KENYA FINANCIAL SECTOR STABILITY REPORT, 2013

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FOREWORD BY THE FSRF CHAIRPERSON

This fifth edition of the Financial Stability Report, 2013 (FSR, 2013) is a joint report of the five financial sector regulators in Kenya, namely: the Central Bank of Kenya (CBK); the Capital Markets Authority (CMA); the Insurance Regulatory Authority (IRA); the Retirement Benefits Authority (RBA); and the Saccos Societies Regulatory Authority (SASRA). This report is prepared as part of the collaboration of the five regulators under the Memorandum of Understanding (MoU) signed in September 2009 and revised in August 2013.

The report presents trend analysis and in-depth assessment of the global and domestic macro-financial developments affecting and emanating from the macroeconomy and the financial system. It analyses the performance and interactions involving the real economy, financial markets, financial institutions, financial infrastructure, and review of the legal and policy frameworks in 2013. The report also discusses the developments in the first half of 2014 to inform the outlook and potential areas of surveillance for 2014/2015.

The financial system has grown tremendously backed by enhanced innovations over the last five years as a result of major reforms undertaken by all the five regulators. The FinAccess National Survey Report 2013 released in October 2013 revealed that about 67 percent of Kenya's adult population access formal financial services up from 41 percent in 2009 and 27 percent in 2006. In addition, the FinAccess GIS Mapping of all financial access touch points report launched in early 2014 show that 77 percent of adult population in Kenya live within 5 km of a financial service provider compared to 35 percent in Tanzania, 47 percent in Nigeria and 43 percent in Uganda. Bringing this proportion of the population into the formal financial system comprising of banking, insurance, pension, capital markets and cooperative unions subsectors is not only a major achievement by the regulators, but also shows how the overall economy is becoming fully integrated with the financial system.

To examine some of the most recent statistics on the sector's contribution to Kenya's economy: Banking subsector by total assets accounted for 71.2 percent of the country's Gross Domestic Product at Current Market Prices in 2013; Pension subsector accounted for 18.3 percent of GDP; Insurance subsector accounted for 9.6 percent; while Saccos subsector accounted 8.8 percent of GDP. Capital Markets measured by market capitalisation accounted for 50.6 percent of GDP in 2013. Overall, the financial sector excluding capital markets accounted for 108 percent of GDP in terms of total assets to GDP at Current Market Prices. This compares with other modern financial systems in countries like Switzerland at 680 percent of GDP, UK at 439 percent, Sweden at 243 percent, and the European banking system average of 191 percent of GDP in 2012.

Successful issuance of the debut Eurobond in the international market in June 2014, which was subscribed more than 5 times against the USD 1.5 billion offered at competitive yields of 5.9 percent to 6.9 percent, underscores the importance of Kenya's financial system. The vibrant capital markets, dynamic and innovative banking system, high performing equities markets, a more stable insurance sector and vibrant pension sector makes the future of the domestic financial system bright. Robust regulation covering all facets of the financial system would guarantee the current growth momentum and further deepen the financial sector.

In recognizing the growing linkage between the real economy and financial system as well interlinkages with global conditions, FSR 2013 highlights emerging risks and vulnerabilities that regulators, policy makers and government should focus on in order to preserve stability. It is essential to develop and implement appropriate macroprudential tools and instruments to facilitate close surveillance and analysis of changes in global economies with implication on domestic macro-financial conditions. This would inform relevant policy decisions to achieve and maintain Kenya's financial system stability.

This FSR 2013 comes at a time when optimism in economic recovery at both the domestic and global level is building up but many headwinds stand on the way for strong and sustainable recovery. The Euro Zone still remains vulnerable, emerging markets are losing steam, structural weaknesses in the BRIC countries have slowed growth momentum, and developing countries are threatened by emerging risks. Continued tensions in Europe over Russia – Ukraine conflicts, in the MENA region, in Africa especially in the Oil producing nations like South Sudan and Nigeria, and Ebola disease outbreak in West African countries, are likely to impact on trade and oil prices. Threats of sanctions and countersanctions between the West and Russia are likely to affect global financial system. Closer home, sanctions to South Sudan could expose Kenyan banks to risks. Increasing punitive litigations involving financial institutions, regulators, companies and even countries on violation of sanctions or breach of contracts should also attract attention of policy makers. Sub-Saharan Africa is also not spared either by the downside risks such as; slowing demand, falling international commodities prices, tightening liquidity in international financial markets, persistent socio-political conflicts, weak fiscal and debt policies in some countries.

Kenya experienced enhanced financial system stability and resilient economic performance in 2013 despite numerous challenges. The forecast for 2014 remains positive in spite of negative shocks and risks in the first half of the year. Stable macroeconomic environment, development-leaning policies of government and international partnerships are key pillars for Kenya's economic and financial stability. This report highlights policy initiatives taken by each regulator to financial system by mitigating any potential risks and vulnerabilities. The level of NPLs continued to reflect the presence of weak performance indicators in some banks, large concentration ratio in capital markets, credit to private sector growth rate, signs of inflationary pressures, some proposed legislations in the financial sector, and public debt level are some of the issues that require close surveillance in 2014 and in the medium term.

To entrench macroprudential policy and surveillance, the Bank in collaboration with the other regulators is at an advanced stage in developing database to support surveillance and analytical framework for the financial system stability assessment. This would enable policy makers and financial sector players to; better evaluate and monitor the degree of financial stability at both micro- and macro- level, anticipate sources and causes of financial stress, and communicate more effectively in a timely manner to address and mitigate weaknesses. The public will therefore find this FSR 2013 useful in understanding developments in the financial sector and thus appreciate efforts taken by the government and regulators to build a stable, liquid, sound and all inclusive financial system.

PROF. NJUGUNA NDUNG'U, CBS
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ACKNOWLEDGEMENT

Publication of this fifth Issue of FSR, 2013 emphasizes the commitment by the Government and the Financial Sector Regulators in collaboration with other stakeholders to foster the development of a liquid, efficient, stable, and sound inclusive financial system in Kenya over the medium term. This is consistent the national development goals, regional integration and international collaboration initiatives including the EAC, COMESA, and International Monetary Fund/World Bank. The report also identifies the regulators' concerns that instability in the global economies and financial markets impacts the domestic macro-financial conditions, thus creating imbalances that may hinder the country's development agenda.

Consequently, close surveillance and diagnostic assessment of potential vulnerabilities and risks, would aid timely policy interventions and mitigation measures by both the regulators and policymakers. Key to achieving this is information sharing, not among the regulators but also creating awareness to the public on new developments. As regulators, we need to work together towards achieving high frequency data, preferably monthly, to ensure that more regular surveillance reports are produced for timely policy actions in case of vulnerabilities. It would also facilitate preparation and publication of semi-annual Financial Stability Reports.

The FSR, 2013 consolidates performance assessment by the five financial sector regulators, namely; the Capital Markets Authority (CMA), Central Bank of Kenya (CBK); Insurance Regulatory Authority (IRA), Retirement Benefits Authority (RBA), and the Sacco Societies Regulatory Authority (SASRA). The financial sector stability assessment and analysis is one avenue through which the Regulators monitors and evaluates developments and performance of the financial sector for timely risks and vulnerabilities mitigation measures. This publication therefore, highlights developments in the calendar year 2013 and policy actions taken to manage emerging risks and fragilities. It also discusses outlook for 2014 based on the developments that took place in the first half of the year.

I wish to extend my gratitude as the lead coordinator of the Financial Stability Sub-Committee of the Forum to the team that worked diligently in writing this report. I also thank the Chief Executive Officers of the five regulators for providing staff, technical support and other resources to facilitate preparation of this FSR 2013. We continue to invite all stakeholders to provide positive inputs on how to improve future reports and the financial stability monitoring and evaluation.

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THE REPORT OVERVIEW

The FSR 2013 provides an assessment of the performance, soundness and stability of Kenya's financial system in 2013 and developments in the first half of 2014. The report also identifies emerging risks and vulnerabilities to the domestic financial system, and outlines some of the policy measures taken by respective domestic regulators and policy makers to achieve and sustain stability in 2013 and beyond.

Globally, macroeconomic and financial conditions improved in 2013 despite some emerging risks and vulnerabilities. Accommodative monetary policies in advanced countries such as asset/bonds purchases in Japan, US and Europe, yielded positive results on the global economic prospects. Advanced countries are now driving recovery in the global economy, although some Euro Area countries remain sluggish with some still struggling to emerge out of recession.

While global credit markets and liquidity conditions improved, emerging markets seem to pose new risks to recovery. The waning domestic demand in countries like China and emerging conflicts in Africa, the MENA region and the West and US against Russia over Ukraine, present new threats to global recovery and stability. Deflationary tendencies in advanced economies despite loose monetary policies, even to the negative in the Euro Area require new approaches to ensure stability. Domestic demand in Latin America and the Caribbean region remained sluggish in 2013, and prospects in 2014 are subdued especially with default of Argentine. Economic activity in the MENA region still face challenges as a result of persistent geopolitical instabilities. But the bumpy recovery and skewed macroeconomic policy mix in advanced economies is sending mixed signals to policymakers in emerging market economies. In Sub-Saharan Africa, economic outlook remains exposed and mixed, on weaker growth in China and delays in resolving fiscal issues in the Euro Area despite strong recovery in the US and UK.

Resilience of the Kenyan economy in 2013 is projected to transform into strong recovery and high sustainable growth in the medium term supported by accelerated infrastructure development and regional trade. The government has also introduced measures to ensure that the private sector gets adequate and affordable credit from credit providers to fund their development programmes. These efforts have led to the introduction of transparent pricing mechanism for credit facilities to be used by all commercial banks. Potential customers will now be able to interrogate and negotiate for their loans application based on this framework.

The macroeconomic indicators are likely to remain stable going forward despite challenges and threats to the economy in the first half of 2014. Credit growth to the private sector rose faster than the targeted level. Monetary authorities are however monitoring this development closely to ensure sustainable private sector credit growth path is maintained. In view of this, the inflationary pressures, although mute, require closer attention to ensure macroeconomic stability and the financial system stability.

The successful issuance of the Eurobond in June 2014 by the government is expected to ease pressure on domestic borrowing and therefore create room for private sector borrowing and invest in employment creating projects. Overall, the macro-financial conditions look promising and the regulators continue to work closely with government to ensure stability and attainment of national development goals. This is the main objective of macroprudential surveillance and diagnostic assessment that underpins this Financial Stability Report, 2013.

2. GLOBAL MACRO-FINANCIAL DEVELOPMENTS

Changes in the global economic and financial conditions have direct and second round effects on Kenya's overall macroeconomic and financial sector performance and stability. This is because the country is fully open in terms of free trade, capital flows, labour movements and foreign exchange market, exposing it to external dynamics.

The World Economic Outlook (WEO), April 2014, reported a better global economic activity in 2013 as a result of strong performance in the second half of 2013. It was expected that the growth momentum would continue in 2014 – 15 with much of the impetus coming from advanced economies, led by the United States of America (U.S). The WEO Update of July 2014 however revised down growth projection to 3.4 percent from an earlier forecast of 3.7 percent. This is due to lower than expected annual growth rate of 2.75 percent in the first quarter of 2014 from 3.75 percent in the second half of 2013. Positive economic activity in Japan, United Kingdom (UK), Germany and Spain was cancelled out by inventory overhang and a harsh winter that dampened demand in the U.S, subdued domestic demand in China, and sharp deceleration in Russia as geopolitical tensions weakened demand. While the stronger than forecast second quarter real GDP in the U.S at 4.0 percent may signal a better 2015, there are emerging risks and vulnerabilities for this growth to be sustained.

Inflation in many advanced economies remains a downside risk to the global recovery, especially in Europe. In some cases, inflation has undershot projections, reflecting still-large output gaps and recent commodity price declines. The monetary policy stance should therefore stay accommodative, given continued fiscal consolidation and downside risks in advanced economies. Emerging market economies (EMEs) also continue to drag global economy given the negative growth effects of supply-side constraints and tightening financial conditions. The EMEs account for more than two-thirds of global growth. Vulnerabilities in these economies appear mostly localized, but still-greater general slowdown remains a risk, as capital inflows could reduce or reverse.

2.1 Global Macro-financial Conditions

Global output growth slowed to 3.2 percent in 2013 from 3.5 percent in 2012. It is estimated to strengthen to 3.4 percent in 2014 (WEO Update, July 2014). The slowdown is driven by legacy weaknesses and new downside risks, including; slower growth potential in emerging markets, reducing credit expansion, and possible tighter financial conditions as a result of the U.S scaling its down monetary and fiscal policy stimulus, which would reduce capital flows. The Euro Area would strengthen and emerge from recession in 2014, but overall recovery in developed economies will remain below 2.2 percent (Table 1).

Prolonged weakness in the Euro Area, U.S fiscal policy, and geopolitical tensions in the Middle East, Russia and Africa as well as Ebola virus outbreak in Africa are additional sources of external risks. A relatively subdued recovery in the Euro Area as a result of unresolved financial fragilities and structural problems despite negative interest rate would slow global trade, with spill over to emerging markets (World Bank GEPR, Jan 2014). The strong recovery in the U.S made the Federal Reserve to continue scaling down monetary stimulus, ushering in tighter monetary and financial conditions, especially in emerging market economies.

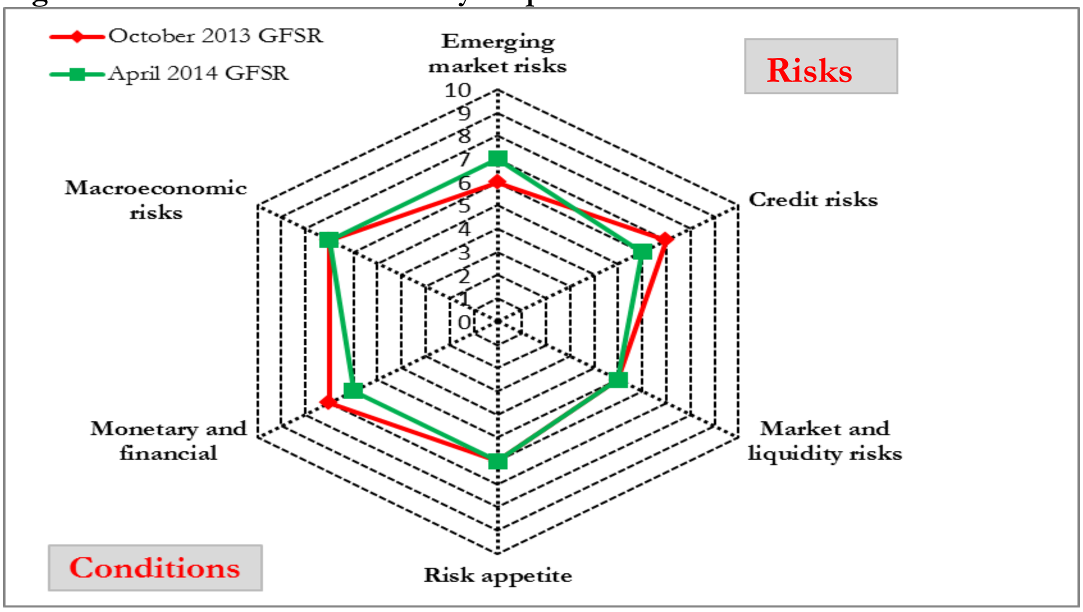
Table 1: World Economic Outlook Update

OUTPUT INDICATORS					Difference from April 2014 WEO projections	
Real GDP Growth (%)	**2012**	**2013**	**2014e**	**2015f**	**2014**	**2015**
World Output	3.5	3.2	3.4	4.0	-0.3	0.0
Advanced Economies	1.4	1.3	1.8	2.4	-0.4	0.1
Euro Area	-0.7	-0.4	1.1	1.5	0.0	0.1
Japan	1.4	1.5	1.6	1.1	0.3	0.1
United States	2.8	1.9	1.7	3.0	-1.1	0.1
Emerging & Developing Countries	5.1	4.7	4.6	5.2	-0.2	-0.1
China	7.7	7.7	7.4	7.1	-0.2	-0.2
Russia	3.4	1.3	0.2	1.0	-1.1	-1.3
Brazil	1.0	2.5	1.3	2.0	-0.6	-0.6
MENA, Afghanistan, Pakistan	4.9	2.5	3.1	4.8	-0.2	0.2
SSA	5.1	5.4	5.4	5.8	0.0	0.2
South Africa	2.5	1.9	1.7	2.7	-0.6	0.0

Source: WEO, April 2014 and WEO Update July 2014

Since the Financial Stability Report (FSR), 2012, global financial stability has improved in the advanced economies and deteriorated in emerging market economies. In the U.S, improving domestic demand continues to strengthen the growth outlook in 2014-15. In the euro area, a pickup in growth has brightened prospects, although high debt, low inflation, and financial fragmentation still present downside risks. Growth outlook for emerging market economies has been scaled down as a result of tightening external conditions coupled with some tightening of policy rates to mitigate given rising domestic vulnerabilities. Together, these developments leave macroeconomic risks unchanged (Figure 1).

Figure 1: Global Financial Stability Map



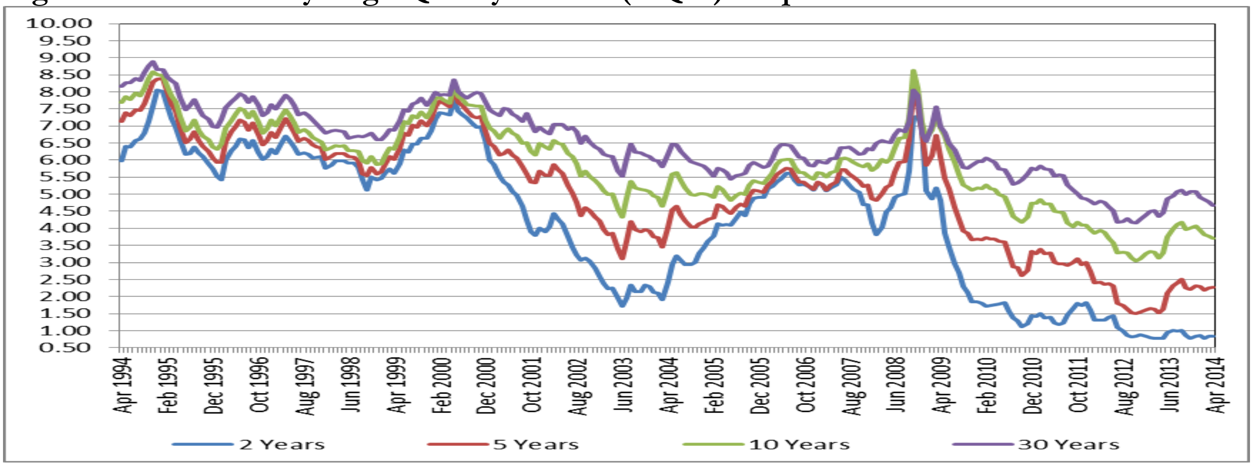
Source: Global financial stability report, April 2014

The Global Financial Stability April 2014 (GFSR, April 2014) shows that the firming up of the recovery in the U.S has led to scaling down of monetary stimulus by the Federal Reserve. This has reduced liquidity in the market, with emerging market economies most affected. Tighter external conditions and rising risk premiums now confront emerging market economies as a number of them address macroeconomic weaknesses and shift to a more balanced and sustainable framework for financial sector activity. Against this backdrop, emerging market risks have risen as external conditions have tightened and the tide of liquidity has turned.

Credit risks have reduced on declining vulnerabilities in banking systems. In the Euro Area, banks have strengthened their capital positions amid on-going deleveraging, leading to higher price-to-book ratios and tighter spreads on credit default swaps. Despite a moderate deterioration in overall corporate credit quality, corporate spreads have narrowed. Enhanced communication to the market regarding the process of normalizing U.S. monetary policy has helped quell the associated market volatility. With improved access to market funding for banks and nonfinancial corporations, market and liquidity risks remain broadly unchanged. The appetite for credit instruments and other risk assets remains firm, but the decline of demand for emerging market assets leaves overall risk appetite unchanged.

Financial markets expect a prolonged period of low interest rates and adequate liquidity amid supportive monetary policy for the Euro Area and Japan. This is explained by persistent weaknesses in bank balance sheets and, weak economic environment aggravated by high unemployment especially in Europe and large debt burdens. Market sentiments towards banks at the globally have continued to improve since the October 2013 GFSR. The aggregate bank price-to-book ratios have risen and aggregate credit default swap spreads tightened, signalling that risks are below their 2008–13 average. The turmoil that accompanied speculation about the end to quantitative easing in the U.S has dissipated and financial markets calmed in the fall of 2013. Long-term yields continue to ease as reflected in the 10-year U.S. bond yields. The actual beginning of the taper was greeted with a muted reaction by financial markets; with US long term bond yields actually narrowing slightly (Figure 2).

Figure 2: U.S. Treasury High Quality Market (HQM) Corporate Bond Yield Curve

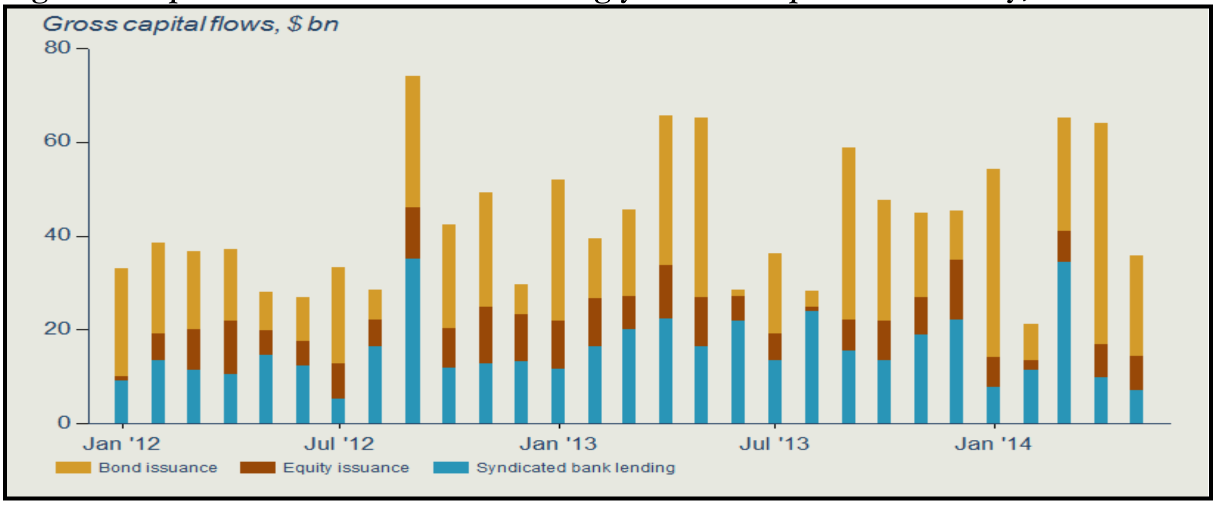


Source: Estimated from the World Bank data, 2014

Initial calm was interrupted toward the end of January 2014, when equity markets began a sell-off in reaction to a string of adverse news, including slowing growth and default risk in the shadow-banking sector in China, the devaluation of the Argentine peso and increased political tensions in several middle income economies. Capital flows to developing countries plummeted by 65 percent in February 2014 driven mainly by 80 percent decline in bond flows (Figure 3) and the currencies of many developing countries depreciated against the US Dollar.

The equity selloff that ensued hit both high-income and developing-country stock-markets equally hard (-6.2 percent in developing countries and -5.8 percent in developed markets). The selloff led to modest flight to safety flows that pushed down US long term yields 45 basis points compared with their peak of 3 percent in late December 2013, causing a 60 basis points spike in developing country bond spreads.

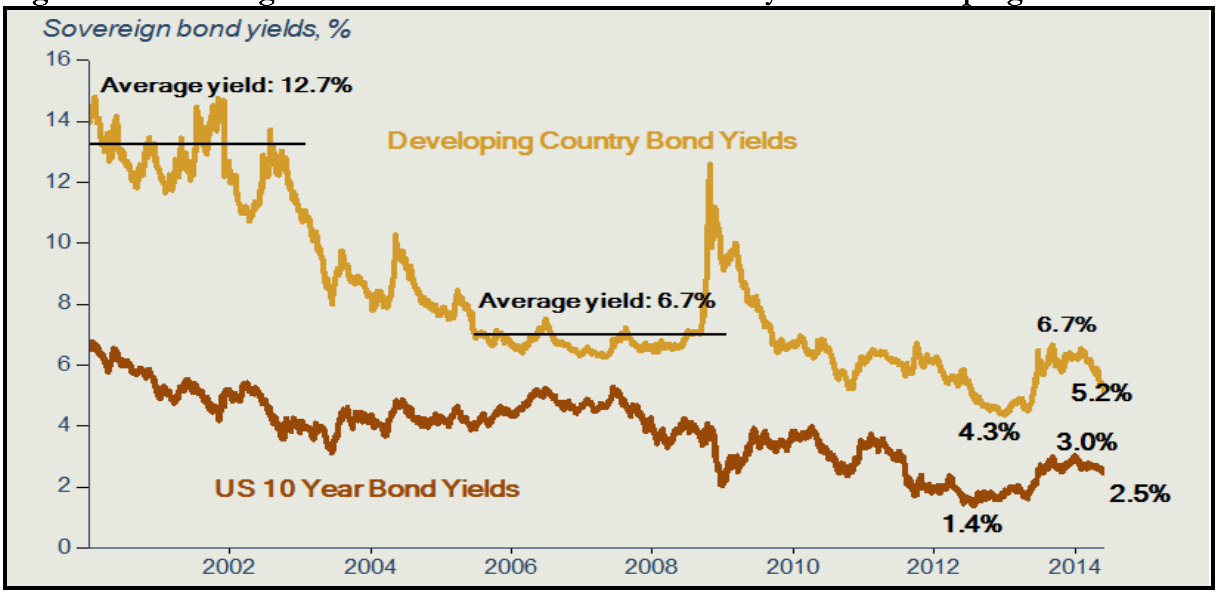
Figure 3: Capital flows have recovered strongly after a steep fall in February, 2014



Source: World Bank Report, 2014

Market jitters were relatively short-lived and capital flows to developing countries bounced back to average USD 54 billion since March 2014, fully recouping the February 2014 loss. The strength of the rebound in bond financing flows meant that volumes for the first quarter exceeded those in 2013 Q4 (Figure 3). Save for the brief episode of volatility in late January 2014, and in contrast with previous expectations of a gradual normalization in long term interest rates and risk premia, global financial markets conditions for developing countries have eased significantly since 2013Q4. Developing countries' sovereign borrowing costs fell to 5.2 percent in early June 2014 from 6.7 percent in early September 2013, unwinding more than half of the 2.3 percent increase in financing costs that occurred in 2013 (Figure 4).

Figure 4: Borrowing costs declined since the start of the year for developing countries



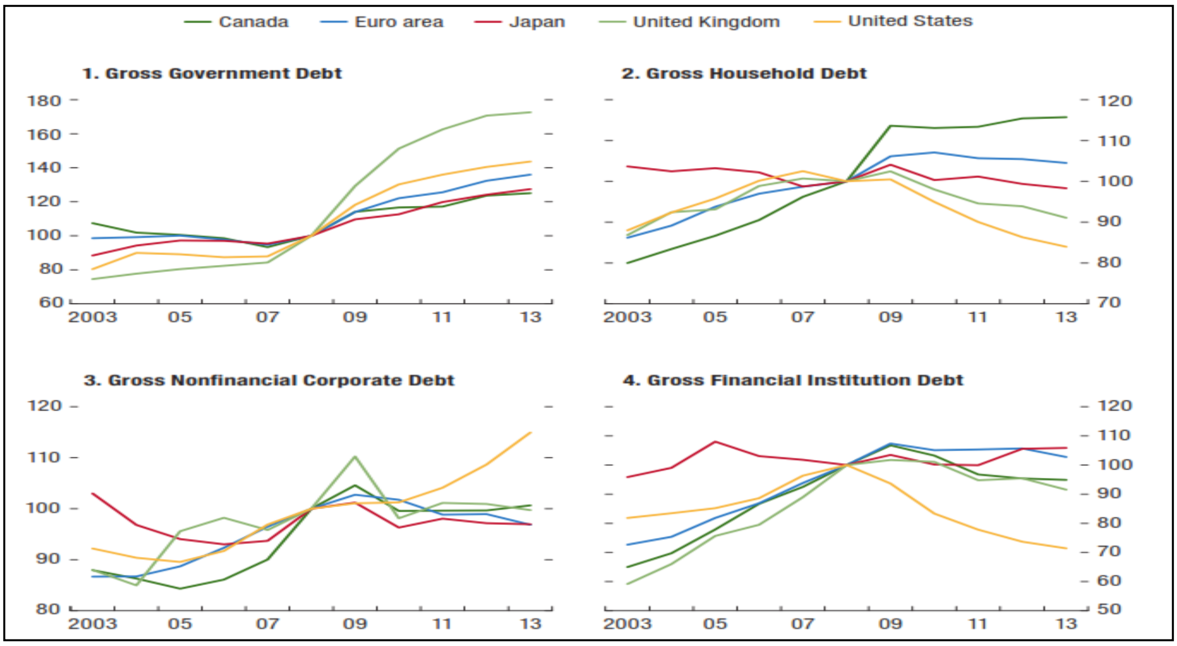
Source: World Bank

Part of the fall can be attributed to declining high income benchmark yields, amid growing expectations that the central banks in the US, Japan and Europe will hold long-term interest rates low for longer than had been expected to support domestic recoveries. In addition, the Euro Area would initiate additional credit easing measures to ward off deflation threats. Two-thirds of the decline in developing countries' borrowing costs is due to a compression in spreads (difference between the yield on a 10-year sovereign bond and that of the US 10-year Treasury bond). The 110 basis points narrowing since late August 2013 could be due to easing in financial market tensions, a renewed search for yield (reflected in the strong rebound in bond financing flows to developing countries since February, 2014) and the policy and economic adjustments in major middle-income countries that have helped to reduce vulnerabilities in these economies. Consequently, overall financing costs for developing countries remain much lower than in the immediate pre-crisis years and are well below average costs at the start of the 2000s (Figure 4). This in turn has allowed a growing number of sovereign borrowers return to the markets in recent months including low-or un-rated sovereign borrowers such as Pakistan and Ukraine.

2.2 Advanced Countries Indebtedness

Financial institutions have generally been the most successful in reducing their debt ratios. Debt has declined most sharply in Greece, Ireland, the U.K, and the U.S. Debt levels however remain high in countries like Ireland, Japan, and the U.K (Figure 5). Japan's debt is wholly owned by domestic institutional investors and therefore acts as a cushion in the event of triggers.

Figure 5: Indebtedness in Select Advanced Economies since the Crisis (Index: 2008 = 100)



Source: Global financial stability report, April 2014

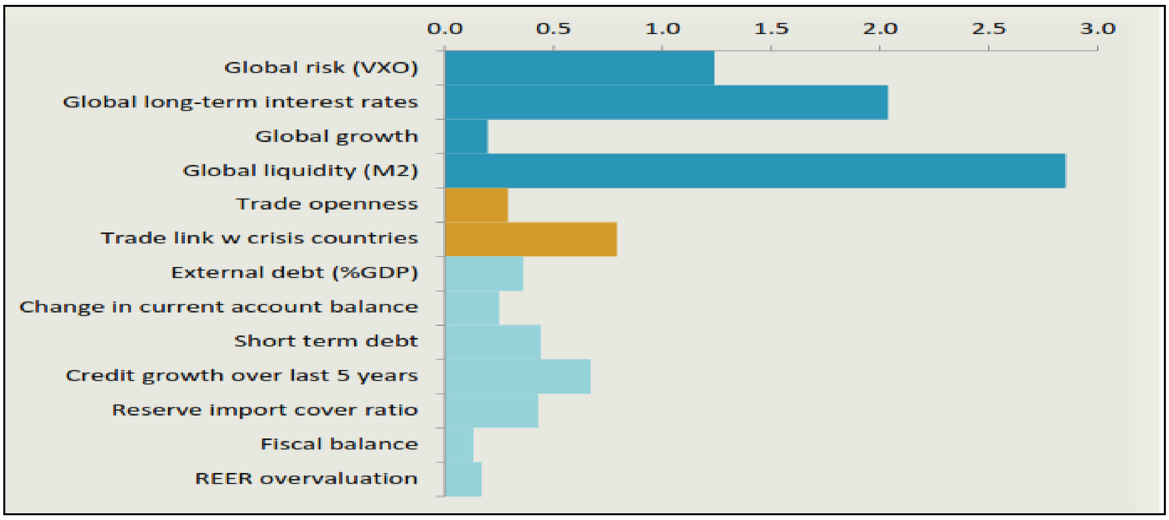
Bank capital positions have improved in stressed Euro Area economies, but credit conditions remain strained, partly due to the incomplete state of bank balance sheet repair. In June 2014, the European Central Bank (ECB) introduced negative deposit rates on bank deposits to spur lending to private sector to support investment. Although leverage among non-financial firms has reduced from its peak in many economies, corporate sector in parts of the Euro Area is still highly leveraged because countries have been slow to address the corporate debt overhang. In the U.S, while corporate leverage is low, companies have raised their borrowing in recent years.

Households have reduced their debt levels as a share of GDP since 2009 significantly, especially in program countries as well as in Japan, the U.K, and the U.S. Gross household debt however still remains high in Ireland, Portugal, and the U.K. Despite optimism in banks and sovereigns, net asset position of households remains weak in Greece, Ireland, and Spain. The substantial progress made in repairing private balance sheets has come at the cost of public indebtedness, which is now at its peak levels in many major economies. With the exception of Germany, government debt levels trended higher in 2013 for most economies, with Greece at the top followed by, Italy, Japan, and Portugal despite Greece and Italy posting primary surpluses.

2.3 Estimated Sensitivity of Banking Crises

The World Bank GEPR, January 2014 reported the estimated sensitivity analysis of banking crises using different variables derived from domestic and global factors. The analyses show absolute value of the relative importance of each identified factor in contributing to an increase or decrease in probability of a crisis. Results show that between 1970 and 2011, the global variables explain about 58 percent of the changes in the risk of a banking crisis at country level (Figure 6).

Figure 6: Estimated Contribution to changes in banking-crisis risk



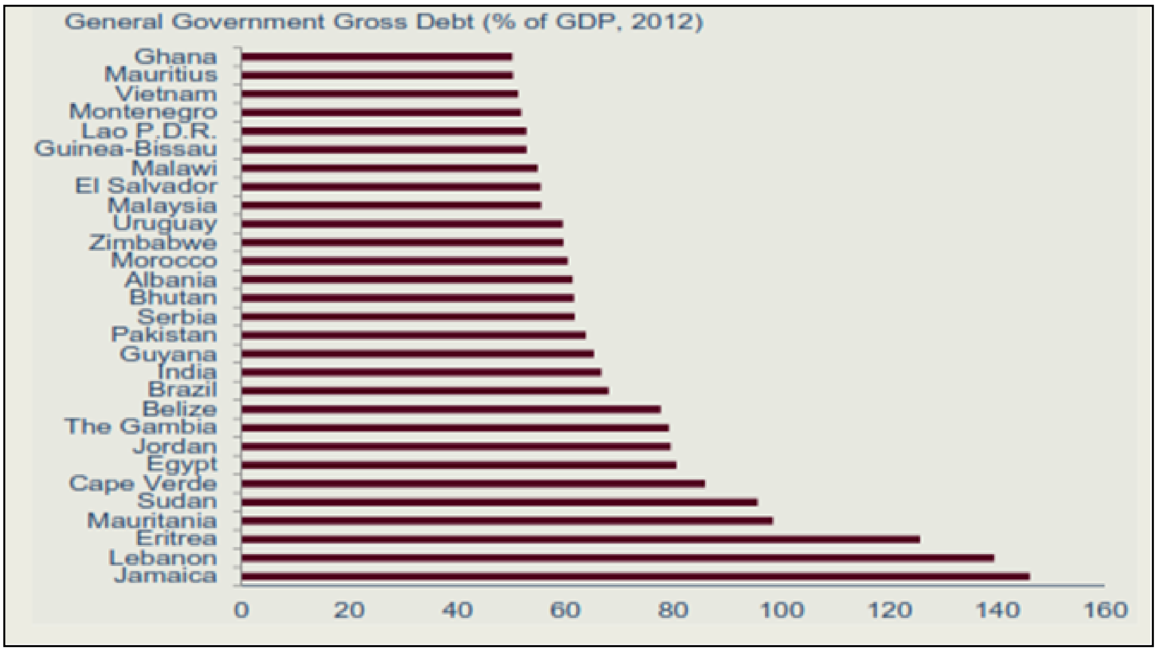
Source: World Bank Global Economic Prospects, January 2014

Domestic factors on the other hand, including; credit growth over the previous five years, short-term debt, and the level of international reserves, explain a large proportion of risks materialization in the banking system. Changes in domestic variables explain 29 percent of all the variation in risk over the sample period. There is however feedback loops between domestic factors and global variables. Loose financial market conditions at the global level for instance can feed through to rapid credit growth, exchange rate movements, and fluctuations in reserves at the domestic level. This can trigger panic, which can evolve into systemic risks with potential spillover into the financial system and real economy.

2.4 Emerging Market and Developing Economies

Public sector indebtedness exceeded 60 percent of GDP in many developing economies in 2013 while a total of five countries had this ratio exceeding 100 percent (Figure 7). The implicit guarantees to banking system in many developing economies and the use of state-owned banks to stimulate domestic credit growth, common in the BRIC (Brazil, Russia, India, and China), could rapidly increase public debt levels or fiscal burdens. Any deterioration in the banking assets would require state support or capital injections using tax payers' money.

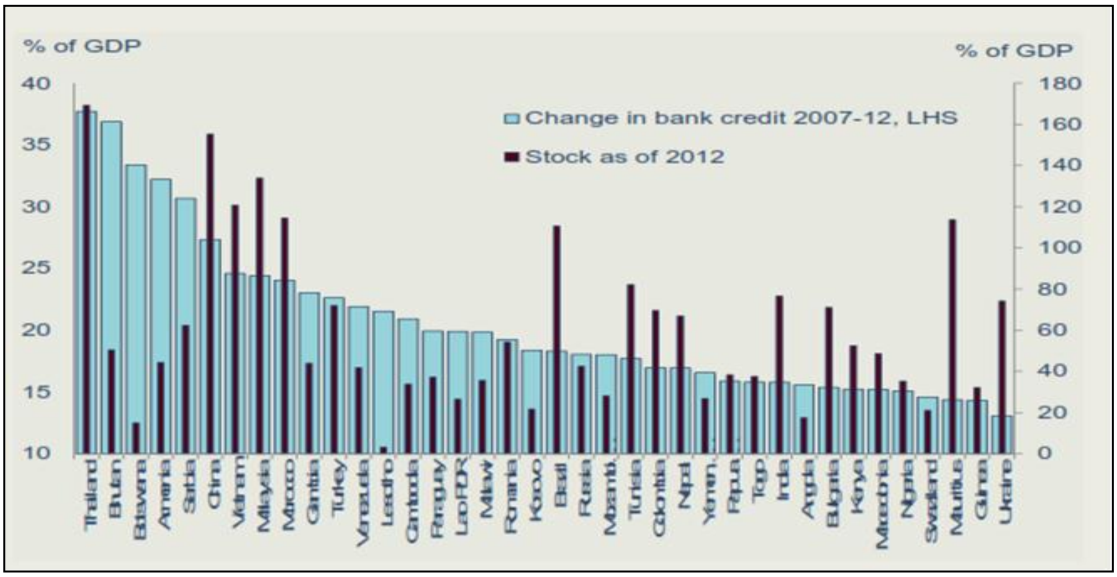
Figure 7: Public Debt in Selected Developing Economies



Source: World Bank Global Economic Prospectus, January 2014

Domestic credit has grown rapidly in several developing countries in recent years, raising the vulnerability of some economies to a rapid tightening of financing conditions. Outstanding credit exceeds 100 percent of GDP in 15 developing economies. Credit growth rose by more than 15 percent of GDP in 40 developing economies between 2007 and 2012 as shown in Figure 8.

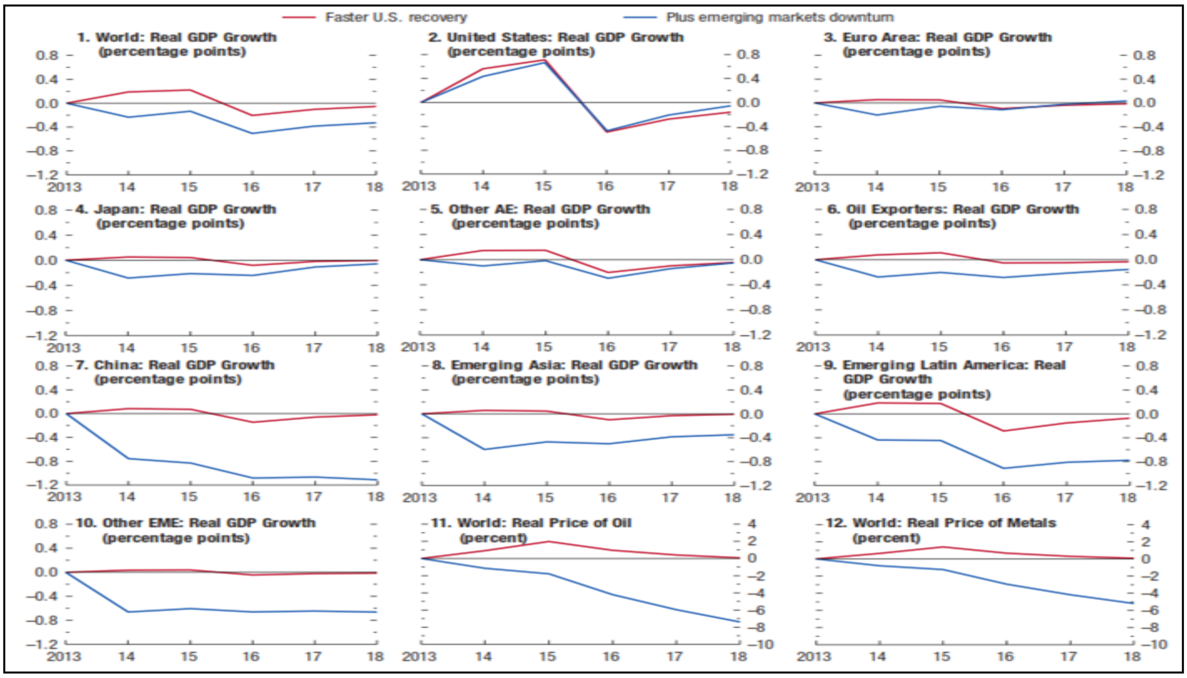
Figure 8: Domestic Credit Expansion



Source: World Bank Global Economic Prospectus, January 2014

The rapid increase in credit in many developing countries over the last five years is attributed to the stimulus programmes at home and spill overs from loose monetary policy in advanced economies that created excess liquidity in global financial markets. This portends difficulties in debt servicing among untested or first-time borrowers and possibly significant increase in the exposure of existing borrowers, with risks to financial stability if economic cycles worsen. Among major middle-income economies, including Brazil, Turkey, Malaysia, Vietnam, Thailand, and Indonesia, the stock of credit has increased in excess of 20 percent of GDP since 2007 (Figure 8). In China, credit stock rose by more than 60 percent since 2007 reaching 210 percent of GDP in 2013Q4. A large proportion originated from the under-regulated shadow banking system. The WEO, April 2014 identifies a number of downside risks to the emerging market economies in comparison with developed economies as captured in figure 9.

Figure 9: Slower Growth in Emerging Markets and a Faster Recovery in the U.S



Source: world economic outlook, April 2014

2.5 Global Risks Outlook

- *Risks of further growth disappointments in emerging market economies:*
  Downside risks to growth in emerging market economies have increased although earlier risks have partly materialized, leading to downward revisions to the baseline forecasts. Many emerging economies are still adjusting to weaker-than-expected medium-term growth prospects, with foreign investors now more sensitive to risks, triggering further tightening of financial conditions. The resultant high cost of capital could sharply slowdown investment and consumer durables, leading to the risk spiral in some countries. Rapid normalization of U.S. monetary policy or increasingly risk-averse portfolio investors could worsen the risks and cause financial turmoil, capital outflows, and difficult adjustments in some emerging market economies.

- *Lower growth in China:* Credit growth and off- budget borrowing by local governments have both been high, serving as the main avenues for the sizable policy stimulus that has boosted growth since the global financial crisis. Although a faster than expected unwinding of this stimulus is warranted to reduce vulnerabilities, such an unwinding would also lower growth more than currently projected.

- *Geopolitical risks related to Ukraine*: The baseline projections incorporate lower growth in both Russia and Ukraine and adverse spillovers to the Commonwealth of Independent States region more broadly as a result of recent turmoil. Greater spillovers to activity beyond neighboring countries and trading partners such as Europe could affect frontier countries like Kenya if further turmoil leads to a renewed bout of increased risk aversion in global financial markets, or disruptions to trade and finance due to intensification of sanctions and countersanctions. In particular, greater spillovers could emerge from major disruptions in production or transportation of natural gas or crude oil, corn and wheat.

- *Conflicts in the MENA region including Iraq, Israel-Palestine, Libya, Nigeria, South Sudan and the Ebola virus outbreak in West Africa* will further escalate risks thus derailing growth projections. Many airlines are canceling flights in such areas and citizens limiting travels, impacting international travel and affecting global oil prices as these are major sources of crude oil for international markets.

- *Increasing litigations* involving huge amounts for violation of international sanctions, standards or even contracts involving financial institutions and even private companies in the U.S and Europe could become a major threat to global financial system stability. If these are extended to foreign companies operating in emerging markets and developing economies, repercussions are enormous given that such institutions are generally Systemically Important in host countries.

2.6. Sub-Saharan Africa (SSA) Regional Economies

The IMF Regional Economic Outlook, April 2014 showed that the SSA region anticipates a pickup in economic growth in 2014 following robust growth in 2013 as shown in Table 2. The growth projection is supported by increased investment in natural resources, infrastructure development and agricultural production. However, this projection faces headwinds from both external and internal factors; slower growth in emerging markets which could impact both export demand and commodity prices. The SSA region growth will also be pulled down by South Africa, where tense industrial relations in the mining sector, tight electricity supply, anemic private investment, and weak consumer and investor confidence kept growth below potential.

Inflation continued to abate in many of SSA countries, averaging of 6.3 percent in 2013 from about 9 percent in 2011/12 reflecting moderate global food and oil prices as well as largely prudent monetary policies. Overall, fiscal and external current account deficits widened in many countries, with fiscal revenue among oil exporters very low. Since June 2013, the currencies of South Africa and some frontier economies have weakened; reflecting capital outflows following tightening global liquidity conditions. In some cases, it also reflects significant external or fiscal imbalances. In Nigeria, growth is expected to accelerate as production picks up after recent supply disruptions that were addressed. Elsewhere, growth accelerations are underpinned by improvement in the domestic political and security situation (Mali), large investments in infrastructure and mining (Democratic Republic of Congo, Liberia), and maturing investments (Mozambique, Niger).

Table 2: Sub-Saharan Africa Real GDP Growth.

REGION	2004-08	2009	2010	2011	2012	2013	2014	2015
SSA except S. Africa	**7.2**	**4.3**	**6.7**	**6.3**	**5.8**	**5.9**	**6.5**	**6.5**
SSA of which:	**6.4**	**2.6**	**5.6**	**5.5**	**4.9**	**4.9**	**5.4**	**5.5**
1.1 Oil-exporters	8.4	4.8	6.7	6.1	5.2	5.7	6.6	6.5
1.2 Middle Income	5.1	-0.8	4.1	4.9	3.4	2.7	3.0	3.3
1.3 Low-Income countries	7.3	5.1	7.0	6.5	6.2	6.8	6.9	6.8
1.4 Fragile states	2.7	3.3	4.8	3.3	7.5	6.0	7.1	7.1
SSA and Emerging Markets	**5.8**	**2.5**	**5.4**	**5.5**	**4.8**	**4.4**	**5.0**	**5.2**

Source: IMF World Economic and Financial Surveys, April 2014

Effects of tightening global liquidity became evident following the U.S. Federal Reserve's "tapering announcement" in May 2013. It was followed by capital outflows from some SSA frontier markets leading to currency depreciations. Bond yields also rose in some markets like in Nigeria and South Africa. Sovereign spreads and market interest rates widened, with Ghana and Zambia being most affected. Stock market valuations continued to increase in various countries such as Ghana, Kenya, Rwanda, Zambia, and the West African Economic and Monetary Union. International credit agencies downgraded Ghana, Zambia, and Uganda, but the outlook for Rwanda was revised to positive, and Senegal and Kenya were revised to stable. Consequently, borrowing costs for governments of frontier economies have risen, making some countries defer several sovereign bond issues totaling about USD4 billion originally planned for end-2013.

Market volatility escalated in countries with weak fiscal and external positions, implying investors discriminated depending on the soundness of policies and other fundamentals. The South African rand depreciated by about 13 percent against the U.S. dollar between May 2013 and June 2014 and maintained a downward trend on persistent economic slack and current account deficits. The Ghanaian cedi lost about 15 percent in 2013 and about 40 percent in the first half of 2014, as concerns about low external reserves and the slower-than expected fiscal adjustment. Zambian kwacha depreciated by 7 percent; the Rwandan franc was down by about 7 percent in the face of a current account deficit of about 7 percent of GDP. In Nigeria, the authorities were able to defend the naira using reserves accumulated earlier, although the naira came under pressure in February 2014 because of policy uncertainty.

Despite currency depreciation episodes, inflation pressures generally eased in 2013 amid favourable conditions associated with prudent monetary policies, good harvests, and more stable international food and fuel prices. Consumer prices for the region are projected to reach annual increases of 6.2 percent in 2014 and 5.8 percent in 2015, but the pass-through to domestic prices of potential currency depreciations may result in renewed upward pressures on prices. Delayed effects of wage increases in some countries, abundant liquidity or rapidly rising private sector credit (in Mozambique), and fiscal consolidation in countries like Ghana and Zambia could escalate the pressures.

Low-and middle-income countries could see a reduction in FDIs as a result of tightening liquidity conditions in some EMEs and the U.S monetary policy tapering. Countries that have depended on favourable international capital flows to finance expanded fiscal and/or current account deficits are particularly vulnerable to the changing global environment.

In Ghana, the increase in primary spending in 2010–13 resulted primarily from a rise in the payroll as a result of a new salary structure, as well as higher capital spending. Similarly, in Zambia, a significant loosening of fiscal policy took place in 2010–13, mainly due to overspending on recurrent items, primarily subsidies and wages, with the latter rising by about 45 percent in 2013. This has resulted in lower credit ratings by international agencies, and may have adverse implications for these countries' debt sustainability. The downside risks in the SSA Region include;

Fiscal vulnerabilities are elevated in several countries, notably in Ghana and Zambia - In Zambia, Civil Servants' wages increased sharply in 2013. In Ghana, twin deficits (fiscal and current account) in the context of weak foreign reserves will make 2014 particularly challenging. In other countries policy uncertainty could rise amid intensifying spending pressures. Countries with high debt levels like Cape Verde, The Gambia, and Sudan have limited room to manoeuvre in the face of shocks.

Deteriorating security situations - On political instability and deteriorating security situations in countries like the Central African Republic and South Sudan should worry all. They have huge humanitarian impact and could lead to a sharp markdown in their growth prospects. The spillovers from these conflicts could significantly affect trade flows and possibly increase security-related outlays in neighbouring countries.

Softening growth in emerging markets- poses risk to natural resource exporters (including South Africa), which could suffer from weakening commodity prices and slowing demand, especially for low value commodities. In addition, the expected rebalancing of growth sources in China, from consumption to investment, will contribute to weakening the demand for investment-related commodities. Tightening financing conditions in China—a major source of new financing for governments and FDI for SSA are likely to increase borrowing costs and potentially affect FDI and FDI-related demand, especially in Greenfield mining projects.

Monetary normalization and eventual tightening in the U.S and other advanced economies. The reversal of capital flows as a result of tightening global monetary conditions is a source of downside risks for the region, especially for frontier markets with weak fundamentals. Main transmission channels include; asset prices, interest rates, and exchange rates.

These could strain some banks and financial markets, reduce domestic demand, and reignite inflation, with potential implications of:

- Increased borrowing costs and refinancing risk for governments if foreign investors exit the market and reduce liquidity in local bond markets. Tightening liquidity and re-pricing of risk would increase both benchmark interest rates and spreads in the global Eurobond markets, making frontier markets to delay plans for bonds issuance. Rising interest rates on Treasuries in countries like Ghana and Zambia could make it hard for refinancing maturing bonds and financing their deficits. This may degenerate into sharper-than-planned fiscal adjustment and/or encourage an inflationary monetization of the deficit. Lastly, depreciation risk could raise governments' debt service costs.
- Tighter private sector funding conditions, especially in developed financial markets with large participation by foreign investors, like Kenya, Nigeria, and South Africa, may lead to a correction in stock market valuations and corporate bond prices. This may spillover to other assets, such as real estate, prompting further tightening of monetary policies.
- Financial sector strain where banks' lending in foreign currency could experience increased NPLs if large currency depreciations reduce borrowers' repayment capacity. Countries with more developed banking systems like Kenya, Nigeria, and South Africa could suffer losses in domestic portfolio and real asset investments as well as increases in nonperforming loans on credit extended against such collateral.

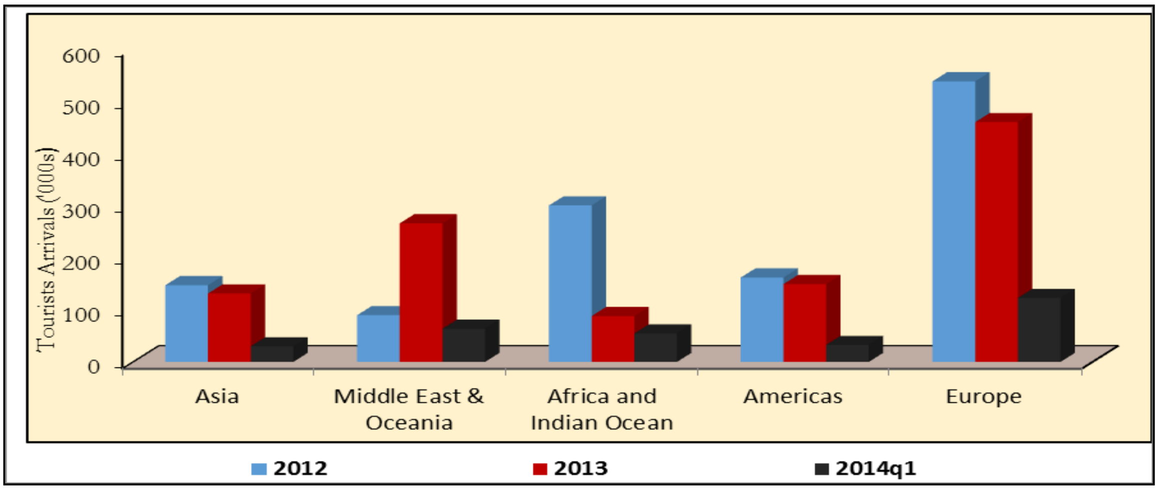
- Renewed inflation concerns emanating from the exchange rate pass-through on domestic prices, in case of large or disorderly adjustments and in countries highly dependent on imports.

2.7 Global Macro-financial Risks Spillovers to Domestic Financial Stability

The global economy continues to show modest recovery, although some advanced economies like the U.S and the U.K lead the way. Emerging market and developing economies are forecast to grow in 2014 supported by strong underlying fundamentals and internal aggregate demand, but face headwinds. Confidence in the global financial markets remain promising, especially in advanced economies, but exposed in emerging and developing markets economies despite improvement in monetary and financial conditions as well as credit markets.

Kenya is an open economy and significantly integrated in the global economy. It is thus exposed to developments in other countries, particularly; dynamics in Europe, U.K, EAC countries, MENA region, Japan, China, and the U.S. Besides remittances, tourism is a key foreign currency earner in Kenya. The on-going conflicts in South Sudan poses country risks to Kenya's banking system given the significant presence of Kenya's banks in that country. The outbreak of Ebola virus in West Africa has significant negative impact on Kenya's economy. Flights cancellations to these countries, a key market for Kenya Airways, and tourists' cancellation of their intended holidays to Africa and Kenya in particular would impact trade and travel negatively. Europe accounts for majority of the tourists. Continued sluggish recovery in the Euro Area would negatively affect foreign exchange earnings, hence worsening trade balance and exchange rates of developing countries. Kenya would be hit hard since majority of tourists that visit the country are from Europe as shown in Figure 10.

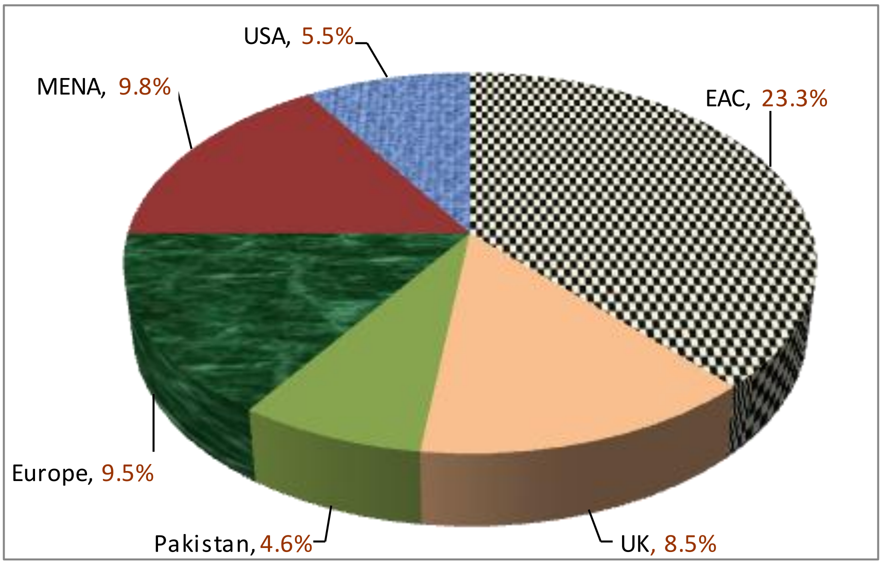
Figure 10: Tourists Arrivals via JKIA, MIAM and Cruise Ships in 2012-2014



Source: Central Bank Database

Another area that would be affected negatively by worsening Euro Area and instability in the MENA region is trade. Most of developing countries have trade links with Europe. Figures 11 and 12 indicate comparative analysis of trade flows in different regions with Kenya in 2012 and 2013.

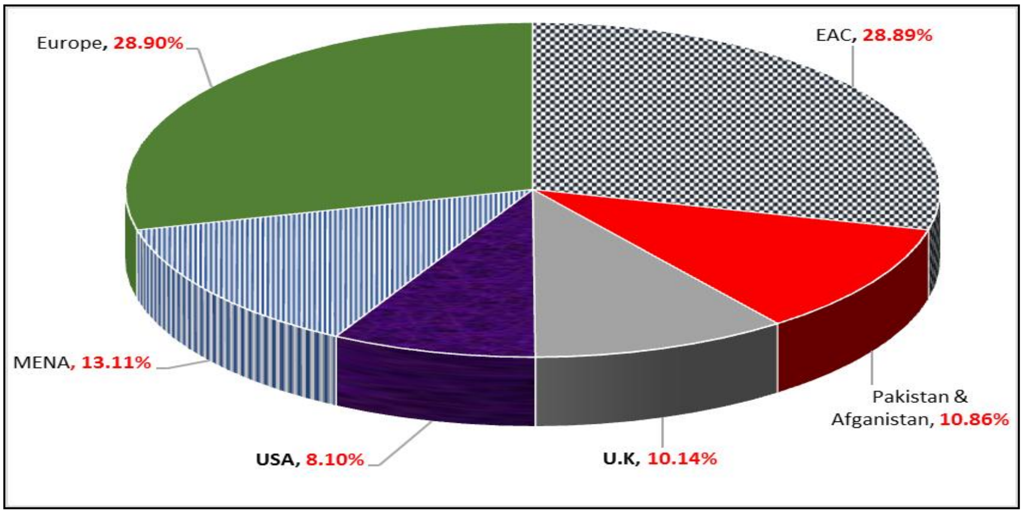
Figure 11: Kenya's Exports Destinations in 2012



Source: Estimated from the Central Bank data on exports

Deterioration of the Euro Area would affect Kenya's trade volume, financial markets and the overall economy. The EAC and Europe are the leading markets for Kenya's exports, accounting for more than 56 percent of the volume of trade in 2013. Negative shocks in these regions would pose risks to the country's trade and overall stability. The continued instability in the Middle East and North Africa (MENA) region, including Pakistan and Afghanistan would affect Kenya's Tea exports as these regions account for about 25 percent of total trade as shown in figure 12.

Figure 12: Kenya's Exports Destinations in 2013



Source: Estimated from the CBK data on exports

Kenya's entry into the international bond markets through the debut USD 2.0 billion Eurobond issued in June 2014 and oversubscribed 5 times has further integrated the country into the global financial system. Consequently, shocks in the global markets are likely to spillover to domestic markets through assets prices movements, capital flows and exchange rate markets. In addition, foreign investors' participation at the NSE account for more than 50 percent of active trading and stock holdings, and therefore developments in global markets especially flight to quality, would make these portfolio investors review their activity, in some cases causing capital reversals.

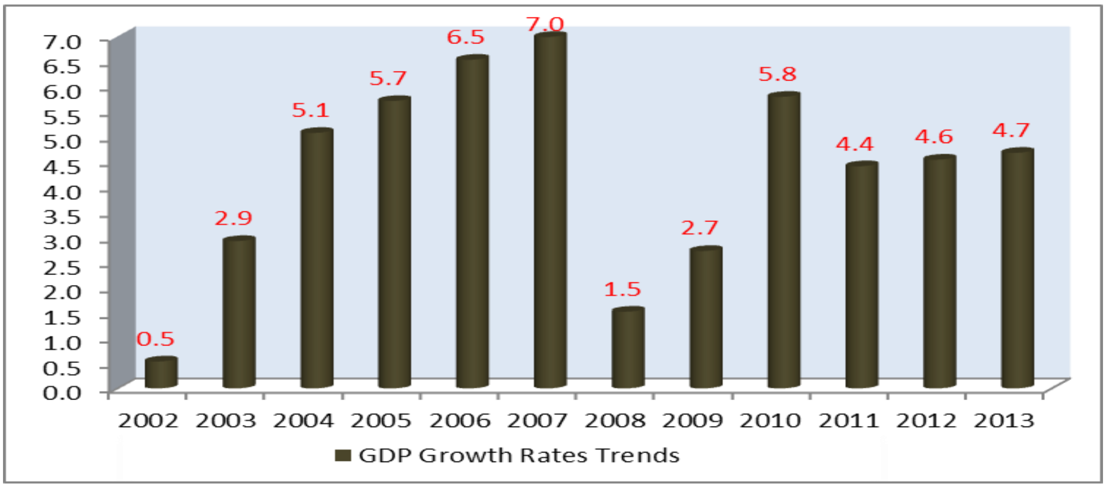
Increased Foreign Direct Investment (FDI) targeting natural resources and infrastructure development would also suffer if the leading source countries are actually affected or experience shocks that are later transmitted into domestic economy. The increasing litigations or judicial rulings targeting financial institutions or even other big companies as well as countries on violations of some international standards, sanctions or even contracts have implications to Kenya's financial system, especially if any of the significantly important firms operating in Kenya meets such a fate. As regulators, we must be on the look out to ensure full compliance to the set regulatory standards.

DOMESTIC MACRO-ECONOMIC ENVIRONMENT

3.1 Economic Growth and Output

Kenya's economy grew by 4.7 percent in 2013 maintaining the pick-up in 2012 when it grew by 4.6 percent following a slowdown at 4.4 percent in 2011 from 5.8 percent in 2010. The main drivers of this growth were the manufacturing sector and services sectors, in particular; financial services and intermediation, wholesale and trade, mining and quarrying. Figure 13 shows annual Gross Domestic Product (GDP) growth rate in the last twelve years. Overall macroeconomic environment remained stable in 2013 despite headwinds emerging from electioneering period.

Figure 13: Annual GDP Growth Rate at Market Prices



Source: Kenya National Bureau of Statistics

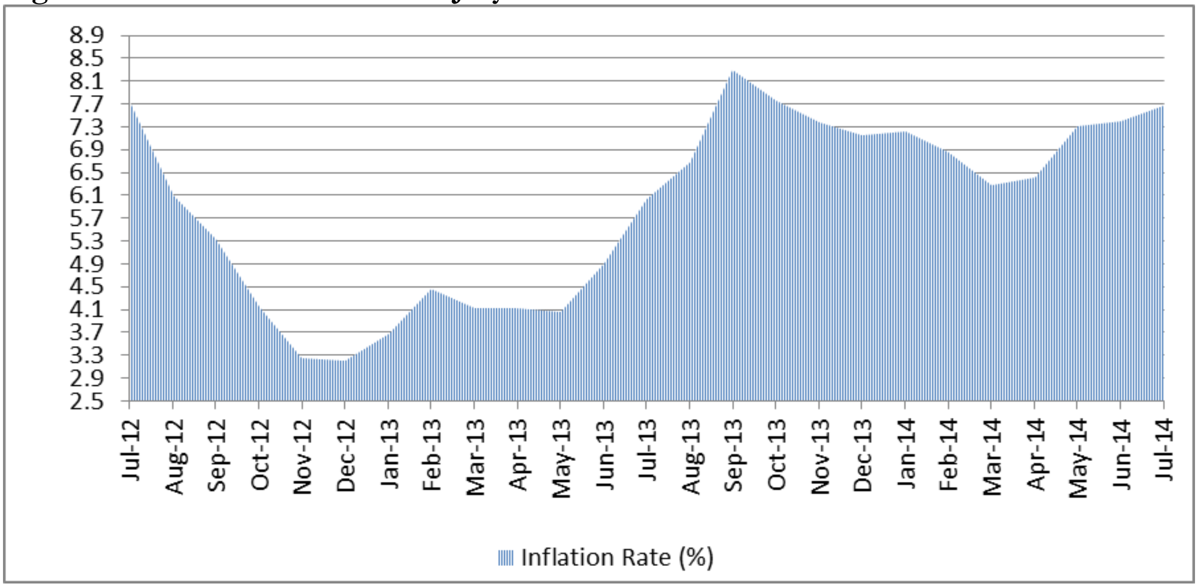
On quarter to quarter growth analysis, the first quarter of 2014 was characterized by relatively stable macroeconomic environment despite interest rates remaining comparatively high. Inflation was moderate, averaging 6.78 percent during the period compared to 4.08 percent in the same quarter of 2013. Against these developments, Kenya's GDP expanded by 4.1 percent in the first quarter of 2014 compared to 5.2 percent in the same quarter of 2013. Main contributors to growth were transport and communication, manufacturing, wholesale and retail trade, mining and quarrying and electricity generating sectors. Agriculture and forestry, and fishing had muted growths while hotels and restaurants sectors contracted in the review period as a result of elevated insecurity concerns coupled with negative travel advisories by some key tourist source countries. This sector will further be affected by Ebola virus outbreak due to tourists' cancellations and cancellation of Kenya Airways flights to some West African countries. There were also erratic weather patterns that resulted in depressed agricultural output. Volume of exports of cut flowers and vegetables declined, but fruits exports rose significantly.

3.2 Inflation

The overall inflation rate at the end December 2013 was 7.15 percent compared to 3.20 percent in December 2012. The Core inflation rate remained stable, easing marginally from 4.81 percent in December 2012 to 4.71 percent in December 2013. The overall inflation rate remained within the government medium term target of 5 percent (+/- 250 basis points) through 2013 as shown in Figure 14. The single digit inflation during the period under review is attributed to sound monetary policy, low global food prices and generally low global oil prices that impacted positively on domestic energy prices.

Inflation pressures, however, seem to be ticking up in the first half of 2014, pointing to the need for policy makers to keep close watch to ensure that price stability is maintained. Overall, inflation breached the upper bound of the government medium term target, reaching 7.67 percent in July 2014 from 6.02 percent in July 2013 as shown in figure 14. A combination of factors notably, rising global crude oil prices, erratic weather patterns that adversely impacted agriculture, and weakening domestic currency as a result of impairment in Current Account Deficits, underlie the evolving inflation developments. There is also accelerated private sector credit growth rate, which monetary authorities should pay attention to.

Figure 14: Overall Inflation since July 2012



Source: KNBS website, July 2014and KNBS Economic Survey 2013

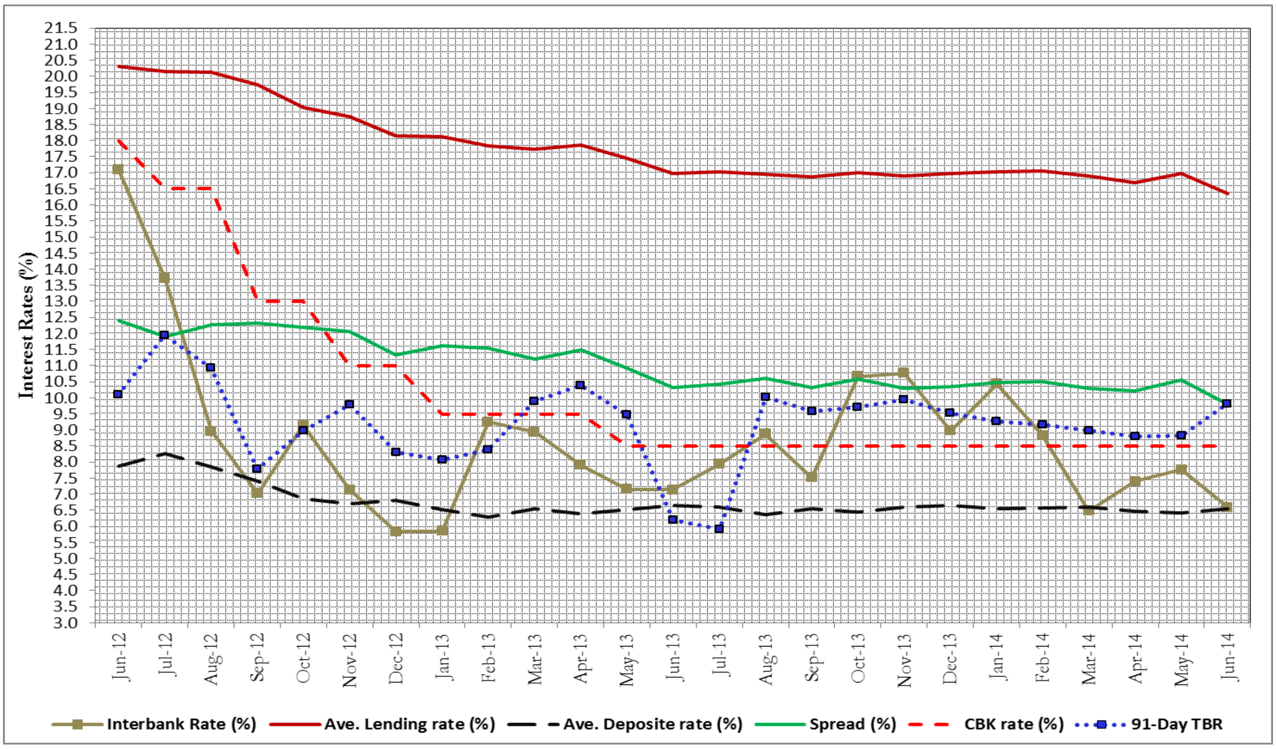
3.3 Interest Rates, Exchange Rates and Private Sector Credit Developments

Overall, the Central Bank of Kenya (CBK) eased the monetary conditions in the period June 2012 to June 2014 to spur growth as reflected in cutting its signalling policy rate, the Central Bank Rate (CBR) by 950 basis points. In response, interbank rate declined by 1049 basis points, average lending rate shed 394 basis points, average deposit rates declined by 132 basis points while the spread between average lending rate and average deposit rate was down 261 basis points and 91-days Treasury bill declined by 28 basis points between June 2012 and June 2014.

The holding of monetary policy rate (CBR) unchanged at 8.5 percent since May 2013 to date, has yielded moderate response in money market rates and lending rates. The interbank rate shed 54 basis points; average lending rate lost 61 basis points, average deposit rates was down 8 basis points, interest rates spread was 52 basis points lower and 91-days Treasury bill rate declined by 34 basis points, reflecting rigidity in the credit markets. There was however notable certainty and stability in interest rates since January 2013, with most rates mimicking the CBR path as shown in Figure 15. This ensured that credit uptake by private sector reached desired level by the monetary authority despite rigidity in lowering lending rates.

Despite improved credit uptake, average lending rates remained elevated responding marginally to monetary policy signaling by the CBK. Where there was marginal decline in average lending rates, it was matched by a reduction in average deposit rates of almost the same proportion, leaving interest rates spread in double digit. This not only defines inefficiencies in credit markets, but is also a potential source of instability in the event of shock to household incomes. To address the rigidity in credit markets so that banks can lend to the private sector at affordable rates, the government introduced transparency in credit pricing through adoption and implementation of the Kenya Banks' Reference Rate (KBRR) in July 2014.

Figure 15: Trends of Some Interest Rates and Spread



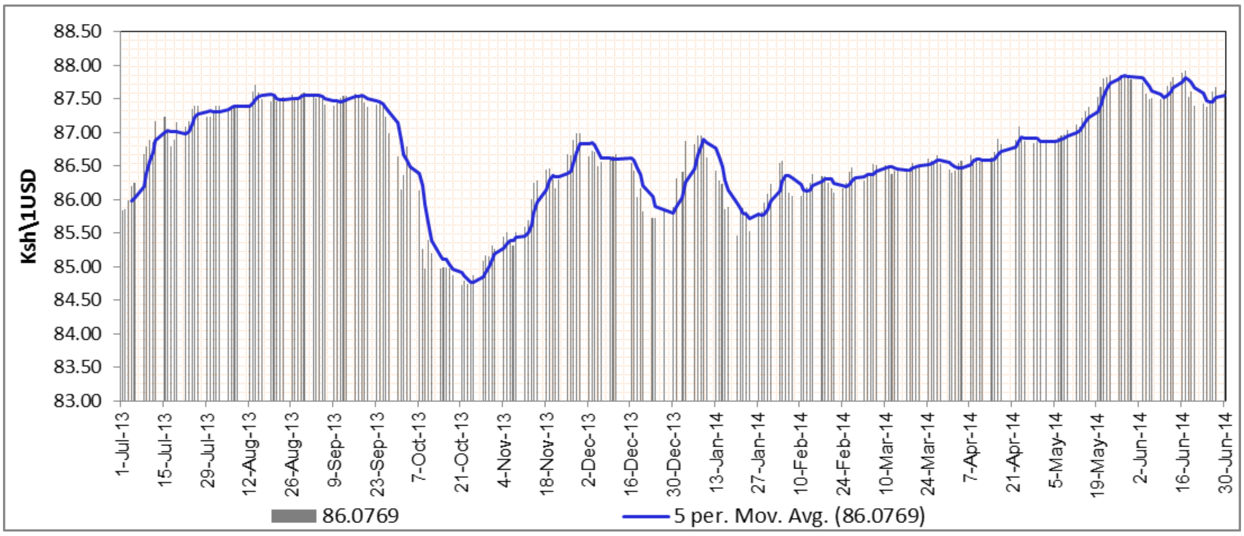
Source: Central Bank of Kenya

KBRR was formulated as one of the instruments to enhance transparency in credit facilities and mortgage pricing in Kenya. It is the base rate for all commercial banks' lending, which enable borrowers to negotiate effective lending rates charged by banks. It is derived as an average of the CBR and the weighted 2-month moving average of the 91-day Treasury bill rates. It will be reviewed and announced by the CBK through MPC Press Releases semi-annually from the effective date and operationalized through a Banking Circular. Borrowers expect to benefit from this policy innovation once banks fully adopt it and borrowers understand the formula in order to help them negotiate for better terms.

3.4 Foreign Exchange Markets

The Kenya Shilling (KSH) daily exchange rate trading against the US dollar has remained stable albeit weakening since the third quarter of 2013 as shown in Figure 16. The slight appreciation in June 2014 could be explained by the inflow from the Eurobond proceeds of USD 2 billion that came at the end of the month. Among the factors behind the local currency depreciation are external shocks to trade that affected key exports like tea, decline in tourism revenues as a result of insecurity jitters, rising import bill and short term capital outflows reflected in foreign investors' net divestiture from the Nairobi Securities Exchange (NSE) between December 2013 and June 2014.

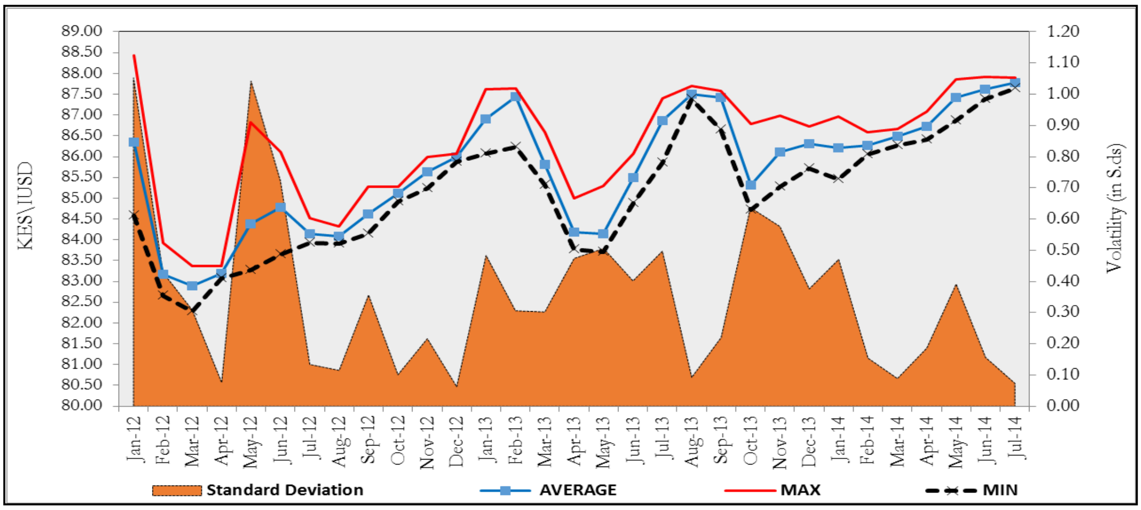
Figure 16: Trends in Daily Ksh Exchange Rate against the US Dollar



Source: CBK data

In terms of volatility around the mean, Figure 17 shows the Maximum, Minimum, Mean and the Standard Deviation of the KSH against the USD in the 2012 (12) to 2014 (6). The market volatility measured by the level of the standard deviation shows that KSH was volatile in first half of 2012, in the second quarter of 2013 and last quarter of 2013.

Figure 17: Volatility in the KSH/USD Exchange Rate



Source: Estimated from the CBK Forex Data

High volatility observed in early 2012 could be attributed to strengthening of the USD globally on its strong economic recovery news and dividend pay-outs to foreign investors at the NS, and prevailing macroeconomic environment. As a result government borrowed USD 600 million through syndicated loan from international banks partly to enhance foreign exchange reserves at CBK. Market volatility in 2013 could be explained by announcement by the U.S Federal Reserve to commence exit from quantitative easing and the reaction by emerging markets and frontier markets to this policy normalization.

The KSH is expected to maintain the current trend in the medium term as interest rates are expected to decline in line with the current Government policy of low interest rates regime to support credit uptake by the private sector. Continued strong recovery in the U.S and U.K will affect portfolio equities outflows thus impacting the exchange rate. Rising international crude oil prices on escalating instability MENA region and Nigeria may also put pressure on the KSH. Against other currencies, the KSH strengthened against Rwanda and Burundi currencies between December 2013 and June 2014. The KSH however weakened against the U.S Dollar, the U.K Pound Sterling, the Euro, Japanese Yen, Tanzania Shilling and Uganda Shilling during the first half of 2014. On year to year trend, the KSH closed 2013 stronger against Japanese Yen, Uganda Shilling, and Burundi Franc. It however depreciated against U.S Dollar, Pound Sterling, Euro, Tanzania Shilling and Rwanda Franc. In the EAC region, Kenya Shilling has underperformed the Tanzania Shilling in the two periods (Table 3)

Table 3: Kenya Shilling Exchange Rate against Select World Currencies

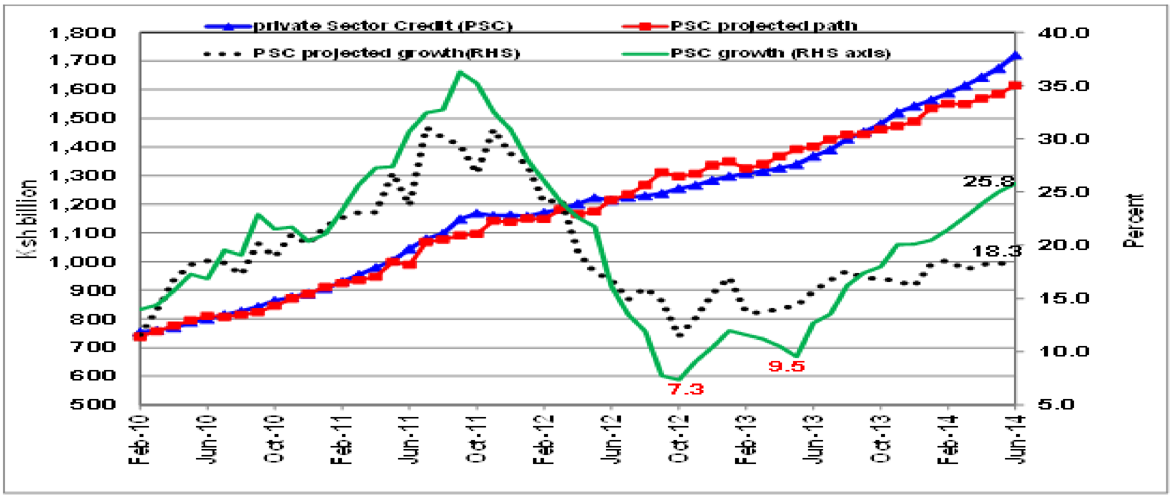
CURRENCY	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	% Change Dec.'12 - Dec.'13	% Change Dec.'13 - Jun.'14
US Dollar	86.03	85.64	86.01	86.65	86.31	86.44	87.63	1.86%	1.53%
Pound Sterling	139.02	129.61	131.33	139.96	142.40	143.81	149.20	7.32%	4.78%
Euro	113.56	109.55	112.40	116.88	119.22	118.92	119.55	5.28%	0.27%
100 Japanese Yen	99.90	90.96	87.04	88.39	82.42	84.18	86.51	-13.40%	4.97%
Uganda Shilling	31.26	30.30	30.17	29.64	29.17	29.48	29.64	-5.18%	1.59%
Tanzania Shilling	18.42	18.86	18.92	18.58	18.62	18.98	18.89	2.51%	1.44%
Rwanda Franc*	7.18	7.40	7.56	7.72	7.75	7.84	7.74	7.71%	-0.18%
Burundi Franc*	17.87	18.40	18.09	17.76	17.85	17.93	17.69	-0.99%	-0.92%
Euro Per US$	0.76	0.78	0.77	0.74	0.72	0.73	0.73	-3.25%	1.25%
** Units of currency per Kenya Shilling*									

Source: Central Bank database

3.5 Credit to Private Sector and Outlook

Credit to the private sector by commercial banks grew faster than projected reaching 25.8 percent in the year to June 2014 from below 9.5 percent in the year to June 2013. The projected credit growth in the year to June 2014 was 18.3 percent as indicated in Figure 18.

Figure 18: Credit to Private Sector



Source: Estimated from CBK database

Increased credit uptake reflects steady decline in commercial banks' average lending rate, from 18.13 per cent in January 2013 to 16.99 percent in December 2013 and 16.36 percent in June 2014. Monthly credit growth rate reflects potential risks of demand-driven inflationary pressure or adverse inflation expectations and therefore is normally watched by CBK for prompt action.

Table 4: Banking Sector Credit Developments (Ksh Billions)

SECTOR	Jan-13	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14
DOMESTIC CREDIT	1,744,373	1,752,203	1,782,950	1,875,279	1,978,522	2,097,873	2,042,914
1.1 Govt. Sector (Net)	396,004	391,017	379,506	382,602	397,164	449,868	283,097
1.2 Other Govt. Sector	50,876	45,140	36,196	40,070	39,620	33,695	39,994
1.3 Private Sector	1,309,289	1,328,352	1,380,034	1,465,824	1,555,586	1,629,175	1,736,149
Sector Contributions to the Domestic Credit (%)							
1.1 Govt. Sector (Net)	22.70	22.32	21.29	20.40	19.38	21.44	13.86
1.2 Other Govt. Sector	2.24	1.87	1.34	1.19	2.00	1.61	1.96
1.3 Private Sector	75.06	75.81	77.40	78.41	78.62	76.95	84.18

Source: Central Bank of Kenya. Note that these figures are at the end of each quarter

In actual amounts, a total of Ksh 2.04 trillion was advanced to the domestic economy by end of June 2014 from cumulative amount of Ksh 1.98 trillion in December 2013 and 1.74 trillion in January 2013. Credit to the private sector accounted for the highest proportion at 84 percent in June 2014, followed by government at 14 percent and the rest at 2 percent. Contribution of the government sector shrunk considerably from 23 percent in January 2013 to 14 percent in June 2014 compared to private sector share which rose by 10 percent as shown in Table 4.

Table 5: Cumulative Credit Distribution to Private Sector

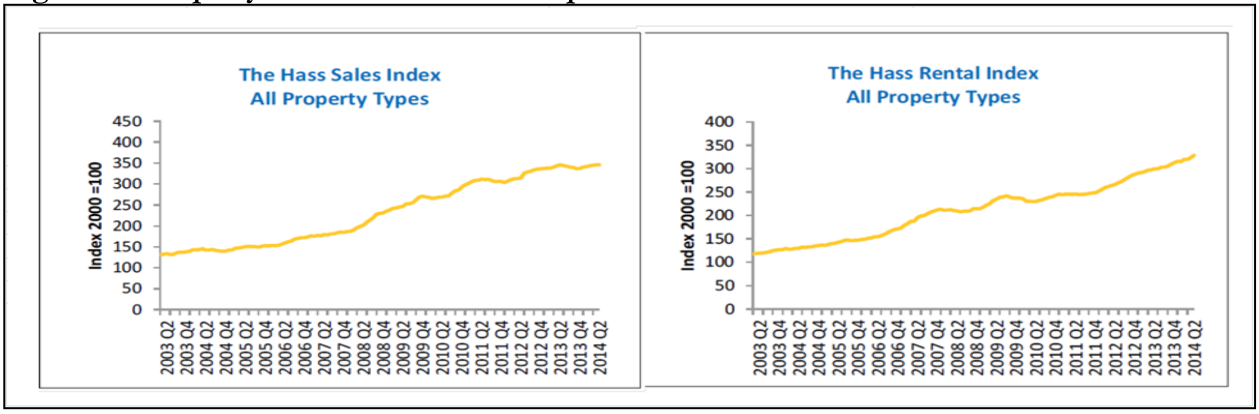
ECONOMIC SECTORS	AMOUNT IN KSH BILLIONS							YEAR -TO- YEAR GROWTH RATE (%)						
	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14
Agriculture	57.48	56.60	55.35	56.06	58.66	60.95	65.27	8.1	11.0	1.9	-0.5	2.0	7.7	17.9
Manufacturing	169.26	172.22	167.91	173.88	181.69	201.95	221.09	15.8	12.6	5.5	6.8	7.3	17.3	31.7
Trade	211.17	216.40	227.94	243.37	253.20	270.88	283.50	32.8	10.2	10.3	20.3	19.9	25.2	24.4
Exports	6.08	6.44	6.98	7.41	10.50	11.49	10.77	16.1	6.0	22.4	28.8	72.8	78.3	54.4
Imports	13.86	13.78	7.19	6.97	10.52	8.73	8.87	5.9	7.6	- 44.6	- 46.7	-24.1	- 36.6	23.3
Domestic	191.23	196.18	213.77	228.99	232.18	250.66	263.85	10.8	10.6	13.7	24.8	21.4	27.8	23.4
Building and construction	69.18	69.36	65.85	70.50	70.77	70.76	75.77	36.2	23.9	11.1	13.5	2.3	2.0	15.1
Transport & communications	75.78	73.67	77.23	83.58	89.49	106.66	111.43	- 13.3	- 15.3	-7.2	13.1	18.1	44.8	44.3
Finance & insurance	32.69	25.18	29.64	27.79	29.92	35.01	38.90	9.3	- 9.5	11.0	- 12.4	- 8.5	39.0	31.2
Real estate	161.94	166.08	176.60	181.75	198.34	213.23	225.14	17.9	15.8	-1.2	14.7	22.5	28.4	27.5
Mining and quarrying	25.05	27.56	21.79	24.22	27.80	25.19	28.47	-0.9	4.3	- 16.0	18.8	11.0	- 8.6	30.7
Private households	177.19	180.97	207.43	230.82	230.01	260.53	266.21	8.2	11.0	27.1	32.9	29.8	44.0	28.3
Consumer durables	80.20	81.70	85.44	92.98	94.67	100.08	103.00	9.4	6.7	13.5	18.3	18.1	22.5	20.6
Business services	88.85	97.67	117.47	119.01	135.57	142.07	162.36	7.5	24.0	45.5	35.5	52.6	45.5	38.2
Other activities	135.09	148.64	134.59	148.64	171.62	127.00	138.68	10.8	19.6	34.8	15.0	27.0	- 14.6	3.0
TOTAL	**1283.87**	**1316.05**	**1367.25**	**1452.61**	**1541.74**	**1614.31**	**1719.82**	**10.4**	**11.2**	**12.7**	**17.4**	**20.1**	**22.7**	**25.8**

Cumulative credit to the private sector increased from Ksh. 1.28 trillion in December 2012 to Ksh. 1.54 trillion in December 2013 and Ksh 1.72 trillion in June 2014 as detailed in Table 5. Credit growth accelerated to 26 percent in June 2014 from 20 percent in December 2013 and 10 percent in December 2012. Manufacturing, trade activity, transport & communication services, business services, finance & insurance and mining & quarrying accounted for the largest credit growth in June 2014.

3.6 Developments in the Real Estate Sector

House prices increases were less robust by end June 2014 following a decline in asking prices for top-of-the-market detached houses. The detached house prices fell by 0.3 percent in 2014Q1 and 2.1 percent on a year earlier, in a price correction from the more than 10 percent post-election surge in detached house prices. Strongest price rally remained for semi-detached houses, rising 3.3 percent in 2014Q2 and 6.7 percent on year earlier. Apartments also consolidated price gains of 2014, with a further 1.3 per cent rise in asking prices in the second quarter. Rental prices however rose far more rapidly than sales prices, averaging 2.7 percent increase in 2014Q. Semi-detached and rental apartments grew above overall average of 3.2 percent (Figure 19).

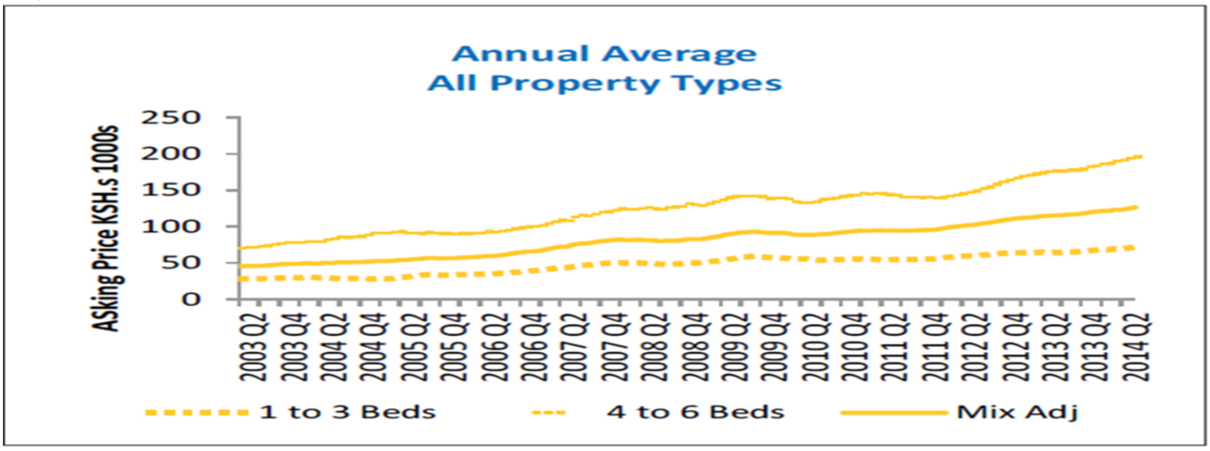
Figure 19: Property Sales and Rental Composite Index



Source: Hass Consult Website, July 2014

Demand for both buying and renting was concentrated in the mid-market, in semi-detached houses and apartments, reflecting the stronger performance in rental yields in the mid-market. Semi-detached houses historically, and currently, recorded the strongest rental yields, at 7.77 percent in 2014Q2. Property values have increased by 3.46 times since 2000.

Figure 20: Property Sales Annual Composite Index



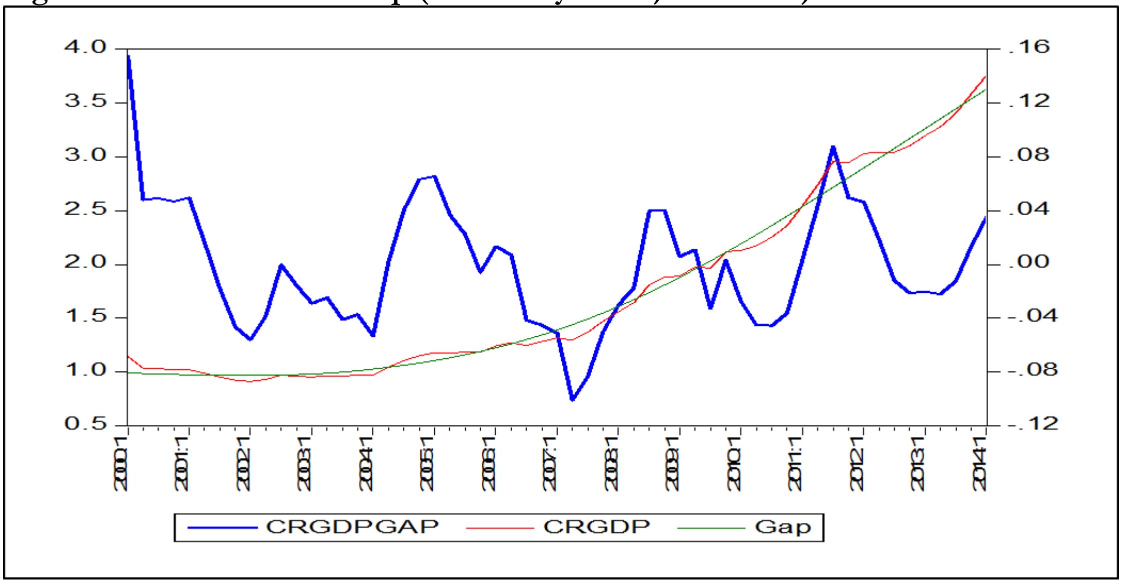
Source: Hass Consult Website, July 2014

The average value for a property has risen from 7.1 mn in December 2000 to 24.8 million in June 2014. The average value for a 4-6 bedroom house currently stand at Ksh 34.9 mn while average value for a 1-3 bedroom house is currently at Ksh 11.6 million (Figure 20). In terms of outlook, we expect both demand and prices to rise further as banks align their mortgage pricing to KBRR to comply with the Government policy implemented in July 2014.

3.6 Macroeconomic imbalances and Credit Growth

Credit growth remains strong going into the second half of 2014. However, like in a number of other SSA countries, the rate of credit expansion has widely deviated from the targeted growth paths, creating imbalances in the economy with feedback loops to the financial system stability.

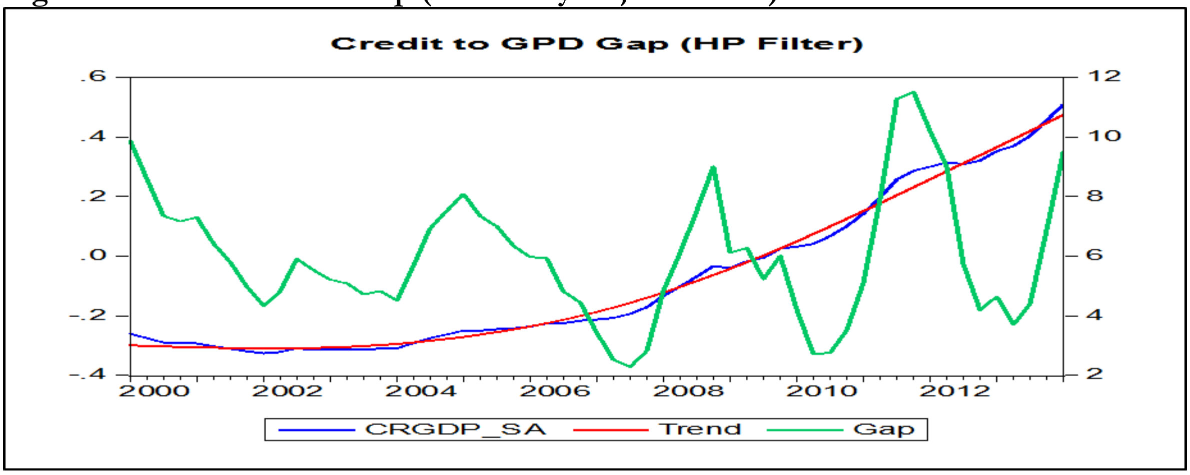
Figure 21: Credit-to-GDP Gap (Seasonally Unadjusted data)



Source: Estimated from CBK database

The estimated Credit-to-GDP gap using HP Filter on quarterly data of credit stock shows that periods of significant deviations from the targets were characterised by instability (Figure 21). Using seasonally adjusted quarterly data, results still show that periods when credit overshoots or undershoots the natural growth path, the economy experienced instability (Figure 22).

Figure 22: Credit-to-GDP Gap (Seasonally Adjusted data)



Source: Estimated from the CBK data

In 2011 for instance, credit growth rate significantly overshot the trend, with net effect materializing in the second half of 2011, yielding excessive volatility and eventually instability. Credit growth then had risen to 36 percent per month against the target of 16 percent. This was associated with the government stimulus programme of 2010 to boost the economy following the 2009 second round effects of global financial crisis. Inflation rate rose significantly, interest rates became more volatile and exchange rate depreciated sharply. The Central Bank of Kenya had to take drastic monetary policy actions, tightening the policy rate, with effects felt in the fast quarter of 2012. It is therefore imperative that the current credit growth rate requires closer observation and necessary actions taken to ensure stability.

3.7 Balance of Payments Developments and Outlook

Overall BOP surplus rose to USD 2,397million in the year to June 2014 from to USD 627million in the year to June 2013 due to Eurobond proceeds. Current Account Deficit (CAD) narrowed by USD 18million in the period. The Financial and Capital Account was also in surplus with gross reserves rising to USD 10,399million in the year to June 2014 as shown in Table 6. The CAD as a share of GDP narrowed from 10.64 percent in June 2013 to 10.6 percent in the year to June 2014 (Figure 23).

Table 6: Balance of Payments (USD Millions)

ITEM	Year to June 2013*	Year to June 2014* Q1 Jul-Sep	Q2 Oct- Dec	Q3 Jan-Mar	Q4 Apr-Jun	Year to June 2014*	Absolute Change
1. OVERALL BALANCE	627	209	174	101	1912	2397	1769.6
2. CURRENT ACCOUNT	-4693	-1283	-1324	-904	-1164	-4674	18.1
2.1 Goods	-10738	-2848	-3030	-2440	-3009	-11327	-589.1
Exports (fob)	6108	1409	1434	1558	1617	6018	-89.8
Imports (cif)	16846	4258	4464	3999	4625	17345	499.3
2.2 Services	6046	1565	1706	1537	1845	6653	607.2
Non-factor services (net)	3495	849	932	1039	1130	3950	454.7
Income (net)	-265	-81	-73	-38	-103	-296	-30.4
Current Transfers (net)	2816	798	848	537	817	2999	182.9
3. CAPITAL & FINANCIAL ACCOUNT	5320	1493	1498	1005	3076	7071	1751.4
3.1 Capital Tranfers (net)	146	11	28	30	134	203	56.7
3.2 Financial Account	5174	1482	1470	975	2942	6869	1694.7
memo:							
Gross Reserves	7889	7959	8483	8279	10399	10399	2509.8
Official	6089	6291	6560	6654	8555	8555	2465.5
*import cover***	*4.0*	*4.2*	*4.3*	*4.4*	*5.5*	*5.5*	1.5
*import cover****	*4.4*	*4.4*	*4.5*	*4.5*	*5.7*	*5.7*	1.4
Commercial Banks	1800	1668	1923	1625	1844	1844	44.3

* Provisional.

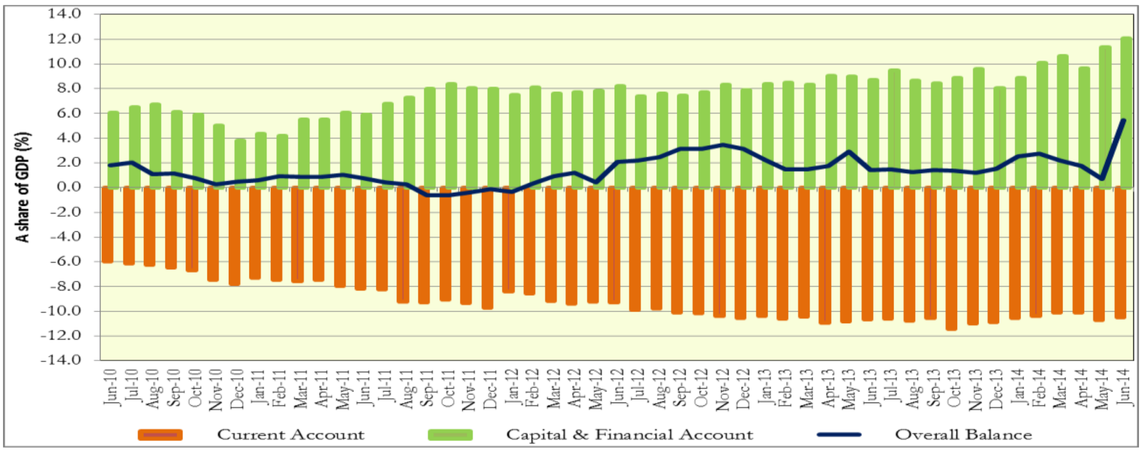
** Based on current year's imports of goods and non-factor services

*** Based on 36 month average of imports of goods and non-factor services

Source: Central Bank of Kenya

The increase in imports account was due to the acquisition of new planes by Kenya Airways. The service account improved due to expansion of transport services in the region following improved Ports' efficiency. The increase in official gross reserves ensured that the country's foreign reserves rose from 4.4 months of import cover to 5.7 months of import cover between June 2013 and June 2014, signalling resilience against external shocks.

Figure 23: Trends in Overall Balance



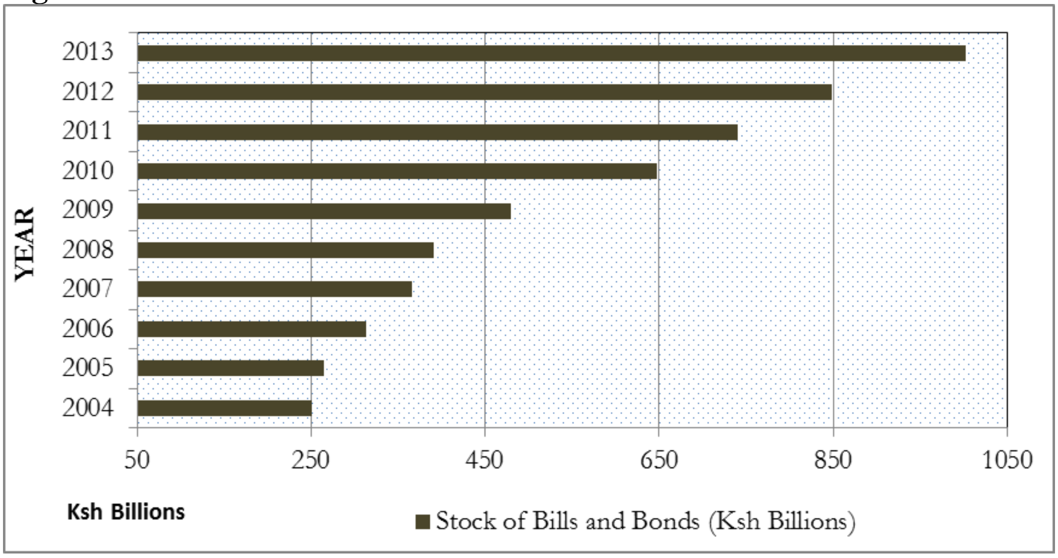
Source: Estimated from the CBK BOP data

3.8 Public Debt and Debt Markets Analysis

3.8.1 Stock of Domestic Debt held in Government Securities

Total Government Securities excluding Treasury bills stock held for Open Market Operations (OMO) increased by 18.04 percent to Ksh. 1,001.89 billion at the end of 2013 from Ksh. 848.78 billion in 2012 as indicated in Figure 24. There was rapid growth in stock of outstanding debt securities from 2010 as a result of more infrastructure bonds issued to fund capital projects.

Figure 24: Stock of Government Securities 2004-2013



Source: National Debt Database at CBK

In terms of stock composition, domestic debt portfolio held in government securities comprised 26.82 percent in Treasury Bills (short term) and 73.18 percent in Treasury Bonds (long term). Details of composition are captured in table 7. This is a complete reversal in the ratio of short term to long term debt that existed in 2001 when CBK together with Government initiated plans to lengthen maturity profile and composition of outstanding debt stock to mitigate potential refinancing risks and develop markets.

Table 7: Composition of Government Securities to Total Stock

YEAR	Treasury Bills	Treasury Bonds	Kenya Long-Term Stock
2000	78.45%	21.18%	0.37%
2001	72.35%	27.40%	0.25%
2002	45.01%	54.57%	0.41%
2003	32.77%	66.94%	0.29%
2004	25.02%	74.67%	0.31%
2005	27.12%	72.59%	0.29%
2006	30.22%	69.54%	0.24%
2007	25.76%	74.09%	0.15%
2008	19.49%	80.36%	0.15%
2009	24.81%	75.07%	0.12%
2010	20.69%	79.31%	Redeemed fully
2011	14.46%	85.54%	Redeemed fully
2012	19.07%	80.93%	Redeemed fully
2013	26.82%	73.18%	Redeemed fully

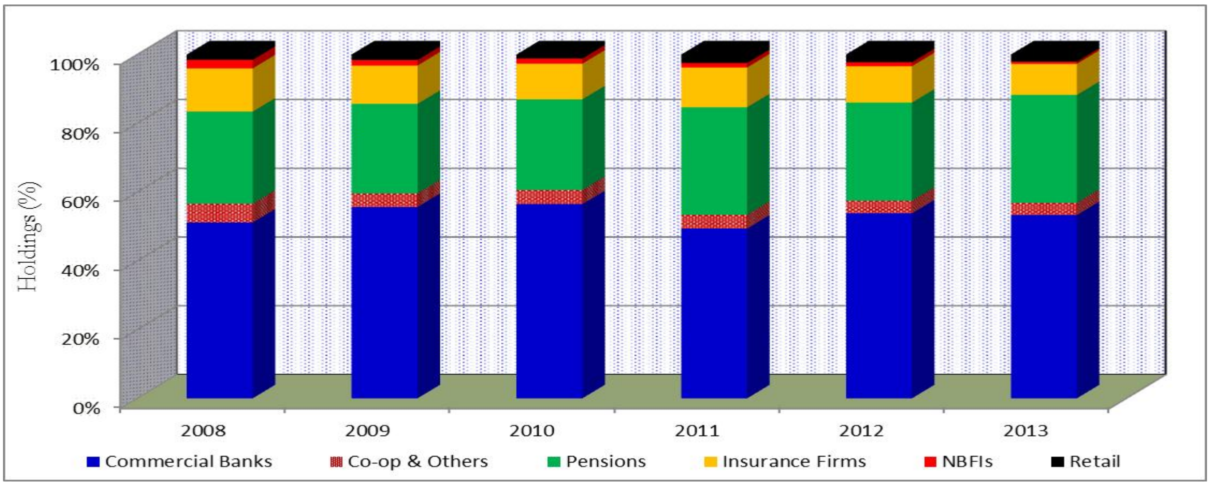
Source: CBK database

This development is also consistent with the Medium Term Debt Strategy (MTDS) targets. Note that the National Treasury stopped issuance of the long term government stock in 1986 due to their illiquidity. Instead long term Treasury bonds are now issued since they are more popular due to their ease of tradability in the secondary market, making them more liquid and attractive to investors. Long term stocks were redeemed fully upon maturity without option of rollover or new issuance of similar instruments.

3.8.2 Holders of Government Securities

The share of Government securities held by various investors has remained relatively unchanged over the last five years. At the end of 2013, banks remained the largest holders of debt issued by government at 53 percent, followed by the Pension sector at 31 percent (Figure 23).

Figure 25: Holders of Government Securities between 2008 and 2013



Source: Financial Markets database

All the rest including Insurance companies, Non-Bank Financial Institutions (NBFIs), Cooperatives Societies and Retail sector accounted for 16 percent in total. Commercial Banks thus bear the greatest risk exposure to Government Securities in the event of excess market volatility. From the issuer's perspective, dominance by commercial banks presents potential risk in the event of emergence of other competing investment opportunities to attract the banks' money. Government may struggle to raise money at affordable cost if banks cut down their participation in the securities' markets significantly.

3.8.3 Primary Market Performance

Treasury bonds recorded full subscriptions in most of 2013 offers, averaging slightly lower at 195 percent in 2013 compared to 234 percent in 2012 as detailed in table 8. This was however still better performance compared to the performance in the period 2008 – 2011. Bid-to-cover ratio declined to 1.56 from 1.77 in the period under review, implying weaker auctions outcomes with high quoted yield to maturity by investors. It however shows that all bond offers were fully covered hence minimal refinancing risk through interest rates but not in auctions failure. Auctions oversubscription and bid-to-cover ratios indicate the ease by which the issuer is meeting borrowing targets through debt securities due to adequate liquidity in the market.

Table 8: Treasury Bonds Primary Market Trend Analysis (Ksh Mns)

Year	Offer Amount	Bid Amount	Allotted Amount	Subscription (%)	Bid-to-Cover Ratio
2008	85,000	94,385	61,532	111.04	1.53
2009	142,500	214,032	140,384	150.20	1.52
2010	176,100	287,027	179,855	162.99	1.60
2011	194,700	238,523	152,061	122.51	1.57
2012	134,700	314,605	177,668	233.56	1.77
2013	201,000	391,993	251,605	195.02	1.56

Source: National Debt Office database at CBK

Similar to the bonds, Treasury bills market was vibrant through 2013 albeit lower appetite relative to the bonds performance, despite interest rate volatility during the second half of 2013. Table 9 details the performance of this segment of the market.

Table 9: Treasury Bills Auctions Performance (Ksh Mns)

Year	Offer Amount	Bid Amount	Allotted Amount	Subscription (%)	Bid-to-Cover Ratio
2008	249,000	279,649	207,507	112.31	1.35
2009	319,000	411,890	295,888	129.12	1.39
2010	297,000	471,115	270,091	158.62	1.74
2011	288,500	398,454	288,280	138.11	1.38
2012	402,000	586,324	374,054	145.85	1.57
2013	452,000	729,221	443,775	161.33	1.64

Source: CBK Research database

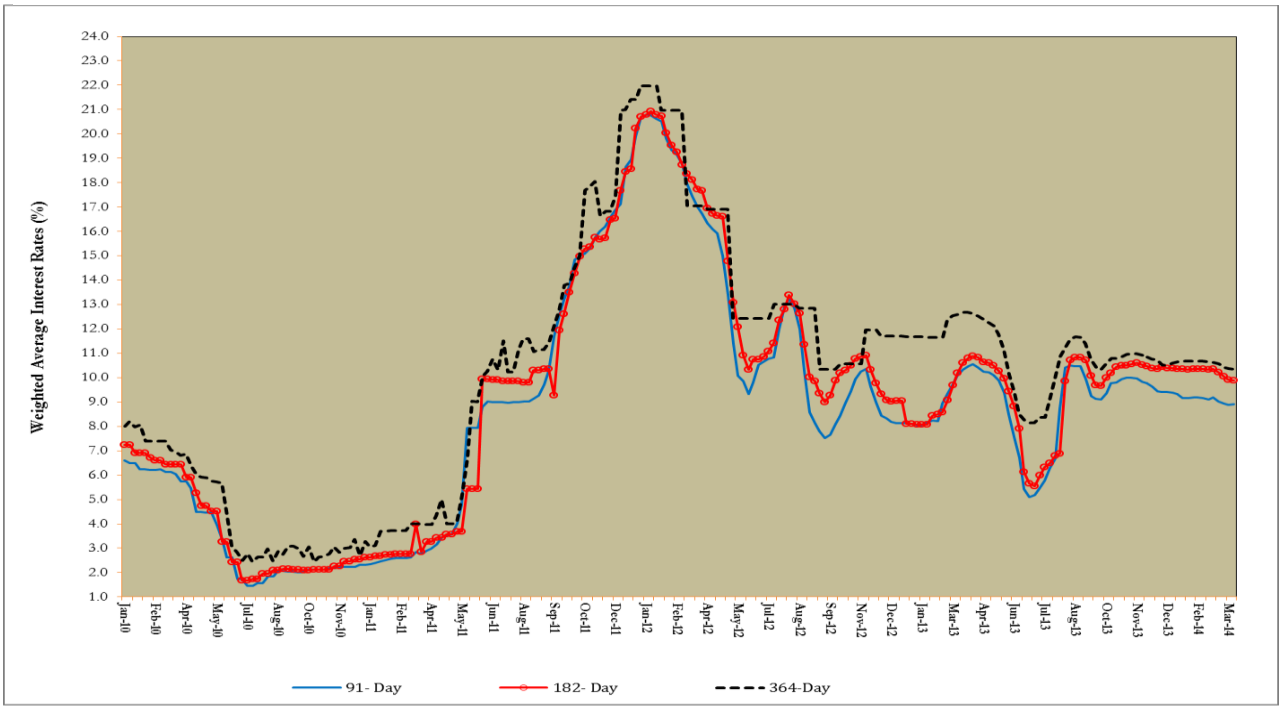
In practice, a high bid-to-cover ratio signals higher investor demand for issued securities at competitive prices to the issuer. A ratio above 2.0 indicates a successful auction with aggressive bids. A lower ratio indicates weak demand and is said to have a long tail to reflect a wide spread between the average and the highest bid yield. This scenario appears more evident in Treasury bills than bonds; perhaps capturing interest rates volatility experienced in the short term market segment, especially in 2011.

The period under review experienced stable interest rates in the second half of 2013 compared to the situation in the first half of the year. This may be explained by investors' shift to bonds market that offered higher yields supported by adequate liquidity in the market following a relaxed monetary policy stance by CBK. It also reflects easing of transition challenges the new Government faced in the implementation of the devolved system of government.

Figure 26 shows trends in the short term interest rates for the 91-days, 182-days and 364-days Treasury bills for the period January 2010 – March 2014. The market has generally recovered from the interest rates shocks in 2011/12. Stability in yields is expected to remain through 2014 given the CBK monetary policy stance, expected lower demand in domestic borrowing by the government following successful issuance of the Eurobond, and the Government's deliberate policy to maintain low and stable interest rates to stimulate banks' lending to the private sector.

Notable from the trend is the upward sloping shape of the money market yield curve (Figure 26), where longer maturity of 364-days Treasury bill offers higher yield than the 91-days Treasury bill yield. The narrow gap between the three curves beginning second half of 2013 further confirms market stability compared to the period 2012 to first half of 2013.

Figure 26: Trends in Treasury Bills Monthly Average Interest Rates

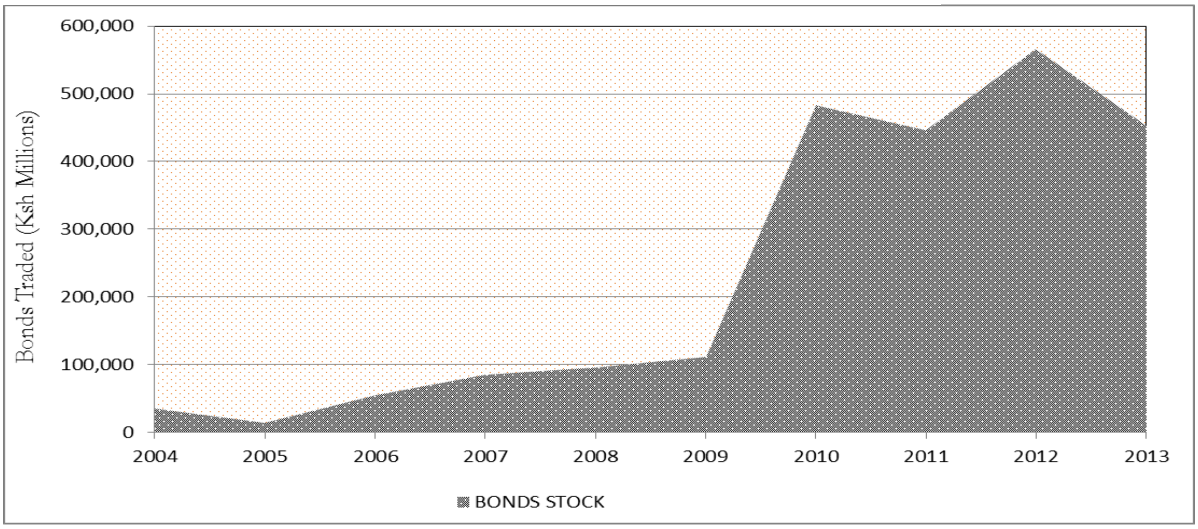


Source: Central Bank of Kenya, Financial Markets database

3.8.4 Treasury Bonds Secondary Market Activity

Bonds trading activity in the secondary market for government was less vibrant in 2013 compared to the turnover in 2012. Overall, trading has remained strong since 2009, reaching a peak of Ksh 522.9 billion in 2012 from annual turnover of below Ksh 100 billion for the years up to 2009. The reforms in the bond markets targeting both primary and secondary segments, including the popular infrastructure bonds issuance that began in 2009 explain the surge in secondary market activity (Figure 27)

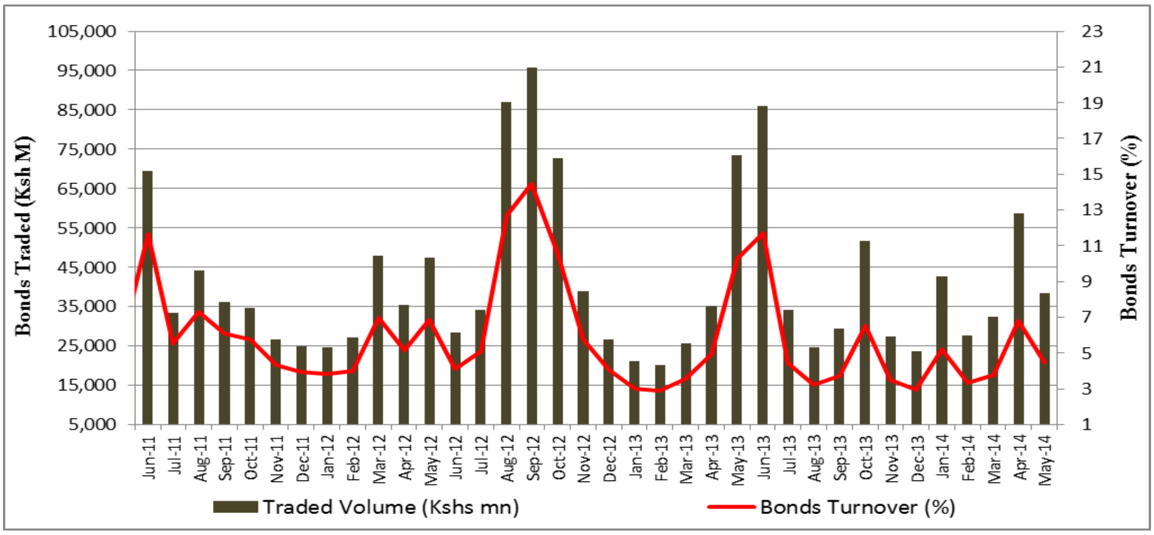
Figure 27: Annual Treasury bonds Trading Turnover at the NSE



Source: Estimated from NSE trading data

Higher trading volumes is due to the issuance of new benchmark bonds, stable interest rates following prevailing monetary policy stance and emergence of bonds as an attractive asset class for institutional investors. Full operationalization of the ATS has further improved trading. Monthly trading was very high in April - July 2014, exceeding Ksh 35 billion, before a decline in the second half of 2013 as indicated in figure 28. The turnover measured as a proportion of the traded volume to the outstanding stock of bonds has remained below 7 percent since July 2013.

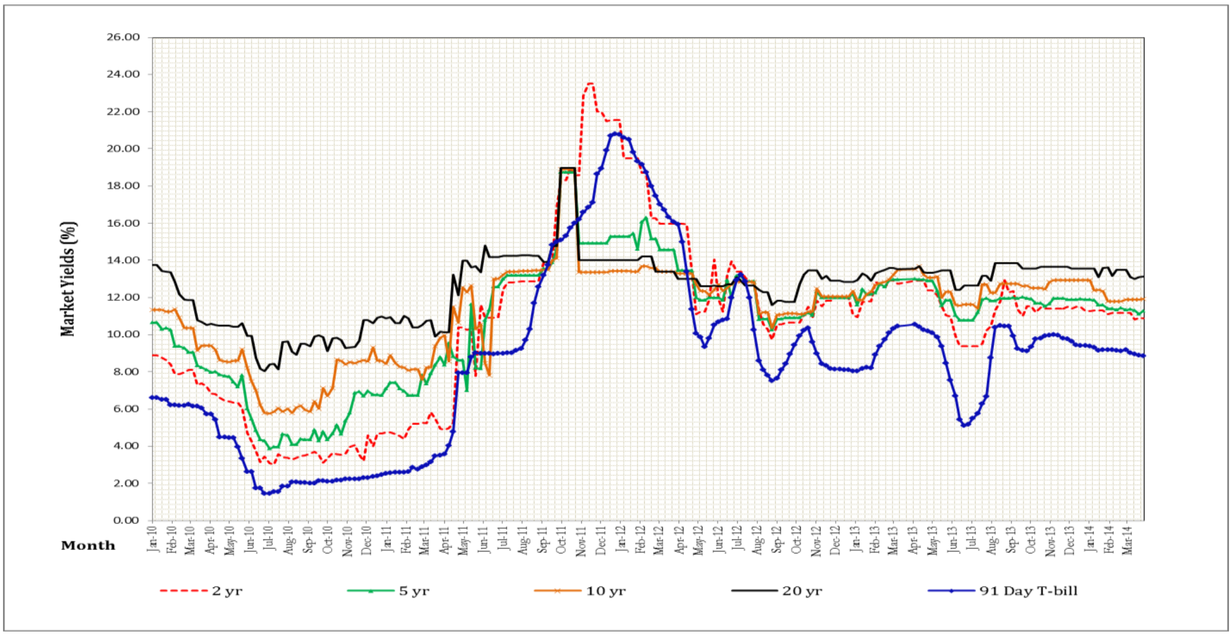
Figure 28: Monthly Bonds Trading at the NSE (Ksh Millions)



Source: CBK, Financial Markets database

Market yields on benchmark yields however remained stable since July 2012 with some mild instability in May – June 2013, perhaps reflecting the announcement of the U.S tapering programme. Yields on all benchmark tenors traded within a narrow band, reinforcing our view on market stability as indicated in Figure 29. Yields had been very low in 2010 due to loose monetary policy by CBK before sharp rise in 2011 on tightening to correct imbalances.

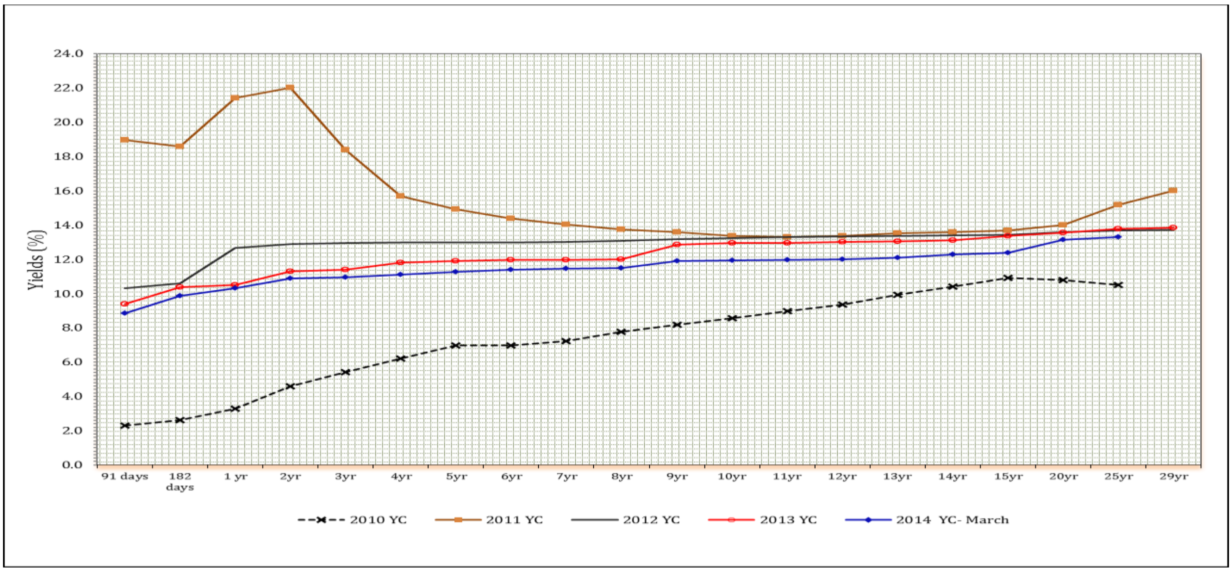
Figure 29: Benchmark Yield Curves (2010 – 2013)



Source: Estimated from NSE trading data

The period between 2012 and March 2014 has been characterised by most stable yields in the bonds market as reflected by the position and shape of the corresponding yield curves in figure 30. Yield curves for the 2012, 2013 and 2014 (March) are generally smooth, upward-slopping with gentle slope and very close to each other signifying minimal shift.

Figure 30: Position and Shape of the Yield Curve 2010 (12) – 2014(3)



Source: Financial Markets database, CBK

Yield curves position and shapes completely mirror market dynamics in 2010 when the yields were very low and a reversal that followed in 2011 resulted in sharp outward shift inverted yield curve with a kink at the short end. Overall, the yields have come down and oscillate in a narrow band in the period 2012 – 2014 (3). This has created a conducive and predictable environment for corporates to mobilise long term capital in corporate debt markets as well as pricing of mortgage facilities.

3.8.5 Risks and Outlook in the Domestic Debt Markets

a. Refinancing (Rollover) Risk

This is the risk that the debt issuer (government) would be unable to raise required funding from domestic markets at sustainable market rates. This manifests itself in auctions undersubscriptions, rollover difficulties of maturing debt and acquiring new debt at much higher interest rates. It is prevalent in floating interest rates regime. This is a risk Kenya has generally minimised since undertaking crucial reforms in the debt markets in 2001. As indicated in Table 10, all auctions offered since 2008 have on average, been fully subscribed and bid-to-cover ratio was above 1, implying moderate refinancing risk. Where it existed, the pass-through was in high interest rates as reflected in the 2011 developments in Figures 29 and 30.

To mitigate redemption or rollover risks, lengthening maturity profile of existing stock of debt is very crucial. The Government and CBK have actively pursued this strategy as espoused in the Medium Term Debt Strategy overtime, yielding Average Time to Maturity (ATM) of outstanding domestic debt stock of 5.14 years in 2013 compared to 3.42 years in 2008 (Table 10).

Table 10: Risks in Treasury Securities primary market

MEASURE	2008	2009	2010	2011	2012	2013
Average Time To Maturity (Yrs.)	3.417	4.250	5.167	5.750	4.917	5.140
Bid-to-Cover Ratio (Bonds)	1.53	1.52	1.60	1.57	1.77	1.56
Bid-to-Cover Ratio (Bills)	1.35	1.39	1.74	1.38	1.57	1.64
Bonds Subscription	111.0%	152.2%	162.9%	122.5%	233.6%	195.0%
Bills Subscription	112.3%	129.1%	158.6%	138.1%	145.9%	161.3%

Source: Derived from National Debt Database

At the start of bond market reforms in 2001, ATM was just 8 months implying very high rollover risks. The decline in 2012 to 4.92 years could be explained by issuance of more short term debt in the first half of 2012 in order to minimize borrowing cost given prevailing high interest rates. It also helped to build investor confidence and re-establish reliable pricing benchmark in the domestic debt market following interest rate shocks in 2011.

b. Interest Rate Risk

Interest rates risks emerge from excessive volatility in the market that eventually impacts on the cost of raising money. In the period under review, the Government did not face significant risks of interest rates on both Treasury bills and bonds since the market was generally liquid. Interest rates of Treasury bills trended within a stable range of 300bps, while yields on Treasury bonds remained steady with a spread of 300bps between the lowest and the highest maturity. Volatility experienced in the market in July 2013, especially on the 3-months Treasury bill and Treasury bond yields reflected investors shift from equities market following decline in stock prices on sentiments from the U.S tapering programme.

c. Market Liquidity Risk

Liquidity risk occurs on inability to unwind a position in a given security through the market. Since the adoption of the Automated Trading System (ATS), trading turnover rose fourfold beginning 2010. This has resulted in increased liquidity in the secondary market, making it easier for traders and investors unwind their positions in a safe and efficient manner. The ATS enables traders to get prices quickly and therefore price their holdings appropriately. The bonds' reopening operations also offered more liquid securities as more liquidity was built in benchmark issues. Overall, the improved liquidity contributed to full subscriptions of all new issues, either by the government or corporate sector and reduced pressure on primary market yields.

d. Overall Public Debt and Debt Sustainability

The country's public and publicly-guaranteed debt grew by 15.62 percent, to Ksh 2.19 trillion in May 2014 from Ksh 1.89 trillion in June, 2013 and Ksh 2.11 trillion in December 2013. Of the total, External Debt excluding the Eurobond was Ksh 957.89 billion (43.74 percent) while Domestic Debt totalled Ksh 1.23 trillion (56.26 percent) as at May 2014. Total debt stock at the end of May 2014 was equal to 57.66 percent of GDP compared with 49.87 percent of GDP in June 2013 and 55.60 percent in December 2013. This is expected to increase as the government embarks on accelerated infrastructure development that would require additional resources. The government would however monitor and evaluate this development to ensure sustainability and stability in the debt markets. Robust Debt Sustainability Analysis is needed for updated assessment of the sustainability of public debt, including government guaranteed public debts.

3. FINANCIAL SECTOR DEVELOPMENTS AND OUTLOOK

Financial sector in Kenya has grown significantly and become highly integrated in the overall economy, regionally and internationally. It comprises of the banking, capital markets, Insurance industry, Pension Industry, safety nets and resolution institutions like the Kenya Deposit Insurance Corporation, financial markets infrastructure, and Saccos sub-sectors. As a proportion of Gross Domestic Product (GDP) at Current Market Prices, total assets of the financial sector excluding capital markets accounted for 108.00 percent in 2013 up from 96.48 percent in 2012. Total value of equity market capitalization accounted for 50.57 percent of GDP (Table 11).

Table 11: Share of the Financial Sector to GDP

GDP/ SUB-SECTOR ASSETS	2012		2013	
	Kshs in Mns	Share of GDP	Kshs in Mns	Share of GDP
Nominal GDP	**3,403,547**	**N/A**	**3,797,988**	**N/A**
Banking Assets	2,330,335	68.47%	2,703,394	71.18%
Pension Assets	548,700	16.12%	696,680	18.34%
Insurance Assets	311,000	9.14%	366,252	9.64%
Saccos Assets	93,765	2.75%	335,437	8.83%
TOTAL	**3,283,800**	**96.48%**	**4,101,763**	**108.00%**
Equities Market Capitalization	1,272,002	37.37%	1,920,719	50.57%

Source: Computed from KNBS, NSE and CBK data

The banking subsector accounted for 71.18 percent, followed by pension and insurance subsectors in that order. This shows significant contribution of the sector to the overall economy, making it very critical to the stability of the economy. This increased integration into the mainstream economy justifies regular macroprudential surveillance and assessment to identify potential risks and vulnerabilities and institute appropriate mitigation measures.

4.1 BANKING SUBSECTOR

As at 31st December 2013, banking subsector comprised of **43** commercial banks, **1** mortgage finance company, **7** representative offices of foreign banks, **9** microfinance banks, **2** credit reference bureaus, **2** money remittance providers and **112** Foreign Exchange Bureaus. All these are regulated and supervised by the Central Bank of Kenya.

4.1.1 Growth of the Subsector

The banking subsector had strong growth across all performance indicators in the year ended December 2013. Pre-tax profits grew by 16.6 percent while total net assets increased by 16 percent to Ksh 2,703.4 billion in December 2013 on account of loans and advances. Loans and advances, government securities and placements were key components of banks' balance sheet items, accounting for 56.7 percent, 21.6 percent and 6.5 percent of total net assets respectively. Net loans and advances rose by 18.2 percent from Ksh 1,296.5 billion in December 2012 to Ksh. 1,532.4 billion in December 2013. Placements increased by 42.6 percent from Ksh 124.4 billion to Ksh 177.4 billion in the year due to higher credit uptake. Total deposits held by commercial banks increased by 13.3 percent from Ksh 1,707.8 billion in 2012 to Ksh 1,935.7 billion in 2013, explained by branch expansion, agency banking, remittances and exports receipts.

4.1.2 Capital Adequacy for the Sector

The Central Bank of Kenya issued revised guidelines on prudential capital adequacy ratios to be complied with by the commercial banks with a capital buffer of 2.5 percent above the traditional ratios from January 2015. The minimum regulatory capital adequacy requirement, which is the ratio of Core Capital (Tier I) and Total Capital (Tier II) to Total Risk Weighted Assets, is 8.0 percent and 12.0 percent respectively. These ratios declined from 20 percent and 23.0 percent in 2012 to 18 percent and 21 percent, 2013 respectively as a result of larger increase in total risk weighted assets, which grew by 17.3 percent and 18.5 percent respectively (Table 12).

Table 12: Trends in Capital Adequacy Ratios (CAR in Percent)

Year/Ratio	Tier I/TRWA	Tier II/TRWA	Tier I/Total Deposits
2010	20%	22%	17%
2011	18%	21%	16%
2012	20%	23%	17%
2013	18%	21%	19%
Minimum CAR	**8%**	**12%**	**8%**

Source: CBK/BSD Annual Report, 2013

The ratio of core capital to total deposits increased from 17 percent in 2012 to 19 percent in 2013 as banks' capital base funded by retained earnings and injection of fresh capital increased. All banks, except one in the small peer group met the minimum core capital base of Ksh 1.0 billion as at December 2013. The bank in question was affected by increased provisions for loan losses, and the regulator took prompt corrective actions to ensure full compliance.

4.1.3 Asset Quality of the Subsector

A mix of high interest rates and subdued economic activities associated with uncertainty around the March 2013 general elections affected quality of loans and advances. Realignment of the National Government operations and implementation of devolved government under the constitution of Kenya 2010 saw delays in payments of services rendered (Table 13).

Table 13: Trends in Asset Quality since 2010 (Ksh Millions)

INDICATOR	2010	2011	2012	2013
Net Assets	1,678,112	2,020,818	2,330,335	2,703,394
Gross Loans	914,910	1,190,985	1,330,365	1,578,768
Total Loans	905,002	1,180,956	1,318,570	1,564,635
Net Loans	876,357	1,152,011	1,296,452	1,532,387
Gross Non-Performing Loans	57,637	52,958	61,917	81,857
Interest in Suspense	9,908	10,029	11,795	14,133
Total Non-Performing Loans	47,730	42,928	50,122	67,724
Specific Provisions	28,645	28,945	27,185	32,247
Net Non-Performing Loans	19,084	13,983	22,937	35,476
Gross Loans/Net Assets (%)	54.52	58.94	57.09	58.40
Gross NPLs/Gross Loans (%)	6.30	4.45	4.65	5.18
Net NPLs/Gross Loans (%)	2.09	1.17	1.72	2.25

Source: Central Bank Database

The delays impacted negatively on the economic activities, leading to increased NPLs by 32.3 percent from Ksh 61.9 billion in 2012 to Ksh 81.9 billion in 2013 (Table 12). The ratio of gross NPLs to gross loans rose from 4.7 percent to 5.2 percent, reflecting elevated credit risk.

4.1.4 Distribution of Gross Loans, Loan Accounts and Non-Performing Loans

The largest proportion of the banking industry loans and advances were channelled through the personal, trade, manufacturing and real estate sectors. In total, these economic sectors accounted for 73 percent of gross loans in 2013 as indicated in Table 15.

Table 14: Loan Book Distribution (Ksh Millions), December 2013

Economic Sectors	No. of Loan Accounts	Share of Total (%)	Gross Loans	Share of Total (%)	Gross NPLs	Share of Total (%)
Agriculture	130,211	4.2	68,926	4.4	5,588	6.8
Manufacturing	24,442	0.8	204,131	12.9	5,580	6.8
Building & Construction	13,460	0.4	72,406	4.6	6,185	7.6
Mining and Quarrying	1,753	0.1	16,322	1.0	482	0.6
Energy and Water	5,971	0.2	66,190	4.2	1,118	1.4
Trade	356,434	11.5	316,707	20.1	20,236	24.7
Tourism, Restaurant, Hotels	8,464	0.3	37,956	2.4	2,610	3.2
Transport& Communication	37,950	1.2	108,831	6.9	6,435	7.9
Real Estate	51,859	1.7	222,735	14.1	10,998	13.4
Financial Services	17,185	0.6	56,397	3.6	1,361	1.7
Personal/Household	2,448,548	79.1	408,168	25.9	21,266	26.0
Total	**3,096,277**	**100.0**	**1,578,768**	**100.0**	**81,857**	**100.0**

Source: Central Bank of Kenya database

In terms of total loan accounts, personal/household sector accounted for 79 percent, translating into 25 percent of the banking sector credit and 26 percent of the NPLs. The sector's NPLs to gross loans ratio was 5.2 percent by end of December 2013 with; Agriculture, Personal, Tourism, Trade, Transport and building and construction recording ratios above the industry average.

4.1.5 Banking Sector Liquidity

All commercial banks operating in Kenya are required under the Banking Act to maintain a minimum liquidity ratio of 20 percent. Liquidity level indicates the bank's ability to fund increases in assets and meet obligations falling due. It is therefore one of the leading financial stability indicators since its deterioration, just to one bank can trigger panic culminating into systemic crisis in the entire banking sector and spillover to the rest of the economy. Banking sector average liquidity by end of December 2013 exceeded the statutory minimum requirement of 20 per cent with all the banks in full compliance as shown in table 14.

Table 15: Trends in Banks' Liquidity

MEASURE	2008	2009	2010	2011	2012	2013
Liquidity Ratio (%)	45.1	39.8	44.5	37.0	41.9	38.6
Minimum Statutory Ratio (%)	**20**	**20**	**20**	**20**	**20**	**20**
Excess/(Deficiency) in %	25.1	19.8	24.5	17.0	21.9	18.6
Gross Loans/Deposits Ratio (%)	73.30	72.40	72.50	78.20	77.30	81.10

Source: Central Bank Database based on unaudited end year results.

Liquidity averaged 38.6 percent in 2013 compared to 41.9 percent in 2012. The 3.3 percent decline is due to the increased lending in 2013 as reflected in the increase in loans to deposits ratio from 77.9 percent to 81.6 percent. Over the last six years, banking sector average liquidity has exceeded the minimum statutory requirements in double digits.

4.1.6 Banking Sector Profitability and Losses

Kenya's banking sector profitability has remained strong, almost tripling in the last six years as indicated in Table 16. The robust profitability in 2013 despite mute economic activities could be explained by growth in credit portfolio, investment in government securities, commissions and earnings from foreign exchange trading.

Table 16: Banking Sector Profitability since 2008

END YEAR	2008	2009	2010	2011	2012	2013
PROFITABILITY IN KSH MILLIONS						
Profit/(loss) before tax and exceptional items- **A**	43,293	48,926	74,272	89,453	107,898	125,760
Profit/(loss) after exceptional items - **B**	43,327	49,006	77,024	89,446	107,890	124,932
Profit/(loss) after tax and exceptional items - **C**	30,149	34,523	57,590	63,955	75,039	88,830
ANNUAL GROWTH RATES (%)						
Growth Rate **A**	21.6	13.0	51.8	20.4	20.6	16.6
Growth Rate **B**	21.1	13.1	57.2	16.1	20.6	15.8
Growth Rate C	20.8	14.5	66.8	11.1	17.3	18.4

Source: CBK Bank Supervision Annual Reports

Industry profits before tax increased by 16.6 percent from Ksh 107.9 billion in 2012 to Ksh 125.8 billion in 2013. Interest income declined to 58.4 percent of total income in 2013 from 60.8 percent in 2012. Three banks had losses totalling Ksh 1.65 billion in 2013 down from four banks that had losses totalling Ksh 2.62 billion in 2012.The banking sub sector performance remains uneven despite strong growth in profitability, assets base, return on assets and return on equity. Since 2010, the top six banks remain far apart from the bottom six banks across all the five performance indicators as shown in Table 17.

Table 17: Banking Sector Performance Comparison (Ksh Billions)

INDICATOR	TOP SIX (6) BANKS				BOTTOM SIX (6) BANKS			
	2010	2011	2012	2013	2010	2011	2012	2013
Net Assets	933,608	1,033,310	1,169,779	1,388,640	18,928	30,552	60,738	73,398
Shareholders' Equity	151,097	166,088	202,052	239,484	5,265	6,229	8,074	9,140
Profits Before Tax	46,955	57,418	73,158	78,926	96	15.96	-2,517	-1,482
Return on Assets (%)	5.03	5.56	6.25	5.68	0.51	0.05	-4.14	-2.02
Return on Equity (%)	31.08	34.57	36.21	32.96	1.82	0.26	-31.17	-16.21

Source: Bank Supervision Annual Reports

In the four-year period, the bottom six banks had negative or below 1 percent return on assets and return on equity compared to the top six banks, whose ratios were above 5 percent. Similar trend is observed in the profits before taxes. This implies that some banks continue to face challenges in a competitive environment and therefore in the event of strong shocks, they will find the going getting tough. Implementation of the recently introduced transparent pricing measures (KBRR) may have implication on the sustainability of the bottom six banks. The regulatory framework should therefore envision such categories of players in the market and ensure they upscale their capital levels accordingly to absorb any losses that may arise.

4.1.7 Sensitivity to market risks

Exposure by banks to foreign exchange rates dynamics improved in 2013. Net foreign exchange position to core capital averaged 2.2 percent in 2013 from an average of 2.6 percent in 2012. Foreign currency loans to foreign currency deposits decreased from 95.7 percent to 95.2 percent over the period, indicating better matching. The ratio of assets to liabilities both denominated in foreign currency declined from 75.8 percent to 71.5 percent as banks tried to match assets and liabilities denominated in foreign currency. Credit risk on foreign currency loans arises when exchange rate depreciates, making repayments burden to increase if income streams of borrowers are in local currency.

4.1.8 Financial Soundness Indicators (FSIs)

The CBK adopted the BIS Basel Committee of Banking Supervision and the IMF prescribed FSIs for monitoring and evaluating soundness of financial institutions. Some of the FSIs provided in the Banking Act and prudential guidelines which banks should adhere to are captured in table 18. All banks met the minimum core capital to deposits ratio, liquidity ratio and the maximum foreign currency exposure limit of 10 percent.

Table 18: End Quarter Core Financial Soundness Indicators (FSIs)

INDICATOR	Dec-11	Jun-12	Dec-12	Jun-13	Dec-13
CAPITAL ADEQUACY RATIO (%)					
Total Capital to Risk-Weighted Assets **(Min 12%)**	21.1	20.3	23.1	23.3	23.2
Core Capital to Risk-Weighted Assets **(Min 8%)**	18.3	17.7	20.2	20.5	19.4
Core Capital to Deposits **(Min 8%)**	16.2	15.3	17.3	17.1	17.1
Total Capital to Total Assets	13.2	13.4	14.2	14.4	14.9
ASSET QUALITY (%)					
NPLs to Gross Loans	4.4	4.5	4.7	5.3	5.0
NPLs Net of Provisions to Capital	3.5	3.6	3.5	6.2	5.8
Earning Assets to Total Assets	87.8	87.7	87.4	88.7	88.9
EARNINGS & PROFITABILITY (%)					
Return on Assets (ROA)	4.4	4.0	4.6	3.9	3.6
Return on Equity (ROE)	30.7	33.3	29.8	31.2	28.9
Interest Margin to Gross Income	38.6	31.5	32.7	36.6	37.2
Non-Interest Expenses to Gross Income	44.6	36.2	37.8	40.7	41.7
LIQUIDITY (%)					
Liquid Assets To Total Assets	33.3	34.2	35.2	35.3	34.3
Liquid Assets to Short-term liabilities (Liquidity ratio) (**Min 20%)**	37.0	38.1	41.9	42.7	38.6
Liquid Assets to Total Deposit	43.8	45.0	46.8	47.5	47.0
Total Loans to Total Deposits	77.4	77.4	76.9	77.8	80.4
SENSITIVITY TO MARKET RISK (%)					
Net open position in Foreign Exchange to Capital **(Max. 10%)**	3.3	3.4	2.6	2.7	2.2
Interest Bearing Assets to Interest Bearing Liabilities	115.4	115.3	116.2	119.3	121.6
FX Currency Denominated Assets to Total Assets	11.8	12.8	13.2	12.1	13.7
FX Currency Denominated Liabilities to Total Liabilities	21.5	22.3	20.9	21.3	22.9
Spread between lending and deposit rate	8.4	9.9	10.3	9.4	8.9

4.1.9 Micro-stress Testing

The CBK conducts monthly stress tests on individual banks (micro-stress testing) to establish sources of vulnerabilities in event of excessive shocks or risk factors. Stress testing involves identifying plausible future changes in economic conditions or other possible events that could trigger unfavourable effects on a bank's risk exposures. Based on the 2013 data, plausible scenarios were used to stress the system's resilience to credit risk; liquidity risk; and market risk; whose results are presented in table 19. Overall, stress tests results on credit risk reveal that it would require significant increase in NPLs for a large bank to fail to meet the minimum statutory CAR. All banks would meet the minimum liquidity requirement of 20 percent in case of a one-off 5 percent deposits withdrawal. If there is a 5 percent sudden depreciation of the shilling, all the banks would comply with the exposure limit of up to 10 percent net open position in foreign exchange to core capital ratio. In addition, the proportion of loans in foreign currency constituted 23.3 percent of the banking sector credit and banks have endeavoured to match loans and liabilities denominated in foreign currency.

Table 19: Micro-Stress Testing Results

Risk	Stress factor (%)	Number of banks impacted
Credit Risk		
Personal and trade sectors	NPLs increase by **15%**	Capital adequacy ratio of 1 bank in a small peer group will drop to **11.9%** below the statutory minimum of **12%.**
Agriculture, manufacturing, tourism & real estate sectors	NPLs increase by **13%**	
Transport & communication, financial services, energy & water, building & construction and mining & quarrying sectors	NPLs increase by **10%**	
Liquidity Risk		
Decline in deposits	**5%** decline in deposits	All banks meet liquidity statutory threshold of **20%.**
Market Risk		
Weakening of the shilling	Kenya Shilling depreciates by **5%** against the USD	A weaker shilling impacts on both credit risk and foreign currency exposure.

Source: CBK Bank Supervision Annual Report, 2013

The CBK issued a prudential guideline on stress testing by individual banks which came into effect in January 2013. Banks are required to conduct stress tests regularly and submit results to CBK on quarterly basis to enable the regulator to monitor and continuously engage them on appropriate contingent plans for mitigating potential risks and vulnerabilities. The latest IMF Mission in March 2014 however has recommended reforms on stress testing exercise to make it more robust and produce better results, including conducting less frequent stress tests.

4.1.10 Regional Kenyan banks' Subsidiaries

As at 31st December 2013, **11** Kenyan banks had subsidiaries operating across the East African Community (EAC) Member States and South Sudan. The subsidiaries had a total of 288 branches as at December 2013 up from 282 in December 2012. A total profit before tax of Ksh.5.2 billion was realised in the year 2013. However, eight (8) subsidiaries registered losses in various countries in the region. Gross loans amounted to Ksh.149.6 billion compared to Ksh.127.3 billion in December 2012. Subsidiaries' total assets were Ksh.306.3 billion as at end December 2013. Given the growing cross border cross sector operations among the Kenyan banks, CBK issued a prudential Guideline on Consolidated Supervision which came into effect from 1st January 2013. This has empowered CBK to supervise banking groups on a consolidated basis, thus managing potential risks spillovers in banking groups. The largest country risk exposure is the Kenyan banks' subsidiaries in South Sudan due to the on-going political instability and threats of sanctions from international community against its leaders.

4.1.11 Banking Sector Outlook in 2014

The banking subsector is expected to maintain a solid growth path and remain stable as indicated by quarterly results of 2014, given emerging opportunities in Kenya and across the EAC region. Entrenchment of devolved system of Government in Kenya provides the sector with a window to revamp its infrastructure to meet the needs of the market. Advances in and use of information and communication technology in the country is expected to significantly impact the banking sector's operating efficiency and capacity. Regional integration is expected to impact the sector both strategically and operationally as more institutions seek to expand their global footprint within the East Africa region.

The Central Banks of EAC are also expected to continue their efforts towards harmonisation of their regulatory frameworks, which should positively affect the banking sector from a regulatory perspective. Roll out of full credit information sharing (CIS) that includes reporting both positive and negative credit information to credit reference bureaus by banks should support efforts towards inculcating financial discipline and bringing the benefits of lower interest rates on loans to good borrowers closer to realisation as well as extending credit facilities to borrowers based on good track record instead of reliance on physical collateral. Large infrastructure projects including Oil, gas and other minerals explorations and extractions in Kenya provide the banking sector with new business opportunities for gainful exploitation of these resources.

In terms of threats and challenges, rapid expansion in the region may come with country risk as a result of cross-border operations. Kenya's banking sector presence in South Sudan is significant and therefore continued conflicts that are likely to attract international sanctions would seriously affect doing business in that country. Closure of all subsidiaries in South Sudan to avoid penalties from International Community if sanctions are applied would greatly impact Kenya's banking system. This is therefore an elevated threat to Kenya's financial system. Threats to overall economy as a result of insecurity in the country, travel advisories by traditional tourists markets, Ebola virus outbreak in West African countries, and negative shock to our key exports would affect asset quality through increased Non-Performing loans since trade and personal loans are the largest recipient. The emerging punitive litigations against banks especially in the U.S and the West (BNP Paribus, JP Morgan) may have significant impact on Kenya's banking system if major foreign banks operating in the country become victims.

Domestically, a case lodged by one customer against her bank and later enjoined the general public affected seeking to compel banks to refund customers monies that were allegedly levied on them without going through the necessary approvals, could have significant impact on the banks if the court rules in the customers' favour. In addition, increasing questioning of legality of some title deeds could lead to major losses among banks if such were used as collateral to acquire loans by some customers from banks.

Introduction of the Kenya Banks' Reference Rate (KBRR) and Annual Percentage Rate (APR) pricing measures on credit facilities may bring challenges as well as opportunities to the sector, especially for less competitive banks, which may affect profitability. To the strong banks, this would create more lending opportunities as more customers are expected to seek credit facilities.

To the less competitive banks however, this may bring challenges not only in pricing their loans, but also mobilising sufficient deposits to meet increased demand by customers.

4.2 DEPOSIT PROTECTION

The Deposit Protection Fund offers protection or insurance of customer deposits in the member institutions. There were a total of 53 member institutions comprising of 43 commercial banks, 1 mortgage finance company and 9 microfinance banks under Deposit Protection Fund. One bank still remains under statutory management and a member of the Fund.

4.2.1 Growth in the Number of Deposit Accounts

Total deposit accounts with the member institutions rose by 35 percent, from 17.62 million in December 2012 to 23.75 million in December 2013. The rapid growth is attributed to; financial inclusion initiatives by the Regulator, introduction of M-Shwari accounts by Commercial Bank of Africa in partnership with Safaricom, increased use of agency banking model by banks; and enhanced marketing by banks. In addition, more employers, both public and private prefer making payments through bank accounts. Table 20 shows quarterly growth in the number of deposits accounts in the member institutions.

Table 20: Quarterly Change in Deposit Accounts

ACCOUNTS	Dec, 2012	Mar, 2013	Jun, 2013	Sep, 2013	Dec, 2013
Total Number	17,617,636	19,085,484	20,907,965	23,009,917	23,747,415
Absolute Change	884,169	1,467,848	1,822,481	2,101,952	737,498
Change (%)	5.00	8.33	9.55	10.00	3.00

Source: Deposit Protection Fund Board Annual Report, 2013

4.2.3 Growth of the Fund

The fund grew by 18.14 percent to Ksh. 44.30 billion by end December 2013 from Ksh 37.52 billion by end December 2012 as a result of prudent investment policies adopted by the Board. The funds are placed in a portfolio mix of both short and long term Government securities as required by Law and in line with the approved Board policy. The Board's policy objective is to achieve an optimum yield on its investment portfolio while considering the prevailing economic environment. Table 21 summarises quarterly changes of the Fund.

Table 21: Fund Growth, Insurance Cover and Deposits

INDICATOR	Dec. 2012	Mar. 2013	Jun. 2013	Sep.2013	Dec. 2013
Total A/Cs	17,617,636	19,085,484	20,907,965	23,009,917	23,747,415
Total Deposits (Sh'000')	1,781, 862	1,798,655	1,884,784	1,940,278	2,014,907
Insurance Cover (Sh'000')	187,439	190,876	192,887	199,669	214,526
Fund Growth (Sh'000')	37,518	38,472	39,464	43,202	44,322

Source: DPFB Annual Report, 2013

The total deposits of member institutions increased by 13.1 percent, to Ksh 2.015 trillion while the total protected deposits rose to Ksh 214.5 billion, or 14.44 percent in 2013. Of the total deposit accounts of 23.75m, those fully protected were 22.66 million implying that 95 percent of the total accounts in the sector were fully protected.

4.2.4 Protection and Risk Exposure

The critical role of deposits protection is to provide insurance cover for customers' accounts. Its presence and level of coverage signify how well the financial system is cushioned against potential risks and therefore overall stability of the system. The Fund Balance stood at Ksh 44.32 billion compared to protected deposits of Ksh 214.53 billion, a considerably high exposure level of 79.3 percent. Overall sector protection and exposure indicators are summarised in Table 22.

Table 22: Trends in Protection and Exposure Indicators of the Fund

	SECTOR PROTECTION	Dec. 2010	Dec. 2011	Dec. 2012	Dec. 2013
1	Total Deposits(Ksh in Mns)	1,279,954	1,556,533	1,781,862	2,014,907
2	Total Protected Deposits (Ksh in Mns)	157,174	169,363	187,440	214,526
3	Protection Level (%)	12.28	10.88	10.52	10.65
4	Fund Balance (Ksh in Mns)	26,944	31,961	37,536	44,322
5	Effective Cover (%)	17.14	18.87	20.03	20.66
	DEPOSIT ACCOUNTS				
6	Total Deposit accounts ('000s')	12,804	15,655	17,618	23,747
7	Total accounts fully protected ('000s')	12,027	14,761	16,647	22,656
8	Share of Protected accounts (%)	93.93	94.29	94.49	95.41
9	Exposure Level (%)	82.86	81.13	79.97	79.34

Source: DPFB Database

Note: Effective Cover is derived as row 4 divide by row 2; Exposure level is (row 2 –row 4)/row 2; Protection level is row 2 divide by row 1; and Share of protected accounts is row 7 divide by row 6.

The total subsector value effectively covered was 20.7 percent, which is way below the 40 percent international benchmark under the International Association of Deposits Insurers (IADI) Core Principles. The current stability of the financial sector in the country however remains a mitigating factor on the low coverage.

4.2.5 The Kenya Deposit Insurance Act, 2012

The Kenya Deposit Insurance Act ("KDI Act") published on May 14th, 2012, establishes Kenya Deposit Insurance Corporation ("KDIC"). The Act is however yet to be granted a commencement date by the Cabinet Secretary. The Act provides for a deposit insurance system for protection of deposits, examination of member institutions, prompt corrective action, receivership and liquidation of deposit taking institutions. Review of the KDI Act by DPFB in November 2012 with technical support from the IADI led to the amendment of the Act through the Kenya Deposit Insurance (Amendment) Act, 2013. The amendments amongst others provide for:

a) Efficiency and effectiveness in the management and resolution of problem banks by introducing various restructuring mechanisms and without recourse to depositors, creditors and shareholders.
b) Grants powers to KDIC to inject resources into an institution, as liquidity support or capital, when financial stability is threatened. To mitigate moral hazard, assistance to an institution is limited to systemic cases, with prior approval of the Cabinet Secretary.
c) Grants KDIC powers to enter into cross-border arrangements with other regulators and / or deposit insurers in the wake of regional financial expansion and integration.
d) Enhances corporate governance by setting criteria for appointment of Board members, increasing the number of Board members and provides for independent directors
e) Provides for instances when funds can be appropriated from the Consolidated Fund.
f) Provides for fixing the Fund size to protect the interest of depositors and creditors.
g) Increases the maximum amount to be borrowed from the Central Bank and indicates who should set the terms and conditions for the borrowing.
h) Provides additional investment options to KDIC to enhance earnings and growth.
i) Makes KDIC a preferred creditor in dividend pay outs to foster financial stability.
j) Introduces efficiency to the deposit pay-out process by granting powers to KDIC to exercise its discretion to make advance, interim or emergency partial payments.

4.2.6. Sector Outlook in 2014

The rapid expansion of the banking subsector across borders and across different sectors comes with different risks. This poses risks especially given the current low level of effective coverage. In addition, increased technological and products innovations like partnerships between banks and mobile money providers in rolling out products like M-Shwari presents challenges as well as opportunities for the KDIC going forward in terms of ensuring sector stability.

The continued fragmentation of Customers' Protection funds like Investor Guarantee Compensation Fund for Capital Markets, Insurance Compensation Fund under IRA and Customer Protection Fund under SASRA in the financial system at national and regional level poses challenges to the KDIC in the event of systemic risks since most of these other Funds are not well funded. Stability of the sector critically depend macroeconomic stability and effectiveness of micro-prudential supervision, both at national and regional level. Any adverse outturn in these areas would be a source of threats to the sector.

4.3 CAPITAL MARKETS INDUSTRY

4.3.1 Industry Performance and Activity

Equity turnover for the calendar year grew by 79.4 percent year-on-year to Ksh 155.7 billion on account of increased local and foreign investors' participation. This was driven by improved macro-economic conditions and strong earnings posted by most of the listed companies. Foreign investors accounted for 59.2 percent of the equity purchases and 43.6 percent of equity sales in 2013. The market closed the year at a P/E multiple of 16.0x compared to 11.0x in 2012, on higher demand for Safaricom, East African Breweries, Kenya Commercial Bank and Equity Bank shares. All these counters crossed their fair values by end of 2013, also being main target by foreign investors. Home Afrika Limited, a property developer was the first company to list on the Growth Enterprise Market Segment (GEMS) of the Nairobi Securities Exchange (NSE) in August 2013. The company listed 405.3 million shares at Ksh12.00 per ordinary share. Access

Kenya was suspended from trading in May 2013 following a take-over notice by Dimension Data. CMC Holdings and Rea Vipingo had take-over offers, expected to be concluded in 2014.

The Fixed Income segment of NSE recorded a 20 percent year-on-year decline in turnover in 2013 compared to 2012. The decline may be as a result of improved risk appetite by investors that prompted asset substitution for more risky but higher return equities rather than bonds. The 41 percent Nairobi All Share Index (NASI) returns in 2013 could explain investors' portfolio shifts between to equities and bonds, as investors preferred the later asset class (Table 23). Overall, the NSE ended 2013 as the best performing bourse in Africa, and fourth globally.

Table 23: Trends in NSE Market Indicators since 2009

Indicator	Dec,2009	Dec,2010	Dec,2011	Dec, 2012	Dec, 2013
NSE 20 Index (Points)	3247.40	4432.60	3205.02	4133.02	4926.97
NASI (Points)	71.64	97.82	68.03	94.86	136.65
Market PE Ratio (%)	n/a	n/a	n/a	11	16
Annual Equity Turnover(Ksh Mn)	38,191	110,324	78,059	86,795	155,749
Annual Average foreign investors Share to Total Equity Turnover	28.52%	22.98%	51.89%	49.17%	51.38%
Annual Bond Turnover (Ksh Mn)	110,645	483,148	445,462	565,675	452,460

Source: CMA database and CBK database

4.3.2 Key Market Developments

Products Development

Derivatives Markets: The CMA developed a handbook on Central Counter Party (CCP) clearing to guide potential participants in Derivatives Exchanges in Kenya on the features and requirements of the country's clearing and settlement infrastructure. In addition, comprehensive manuals were developed on policies and check-lists to assist the Authority in reviewing applications, market supervision, risk management, surveillance and enforcement in Derivatives Market; as well as a tax and accounting framework for the industry. CMA is also reviewing an application by the NSE to engage in the listing, trading, clearing and settlement of some derivatives contracts.

***Real Estate Investment Trusts (REITs)*: Following the establishment of the legal framework, the CMA licensed REITS Managers as it sought to operationalize this new product. Further, capacity building on REITs was undertaken for CMA staff, investors, potential issuers and market intermediaries.

***Capital Markets (Amendment) Act, 2013*: The Capital Markets (Amendment) Act, 2013 was enacted in December 2013. The Act provides for regulation of; derivative markets; securitization/asset backed securities; and public offer of securities. It also strengthens CMA's supervision, investigation, intervention and licensing powers; prohibition of insider trading and other market abuses; and facilitates implementation of the EAC Common Market Protocol as well as harmonization of EAC capital markets legal and regulatory frameworks.

Risk-Based Supervision (RBS): CMA is implementing the new RBS system for both internal and external customers. Following the launch of the system in September 2013, most of the connected external users now submit their reports online reducing significantly the turnaround time for licensing and approvals to twenty-five working days. The RBS system has two other internal modules; a risk profiling module and inspection module, interlinked to enhance the supervision process.

***Compliance with International Organization of Securities Commissions (IOSCO) new principles*:** The CMA in collaboration with World Bank carried out an independent assessment to establish the country's compliance with IOSCO's 9 new principles. The new principle focuses on establishing the robustness of the country's systems to address any emerging systemic risks. The assessment also focused on audit oversight standards and independence

***Anti-Money Laundering (AML) Guidelines*:** CMA drafted the Anti-Money Laundering Guidelines for market intermediaries dealing in the capital markets. The guidelines provide for measures to prevent, detect and report suspicious transactions.

Capital Markets Intermediaries Financial Soundness Indicators: All licensed firms maintained capital adequacy levels in line with statutory requirements. In addition, statutory limits on paid up share capital, shareholders' funds, working capital and unsecured advances were all in good standing during the review period.

***Enterprise Resource Planning*:** To enhance its efficiency and service delivery, CMA invested in a world-class Enterprise Resource Planning (ERP) system which integrates its internal processes. This is expected to improve service delivery to all stakeholders including licensees, the investing public, vendors, and staff members. The CMA has now fully automated and integrated its procurement, payroll, leave, finance payment modules, receivable modules

4.3.3 The Market Structure

As at end of December 2013, local institutional and retail investors held 58.02 percent of all listed and trading equities at the NSE by category. Foreign institutional investors however held the highest proportion of listed equities at the NSE with 39.8 percent. East African investors accounted for the lowest stake at only 1.6 percent. The local retail category had the highest number of investors, accounting for 21 percent of shares held as summarized in Table 24.

Table 24: Equity Holdings as at Dec 2013

Category of Investor	No. of Investors	No. of Shares	Shares held (%)
East African Corporate	233	457,335,315	1.26
East African Individuals	5,202	128,977,759	0.35
Foreign Investors (Corporate)	433	14,456,954,517	39.77
Foreign Investors (Individuals)	3,878	214,478,076	0.59
Local Corporate	36,784	13,581,455,758	37.36
Local Individuals	844,490	7,511,892,169	20.66

Source: CDSC/CMA database

The market structure in equity holdings at the NSE has evolved over the last six years. While the East African institutional investors' category declined, foreign investors' interest has more than doubled since 2008 as summarized in Table 25. The increased interest by foreign investors is due to strong performance of many blue chip counters like Safaricom, Kenya Commercial Bank, Equity Bank, East African Breweries that were most attractive. This upward trend in foreign investors' activity is further reflected in the net foreign equity inflows at NSE. The highest net foreign inflows at Ksh 25.56 billion occurred in 2013 up from Ksh 21.73 billion in 2012, and three times higher than the 2009 inflows.

Table 25: Trends in Investor Holdings at the NSE (2008 – 2013)

Type of Investor	2008	2009	2010	2011	2012	2013
E.A. Institutions (%)	77.2	74.2	73.6	68.33	66.70	38.62
E.A. Individuals (%)	14.9	15.7	13.8	12.23	12.01	21.02
Foreign Investors (%)	7.9	10.1	12.6	19.44	21.29	40.36

Source: CMA database

Strong shareholding in Kenya's equity market by the local investors is important in mitigating possible high foreign investors' portfolio outflows. Currently, foreign investor net portfolio flows have continued to increase. The expected end of Quantitative Easing in the U.S and monetary policy normalization may reduce global liquidity, leading to flight to safety. This is likely to have significant negative impact on our capital markets, and therefore calls for regulators to stand ready and manage any instability that may emerge.

Table 26: Foreign Investors Net Equity Portfolio Inflow (Ksh Millions)

MONTH	2009	2010	2011	2012	2013
January	-342	2,517	1,987	-812	2,133
February	66	489	622	795	-3,927
March	329	1,998	1,552	2,651	1,810
April	49	151	-3,024	1,771	3,026
May	496	-325	-3,334	1,099	3,475
June	884	1,601	-1,597	1,639	2,602
July	791	1,159	1,173	828	1,625
August	861	471	621	1,048	9,839
September	937	1,206	535	3,286	2,063
October	2,425	2,147	719	2,965	2,723
November	1,528	2,526	31	4,335	884
December	300	1,186	935	2,129	-690
NET CASH FLOW	**8,324**	**15,126**	**220**	**21,734**	**25,563**

Source: CMA/NSE database

There has also been marked increase of new investors at the market as reflected by the number of new CSD accounts opened (Table 27). The 2008 surge was triggered by the Safaricom Initial Public Offering while the rest attributed to improved confidence in the market.

Table 27: Trends in Number of Accounts Opened at CDSC

INVESTOR CATEGORY	2008	2009	2010	2011	2012	2013
East African Corporate	342	13	49	17	22	22
East African Individuals	7,986	79	92	108	96	258
Foreign Corporate	222	144	621	409	414	721
Foreign Investors (Individuals)	2,586	334	440	338	300	1,446
Local Corporate	109,533	2,143	3,981	1,229	877	3,945
Local Individuals	843,979	52,836	120,756	31,607	19,473	173,157
TOTAL	**964,648**	**55,549**	**125,939**	**33,708**	**21,182**	**179,549**

Source: CDSC database

EC- East African Company; EI-East African individual; FC-foreign Company; FI-foreign individual; LI-local individual; LC-local Company

4.3.4 Market Concentration and Trading Infrastructure

The Automated Trading System (ATS) recorded 99 percent system up-time, with no incidents within the CDS system during the period.[1] Concentration Risk can be defined as the risk of loss within the financial markets resulting from the failure of a dominant market player[2]. As at end December 2013, of the 21 operating Brokers and Investment Banks, the top six (6) accounted for 77 percent of all equities traded at NSE and 87 percent of bonds traded. Higher concentration may either increase or decrease the probability of a firm leaving the market as a result of distress. However, anecdotal evidence indicates that the market disruption generated by such an event would be more *severe* in concentrated markets.

In the Kenyan market, severity of disruptions from a dominant player is minimized by the availability of ready substitutes and product standardization. In addition, demutualization of the NSE in the second half of 2014 will eliminate privileged access to the trading platform, thereby further reducing the potential severe impact of concentration risk. Establishment of the Settlement Guarantee Fund (SGF) to cover market intermediaries was also meant to minimize concentration risk and risks of failure to settle. As at end of 2013, the Settlement Guarantee Fund Coverage Ratio was 29 percent of daily equity trading volume. Treasury bonds settlement through CDS occur on a trade by trade basis using central bank money. It concludes if and only if both securities and funds are present hence no settlement risk. The fund is adequate to cover for the daily trading volumes of the largest participants in the market. SGF also has a line of credit with a shilling for shilling equivalent of the actual GF thereby bringing the coverage ratio to 57 percent. Lastly, settlement caps were introduced and participant contributions enhanced.

4.3.5 Market Liquidity, Foreign Investment and Concentration Risk

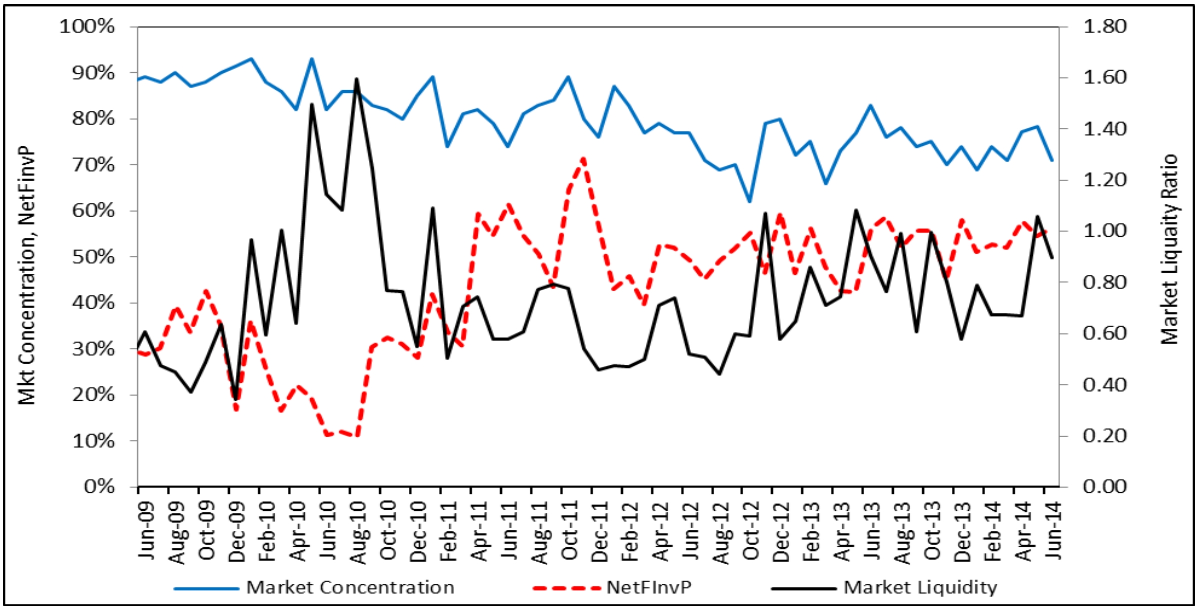
Market concentration in terms of dominant stocks is defined by the total volume of the top 5 traded counters at the NSE in any one month. The lower the percentage/proportion to the total shares traded, the less the concentration and therefore the more stable is the market due to diversity. High concentration signifies instability in the event of shocks to the market.

Figure 31 indicates that market concentration is still high albeit notable decline since June 2009, to average about 70 percent in June 2014. Market liquidity ratio refers to the volume of shares traded in any one month as a proportion of total outstanding shares issued. It shows the ease with which shares are traded at the exchange and therefore convertibility into cash for those who need money. The higher the ratio, the more liquid the exchange is and therefore better prepared to absorb mild shocks. The figure shows that as concentration declines, market liquidity improves, hence a more stable stock market, attractive to foreign investors. Foreign investments flows accounted for more than 50 percent of the equities market since second half of 2011, but generally below 70 percent implying moderate exposure to risks of pull out by this category of investors.

1 Nevertheless, in terms of operational opportunity cost to market participants, the 1% downtime equated to approximately KES 7bn (1.6bn (ADTO)*4.3days (app 30hrs DT).

2 Authors conceptualization and definition

Figure 31: Market Concentration, Liquidity and Foreign Investors



Source: Estimated from NSE market data

4.3.6 Risk Assessment

Market Risk: Addresses major risks in the marketplace that can impact market prices and interest rates, thus affecting the value of securities. This includes the risk of market collapse, as opposed to risk associated with an individual entity, group or segment of the capital markets. Weak corporate governance in the regulated institutions and market intermediaries, poor internal controls among licensees, low capitalization of market intermediaries, weak trading and settlements systems, weaknesses in enforcement capacity, as well as gaps in the regulatory framework are potential causes. CMA is reviewing its legal and regulatory framework, enhancing corporate governance and capital adequacy of market intermediaries and listed companies; automation of the entire trading, clearing and settlement infrastructure as well as implementation of risk based supervision and enhanced market surveillance to mitigate market risks.

Credit Risk: Addresses the possibility that the counterparty in a trade will be unable to meet its financial obligations in a transaction. Establishment of SGF administered by CDSC and adoption of Risk Based Capital Adequacy framework for market intermediaries are aimed to mitigate the risk. The CDSC has also introduced settlement caps for Central Depository Agents (CDA's), has negotiated a Line of Credit (LC) of an equivalent amount to the SGF and increased CDA annual contribution to the SGF.

Operational Risk: Human error, fraud, inadequate management, and system and facility failure constitute operational risks, which affect investor confidence. CMA has undertaken various regulatory and technological measures to mitigate the risks. These include: regulations on conduct of business, internal controls and corporate governance; requirement of professional indemnity insurance; implementation of the Broker Back Office System and installation of surveillance system. NSE has also fully automated its trading platform while CDSC is currently overhauling its systems make them more robust.

Narrow product base, High Market Concentration and Low Market Liquidity: Kenya's capital markets face the challenge of broadening the product portfolio base; reduce market concentration where eight (8) out of fifty nine (59) listed and actively trading firms account for 70 percent of market capitalization; and increasing market liquidity to minimize market volatility. These accentuates market and liquidity risk. To address these, CMA is spearheading initiatives to develop a commodity and futures market as well as a 'hybrid'[3] OTC bond market. An alternative market for raising capital by Small and Medium Enterprises was also established. Introduction of REITs and *Shariah* Compliant capital market products specifically Sukuk and Islamic Collective Investment Schemes would further broaden products base. Plans to introduce margin trading, securities borrowing/lending arrangements, short-selling and market-making as well as initiatives to shorten trading and settlement cycle via reliable market infrastructure, including the introduction of liquidity products like ETF's and GDR's.

Money Laundering and related activities: CMA acknowledges that money launderers may target the securities industry. The extent at which brokers/dealers, investment banks and Collective Investment Schemes may be used for money laundering is not clear. In addition, the industry's overall vulnerability is impacted by the extent to which it is covered by anti-money laundering requirements and mitigated by appropriate measures through enactment of the Proceeds of Crime and AML Act. CMA in compliance with the Proceeds of Crime and AML Act drafted AML Guidelines for market intermediaries to be gazzetted soon.

***Legislative Risk*:** legislative changes, especially tax laws impact financial returns of a particular security or firm. Kenya's tax laws are currently under review and some provisions may affect the capital markets industry adversely rather than positively. Delays in proposed laws to securities industry create uncertainty. For instance, Capital Markets Authority Bill and the Securities and Investments Bill have been pending in Parliament since June 2011. There are also various regulatory frameworks awaiting gazettement by the National Treasury, which has stalled many market development initiatives. The proposed review of the Capital Gains Tax (CGT) under the Income Tax Act to reintroduce capital gains tax will impact capital markets transactions, hence affecting the industry growth. The pending amalgamation of financial services regulators, currently supervising the securities, pensions, insurance and Sacco's industries into a single supervisor has also created uncertainty.

4.3.7 Capital Markets Outlook in 2014

In 2014 the CMA expects to conclude the demutualization of the Nairobi Securities Exchange (NSE) thereby successfully addressing substantial reform of its corporate governance, ownership and operational structures in line with global trends. This is expected to increase its competiveness through adoption of a for-profit business model supported by the introduction of clear separation of ownership from management, the institutionalization of an independent board, the removal of perceived barriers to competitive access to providing securities trading business as well as laying the ground for further work to support its recognition as a Self-Regulatory Organization (SRO). This will also allow it to self-list thereby further diversifying its ownership structure as well as allowing it to raise capital from the public markets to support infrastructure development and new business lines.

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3 Both electronic and OTC

Capital Markets Master Plan has been concluded as a key Vision 2030 Flagship projects under Financial Services within the 2nd Medium Term Plan (MTP II). The Plan which is an output of all stakeholders in the markets charts the strategic direction of the Country's capital markets in the next 10 years. The CMA expects to conclude its publication in 2014 and oversee the strict implementations of its 2014 Action-Plan in the year, particularly on introduction of Derivatives, Islamic Capital Markets Products, Real Estate Investment Trusts (REITS), Asset Backed Securities (ABS) and Exchange Traded Funds (ETFs). These initiatives are expected to enhance the level of financial inclusion, efficiency and stability in the capital markets in 2014.

Despite the robust outlook, regulators should enhance surveillance for timely detection of any source of vulnerabilities. With the expected end to easy liquidity programmes in advanced economies as tapering sets in, the market may experience excessive volatility if there is flight to safety and quality. This is because foreign investors account for 50 percent of monthly equity trading. Significant exit would therefore require robust mitigation measures. In the medium term, stock market performance will be largely dependent on overall macroeconomic stability anchored on domestic and external factors.

4.4 INSURANCE INDUSTRY

4.4.1 The Industry Performance

Insurance industry maintained an upward trend, with Gross Written Premiums growing by 21 percent to Ksh 135 billion in 2013 from Ksh. 112 billion in 2012 as indicated in Table 28. The assets grew by 18 percent to Ksh. 366 billion in year under review. Of the total industry assets, 79 per cent were held in income generating investments. Over the last six years, the industry recorded a two-digit growth rate on account of growth in insurers and intermediaries, new innovative products supported by new distribution channels.

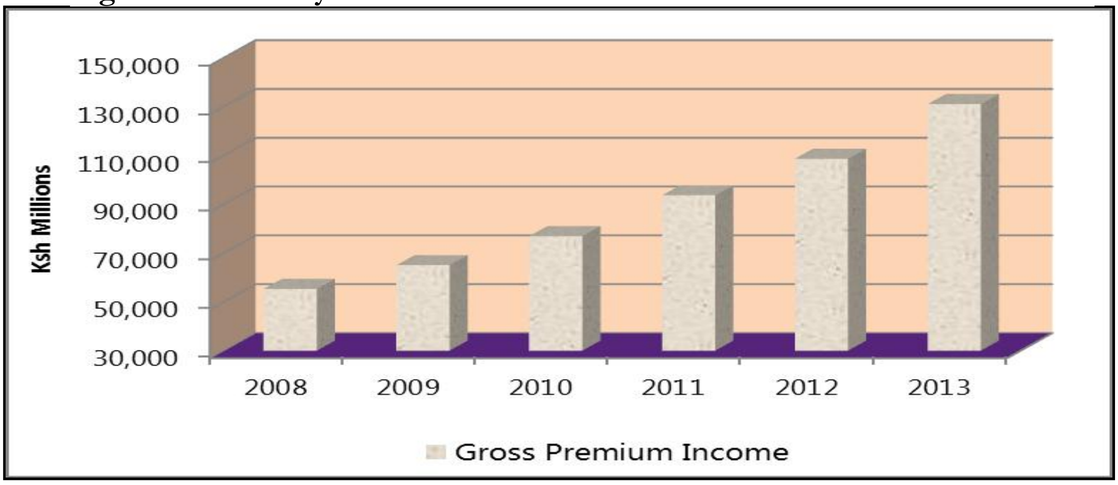
Table 28: Trends in Insurance Sector Performance (Ksh Millions)

INDICATOR	2008	2009	2010	2011	2012	2013
Gross Premium Income	55,246	65,013	76,909	91,806	111,911	135,385
Net Premium Written	45,593	45,593	64,123	75,069	87,476	105,013
Claims Incurred (Gen. Business)	15,884	19,768	21,629	25,169	29,466	34,170
Commissions	7,252	8,715	10,270	6,329	6,760	7,204
Management Expenses	12,602	14,641	16,758	17,111	20,239	24,808
Underwriting Profit(Gen. Business)	873	402	1,271	2,416	3,107	3,403
Investment Income (P&L)	8,191	12,112	23,369	5,457	11,120	9,429
Operating Profit/Loss after Tax	3,350	3,421	7,634	6,909	13,104	20,236
Investments	123,621	113,453	177,521	191,791	240,125	296,337
Assets	154,453	178,404	223,491	245,597	366,252	366,257
Shareholders' Funds	38,161	41,469	58,649	44,880	77,116	100,958

Source: Industry audited returns, 2013

The demand for insurance also increased significantly owing to the increasing public awareness on the need and benefits of insurance. Figure 32 details the trends in the industry's growth of insurance premiums over a six-year period to 2013.

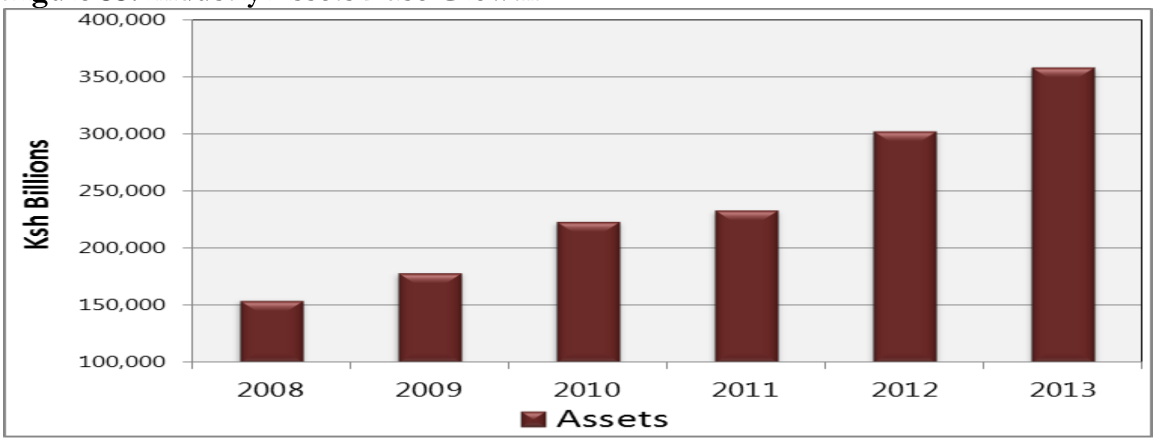
Figure 32: Industry Gross Premium Income



Source: Industry unaudited returns 2013

Asset base of the industry has grown steadily through to 2013 as shown in figure 33, further confirming the robustness of the industry.

Figure 33: Industry Assets Base Growth



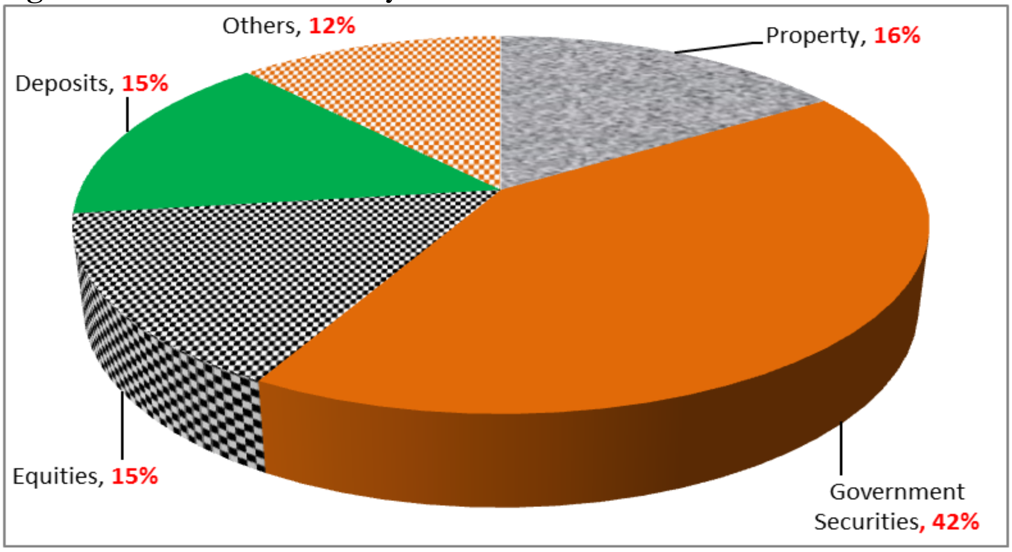
Source: Industry audited returns 2013

4.4.2 Trends in Industry Investments Growth

Insurance industry investments grew to Ksh 296 billion in the period under review. The year-on-year growth was 23 percent, reflecting availability of very attractive investment opportunities especially in the domestic markets.

Under section 50 of the Insurance Act**,** Cap 487 Laws of Kenya, IRA regulates investments in terms of asset mix, asset quality and portfolio maturity. The insurance companies held a large proportion of their investments in risk-free government treasuries as at the end of 2013 as shown in figure 34.

Figure 34: Insurance Industry Investment Portfolio



Source: IRA database, 2013

4.4.3 Recent Supervisory Developments

The industry's licensed players totalled 5,197 by end of December 2013, signifying growing compliance with legal, regulatory and supervisory requirements as well as good risk management practices. Licensees include; insurance companies, insurance intermediaries and service providers as detailed in Table 29**.** Over the same period, a new life insurance company was licensed.

Table 29: Industry Licensees in 2013

LICENSEE CATEGORY	TOTAL NUMBER	SHARE (%)
Insurance Agents	4,631	89.11
Insurance Brokers	187	3.60
Insurance Investigators	134	2.58
Motor Assessors	105	2.02
Insurance Companies	48	0.92
Medical Insurance Providers	29	0.56
Insurance Surveyors	27	0.52
Loss Adjusters	22	0.42
Risk Managers	8	0.15
Reinsurance Companies	3	0.06
Claims Settling Agents	2	0.04
TOTAL	**5,197**	

Source: IRA Database, 2013

4.4.4 Risk Based Supervision and Electronic Regulatory System

The IRA successfully migrated from Compliance (rule based) supervisory model to full Risk Based Supervision (RBS) model in 2013. The shift to RBS has hastened industry surveillance through informs timely preventive and corrective interventions to promote a safe, sound and stable insurance industry. Over the same period, IRA embarked on process of fully automating the supervisory function by deploying the Electronic Regulatory System (ERS). This process has enabled timely submission of periodic returns by licensees via an online platform. It has also aided effective risk analysis, profiling and reporting.

4.4.5 Insurance Industry outlook

Kenya remains East Africa's largest insurance market with an insurance penetration of 3.4 percent and ranks amongst the top five insurance markets in Africa by penetration after, South Africa, Mauritius, Namibia and Morocco. This outlook is due to sustained growth in insurance uptake owing to improved governance and stability, favorable demographics, improving business environments, rising middle class and urbanization and growing ties to emerging economies. Despite this positive outlook and growing opportunities for industry expansion, the risks faced by industry players remain high to moderate which is generally comparable to other growth markets such as Tunisia, Nigeria and Ghana.

4.5 PENSION INDUSTRY

4.5.1 The Pension Industry Performance in 2013

The Retirement Benefits Authority (RBA) implemented various policies and initiatives geared towards enhancing development and growth of the pensions subsector. The target was increased pension coverage; promote good governance and ensure better risk management for licensees. Total industry assets grew by 26.97 percent between December 2012 and December 2013 as shown in Table 30.

Table 30: Overall Industry Investment Portfolio (Ksh, Billions)

Assets Class	December 2012		June 2013		December 2013		% Change (Jun - Dec. 2013)
	Ksh	%	Ksh	%	Ksh	%	
Government Securities	190.30	34.68	211.00	33.31	235.16	33.75	11.45
Quoted Equities	130.40	23.77	147.69	23.31	177.41	25.47	20.12
Immovable Property	101.60	18.52	121.30	19.15	119.84	17.20	-1.21
Guaranteed Funds	48.10	8.77	65.41	10.33	71.46	10.26	9.25
Fixed Income	26.70	4.87	25.24	3.98	30.38	4.36	20.37
Fixed Deposits	27.10	4.97	32.92	5.20	34.17	4.91	3.80
Offshore	8.50	1.55	14.90	2.35	15.29	2.19	2.62
Cash	12.90	2.35	10.80	1.70	9.03	1.30	-16.37
Unquoted Equities	3.10	0.52	3.75	0.59	3.94	0.57	5.04
Unclassified	-	-	0.45	0.07	0.00	0.00	0.00
TOTAL	**548.70**	**100.00**	**633.46**	**100**	**696.68**[4]	**100**	**9.98**

Source: Retirement Benefits Authority database

Actual assets grew from Ksh. 548.7 billion to Ksh. 696.68 billion in the review period. Of the total fund managers and insurance firms held Ksh.564.82 billion; National Social Security Fund (NSSF) internally administered Ksh.92.86 billion and Ksh.39 billion of property investments directly managed by scheme trustees[5]. In terms of portfolio allocations, fund managers preferred Government Securities and Quoted Securities, which accounted for 59.2 percent of the total industry assets under management. All asset classes recorded market growth except for the cash

4 The Internal administered funds of NSSF are from the June 2013 Financial Accounts
5 The amount was consolidated from schemes Financial Accounts for the year 2012

and property asset classes which registered divestiture of 16.37 percent and 1.21 percent, respectively. Overall, all investment categories were within statutory maximum guidelines provided in the RBA Regulations.

4.5.2 Individual Retirement Benefits Schemes and Service Providers

Individual retirement benefits schemes membership grew steadily from 88,509 in December 2012 to 113,316 registered members in December 2013. Total assets on the other hand grew from Ksh. 13.65 Billion to Ksh. 17.4 billion in the period under review. The growth is attributed to the public awareness undertaken by the RBA and various service providers. The Blue MSME's Jua Kali retirement benefit scheme popularly known as "*Mbao Pension Plan*" which caters mainly for the individuals in the informal sector grew significantly, from 39,013 members in December 2012 to 50,057 members in December 2013. Its assets grew from Ksh 39.8 million to Ksh. 64.4 million during the period. There were 16 registered fund managers, 31 administrators and 10 custodians by end of December 2013.

4.5.3 Policies Development in the Industry

RBA undertook various initiatives and programmes to widen pension coverage and adequacy of retirement benefits. NSSF Act, 2013 was enacted with the need to improve the adequacy of benefits as well as provide basic social security for its members and their dependents. RBA also continued to implement the Risk-Based Supervision and the Trustee certification programme to ensure better risk management practices.

4.5.4 The National Social Security Fund Act, 2013

The National Social Security Fund Act, 2013 was assented to on 24th December 2013, ushering in a new Fund to replace the previous National Social Security Fund. Its objectives include;

a. Provision of basic social security for its members and their dependants for various contingencies
b. Increase membership coverage of the social security scheme
c. Improve adequacy of benefits paid out of the scheme by the fund
d. Provide a full opt-out at tier II level contributions for employers who have or are contributing to pension schemes approved and registered by the Authority
e. Bring within the ambit of the Act self-employed persons to access social security for themselves and their dependants
f. Operate and manage a scheme that is value adding to its members by inter-alia –
    - Ensuring that the fund and its social security system are sustainable and affordable; and
    - Retaining the old provident fund for purposes of dealing separately with liabilities, obligations, assets and any other matters or issues connected therewith to avoid transferring the same to the Fund
g. Ensuring that liabilities of the old provident fund are settled within five years from commencement of the new provident fund and then close provident fund
h. Undertake any other measures under the Act for purposes of attaining any or all the objects and for purposes of effective enforcement and application of the Act.

The new Fund differs from old fund in that it has both the pension fund and the provident fund; the former was purely a provident fund. Contribution rates also rose from the current Ksh. 400

(Ksh. 200 employee and Ksh. 200 employer) to 12 percent of the pensionable earnings where both employer and employee contribute 6 percent each of pensionable earnings of the employee.

4.5.5 Implementation of Risk-Based Supervision (RBS)

The RBS model was adopted in 2010 after amendment to the Retirement Benefits Act that gave RBA powers to issue statutory guidelines on Risk Based Supervision. This has enabled RBA to focus and direct its resources on schemes whose systems require greater attention and supervision. The Authority easily identifies schemes and areas where problems exist or are likely to emerge, thus encouraging effective and efficient use of resources. In addition, RBA is able to take prompt intervention and timely corrective action.

Since RBS implementation, RBA has reduced the Overall Risk Score from 1.15 in 2011 to 0.854 in 2013. The model follows a traffic-light analogy to map the risk ratings of a scheme to its supervisory action. Since 0.854 falls under amber, it shows that the pension sub-sector is relatively stable with most schemes falling within acceptable risk levels.

To strengthen the implementation of the RBS model, the RBA procured Integrated Risk-Based Supervision and Back-Office System Project for integrated information management. The system has a Risk-Based Supervision System (RBSS) that will interface with all supervised entities and enable them to apply for registration and file returns online. The Back-Office System component will integrate all administrative functions of the Authority and also enable reconciliation of collected levy, thus enhancing automation and service delivery in the pension sector.

4.5.6 Policy Changes in the 2012/2013 Budget

i) Amendment of the Retirement Benefits Act (No. 3 of 1997)

a. Introduced **Section 5A** in the Retirement Benefits Act to allow RBA provide assistance in investigating a person contravening any legal or regulatory requirements which are enforced or administered by RBA or related transactions regulated by that regulatory body. **Section 5B** of the Act empowers RBA to appoint a qualified person to conduct investigations on its behalf in case of embezzlement, fraud, misfeasance or other misconduct in connection to the regulated activity by the pension service providers and trustees, including; manager, custodian, trustee or administrator.

b. **Section 22A** of the Act outlines the criteria for selecting a trustee, manager, custodian or an administrator. These include: Financial status or solvency; Educational or other qualifications or experience necessary for the function; Status of other licence or approval granted to the person by any financial sector regulator; Ability of the person to carry out the regulated activity competently, honestly and fairly; Reputation, character, financial integrity and reliability of individuals, directors, shareholders, CEO, management and personnel, all shareholders of a company. The amendment also introduces a fit and proper test which takes into account: Contravention of the provisions of any law designed for protection of members of the public; Previous directorships; involvement in fraudulent or unsound business practises; association with any business practice or actions that cast doubt on a person's competence and soundness of judgment; and adoption of effective internal controls and risk management systems.

4.6 SAVINGS AND CREDIT CO-OPERATIVE SOCIETIES (SACCOs)

The Sacco sub-sector recorded sustained upward growth in all key performance indicators in 2013 as detailed table 31. Industry's total assets grew by 14.2 percent to Ksh.335.4 billion in 2013 from Ksh. 293.8 billion in 2012. Loans grew by 13.7 percent to close at Ksh. 251.9 billion, accounting for 75.1 percent of total assets. Deposit liabilities being the main source of funding for loans grew by 13 percent, from Ksh. 213.1 billion to Ksh. 240.8 billion in the review period.

Table 31: Trends in Performance of Active Saccos (Ksh Millions)

MEASURE	2010	2011	2012	2013
Assets	261,144.06	248,765.06	293,826.70	335,436.86
Deposits	157,540.40	180,003.42	213,079.98	240,805.10
Loans and Advances	157,926.00	186,149.24	221,554.22	251,878.98
Total Capital	N/A	20,115.04	21,323.64	25,296.64
Turnover	27,721.31	31,463.69	37,286.45	43,271.42
Number of Saccos	1,821	1,954	1,989	1,955
Deposit Takers	216	216	215	215

Source: SASRA Database 2013

There were 1955 active Saccos by close of 2013, of which, 215 were Deposit Takers and 1780 non-deposit taking Saccos. The latter group filed their 2013 audited financial statements with the Commissioner for Cooperative Development as required by law. Membership in the Saccos grew from 2.97 million to 3.31 million representing 11.4 percent increase from the previous year.

4.6.1 Performance of Deposit Taking Sacco Societies

Deposit taking Saccos, also known as FOSA operating Saccos accounted for over 75 percent of the industry's assets, deposits and loans to members as shown in Table 32.

Table 32: Deposit Taking Sacco Societies (FOSAs) in 2013

MEASURE/YEAR	2012	2013	Y/Y Change (%)	Industry Share (%)
Total Assets	223,534.83	261,586.51	17.02	77.89
Deposits	160,481.60	185,787.91	15.77	77.15
Loans	167,598.15	196,857.60	17.46	78.16
Turnover	30,009.41	35,660.12	18.83	82.41

Source: SASRA database (Figures in Ksh. Millions where applicable)

4.6.2 Financial Soundness of FOSAs

The Sacco Societies Act 2008 and the Regulations thereunder stipulated key prudential norms and operation requirements to enhance the financial stability of the deposit taking Sacco societies. The key requirements include capital adequacy, asset quality and liquidity. Profitability while not a regulatory requirement is implied to ensure financial and operational sustainability of the Sacco business. Table 33 summarizes the financial soundness indicators for 135 out of the total 215 DT Saccos licensed in 2013 that filed their returns with SASRA.

Table 33: Financial Soundness Indicators (FSIs) for Licensed DTS

Financial Soundness Indicators	Dec.2012	Dec.2013	Change
CAPITAL ADEQUACY			
Core capital to Total Assets (***Min. 10%)***	10.29%	10.47%	0.18%
Core Capital to Total deposit liabilities (***Min. 8%)***	14.29%	14.66%	0.37%
ASSET QUALITY			
NPLs to Total Gross Loans	7.34%	4.72%	-2.62%
NPLs Net of Provisions to Capital	16.29%	12.45%	-3.84%
Earning Assets to Total Assets	81.95%	84.30%	2.35%
EARNINGS & PROFITABILITY			
Return on Assets (ROA)	2.02%	2.27%	2.02%
Return on Equity (ROE)	18.54%	18.75%	0.21%
Interest Margin to Gross Income	49.21%	47.00%	-2.21%
Non-Interest Expenses to Gross Income	34.44%	34.65%	-2.21%
LIQUIDITY			
Liquid Assets to Total Assets	9.81%	10.30%	0.49%
Liquid Assets to Short-term liabilities(Liquidity ratio)	46.14%	47.18%	1.04%
Liquid Assets to Total Deposit	13.64%	14.42%	0.78%
Total Loans to Total Deposit	105.35%	106.97%	1.62%

Source: SASRA database

The loans stock exceeded the members' deposits by 7 percent, implying that part of the loans were funded from capital and borrowed funds. The lending model for Saccos should ideally minimize default level. With licensed DTs Saccos fully embracing the prudential norms in credit risk management, default level has significantly reduced as shown in the declining ratio of NPLs to gross loans, which declined from 7.34 percent in 2012 to 4.72 percent in 2013.

4.6.2.1 Capital Adequacy

All DTs Saccos must comply with minimum capital requirements including accompanying ratios. Minimum regulatory capital requirement is Ksh. 10 million, to be maintained at all times. The ratio of core capital to total assets is 10 percent while core capital to total deposits ratio of 8 percent. Full compliance to these requirements still remains a challenge for a number of individual Saccos. However, the average capital ratios for the licensed Saccos marginally satisfied the regulatory minimum. This indicates sustained efforts by Saccos to retain earnings and raise new capital from members. SASRA will ensure enforcement for compliance by licensed Saccos to ensure that capital risk management practices are adequately aligned to sound financial management practices for the stability of the Sacco industry.

4.6.2.2 Asset Quality

SASRA requires Saccos to adhere to set regulations on classification of risk assets and provisioning. Specifically, the regulation requires that the credit facilities to members are classified based on performance against the loan terms as per loan contract. Table 34 summarizes of the outstanding loans and advances by the licensed DTs Saccos by close of 2013. The licensed DTs Saccos increased the outstanding loans by 17.7 percent to close the year at Ksh 188.6 billion up from Ksh 160.3 billion in December 2012.

Table 34: Risk Classification of Loans and Provisioning

Loans Classification	2012		2013	
	Amount (Ksh Mns)	Share of Total	Amount (Ksh Mns)	Share of Total
Performing	138,179.13	86.2%	170,356.23	90.3%
Watch	10,316.62	6.4%	9,338.69	5.0%
Substandard	5,385.88	3.4%	4,352.94	2.3%
Doubtful	1,843.24	1.2%	1,410.63	0.7%
Loss	4,533.02	2.8%	3,138.32	1.7%
TOTAL	**160,257.89**	**100.0%**	**188,596.81**	**100.0%**

Source: SASRA database

Improved risk management practices among the DTs Saccos has increased NPLs by 23.3 percent, from Ksh 138.2 billion in December 2012 to Ksh 170.4 billion in December 2013 as indicated in table 34. Loan losses provisioning rose to Ksh 4.1 billion from Ksh 3.1 billion in 2012. Increased provisioning reflects enhanced compliance with regulatory requirements on loan losses. Full compliance is expected by the end of 2014, implying strong first line of defence against credit risks and consequently protection of members' deposits. Table 35 shows provisioning requirements for NPLs based on the number of days or months a loan remains in default.

Table 35: Regulation of Risky Loans

Loan Category	Period in Default	Provisioning
Performing	Performing as per the contract	1.00%
Watch	One to thirty (1-30) days	5.00%
Substandard	One to Hundred and Eighty (1-180) days	25.00%
Doubtful	One to Three Hundred and sixty (1-360) days	50.00%
Loss	Over Three Hundred and sixty five (over 365) days	100.00%

4.6.2.3 Industry Earnings

The licensed DT Saccos reported better performance in total income and net surplus, growing by 17.75 percent and 53.98 percent in 2013 compared to 2012. Net surplus for the licensed Saccos grew by 40.60 percent during the review period (Table 36).

Table 36: Statement of Comprehensive Income

MEASURE	2012		2013		Y-on-Y Change (%)
	Amount (Ksh Mns)	% of Total Income	Amount (Ksh Mns)	% of Total Income	
Income from Loans	24,126.60	94.53	29,004.16	86.0	20.26
Investments Income	1,379.25	5.40	1,028.38	13.9	-25.44
Other Income	16.98	0.07	20.33	0.1	19.72
Total Income	**25,522.83**	**100.0**	**30,052.87**		**17.75**
Financial Expenses	13,841.10	54.23	15,767.34	46.7	13.92
Net Financial Income	**11,681.73**		**14,285.53**		**22.29**
Loan Loss Provisioning	780.11	3.06	1,187.06	3.5	52.17
Operating Expenses	9,892.52	38.76	11,680.14	34.6	18.09
Net Surplus before Tax	**1,009.10**		**1,418.33**		**40.55**

Source: Sacco's database

The increased retained earnings in the industry are a significant development given that for long time, earnings were distributed to members as interest on deposits and dividends. This left the Sacco business with little funds to plough back and improve member services or protect the business from unforeseen losses. The retained surplus partly improved the core capital for majority of the licensed Saccos. Table 36 shows the industry performance by comprehensive income. The improved operating efficiency, increased loan loss provisions and retention of earnings are critical ingredients in enhancing the financial stability and sustained competitiveness of deposit taking Saccos as financial institution.

4.6.2.4 Liquidity

Liquidity level indicates an institutions ability to fund increase in assets and meet obligations when they fall due. DTs Saccos like other financial institutions require to match the level of liquid resources to the short term FOSA deposits and other liabilities in order to remain liquid. The minimum regulatory ratio is 15 percent. To enhance sound liquidity management, DTs Saccos can only acquire external borrowings up to the 25 percent of total assets. The average liquidity for the whole of 2013 was 47.2 percent compared to 46.1 percent in 2012, which is well above the regulatory requirement of 15 percent. The computed external borrowings ratio averaged 9.3 percent of total assets, implying the licensed Saccos were more liquid and relied largely on internal resources to finance their liabilities. The increased liquidity is attributable to the rise in short term placements and matching of short term assets and short term liabilities.

4.6.3 Policy Developments

Prudential regulatory framework is in the fourth year of implementation. SASRA has however noted a few challenges to full compliance by the licensees, in terms of the definition and computation of capital adequacy as well as provisions on investments in equities and properties by the deposit taking Saccos. The Authority has however commenced review of some policy and regulatory provisions to address challenges noted while also aligning them to international best practices in regulation of deposit taking institutions. The Authority expects to expose the proposed amendments to the stakeholders in early 2014 and end the review by close of 2014.

In 2013, SASRA initiated development of regulatory guidelines on good governance, risk management and business continuity to enhance the industry's corporate governance and risk management. These guidelines will be completed and issued in the course of 2014 after stakeholders input. The Authority is also exploring ways of rationalizing and consolidating the Sacco industry to ease the regulatory compliance burden by small and medium size DT Saccos. The Sacco subsector is currently characterised by many small DT Saccos geographically spread across the country. While this may favour members in terms of proximity, stiff competition in the financial landscape calls for a policy review in development of the Sacco industry.

4.6.4 The Subsector Outlook

Licensed DT Saccos constitute over 75 percent of key financial indicators of the entire industry in terms of membership, assets, loans, deposits and capital. Consequently, the financial soundness of the licensed DT Saccos reflects the soundness of the entire Sacco industry. The subsector was relatively stable in 2013 as supported by compliance with the minimum prudential requirements in capital, liquidity, improved asset quality and overall earnings. This is expected to be maintained in the near to medium term as SASRA continues to implement a risk rating framework to monitor financial soundness of the industry and also issue regulatory guidelines to enhance compliance with sound business practices.

The introduction of the 10 percent excise/VAT tax on Sacco industry's services may impact negatively on the very purpose of promoting savings through Saccos. The Authority is therefore engaging the government on the way out. The proposed consolidation of regulators in the financial sector into one may be counterproductive in achieving the original intention of establishing Saccos. Although, the lending model of Saccos is self-insuring through members and share guarantees, unfavourable economic environment may lead to increased delinquencies and thus NPLs. The recently introduced loans pricing framework in the banking subsector may have spillover to the Saccos industry, thus affecting a number of its performance indicators like interest income, if the former becomes competitive.

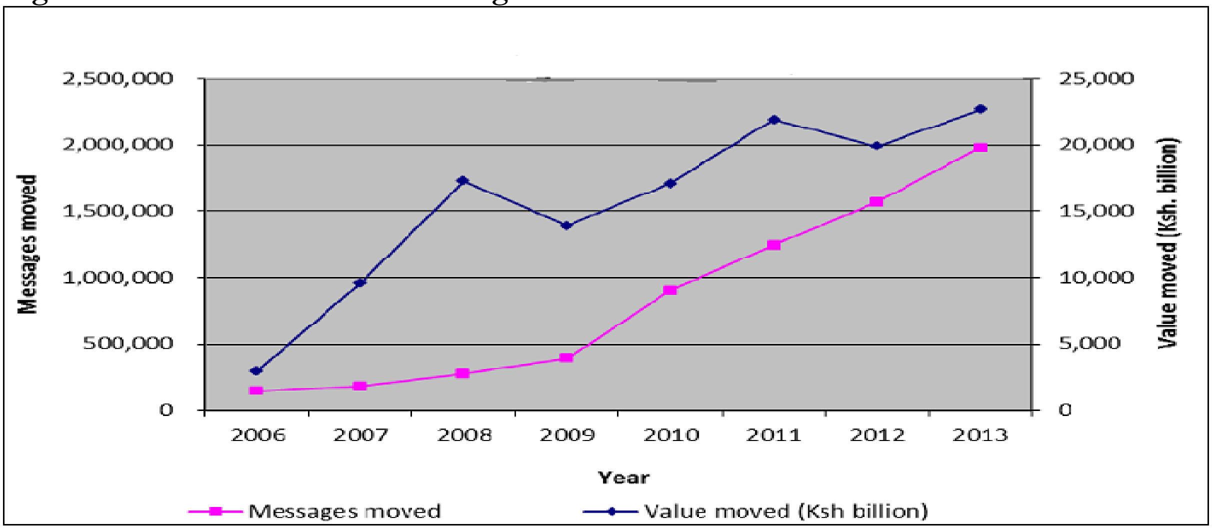
4.7 PAYMENTS INFRASTRUCTURE

The CBK embarked on a comprehensive modernization of the National Payment System that saw the introduction of the cheque truncation that reduced cheque clearing time from 3 days to one, and commissioning of the East African Payment System (EAPS) to enable the public and banks within the East African Community (EAC) to transact large value, time critical payments on a real time basis rather than waiting for clearing procedures. To guarantee safety and achieve efficiency, the National Payments System (NPS) Division at CBK formulates and implements policies that promote the establishment, regulation and supervision of payments, clearing and settlement systems. These powers are enshrined in CBK Act section 4A (d) and the National Payments System Act, 2011. In the year ending December 2013, payment systems infrastructure operated smoothly, despite increased values and volumes transacted.

4.7.1 Real Time Gross Settlement (RTGS) System

Kenya Electronic Payment and Settlement System (KEPSS) is the country's inter-bank settlement system that supports daily inter-bank transactions. It is the only Systemically Important Payment System (SIPS) and thus the Bank's main focus in mitigating systemic risks inherent in the financial system.

Figure 35: Volume and Values through KEPSS for 2006 - 2013



Source: NPS database

During 2013, KEPSS had 1.98 million transaction messages worth Ksh. 22,668 billion compared to 1.57 million transaction messages worth Ksh. 19,880 billion in 2012. Trends in the KEPSS operations for the last 8 years are shown in Figure 35. The increase in volume and value by 26.1 percent and 14.0 percent respectively, reflects more KEPSS usage by the public as the most secure and faster mode of payment. Direct settlements through KEPSS by commercial banks accounted for an average of 98 percent of the total activity through KEPSS while the Net Settlement Instruction (NSI) or activity through the ACH to KEPSS accounted for 2.0 percent of the total activity (Table 37).

Table 37: KEPSS System Transactions

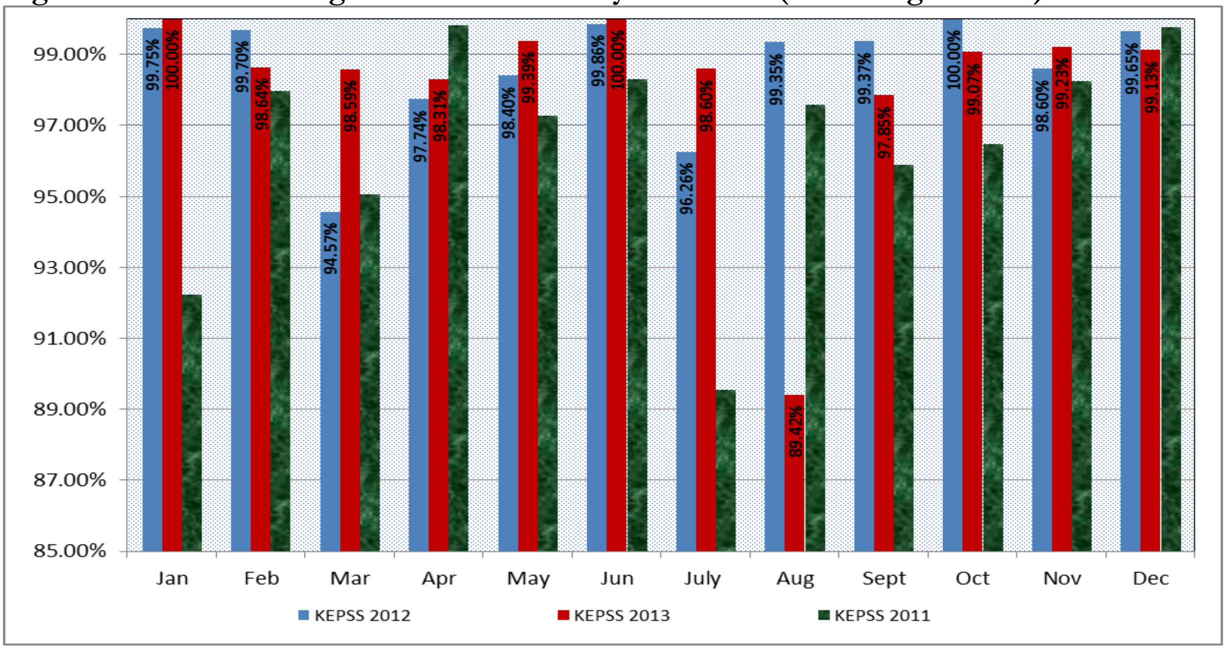
Year End	Amount transferred		Messages moved	
	(Ksh. Billion)	Change (%)	Number	Change (%)
2007	9,599	226.9	180,312	26.6
2008	17,269	79.9	273,941	51.9
2009	13,925	-19.4	390,737	42.6
2010	17,101	22.8	904,717	131.5
2011	21,894	28.0	1,241,531	37.2
2012	19,880	-9.2	1,568,125	26.3
2013	22,669	14.1	1,977,885	26.1

Source: Central Bank of Kenya

4.7.3 KEPSS Window Availability

During January to December 2013 period, KEPSS operations were smooth with an average system availability level of 98.19 per cent as indicated in Figure 36. The months of March and July seem to have the lowest availability while 2011 experienced most KEPSS outages

Figure 36: KEPSS Average Annual Availability since 2011 (Percentage Points)

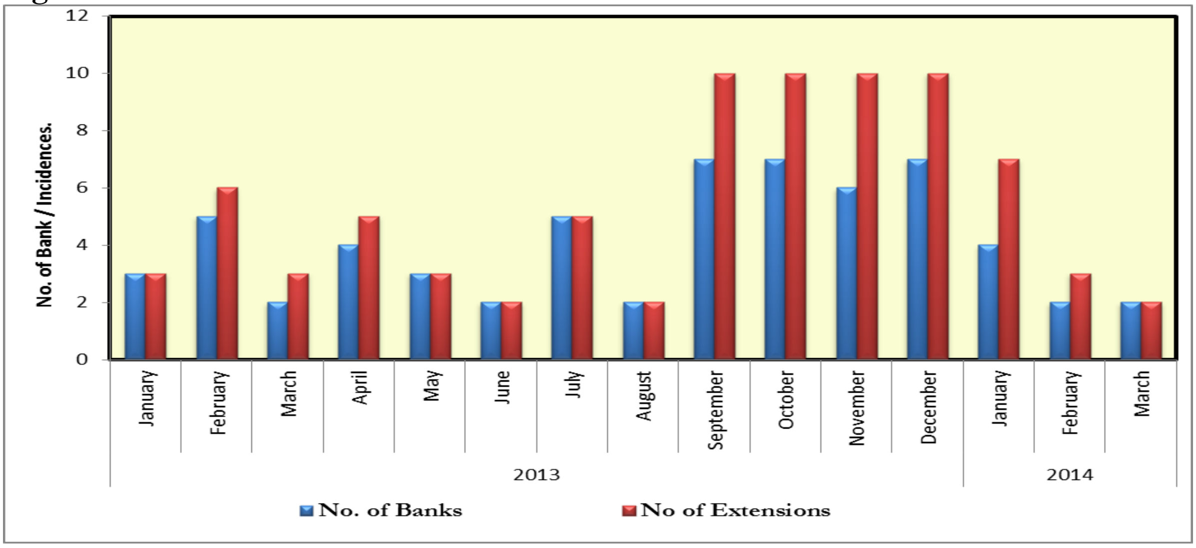


Source: NPS database

4.7.4 KEPSS Window Extensions

Extension of 'operating window' is granted on request by a bank to enable it meet its obligation in the KEPSS. The number of KEPSS window extensions granted in 2013 increased due to requests by banks in the last quarter of 2013 on account of high inter-bank activity. Figure 37 shows graphical representation of KEPSS window extensions in 2013.

Figure 37: KEPSS Window Extensions

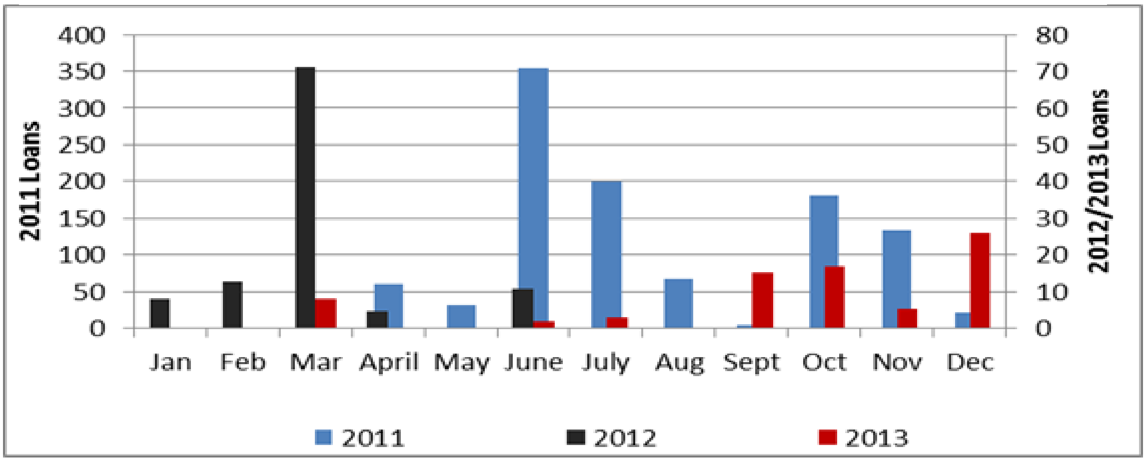


Source: NPS database

4.7.5 Liquidity Management by KEPSS Participants

KEPSS participants borrowed a total of Ksh. 76.6 billion in 2013 compared to Ksh 107.6 billion in 2012, reflecting a decline of 28.8 percent in overnight loans. The drop shows adequate liquidity in the banking system and overall stability in the payment industry. Figure 38 captures comparative overnight window loans extended to different banks through KEPSS over the last three years. The year 2011 had the highest and most frequent loans borrowed while 2013 is considered as the most liquid year.

Figure 38: Overnight Loans to Local Banks (Ksh Millions)



Source: NPS database

Over the last three years, overnight loans to banks have shrunk from Ksh 1.07 trillion in 2011 to Ksh 76.61 billion in 2013. A total of seven (7) months in 2012 had no overnight loans compared to four (4) months in 2013, implying increased short term liquidity needs in 2013. Summarized liquidity trends are captured in Table 38.

Table 38: Trends in Overnight loans to banks (Ksh. million)

Month	2011	2012	2013
	Loans Amount	Loans Amount	Loans Amount
January	750	7,950	-
February	425	12,827	-
March	17,046	71,288	8,088
April	60,563	4,770	-
May	31,403	-	200
June	353,623	10,745	2,010
July	199,049	-	2,800
August	67,257	-	-
September	5,034	-	15,210
October	180,313	-	16,911
November	134,250	-	5,448
December	20,680	-	25,936
TOTAL	**1,070,393**	**107,580**	**76,606**

Source: NPS database at CBK

4.7.6 Automated Clearing House (ACH)

The ACH recorded increased volume and value of cheques and EFTs cleared through its system, where 0.87 million instructions valued Ksh 179 billion took place in 2013. This translated into a 3.1 percent increase in volume and 7.0 percent increase in value. The marginal increase in value and volume of cheques and EFTs through the ACH reflects increased usage of other payment systems like KEPSS, mobile payments and others.

Table 39: Automated Clearing House (ACH) Performance since 2010

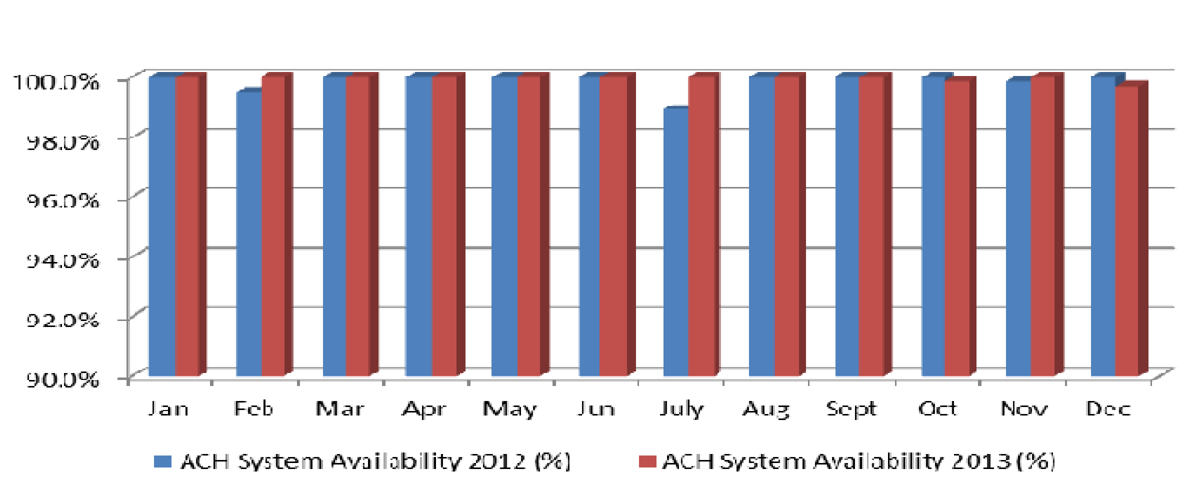
YEAR	Volume cleared (000's)	Change (%)	Value cleared (Ksh. billion)	Value (% Change)
2010	28,793	5.2	2,145	-46.6
2011	27,736	-3.7	2,395	11.7
2012	27,718	0.0	2,554	6.6
2013	28,588	3.1	2,733	7.0

Source: NPS database

4.7.7 Automated Clearing House Availability

Implementation of the cheque truncation system has enhanced safety, efficiency and effectiveness of the clearing house operations. Clearing period has been reduced from T+3 to T+2 and finally T+1 during the period under review. The ACH system maintained an average availability level of 99.97 per cent in 2013 (Figure 39).

Figure 39: ACH System Availability



Source: NPS database

4.7.8 Cards Transactions

The year under review had remarkable increase in usage of Automated Teller Machines (ATMs) cards, credit cards, debit cards, and Point of Sale (POS) terminals. The number of active cards increased from 10.7 million in 2012 to 11.5 million in 2013 (Table 40).

Table 40: Payment Cards Usage

YEAR	Cards (Millions)	ATMs	POS Terminals	Transacted Volume (million)	Transacted Value (Ksh. mn)
2011	10.1	2,205	16,604	122.4	577,852
2012	10.7	2,381	18,478	224.6	1,009,758
2013	11.5	2,487	21,089	338.1	1,532,778

Source: NPS database

Corresponding transactions and value moved increased from 224.6 million transactions worth Ksh. 1,009.8 billion in 2012 to 338.1 million transactions worth Ksh. 1,532.8 billion in 2013. The increased uptake and usage of cards may be attributed to the growing middle class who prefer cards to cash and migration of the industry to Europay, MasterCard and Visa (EMV) Standards leading to growing acceptance of cards as a safe and convenient mode of payment.

The number of ATMs increased by 4.5 percent, from 2,381 in 2012 to 2,487 in 2013 as a result of expansion of commercial banks' branch network and ATMs coverage. The number of Point of Sale (POS) terminals grew by 14.1 percent from 18,478 terminals in 2012 to 21,089 terminals in 2013 due to wide acceptance of settlements through payment cards by merchants and expansion of the merchants as well. Increased usage of payment cards has ushered in enhanced strengthening of risk mitigation measures by Kenya Bankers Association in collaboration with Central Bank of Kenya. The two continue to monitor and encourage full adoption of Europay, MasterCard and Visa (EMV) global security standards in the payment cards by March 2014.

4.7.9 Mobile Phone Money Transfers

Mobile Phone Money Transfer services remained popular in Kenya, with the number of agents as well as users growing significantly. Agents grew by 47.1 percent in 2013 to reach 113,130 from 76,912 agents in 2012. Mobile Money Users grew by 19.9 percent to end 2013 at 25.3 million from 21.1 million customers in 2012. The volume and value of Mobile Phone Money Transfers maintained upward trend, reaching 733 million transactions valued Ksh 1,901.6 million in 2013 from 575 million transactions worth Ksh. 1,537.5 million in 2012. The 27.5 percent and 23.7 percent increase in volume and value respectively during the period signify the importance of this payment platform in terms of outreach and impact to the economy (table 41).

Table 41: Mobile Money Transfers By end December 2013

MEASURE	2007	2008	2009	2010	2011	2012	2013
Total number of agents	1,582	6,104	23,012	39,449	50,471	76,912	113,130
Total customers (Mns)	1.3	5.1	8.9	16.4	19.2	21.1	25.3
Transactions (million)	5.5	62.7	193.5	311	433	575	733
Transactions Value (Ksh bn)	16.3	166.6	473.4	732.2	1,169.2	1,537.5	1,901.6
Value per transaction (Ksh)	2,983	2,655	2,447	2,354	2,700	2,672	2,594

Source: NPS database at CBK

Increased usage of mobile phone money transfer platforms reflect penetration of digital transaction culture that has spilled over to creative renaissance in Kenya's software-development. Improved telecommunication infrastructure after successful liberalization, social dynamics, and enabling regulatory environment also explain this rapid expansion.

4.7.10 Business Continuity Plan (BCP)

The BCP is an essential part of any organisation's response unforeseen disruptions. It offers alternative operation sites following an incident. It details how it expects to return to 'business as usual' in the quickest time possible. CBK in collaboration with Kenya Bankers Association (KBA) and other stakeholders have put in place appropriate BCPs arrangements. These include; operationalization of back-up systems and Disaster Recovery Sites in accordance with B.I.S principles for financial market infrastructures. The Bank has also devised collaborative initiatives to effectively and efficiently monitor payment systems in the country.

4.7.11 Integrity in National Payment Systems

The number of fraudulent activities recorded in the past has been alarming, notably in the mobile money transfers, payment card industry and the cheque payment system. Fraud remains a major problem in electronic payment systems, making fraud detection a key issue. Reducing fraud is a complex process and demands a multidisciplinary approach. It should be detected in real-time, but this is not easy, hence many fraud systems have serious limitations.

To mitigate the problem in Kenya, KBA in conjunction with CBK initiated a process to migrate payment cards from magnetic strip-based to Europay, MasterCard and Visa (EMV) standards, which are CHIP-based. The latter are more secure and less susceptible to fraud. In addition, full implementation of cheque truncation system ensured extra security features embedded in cheques, hence more security. Mobile Payment Service providers also continued to sensitize the public on security measures when using their service as well as training their agents on fraud and mitigation measures. Dynamic technology provides value adding services in the existing payment systems, and can also be used to create new solutions like fraud management systems which can reduce fraud significantly by using and combining different techniques.

4.7.12 Policy Changes, Recent Developments and Risks in the NPS

CBK prepared NPS regulations in 2013 following the enactment of the NPS Act in 2011. Once gazetted, the regulations provides for supervision and regulation of payment systems and payment service providers, and connected purposes in the country. The overriding objective of modernization process currently being undertaken by the CBK together with other stakeholders is to systematically and continuously implement policies that would ultimately enable the country improve safety, efficiency and effectiveness of the payment system. It also seeks to promote access and inclusion to financial services by wider populace. The CBK works closely with the Government, the KBA and other stakeholders to meet this objective.

4.7.13 The Subsector Outlook

Globally, payment systems differ widely in efficiency, especially in emerging economies where cash payments dominate and infrastructure is often underdeveloped. The social cost of cash is high. Migration to digitized payments platforms can reduce costs to banks, governments and merchants; stimulate economic growth; and facilitate financial transparency across the globe. Industry players and all stakeholders in the payments industry must work closely to achieve and sustain a robust payments system that will deliver economic dividends.

To move forward, many industries are now increasingly embracing digitization of payments, replacing cash-based transactions with electronic transactions. Supported by many emerging technological initiatives, current efforts are targeting to entrench cashless system in payment of goods and services. This will not only contribute to significant economic growth, but will also reduce costs of handling cash and notes replacement costs. Efficiency, safety and effectiveness in the payment systems are ultimate objectives.

5.0 SUMMARY AND OUTLOOK FOR 2014

5.1 Threats from Global developments

- China's current fiscal and financial sector reforms have implications on the credit conditions domestically. Given its critical role in emerging markets and developing economies, there are likely spillover effects through constrained capital flows, slower foreign direct investment and reduced demand for commodities markets.
- Geopolitics of the MENA region (including Pakistan), West versus Russia (over Ukraine), East (South Sudan and Somalia) and Central Africa regions remain a threat to global economy through impact on trade due to sanctions, international oil markets and global financial system
- Persistent inflation below many central banks' targets, especially in advanced countries, poses risks of deflation, likely to affect recovery, especially in the Eurozone.
- Unemployment and unequal economic growth and distribution could slowdown global economic recovery than forecast and therefore pose risks to global stability.
- A slowdown in emerging markets economies, especially the BRICS, which supported global economy at the height of financial crisis, could drag the global recovery pace and even introduce another round of slowdown.
- Outbreak of Ebola virus outbreak in Western African countries has resulted in flight cancellations by some airlines, including Kenya Airways. It has also led to travel restrictions, affecting tourism and international trade, with significant impact on the economy.

5.2 Threats within Domestic environment

- Kenya remains exposed to regional risks in terms of trade and financial system. International sanctions to South Sudan would impact greatly on financial institutions operating in South Sudan, and in turn affect overall position of parent institutions.
- Concentration risks in the capital markets in terms of foreign investor activity, trading stocks and intermediaries still remain as reflected in the analysis.
- Kenya shilling remains vulnerable given the flight to safety tendencies. Tighter financial conditions on events like the U.S halting its monetary policy stimulus combined with reduced inflows from tourism sector as well as exports will impact Kenya.
- Government fiscal operations remain a challenge especially to the CBK bottom line. More Government spending enhances scope for OMO sales to mop liquidity, which impairs the CBK balance sheet. Conversely, excessive accumulation of Government deposits at the CBK tightens liquidity conditions, prompting CBK to inject liquidity in the money market to ease pressure on the short term interest rates. Effective liquidity management is a must for the CBK in order to stabilise interbank liquidity.
- Overall public and publicly-guaranteed debt remains sustainable even as the government pursues more borrowing to finance infrastructure development. However, the rate of debt growth is much faster, which require closer monitoring.
- Insecurity posed by the terrorists (Al Shabab) militia is a major challenge, especially to the tourism sector, a key contributor to the economy.

- There are also erratic weather patterns that may negatively affect food production, leading to food imports. This has implications on raising import bill and widening CAD if exports growth remains low.

5.3 Policy Suggestions

- Enhanced micro-and macro-prudential surveillance and analysis are critical to ensure early detection of risks emanating from both domestic and global sources. This cover analysis of the U.S monetary and fiscal policy actions, developments in our regional trading partners, trends in the BRICS, dynamics in global financial markets, and commodity prices.
- The CBK in collaboration with National Treasury and other stakeholders must continue to pursue avenues for addressing high interest rates that continue to weigh heavily on Small and Medium Enterprises (SMEs). This would ensure sustainable and effective credit market developments to boost borrowing and lending to spur economic growth.
- Government need to spearhead reforms to create fiscal space and monitor public debt (central and county governments' deficits and contingent liabilities). County balances at the CBK remain non-inflationary as long as the required structures to facilitate draw down by counties take time to implement.
- For effective liquidity management in the system, the Government should consider using major banks for its deposits as is the case of Loan-Tax accounts in South Africa. This would in addition signal the Government's confidence in the banking system and also be a source additional income from interest on deposits with these banks. It would also minimise monetary policy costs to the Central Bank.
- The government policy on requiring banks to reduce lending rates should be consistent with Credit growth paths and government borrowing programme for effective coordination and stability. This would avoid potential threats of macroeconomic imbalances.
- Kenya's banking system faces opportunities in funding large corporate projects as more foreign companies intend to exploit natural resources and larger infrastructure projects get underway. However, the Ksh 1 billion (about USD 11 Million only!) minimum capital requirement may actually constraint financing potential of some large banks. The CBK may consider raising this minimum capital requirement to make the industry move to the level of Egypt, Angola, Nigeria, and South Africa.

ABBREVIATIONS

ACH	Automated Clearing House
ATMs	Automated Teller Machines
BIS	Bank for International Settlements
BOP	Balance of Payments
CBK	Central Bank of Kenya
CBR	Central Bank Rate
CMA	Capital Markets Authority
CDSC	Central Depository for Securities Corporation
DPFB	Deposit Protection Fund Board
DSA	Debt Sustainability Analysis
DTS	Deposits Taking Saccos
EAC	East African Community
EFT	Electronic Funds Transfer
ERS	Electronic Regulatory System
ETF	Exchange Traded Fund
FDI	Foreign Direct Investment
FOSAs	Front Office Savings Activities
FSI	Financial Soundness Indicators
FSR	Financial Stability Report
FSRF	Financial Sector Regulators Forum
FSSTC	Financial Sector Stability Technical Committee
GDP	Growth Domestic Product
IAIS	International Association of Insurance Supervisors
IADI	International Association of Deposits Insurance
IOSCO	International Organization of Securities Commission
IMF	International Monetary Fund
IRA	Insurance Regulatory Authority
KEPSS	Kenya Electronic Payment & Settlement
MENA	Middle East and North Africa
MTDS	Medium Term Debt Strategy
NPLs	Non-Performing Loans
NSSF	National Social Security Fund
OTC	Over-The Counter Trading
RBA	Retirement Benefits Authority
RBS	Risk Based Supervision
REITs	Real Estate Investment Trust
SACCOs	Saving and Credit Co-operatives Societies
SASRA	Saccos Societies Regulatory Authority
SIPS	Systemically Important Payment System
SMEs	Small and Medium Enterprises
SSA	Sub-Saharan Africa
TRWA	Total Risk Weighted Assets
USA	United Sates of America
USD	United States Dollar
VAT	Value Added Tax
WEO	World Economic Outlook