THE FINANCIAL SECTOR STABILITY REPORT, 2012

December 2012, Issue No. 4

Annual Review by Financial Sector Regulators, July 2013

CAPITAL MARKETS AUTHORITY

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
BOS	Back Office System
CBK	Central Bank of Kenya
CBR	Central Bank Rate
CMA	Capital Markets Authority
CTS	Cheque Truncation System
DSA	Debt Sustainability Analysis
DTS	Deposits Taking Saccos
EAC	East African Community
ERS	Electronic Regulatory System
FLSTAP	Financial and Legal Sector Technical Assistance Project
FOSAs	Front Office Savings Activities
FSI	Financial Soundness Indicators
FSR	Financial Stability Report
FSSTC	Financial Sector Stability Technical Committee
GDP	Growth Domestic Product
IAIS	International Association of Insurance Supervisors
IMF	International Monetary Fund
IPO	Initial Public Offering
IRA	Insurance Regulatory Authority
KEPSS	Kenya Electronic Payment & Settlement
MENA	Middle East and North Africa
MTDS	Medium Term Debt Strategy
NPLs	Non-Performing Loans
NPV	Net Present Value
NSI	Nat Settlement Instructions
NSSF	National Social Security Fund
RBA	Retirement Benefits Authority
RBS	Risk Based Supervision
REITs	Real Estate Investment Trust
SADC	Southern Africa Development Community
SASRA	Saccos Societies Regulatory Authority
SIPS	Systemically Important Payment System
SMEs	Small and Medium Enterprises
SSA	Sub-Saharan Africa
USA	United Sates of America
USD	United States Dollar
WEO	World Economic Outlook

FOREWORD BY THE CHAIR

The Financial Stability Report, 2012 (FSR, 2012) is a joint publication of the five financial sector regulators in Kenya: the Central Bank of Kenya (CBK); the Capital Markets Authority (CMA); the Insurance Regulatory Authority (IRA); the Retirement Benefits Authority (RBA); and the Saccos Societies Regulatory Authority (SASRA).

The report presents diagnostic assessment of the global and domestic macro-financial developments encompassing real economy, financial markets, financial institutions, financial system infrastructure, and the legal and policy frameworks in 2012 and the outlook for 2013. Recognizing the linkage between the macroeconomy and financial system, FSR 2012 highlights emerging risks and vulnerabilities and suggests mitigating measures by line institutions to arrest undesired outcomes if such risks materialise. In appreciating that Kenya operates within an international context, the report captures developments in global economies and how such changes affect domestic macro-financial conditions. This will help the public to understand recent developments in the financial system and appreciate the need to achieve and maintain financial system stability.

As a pillar of economic development, the financial system provides intermediation of funds by bringing together savers and investors, and channels the funds to productive investments that promise positive return. A sound, stable, safe, effective and efficient financial system pools surplus funds, transfers, and minimizes risks, while at the same time increasing liquidity and information sharing through financial innovations and technology. In this regard, the financial sector regulators contribute immensely to economic development through provision of a wide range of regulatory and supervisory services that promote orderly growth, development and functioning of financial institutions, financial markets and financial infrastructure. They identify and take measures to mitigate potential vulnerabilities and downside risks. They continuously monitor and evaluate performance, soundness and stability of regulated institutions in order to isolate system-wide risks.

This FSR 2012 comes at a time when optimism in economic recovery at both the domestic and global level is being threatened by old and new risks. Sovereign stress in the Euro Zone remains elevated, with possible spillover to Sub-Saharan Africa. Slowing demand and falling prices in the commodities markets, slowing credit, financial markets volatility, weaker domestic demand and slower potential growth in emerging market and developing economies pose risks to global recovery and stability. The unresolved socio-political unrest in the Middle East and North African region remains a source of threats to stability.

In 2012, Kenya experienced enhanced stability in the financial system and resilience of economic performance. The local currency stabilised against the US dollar, while inflation stabilized below the government target, and the capital markets regained momentum. This report highlights policy initiatives taken by each regulator to cushion the economy and financial system in particular, to mitigate any potential vulnerability. There are, however, signs of vulnerabilities on both macroeconomic and financial sector fronts. The large current account deficit to GDP ratio in the balance of payments, rising level of NPLs, probability of some banks failing stress tests in case of large shocks, large concentration ratio in capital markets, and aggregate moderate to high risk level in insurance sector, are some of the issues that require close surveillance in 2013.

As part of on-going policy initiatives, the Bank in collaboration with the other regulators is working to develop aggregate measures that could signal the degree of financial system stability, or stress at any moment in time. Such composite quantitative measures, sometimes presented in the form of risk surveillance heat maps of the financial system stability, could enable policy makers and financial system players to; better monitor the degree of financial stability of the system at micro- and macro- level, anticipate sources and causes of financial stress to the system, and communicate more effectively in a timely manner the impact of such conditions. This process will once completed, provide a more rigorous and better approach to conducting macro-prudential surveillance, diagnostic assessments and formulation of appropriate policy actions.

Overall, the public will find this FSR 2012 invaluable in enhancing knowledge on financial sector developments and performance, and in turn appreciate efforts taken by various regulators in promoting and sustaining stability of the financial system to enable it play its rightful role in the economy and society at large.

PROF. NJUGUNA NDUNG'U, CBS
GOVERNOR, CENTRAL BANK OF KENYA

ACKNOWLEDGEMENT

Dissemination of FSR, 2012 reinforces commitment by the Joint Regulators Board to achieve and maintain an inclusive, stable and sound financial system in Kenya in line with the national development goals espoused under Vision 2030, EAC and COMESA regional integration efforts. The report also identifies the regulators' concern that instability in the global economies and financial markets impacts the domestic macro-financial conditions, thus creating imbalances that may hinder the country's development agenda. Consequently, close surveillance and diagnostic analysis of potential vulnerabilities and risks, would aid timely policy interventions by both regulators and policymakers.

The FSR, 2012 consolidates performance assessment reports by the five financial sector regulators, namely: the Capital Markets Authority (CMA), Central Bank of Kenya (CBK); Insurance Regulatory Authority (IRA), Retirement Benefits Authority (RBA), and the Sacco Societies Regulatory Authority (SASRA). The financial sector stability assessment and analysis is one avenue through which the Joint Regulators Board monitors and evaluates developments and performance of the financial sector in order to mitigate risks and vulnerabilities that threatens stability. This publication therefore, highlights developments in the calendar year 2012 and policy actions taken to manage emerging risks and fragilities.

Let me take this opportunity as the chairperson of the Financial Sector Stability Technical Committee (FSSTC), to thank officers and Chief Executive Officers of CBK, CMA, IRA, RBA, and SASRA for providing staff, technical support and approval of the FSR 2012. At this juncture, I wish to recognize efforts by FSSTC members who undertook the analysis and writing of this Report. The team worked diligently to ensure timely publication of FSR 2012. In order to update the public more effectively, the FSR will be published semi-annually effective October 2013 in conformity with global best practices. We will continue to invite all stakeholders to provide positive inputs on how to improve future reports.

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

1. OVERVIEW

The Financial Stability Report 2012 provides a comprehensive diagnostic assessment of the performance, soundness and stability of Kenya's financial system in 2012. The report parades performance indicators, identifies emerging risks and vulnerabilities to the system, and highlights policy actions taken by respective regulators and policy makers to achieve and sustain stability in 2012 and beyond.

Globally, macroeconomic conditions improved in 2012 despite persistent fragility and constraints in the financial system. Accommodative monetary policies in advanced countries such as asset/bonds purchases in Japan and USA had temporary positive effects on the global economic prospects. Despite the optimism, the Euro Area posed formidable risks to global recovery. Unending recession in Europe has subdued job markets, sustaining an unemployment rate above 12 per cent by end of 2012. This has led to social unrest, with more resistance targeting austerity measures in Spain, France, Greece, among others. In response, central banks further loosened monetary policy to stimulate growth. This inflated balance sheets and lowered interest rates to near-zero in countries like the US, Japan and in the Euro Zone. Global financial markets experienced steady recovery, with yields on the Euro Area sovereign debt declining over a wide-range of maturities to sustainable levels, which signifies reduced price of risk and easier access to private-sector capital. In a sense, monetary policy veered into previously uncharted areas in order to mitigate risks to global economic growth and financial system stability.

Emerging markets on the other hand, recorded better economic performance in 2012, driven by robust domestic demand in China, Indonesia, Malaysia, Philippines and Thailand, and a surge in exports. Inflationary pressures were contained within the targets, but the summer drought cut agricultural production in Russia and Eastern Europe, leading to inflation in the second half of 2012 as food prices rose amid supply constraints. Domestic demand in the Latin American and the Caribbean region boosted GDP growth to 1.9 per cent, but slowed in the fourth quarter of 2012. Economic activity in the MENA region was undermined by political instabilities, with aggregate output declining and unemployment worsening. But the bumpy recovery and skewed macroeconomic policy mix in advanced economies is sending mixed signals to policymakers in emerging market economies. In Sub-Saharan Africa, economic outlook remains exposed and mixed, on weaker growth in China and delays in resolving fiscal issues in the Euro Area and the USA.

Resilience of the Kenyan economy in 2012 is projected to transform into enhanced recovery along the Vision 2013 growth trajectory in 2013 based on the economic reforms both implemented and underway. Most macroeconomic indicators are likely to remain stable. Implementation of the devolved system of government may however divert resources from targeted key investments creating a downside risk to growth. Credit growth to the private sector decelerated below target, but lending interest rates albeit declining, remained high and matched by high interest rates spreads.

2. PURSUIT FOR FINANCIAL SYSTEM STABILITY

Achieving and sustaining macro-financial stability forms the base for sustainable, broad-based economic growth and employment creation, vital for realizing the country's development agenda as outlined in the Vision 20130. Unlike price stability, financial stability is difficult to define, or measure, given the interdependence and the complex interactions of different elements within the financial system and with the real economy on the other hand. This is further complicated by the inter-temporal and cross-border dimensions of such interactions due to presence of financial services providers across countries giving rise to cross border transactions and risks coupled with different country risks.

Financial stability is defined as the smooth operation of financial intermediation between households, firms and the government through a range of financial institutions supported by financial markets and infrastructure. Stability in the financial system is reflected in an efficient and effective infrastructure, well-developed and functioning financial markets, and efficient and sound financial institutions. In its pursuit of financial stability, the Financial Sector Regulators in Kenya rely on market forces with the understanding that any measures to contain systemic risks and vulnerabilities should be at the optimal. The regulators have signed into memorandum of understanding in this respect.

On the contrary, financial instability manifests through financial institutions failures, extreme asset-price volatility, collapse of financial market liquidity and, eventually, a disruption in the payments and settlements systems. It affects the real sector, imposing major macroeconomic costs by interfering with production, consumption and investment. Sustaining financial system stability is, therefore, important for sustainable economic growth and employment creation.

In theory the close interaction between the real sector and financial system should help achieve and maintain financial stability. This reflects through the feedback loop between macroeconomic conditions and leading financial system soundness indicators. This in turn, underscores the need for ensuring stability of the macro-financial conditions, which is always a tricky balance act between central banks and governments. For instance, emerging global trends of fiscal and debt sustainability, and their impact not only on macroeconomic stability, but also on financial system stability, have focused intense efforts by policymakers and regulators to mitigate financial instability.

The Financial Stability 2012 Report highlights current and potential risks, vulnerabilities and strengths of the entire financial system in Kenya. The report leans on both qualitative and quantitative assessment of information to capture developments in 2012 and provide outlook for 2013.

3. GLOBAL ECONOMIC AND FINANCIAL CONDITIONS

Developments in the global economy impact on Kenya's overall macroeconomic and financial sector performance. The country's exposure to global changes through; trade, net capital flows, labour movements and foreign exchange market makes it vulnerable to external dynamics. The global economic activity improved in 2012, but meaningful recovery in developed countries remained bumpy and slow with mixed signals. The World Economic Outlook (WEO), July 2013 projects a subdued global growth in 2013, due to weaker domestic demand, slower growth in key emerging market economies, and prolonged recession in the Euro Area.

3.1. Global Macro-financial Developments Update

Global growth remained fragile in 2012, weakening to 3.1 percent from 3.9 percent in 2011 and estimated to remain at 3.1 percent in 2013 (WEO Update, July 2013). Unlike in 2012, the slowdown is driven by old and new downside risks, and lower potential growth in emerging markets economies, slowing credit, and possible tighter financial conditions if the U.S cuts monetary and fiscal policy stimulus that would reduce capital flows. The Euro Area would remain in recession in 2013 as recovery in developed economies teeters below 2 per cent (Table **1**).

Table 1: World Economic Outlook Update

					Difference from October 2012 WEO	
Real GDP Growth (%)	**2011**	**2012**	**2013e**	**2014f**	**2013**	**2014**
World Output	3.9	3.1	3.1	3.8	-0.2	-0.4
Advanced Economies	1.7	1.2	1.2	2.1	-0.3	-0.2
Euro Area	1.5	-0.6	-0.6	0.9	-0.5	-0.2
Japan	-0.6	1.9	2.0	1.2	0.7	-0.7
United States	1.8	2.2	1.7	2.7	-0.3	-0.1
Emerging & Developing Countries	6.2	4.9	5.0	5.4	-0.4	-0.3
China	9.3	7.8	7.8	7.7	-0.3	-0.6
Russia	4.3	3.4	2.5	3.3	-1.1	-0.6
Brazil	2.7	0.9	2.5	3.2	-0.9	-1.0
MENA	4.0	4.5	3.0	3.7	-0.3	0.1
SSA	5.4	4.9	5.1	5.9	-0.4	-0.1
South Africa	3.5	2.5	2.0	2.9	-1.0	-0.1

Source: The World Economic Outlook Update, July 2013

Global financial markets had improved in 2012 following the Euro Area holding together amid financial difficulties, especially in Cyprus and Greece, and actions taken to avert the US going burst on the fiscal cliff. Consequently, yields on the Euro

Area sovereign debt declined (Figure **1**) and over a wide-range of maturities to low levels previously attained in 2010, signifying reduced price of risk and, thus, easier access to private-sector capital with reduced borrowing costs.

Figure 1: Decline in Price of Risk in the Euro Area

Source: The World Bank Global Economic Prospects Jan 2013

Sustainability, however, did not last long, with volatility in financial markets emerging in May and June 2013. Longer term interest rates and financial markets volatility in the advanced economies rose, sovereign spreads in the Euro Area periphery widened, and emerging market economies have been hit hardest through increased capital outflows, equity price declines, rising domestic yields and currency depreciation.

The rising risk perceptions will raise cost of borrowing, thus undermining capital flows, and inability of some governments to access funding from international markets. Key risks identified that threaten potential global growth include:

- Persistent recession in the Euro Area due to delays in implementation of key monetary, fiscal and financial policies, low demand, depressed confidence, weak balance sheets and base effects from delayed recovery. Potential negative impact is 1.1 percent fall in GDP of developing economies.
- Tighter financial conditions on anticipated unwinding of monetary policy stimulus in the U.S likely to cause capital flow reversals which will hurt mostly emerging market and developing economies.
- Longer growth slowdown in emerging market economies, slowing credit, weak domestic demand, deteriorating commodity prices compounded by low demand, increased unemployment and weaker external demand for Sub-Saharan exports.

The World Bank's vulnerabilities simulations in January 2013 indicate that the Euro Area crisis can degenerate to a major crisis and a prolonged U.S. fiscal policy paralysis scenario can actually materialise. As a result, two Euro Area members could exit international capital markets, and thereby undergo cuts in government expenditure and business investment spending of about 9 per cent of the GDP.

Table 2: World Bank's Simulation of a Crisis

	Euro crisis			US fiscal paralysis		
	2013	2014	2015	2013		
	(% change in level of GDP)			Real GDP	Current account balance	Fiscal balance
				(% change in level)	(change, % of GDP)	
U.S.	-1.0	-0.6	-0.2	-2.3	0.6	-0.5
World	-1.3	-0.8	-0.4	-1.4	0.0	-0.5
High-income countries	-1.4	-0.9	-0.4	-1.5	0.1	-0.6
Euro Area	-2.3	-1.4	-0.8	-1.1	0.2	-0.4
Developing countries	-1.1	-0.7	-0.3	-1.0	-0.1	-0.5
Low-income countries	-0.6	-0.4	-0.1	-0.7	0.1	-0.2
Middle-income countries	-1.1	-0.7	-0.3	-1.0	-0.1	-0.5
Developing oil exporters	-1.3	-0.9	-0.4	-1.2	-1.1	-1.0
Developing oil importers	-0.9	-0.6	-0.3	-0.9	0.3	-0.2
East Asia & Pacific	-1.0	-0.7	-0.3	-1.1	0.4	-0.2
Europe & Central Asia	-1.3	-0.9	-0.4	-0.9	-1.0	-0.8
Latin America & Caribbean	-1.2	-0.8	-0.3	-1.2	-0.4	-0.6
Middle East & N. Africa	-1.0	-0.7	-0.3	-0.8	-0.7	-1.4
South Asia	-0.5	-0.3	-0.2	-0.4	0.6	0.0
Sub-Saharan Africa	-1.0	-0.7	-0.3	-0.9	-1.3	-0.8

Source: The World Bank Global Economic Prospects Jan 2013

The simulation assumes that the shock will be spread over two years, with 3/4 of the impact in 2013 and a 1/4 in 2014. The resultant spill-overs of this scenario to developing countries would be through decline in remittances by 1.7 per cent or more, accounting for 1.4 per cent of GDP among countries heavily dependent on remittances. Tourism especially from high-income Europe would be reduced and foreign direct investments could suffer more setbacks. A crisis scenario could accelerate the process of bank deleveraging in Europe affecting banks in developing countries, especially those with close and direct linkages.

3.2. Emerging Market and Developing Economies

Growth of output in emerging market and developing economies had been projected to decelerate to 5.3 per cent (WEO October 2012) before further downward revision to 4.9 per cent (WEO July 2013) (Figure **2**). The robust domestic demand in China, Indonesia, Malaysia, Philippines and Thailand, and a surge in exports in 2012 have since retreated. Forecasts for the BRICS have been revised down in the range of 0.25 – 0.75 per cent. Decline in external demand for commodities, falling commodity prices and internal problems remain threat to growth. The MENA region growth is undermined by continued political instabilities and economic transition. Many MENA region countries face the risk of rising fiscal challenges due to heavy spending to dampen domestic discontent. In addition, prospects of monetary policy normalization in the U.S and potential capital outflows have further heightened policy trade-offs in the emerging markets, developing economies and MENA region. There is need to design appropriate policy framework targeting regulatory oversight and macroprudential policies to supplement macroeconomic policies in order to manage potential financial markets stability risks.

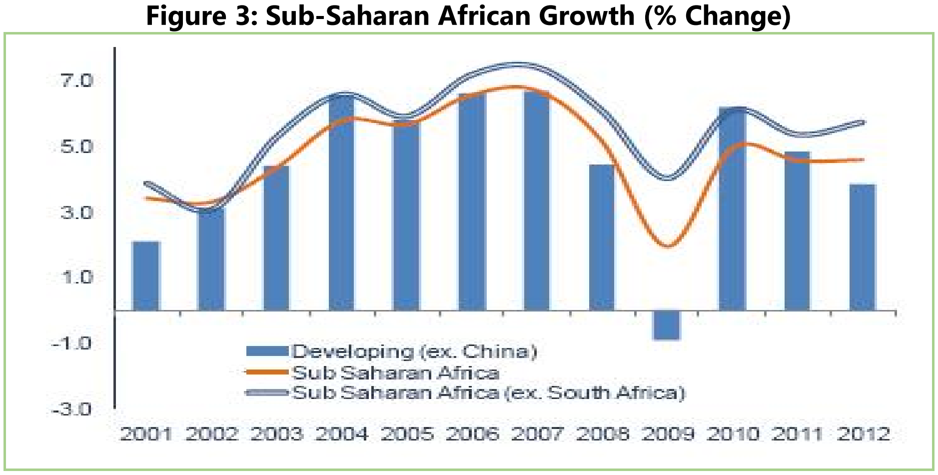
Figure 2: Growth in Emerging and Developing Economies

Source: The World Bank Global Economic Prospects Jan 2013

3.3. Sub-Saharan Africa (SSA) and the East African Community Economies

Sub-Saharan Africa maintained robust growth of 4.9 per cent in 2012 anchored on strong domestic demand and relatively high commodity prices (figure **3**).

Figure 3: Sub-Saharan African Growth (% Change)



Source: The World Bank Global Economic Prospects Jan 2013

Financial markets in the SSA region attracted domestic and global appetite that saw Zambia's debut $750 million Euro bond in September 2012 oversubscribed 15 times. Exports in several countries on account of discovered mineral deposits have further supported growth prospects. The SSA region is projected to grow at its pre-crisis average rate of above 5 per cent over 2013-14 and at 6 per cent excluding South Africa. The region's outlook remains exposed, given weaker growth in China, delayed solution to the fiscal issues in the Euro Area and the United States, political instability concerns within SSA and MENA regions, and low domestic demand and unemployment. A potential credit strain to any of the larger troubled Euro Area economies would weigh down on the SSA region to the tune of 1 per cent of GDP growth. Since China accounts for about 50 per cent of many industrial metals exported from Africa, major unwinding of China's high investment rate could worsen current account positions and knock off the region's growth prospects.

3.4. Financial Sector Linkages: African Banking Groups

Sub-Saharan Africa's two largest economies, Nigeria and South Africa, have seen their financial institutions expand rapidly across borders. South Africa-based banks opened subsidiaries in 16 SSA countries including Kenya. In 11 of those countries, these subsidiaries are among the five largest banks. Most of these banks fund their operations with local deposits but cross-border loans are modest. Nigerian banks have 44 subsidiaries in 21 SSA countries, with United Bank for Africa having 16 subsidiaries; Access Bank 8; and Guaranty Bank 5 subsidiaries. At the EAC regional level, Kenya has 11 banks with cross-border branch network totalling to 282 branches, and extending into South Sudan with 31 branches.

Cross-border expansion creates room to transmit financial system shocks and risks in home country across the host countries and vice versa. Nigeria experienced strain in the financial system in 2009-2010 following two years of a credit boom, amidst poor risk management. The Central Bank of Nigeria (CBN) intervened in 10 out of the 24 banks in 2009. However, the banking crisis did not transform into systemic contagion across the region due to the fact that banks with cross border operations were not among the troubled ones and that the banking systems of the host countries were mainly funded by local deposits and, therefore, did not significantly depend on Nigerian funding. A similar situation is applicable to Kenyan banks' branches in other countries where they operate as subsidiaries. However, potential country and group contagion pose risks to the financial systems in the region, hence need for collaboration in regulatory and supervisory practices and cooperation.

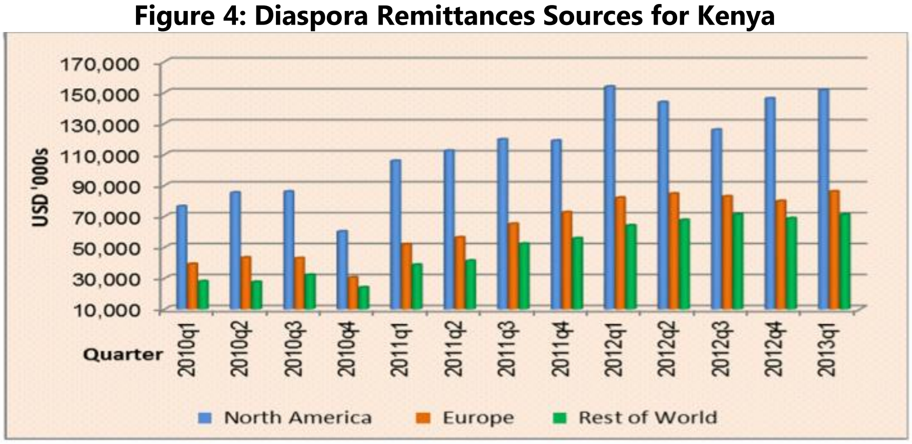
The South Africa linkages with the rest of the continent have grown steadily but these linkages are of macroeconomic significance mainly to Southern Africa Development Community (SADC) region at the moment. Nigeria's financial linkages are strong with its francophone neighbours and are unlikely to infiltrate the rest of the region given tighter risk management and supervision by the Central Bank of Nigeria. For Kenya, the banking footprint is more concentrated to Eastern Africa where there is significant homogeneity in regulatory, supervisory and risk management frameworks that have ensured stability.

3.5. Global Macro-financial Risks Spillovers to Domestic Financial Stability

Although macroeconomic conditions have nearly stabilized globally, growth is uneven across regions. The WEO Update of January 2013 projected the U.S growth at 2 per cent in 2013 and the Euro Area to contract by 0.2 per cent. In the U.S, authorities have embarked on gradual fiscal consolidation to avoid the negative impact on growth, while in the Euro Area, maintaining the momentum for fiscal and regulatory reforms is critical. Emerging market and developing economies are forecast to grow in 2013 supported by strong underlying fundamentals and internal aggregate demand.

Confidence in global financial markets remains fragile, exposed to high volatility and risk aversion. While the outlook may have eased, heightened regulation and supervision, which may weigh on earnings and profitability, and uncertainties on the fiscal path, underline the delicate situation of international financial institutions. However, regulatory reforms if implemented well, will make the financial system safer, sound and stable by ensuring that financial institutions and markets are transparent and less complex.

Figure 4: Diaspora Remittances Sources for Kenya

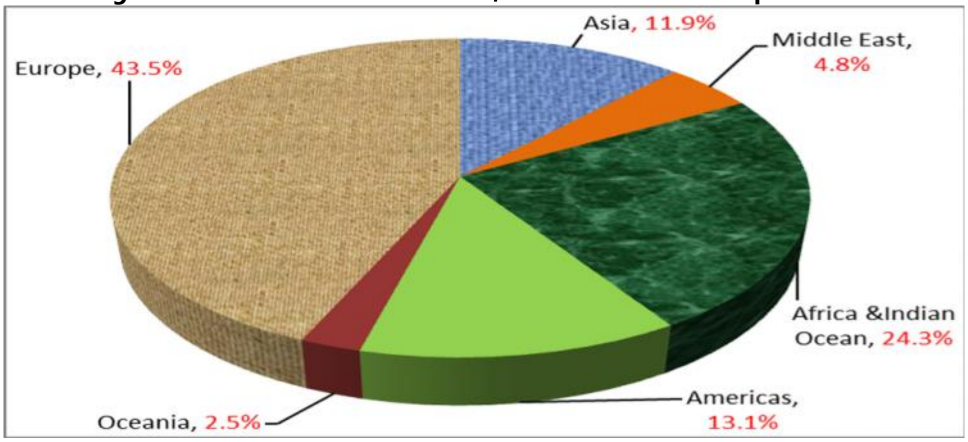


Source: Central Bank of Kenya database

The Euro Area crisis has significantly impacted developing economies through slow GDP growth. Further deterioration of conditions as simulated would heighten risks to developing countries through transmission channels such as; diaspora remittances, trade, tourism and net capital flows. Further worsening of Euro Area crisis would cut remittances to developing countries by at least 1.7 per cent or 1.4 per cent of GDP of countries heavily dependent on remittances. Kenya would also be affected as statistics in Figure **4** indicate that Europe and North America account for the largest sources of Diaspora remittances.

Besides remittances, tourism is another major source of foreign currency inflows in developing economies. Europe accounts for majority of the tourists. Persistent Euro Area crisis, especially among high-income Europeans would negatively affect foreign exchange earnings, thus affecting trade balance and exchange rates of developing countries. Kenya would be hit hard since 44 per cent of tourists that visited the country in 2012 were from Europe as shown in Figure **5**. More austerity measures in Europe would reduce disposable incomes and increase unemployment, thus reducing overseas travel and holiday spending.

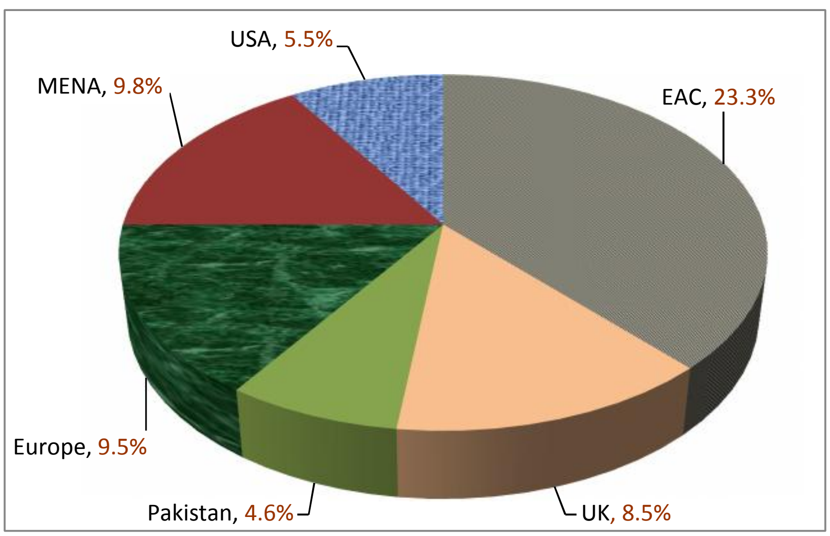
Figure 5: Tourists Arrivals via JKIA, MIAM and Cruise Ships in 2012



Source: Central Bank Database

Another area that would be affected negatively by worsening Euro Area is trade, since most of developing countries have trade links with Europe. Figure **6** indicate that Europe is second to EAC as preferred destination of Kenya's exports. Deterioration of Euro Area would affect Kenya's trade balance, financial markets and overall economy growth prospects.

Figure 6: Kenya's Exports Destinations in 2012

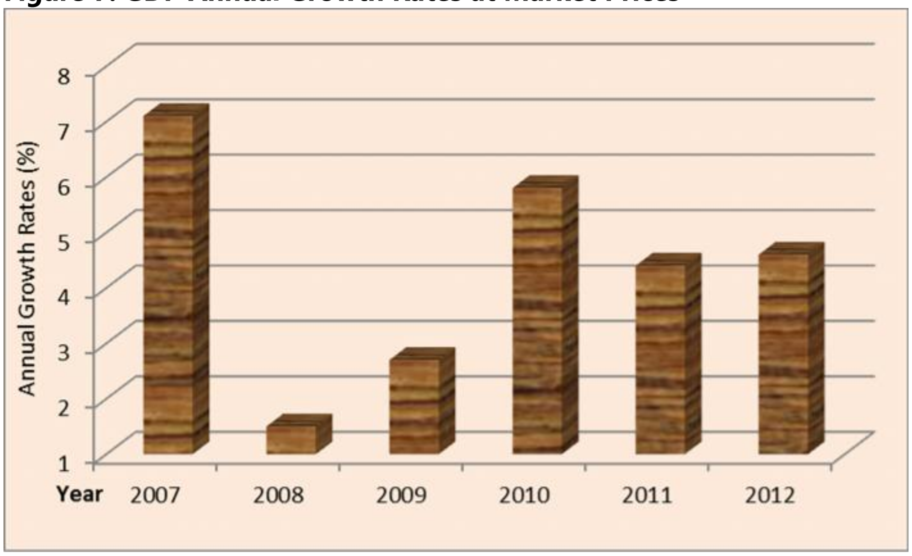


Source: Central Bank Database

4. DOMESTIC MACRO-ECONOMIC ENVIRONMENT

Kenya's economy grew by 4.6 per cent in 2012 compared to 4.4 per cent in 2011 and 5.7 per cent in 2010 anchored on general macroeconomic stability (Figure **7**). Electricity, financial services and wholesale and retail trade were the main drivers of growth in 2012. Agriculture accounted for 25.9 per cent of GDP in 2012 up from 23.8 per cent in 2011.

Figure 7: GDP Annual Growth Rates at Market Prices



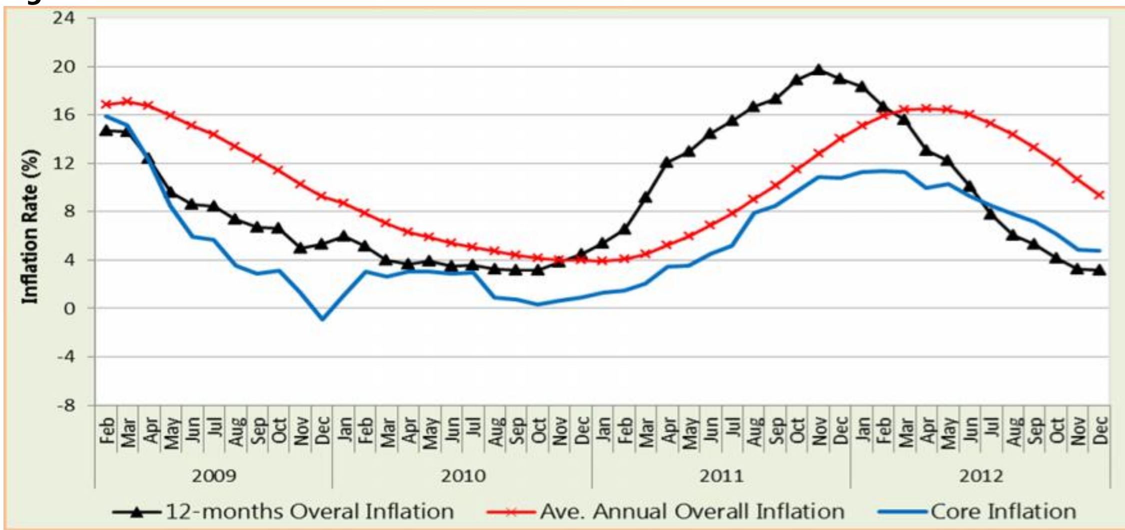
Source: Kenya National Bureau of Statistics

The economy is projected to perform better in 2013, with growth estimate of 5.8 per cent reported in the Kenya's economic programme 2011-14 supported by the IMF's Extended Facility (ECF). The recovery is anchored on the peaceful conclusion of the general elections held in March 2013 and sustained prudent macroeconomic policies.

4.1. Inflation Trends

Inflation decelerated sharply in 2012 (figure **8)**. Both the annual average and month-on-month overall inflation rates eased to 9.38 per cent and 3.20 per cent, respectively in December 2012, compared to 14.02 per cent and 18.93 per cent, respectively, in December 2011. The month-on-month overall inflation rate for 2012 was within the (5± 2.5) per cent target set by National Treasury. The non-food non-fuel inflation also decelerated from 11.3 per cent in January 2012 to 4.8 per cent in December 2012. Moderate inflationary pressure was forecast in the first half of 2013 on account of food and energy prices, but the proactive monetary policy stance currently pursued managed to stem off any potential threats.

Figure 8: Overall Inflation Trends

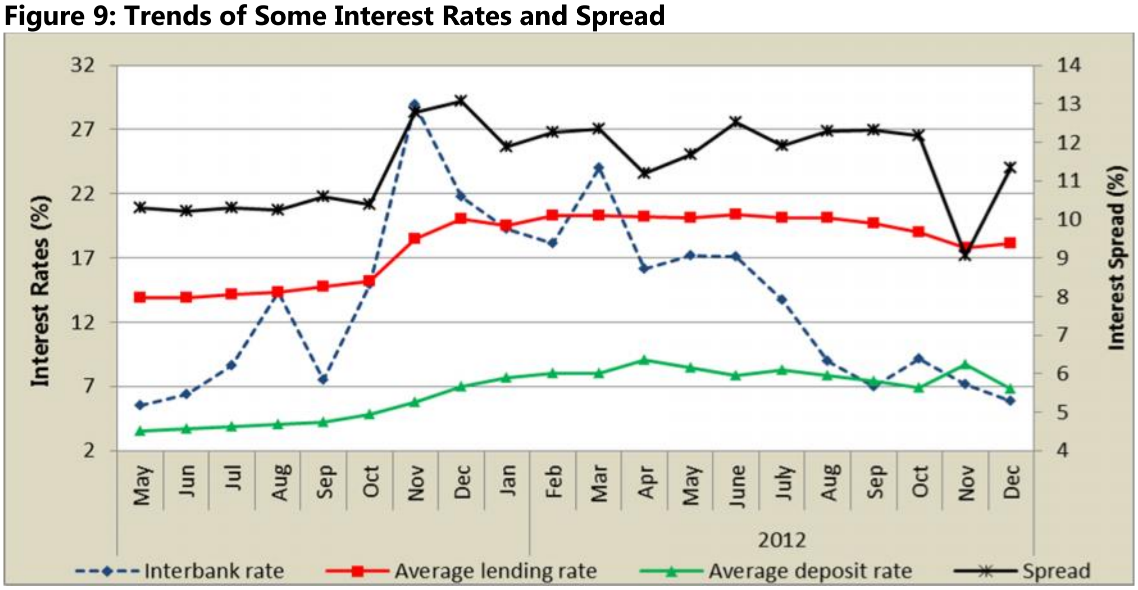


Source: Kenya National Bureau of Statistics

4.2. Interest Rates

To ease inflationary expectations and by extension pressure on interest rates, the CBK lowered its policy rate (CBR) starting July 2012 from the 18 per cent level previously maintained from January June 2012 to 11 per cent by December 2012. The aim was to signal to credit markets to follow suit and lower lending rates. Figure **9** shows that banks reciprocated by slightly reducing their base lending rates, translating into marginal decline in average lending rates. Interest rates spread, however, remained high due to marginal downward adjustment of average lending rates against deposit rates.

Figure 9: Trends of Some Interest Rates and Spread



Source: Central Bank of Kenya

The average deposit rate for banks was reduced with a bigger margin than average lending rates, thus, raising the spread as at end 2012. Rigidity in credit market adjustment of interest rates is a source of credit risk to borrowers and lenders.

4.3. Foreign Exchange Markets

The Kenya Shilling exchange rate was stable against the US dollar and EAC national currencies in 2012 compared to high volatility in 2011 (Table **3**). The stability is attributed to prudent monetary policy, effective management of interbank liquidity and improvement on conditions in the global markets in 2012. As a result, overall inflation responded positively, further bolstering confidence in the financial sector and in economic management.

Table 3: Kenya Shilling Against Select World Currencies

	2011	2012						
CURRENCY	Dec	Jan	Mar	June	August	Oct	Dec	% change: Dec. '11 - Dec. '12
US Dollar	86.66	86.34	82.90	84.79	84.08	85.11	85.99	- 0.77
Pound Sterling	135.10	133.94	131.18	131.95	132.05	136.81	138.78	2.73
100 Japanese Yen	111.33	112.23	100.60	106.91	106.93	107.84	102.79	- 7.67
Uganda Shilling*	28.25	27.90	29.96	29.30	29.63	30.29	31.09	10.06
Tanzania Shilling*	18.65	18.44	19.23	18.68	18.74	18.55	18.55	- 0.55
Rwanda Franc*	6.96	6.98	7.29	7.12	7.23	7.27	7.19	3.26
Burundi Franc*	15.11	15.18	15.64	16.49	17.03	17.30	17.57	16.31
Euro	114.15	111.42	109.55	106.51	104.20	110.35	112.77	- 1.21
Euro per US dollar	0.76	0.77	0.76	0.80	0.81	0.77	0.76	0.44
* Units of currency per Kenya Shilling								

Source: Central Bank

4.4. Balance of Payments Developments and Outlook

Kenya’s overall Balance of Payments position improved from a deficit of US$ 43 million in 2011 to a surplus of US$ 1,270 million in the year to December 2012. This was due to the increase in capital and financial account surplus that more than offset deterioration in the current account deficit (Table **4**).

The current account deficit widened to US$ 4,537 million or by 36.2 per cent in 2012 from US$ 3,330 million in 2011. This was driven by large increases in imports, which outstripped growth in export receipts. The deficit was financed through the financial account which recorded a US$ 2,556 million surplus on account of short term capital flows, official flows in form of syndicated loan and commercial banks’ reduction in foreign deposits holdings. Total foreign exchange holdings in the banking system increased from US$ 6,045 million in December 2011 to US$ 7,160 million in December 2012, and almost entirely in the holdings of official reserves.

Official reserves increased from US$ 4,248 million or 3.7 months of import cover in December 2011 to US$ 5,702 million or 4.3 months of import cover in December 2012. The reserve cover by December 2012 was within the statutory required minimum of 4 months. The level of foreign exchange reserves impacts on financial stability through the confidence and expectations channels. Significant deterioration in reserves could adversely impact the sentiments and expectations of foreign and local investors.

Table 4: Balance of Payments (US $ Millions)

ITEM	Year to Dec 2011*	Year to December 2012* Q1 Jan-Mar	Q2 Apr-Jun	Q3 Jul-Sep	Q4 Oct-Dec	Year to Dec 2012*	Absolute Change	% Change
1. OVERALL BALANCE	-43	448	487	185	106	1227	1270	-2960.6
2. CURRENT ACCOUNT	-3330	-965	-940	-1390	-1242	-4537	-1206	36.2
2.1 Goods	-9007	-2352	-2613	-2592	-2606	-10163	-1156	12.8
Exports (fob)	5807	1556	1470	1526	1575	6127	320	5.5
Imports (cif)	14814	3908	4083	4118	4181	16290	1476	10.0
2.2 Services	5676	1387	1673	1202	1364	5626	-50	-0.9
Non-factor services (net)	2566	799	1011	701	756	3266	700	27.3
Income (net)	7	-23	-48	-38	-28	-137	-145	-1985.9
Current Transfers	3103	611	710	539	636	2497	-606	-19.5
3. CAPITAL & FINANCIAL ACCOUNT	3288	1413	1427	1575	1348	5764	2476	75.3
3.1 Capital Tranfers (net)	235	47	51	15	42	155	-80	-34.0
3.2 Financial Account	3053	1366	1376	1560	1307	5609	2556	83.7
memo:								
Gross Reserves	6045	6165	7030	7214	7160	7160	1115	18.5
Official	4248	4688	5283	5476	5702	5702	1454	34.2
*imports cover***	3.1	3.4	3.7	3.8	3.9	3.9	1	24.1
*imports cover****	3.7	3.9	4.3	4.3	4.3	4.3	1	16.2
Commercial Banks	1797	1477	1747	1738	1458	1458	-339	-18.9

* Provisional.

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

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

Source: Central Bank of Kenya

As a share of GDP, current account deficit worsened from 9.70 per cent in December 2011 to 10.45 per cent in 2012. But some of the imports leading to the larger deficit are in infrastructure and power generation, which is largely growth promoting in the medium term to long term. Given the current account deficit the country faces, adverse developments in international financial markets would severely affect the domestic foreign exchange markets through to macroeconomic and financial stability. The exchange rate takes the first direct impact if deterioration worsens followed by foreign currency assets and liabilities of financial institutions.

4.5. Credit Markets and Outlook

Domestic credit from the banking sector grew by Ksh 197.4 billion (13.1 per cent) in 2012 down from Ksh 316.7 billion (26.7 per cent) in 2011 (Table **5**). The reduction is due to monetary policy tightening in the first half of 2012 and uncertainty in the run up to the March 4, 2013 general election. But private sector credit accounted for 75.4 per cent of total lending in December 2012 compared with 77.3 per cent in similar period in 2011. The private sector credit annual growth rate was 10.4 per cent in 2012 compared with 30.9 per cent in the year to December 2011 and against a target of 15.4 per cent in December 2012. The shortfall in credit to the private sector poses a risk to recovery of economic growth, with indirect knock on effect on financial sector stability especially when non-performing loans rise. In terms of credit allocation by private sector activity, the real estate accounted for 20.3 per cent; manufacturing accounted for 19 per cent; trade accounted for 16.7 per cent; building and construction accounted for 15.2 per cent; households accounted for 11.1 per cent; consumer durables accounted for 5.7 per cent; and business services accounted for 5.1 per cent.

Table 5: Banking System Net Domestic Credit (Ksh Billions)

	2011 December		2012 December		Absolute Change December		Annual %age Change December	
	Ksh bn	Share (%)	Ksh bn	Share (%)	2010/11	2011/12	2010/11	2011/12
1. Credit to Government	**311.6**	**20.7**	**368.8**	**21.7**	**33.8**	**57.3**	**12.2**	**18.4**
Central Bank	54.8	3.6	10.9	0.6	58.5	-43.9	-1573.4	-80.2
Commercial Banks & NBFIs	256.8	17.1	358.0	21.0	-24.7	101.2	-8.8	39.4
2. Credit to other public sector	**30.8**	**2.0**	**49.8**	**2.9**	**8.6**	**19.0**	**38.9**	**61.7**
Local government	2.3	0.2	2.9	0.2	2.4	0.6	-2088.2	24.8
Parastatals	28.5	1.9	46.9	2.8	6.2	18.4	27.8	64.7
3. Credit to private sector	**1162.7**	**77.3**	**1283.9**	**75.4**	**274.3**	**121.1**	**30.9**	**10.4**
Agriculture	53.2	3.5	57.5	3.4	11.5	4.3	27.6	8.1
Manufacturing	146.2	9.7	169.3	9.9	34.0	23.1	30.3	15.8
Trade	190.9	12.7	211.2	12.4	37.3	20.3	24.3	10.6
Building and construction	50.8	3.4	69.2	4.1	18.2	18.4	55.7	36.2
Transport & communications	87.4	5.8	75.8	4.5	27.2	-11.6	45.3	-13.3
Finance & insurance	29.9	2.0	32.7	1.9	7.1	2.8	31.2	9.3
Real estate	137.4	9.1	161.9	9.5	38.5	24.5	39.0	17.9
Mining and quarrying	25.3	1.7	25.0	1.5	10.7	-0.2	73.3	-0.9
Private households	163.8	10.9	177.2	10.4	40.2	13.4	32.5	8.2
Consumer durables	73.3	4.9	80.2	4.7	15.4	6.9	26.7	9.4
Business services	82.6	5.5	88.9	5.2	-5.0	6.2	-5.8	7.5
Other activities	121.9	8.1	135.1	7.9	39.2	13.2	47.4	10.8
4. TOTAL (1+2+3) *	**1505.1**	**100.0**	**1702.5**	**100.0**	**316.7**	**197.4**	**23.7**	**13.1**

* Absolute and percentage changes may not necessarily add-up due to rounding

Source: Central Bank of Kenya

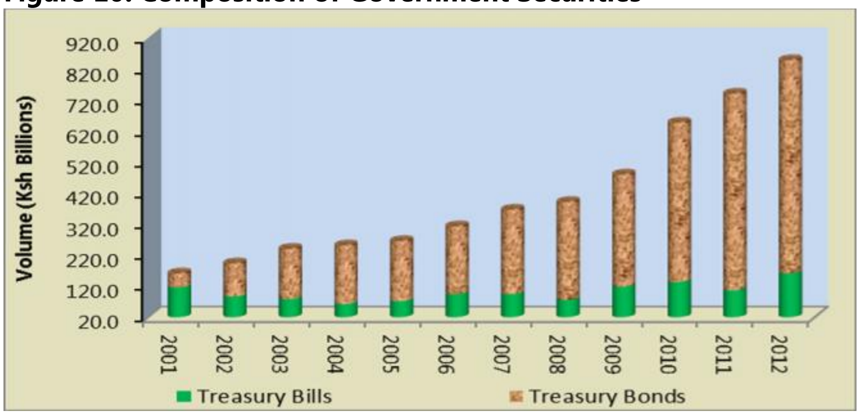
Net credit to government, at 21.7 per cent of total bank credit in 2012, grew to Ksh 368.8 billion in 2012 from Ksh 311.6 billion (20.7 per cent of all banks credit) in 2011. The stability in Government access to domestic banking resources show minimal risk of the crowding out private sector borrowing.

4.6. Domestic Debt markets and Cost-Risks Analysis

Domestic debt markets have been transformed since the re-launch of the Treasury Bonds Programme in early 2001. The aim was to restructure domestic debt from predominantly short to long-term. At the time, the ratio of Treasury Bonds to Bills was 21:78, with actual stock composition shown in figure **10**.

Deliberate strategies were adopted that reversed this unsustainable mix, such that by end of 2012, the composition of the domestic debt portfolio had changed to 81:19 in favour of Treasury Bonds. Consequently, average maturity of domestic debt lengthened from 8 months in 2001 to about 6 years before shortening to 5 years in 2012. The CBK issued more short term debt to balance cost and risk in the face of high interest rates in 2012. Short term debt means more frequent maturities, which is risky to the government in meeting its obligations, especially in times of uncertainty.

Figure 10: Composition of Government Securities



Source: Central Bank database

Lengthening of maturity profile imply that rollover risk of domestic debt reduced significantly, allowing the government enough time to raise revenues to settle both interest and principal amounts falling due. In addition, less frequent rollovers reduces pressure on interest rates, thus lowering interest rates risk to both issuer and investors. From investors' perspective, liquidity risk has been minimised as the bond holders have adequate time to trade their stocks, enabling them to fund their immediate liquidity needs. In terms of total stock, Government Securities (excluding Treasury bills held for Open Market Operations), rose from Ksh 160.9 billion in 2002 to 740.6 billion in 2011 and Ksh 848.8 billion in 2012.

The Bid-to-Cover Ratio that measure demand for government securities and liquidity conditions in the primary market signal the government's ability to meet its borrowing targets. The ratio can be computed in two ways: either as the number of bids received divided by the number of bids accepted, or the value of bids received divided by the value of bids accepted. A higher ratio indicates a strong or "bought" auction while a low ratio shows weak demand from the market1. This however assumes that the accepted amount is the same as the amount offered in order to accurately reflect the investor demand.

1 A ratio above 2.0 indicates a successful auction comprising of aggressive bids with narrow bid-ask spreads. A low ratio, especially below 1.0 signifies a disappointing auction, characterised by a wide bid-ask spreads. In such a scenario, investor demand for Treasury securities at anticipated rates is below expectation, which could lead to an underbought issue if the ratio falls below 1.0. The later outcome signals tight liquidity conditions while the former indicates a more liquid market.

As indicated in table **6**, the demand for Treasury Bonds was robust in 2012 compared to 2011. Overall, demand for government bonds in both 2011 and 2012 were above average as all the ratios are above 1.0. Note however the differences in the accepted bids against the offers, which can alter these ratios if the government accepted the exact amount it offered for sale.

Table 6: Demand for Treasury Bonds (Ksh Millions)

Month	2011			Bid-to-Cover Ratio	2012			Bid-to-Cover Ratio
	Offer	Receipt	Accepted		Offer	Receipt	Accepted	
Jan	16,000	30,504	11,896	2.56	10,000	31,793	14,942	2.13
Feb	18,000	36,420	23,015	1.58	27,700	52,431	28,147	1.86
Mar	18,000	28,390	20,369	1.39	10,000	15,147	14,970	1.01
Apr	18,000	10,492	6,253	1.68	5,000	27,715	6,469	4.28
May	18,000	19,140	18,715	1.02	3,000	6,357	4,980	1.28
Jun	18,000	19,006	9,001	2.11	5,000	4,069	446	9.12
Jul	13,000	15,323	6,793	2.26	10,000	17,211	12,505	1.38
Aug	10,000	8,715	3,525	2.47	10,000	30,301	16,315	1.86
Sep	30,000	21,223	14,775	1.44	15,000	24,154	19,526	1.24
Oct	10,000	2,630	233	11.29	12,000	25,120	13,787	1.82
Nov	20,000	24,503	23,603	1.04	12,000	10,924	3,175	3.44
Dec	10,000	18,119	11,103	1.63	15,000	37,894	20,777	1.82

Source: Central Bank

The Bid-to-Cover ratio for short term securities also reflect strong demand in 2012 as the government was able to cover its monthly borrowing targets. All indicators were above 1.0 as shown in Table **7**, implying adequate liquidity in the market and full funding of tender offers at the short end of the market. The performance in 2012 was more impressive owing to market normalcy and reduced volatility.

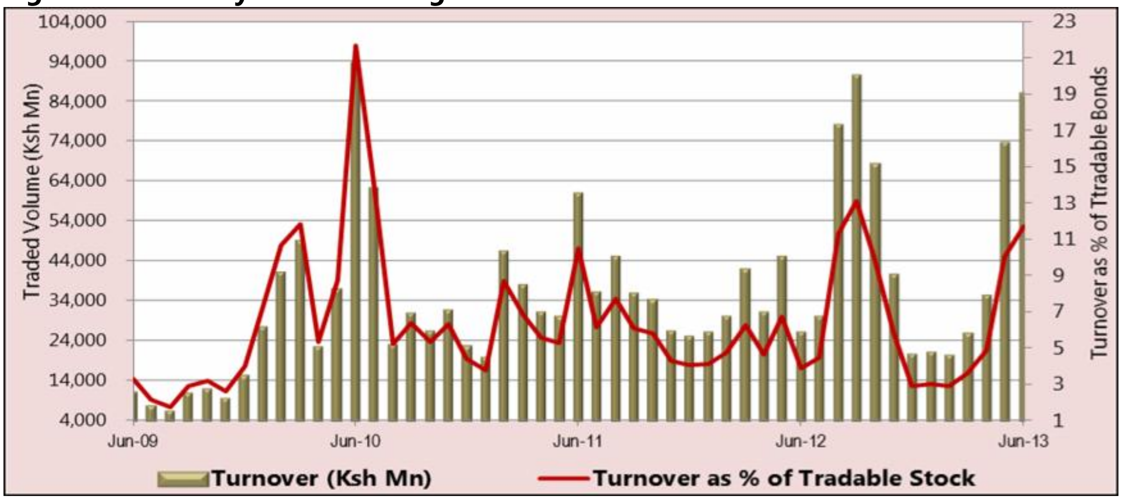
Table 7: Demand for Treasury Bills (Ksh Millions)

Month	2011			Bid-to-Cover Ratio	2012			Bid-to-Cover Ratio
	Offer	Receipt	Accepted		Offer	Receipt	Accepted	
Jan	30,000	32,847	26,636	1.23	38,000	53,470	38,316	1.40
Feb	19,500	26,723	22,708	1.18	31,000	49,662	39,334	1.26
Mar	18,000	27,965	19,746	1.42	31,000	46,352	29,466	1.57
Apr	17,500	19,299	12,196	1.58	35,000	45,052	33,724	1.34
May	21,000	33,810	29,036	1.16	18,000	38,689	17,265	2.24
Jun	19,500	84,174	42,018	2.00	18,000	9,428	9,218	1.02
Jul	18,500	18,814	14,464	1.30	29,000	21,103	14,939	1.41
Aug	10,000	19,279	16,835	1.15	39,000	106,176	47,398	2.24
Sep	32,500	43,800	36,481	1.20	39,000	42,179	31,186	1.35
Oct	40,000	41,517	35,137	1.18	46,000	34,837	23,369	1.49
Nov	31,000	12,564	12,186	1.03	36,000	107,545	60,490	1.78
Dec	31,000	37,662	20,837	1.81	42,000	31,831	29,347	1.08

Source: Central Bank

Bonds' trading at the Nairobi Securities Exchange was vibrant in 2012 as indicated in figure **11**. This was supported by issuance of new benchmark bonds, and declining interest rates hence rising bond prices, making returns on bond more attractive as compared to 2011. The CBK monetary policy actions restored investor confidence in the market, hence improved demand for Government securities, both in the primary and secondary markets. The 2012 trading activity mirrored trading in 2010.

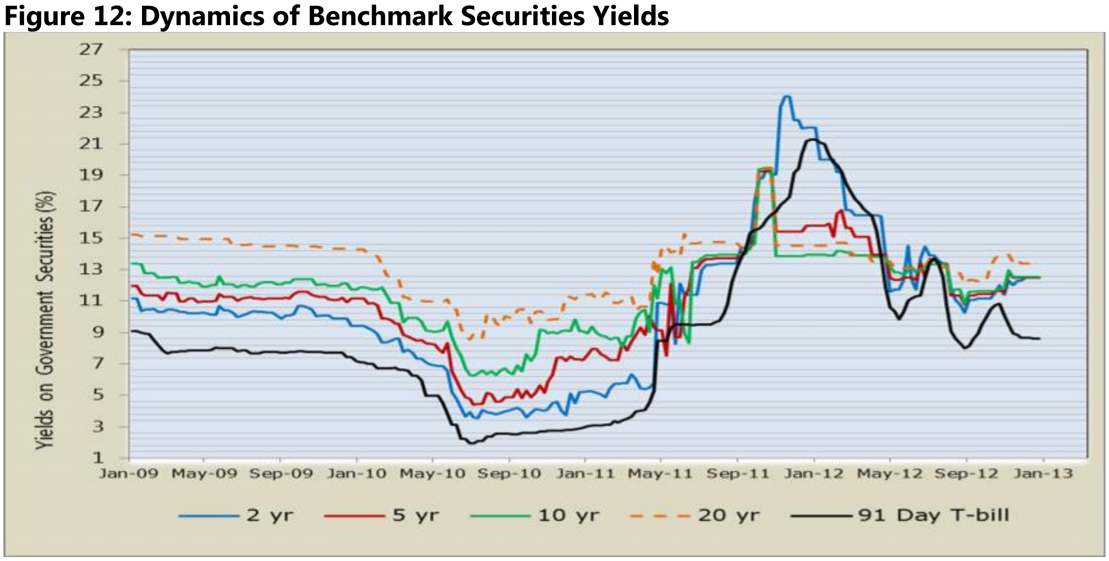
Figure 11: Monthly Bonds Trading at the NSE for 2009 - 2012



Source: Central Bank of Kenya and Nairobi Stock Exchange

Yields on government bonds normalised both in the primary and secondary markets in 2012, albeit with some volatility as macroeconomic environment improved. Yield curves of all benchmark tenors drifted downward in the second half of 2012 as shown in figure **12.** This was after hitting historical highs in the second half of 2011 to early 2012. The yields in 2012 have declined to levels last attained around mid-2010. Short end of the yield curve however remained under downward pressure.

Figure 12: Dynamics of Benchmark Securities Yields



Source: Central Bank of Kenya and Nairobi Stock Exchange

The government yield curve was inverted in 2011 following pressure on short term interest rates shown in figure **13.** The market has since undergone correction in response to policy actions taken by the CBK. The 2012 yield curve has now assumed the shape it was in 2010 and its current position is consistent with the overall stability in the macro-financial conditions in the country as opposed to instability of 2011.

Figure 13: Government Securities Yield Curves, 2009 - 2012

Source: Financial Markets database, CBK

4.7. Risks in the Domestic Debt Markets

4.7.1. Refinancing Risk

One of the most important factors that influence Government debt issuance strategy is ***refinancing (rollover) risk***. Refinancing risk is the possibility that a borrower cannot refinance maturing obligations through new borrowing in the market if current investors are not willing to reinvest their money in the same securities for whatever reasons. In absence of other funding alternatives, this can lead to government default on its debt falling due in the face of fiscal constraints. Refinancing risk can be measured by the average time to maturity of the debt stock. The higher the average time to maturity, the lower the refinancing risk of debt and less upward pressure on interest rates.

Table 8: Average Time to Maturity Domestic Debt

Year	**2008**	**2009**	**2010**	**2011**	**2012**
Average Time To Maturity (Years)	3.42	4.25	5.17	5.75	4.92

Source: Central Bank

Taking cognizance of this risk, the National Treasury and CBK have pursued deliberate policy measures, including benchmark bonds issuance and extending the yield curve to 30 years and reopening of existing maturities. Consequently, the average maturity profile of all outstanding Treasury securities lengthened from 8 months in 2001 to 5.8 years in 2011 before shortening to 4.9 years in 2012 as shown in table **8.** The shortening in 2012 was due to issuance of more short-term debt to minimize interest risks and cost to government when market rates were very volatile.

4.7.2. Interest Rate Risk

Interest rate risk arises from volatility of interest rates and affects both issuers and investors. In designing a debt management strategy, a key strategy is to conduct the cost-risk analysis on the type of debt to procure. The interest rate risk level on a security depends on how sensitive its price is to the changes in the market interest rate, with securities' time to maturity, and price or coupon being key factors. The interest rates risk was higher in 2011 than it was in 2012 (figure **12**).

4.7.3. Market Liquidity Risk

Liquidity risk is associated with inability to unwind a position or sell off a security through the market without significant change in prices. Market reforms like introduction of the Automated Trading System (ATS) and, benchmark bonds reopening, saw trading rise and liquidity in the secondary market increase. It is now easier to liquidate bonds at NSE, which has materially lowered market liquidity risk.

4.8. Public Debt Sustainability Analysis (DSA)

Kenya's risk of external debt distress still remains low2. Under both the baseline scenario and the stress tests, Kenya's external debt ratios do not breach the relevant policy-dependent thresholds. All debt burden indicators have improved compared to the previous DSA results on lower than expected primary deficit and non-interest current account deficit for both 2011 and 2012. Appreciation of the local currency against USD also contributed to this scenario.

The 2012 Joint IMF/World Bank DSA for Kenya shows more favourable indicators compared to the January 2011 DSA. At 43 per cent, the public debt-to-GDP ratio in 2012 was lower than originally projected (at 48 per cent) in the 2011 DSA due to fiscal consolidation, improved macroeconomic environment, and better debt and budget management capacities. While external debt sustainability is threatened by a shock to the exchange rate and less favourable terms on new public sector loans, the biggest risk to overall public debt sustainability would be a lower economic growth rate and contingent liabilities materialising. Sustainability of Kenya's debt depends on continuing with a prudent borrowing strategy and maintaining stable macroeconomic outlook.

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2 World Bank classifies Kenya as a "medium performer" in terms of the quality of its policies and institutions as measured by a 3-year average of the World Bank's Country Policy and Institutional Assessment (CPIA) Index. The thresholds for this category are: 40% for the NPV of debt-to-GDP ratio, 150% for the NPV of debt-to-exports ratio, 250% for the NPV of debt-to-revenue ratio, 20% for the debt service-to-exports ratio, and 30% for the debt service-to-revenue ratio. The thresholds are applicable to public and publicly guaranteed external debt.

5. FINANCIAL SECTOR DEVELOPMENTS AND OUTLOOK

This chapter covers trend analysis and Financial Soundness Indicators for the; banking, capital markets, Saccos, Insurance, Deposit Insurance, Pension industry, and payments infrastructure.

5.1. BANKING INDUSTRY

As at 31st December 2012 banking system comprised of **43** commercial banks, **1** mortgage finance company, **5** representative offices of foreign banks, **8** Deposit-Taking Microfinance Institutions, **2** credit reference bureaus, and **112** Foreign Exchange Bureaus, all under the regulatory and supervisory oversight of the Central Bank of Kenya, as the regulator and monetary authority.

5.1.1. Growth of the sector

The banking system performed better in 2012; with growth in pre-tax profits, total assets, and total deposits. But, assets quality declined due to high interest rates in 2011 that extended into the first half of 2012. Total net assets increased by 15.3 per cent from Ksh 2,020.8 billion in December 2011 to Ksh 2,330.3 billion in December 2012 due to growth in loans and advances. Loans and advances, government securities and placements were key components of banks' balance sheet, accounting for 55.6 per cent, 17.7 per cent and 6.2 per cent of total net assets respectively. Net loans and advances rose by 12.5 per cent from Ksh 1,152.0 billion in December 2011 to Ksh. 1,296.5 billion in December 2012. However, placements decreased by 12.4 per cent from Ksh 116.8 billion to Ksh 102.3 billion during the period, due to higher credit uptake. Customer deposits, the main source of the banks funding, increased by 14.8 per cent from Ksh 1,488.2 billion in 2011 to Ksh 1,707.8 billion in 2012 due to branch network expansion and receipts from exports.

5.1.2. Capital Adequacy

The Bank requires commercial banks to comply with capital adequacy prudential ratios. The minimum regulatory capital adequacy requirement which is measured by the ratio of core capital and total capital to total risk weighted assets is 8 per cent and 12 per cent respectively. The observed ratios increased from 18 per cent and 21 per cent in 2011 to 20 per cent and 23 per cent, respectively in 2012. Similarly, the ratio of core capital to total deposits increased from 16 per cent in 2011 to 17 per cent in 2012, reflecting an increase in banks' capital base funded by retained earnings and injection of fresh capital. All banks, except two in the small peer group met the minimum core capital base of Ksh 1.0 billion as at December 2012. The two banks were affected by increased provisions for loan losses and CBK took appropriate and prompt corrective actions to ensure these banks upscale their capital in line with the set requirements because of downside risks posed to the system.

5.1.3. Asset Quality

The high interest rates regime that extended up to the first half of 2012 impacted negatively on the quality of loans and advances. Non-performing loans (NPLs) increased by 16.8 per cent from Ksh 53 billion in 2011 to Ksh 61.9 billion in 2012. The ratio of gross NPLs to gross loans increased from 4.4 per cent to 4.7 per cent, reflecting elevated credit risk. The CBR, a signalling tool on the direction of lending rates, declined from 18 per cent in January 2012 to 11 per cent in June 2012, and remained at this level by end December 2012. This affected interest rates charged by banks and subsequently a strain on assets quality.

5.1.4. Liquidity

Liquidity held by commercial banks reflects their ability to fund increases in assets and meet obligations falling due. As one of the key indicators of financial stability, shortfall in liquidity in one bank can cause systemic crisis in the entire banking sector due to their linkages in operations. The banking sector average liquidity in 2012 was above the statutory minimum requirement of 20 per cent, rising to 41.9 per cent as at December 2012 compared to 37.0 per cent in 2011 for the sector. This increase was attributed to increased deposits being channelled to liquid assets than to lending. Consequently, the ratio of gross loans and advances to deposits reduced from 80.0 per cent in 2011 to 77.9 per cent in 2012.

5.1.5. Profit and Loss

Profit before tax for the banking industry rose by 20.6 per cent from Ksh 89.5 billion in 2011 to Ksh 107.9 billion in 2012 due to the growth in credit portfolio and investment in government securities. Interest income constituted 60.8 per cent of total income in 2012 compared to 55.4 per cent in 2011. Four banks returned losses totalling Ksh 2.62 billion in 2012 compared to two banks that had losses totalling Ksh 0.22 billion in 2011. Losses were due to high interest rates in the first half of 2012.

5.1.6. Sensitivity to market risks

Exposure by banks to changes in foreign exchange rates improved in 2012. The net foreign exchange position to core capital declined from an average of 3.3 per cent in 2011 to an average of 2.6 per cent in 2012. Foreign currency loans to foreign currency deposits increased from 77.0 per cent to 95.7 per cent in the same period, indicating improved matching. Similarly, the ratio of assets to liabilities both denominated in foreign currency improved from 65.0 per cent to 75.8 per cent 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.

5.1.7. Distribution of Gross Loans, Loan Accounts and Non-Performing Loans

Majority of the loans and advances were extended to personal, trade, manufacturing and real estate sectors, accounting for 71 per cent of gross loans in 2012. Over 72 per cent of the total loan accounts were in personal/household sector, with 25 per cent share of the banking industry credit and 33 per cent of the NPLs. Trade, manufacturing and real estate sectors accounted for 46.6 per cent of the sector's credit and 40.5 per cent of NPLs as shown in Table **9**.

Table 9: Loan Book Distribution (Ksh Millions)

Sectors	No. of Loan Accounts	% of Total	Gross Loans	% of Total	Gross NPLs	% of Total
Agriculture	118,508	5.7	65,085	4.9	4,435	7.2
Manufacturing	22,577	1.1	179,608	13.5	4,016	6.5
Building & Construction	12,560	0.6	68,622	5.2	2,553	4.1
Mining and Quarrying	1,338	0.1	14,242	1.1	307	0.5
Energy and Water	6,168	0.3	52,177	3.9	1,002	1.6
Trade	327,713	15.6	263,743	19.8	13,852	22.4
Tourism, Rest. & Hotels	5,875	0.3	32,297	2.4	1,846	3.0
Transport & Communication	32,484	1.6	98,849	7.4	4,751	7.7
Real Estate	25,277	1.2	176,920	13.3	7,181	11.6
Financial Services	18,208	0.9	51,379	3.9	1,435	2.3
Personal/Household	1,524,744	72.8	327,444	24.6	20,540	33.2
Total	**2,095,452**	**100.0**	**1,330,365**	**100.0**	**61,917**	**100.0**

Source: CBK database

The sector's NPLs to gross loans ratio stood at 4.7 per cent as at end of December 2012 with six sectors; Agriculture, Personal, Tourism, Manufacturing, Trade and Transport registering ratios above the industry average.

5.1.8. Financial Soundness Indicators (FSIs)

CBK adopted the Bank for International Settlements (BIS) Basel Committee of Banking Supervision and the IMF prescribed FSIs for monitoring and evaluating performance of financial institutions. Some of the FSIs provided in the Banking Act and prudential guidelines which banks should adhere to are captured in Table **10**. As at end of December 2012, all banks except two, met the minimum capital adequacy ratios. All institutions also observed the minimum core capital to deposits ratio, liquidity ratio and the maximum foreign currency exposure limit of 10 per cent.

Table 10: Core Financial Soundness Indicators (FSIs)

	Measure	Dec-2011	March 2012	June 2012	Sept-2012	Dec-2012
	CAPITAL ADEQUACY					
1	Total Capital to Risk-Weighted Assets **(Min 12%)**	21.1	19.7	20.3	20.5	23.1
2	Core Capital to Risk-Weighted Assets **(Min 8%)**	18.3	17.4	17.7	17.6	20.2
3	Core Capital to Deposits **(Min 8%)**	16.2	15.4	15.3	15.2	17.3
4	Total Capital to Total Assets	13.2	13.1	13.4	13.3	14.2
	ASSET QUALITY					
5	NPLs to Gross Loans	4.4	4.3	4.5	4.6	4.7
6	NPLs Net of Provisions to Capital	3.5	3.1	3.6	4.0	3.5
7	Earning Assets to Total Assets	87.8	87.6	87.7	87.0	87.4
	EARNINGS & PROFITABILITY					
8	Return on Assets (ROA)	4.4	3.8	4.0	3.7	4.6
9	Return on Equity (ROE)	30.7	32.9	33.3	32.0	29.8
10	Interest Margin to Gross Income	38.6	31.3	31.5	31.7	32.7
11	Non-Interest Expenses to Gross Income	44.6	36.9	36.2	36.8	37.8
	LIQUIDITY					
12	Liquid Assets To Total Assets	33.3	33.3	34.2	35.4	35.2
13	Liquid Assets to Short-term liabilities (Liquidity ratio) (**Min 20%)**	37.0	37.3	38.1	41.2	41.9
14	Liquid Assets to Total Deposit	43.8	44.4	45.0	47.0	46.8
15	Total Loans to Total Deposits	77.4	78.7	77.2	76.2	76.9
	SENSITIVITY TO MARKET RISK					
16	Net open position in Foreign Exchange to Capital **(Max. 10%)**	3.3	3.4	3.4	3.3	2.6
17	Interest Bearing Assets to Interest Bearing Liabilities	115.4	116.9	115.3	115.7	116.2
18	FX Currency Denominated Assets to Total Assets	11.8	12.1	12.8	12.8	13.2
19	FX Currency Denominated Liabilities to Total Liabilities	21.5	21.6	22.3	20.7	20.9
20	Spread between lending and deposit rate	8.4	10.0	9.9	10.0	10.3

Source: Bank Supervision, CBK

5.1.9. Stress Testing

CBK conducts monthly stress tests on individual banks to establish points of weaknesses against certain shocks or risk factors. Stress testing involves identifying plausible future changes in economic conditions or other possible events that could trigger unfavourable effects on a bank's risk exposures. For illustration, we assume that the GDP for 2013 grows below the 4.6 per cent registered in 2012 due to effects of high oil prices, high interest rates and expectations of high inflation. This will impact negatively on certain sectors in servicing their credit. CBK analysed the monthly changes in NPLs, deposits and exchange rates over a 10 year period to study the trends for purposes of designing appropriate stress factors in assessing banking system resilience. Based on the 2012 data, plausible scenarios were used to stress the system's resilience to credit risk; liquidity risk; and market risk; whose results are presented in Table **11**.

Table 11: Micro-Stress Testing Results

Risk	Stress factor (%)	Number of banks impacted
Credit Risk		
Personal and trade sectors	15% increase in NPLs	Capital adequacy ratio of **1** bank in a small peer group will drop to 9.6% 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 sectors	10% increase in NPLs	
Liquidity Risk		
Decline in deposits	5% decline in deposits	**4** banks will have liquidity range between 14.1% and 19.0% below the statutory threshold of 20%.
Market Risk		
Weakening of the shilling	Kenya Shilling depreciates by 5% against the USD	A weakening shilling impacts on both credit risk and foreign currency exposure.

Source: Bank Supervision

Overall, stress tests results on credit risk reveal that it would require significant increase in NPLs for a large bank to fail to meet the minimum statutory capital adequacy ratio. A total of **3** banks in small peer group and **1** bank in the medium 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. However, these banks have instituted mechanisms including interparty agreements to manage their short-term liquidity requirements. If there is a 5 per cent sudden depreciation of the shilling, all the banks would comply with the exposure limit of up to 10 per cent net open position in foreign exchange to core capital ratio. In addition, the proportion of loans in foreign currency constituted less than 22 per cent of the banking sector's credit and banks have endeavoured to match loans and liabilities denominated in foreign currency.

The CBK issued a prudential guideline on stress testing which will come into effect in January 2013. Under the guidelines, banks are required to conduct stress tests regularly and submit reports to CBK on quarterly basis to enable the regulator to monitor and continuously engage banks on the kind of contingent plans they have put in place to mitigate risks and vulnerabilities in their businesses.

5.1.10. Regional Expansion of Kenyan banks

Kenyan banks have established subsidiaries in the East African Community (EAC) including South Sudan. As at end of 2012, eleven Kenyan banks had 282 subsidiaries operating in the region and returned a profit before tax of Ksh. 5.1 billion. The CBK signed Memorandum of Understanding (MoU) with the other regional central banks to promote information sharing on supervisory areas. The MoU allows the respective central banks to share supervisory information including undertaking joint inspections of banks with cross-border operations. Joint inspections have necessitated the on-going harmonization of supervisory regulatory frameworks and practices. CBK has also issued a guideline on consolidated supervision effective January 2013 to allow it to effectively supervise banks that operate as groups. This will ensure that the subsidiaries are closely monitored to minimize potential risks from their operations that may affect the bank and the group.

5.1.11. Banking System Stability Outlook

The banking system is forecast to sustain its growth trajectory supported by the increased regional expansion of Kenyan banks and large domestic potential as devolved county government system takes effect. However, the sector will continue to face some downside risks. During the first half of 2013, interest income is likely to be affected by the reduction in CBR. The aggregate credit risk to the banking system though mild, the increase in NPLs remain a concern for the soundness of some banks. However, the reduction in inflationary pressures should have a positive impact on the economic activities and subsequently enable various economic sectors to service their loans and advances. CBK will closely monitor those banks whose stability is threatened by NPLs to ensure that lending standards remain high and that loans quality does not deteriorate further.

5.2. DEPOSIT PROTECTION

At close of December 2012, total number of member institutions was **52** comprising **43** commercial banks, **1** mortgage finance company and **8** deposit taking microfinance institutions. Charterhouse Bank still remains under statutory management and a member of the Fund. Total deposit accounts with the member institutions increased from 15.65 million in 2011 to 17.62 million in 2012, a 13 per cent increase. This growth is due; financial inclusion initiatives by CBK, introduction of M-Shwari accounts by Commercial Bank of Africa in conjunction with Safaricom, Agency banking by banks; aggressive marketing by banks and stable macroeconomic environment. Table **10** shows quarterly growth in accounts numbers.

Table 12: Growth in the Number of Deposit Accounts

	Dec 2011	Mar 2012	June 2012	Sept 2012	Dec 2012
Total No. of A/Cs	15,655,180	15,878,056	16,470,987	16,733,467	17,617,636
Quarterly Increase	489,640	221,281	592,931	262,480	884,169
Change in A/Cs Nos.	3.2%	1.4%	3.7%	1.6%	5%

Source: Deposit Protection Fund Board

5.2.1. Growth of the Fund

The Protection Fund grew by Ksh 5.6 billion on account of prudent investment policies adopted by the Board. The funds are placed in a portfolio mix of both short and long terms Government securities as required by Law and in line with the approved Board policy, which seeks to achieve optimum yield mix in its investment portfolio while taking cognisance of the prevailing economic environment. The positive growth is also due to stable financial sector on enhanced supervision, risk management policies adopted by the industry, and financial inclusion initiatives.

Table 13: Growth of the Fund, Insurance Cover & Deposits

Indicator	Dec 2011	Mar 2012	June 2012	Sept 2012	Dec 2012
Total A/Cs	15,655,180	15,878,056	16,470,987	16,733,468	17,617,636
Total Deposits (Sh'000')	1,556,532,722	1,577,267,839	1,678,444,307	1,737,312,114	1,781,861,978
Insurance Cover (Sh'000')	169,363,100	167,838,038	170,931,327	174,787,812	187,439,829
Fund Growth (Sh'000')	31,961,400	32,363.000	33,284,581	36,560,976	37,517,558

Source: Deposit Protection Fund Board

By end of 2012, deposits with member institutions totalled Ksh1.78 trillion, an increase of 14.5 per cent while total protected deposits amounted to Ksh187.44 billion an increase of 10.7 per cent over the previous year. Total deposit accounts in the sector were 17.62million while the fully protected accounts were 16.65million, representing 94 per cent of the total accounts in the sector.

5.2.2. Protection and Risk Exposure

As at 31st December 2012, the Fund Balance was Ksh 37.52 billion compared to protected deposits of Ksh.187.44 billion, leaving high exposure level of 80 per cent. However, the number of deposit accounts fully covered was 16.65 million out the total 17.62 million, implying 94 per cent coverage in number but 20 per cent coverage in value. Value coverage falls below the international benchmark of 40 per cent coverage. This is however mitigated by a stable financial sector. The protection and exposure indicators have been summarised in table **12**.

Table 14: Protection & Exposure Indicators as at End of December 2012

	BANKING SECTOR DEPOSITS	Dec 2011	Dec 2012	% Change
1	Total Deposits(Ksh. M)	1,556,533	1,781,862	14%
2	Protected Deposits (Ksh. M.)	169,363	187,440	11%
3	Protection Level (2/1)	11 %	11%	0
4	Funds Balance (Ksh. M)	31,961	37,518	17 %
5	Effective Cover (4/2)	19%	20%	5%
	DEPOSIT ACCOUNTS			
6	Deposits accounts ('000')	15,655	17,618	13%
7	Accounts fully protected ('000')	14,762	16,647	13%
8	Share of Protected accounts (7/6)	94 %	94%	0
9	Exposure Level (row 2-row 4/row2)	81%	80 %	(1%)

Source: Deposit Protection Fund Board

5.2.3. The Kenya Deposit Insurance (KDI) Act, 2012

In efforts to transform the current Deposit Protection Fund Board (DPFB), The Kenya Deposit Insurance Act, 2012 ("the Act") was assented to by the President and published on May 14th, 2012. The Act will become operational by gazette notice when published by the Minister of Finance.

The KDI Act establishes the Kenya Deposit Insurance Corporation ("KDIC") as a body corporate that shall take over the powers, obligations, assets and liabilities of DPFB. The key highlights of the KDI Act are:

a) KDIC mandate is much broader than that of DPFB. KDIC is empowered to undertake supervision and problem bank resolution functions.
b) Enhances the corporate governance of KDIC, by providing a wider Board composition under a non-executive Chairman.
c) The Act contains elaborate provisions for the inspection of member institutions in collaboration with the Central Bank and for enforcement actions that may be taken to remedy breaches.
d) Provides for appointment of KDIC as Receiver or liquidator in instances where an institution has been declared insolvent or engaged in malpractices or activities that are contrary to the provisions of Kenyan or other applicable law.
e) The Act provides for offences and penalties, and has elaborate provisions for efficient transition from DPFB to KDIC.

The DPFB will in the year 2013 embark on the drafting of regulations and guidelines to operationalize The Kenya Deposit Insurance Act, 2012

5.3. CAPITAL MARKETS INDUSTRY

Primary markets recorded good performance in 2012, with two (2) companies - Longhorn Kenya and CIC Insurance Group listing by introduction at the Nairobi Securities Exchange (NSE). The UAP Holdings launched a public share sale while SMEP Deposit Taking Microfinance Limited launched a share offer to raise Sh1.6 billion for its expansion. Uganda's power distributor, Umeme Limited, was cross-listed at the NSE. The Bond segment of NSE had eleven (11) new Government Bond issues and three (3) re-openings, raising a total of Ksh 146.7 billion (USD 1,725 Million), most of which were highly oversubscribed.

Table 15: Select Stock Markets Performance - US Dollar-Adjusted Returns by end 2012

Market Index	1-Year Return	3-Year Return	5-Year Return	6-Year Return
Botswana Stock Exchange	3.5	-9.8	-28.3	-3.5
Dar es Salaam Stock Exchange	13.5	6.4	5.5	21.9
Ghana Stock Exchange	17.0	9.0	N/A	N/A
Johannesburg Stock Exchange	16.4	31.3	24.8	44.2
Lusaka Stock Exchange	-12.4	21.7	-22.2	76.7
Nairobi Securities Exchange	53.9	40.5	-17.3	-1.3
Namibian Stock Exchange	18.3	62.0	68.2	153.%
Nigerian Stock Exchange	54.5	59.4	-52.7	-0.6
Stock Exchange of Mauritius	-4.6	1.5	-25.9	77.0
Uganda Securities Exchange	28.0	17.6	-22.2	-6.0
S&P 500	13.4	26.6	-2.9	0.6

Source: http://investinginafrica.net/african-stock-markets/african-stock-market-performance/

In the secondary market, NSE 20 Share Index and FTSE 15 index closed the year at 4,133.02 and 125.75 points respectively, gaining 28.95 per cent and 39.24 per cent from its opening level in January 2012. In addition, the NSE 20 Share index, which closed at 3,205.02 points in 2011, has become the third highest gainer among stock exchanges in Africa and Middle East, after the Egyptian and Nigerian Securities Exchanges, and the eighth globally, as indicated in table **15**.

5.3.1. Foreign Portfolio Investment

Foreign investors accounted for about 49 per cent of total traded equity value as indicated in table **16,** most of them on the buy side.

Table 16: Net Foreign Investors Equity Flows at NSE (Ksh Millions)

Month	Dec. 2010	Dec. 2011	Dec. 2012
January	2,516.57	1,987.00	-812.00
February	489.43	622.21	795.00
March	1,997.76	1,552.00	2,651.00
April	151.06	-3,024.00	1,771.00
May	-325.37	-3,334.00	1,099.00
June	1,601.05	-1,597.00	1,639.00
July	1,160.19	1,173.00	828.00
August	472.56	621.00	1,048.00
September	1,205.49	535.00	3,286.00
October	2,146.91	719.00	2,965.00
November	2,525.68	31.00	4,335.00
December	1,185.52	935.00	2,129.00
Total	**15,126.84**	**220.21**	**21,734.00**

Source: Source: CMA Statistical Database and NSE

Foreign portfolio equity inflow between 2011 and 2012 rose from Ksh 0.22 billion to Ksh.21.73billion, a 9769.7 per cent increase. This was mainly driven by strong gains across all the counters, which were generally under-priced. Local investors also switched to equities as money market yields declined following general downward trend in the short term interest rates.

As indicated in table **17**, capital markets were bullish in 2012 as reflected in leading market indicators. Number of listed firms, market capitalization, share of equity turnover to GDP, and foreign investor participation, all had impressive growth. Secondary bond market had a 27 per cent increase in bond turnover, from Ksh 445 billion in 2011 to Ksh 566 billion in 2012. The year also saw 5 Rights Issues in the market, four of which were heavily oversubscribed and one was undersubscribed at 70 per cent. Market capitalization added Ksh 403 billion to close 2012 at Ksh 1.3 trillion, a mark last reached in 2008 on Safaricom share listing.

Table 17: Secondary Markets Performance Indicators

MEASURE	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12
Market Performance					
NSE 20 Share Index *(End of Period)*	3,205	3,367	3,704	3,972	4,133
Foreign Investors					
Domestic Shareholders (%)	80.6	80.9	80	79.6	78.7
Foreign Shareholders (%)	19.4	19.1	20	20.4	21.3
Foreign Investors (Turnover)	36.75	42.84	51.33	48.75	53.74
Foreign investors' equity holdings (%)	28	31	32	32	42.8
Market Concentration					
Top 3 firms to Market Capitalisation (%)	37.3	39.4	36.6	36.2	37.7
Top 10 firms to Market capitalisation (%)	72	77	70	73	72
Market Size					
Number of Listed Domestic Firms	57	58	59	60	61
End year Market Capitalization - (Ksh Bn)	868.2	940	1,048	1,143	1,272
Quarterly Equity Turnover (Ksh Bn)	12.4	13.42	22.67	21.50	29.20
Equity Turnover as a % of GDP	0.5	0.44	0.74	0.70	0.96
Market liquidity					
Quarterly Equity Turnover Ratio–(%)	1.4	1.4	2.17	1.88	2.30
Bond Market					
Quarterly Bonds Turnover (Ksh Bn)	86.14	99.45	111.11	216.26	138.16
Bond Turnover as a % of GDP	3.2	3.3	3.6	7.1	4.5

Source: CMA Statistical Database and NSE

5.3.2. Capital Markets Licensees

A total of 11 categories of capital market intermediaries comprising 97 players were licensed in 2012 compared to 94 players in 2011. There were additional 2 fund managers and 1 custodian licensed to operate. Total profits before tax for the licensees of CMA (Investment Advisors, Fund Managers, Investment Banks and Stock Brokers) grew by 114 per cent from 634.39 million in 2011 to Ksh 1.36 billion in 2012, with total assets rising marginally, from Ksh 16.31 billion to Ksh 16.65 billion respectively. Collective investment schemes posted better results in 2012 compared to 2011 as profits grew by 365 per cent from a total loss of Ksh 1.69 billion in 2011 to a total profit of Ksh 4.2 billion in 2012. This was mainly due to the unrealized losses on many investments in 2011, which reversed in 2012 as prices of most securities appreciated. Total assets under management in all the Collective Investment Schemes (CISs) grew by 22 per cent from Ksh 23.04 billion in 2011 to Ksh 28.16 billion in 2012. Aggregate Return on Assets for all licensees increased from 3.9 per cent in 2011 to 8 per cent in 2012 while Aggregate Return on Equity (ROE) grew from 5.7 per cent in 2011 to 12.44 per cent in 2012.

5.3.3. Capital Adequacy

All stock brokers and investment banks maintained or exceeded capital adequacy ratios as per the statutory requirements. In addition, statutory limits on paid up share capital, shareholders' funds, working capital and unsecured advances improved in 2012 as shown in Table **18**.

Table 18: Capital Markets Soundness Indicators

FINANCIAL SOUNDNESS INDICATORS	31 Dec 2011	31 Dec 2012
CAPITAL ADEQUACY		
Core capital to Total Assets (%)	71.5	62.0
Core Capital to Total deposit liabilities (%)	353.0	304.5
Institutional Capital to Total Assets (%)	72.0	64.0
Cost to Income Ratio (%)	97.0	84.0

Source: CMA Statistical Database and NSE

5.3.4. Profit and Loss

Except for investment advisors, all other licensees reported increased profits before tax in 2012 compared to 2011 as indicated in Table **19**. Total investments by shareholders of licensees were unchanged, implying more returns on their investments in 2012 compared to 2011. Shareholders of fund managers got the highest returns of 29.44 per cent on their investments compared to Stock brokerage owners that got 3.29 per cent.

Table 19: Performance Indicators for Licensees

Year Ended Dec 31, 2012									
	Total Income	Total expenses	Profit before tax	Income after tax	Total assets	Total Liabilities	Net Assets	Return on Equity	Return on Assets
	Kshs' 000	Kshs' 000	Kshs' 000	Kshs' 000	Kshs' 000	Kshs' 000	Kshs' 000	%	%
Stock Brokers	915,463	817,925	97,538	32,855	4,071,646	1,109,704	2,961,942	3.29	2.40
Investment Banks	2,399,375	1,897,026	502,349	432,400	8,642,795	3,564,399	5,078,396	9.89	5.81
Fund Managers	3,306,541	2,579,433	727,108	493,901	3,338,723	869,199	2,469,524	29.44	21.78
Investment advisers	617,017	582,432	34,585	23,342	599,522	160,293	439,229	7.87	5.77
Totals	**7,238,396**	**5,876,816**	**1,361,580**	**982,498**	**16,652,686**	**5,703,595**	**10,949,091**	**12.44**	**8.18**
Year Ended Dec 31, 2011									
	Total Income	Total expenses	Profit before tax	Income after tax	Total assets	Total Liabilities	Net Assets	Return on Equity	Return on Assets
	Kshs' 000	Kshs' 000	Kshs' 000		Kshs' 000	Kshs' 000	Kshs' 000	%	%
Stock Brokers	870,658	887,676	(17,018)	769	4,304,746	1,010,020	3,294,726	(0.52)	(0.40)
Investment Banks	2,067,902	1,906,747	161,155	33,615	8,783,774	3,131,627	5,652,147	2.85	1.83
Fund Managers	2,485,014	2,062,511	422,503	134,101	2,687,826	837,800	1,850,026	22.84	15.72
Investment advisers	723,928	656,180	67,748	27,959	535,418	142,591	392,827	17.25	12.65
Totals	**6,147,502**	**5,513,114**	**634,388**	**196,444**	**16,311,764**	**5,122,038**	**11,189,726**	**5.67**	**3.89**

Source: CMA Database

5.3.5. Market Developments

- Demutualization of Nairobi Securities Exchange (NSE) remains on track and necessary legal framework to facilitate the process was gazetted. NSE has also commenced process to self-list.
- Various regulations to further deepen bond markets were submitted to the National Treasury for gazettement. These include: amendments to the Capital Markets (Licensing Requirements) (General) Regulations, 2002 to facilitate licensing of Authorized Securities Dealers (ASDs); and amendments to the Capital Markets (Securities Public Offers, Listing and Disclosure Requirements, 2002) to facilitate regional fixed income securities issuance. NSE has in addition, developed draft OTC Trading Rules, currently under review by CMA to facilitate timely reporting of OTC transactions.
- CMA continues to build capacity in preparation for introduction of the Futures and Derivatives market in Kenya. The long-term futures expert, whose key mandate includes delivery of additional regulatory framework; operationalizing the Futures Unit and organizing capacity building and sensitization programs, is expected to commence his consultancy in January 2013.
- CMA enhanced capacity building and sensitization initiatives on the policy and regulatory framework for the proposed Real Estate Investment Trusts (REITs) for both its internal and external stakeholders. The Authority has since submitted further tax proposals to the Minister for Finance for consideration in preparation of 2013-14 Finance Bill.

- The Authority installed an information system to support implementation of Risk Based Supervision. The system will facilitate online reporting for both listed companies and CMA licensees as well as calculating the capital adequacy levels for licensees among other financial soundness indicators. In addition, Financial Resources Requirements (FRR) regulations as well as the draft amendments to the Capital Markets (Licensing Requirements) (General) Regulations, 2002 were submitted to the National Treasury for approval and gazettement.
- CMA in collaboration with industry players resolved to develop a Capital Markets Master Plan (CMMP) for Kenya's securities market. A committee of experts to steer the process was launched in October 2012 and has commenced work.
- CMA is also leading the development effort towards the introduction of the market for Islamic Investment products - Sharia-compliant products and services.

5.3.6. Risk Assessment

- **Market Risk:** Refers to events at the marketplace that can impact market prices and rates, and thus the value of positions in a given instrument. Collapse of the entire market as opposed to risk on an individual firm, group or segment of the capital markets is one of such events. Weak corporate governance within licensees and market intermediaries, poor internal controls in the conduct of licensed businesses, low capitalization of market intermediaries, weak trading and settlements systems, weaknesses in enforcement capacity, as well as weaknesses in the regulatory framework are likely causes of market risk. CMA has undertaken various initiatives including comprehensive reforms on the legal and regulatory framework, enhancing corporate governance practices and capital adequacy of licensees 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 minimize chances of such risks materializing.

- **Credit Risk:** Deals with the possibility that the counterparty in a trade will be unable to meet its financial obligations arising from the transaction. This risk is mitigated by the Settlement Guarantee Fund administered by the CDSC. In addition, guidelines on financial resource requirements have been developed for market intermediaries as a base for adoption of Risk a Based Capital Adequacy Framework.

- **Operational Risk**: Arises from human error, fraud, inadequate management, and system and facility failures, and have huge impact on investor confidence.

These risks have been mitigated by various regulatory and technological tools, including: internal controls and corporate governance regulations; professional indemnity insurance requirement; implementation of the Broker Back Office System and installation of a modern Surveillance System.

- **Economic Risks**: Include; Interest Rate Risk from volatile interest rates environment that affects portfolio valuations, Equity Risk/Inflationary Risk that shows the sensitivity of a security's price to general changes in market values, as well as to changes in value of the security's underlying assets; Currency Risk arising from fluctuation in currency rates, individually and relative to floating indices. A slowdown in global economic recovery and weaknesses in global credit markets will significantly impact Kenya's economy, which will in turn affect earnings of listed companies negatively. This translates into a decline in market activity as well as performance.

- **Market Microstructure risks**: Arises from the Narrow Products Range, High Market Concentration and Low Liquidity. NSE is characterized by a narrow product base (limited new listings), high market concentration (8 firms out of 61 listed companies account for about 70 per cent of market capitalization). The low market liquidity exacerbates market volatility and consequently accentuates market and liquidity risk. To mitigate the risks, CMA is spearheading market diversification initiatives such as establishment of derivatives market, a hybrid OTC bond market, a formal equity OTC market, introduction of Shariah-compliant capital markets products and services as well as the establishment of an alternative market for Small and Medium Enterprises (GEMS). There are also plans to introduce margin trading, provide for securities borrowing and lending arrangements as well as short-selling and market-making. There are also initiatives to shorten the trading and settlement cycle by investing in market infrastructure.

- **Emerging Risks**: Money Laundering and related activities are major threats to the securities industry. The industry's overall vulnerability is impacted by the extent to which it is covered by anti-money laundering requirements and mitigated by appropriate measures implemented by licensees by virtue of the enactment of the Proceeds of Crime and Anti-money Laundering Act.

- **Legislative Risk**: Legislative changes, for instance tax laws like capital gain tax, affect the financial returns of a particular security or firm. Kenya's tax laws are currently under review and some provisions may affect the capital markets industry adversely rather than positively. In addition, delays in enacting securities industry laws impacts negatively on securities market development by stifling innovations.

- **Low Public Awareness and Investor Apathy:** There is a general unawareness on capital markets and their workings in Kenya. This in turn has led to a very low uptake of the products by the retail sector. In addition, fraud incidents have led to general state of domestic retail investor apathy and this may be affecting liquidity in the market. This could also be attributable to low financial literacy and savings levels in general.
- **Lack of Innovation;** this is mainly a symptom of the Legislative environment outlined above. Market players are of the view that the current regulatory framework is too stringent and inhibitive to market innovation.

5.3.7. Capital Markets Outlook

Capital markets performance will largely depend on efforts aimed at overall stability of the macro-economic environment and financial markets. The financial sector reforms being undertaken are aimed at rejuvenating the capital markets to make them more vibrant, fair and orderly to enhance investor confidence and spur increased market activity.

5.4. INSURANCE INDUSTRY

As of 2012, insurance industry continued on a positive growth path and stability registering double digit growth in gross written premium income. It led the EAC region in terms of key performance indicators such as insurance penetration and insurance density at 3.1 per cent and 26.1 per cent, respectively. Gross Written Premium income crossed the Ksh 100 billion-mark in 2012, a 16 per cent growth rate compared to the average industry growth of 19 per cent since 2008 (Table **20**). Both assets and investments for the insurance industry grew by 30 per cent, to Ksh 302 billion and Ksh 236 billion respectively, with gross premium written income growing remarkably**.**

Both assets and investments of the insurance industry grew by 30 percent, to Ksh 302 billion and Ksh 236 billion, respectively. Gross premium written income almost doubled by 2012 compared to 2008 as shown in table **20.**

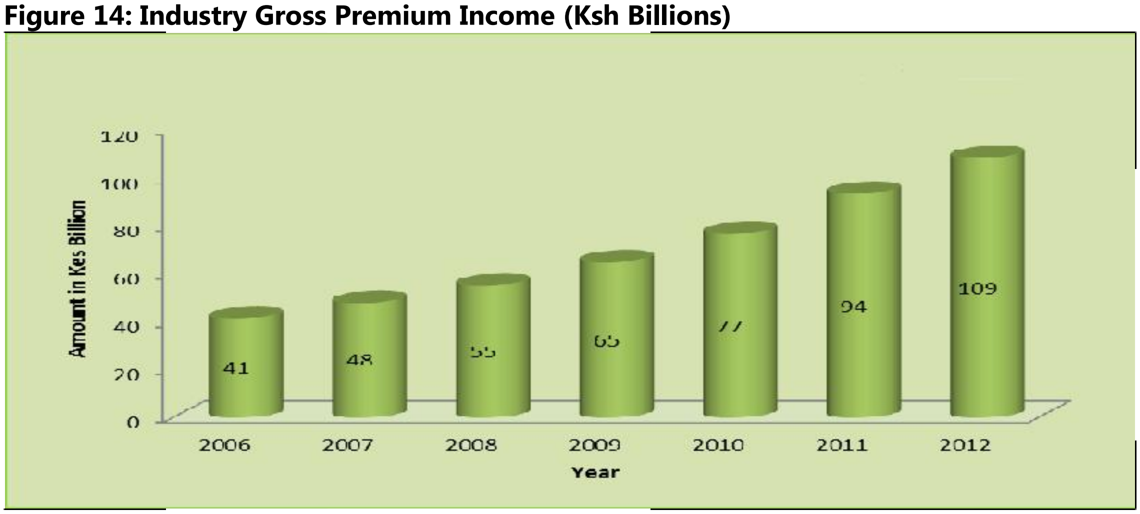
Table 20: Insurance Industry Performance (Ksh Millions)

INDICATOR	2008	2009	2010	2011	2012
Gross Premium Income	55,245.89	65,012.84	76,908.99	93,631.98	108,609.89
Net Premium Written	45,593.02	45,592.66	64,123.29	77,344.04	87,839.99
Claims Incurred (Gen. Business)	15,883.57	19,768.32	21,628.87	25,052.95	29,433.20
Commissions	7,252.12	8,714.71	10,269.67	9,406.71	7,034.22
Management Expenses	12,602.25	14,640.68	16,758.48	18,889.35	19,551.73
Underwriting (G/Business)	872.50	401.81	1,271.44	2,591.76	3,398.43
Investment Income (P&L)	8,191.11	12,112.00	23,369.31	5,626.42	7,593.89
Operating Profit/Loss after Tax	3,349.99	3,420.97	7,634.27	6,81.49	13,350.34
Investments	123,621.4	113,452.50	177,521.00	181,179.61	235,564.75
Assets	154,452.74	178,403.82	223,490.78	233,172.36	302,233.26
Shareholders' Funds	38,161.22	41,468.97	58,648.78	57,828.25	74,812.41

Source: Industry unaudited returns 2012 – Figures in (Ksh Millions)

Premium income growth since 2008 has averaged 15 per cent as indicated in figure 14, mostly attributable to the licensing of new companies in the industry, innovations in new insurance products, increased demand due to awareness on the need and benefits of insurance and growing middle class with demand for high value goods and services. Overall, industry and premium growth through 2012 remains sustainable as shown in figure **14**.

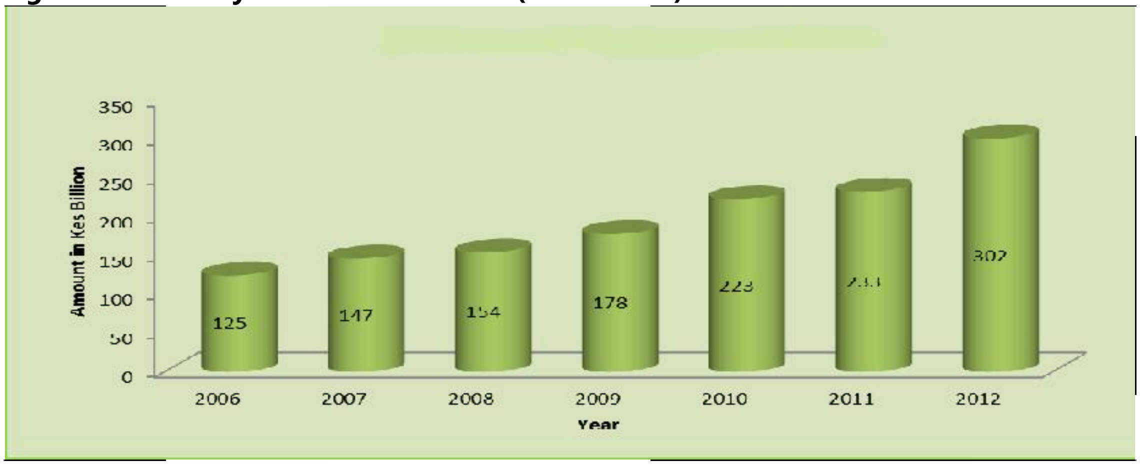
Figure 14: Industry Gross Premium Income (Ksh Billions)



Source: Industry unaudited returns 2012

Asset base of the industry has grown steadily over the years through to 2012 as shown in figure 15. Growth rate in assets has averaged about 13 per cent in the last five years owing to the increase in gross premium income over the same period.

Figure 15: Industry Assets Base Growth (Ksh Billions)



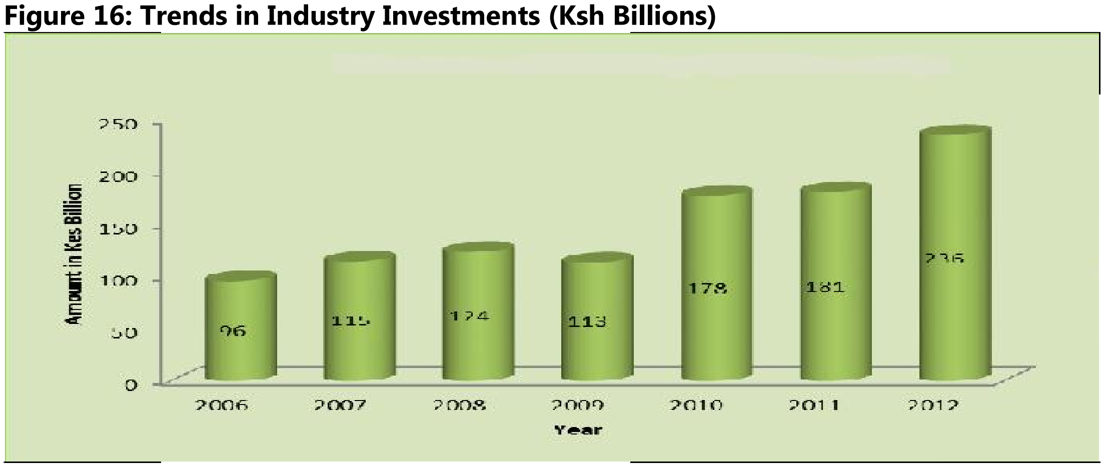
Source: Industry unaudited returns 2012

Insurance companies use premiums to buy assets hence, a direct positive relationship between gross premium income and total assets. Asset growth reflects diversified risk portfolio and growth, and overall stability of the industry. Asset growth also signifies the ability of insurance companies to take in new and more risks.

5.4.1. Trends in Industry Investments Growth

Insurance industry investments have grown over the period as indicated in figure **16**, with slight fall in 2009. Growth rate has averaged 13 per cent since 2006. Growth in investment indicates the ability of insurance companies to meet their obligations to policy holders as and when they fall due.

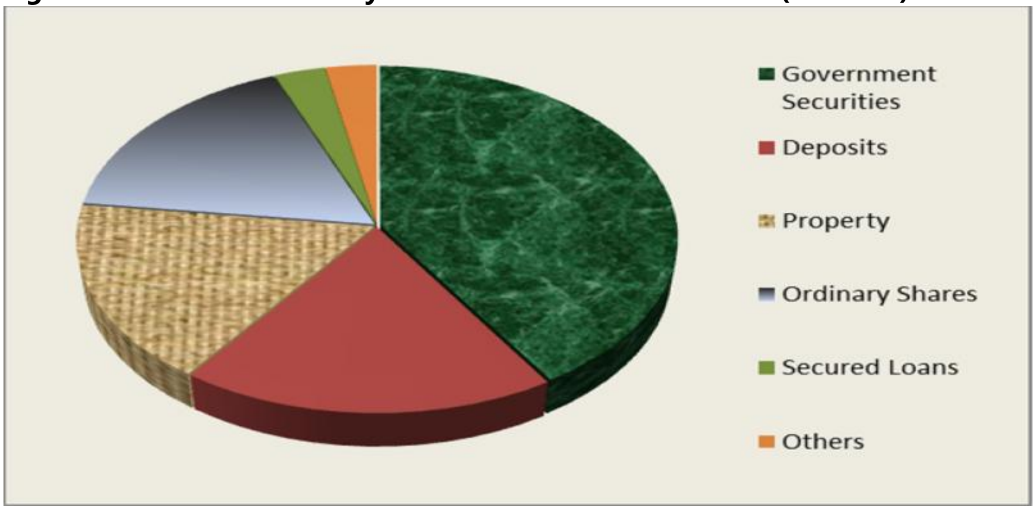
Figure 16: Trends in Industry Investments (Ksh Billions)



Source: Industry unaudited returns 2012

Under section 50 of the Insurance Act**,** Cap 487 Laws of Kenya, IRA regulates investments in terms of asset mix, apportionment (proportionality) of admitted assets, and portfolio maturity. Overall, at the end of 2012, the insurance industry's investments portfolio was distributed as indicated in figure **17**.

Figure 17: Insurance Industry Investments Portfolio in 2012 (Per Cent)



Source: IRA database, 2012

5.4.2. Recent Supervisory Developments

Licensing of New Players - Applications for 2013 licensees from various industry players were reviewed based on the Insurance Act. Many Insurance Agents could not meet the minimum requirements as indicated in table **21** and were therefore deregistered.

Table 21: Insurance Industry Licensees

CATEGORY	APPLICANTS	LICENSED	Change
Insurance Companies	47	45	-2
Reinsurance Companies	3	3	0
Insurance Agents	4,705	4,374	-331
Insurance Brokers	174	158	-16
Loss Adjusters	21	20	-1
Insurance Investigators	132	129	-3
Risk Mangers	11	10	-1
Medical Insurance Providers	27	23	-4
Motor Assessors	85	81	-4

Source: Insurance Regulatory Authority Database, 2012

Two Insurance companies closed down so were 16 Insurance brokers on difficult business environment and failure in compliance with regulations. Motor Assessors and Medical Insurance providers also lost 4 members each. IRA is determined to ensure stability of the industry through effective regulation and supervision as indicated by these developments where enforcement has been enhanced. Only those players that are able to meet all legal, regulatory and supervisory requirements and good risk management practices are permitted to continue doing business. These efforts go a long way in mitigating emerging risks in the industry. Other initiatives include:

Development of Guidelines – IRA is a member of the International Association of Insurance Supervisors (IAIS) which, is a standards setting body for all insurance supervisors globally to ensure a fair, safe and stable insurance industry for the benefit and protection of policyholders as well as contribution to financial system stability. IRA benchmarks its supervisory initiatives to the IAIS Core Principles and Prudential Standards. Since adoption of RBS, IRA has developed guidelines covering: submission of audited accounts by brokers and Medical Insurance Providers, claims management, product development, market conduct for investigators and motor assessors and group life (listed risks). IRA ensures compliance with the guidelines through regular supervisory activities in addition to the pre-licensing assessments.

On-Line Filing of Un-Audited Quarterly Returns - Section 54 of the Insurance Act requires that all insurance companies incorporated in Kenya prepare and submit quarterly unaudited returns to IRA as prescribed in the second and third schedules of the Act within thirty (30) days after the end of each quarter. However, it has been noted that most insurers have not been submitting data as required in the prescribed format making it difficult for IRA to analyse data across companies for varying periods on a timely basis. IRA has since developed a standard template for filing of quarterly returns, which insurers are now using to submit quarterly returns online.

Consumer Complaints Resolution - New constitutional dispensation and enactment of the consumer protection law have necessitated numerous measures by IRA to ensure compliance with consumer protection requirements. A Customer Relationship Management (CRM) system was adopted that allows expeditious resolution and handling of complaints. The use of the software has greatly enhanced efficiency and effectiveness in resolution of consumer complaints. Customer data and complaints are captured, analysed and reports prepared that contain recommendations for improvement in service delivery.

Adoption of Risk Based Supervision - IRA with support FLSTAP – Kenya, adopted Risk Based Supervision (RBS) effectively shifting supervisory model from Compliance (rule) Based approach. RBS enables timely preventive and corrective measures to promote safe, sound and stable insurance industry. Electronic Regulatory System (ERS) was adopted as a key vehicle for the success of RBS.ERS requires the insurance companies to submit their returns to IRA electronically, thus ensuring:

i. Timely data collection from the industry to support the implementation of RBS

ii. Analysis of industry data to provide Financial Soundness and Early Warning Indicators; and
iii. Establishment of credible databases for the industry

Development of Micro Insurance Policy Paper: To enhance financial inclusion espoused in Vision 2030 and deepen the insurance market, IRA developed a draft micro-insurance policy framework in collaboration with industry stakeholders. Once implemented, we expect a well regulated and robust micro insurance business in Kenya to facilitate improved penetration particularly to low income households and micro and small enterprises.

Standardization of Insurance Contracts: Insurance contracts have been labelled as generous in wording but scanty on information for customers to make informed choices of insurance services and products. This has led to many consumer complaints. To address this concern, IRA standardized insurance contracts for all the licensees so that consumers easily understand them before committing themselves.

5.4.3. Risk Management

Insurance as a business is risky and therefore the industry is a risk management business. IRA adopted RBS system, a risk management tool in which the solvency and operations of licensees is monitored continuously to ensure that key ratios of a licensee matches its risk appetite. RBS also reduces level of unpaid insurance claims and minimizes closure of insurance firms, thus promoting stability. IRA identified and rated numerous risks in the industry in 2012. Ratings were on scale of 1 to 3 where **1= low** risk and **3 = high** risk. Results are summarized in table **22**.

A low risk rated company implies its operations are normal while a high risk rating signals trouble in operations of the institution concerned, hence IRA needs to step in remedial plan to restore financial soundness and stability. A moderate rating would require enhanced information collection, surveillance and possible increase in minimum capital requirements.

Each of the risks identified in table 22 can adversely affect performance and stability of the insurance industry. Insurers have been sensitized to identify and institute measures to manage and mitigate these risks. Supervision of the insurance industry was enhanced to mitigate the actual and potential risks and vulnerabilities. In addition, IRA is developing guidelines for industry-wide risk management.

Table 22: Industry Risk Assessment in 2012

CATEGORY	DESCRIPTION	OVERALL RATING
Insurance Risk	Inappropriate/inadequate underwriting, pricing, claims management, product design and reinsurance arrangements likely cause of financial loss and hence inability to meet its liabilities.	**Rated 2.25** = High Risk Insurance firms are not operating properly, need for remedial plan.
Operational Risk	Risk of financial loss resulting from inadequate or failed internal processes, people and systems or from external events.	Not Computed in 2012
Strategic Risk	Associated with insurer business and strategic plans, and their implementation	**Rated 1.59 =** Moderate. IRA remedial actions on strategies of licensees
Contagion and Related Party Risk	Problems in other group members or insurers in the industry, the entire financial system or owners of a company may compromise the financial and operational position of the insurer.	**Rated 1.13** = Low. Insurance firms are operating normally relative to contagion risks.
Liquidity Risk	Here, insurer fails to meet all cash outflow obligations to policyholders (and other creditors) as and when they fall due.	**Rated 1.98** = Moderate. Needs remedial action to mitigate potential liquidity problems.
Balance Sheet and Market Risk	Balance sheet assets are overstated and/or liabilities are understated, and losses arising from adverse change in market rates or prices.	**Rated 1.89** = Moderate. Remedial action to ensure accuracy of balance sheet information and managed changes in prices/rates.
Counterparty/ Credit default risk	Default by borrowers and other parties; and loss of assets value on impaired credit quality. Originates from financial transactions with securities issuers, debtors, borrowers, brokers, policyholders, reinsurers and guarantors.	**Rated 1.26** = Low. The industry is operating well in terms of counterparty risk
Legal and regulatory Risk	Arises from Non-Compliance with rules and regulations	**Rated 1.58** = Moderate. Industry generally complies with set rules and regulations

Source: IRA Database, 2012

5.5. PENSION INDUSTRY

The Pension Industry initiated various policy actions and plans geared towards the development and growth of the retirement benefit industry. The initiatives specifically targeted at increasing pension coverage and promotion of good governance in management of pension funds. In 2012, there were 16 registered fund managers, 26 administrators and 12 custodians. The retirement schemes stood at 1262 while, the membership was 1.7 million members. The pension coverage, however, stagnated at 15 per cent the total formal labour force.

The sub-sector assets grew by 26.8 per cent, rising from Ksh 432.8 billion in 2011 to Ksh 548.8 billion in 2012 (Table **23**). Of this, Ksh 436.7 billion were managed by Fund

Managers and Ksh 82.1 billion held by the National Social Security Fund (NSSF). A total of Ksh 30 billion in property investments were held by schemes but not under the Fund Managers. Assets under Fund Managers included Ksh 39.4 billion of NSSF assets transferred to the managers in 2012.

Table 23: Industry Performance Indicators

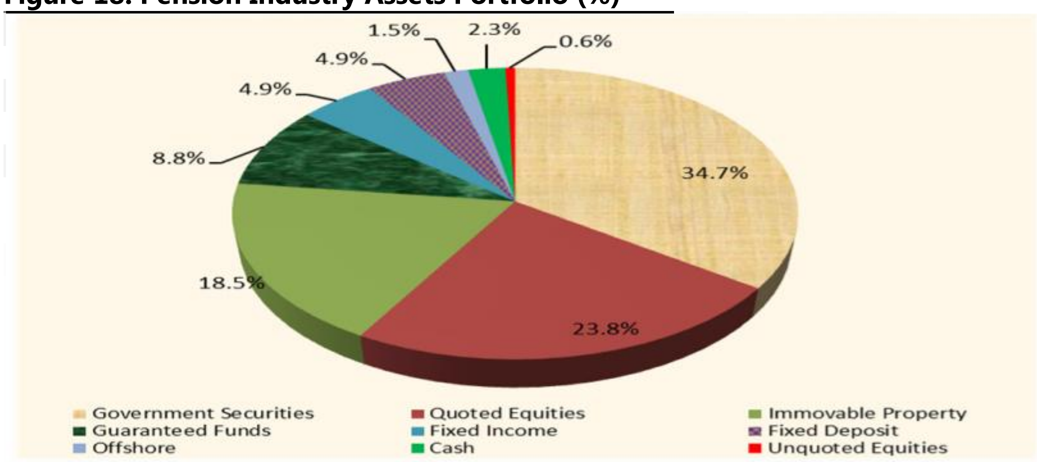
Measure	Dec'08	Dec'09	Dec'10	Dec' 11	Dec'12
Assets (Ksh. Billion)	302.8	343.8	450.69	432.8	548.83
Annual increment (%)	3.1	13.5	31.2	-4.1	26.8
Schemes Ave. return (%)	-2.8	11.0	27.8	-9.9	-

Source: Retirement Benefits Authority Database, 2012

Notable growth in assets is attributed to better performance of the stock market, with prices of most shares rising considerably. Also, the decline in interest rates in the year saw the increase in value of bonds held by the schemes as price rose.

Majority of the industry's assets were in government securities at 34.7 per cent as indicated in figure 18. Quoted equities accounted for 23.8 per cent while immovable property closed the top three asset classes at 18.5 per cent. These allocations in asset classes were within the statutory limits.

Figure 18: Pension Industry Assets Portfolio (%)



Source: RBA Database 2012

Table **24** further illustrates end of year asset classes since 2010 indicating that government securities remain the preferred investment. Quoted equities declined significantly in 2011 due to low prices.

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3 This excludes data for schemes under Zimele Assets Managers and Guaranteed funds from CFC insurance.

Table 24: Industry Investment Portfolio as at December 2012

Asset Class	December 2010		December 2011		December 2012	
	Ksh (Bn)	Share (%)	Ksh (Bn)	Share (%)	Ksh (Bn)	Share (%)
Government Securities	143.6	32	145.7	34	190.3	34.7
Quoted Equities	130.3	29	93.0	21	130.4	23.8
Immovable Property	80.0	18	87.8	20	101.6	18.5
Guaranteed Funds	33.3	7	48.0	11	48.1	8.8
Fixed Income	21.1	5	20.7	5	26.7	4.9
Fixed Deposit	17.3	4	21.9	5	27.1	4.9
Offshore	15.4	3	5.2	1	8.5	1.5
Cash	7.3	2	6.8	2	12.9	2.3
Unquoted Equities	2.5	1	3.7	1	3.1	0.6
TOTAL	**450.7**	**100**	**432.8**	**100%**	**548.8**	**100%**

Source: RBA Database 2012

5.5.1. Policy and Legislative Developments in 2012/2013

During the 2012/2013 budget statement several key policy changes were initiated, including:

Amendment of the Retirement Benefits Act (No. 3 of 1997): Section 45 of the RBA Act was amended to provide that the costs of an Interim Administrator of a scheme be met by the RBA if the later places a scheme under interim administration. Previously such costs were met by the respective Scheme. This has implications to the stability of the industry through effective supervision and compliance.

5.5.2. Risks and Mitigation Strategies

The Retirement Benefits Authority conducted risk assessment exercise on its licensees in 2012. The results indicate that the industry was largely stable and vibrant. Detailed findings of the assessment are presented in Table **25**. It is noteworthy to highlight that while the industry generally reflects stability, there is concerns about the small coverage, mainly targeting formal labour force. In addition, the high administrative costs in some schemes like the NSSF as well as concentration of investment portfolio in government securities may undermine the level of returns to pensioners. Existence of a large number of Defined Benefit Schemes, especially in associated with government corporations can be a source of risks to the industry. RBA has however taken commensurate measures to address all these concerns.

Table 25: Risks Assessment for Pension Industry in 2012

CATEGORY	STATUS	MITIGATION
Investment/ Market Risk	Low market risks recorded in 2012 on rise in share prices. Investments were within statutory limits, with 55.6% in safe assets and 44.4% in risky asset classes. All Schemes had flexible investment policies reviewed after 3 years.	RBA reviewed guidelines to broaden asset classes and bring in additional products for risk mitigation through assets diversification.
Counterparty / Credit Risk	No Counterparty Risk reported in 2012. All licensees were assessed and published in the media. Schemes were also advised to use the registered service providers to reduce counter party risk. Schemes also advised to use services of different/ unrelated service providers like fund managers and administrators.	Regulation 9 of the retirement benefits (single Retirement Benefits Schemes) amended to prohibit any retirement scheme from appointing a trust firm whose ownership is related to its sponsor as the scheme's trustee.
Funding/ Solvency Risk	Existence of 90 Defined Benefits Schemes in 2012 mainly by state corporations poses solvency risks as they are not fully funded. A total of 38 DB Schemes underfunded in 2012 and only 19 were fully funded. More DBs are converting to DCs after Treasury's circular. DBs are meeting 100% funding in transition to DCs.	RBA issued prudential guidelines in August 2012 to guide the conversion process. Underfunded schemes are also required to submit and implement a remedial plan.
Liquidity Risk	No scheme had liquidity problems in 2012. But NSSF still holds 34% of its assets in immovable property, above the 30% statutory limit. More liquid assets like government securities are preferred assets to mitigate liquidity risks	RBA requires all its members to have investment policy, reviewed every three years. Schemes' trustees identify liquidity risks and devise mitigation measures
Actuarial Risk	Originates from making wrong assumptions on mortality, discount and inflation rates, leading to wrong Fund valuations. No actual risk reported in 2012. Normally required for DB Schemes, and expected to fall with more DCs.	RBA employs Risk-based framework to ensure triennial statutory valuations are submitted on time together with remedial action plans if needed.
Governance/ Agency Risk	Administrative costs still high in some schemes like NSSF. NSSF Act being reviewed to enhance corporate governance and contribution rates.	RBA adopted Integrated Risk-Based Supervision and Back-Office System (BOS) Project to interface with licensees to enable online applications and filing of returns. BOS will enhance administrative functions and ensure quick reconciliation of collections. RBA uses Trustee Development Program to certify trustees.

Source: RBA Database, 2012

5.6. SAVINGS AND CREDIT CO - OPERATIVE SOCIETIES (SACCO) INDUSTRY

The Sacco sub-sector comprises individual Sacco societies, unions of Sacco societies (Kenya Union of Saving and Credit Cooperatives (KUSCCO) and Kenya Rural Sacco Societies Union (KERUSSU)) and Sacco Societies Regulatory Authority (SASRA). As at 31st December 2012, there were 7540 registered Sacco societies. A total of 4047 were active, of which 215 were deposit-taking or offering quasi-banking services through Front Office Savings Accounts (FOSA) while the rest are non-deposit taking Sacco societies. The latter group are regulated and supervised by SASRA.

The Saccos industry's total assets grew by 17.8 per cent to Ksh.292.9 billion in 2012, from Ksh. 248.7 billion, in 2011. At Ksh. 220.3 billion, loans and advances accounted for 75 per cent of total assets, with growth rate of 18.6 per cent over 2011 balances. The assets were mainly funded from member deposits and capital, which rose by 17.8 per cent and 25.8 per cent respectively as indicated in table 26.

Table 26: Performance of Active Saccos

MEASURE	2012	2011	CHANGE (%)
Assets	292,924,859,306	248,765,061,947	17.75
Deposits	212,073,191,184	180,003,423,979	17.82
Capital	25,300,225,898	20,115,041,640	25.78
Loans	220,342,928,891	186,149,239,603	18.37
Turnover	37,012,081,579	31,463,685,247	17.63

Source: SASRA Database 2012

5.6.1. Performance of Deposit Taking Sacco Societies

Sacco societies operating FOSAs provide a wide array of financial products including demand savings account, credit facilities Automated Teller Machines (ATMs) and Mobile Money Transfer (MMT) services. Members enjoy quasi-banking services unlike in traditional Sacco societies where members' savings are only accessible upon exiting the Sacco. Thus members save primarily to access loans and earn a return from their long-term savings. The ability of the FOSA Saccos to offer many and flexible financial services and products, has enabled their faster growth relative to non-deposit taking Saccos expansion such that they account for over 75 per cent of the industry's subsector's assets and deposits as shown in Table **27**. Dominance of FOSA operating Saccos underscores the attractiveness of the new Sacco business model to members in terms of their personal financial needs.

Table 27: Performance of Deposits Taking Saccos in 2012

YEAR	Total Assets	Deposits	Loans	Turnover
2012	223,535	160,483	167,598	30,009
2011	196,342	140,650	147,737	25,000
Change (%)	13.8	14.1	13.4	20.0
Share of Industry (%)	76.4	80.8	76.4	76.8

Source: SASRA database (Figures in Ksh. Millions)

5.6.2. Financial Soundness of Deposit Taking Sacco Societies

Transformation of the Sacco societies to offer 'banking like' services and expansion of membership definition has led to additional risks in a traditionally conservative and closed industry. This development has created systemic importance of the deposit taking Saccos (DTS). As at the end of 2012, ten (10) of the largest FOSA operating Saccos accounted for 49 per cent of the total member deposits held by the 124 licensed Saccos.

SASRA supervises the licensed FOSA operating Saccos which are required to observe the minimum operational and prudential standards in the conduct of Sacco business. SASRA adopted CAMELS evaluating framework to measure and monitor the financial soundness of the deposit taking Sacco societies. Table **28** summarizes FSIs assessment results of the 124 DTSs.

5.6.2.1 Capital Adequacy

Regulatory capital adequacy requirement which is measured by the ratio of core capital and institutional capital to total assets was 8.6 per cent and 5.0 per cent, which is below the regulatory minimum of 10 per cent and 8 per cent, respectively. The licensed DTS have until June 2014 to build capital ratios to the regulatory minimum. SASRA is monitoring the progress of individual DTS to ensure full compliance by the set deadlines.

5.6.2.2 Asset Quality

The licensed DTS had gross non-performing loans (NPLs) of Ksh.11.6 billion in 2012 from the Ksh.12.2 billion in 2011. The ratio of gross NPLs to gross loans improved from 9.6 per cent to 7.3 per cent in the period. The improvement is attributable to enhanced credit administration. New regulatory requirements ensure monitoring of NPLs and loan loss provisions for defaults.

Table 28: Financial Soundness Indicators for Licensed DTS

FSIs Measures	31 Dec 12	31 Dec 11
CAPITAL ADEQUACY		
Core capital to Total Assets (10%)	8.64%	8.36%
Core Capital to Total deposit liabilities (8%)	11.94%	11.36%
Institutional Capital to Total Assets (8%)	5.02%	4.45%
ASSET QUALITY		
NPLSs to Total Gross Loans	7.34%	9.6%
NPLs Net of Provisions to Capital*	43.4%	70.4%
Earning Assets to Total Assets	81.95%	80.55%
EARNINGS & PROFITABILITY		
Return on Assets (ROA)	2.02%	1.98%
Return on Equity (ROE)*	53.79%	53.07%
Interest Margin to Gross Income*	38.05%	41.54%
Non-Interest Expenses to Gross Income	34.44%	35.24%
LIQUIDITY		
Liquid Assets to Total Assets	12.83%	12.62%
Liquid Assets to Short-term liabilities (Liquidity ratio)	61.39%	45.42%
Liquid Assets to Total Deposit	17.74%	17.08%
Total Loans to Total Deposit	106.23%	102.28%

Source: SASRA Database 2012

NPLs net of provisions to core capital ratio remains very high relative to the banking or DTMs reflecting inadequate provisioning for loan losses. This is compounded by the difficulties of adjusting the gross NPLs for realizable value of collaterals held by the Sacco against the problem loan accounts. However, there was remarkable improvement in 2012 as loan loss reserves increased by 69 per cent to Ksh. 2.99 billion from Ksh 1.81 billion in 2011 as more Saccos adopted prudent credit risk management practices envisaged in the Act.

5.6.2.3 Liquidity

Liquidity is an important indicator of financial stability in a Sacco society as it shows the Sacco's ability to meet obligations as they fall due. As at 31st December 2012, average liquidity (net liquid assets divided by savings deposits and short term liabilities) for the licensed DTS stood at 36 per cent against a statutory minimum of 15 per cent. However, the demand for loans continues to put pressure on liquidity with the industry ratio of loans to deposits exceeding 100 per cent, implying that Saccos have to seek external funding, which are expensive to members.

SASRA recognises the systematic importance of liquidity management in the industry especially for FOSAs and thus the need for a more effective mechanism of monitoring liquidity both at industry level and individual Sacco societies. This includes a system of borrowing for temporary liquidity needs to ensure stability in the sub-sector. Full integration of Sacco societies to the rest of the financial system as is the case in Canada and Brazil will enhance their competitiveness as non-bank financial institutions. SASRA is thus drafting policy proposals for discussion with the stakeholders in 2013 to improve legal and regulatory framework on liquidity management across the industry.

5.6.3. Overall Financial Stability of the Sacco Subsector

While the licensed deposit taking Sacco Societies account large proportion of the Sacco industry's assets and deposits, the non-licensed deposit taking Saccos remain a source of concern on the development and stability of the subsector. The 91 non-licensed DTS comprise of small Sacco societies (in asset size and membership) that continue to experience financial and operational challenges hence inability to meet set licensing requirements since 2010. By June 2014, all the deposit taking Sacco societies should be licensed and in full compliance with the operational and prudential standards set by SASRA. Consequently, SASRA is engaging the non-licensed deposit taking Sacco societies on individual basis while considering possible policy interventions to enhance compliance by end of the transition period. Overall, the stability of the industry has improved. SASRA will continue to enhance surveillance and enforcement to foster stability in the face of emerging potential risks and vulnerabilities.

5.6.4. Policy Developments

In 2012, SASRA commenced review of the Sacco Societies Act to address key policy aspects critical to the stability and development of Sacco subsector. This includes:

5.6.4.1. Credit Information sharing: The current provision in the Sacco Societies Act 2008 restricts credit information sharing on NPLs. SASRA is thus pursuing legislative amendments to allow full file sharing of credit information of borrowers by the Sacco societies. This is expected to contribute to better credit assessments and ultimately make credit more affordable as overall loan portfolio quality improves.

5.6.4.2. Prudential Regulation of Saccos in a Devolved System of Governance: The Constitution provides that trade development and regulation, including Cooperative Societies is a function of the County Government. It did not however provide for the regulation and development of Sacco societies under the devolved government. SASRA is spearheading a policy change and legislative amendment to the substantive Act to align it with the Constitution by recognizing the uniqueness of Sacco Societies in the national financial system, including their regulation and supervision. The proposals shall emphasize preservation of the gains already made in enhancing the regulatory framework for the Sacco subsector and the need for a standardized and centralized regulation of DTSs, which provide quasi-banking services to their members similar to other financial institutions.

5.7. PAYMENTS AND SETTLEMENTS SYSTEMS

The Payments and Settlements Systems infrastructure operated smoothly in 2012, with an overall increase in values and volumes transacted. The Kenya Electronic Payment and Settlement System (KEPSS) is the country's inter-bank settlement system that supports daily inter-bank dealings. It is the only Systemically Important Payment System (SIPS) and hence remains the Bank's main concern for the purposes of financial system stability but does not downgrade the retail payment systems.

Table 29: KEPSS System Flows

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

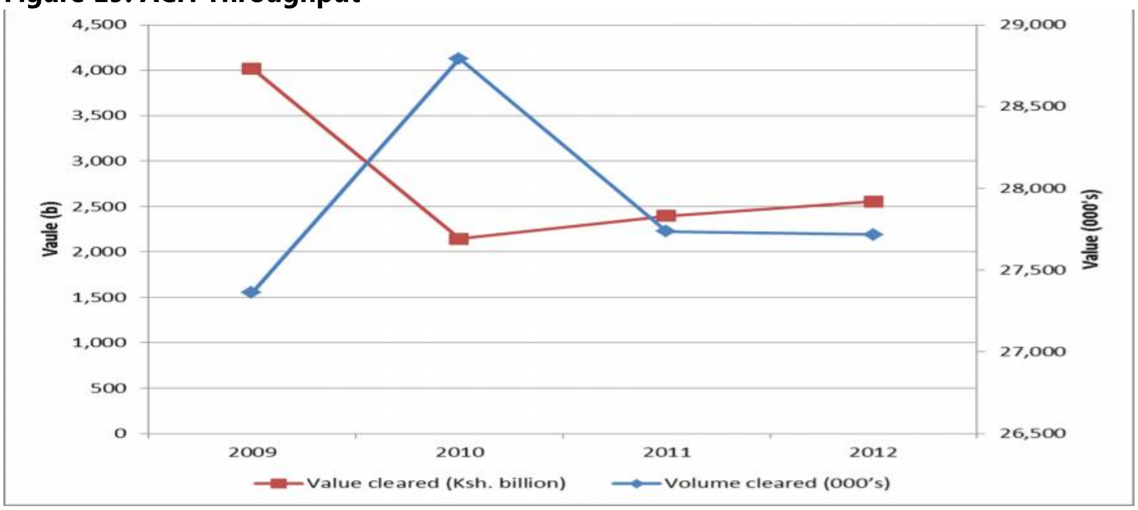
Source: www.centralbank.go.ke

KEPSS processed 1.24 million transaction messages worth Ksh 21,894 billion in 2011. In 2012, the system recorded a throughput of 1.57 million transaction messages worth Ksh 19,880 billion. This represents an increase of 26.3 per cent in volume and a decrease of 9.2 per cent in value (Table **29**).

The higher volume reflects increased usage of KEPSS by the public as the most secure and faster mode of payment. The decrease in value is attributed to the implementation of Cheque Truncation System (CTS) which shifted considerable value from the KEPSS to the Automated Clearing House (ACH) as a result of the improved efficiency and cost effectiveness associated with the CTS. Commercial banks settlements through KEPSS accounted for 98 per cent of the total activity while the Net Settlement Instruction (NSI) or activity through the ACH to KEPSS accounted for an average 2.0 per cent

The usage of Automated Clearing House (ACH) remained almost unchanged in 2012, with a slight increase in value and a marginal decline in the volume of Cheques and EFTs cleared through it. Figure **19** illustrates the ACH throughput since 2009, showing minimal difference in value and volume cleared between 2011 and 2012.

Figure 19: ACH Throughput



Source: Central Bank, NPS

5.7.1. Cards Transactions

Payments Card usage grew strongly in terms of Automated Teller Machines (ATMs) cards, Credit & Debit cards, and Point of Sale (POS) terminals in 2012 compared to 2011. The number of transactions and equivalent value increased from 122.4 million transactions worth Ksh. 577.9 billion in 2011 to 224.6 million transactions worth Ksh. 1,009.8 billion in 2012 (Table **30**).

Table 30: Payments Cards Usage (Millions)

MEASURE	2011	2012	Change (%)
Number of Cards	10.1	10.7	5.9
Number of ATMS	2205	2381	8.0
POS Terminals Number	16604	18478	11.3
Transactions Volume	122.4	224.6	83.5
Transactions Value	577,852	1,009,758	74.7

Source: Central Bank, NPS data

Uptake in usage of cards may be due to growth of the economy which boosted domestic demand as well as the growing acceptance of cards as a safe and convenient mode of payment. Increased usage of payment cards has also raised risks profile, prompting KBA and the CBK to devise mitigation measures, including; adoption of Europay, MasterCard and Visa (EMV) that have global security standards in the payment card industry.

5.7.2. Mobile Phone Money Transfers

Mobile Phone Money Transfer services maintained growth momentum in 2012, with agents and users recording 52.4 per cent and 9.9 per cent growth rates, Respectively, as indicated in Table **31**. The platforms moved about 575 million money transfer messages worth Ksh 1,538 billion in 2012, representing an increase of 32.8 per cent and 31.5 per cent in volume and value respectively compared to 2011.

Table 31: Mobile Money Transactions

MEASURE	2007	2008	2009	2010	2011	2012
Number of Agents	1582	6104	23012	39449	50471	76912
Customers (Millions)	1.3	5.1	8.9	16.4	19.2	21.1
Transactions Nos. (Millions)	5.5	62.7	193.5	311	433	575
Transactions Value (Ksh Bn)	16.3	166.6	473.4	732.2	1,169.20	1,537.50
Value per Transaction (Ksh)	2,983	2,655	2,447	2,354	2,700	2,672

Source: Central Bank, NPS database

The average value per transaction declined from Ksh 2,700 in 2011 to Ksh. 2,672 per transaction in 2012. This reflects increased small value transactions probably, to support more people faced with economic difficulties in 2012. It also reflects more financial inclusion by poor people.

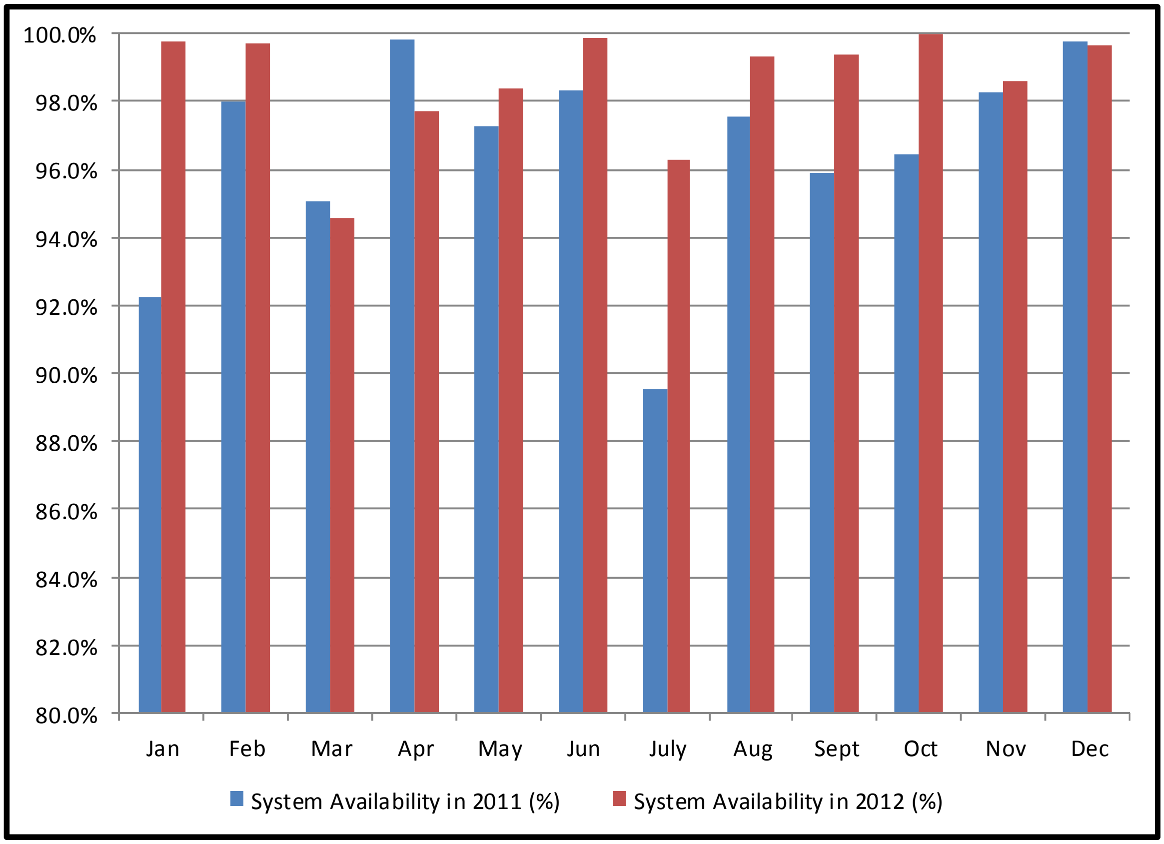
5.7.3. Policy Changes in the National Payment Systems

Following enactment of the National Payment System (NPS) Act in 2011, CBK has prepared regulations to operationalize the Act. These regulations provide for the regulation and supervision of payment systems and payment service providers. They include: Regulation for the Provision of Electronic Retail Transfers; E-Money Regulation; Regulation for the Designation of a Payment System; Regulation for the Designation of a Payment Instrument; and Anti-Money Laundering Guidelines for the provision of Mobile Payments.

5.7.4. Risk Assessment for Payments Infrastructure in 2012

One key measure of the payments infrastructure stability in 2012 was availability of KEPSS. It is the only Systemically Important Payment System (SIPS) in Kenya. KEPSS operations recorded improved average system availability level to 98.6 per cent in 2012 compared to 96.5 per cent availability level attained in 2011 as indicated in figure **20**.

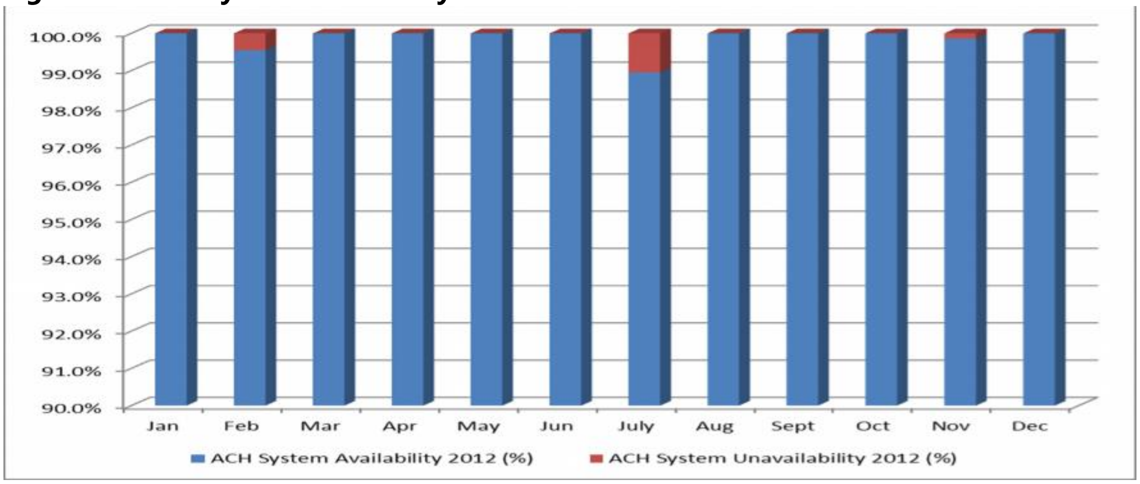
Figure 20: KEPSS Availability



Source: Central Bank, NPS database

Automated Clearing House facilitates the clearing of cheques and Electronic Fund Transfers (EFTs) in Kenya. Implementation of the CTS has enhanced safety, efficiency and effectiveness of the clearing house operations. In 2012, the ACH system had an average availability level of 99.86 per cent, indicating stability in liquidity circulation and efficiency in cheques and EFTs settlement (Figure **21**).

Figure 21: ACH System Availability



Source: Central Bank, NPS database

As part of risks mitigation measures, CBK and KBA have put in place elaborate and effective Business Continuity Management plans in the form of well-resourced Back-up and Disaster Recovery arrangements. Other measures taken by CBK to ensure system stability failures include:

- Acquisition of 2 mobile phones (+254-733-898-167, +254-711-615-762) as hotlines in the event landlines are down / vandalized.
- Installation of VPN access and software to facilitate offsite access of KEPSS in cases of emergencies.
- Operationalization of Back-up Systems and Disaster Recovery Sites.
- Enhanced collaboration among the CBK, KBA and other stakeholders in addressing weaknesses in the system and fostering development.

6. SUMMARY AND OUTLOOK FOR 2013

Globally, economic and financial conditions improved though slowly with mixed results in several jurisdictions. In some markets the recovery is significant, while in others, conditions either deteriorated or remained subdued. Overall, the recovery or optimism witnessed in the international financial markets in 2012 has not only enabled some countries, initially faced with problems to access funding from international capital markets, but it has also created momentum for private capital availability to both governments and private sectors. Macroeconomic environment also showed signs emerging recovery in majority of countries, going into 2013. Fragilities and financial constraints however, still remain, given a drag in the euro zone, slowdown in emerging markets especially in China, and political unrest in the MENA region. These potentially threaten this nascent global recovery.

Domestically, performance of various segments of the financial system reflected improvement in global macro-financial conditions. It also demonstrates policy effectiveness by regulators in restoring and maintaining stability as well as improved macroeconomic conditions. With conclusion of general elections early in 2013, we expect growth momentum to gather speed and vibrancy in the financial markets to resume supported by robust institutional, legal and infrastructure frameworks. Despite the optimism, the following areas require closer surveillance, appropriate diagnostic tests and timely policy interventions or remedial actions by respective regulators or institutions to achieve and maintain safety, soundness and stability of the financial system. These include:

- **Globally,** the potential of further deterioration of macro-financial conditions especially in the US and the Euro Area coupled with political instabilities in the MENA and Sub-Saharan Africa regions will negatively impact on short term financial flows, tourism, and exports may impair stability of domestic financial system. Declining domestic demand in emerging market and developing economies, weaker growth prospects across all regions and potential volatility in global financial markets have compounded vulnerability of global growth.

- **Domestically,** the positive domestic economic recovery outlook, employment creation and poverty eradication efforts face challenges due to several emerging downside risks and vulnerabilities. These include;
    - High rate of unemployment, which if it persists, will not only deny the young people to contribute positively to economic development, but may also create environment for them to engage in criminal activities

and drug abuse, a precursor to insecurity, further undermining growth targets.
  - Increasing industrial disputes degenerating into labour unrest with implications on productivity and high public wage bill where salary demands have to be met.
  - Deterioration of Current Account Deficits by 36.2 per cent in 2012, which requires closer attention to safeguard economic growth prospects and cushion the domestic financial system in case of shocks.
  - Prevailing high interest rates spreads that have negative impact on the private investment in the economy. Interest rates volatility, especially at the short end require proper management so that we avoid distortion to the yield curve and associated instability as was the case in 2011 and early 2012. A stable yield curve consistent with macroeconomic and financial markets fundamentals is crucial in achieving and sustaining stability.
  - Monitoring and evaluation of public debt sustainability risks, in view of devolution and contingent debts is crucial to stability.

- **Kenya's banking system** remains robust going into 2013. However, policy makers need;
  - To monitor and analyse assets quality as well as those banks making losses when others are growing in profits. The uptick in Non-Performing Loans (NPLs) in 2012 indicates that external shocks can easily impair loan books of many banking institutions and therefore require close monitoring.
  - Cross-border and cross-sector analysis of banking groups is required to detect potential sources of vulnerabilities for timely remedial actions. Perhaps fast tracking consolidated supervision through initiatives such as Supervisory Colleges and MOUs already underway would address this issue and mitigate contagion effects in case of external weaknesses. Macro-prudential surveillance requires upscaling to effectively achieve this objective.
  - Concentration of the banking sector credit to real estate, although positive, has potential to cause instability in the financial system if the former experience shocks, hence need for other financing modes for the sector.

- **Other financial system participants** have had major successes amid some challenges, that need to be addressed going into 2013;
  - Foreign investors' participation at the capital markets, targeting equities grew by 9769.7 per cent in 2012 compared to participation in 2011. While this is good, it needs close monitoring for appropriate

measures to maintain stability in case of significant outflows against constrained purchases if unfavourable conditions emerge.

- Market concentration where top 10 of the 63 listed companies, control 72 per cent of the market liquidity is a potential source of risks to capital markets. The proposed SMEs segment among other products need fast-tracking to mitigate this scenario.
- Fragmentation of customer protection funds such as Investor Compensation (CMA), deposit protection fund for banking and DTMs (CBK), and customer protection fund for insurance companies and Saccos (IRA) and deposit savings guarantee fund for SASRA require to be addressed in terms of coverage, funding and even consolidation.
- The 20 per cent value coverage against the international benchmark of 40 per cent by the deposit protection fund needs to be evaluated in the medium to long term. The current stability of the financial sector is not sufficient as a safety net for the financial system.
- To sustain growth and stability of the insurance industry, a combination of onsite and offsite measures in line with RBS framework will require deepening. The 2012 risk assessment results calls for sustained remedial actions by IRA in 2013 to ensure mitigation measures bear fruit on both demand side and supply side drivers of growth.
- Sacco's industry regulatory and supervisory framework should be enhanced to incorporate surveillance and monitoring to ensure full compliance with the set prudential standards to safeguard and guarantee stability.

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