KENYA'S FINANCIAL SECTOR STABILITY REPORT, 2011

December 2011, Issue No. 3

Joint Annual Report by Financial Sector Regulators, June 2012

TABLE OF CONTENTS

LIST OF FIGURES

LIST OF TABLES

ABBREVIATIONS

ATMs	Automated Teller Machines
BCPS	Bank Claims on Public Sector
BIS	Bank for International Settlements
BL	Bank Leverage
BOP	Balance of Payments
BOSAs	Back Office Savings Activities
BRICs	Brazil, Russia, India and China
CBK	Central Bank of Kenya
CBR	Central Bank Rate
CMA	Capital Markets Authority
CDSC	Central Depository and Settlement Corporation
COMESA	Common Market for Eastern and Southern Africa
DSA	Debt Sustainability Analysis
EAC	East African Community
EMDEs	Emerging Markets and Developing Economies
FDI	Foreign Direct Investment
FIGD	Financial Institutions Gross Debt
FOSAs	Front Office Savings Activities
FSI	Financial Soundness Indicators
FSR	Financial Stability Report
GD	Government Debt
GDHA	Government Debt Held Abroad
GDP	Growth Domestic Product
GFSR	Global Financial Stability Report
GGD	Government Gross Debt
GND	Government Net Debt
HHGD	Household Gross Debt
HHND	Household Net Debt
IMF	International Monetary Fund
IPO	Initial Public Offering
IRA	Insurance Regulatory Authority
KEPSS	Kenya Electronic Payment & Settlement
LICs	Least Industrialized Countries
MTDS	Medium Term Debt Strategy
NBIs	Non-Banking Institutions
NCDE	Non-financial Corporate Debt over Equity
NFCGD	Non-financial Corporate Gross Debt
NDA	Net Domestic Assets
NFA	Net Foreign Assets
NPLs	Non-Performing Loans
NPV	Net Present Value
PB	Primary Balance
RBA	Retirement Benefits Authority
REITs	Real Estate Investment Trust
SASRA	Saccos Societies Regulatory Authority
SIPS	Systemically Important Payment System
SMEs	Small and Medium Enterprises
SSA	Sub-Saharan Africa

TEGEL	Total Economy Gross External Liabilities
TENEL	Total Economy Net External Liabilities
WEO	World Economic Outlook

FOREWORD BY THE CHAIR

Financial Stability Report 2011 (FSR, 2011) is a joint publication of the five financial sector regulators: Central Bank of Kenya (CBK); Capital Markets Authority (CMA); Insurance Regulatory Authority (IRA); Retirement Benefits Authority (RBA); and Sacco Societies Regulatory Authority (SASRA). It is an information tool relating to developments in the financial sector in the period January – December, 2011.

The primary goal of the FSR 2011 is to share with stakeholders and the general public an assessment of recent developments and potential sources of risks in the financial system encompassing financial markets, institutions, and infrastructure as well as legal and policy frameworks in Kenya in the year 2011. The report highlights possible risks and vulnerabilities in the financial system and outlines policy actions or mitigating measures being undertaken by respective regulatory bodies to reduce possible ocuurence of such risks. It also provides insights into the most recent financial sector developments by the industry as well as the commensurate policy initiatives to create a robust base to mitigate potential vulnerabilities.

In recognition that Kenya is integrated into the global financial and economic system, the FSR 2011 evaluates the impact of developments in global macro-financial conditions to domestic economy and financial system. This report, therefore, creates a platform for public awareness on dynamics in the domestic financial sector in response to developments in the global arena. It thus sensitises key stakeholders aim to achieve and maintain stability of the domestic financial system so as to enable it play its rightful role.

The financial system plays a critical role in economic development across the globe. It provides intermediation services by mobilising savers and channel surplus funds to investors for investments that promise a positive return. A stable and efficient financial system pools and transfers resources while minimising risks. At the same time, it increases liquidity and enhances information shairing through the use of more sophisticated financial products and technological innovations. Therefore, the regulators contribute immensely to economic development by providing a wide range of regulatory and supervisory services that promote orderly growth and functioning of financial institutions, financial markets and financial infrastructure. They identify potential weaknesses and downside risks and take measures to mitigate them. In Kenya, the five financial sector regulators; CBK, CMA, RBA, IRA and SASRA, continuously monitor and evaluate performance, soundness and stability of their respective industries to ensure overall stability for the whole system. These measures are captured in this FSR 2011.

This FSR 2011 is being published at a time when, a combination of both domestic and global shocks pose significant risks to the domestic financial system stability. Sovereign stress in the Euro Zone has spilled over to banking industry, pushing up markets risks and exercerbating economic difficulties. More downgrades by leading Credit Rating Agencies of the once robust banking system in the developed world, have compounded the risks.

Domestically, the year 2011 remains very challenging in terms of instability in the financial markets and slow economic recovery in response to external shocks and structural weaknesses affecting the economy. During the period under review, the economy experienced rapid weakening of the Kenya Shilling, steeply rising inflation, and high interest rates, together with drying up of capital markets. This situation was replicated across the EAC region, where spillover effects from instability in global markets were experienced throughout. Combined with steep rise in crude oil prices, the effects of drought on food security and uncertainty in the economy, most investors and traders, as well as the general public, were affected negatively.

This report highlights policy initiatives undertaken by each regulator to cushion the economy, and the financial sector in particular, to mitigate any further risks that threatened stability. The public will find the document invaluable in terms of enhancing its knowledge of financial sector developments and performance as well as appreciating the role played by various regulators in restoring and sustaining stability of the financial system in the course of this difficult period.

PROF. NJUGUNA NDUNG'U
GOVERNOR, CENTRAL BANK OF KENYA, AND
THE CHAIR, JOINT REGULATORS BOARD

ACKNOWLEDGEMENT

Publication of this third edition of Financial Stability Report (FSR, 2011) is a chronical of the efforts by the Joint Regulators Board to promote soundness and stability of Kenya's financial system, a necessary prerequisite towards achieving the national development agenda under Vision 2030 and EAC regional integration. It also gives an overview of the regulators' concerns that instability in global economies and financial markets have implication to the domestic macro-financial conditions. As a result, close surveillance for timely policy actions remain necessary for both regulators and policymakers.

As was the case with the FSR 2010, this report has inputs from 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 Ministry of Finance and the Ministry of Co-operative Development and Marketing were observers during the writing of this report. The joint financial sector stability assessment and analysis is one avenue through which the Joint Regulators Board Forum monitors and evaluates developments and performance of the financial sector in order to mitigate risks and vulnerabilities that may cause instability. This publication is, thus, important in highlighting developments that took place in 2011 and the policy responses taken to manage the emerging risks.

I take this opportunity to thank senior management of regulators in the sector, and their chief executive officers for providing staff, technical support and approval of this Report. I wish to thank in particular members of Financial Sector Stability Technical Committee (FSSTC) who undertook the analysis and production of this Report. In particular, the CMA; CBK; Deposit Protection Fund Board; IRA; RBA and SASRA have worked intensely to ensure the report is published six months earlier than Issue Two. I wish to encourage the team, in this case, FSSTC, to work towards reducing publication period to semi-annual production in order to be in conformity with the global practice.

<u>CHARLES G. KOORI</u>

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CENTRAL BANK OF KENYA AND CHAIR OF THE FSSTC

1. OVERVIEW

The Financial Stability Report, 2011 provides a comprehensive assessment of performance and soundness of Kenya's financial system at the macro-level in the year 2011. The report not only discusses the performance indicators, but it also identifies emerging risks and vulnerabilities to the system as well as policy actions taken by line regulators to achieve and sustain stability. In addition, this FSR outlines the regulators' capacity to deal with any adverse shocks to the system.

Globally, growth of output declined to 3.9 percent in 2011 down from 5.3 percent in 2010. The slow down reflected the escalating strains in the Euro Area and fragilities in the financial and economic conditions of the major developed economies. The unprecedented policy measures taken by Governments during the early stage of the crisis did not help much to stabilize financial markets and jump-start recovery. The 2012 global output is therefore projected to decline further to 3.4 percent in 2012. The bleak outlook factors in the forecasted mild recession in the Euro Area in 2012 following the increase in sovereign yields, the effects of bank deleveraging on the real economy, and the impact of additional fiscal consolidation. Growth in emerging and developing economies is also expected to slow down on account of the worsening external environment and weakening internal demand. These developments impacted the domestic economy and perfromance performance of the financial sector.

Domestically, the year 2011 recorded a slowing economy with real GDP growth rate down to 4.4 percent compared to a revised growth rate of 5.7 percent in 2010. This is however a better performance given the extent of shocks experienced during the period. Overall inflation increased to double digits, as interest rates escalated mainly as a result of tightening of the monetary policy and exchange rate weakened markedly. Overall public and publicly guaranteed debt rose by 21.3 percent by end June 2011 to Ksh 1,487.11 billion or 53.8 percent of GDP up from KSh.1, 225.7 billion or 51 percent of GDP by end June 2010. By end December 2011, the public debt stock declined to Ksh 1,486.29 billion or 49.9 percent of GDP due to the strengthening of the Kenya Shilling. The Government liabilities to Central Bank was up due to the Treasury securities rediscounted by holders to support liquidity following the tightening of monetary policy. The remittances inflows were up 39 percent, reflecting the confidence Kenyans in the Diaspora have in the domestic economy.

Domestic financial sector maintained its strong performance in 2011, with profits before tax rising by 20.5 percent as revenue inflows grew much faster. Total NPLs declined by 10.1 percent while stress test results indicated that Kenya's banking sector was stable and able to absorb substantial negative shocks. The value of money transfers via mobile phones rose by 59.7 percent, while the number of users grew by 17.1 percent from 16.4 million customers in December 2010 to 19.2 million customers in December 2011

There was a relative strong interest in the primary equities market during 2011. However a relative market downturn resulted in a notable reduction in secondary market equity performance. In the bonds market, a key milestone was achieved by the issuing of the longest dated central government debt instrument in Kenya's history (including East and Central Africa), a 30-year Savings Development Bond in February 2011. The retirement benefits industry assets declined by 4.1 percent from Ksh.450.69 billion in December 2010 to Ksh.432.8 billion in December 2011 with schemes returns averaging -9.9 percent down from 27.8 percent in 2010.

The total industry assets stood at Ksh.233 billion as at December 2011; representing 4.7 percent growth in asset base.

Overall, growth of output in the global economy slowed down, affecting the domestic economy. Despite this, developing economies remain exposed to global risks which might weigh heavily on the 2012 growth projections, with negative spillovers felt in the domestic economy. First, increasing portfolio capital inflows will put pressure on some financial markets, contributing to higher leverage, potential asset price bubbles, and inflation. Many Emerging Markets & Developing Economies(EMDEs) have introduced more flexibility in their exchange rate regimes over time, with a view to promote a more efficient allocation of resources and a smoother adjustment of external current account balances. Nevertheless, it can also mean periods of high exchange rate volatility, often in response to shifts in global economic conditions, resulting in sizable capital inflows or outflows (also in many EMDEs) and high volatility in those flows.

Second, the presence of foreign-owned banks also entails potential risks for host EMDEs. Liquidity or solvency problems may spill over from a parent bank to its operations in host countries. Third, the rapid pace of growth of the Non-Bank Financial Institutions (NBFIs) sector, combined with worsening asset quality, may potentially have adverse consequences for financial stability in some EMDEs. To the extent that NBFIs are increasingly moving into, or are interconnected with, traditional financial intermediation, their failure may adversely impact depositors and, under certain circumstances, result in contagion to other financial institutions. Erosion of public confidence in NBIs may encourage further growth in the informal financial system and thus undermine public policies to promote financial inclusion.

The FSR 2011 allows the oversight function of each of the financial sector regulators to focus on identifying and mitigating potential weaknesses and downside risks in their respective industries. As a result, the regulators are better prepared to:–

- Identify and deal with any imbalances and risks in the economy before they become a threat to the overall financial system stability.
- Create a well-functioning, sound and stable financial system, based on prudent risk management and business continuity strategies and market-disciplining mechanisms that achieve resilience and prevent financial crises.
- Promote a financial system that fulfils its role of effectively and efficiently allocating resources among economic agents, while managing and mitigating risks, mobilizing savings and facilitating wealth creation for wider economic development.
- Pursue policies that would improve access to finance for a majority of the population, thus, raising the level of monetization in the economy for economic development and effective implementation of monetary policy.

This report comes at a time when there are shocks and instabilities in the domestic and global economies emanating from the euro area debt crisis, high oil prices, high commodity prices locally and abroad, and sluggish economic recovery in advanced economies. It thus provides a perspective of financial system risks and threats and an early warning system for strengthening financial system stability.

2. RATIONALE FOR FINANCIAL STABILITY

Financial stability is not an end in itself but, like price stability, is generally regarded as an important precondition for sustainable economic growth and employment creation.

Financial stability is defined as the smooth operation of the system of financial intermediation between households, firms and the government through a range of financial institutions supported by a myriad financial infrastructure. Stability in the financial system would be reflected in an efficient regulatory infrastructure, efficient and well-developed financial markets and, efficient and sound financial institutions. In its pursuit of financial stability, Financial Sector Regulators in Kenya rely on market forces fully and believe that any measures to contain systemic risk should be at the minimum level required to be effective.

Financial instability, on the other hand, could manifest through banking failures, extreme asset-price volatility, collapse of market liquidity and, in the end, a disruption in the payment and settlement system. Financial instability affects the real sector due to its links to the financial sector. It has the potential to cause significant macroeconomic costs by interfering with production, consumption and investment. This ultimately defeats the national goals of broader economic growth and development.

Positive interaction between the macroeconomic conditions and financial sector is critical in achieving and maintaining financial system stability, hence the argument for the stability of macrofinancial conditions. Emerging trends of fiscal and debt sustainability, and their impact not only on macroeconomic stability, but also on financial system stability, have demonstrated intense efforts policy- makers and regulators must undertake to mitigate financial instability. Financial Stability Report therefore remains an overarching instrument in communicatingthe prevailing vulnerabilities and strengths of wholesome financial system given the dynamics in the macroeconomy, financial system itself and general public. In preparing the report, both qualitative and quantitative data/information are useful.

3. GLOBAL ECONOMIC AND FINANCIAL SECTOR DEVELOPMENTS

Dynamics in global macroeconomic environment impacts on Kenya's overall economy and financial sector performance in particular. Channels via which impact is transmitted include; trade balances, net capital inflows and foreign exchange market. These, in turn have a bearing on the financial sector stability. Global imbalances and other unfavourable developments significantly impacted on the global economic and financial recovery in 2011.

3.1. Global Economic and Financial Developments in 2011

Global economy expanded by 3.9 percent in 2011 down from 5.3 percent growth rate in 2010 **(Table 1 and Figure 1)**. This derailed global recovery was reflected by the dimmed growth prospects and the sharp escalation of risks in the fourth quarter of 2011. There was an overall downward performance across all economic groups **(Table 1)**, but advanced economies performed better than forecasted, mainly due to unexpected lowering of saving rates in the US and the business fixed investments staying strong.

Table 1: World Economic Outlook Projections (Percentage Change)

GROUP	2009	2010	2011	2012	2013
World Economy	-0.6	5.3	3.9	3.5	4.1
Advanced Economies	-3.6	3.2	1.6	1.4	2.0
Emerging & Developing Economies	2.8	7.5	6.2	5.7	6.0
Sub-Saharan Africa	2.8	5.3	5.1	5.4	5.3
BRICs	1.9	8.2	5.9	5.5	6.0

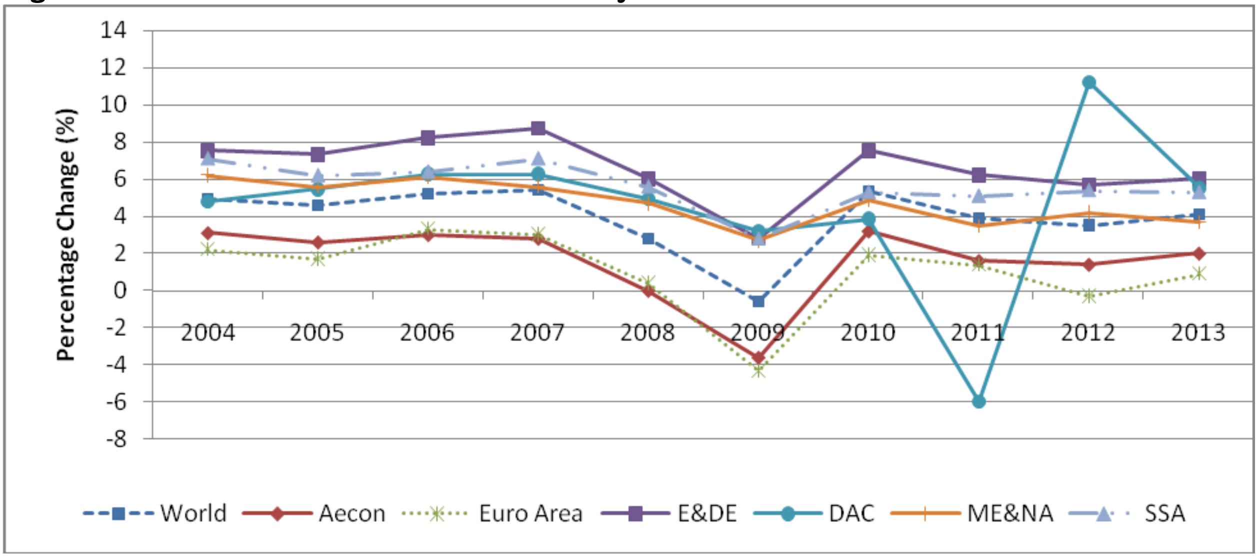
Source: World Economic Outlook, April 2012

Emerging and developing economies however slowed relative to the forecast to an annualized rate of 6.2 percent as a result of a more than expected effect of macroeconomic policy tightening coupled with weaker underlying growth. The SSA region performance was robust, with many economies growing at rates close to their pre-crisis averages.

Global growth is projected to drop from about 4 percent in 2011 to about 3.5 percent in 2012 because of weak activity during the second half of 2011 and the first half of 2012. The January 2012 WEO Update had already marked down the projections of the September 2011 World Economic Outlook, mainly on account of the damage done by deteriorating sovereign and banking sector developments in the euro area. For most economies, including the euro area, growth is now expected to be modestly stronger than predicted in the January 2012 WEO Update.

The most immediate policy challenge for the stalling global recovery is to restore confidence and put an end to the euro area crisis. This would require major advanced economies to address medium-term fiscal imbalances, repair and reform financial systems while sustaining recovery. The emerging and developing economies should focus on moderating domestic growth and slowing external demand from advanced countries while dealing with volatile capital flows.

Figure 1: Global GDP Growth Rate and Projections for 2004-2013



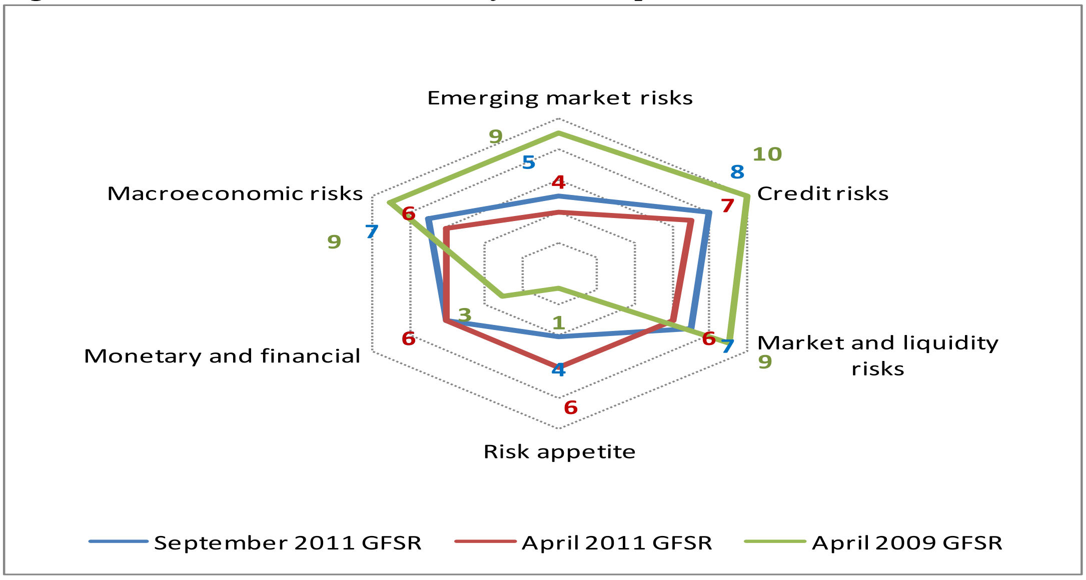
Source: Estimated from World Economic Outlook Database April 2012

The Global Financial Stability Report September 2011 shows that risks increased, reflecting a partial reverse in progress made over the past three years. Sovereign financing remains a challenge and downward risks continue despite various policy measures to contain the crisis and banking problems. Against the Global Financial Stability Heat Map, September 2011**(Figure 2)**, macroeconomic risks increased from level **7** in the April 2011 FSR to **8** in September 2011 FSR reflecting a significant rise in sovereign risks in advanced economies, and unexpected weakness in economic activity. Similarly, market and liquidity risks rose from level **6** to **7** over the period. Higher volatility on government bonds issued by euro area countries in the periphery led to heightened uncertainty about future funding conditions. As a result, global risk appetite among investors dropped from level of **6** to **4**, prompting investors to reduce exposure to sovereign and macroeconomic risks.

Credit risks rose from level **7** to **8** between April and September 2011 as concerns over sovereign strains spilled over to the banking system, escalating market measures of contagion risk. Monetary and financial conditions stabilized at a level **6,** but interest rates in advanced economies were low pushing investors into search for better yields. This contributed to strong capital inflows, though volatile, and high credit growth in emerging markets, raising emerging market risks to level **5** from **4**. This has countercyclical risks as noted in the GFSR 2011- global downsides weighing on emerging markets lead to sharp reduction in demand, a reversal in capital inflows and a rise in funding costs that could impact the financial soundness of domestic banks.

Concerns about banking sector losses and fiscal sustainability widened sovereign spreads for many euro area countries in the last quarter of 2011, reaching the highs not seen since the launch of the Economic and Monetary Union. Bank funding dried up in the euro area while lending conditions deteriorated across a number of advanced economies.

Figure 2: Global Financial Stability Heat Map

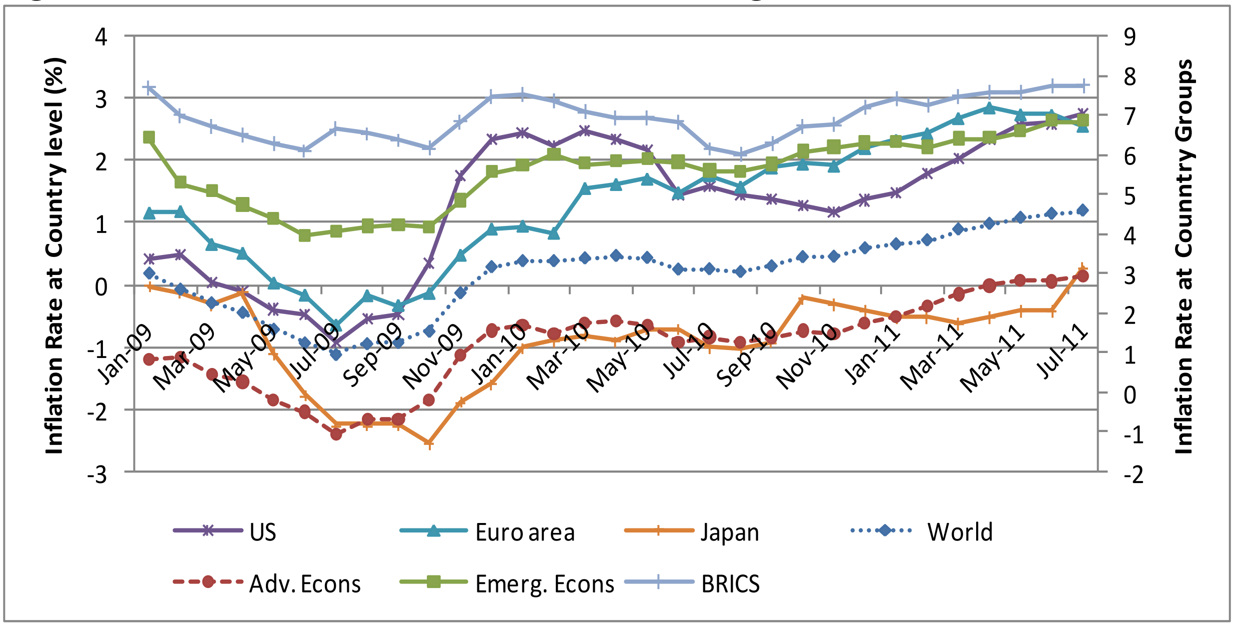


Source: Global Financial Stability Report, September 2011

Capital flows to emerging economies fell sharply while many emerging market currencies depreciated significantly. With accumulating signs of weakness in key advanced economies, equity markets have fallen sharply and equity price volatility has gone up. Prices of strong sovereign bonds and gold rose, indicating more cautious investors on the prospects of the major advanced economies.

As indicated in Figure 3, headline inflation has been on the rise in many parts of the world. Inflation pressure and surging housing prices are still elevated especially in emerging and developing economies, with China accounting for about 40 percent of global metal consumption and 18 percent of energy consumption. In the major advanced economies, inflation appears to be losing some momentum.

Figure 3: Global Headline Inflation Trends (Percentage)



Source: IMF, World Economic Outlook Database, September2011

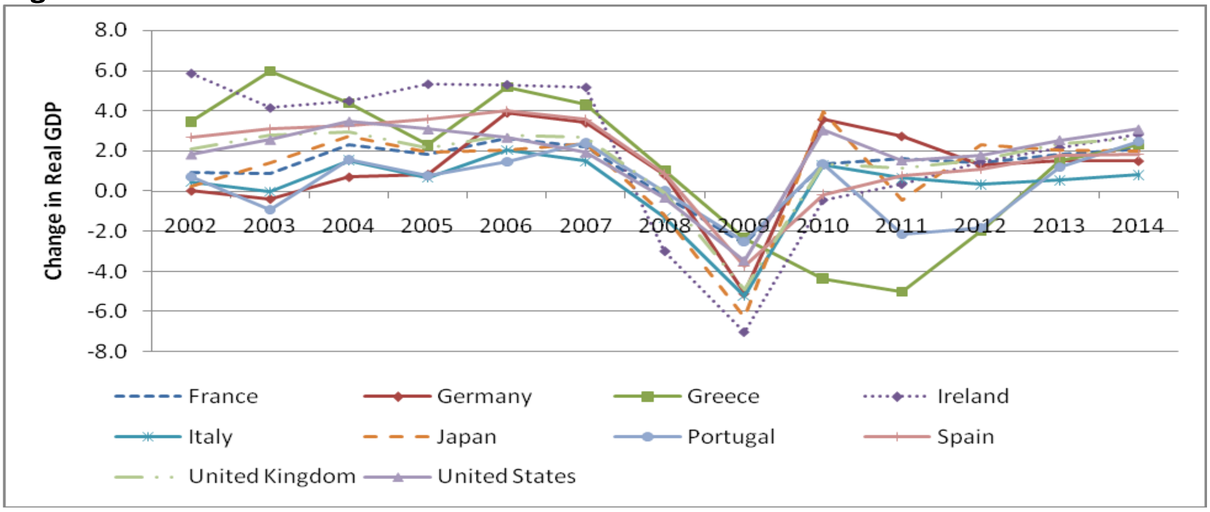
3.2. Developments in Advanced Economies

Advanced economies recorded a weaker growth of 1.6 percent in 2011 after a 3.2 percent growth in 2010. Of the 10 selected advanced economies in Figure **4**, Germany had the highest economic expansion averaging 2.7 percent while Japan, Greece and Portugal economies shrunk. Stalling of two rebalancing acts slowed down recovery momentum. For internal rebalancing, tight bank lending, housing boom legacy, and high leverage for many households all turned out to be putting stronger brakes on the recovery than was anticipated. The need of external rebalancing, most notably in the United States, is not taking place. While imbalances decreased during the crisis, this was due more to a large decrease in output in advanced relative to emerging market economies than to structural adjustment in these economies. These imbalances are forecast to increase rather than a decrease.

The dimmed growth prospects have stalled the progress in balance sheet repair in many advanced economies. Sovereign stress in the euro area has spilled over to banking systems in the advanced economies, pushing up credit and market risks. Worries about sovereigns have translated into worries about the banks holding these sovereign bonds, mainly in Europe, in turn, leading to a partial freeze of financial flows, with banks keeping high levels of liquidity and tightening lending. Sovereign credit risks experienced by banks are amplified through the network of highly interconnected and leveraged financial institutions.

Sharp declines in bank equity prices prompted the U.S. money funds to further reduce lending to European banks, thus worsening the Euro area interbank financing conditions, and sending the Euribor-OIS spread to its widest level since April 2009. Banks in some economies lost access to private funding markets, raising the risk of more severe deleveraging, credit contraction, and economic drag. This calls for credible fiscal consolidation strategies and enhancing the robustness of banks.

Figure 4: GDP Growth Rate for Select Advanced Economies

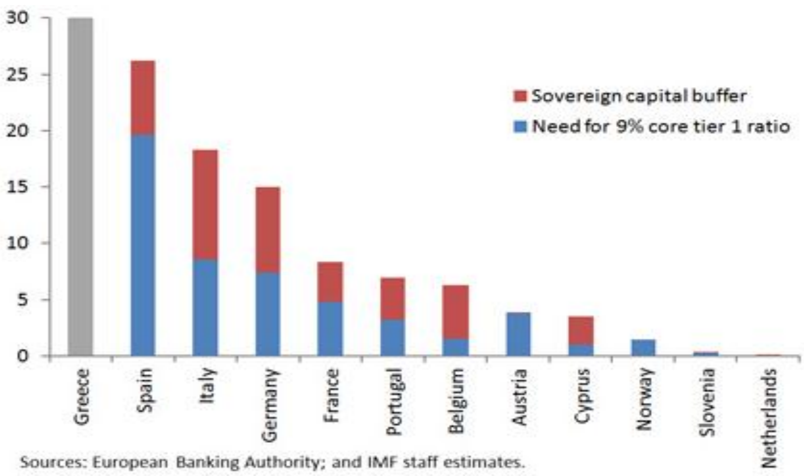


Source: The IMF Statistics Database, 2012

Low interest rates and excess liquidity have spurred the search for yield, diverting credit creation into more obscure channels. Although the low rates are appropriate as a natural policy response to weak economic activity, this condition increases the potential for a sharper and more powerful turn in credit, risk greater deterioration in asset quality in the event of new shocks.

Pressure on European banks has escalated, reflecting the increase in sovereign stress and the closure of many private funding channels. As a result, the European Banking Authority (EBA) has initiated a process calling for banks to reach higher capital ratios of 9 percent core Tier 1 ratio and provide an adequate sovereign capital buffer (Figure **5**).

Figure 5: European Bank Capital Needs (Euros in Billions)



Banks are to use private sources of funding to first strengthen their capital position to meet the required target, including retained earnings, reduced bonus payments, new issuances of common equity and suitably strong contingent. Sovereign risks have also affected banks on the liabilities side of their balance sheet as implicit government guarantees have been eroded, the value of government bonds used as collateral has fallen, margin calls have been raised, and bank ratings downgraded following cuts to sovereign ratings.

The impact of sovereign risks spill-over has been greatest on the most exposed banks in high-spread euro area countries. The disruption to funding markets could spread further, which would increase deleveraging pressures on banks and reduce credit growth in the most affected economies, reigniting a negative feedback loop with the real economy. Credible efforts are required to strengthen the resilience of the financial system.

As indicated in **Table 2**, the peak in sovereign debt burdens coincides with that of private debt burdens. Government debt is generally high and on a worrying upward path in a number of advanced economies. Except for Italy and Germany, all other advanced economies had negative Primary balance in 2011, signifying persistent fiscal deficits and therefore potential high public debt accumulation. Many advanced economies face high public debt funding needs, as primary balances remain in deficit and shorter-term debt issued during the financial crisis matures over the next year and a half, posing rollover risks. Notably, of the eleven countries selected, all, but Portugal's gross government debt (GGD) exceeded 70 percent of GDP in 2011, with other five countries exceeding 100 percent.

Table 2: Indebtedness and Leverage in Some Advanced Economies (Percent of 2011 GDP except as noted)

Measure	US	Japan	UK	Canada	Euro Area	Germany	Greece	Ireland	Italy	Spain	Portugal
GGD	100	233	81	84	89	83	166	109	121	106	67
GND	73	131	73	35	69	57	n.a	99	100	102	56
PB	-8	-8.9	-5.6	-3.7	-1.5	0.4	-1.3	-6.8	0.5	-1.9	-4.4
HHGD	92	77	101	n.a	70	60	71	123	50	106	87
HHND	-232	-236	-184	n.a	-126	-132	-57	-67	-178	-123	-78
NFCGD	90	143	118	n.a	138	80	74	245	110	149	192
NCDE (%)	92	181	83	70	106	92	182	90	125	136	134
FIGD	94	188	547	n.a	143	98	22	689	96	61	111
BL	12	24	24	18	26	32	17	18	20	17	19
BCPS	8	80	9	19	n.a	23	28	25	32	24	24
TEGEL	151	67	607	98	169	200	202	1680	140	284	212
TENEL	16	-54	11	12	13	-41	104	98	26	106	88
GD Abroad	30	15	19	16	25	41	91	61	51	53	28

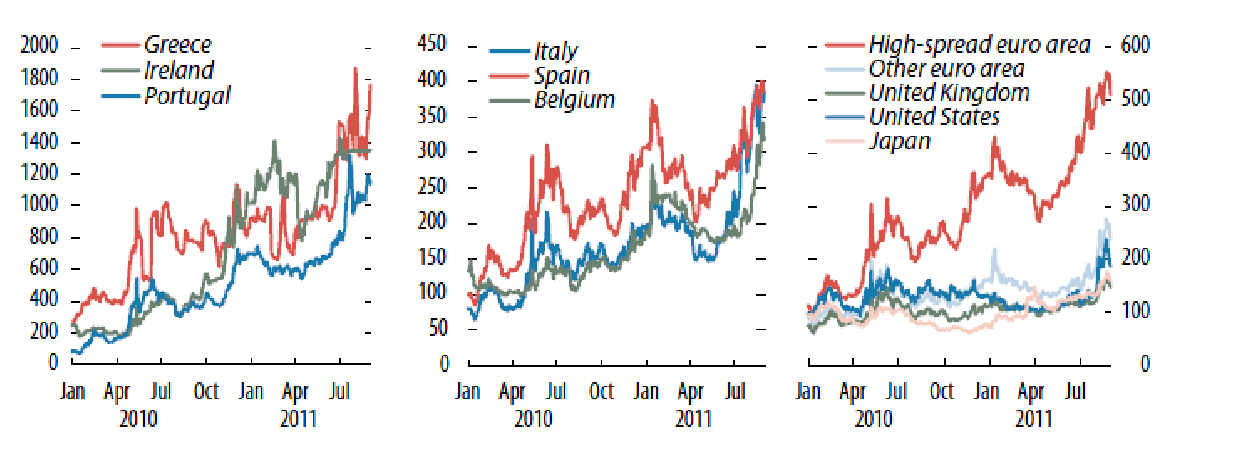
Source: Global Financial Stability Report, September 2011

Households remain highly indebted on net basis in all advanced economies, with Greece having the least at 57 percent. High mortgage debt and sharp fall in house prices left many U.S households with negative equity and raised risks to banks from mortgage defaults. There is need for additional policy efforts to secure a comprehensive solution to the fiscal problems and prevent further contagion. Ireland and Spain face similar vulnerabilities due to bursting of housing bubbles. Portugal, Italy, Germany, Euro Area and the United Kingdom also face high household debt. Greece, Italy, Republic of Ireland and Spain were indebted to foreign lenders by more than 50 percent of their respective GDPs in 2011.

In the euro area, prospects for the financial sector remain closely tied to sovereign stress. Spillovers from high-spread euro area sovereigns have not only affected local banking systems but, have also spread to institutions in other countries with operations in the high-spread euro area and with cross-border asset holdings. Many banks still face investor doubts about their financial future despite relatively better capital ratios.

More generally, persistent high bank leverage means that many financial institutions find it difficult to secure market funding on adequate terms in the absence of some form of public support. In countries perceived as most vulnerable by markets, an adverse feedback loop developed, with widening sovereign spreads raising concerns about bank exposures. Since banks lend to banks, the system is highly interconnected, both within and across borders. As a result, the banking system can amplify the size of the original sovereign shock through funding markets, and with sovereign spillovers, it impacts on bank funding markets. This can be illustrated by the sharp widening in credit default swap spreads for banks in the high-spread euro area countries (Figure **6**) and the difficulties that some banks in these countries faced in issuing debt.

Figure 6: Spreads on Bank Five-Year Credit Default Swaps (basis points)



Source: Global Financial Stability Report, 2011

Interbank markets also began differentiating between types of euro government collateral and the borrowing institution's country of origin. High volatility and rising yields on government bonds issued by countries on the periphery of the euro area are threatening a loss of investor confidence, weakening the investor base, and further driving up funding costs. Consequently, public debt has become more difficult to finance, while higher sovereign risk premiums are disrupting bank funding markets. These concerns are eroding confidence in broader markets, reflected in a two-notch contraction in risk appetite. Greece still poses greatest vulnerability to the Euro Area through cross-border exposures and foreign holders of Greek debt.

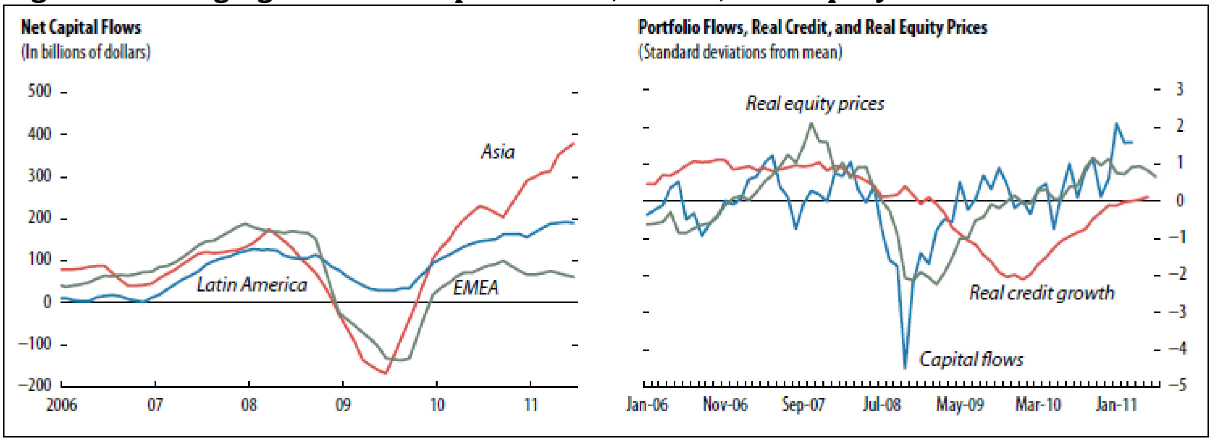
3.3. Emerging Markets and Developing Economies (EMDEs)

EM&DEs recorded a 6.2 percent growth in 2011, a significant slowdown from 7.3 percent in 2010. This reflects the deterioration in the external environment. China led the pack with a 9.2

percent economic growth in 2011, maintaining as the world's fastest-expanding major economy. The growth in EM&DEs is however expected to further slow down to an annual growth target of 5.4 percent in 2012 due to the external worsening external environment and a weakening of internal demand. Brighter growth prospects and stronger fundamentals, combined with low interest rates in advanced economies, resulted in EMDEs attracting strong capital inflows. As indicated in Figure **7**, net capital flows to emerging markets remained relatively strong, although volatile, during the first half of 2011.

However, emerging markets face the risk of sharp reversals prompted by weaker global growth, sudden capital outflows, or a rise in funding costs that could weaken domestic banks. Banks in Latin America are more vulnerable to terms-of-trade shocks, while banks in Asia and emerging Europe are more sensitive to increases in funding costs. As a result, emerging markets risks have increased since the April 2011 GFSR.

Figure 7: Emerging Markets: Capital Flows, Credit, and Equity Prices

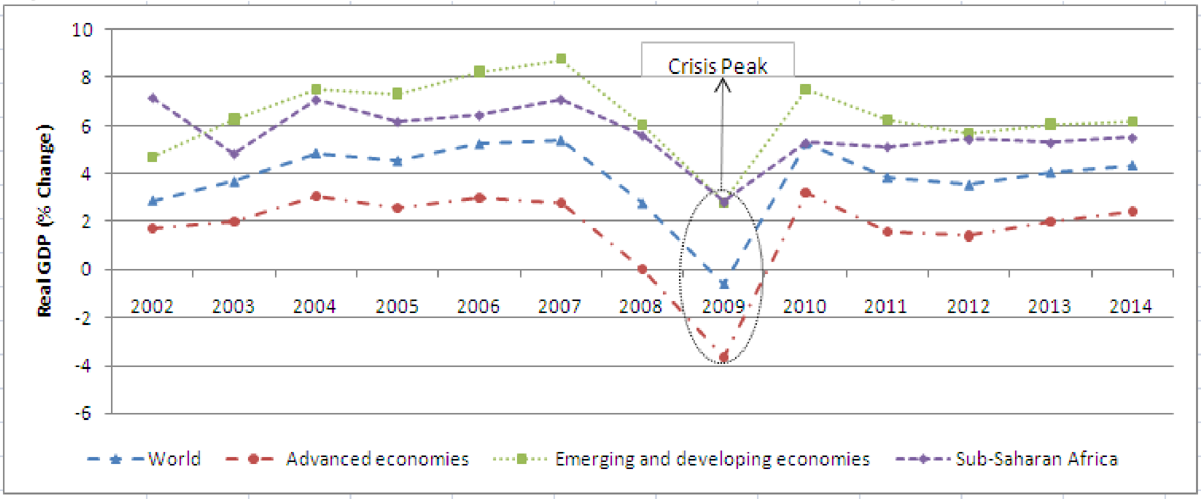


Source: Global Financial Stability Report, 2011

3.4. Sub-Saharan Africa and East African Economies

Growth in Sub-Saharan Africa in 2011 was 5.13 percent from 5.29 percent in 2010 and is projected to expand further to 5.44 percent in 2012 as indicated in the Figure **8.**

Figure 8: GDP Growth rate in Sub-Saharan Africa Vs Other Regions



Source: IMF, World Economic Outlook database, April 2012

The global slowdown has not significantly affected the region thus far, but downside risks have risen. Most of the region's low-income countries (LICs) have returned to their pre-crisis growth rates. Average growth for the LICs group was at 5.8 percent in 2011, on the back of strong domestic demand and accelerating exports. In 2012, growth is expected to expand to 5.9 percent as shown in **Table 3**.

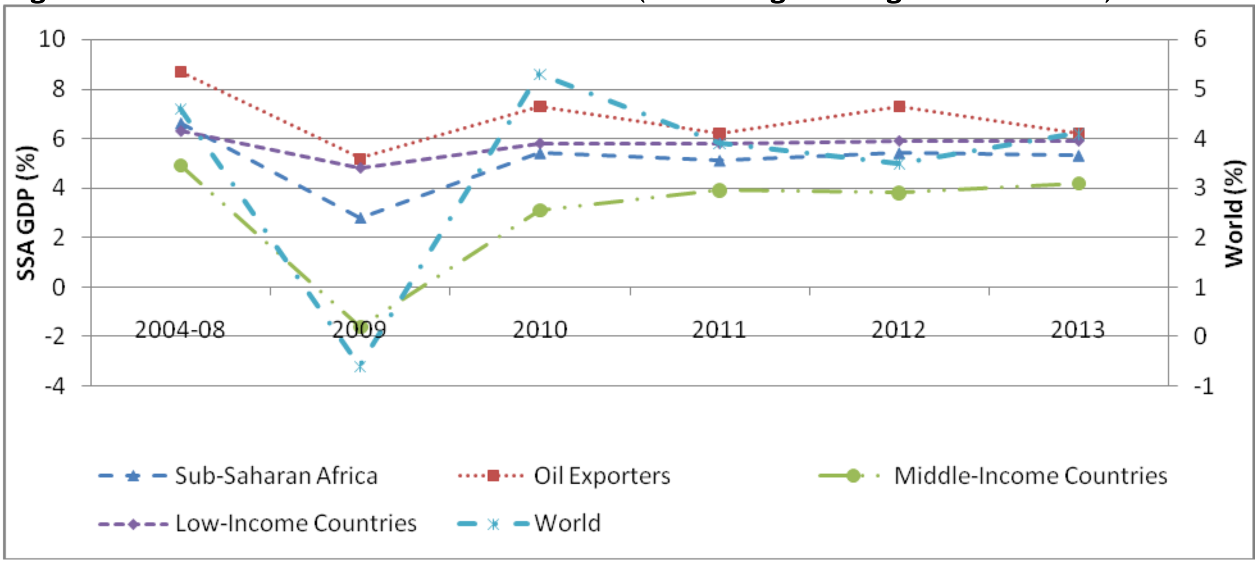
Table 3: Sub-Saharan Africa - Growth by Country Groups

Regions in Sub-Saharan Africa	**2004-08**	**2009**	**2010**	**2011**	**2012** Projections	**2013**
Sub-Saharan Africa	6.6	2.8	5.4	5.1	5.4	5.3
Oil Exporters	8.7	5.2	7.3	6.2	7.3	6.2
Middle-Income Countries	4.9	-1.6	3.1	3.9	3.8	4.2
Low-Income Countries	6.3	4.8	5.8	5.8	5.9	5.9
World	4.6	-0.6	5.3	3.9	3.5	4.1

Source: IMF, World Economic Outlook Report, April 2012

Oil-exporting economies recorded a slow down in growth to 6.2 percent in 2011, however with a positive outlook of 7.3 percent in 2012 **(Table 3).** Middle-income countries (MICs), whose greater integration with global markets made them more vulnerable to the crisis; are yet to fully recover from its impact. A surge in unemployment, high household debt, low capacity utilization, the slowdown in advanced economies, and substantial real exchange rate appreciation are making for a hesitant recovery in South Africa. However, its output gap is projected to close as growth picks up to 3.9 percent in 2012 **(Table 4).**

Figure 9: Sub-Saharan Africa and the World (Percentage Change in Real GDP)



Source: IMF, World Economic Outlook Report, April 2012

Economic growth in South Africa will be driven by private consumption and reinvigorated investment, supported by a low interest rate regime and a return to licensing new mines. A further deterioration of the global economic environment could have substantial spillovers to the SSA region. This is likely to pull back recovery momentum especially in non-oil commodities market, thus slowing down trade. More immediately, sharp increase in oil prices, while boosting growth in oil exporters, would pose significant challenges for oil importers. Similarly, a continued surge in non-oil commodity prices would entail large social and fiscal costs for the region's net commodity importers. Other risks to the outlook are political uncertainty and weather shocks which also have the potential to dampen growth prospects.

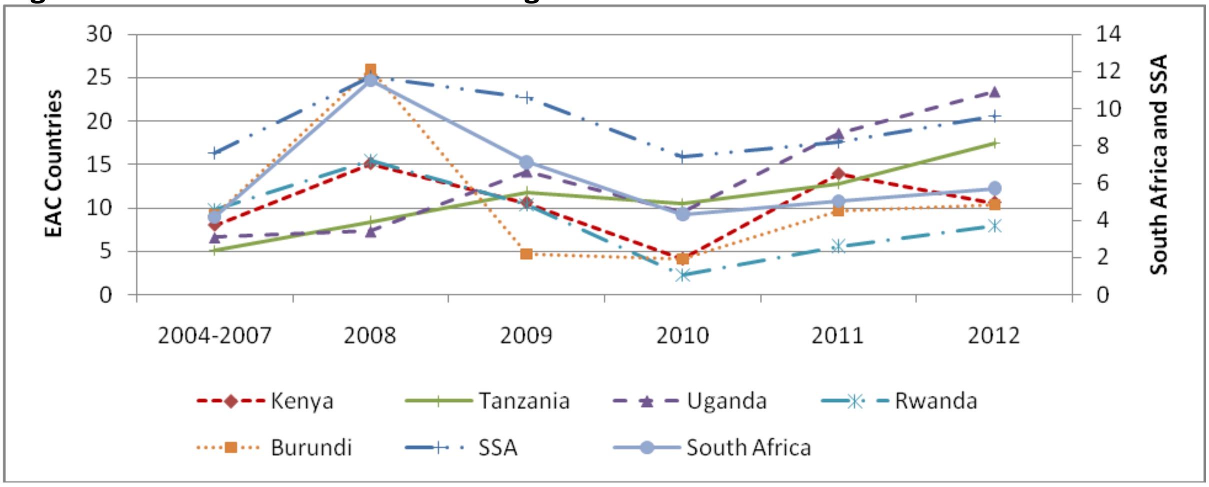
Table 4: Actual and Projected Output for EAC Region and South Africa

Country/Region	2004-07	2008	2009	2010	2011	2012*
SSA	6.69	5.6	2.80	5.3	5.1	5.4
South Africa	5.25	3.6	-1.5	2.9	3.1	2.7
Kenya	5.80	1.5	2.6	5.7	4.4	5.2
Tanzania	7.29	7.73	6.70	6.5	6.7	6.4
Uganda	8.08	8.8	7.2	5.9	6.7	4.2
Rwanda	7.89	11.2	4.1	7.5	8.8	7.6
Burundi	3.61	5.0	3.5	3.8	4.2	4.80

Source: IMF World Economic Outlook Report April 2012 and Kenya Economic Survey 2012

Across the SSA region, inflation showed signs of deceleration in late 2011, going into 2012 as countries took bold steps in reducing inflation. In the EAC, Rwanda was the only country which maintained single digit inflation throughout the year, averaging 5.6 percent. Inflation peaked at one point to 30.5 percent in Uganda and 19.8 percent in Tanzania. In 2011, Kenya recorded the highest overall inflation in November at 19.7 percent.

Figure 10: Inflation Rates in EAC Region and South Africa



Source: IMF World Economic Outlook Report April 2012 and Various Bank Annual Reports

3.5. Impact of Global Macro-financial Developments to Domestic Financial Stability

Kenya is an open economy with fully liberalized financial markets with free movement of capital into and outside the economy. The country has fairly diversified export and import of goods and services where exports include tea, coffee, horticulture, industrial goods, and limited minerals. Services are mainly hospitality industry, with tourism, financial services and technology leading. The main trading partners include EAC, COMESA, Europe, and the US. Therefore, economic recovery in the main trading partners has positive impact on Kenya's macroeconomic environment and in turn overall financial system stability. It is worthwhile to note the continued fragility in Europe, declining demand in Asia and slow recovery in the US pose significant threats to Kenya's macroeconomic and financial stability.

Besides Kenya's improved Balance of Payments, stability of these countries' currencies will ensure stability of Kenya Shilling, thus ensuring foreign exchange stability. In addition, the Kenya benefits from improved capital flows both in terms of foreign direct investment (FDI), capital transfers, investment in capital markets and Diaspora remittances. Improved equities markets abroad, reflecting higher risk appetite, means foreign investors look for higher yields/return in emerging markets like Kenya, thus leading to stability of domestic financial markets. The weaker global demand for commodities in 2011 contributed to a lower GDP growth rate for Sub-Saharan Africa from 5.4 percent in 2010 to 5.1 percent in 2011.

Despite positive performance and outlook from global and regional economies, Kenya's economy and financial system stability face vulnerabilities associated with global risks. For instance, there were downside risks emanating from sharp increase in commodity and fuel prices, especially in non-oil producing countries. This led to imported inflation and impacted negatively on the stability of exchange rate. This was compounded by continued socio-political tensions in the MENA region, a key source market for oil and consumers of Kenya's tea exports.

Rising unemployment among the youth, fiscal imbalances, households' debt problems amid weak disposable incomes, deflation signs in some countries and vulnerabilities in real estate markets in advanced economies pose significant risks to Kenya's macroeconomic indicators. High unemployment in Europe and declining incomes in Asia reduces disposable income and therefore impacts negatively on tourism sector. These compounded with signs of overheating, inflationary pressures, and cautious global capital and credit markets do considerably impact negatively on Kenya's financial sector stability.

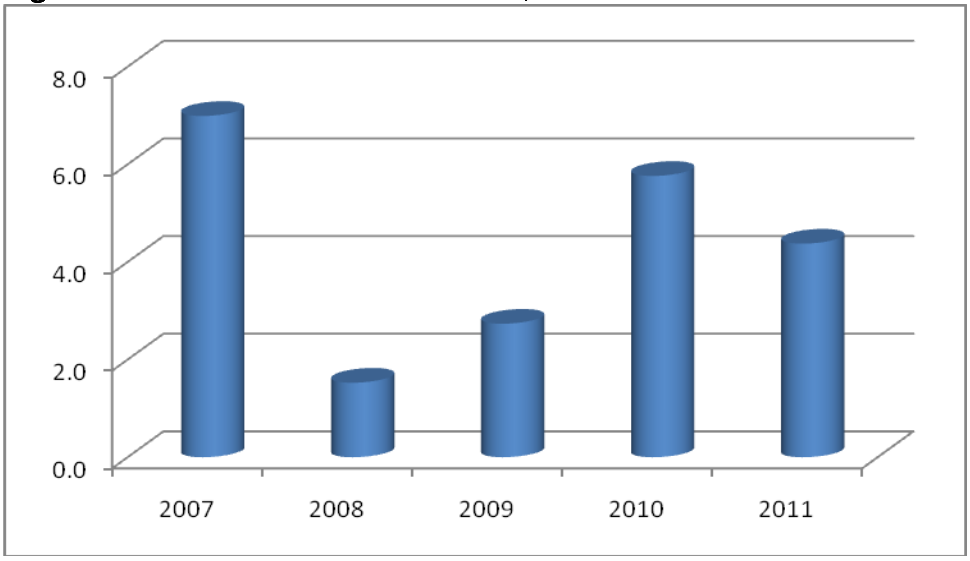
The instability in exchange rate, high inflation, foreign reserves erosion thus affecting BoPs, reduced exports markets, and strained foreign capital inflows for Kenya in 2011 could be explained largely by shocks emanating from global and regional macrofinancial developments. Data shows net sell-off of equities by foreign investors in domestic financial markets, perhaps signaling flight to safety rather than appetite to return.

4. DOMESTIC MACRO-ECONOMIC ENVIRONMENT

4.1. Macroeconomic Developments in Kenya in 2011

Overall, Kenya's economy was resilient despite the growth momentum in 2011 slowing to 4.4 percent from the 5.7 percent growth rate in 2010. The decline was attributed to high oil prices, unfavourable weather conditions in some parts of the country that impacted on food and energy prices, and weakening of the Kenya shilling which, suppressed domestic demand.

Figure 11: Annual GDP Growth Rate, 2007-2011



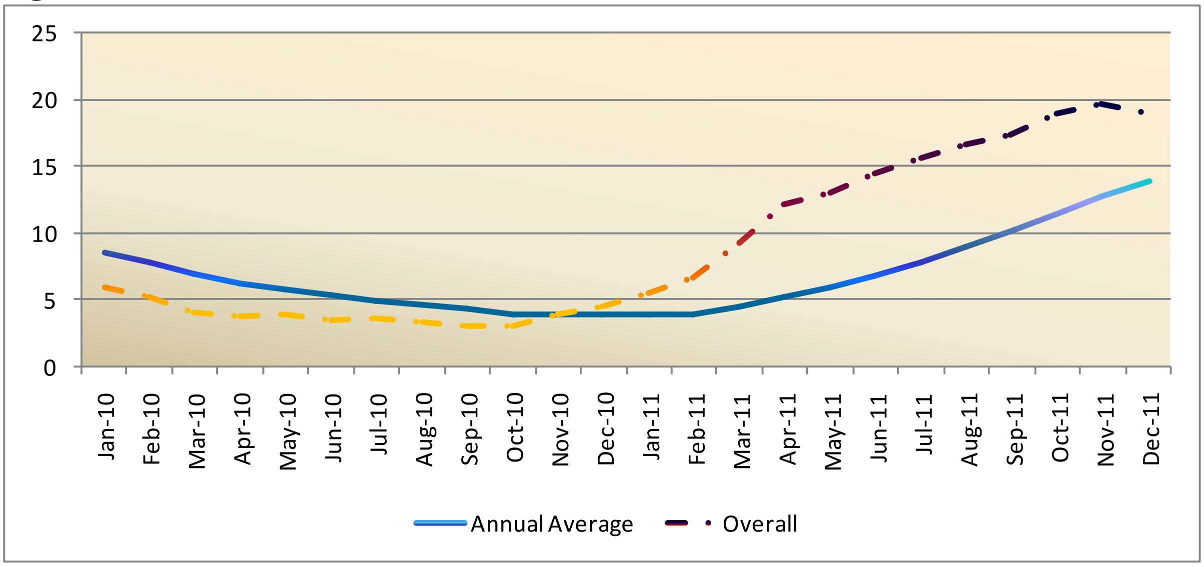
Source: Central Bank of Kenya and KNBS Database, September 2011

Manufacturing, Transport and Communication, Financial Intermediation and Construction sectors recorded a growth of 3.3 percent, 4.5 percent, 7.8 percent, and 4.3 percent in 2011 compared with 4.5 percent, 5.9 percent, 9.0 percent, and 4.5 percent respectively. Electricity and Water sector recorded a growth rate of -2.6 percent in 2011 from expansion of 9.7 percent in 2010. This contraction was due to insufficient rainfall during the long rains season in 2011, leading to reliance on more expensive thermal power generation to meet demand. Agriculture and Forestry had slower growth of 1.5 in 2011 from 6.4 percent in 2010.

4.1.1. Inflation Developments

Inflation rose significantly in 2011 compared with the levels in 2010. The annual average and month-on-month overall inflation were 7.99 percent and 13.97 percent, respectively in 2011, compared to 5.6 percent and 3.9 percent, respectively, in 2010 (Figure **12)**. Month-on-month overall inflation peaked at 19.72 percent in November 2011 before starting to ease in response to monetary policy actions. High crude oil prices, credit-funded consumption and drought contributed towards the high inflation experienced in 2011.

Figure 12: Inflation Trends



Source: Central Bank of Kenya and KNBS database

4.1.2. Money and Credit Markets

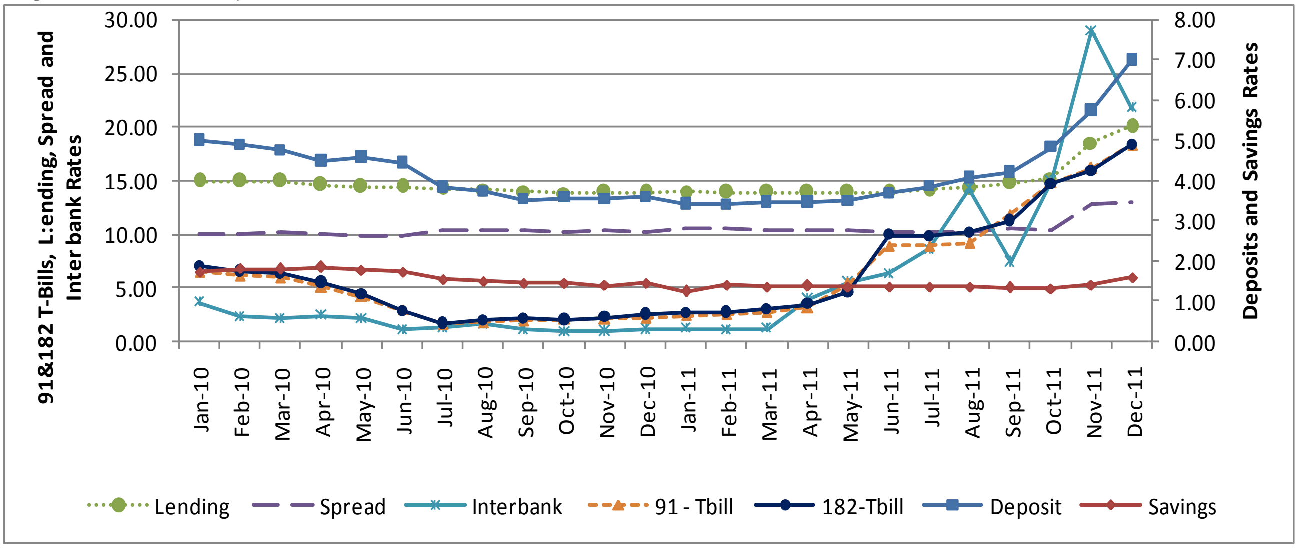
As indicated in Figure **13**, money and credit markets experienced increased pressure, especially in terms of declining interest rates levels and deceleration of credit growth. This was in response to policy actions taken to restore the run-away inflation and enhance stability in foreign exchange markets.

The Monetary Policy Committee (MPC) raised the Central Bank Rate (CBR) by 1,200 basis points on 1st December 2011 to 18.0 percent from 6.0 percent in December 2010. The sharp increase in the CBR was to send a strong signal of tightening of the monetary policy stance that would rein in inflation and inflationary expectations and stabilize the exchange rate.

The policy move yielded positive results, but it also affected interest rates because it had to adjust faster as follows. The weighted average interbank rate increased to 21.75 percent in December 2011 from 1.18 percent in December 2010. The average 91-and 182-days Treasury bill rates increased to 18.30 percent in December 2011 from 2.28 and 2.59 percent in December 2010, respectively. Commercial banks average lending rates increased by 617 basis points to 20.04 percent in December 2011 from 13.87 percent in December 2010. The average deposit rate rose by 340 basis points to 6.99 percent in December 2011 from 3.59 percent in December 2010. Following a higher increase in the average lending rate relative to deposit rate, the interest rate spread widened to 13.06 percent in 2011 from 10.28 percent in December 2010.

Despite monetary policy tightening, domestic credit still expanded by Ksh 316.7 billion (26.7 percent) in the year to December 2011 compared with Ksh 232.6 billion (24.3 percent) over the previous year (Table **5**). This reflected an increased growth in credit to the private sector that started in 2010 as result of the prevailing monetary policy regime at the time.

Figure 13: Money and Credit Markets Interest Rates



Source: Central Bank of Kenya Database

The net increase in private sector credit in the year to December 2011 was Ksh 274.3 billion compared with Ksh 150.2 billion recorded in the year to December 2010. This translated into an annual growth rate of 30.9 percent compared with 20.3 percent in December 2010 and corresponding target of 28.6 percent for December 2011.

Table 5: Banking Sector Net Domestic Credit (Ksh Billion)

	2010 December		2011 December		Absolute Change December		Annual %age Change December	
	Ksh bn	Share (%)	Ksh bn	Share (%)			2009/10	2010/11
1. Credit to Government	**277.8**	**23.4**	**311.6**	**20.7**	**72.7**	**33.8**	**35.5**	**12.2**
Central Bank	-3.7	-0.3	54.8	3.6	21.7	58.5	-85.40	-1573.4
Commercial Banks & NBFIs	281.5	23.7	256.8	17.1	51.0	-24.7	22.1	-8.8
2. Credit to other public sector	**22.2**	**1.9**	**30.8**	**2.0**	**9.7**	**8.6**	**77.7**	**38.9**
Local government	-0.1	0.0	2.3	0.2	6.6	2.4	-98.3	-2088.2
Parastatals	22.3	1.9	28.5	1.9	3.1	6.2	16.1	27.8
3. Credit to private sector	**888.4**	**74.8**	**1162.7**	**77.3**	**150.2**	**274.3**	**20.3**	**30.9**
Agriculture	41.7	3.5	53.2	3.5	4.4	11.5	11.9	27.6
Manufacturing	112.2	9.4	146.2	9.7	24.3	34.0	27.7	30.3
Trade	153.6	12.9	190.9	12.7	18.5	37.3	13.7	24.3
Building and construction	32.6	2.7	50.8	3.4	-13.1	18.2	-28.7	55.7
Transport & communications	60.1	5.1	87.4	5.8	-3.8	27.2	-5.9	45.3
Finance & insurance	22.8	1.9	29.9	2.0	-1.0	7.1	-4.2	31.2
Real estate	98.9	8.3	137.4	9.1	46.0	38.5	87.1	39.0
Mining and quarrying	14.6	1.2	25.3	1.7	6.4	10.7	78.0	73.3
Private households	123.6	10.4	163.8	10.9	33.0	40.2	36.4	32.5
Consumer durables	57.9	4.9	73.3	4.9	6.4	15.4	12.5	26.7
Business services	87.7	7.4	82.6	5.5	25.8	-5.0	41.6	-5.8
Other activities	82.7	7.0	121.9	8.1	3.2	39.2	4.1	47.4
4. TOTAL (1+2+3) *	**1188.4**	**100.0**	**1505.1**	**100.0**	**232.6**	**316.7**	**24.3**	**26.7**

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

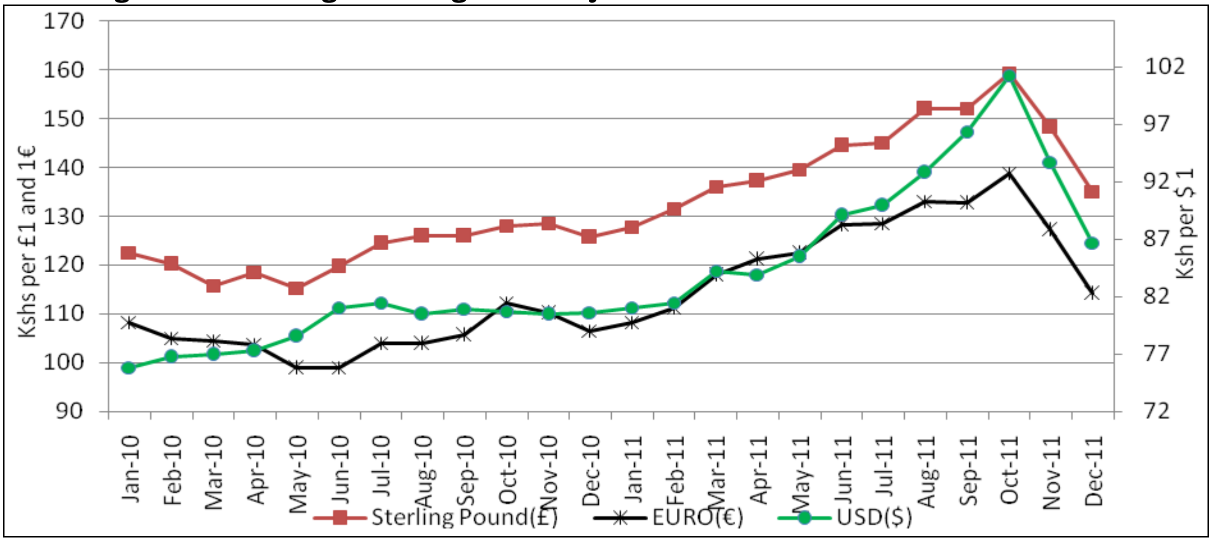
Source: Central Bank of Kenya

4.1.3. Exchange Rates Movement

Kenya Shilling weakened against major world currencies in the year 2011. Against the US dollar, the shilling averaged 101.270 in October 2011 from 81.029 in January 2011. It has since strengthened to average Ksh 83.188 per USD in April 2012 following tightening of monetary policy. The successful conclusion of the second review of the IMF supported economic programme and the associated inflow of foreign exchange reserves positively impacted the exchange rate. Against the Sterling Pound and the Euro the shilling appreciated from an average of Ksh 159.405 and Ksh 138.737 in October 2011 to Ksh 133.191 and Ksh 109.572 respectively in April 2012 (Figure **14**).

In extreme local currency depreciation, there is likelihood of induced instability in the financial sector through trade imbalance, higher external debt service, foreign reserves depletion, flight by foreign investors from domestic financial markets and heightened inflationary pressures. It is notable to observe that Kenya's policymakers arrested the Shilling slide before it reached alarming levels. The instability witnessed by end of 2011 was restored in early 2012, hence strengthening of local currency against all world major currencies by April 2012.

Figure 14: Average KES against Major World Currencies



Source: Central Bank of Kenya Database

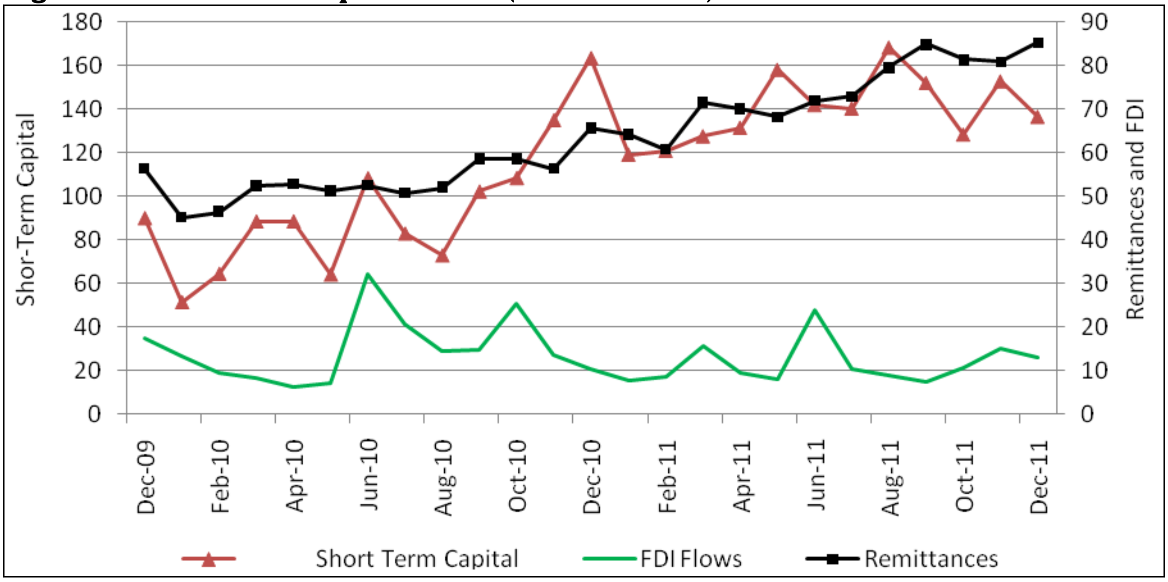
The monetary policy initiatives to address exchange rate volatility and high inflation were coordinated by all EAC central banks in October 2011 at the height of inflation and exchange rate volatility. The ensuing stability in the exchange rate positively impacted overall inflation, thereby restoring confidence in the banking sector and economic management. The high interest rates also attracted short term capital flows, further consolidating exchange rate stability.

4.1.4. Capital Flows

Remittances inflows from Kenyans in the Diaspora maintained an upward trend in 2011, realising 39 percent growth rate above the December 2010 level. The flow of remittances gained US$ 20.8 million to average US $ 74.3 million in 2011 from US$ 53.5 million in 2010 as indicated in Figure **15**.

The short-term capital inflows including portfolio flows were largely oscillating around USD 140 millions in 2011 while net Foreign Direct Investment (FDI) stayed below USD 30 million. Stability of capital flows is important in balancing the capital account. In terms of financial system stability, it is important to monitor large inflows that are speculative in nature in order device strategies to mitigate potential triggers to instability.

Figure 15: Trends in Capital Flows (USD Millions)



Source: Central Bank of Kenya Database

4.2. Macro-economic Risks to Financial System Stability

A stable financial system requires macro-economic stability, characterised by stable employment, predictable prices and high growth prospects. High unemployment and economic stagnation impact negatively on financial stability via elevated credit risk perceptions, and constrained debt servicing capacity by borrowers. Lenders reacted by hiking interest rates as insurance against household defaults.

Macro-economic indicators for 2011 show a GDP growth rate of 4.4 percent in the year 2011 compared to 5.7 percent growth in 2010. This slowdown is attributed to the threats emanating from inflation and foreign exchange rate volatility as well as slowdown in economic recovery of Kenya's major trading partners. In addition, persistent upward pressure on the international crude oil prices further dampened accelerated economic growth.

Volatile exchange rates impact negatively on potential foreign investors, worsen the external debt service and increase the import bill. This makes a country less competitive as an investment destination, leading to economic stagnation and/or contraction. The significant depreciation of the Kenya Shilling reaching a historical low with respect to the USD in the fourth quarter of 2011 had devastating effect on the overall economy, especially Kenya being a net importer.

Risk factors from the external sector include a further deterioration of the global economic environment, with negative spillovers to the domestic economy. A faltering U.S. or European recovery would undermine prospects for exports, remittances, official aid, and private capital flows. There was also the fear that international investors would perceive higher risks in African markets, which could lead to capital reversals as potential investors scale down their portfolio. This would be detrimental to the stock market, the economy and financial stability. All these risks required close monitoring to mitigate emerging threats.

4.3. Monetary Developments and Linkage to Financial System Stability

Growth in broad money supply, M3, decelerated to 19.1 percent by end December 2011 from 21.6 percent in December 2010. This reflected a deceleration in the growth of both net domestic assets (NDA) and net foreign assets (NFA) of the banking sector. Money supply, M2, that is, M3 excluding foreign currency deposits, grew by Ksh 154.7 billion (14.1 percent) in 2011 compared with an increase of Ksh 201.1 billion (22.4 percent) in 2010. Foreign currency deposits, in M3, increased by Ksh 87.8 billion (50.9 percent) in 2011 compared with Ksh 24.8 billion (16.8 percent) increase in 2010. Growth in NFA of the banking sector declined to Ksh 25.4 billion (9.4 percent) in 2011 compared with an increase of Ksh 26.1 billion (10.7 percent) in 2010. The deceleration in NFA was reflected in the holdings of the Central Bank of Kenya that increased by only Ksh 6.3 billion compared to an increase of Ksh 29.6 billion in 2010.The NFA of commercial banks increased by Ksh 19.1 billion compared with a decline of Ksh 3.5 billion in the previous year. The contribution of NDA to the annual change in M3 increased to 89.5 percent in December 2011 compared with 88.5 percent in December 2010, while that of NFA declined to 10.5 percent in December 2011 from 11.5 percent the previous year.

Table 6: Money supply and its sources (Ksh. billion)

				Absolute Change		%age change	
	2009 Dec	2010 Dec	2011 Dec	2009/10 Dec	2010/11 Dec	12 months Dec-10	12 months Dec-11
1. Money supply, M3 (2+3) 2/	**1045.7**	**1271.6**	**1514.2**	**226.0**	**242.5**	**21.6**	**19.1**
1.1 Money supply, M2 3/	898.1	1099.2	1254.0	201.1	154.7	22.4	14.1
1.2 Money supply, M1	442.2	577.2	622.7	135.0	45.5	30.5	7.9
1.3 Currency outside banks	100.9	122.9	137.0	22.1	14.1	21.9	11.4
2. Net foreign assets 4/	**243.8**	**269.8**	**295.2**	**26.1**	**25.4**	**10.7**	**9.4**
Central Bank	222.8	252.4	258.7	29.6	6.3	13.3	2.5
Banking Institutions	21.0	17.4	36.5	-3.5	19.1	-16.9	109.4
3. Net domestic assets (3.1+3.2)	**801.9**	**1001.8**	**1218.9**	**199.9**	**217.1**	**24.9**	**21.7**
3.1 Domestic credit (3.1.1+3.1.2)	**955.8**	**1188.4**	**1505.1**	**232.6**	**316.7**	**24.3**	**26.7**
3.1.1 Government (net)	205.1	277.8	311.6	72.7	33.8	35.5	12.2
3.1.2 Private sector and other public sector	750.7	910.6	1193.5	159.9	282.9	21.3	31.1
3.2 Other assets net (3-3.1)	**-153.9**	**-186.6**	**-286.2**	**-32.7**	**-99.6**	**21.2**	**53.4**
Memorandum items							
1. Overall liquidity, L 1/	**1280.4**	**1569.6**	**1876.1**	**289.1**	**306.6**	**22.6**	**19.5**
2. Reserve money	**182.0**	**222.6**	**255.0**	**40.7**	**32.4**	**22.4**	**14.5**
Currency outside banks	100.9	122.9	137.0	22.1	14.1	21.9	11.4
Bank reserves	81.1	99.7	118.0	18.6	18.3	22.9	18.4

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

1/ Overall liquidity, L, comprises M3 and non banking public holding of Government securities. It is comparable to M3XT in the past publications.

2/ Broader money, M3, comprises M2 and residents foreign currency deposits with local banks. It is comparable to M3X in the past publications. Foreign currency deposits are valued at current exchange rate from July 2008.

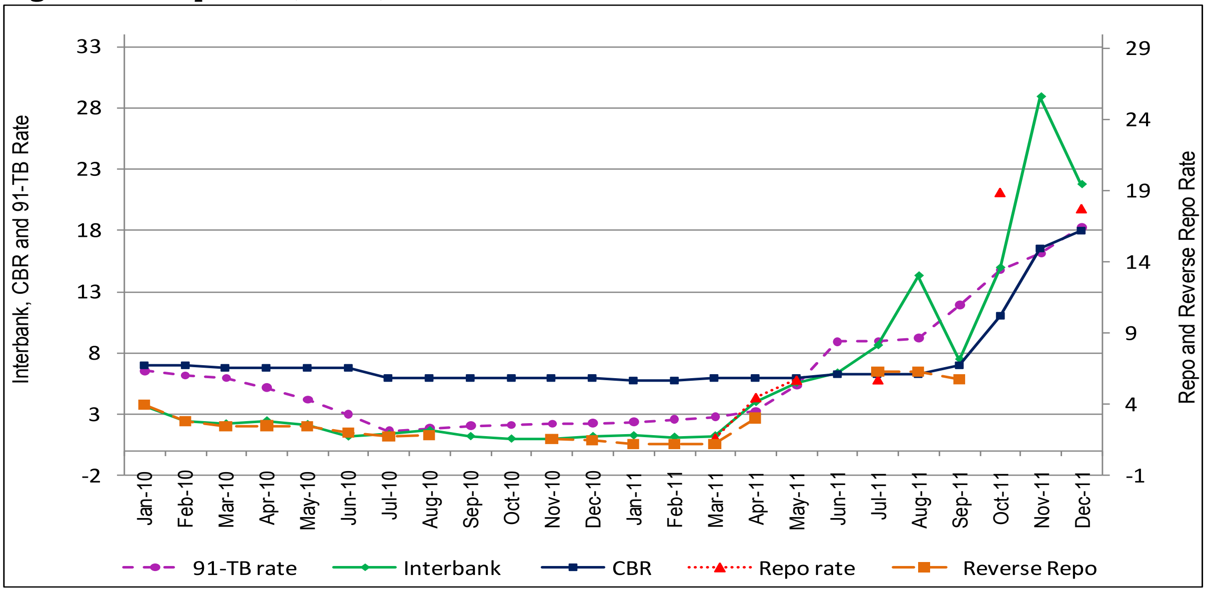
3/ Broad money, M2, comprises currency outside banking institutions, and all private and other public sector holdings of demand savings and time deposits. It excludes central and local Government deposits with banking institutions.

4/ Net Foreign Assets at current exchange rate to the US dollar.

Source: Central Bank of Kenya

Domestic credit grew by 26.7 percent to Ksh 316.7 billion in 2011 compared with Ksh 232.6 billion or 24.3 percent in 2010 as indicated in Table **6**. The banking sector credit to the private sector was 77.3 percent of total lending in December 2011 compared with 75.0 percent in December 2010. The net credit to private sector grew by 30.9 percent in 2011 compared with 20.3 percent in 2010. The 2011 accelerated credit growth partly explain higher inflationary pressures experienced during the year and the exchange rate depreciation. Through a proper mix of Central Bank Rate (CBR), Repurchase Agreements (Repo) and Reserve Money, CBK is able to balance between the quantity and price of money in the economy at any point in time in order to achieve macro-economic stability. If either price or quantity is pursued at the expense of the other, it is likely to impact negatively on the financial system stability through unstable macroeconomic indicators such as interest rates, exchange rates, and inflation was experienced in quarter 4 of 2011 in Figure **16**.

Figure 16: Repo rate, CBR, interbank and 91-TB rate



Source: Central bank database

Very low short term interest rates driven by loose monetary policy results in very low yields on fixed income securities, making them unattractive to foreign investors as was the case in 2011. If investors dump their holdings to cut losses as was with the case following Safaricom Initial Public Offering (IPO) burst, local currency will be hit as they repatriate their proceeds. On the other hand, interest rates reversals in response to tightening monetary policy as was the case in late 2011, leads to credit crunch and higher yields that increases losses to securities already held. These two actions can lead to capital flight or reallocation of portfolio by foreign investors, thus undermining foreign exchange market stability, a scenario experienced in 2011. In addition, very low interest rates are inflationary especially if credit to private consumption outweighs production. All these are potential threats to financial sector stability and therefore pertinent to monetary policy to ensure financial sector stability.

4.4. Balance of Payments

Kenya's overall balance of payments position declined from a surplus of US$ 163 million in the year to December 2010 to a deficit of US$ 43 million in the year to December 2011 as indicated in Table **7**. This deterioration in the external position is explained by the widening current account deficit, which surpassed improvement in the capital and financial account. The deficit in the current account expanded from US$ 2,512 million in 2010 to the US$ 3,330 million in 2011. Merchandise account deficit accounted for 25.91 percent while Services account deteriorated by 1.99 percent mainly due to a decline in net receipts of non-factor services and current transfers.

Implications of persistently deteriorating Balance of Payments position not only impact the health of macro-economy, but also affect the soundness of the financial system. With imports of goods at USD 14,814 million in 2011 from USD 12,395 million in 2010, against a modest growth in export of goods of USD 5,807 million in 2011 from USD 5,225 million in 2010, the country's financial system remained exposed to shocks.

Table 7: Balance of Payments (US $ M)

ITEM	Year to Dec-10	Year to December 2011				Year to Dec-11	Absolute Change
		Q1 (Jan-Mar)	Q2 (Apr-Jun)	Q3 (Jul-Sep)	Q4 (Oct-Dec)		
1. OVERALL BALANCE	**163**	**43**	**8**	**-217**	**123**	**-43**	***-206***
2. CURRENT ACCOUNT	**-2512**	**-528**	**-813**	**-1003**	**-987**	**-3330**	***-819***
2.1 Goods	-7169	-2030	-2130	-2416	-2431	-9007	*-1837*
Exports (fob)	5225	1448	1452	1489	1419	5807	*582*
Imports (cif)	12395	3478	3582	3904	3849	14814	*2419*
2.2 Services	4657	1502	1317	1413	1444	5676	*1019*
Non-factor services (net)	2527	619	588	705	654	2566	*39*
Income (net)	-158	90	-45	-30	-8	7	*165*
Current Transfers	2288	793	774	738	798	3103	*815*
3. CAPITAL & FINANCIAL ACCOUNT	**2675**	**570**	**821**	**786**	**1110**	**3288**	***612***
3.1 Capital Transfers (net)	154	108	40	34	53	235	*81*
3.2 Financial Account	2522	462	781	752	1057	3053	*531*
Memo:							
Gross Reserves	**5123**	**5454**	**5249**	**5557**	**6045**	**6045**	***922***
Official	4002	4138	4142	3986	4248	4248	*246*
*imports cover**	*3.5*	*3.5*	*3.3*	*3.0*	*3.1*	*3.1*	*-0.4*
*imports cover***	*3.9*	*3.9*	*3.8*	*3.6*	*3.7*	*3.7*	*-0.1*
Commercial Banks	1121	1316	1106	1571	1797	1797	*676*

Source: Central Bank of Kenya

The demand for hard currency to finance these imports, especially oil outweighed the hard currency inflows from exports, leading a large deficit in Goods Account of USD 9,007 million. This was translated into faster depreciation of the local currency against the international currencies, exerting inflationary pressures witnessed in 2011. These in turn had spillover into interest rates market as investors sought premium to compensate falling return on their investments. Lenders also adjusted interest rates upwards to match the inflation spiral. These changes induced instability in the foreign exchange markets, interest rates markets, credit markets and commodities markets as prices rose further.

Dynamics in the external position also impacted on the foreign reserves of the country. During the year 2011, Gross reserves grew by 18 percent, mainly supported by 60.3 percent growth in commercial banks' reserves and 6.15 percent rise in Official Reserves. This translated to 3.7 months of imports cover in December 2011 from 3.9 months of imports cover in December 2010 based on the 36 months average of imports. This indicator fell short of the revised 4.5 months target under the EAC Integration convergence criteria as well as the statutory requirement of 4 months on import cover.

Policy intervention by the Central Bank, Kenya Bankers' Association and the Government reversed the situation leading to stability and a restoration of confidence. In addition, the Government's proceeds from its Syndicated Loan and the disbursements from the IMF financing programme have raised imports cover to 4.14 months by end April 2012, buttressing stability and confidence.

5. PUBLIC DEBT AND DEBT SUSTAINABILITY ASSESSMENT

5.1. Government Revenue Performance

In 2011, government revenues and grants increased to Ksh 345.4 billion compared to Ksh 309.2 billion collected in 2010. However, this performance fell short by Ksh 35.0 billion and Ksh 9.7 billion, respectively, with respect to the stated budget targets of Ksh 373.3 billion and Ksh 16.8 billion for 2011. Tax revenue grew by 13.4 percent, from Ksh 270.1 billion collected in 2010 to Ksh 306.2 billion in 2011. The proportion of excise duty in total revenue was down from 12.8 percent in 2010 to 10.7 percent in December 2011, due to low excise duty on petroleum products, beer and airtime. External grants constituted 2.0 percent of total revenue.

5.2. Government Borrowing from the Central Bank

Government indebtedness to the Central Bank increased to Ksh 67.7 billion in 2011 from Ksh 55.0 billion in 2010. This was due to rediscounted Treasury securities by holders who sought liquidity due to the difficulties of trading them in the secondary market. Treasury securities' rediscounts amounted to Ksh 11.2 billion in 2011 compared to zero rediscounts in 2010 as shown in Table **8**. While rediscounting treasury securities at the Central Bank helps in easing liquidity pressure to holders in the circumstances where there is no immediate market and therefore supports investor confidence in the securities and stabilizes prices, such practices pose inflationary risks. If large amounts are involved, it means the Central Bank releases liquidity through rediscounted securities in the system before maturity of such debt. In addition, it may affect price distortion of securities involved if large amounts are involved since Central Bank rediscount price has penalties and therefore does not reflect true market value of the securities.

Table 8: Government Indebtedness to CBK (Ksh Billions)

INSTRUMENT	December 2010	December 2011	Change
Total Credit	**55.0**	**67.7**	**12.7**
1. Overdraft	22.7	25.4	2.7
2. Rediscounted securities	0.0	11.2	11.2
Treasury bills	0.0	7.1	7.1
Treasury bonds	0.0	4.1	4.1
3. Pre-1997 Government Overdraft at CBK	32.2	31.1	-1.1
4. IMF funds on-lent to Government	0.0	0.0	0.0
5. Cleared items in transit	0.1	0.0	-0.1
Memorandum			
Authorised overdraft limit	**22.9**	**25.4**	2.5
Amount utilised to date	22.7	25.4	3.5
Amount available	0.2	0.0	-0.2

Source: Central Bank Database

Amortization of the pre-1997 overdraft reduced Government indebtedness at the Central Bank by Ksh 1.1 billion after the government reduced its stock at the Bank.

5.3. Public Debt and Debt Sustainability

Kenya's public and publicly guaranteed debt increased by 21.3 percent by end June 2011 to Ksh 1,487 billion or 53.8 percent of GDP up from KSh.1, 226 billion or 51 percent of GDP by end June 2010. By end December 2011, the public debt stock dropped to Ksh. 1,486 billion or 45.1 percent of GDP due to a decrease in external debt occasioned by the drop in the Kenya Shilling price of the USD.

Table 9: Stock of Public Debt

Measure	Ksh. (Bn)	% of GDP	% of Total Debt	Weighted Average Interest Rate (%)
June 2010				
Domestic	660.3	27.4	53.7	10.4
External	569.2	23.6	46.3	1.3
TOTAL	**1,225.7**	**51.0**	100.0	**6.2**
June 2011				
Domestic	764.2	27.67	51.4	
External	722.9	26.17	48.6	0.8
TOTAL	**1,487.1**	**53.84**	**100.0**	
December 2011				
Domestic	800.7	24.3	53.9	
External	685.6	20.8	46.1	1.0
TOTAL	**1,486.3**	**45.1**	**100.0**	

Source: December2011 Monthly Debt Bulletin, and June 2011 MTDS

The composition of public and publicly guaranteed debt remained almost unchanged between December 2010 and December 2011 as indicated in Table **10**. Domestic debt which consists of Treasury securities, Long-term Stock, Overdraft at the CBK and items in transit accounted for 54 percent while external debt was 46 percent. Average maturity of total debt was down to 8.4 years in 2011 from 8.9 years in 2010, occasioned by external debt as domestic debt average maturity rose to 5.9 years from 4.6 years in 2010.

Table 10: Characteristics of the Public Debt by End of 2010/11

Measure	June 2010	June 2011	Dec 2011
Portfolio Composition			
Domestic	54	57	53.9
External	46	43	46.1
Refining Risk			
Average maturity of entire debt (years)	8.9	8.4	8.4
Average maturity of domestic debt (years)	4.6	5.9	5.9
% of domestic debt maturing in 12 months	28	18	18
Cost			
Average Interest Rate (%)	6.2	4.9	4.9

Source: June 2011 MTDS

Average maturity has implications on rollover/refining risk whereby short average maturity implies high refinancing risk through pressure on interest rates and liquidity.

5.4. Developments in the Debt markets in 2011

Treasury bonds recorded full subscriptions in all the 2011 tender offers. Investors' appetite however dropped to 124 percent compared to 163 percent in 2010. Bid-to-cover ratio was down to 1.57 from 1.60 in 2010, implying weak auction outcomes as compared to 2010 performance (Table **11**).

Table 11: Treasury Bonds Primary Market Performance (Ksh Mns)

Year	Offer	Bid	Allotment	Performance (%)
2007	87,000	143,744	84,980	165
2008	85,000	94,385	61,532	111
2009	142,500	214,032	140,384	150
2010	176,100	287,027	179,855	163
2011	189,000	233,670	149,108	124

Source: Central Bank of Kenya, Financial Markets database

Subdued demand and bid-to-cover shows general difficulty in meeting borrowing targets through bond auctions due to tight liquidity in the market and high inflation during 2011. As a result, yields rose sharply, pushing the yield curve outward. However as shown in Table **12,** Treasury bills market remained vibrant in 2011, with all offers fully subscribed, except in November when the market experienced tight liquidity conditions following the September/October Monetary Policy Committee decision to adjust monetary policy stance to rein in inflation by increasing CRR and CBR.

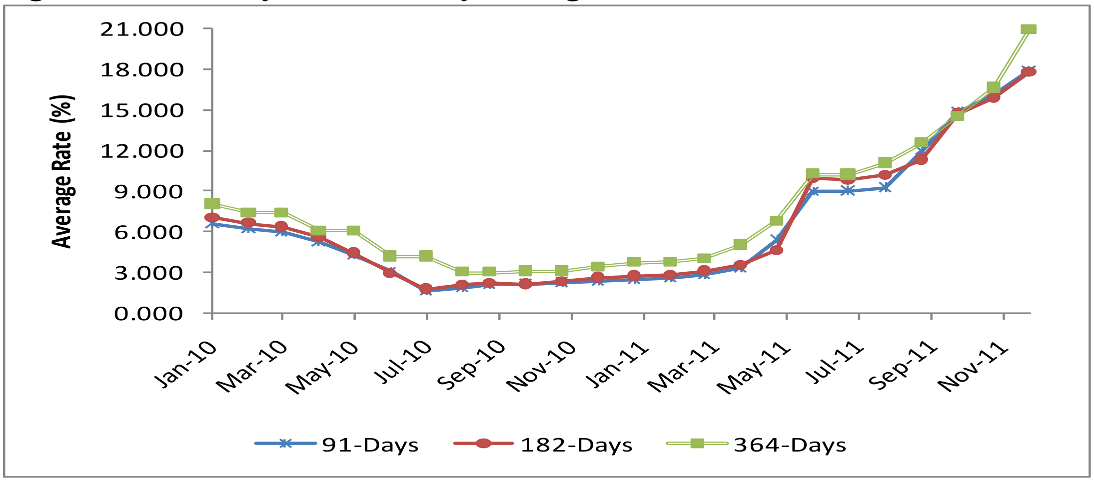
Table 12: Treasury Bills Auctions Performance (Ksh Millions)

Month	2009			2010			2011		
	Offer	Receipt	Taken	Offer	Receipt	Taken	Offer	Receipt	Taken
Jan	13,500	25,773	21,568	20,000	32,979	20,796	30,000	32,847	26,636
Feb	22,500	42,420	22,637	22,000	23,399	21,419	19,500	26,723	22,708
Mar	32,500	31,595	27,146	26,000	45,099	27,726	18,000	27,965	19,746
Apr	23,500	23,441	18,265	21,500	48,230	26,204	17,500	19,299	12,196
May	24,000	19,053	12,162	21,000	39,065	24,766	21,000	33,810	29,036
Jun	32,000	55,084	40,289	10,000	42,358	9,596	19,500	84,174	42,018
Jul	23,000	24,499	17,928	15,000	19,239	15,074	18,500	18,814	14,464
Aug	37,000	40,655	27,638	15,000	11,772	11,772	10,000	19,279	16,835
Sept	24,500	34,036	24,425	11,000	12,780	11,499	32,500	43,800	36,481
Oct	22,500	27,885	22,912	20,000	35,375	23,681	40,000	41,517	35,137
Nov	25,500	37,072	26,002	30,000	26,829	24,802	31,000	12,564	12,186
Dec	21,500	24,828	20,793	24,000	30,649	19,667	31,000	37,662	20,837

Source: Central Bank of Kenya, Financial Markets database

Demand for short term securities was largely supported by rising interest rates (Figure **17**) in the second half of 2011 as investors sought higher yields following CBK actions, rising inflation and Government's intend to borrow more to fill the shortfall in the annual borrowing target.

Figure 17: Treasury Bills Monthly Average Rates



Source: Central Bank of Kenya, Financial Markets database

Bonds trading activity in the secondary market was vibrant in the first half of 2011 as indicated in Table **13**. This was supported by issuance of new benchmark bonds with attractive prices in the primary auctions and excess liquidity that ensured low bond yields at the time.

Table 13: Treasury Bonds Trading in Secondary Market (Ksh. Millions)

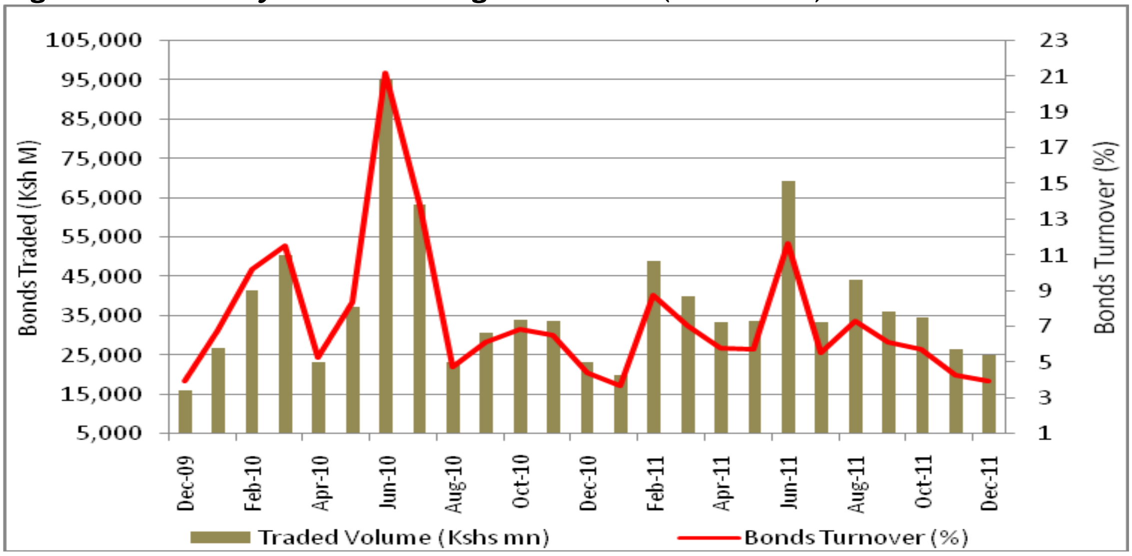
MONTH	2008	2009	2010	2011
January	4,870.95	5,647.80	27,282.10	19,672.20
February	3,177.55	6,861.80	41,058.50	46,189.95
March	14,291.35	8,449.60	49,048.60	37,937.70
April	3,073.10	4,533.42	22,376.90	31,009.15
May	3,037.20	10,477.35	36,733.40	30,034.65
June	2,446.70	11,099.35	93,377.45	60,734.45
July	1,893.93	7,542.80	62,231.55	35,926.60
August	8,416.85	6,138.80	22,865.65	45,095.65
September	10,988.71	10,672.60	30,650.65	35,809.60
October	4,320.85	11,713.15	26,314.50	34,127.85
November	3,118.60	9,434.70	31,557.90	26,275.20
December	3,577.00	15,280.00	22,570.65	24,873.55
TOTAL	**63,212.79**	**107,851.37**	**466,067.85**	**427,686.55**

Source: Financial Markets database, CBK

The second half of 2011 experienced excessive volatility, with bonds yields rising significantly to factor in the risks associated with short term interest rates swings, high inflationary pressures and general lack of demand from investors. Bondholders panicked and resorted to selling their stocks at deep discounts to cut losses while others who had no immediate liquidity needs withdrew from secondary market participation, resulting into the volumes indicated in Figure **18**.

To restore market confidence, CBK and the Market players introduced Sell-Buybacks in October 2011 to provide liquidity for bondholders who required immediate cash but faced difficulties in selling their bonds. Sell-buybacks refers to transactions where two parties, a seller and a buyer agree to exchange a security for cash at a bilaterally agreed price with a promise to reverse the same security and cash at a future date for a specific price. As a result, pricing mechanism adopted is not mainly dependent on the current market conditions and this preserves the value of the securities being exchanged. This market innovation safeguarded loss of bond values, provided liquidity to those bondholders that needed it urgently and reduced panic sales declined significantly by end of 2011 as investors held off selling bonds to allow market correction.

Figure 18: Monthly Bonds Trading at the NSE (2009 – 11)

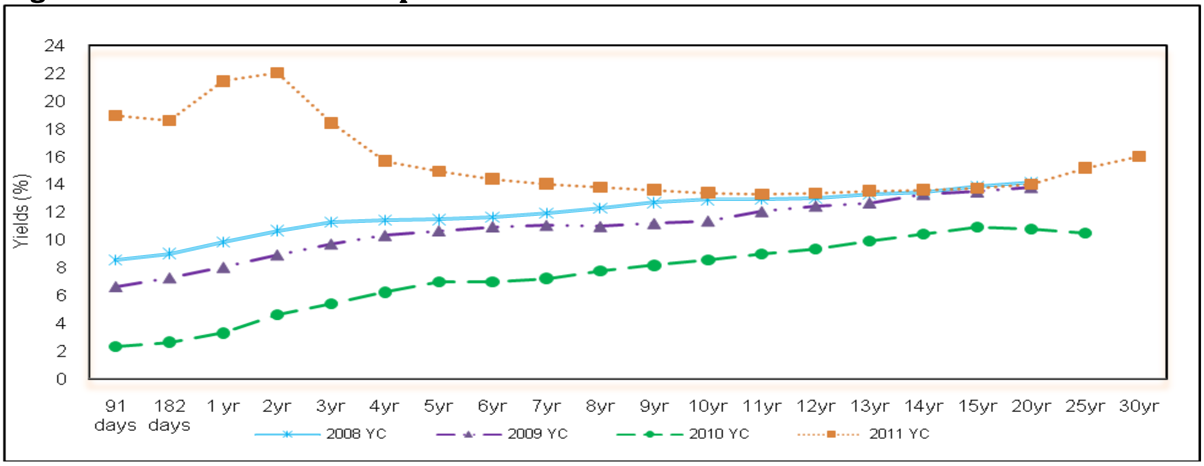


Source: Central Bank of Kenya and Nairobi Stock Exchange

The expectations of higher interest rates in response to tight monetary policy stance adopted by the Bank to mitigate rising inflation put upward pressure on the yields of government bonds, especially in the third quarter of 2011. Yields on all benchmark tenors rose sharply making bondholders with 'available-for-sale' portfolios incur heavy 'losses' due to the mark-to-market valuation rules. As a result, they stopped bonds trading at NSE to cut the losses and allow market correction, leading to market stagnation. Consequently, short-term yields, especially on treasury bills rose faster than those for long term tenors, resulting into inverted yield curve in the last quarter of 2011 as shown in Figure **19**. This scenario was buttressed by expectations of less than projected economic growth, signalling further uncertainty. This development heightened liquidity risks, driving the market to a halt. However, Sell-Buybacks operations and CBK move to concentrate at the short end of the yield curve restored confidence, allowing the market to correct itself.

The market is yet to recover fully to the 2010 levels and early 2011 in terms of turnover, pricing and stability of the yield curve. Primary market issuance for instance, continues to offer maturities of up to 1-year to enable price correction since long term bonds in a distressed market would attract less demand and lead to aggressive bidding to compensate perceived risks, further distorting the yield curve. Corporate bonds market, whose pricing is benchmarked on government bonds, also collapsed during the period, due to unpredictable pricing, that was also punitive.

Figure 19: Position and Shape of the Yield Curve Since 2008



Source: Financial Markets database, CBK

5.5. Public Debt Sustainability Analysis

The latest Joint IMF/World Bank Debt Sustainability Analysis of November 2011(DSA, 2011) concludes that debt sustainability indicators have not changed significantly since the January 2011 DSA. A lower than anticipated fiscal deficit in 2010 was offset by a rise in external debt-to-GDP ratio due to exchange rate depreciation and increased funding from the IMF. Risks are however greater for external debt, mainly due to widening current account deficit in 2011, but overall, Kenya remains at low risk of external and domestic debt distress as captured in Table **14**.

From the DSA, the baseline scenario show that the initial debt ratios are well below all of indicative thresholds for a medium performer, even if they increase over the medium-term. Under stress tests using different scenarios, Kenya's external debt situation is resilient. However, over the period 2011-14, a shock combining lower GDP growth, weaker exports, lower GDP deflator, and decline in non-debt creating flows would push the NPV of external debt as a share of GDP to 26 percent from 18 percent, and the NPV of debt-to-exports from 57 percent to 89 percent.

Table 14: Sensitivity Analysis for Key Indicators of Public Debt

Measure	**Benchmark under CPIA)**	**June 2011**	**Impact of a 10% of GDP rise in 2011 borrowing on debt indicators in 2014**
NPV of Debt as a % of			
GDP	40	40	52
Revenues	250	161	181
Debt Service as a % of Revenues	30	23	26

Source:June, 2011 MTDS, www.treasury.go.ke

In the event of the most extreme shocks to debt dynamics, such as a one-time 30 percent depreciation of Kenya Shilling or from a one standard deviation shock to the growth of exports proceeds, Kenya's debt could become unsustainable. The resilience of Kenya's economy and proactive policy measures by CBK, however, remain the main source of cushion to such unfavourable debt sustainability outcome if risk occurrence happened.

Lessons from the financial crisis in the Euro area, with spillovers across the globe, show that policymakers must pay closer attention the levels and rate at which public debt should grow. They should ensure regular conduct of credible debt sustainability analysis and take appropriate measures if the indicators show signs of weaknesses that could be destabilising, especially to the financial system, through volatility in interest rates and foreign exchange markets, liquidity problems affecting credit flows and stifles efficiency and deepening of capital markets.

6. FINANCIAL SECTOR DEVELOPMENTS

Kenya's financial sector is segmented and dualistic (formal and informal) in structure. Formal financial sector comprises of (banking, pension, insurance, capital markets, SACCOs Societies, and Development Finance Institutions like Kenya Post Office Savings Bank and the Agricultural Finance Corporation). It supported by the financial infrastructure to facilitate trading, payments and settlements systems. The informal sector on the other hand comprises of unregulated financial services providers such as ROSCAs and ASCAs, merry go rounds or *chamas*, shopkeepers and moneylenders, among others.

6.1. Banking Industry

As at 31st December 2011, the banking sector comprised of the Central Bank of Kenya, as the regulatory authority, 43 commercial banks, 1 mortgage company, 4 representative offices of foreign banks, 6 Deposit-Taking Microfinance Institutions (DTMs), 118 Forex Bureaus and 2 Credit Reference Bureaus (CRBs).

6.1.1. Industry Performance in 2011

Banking subsector registered enhanced growth in year 2011. Total net assets were up, 20.4 percent from Ksh 1,678.1 billion in 2010 to Ksh. 2,020.8 billion in 2011. Loans and advances, government securities and placements accounted for 57.0 percent, 15.1 percent and 5.8 percent of total assets, respectively. Net Loans and Advances grew by 31.4 percent, with bigger share going to personal, trade, manufacturing and the real estate sectors. However, investment in Government securities declined from Ksh. 443.4 billion in 2010 to Ksh. 380.4 billion in 2011, which may be due to low return on paper in the first half of 2011 compared to lending rates. Towards end of 2011, banks could not invest in Treasury bonds due to high rates, affecting valuation of bond portfolios and leading to trading difficulties. The source of funding in the banking sector, mainly customer deposits grew by 20 percent from Ksh 1,236.5 billion in 2010 to Ksh. 1,488.2 billion. The growth was supported by branch expansion, agency banking and receipts from exports. The increased deposits enhanced the banks' capacity to extend credit to various economic sectors.

6.1.2. Asset Quality

Gross non-performing loans (NPLs) declined by 8 percent from Ksh. 57.6 billion in 2010 to Ksh. 53 billion in 2011. As a result, the ratio of gross non-performing loans to gross loans improved from 6.3 percent by end December 2010 to 4.4 percent as at end December 2011. The decline in gross NPLs was attributable to write-offs, recoveries and improved credit appraisal monitoring standards, especially with licensing and operationalization of Credit Reference Bureaus. Total NPLs, net of interest in suspense dropped by 10.1 percent to Ksh. 42.9 billion by end December 2011 from Ksh. 47.7 billion by end 2010. As a result, the asset quality, which is measured by the ratio of net non-performing loans to gross loans improved from 2.1 percent to 1.2 percent during period of review.

6.1.3. Capital Adequacy

Minimum regulatory Capital Adequacy requirement which is measured by the ratio of Core Capital and Total Capital to Total Risk Weighted Assets is 8.0 percent and 12.0 percent respectively. These ratios declined marginally from 20.0 percent and 22.0 percent in 2010 to 18.0 percent and 21.0 percent respectively in December 2011 but remained well above the minimum regulatory requirement. The decline was as a result of faster loans and advances uptake than the increase in Core and Total Capital. Growth in deposits mobilization saw the ratio of core capital to total deposits fall from 17 percent in 2010 to 16 percent in 2011.

6.1.4. Liquidity

Liquidity is an important financial soundness indicator as it signals ability of the financial institutions to fund increases in assets and meet obligations when due. Importance of liquidity goes beyond an individual bank. Liquidity shortfall at an individual bank can have systemic repercussions in the overall banking sector. In the twelve months to December 2011, Kenya's banking sector average liquidity ratio was above the statutory minimum requirement of 20 percent. This ratio stood at 37 percent by end December 2011 compared to 44.5 percent in 2010. The reduced liquidity ratio, although still above the threshold, is attributable to increased loans and advances in 2011, resulting from the increase in gross loans to gross deposits ratio from 74 percent in 2010 to 80 percent in 2011.

6.1.5. Sectoral Distribution of Gross Loans, Loan Accounts & NPLs

During the year ended 31st December 2011, over 72 percent of the sector's numbers of loan accounts were in personal/household sector which also accounted for over 26 percent of the banking sector credit and 35 percent of the NPLs. Trade, Manufacturing and Real Estate sectors accounted for about 45 percent of the sector's credit and 40 percent of NPLs as shown in Table **15**.

Table 15: Sectoral Distribution of Loan Accounts, Gross Loans & NPLs in 2011

SECTOR	No. of Loan Accounts	Share of Total (%)	Gross Loans (Ksh mn)	Share of Total (%)	Gross NPLs (Ksh mn)	Share of Total (%)
Agriculture	109,873	5.5	61,937	5.2	4,219	8.0
Manufacturing	20,559	1.0	156,714	13.2	5,313	10.0
Building & Const.	11,580	0.6	41,210	3.5	1,749	3.3
Mining & Quarrying	1,586	0.1	16,179	1.4	95	0.2
Energy & Water	5,247	0.3	36,483	3.1	203	0.4
Trade	315,076	15.8	232,729	19.5	9,661	18.2
Tourism, Rest. & Hotels	5,791	0.3	27,685	2.3	1,989	3.8
Transport & Comm.	28,587	1.4	98,252	8.2	3,239	6.1
Real Estate	23,157	1.2	146,435	12.3	6,177	11.7
Financial Services	18,355	0.9	54,511	4.6	1,281	2.4
Personal/Household	1,450,642	72.9	318,849	26.8	19,031	35.9
Total	**1,990,453**	**100.0**	**1,190,985**	**100.0**	**52,958**	**100.0**

Source: Bank Supervision Annual Report, 2011

6.1.6. Profit and Loss

The banking sector's profit before tax increased by 20.5 percent from Ksh. 74.3 billion in December 2010 to Ksh. 89.5 billion in December 2011. The growth in profit was attributed to higher levels of revenue inflows from the growth in credit portfolio and fees on innovative products offered by institutions.

6.1.7. Financial Soundness Indicators

The CBK uses the BIS Basel Committee of Banking Supervision and International Monetary Fund (IMF) defined Financial Soundness Indicators (FSIs) to monitor and evaluate the performance of financial institutions. CBK has defined some of the FSIs in the Banking Act and financial institutions are required to adhere to them as captured in Table **16**. All institutions met the minimum capital adequacy ratios, core capital to deposits ratio and the liquidity ratio. Institutions also observed the maximum foreign exposure limit of 10 percent.

Table 16: Financial Soundness Indicators for Banking Industry (Dec 2010-Dec 2011)

	Period/ Items	10-Dec	11-Mar	11-Jun	11-Sep	11-Dec
	Capital Adequacy Ratios (%)					
1	Regulatory Capital to Risk-Weighted Assets **(Min 12%)**	20.80	21.10	19.00	18.10	19.40
2	Regulatory Tier 1 Capital to Risk-Weighted Assets **(Min 8%)**	18.70	18.90	16.90	16.00	17.30
3	Core capital/Deposits **(Min 8%)**	15.60	16.00	15.20	14.50	15.50
4	Total Capital to Total Assets	13.20	13.30	12.80	12.40	13.20
	Asset Quality Ratios (%)					
5	NPLs to Total Gross Loans	6.30	6.00	5.40	4.90	4.40
6	NPLs Net of Provisions to Capital	6.40	5.70	5.80	5.00	3.50
7	Earning Assets to Total Assets	88.80	89.50	89.00	88.50	87.80
	Earnings and Profitability Ratios (%)					
8	Return on Assets (ROA)	3.70	3.70	3.40	3.30	3.30
9	Return on Equity (ROE)	30.70	29.40	29.70	31.10	32.20
10	Interest Margin to Gross Income	34.70	40.40	40.90	40.50	38.60
11	Non-Interest Expenses to Gross Income	48.20	49.40	48.20	47.70	44.60
	Liquidity Ratios (%)					
12	Liquid Assets to Total Assets	38.40	38.10	34.90	33.80	33.30
13	Liquid Assets to Short-term liabilities (Liquidity ratio) **(Min 20%)**	44.50	43.50	38.90	37.30	37.00
14	Liquid Assets to Total Deposit	51.00	50.90	46.30	44.90	43.80
15	Total Loans to Total Deposit	72.50	73.50	76.60	78.10	77.40
	Sensitivity to Market Risk Ratios (%)					
16	Net open position in Foreign Exchange to Capital **(Max. 10%)**	4.30	5.10	4.60	6.40	3.30
17	Interest Bearing Assets to Interest Bearing Liabilities	117.80	119.70	117.90	117.40	115.40
18	FX Currency Denominated Assets to Total Assets	10.60	10.70	12.40	13.50	11.80
19	FX Currency Denominated Liabilities to Total Liabilities	17.10	16.80	18.20	20.60	21.50
20	Spread between lending and deposit rate	9.30	9.90	9.40	9.00	8.40

Source: Bank Supervision, CBK

6.1.8. Stress Testing

CBK conducts monthly stress tests to determine the sector's stability against certain shocks or risk factors. Stress testing identifies plausible future changes in economic conditions or other possible events likely to have unfavourable effects on a bank's risk exposures. By end of December 2011 and based on the decline in GDP growth in 2011 to 4.4 percent from a revised growth of 5.8 percent in 2010, it was observed that the GDP growth in 2012 is likely to slow-down due to the high oil prices, high interest rates and expectations of high inflation. As a result, this is likely to impact negatively on certain sectors in servicing their credit. Consequently, plausible scenarios were used concurrently to stress the banking sector resilience to credit risk, liquidity risk and market risk.

Overall Risk –stress test results indicated that Kenya's banking sector was stable and able to absorb substantial negative shocks. However, inflationary pressures and household debt in terms of personal loans are downside risks. However, CBK and KBA's initiative to extend maturity period of loans in the face of rising interest rates has cushioned the industry against adverse impact.

6.1.9. Banking Sector 2012 Outlook

Banking sector is expected to sustain its growth momentum largely driven by adoption of cost effective delivery channels and increased presence of Kenyan banks in the East African Community (EAC) Partner States and South Sudan. The downside risks of growth prospects, inflationary pressures and the resultant high interest rate regime are expected to abate in the course of the year.

6.2. Deposit Protection Fund Board (DPFB)

At the end of December 2011, the number of member institutions was **50** comprising **43** commercial banks, **1** mortgage finance company and **6** DTMs. One bank still remains under statutory management and a member of the Fund.

6.2.1. Growth in the Number of Deposit Accounts

Total number of deposit accounts with the member institutions increased by 2.85 million from 12.80 million in December 2010 to 15.66 million in December 2011, a 22.2 percent rise as shown in Table **17**. This significant growth is attributed to various factors including:

- Reduced cost of maintaining micro-accounts and introduction of innovative products
- Increased banks' branch outlets and rapid adoption of agency banking model
- Aggressive approach by commercial banks to capture the lower end market segment
- Central Bank initiatives in promoting financial inclusion to cover the unbanked through licensing of microfinance institutions.

Table 17: Growth in the Number of Deposit Accounts

ITEM	DEC 2010	MARCH 2011	JUNE 2011	SEPT 2011	DEC 2011
Total No. of A/Cs	12,803,561	13,478,376	14,213,264	15,165,540	15,655,180
Quarterly Increase	803,111	674,815	734,888	952,276	489,640
Change in Deposit a/c	6.7%	5.27%	5.45%	6.7%	3.2%

Source: Deposit Protection Fund Board Database

6.2.2. Growth of the Fund

The Fund grew by 18.6 percent between December 2010 and December 2011, mainly as a result of prudent investment policies adopted by the Board. Funds are placed in a portfolio mix of both short and long-term Government securities as required by Law and in line with the approved Board policy. The Board's policy objective is to maximize return on its investment portfolio while taking cognizance of the prevailing economic environment. The positive growth was also due to:

- Increased insurance premiums as a result growing deposits arising from banks expansion through branch outlets and agency banking as well as Deposit Taking Microfinance Institutions.
- Stable banking sector arising from enhanced supervision by CBK.
- Risk management policies embraced by the banking sector.
- Financial inclusion initiatives.

Table 18: Growth of the Fund, Insurance Cover & Deposits

ITEM	DEC 2010	MARCH 2011	JUNE 2011	SEPT 2011	DEC 2011
Total No. of A/Cs	12,803,561	13,478,376	14,213,264	15,165,540	15,655,180
Total Deposits (Sh'000')	1,279,954,382	1,360,664,625	1,420,456,869	1,532,242,495	1,556,532,722
Insurance Cover (Sh'000')	157,173,795	158,366,546	160,452,944	164,991,454	169,363,100
Fund Growth (Sh'000')	26,943,600	27,617,500	28,123,574	30,587,100	31,961,400

Source: Deposit Protection Fund Board Database

6.2.3. Deposit Protection

In the period ending 31st December 2011, total deposits with member institutions amounted to Ksh 1.557 trillion, a 21.6 percent growth from 2010, while total protected deposits amounted to Kish 169.363 billion. The number of deposit accounts in the sector was 15.66 million while the number of fully protected accounts was 14.76 million, representing 94.2 percent of the total number of accounts in the sector. However, this coverage represents only 10.88 percent of total value of deposits in the sector.

6.2.4. Risk Exposure

As captured in Table **19**, the current Fund Balance stands at Ksh. 31,961 million compared to protected deposits of Ksh. 169,363 million, a considerably high exposure level of 81.13 percent. Deposit Accounts fully covered as at 31st December 2011 were 14.76 million out of the total 15.66 million accounts, or 94.29 percent coverage. This was however 10.88 percent in value of total deposits, which is way below the 40 percent international benchmark. Although the rate of protection level decelerated by 11.4 percent, a stable financial sector supported by sound prudential supervision remains a mitigating factor to potential risks.

Table 19: Protection & Exposure Indicators as at end December 2011

	Banking Sector Deposits	**31/12/2010**	**31/12/2011**	**% Change**
1	Total Deposits(Ksh. Mn)	1,279,954	1,556,533	21.60
2	Total Protected Deposits (Ksh. Mn)	157,174	169,363	7.76
3	Protection Level (2/1)	12.28%	10.88%	-11.4%
4	Funds Balance (Ksh. Mn	26,944	31,961	18.60%
5	Effective Cover (4/2)	17.10%	18.87%	10.35%
	Deposit Accounts			
6	No. of Deposits accounts ('000')	12,804	15,655	22.20
7	No. of accounts fully protected ('000')	12,027	14,761	22.70
8	Share of Protected accounts (7/6)	93.93%	94.29%	0.38%
9	Exposure Level 2-4/2)	82.86%	81.13%	-2.09%

Source: Deposit Protection Fund Board Database

6.3. National Payment Infrastructure

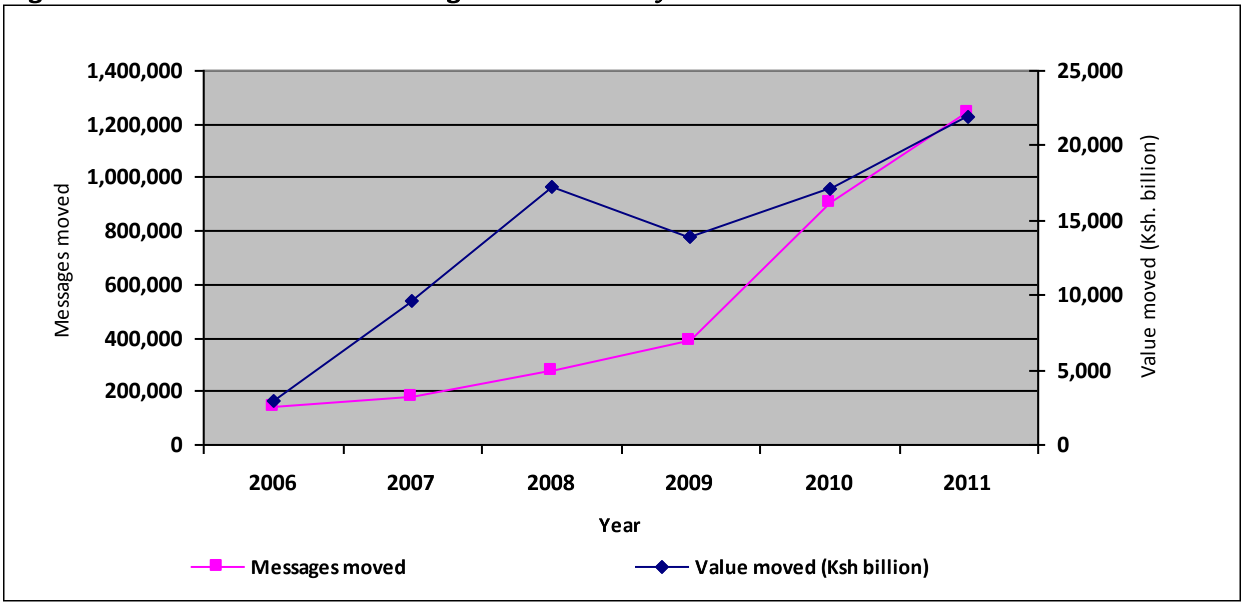
6.3.1. Real Time Gross Settlement (RTGS) System

Kenya Electronic Payment and Settlement System (KEPSS) is the country's inter-bank settlement system that supports daily inter-bank dealings. It is the only Systemically Important Payment System (SIPS) and hence remains the Bank's main concern for purposes of mitigating systemic payment risks that are inherent in the financial system. It is therefore the most important infrastructure to the financial system stability.

The system moved Ksh 21.89 trillion in 1.24 million transaction messages in 2011 compared with Ksh. 17.10 trillion in 0.90 million in 2010, translating to 28 percent increase in value moved and 37 percent increase in the volume of transaction messages (Figure 20). In terms of GDP, KEPSS system moved value equivalent to 14.2 times the country's GDP. The fall in the value moved between 2008 and 2009 was due to the Safaricom Initial Public Offer (IPO) of 2008 while the sharp increase in the volume of transaction messages between 2009 and 2010 is attributed to the cheque value capping policy, implemented on October 1, 2009.

Table **20** presents transactions activities through KEPSS in terms of actual numbers, showing tremendous growth in usage since inception. One of the most important measures of robustness of the payment system is its availability to users.

Figure 20: Volume & Values through the KEPSS System 2006-2011



Source: National Payments System database, CBK

The average month-on-month KEPSS availability in 2011 was 96.52 percent compared with the agreed availability target of 99 percent. Although this was below the target, 97 percent performance remains a good indicator of the system stability. SWIFT, Telecommunication connectivity and power outages affected the delivery of the system availability and therefore hitting below the target in actual performance.

Table 20: KEPSS System Flows

Year End	Amount transferred		Messages moved	
	(Ksh. Billion)	% increase	Number	% increase
2006	2,937	-	142,445	-
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

Source: *www.centralbank.go.ke*

6.3.2. Cards Transactions

Payment cards industry continued to grow through 2011, with remarkable usage of Automated Teller Machines (ATMs) cards, credit & debit cards, and Point of Sale (POS) terminals. ATM card transactions increased by 46.3 percent from 533,155 transactions in December 2010 to 780,079 transactions in December 2011 as captured in Table **21**. Credit and debit usage grew by 19.7 percent and 11.6 percent between the period 2010 and 2011. The growth in this industry in the year 2011 is attributed to several factors like expansion of the retail payment industry, branch expansion by banks and investment in the acquisition of ATMs by banks among others.

Table 21: Monthly Number of Transactions by Cards

Year 2010	ATMs	Credit	Debit	POS Machines
December	533,155	56,804	10,068,430	558,505
Year 2011	**ATMs**	**Credit**	**Debit**	**POS Machines**
January	503,217	57,113	9,404,135	444,195
February	470,128	51,605	8,902,929	474,119
March	525,549	54,115	10,114,734	518,490
April	590,768	53,848	11,697,445	513,283
May	595,762	61,441	11,850,488	530,530
June	623,045	58,451	11,723,836	526,401
July	541,444	57,889	6,926,952	571,628
August	554,020	65,244	7,732,688	574,166
September	518,611	65,619	7,534,751	634,125
October	562,246	69,646	8,905,979	563,946
November	562,538	69,881	8,714,272	573,213
December	780,079	67,977	11,236,340	646,055

Source: http://www.centralbank.go.ke

Table **22** shows that ATMs processed transactions worth Ksh 140.8 billion, a 19.7 percent increase over the value moved in 2010. Debit cards transactions were Ksh. 432.3 billion in 2011 more than Ksh. 395.1 moved in 2010. Although transactions via Credit cards and POS increased, the values are small and therefore systemically less significant to stability.

Table 22: Value of Cards Transactions (Ksh Mns)

Year – 2010	ATMs	Credit	Debit	POS Machines
Total	**117,627**	**3,747**	**395,141**	**43,615**
Year – 2011	**ATMs**	**Credit**	**Debit**	**POS Machines**
January	11,202	329	39,202	4,381
February	10,464	287	36,349	4,190
March	11,901	304	42,424	4,416
April	11,339	306	30,921	4,244
May	11,278	344	31,781	4,294
June	11,382	322	30,554	4,358
July	9,982	314	43,749	5,156
August	12,333	351	34,202	5,915
September	12,124	358	33,475	6,780
October	12,384	376	34,124	6,616
November	12,373	373	32,726	6,342
December	14,063	400	42,759	7,831
TOTAL	**140,825**	**4,065**	**432,265**	**64,523**

Source: http://www.centralbank.go.ke

Number of ATMs in the retail payment industry increased by 5.5 percent from 2,091 ATMs in December 2010 to 2,205 ATMs in December 2011 as the banking industry invested more. Similarly, Credit and debit cards also recorded remarkable growth in this period increasing by 8.0 percent and 38.1 percent respectively. POS terminals declined by 8.7 percent from 18,179 terminals in December 2010 to 16,604 terminals in December 2011.

6.3.3. Mobile Phone Money Transfers

Table **23** shows transactions via Mobile Phone Money Transfer services in 2011, with the number of agents and users rising by 27.9 percent and 17.1 percent respectively between December 2010 and December 2011. Mobile phone money transfer retail payment system moved a total of Ksh 1,169 billion with 433 million transactions in the year 2011, translating to 59.7 percent and 39.2 percent respectively.

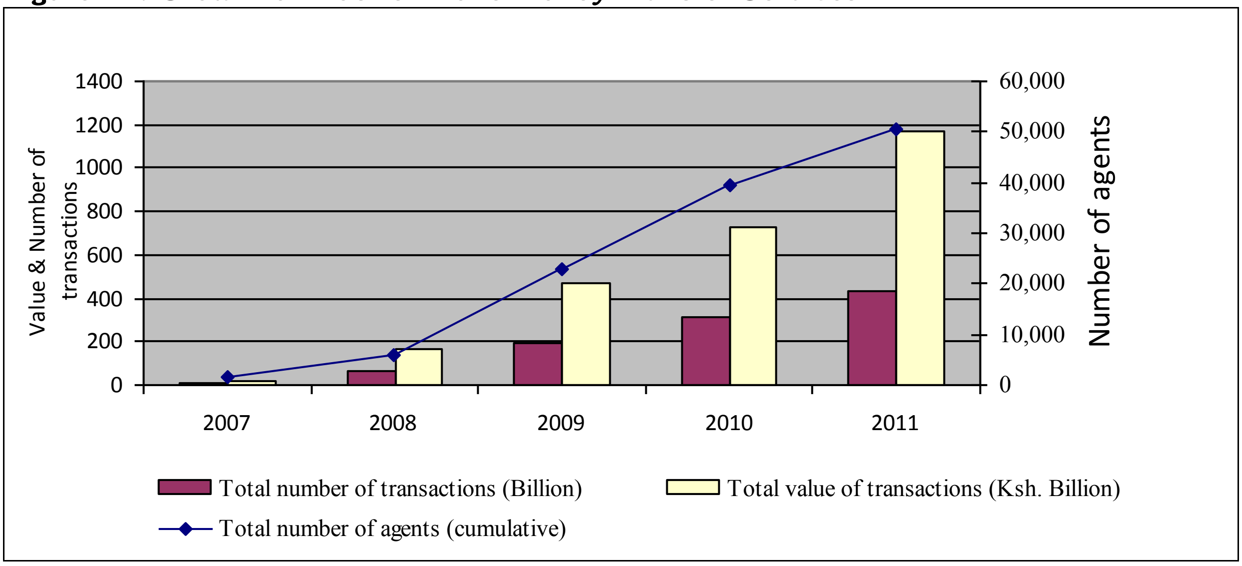
Table 23: Mobile Money Transfer by end December 31st

Measure	2007	2008	2009	2010	2011
Total number of agents	1,582	6,104	23,012	39,449	50,471
Total customers (million)	1.3	5.1	8.9	16.4	19.2
Number of transactions (million)	5.5	62.7	193.5	311.0	433.0
Transactions Value (Ksh billion)	16.3	166.6	473.4	732.2	1,169.2
Average value per transaction (Ksh)	2,983	2,655	2,447	2,354	2,700

Source: http://www.centralbank.go.ke

Figure **21** presents growth of the service by numbers and value in the year 2011. Although Mobile money payment system is widely used, it is not systemically important in terms of the financial system stability compared to KEPSS due to the relatively low value involved. However, its wider usage makes it important to financial sector development and therefore its stability is critical to the overall financial system efficiency.

Figure 21: Growth of Mobile Phone Money Transfer Services



Source: http://www.centralbank.go.ke

6.4. Savings and Credit Co-operative Societies (Sacco) sub-sector

The Savings and Credit Cooperative Societies (Sacco) have continued to play a critical role in Kenya's financial sector in terms of access, savings mobilization and wealth creation. Representing a considerable part of the Kenya financial sector, Sacco societies are member-based organizations focusing on meeting financial needs of members for personal and enterprise development. Membership cuts across different economic activities, both in rural and urban areas and are engaged either in Back Office Savings Activities (BOSAs) or the Front Office Savings Activities (FOSAs), or both. The Sacco societies operating FOSAs reflect near retail banking business operations.

There were 6,570 registered Sacco societies as at December 2011 out of which 2,168 were active. Of the active Saccos, 216 operated FOSAs, accounting for 9.96 percent of the total active Saccos, with a combined total asset base of Ksh. 196.5 billion. Total assets for all Saccos (both deposit and non-deposit taking) were Ksh. 248.8 billion; implying FOSAs controlled 78.97 percent of the industry. The industry recorded an improvement in annual accounting presentation with most of Saccos adopting a uniform chart of accounts. However, unrealistic or lack of provisioning and poor compliance with International Financial Reporting Standards (IFRS) still remains a constraint to the subsector.

6.4.1. Overall performance of FOSA Operating Sacco Societies

Table **24** shows improved performance of Sacco industry in terms of growth in 2011. In the year ending 31st December 2011, the total assets for Saccos subsector grew by 13 per cent with member deposits rising 23 per cent. Turnover was 12 per cent up as loans to members rose by Ksh 28.2 billion or 15 per cent, mainly driven by growth in FOSA savings. Sacco societies have not been subjected to prudential regulation and supervision like commercial banks and deposit-taking microfinance institutions. This makes it difficult to objectively analyze their financial statements using CAMEL rating, key indicators of financial soundness and stability.

Table 24: Performance of the Sacco Industry in 2011

YEAR	DEPOSITS	TURNOVER	LOANS	ASSETS
2011	180,003,423,979	31,463,685,247	186,149,239,603	248,765,061,947
2010	157,540,403,199	27,721,308,588	157,926,001,644	216,144,059,635
Change	22,463,020,780	3,742,376,659	28,223,237,959	32,621,002,312
% Change	↑ 22.5	↑11.9	↑15.2	↑ 13.1

Source: SASRA database

Saccos serve largely personal loans market lending on a guarantee system, with credit risk perceived to remain high and hence posing the greatest risk to the industry. This is largely manifested in high external borrowing, which has resulted in low liquidity and solvency margins in many Sacco Societies. In terms of industry soundness and stability, core capital to total assets and core capital to total deposit liabilities were way above required ratios, but institutional capital to total assets fell way below as indicated in Table **25**. However, there was significant improvement over the 2010 indicators, although many FSIs are yet to be compiled by Saccos.

Table 25: Sacco Societies Financial Soundness Indicators (FSIs)

FINANCIAL SOUNDNESS INDICATORS	31 Dec 09	31 Dec 10
CAPITAL ADEQUACY (%)		
Core capital to Total Assets (Min. 10%)	7%	16%
Core Capital to Total deposit liabilities (Min. 8%)	9%	21%
Institutional Capital to Total Assets (Min. 8%)	1%	3%
ASSET QUALITY (%)	**N/A**	**N/A**
NPLSs to Total Gross Loans		
NPLs Net of Provisions to Capital		
Earning Assets to Total Assets		
EARNINGS & PROFITABILITY (%)	**N/A**	**N/A**
Return on Assets (ROA)		
Return on Equity (ROE)		
Interest Margin to Gross Income		
Non Interest Expenses to Gross Income		
LIQUIDITY (%)		
Liquid Assets to Total Assets		
Liquid Assets to Short-term liabilities(Liquidity ratio)		
Liquid Assets to Total Deposit		
Total Loans to Total Deposit (%)	97	99

Source: SASRA *N/A – Not available*

6.4.2. Licensing of FOSA Operating Saccos

The Sacco Societies Act, 2008 and Sacco Societies (Deposit-Taking Sacco Business) Regulations, 2010 provide legal, regulatory and supervisory framework commensurate to the risks in deposit taking business of Saccos. Licensing of FOSA operating Saccos commenced in March 2011 and by 31 December 2011, 83 had been licensed while 12 had been issued with letters of intents. A total of 200 Saccos had submitted application for licensing. Saccos had up to June 2011 to apply for a license to conduct deposit taking Sacco Business. The priority of SASRA is on the 216 deposit taking Sacco societies (FOSAs), which control more than 78 percent of deposits and total assets in the Sacco industry.

6.4.3. Policy Developments

The Sacco Societies Regulatory Authority (SASRA) is mandated under an Act of parliament, to license, regulate and supervise Sacco societies. It seeks to enhance the regulatory and supervisory requirements such as corporate governance, transparency and accountability, liquidity, loan classification and provisioning, capital adequacy requirements, investment, risk management frameworks and financial reporting. The Act establishes Deposit Guarantee Fund (DGF) to protect members' deposits up to Ksh.100, 000 per account.

6.5. Capital Markets

Kenya's capital markets were bearish but resilient in 2011, with visible improvement in the primary markets. Capital markets remain a key source of financing of Vision 2030 projects, the Government and private sector. A total of **11** categories of capital market intermediaries comprising **94** players were licensed to operate in 2011 compared to **100** players in 2010 as indicated in table **26**.

Table 26: Kenya Capital Markets – No. of Licensed/Approved Institutions

Player/Licensee	Dec-08	Dec-09	Dec-10	Dec-11
Securities Exchange (NSE)	1	1	1	1
Central Depositories (CDSC)	1	1	1	1
Investment Banks	17	19	19	11
Inv. Banks with Extended Licenses	-	-	-	1
Stockbrokers	8	7	5	10
Investment advisers	20	23	21	18
Fund Managers	16	16	20	19
Collective Investment Schemes	11	11	13	16
Auth. Depositories/Custodians	11	12	17	14
Credit Rating Agencies	1	1	1	1
Venture Capital Companies	1	1	1	1
Dealer	-	-	1	1
Total	**87**	**92**	**100**	**94**

Source: CMA Statistical Database and NSE

6.5.1. Industry Performance in 2011

6.5.1.1. Equities Market

Primary market for equities remained relatively strong, albeit bearish in 2011, with one Initial Public Offer (IPO) and Two (2) companies listed by introduction at the NSE. Most important development is the participation of East African retail investors in the IPO, a key pointer to EAC integration critical in financial sector stability. Another company split and listed its shares separately between insurance and banking business as well as asset management and investment banking businesses. This separation of risk from the originally joint group is critical in financial stability, given that investors were allowed a 50/50 exposure.

Secondary market experienced relative downturn, reflected in notable equity performance. Total market turnover at NSE decreased by 26 percent, from Ksh. 110 billion in 2010 to Ksh. 81billion in 2011. The end-2011 NSE 20-Share index dropped by 27 percent to 3205 points from 4432 points on December 31st 2010, while market capitalization was down 25 percent from Ksh. 1,167 billion to Ksh. 868 billion by end December 2011. Total shares traded fell 15 percent from 7.18 billion to 6.1 billion shares.

6.5.1.2. Bonds Market

In 2011, seven (7) new Treasury bonds were issued while eight were re-opened. A key milestone also in 2011 was issuance of the longest-dated Treasury bond in Kenya's history (including East and Central Africa), a 30-year Savings Development Bond in February 2011.

Table 27: Gross Secondary Market Statistics (Includes corporate bonds)

	Month	NSE 20-Share Index	Shares Volume Traded (Mn)	Equity Turnover (Ksh. Bn)	Bond Turnover (Ksh. Bn)	End-Month Mkt. Cap (Ksh. Bn)
2011	**January**	4,465	725	9.5	19.89	1,192
	February	4,240	335	6.2	49.04	1,177
	March	3,887	469	8	40.12	1,090
	April	4,029	497	7.9	33.38	1,155
	May	4,078	411	8.4	33.65	1,144
	June	3,968	411	7.1	69.42	1,121
	July	3,738	452	7.3	33.41	1,049
	August	3,465	552	6.1	44.11	950
	September	3,284	582	5.4	36.11	886
	October	3,501	656	4.2	234.74	927
	November	3,103	345	3.6	26.60	836
	December	3,205	336	4	25.00	868
TOTAL	**2011**	**3,224**	**6,122**	**81.2**	**445.46**	**880**
	2010	**4,432**	**7,181**	**110**	**483.15**	**1,167**
	% Change	**-27**	**-15**	**-26**	**-7.8**	**-25**

Source: CMA Statistical Database

Corporate bond segment was however subdued, with only one company issuing a corporate bond. Tight liquidity in the market towards the end of 2011 led to significant under-subscriptions and volatility in yields in the bonds market. Tight conditions in the primary market saw secondary market for bond trading (including corporate bonds) decline in 2011 compared to 2010 by 7.8 percent, to Ksh. 445 billion from Ksh. 483 billion as unpredictable interest rates in the tail-end of 2011 catalyzed speculation leading to demand for higher yields and tightening liquidity. Of the total traded volume, corporate bonds turnover was Ksh 18.8 billion in 2011 compared with Ksh 17.1 billion in 2010.

6.5.2. Manifestations of Bearish Stock Market Performance

i. **Reduced securities issued –** Several planned IPOs, Rights Issues and Corporate Bond issues were shelved due to unfavourable market conditions.
ii. **Treasury bonds under-subscriptions -** Although under-subscription to government securities was experienced as early as April 2011, third to forth quarters of 2011 had very high investor demand in government paper, until the Treasury embarked on only 1-year maturity in December 2011 that attracted 181 percent subscription.
iii. **Profit warnings -** Among the indicators of slowed market performance is the issuance of profit warnings by listed companies. In 2011, **5** listed companies issued profit

warnings citing low investment income, tough business environment, a weaker local currency and bad debts write-offs.

iv. **Reduced foreign equity inflows –** The 98 percent decrease in equity inflow between 2010 and 2011 may signal capital flight by foreign investors in 2011.

Table 28: Kenya foreign equity flows

MONTH	2009	2010	2011
January	(342.01)	2,516.57	1,987.00
February	66.40	489.43	622.21
March	329.23	1,997.76	1,552.00
Apr il	49.43	151.06	(3,024.00)
May	496.38	(325.37)	(3,334.00)
June	883.92	1,601.05	(1,597.00)
July	791.30	1,160.19	1,173.00
August	860.95	472.56	621.00
September	937.46	1,205.49	535.00
October	2,424.94	2,146.91	719.00
November	1,528.02	2,525.68	31.00
December	300.02	1,185.52	935.00
Total	**8,326.05**	**15,126.84**	**220.21**

Source: CMA Statistical Database and NSE

The massive divestiture from the NSE by foreign investors in quarter two of 2011, covering April – June 2011 may be explained by the heightened Euro Zone crisis and the near-default on debt by the U.S, sending panic to investors to buy the USD. Overall, foreign investors' subdued participation at the NSE may also have been influenced by poor performance of the bourse as companies reported hostile business environment and therefore declining returns compared to the 2010 market scenario.

6.5.3. Financial Soundness of Market Intermediaries

The Financial Soundness Indicators (FSIs) were developed by the IMF, together with the international community, with the aim of supporting macroprudential analysis and assessing strengths and vulnerabilities of financial systems. The FSIs are compiled for both Deposits Takers like banks and Non-Deposit Takers, which include financial intermediaries like Capital Markets. A total of four indicators of financial soundness for market intermediaries were compiled and show significant improvement in 2011 over the 2010 level. As indicated in Table **30**, Capital adequacy ratios and Earnings & Profitability ratios that were compiled were robust. There was no data on asset quality and liquidity, and therefore will become part of improvement in 2012.

i. **Capital Adequacy -** All licensed firms maintained or exceeded capital adequacy levels as per the statutory requirements, with limits to paid-up share capital, shareholders funds, working capital and unsecured advances, all in acceptable levels.

ii. **Profit and Loss -** Year 2011 witnessed a decrease in profits after tax due to the bearish trends sustained in the market. Nevertheless, aggregate commission income increased, but the net effect was eroded due to an increase in the aggregate cost to income ratio.

Table 29: Capital Markets Intermediaries FSIs

FINANCIAL SOUNDNESS INDICATORS	31 Dec 2010	31 Dec 2011
CAPITAL ADEQUACY (%)		
Core capital to Total Assets (NA)	61%	67%
Core Capital to Total deposit liabilities (NA)	N/A	NA
Institutional Capital to Total Assets (NA)	53%	72%
ASSET QUALITY (N/A)	N/A	N/A
NPLSs to Total Gross Loans		
NPLs Net of Provisions to Capital		
Earning Assets to Total Assets		
EARNINGS & PROFITABILITY (N/A)		
Return on Assets (ROA)	21.3%	24.6%
Return on Equity (ROE)	35%	36.5%
Interest Margin to Gross Income	N/A	N/A
Non Interest Expenses to Gross Income	N/A	N/A
LIQUIDITY (N/A)	N/A	N/A
Liquid Assets to Total Assets		
Liquid Assets to Short-term liabilities(Liquidity ratio)		
Liquid Assets to Total Deposit		
Total Loans to Total Deposit		

Source: CMA Statistical Database and NSE

6.5.4. Capital Markets Reforms

CMA continued with reforms and other initiatives to ensure efficiency in market operations, investor confidence, capital markets deepening and ultimately, achieve financial markets stability. Such reforms and initiatives include;

i. **Demutualization of the Nairobi Securities Exchange (NSE) -** CMA continues to advance demutualization process in coordination with the Demutualization Steering Committee. Public participation on the Capital Markets (NSE Demutualization) Regulations 2011 and Capital Markets (Licensing Requirements) Regulations, 2012 was conducted. The regulations gazettement by the Minister for Finance expected soon.

ii. **Bond Market Reforms -** Draft amendments to the existing legal and regulatory framework were submitted to the Minister for Finance. They targeted: removal of barriers to trading listed securities off-exchange; creating legal framework to govern trade reporting, clearing and settlement and intermediary licensing in respect of the Over-The-Counter (OTC) market for listed debt securities; and reviewing the supervision and enforcement powers of CMA to regulate OTC market for prescribed instruments. These were passed vide the Finance Act 2010 and became effective in January 2011. As a result, an operational framework for the Hybrid bond market has been developed.

iii. **Commodities and Futures Market -** Capital Markets Act was amended to facilitate the establishment of a Futures Exchange in Kenya as a Self Regulatory Organization. The policy framework for a Futures market was developed and reviewed by a number of regulators from other jurisdictions.

iv. **Small and Medium sized Enterprises (SME) market segment -** CMA, in conjunction with NSE and CDSC, developed policy and regulatory framework for the establishment of SMEs market segment at the Nairobi Securities Exchange. The Draft regulations to introduce Growth Enterprise Market Segment in Kenya were submitted to the Minister for Finance for gazettement in December 2011.

v. **Capital Markets Legal Framework Review -** The REITs policy framework was approved by the Board and regulations finalized. In addition, the Capital Market and CDSC (Amendment) Bills 2011 were enacted into law. The Securities Industry Bill and the Capital Markets Authority Bill are still awaiting enactment. Other legal frameworks awaiting finalization of the policy framework include: amendments to the Public Offers Regulations to provide for cross-listings of securities listed in the East African Community.

vi. **Risk Based Supervision (RBS) -** CMA continued its incremental implementation of RBS. Consequently, it issued Management Supervision Internal Control Guidelines 2012

vii. **Special projects, Investor education and public awareness -** CMA continues to progress the development of Islamic Capital Markets in Kenya as well as development of the Capital Markets Master Plan.

6.5.5. Risk Assessment and Mitigation Measures

i. **Market Risk –** are risks associated with major events in the marketplace that can impact market prices and rates, thus affecting the value of positions in given assets. They include; collapse of the entire market, as opposed to risk associated with any one individual entity or group. Such risks are caused by institutional and operational weaknesses, and CMA is undertaking wholesale reforms including; review of the legal and regulatory framework, enhanced corporate governance and capital adequacy of market intermediaries and listed companies, automation of the entire trading, clearing and settlement infrastructure as well as implementation of risk based supervision and enhanced market surveillance to mitigate such a risk.

ii. **Credit Risk-** addresses the possibility that the counterparty, the other side of the trade, will be unable to meet its financial obligations in the transaction. This risk is mitigated by the settlement guarantee fund of which the CDSC administers. In addition, guidelines on financial resource have been developed for market intermediaries.

iii. **Operational Risk**; Human error, fraud, mismanagement, and systems failure are examples of operational risks of which have a huge impact on investor confidence. CMA undertook various measures, including gazettement of conduct of business, internal controls and corporate governance regulations; requirement for professional indemnity insurance; implementation of the Broker Back Office System and installation of surveillance system.

iv. **Economic Risk** including;

- *Interest Rate Risk* - interest rates changes adversely impact the value of the instrument;
- *Equity Risk/Inflationary Risk* - 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 or Foreign Exchange Risk* - fluctuation in currency rates, individually and relative to floating indices.

The global economy is recovering only slowly and global credit markets remain modestly vulnerable. A reversal in the global recovery will significantly impact Kenya's economy, thus negatively affecting earnings of listed companies, which of course will translate into a decline in market activity as well as performance. In addition, tight monetary policy stance being implemented, albeit taming inflation, has a negative impact on the bond markets due to sustenance of high interest rates.

v. **Low Market Confidence:** Investor confidence is critical in fostering market development and stability. The Safaricom IPO performance, collapse of stock brokers and slow compensation of victims of fraud at NSE negatively affected retail investors' confidence. To improve investor confidence, CMA instituted measures such as compensation of investors affected, establishment of the Capital Markets Fraud Investigation Unit and gazettement of corporate governance and business conduct regulations.

vi. **Volatility:** Stock market volatility and the associated uncertainties can impair the allocation of credit in the financial system and create funding constraints with potential instability undertones. This, coupled with heightened perception of risk by market participants, can accelerate the potential of stability problems locally. As indicated in Table **30**, NSE experienced significant volatility with shock divestiture of Ksh 7,955 million worth of equities in quarter two of 2011, before closing the year with investment of Ksh 1,685 million in quarter four. The proportion of foreign investors trading to total turnover almost halved to 36.75 percent in quarter four of 2011 from 60 percent for similar period in 2010. It is in recognition of such swings that CMA is working on the introduction of risk-hedging products such as derivatives to mitigate for volatility risk.

vii. **Narrow product and service base and Low Market Liquidity:** NSE is characterized by narrow product base and low market liquidity. To enhance liquidity, CMA is in the process of creating environment for products such as commodity futures and a hybrid bond market as well as alternative market for raising capital by SMEs. Internet trading, securities borrowing arrangements for short selling and market making, margin trading and shorter-trading and settlement cycle are also underway.

viii. **Market Concentration:** Ten out of the fifty eight (58) listed companies accounted for 72 percent of market capitalization in 2011 (Table **30**). This is risky incase of collapse of some of these firms. CMA has proposed incentives to encourage more listings at the NSE, both at main market and SMEs segments, and increased public awareness on advantages of diversifying investment across listed companies.

ix. **Market Liquidity:** Illiquid market is quite risky as it cannot withstand external shocks. Both the bond and equities markets were illiquid in 2011 as shown by their turnover ratios in Table **30**. Such markets face settlement and credit risks.

Table 30: Secondary Markets Financial Soundness Indicators

	Dec–10	Mar-11	Jun-11	Sep-11	Dec-11
Market Stability					
NSE 20 Stock Market Index *(End of Period)*	4,432	3,887	3,968	3,284	3,205
Volatility of Stock Market Index					
Net foreign equity flow (Ksh Million)(Quarterly Aggregate Total)	5,859	4,161	-7,955	2,329	1,685
Domestic Shareholders (%)	87.4	84.3	82.37	81.98	80.6
Foreign Shareholders (%)	12.6	15.7	17.63	18.02	19.4
Foreign Investors Trading Turnover (%)	60	30.53	30.26	30.02	36.75
Foreign investors' equity holdings (%)	21	26	27	27	28
Market Concentration					
Share of biggest three (3)/ total Market Capitalisation (%)	38.22	35.6	36.3	35.2	37.3
Share of biggest ten (10)/total Market Capitalisation (%)	73.23	73.39	73.87	70.67	72
Market Size					
Total Number of Listed Domestic Firms	55	55	55	56	57
Market Capitalization - (Ksh Billion) *(End of Period)*	1,670	1,090	1,121	884.8	868.2
Equity Turnover (Ksh Bn)(Quarterly Total)	25.48	23.66	23.34	18.7	12.4
Equity Turnover as a % of GDP	0.9	0.9	0.9	0.7	0.5
Market liquidity					
Equity Turnover Ratio (Quarterly Aggregate - %)	1.5	2.2	2.1	2.1	1.4
Free float	36	34.7			
Bonds Market Size					
Bonds Turnover (Ksh Billion)(Quarterly Total)	83.98	109.05	136.45	114.02	86.14
Bond Turnover as a % of GDP	3.65	4.03	5.1	4.2	3.2
Bond Turnover Ratio (BTR as % of Outstanding Bonds)	6.08		41		29.2

Source: CMA Statistical Database and NSE

6.5.6. Emerging Risks

i. **Money Laundering and related activities:** The securities industry regulator acknowledges that money launderers may target the securities industry. However, the extent to which brokers/dealers, investment banks and Collective Investment Schemes are actually used for money laundering remains unclear. In addition, the industry's overall vulnerability is impacted by the extent to which it is covered by anti-money laundering requirements and mitigated by the anti-money laundering measures implemented by these firms by virtue of the enactment of the Proceeds of Crime and Anti-money Laundering Act.

ii. **Legislative Risk:** The possibility that legislative changes, especially tax laws, will affect the financial returns of a particular security or firm is real. Kenya's tax laws are currently under review and some provisions may affect the capital markets industry adversely rather than positively. Tax levies or other charges on foreign investors, capital gain, withholding tax or even listing do have negative impact on the capital markets. In addition, the proposed securities industry laws are awaiting enactment with no certainty as to when the same will be actualized.

iii. **Political Risk:** Kenya is currently preparing for elections and the prevailing uncertainty that always comes when an election period is near

iv. **Economic Risk:** the tight monetary policy stance being implemented, albeit taming inflation has a negative impact on the securities markets due to sustenance of high interest rates. This is compounded by the reduced growth in the domestic as well as the global economy.

Given these emerging risks, stock market performance will be largely dependent upon concerted efforts aimed at overall stability of the macro-economic environment as a result of both internal and external factors. The sector reforms currently being spearheaded by the Authority are aimed at rejuvenating the capital markets with the aim of making the market more vibrant, fair and orderly. These issues will continue to enhance investor confidence further and spur increased market activity.

6.6. Retirement Benefits/ Pension Industry

6.6.1 Industry Growth

The retirement benefits industry comprises the Retirement Benefits Authority which is the regulator of the industry, the retirement benefits schemes and the service providers including fund managers, custodians, and administrators. In 2011 there were 1262 registered retirement benefits schemes, 16 fund managers, 12 custodians and 26 registered external administrators as illustrated in Table **31**.

Table 31: Pension Industry Licensees' by end December 2011

Number of	Dec '07	June '08	Dec '08	June '09	Dec '09	Dec '10	Dec 11
Retirement Benefit Schemes	1,205	1,225	1,246	1,266	1,284	1,288	1262
Registered Fund Managers	13	16	16	17	17	17	16
Registered Custodians	5	6	6	10	10	10	12
Registered Administrators	13	23	23	24	22	25	26

Source: RBA.

6.6.2 Risk Based Supervision

RBA has implemented risk based supervision for all Schemes, whereby they are scored based on a comprehensive risk parameters matrix ranging from 0 to 4. A higher score indicates higher risk while a lower average score reflects a more secure industry, with ability to grow and deliver benefits to scheme members. As at 31st January, 2011, over 1298 schemes had been scored giving an overall average score of **1.15.** This indicates the industry had a lower risk of failure, despite the fact that this number included 36 unregulated Schemes.

6.6.3 Asset Growth and Composition

Retirement benefits industry assets declined by 4.1 percent from Ksh.450.69 billion in December 2010 to Ksh.432.8 billion in December 2011 as shown in Table **33**. The subsector is diversified in terms of ownership and composition of assets, with 22.6 percent or Ksh. 98 billion of total assets held by the National Social Security Fund, while the remainder 77.4 percent was held by occupational and individual retirement benefits schemes. The decline in total assets was due to short-term volatility, including the fall in the value of quoted equities at the NSE during the year as well as rising interest rates by end of 2011, which reduced the value of the schemes' holdings in government securities.

Table 32: Industry Performance Indicators

Measure	Dec '07	Dec '08	Dec '09	Dec '10	Dec 11
Assets (Ksh. Billion)	293.7	302.8	343.8	450.69	432.8
Annual increment (%)	-	3.1	13.5	31.2	-4.1
Schemes Average return (%)	8.7	-2.8	11.0	27.8	-9.9

Source: RBA

In terms of portfolio diversification, government securities (Treasury bills and bonds), quoted securities and immovable property accounted for the largest share at Ksh.146 billion (34 percent), Ksh.93 billion (21 percent), and Ksh.88 billion (20 percent), respectively (Table **33**). The assets in the form of guaranteed funds investments amounted to Ksh 48 billion.

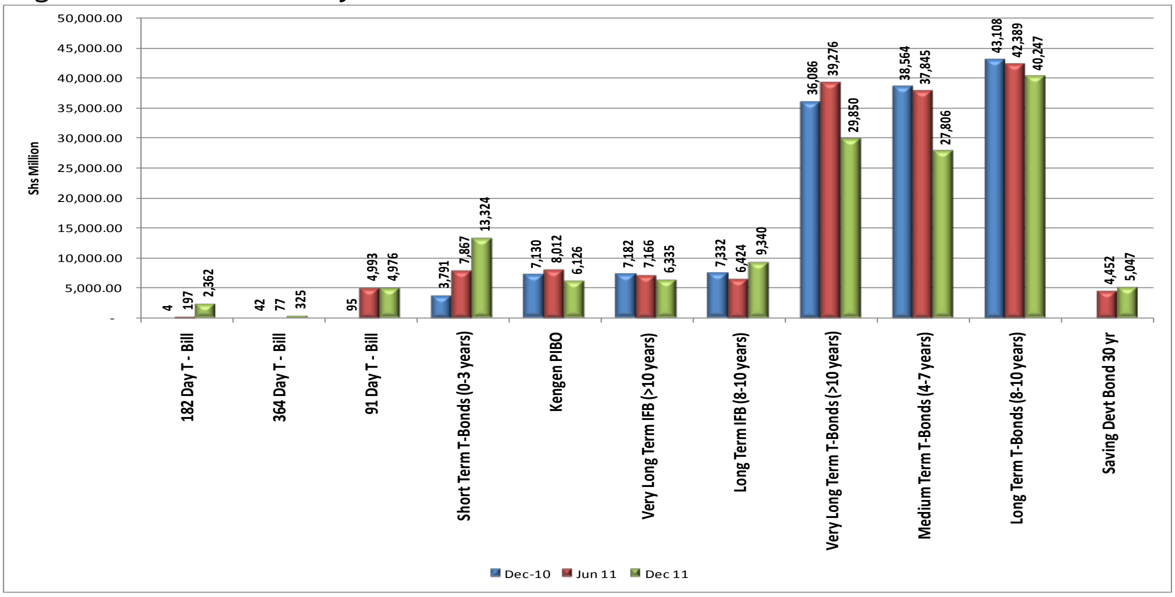
Table 33: Pension Industry Investment Portfolio as at December 2011

		December 2010		December 2011		Statutory Limit (%)
		Ksh Bn	%	Ksh Bn	%	
1	Government Securities	143.6	32	145.7	34	90
2	Quoted Equities	130.3	29	93.0	21	70
3	Immovable Property	80.0	18	87.8	20	30
4	Guaranteed Funds	33.3	7	48.0	11	100
5	Fixed Income	21.1	5	20.7	5	30
6	Fixed Deposit	17.3	4	21.9	5	30
7	Offshore	15.4	3	5.2	1	15
8	Cash	7.3	2	6.8	2	5
9	Unquoted Equities	2.5	1	3.7	1	5
	TOTAL	**450.7**	**100**	**432.8**	**100**	

Source: RBA

Overall, all the categories of investment were within the statutory maximum guidelines as provided for in the retirement benefits regulations shown in the last column of Table **33**. Composition of assets under management continues to register dominance in government securities and quoted equities with a majority of 55 percent of the total retirement benefits industry assets. The perceived risky assets such as real estate, quoted and unquoted equity, offshore investments and "other assets", accounted for 43 percent of the total industry investment portfolio as at December 2011 down from 51 percent at end of 2010. Although long-term securities remained the largest component of schemes' holding of government securities as shown in Figure **22**, their value fell sharply due to increase in interest rates.

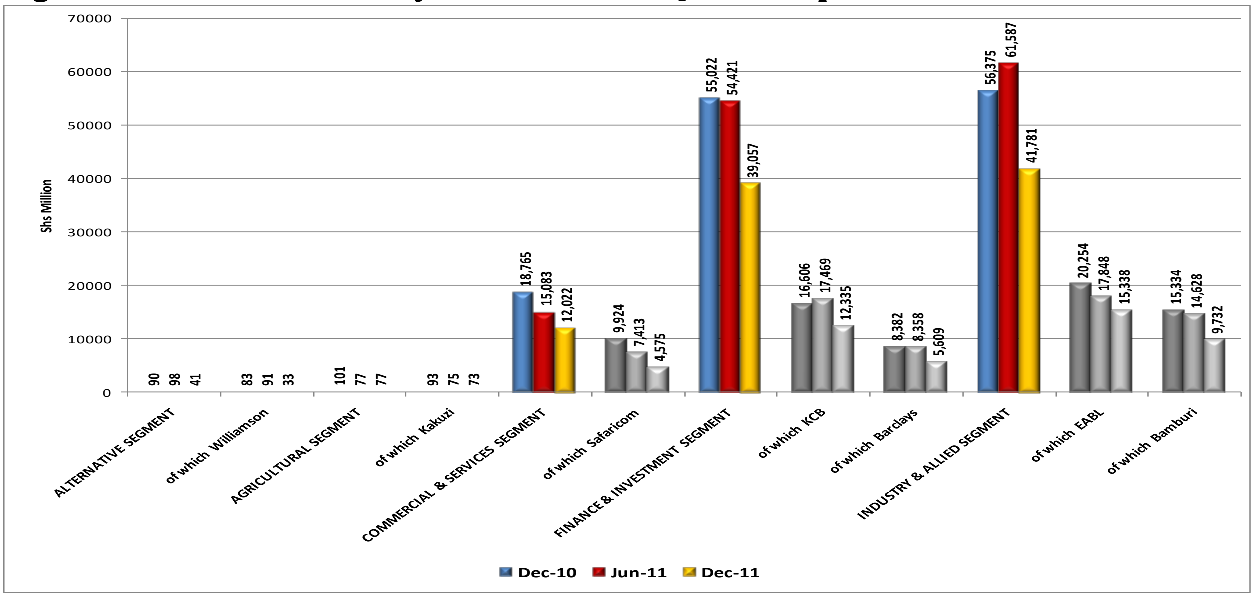
Figure 22: Pension Industry Investment in Government Securities



Source: RBA

Short term component rose in 2011, not because of a deliberate strategy, but to supply constraints at the long end, as CBK/Government concentrated issuance up to 2-years to manage interest rates volatility and restore market demand in the primary market. The industry investment in stock markets in the East African Community declined by a massive 24 percent in the second half of 2011, as uncertainties eroded the equities values at the NSE. Figure **23** show that the subsector concentrated their investments in two sector; Finance & Investment and Industry & Allied, which are considered to having more blue-chip counters.

Figure 23: Pension Industry Investment in Quoted Equities

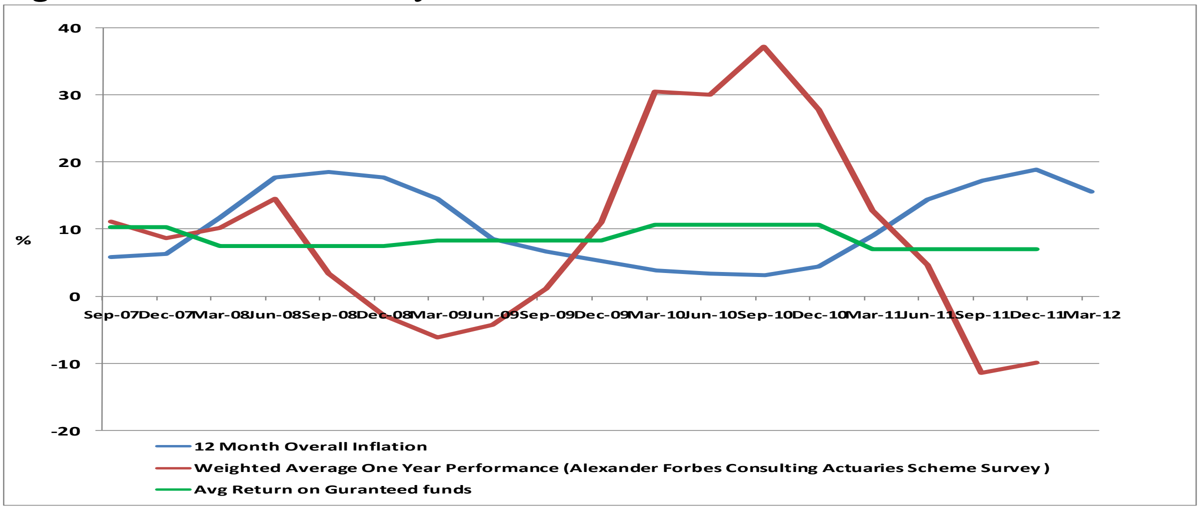


Source: RBA Database, December 2011

6.6.4 Rates of Return

As indicated in Figure **24,** average rates of return of the industry fell significantly in 2011. A sample survey of schemes saw weighted average one-year return down from 27.8 percent in December 2010 to negative 11.4 percent in September 2011.

Figure 24: Pension Industry Rates of Return Vs Overall Inflation



Source: RBA

There was, however, some improvement in December 2011 with average returns reported at negative 9.9 percent but this was well below the overall inflation which stood at 18.9 percent.

6.6.5 Retirement Benefits Industry Outlook

Asset values are expected to rebound strongly in the first half of 2012 due to; recovery at the NSE, easing in inflation pressures and correction in interest rates, more new retirement benefits schemes as well as the continued rapid increase in membership of existing schemes in particular the Mbao Pension Plan.

6.6.6 Risks and Mitigation Strategies

The retirement benefits industry is faced with the following risks that were evident in 2011, but a number of mitigation measures were devised to ensure stability:

Investment or market Risks: Adverse movements in interest rates and other market prices, investment in unregulated /unlisted products, and lack of adequate diversification in retirement benefits assets or portfolio hence exposure to one asset or issuer (concentration risk) pose risks to pension industry. In 2011, the industry experienced a sharp decline in the quoted equity portfolio mainly due to the unfavorable stock market prices at NSE. The assets were also affected negatively by high inflation and interest rates. To mitigate these risks, RBA is currently reviewing the Investment Guidelines so as to incorporate new investment products in the market and enhance greater flexibility in the investment of pension funds by Fund Managers. The revision would also achieve greater portfolio diversification through investment in broader asset classes. The Authority also ensures that all schemes have investment policies and are reviewed after every three years.

Counterparty or credit risks: This occurs due to failures by a counterparty to meet its obligations. RBA normally carry out annual due diligence before registering various service providers, who are then published in the print media and the Authority's website. All schemes are advised to use the registered service providers to reduce counter party risk as well as the use of different service providers while using fund managers and administrators.

Funding or solvency risk: this occurs when a pension fund does not have sufficient assets to meet its liabilities, and, the risk of insolvency in the plan sponsor affecting its ability to fund the plan. It is common among Defined Benefits Pension Funds. To mitigate this risk, RBA is overseeing implementation of Government policy on adoption of Defined Contribution schemes by all parastatals; with most schemes ensuring that they meet the 100 percent funding level before the transition. There were 121 Defined Benefits schemes, constituting only 7 percent of the total number of schemes by December 2011, hence expected decline of this risk in 2012.

Liquidity risk: Inability of a scheme to meet its financial obligations as they fall due for lack of fungibility is a risk. RBA requires all schemes to have an investment policy before they are registered. The investment policy is then reviewed every three years or more frequently if need be. The policy helps the scheme trustees to identify potential liquidity risks and institute mitigants necessary.

Actuarial risk: arises from inappropriate use of the actuarial valuation methods and assumptions (e.g. mortality; discount rate; longevity; disability; inflation; and liquidity). RBA encourages prudent setting of assumptions of mortality and discount rates and the realistic inflation rate assumption. It also ensures that the assumptions used are consistent with those used in previous valuations and changes made on financial impact in the funding are illustrated. Using risk-based framework, RBA also ensures that triennial statutory valuations are submitted on time and attendant remedial plans of action are submitted.

6.6.7 Key Development Programs

The Authority launched and implemented the Trustee Development Programme in partnership with the College of Insurance and the Humber Institute of Technology of Canada to train at least **1** trustee in each scheme in 2011. As of March 2012, 146 trustees had been trained under the certification programme. RBA is also working with the informal sector to involve as many individuals in saving for retirement. Through the Mbao Pension Plan, RBA has increased the number and coverage of individuals saving for retirement, growing from 7,898 in June 2011 to 16,036 in December 2011.

6.7. Insurance Industry

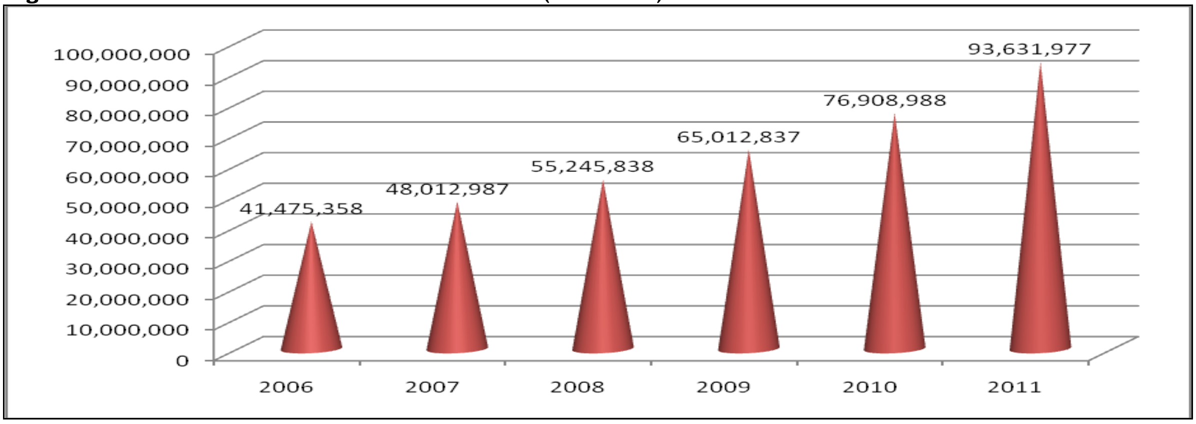
Insurance industry consists of re-insurance companies, insurance companies, insurance brokers, medical insurance providers, insurance agents, loss assessors, insurance investigators, loss adjusters, surveyors and claims settlement agents. As at 31st December 2011, the industry had **47** insurance companies and **2** re-insurance companies. The other regulated entities were: Insurance brokers, medical insurance providers, insurance agents, insurance surveyors, loss adjustors, claim settling agents and risk managers.

6.7.1. Industry Performance in 2011

Developments in the local, regional and international financial markets remain of great concern to the insurance industry as a whole. The economic shocks generated mainly as a result of erratic weather conditions, escalating oil prices, high inflation, global financial crisis, and weakening of the Kenya shilling against major currencies continue to paint a gloomy picture of future economic prospects of the Kenyan economy. For instance, the resultant high inflation (in double digits) and high interest rates spread worsened the financial subsector prospects. The insurance industry exposures to these macroeconomic sensitivities had decisive implications on overall industry growth and performance in the year 2011. These cyclical downturns did manifest themselves mainly in asset base fluctuations and subsequently capital base and solvency downturns.

Assessment of macroeconomic outlook and risk management projections shows that the insurance industry has potential to expand given the current general stability in the domestic economy resulting from the recent policy actions by the Kenyan government and the Central Bank of Kenya like stabilization policies to stabilize the local currency and ease inflationary pressures. Further, this positive trajectory is underpinned by improving regional conditions and robustness of regional trade partners within the EAC market. Given these developments, assessment of the insurance industry outlook remains promising despite setbacks. Gross premium income rose to Ksh 93.63 billion in 2011 from 76.91 billion realized in 2010, a 21.7 percent growth rate while Net premium written was 20.62 percent up captured in Figure **25**.

Figure 25: Five - Year Gross Premium Income (Ksh'000s)



Source: Insurance Industry Returns in 2011

Total industry assets rose by 4.33 percent to Ksh.233.17 billion as at December 2011 up from Ksh 223.49 billion in 2010. Other increasing results were noted in Claims incurred in General Business, Management expenses, investments and Underwriting general business that grew a massive 104 percent as shown in Table **34**. However, there was a drastic fall in investment income which recorded a 75.92% sinking. The other components results that registered a downfall included; 11.17 percent decline in profits after taxation, 8.4 percent decline in commissions and reduced shareholders' funds by 1.40 percent against the 2010 performance.

Table 34: Insurance Industry Performance (Ksh '000s)

ITEM/YEAR	2008	2009	2010	2011	Change in 2011 (%)
Shareholder's funds	38,161,222	41,468,967	58,648,780	57,828,246	**-1.40**
Assets	154,452,739	178,403,820	223,490,783	233,172,363	**4.33**
Investments	123,621,370	113,452,503	177,520,999	181,179,611	**2.06**
Investment income (P&L)	8,191,112	12,112,000	23,369,307	5,626,415	**-75.92**
Gross Premium Income	55,245,838	65,012,837	76,908,988	93,631,977	**21.74**
Net premium written	45,593,023	45,592,656	64,123,285	77,344,046	**20.62**
Claims incurred (General Business)	15,883,565	19,768,322	21,628,871	25,052,948	**15.83**
Commissions	7,252,116	8,714,712	10,269,674	9,406,710	**-8.40**
Management Expenses	12,602,253	14,640,675	16,758,479	18,889,354	**12.72**
Underwriting results (Gen. business)	872,496	401,806	1,271,437	2,591,764	**103.85**
Operating profit/loss after taxation	3,349,997	3,420,972	7,634,272	6,781,494	**-11.17**

Source: Insurance Regulatory Authority Industry Returns, 2011

The growth in assets, investment, gross premium income and net premium income was mainly driven by increased credit to the private sector, higher public investments in infrastructure and higher inflows of remittances from the Diaspora. The registered growth in management expenses can be attributed to additional workforce, duties and responsibilities and human capital welfare enhancement. This contextualized market growth is expected to be sustained following IRA's efforts to institute targeted measures through the strategic plan aimed at ensuring stability and competition in the industry.

6.7.2. Risks and Mitigation Measures

Given operations of the insurance industry and the nature of changes occurring in the operating environment, the industry is predisposed to a number of risks. Among the key risks identified are; insurance risk, operational risk, liquidity risk, strategic risk, contagion and related party risk, balance sheet and market risk, counterparty default risk and legal and regulatory risk.

i. **Insurance Risk:** This relates to the types of business underwritten by insurance companies as some products carry a lower risk (e.g. whole of life) than others (e.g. total and permanent disability business). Among the key issues to be considered include product pricing *viz a viz* profitability and consumer protection objectives, evaluation of claims before payouts, frequency of payouts and re-insurance arrangements put in place given insurer business portfolio.

ii. **Operational Risk:** Arises from how underwriting, claims, investments processes are run and managed in terms of qualifications and experience of staff, robustness of systems, policies, processes and procedures and how often they are updated.

iii. **Strategic Risk:** This is a risk that faces all regulated entities and more so insurers in terms of soundness of overall company strategy with regard to new business opportunities and how they are harnessed, investment appetite and how all this is aligned to key processes and procedures. Also important is how the risks are identified, monitored, evaluated and reported upon. The industry is yet to fully reach optimal level.

iv. **Contagion and Related Party Risk:** Insurers like other players in the financial services sector are affected by other factors beyond their control such as inflation, financial crises, unemployment, and interest rate swings. If not mitigated, these may lead insurer to collapse with added implication of reputational risk to the industry. Related party risk emanates group owners diverting resources from the insurance company to other members of the group.

v. **Risk Mitigation Measures:** Each of these risks has potential to adversely affect performance of the insurance industry. Insurers have been sensitized to identify and put in place measures to mitigate them. Sensitization process targets Board of Directors, Senior Management and middle Management, who identify risks and undertake independent reviews.

6.7.3. Policy Developments and Other Initiatives

The IRA undertook a number of initiatives backed by policy developments to, not only ensure dependable, transparent, effective and efficient insurance industry, but also a stable, competitive and prosperous subsector. These initiatives include;

i. **Development of Guidelines:** IRA developed operational guidelines covering claims management, product development, market conduct for investigators and motor assessors and group life to manage listed risks.

ii. **On-Line Filing of Un-Audited Quarterly Returns:** Section 54 of the Insurance Act requires that all insurance companies incorporated in Kenya submit quarterly unaudited returns to the Authority as prescribed in the second and third schedules of the Act within 45 days after the end of the quarter to which they relate. However, compliance level was low for data submission as required and was not done uniformly in the prescribed format. This made it difficult for IRA to compile and compare data between companies over time. To enhance data uniformity, templates were prepared to facilitate on-line submission of returns and facilitate comparability and analysis of industry performance.

iii. **Resolution of Consumer Complaints:** Significant progress has been made by the Authority in the development of a Customer Relationship Management (CRM) Software which, once fully implemented will entrench efficiency and effectiveness in resolution of consumer complaints.

iv. **Adoption of Risk Based Supervision:** The Authority in line with the general strategic direction taken to change the supervisory approach from compliance (rule) based to risk based. The Model is aimed at ensuring that preventive and corrective measures are taken in a timely and suitable manner based on the risk profile of the insurer. Training of staff and chief executive officers of insurance companies on risk based supervision has been carried out. In addition, risk profile and RBS Capital model for General Business as well as Capital Adequacy Requirement (CAR) model for General Business developed.

v. **Peer Review of Level of Compliance with Insurance Core Principles (ICP's):** A peer review assessment on the level of compliance with the International Association of Insurance Supervisors (IAIS) Insurance Core Principles (ICP's) was carried out. This enables the Authority to determine its level of compliance with the international standards in supervision and regulation and insurance business.

vi. **Review of the Insurance Act:** Insurance Sector Policy Paper was completed. Once adopted, it will be aligned with the Insurance Bill.

vii. **Development of Micro Insurance Policy Paper:** To enhance financial inclusion in line with Vision 2030 and deepen insurance uptake especially among the low income households, an enabling policy framework has been developed. The policy identifies demand side, supply side and legal and regulatory issues for up-scaling insurance usage among low end populations.

viii. **Standardization of Insurance Contracts:** Insurance contracts have in the past been labeled as generous in generating content with fine print to the extent that consumers of insurance services seldom connect with the insurers, leading to numerous complaints. To address this concern, IRA embarked on insurance contracts standardization to ensure that they are easily understood, compared and valued by consumers with a higher degree of precision and certainty. Four classes of insurance policies- Burglary, Domestic Package, Money and Public Liability have been standardized.

ix. **Statutory Management**: Three Insurance Companies still remain under statutory management after failing to meet requirements for operation of insurance business in Kenya as provided by the Insurance Act.

7. SUMMARY AND OUTLOOK

This Financial Stability Report 2011 recognizes the linkage between financial system stability and overall macroeconomic developments, both at global and domestic level. The prevailing Global Macrofinancial risks remain elevated and pose potential threats to Kenya's financial system stability going into 2012 and beyond. In 2011, main sources of risks globally were; Market and liquidity, volatility in credit markets and macroeconomic instability, which escalated in the first quarter of 2012 as fragility in the European banking system, vulnerabilities in the global economy, particularly in the Euro Zone, and waning demand in emerging markets like India and China. Indeed the G-20 meeting in Mexico in June 2012 to spearhead policy initiatives to mitigate extended risks and spillovers to the rest of the world singled out euro zone crisis as "the single biggest risk for the world economy".

At regional level, Africa's rebound from the recession was faster and stronger than from previous global downturns. In 2011, SSA economies expanded by 5.2 percent compared to 5.4 percent in 2010, with a 5.8 percent growth projection for 2012. This is supported by strong domestic demand, rising commodity prices in the world market, and increased trade within SSA. However, the renewed turmoil in global financial markets and the weak prospects for growth in advanced economies may heighten downside risks in a number of SSA countries. At the EAC level, high inflationary pressures, volatile exchange rates, and subdued stock markets had knock-on effect on growth and stability in 2011. However, concerted efforts and close coordination by EAC central banks continue to have positive impact in restoring stability and jumpstart growth albeit slowly, going into 2012.

Domestically, there are risks emanating from global dynamics as well as those specific to Kenya. While the local currency has stabilized and inflation continue to ease, volatility in global financial markets, down- turn in developed economies and high fuel prices remain key risks to domestic financial system stability. The situation will improve considerably, depending on the trends in Europe, emerging markets economies like China, and Americas as well as growth momentum in the EAC. The CBK, other financial sector regulators together with the Ministry of Finance and Kenya Bankers Association have been steadfast in managing any signs of vulnerabilities. This has seen easing of inflation pressure and stabilization of the currency as the government moved to externalize part of its debt through syndicated loan. Debt externalization eases pressure on interest rates, and thus boosts banking sector credit to support the private sector growth. Besides vulnerabilities directly associated with macroeconomic vulnerabilities, there are signs of growing household debt (personal loans) and cooling mortgage market due to upward pressure on interest rates. There was also significant fall in return on pension subsector portfolio investments, and regulatory weaknesses in the Saccos and Insurance industries and exposure on protection level for deposits in the deposit-taking institutions. Delays to undertake reforms in the capital markets amid emerging risks present fertile ground for vulnerabilities. These coupled with focus on forthcoming general elections are likely to remain areas of concerns to the financial sector stabilize.

All these downside risks are mitigated by a number of ongoing regulatory efficiencies and new reforms. Robust risk-based supervision by CBK ensures stability of deposit-taking institutions it regulates; introduction of Agency banking, DTMFIs, establishment of Credit Reference Bureaus

(CRBs) ensures financial deepening; adoption of Mobile Phone Financial services (MFS) ensures efficiency in financial services thereby contribute to financial stability; revision of operational and regulatory guidelines by CMA, SASRA, IRA and RBA ensures overall stability to financial system going in to 2012. Continued stabilization monetary policy regime by CBK to rein in on inflation and volatility in local currency, externalization of domestic debt by the government and adoption of risk-based supervisory framework other regulators as well as close coordination with other EAC regional regulators will ensure sustenance of stability going into 2012 and beyond.

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