KENYA FINANCIAL SECTOR STABILITY REPORT 2014

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The Kenya Financial Sector Stability Report, 2014 was prepared by the Financial Sector Regulators Forum, which brings together the Central Bank of Kenya, Capital Markets Authority, Insurance Regulatory Authority, Retirement Benefits authority and Sacco Societies Regulatory Authority under a Memorandum of Understanding (MOU) for collaboration in several areas of mutual interests. The National Treasury, Ministry of Industrialisation and Enterprise Development Kenya Deposit Insurance Corporation and the Insurance Policy Holders Compensation Fund have observer status under the MOU.

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CAPITAL MARKETS AUTHORITY

BANKI KUU YA KENYA

IRA

RBA Retirement Benefits Authority

THE SACCO SOCIETIES REGULATORY AUTHORITY SASRA SECURING SACCO FUNDS

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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

FOREWORD

This 6th edition of the annual Financial Stability Report, 2014 (FSR, 2014) is a joint report of the five financial sector regulators in Kenya, namely: The Central Bank of Kenya (CBK); Capital Markets Authority (CMA); Insurance Regulatory Authority (IRA); Retirement Benefits Authority (RBA); and Saccos Societies Regulatory Authority (SASRA). This report covers the period 2014 highlighting key developments in the financial system.

The Report captures global and domestic macro-financial developments in the macroeconomy and the financial system in 2014. It analyses the performance and interactions involving the real economy, financial markets, financial institutions, financial infrastructure, and policy changes over the review period.

The financial sector has grown significantly in terms of its contribution to overall Gross Domestic Product (GDP) in Kenya. The sector's assets stood at 89.52 percent of GDP in December 2014 compared to 85.93 percent in 2013. Market Capitalization for all listed and actively trading equities at the Nairobi Securities Exchange (NSE) accounted for 42.93 percent of GDP at the end December 2014 compared to 40.60 percent at the end December 2013. The Bonds turnover at the NSE accounted for 9.25 percent of GDP in 2014 compared to 9.56 percent in 2013. In terms of the contribution by subsector, the total Banking subsector assets accounted for 60.87 percent of the country's nominal GDP by end December 2014; the Pension subsector accounted for 14 percent of GDP; Insurance subsector accounted for 7.96 percent of GDP; SACCOs subsector accounted for 5.63 percent of GDP; and the Microfinance banks accounted for 1.06 percent.

The issuance of the Eurobond in 2014 has further integrated domestic financial system to the global macro-financial system. The vibrant capital markets, dynamic and innovative products and delivery channels, growing Saccos and microfinance banks, coupled with growing insurance and pension subsectors continue to drive growth of the financial system, making it significantly important to the rest of the economy. A more robust regulatory framework covering all facets of the financial system would ensure integrated financial sector oversight that enhances the sector's development towards elevating Kenya to a regional financial hub.

Kenya's financial system remained stable supported by resilient economic performance in 2014. The prospects for 2015 remain positive, driven by heavy investments in infrastructure development and stable overall macroeconomic environment.

The downside risks to Kenya's macro-financial stability are both related to domestic and global developments. The strong U.S. dollar has made the Kenya Shilling more vulnerable, exhibiting notable volatility in the first half of 2014 but moderated by Monetary Policy measures and proceeds from the Eurobond. Decline in exports to the EAC partly reflecting competition from Chinese goods negatively affected trade balance for Kenya. The continued conflicts in the MENA region and falling global tea prices as well as a slump in tourism sector following terror threats and subsequent travel advisories put pressure on the Kenya Shilling. The recovery in the developed markets saw significant outflow by foreign investors at the Nairobi Securities Exchange. The 12-month cumulative current account deficit as a proportion of GDP widened from 8.5 percent in June 2014 to 10.1 percent in December 2014 mainly reflecting increased imports of capital goods and lower than expected exports. Other notable pockets of vulnerabilities include increasing NPLs in both banks and SACCOS, concentration risks in capital markets, delayed critical legislations, and increasing commercial debt.

At the regional level, Sub-Saharan Africa faces numerous downside risks that are likely to slow down the growth momentum. These include fiscal pressures, declining reserves in effort to stabilize local currencies, security threats, political instability and conflicts, and weakening balance of payments positions. The continued geopolitical tensions in Russia and Ukraine, political instability and terror threats in the MENA region will impact negatively to SSA region. The prolonged decline in global oil prices will negatively affect growth in oil exporting countries thus offsetting gains in oil importers. Tighter global financial conditions in developed economies such as the US may also result in the outflow of private capital and increase currency volatility. Weather shocks would negatively affect agricultural productivity and electricity generation, while civil unrests may undermine service and mining sectors hence economic outlook.

To foster macroprudential policy and surveillance, the Bank in collaboration with East African Community through the Monetary Affairs Committee (MAC) is at an advanced stage in developing surveillance and analytical framework for both national and regional financial system stability assessment and analysis. In addition, the Bank with Technical Assistance from the International Monetary Fund has enhanced its Stress Testing Framework for regular macro-and micro-stress testing exercises. These efforts would enable policy makers, regulators and financial sector players to better monitor financial system risks at both micro- and macro- level and put in place mitigation measures in a timely manner to foster financial stability. This annual FSR 2014 therefore, presents information to the public on developments in the financial sector and efforts taken by the Government and Regulators to build a safe, sound and efficient inclusive financial system.

Patrick Njoroge

DR. PATRICK NJOROGE
GOVERNOR, CENTRAL BANK OF KENYA

ACKNOWLEDGEMENT

The Financial Stability Report (FSR) 2014 emphasizes commitment by the Government and Financial Sector Regulators in collaboration with other stakeholders to foster the development of a safe, stable and efficient inclusive financial system in Kenya. The report covers developments in macro-financial conditions for the year 2014. Going forward, we expect the publication of future FSR to be semi-annual commencing in 2017.

The semi-annual publication of the FSRs targets to provide more current information in a timely manner. It is also consistent with good practices in several jurisdictions in developed and emerging countries as well as other international bodies like the International Monetary Fund (IMF), Financial Stability Board (FSB) and Bank of International Settlement (BIS). The report 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 and financial system stability.

Consequently, close surveillance and diagnostic assessment of potential vulnerabilities and risks to the financial system stability, can aid timely interventions and mitigation measures by the Regulators, policymakers and financial market players. This in turn requires as a precondition, information sharing, not only among the Regulators but also among other key stakeholders and the general public. The report reflects Kenya's efforts towards EAC integration process in fostering a stable and well-integrated financial system.

Sustained efforts by all Regulators under the Financial Sector Regulators Forum (FSRF) have supported collection of relatively high frequency data needed for enhanced financial system surveillance.

As the lead coordinator of the Financial Stability Sub-Committee initiatives including preparation of the FSRs, I wish to thank the entire FSRF team for working hard to produce this report. I also thank the Chief Executive Officers of the five Regulators for providing the necessary resources and leadership in the Forum's activities. We continue to invite the public for feedback on this publication in order to improve future reports. Feedback can be channeled through researchstat@centralbank.go.ke.

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

1.0 GLOBAL DEVELOPMENTS

1.1 Macro-Financial Conditions

The World Economic Outlook (WEO), October 2014, reported an imbalanced recovery due to weaker-than-expected global economic activity in the first half of 2014. The world growth forecasts were revised downward to 3.3 percent from 3.4 percent in the WEO Update of July 2014 on imbalanced growth in the developed economies, population aging and declining potential growth, increased interest rates and risk spreads for many commodity exporting emerging market economies as well as increase in spreads on high-yield bonds. The WEO, July 2015 revised down its 2015 growth projection to 3.3 percent (Table 1).

The UK and US exuded strong growth in the last three quarters of 2014 on account of increased domestic demand, appreciating U.S. dollar, lower oil prices, increased consumer confidence and improved labour markets. During the period, however, activity in the Euro Area and Japan were disappointing, especially in third quarter of 2014. Japan's growth contracted as a result of aftereffects of the financial crisis and lacklustre private demand and residential investment despite increased infrastructure spending and consumption rate. The Euro Area less impressive growth was due to weak investments and deflation fears. Among the emerging markets, China was undergoing a prudently managed deceleration in credit and investment boom, while Russia was seriously hit by sharp decline in oil prices and heightened geopolitical tensions that contributed to rapid depreciation of the rouble.

Inflation in many major economies declined further reflecting soft commodity prices, sharp decline in oil prices and decrease in domestic demand in the Euro Area and Japan. In Europe, inflation fell below 0.5 percent with medium to long term inflation expectations also declining. Persistently low inflation combined with low growth is a threat to financial stability.

Changes in growth and monetary policies expectations have yielded considerable exchange rate volatility in fourth quarter of 2104. The U.S dollar appreciated by 14 percent in real effective terms against currencies of major advanced economies. The Russian rouble, Canadian dollar and Norwegian krone depreciated by 30 percent, 8 percent and 7 percent, respectively, whereas the Indian rupee, appreciated by 10 percent in real terms. These exchange rate movements have distributive effects of demand across countries, thereby improving global demand and reduction in severe distress risk. However, in countries experiencing depreciation, it can lead to rapid increases in the value of foreign-currency debt, impacting their financial stability. Macro-financial conditions could become volatile as high-income economies tighten monetary policy on diverging timelines. Weak global trade growth is anticipated to persist during the forecast period, potentially for longer than expected should the Euro Area and/or Japan experience a prolonged period of stagnation or deflation (World Bank GEPR, Jan 2015).

Table 1: World Economic Outlook Update

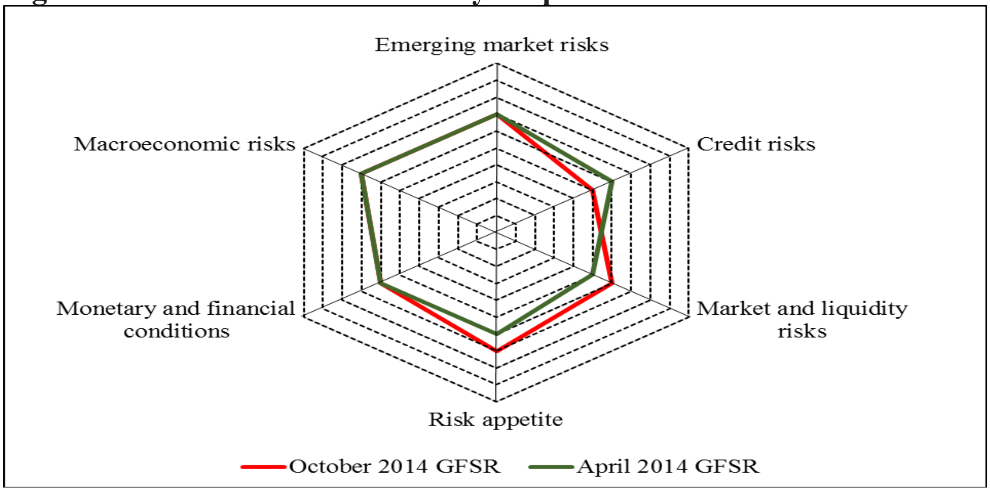
OUTPUT INDICATORS					Difference from April 2015 WEO Projections	
Real GDP Growth (%)/Year	2013(1)	2014(1)	2015e(2)	2016f(2)	2015	2016
World	3.3	3.3	3.3	3.8	-0.2	0.0
Advanced Economies	1.3	1.8	2.1	2.4	-0.3	0.0
Euro Area	-0.5	0.8	1.5	1.7	0.0	0.1
Japan	1.6	0.1	0.8	1.2	-0.2	0.0
United States of America	2.2	2.4	2.5	3.0	-0.6	-0.1
Emerging & Developing Econ.	4.7	4.4	4.2	4.7	-0.1	0.0
China	7.8	7.4	6.8	6.3	0.0	0.0
Russia	1.3	0.6	-3.4	0.2	0.4	1.3
Brazil	2.5	0.1	-1.5	0.7	-0.5	-0.3
MENA, Afghanistan, Pakistan	2.2	2.8	2.6	3.8	-0.3	-0.5

Source: WEO Update January 2015(1) and WEO Update July 2015(2)

Improving domestic demand, more moderate fiscal adjustment, lower oil prices and monetary policy easing continues to strengthen the growth outlook in 2015-16 for the U.S. Weak investment and declining inflation have imposed downward risks to the Euro Area. Growth outlook for emerging market economies was revised downwards by 0.1 percent and maintained for 2015-16 to 4.2 and 4.7 percent, respectively, as a result of lower growth in China and its implications for emerging Asia, weaker outlook in Russia and downward revisions to potential growth in commodity exporters. These developments have left macroeconomic risks unchanged (Figure 1).

The Global Financial Stability Report (GFSR), October 2014 showed that increased risk appetite had fuelled the pursuit for returns thus leading to increase in market and liquidity risks with reduced credit risks.

Figure 1: Global Financial Stability Map



Source: Global financial stability report, April 2014

Decline in credit risk is attributed to improved asset quality and improved access to market funding for banks and nonfinancial corporations. Banks have strengthened their capital positions amid post 2008 tightening regulatory frameworks although this has made profitability a challenge. Macroeconomic risks remained unchanged due to lagging economic risk in developed economies. Economic risk in Emerging Markets economies continues to grow, but the increasing leverage could worsen credit quality. Monetary and financial conditions also remained unchanged due to market expectations of low interest rates. Market and liquidity risk increased reflecting the continuing pursuit for returns; pushing up asset prices and squeezing spreads, except for emerging markets where bonds yields remain high. Favourable external funding conditions offset by increased geopolitical risks, especially in Ukraine and Russia and Middle East, left emerging market risks unchanged.

1.2. The Sub-Saharan Africa (SSA)

Sub-Saharan Africa's economies maintained growth trajectory since 2013, outpacing other regions except China to an average of about 5 percent in 2014 and forecast at 5.7 percent in 2015 (Table 2) . Growth expanded in Côte d'Ivoire buoyed by increase in cocoa production. Growth in Mozambique and Zambia was supported by increased agricultural production, while in Kenya, Nigeria, Tanzania, and Uganda growth expanded supported by expansion in transport, telecommunication and financial services. According to the World Economic Situation and Prospects (WESP, January 2015), SSA growth is expected to remain strong in 2015 at 5.75 percent underpinned by strong investments in infrastructure, energy, private investment and consumption expenditure from an expanding middle class. Other key drivers include increasing consumer confidence; improvement in business environment and a reduction in the costs of doing business.

Table 2: Sub-Saharan Africa Growth

Real GDP growth (Annual % change)	2002-2012	2013	2014e	2015f	2016f
Côte d'Ivoire	1.6	8.7	8.5	7.9	7.8
Ghana	7.1	7.1	4.5	4.7	7.2
Kenya	4.5	4.6	5.4	6.2	6.4
Nigeria	10.4	5.4	7.0	7.3	7.2
South Africa	3.5	1.9	1.4	2.3	2.8
Tanzania	7.0	7.0	7.2	7.0	7.1
Uganda	6.7	5.8	5.9	6.3	6.5
Zambia	7.5	6.7	6.5	7.2	7.7
Sub-Saharan Africa	6.3	5.0	5.0	5.7	6.0

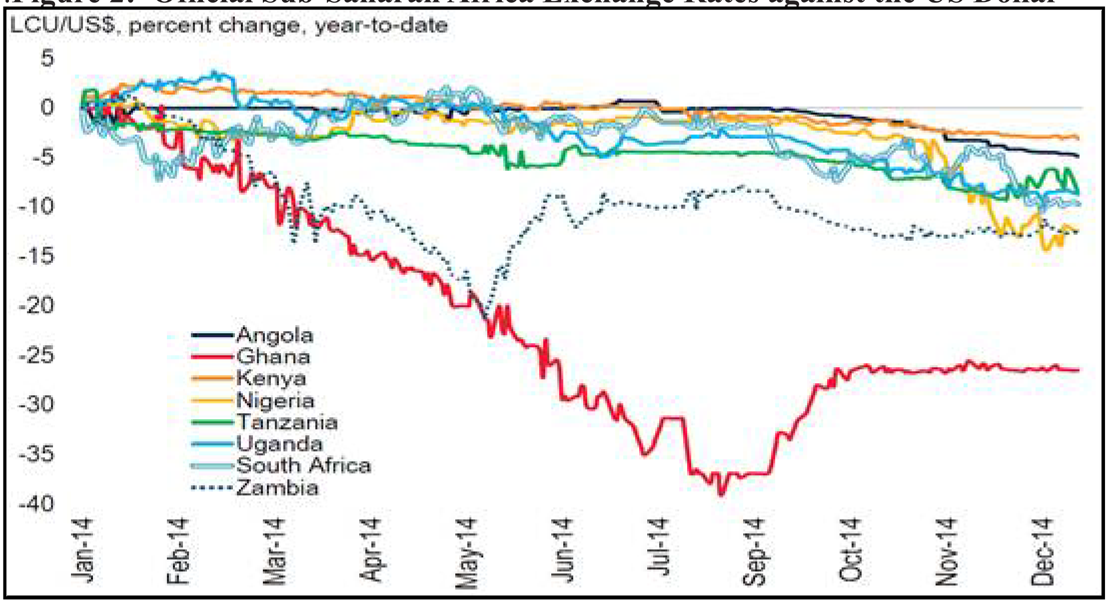
Source: World Bank data, 2014 *Note: e - estimate, f - forecast*

East Africa is expected to experience the fastest growth, reaching 5.7 per cent in 2015 and 6.0 per cent in 2016 with Kenya and Uganda being key drivers of growth. Kenya's growth prospects are anchored on declining oil prices, enhanced energy production from wind power and geothermal, rapid expansion in banking and telecommunication services and investment in infrastructure. Uganda's growth will be supported by increased activity in construction, financial services, transport and telecommunications.

North and Southern Africa are expected to experience accelerated growth, from 1.6 per cent and 2.9 per cent in 2014 to 3.9 per cent and 3.6 per cent in 2015, respectively. Enhanced growth prospects for North Africa are underpinned by improving political stability in Egypt and Tunisia. In Southern Africa, although Angola, Mozambique and Zambia will continue to be the fastest-growing economies, the 2015 growth acceleration is expected to be mainly driven by more investment in the non-diamond sector in Botswana, a recovery in private consumption in South Africa, and increased investment in mining and natural gas exploration in Mozambique. Central and West Africa will experience moderate growth, from 4.3 per cent and 5.9 per cent in 2014 to 4.7 per cent and 6.2 per cent in 2015, respectively due to political instability and terrorism in Mali, Nigeria, and the Central African Republic. The containment of Ebola outbreak and political stability following peaceful elections in Nigeria will dampen the downside risks in West Africa.

Most SSA region currencies depreciated against the U.S dollar, with Ghanaian cedi and Zambian kwacha being most hit (Figure 2). The Nigerian naira also weakened markedly against the U.S. dollar on account of depressed global oil prices, heightened terror activity and uncertainty of elections outcome. The Zambian Kwacha depreciated by 20 per cent in the first half of 2014 before regaining strength in the second half of the year.

.Figure 2: Official Sub-Saharan Africa Exchange Rates against the US Dollar

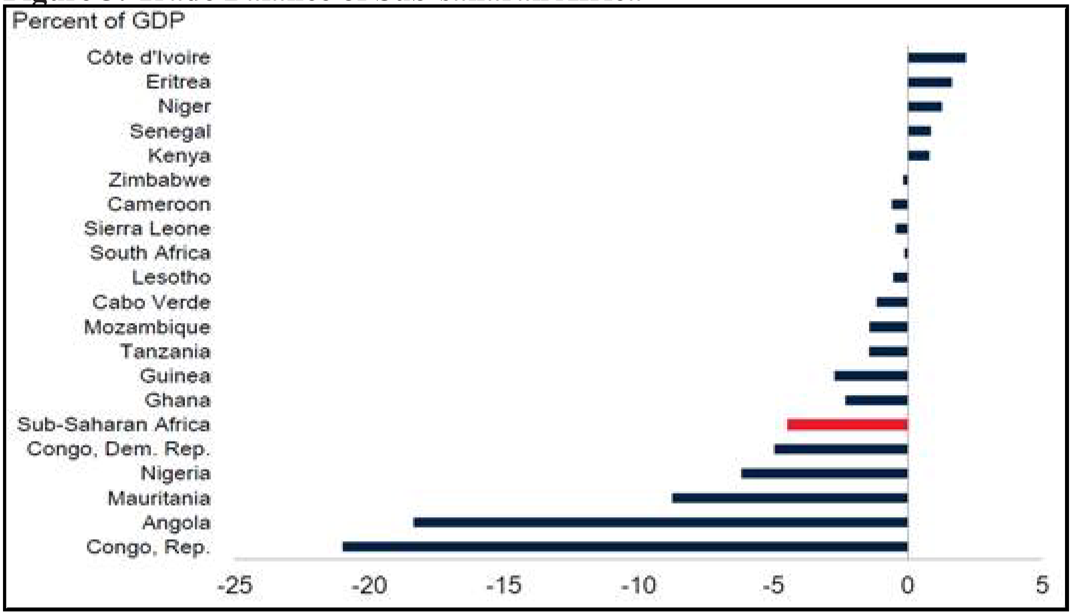


Source: World Bank Report, 2014

The Ghanaian cedi also stabilized after concerns about loose fiscal stance and low external reserves led to 40 percent depreciation against the U.S. dollar in the first 9 months of the year. Meanwhile, the South African rand continued to fall on concerns about the country's larger-than-expected current account deficit.

Many SSA countries rely on commodities exports, making them more vulnerable to price swings, particularly those that depend on a narrower natural resource base. Simulations conducted by the World Bank in January 2015 showed that a sharp decline in commodity prices would weaken trade balances across Sub-Saharan Africa (Figure 3). The scenario considered has a price decline from the baseline of 10 percent for metals (aluminum, copper, gold, iron ore, and silver), 5 percent for agricultural commodities (cocoa, coffee, tea, cotton, and tobacco) and 30 percent for crude oil. Even though all oil exporters would face sharp deterioration in their terms of trade, those with a narrow economic base such as Angola and the Republic of Congo would be affected the most. The positive effect on oil importers is reflected in large trade balance improvements for Côte d'Ivoire, Eritrea, Kenya, Niger, and Senegal and moderate trade balance deterioration in South Africa.

Figure 3: Trade Balance of Sub-saharan Africa

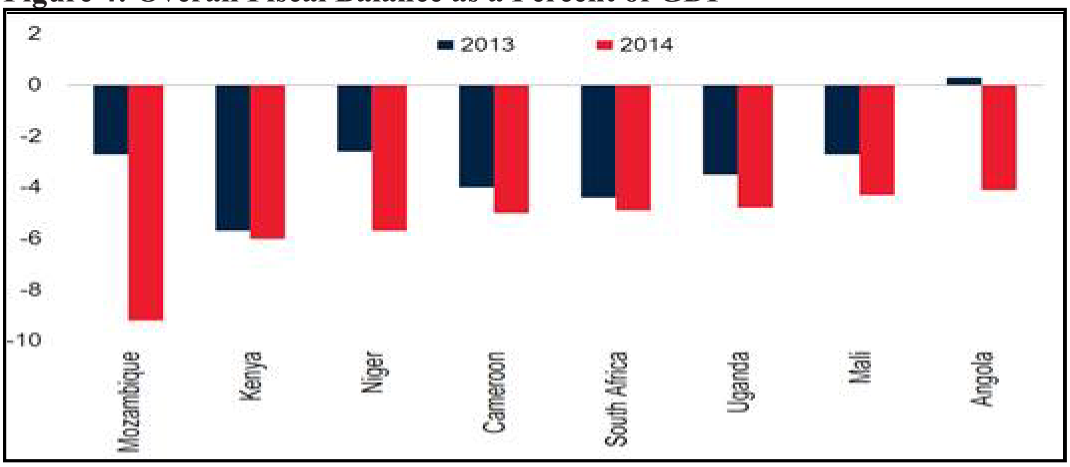


Source: World Bank

1.2.1: Eurobonds Integrated Sub-Saharan Africa into Global Markets

Several African countries including Kenya, Rwanda, Senegal, Ghana, and Zambia have successfully issued Eurobonds to finance infrastructure projects needed to boost their economies. But this has exposed these countries to increased debt levels due to currency risks and change in global interest rates (Figure 4). Fiscal positions deteriorated in some countries like Ghana and Zambia due to increases in the wage bill, higher spending associated with the frontloading and scaling up of public investment (Mali, Niger, and Uganda). In other countries, the higher deficits reflected declining revenues, especially in oil-exporting countries as production and declining oil prices (Angola).

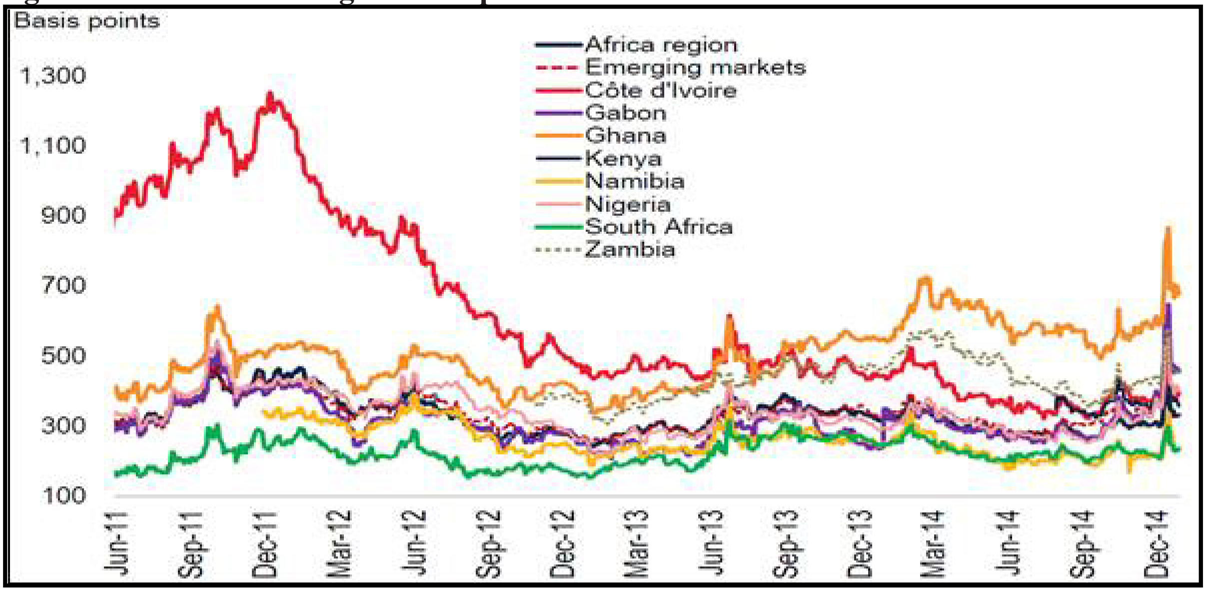
Figure 4: Overall Fiscal Balance as a Percent of GDP



Source: World Bank January 2015

Sovereign bond spreads may indicate the perception of investment risk in the region. Sovereign bond spreads fell across the region but remained relatively high in oil exporting countries such as Gabon, Ghana and Nigeria, explained by declines in international oil prices, (Figure 5).

Figure 5: 10 Year Sovereign Bond Spreads

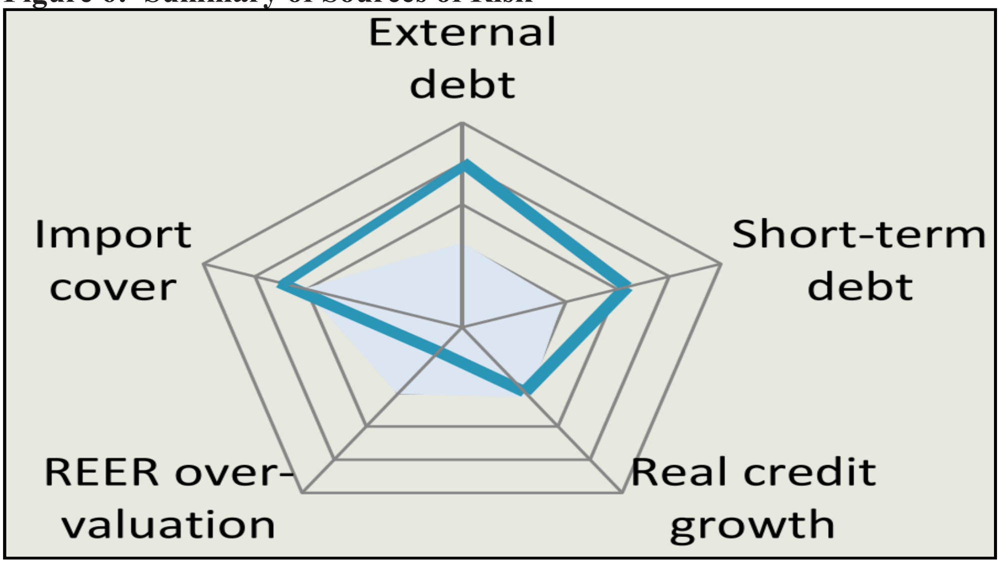


Source: JP Morgan and World Bank

1.2.2 Risks to Sub-Saharan Africa Outlook

Despite positive economic growth outlook for Sub-Saharan Africa, there are downside risks likely to slow down the momentum. Significant risks are coming from increased fiscal strains, declining reserve assets, currency weaknesses, terrorism threat, and political instability. These have threatened accelerated investment, capital inflows and tourists following travel advisories (Figure 6). The region is also likely to suffer from increased geopolitical tensions in Russia and Ukraine, political instability and terror threats in the MENA region particularly Yemen, Syria and Iraq as well as Somalia and South Sudan. Prolonged decline in global oil prices will negatively affect oil exporting countries thus offsetting gains to oil importers. Tighter global financial conditions in developed economies such as the US may also result in the outflow of private capital and increase currency volatility. Weather shocks would negatively affect agricultural productivity and electricity generation, while civil unrests may undermine key services like transport and mining sectors.

Figure 6: Summary of Sources of Risk



Source: World Bank

2.0 DOMESTIC MACROECONOMIC DEVELOPMENTS

Real GDP growth was 5.4 percent in 2014 down from 5.7 percent in 2013, with the fourth quarter of 2014 growing by 5.5 percent compared to 3.0 percent in similar period of 2013 (Figure 7). Key sectors driving growth were construction, finance and insurance, wholesale and retail trade, and agriculture and forestry. Accommodation and restaurant sector contracted by 14.6 percent on a slump in tourists' arrival. The economy is expected to pick-up on account of increased investment in infrastructure and enhanced investor confidence following stable sovereign rating outlook by S&P and Moodys of B+/B and B1 respectively. In addition, there is relatively favourable macroeconomic environment as a result of the decline in average lending rates from 17.04 percent in January 2014 to 15.99 percent in December 2014, partly explained by introduction of Kenya Banks Reference Rate (KBRR) in July 2014.

Figure 7: Quarterly Real GDP Growth Rates

Source: Kenya National Bureau of Statistics

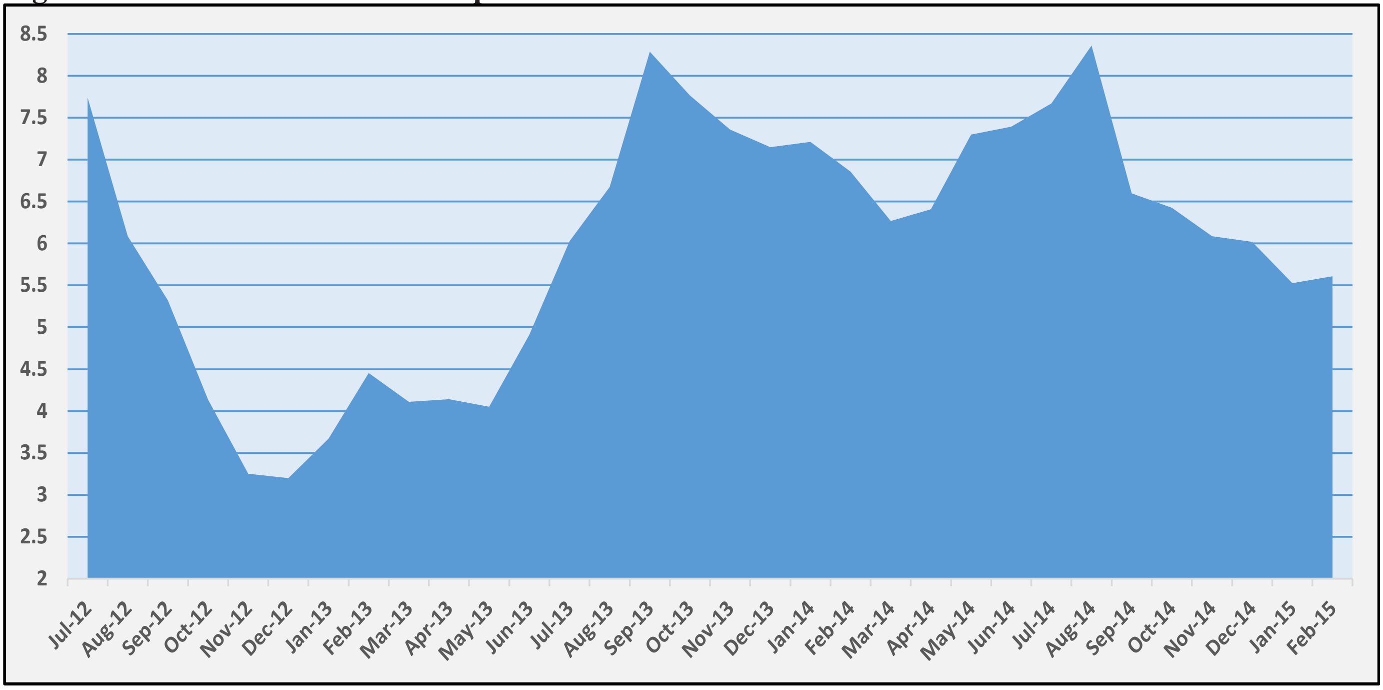
Threats to stronger growth in 2015 include; declining exports especially to the EAC region partly due to increased competition from China, subdued tea prices exacerbated by conflict in the MENA region, and insecurity that has impacted both domestic and foreign tourists. The downside risks may partially be offset by low global oil prices.

2.1 Overall Inflation Developments

The overall inflation rate in December 2014 was 6.02 percent compared to 7.67 percent in July 2014 and 7.15 percent in December 2013. It remained within the government target range from June 2014 to December 2014 except in July and August 2014 as shown in Figure 8. The single digit inflation is attributed to sound monetary policy, low global food prices and generally declining global oil prices that impacted positively on domestic energy prices.

Inflation pressures, however, tickled up in the first quarter of 2015, 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 and 8.36 percent in July and August 2014, respectively, from 6.02 and 6.67 percent in same period in 2013 as shown in Figure 8 on account of erratic weather patterns that adversely impacted agriculture.

Figure 8: Overall Inflation Developments



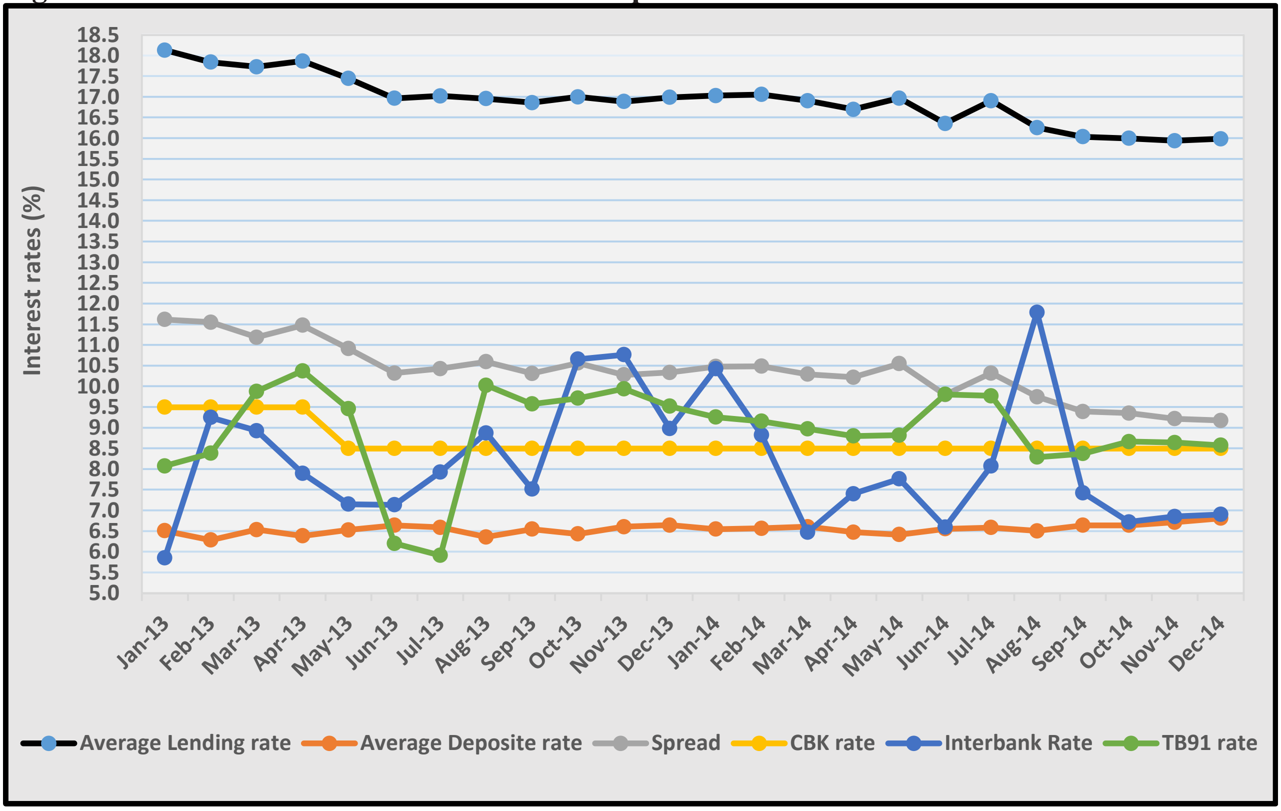
Source: Central Bank of Kenya

2.2 Interest Rates Developments

Following rentention of the Central Bank Rate (CBR) at 8.5 percent since 2013, the interbank rate, remained fairly stable, while the commercial banks average lending rate shed 37 basis points while the average interest rates spread was down 62 basis points. The 91-days Treasury bill rates declined by 123 basis points between June 2014 and December 2014. A key positive outcome was certainty and stability in interest rates since January 2013 (Figure 9). This contributed to improved credit uptake by private sector.

Commercial banks' average lending rates have been fairly stable, decreasing marginally to 15.99 percent in December 2014 from 16.36 percent in June 2014. With average deposit rate at 6.81 percent compared to 6.56 percent in June 2014, the interest rates spread declined to 9.2 percent in December 2014 from 9.80 percent in June 2014. This may partially be due to adoption of Kenya Banks Reference Rate (KBRR) in July 2014 as a pricing benchmark for credit facilities. The interbank rate has oscillated close to the CBR except for a few instances since January 2014 reflecting structural rigidities in Government cash management following the implementation of Devolved Government, and seasonality of interbank liquidity. Liquidity distribution in the interbank market improved across banks, thereby easing pressure on the rest of the money markets. The Government commitment to lower interest rates contributed to interest rates stability in 2014 (Figure 9)

Figure 9: Trends of Some Interest Rates and Spread



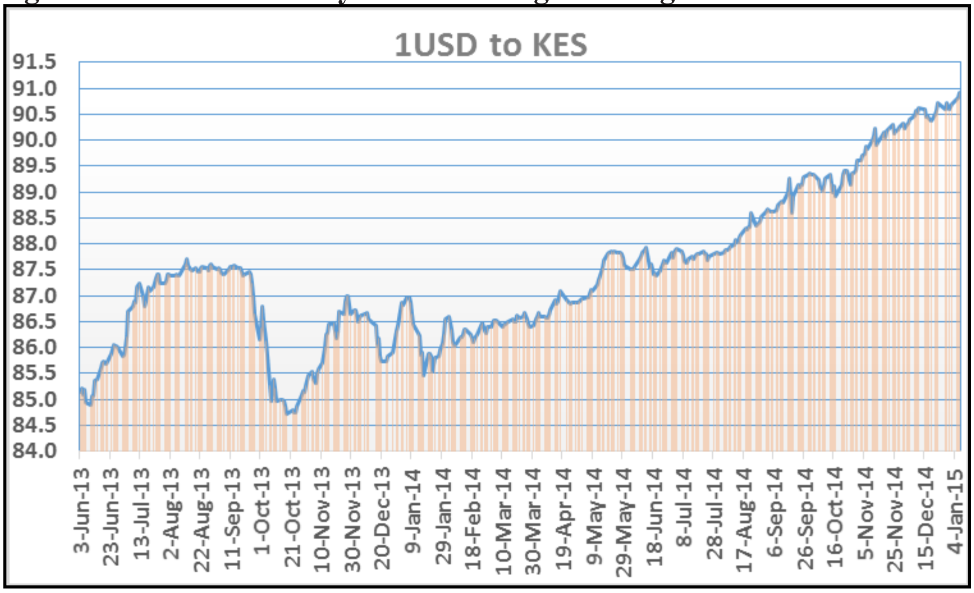
Source: Central Bank of Kenya

The continued rigidity in the cost of credit despite measures taken by the Government not only defines inefficiencies in credit markets, but is also a potential source of risk in the event of shock to household incomes. The introduction of the KBRR in July 2014, which is based on 91-days Treasury bill and CBR in July 2014, is meant to bring transparency in pricing of credit facilities and mortgages by credit providers. Partial reduction in the interest rates spreads may be attributed to implementation of this pricing benchmark. KBRR is reviewed and announced by the CBK semi-annually from the effective date and operationalized through a Banking Circular to reflect credit markets conditions.

2.3 Foreign Exchange Markets

The Kenya shilling depreciated gradually against the U.S. dollar in 2014. This reflected the strengthening of the U.S. dollar, reduced regional trade due to competition from China, low exports revenue on falling global tea prices, decline in tourism revenues on insecurity jitters, rising import bill and shocks to short term capital flows reflected in relative decline in foreign investors' participation at the NSE between June and December 2014.

Figure 10: Trends in Daily KSh Exchange Rate against the US Dollar



Source: Central Bank of Kenya

Declining global oil prices and world food prices may lessen pressure on the KSh, but instability in the Middle East and North America (MENA) region, declining regional trade, interest rates reversals in the U.S, terror threats accompanied by travel advisories from traditional tourists markets, pose a new round of risks. Against other selected world currencies, the KSh strengthened against UK Pound, Euro, Japanese Yen, Rwanda and Burundi currencies between June 2014 and December 2014. It however, weakened against the Tanzania Shilling and Uganda Shilling during the second half of 2014 (Table 3).

Table 3: KSh Exchange Rate against Select World Currencies

Currency	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	% Change June '13 - Dec '13	% Change June'14 - Dec '14
USD	85.64	86.01	86.65	86.31	86.44	87.63	89.28	90.60	0.35	3.39
UK POUND	129.61	131.33	139.96	142.40	143.81	149.20	145.12	140.95	8.42	-5.53
EURO	109.55	112.40	116.88	119.22	118.92	119.55	113.29	110.17	6.07	-7.85
Japanese Yen [100]	90.96	87.04	88.39	82.42	84.18	86.51	81.63	75.30	-5.31	-12.96
Ugandan Shillings*	30.30	30.17	29.64	29.17	29.48	29.64	29.68	30.57	-3.31	3.16
Tanzania Shillings*	18.86	18.92	18.58	18.62	18.98	18.89	18.77	19.10	-1.58	1.10
Rwanda Franc*	7.40	7.56	7.72	7.75	7.84	7.74	7.71	7.61	2.48	-1.71
Burundi Franc*	18.40	18.09	17.76	17.85	17.93	17.69	17.36	17.17	-1.32	-2.91
*Units of Currency per Kenya Shillings										

Source: Central Bank of Kenya

2.4. Credit to Private Sector and Outlook

Commercial banks annual growth in credit to the private sector declined to 22.2 percent in December 2014 from 25.4 percent in June 2014 (Table 4), due to large net debt repayment in the Mining & Quarrying, and Other Services sectors, and reduced tourism earnings. In actual amounts, a total of KSh 2.14 trillion was advanced to the domestic economy by end of December 2014, with credit to the private sector accounting for 88.2 percent. Public sector received 9.6 percent of the total, down from 13.9 percent in June 2014. The largest recipients were Finance & Insurance, Households, Transport & Communication, Real Estate, and Agriculture. The largest drop was in Mining & Quarrying, and Other Activities.

Table 4: Credit in Private Sector KSh. Billions (June-December 2014)

SECTOR	Jun-14	Dec-14	Actual Change	Change (%)
Agriculture	65.0	75.0	10.0	15.4
Manufacturing	221.0	237.0	16.0	7.2
Trade	283.0	307.0	24.0	8.5
Exports	11.0	12.0	1.0	9.1
Imports	9.0	9.0	0.0	0.0
Domestic	264.0	286.0	22.0	8.3
Building & Construction	76.0	80.0	4.0	5.3
Transport & Communication	111.0	130.0	19.0	17.1
Finance & Insurance	39.0	50.0	11.0	28.2
Real Estate	225.0	263.0	38.0	16.9
Mining & quarrying	28.0	23.0	-5.0	-17.9
Private Households	266.0	320.0	54.0	20.3
Consumer Durables	103.0	112.0	9.0	8.7
Business Services	162.0	169.0	7.0	4.3
Other Activities	139.0	116.0	-23.0	-16.5
Total	1,720.0	1,884.0	164.0	9.5

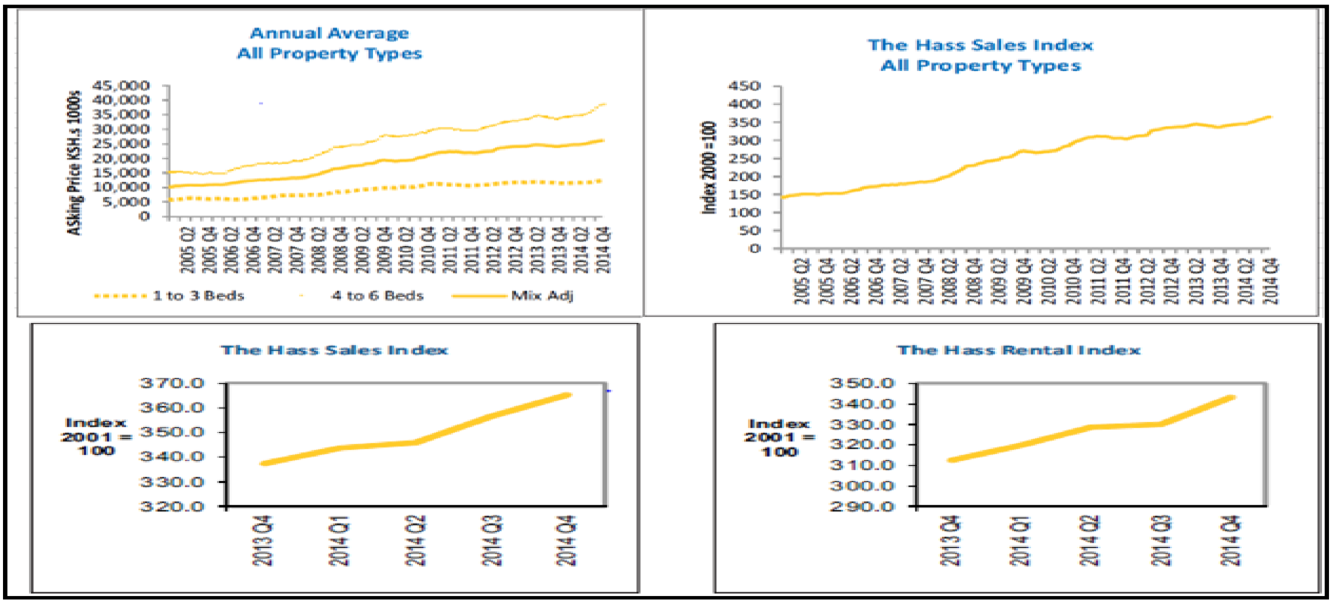
Source: Central Bank of Kenya

2.5 Real Estate Prices and Demand

Property prices rose by 2.4 percent in the fourth quarter of 2014, maintaining a steady recovery across all market segments according to Kenya Bankers Association (KBA). The biggest gain was recorded in the asking prices of apartments, which averaged 5.5 percent quarter-on-quarter, and 13.2 percent year-on-year. Detached and semi-detached houses recorded moderate increases, averaging 1.9 per cent and 1.8 per cent, respectively. This may be explained by limited supply of such units as the existing ones are demolished to develop apartments. Rental prices continued to rise, averaging 4 percent above third quarter of 2014. Apartments' rental prices recorded an increase of 5.1 percent in the fourth quarter of 2014 down from to 10.4 percent of the same quarter in 2013.

The Hass Consult Real Estate Limited Property Index rose by 2.4 percent in the fourth quarter of 2014 compared with 8.3 percent increase in a similar period in 2013. The annual average value for a property increased from KSh 15 million in 2005q4 to KSh 30 million in the fourth quarter of 2014 (Figure 12). Demand for both buying and renting was concentrated in the mid-market comprising of semi-detached houses and apartments, reflecting strong mid-market rental yields.

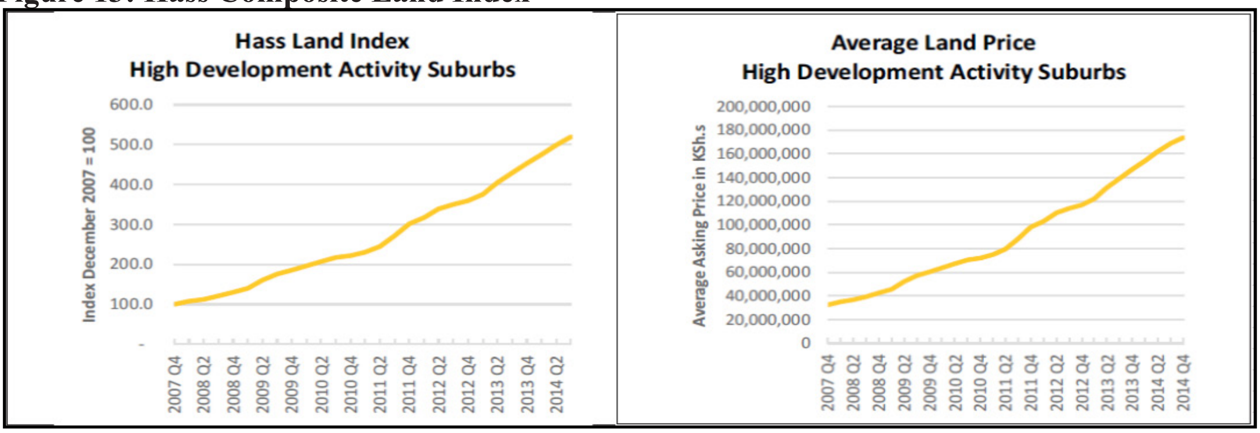
Figure 12: The Hass Property Index



Source: Hass Consult, March 2015

Hass Composite Land Index reflects land sales in Nairobi covering nine (9) high development activity suburbs. The advertised land process in Nairobi have increased by more than 5.35 times, averaging KSh 173.7 million in 2014 compared to KSh 32.5 million per acre in 2007 (Figure 13). Commercial and high-density housing units were key drivers of the prices. This sharp increase in land prices compared to the rate of increase in house prices or rentals require moderation to avoid build-up of risks that may spillovers to credit markets despite the fact the probability of any real estate bubble in Kenya is still low given shortage of housing units.

Figure 13: Hass Composite Land Index



Source: Hass Consult, March 2015

2.6 Balance of Payments (BOP) Developments and Outlook

Overall BOP surplus rose to USD 1,378 million in the year to December 2014 from USD 685 million in the year to December 2013 due to Eurobond proceeds. Current Account Deficit (CAD) narrowed by USD 16.6 million, Financial and Capital Account was in surplus with gross reserves rising to USD 9,738 million in the year to December 2014 (Table 5).

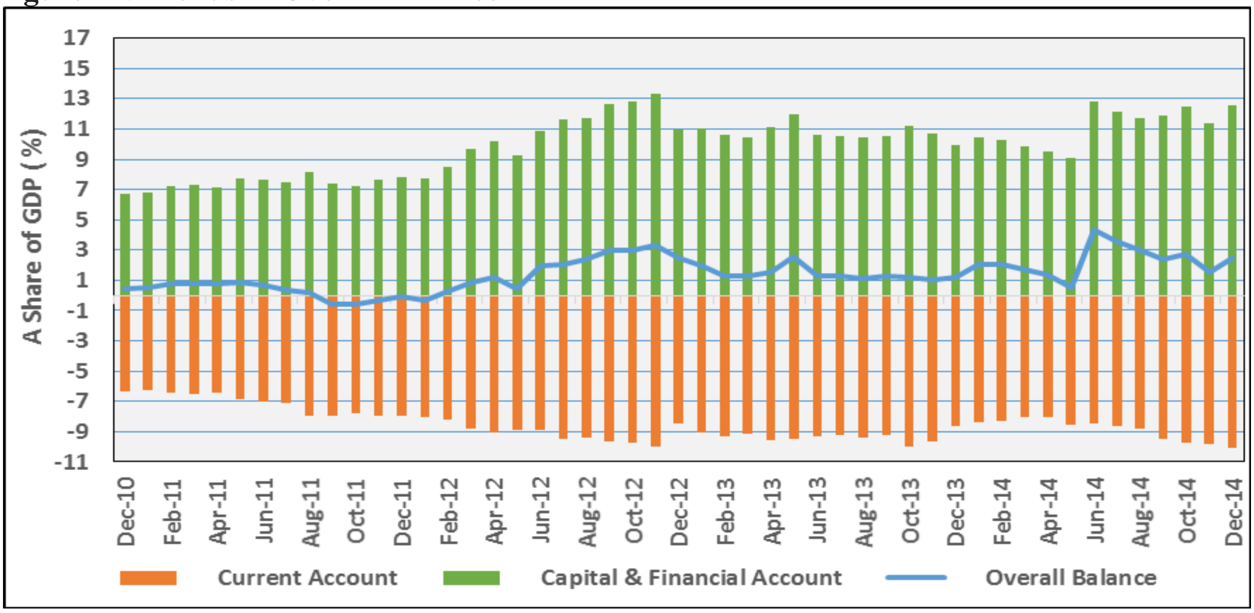
Table 5: Balance of Payments (USD Millions)

ITEM	Year to Dec 2013	Year to December 2014* Q1 Jan-Mar	Q2 Apr-June	Q3 Jul-Sep	Q4 Oct-Dec	Year to Dec 2014*	Absolute Change	% Change
1. OVERALL BALANCE	685	108	1906	-870	235	1378	693.6	101.3
2. CURRENT ACCOUNT	-4786	-904	-1164	-1863	-1653	-5583	-796.7	16.6
2.1 Goods	-11229	-2440	-3009	-3684	-3217	-12351	-1121.3	10.0
Exports (fob)	5822	1558	1617	1444	1427	6046	224.4	3.9
Imports (cif)	17051	3999	4625	5129	4644	18397	1345.7	7.9
2.2 Services	6443	1537	1845	1822	1564	6768	324.6	5.0
Non-factor services (net)	3646	1039	1130	1124	951	4243	597.8	16.4
Income (net)	-339	-38	-103	-73	-111	-325	13.6	-4.0
Current Transfers	3137	537	817	771	725	2850	-286.9	-9.1
3. CAPITAL & FINANCIAL ACCOUNT	5471	1011	3070	992	1888	6961	1490.3	27.2
3.1 Capital Tranfers (net)	98	30	134	0	60	224	126.6	129.5
3.2 Financial Account	5373	981	2935	992	1828	6737	1363.7	25.4
memo:								
Gross Reserves	8483	8279	10399	9336	9738	9738	1254.4	14.8
Official	6560	6654	8555	7676	7895	7895	1334.7	20.3
*imports cover***	*4.3*	*4.4*	*5.5*	*4.7*	*4.8*	*4.8*	0.5	12.0
*imports cover****	*4.5*	*4.5*	*5.7*	*5.0*	*5.1*	*5.1*	0.6	13.2
Commercial Banks	1923	1625	1844	1659	1843	1843	-80.4	-4.2

Source: Central Bank of Kenya

The country's foreign reserves rose from 4.5 months of import cover to 5.1 months of import cover between December 2013 and December 2014, a key indicator for stability. The CAD as a share of GDP widened from 8.5 percent in June 2014 to 10.1 percent in the year to December 2014 as a result of reduced exports revenue attributed to low global tea prices, decline in regional trade and increased terrorism threats that have negatively impacted tourism.

Figure 14: Trends in Overall Balance

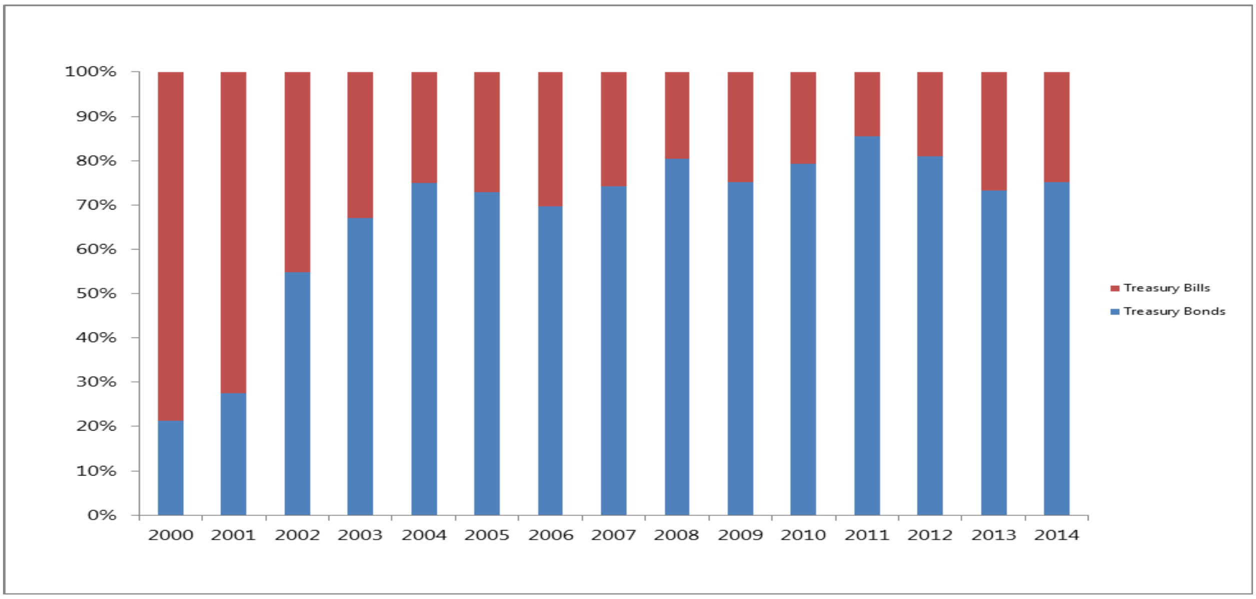


Source: Central Bank of Kenya

2.7. Government Debt and Domestic Debt Markets

Outstanding stock of Treasury bills and bonds rose to KSh. 1,203.2 billion in 2014 from KSh. 1,001.9 billion in 2013. The rapid increase since 2010 is attributed to increased Government domestic borrowing to meet its budgetary needs. In terms of maturity structure, the ratio of Treasury bonds to bills was 75:25, which is consistent with the medium term debt strategy (MTDS) of the Government (Figure 15).

Figure 15: Composition of Government Securities

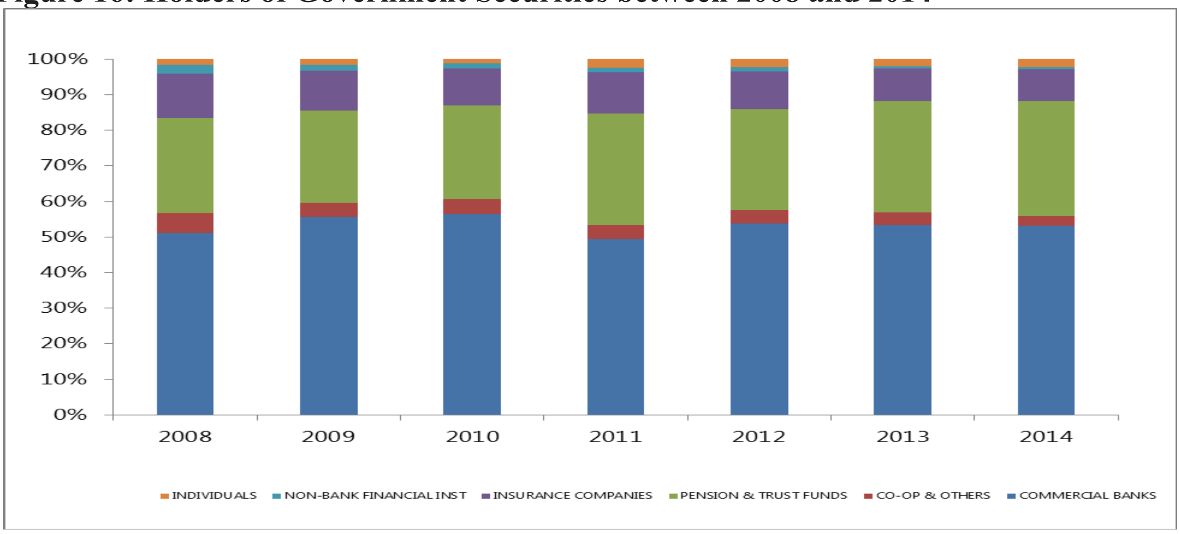


Source: Central Bank of Kenya

2.7.1 Government Securities Holders

The proportionate holding of Government Securities portfolio by various investors remained relatively unchanged since 2008. Commercial banks accounted for the largest proportion 53 percent, followed by Pension funds at 33 percent while all Others accounted for 14 percent of the total (Figure 16). The structure indicates relative stability, unless a shock to the banking system that may force them to offload their stock.

Figure 16: Holders of Government Securities between 2008 and 2014



Source: Central Bank of Kenya

2.7.2 Primary Market Performance

Treasury bonds were fully taken up in most of the 2014 offers, with subscription rate averaging 156 percent compared to 195 percent in 2013 while Bid-to-cover ratio was 1.25 compared to 1.56. This implies weaker auctions despite full subscriptions, a reflection of more costly funds (Table 6).

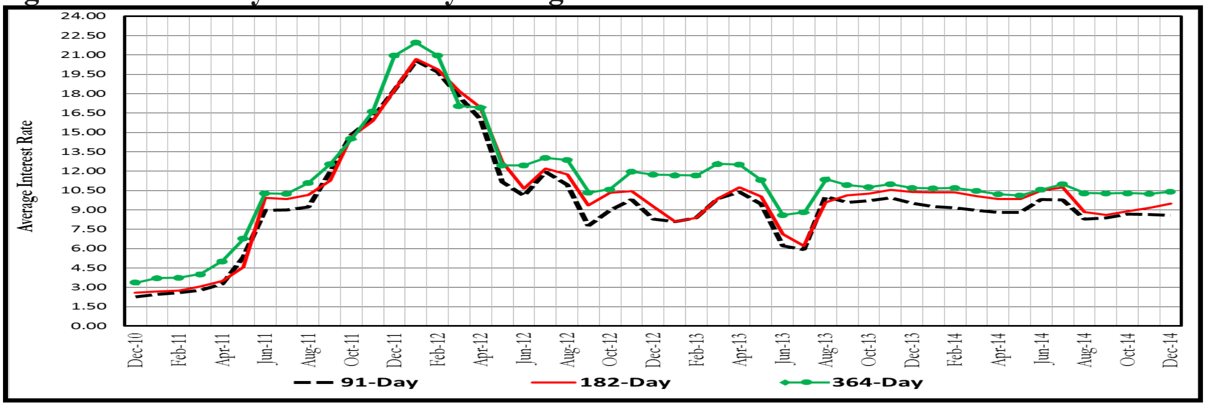
Table 6: Treasury Bills and Bonds Quarterly Auctions (Ksh Mns)

Period	TREASURY BONDS					
	2013			2014		
	Offer	Bids	Accepted	Offer	Bids	Accepted
Quarter 1	50,000	130,861	79,689	35,000	113,134	49,465
Quarter 2	55,000	114,569	70,988	60,000	70,686	56,576
Quarter 3	55,000	78,701	44,716	60,000	69,506	42,772
Quarter 4	41,000	67,863	56,211	70,000	96,823	66,483
TOTAL	201,000	391,994	251,604	225,000	350,149	215,296
TREASURY BILLS						
Quarter 1	119,000	134,130	97,833	111,000	128,664	103,602
Quarter 2	127,000	317,077	163,312	129,000	137,442	122,540
Quarter 3	122,000	184,228	104,450	146,000	166,147	114,316
Quarter 4	84,000	93,786	78,180	156,000	144,234	116,126
TOTAL	452,000	729,221	443,775	542,000	576,487	456,584

Source: Central Bank of Kenya

Treasury bills market remained vibrant in 2014, despite interest rate fluctuations between the months of May - July 2014. Demand for short term securities was largely supported by stable interest rates (Figure 17) in 2014 as a result of reduced government domestic borrowing appetite following successful Eurobond issuance, which was critical in implementing Government projects.

Figure 17: Treasury Bills Monthly Average Rates



Source: Central Bank of Kenya

2.7.3 Secondary Market Activity

Bonds trading activity in the secondary market was vibrant in 2014 as indicated in Figure 18 and Table 7. Trading has remained strong from 2009 due to reforms in the bond markets targeting both primary and secondary segments, including the continued issuance of attractive infrastructure bonds and benchmark bonds in the face of stable market yields.

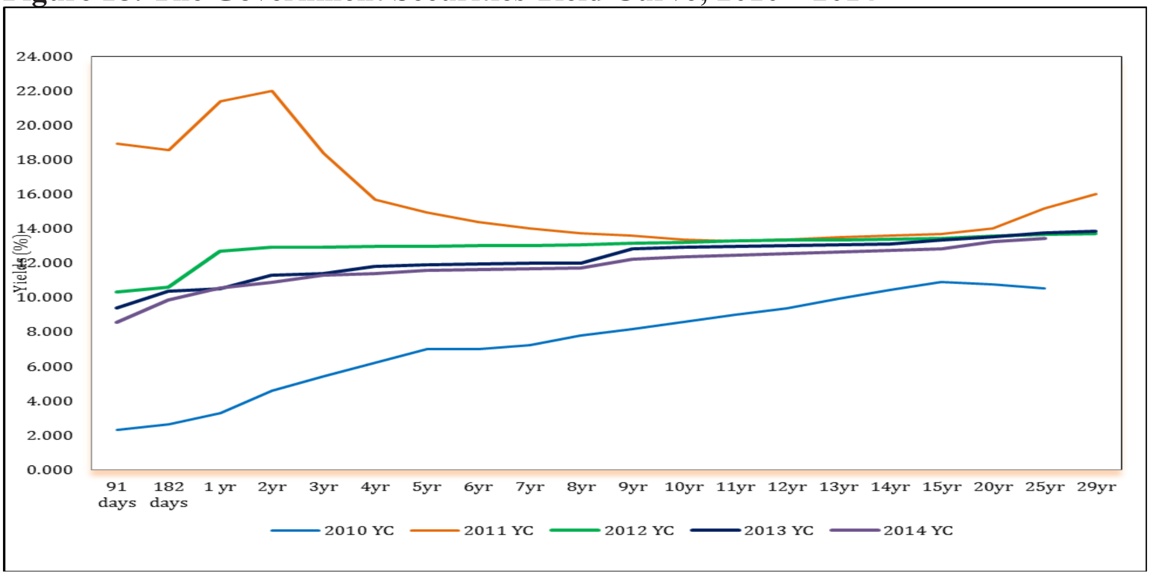
Table 7: Treasury Bonds Secondary Market Trading (KSh Mns)

TOTAL	2012	2013	2014
Quarter 1	86,069	59,722	99,287
Quarter 2	102,093	191,788	112,460
Quarter 3	198,171	88,198	133,548
Quarter 4	136,556	102,692	122,105
ANNUAL TOTAL	522,890	442,399	467,410

Source: Central Bank of Kenya

The period between 2012 and 2014 was characterized by most stable yields in the bonds market as reflected by the position and shape of corresponding yield curves in Figure 18. Yield curves for the 2012, 2013 and 2014 are generally smooth, upward-slopping with gentle slope and close to each other signifying minimal shift. Between 2012 and 2014, the yield curve remained unchanged reflecting overall stability in the economy during the period.

Figure 18: The Government Securities Yield Curve; 2010 – 2014



Source: Central Bank of Kenya

2.7.4 Risks in the Domestic Debt Markets

There are three key risks in the domestic debt markets that this report focused on – refinancing risk, interest rate risk and market risk. These affect both the debt management capacity of the government and financial markets stability.

a. Refinancing Risk

This risk is associated with inability of the debt issuer to raise required funding from domestic markets to meet new obligations or retire maturing debt at sustainable interest rates. This risk has been mitigated by continued implementation of the Medium Term Debt Strategy that has yielded Average Time to Maturity (ATM) of 4.917 years in 2014 compared to 5.14 years in 2013 for outstanding domestic debt stock (Table 8).

Table 8: Treasury Securities Risk Indicators; 2010 – 2014

INDICATOR	2010	2011	2012	2013	2014
Average Time To Maturity (Years)	5.17	5.75	4.92	5.14	4.92
TREASURY BONDS					
Subscription Rate (%)	162.99	118.89	224.62	196.17	189.88
Bid-to Cover Ratio	1.02	0.73	1.17	1.25	1.56
TREASURY BILLS					
Subscription Rate (%)	156.17	149.99	145.85	161.33	106.36
Bid-to Cover Ratio	1.01	1.11	1.57	1.64	1.26

Source: Central Bank of Kenya

b. Interest Rate Risk

Interest rates risk impacts on the cost of borrowing by the Government. In the period under review, interest rates on Government securities remained generally stable albeit a few incidences of volatility. Interest rates of Treasury bills trended within a stable range of 400bps while Treasury bond yield curve was steady within a 300bps across maturities spectrum.

c. Market Liquidity Risk

Liquidity risk emerges when market players are unable to convert their stocks into cash when required. This may be due to infrastructure inefficiencies and general market tightness. Since the introduction of automated trading system (ATS) in 2010, it is now easier to trade and settle real time, contributing to improved liquidity in the secondary market. In 2014, the market turnover was KSh 467 billion up from KSh 442 billion in 2013. There was also increased bonds supply on account of full subscriptions for government and corporate bonds, thus enhancing liquidity. Overall stability of short term interest rates also contributed to liquidity in the market.

2.7.5 Public Debt Sustainability

The joint IMF-World Bank Debt Sustainability Analysis (DSA) report of October 2014 shows that Kenya's debt outlook is favourable in present value (PV) terms compared to the Debt Sustainability Analysis (DSA) of 2013. Kenya's risk of external debt remains low, while overall public sector debt dynamics continue to be sustainable.

Under the baseline scenario and all the stress tests, Kenya's external debt burden indicators do not breach any of the relevant policy-dependent thresholds, hence low risk of both domestic and external debt distress. Exchange rate shocks and less favorable terms on new public sector loans represent the largest upside risks to external debt, while overall public debt would increase most in the event of significantly lower than anticipated economic growth. A scenario of this type could be triggered by severe drought, deterioration in security conditions, reduced capital inflows, imported inflation and domestic fiscal challenges.

3.0 FINANCIAL SECTOR DEVELOPMENTS AND OUTLOOK

Kenya's financial system has grown significantly and become innovative and highly integrated, regionally and internationally supported by well-developed financial markets infrastructure. It comprises of the banking, capital markets, insurance, credit unions (Saccos) and pension subsectors. The sector has several safety nets, crisis management and resolution frameworks that include Kenya Deposit Insurance Corporation for banks, Investor Compensation Fund (by CMA), Policy Compensation Fund (by IRA) and the Saccos Deposit Guarantee Fund run by SASRA. It also encompasses financial sector infrastructure that includes of payments, trading, settlement and custodial services. As a proportion of Nominal Gross Domestic Product (GDP), total assets of the financial sector excluding capital markets accounted for 89.52 percent in 2014 while equities' market capitalization was 42.93 percent (Table 9).

Table 9: Financial Sector Assets as a Share of GDP

Gross Domestic Product/Sector Assets	End Dec. 2012		End Dec. 2013		End Dec. 2014	
	KSh Mns	% of GDP	KSh Mns	% of GDP	KSh Mns	% of GDP
Nominal GDP	**4,261,151**	**n/a**	**4,730,801**	**n/a**	**5,357,672**	**n/a**
Banking Sector Assets	2,330,335	54.69	2,703,394	57.14	3,261,095	60.87
Micro Finance Assets	N/A	N/A	41,400	0.88	56,900	1.06
Pension sector Assets	548,700	12.88	696,680	14.73	750,040	14.00
Insurance Assets	311,000	7.30	366,252	7.74	426,310	7.96
Saccos Assets (DTSs)	93,765	2.20	257,368	5.44	301,537	5.63
TOTAL ASSETS	**3,283,800**	**77.07**	**4,065,094**	**85.93**	**4,795,882**	**89.52**
Equities Market Cap.	1,272,002	29.85	1,920,719	40.60	2,300,000	42.93

Source: Various from Regulators data and Kenya National Bureau of Statistics

3.1 Banking Industry Developments

As at 31st December 2014, Kenya's banking industry comprised of the Central Bank of Kenya, as the regulator, 43 commercial banks, 1 mortgage finance company, 8 representative offices of foreign banks, 9 microfinance banks, 2 credit reference bureaus, 13 money remittance providers and 87 Foreign Exchange Bureaus.

3.1.1 Growth

The banking industry accounts for the largest proportion of the financial sector at 60.87 percent of nominal GDP in 2014. The subsector experienced growth in 2014, despite a cumulative decline in unaudited pre-tax profits by 1.6 per cent from KSh. 71.1 billion in the period ended June 2014 to KSh. 69.9 billion in the period ending December 2014. Total net assets grew by 9.9 per cent from KSh. 2,967.6 billion in June 2014 to KSh. 3,261.1 billion in December 2014, driven by growth in loans and advances. Loans and advances and government securities were key components of banks' balance sheet items, accounting for 58.3 percent, 20.4 per cent and 5.3 per cent of total net assets, respectively. Net loans and advances rose by 10.5 percent to KSh. 1,901.5 billion in December 2014. Investment in Government Securities increased from KSh. 633.3 billion in June 2014 to KSh. 664.7 billion in December 2014. Customer deposits, key to the banks funding, increased by 8.6 per cent to KSh. 2,331.6 billion in December 2014 on account of bank branch expansion and agency banking as well as receipts from exports.

3.1.2 Asset Quality and Trends

The lag effects of high interest rates in 2011 and economic slowdown in 2014 impacted negatively on quality of loans and advances. The NPLs increased by 5.3 per cent to KSh. 107.1 billion in December 2014 from KSh. 101.7 billion in June 2014. The ratio of gross NPLs to gross loans fell marginally to 5.4 per cent from 5.7 per cent, reflecting reduced credit risk (Table 10).

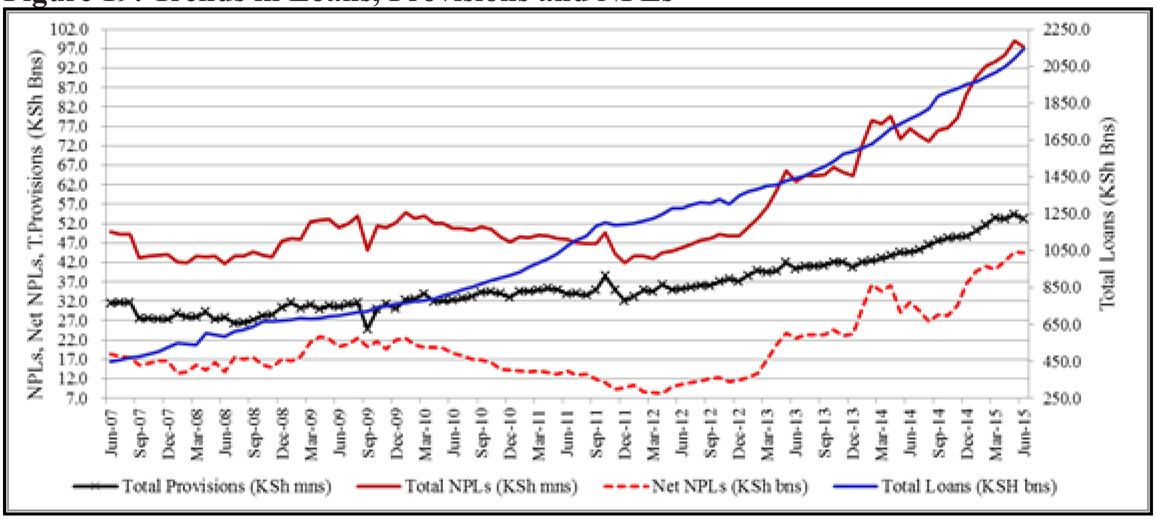
Table 10: Indicators of Asset Quality (KSh Mn)

Indicator	Jun-14	Dec-14
Net Assets	2,967,623	3,261,095
Gross Loans	1,784,272	1,972,096
Total Loans	1,764,902	1,950,731
Net Loans	2,147,933	1,901,512
Gross Non-Performing Loans	101,655	107,102
Interest in Suspense	19,370	21,345
Total Non-Performing Loans	82,285	85,757
Specific Provisions	31,679	35,286
Net Non-Performing Loans	37,636	36,537
Gross Loans/Net Assets (%)	60.1	60.4
Gross NPLs/Gross Loans (%)	5.7	5.4
Net NPLs/Gross Loans (%)	2.1	2.0

Source: Central Bank of Kenya

The NPLs have however been growing faster than provisions since late 2011 into 2015 (Figure 19)

Figure 19: Trends in Loans, Provisions and NPLs



Source: Central Bank of Kenya

The largest proportion of loans and advances went to personal/household, trade, real estate and manufacturing sectors; together accounting for 72.6 per cent of gross loans as at December 2014 (Table 11). The same sectors had the highest levels of loan accounts and the value of NPLs.

Table 11: Distribution of gross loans, Loan Accounts and Gross NPLs

Economic Sectors	Loan Accounts	Share (%)	Gross Loans (KSh. Bn)	Share (%)	Gross NPLs (Ksh. Bn)	Share (%)
Agriculture	127,244	4.36	81.89	4.15	4.47	4.17
Building & construction	17,762	4.10	88.20	4.47	9.77	9.12
Energy and water	7,403	5.40	89.56	4.54	1.07	1.00
Financial Services	19,235	4.05	73.69	3.74	1.68	1.57
Manufacturing	17,946	11.30	241.44	12.24	1.10	9.32
Mining and Quarrying	2,629	0.98	19.01	0.96	9.98	1.03
Personal/Household	3,679,870	21.02	521.94	26.47	27.61	25.78
Real Estate	34,810	15.77	286.60	14.53	12.18	11.37
Tourism, restaurant & hotels	11,885	1.86	34.60	1.75	2.58	2.40
Trade	427,926	22.00	381.30	19.34	27.60	25.27
Transport& Communication	44,607	9.16	153.72	7.80	9.60	8.97
Total	**4,391,317**	**100.00**	**1972.10**	**100.00**	**107.10**	**100.00**

Source: Central Bank of Kenya

3.1.3 Capital Adequacy

CBK issued revised prudential guidelines on capital adequacy in 2013, introducing new capital requirements for banks, including capital charge for market and operational risks and capital conservation buffer of 2.5 per cent above the minimum capital adequacy ratios. The banks were given transition period to enable them to prepare for compliance. The capital charge for market and operational risks became effective on 1st January 2014 whereas capital conservation buffer became effective on 1st January 2015. The minimum regulatory capital adequacy requirements, measured by the ratio of core capital and total capital to total risk weighted assets are now 10.5 per cent and 14.5 per cent respectively.

The core capital and total capital to total risk weighted assets ratios as at December 2014 were 15.9 per cent and 19.2 per cent, respectively, mainly attributed to banks raising their capital levels through retained earnings and fresh capital injection to comply with the new capital requirements. Banks are also required to maintain a ratio of core capital to total deposits of not less than 8 per cent. By end 2014, this ratio was 18.1 per cent, with all banks meeting the minimum core capital requirement of KSh. 1.0 billion. Only two banks did not meet the minimum total capital to total risk weighted assets ratio of 12 per cent due to increased loan loss provisions. The affected banks have provided capital restoration plans to ensure compliance with all capital requirements.

3.1.4 Liquidity

Liquidity is one of the key financial stability indicators given that its shortage in one bank can cause systemic crisis in the banking sub-sector due to interconnectedness. Liquidity held by commercial banks reflects their ability to fund increases in assets and meet their obligations.

Table 12: Banks' Liquidity Ratios

MEASURE	End of Jun-14	End of Dec-14
Liquidity Ratio (%)	38.7	37.7
Minimum Statutory Ratio (%)	20.0	20.0
Excess/(Deficiency) in %	18.7	17.7
Gross Loans/Deposits Ratio (%)	83.1	84.6

Source: Central Bank of Kenya

The industry's average liquidity in the six months to December 2014 was above the statutory minimum of 20 per cent, with all the banks meeting the requirement. The liquidity ratio was 37.7 per cent as at December 2014 compared to 38.7 percent in June 2014. The decline was due to increased lending as reflected in the loans portfolio (Table 12).

3.1.5 Sensitivity to market risks

Banks' exposure to foreign exchange dynamics worsened as reflected by increase in net foreign exchange position to core capital that increased from an average of 2.9 per cent in June 2014 to an average of 4.3 per cent in December 2014. Banks foreign currency loans to foreign currency deposits declined to 82.0 per cent in December 2014 from 94.0 per cent in June 2014. The ratio of assets in foreign currency to liabilities denominated in foreign currency also declined marginally to 99.8 per cent in December 2014 from 99.95 per cent in June 2014 as banks tried to match assets and liabilities denominated in foreign currency. Credit risk on foreign currency loans may arise from exchange rate depreciation as the repayment burden increases if income streams of borrowers are in local currency.

3.1.6 Profitability

The banking industry profitability declined marginally in the six months to December 2014 on account of mute economic activities, low yields of government securities, commissions and earnings from foreign exchange trading. The industry's profit before tax declined by 1.6 per cent to KSh. 69.9 billion in December 2014 from KSh. 71.0 billion in June 2014. Three banks had cumulative losses of KSh. 1.01 billion as at December 2014 compared to KSh. 0.57 billion reported in June 2014.

The overall performance remains uneven among banks despite strong growth in profitability, assets base, return on assets and return on equity. The top five banks remain far apart from the bottom five banks across all the five performance indicators (Table 13). In 2014, the bottom five banks had negative return on assets and return on equity compared to the top five banks, whose ratios were strong and positive.

Table 13: Performance of top and bottom banks

INDICATOR	Top five (5) Banks		Bottom five (5) Banks	
	14-Jun	14-Dec	14-Jun	14-Dec
Net Assets (KSh Mns)	1,333,166	1,418,115	29,391	31,343
Shareholders' Equity (KSh Mns)	228,191	221,024	6,009	6,193
Profits Before Tax (KSh Mns)	41,507	80,213	-4,996	-171
Return on Assets (%)	5.02	4.6	-0.56	-0.86
Return on Equity (%)	36.2	30.82	-3.68	-3.94

Source: Central Bank of Kenya

3.1.7 Stress testing

CBK adopted the Cihak Stress Testing Framework for conducting both Macro-and Micro-prudential Stress Testing in line with EAC Monetary Affairs Committee (MAC) of Central Bank Governors' Decision during the 16th MAC meeting held in May 2013 in Kampala, Uganda. The framework will also be used for both reverse stress testing and stress testing for both macro-and micro-surveillance. This framework is forward-looking and utilizes macroeconomic model output and other satellite models in scenario design and shocks calibration. Once fully implemented, it is expected that CBK will migrate from the current CR+ that rely on probability of default (PDs). However, there is need to recompute the PDs used in the model. CBK is expected to use the Cihak framework for regular stress tests whose results will be important for both macroprudential policy and microprudential surveillance. Key risks of focus are credit risk, liquidity risk, interbank (pure contagion risk), interest rate risk and foreign exchange risk.

Currently, CBK conducts monthly stress tests on individual banks using CR+ framework to assess vulnerabilities to certain risks in the event of shocks to the economy or other triggers unfavorable to banks' risk exposures. CBK analyzed the monthly changes in non-performing loans (NPLs), deposits and exchange rates over a 10-year period to study the trends for purposes of designing appropriate stress factors for use in assessing banking system resilience. Based on the 2014 data, plausible scenarios (stress factors) were used to stress the banking system's resilience to credit risk; liquidity risk; and market risk; whose results are summarized in Table 14.

Overall, stress test results on credit risk reveal that it would require significant increase in NPLs for a large bank to fail to meet the minimum statutory capital adequacy ratio. Only two banks in the small peer group would fail to meet the minimum liquidity requirement of 20 per cent in case of a one-off 5 per cent deposits withdrawal. A 5 per cent sudden depreciation of the Kenyan shilling would not affect banks as they still comply with the exposure limit of up to 10 per cent net open position in foreign exchange to core capital ratio.

Table 14: Stress Tests Results

Risk	Stress factor	Number of banks impacted
Credit Risk		
Personal and trade sectors	15% increase in NPLs	Capital adequacy ratio of **2** banks in a small peer group dropped to 10.1% and 10.9% below the statutory minimum of 12%.
Agriculture, Manufacturing, Tourism & Real Estate Sectors	13% increase in NPLs	
Transport & Communication, financial Services, Energy & Water, Building & Construction and Mining & Quarrying	10% increase in NPLs	
Liquidity Risk		
Decline in the banking sector deposits	5% decline in deposits	**Two** banks in small peer group failed to meet the liquidity statutory threshold of 20%.
Market Risk		
Weakening of the shilling	5% depreciation of Kenya Shilling against the USD	**All** banks comply with the 10% foreign currency exposure to core capital limit.

Source: Central Bank of Kenya

Stress test results as at December 2014 indicated that all banks would remain solvent after applying the plausible stress test scenarios but CBK continues with its close surveillance of those banks that fail stress tests to ensure stability in the banking industry.

3.2 Capital Markets Developments

Capital markets comprises of equities and fixed income securities, both newly issued in the primary markets and/or now trading in the secondary market. Fixed income consists of Treasury bonds and corporate bonds and notes, listed and trading in the market. Players include; market intermediaries, investors/traders, regulators, infrastructure providers as well as issuers.

3.2.1 Primary Markets for Equities and Bonds

The capital markets recorded one Initial Public Offering (IPO) in 2014 involving the self-listing of the Nairobi Securities Exchange (NSE) in August 2014 at introductory price of KSh 9.50 per share. It was subscribed at 763.92 per cent, the largest in the history of NSE. There were also two (2) new companies introduced at the NSE by private placement, namely; Flame Tree Group at KSh 8 per share and Kurwitu Ventures, a Sharia compliant firm at KSh 1,250 per share. Both were listed on the Growth Enterprise Market Segment (GEMs) of NSE. Both companies' shares were oversubscribed due to strong demand. In December 2014, the London Stock Exchange listed company, Atlas Development and Support Services Limited was cross-listed on the NSE's GEMS, becoming the first dual listing between the two Exchanges. Three Rights Issues by Diamond Trust Bank, NIC Bank and Uchumi Supermarkets were all oversubscribed.

The Government issued a total of Sixteen (16) Treasury bonds through new issues and re-openings for funding its deficit, market development and infrastructure financing. A total of KSh 309 billion was subscribed against KSh 205 billion offered, with KSh. 176.5 billion accepted. This is lower than KSh. 392 billion was received against KSh 201 billion offered and KSh. 254 billion accepted in 2013. The Corporate bonds segment saw seven (7) companies; Britam, UAP Holdings, NIC Bank, CIC Insurance, Home Africa, Commercial Bank of Africa and CfC Stanbic Bank issue bonds to raise KSh. 30.4 billion. All the offers except for Home Africa were fully taken up after receiving combined bids worth KSh. 38.26 billion. This reflects improved liquidity, positive economic prospects and accelerated government securities market development providing reliable pricing benchmarks for other issuers/products in the market.

3.2.2 Secondary Market for Equities and Bonds

The NSE 20 Share Index rose by 3.77 per cent to close at 5112.65 points in 2014 up from 4926.97 points in 2013. Equity turnover rose to Ksh 215 billion from KSh 155 billion in the period (Table 15). A total of 8.1 billion shares were traded in 2014 up from 7.6 billion shares in 2013, with market capitalization at KSh.2.3 trillion from KSh.1.92 trillion.

Table 15: Equity Trading in 2014

MONTH	Equity Turnover (KSh Mns)	Share Volume (Mns)	NSE 20 Share Index (points)	Market Cap (KSh Bn)
January	16	638	4856	1,898
February	14.7	545	4933	1,960
March	13	544	4946	2,003
April	15.7	728	4949	2,106
May	23	854	4882	2,092
June	18.5	731	4885	2,107
July	13.4	531	4864	2,108
August	15.5	629	5139	2,217
September	19.2	767	5256	2,293
October	19.3	506	5195	2,248
November	14.3	666	5156	2,307
December	33.1	995	5112	2,300
TOTAL	**215.7**	**8,134**	**5112**	**2,300**

Source: Nairobi Stock Exchange

3.2.3 Market Intermediary Soundness Indicators and Performance Trends

All licensed firms maintained capital adequacy levels above the required statutory requirements. The capital markets intermediaries statutory limits on paid up share capital, shareholders' funds, working capital and unsecured advances also met the minimum requirements in 2014 (Table 16).

Table 16: Market Intermediaries' Profitability, Liquidity and Leverage

Category	ROE	Current Ratio	ROA	Leverage Ratio
Fund Managers	0.2	5.7	0.1	0.4
Investment Advisors	0.1	18.3	-0.1	0.1
Investment Banks	0.1	24.4	0.03	0.4
Stock Brokers	0.2	2.3	0.1	0.5

Source: Capital Markets Authority

All leading market performance indicators have grown significantly in the five years as shown in Table 17. Shareholders' wealth measured by market capitalization grew by KSh 1,133 billion, foreign activity as a proportion of total equity turnover rose by 23 per cent, NSE 20 Share Index added 680.05 points and NASI was up 65.07 points during the five-year period.

Table 17: Trends in NSE Market Indicators since 2010

Indicator	Dec. 2010	Dec. 2011	Dec. 2012	Dec. 2013	Dec-14
NSE 20 Index (Points)	4432.6	3205.0	4133.0	4927.0	5112.7
NASI (Points)	97.8	68.0	94.9	136.7	162.9
Market PE Ratio (%)	-	8.0	11.0	16.0	15.0
Equity Turnover(KSh Bn)	110.3	78.1	86.8	155.8	215.7
Volume (KSh Bn)	7.2	5.7	5.5	7.6	8.1
End Year Market Capitalization (KSh Bn)	1,167.0	868.0	1,272.0	1,921.0	2,300.0
Foreign investors share of Gross Equity Turnover (%)	23.0	52.0	49.0	51.0	51.0
Bond Turnover (KSh Bn)	483.2	445.5	565.7	452.5	495.8

Source: Capital Markets Authority

Foreign investors dominated the NSE, averaging above 51 per cent of total market turnover. The Bonds market recorded 9.09 per cent rise in turnover to KSh 494 billion in 2014 from KSh 453 billion in 2013.

3.2.4 Investor Holdings and Trends

Local institutional and retail investors held 76.8 per cent of all listed and trading equities at the NSE in 2014 from 58.02 per cent in 2013. Foreign institutional investors held 21.5 per cent down from 39.8 per cent in 2013. East African investors' stake remained the lowest at only 0.68 per cent, down from 1.6 per cent in 2013. Local retail investors remained highest (Table 18).

Table 18: Equity Holdings as at December 2014

Category of Investor	No. of Investors	No. of Shares	shares held
East African Corporate	256	448,480,572	0.55%
East African Individuals	7,845	109,587,987	0.13%
Foreign Investors (Corporate)	593	17,497,162,894	21.49%
Foreign Investors (Individuals)	7996	816,460,050	1.00%
Local Corporate	43,585	20,179,761,230	24.78%
Local Individuals	1,241,187	42,372,609,192	52.04%

Source: Capital Markets Authority

The proportion of shares held by the East African institutional investors declined but foreign investors' interest has more than doubled since 2008, with slight reversal in 2014 (Table 19).

Table 19: Investor Holdings at the NSE (2008 – 2014)

Type of Investor	2008	2009	2010	2011	2012	2013	2014
E.A. Institutions (%)	77.2	74.2	73.6	68.3	66.7	38.6	65.4
E.A. Individuals (%)	14.9	15.7	13.8	12.2	12.0	21.0	13.0
Foreign Investors (%)	7.9	10.1	12.6	19.4	21.3	40.4	21.6

Source: Capital Markets Authority

The strong interest in equities by locals helps in stemming risks of excessive foreign portfolio outflows. Aggressive profit taking by foreigners in 2014 led to 86 per cent decline in portfolio inflows year-on-year, perhaps explaining volatilities in the foreign exchange market (Table 20).

Table 20: Foreign Investors Net Equity Portfolio Inflow (Ksh Millions)

MONTH	2010	2011	2012	2013	2014
January	2,517	1,987	-812	2,133	-876
February	489	622	795	-3,927	-1,505
March	1,998	1,552	2,651	1,810	-399
April	151	-3,024	1,771	3,026	1,409
May	-325	-3,334	1,099	3,475	-2,578
June	1,601	-1,597	1,639	2,602	2,586
July	1,159	1,173	828	1,625	142
August	471	621	1,048	9,839	3,253
September	1,206	535	3,286	2,063	-850
October	2,147	719	2,965	2,723	-1,208
November	2,526	31	4,335	884	2,535
December	1,186	935	2,129	-690	1,021
Net Cash Flow	**15,126**	**220**	**21,734**	**25,563**	**3,530**

Source: Capital Markets Authority

The number of new investors at the NSE increased in 2014 as reflected by the number of new Central Securities Depository accounts. Since 2008 which recorded highest number of accounts opening to participate in the Safaricom Initial Public Offering, accounts opening have been low, with individuals accounting for the largest proportion (Table 21).

Table 21: Trends in Number of Accounts Opened at CDSC

INVESTOR CATEGORY	2008	2009	2010	2011	2012	2013	2014
East African Corporate	342	13	49	17	22	22	34
East African Individuals	7,986	79	92	108	96	258	447
Foreign Institutional	222	144	621	409	414	721	769
Foreign Individuals	2,586	334	440	338	300	1,446	630
Local Corporate	109,533	2,143	3,981	1,229	877	3,945	1,989
Local Individuals	843,979	52,836	120,756	31,607	19,473	173,157	37,141
TOTAL	**964,648**	**55,549**	**125,939**	**33,708**	**21,182**	**179,549**	**41,010**

Source: Capital Markets Authority

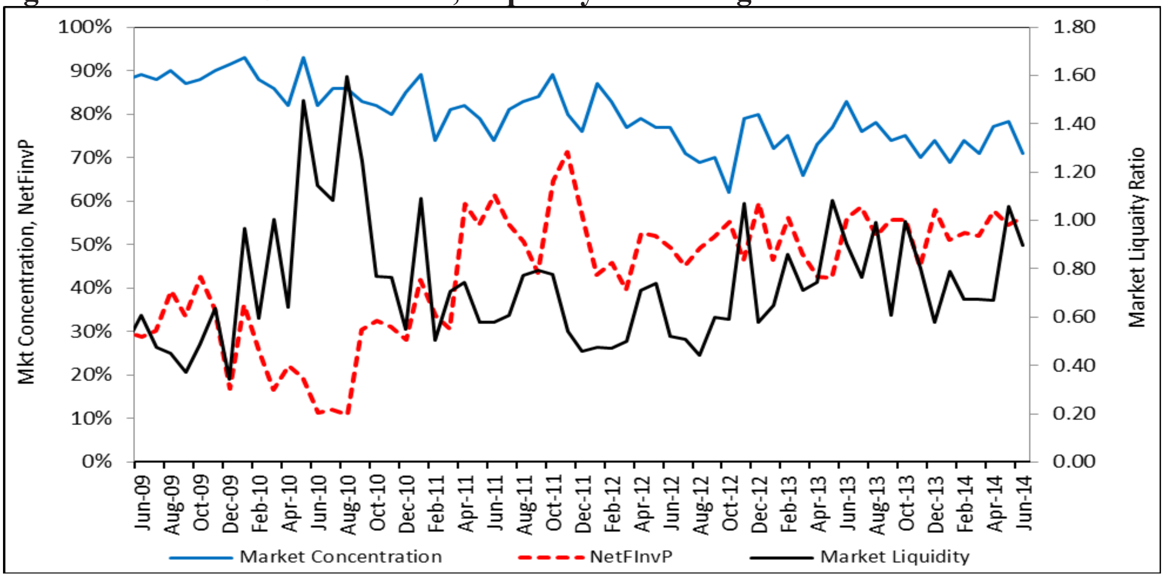
To ensure efficiency and safety in the markets, the NSE developed and implemented an Automated Trading System (ATS), which recorded 100 percent system up-time in 2014. There were no downtime incidents within the CDS during the period.

3.2.5 Market Concentration Risks

Concentration risk arises from the failure of a dominant market player . As at end of December 2014, the top five (5) out of 22 operating Brokers and Investment Banks accounted for 71 percent of all equities and 78 percent of all bonds traded at the NSE. Higher concentration may either increase or decrease the probability of a firm leaving the market due to financial distress. Kenya's market is more diverse, severity of disruptions from a dominant player is minimal. In addition, demutualization and self-listing of the NSE in 2014 is expected to eliminate privileged access to the trading platform, hence reducing the potential severe impact of concentration risk.

Market concentration in terms of dominant stocks refers to 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. Market concentration has gradually declined since June 2009 to average about 72 percent of the top 10 listed counters by market capitalization in December 2014 (Figure 19). These counters accounted for 78 per cent of total Equity Turnover.

Figure 20: Market Concentration, Liquidity and Foreign Investors



Source: Nairobi Stock Exchange

Market liquidity ratio refers to the volume of shares traded in any one month as a proportion of total number of all outstanding shares issued as well as the ease with which shares are traded at the NSE and therefore convertibility into cash for those who need money. The higher the ratio, the more liquid the exchange is and therefore less prone to risks. Figure 19 shows that as concentration declines, market liquidity improves, hence a more stable stock market attractive to foreign investors. Foreign portfolio flows have also accounted for on average 51 percent of the equities market in 2014, implying moderate exposure to risks.

Improving global economic recovery in advanced economies seems to be a key factor contributing to increased appetite for risky assets like equities. This would make portfolio investors in developing and emerging markets reduce their activity and refocus on developed markets considered safe and offer better returns. Constant surveillance is being conducted to detect any source of vulnerabilities for Prompt Corrective Action. Efforts towards regional integration also provide opportunities for the industry's further development, but also come with country risks.

3.2.6 Risk Assessment

Market Risk is associated with major events in the marketplace that can impact market prices and rates, thus affecting the value of positions held by investors. They include the risk of collapse of the entire market. Main causes include; weak corporate governance, poor internal controls among licensees, low capitalization of market intermediaries, weak trading and settlements systems, weak enforcement, and weaknesses in the regulatory framework. CMA has undertaken comprehensive reforms covering legal and regulatory framework, 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.

Settlement Risk occurs when counterparty in a trade fails to meet its financial obligations. Establishment of the Securities Guarantee Fund (SGF) administered by CDSC and adoption of a 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's annual contributions to the SGF. Finally, Settlement in Central Bank money is expected to begin in the first quarter of 2015.

Operational Risk occasioned by human error, fraud, inadequate management, and system and facility failure are examples of operational risks with huge impact on investor confidence. CMA has undertaken various regulatory and technological measures to mitigate these risks. CMA gazetted regulations on conduct of business, internal controls and corporate governance; introduced requirement of professional indemnity insurance; required implementation of Broker Back Office System and installation of modern surveillance system to address this risk. In addition, the Inspection Process, using Risk Based Supervision System (RBSS) approach, has been enhanced to include on-line reporting as well as an early warning system in monitoring intermediary risks. NSE has also fully automated and upgraded its trading platform, while CDSC is overhauling its systems to make them more robust.

Narrow product base, High Market Concentration and Low Market Liquidity: Kenya's capital markets has six (6) out of sixty four (64) listed and actively trading firms accounting for 66 percent of market turnover and seven (7) accounting for 66 percent of Market Capitalization. To address these, CMA is working on initiatives to develop a commodity and futures market as well as an Over The Counter Trading (OTC) bond market. An alternative market for raising capital by Small and Medium Enterprises (GEMS) was also established. Introduction of REITs and Shariah Compliant capital market products specifically Sukuk and Islamic Collective Investment Schemes would further broaden products base. Initiatives to introduce margin trading, securities borrowing/lending arrangements, short-selling and market-making, and shortening of trading and settlement cycle via reliable financial markets infrastructure, including introduction of liquidity products like Exchange Traded fund (ETF's) and Global Depository Receipt (GDR's) are meant to address this risk.

Money Laundering and related activities: CMA is aware that money launderers may target the securities industry, but it is not clear the extent to which brokers, investment banks or Collective Investment Schemes may be used. 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 the anti-money laundering measures implemented through the Proceeds of Crime and AML Act. CMA is working with Financial Reporting Centre to comply with the Proceeds of Crime and AML Act and has drafted AML Guidelines for market intermediaries to address anti-money laundering and combating terrorism financing activities.

Legislative Risk emanates from legislative changes; especially tax laws that affect financial returns. In addition, 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 introduction of the Capital Gains Tax (CGT) under the Income Tax Act will impact capital markets transactions, and may negatively affect industry growth. The pending amalgamation of financial services regulators (currently supervising the securities, pensions, insurance and Sacco's industries) into a single regulator, has also created uncertainty.

3.2.7 Key Market Developments

CMA spearheaded a number of policy and regulatory measures aimed at developing the Kenyan securities markets in terms of new products, players and regional integration. Among the key measures include amendments to the legislation or new regulatory framework to promote pooling of investments in income producing real estate assets through Real Estate Investment Trusts (REITs); for licensing of futures exchanges to enable trading of futures and other derivatives; for issuance of securities to the public in the East African Community as well as provide for book building process in public offers of securities; to introduce the risk based supervision model for capital markets intermediaries; reform the Authorized Securities Dealers (ASDs); streamline the process of transfer of listed securities outside a securities exchange; for authorization of additional corporate bodies that intend to offer central depository services; and to allow free movement of capital across the EAC region and regulation of cross border service providers to implement the EAC Common Market Protocol on securitization and derivatives markets.

3.2.8 Derivatives Market

The CMA received applications by the NSE and Bourse East Africa for licenses to operate derivatives contracts business in Kenya. Approval was granted to NSE subject to full compliance with IOSCO principles on Commodity Derivatives as stipulated in the Capital Markets Futures Licensing Regulations 2013. The Authority is further currently discussing tax and accounting issues in relation to trading, clearing and settlement of derivatives instruments. The Authority is also cognizant of the crucial role of capacity building and public sensitization on derivatives and continues to build skills in this area.

In preparation of full East African Community (EAC) Capital Markets integration, CMA participated in the drafting of eight new EAC Council Directives in 2014. The Directives cover Credit Rating Agencies, Evaluative and Analytical Services, Regulated Activities, Regulatory Authorities, Real Estate Investment Trusts, Securities Exchanges, Central Securities Depositories and Business Continuity.

In order to comply with Principle 9 of IOSCO Principles for Financial Market Infrastructure, the Central Depository and Settlement Corporation, the CBK and CMA modified the settlement infrastructure as well as amended the regulatory framework to facilitate settlement of securities (equities and fixed income) using central bank money. CMA also approved the amendments to NSE Listing and Trading Rules to incorporate listing and trading of REITs. As part of widening market products, CMA issued a Guidance Note (GN) on issuance and listing of Exchange-traded funds (ETFs). To promote Corporate Governance among listed companies, CMA undertook steps to overhaul Corporate Governance Framework by drafting the Corporate Governance Blueprint and Code of Corporate Governance Practices for Public Listed Companies. This includes requirements that the chairperson of the board of the company shall be independent and non-executive and must not hold the same position in more than two listed companies; the role of chairperson must be separate from that of the chief executive officer; the Chief Finance Officer and the auditor must be members of the Institute of Certified Public Accountants of Kenya (ICPAK); and every public listed company must be assisted by a Company Secretary who must be a member of the Institute of Certified Public Secretaries of Kenya (ICPSK).

3.2.9 Securities Settlement and Depository

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 2014, SGF net assets increased by 20 percent; the Fund's Coverage Ratio rose by 66 per cent on year-on-year basis, and daily equity trading turnover was up 29 percent. 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 fund coverage ratio to 132 percent of daily equity turnover

In addition, Treasury bonds settle through CDS on a trade-by-trade basis using central bank money will eliminate settlement risks. This is because a trade only occurs if there is cash and securities in the system. This is aimed at improving efficiency in equities and corporate bonds settlement and aligns the process to international best practice. The cash side of the settlement process for transactions concluded on the NSE will now be coordinated through the CBK's Real Time Gross Settlement (RTGS) system. Previously, the cash settlement for securities transactions was effected through four commercial banks appointed as settlement banks by the CDSC. The securities leg of the settlement process, which entails the transfer of securities between the buyers and sellers, will continue to be carried out at CDSC. Lastly, settlement caps were introduced and participant contributions enhanced to further contribute towards stability.

3.2.10 Capital Markets Outlook in 2015

The positive economic outlook in 2015 and expectations of lower inflation levels, signaling a stable macroeconomic environment provides opportunities for capital markets to outperform 2014. Global equities markets began 2015 on a volatile note, as plummeting commodity prices aggravated fears of slowing global growth. Speculation ahead of the February - April 2015 reporting season is expected to support activity and enhance price stability through Q1, 2015, supporting the Bull Run that existed for most of 2014.

According to global financial reporting firms such as Bloomberg, CBS and Thomson-Reuters, the Tanzanian bourse was ranked as Africa's best performing securities exchange in 2014, with a 66 per cent index upturn . The Egyptian Stock Exchange came in second with its main index achieving a 31.6 per cent increase, while the Uganda Securities Exchange (USE) emerged third with a jump of 26.5 per cent. The NSE, which emerged fourth, registered a drop at 19.2 per cent . The National Treasury's Budget Policy Statement (BPS) Paper for the 2015-16 financial year shows that the estimated budget deficit for the next financial year will be KSh 479.7 billion up from earlier estimate of KSh.383.7 billion, reflecting increased borrowing, both domestically and abroad. While this may contribute to increased volume, it is likely to put upward pressure on interest rates, thus impacting the market negatively.

Among the vulnerabilities to the capital markets in 2015 are excessive volatility of local currency, interest rates tightening in the U.S, increase in domestic interest rates due to increased borrowing, problems in some of the listed companies and legal and regulatory risks. Continued security threats also poses risks to capital markets through subdued economic performance. Uncertainty around the implementation of CGT also has implications to the market.

3.3 Insurance Industry Performance and Outlook

The IRA received new applications and renewals from potential licensees in 2014 as part of regulatory requirements under the Insurance Act. A total of 5,497 licensees were authorized to conduct insurance business in Kenya compared to 5,198 in 2013 and 3,403 in 2013 (Table 22). Insurance Agents account for the largest share.

Table 22: Insurance industry licensees

Regulated Entity	Number of Registered		
	2012	2013	2014
Insurance Companies	47	48	48
Reinsurance Companies	3	3	3
Insurance Brokers	149	187	175
Reinsurance Brokers	2	2	4
Medical Insurance Providers	24	29	26
Insurance Investigators	116	134	133
Motor Assessors	83	105	108
Insurance Agents	2,930	4,631	4,942
Insurance Surveyors	22	27	24
Loss Adjusters	19	22	24
Claims Settling Agents	1	2	2
Risk Managers	7	8	8
INDUSTRY TOTAL	3,403	5,198	5,497

Source: Insurance Regulatory Authority

Insurance brokers, Medical Insurance Providers, Investigators, and Surveyors lost members in 2014 compared to 2013. Reinsurance Companies, Claims Agents, risk managers, and Insurance Companies were unchanged. There were however increases in membership of Reinsurance brokers, motor assessors, insurance agents, and loss adjustors.

Gross written premiums have maintained a steady upward trend since 2010, growing by 20.4 per cent in 2014, while industry asset base grew to KSh 426.31 billion (Table 23).

Table 23: Industry Performance for 2010-2014 (KSh '000s)

MEASURE	2010	2011	2012	2013	2014
Gross Premium Income	76,909	93,632	108,610	131,003	157,779
Net Premium Written	64,123	77,344	87,840	104,948	126,636
Claims (General Bus.)	21,629	25,051	29,433	33,442	41,895
Commissions	10,269	9,407	7,084	7,205	9,257
Management Expenses	16,759	18,889	19,552	24,808	30,418
Underwriting (Gen. Bus.)	1,271	2,592	3,398	4,247	2,470
Investment Income(P&L)	23,369	5,626	7,594	9,429	9,544
Profit/Loss after Tax	7,634	6,782	13,350	20,236	24,619
Investments	177,521	181,179	235,565	296,337	352,371
Assets	223,491	233,172	302,233	366,252	426,310
Shareholders' Funds	58,649	57,828	74,812	100,958	122,544

Source: Insurance Regulatory Authority

Life insurance business premiums grew faster at 27.37 per cent in 2014 compared to Non-Life insurance business that rose by 16.89 percent. Fire Domestic and Marine & Transit business recorded contraction during the review period (Table 24).

Table 24: Insurance premiums Breakdown by Business

Class of Business	2013 (KSh'000s)	2014 (KSh'000s)	% Change
A. Life Insurance Business			
Ordinary Life	17,591,926	24,978,558	41.99
Group Life	10,684,456	13,412,177	25.53
Pensions	16,069,853	18,091,770	12.58
Industry Total	**44,346,235**	**56,482,505**	**27.37**
B. Non-Life Insurance Business			
Aviation	1,145,069	1,277,800	11.59
Engineering	2,955,353	3,871,330	30.99
Fire Domestic	1,553,883	1,331,035	-14.34
Fire Industrial	7,989,598	9,232,191	15.55
Liability	1,555,890	2,051,650	31.86
Marine and Transit	2,960,632	2,773,515	-6.32
Motor Private	14,136,305	16,863,943	19.30
Motor Commercial	19,586,506	22,664,892	15.72
Personal Accident	3,519,775	3,610,676	2.58
Theft	3,328,709	3,661,540	9.99
Workmen's Compensation	4,458,726	5,098,159	14.34
Medical	21,064,339	25,530,783	21.20
Miscellaneous	2,401,439	3,329,051	38.63
TOTAL	**86,656,226**	**101,296,565**	**16.89**

Source:Insurance Regulatory Authority

Uptake of insurance products increased mainly in the Ordinary Life policies, Engineering and Liability, thus signaling increased construction sector that largely use these policies. The industry witnessed tremendous growth in investments in Other Sectors, rising 341 percent. The industry recorded average growth of 34.39 percent, with property at 34.55 percent, Term Deposits with banks at 34 per cent and Government securities the least with 12.57 per cent (Table 25).

Table 25: Insurance industry investments (KSh '000s)

Investment Type	2013	2014	%Change
Property	45,511,629	61,236,722	34.55
Government Securities	120,349,032	135,480,062	12.57
Ordinary Shares – Quoted	43,990,849	52,384,536	19.08
Term Deposits	41,569,186	55,706,861	34.01
Others	10,788,060	47,562,278	340.88
Total	262,208,756	352,370,439	34.39

Source: Insurance Regulatory Authority

In order to enhance capacity, IRA introduced the Executive Certificate of Proficiency (ECOP) Programme to train insurance agents at the County level, which has seen 1,820 agents in 16 counties trained in 2014. This is expected to help the Authority develop the industry while fostering accessibility to insurance services. To accelerate insurance uptake as part of financial inclusion initiatives, IRA has recognized micro-insurance as the best product to achieve this objective. It is expected to play a vital role in deepening insurance access and penetration by insuring the low income population. Consequently, IRA is developing a micro-insurance framework, micro insurance regulations and guidelines to aid in operations and supervision of micro insurance products. As of December 2014, a total of KSh 603.26 million was reported under micro-insurance business compared to KSh 346.58 million of premiums in 2013.

Given the growth prospects in Kenya and Africa at large arising from relatively untapped insurance market, increasing middle income class and the discovery of more minerals including oil in Kenya and other African countries, several insurance firms are strategically positioning themselves through mergers and acquisitions. In Kenya, insurance and investment groups that have acquired stakes in existing companies include Metropolitan International Holdings, Prudential PLC, Pan Africa Insurance Holdings Limited and LeapFrog II Holdings Limited. Going by the mergers and acquisitions activities as well as new entrants, the country's insurance industry looks bright as a result of positive prospects in investments and growth. Premium growth is likely to accelerate and growth in capitalization on account of capital inflows from multinational insurance corporations.

3.4 Pension Industry Performance and Developments

As at the end of December 2014, RBA had registered and regulating 17 fund managers, 29 administrators and 10 custodians.

The industry's total assets grew by 7.7 percent in 2014H2 to reach KSh 750.04 billion, of which KSh 628.18 billion was held by the fund managers and insurance firms, KSh76.8 billion was internally administered by National Social Security Fund (NSSF) and KSh 45.02 billion of property investments was directly managed by scheme trustees. Assets under fund management included KSh 70.8 billion of NSSF funds that are externally managed by six (6) contracted managers. The industry has continued to invest heavily in the traditional asset classes, namely; government securities and quoted equities, with the two investments constituting the largest share of the industry assets standing at 58 per cent of total assets under management. There was also a marked growth across all asset classes except in the offshore and unquoted equity asset classes which had negative growth of -4.71 per cent and -1 percent respectively. On average, all categories of investments were within the statutory maximum limits provided in the Retirement Benefits Regulations (Table 26).

Table 26: Industry Investments Portfolio (KSh Billion)

		Jun-13		Dec. 2013		Jun-14		% Change Dec'13 to Jun'14
		KSh	%	KSh	%	KSh	%	
1	Government Securities	211.00	33.31	235.16	33.75	239.04	32.00	1.65
2	Quoted Equities	147.69	23.31	177.41	25.47	198.73	26.00	12.02
3	Immovable Property	121.30	19.15	119.84	17.20	127.52	17.00	6.41
4	Guaranteed Funds	65.41	10.33	71.46	10.26	84.65	11.00	18.46
5	Fixed Income	25.24	3.98	30.38	4.36	33.23	4.00	9.38
6	Fixed Deposits	32.92	5.20	34.17	4.91	38.05	5.00	11.35
7	Offshore	14.90	2.35	15.29	2.19	14.57	2.00	-4.71
8	Cash	10.80	1.70	9.03	1.30	10.35	2.00	14.62
9	Unquoted Equities	3.75	0.59	3.94	0.57	3.90	1.00	-1.02
10	Un Classified	0.45	0.07	0.00	0.00	0.00	0.00	0.00
	TOTAL	**633.46**	**100.00**	**696.69**	**100.00**	**750.04**	**100.00**	**7.66**

Source: Retirement Benefits Authority

3.4.1 Individual Retirement Benefits Schemes

The assets and membership of the Individual Retirement Benefits Schemes grew considerably during the period from 116,333 members in 2013 to 144,640 members in 2014. The assets grew from KSh 18.9 billion to KSh 22.9 billion in the period. Growth in membership is attributed to sustained investor education and public awareness conducted by RBA and the 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 during the period. Its membership grew from 50,057 members in 2013 to 66,228 members in 2014, while its Assets grew from KSh 64.4 million to Kshs 98 million. New pension products targeting the self-employed and the individuals working in the informal sector have also been rising, leveraging on mobile technology, e.g. the M-pension scheme.

3.4.2 Policies and Initiatives

In 2014, the pension industry implemented various initiatives and programmes geared towards enhancing pension coverage and adequacy of retirement benefits. The Authority also continued to implement the Risk Based Supervision and the Trustee certification programme.

Among the initiatives was continued implementation of the Pension Trustee Development Programme, initially launched on 29th August 2011. The programme is aimed at improving governance in the management of pension funds, and also acts as a response to the requirement under Regulation 8 (1) (c) (iii) of the Retirement Benefits (Occupational Retirement Benefits Schemes) Regulations, 2000, for every scheme or a corporate trust to have in the Board of Trustees, at least one member who has been vetted by the Authority to provide trust services. All trustees of retirement benefits schemes and directors of corporate trustees of retirement benefit schemes in Kenya were required to train on the programme by 2014 in order to get certification by RBA granting license to provide trust services. By end of 2014, a total of 2,334 trustees had been trained, of which 1,191 trustees were trained in the year under review. This number is still low given that it is only 50 percent of the target of over 4,600 trustees.

Since the adoption of Risk Based Supervision approach in 2010, RBA has been able to focus and direct its resources efficiently on schemes whose systems require greater attention and supervision. It has also been able to identify schemes and areas within schemes where problems exists or are likely to emerge. It has also enabled RBA to take prompt intervention and timely action.

Since its implementation, RBA has reduced the Overall Risk Score from 1.15 in 2011 to 0.759 in 2014. The risk assessment matrix uses the “traffic light” system to prioritize the supervisory response: “red” cases requiring priority intervention, “amber” cases indicating medium risk and “green” cases indicate low risk and limited surveillance required. During the period, the industry was in the medium risk category (“amber”) indicating that the industry is relatively stable.

3.4.3 Challenges and Outlook

Although the pension industry is relatively stable and has witnessed strong growth, numerous challenges ranging from low pension coverage to inadequate diversification of the pension assets remain. The pension coverage has stagnated at 15 percent of the recorded employment owing to the ever growing informal sector and the voluntary nature of the Kenyan pension system. The pension assets has also been predominantly invested in the traditional asset classes; government securities and quoted equities; thus limiting opportunities for higher returns from non-traditional asset classes such as private equity, venture capital and other alternative assets. In addition, inadequate diversification may expose schemes to counterparty risks and concentration risks. The pension assets are expected to grow by about 10 percent in the first half of 2015 owing to the stable macro-economic conditions and the vibrant stock market. Emerging assets class such as private equity and venture capital also provide opportunity for the industry to grow.

3.5 Payments Infrastructure Performance and Development

Payments platforms and mode globally are changing rapidly owing to proliferation of the internet and mobile phones, the rapid growth of e-commerce, technological developments and Near Field Communication (NFC). Kenya is on the forefront of this revolution and innovations. Cross-border payments can now be made in exactly the same way as national payments, allowing the most innovative payments firms to compete in the retail payments arena but with them, also comes risks and cross-border challenges. The National Payment Systems Act provides for harmonised and systematic oversight of payment, clearing and securities settlement. To ensure smooth payments, clearing and securities settlement systems, CBK cooperate closely with other regulators like Capital Markets Authority (CMA), Communications Authority of Kenya (CA) and Competition Authority (CAK) domestically as well as other international bodies.

3.5.1 Real Time Gross Settlement (RTGS) and Automated Clearing House (ACH)

In 2014, payment systems operated smoothly recording increase in values and volumes transacted (Table 27). The Kenya Electronic Payment & Settlement System (KEPSS) recorded 2.53 million transaction messages worth KSh. 25,561 billion compared to 1.98 million transaction messages worth KSh. 22,669 billion in 2013. The increase in volume and value reflects increased usage of KEPSS by the public as the most secure and faster mode of payment. Direct settlements via KEPSS by commercial banks averaged 98 per cent of the total activity through KEPSS while Net Settlement Instruction (NSI) via the ACH to KEPSS accounted for 2.0 per cent of the total.

Table 27: KEPSS System Flows (Volume and Messages)

YEAR	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	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
2014	25,561	12.8	2,525,337	27.7

Source: Central Bank of Kenya

The ACH recorded an increase in volume and value of cheques and EFTs cleared through its system in 2014. Compared to the same period in 2013, the volume increased with 0.73 million instructions valued KSh 131 billion.

Table 28: Automated Clearing House (ACH) Performance

PERIOD	Volume Cleared ('000s)	% Change	Value cleared (KSh. billion)	% Change
Jul. – Dec. 2012	13,994	N/A	1,302	N/A
Jan. – Jun. 2013	13,827	-1.19	1,305	23.00
Jul. – Dec. 2013	14,760	6.75	1,428	9.43
Jan. – Jun. 2014	14,788	0.19	1,462	2.38
Jul. – Dec. 2014	15,494	4.77	1,559	6.63

Source: Central Bank of Kenya

The 6.33 percent increase in value and 4.77 percent in volume of cheques and EFTs through the Clearing House may be due to more usage of cheques following reduction of clearing cycle from T+3 to T+1 (Table 28).

3.5.2 Cards Transactions

Payment cards holders in Kenya increased steadily partly due to a campaign spearheaded by CBK, Kenya Credit and Debit Card Association and commercial banks to move from cash to plastic money. As a result, banks came out strongly to woo payment card users, which have seen the number of active cards rise from 11.5 million users in 2013 to 13.9 million users in 2014.

The number of transactions and value moved declined from 28.3 million transactions worth KSh. 120.7 billion in December 2013 to 18.6 million transactions worth KSh. 110.7 billion in 2014 (Table 29). The decrease may be attributed to the availability of alternative payment modes such as mobile payment services.

The number of ATMs in the retail payment industry increased by 5.07 per cent from 2,487 ATMs in 2013 to 2,613 ATMs in 2014 on account of expansion by commercial banks in terms of branch network and ATM coverage. However, the number of Point of Sale (POS) terminals in the industry declined from 21,089 terminals in 2013 to 17,511 terminals in 2014 as a result of decommissioning of non-EMV compliant machines during the EMV migration period.

Table 29: Payment Cards Developments

INSTRUMENT/YEAR	2011	2012	2013	2014	% change in 2014
No. of Cards	10.1	10.7	11.5	13.9	20.9
No. of ATMs	2205.0	2381.0	2487.0	2613.0	5.1
POS Terminals (No.)	16604.0	18478.0	21089.0	17511.0	-17.0
Transaction Volume (Mns)	12.1	28.9	28.3	18.6	-34.3
Transaction Value (KSh Mns)	57290.0	101929.0	120670.0	110660.0	-8.3

Source: Central Bank of Kenya

3.5.3 Mobile Phone Money Transfers

Mobile Money Transfer window recorded phenomenal growth, becoming a major catalyst for economic growth and social development in Kenya. Table 30 and Figure 21 show how Mobile Phone Financial services have grown since in 2007. In particular, the number of agents grew by 9.4 per cent from 113,130 in 2013 to 123,703 agents in 2014 although the number of mobile money transfer accounts declined marginally from 25.3 million to 25.2 million accounts.

The volume and value transacted through this channel increased from 733 million transactions worth KSh. 1,901.6 million in 2013 to 911 million transactions worth KSh. 2,371.8 million in 2014, representing 24.3 per cent and 24.7 per cent increase in volume and value respectively.

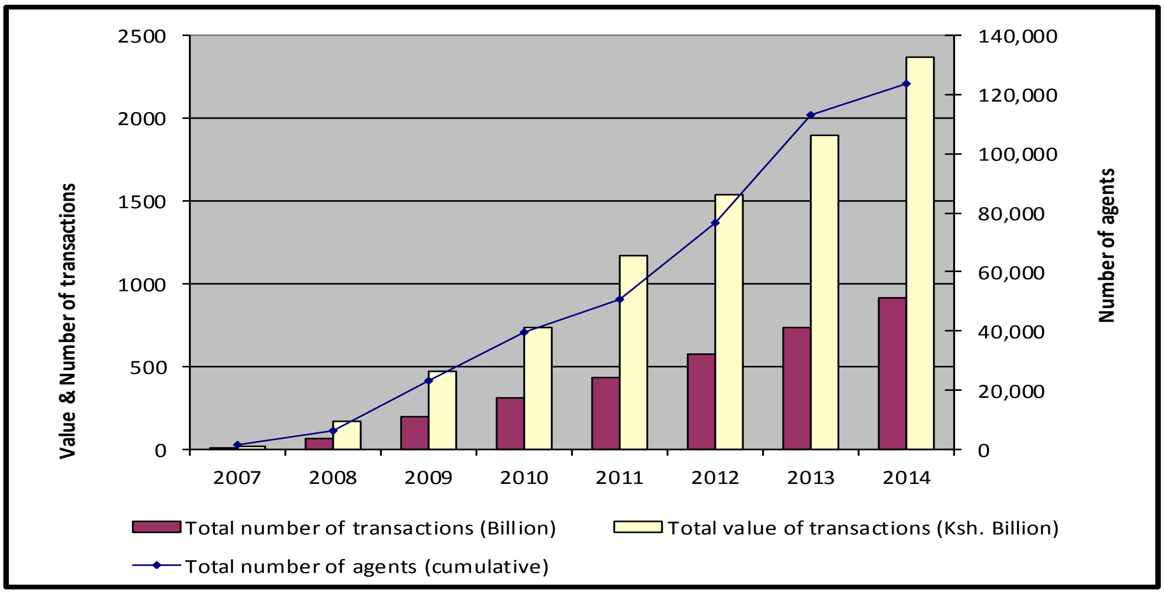
Table 30: Mobile Money Transfers by end December 31st 2014

Measurement	2010	2011	2012	2013	2014
Total number of agents	39,449.0	50,471.0	76,912.0	113,130.0	123,703.0
Mobile money transfer accounts (mns)	16.4	19.2	21.1	25.3	25.2
Total number of transactions (millions)	311.0	433.0	575.0	733.0	911.0
Total value transacted (Ksh billion)	732.2	1,169.2	1,537.5	1,901.6	2,371.8
Average value per transaction (Ksh)	2,354.0	2,700.0	2,672.0	2,594.0	2,604.0

Source: Central Bank of Kenya

Increased usage of mobile phone money transfer even after the exit of one Payment Service Provider is due to adoption of these services by organizations like microfinance banks (MFIs), NGOs and insurance firms cash disbursement, procurement and salary payments.

Figure 21: Growth of Mobile Money Transfer Services



Source: Central Bank of Kenya

3.5.4 Policy Changes and Initiatives in the National Payment Systems

Payment systems are a central part of the financial markets infrastructure and are crucial to the smooth functioning of economies. The enactment of the National Payment System (NPS) Act in 2011 paved way for CBK to prepare NPS regulations 2014 that were gazetted in august 2014. This Act and regulations issued provide thereunder regulatory and supervisory framework for payment systems and payment service providers in Kenya.

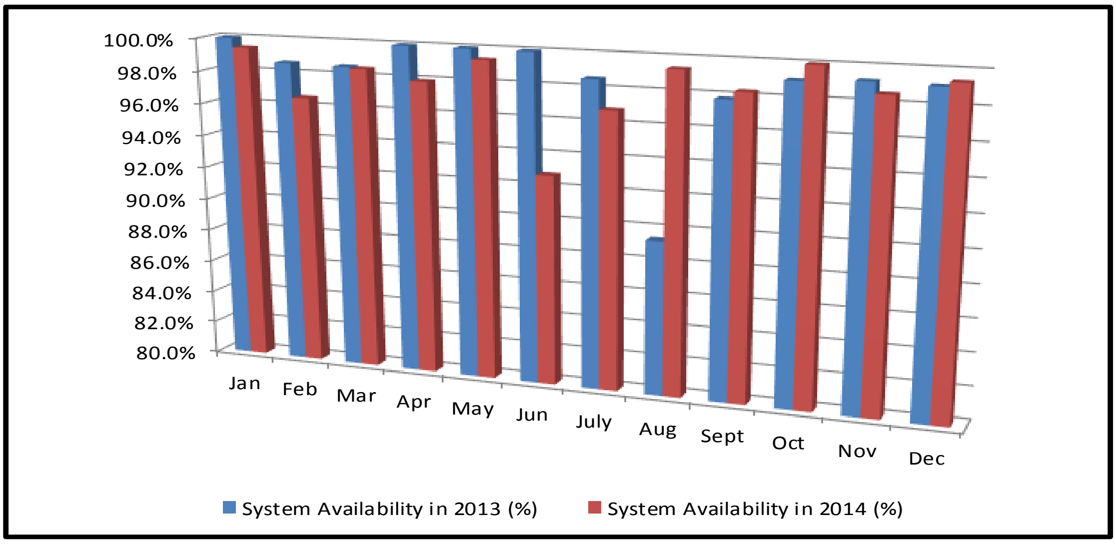
The East African Payment System (EAPS) established by East African Community (EAC) Monetary Affairs Committee (MAC) resolutions to facilitate trade in the EAC went live in November 2013 in Kenya, Uganda, Tanzania and Rwanda. The system integrates individual country RTGSs to facilitate regional transactions. The Regional Settlement and Payment System (REPSS), a multilateral netting system managed by the Common Market for Eastern and Southern Africa (COMESA) Clearing House and hosted in Zimbabwe and with backup operations in Mauritius went live in Kenya in November 2014. Bank of Mauritius is the settlement bank for REPSS. REPSS is meant to facilitate trade among the 19 member States in the COMESA region. CBK signed agreements with the COMESA Clearing House and the Settlement Bank (Bank of Mauritius) and prefunded the accounts at the Bank of Mauritius.

As part of fostering the development and integration of the national systems, the CDSC started settling Equities and Corporate Bonds through KEPSS, which is RTGS to mitigate settlement risks through commercial banks. This is expected to achieve safety, efficiency and effectiveness in the payments and settlement systems. In addition, a robust payment and settlement system is crucial in effective monetary policy transmission mechanism and fostering financial system stability, since a default by one participant can easily cause contagion effect in the entire system.

3.5.5 KEPSS and ACH Availability

In 2014, KEPSS operations were smooth with an average system availability level of 98.10 per cent (Figure 22).

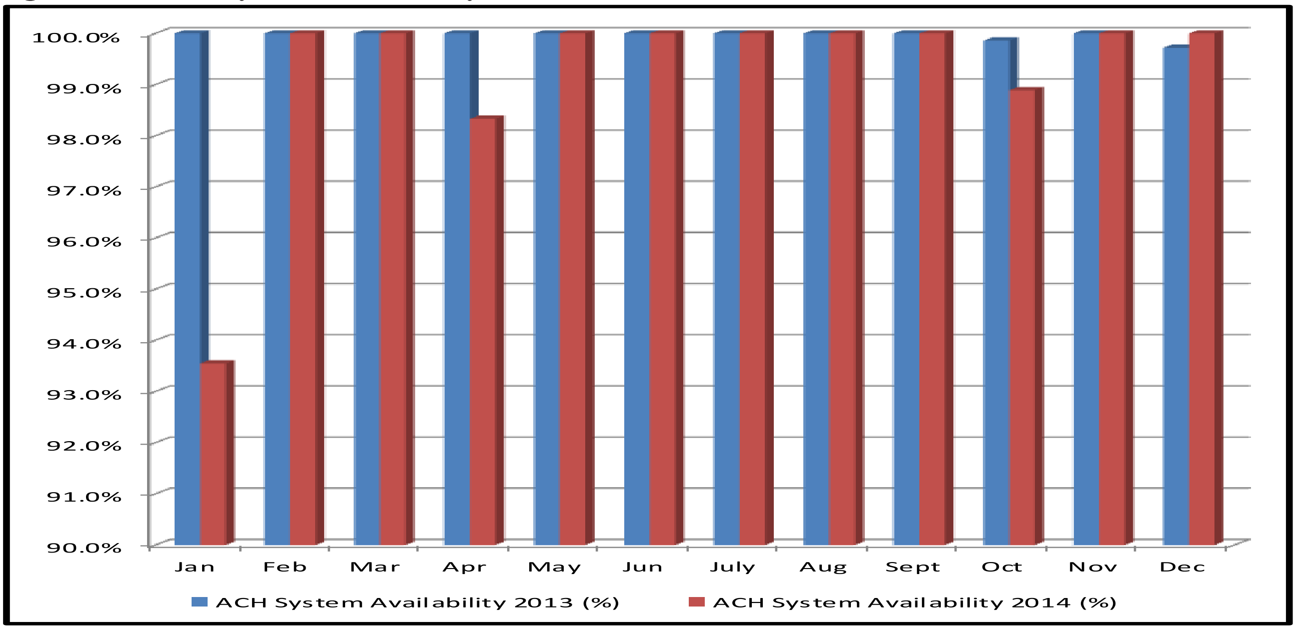
Figure 22: KEPSS Availability 2014



Source: Central Bank of Kenya

The ACH system average availability was 99.23 per cent (Figure 23), reflecting stability of the system in 2014.

Figure 23: ACH System Availability



Source: Central Bank of Kenya

3.5.6 Liquidity Management by KEPSS Participants

In 2014, KEPSS participants borrowed a total of KSh. 70.1 billion compared to KSh 76.6 billion borrowed in 2013 through overnight loans. The 8.47 per cent decline reflects adequate liquidity and enhanced stability in the industry's liquidity positions (Table 31)

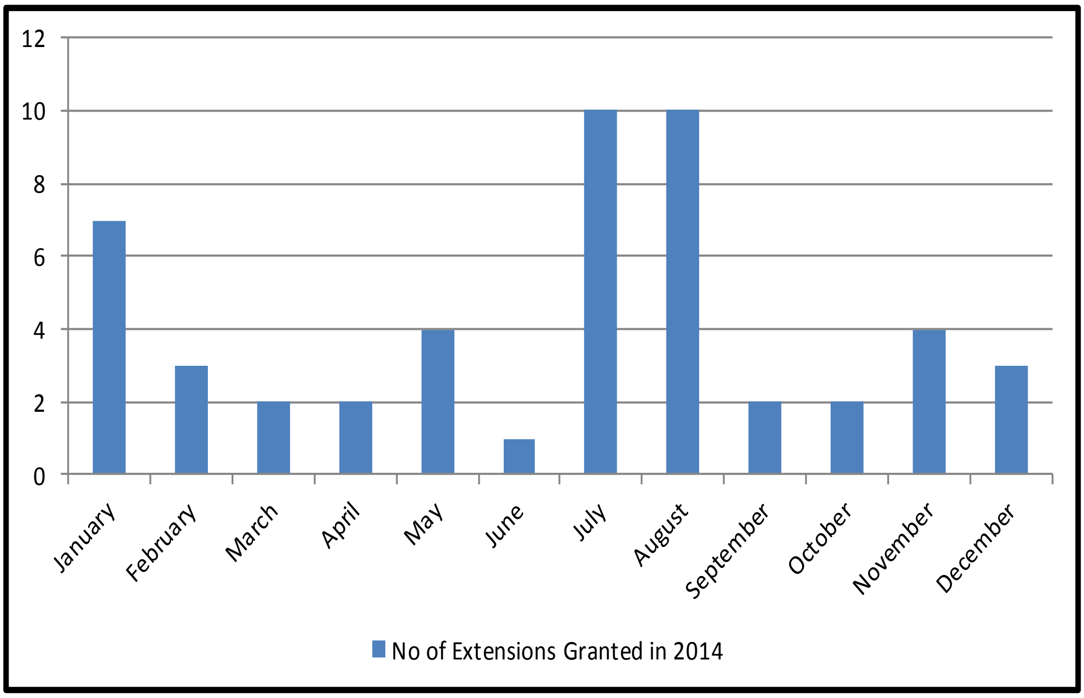
Table 31: Overnight loans to commercial bank (KSh. Millions)

MONTH	2013		2014	
	Loans	Cum. Loans	Loans	Cum. Loans
January	-	-	2,500	2,500
February	-	-	-	2,500
March	8,088	8,088	480	2,980
April	-	8,088	6,510	9,490
May	200	8,288	15,172	24,662
June	2,010	10,298		24,662
July	2,800	13,098	19,656	44,318
August	-	13,098	22,400	66,718
September	15,210	28,308	-	66,718
October	16,911	45,219	-	66,718
November	5,448	50,667	-	66,718
December	25,936	76,603	3,400	70,118

Source: Central Bank of Kenya

To enable commercial banks meet their obligation in KEPSS, extension of 'operating windows' is granted upon request. Figure 24 shows the number of window extensions granted in 2014.

Figure 24: KEPSS Window Extensions



Source: Central Bank of Kenya

3.5.7 Business Continuity Program and Outlook

One of the basic statutory tasks of CBK is to promote secure and smooth operation of payment systems through effective oversight. CBK has established a set of business continuity plans (BCPs) for KEPSS and the regional EAPS, defining how the business will operate following an incident and how to return to 'business as usual' in the quickest possible time afterwards. In addition, CBK also organises business continuity exercises for participants.

The payments landscape is changing fast, due to technological transformation and innovations as evidenced by mobile financial services and linkages to banking and cheque truncation system. These changes have dramatically transformed the way businesses, financial sector institutions, governments, and the public interact. The NPS remains on the forefront in fostering achievement of these objectives for stability and smooth functioning of the economy.

3.6 Kenya Deposit Insurance Corporation (KDIC)

At the end of December, 2014, there were 43 commercial banks, 1 mortgage finance company and 9 microfinance banks as members of the Deposits Insurance Fund under KDIC. Charterhouse Bank Limited still remains under statutory management and a member of the Fund.

The total number of deposit accounts increased from 23,747,415 in 2013 to 30,697,704 in 2014, a 29.27 percent increase. This is attributed to; financial inclusion initiatives by CBK and interventions such as introduction of commercial banks mobile phone products like the M-Shwari accounts and M-Kesho by Telcos. The use of agency banking; aggressive marketing by commercial banks and stable macroeconomic environment also contributed (Table 32).

Table 32: Growth in the number of Deposit Accounts

Measure	Sept.2013	Dec.2013	Mar.2014	Jun. 2014	Sept.2014	Dec.2014
Total No. of Accounts	23,009,917	23,747,415	25,971,129	27,423,271	28,798,674	30,697,704
Actual Change	2,101,952	737,498	2,223,714	1,452,142	1,375,403	1,899,030
% change	10.00%	3.20%	9.36%	5.82%	5.02%	6.59%

Source: Kenya Deposit Insurance Corporation

3.6.1 Growth of the Fund

During the period under review, the Fund grew by KSh. 1.32 billion to close at KSh. 52.17 billion as a result of prudent investment policies adopted by KDIC (Table 33). The funds are placed in both short and long term Government securities as required by Law and in line with the approved Board policy, which seeks to achieve an optimal return. Other factors include; stable financial sector arising from enhanced Supervision by the CBK, risk management policies embraced by commercial banks, and enhanced financial inclusion initiatives.

Table 33: Growth of the fund, Insurance Cover & Deposits

Measure	Dec.2013	Mar. 2014	Jun. 2014	Sept.2014	Dec.2014
Total No. of A/Cs	23,747,415.00	25,971,129.00	27,423,271.00	28,798,674.00	30,697,704.00
Total Deposits (KSh. mns)	2,014.91	2,075.10	2,188.07	2,288.12	2,384.72
Insurance Cover (KSh. mns)	214,525.78	208,909.34	213,708.02	221,073.95	224,867.76
Fund Growth (KSh mns)	44,322.47	45,350.04	47,176.75	50,849.55	52,165.03

Source: Kenya Deposit Insurance Corporation

As at end of 31st December 2014, total member institutions' deposits amounted to KSh. 2.384 trillion reflecting a 4.03 percent rise while total protected deposits amounted to KSh. 224.868 billion. Of the total deposit accounts of 30,697,704, accounts fully protected were 29,552,118, translating to 96.27 percent coverage.

3.6.2 Risk Exposure

The protection and exposure indicators of the Fund are captured in Table 34. As at 31st December, 2014, KDIC balance was KSh.52.17 billion compared to protected deposits of KSh. 224.87 billion, reflecting a high exposure level of 76.8 percent. But the deposit accounts fully covered were 29.55 million out of a total number of 30.698 million accounts, representing 96 percent coverage and 23 percent in terms of value. The 23 percent value coverage is low when compared to 40 percent international benchmark.

Table 34: Protection & Exposure indicators by end December 2014

	Banking Sector Deposits	Dec. 2013	Dec.2014	% Change
1	Total Deposits (KSh. Mn)	2,014,907	2,384,723	18.35
2	Total Protected Deposits (KSh.Mn)	214,526	224,868	4.82
3	*Protection Level (2/1)*	*10.65%*	*9.43%*	*-1.22*
4	Funds Balance (KSh.Mn)	44,322	52,165	17.70
5	*Effective Cover (4/2)*	*21.63%*	*23.20%*	*1.57*
	Deposit Accounts			
6	No. of Deposits accounts ('000')	23,747	30,698	29.27
7	No. of accounts fully protected ('000')	22,656	29,552	30.57
8	Share of Protected accounts (7/6)	95.40%	96.26%	0.86
9	Exposure Level (row 2-row 4/row2)	79.34%	76.80%	-2.54

Source: Kenya Deposit Insurance Corporation

3.6.3 Other Initiatives and Developments

The Kenya Deposit Insurance Act ("KDI Act"), 2012 became operational on July 1st, 2014. The KDI Act establishes a deposit insurance system and provides for the receivership and liquidation of deposit taking institutions licensed by CBK, and establishes the Kenya Deposit Insurance Corporation ("KDIC"), and for connected purposes.

Following the enactment of KDI Act 2012, an initiative by the International Association of Deposit Insurers ("IADI") and Deposit Protection Fund Board ("DPFB"), carried out an assessment to determine DPFB's compliance with international best practices, and in particular, the IADI core principles of deposit insurance in November, 2012. The findings and recommendations by assessors led to further review of the KDI Act, 2012 resulting to further amendments hence the KDI amendment Act, 2013, which was assented to on November 27th, 2013. The amendment to the KDI Act provides the following:

a) Efficiency and effectiveness in management and resolution of problem banks by introducing various options of restructuring mechanisms and without recourse to depositors and other creditors, including shareholders.
b) Limits the powers of the Kenya Deposit Insurance Corporation to inject resources into an institution, as liquidity support or capital, when financial stability is not in threat. To mitigate moral hazard assistance to an institution is limited to systemic cases, and 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 increasing the number of Board members, bringing professionalism to Board appointments, and appointment of independent directors.
e) Provides for instances when funds can be appropriated from the Consolidated Fund.
f) Provides for fixing the size of the Fund 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 Fund's growth.
i) Provides for risk based contributions, and related matters.
j) Permits KDIC to call in advance and appropriate from future contributions from member institutions under exigent circumstances.
k) Brings efficiency to the deposit pay-out process by giving powers to KDIC to exercise its discretion to make advance, interim or emergency payments.

To ensure compliance with the Kenya Constitution and the Statutory Instruments Act, the Draft Regulations to operationalize the KDIC Act were prepared and the draft regulations forwarded to the National Treasury for review and consideration. The National Treasury reviewed the Draft and forwarded it for presentation to Parliament and is now awaiting Parliamentary consideration and approval in line with the Statutory Instruments Act.

3.7 Savings and Credit Cooperative Societies (SACCOs)

The period ending June 2014 marked end of transition period under the Sacco Societies Act (Cap 490B) and Sacco Societies (Deposit-Taking Sacco Business) Regulations, 2010. During the transition period the Deposit Taking Saccos (DTS) were required to comply with the regulatory standards including capital adequacy requirements, external borrowings and non-earning assets, among others. By close of the transition period on 30th June 2014, thirty-one (31) DTSs did not to satisfy the minimum core capital and other licensing requirements and were directed to cease DTSs business. Another three (3) failed to address persistent non-compliance matters affecting their financial condition resulting in non-renewal of the licenses in 2015 and cessation of DTS business. A fourth Sacco was put under statutory management in October 2014 due to severe liquidity problems amongst other regulatory concerns. Thus, SASRA renewed licenses for 180 Saccos and granted a new license to one Sacco, bringing the total licensed Saccos to 181. Table 35 shows key performance indicators for DTSs, which improved in 2014 compared to 2013.

Table 35: Trends in Performance of DTSs (KSh Mns)

MEASURE	2014	2013	% Growth
Assets	301,537	257,368	17.20%
Deposits	205,974	182,683	12.70%
Loans and Advances	228,524	197,409	15.50%
Capital Reserves	43,086	32,991	30.60%

Source: Sacco Societies Regulatory Authority

Total assets grew by 17 percent on account of deposits and capital reserves growth. Issuance of loans remains the single largest asset in Saccos' balance sheet accounting for over 75 percent of total assets.

3.7.1 Financial Soundness Indicators

Full implementation of Sacco Societies Act (Cap 490B) have seen Saccos comply with minimum operational and prudential standards, thus promoting proper and stable functioning of the subsector as indicated in table 36.

Table 36: Financial Soundness Indicators (FSIs) for Saccos

Financial Soundness Indicators	2014	2013
CAPITAL ADEQUACY		
Core capital to Total Assets (***Min. 10%)***	11.20%	10.90%
Core Capital to Total deposit liabilities (***Min. 8%)***	16.40%	10.90%
ASSET QUALITY		
NPLs to Total Gross Loans	5.74%	4.72%
NPLs Net of Provisions to Capital	17.06%	14.50%
Earning Assets to Total Assets	79.45%	82.62%
EARNINGS & PROFITABILITY		
Return on Assets (ROA)	2.56%	2.32%
Return on Equity (ROE)	18.78%	19.03%
Interest Margin to Gross Income	45.70%	46.86%
Non-Interest Expenses to Gross Income	38.40%	43.76%
LIQUIDITY		
Liquid Assets to Total Assets	9.95%	7.76%
Liquid Assets to Short-term liabilities(Liquidity ratio)	47.32%	36.40%
Liquid Assets to Total Deposit	14.57%	10.93%
Total Loans to Total Deposit	110.95%	108.06%

Source: Sacco Societies Regulatory Authority

There was improvement in all capital ratios for the 181 licensed Saccos compared to 2013 as shown in Table 36. However, full achievement of capital adequacy ratios remains a challenge for a number of individual Saccos with institutional capital to total assets ratio being the most non-complied with.

Loans and advances account for over 75 percent of total assets, hence the single largest asset in Saccos' balance sheet yet the most risky. Loans issued rose by 17.7 percent, which was accompanied by increased non-performing loans from 4.71 percent 2013 to 5.73 percent in 2014, indicating elevated credit risk. Most affected were Agricultural sector loans due to low tea bonuses, adverse weather that led to crop failure (Table 37).

Table 37: Risk Classification of Loans and Provisioning

Loans Classification	2014		2013	
	KSh Millions	% of Total	KSh Millions	% of Total
Performing	202,950	88.80%	178,344	90.30%
Watch	12,476	5.50%	9,739	4.90%
Substandard	7,082	3.10%	4,557	2.30%
Doubtful	2,456	1.10%	1,478	0.70%
Loss	3,560	1.60%	3,291	1.70%
TOTAL	**228,524**	**100.00%**	**197,409**	**100.00%**
NPLs	13,097		9,325	
Loan loss provisions	5,294		4,053	
NPL/Gross Loans	5.73%		4.72%	

Source: Sacco Societies Regulatory Authority

The elevated credit risk has prompted Saccos to increase provisioning for loan losses. The NPLs are computed on gross terms due to challenges of netting off deposit collaterals from defaulted loans mainly due to the co-guaranteeing mechanism.

Saccos rely on loan interest income as their main source of earnings, which account for over 84 percent of total income, while non-funded incomes grew by 27.8 percent in 2014 (Table 38). This reflects credit growth during the year where KSh. 30.8 billion was recorded representing 15.7 percent increase. The growth reinforces member's confidence in deposit taking Saccos as formal financial services provider. Adoption of technology and innovation in delivery of services and products remains as a key driver of growth in the Saccos Industry.

Table 38: Statement of Comprehensive Income

MEASURE	2014		2013		Y-on-Y Change (%)
	Amount (Ksh Mns)	% of Total	Amount (Ksh Mns)	% of Total	
Income from Loans	33,057	84.03	30,263	85.35	9.23
Income from Investments	1,092	2.78	1,135	3.20	-3.80
Other Income	5,190	13.19	4,060	11.45	27.83
Total Income	**39,339**		**35,458**		**10.90**
Financial Expenses	17,021	43.27	16,310	46.00	4.36
Net Financial Income	**22,318**		**19,148**		
Provision for Loan Loss	1,471		1,131		30.09
Operating Expenses	13,777	35.02	12,560	35.42	9.68
Net Surplus before Tax	**7,071**		**5,457**		**29.60**

Source: Sacco Societies Regulatory Authority

Liquidity level indicates an institutions ability to fund increase in assets and meet obligations when they fall due. Regulatory requirements provide that DTS maintain liquidity level of 15 percent of their savings deposits and other short term liabilities in liquid assets. While the withdrawable savings do not comprise significant portion of the balance sheet, Saccos are usually faced with liquidity mismatch when issuing loans based on multiplier of savings. However, there has been a shift from the multiplier factor to earnings especially with employer based Saccos, which has contributed to improved liquidity for DTSs in line with regulatory requirements. While the law

provides that Saccos could borrow externally up to 25 percent of total assets, part of the acquired funds have been applied to fund increased appetite for credit. DTSs continue to grow above 12 per cent in all the key performance indicators, accounting for 75 percent of the total assets and deposits in the Sacco subsector (Table 39).

Table 39: Asset Based Categorization of Deposit Taking Saccos

ASSET BASE RANGE		ASSETS				DEPOSITS			
	No.	Amount in 2013	Share (%)	Amount in 2014	Share (%)	Amount in 2014	Share (%)	Amount in 2013	Share (%
>KSh 5 billion	14	152.01	50	127.27	49	104.68	51	91.88	50
KSh 2 bn but < KSh 5 bn	23	66.7	22	56.83	22	45.52	22	40.56	22
KSh 1bn but < KSh 2 bn	31	45.34	15	39.69	15	31.41	15	27.81	15
<KSh 1bn	113	37.49	12	33.58	13	24.36	12	22.43	12
Total	**186**	**301.54**		**257.37**		**205.98**		**182.68**	

Source: Sacco Societies Regulatory Authority

3.7.2 Policy Developments

During the transition period ended June 2014, SASRA identified several challenges which require amendments to the Sacco Societies Act (Cap 490B) to strengthen the legal framework and improve governance in DTSs. Among the key regulatory policy changes proposed include:

a) Central Finance Facility: The Sacco Societies Act (Cap 490B) requires DTSs to hold and maintain minimum liquidity, develop and implement contingency liquidity plans so as to effectively serve its members. This has led to situations where the Sacco Societies borrow expensively from commercial banks to bridge temporary liquidity needs and this has evidently threatened financial soundness of DTSs and hence safety of member deposits.

To address this challenge, SASRA proposes establishment of a Sacco system driven Central Finance Facility (CFF) to aid in liquidity management for the Saccos. The CFF will:

i. Facilitate pooling of liquidity as Sacco societies will hold minimum funds with CFF
ii. Promote inter-lending within the Sacco system
iii. Ensure access to funds in the event of temporary liquidity shortage, outside the commercial banks' system
iv. Foster competitiveness of DTSs as alternative financial service providers to Kenyans in under the Vision 2030 and the Medium Term Plan for the Financial Services Sector.

The CFF model is being used in countries such as the U.S, Canada and Brazil, thus Credit Unions deepen their role in providing financial services to individuals and small businesses.

b) Credit Information Sharing (CIS): The current legal framework on CIS is limited to inter-Sacco sharing of negative information only, and with the Authority. It excludes sharing of positive information or sharing with other financial institutions, which is contrary to the prevailing arrangement for banks in which the sharing of credit information has been expanded to both negative and positive. In 2014, SASRA proposed amendments to the Sacco Societies Act (Cap 490B) to allow CIS by Saccos with other licensed financial institutions through the licensed credit reference bureaus, and also the sharing of full-file information. This will equally align the Sacco Societies Act (Cap 490B) with the Banking Act as amended in 2013, the Microfinance Act, and the Credit Reference Bureau Regulations, 2013.

c) Amendments to provide criteria for determining the suitability of officers for DTSs: The Sacco societies Act (Cap 490B) envisages that SASRA shall vet key officers of Sacco societies, through the "Fit & Proper Test" form provided in the Regulations. In order to ensure competences of persons elected as directors and Seniour members, SASRA has proposed a provision to stipulate in non-ambiguous minimum criteria for assessing the fitness and propriety of senior officers of Saccos, which includes the members to the Board of Directors and senior management officers. The proposal is tailored along the standards used in the Capital Markets Act, Microfinance Act and Banking Act.

d) Use of Information Communication Technology (ICT): SASRA has been implementing risk based supervision (RBS) approach, which uses real time accurate data and other statistics from the SACCOs to deliver real time analysis and prompt feedback and actions. SASRA has proposed amendments to the regulatory framework to institutionalize the use of ICT as a reporting tool and overall supervision of SACCOs. Use ICT also brings comparative advantage of greatly reducing the regulatory reporting burden on SACCOs. It ensures faster, efficient and accurate reporting, monitoring and evaluation of the SACCOs financial conditions at any time.

3.7.3 The Outlook

The increasing demands from prudential compliance coupled with the fact that majority of the small Saccos are financially and technically constrained remains a key challenge for this category of DTSs. The growth momentum for the large and medium sized DTSs is expected to continue exerting pressure, thus fostering competition. SASRA expects more of the small DTSs to exit the business and concentrate in non-DTS business or merge with financially stable deposit taking Saccos. Failure to take deliberate and strategic decisions will see members from the small DTSs opting out in favour of DTSs that can effectively serve their financial needs and comply with Sacco Societies Act.

4.0 SUMMARY AND OUTLOOK FOR 2015

4.1 Global Outlook in 2015

Growth in 2015 is expected to be slightly higher than that of 2014, improving in advanced economies enough to offset slower growth in emerging market and developing economies. Sharp decline in oil and commodity prices, coupled with lower interest rates and inflation from expanded monetary accommodation, are expected to support growth through 2016.

Bold monetary policy actions have been taken in both the euro area and Japan to arrest and reverse disinflationary pressures. Quantitative easing provides a strong framework for addressing deflation risks, and some key transmission channels are already working. Spreads on credit have narrowed in the euro area, equity prices have surged, and the euro and yen have depreciated significantly, helping to raise inflation expectations.

- The main downside risks to global economic and financial stability are the interest rates hike by the U.S that would spillover to emerging and developing countries.
- Geopolitical tensions involving Russia and the West on one hand, the U.S and China on the other, and the persistent violence in the MENA region poses threats to stability through reduced trade and political tensions
- China's declining commodities demand will affect commodity-dependent emerging and developing countries, thus impacting their revenues and fiscal positions.
- Increased borrowing from international markets by emerging market economies and developing economies may be a source of risks in the event of interest rates reversals and persistent currencies volatility.

4.2 Domestic Outlook in 2015 and Risks

Domestically, economic prospects look positive driven by heavy investments in infrastructure developments, discovery of oil and other minerals, stable macroeconomic environment and stable and vibrant financial system. There are however downside risks;

- Security threats remain the largest risk to the economy and financial system through reduced tourism earnings and worsened business environment
- Falling exports within the EAC region and to the rest of the world due to competition from cheap Chinese
  products and violence in the MENA region is a risk to BOP and local currency stability
- Faster growth in NPLs in both banking and Deposit Taking Saccos is signaling rising credit risks and therefore may lead to credit tightening by credit providers.
- Rising public debt, especially the commercial component poses medium to long term risks
  through high interest rates and cost of credit in the face of weaker local currencies and fiscal positions.
- Market Concentration and legislative risks in the capital markets require close attention by regulators and policy makers to ensure stability.