt sustainability has deteriorated among sub-Saharan African PRGT eligible low-income developing countries **(Chart 7).** As of the end of 2017, six countries have been assessed to be in debt distress (Chad, Eritrea, Mozambique, Republic of Congo, South Sudan, and Zimbabwe). The previous moderate ratings for Zambia and Ethiopia were changed to "high risk of debt distress." While the causes of sliding into debt distress are country specific, most of the countries in debt distress are those in fragile situations or those facing adjustment to a very large shock to the price of their major export commodity.

Chart 7: SSA Debt Risk Status for PRGT Eligible Low-Income Developing Countries, 2011–17

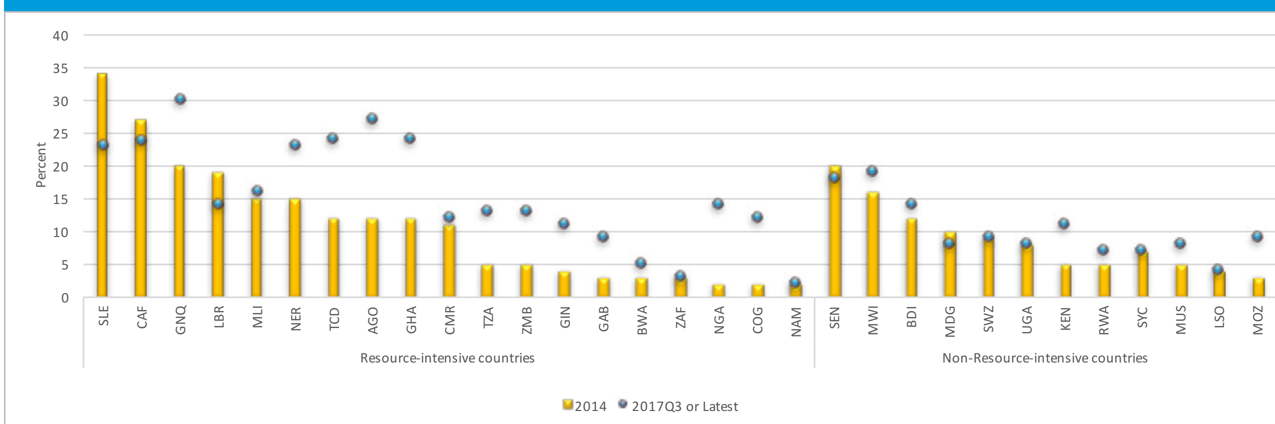


Source: SSA Regional Economic Outlook, April 2018

Additional downside risks to growth recovery momentum are rising credit risks reflected in sharp increase in non-performing loans and persistent decline in credit to the private sector. Although banking systems have been generally stable, with adequate capital and liquidity buffers, nonperforming loan ratios have surged across the region **(Chart 8).** The increases were large among resource-intensive countries, where weak economic activity has translated into a decline in credit quality and where government arrears have continued to affect the banking sector (Zambia). Nonperforming loans tend to be concentrated in a few banks and, in several instances, predominantly incurred by public entities.

This is consistent with evidence that periods of declining commodity prices tend to be associated with deteriorating financial sector conditions in commodity-dependent countries, including higher numbers of nonperforming loans and more banking crises (IMF 2015a).

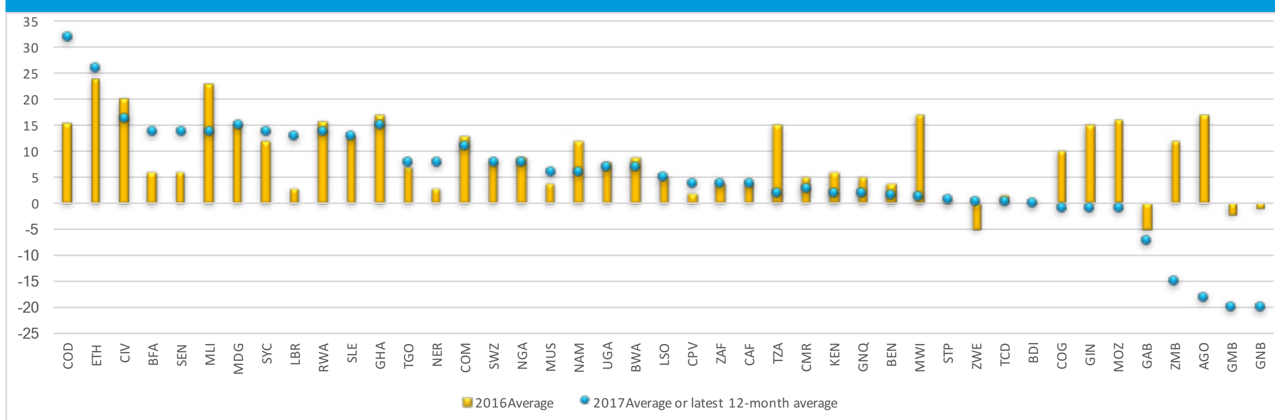
Chart 8: SSA Bank Nonperforming Loans to Total Loans, 2014–16



Source: SSA Regional Economic Outlook, April 2018

The broad-based deceleration in private sector credit growth raises additional concerns **(Chart 9).** In 2017, private sector credit growth was negative in real terms in many countries and, in several cases (Angola, Gabon, Zambia), it was negative even in nominal terms. Demand-side factors dominated some countries, with the private sector still struggling with the legacy of the crisis, while in other countries supply-side factors were more important, reflecting a combination of tight liquidity (WAEMU), government arrears (Gabon), high levels of nonperforming loans (Angola), crowding out by the public sector (Zambia), or interest rate controls (Kenya). The slowing down of private sector credit poses a threat to recovery, especially where fiscal space became constrained by the rising public debt burden.

Chart 9: Sub-Saharan Africa: Private Sector Credit Growth, 2016–17



Source: REO-Sub Saharan Africa

In many of these countries, the government's reliance on domestic banks to raise public debt could crowd out the private sector and undermine banking sector stability. These countries should address this emerging bank-sovereign nexus by rebalancing the incentives in place that favor holding government securities and discourage credit to the private sector;

implement macroprudential measures to limit exposure to sovereign debt; and gradually tighten central bank refinancing of commercial banks (IMF 2017a). Enhancing transparency in the corporate sector, reducing information asymmetry and improving the resolution framework for banks would encourage exposure to the private sector.

To achieve sustained growth in SSA, policy makers need to reduce vulnerabilities and work towards raising the medium-term growth potential. This would require sustained fiscal discipline to reduce rapid public debt accumulation and a monetary policy that achieves and maintains low inflation. Achieving the latter involves structural policies to reduce market distortions, shaping an environment that fosters private investment, and strengthening revenue mobilization, so that governments can invest in physical and human capital and protect social spending, even during fiscal consolidation.

1.2 Financial conditions in the East Africa community

In the EAC region, economic growth moderated in 2017 driven by cyclical, structural and geopolitical factors. Inflation remained low and in single digits in 2017, except for Burundi and South Sudan. The outlook is for growth to gain momentum in 2018 (IMF WEO April 2018), with positive spill overs for enhanced financial stability.

Despite the positive outlook, there are several major risks to the growth outlook stemming from a possible rise in oil prices, reduced trade and tighter global financial conditions, leading to exchange rate and debt service pressures. If an abrupt tightening of global financial conditions were to occur, triggered by a rise in global interest rates and a change in investor appetite, the EAC Partner States would face potential adverse consequences including a "flight to quality" and reversal of capital flows; higher funding costs both on and offshore and exchange rate depreciation. Given the rise in government budget deficits and substantial reliance on foreign borrowing seen over recent years, governments could have little room to respond to changing global conditions, which may adversely affect financial stability.

Some vulnerabilities in the regional banking sector have remained elevated in the year to December 2017 from both micro and macro risks. This can be observed in the trend of key indicators for credit risk (including slow credit growth, sectorial distribution of credit, loan quality) and liquidity risk (volatility of the interbank rate and funding) and interest rate spreads. Credit risk, as measured by non-performing loans to gross loans (NPL ratio), increased across the region. As at March 2018, Burundi had the highest NPL ratio of 16.6 percent followed by Kenya with 9.6 percent and Rwanda with 7.7 percent. The increase in NPLs was due to varying factors across the region, including a slow-down in economic activity, fiscal consolidation, geopolitical risks and a rise in foreign currency loans following depreciation pressures and a reduction in real estate occupancy rates which affected commercial property developers. In the medium term, NPLs are likely to reduce on account of economic recovery and banks tightening their credit standards.

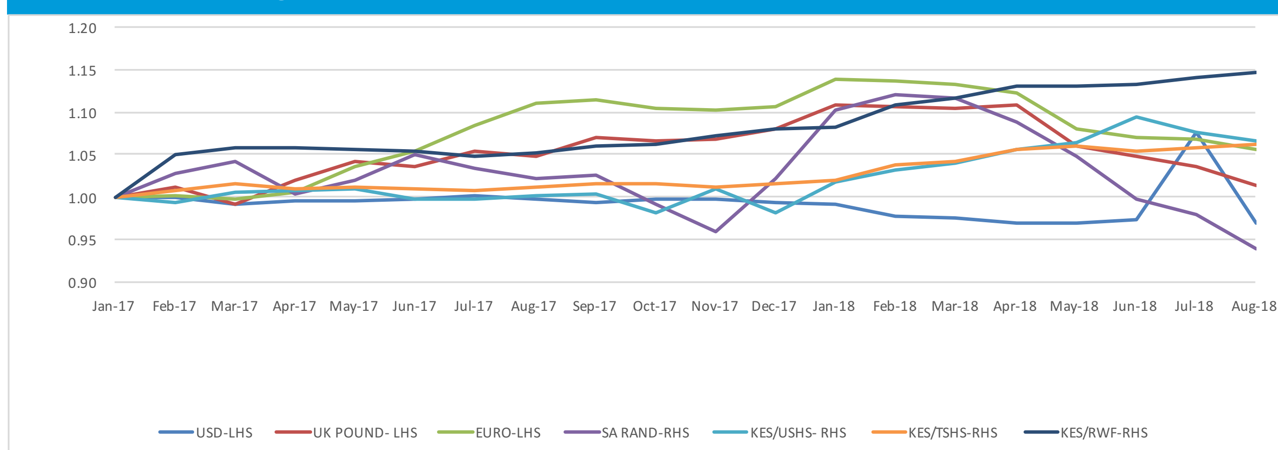
While liquidity risk remained low, increasing banks' exposure to government securities raises concerns on sovereign debt and re-pricing risk on these securities, should global interest rates rise more rapidly than currently expected, which could have implications for financial stability in future. The banking sector in the EAC remains largely profitable although there is a declining trend in the magnitude of profits.

Chapter 2: Developments in Domestic Economic Conditions

Kenya's economy was resilient in the face of two major shocks in 2017 – drought that affected food supply, and extended electioneering period that impacted almost all sectors of the economy. The economy however expanded by 4.9 percent in 2017 compared to 5.9 percent growth in 2016. The slow down reflects poor performance in agricultural sector due to adverse weather conditions, underperforming manufacturing, wholesale and trade sectors. Inflation and exchange rates were generally stable in the year 2017 compared with 2016, on account of improved rainfall, lower transport prices, housing and utilities, and lower international oil prices. However, conclusion of the 2017 general elections, improved weather conditions, a stable macroeconomic environment and a high priority on the Big-4 government agenda is expected to spur economic growth. Downside risks to the outlook include; the pace of monetary policy normalization in advanced economies which could weaken the Kenya Shilling as well as unfavourable weather conditions.

The Kenya Shilling was fairly stable against both the regional and international currencies in 2017. Against the U.S dollar, Kenya Shilling averaged 103.41. In the EAC region, the Kenya shilling appreciated slightly against all the national currencies (Chart 10)[1]. The stability of Kenya shilling could be explained by a narrower Current Account Balance (CAB) of below 5.2 percent of GDP on account of increased diaspora remittances and foreign borrowings. The Euro and SA Rand recorded higher volatility as compared to other currencies. There were pockets of demand pressure on CAB arising from high import bill occasioned by food, oil and transport and office equipment as well as wagons and locomotives related to the Standard Gauge Railway (SGR) project phase I. Remittances increased from U.S$ 447.19 million in the fourth quarter of 2016 to USD 564.51 million in quarter four of 2017, imparting some positive impact on the local currency.

Chart 10: Exchange Rate Performance (January 2017=100)



Source: Central Bank of Kenya

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

The Kenya Shilling is expected to remain stable in 2018 on account of strong foreign exchange reserves, upward remittances flows, improving exports and stable import bill. Downside risks include; faster than projected increase in global oil prices; global trade wars, Brexit and geopolitical tensions.

Kenya's public debt remains sustainable but the pace of debt accumulation and terms of new debt require closer monitoring. Total public debt grew by 21.45 percent in December 2017 compared to its stock in December 2016, with external component rising much faster than domestic component **(Table 2).** Most of the new borrowing targeted infrastructure financing, especially the Standard Gauge Railway and roads. While the bulk of Kenya's external public debt has been on concessional terms, there is increasing uptake of commercial borrowing entailing harder terms (the 2015 syndicated loan) and Eurobonds.

Table 2: Kenya's Public Debt Stock in KSh Billions

DEBT TYPE	16-Mar	16-Jun	16-Sep	16-Dec	17-Mar	Jun-17	Sep-17	Dec-17
EXTERNAL	1,665.58	1,803.20	1,838.42	1,832.45	2,101.39	2,294.40	2,310.20	2,349.28
Share of Total (%)	**50.29**	**49.84**	**49.78**	**48.69**	**51.93**	**52.07**	**51.49**	**51.41**
DOMESTIC	1,646.53	1,815.13	1,854.55	1,930.98	1,944.95	2111.71	2176.59	2220.35
Share of Total (%)	**49.71**	**50.16**	**50.22**	**51.31**	**48.07**	**47.93**	**48.51**	**48.59**
GRAND TOTAL	**3,312.11**	**3,618.34**	**3,692.97**	**3,763.43**	**4,046.35**	**4,406.11**	**4,486.79**	**4,569.63**

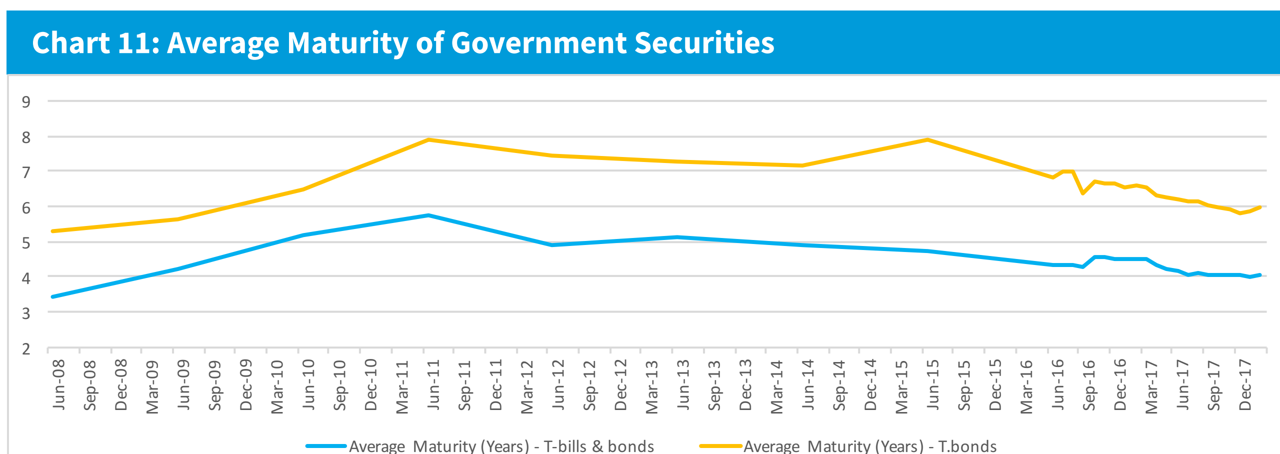
Source: Central Bank of Kenya and The National Treasury

Total Government Securities, excluding Treasury bills stock held for Open Market Operations (OMO), increased to KSh. 2,145.99 billion at the end of December 2017, from KSh. 1,869.53 billion in December 2016. The increase mainly targeted infrastructure financing.

Domestic debt maturities continue to shorten, posing potential rollover risks in the medium term if the trend is not reversed. By end of December 2017, Treasury bonds (long term) to Treasury bills ratio was 65:35 down from 67:33 in December 2016 and 73:27 in December 2015. The average time to maturity of all Government securities reduced to 4.05 years in December 2017 and 4.5 years in December 2016 **(Chart 11).** These are way below the maturity profile target of 70:30 (long term to short term) under the 2017 Medium Term Debt Strategy (MTDS).

The primary markets for government securities performed well through 2017, signalling adequate liquidity in the market, albeit moderate performance in the Treasury bills market segment. The Central Bank Kenya held twelve (12) auctions for Treasury bonds to raise KSh 370 billion to cover new borrowing and maturities. All the offers were fully subscribed at 122.36 percent on average, signalling strong investors' appetite for long term securities in 2017. This was however lower than the 146.28 percent performance against the KSh 355 billion targeted in 2016. The appetite for Treasury bills was very high in 2017 just as it was in 2016. The government offered Treasury bills worth KSh 1,136.0 billion and received 5.42 percent oversubscription in 2017 compared to KSh 816 billion offered in 2016 that registered 64.38 percent oversubscription rate. Six (6) months in 2017 recorded undersubscription in Treasury bills compared to only one (1) month in 2016 whose bills offer was undersubscribed. This indicates reduced liquidity in 2017 compared with 2016 as the credit market recovered slowly.

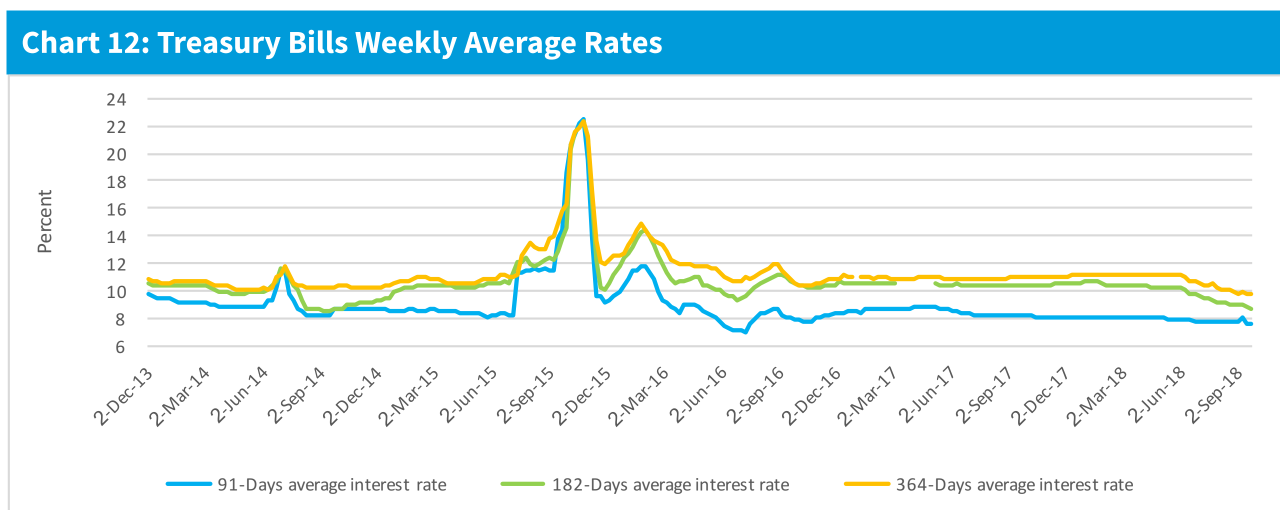
Chart 11: Average Maturity of Government Securities



Source: Central Bank of Kenya

Interest rates on treasury bills have been stable market since the fourth quarter of 2016, reflecting improved market liquidity and overall market stability after the 2015-2016 crisis in the banking sector **(Chart 12).** The period of excess volatility in fourth quarter of 2015 to the first half of 2016 reflects instability in the banking sector following placement of one bank into liquidation and two banks in receivership and the liquidity crunch that followed afterwards. Implementation on the interest rates capping law in September 2016 saw interest rates decline and stabilize at lower level as banks preferred lending to government instead of the private sector, thus driving the rates down. There is however a downside risks of interest rates reversal as uptake of credit to private sector recover gradually, especially with anticipated elimination of interest rates controls.

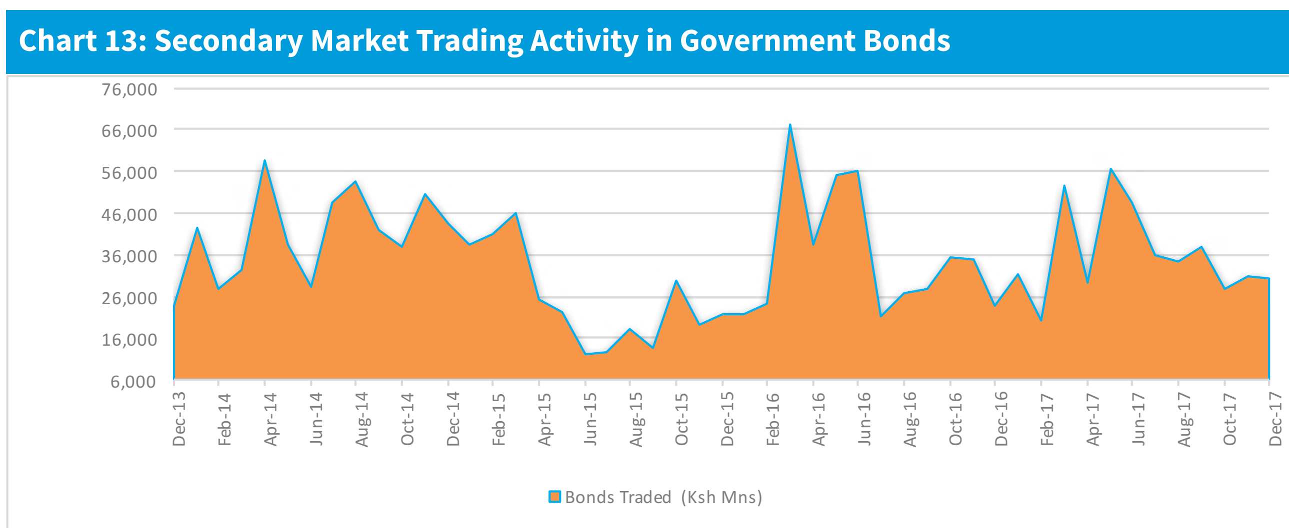
Chart 12: Treasury Bills Weekly Average Rates



Source: Central Bank of Kenya

Stability in the interest rates and improved liquidity in the primary market for government securities contributed to a recovery in secondary market trading of government bonds in the first quarter of 2017 **(Chart 13).** The market was more active in the second quarter of 2017 by closed the year at below KSh 30 billion per month. The reduced appetite for fixed income in the last quarter of 2017 may reflect seasonal factors, characterised by end- of-year festivities.

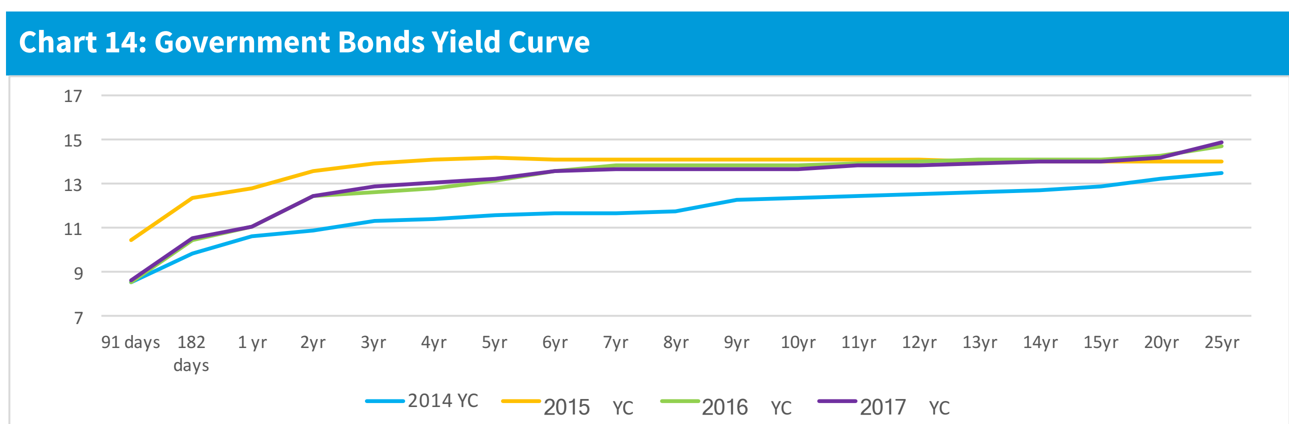
Chart 13: Secondary Market Trading Activity in Government Bonds



Source: Central Bank of Kenya

The uncertainties surrounding the general elections in 2017 could be reflected in the steep slope of the yield curve in 2017 **(Chart 14).** However, the steep slope of the Yield curve in 2016 as compared to 2014 and 2015, could be a reflection of the instability in the banking sector the resultant liquidity challenges following the placement of Imperial Bank and Chase Bank in receivership in October 2015 and April 2016, respectively. The increase in the slopes of the 2016 and 2017 yields curves indicates elevated risks perception in the overall economy by investors. We expect the slope to reduce as risks dissipate following conclusion of elections, improved weather conditions, and restoration of stability in the banking sector. The downside risk to this positive outlook on the yield curve in 2018 and beyond is the relatively high fiscal deficits concerns and reserves emanating from global markets if interest rates increase.

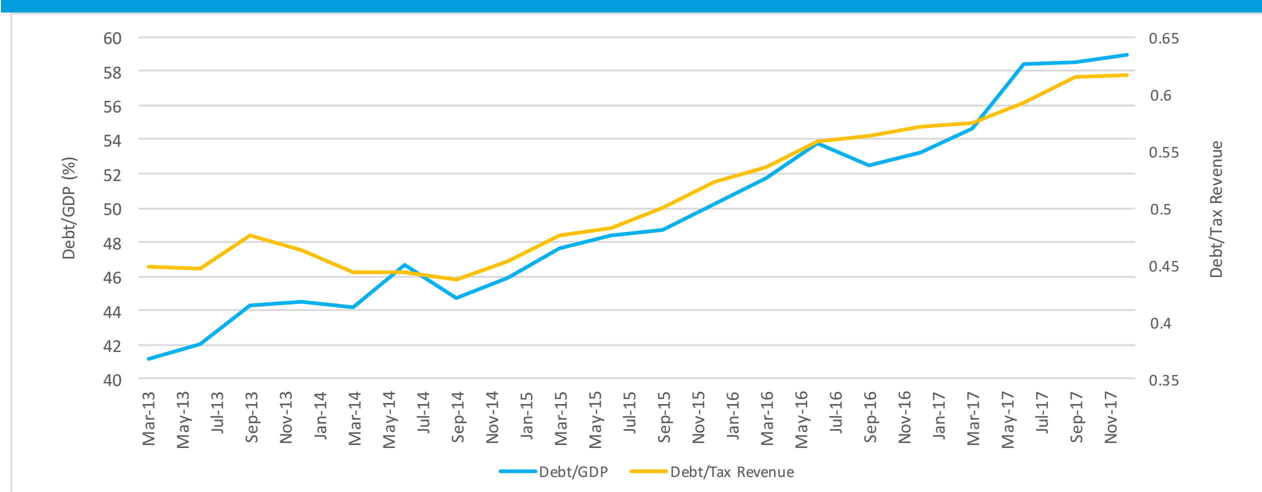
Chart 14: Government Bonds Yield Curve



Source: Central Bank of Kenya

The level of indebtedness as measured by be the ratio of total debt to GDP has increased from about 42 percent in third quarter of 2010 to about 56.8 percent in the third quarter of 2017 **(Table 3).** This has raised the solvency concerns as public debt to GDP ratio rose sharply over the period. In addition, liquidity measure of public debt to tax revenue continue to narrow, reflecting weakening capacity of government to service its debt using tax revenues. Specifically, public debt to GDP ratio has increased from 42 percent in the third quarter of 2010 to 57 percent in the third quarter of 2017 so is the public debt to tax revenue ratio, exposing the economy to sovereign solvency risk **(Chart 15).**

Chart 15: Solvency and Liquidity Public of Debt



Source: Central Bank of Kenya

Despite rapid increase in public debt, growth in tax revenues was sluggish in tandem with the rate of public debt accumulation **(Table 3)**, thus reducing room for the government to meet its debt obligation from tax revenue. In table 3 an increase in foreign debt service relative to exports from the last quarter of 2014 indicates that the economy is not earning sufficient foreign exchange to settle maturing foreign debt. Tax revenue used to service domestic debt has also increased as indicated by the ratio of domestic debt service to tax revenue. This implies that incremental tax revenue was used to service domestic debt.

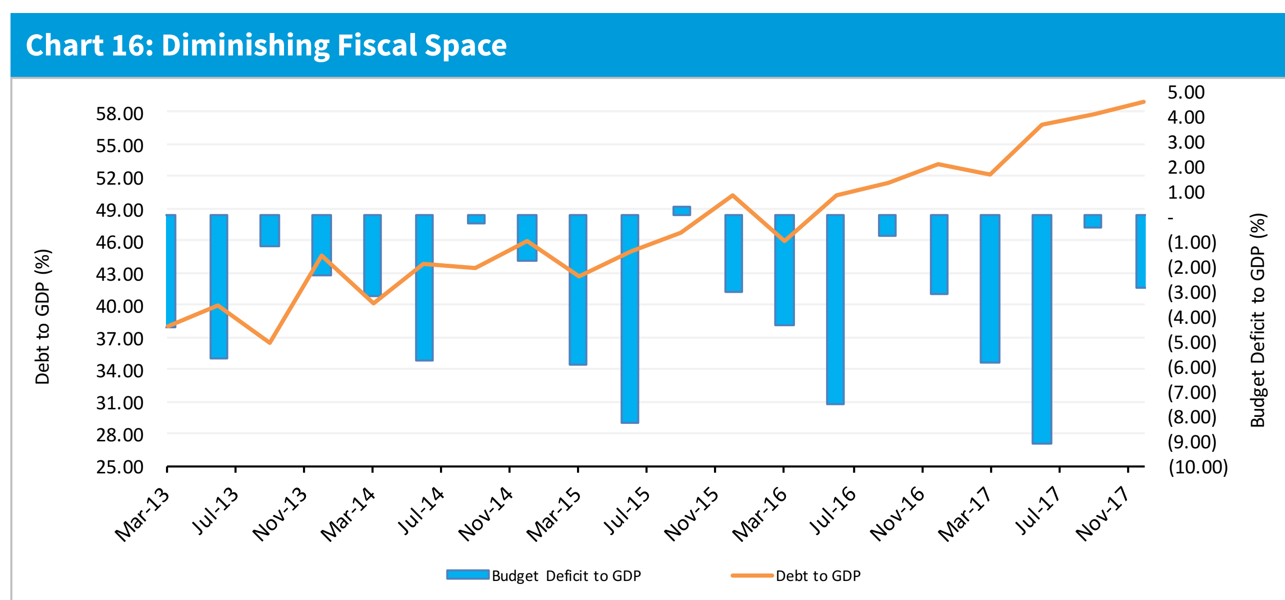
Table 3: Public debt, GDP and Tax revenue (Percent)

	Public debt/ GDP	Public Debt/ Tax Revenue	Foreign debt service/Export	Foreign debt service/ Export and Taxes	Domestic debt service/Tax
Dec-15	50.40	52.22	75.40	1.85	3.00
Mar-16	51.89	53.65	23.11	0.56	3.08
Jun-16	53.73	55.75	123.94	2.70	2.36
Sep-16	52.48	56.32	32.82	0.69	3.47
Dec-16	53.20	57.05	111.33	2.25	3.72
Mar-17	54.63	57.37	66.16	1.39	3.61
Jun-17	58.38	59.25	99.66	1.96	3.38
Sep-17	58.54	61.51	66.77	1.30	4.13
Dec-17	58.97	61.66	91.65	1.81	3.51

Source: KNBS (GDP) and The National Treasury's Budget Outturn (Debt)

Despite the narrowing fiscal space, Kenya's public debt is still sustainable over the medium term **(Chart 16).** The risk of external debt distress remains low, while overall public debt dynamics continue to be sustainable. Furthermore, implementation of the proposed fiscal consolidation programme over the medium term will buttress sustainability of public debt in line with the Medium Term Debt Strategy.

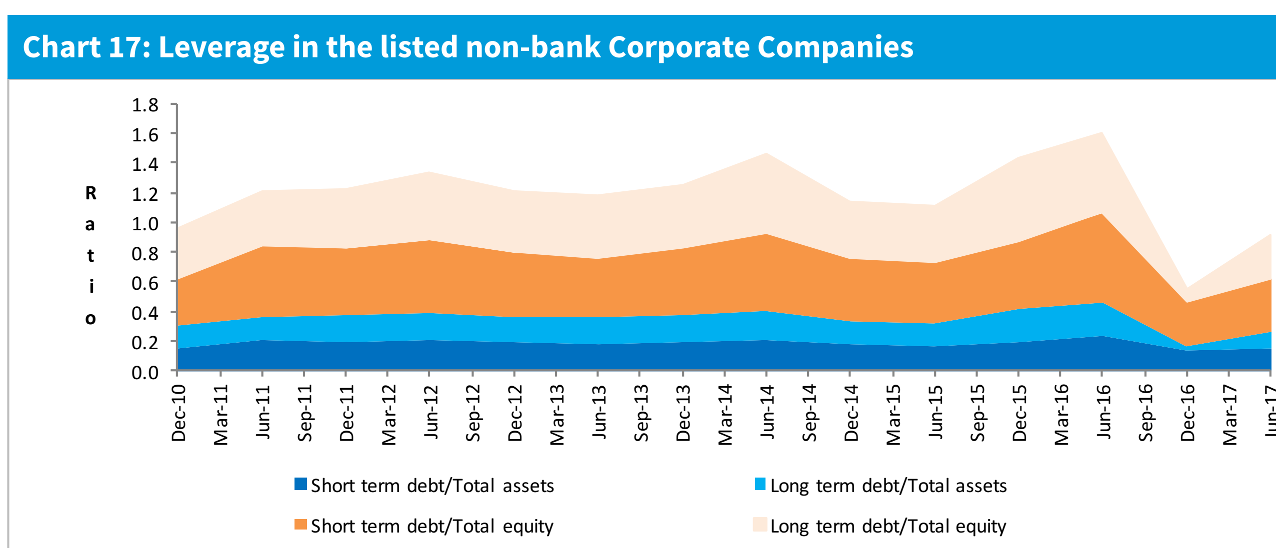
Chart 16: Diminishing Fiscal Space



Source: Central Bank of Kenya

Private sector indebtedness, reflected in the private firms' ability to meet their debt obligations increased in 2017 compared to 2016 **(Chart 17).** The indebtedness of non-bank listed companies declined sharply by end of 2016, reflecting either banks' inability to extend credit or firms' unwillingness to borrow due to limited borrowing space. Note that the decline in indebtedness mirrors the reduction in private sector credit from commercial banks in 2016-17 as companies scaled down expansion plans to given the electioneering periods and liquidity problems that faced some of them. It is also possible that some firms used their own funds for operating capital instead of borrowing to finance critical investments. The decline further reflects private firms' absence from corporate debt market given the uncertainties prevailing then associated with the general elections and instability induced by placement of Imperial Bank and Chase Bank in receivership in October 2015 and April 2016, respectively. The two banks had issued bonds in the market just before their collapse.

Chart 17: Leverage in the listed non-bank Corporate Companies

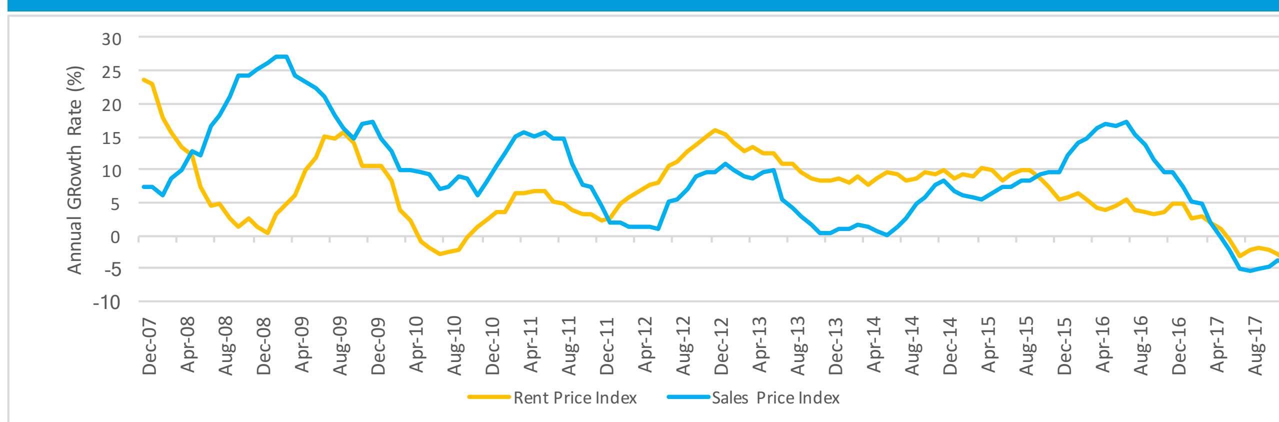


Source: CBK Staff Computations

Just like 2016, the non-financial corporate sector firms experienced further decline in profitability in 2017, highlighting challenging business environment. This has implications on their ability to service their debt and/ or obtain favourable credit risk pricing. In particular, declining profitability undermines lenders' confidence to advance credit to the level desired by potential borrowing firms and therefore, companies resort to funding their operations and/or expansion either through equity, debt or reserves.

The property prices in terms of sales and rents prices in Kenya maintained a downward trend through 2017 as indicated from various reports by Hass Consult and Kenya Bankers' Association (KBA). The Hass Consult All Types Property Index show that property prices declined sharply from mid-2016, with negative growth rates reported from around May 2017 (Chart 18). House selling prices reduced by about 4.10 percent in the fourth quarter of 2017, compared to a 10.21 percent increase in the fourth quarter of 2016, as the market experienced large unsold stocks.

Chart 18: Selling Price and Rental Price Indices



Source: Hass Consult Limited Report December 2017

Growth rates in rental prices on the other hand, maintained a downward trend since January 2013, with faster deceleration starting in December 2016 and remaining in negative territory since May 2017. The fourth quarter of 2017 recorded a 3 percent decline in rent growth rates compared to an increase of 4 percent in quarter fourth of 2016. A combination falling growth rates in rental income and selling prices signals low demand for properties, perhaps explained by reduced purchasing power for properties.

The decline in effective demand for real estate properties is also indicated by the rate of growth rates of asking price and rental income per month in Nairobi and its satellite towns. From the third quarter of 2015 the first quarter of 2017 the rate of growth of property sales asking price was higher than the rate of growth rental income.

However, correction seem to have occurred from July 2016, whereby selling price reduced due slow growth in rental income as a result of excess supply property. This is mainly affecting the apartments in middle to high end market and class B commercial properties market.

Financing of real estate has continued to grow outside the banking sector, though notable improvement for banks' credit was noted in 2017 (Table 4). Banks' credit to the real estate grew by 30.82 percent in 2017 compared with 18.33 percent growth rate for pension funds. Private Equity and insurance companies are also significant financiers of property markets in Kenya. Other financing sources include; mortgage finance companies, Savings and Credit Cooperatives (Saccos), capital markets (Real Estate Investment Trusts), off-plan purchases, and private sources.

Table 4 Funding Options in Real Estate (Ksh Billions)

Year	Insurance	Pension	Private Equity	Commercial Banks
2012	39.32	101.60	-	130.92
2013	54.26	119.84	0.12	162.33
2014	62.55	130.39	0.32	218.68
2015	68.62	150.78	18.72	262.48
2016	73.24	178.42	95.94	284.09
2017	76.04	226.72	83.15	371.65

Source: various reports of Real Estate Firms and regulators

While Saccos have focused on funding land purchases and construction of residential houses for their members in urban areas, through investment units, local pensions institutional funds like National Social Security Fund (NSSF), Insurance companies (Old Mutual Towers), and Pension Funds, have also invested substantial amounts in real estate, without resorting to bank loans.

The real estate market outlook for 2018 remains mixed for both rental and sale markets, on account of interest rates capping law and sluggish demand side. There are no foreseeable property bubble due to large housing deficit, especially in low income segment of the population (supply-side) and tight lending conditions (demand side) given the low approval rates of new plans **(Table 5).**

Table 5: Selling Price and Rental Price Indices in 2017

	Actual Value of Buildings			Real		
Month	**Residential**	**Non-Residential**	**Aggregate**	**Residential**	**Non-Residential**	**Aggregate**
January	10,822.40	9,503.42	20,325.82	128.37	108.53	236.9
February	11,275.50	8,475.84	19,751.34	133.74	96.8	230.54
March	11,765.56	9,867.06	21,632.62	139.56	112.69	252.25
April	11,800.44	10,039.54	21,839.98	139.97	114.66	261.77
May	12,401.97	9,739.09	22,141.06	147.11	111.23	257.13
June	12,300.63	10,679.08	22,979.71	145.9	121.96	337.2
July	18,146.46	2,691.63	20,838.09	215.24	30.74	245.98
August	-	-	-	-	-	-
September	-	-	-	-	-	-
October	-	-	-	-	-	-
November	10,589.01	5,814.25	16,403.26	125.6	66.4	192
December	12,961.45	5,847.21	18,808.66	153.74	66.78	220.52

Source: Kenya National Bureau of Statistics Report 2017

Chapter 3: Vulnerabilities and Risks Assessment in the Financial System

Kenya's financial sector remained resilient in 2017, growing on average by 9.93 percent in terms of assets. In terms of assets, the insurance industry grew by 18.2 percent, banking by 8.1 percent, capital markets by 12.6 percent, pensions by 10.6 percent, and Saccos by 9.6 percent. While the insurance, SACCOs and pension subsectors recorded increase in profitability, the banking industry recorded decline in profits in 2017. This could be explained by impact of interest rates capping law and reduced credit flow to the private on account of uncertainties in the economy. The deposits insurance, Kenya Deposit Insurance Corporation (KDIC) had Effective Cover of 31.6 percent in 2017 up from 28.3 percent in 2016. Elections jitters induced some volatility in capital markets, already affected by poor financial results of listed companies. Both primary and secondary markets activities for bonds recorded reduced issuances and trading.

As a share of nominal GDP, financial sector aggregate assets grew by 7.71 percent in 2017 compared to 2016 to, with the banking industry's assets accounting for 58.3 percent of the total in 2017 (Table 6). All the subsectors recorded growth in assets, with least growth recorded in insurance industry. The significance growth in banking industry's assets is attributed to increased investment in government securities.

Table 6: Share of Financial Sector to GDP

YEAR	2017		2016	
Indicator/ Industry	Total Assets (KSh Bns)	Share of GDP (%)	Total Assets (KSh Bns)	Share of GDP (%)
Nominal GDP (billions)	**7,749.43**		**7,194.15**	
Banks (excludes MFBs)	4,002.7	58.30	3,695.9	52.30
Insurance	584.84	7.55	528.75	7.35
Pensions	1,081.10	13.95	912.66	12.69
Saccos	442.90	5.72	393.50	5.47
TOTAL	**6,627.04**	**85.52**	**5,530.60**	**77.81**
Market Capitalization	2,521.77	32.54	1,931.61	26.85

Source: KNBS Economic Survey 2018 and financial sector regulators' reports

3.1 The Banking Industry

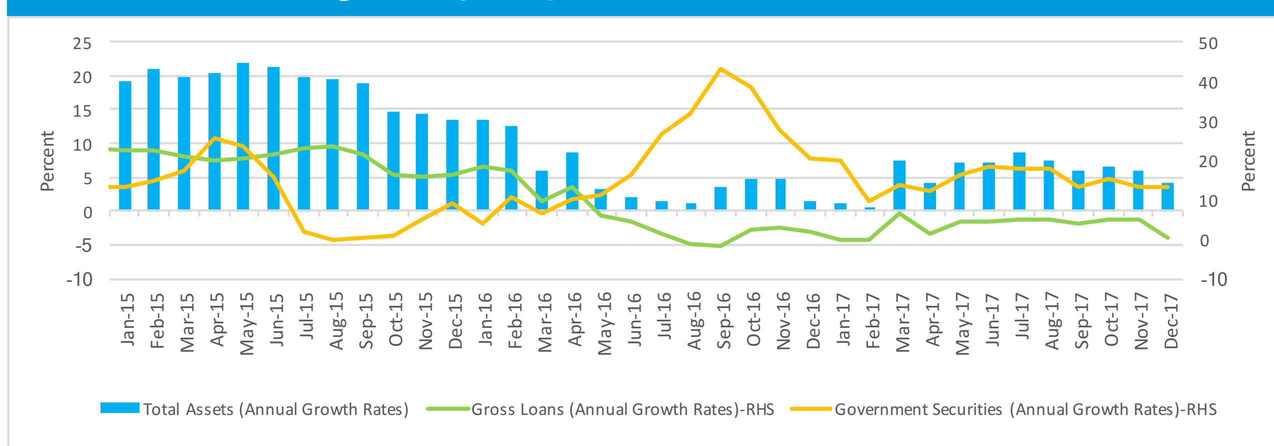
Banking industry comprised 42 commercial banks[2], 1 mortgage finance company, 13 microfinance banks, 8 representative offices of foreign banks, 73 foreign exchange bureaus, 19 money remittance providers, 8 non-operating bank holding companies and 3 credit reference bureaus in 2017. In 2017, DIB Bank Kenya Limited and Mayfair Bank Limited were licensed to operate banking business in Kenya. Société Générale of France opened a Representative Office in Kenya while Central Bank of India (CBI) closed down its Representative Office. In 2017, Fidelity Commercial Bank Ltd, Giro Commercial Bank Ltd and Habib Bank (K) Ltd were acquired by SBM Holdings Ltd, I&M Holdings Ltd, and Diamond Trust Bank Kenya Ltd respectively.

[2]*Charterhouse Bank is under Statutory Management, while Chase Bank and Imperial Bank are under Receivership. These three banks have been excluded in this report.*

On aggregate, banks were well-capitalized in terms of meeting the minimum capital requirements and capital adequacy ratios remaining above the minimum regulatory ratios. Total Capital to Total Risk Weighted Assets ratio was 18.8 percent as at December 2017 against the minimum required ratio of 14.5 percent.

The aggregate banks' balance sheet expanded in 2017, albeit at a slower growth rate. Total net assets grew by 8.1 percent from KSh.3.2 trillion in December 2016 to KSh.4.0trillion in December 2017 (Chart 19). Growth in assets is mainly explained by higher investment in government securities, growing at 15.3 percent to Ksh. 998.41 billion in 2017. Perceived risks uncertainties in the private sector during elections year, mainly explain the slow growth in credit to private sector at 4.8 percent to KSh. 2,452.68 billion in 2017. Majority of loans were allocated to Manufacturing; Real Estate; Energy and Water; and Personal/Household sectors.

Chart 19: Annual Changes in Key Components of Banks Balance Sheet

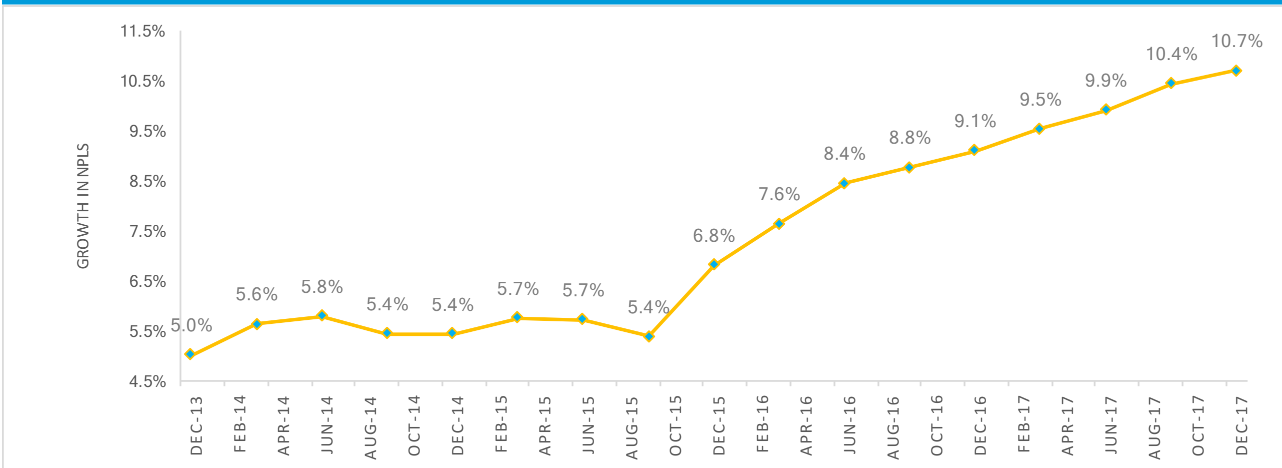


Source: Central Bank of Kenya

Aggressive mobilisation of deposits by banks saw 10.8 percent growth in deposits to KSh.2,900.07 billion in December 2017. Most deposits were demand local currency deposits, implying limited capacity to finance long term assets. Note however that the industry financed its assets through deposits, which accounted for 72.5 percent of total liabilities and shareholders' funds while borrowed funds and shareholders' funds accounted for 4.2 percent and 16.1 percent of the total liabilities and shareholders' funds, respectively.

The asset quality, measured as a proportion of non-performing loans to gross loans, deteriorated from 9.3 percent in December 2016 to 11.0 percent in December 2017, signifying increased credit risks in 2017 (Chart 20). In actual amounts, gross non-performing loans (NPLs) grew by 23.4 percent from KSh.214.4 billion in December 2016 to KSh.264.6 billion in December 2017. Trade, personal/household, real estate and manufacturing sectors accounted for the largest share of NPLs, at 73.1 percent of gross NPLs. Trade sector recorded the largest increase in NPLs, highlighting challenges facing Small and Medium Enterprises (SMEs) and commercial and retail sectors. Many companies, including the listed ones faced cash flow problems due to low business environment, making it difficult to service their loans.

Chart 20: Gross Non-Performing Loans to Total Gross Loans Ratio

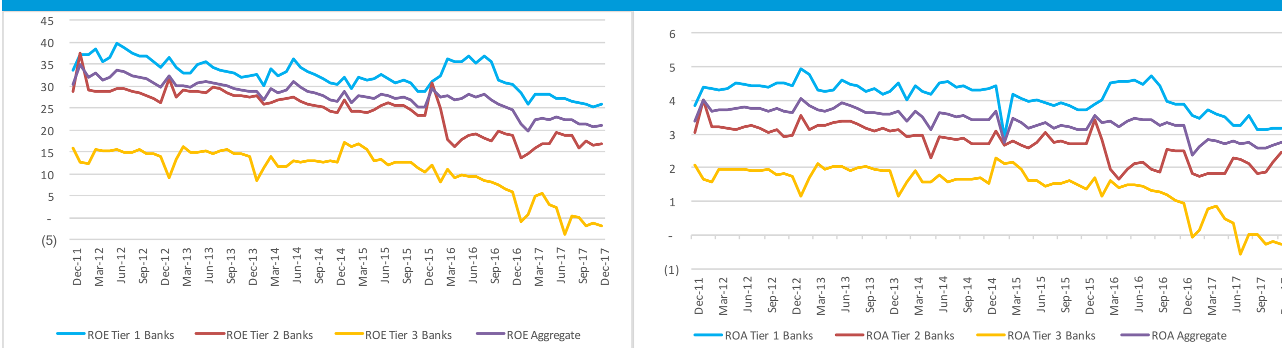


Source: Central Bank of Kenya

In terms of relationship between bank size and NPLs, large tier group banks had lowest Gross NPLs to Gross Loans ratio below the industry average in 2017. Banks in the medium and small peer groups had 'Gross NPLs to Gross Loans' ratios above the industry average in 2017. Decline in the quality of assets in 2017 across the industry could be attributed to slow economic growth. The coverage ratio, measured as a percentage of specific provisions to total NPLs, decreased from 37.6 percent in December 2016 to 34.5 percent in December 2017, implying more exposure.

The banking sector's pre-tax profits decreased by 9.6 percent to Ksh.133.2 billion in December 2017 (Chart 21).

Chart 21: Profitability growth of the Banking sector (Percent)

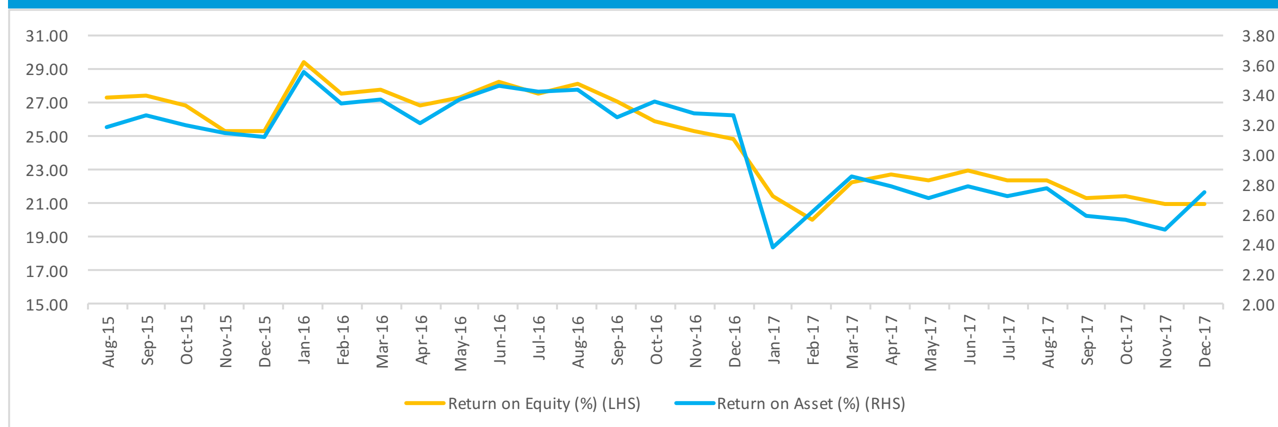


Source: Central Bank of Kenya

Total income decreased by 3.1 percent in 2017 to KSh. 486.3 billion, while total expenses fell by 0.5 percent to Ksh.353.1 billion in December 2017. The decrease in profitability resulted from reduced lending to the private sector, high cost of deposits and slow economic growth in 2017 compared to 2016. A decline in profitability undermines the capacity of banks to build capital buffers using retained earnings to absorb shocks. Profitability declined further in post-caps period, especially from November 2016, making banks more vulnerable to shocks.

Return on Equity (ROE) and Return on Asset (ROA) of the banking sector have continued to decline since late 2016 (Chart 22). The ROE touched the lowest level of 19.8 percent in February 2017 with ROA reaching the lowest level of 2.3 percent in January 2017. As at December 2017, ROA was 2.6 percent from 3.2 percent in December 2016 while the ROE was 20.6 percent from 24.4 percent in December 2016. Erosion of earnings over time may pose risks to financial stability through increased balance sheet risks. Also reduces build-up of capital buffers to absorb any shocks. Profitability was the most affected by this interest rates capping law, although the decline started earlier in 2016.

Chart 22: Return on Asset (ROA) and Return on Equity (ROE)

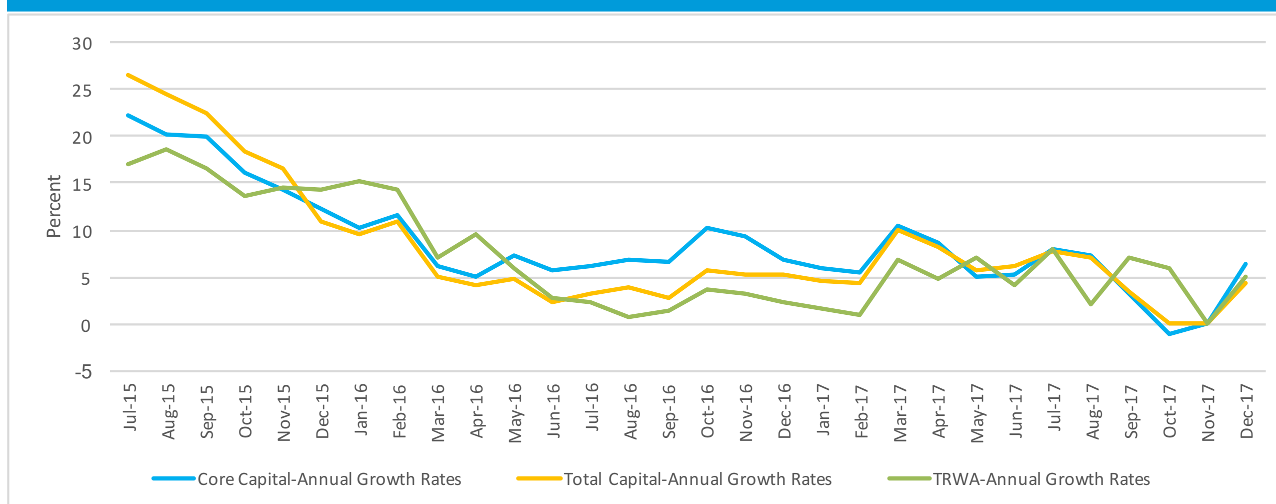


Source: Central Bank of Kenya

Banks' overall liquidity rose from 41.4 percent in December 2016 to 43.7 percent in December 2017 against a minimum ratio of 20 percent. The increase is attributed to 16.3 percent growth in total liquid assets, which are mainly government securities. Total short-term liabilities grew by 10.4 percent. Over the same period, the ratio of gross advances to gross deposits reduced to 83.1 percent in December 2017 from 87.4 percent in December 2016 as deposits grew faster than advances. Liquidity held by a bank signifies its ability to fund increases in assets and meet obligations as they fall due.

Data shows that commercial banks adjusted their business models, in favour of lending to large corporate borrowers and purchase of Government debt. This in turn has reduced lending to small and perceived risky borrowers. Overall, banking sector remains resilient despite interest rates caps. As at December 2017, banks were well-capitalized with core and total capital to risk weighted assets averaging 16.5 percent and 18.8 percent above the regulatory requirements of 10.5 percent and 14.5 percent, respectively **(Chart 23)**.

Chart 23: Growth of Capital of Banking Sector



Source: Central Bank of Kenya

The industry faced a number of risks in 2017, but have been easing over time into 2018. These include;

i) **Credit Risk –** NPLs remained high, with an upward trend in 2017.

ii) **Liquidity Risk –** Liquidity risk was high in some banks, but begun easing towards end of 2017.

iii) **Cyber-Risk –** As banks' operations adopted more technology, threat to cybersecurity became real 2017, making CBK to issue a Guidance Note to banks on cybersecurity in August 2017 as a preemptive measure to mitigate the growing threat.

iv) **Weak viability –** industry profitability has reduced, especially for small banks, thus raising viability concerns.

Going forward, the banking industry is projected to remain robust and stable, with large and medium size banks expected to register robust growth, while small banks may register marginal to no growth. Credit risk and liquidity risks are expected to ease.

3.2 Capital Markets

As of December 2017, the Capital Markets Authority of Kenya licensed firms in the following categories as follows: Securities Exchange (1), Central Depositories (1), Investment Banks (14), Stockbrokers (10), Investment advisers (14), Fund Managers (26), Collective Investment Schemes (23), Authorized depositories/Custodians (14), Credit Rating Agencies (3), REIT Managers (8), REIT Trustees (3), Employee Share Ownership Plans (ESOPS) (14) and Authorized Real Estate Investment Trusts (1). The industry licensees 'assets totalled KSh 26.50 billion from KSh 22.42 billion in 2016 **(Table 7).**

Corporate bond primary market was less active, with only the East African Breweries (EABL) issuing the second and final tranche of its 5-year Medium Term Note (MTN) in May 2017 to raise KSh 6 billion. The EABL-FXD02/2017/5 received bids worth KSh 8.45 billion or 141 percent subscription rate. This brought the total corporate bond amount outstanding to KSh 71.09 billion in 2017 down from KSh 81.12 billion in 2016 following maturities of Centum, Housing Finance of Kenya Corporation, KenGen and Consolidated Bank bonds. Trading in the secondary corporate bond market was just KSh 3.08 billion in 2017, but better than KSh 1.53 billion traded in 2016.

Table 7: Performance of Capital Market Licensees in 2016/17 (KSh Mns)

Name	Year	Total Assets	Total Liabilities	Net Assets	Total Income*	Profit Before Tax	Net Profit/ Loss After Tax
Fund Managers**	2017	7,877.7	1,739.3	6,138.5	5,247.2	953.3	541.1
	2016	5,243.3	2,957.9	2,285.4	4,175.3	-338.0	-244.0
Investment Advisers	2017	1,092.4	1,214.4	-121.9	713.8	444.0	314.6
	2016	675.4	41.9	633.5	499.3	226.5	158.7
Investment Banks	2017	11,281.6	3,065.0	8,216.5	2,438.1	447.7	333.8
	2016	9,122.4	2,053.2	7,069.2	1,972.7	35.9	-26.0
REIT Managers	2017	635.0	159.4	475.6	217.7	13.7	9.6
	2016	737.9	615.2	122.8	268.4	25.9	15.1
Stock Brokers	2017	3,138.4	917.6	2,220.8	503.4	-18.9	-41.4
	2016	4,170.4	1,416.8	2,753.7	641.2	-235.9	-249.1
Total* **	**2017**	**24,025.1**	**7,095.7**	**16,929.4**	**9,120.2**	**1,839.7**	**1,157.7**
	2016	**19,949.4**	**7,084.9**	**12,864.5**	**7,556.9**	**(285.5)**	**(345.3)**
Change (%)		20.43%	0.15%	31.60%	20.69%	744.41%	435.28%

excludes unrealized gains; ** own Assets; * Excluding NSE and CDSC figures*

Source: CMA

Equity turnover for 2017 was KSh 171.6 billion compared to KSh 147.2 billion in 2016, with improved investor participation at the bourse mainly coming from investors. Market Capitalization, a measure of shareholders' wealth grew by 30.55 percent in 2017 to KSh 2,521.8 billion (Table 8).

Table 8: Equity Market Performance

Month/Year	Turnover (KSh Bns)	Share Volume (Mns)	NSE 20 Share Index (Points)	NASI (Points)	Market Capitalization (KSh Bns)
Jan -2017	12.05	572.99	2,794.27	122.23	1,827.27
Feb – 2017	12.60	651.01	2,962.00	124.89	1,812.45
Mar-2017	12.46	636.67	3,112.52	130.50	1,894.34
April-2017	11.41	446.64	3,157.58	133.28	1,935.28
May-2017	16.35	697.06	3,441.05	148.40	2,151.08
June-2017	17.14	749.91	3,607.18	152.92	2,221.29
July-2017	21.30	823.04	3,797.53	161.35	2,358.73
Aug-2017	16.02	640.17	4,027.12	169.16	2,478.62
Sept-2017	16.25	556.71	3,751.46	162.21	2,376.69
Oct-2017	9.39	314.57	3,729.62	161.99	2,373.43
Nov-2017	14.76	524.64	3,804.69	172.92	2,562.41
Dec-2017	11.87	451.94	3,711.94	171.20	2,521.77
Total (2017)	**171.61**	**7,065.36**	**3,711.94**	**171.20**	**2,521.77**
Total (2016)	**147.18**	**5,813.49**	**3,186.21**	**133.34**	**1,931.61**
% Change	**16.60%**	**21.53%**	**16.50%**	**28.39%**	**30.55%**

Source: Nairobi Securities Exchange, 2017

Foreign Investors dominated trading at the NSE, with average net foreign investor participation to total equity turnover at 64.96 percent in 2017, slightly lower than 67.82 percent in 2016 (Table 9). The bourse recorded net foreign portfolio outflow of KSh 11.58 billion in 2017 compared to net portfolio inflow of KSh 5.76 billion in 2016. Equities held by foreign investors were 20.2 percent as at December 2017, down from 21.1 percent in December 2016. The net outflow reflects foreign investors risk jitters in the electioneering year.

Table 9: Foreign Participation Exposure (Equity) in KSh. Millions

Period (Month)	Amounts in KSh Millions				Share to Total Equity Turnover (%)		
	Equity Turnover	Pur-chases (Inflows)	Sales (Out-flows)	Net Portfo-lio Flows	Purchases to Equity Turnover	Sales to Equity Turnover	Average Port-folio flows to Equity Turnover
Jan-17	12,055	10,425	8,817	1,608	86.48	73.14	79.81
Feb-17	12,580	9,448	9,013	435	75.10	71.64	73.37
Mar-17	12,461	9,551	9,601	-50	76.65	77.05	76.85
Apr-17	11,410	8,479	8,045	434	74.31	70.51	72.41
May-17	16,348	9,420	11,308	-1,888	57.62	69.17	63.40
Jun-17	17,144	9,526	10,339	-813	55.56	60.31	57.94
Jul-17	21,305	9,442	11,496	-2,054	44.32	53.96	49.14
Aug-17	16,024	7,507	10,776	-3,269	46.85	67.25	57.05
Sep-17	16,248	6,149	11,947	-5,798	37.84	73.53	55.69
Oct-17	9,390	7,042	6,556	486	74.99	69.82	72.41
Nov-17	14,761	8,142	8,592	-450	55.16	58.21	56.69
Dec-17	11,868	7,575	7,793	-218	63.83	65.67	64.75
Total in 2017	**171,593**	**102,708**	**114,284**	**-11,577**	**62.39**	**67.52**	**64.96**
Total in 2016	**147,178**	**104,270**	**98,511**	**5759**	**69.44**	**66.13**	**67.82**

Source: Capital Markets Authority Report, 2017

Annual Liquidity Ratio averaged 6.81 percent in 2017 down from 7.62 percent in 2016. Gazettment of the Securities Lending and Borrowing Regulations to operationalize the introduction of Securities lending and borrowing and short selling could increase overall market liquidity and flexibility of financing by increasing the volume of securities potentially available for trading. This could further increase the depth and efficiency in the capital markets through price discovery **(Table 10).**

Table 10: Market Liquidity

Year	Equity Turnover (KSh Billions)	Market Capitalization (KSh Billions)	Liquidity Ratio (ET/Market Cap)
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%

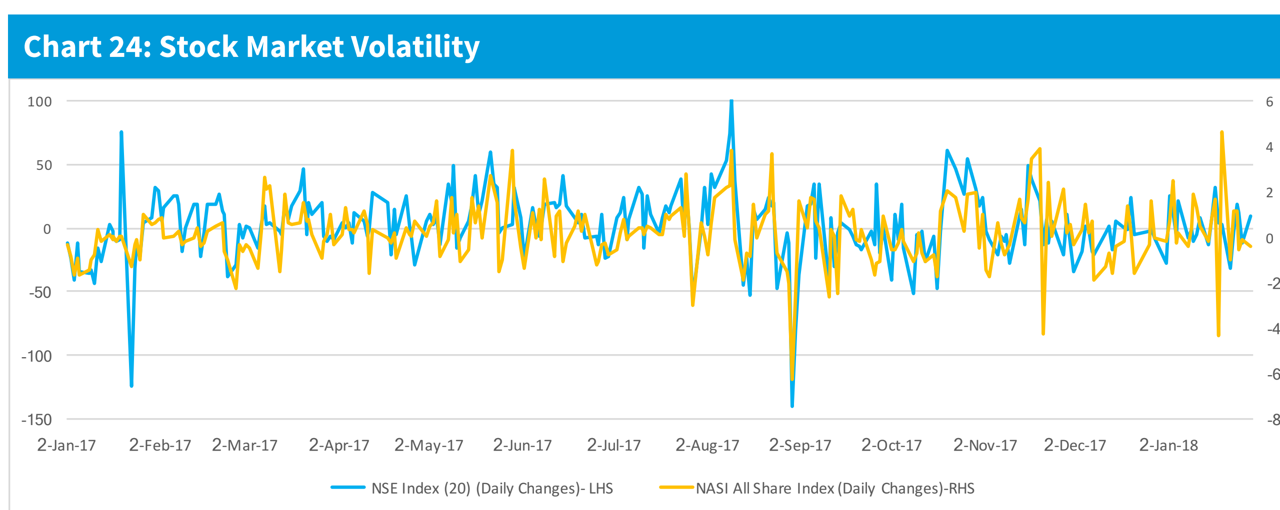
Source: Capital Markets Authority Report, 2017

Risks in the capital markets include high concentration by counters and investor category, low liquidity, low products uptake, political and economic risks. As at December 2017 the market concentration risk exposure of the top five companies by market capitalization was 64.83 percent, with Safaricom accounting for 42.50 percent of the total market capitalization. Exchange Traded Funds (ETFs) and IREIT recorded low uptake in 2017, pointing to sub-optimal levels of uptake. Macro-economic and Political risks in 2017 impacted the market negatively.

Negative sentiment around political risk in Kenya during 2017 elections significantly impacted performance of stock markets and overall economy. Rapid growth in public debt, accompanied by debt sustainability concerns is threatening uptake of more bonds, hence reduced liquidity. CMA has been active in highlighting the risks in market issuances.

Stock market Volatility was observed in the run-up to the two elections (August and October 2017), reflecting investors' risks perception. Volatility eased towards the end of 2017 **(Chart 24).**

Chart 24: Stock Market Volatility



Source: Capital Markets Authority Report

3.3 Insurance Industry

The insurance industry grew by 5.62 percent in Gross Premium Income, 18.58 percent in investments and 10.61 percent in Assets in 2017 (Table 11). To ensure stability of the industry, IRA introduced several regulatory changes through Insurance (Amendment Act) No. 22 of 2017, covering: Introduction of perpetual licensing for insurers, Introduction of group wide supervision and the harmonization of the Capital requirement provisions in the Insurance Act.

Source: Insurance Regulatory Authority Report, 2017

Table 11: Summary of Industry performance for last five Years

Indicator	Amounts in KSh Millions				
	2013	2014	2015	2016	2017
Gross Premium Income	135,384.92	157,732.06	174,039.16	196,635.84	209,001.30
Net Premium Written	105,013.41	126,333.48	139,377.05	158,362.43	165,852.03
Claims Incurred (general business)	34,170.15	42,677.70	48,811.20	54,857.50	56,151.97
Net commissions	7,204.45	14,332.66	10,833.47	12,578.74	12,495.18
Expenses of Management	24,808.27	49,249.46	35,991.67	39,982.77	41,197.26
Underwriting Results (general business)	3,402.77	1,604.51	(274.19)	(2,125.73)	(1,027.85)
Investment Income(P&L)	9,429.21	11,095.06	6,294.52	5,338.51	6,596.59
Operating profit/loss after taxation	20,235.88	17,232.02	13,564.43	12,835.31	13,642.97
Investments	296,336.80	355,009.40	390,225.35	425,304.14	483,799.66
Assets	366,252.34	430,536.10	478,752.46	528,748.19	590,953.33
Shareholder's Funds	100,958.03	114,141.21	125,830.03	134,455.22	147,255.00

Source: Insurance Regulatory Authority Report 2017

The Act was also amended to replace the requirement of admitted assets with that of total assets. The IRA also published guidelines to operationalize the Risk based capital and investment - Insurance (Valuation of Technical Provisions for General Insurance Business) Guidelines, 2017 (L.N 37 of 2017). Insurance (Valuation of Technical Provisions for Life Insurance Business (Guidelines, 2017 (L.N 38 of 2017). Insurance (Capital Adequacy) Guidelines, 2017 (L.N. 39 of 2017). The industry is expected to perform better in 2018 as the economy picks up and political tensions disappear.

3.4 Pensions Industry

The assets under management for retirement benefits industry registered robust growth of 18.35 percent in 2017 compared to 2016, driven mainly by growth in investments quoted equities and immovable property **(Table 12).**

Table 12: Overall Industry Investment Portfolio (KSh. Billion)

Asset Category	December, 2015		December, 2016		December, 2017	
	KSh. Billions	Percent	KSh. Billions	Percent	KSh. Billions	Percent
Government Securities	242.43	29.78	349.15	38.26	394.19	36.5
Quoted Equities	186.81	22.95	159.07	17.43	210.17	19.46
Immovable Property	150.78	18.52	178.42	19.55	226.72	20.99
Guaranteed Funds	99.4	12.21	129.58	14.2	142.97	13.24
Listed Corporate Bonds	48.09	5.91	46.95	5.14	41.99	3.89
Fixed Deposits	55.61	6.83	24.57	2.69	32.88	3.04
Offshore	7.16	0.88	6.96	0.76	12.77	1.18
Cash	11.26	1.38	12.93	1.42	12.95	1.2
Other Assets*	12.57	1.54	5.03	0.55	5.47	0.5
TOTAL	**814.11**	**100.00**	**912.66**	**100.00**	**1080.11**	**100.00**

Source: Retirements Benefits Authority

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

Total assets crossed the KSh 1 trillion psychological mark in the second half of 2017 for the first time since RBA was established. Growth in the assets is attributed to improved compliance, gradual recovery in the stock market after the bank crisis in 2016 and modest recovery in property market. The top three asset classes that accounted for a total of 76.95 percent of all portfolio of assets are; government Securities at 36.5 percent, immovable property at 20.99 percent and investments in quoted equities at 19.46 percent. Pensions industry however face a number of risks and vulnerabilities, including but not limited to:

- **Investment Risks** -schemes' highly exposed to government securities and quoted equities face interest rates and market risks while those invested heavily in immovable property (buildings and land), face liquidity risks. Schemes also face inflation risk, currency (exchange rate) risk, and credit or counter party risk. To mitigate these risks, RBA expanded amended table G of investment guidelines to broaden asset classes, allowing schemes to invest in new asset classes such as private equity, real estate investment trusts and derivatives. Schemes are also to invest in infrastructural projects for a reasonable rate of return even they provide long funding for government projects.

- **Operational and legal risks:** emanating from inadequate or failed internal processes, people and systems or external events due to weak policies among various schemes. Lack of clear policies on appointment of service providers and other outsourced providers to the schemes has resulted to increased member complaints due to missing records and wrong computation of benefits, leading to increased litigations. The sector has recorded increased litigations from members on low benefits, wrong benefits computations especially following conversion of schemes from defined benefits to defined contribution, unremitted contribution and retrenchments, with quasi government schemes most affected.

- **Governance Risks:** arising from conflict of interest either by service providers or the trustees.

- **Funding Risks:** common to defined benefits schemes largely due to increasing longevity risk of members, limited long term investments vehicles, and unremitted contributions.

The 2018 growth projections is expected to outperform 2017 as the economy rebounds, with positive impact on capital markets, lifting up stock prices and therefore improved returns.

3.5 The SACCOs Industry

Deposit-taking Sacco's remain significant players in providing credit to households owing to their social nature in formation and operation **(Table 13).** The full effects of the Banking Amendment Act, 2016, commonly known as interest capping law will have an impact on the comparative advantage DTS have been making to their members through interest rebates as banks are statutorily required to pay interest based on predetermined rate published by CBK. SASRA renewed licenses for all the 176 deposit-taking Sacco's. SASRA received five (5) new applications from Sacco's intending to conduct DT-Sacco business in 2017. Savings deposits remain the single largest source of DT Sacco's finance, reinforcing the Sacco model of deposit mobilization for on-lending. Table 13 summarizes performance of DT – Saccos.

Table 13 Saccos Performance Indicators

Indicator	Amounts in KSh. Millions 2017	2016	Change in Percentage (%)
Assets	442,277	393,499	12.4
Loans	331,212	297,604	11.29
Deposits	305,305	272,579	12.01
Capital and Reserves	72,328	61,261	18.07
Core Capital	64,254	54,943	16.95

Source: SASRA

Key stability indicators show strong cushion for institutions to absorb business risks as measured by capital adequacy, capacity to generate earnings and liquidity (Table 14). Credit risk with rising non-performing loans on account of unfavourable weather conditions that impacted negatively Saccos in the Agricultural sector, slow economy and prolonged political uncertainty.

Table 14: SACCO Subsector Stability Indicators

Capital Adequacy	2016	2017
Core Capital (Ksh. Million)	54,943	64,254
Core Capital/Total Assets	14.0%	14.5%
Core Capital/Total Deposits	20.2%	21.1%
Institutional Capital/Total Assets	7.7%	8.2%
Asset Quality		
Non-Performance Loans(NPLs) to Gross Loans	5.2%	6.1%
NPLs net of Provisions to Core Capital	7.6%	9.9%
Earning Assets to Total Assets	80.7%	78.5%
Earning Rating		
Return on Assets	2.5%	2.7%
Cost Income Ratio	62.8%	66.1%
Non-Interest Expenses to Gross Income	41.4%	43.9%
Operating Expenses to Total Assets Ratio	5.4%	5.3%
Liquidity Ratio		
Liquid Assets/ Savings Deposits +STLs (Liquidity Ratio)	49.9%	54.1%
Liquid Assets/Total Deposits	18.1%	17.2%
External Borrowings/ Total Assets	5.0%	4.8%
Liquid Assets/ Total Assets	12.5%	11.9%
Total Loans / Total Deposits	**108.4%**	**108.5%**

Source: SASRA annual Report 2017

In 2017, SASRA held various stakeholders forums to address identified legal and regulatory gaps in response to changing market dynamics in order to strengthen member institutions. The forums addressed the following proposals;

- **Baseline Survey on Sectoral Lending-** With the opening of common bonds, deposit taking Saccos are serving wider segment of the society. DT-Saccos support farmers, teachers, government employees, Community-based and employees working in the private sector. There is no uniform activity that DT-Saccos lend, making it difficult to assess their contribution to the economy.

- **Central Liquidity Facility-** Deposit taking Sacco's do not have authorization to directly access the national payment system, lender of last resort, credit bureau and deposit insurance. This limits them in attaining efficiency benefits in financial intermediation and stability. SASRA engaged a Consultant to develop CLF, whose interim report is out and under consideration.

- **Deposit Guarantee Fund -** While establishment of deposit protection fund is provided for in the Sacco Societies Act, it has not been operationalized due to financial and legal challenges. This has the risk of eroding members' confidence in the Saccos, thus limiting mobilization of domestic savings for economic growth. SASRA, with support from FSSP, has engaged a consultant to review the legal framework for the full operationalization of the fund.

- **Risk Based Supervision –** SASRA has been implementing RBS model while applying the CAMEL rating framework as proactive approach in identifying risks associated with deposit taking Sacco business. The approach uses onsite and offsite examinations, information sharing and prudential meetings. The lessons learnt include entrenching risk management culture in governance and management of the Sacco's to guarantee safe and sound business practices. SASRA is reviewing its supervisory framework to align it to Basel Core Principles, ICURN guiding principles for effective Credit Union Supervision.

3.6 Deposit Insurance

KDIC's mandate is a "risk minimiser" with comprehensive risk minimisation functions that include risk assessment and management, a full suite of early intervention and resolution powers, and in some cases prudential oversight responsibilities. KDIC provides a deposit insurance scheme for customers of member institutions' licensed by the Central Bank of Kenya as deposit taking Institutions. Membership is mandatory for all deposit taking institutions licensed by CBK. As at 31st December, 2017 there were 55 member institutions comprising of 41 commercial Banks, 1 Mortgage Finance Company and 13 deposit taking microfinance banks. The total number of deposit accounts with the member institutions increased from 43,247,522 in to 49,882,056 in 2017 **(Table 15).**

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

PERIOD ENDING/INDICATOR	June-2015	December-15	December-16	December-17
Total No. of A/Cs	33,936,072	37,353,419	43,247,522	49,882,056
Total No.of Deposit A/Cs	33,936,072	37,353,419	43,247,522	49,882,056
Semi-Annual Increase	3,238,368	3,417,347	5,894,103	6,634,534
Change Deposit A/Cs (%)	-	10.07	15.80	13.00
Total Deposits (KSh'000')	2,630,907,822	2,673,953,860	2,783,718,808	3,075,472,267
Insurance Cover (KSh'000')	246,771,544	244,646,706	255,534,863	271,991,383
Fund Growth (KSh'000')	54,914,117	61,726,669	72,184,024	85,955,018

Source: Kenya Deposits Insurance Corporation Report, 2017

Fully protected accounts stood at 97 Percent, thus meeting the public policy objective. Of the total deposits of KSh.3.07 trillion, KSh. 271.991 billion were fully protected in 2017 or just 9 percent of the total deposit value against a recommended value of 20 percent by International Association of Deposit Insurance (IADI). With a fund balance of KSh. 85.956 billion, only 32 percent of total exposure was covered **(Table 16).**

Table 16: Summary of Protection & Exposure Indicators

Banking Sector Deposits	Dec. 2015	Dec. 2016	Dec.2017	Change
Total Deposits (KSh M)	2,673,956	2,783,719	3,075,472	10.5%
Total Protected Deposits (KSh M.)	244,647	255,535	271,991	6.4%
Protection Level (2/1)	9.20%	9.20%	9.00%	-0.2%*
Funds Balance (KSh M)	61,730	72,184	85,955	19.1%
Effective Cover (4/2)	23.20%	28.30%	31.60%	3.3%*
Deposit Accounts				
Number of Deposits ('000)	37,353	43,247	49,882	15.3%
No. of accounts fully protected ('000)	36,096	41,833	48,306	15.5%
Share of Protected accounts (7/6)	96.70%	96.80%	97.00%	0.2%*
Exposure Level	74.80%	71.80%	68.00%	-3.8%*

Source: Kenya Deposits Insurance Corporation Report, 2017

** means percentage points*

3.7 Financial Markets Infrastructure

Payment systems in Kenya have been undergoing changes in recent years, including innovations around electronic-based payment systems. The CBK has actively supported these innovations, thus promoting efficiency in business operations, cost reductions, enhanced security, and wider payment channel choice. However, these have come with cybersecurity threats given its interconnectedness and heavy reliance on information technology. The Bank has intensified its surveillance and monitoring role to identify and take action to mitigate against in a timely manner for enhanced financial system stability.

The RTGS activities recorded an average increase of 5.03 per cent in value but declined by 1.93 per cent in volume in 2017 (Table 17). Kenya Electronic Payment and Settlement System (KEPSS) had 4.4 million transaction messages worth KSh 29.1 trillion compared to a volume of 4.0 million transaction messages worth KSh 26.7 trillion in 2016. This reflects increased usage of KEPSS. Direct settlements through KEPSS by commercial banks accounted for an average of 98.0 per cent of the total activity through KEPSS while the Net Settlement Instruction (NSI) or activity through the ACH to KEPSS accounted for an average 2.0 per cent of the total activity.

Table 17: KEPSS System Flows

YEAR	Amount (KSh Bns)	Growth (%)	Messages Moved	Growth (%)
2012	19,879	7.2	1,568,125	14.9
2013	22,669	14.03	1,977,885	26.13
2014	25,561	12.76	2,525,337	27.68
2015	29,579	15.72	3,105,850	22.99
2016	26,694	-9.75	3,974,327	27.96
2017	29,142	9.17	4,375,207	10.09

Source: Central Bank of Kenya

The ACH activity rose marginally in transactions volume cleared and settled in December 2017 but the values declined significantly (Table 18). The decrease in transactions value of cheques and EFTs through ACH may reflect the impact of innovations such as Pesalink offered by Integrated Payment Services Limited. Pesalink is a real time mobile based interbank account money transfer service whose limits are the same as the cheques and EFTs.

Table 18 Automated Clearing House Performance

Year	Volume cleared (000's)	Value cleared (KSh. billion)
2014	30,282.40	3,021
2015	30,954.80	3,169
2016	31,220.50	3,180
2017	31,279.90	1,704

Source: Central Bank of Kenya

Electronic payment card market has been dominated by commercial banks and merchants over the years, comprising of credit cards, debit cards, prepaid cards, charge cards and proprietary Automated Teller Machine (ATM) cards which have been phased out. The number of active cards in 2017 increased from 14.8 million in 2016 to 15.4 million cards in 2017 but transactions processed through ATMS and POS terminals decreased from 216.2 million transactions valued at KSh 1.40 trillion in 2016 to 215.6 million transactions valued at KSh 1.39 trillion. The usage of cards faces competition from other payment channels especially from mobile money payment services **(Table 19).**

Table 19: Payment Cards Developments

Year	No. of Cards	No. of ATMs	No. of POS Terminals	Transactions Volume(Mns)	Transactions Value (KSh. Mns)
2014	13.9	2,613	17,511	265.1	1,265,261
2015	13.2	2,718	22,230	229.9	1,348,215
2016	14.8	2,656	30,133	216.2	1,396,522
2017	15.4	2,825	35,466	215.6	1,389,381
Change	**4.05%**	**6.36%**	**17.70%**	**-0.28%**	**-0.51%**

Source: Central Bank of Kenya

Mobile money continues to deepen financial inclusion, with the number of subscribers to mobile money services increased to 37.4 million in 2017 from 35 million in 2016. The values transacted through the mobile money platform grew by 8 percent in 2017 compared to 19 percent growth rate in 2016 **(Table 20).**

Table 20: Mobile Money Activity

Indicator / Year	2014	2015	2016	2017
Number of agents	123,703	143,946	165,908	182,472
Mobile money Accounts (Mns)	25.8	28.6	34.9	37.4
Number of transactions (Mns)	911.3	1,114.20	1,331.00	1,543.50
Value of transactions (KSh. Bns)	2,371.80	2,816.10	3,355.10	3,638.50
Average value per transaction (KSh)	2,602.66	2,527.46	2,520.74	2,357.30

Source: Central Bank of Kenya

A reliable payment system instils confidence among domestic and international investors that the payments can always be made, even in the most extreme circumstances. The ability of an RTGS system to provide certainty of settlement without or minimal payment risk is an essential component of the financial infrastructure of an economy. During January to December 2017 period, KEPSS operations were smooth without outages. The system recorded an optimum 99.99 per cent availability.

Stable liquidity in the interbank in 2017, saw the Bank advanced less overnight loans to commercial banks in its role as lender of last resort. KEPSS participants borrowed a total of KSh.1.2 billion in 2017 compared to KSh.16.9 billion in 2016 or 92.86 per cent decline. However, Window Extensions granted to banks in KEPSS in 2017 remained active indicating liquidity distribution challenges for some banks.

The CBK has developed a framework for identifying internal and external threats to KEPSS in order to enhance the ability of the payment system to effectively withstand and respond to threats such as natural disasters or data breaches. Business Continuity Plans (BCPs) includes disaster recovery, business recovery, crisis management, incident management, emergency management and contingency planning. Under the BCP,

the KEPSS has internal and external continuity as well as back up arrangements that are effective and compatible. The backups systems are able to resume and sustain critical operations following the loss or inaccessibility of one major operating site; or following a wide-scale, regional disruption.

In the mobile money space, mobile network operators (MNOs) have interconnected their services on a trial basis in April 2017 from pressure from CBK and the Ministry of Information, Communication and Technology. This has created account-to-account (A2A) interoperability in mobile money transfer services, which allows customers to transact between different mobile money schemes. The A2A interoperability aims to increase the value of mobile money for providers and customers alike, including a larger addressable market and enhanced customer service.

Going forward, we expect market infrastructure to remain stable and robust and characterized by accelerated innovations and technological transformation especially in the retail space. The regulators stand ready to ensure stability and appropriate risk mitigation measures against potential cyber threats.

Chapter 4: Risks Outlook and Prospects in 2018

Kenya's financial sector is stable and resilient albeit emerging vulnerabilities associated with both domestic and external uncertainties. In particular;
Risks to the outlook are broadly balanced in the near term;

- Tightening of global financing conditions from their current, either in the near term or medium term.
- Global trade tensions involving developing economies and protectionist policies are a threat to global stability.
- Brexit trade negotiations are creating uncertainties, with potential implications to stability.

Downside risks in Sub Saharan Africa are real and emanate from advanced economies and geo-political tensions. These include;

- **Higher external market premium for sovereign bonds** due to changing investor sentiment, a more rapid than expected tightening of global monetary conditions, and a further drop in commodity prices.
- **Sovereign downgrade risks could further weigh on the investment** climate and adversely affect growth, particularly in South Africa, with potential regional spillover effects. In the medium term, risks are skewed to the downside.
- **Delays in implementing policy adjustments would reduce fiscal space,** adversely impacting the economies through crowding out of the private sector.

Domestically, downside risks are associated with;

- Potentially low bank credit to the private sector on weak corporate balance sheets and delays in reversing the interest rates capping law.
- Slow pace of easing credit risks, which may slow down the speed of credit expansion to support accelerated investments.
- Rapid public debt accumulation need to match with accelerated GDP for it to remain sustainable.

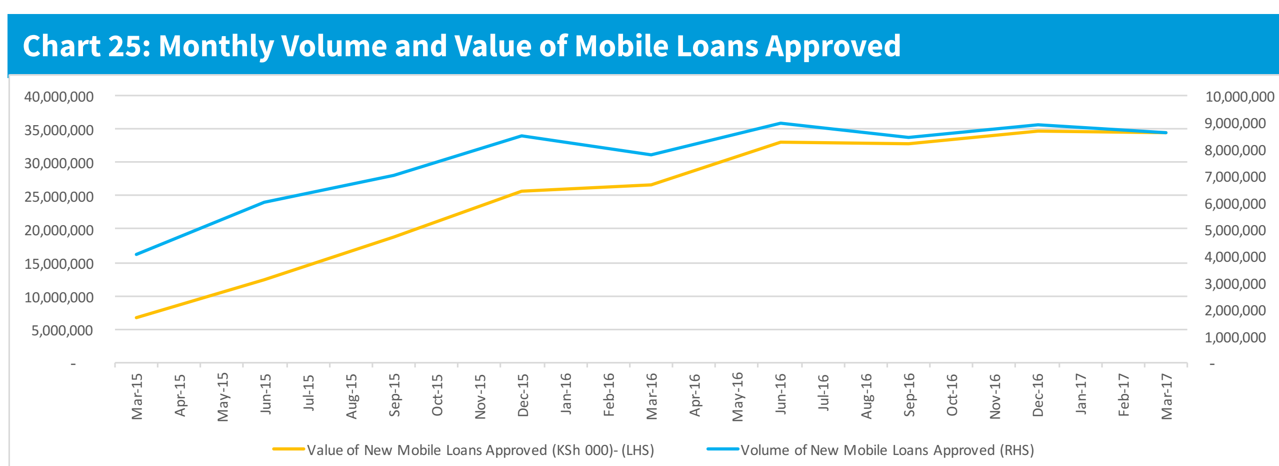
Opportunities however exist despite the risks above;

- Continued public infrastructure development key to supporting growth, with positive effects on financial sector.
- The continued banking sub-sector reforms under the 'new normal' regulation is expected to enhance stability of the Kenyan financial systems hence unlocking credit flows and capital flows to propel economic growth.
- Future positive growth prospects hinged on discovery of natural resources and growing middle class.

Special Feature: Balancing Financial Inclusion and Stability in the Digital Credit Space

Digital credit has expanded dramatically in Kenya since adoption in 2015. Financial institutions seek ways to leverage digital channels to expand access to credit products among previously excluded and credit-constrained populations.[3] FinAccess Digital Credit Tracker 2017 show that 26 percent of Kenyans are digital borrowers, and about 17 percent borrowed digital loans in the last 90 days.[4] There are more than 20 digital credit providers in Kenya, including; Mshwari, KCB M-Pesa, M-Coop Cash, and Equity Bank's Eazzy Loan. The digital credit ecosystem also includes a range of non-bank, credit-only lenders that currently operate outside of the regulatory perimeter of CBK. As at March 2017, the volume of new mobile loans approved monthly by commercial banks had increased by 53 percent, while the value of new mobile loans approved monthly increased by 81 percent. In March 2017, 8.6 million mobile loans were approved, representing a total value of KSh 34.5 million **(Chart 25).**

Chart 25: Monthly Volume and Value of Mobile Loans Approved



Source: Central Bank of Kenya

Digital loans tend to be short-term and require no collateral, and are generally low in value. Most of the lending platforms use mobile phone-based data, such as call records or social media data, to make near-immediate lending decisions via automated processes. The convenience of these platforms have in part driven their rapid growth, with Mshwari reaching 12 million customers in only three years.[5] The loan sizes range, on average, between KSh 1000 to 5000 to start, but larger loans can be accessed through repeated borrowing or positive savings behaviour, among other factors as determined by specific lenders. The fees charged on digital loans generally range between 6 percent to 10 percent monthly for a one-month loan, which is relatively expensive as compared to traditional formal loans, (microfinance institutions, for example, tend to average near 30 percent annually).[6]

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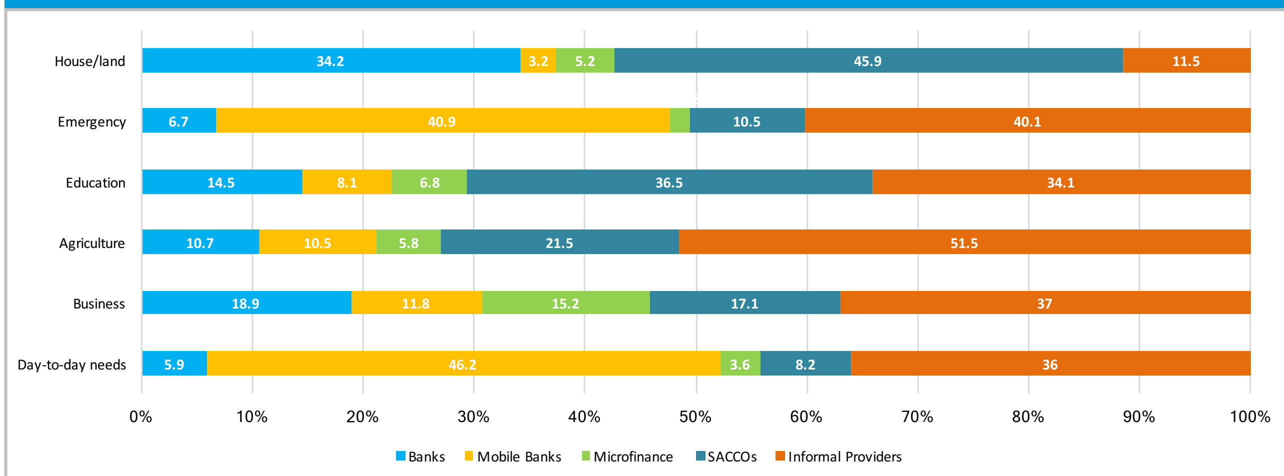
[3]For the purposes of this publication, "digital credit" refers to unsecured loans that are obtained fully via digital channels, such as mobile phones or the Internet, without the involvement of a salesperson, that use digital channels for loan disbursement and collection, and that leverage digital data to make lending decisions via automated processes (CGAP, 2017).
[4]The Digital Credit Tracker Survey was conducted in 2017 with a nationally representative sample of N=3,150 phone owners, of who 1,037 have ever used digital credit. Mobile phone ownership is estimated from FinAccess Household Survey 2016 data.
[5]"Digital Credit's Evolving Landscape: 3 Things You Need to Know," CGAP, Vidal and Hwang, 20 April 2017.
[6]"Consumer Protection in Digital Credit," CGAP Focus Note No. 108, Mazer and McKee, August 2017.

The FinAccess Digital Credit Tracker Survey 2017 showed that 35 percent of Kenyan phone owners are digital borrowers, therefore yielding an estimated market of 6.1 million unique digital borrowers in Kenya. The most commonly-used digital lending product is the Mshwari product, though competitors such as KCB Mpesa, Equity Eazzy, Tala, MCoop Cash and Branch are increasingly being used. Demonstrating the ease of accessing digital credit, 14 percent of digital borrowers were repaying multiple digital loans at the time of the survey. Analysis of the demographic profile show that digital credit users are more likely to be male, young, more educated, and to run their own business or be employed.

Credit extension via digital channels holds promise for expanding financial inclusion. As an instant, fully automated process that does not require a bank branch, digital credit creates an alternative avenue of financing for borrowers who may have previously faced constraints in accessing more traditional forms of credit. Digital credit can thereby enable previously credit-constrained individuals and entrepreneurs to smooth consumption, mitigate risks, and to invest in productive enterprises or human capital, in order to grow their businesses and improve their livelihoods. Usage of these products can further enable new credit users to build digital credit records, which they can leverage to enter formal financial system.

FinAccess Household Survey 2016 shows that digital credit fills an important gap in the credit market – providing short-term, easy-to-access liquidity. Mobile banks are the primary source of funds for both meeting day-to-day spending needs and emergencies, which are not met by banks or microfinance institutions, that traditionally target longer-term loans for houses/ land or business . The FinAccess Digital Credit Tracker Survey 2017 corroborates the evidence that most digital borrowers use digital credit for business purposes, meet household needs, and meet education expenses **(Chart 26).**

Chart 26: Reasons for Taking Loans by Institution Type (%)

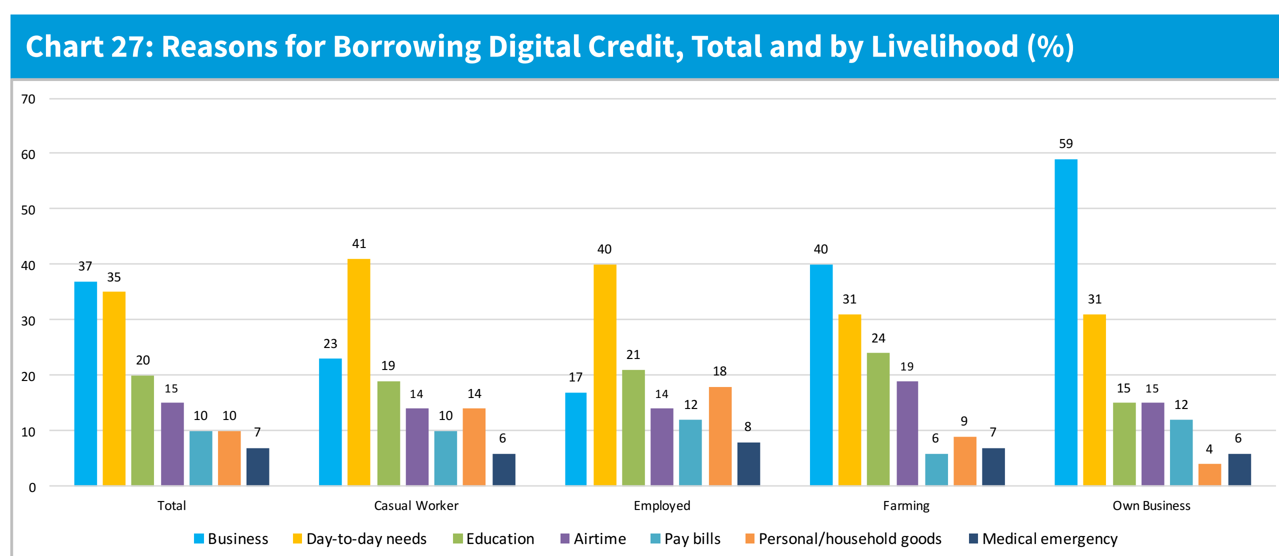


Source: Central Bank of Kenya

In terms of digital loans for livelihood, entrepreneurs and farmers mainly use digital credit for business, while employees and casual workers tend to use digital loans to meet day-to-day needs **(Chart 27).**

There are concerns that increased usage of digital credit predisposes the economy to risks in terms of credit risks, money laundering/terrorist financing risks, and technology risks. Whereas digital credit channels can expand inclusion by reducing borrowing constraints, research has shown that financial stability risks increase when access to credit is expanded without proper supervision. It is therefore important that regulators are cautious to protect consumers and enhance stability of the financial sector.

Chart 27: Reasons for Borrowing Digital Credit, Total and by Livelihood (%)



Source: Central Bank of Kenya

Statistics from CBK indicate that the NPL ratio for digital loans extended by banks is consistently higher than that for the entire bank loan portfolio (Table 21). In 2016, the NPL ratio for bank digital loans averaged 26.98 percent as compared to 8.53 percent for all bank loans. In 2017, the difference was less pronounced, with an 11.4 percent NPL ratio for digital loans as compared to a 9.69 NPL ratio on average for all bank loans.

Table 21: Non-Performing Loans > 90 Days: Digital vs. Total Bank Loans

INDICATOR/YEAR	2015	2016	2017
Non-performing loans (KSh '000) > 90 Days Balance [A]*	1,158,147	4,473,909	1,457,247
Total outstanding loans (KSh '000) [B]*	10,220,712	16,584,870	12,780,769
Non-Performing Loans>90 Ratio [A/B]*	11.33%	26.98%	11.40%
Non-Performing Loans>90 Ratio (All Banks Annual Avg.)	5.71%	8.53%	9.69%

Source: Central Bank of Kenya

** for digital loans from commercial banks only*

FinAccess Digital Tracker Survey 2017 data show that 49 percent of male and 45 percent of female digital borrowers have delayed in repaying their digital loans, with poor business performance, loss of the source of income and poor planning cited as the main reasons for late repayment. In general, 25 percent of digital borrowers reported that repayment periods were too short, while 19 percent noted lack of transparency in terms of fees or loan terms. Digital borrowers are almost twice as likely to have tried mobile betting at least once in their life, as compared to non-users of digital credit. This suggests that digital lending may tempt individuals to take digital loans to finance gambling or other risky behaviors, and in turn reduce the ability to re-pay loans. This can increase household indebtedness.

In some jurisdictions, efforts to enhance financial inclusion have entailed a shift in know-your-customer (KYC) regimes - tiered-KYC systems to allow the opening of basic, "no frills" bank accounts with minimal KYC requirements. While this can be a useful strategy to bring the unbanked into the formal financial system, it also has the potential to bring Anti-Money Laundering (AML) / Counter-Terrorist Financing (CFT) risks, in the absence of strong AML/CFT frameworks. In the context of digital credit, these risks may further be amplified, as digital lenders generally do not require in-person KYC assessment prior to extending digital loans. Despite increasingly strong digital identity systems and even the emergence of e-KYC platforms, there may be a trade-off between the ease and speed of obtaining digital loans, and protection against AML/CFT risks. This is particularly true when considering credit-only digital lenders that are operate outside of the current regulatory perimeter and thus are not subject to the same regulatory oversight as commercial bank digital loan products.

Appropriate and timely policy intervention may mitigate stability risk emanating from financial inclusion through digital credit. The CBK has taken actions to ensure that inclusion does not come at the expense of stability. In particular, the Bank and other financial sector regulators are strengthening policies in consumer financial protection, anti-money laundering (AML) and counter-terrorist financing (CFT), and technology risk mitigation.

i. **Consumer Protection and Financial Education:** Building strong consumer protection frameworks and policies can ensure that financial inclusion does not create financial stability risks. As newly-banked consumers enter the financial system, consumer protection regulations are necessary to protect them against exploitation. Regulators need to ensure effective transparency in credit pricing and disclosure of terms and conditions to enable consumers make informed decision in borrowing. To this end, CBK and the Kenya Bankers' Association (KBA) launched in 2017 a Cost of Credit portal, which allow consumers to compare the cost of credit across different products and providers to enhance transparency. Other consumer protection concerns include data privacy, agent liquidity, and unclear or limited recourse in the case of disagreements between consumers and providers. CBK continues to prioritize these issues, which require collaboration with other national and international regulators.

ii. **AML/CFT Frameworks:** Continued strengthening of AML/CFT frameworks will ensure that any leniency in KYC procedures in an attempt to increase inclusion does not unintentionally create AML/CFT risks. This requires coordination across domestic and international entities, as interconnections among financial service providers and cross operations rise.

iii. **Technology Risk** - As digitization of lending takes root, new technology risks have emerged, with implication on financial stability and consumer trust, hence the need for strong mitigation measures for data privacy breaches and cybercrimes. CBK issued cyber-security guidelines to commercial banks in 2017, and continues to work with national and international stakeholders to mitigate cyber-security risks.

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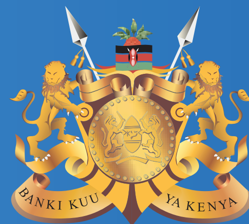

Haile Selassie Avenue P. O. Box 60000 - 00200 Nairobi
Tel: 20 - 2860000/2861000/ 2863000 Fax: 20 - 340192