



Financial regulation in Kenya:

Balancing inclusive growth with financial stability

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Abstract

This case study investigates the potential tradeoffs between regulations and stability of Kenya's financial sector and their implications for inclusive growth. This is done in the context of six areas: (i) size and growth of the financial sector relative to LICs and MICs; (ii) implications of a mixture of local banks (some of which have spread to neighbouring countries), foreign banks and development finance institutions; (iii) evolution and macroeconomic implications of financial innovations and inclusion; (iv) cost and access to credit, especially to SMEs; (e) prudential regulations; and (f) management of capital flows in the context of large current account deficits, mainly financed by short-term net capital inflows such that their easy reversibility could potentially generate a currency crisis.

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1 Introduction¹

In the wake of the global financial crisis (GFC), many countries are prioritizing stability by strengthening financial regulation. Although important, this might be at the expense of inclusive growth, especially in poor countries. Without effective regulation, financial systems can become unstable, triggering crises that can devastate the real economy as evidenced by the recent GFC that began in 2007 (Spratt 2013). Given the primary purpose of finance is to facilitate productive economic activity, the aim of regulation is to maintain financial stability and to promote economic growth. This is a delicate balancing act, as too great a focus on stability could stifle growth, while a dash for growth is likely to sow the seeds of future crises.

There are two different ways that regulation could impact on growth and stability (Spratt 2013). The first is by influencing the day-to-day behaviour of financial market actors so that financial regulation has direct effects, for example, on how much a bank chooses to lend to small and medium enterprises (SMEs). The second is by influencing how the financial system evolves structurally, thereby creating indirect effects. The diversity of the banking system, for example, will influence the pattern of lending by sectors.

This case study investigates the potential tradeoff between regulation and stability in Kenya, a small open economy which is highly vulnerable to domestic and external shocks, but with a lightly regulated financial system and a fairly open capital account. The study adopts an empirical approach, entailing quantitative work and focused policy analysis. The specific objectives of the Kenya case study are therefore to identify and analyze (i) key national risks to financial stability as well as obstacles or gaps in financial sector for funding inclusive growth; (ii) domestic regulatory measures that have been implemented, future options to support financial stability and the advantages and problems of different mechanisms for such regulation, given the country characteristics (e.g. weak institutions, governance and law enforcement, and information problems); and (iii) the management of capital account to support financial stability prior, during and after the recent global financial crisis.

To make the research manageable, the study mainly focuses on the banking sector, although capital markets, pension funds and other financial institutions may facilitate more long term finance if banks do not provide sufficiently. The Terms of Reference for the research project identify a number of issues that require investigation. The paper is therefore organized around these issues. Section 2 analyzes the size and growth of the financial sector and its linkages to economic performance; Section 3 investigates the role of foreign banks, state-owned banks and development finance institutions (DFIs); Section 4 examines the evolution of financial inclusion in the country; Section 5 discusses access and cost of credit; Section 6 explains prudential regulations; while Section 7 analyzes the management of capital flows in the country. The paper is concluded in Section 8.

¹ This draws on the study's Terms of Reference.

2 Size and growth of the financial sector

2.1 The financial sector in Kenya's Vision 2030

The starting point of the study is an analysis of the features and vision of development of the country in the medium term for example as articulated in Kenya Vision 2030 and the Medium Term Plans (MTPs), given the country's main opportunities (such as the recent discovery of commercially viable oil deposits and of rare minerals in the country) and challenges (such as continued lack of access and high cost of credit, especially for SMEs).

Kenya Vision 2030 is the country's development blueprint which was launched in 2008 (Kenya 2007). It aims to transform Kenya into a "newly industrializing, middle-income country providing a high quality life to its citizens by the year 2030". Its overarching objective is to make Kenya a "globally competitive and prosperous nation with a high quality of life by 2030". The Vision is based on three "pillars": the economic, the social and the political. The economic pillar aims to improve the country's prosperity through an ambitious economic development programme that would achieve an inclusive average GDP growth rate of at least 10% per annum over a period of 25 years. The social pillar seeks to build "a just and cohesive society with social equity in a clean and secure environment". The political pillar aims to realize "a democratic political system founded on issue-based politics that respects the rule of law, and protects the rights and freedoms of every individual in Kenyan society". These three pillars are anchored on macroeconomic stability; continuity in governance reforms; enhanced equity and wealth creation opportunities for the poor; and investment in infrastructure; energy; science, technology and innovation; land reforms; human resources development; security; and public sector reforms.

The Vision identifies financial services as one of six sectors that are the key drivers of the economy. The others are tourism; agriculture and livestock; wholesale and retail trade; manufacturing; and business process outsourcing as well as other IT enabled services. Subsequently, oil and mineral resources sector was added in the second MTP after the discovery of commercially viable oil deposits and of rare minerals in the country in 2012. The Vision aims to create "a vibrant and globally competitive financial sector that will create jobs and also promote high levels of savings to finance Kenya's overall investment needs". It envisages a dynamic financial sector comprised of banks, the capital market, insurance, pensions, development finance and financial co-operatives (SACCOs). The Vision therefore aims to revamp Kenya's fairly diversified financial sector which currently includes the following institutions:

- The capital market, with the stock market the 5th largest by market capitalization in Africa after South Africa, Egypt, Nigeria and Morocco.

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- 38 insurance companies.
 - 5 Development Finance Institutions (DFIs) that provide medium and long-term finance.
 - 1 mortgage company.
 - 7 representative offices of foreign banks.
 - 101 foreign exchange bureaus, first licensed in January 1995.
 - A Post Office Savings Bank, supported by 890 post offices spread throughout the country.
 - About 2700 Savings and Credit Co-operative Organizations (SACCOs) in both rural and urban areas.
 - 2 credit reference bureau.
 - 9 deposit-taking microfinance institutions, and so on.

The envisaged policy actions and targets of the financial sector under Vision 2030 include:

- Raise savings rates from 17% to 30% of GDP. This would be achieved, for example, by increasing bank deposits from 44% to 80% of GDP and by lowering borrowing costs. With an average loans deposits ratio of 76% (over 1978-2012), this implies an increase in the bank loans from 33% to 61% of GDP. These targets indicate what the Vision envisages as the desirable scale of banking sector to achieve middle income status.
- Enhance financial inclusion by decreasing the share of population without access to finance by about 20%.
- Increase stock market capitalisation from 50% to 90% of GDP.
- Source foreign savings for investment by up to 10% of GDP from foreign direct investments (FDI), overseas development assistance (ODA) and sovereign bonds.
- Undertake reforms of the banking sector to facilitate the transformation of the large number of small banks in Kenya to few larger and stronger ones.
- Introduce credit reference bureau.
- Streamline informal finance, SACCOs and microfinance institutions.
- Deepen financial markets by raising institutional capital through pension fund reforms and expanding bond and equity markets.
- Introduce legal and institutional reforms that would enhance transparency in all transactions, build trust and make enforcement of justice more efficient.
- Create a critical mass of skills in financial management.

The Kenya Vision 2030 was to be implemented in successive five-year Medium-Term Plans, with the first MTP covering the period 2008 – 2012 (recently completed), and the current second MTP covering the period 2013-2017 (Kenya 2013).

The flagship projects and policies that were to be implemented during the First MTP (2008-2012) included (i) transformation of the banking sector to bring in fewer stronger, larger scale banks; (ii) development and execution of a comprehensive model for pension reform; (iii) pursuance of a comprehensive remittances strategy; (iv) formulation of a policy for the issuing of benchmark sovereign bonds; and (v) implementation of legal and institutional reforms required for a regional financial centre.

According to the Second MTP (2013-2017), some of these projects and policies have not been implemented at all or have been implemented only partially. The MTP attributes this to a number of factors which include (i) the post-election violence of 2007/2008; (ii) adverse weather impacting the agricultural sector and the economy; and (iii) the GFC of 2007/08 and the subsequent worldwide economic slowdown.

As a result:

- Gross national savings as percent of GDP actually decreased from 15.4% in 2007/08 to 10.4% in 2011/12, well below the First MTP set target of 24.4%.
- Total investments as a percentage of GDP rose marginally to 21.9% in 2012/2013 compared to 20.1% in 2010/2011 against a set target of 30-32%.
- Credit extended to the private sector amounted to 36.8% of GDP in 2012 compared to 28.3% in 2007.

Nevertheless, the Second MTP identifies some of the following key achievements under the First MTP:

- Increased efficiency of financial services that directly supports improved credit access by reducing transaction costs. A number of interventions, including in the payments system, capital markets infrastructure and credit referencing contributed to efficiency gains during the period.
- Introduction of credit reference bureau. The Banking (Credit Reference Bureau) Regulations, 2008, were first rolled out in July 2010 and by December 2013, the two licensed credit referenced bureaus (Credit Reference Bureau Africa Limited and Metropol Credit Reference Bureau Limited) had received a total of 3.5 million credit requests from banks, more than 53,000 requests from individual customers and 12,851 customer inquiries prompted by adverse actions by institutions. Revised regulations allowing for sharing of positive and negative credit information by banks and deposit-taking microfinance institutions were gazetted in January 2014².
- Implementation of policies to enhance the stability of the financial system. Attention has been focused on the deposit-taking institutions, which account for the largest proportion of the assets in the system. Oversight of insurance, pension and other investment funds had also been strengthened with all the regulators adopting a risk-based approach to the supervision of institutions/entities under their regulation³.

² According to the CBK, Credit Reference Bureaus (CRBs) complement the central role played by banks and other financial institutions in extending financial services within an economy. CRBs help lenders make faster and more accurate credit decisions. They collect, manage and disseminate customer information to lenders within a provided regulatory framework. Credit histories not only provide necessary input for credit underwriting, but also allow borrowers to take their credit history from one financial institution to another, thereby making lending markets more competitive and, in the end, more affordable. CRBs assist in making credit accessible to more people, and enabling lenders and businesses reduce risk and fraud. Sharing of information between financial institutions in respect of customer credit behaviour, therefore, has a positive economic impact.

³ Other achievements were (i) progress towards the formation of the Nairobi International Financial Centre (NIFC); and (ii) the enactment of the Anti-Money Laundering and Combating Financing of Terrorism Act (AML/CFT Act) in 2009.

2.2 Financial Sector and economic performance

A lot of work has been done on the relationship between the size of the financial sector and economic performance. Many studies find a close linkage between financial deepening, productivity and economic growth. It is for example estimated that policies that would raise the M2/GDP ratio by 10% would increase the long-term per capita growth rate by 0.2–0.4% points (Easterly and Levine 1997, Ndulu and O’Connell 2008). According to Levine (1997), there are five functions of the financial system through which it enhances economic growth: reducing risk; allocating resources; monitoring managers and exerting corporate controls; mobilizing savings; and facilitating exchange of goods and services. The impact of these factors on growth depends, among others, on the level of financial intermediation; the efficiency of financial intermediation; and the composition of financial intermediation. In the simple AK model, the financial sector promotes the growth of the economy by raising the saving rate; the marginal productivity of capital, and the proportion of savings that is channeled to investment. However, while low income countries need to increase the size of their financial sectors, there are limits to this (Spratt 2013). Beyond a certain level, estimated at around 80–100% of private credit to GDP, financial sector development becomes negative for economic growth, both through heightened financial instability and the misallocation of financial resources. The same applies to a too rapid growth of private sector credit which might lead to output volatility and adverse growth effects (Griffith-Jones with Ewa Karwowski 2013).

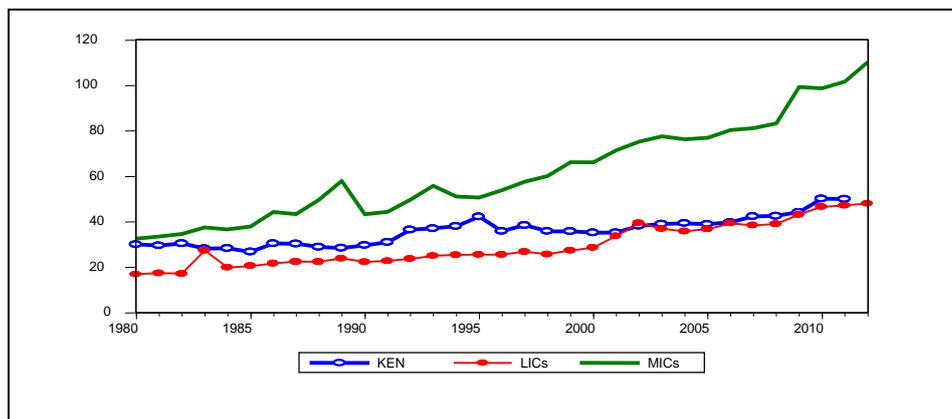
Kenya has a well developed financial system for a country of its income level (Beck and Fuchs 2004). Kenya’s level of financial development is not too far off from the predicted level in a global cross-country model (Allen et al. 2012). Christensen (2010) classifies Kenya as a frontier market economy whose financial market is advanced, but not to the same extent as emerging markets e.g. S. Africa, given that its M3/GDP ratio was about 34% compared to an average of 63% for emerging market economies in 2008–10 although these indicators have improved over time. It is therefore unlikely the size of the Kenya’s financial sector is beyond the threshold to negatively impact on economic growth. Griffith-Jones and Karwowski (2013) also show that credit expansion in Kenya has been relatively modest in the last decade (at 19.5% over 2000–10) compared to other selected SSA countries (for example Angola 1545.5%, Malawi 215.6%, Mali 286.7%, Niger 174.4%, Nigeria 173.0%, Sao Tome and Principe 709.8%, Sierra Leone 384.2%, Sudan 505.6%, Tanzania 274.4 and Uganda 152.8%).

Two measures of the depth and coverage of financial systems is the M2/GDP and private credit/ GDP ratios. As seen in Figure 1, while the M2/GDP ratio in Kenya closely tracks that of low-income countries (LICs), it is far below that of middle-income countries (MICs), with a clear divergence over time. Between 1980 and 2011, their respective ratios increased from 29.9% to 49.9% for Kenya, 16.8% to 47.2% for LICs and 32.2% to 101.6% for MICs. Figure 2 also shows a similar pattern with respect to credit to the private sector GDP ratio, with the Kenya ratio tending to decline from the early 1990s. Between 1980 and 2011, their respective ratios increased from 29.5% to 37.4% for Kenya, 10.5% to 29.9% for LICs and 31.3% to 76.1% for MICs.

With the country aspiring to MIC status by 2030, it apparently has a long way to go in building its financial sector. In its monetary programming, the CBK endeavours to keep the path of private sector credit growth rate close to the projected nominal GDP path. As seen in Figure 3, domestic credit to the private sector (DCP) closely tracked the nominal GDP over 2005–2009, with acceleration in 2010–2011, which was broadly reversed in 2012, with another acceleration in the second half of 2013.

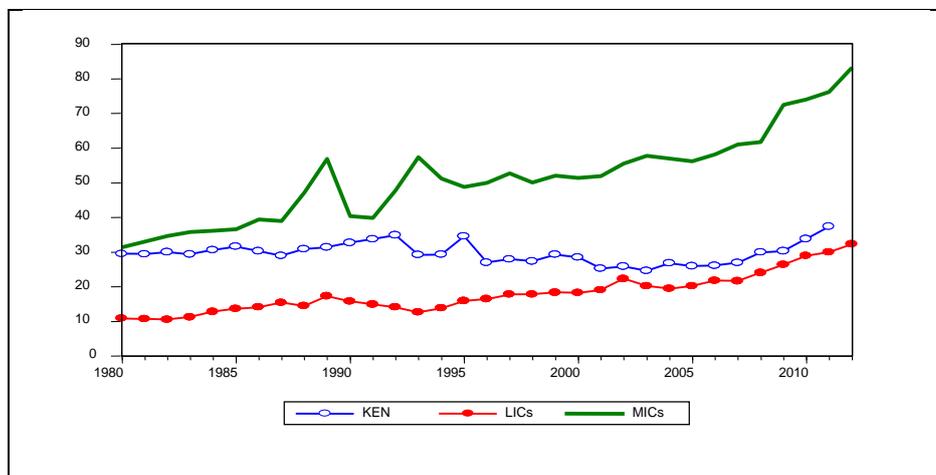
Private sector credit growth picked-up during the first half of 2013 in response to the gradual easing of the monetary policy stance, pick-up in economic activity and, improved investor confidence in the economy after the March 2013 elections. The CBK reduced the Central Bank Rate (CBR) from 9.50% to 8.50% in May 2013 and retained it at this level in the rest of 2013. Consequently, the annual growth in the overall private sector credit rose from 12.69% in June 2013 to 21% in December 2013, above the projected growth path of 16.2% in the year to December 2013.

Figure 1: M2 as % of GDP in Kenya versus LICs and MICs



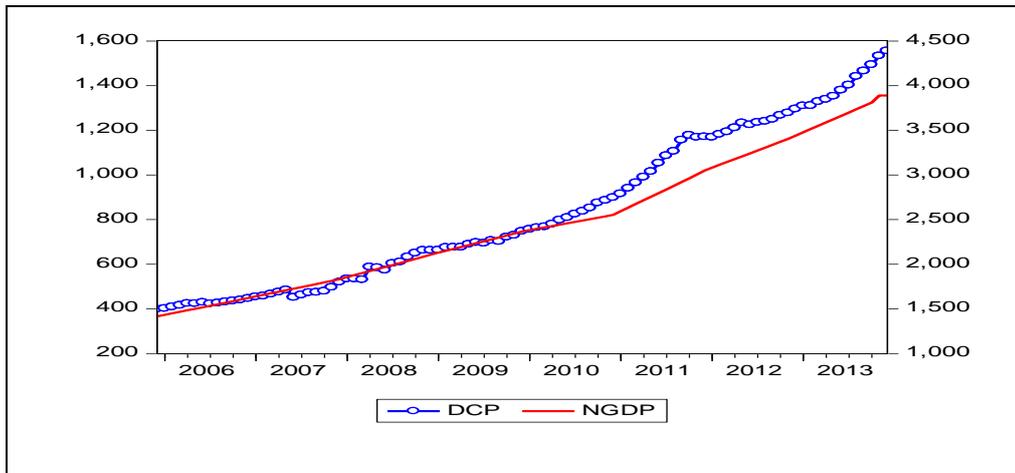
Source: World Bank, World Development Indicators

Figure 2: Domestic credit to the private sector as % of GDP in Kenya versus LICs and MICs



Source: World Bank, World Development Indicators

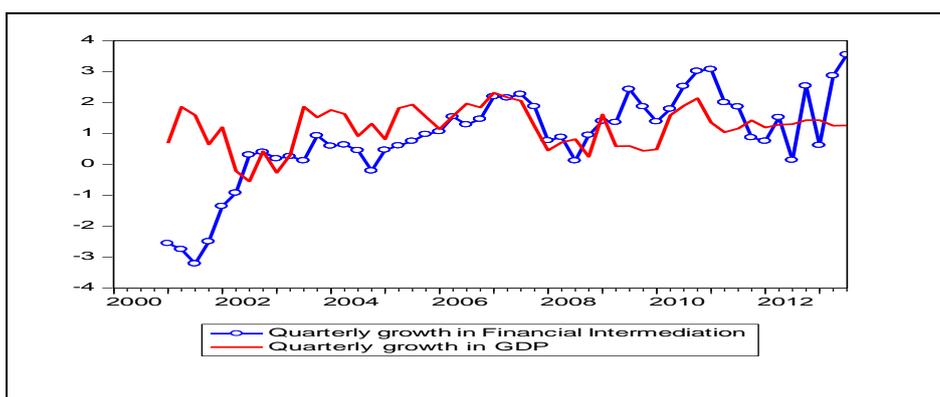
Figure 3: Domestic credit to the private sector (DCP) and nominal GDP in Kenya, 2005:12 – 2013:12



Source: Central Bank of Kenya

The Kenya National Bureau of Statistics (KNBS) provides quarterly GDP and growth data since 2000. Figure 4 shows four-period moving average growth rates in financial intermediation and GDP in Kenya over 2001Q1-2013Q3. There is clearly some correlation (0.24) between the two series during the study period, with the moving average quarterly GDP growth rate generally less volatile than growth in financial intermediation (standard deviation of 0.660 versus 1.465, respectively). Granger causality tests show significant causality from financial intermediation to growth at 3 and 4 lags at the 5% level, with the other lags non-significant (Table 1), supporting Kenya Vision 2030 designation of the financial sector as one of the drivers of growth in Kenya, at least in the short-run⁴. On an annual basis, the financial sector growth has consistently outpaced the real GDP growth since 2009.

Figure 4: Quarterly Growth in Financial Intermediation and GDP in Kenya, 2001Q1-2013Q3



Source: Kenya National Bureau of Statistics (www.knbs.go.ke)

⁴ In contrast, the KNBS reports growth data on a quarter-on-quarter basis to remove the seasonal effects. By ignoring the intermediate values, none of the Granger causality tests are significant, although there is more correlation in the two series (0.28).

Table 1: Ganger-causality between quarterly growth in financial intermediation (QGFI) and growth in GDP (QGGDP)

	3 lags		4 lags	
	F-Statistic	Prob.	F-Statistic	Prob.
QGGDP does not Granger Cause QGFI	0.867	0.466	1.426	0.244
QGFI does not Granger Cause QGGDP	2.809	0.050	2.751	0.042

In Kenya, the Second MTP identifies the following emerging issues and challenges: (i) inadequate access to finance for SMEs; (ii) high bank lending rates and wide interest rate spreads; (iii) high level of exclusion from financial services; and (iv) low insurance penetration and pension coverage. We address the first three challenges later in the paper.

3 The roles of foreign banks, state-owned banks and DFIs in Kenya

3.1 Foreign and state-owned commercial banks

According to the framework papers for the project (Spratt 2013, Griffith-Jones with Ewa Karwowski 2013), opinion on the merits of foreign banks and state-owned banks has shifted considerably since the 2007-8 GFC. Foreign banks can have both positive and negative effects. While they can bring valuable skills, technology and capital, they can also bring risks. Evidence from the recent financial crisis shows that countries where foreign banks dominate the market could suffer negative lending shocks, as turmoil in the home markets cause parent banks to withdraw capital from the developing countries where they operate. They can have negative impacts, particularly by bypassing the supply of credit to the less lucrative sections of the country. Critics of foreign bank participation therefore argue that foreign banks may have an overall negative effect on financial deepening and inclusion (Beck 2013). Distance constraints and informational disadvantages may prevent foreign banks from lending to SMEs. The competitive advantage of foreign banks can result in domestic banks being crowded out of the market and foreign banks focusing on the top-end of the market, thus leaving SMEs and poorer households without access to financial services. Specifically, the greater reliance of foreign banks on hard information about borrowers as opposed to soft information can have negative repercussions for riskier borrowers if foreign banks crowd-out domestic banks. The existing empirical literature has not provided unambiguous findings on the repercussions of foreign banks for financial development and inclusion and neither has the African experience (Beck 2013).

Similarly, there has been a change in the negative perception of state-owned commercial banks, with some studies finding that these banks performed a valuable counter-cyclical role in some countries; while others find them to be associated with higher rates of economic growth (Spratt 2013). The challenge therefore is to design and regulate them so that they can successfully fulfill their development mandate, while avoiding the well-documented failures of the past.

Kenya currently (in December 2013) has 43 banks, with 1,313 branches and 34,064 employees, accounting for about two thirds of the financial system's assets. In terms of shareholding, the Central Bank identifies 14 banks with foreign ownership, accounting for 32.2% of net assets in 2012. The Central Bank also identifies 6 banks with state ownership accounting for 24.8.2% of net assets in 2012, with the government having majority ownership in three of these, which account for 4.2% of net total assets (Consolidated Bank; Development Bank of Kenya; and the National Bank of Kenya)⁵. The remaining 23 are local private

⁵ The other three banks are CFC Stanbic, Housing Finance; and Kenya Commercial Bank.

banks, accounting for 43.0% of the banking sector's net assets. Hence Kenya's banking system is dominated by local private banks and foreign banks.

We therefore study the relative performance of the 14 foreign banks and the 6 banks with state ownership *versus* the local private banks in the country. Specifically, this section addresses the following research issues:

- How well have foreign banks and banks with state ownership performed, for example, in terms of financial indicators, such as ROAs, NPLs, etc, but also in terms of economic indicators, such as providing access to credit to SMEs, as well as other parts of the private sector?
- What are the key challenges of regulating Kenya banks in other countries? Foreign banks in Kenya are treated symmetrically with the other banks in the country.

Oloo (2013) proposes a number of indicators to identify the different strengths and weaknesses of Kenyan banks and provides data on individual banks, which we aggregate into the various ownership components, weighted by the value of assets in 2012. These include the rates of return on assets and capital; cost of funds, efficiency ratio and the ratio of non-performing loans (see Table 2).

Table 2: The performance of commercial banks in Kenya by ownership

	Foreign banks	Banks with state-ownership	Banks with majority state ownership	Local private banks	All banks
	Return on assets, % ⁶				
2009	3.6	2.8	3.7	3.8	3.6
2010	4.7	3.7	4.2	4.8	4.6
2011	4.7	4.1	3.1	4.8	4.7
2012	5.2	4.1	1.4	4.8	4.9
	Return on capital, % ⁷				
2009	36.7	30.0	27.2	30.3	32.3
2010	46.1	23.4	30.8	46.6	40.7
2011	50.6	44.9	27.6	50.4	49.1
2012	51.9	38.0	12.7	50.9	48.0
	Average cost of funds, % ⁸				
2009	3.0	2.7	3.5	4.0	3.4
2010	2.2	2.1	2.9	3.4	2.7
2011	2.5	2.3	3.8	3.8	3.0
2012	4.9	5.3	7.6	7.0	6.0

⁶ Return on assets (ROA) is the ratio of profits before tax to average total assets (at beginning and end of the year). A higher ratio is desirable.

⁷ Return on capital (ROC) is measured as the return to the average core capital (at the beginning and end of the year). A higher ratio is desirable.

⁸ The ability of a bank to acquire external funding cheaply to boost its investments is a critical measure. There are two main sources of funds for the bank: (a) deposits from customers; and (b) borrowed funds. This ratio therefore is a measure of how cheaply, or expensively these funds have been acquired: it reflects the ease with which a bank is able to secure such funds. A lower rate is desirable.

	Efficiency ratio, % ⁹				
2009	53.1	66.4	64.4	58.8	60.0
2010	47.1	61.4	58.0	51.6	53.6
2011	45.8	56.8	63.1	51.6	52.0
2012	50.7	57.0	74.8	52.0	53.9
	Non-performing loans to advances ratio, % ¹⁰				
2009	4.5	9.7	10.1	6.4	6.7
2010	3.6	6.4	6.6	5.1	5.0
2011	2.7	4.4	6.5	3.7	3.6
2012	2.4	5.2	8.8	3.6	3.7

The foreign banks have done as well as local private banks with both having an average rate of return on assets of 4.6% over 2009-2012, ahead of banks with state ownership (3.7%) and state-owned banks (3.1%). The poor performance of the latter is attributed to poor legacy in the past of poor governance and massive interference by the state in their management.

The same pattern is repeated in the other indicators. Foreign banks have on average done slightly better on the rate of return on core capital (46.3%) over 2009-2012 when compared to local private banks (44.6%), ahead of banks with state ownership (34.1% and 24.6%, respectively). They also have the lowest cost of funds (index of 3.2%) together with banks with state ownership (index of 3.1% and 4.5%, respectively) and local private banks (index 4.6%). Foreign banks are also the most efficient (with an average score of 49.1%) slightly ahead of local private banks (score of 53.5%), with banks with state ownership the least efficient (scores of 60.4% and 65.1%, respectively). Finally, foreign banks have the least non-performing loans ratio (average 3.3% over 2009-2012), followed by local private banks (4.7%) and banks with state ownership (6.4% and 8.0%, respectively).

It is therefore apparent that foreign banks largely behave like local private banks, except that they have cheaper sources of finance due to their reputation capital. They are also very diverse so that it is difficult to generalize their behavior. They include for example (i) the traditional multinational banks from Europe and USA (Barclays, Citibank, Habib A.Z. Zurich and Standard)¹¹; (ii) banks from Asia and the Middle East (Bank of Baroda, Bank of India, Gulf African Bank, Habib Bank and Diamond Trust Bank, the last two from Pakistan and owned by the Aga Khan Fund for Economic Development); (iii) pan-African banks (Bank of Africa, United Bank of Africa; and Ecobank); and (iv) Islamic banks (First Community Bank licensed in 2007 with some shareholding from Tanzania and Gulf African Bank licensed in 2008). K-Rep Bank was incorporated as a commercial bank in 1999, from microfinance NGO and has largely maintained the microfinance banking model.

According to World Bank (2013), most foreign banks have dedicated units serving SMEs. There are however a few exceptions such as Citibank and, to a less extent, Standard that focus on corporate and high-end clients, and hence do not lend to SMEs. Oloo (2013) simulates the cost of provision of banking services to SMEs from customers' perspective. In the first scenario, he considers a small business

⁹ The efficiency ratio is measured by taking the total operating expenses, which include the bank's overheads and weighting them against the total operating income. A lower ratio is desirable.

¹⁰ Non-performing loans is the single most important threat that a bank can face. To assess its magnitude, it is weighted against the total portfolio of all loans and advances that the bank has extended. A high ratio is a reflection of imprudent lending practice and poor credit management. A low ratio is therefore desirable.

¹¹ Barclays and Standard have been in the country for more than 90 years.

firm, with a turnover of about US\$ 60,000 (at the exchange rate on Ksh 84.5 per US dollar in 2012). He assumes the annual cost of opening and maintaining a business current account to require 6 50-leaf cheque books, 48 customer withdraws, 48 bankers cheques, 24 standing orders, charges for 600 transactions and 12 ledger fees. In the second scenario, he considers a medium-sized business enterprise with a turnover of about US \$ 6 million per year. He assumes the annual cost of opening and maintaining a business current account requires 12 50-leaf cheque books, 96 customers withdraws, 96 bankers cheques, 96 standing orders, charges for 6,000 transactions and 12 ledger fees.

He derives the following total costs of operating the accounts by type of bank ownership. The results show that local private banks have the lowest costs to SMEs, followed by foreign banks and then banks with state ownership.

Table 3: Simulated cost of banking services to SMES

	Small firm, US\$	Medium-sized firm, US\$
Foreign banks	795.5	1751.0
Banks with state ownership	825.3	1902.0
Banks with majority state ownership	800.6	1835.5
Local private banks	733.0	1667.7

3.2 Challenges of Regulating Kenya banks in other countries

In Kenya, some banks have expanded their branch networks in the region. By December 2012, Kenyan banks had established 282 branches in neighbouring countries (Uganda 125, Tanzania 70, Rwanda 51, Burundi 5, and South Sudan 31). Such banks pose an increasing challenge for regulators across Africa (Beck 2013). Financial integration implies that the negative externality costs of bank failure go beyond national borders that are not taken into account by national regulators and supervisors. Close cooperation that can help internalize these cross-border externalities, although the institutional extent of such cooperation should be a function of the strength of externalities but also the heterogeneity of countries' legal and regulatory frameworks.

Central banks in Eastern African countries have, for example, signed a Memorandum of Understanding (MOU) to facilitate information sharing and supervisory co-operation for regional banking groups. The CBK has developed and implemented a consolidated supervision program for the effective oversight of banking groups. As part of efforts aimed at implementing consolidated supervision, it launched Prudential Guidelines on Consolidated Supervision and convened two Supervisory College meetings in 2012 and 2013 bringing together all Central Banks of the East African countries where Kenyan banks currently have operations. The introduction of guidelines on Country and Transfer Risk, Risk-based Supervision and Consolidated Supervision is timely given the increasing cross border risks faced by the Kenyan banks as they expand regionally¹². The East African Central Banks are also currently working to harmonise their banking sector supervisory rules and practices as a prerequisite for the envisaged East African Monetary Union (EAMU). The recently established Committee of African Bank

¹² Interview with CBK Governor in Oloo (2013).

Supervisors as part of the African Association of Central Banks can give this cooperation further impetus, by enabling informal exchange of information and experiences and networking possibilities (Beck 2013).

Two issues appear critical in this increasing regulatory cooperation (Beck 2013). First, based on the experience of European countries, there should be a focus on proper preparation for resolution. Non-binding MOUs and Colleges of Supervisors limited to information exchange are of limited use in times of bank failure. Second, it is important not to ignore development benefits of foreign banks when considering them as potential source of fragility. Financial stability is not an objective in itself, but rather a necessary condition for sustainable financial deepening, with the main goals of economic development and poverty alleviation.

3.3 3.4: Development Finance Institutions¹³

It has long known that commercial banks will under-supply long-term finance, and under-serve key sectors, such as agriculture or small and medium enterprises (SMEs), and that these ‘market failures’ are more acute in LICs (Spratt 2013). Although DFIs are an obvious solution, they were widely seen as inefficient, ineffective and corrupt so that the ‘cure’ was thought worse than the ‘disease’. This perception has shifted significantly since the recent financial crisis, where some countries with significant DFIs saw them fill the gap left by the commercial banks. The success of DFIs in countries as diverse as Brazil, South Africa and Germany has shown it is possible to avoid many pitfalls.

Is there a need for a greater role for DFIs in Kenya, to cover gaps in financing in key sectors, essential for inclusive growth, as in Asia (Hosono 2013)? What are experiences of DFIs in Kenya? How can good DFIs be expanded /created, taking into account issues of incentives and governance?

There is no doubt that DFIs in Kenya could play a significant role in the financial sector by providing long-term finance (CBK 2013). Targeted interventions for specific sectors or groups like SMEs, youth, women, and so on would best be served by DFIs. This is recognized under Vision 2030, where DFIs are expected to contribute towards enhanced financial access and investment goals. For DFIs to play this role and fulfill market expectations, they require enhanced capacity with clear ground rules and enhanced finance allocation. In Kenya, DFIs are under the purview of the National Treasury. But the sector remains small. The five existing DFIs account for less than 1% of the assets of the banking sector and had lent only Ksh.6.8 billion (approximately USD80.73 million) as of June 2012 when compared to Ksh 1,224.11 billion (approximately USD 14.53 billion) of credit to the private sector from the county’s banking sector (CBK 2013). Hence these DFIs supplied only about 0.56% of the banking sector credit to the private sector.

According to CBK (2013), some Kenyan DFIs converted to commercial banks in the 1990s (e.g. DFCK to DBK Ltd) in order to mobilize deposits. But the journey was not smooth due to their inability to comply with the prudential. As a result, they experienced high non-performing loans and high concentration risk due to dependence on a few borrowers. The DFIs-turned-banks non-compliance with the prudential requirements could have mainly been driven by the conflict of their primary mandate of long term lending and the banking regulatory framework which is applicable to all banks irrespective of their circumstances. They were therefore unsuccessful in mobilizing long term local deposits to match their assets profile.

¹³ The five existing DFIs service industry and commerce (IDB Capital, Kenya Industrial Estates and Industrial and Commercial Development Corporation); agriculture (Agricultural Finance Corporation); and tourism (Kenya Tourist Development Corporation).

The failure of DFIs to customize their policies and practices towards commercial bank orientation was compounded by weak corporate governance structures arising from operating for a long period without prudential guidelines.

According to a Presidential Task Force on Parastatals Reform (2013), the role of DFIs has atrophied since the mid-1980s which the Task Force attributes to DFIs inability to respond successfully to the change to a liberal policy regime in the 1980s and 1990s; narrow credit focus and limited sources of financing from donors and government; as well as poor governance in part due to state interference, coupled with ineffective management and low staff morale. The Task Force therefore advocates consolidating DFIs under a Kenya Development Bank (KDB) with sufficient scale, scope and resources to place a catalytic role in Kenya's economic development by providing long-term finance and other financial and advisory, investment and advisory services. CBK (2013) as well calls for introduction of prudential regulation and supervision consistent with their mandate (for example the AADFI standards of the Association of African DFIs) as done in several countries including Tanzania, Nigeria, China, Swaziland and Korea which already regulate and supervise DFIs. As a result, Kenya would only customize the regulatory and supervisory frameworks to local circumstances. An effective regulatory and supervisory framework should adequately address the potential risks faced by DFIs by tailoring them to suit their unique features, especially the tradeoff between the focus on economic development orientation and long term structure of assets. Regulation and supervision must also continuously evolve to keep pace with innovations.

4 Financial inclusion in Kenya

4.1 Trends and patterns of financial inclusion

The envisaged targets of the financial sector under Vision 2030 included enhancing financial inclusion by decreasing the share of population without access to financial services by about 20%. Financial inclusion in Kenya has been monitored through financial access surveys of which three so far have been conducted: in 2006, 2009 and 2013. These surveys reveal that Kenya's financial inclusion landscape has undergone considerable change. The proportion of the adult population using different forms of formal financial services has increased from 27.4% in 2006, to 41.3% in 2009 and stood at 66.7% in 2013, amongst the highest in Africa (Table 4)¹⁴. In addition, the proportion of those accessing informal financial services has declined substantially from 33.3% in 2006 to 27.2% in 2009 and to only 7.8% in 2013¹⁵. Overall, the proportion of the adult population totally excluded from financial services has declined from 39.3% in 2006 to 31.4% in 2009 and to 25.4% in 2013. With a decline of 35% between 2006 and 2013, this has substantially exceeded Vision 2030's expectations.

Table 4: Financial inclusion and exclusion in Kenya, %

	2006	2009	2013
Formal	27.4	41.3	66.7
Informal	33.3	27.2	7.8
Excluded	39.3	31.4	25.4

Source: *Financial Sector Deepening Kenya (2013)*

The last half decade has therefore seen a massive increase in access to financial services in the country. Deposit accounts have, for example, increased from about 2 million to 18 million while loan accounts have increased from 1 to 3 million since 2007¹⁶. This is reflected in Table 5 which shows a substantial increase in the use of bank services, from 13.5% in 2006, to 17.1% in 2009 and to 29.2% in 2013. However, the most dramatic increase is usage of mobile money services from virtually 0% in 2006 to 28.4% in 2009 to 61.6% in 2013. The rapid growth of

¹⁴ Formal financial institutions are defined broadly to include commercial banks, deposit-taking microfinance institutions (DTMs), foreign exchange bureau, capital markets, insurance providers, deposit-taking SACCOs (DTSS), mobile phone financial service providers (MFSP), Postbank, NSSF, NHIF, credit-only MFIs, credit-only SACCOs, hire purchase companies and the government.

¹⁵ The informal financial sector includes informal groups, shopkeepers and merchants, employers, and money lenders who are all unregulated under structured law provisions.

¹⁶ Interview with the Governor, Central Bank of Kenya. *EastAfrican*, August 24-30, 2013.

mobile money banking services shows its ability to overcome problems of physical access and high relative costs (Spratt 2013). Mobile banking has introduced alternative channels at financial service provision to conventional banking and has provided clear, quick and convenient platforms to conduct a range of financial transactions. The adoption of mobile money service M-PESA in 2007 far exceeded expectations. Currently, the four mobile money services (M-PESA, Airtel Money, YuCash and Orange Money) have close to 20 million customers, handling over US\$ 54.4 million worth of transactions per day. M-PESA however remains dominant with 82% of market share, Airtel Money 15%, YuCash 2% and Orange Money 1%.

Table 5: Overall Use of financial services, %

Usage of:	2006	2009	2013
Banks	13.5	17.1	29.2
SACCOs	13.5	9.3	9.1
Microfinance institutions	1.8	3.5	3.5
Informal groups	39.1	29.5	27.7
Mobile money financial services	0.0	28.4	61.6

Source: *ibid.*

Financial inclusion has varied with the socio-economic statuses of the population. According to FSDK (2013), financial exclusion in 2013 varied from 55.3% for the poorest 20% of the population to 5.7% for the wealthiest 20% of the population. As well, financial exclusion was highest for those without any education (60.7%) and lowest for those with tertiary education (1.8%). Table 6 shows that women use of formal financial services has lagged behind that of men, but the gap substantially reduced between 2009 and 2013, while exclusive use of informal financial services have declined for both men and women. Similarly, Table 7 show that rural areas have lagged behind urban areas in access to financial services

Table 6: Financial inclusion in Kenya by gender

	2006		2009		2013	
	Male	Female	Male	Female	Male	Female
Formal financial institutions	34.3	21.0	49.3	34.4	71.1	62.7
Informal	27.0	39.2	19.8	33.9	4.7	10.8
Excluded	38.7	39.8	31.0	31.8	24.2	26.6

Source: *ibid.*

Table 7: Financial inclusion in Kenya by location

	2006		2009		2013	
	Rural	Urban	Rural	Urban	Rural	Urban
Formal financial institutions	24.6	35.7	35.5	63.1	59.6	80
Informal	37.0	22.2	30.0	16.8	9.8	4.4
Excluded	38.4	42.0	34.5	20.1	30.6	15.6

Source: *ibid.*

On use of financial services by business owners, 36.8% used banks; 4.2% SACCOs, 7.8% microfinance institutions, 33.5% informal groups and 72.6% mobile money financial services, exhibiting the same pattern as for the wider population.

4.2 Is regulation of M-PESA and other mobile money platforms adequate?

The success of M-PESA in Kenya is often used to argue for a light-touch approach, where mobile banking was allowed to flourish (Spratt 2013). Possible systemic and individual users' risks seem to require careful evaluation, however. It is clearly important to enable, rather than stifle, innovation but it is also clear that regulation should be comprehensive in the longer term. How to strike the right balance here is an important area of research.

In responding to this question, the CBK admits that the technology used to deliver the mobile money services carries inherent threats, the main ones being operational risk, financial fraud and money laundering¹⁷. However, prior to the launch of mobile banking services by the various companies, the CBK requires them to provide a detailed risk assessment, outlining all potential risks and satisfactory mitigating measures they have put in place. In the case of M-PESA, Safaricom sought authorization from CBK to undertake the money transfer business. In evaluating the proposal, the CBK considered the request on the basis of safety, reliability and efficiency of the service. In addition, precautionary measures were put in place to ensure that the service did not infringe upon the banking services regulatory framework as provided for in the Banking Act. Following the enactment of the National Payments System Act in 2011, the CBK now has the oversight mandate of the National Payments System. All payment service providers including mobile phone service providers offering money transfer services fall under the CBK's regulatory framework¹⁸.

The Kenya Bankers Association (KBA) has however complained that the Mobile Network Operators (MNOs) offer services similar to those offered by banks, yet

¹⁷ Interview with the CBK Governor in Oloo (2013). This section draws on this interview.

¹⁸ According to the December 2013 Monetary Policy Statement, "The CBK will continue to support development of new products and innovations towards enhancing financial access in order to encourage economic growth. In this regard it will continue to propose suitable legislation aimed at ensuring that such innovations are regulated accordingly to enhance market confidence. The Bank will also continue to monitor any new financial derivatives and /or innovations in the market that could have adverse effects on market stability".

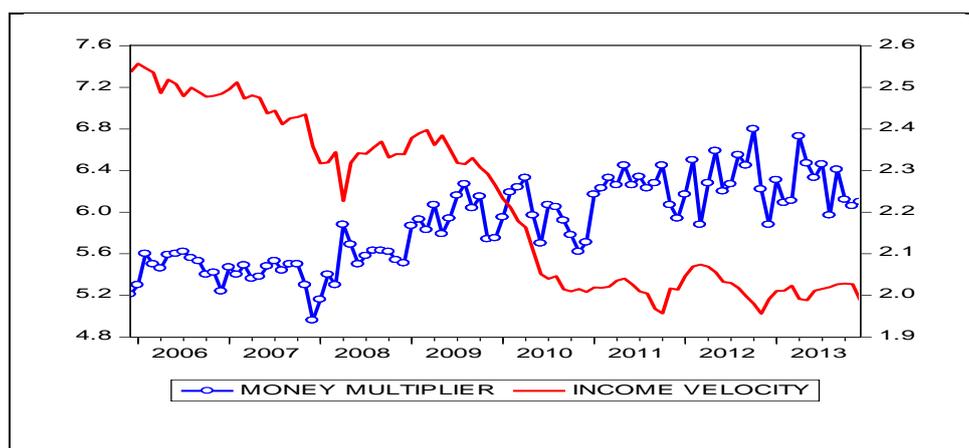
they are not subject to similar regulations¹⁹. KBA argues that there is a blurred line between what constitutes taking deposits from customers as done by MNOs and taking deposits for savings as done by banks. The e-float for example which is kept in special accounts in banks by MNOs is not subject to banking regulations such as subjecting them to deposit insurance, undermining the security of such deposits in case of a bank failure or financial crisis. The response by MNOs is that the possibility of such risks making a huge impact on clients is very rare as the e-float is relatively small, and it is distributed across several banks.

4.3 Financial inclusion (innovations) and macroeconomic stability in Kenya

Increased financial inclusion through financial innovations does not seem to have compromised financial stability. First, the stock of e-money is backed 100% by accounts held at commercial banks. The mobile money e-float is also a small proportion of the other monetary aggregates in terms of size for it to matter much for monetary policy. Weil et al. (2011) estimate the outstanding stock of M-PESA e-float at 1.6% of M0 and 0.4% of M1.

Second, while there has been increased instability in monetary relationships post-2007, reflected in a decline in the income velocity of circulation and an increase in the money multiplier undermining the conduct of monetary policy which assumes stable monetary relationships, stability seems to have been re-established since 2010. The instability was therefore a temporary phenomenon. Velocity which is the ratio of nominal GDP to money supply (M3X) declined significantly from a monthly average of 2.50 in 2006 to 2.09 in 2010 and stabilized at that level thereafter. Similarly, the money multiplier increased from a monthly average of 5.49 in 2006 to 5.96 in 2010 and stabilized at that level. The demand for money also shows stability post-2010 (Weil et al. 2011).

Figure 5: The money multiplier and income velocity in Kenya, December 2005 to December 2013



Source: Central Bank of Kenya

¹⁹ See the *Daily Nation*, January 26, 2014, 'Banks revive battle with money service providers'

5 Access and cost of credit in Kenya

5.1 Introduction

This section looks at access to finance, where the key problem is how to provide financial access that is both affordable and suited to the needs of poor people (Spratt 2013). On this, the costs of providing basic banking services are often prohibitive, and credit is either unavailable or too expensive. The reasons are well understood: providing physical access in rural areas is inherently expensive, and providing financial services for people with few financial resources entails high relative costs; a lack of credit history and collateral is a key constraint on extending credit, and small loan sizes also mean high transaction costs. Extending financial access thus tends to be unattractive for banks in LICs. Although microfinance institutions (MFIs) have partially filled this gap, their record is mixed.

Kenya's financial sector has undergone reforms since the late 1980s aimed at achieving (i) stability so as to ensure that banks and other financial institutions taking deposits can safely handle the public's savings and ensure that the chances of a financial crisis are kept to a minimum; (ii) efficiency in the delivery of credit and other financial services to ensure that the costs of services become increasingly affordable and that the range and quality of services better caters to the needs of both savers and investing businesses; and (iii) improved access to financial services and products for a much larger number of Kenyan households (Nyaoma 2006). The country formally adopted financial sector reforms in 1989, supported by a \$170 million World Bank adjustment credit. Financial reform proposals were first incorporated in the 1986–90 structural adjustment program. The main features of the program included: (i) interest rate liberalization which was achieved in July 1991; (ii) liberalization of the treasury bills market in November 1990 which was accompanied by introduction of the treasury bonds of long-term maturities - one, two and five-year maturities; (iii) setting up a Capital Markets Authority in 1989 to oversee the development of the equities market; (iv) abolition of credit guidelines in December 1993 (which were in existence since 1975 in favour of agriculture); and (v) improving and rationalizing the operations and finances of the DFIs.

Financial sector reforms have undoubtedly strengthened Kenya's banking sector in the last decade or so, in terms of product offerings and service quality, stability and profitability (Kamau 2009). Major indices show an improvement, including: (a) the capital adequacy ratio; (b) rates of return on assets (ROA); (c) non-performing loans; (d) growth and composition of credit to the private sector; and (e) composition of banks assets and liabilities²⁰.

²⁰ Assets of the banking system in Kenya are dominated by loans and advances, government securities and cash reserves at CBK. Kenya commercial banks hold minimal derivatives or asset-based securities in their portfolios. They mainly hold risk-free government securities.

5.2 Banks lending to SMEs in Kenya

The World Bank (2013) devotes itself to this issue. The report notes that although retail banking has improved markedly in Kenya in the last decade, access to credit for SMEs is still limited, with SMEs accounting for about 90% of all enterprises in the country, according to the Kenya Private Sector Development Strategy 2006-10. SMEs are provided with financial services by a range of institutions, including banks, non-bank financial institutions, savings and credit cooperatives (SACCOs), and microfinance institutions. The report cites an analysis of firms that made it to the 2013 Top 100 mid-sized companies' survey that showed that the number of SMEs that turned to lenders for credit lines and overdrafts increased to 67% compared to 57% in 2012. Most of the surveyed entrepreneurs cited the high cost of credit as the reason for cash flow challenges they face, leaving them with no recourse but to dig deeper into their personal savings or turn to family friends to raise funds for day to day operations.

The report notes there is some evidence that Kenyan banks are actually ahead of their counterparts in Nigeria and South Africa in lending to SMEs. From field surveys, about 17.4% of total bank lending goes to SMEs in Kenya, compared to only 5% in Nigeria, and 8% in South Africa. Kenya's ratio is comparable to that of Rwanda, which is a smaller market with a relatively small presence of large-scale firms (Aziz and Berg 2012). These numbers are supported by the innovations in the banking sector that suggest a strong appetite for SME lending.

According to a survey reported in the World Bank (2013), involvement of Kenyan banks in the SME segment is growing, both in terms of size and the diversity of their approaches to the SME client relationship. This has been driven by innovations specifically targeting this market. These innovations started through microfinance-rooted institutions scaling up to becoming commercial banks and now include innovations with lending models and technology in the retail banking segment by other institutions, most notably Equity Bank. In addition, in Kenya there are active markets for hire-purchase and invoice-discounting mainly provided by banks to SMEs which deliver to government and larger enterprises with reputable payment histories. Adoption of these instruments has facilitated entry by some mid-sized Kenyan banks into the SME financing.

According to this survey, Kenyan banks tend to provide more working capital than investment loans. Demand factors play a role with Kenyan firms citing working capital shortages as the primary reason for approaching banks. The distribution of loans may also reflect an assessment by banks that long-term loans are too risky. According to the banks interviewed, on average it takes 190 days to recover bad loans in Kenya, with a rate of recovery of about 80%; the cost is about 40% of the amount of the loan. The situation seems somewhat better in Rwanda, where on average it takes 135 days to recover loans, the rate of recovery is about 85%, and the cost is about 10% of the loan. Nigerian banks operate in the most difficult environment: on average they need 246 days to recover a loan and are able to recover on 30% of the loan.

According to the World Bank (2013), most Kenyan banks have dedicated units serving SMEs. At most institutions, however, the unit is a subunit of the retail banking unit rather than a division. Products are largely standardized, although the number of banks such as Equity Bank, Cooperative Bank and K-Rep Bank are producing customized loan products for the SME sector. Some banks provide training to their clients to improve their management skills and financial reporting. Lending remains based on collateral. Risk management is increasingly automated,

although domestically owned banks have not yet embraced the use of scoring and risk-rating technologies on a large scale.

The report notes that banks prefer to engage with formal firms rather than with informal or semi-informal firms. As part of the loan application, they require SMEs to provide a variety of documents certifying their compliance with government regulations and providing details about their finances. The most common documents required include the registration certificate from the Business Registrar (Attorney General's Office); the Single Business Permit, obtained from the City Councils; and sometimes the certificate of compliance from the Kenya Revenue Authority. These filing requirements are quite onerous and often discourage SMEs from seeking bank financing.

According to World Bank (2013), donors have been encouraging banks to engage in SME financing, providing bank-specific lines of credit and partial credit guarantees. Donors prefer this bank-specific approach to establishing schemes that are open to all qualified institutions, although a more open approach would be better suited to encouraging competition. In markets where SME financing is in its infancy, schemes can augment banks' willingness to push the frontier and demonstrate that lending to SMEs can be a viable and profitable business line. USAID reportedly operates the largest credit guarantee scheme in Kenya, a US\$70 million program. ARIZ, a risk-sharing program funded by the African Development Bank, guarantees 50% of all loans in the portfolio. Other donors that are encouraging lending to SMEs include the European Investment Bank, Proparco, FMO, DEG, SIDA, KfW, Norlund, and the China Development Bank.

On policy, the report recommends that tapping the full growth and job-creating potential of the SME sector will entail a move towards providing growth capital and not just working capital. A growing number of private equity providers are active in East Africa in general and in Kenya in particular. Most of them are not interested in SMEs. A number of new entrants cite lack of information and expertise as a deterrent to venturing into this market. Technical assistance could help bridge the distance between the demand for and the supply of private equity.

Improving the listability of SMEs as well could increase their access to equity finance. Kenyan SMEs have shown some interest in tapping equity financing to grow, by turning to the growing number of private equity funds or by issuing shares on the stock market. In fact, about 28% of firms surveyed in the Top 100 Mid-Sized Companies said they were considering listing on the Nairobi exchange, which now has a special segment, the Growth Enterprise Market Segment (GEMS) for SMEs.

5.3 Cost of credit and interest rate spreads in Kenya

One of the key criticisms of the Kenyan banking sector is that the cost of credit and the interest rate spread remains high. This has raised concerns from government, regulators and parliament, with the latter trying severally to introduce legislation to control them. As seen in Figure 6, the interest rate spread was fairly stable, although gradually increasing, between January 2005 and October 2011, averaging 9.56%. It jumped to a peak of 13.05% in December 2011 following a decision by the Central Bank of Kenya to raise the policy Central Bank Rate (CBR) from 11% to 16.5% in November 2011 and to 18% in December 2011 where it stayed until June 2012. As a consequence, both deposit and lending rates rose sharply as the CBK attempted to control inflation and stem currency depreciation. As seen in the figure, the increase in the spread was because banks raised the lending rate more than the deposit rate. The spread subsequently gradually decreased as the central

bank has relaxed monetary policy, lowering the CBR from 18% to 9.5% during January-April 2013 and to 8.50% since May 2013.

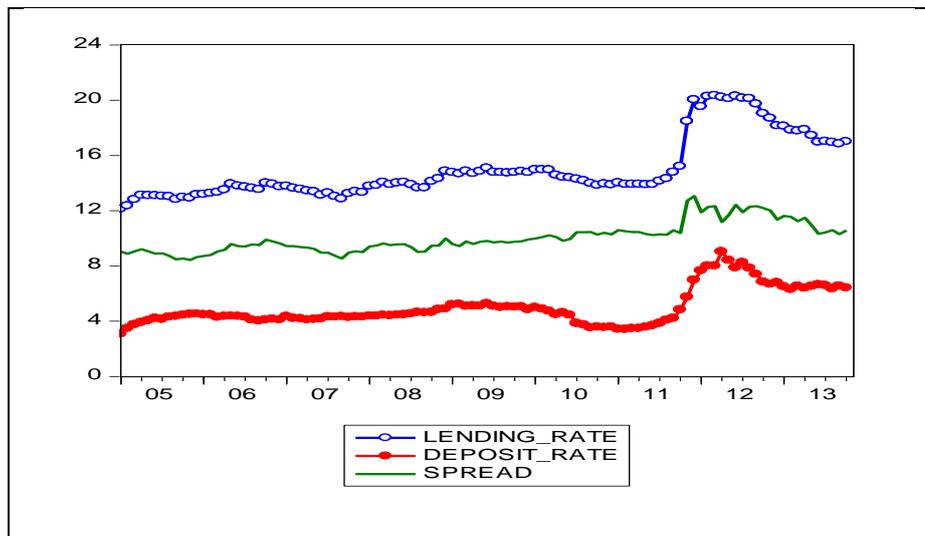
At an average of 10.02% over 2005-13, the interest rate spread has therefore remained high despite improved economic conditions in the country. According to the critics of commercial banks, there have been many developments that have taken place in the country that should have significantly reduced the spread (Oloo 2013). These include (i) improvements in technology (ATMs, mobile phones, etc) that have reduced the cost of doing business, and the need for human resource requirements; (ii) agency banking, with 16,000 agents that are now available to banks at nominal cost; and (iii) introduction of credit reference bureau to reduce information asymmetries and risk. As well, the opening of Currency Centres across the country has reduced costs associated with transporting cash for the banks.

The spread between the lending rate and the risk free 91-days Treasury bill rate is also high and more volatile at an average of 7.43% over 2005-13 (Figure 7). This spread can be taken as a measure of the risk premium faced by banks. It captures perceived risk by lenders of borrowers' ability to pay; as well as inefficiency in the banking system. It has however declined since the mid-2011 denoting a decline in the risk premium. The collapse of the 91-days TBR in 2005 was due to a reduction of the required cash ratio from 10% to 6% in 2003 which injected a lot of liquidity into the economy, drastically lowering interest rates.

Table 8 compares interest rate spreads in Kenya vis a vis a few selected comparator countries over 2000-2012. The spreads are on average relatively higher in Kenya than in Malaysia, Botswana, South Africa, Nigeria and Tanzania. They are only on average higher in Uganda. The high spread in Kenya may reflect the comparably higher lending by Kenyan banks to SMEs that are perceived to have a higher risk premium.

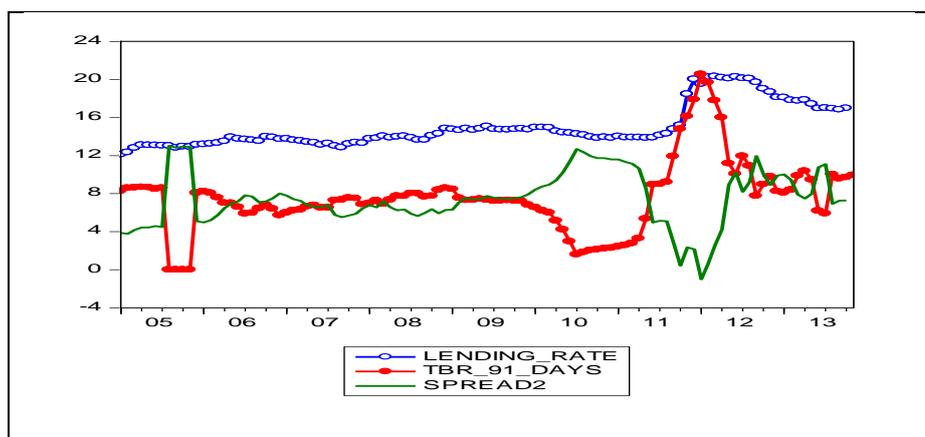
Alongside high lending interest rates and wide spreads, the banking sector profits have increased over time. Profits before tax increased from about US\$ 70 million in 2002 to US\$ 1,256 million in 2012, an average growth rate of 38.7%. The major sources of income were interest on loans and advances (average of 49.6% of total income during the period) which increased over time reflecting an increase in the spread; and fees and commissions (14.6%), and government securities (19.8%) which declined during the period (Figure 8). As also seen earlier in Table 2, the banking sector experienced a general improvement in performance indices over 2009-2012, although there were some setbacks in 2012 with respect to the average return in core capital, average cost of funds, the efficiency ratio and non-performing loans ratio due to an adverse macroeconomic environment in late-2011.

Figure 6: The interest rates spread in Kenya (ex post lending minus deposit rate)



Source: Central Bank of Kenya

Figure 7: The interest rates spread in Kenya (ex post lending rates minus the 91 days TBR)



Source: Central Bank of Kenya

Table 8: Comparative Analysis of Commercial Banks' Ex Post Spreads in Kenya and Selected Countries (%)

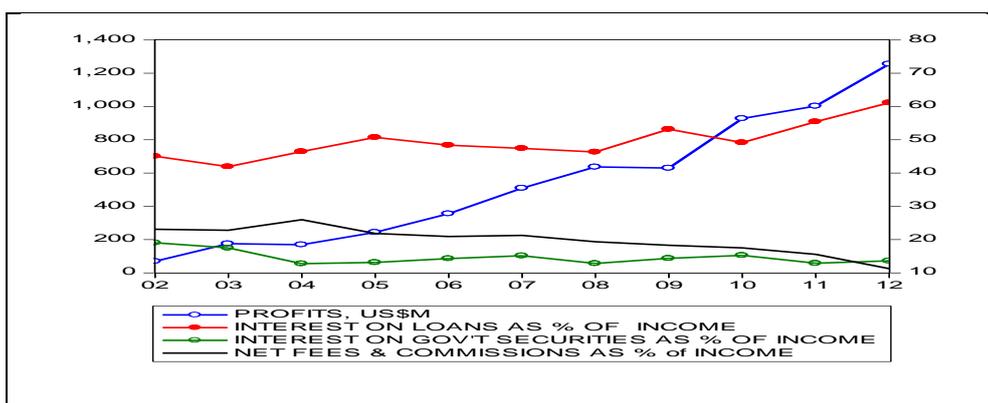
Year	Malaysia	Botswana	South Africa	Nigeria	Kenya	Tanzania	Uganda
2000	4.31	6.06	5.30	9.58	14.24	14.19	13.08
2001	3.75	5.66	4.40	8.18	13.03	15.25	14.19
2002	3.32	5.75	4.98	8.10	12.97	13.11	13.53
2003	3.23	6.45	5.20	6.50	12.44	11.47	9.09

2004	3.05	5.90	4.74	5.48	10.10	9.94	12.86
2005	2.95	6.48	4.58	7.42	7.80	10.52	10.85
2006	3.34	7.59	4.03	7.16	8.50	8.93	9.61
2007	3.24	7.60	4.01	6.65	8.18	7.39	9.84
2008	2.95	7.87	3.51	3.51	8.71	6.73	9.78
2009	3.00	6.29	3.17	5.07	8.84	7.06	11.20
2010	2.50	5.86	3.37	11.06	9.81	7.98	12.49
2011	2.00	5.85	3.33	10.32	9.42	8.18	8.81
2012	1.81	7.39	3.31	8.39	8.15	5.95	10.08
Average	3.04	6.52	4.15	7.49	10.17	9.75	11.19

Source: World Bank, World Development Indicators

The persistently high spreads and growing profitability of the industry have left it open to repeated criticisms of collusive price-setting behaviour (World Bank 2013, Oloo 2013). In the popular press and elsewhere, Kenyan banks have repeatedly been portrayed as using their market power to extract high interest rates from businesses, especially SMEs. The larger banks have been particularly subject to this criticism, based on the perception that they use their reputational advantage to charge higher rates on loans and advances, while not having to pay high interest rates to attract deposits. This perception of high spreads at big banks is reinforced by data showing them to be the most profitable segment of the industry. The competition Commission has launched an investigation into the price-setting behaviour of commercial banks, based largely on the concerns of consumers regarding interest rate spreads.

Figure 8: The Performance of the banking Sector, 2002-2012



Source: Central Bank of Kenya

There have been several studies of interest rate spreads in Kenya (Abdul et al. 2013, Were and Wambua 2013, World Bank 2013). The World Bank (2013) provides a good summary of these studies, first noting that that, while no hard rules prescribe the optimal interest spreads that correspond to specific market conditions, market lending rates are typically a mark-up over the risk-free (government paper) interest rate, the magnitude of the mark-up depending on a host of factors,

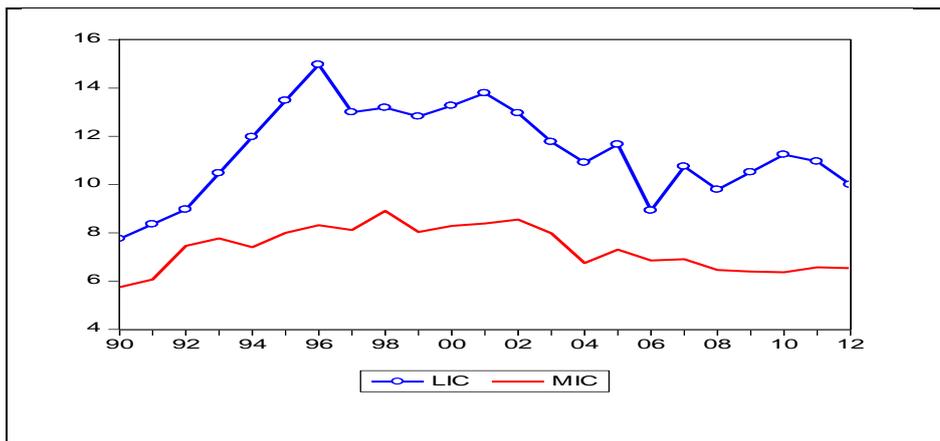
including industry structure, tenor, overhead costs, and risk. Determining this mark-up when information markets are incomplete is especially challenging.

According to the Kenya Bankers Association (Oloo 2013), interest rate spreads reflect the macroeconomic, regulatory and institutional environment under which banks operate such that the determinants of the spread are in four categories: macroeconomic factors and the state of financial sector development; industry-specific factors; and bank-specific factors. We discuss these factors below.

(a) Macroeconomic environment. The size of the spread will depend on the macroeconomic environment and the country's monetary policy stance. There is a high correlation between the spread and the CBR. The Central Bank of Kenya, for example, raised the benchmark interest rate by nearly 300% (from 6.25% to 18%) in less than three months in late-2011. As a result, banks raised their lending and deposit rates. After August 2012, when the central bank started to lower the policy rate as inflation moderated, bank lending rates were not as responsive. Although banks did eventually lower their lending rates, the interest rate spread remained high. According to the Kenya Bankers Association (Oloo 2013), the banks best interests are served when interest rates remain low and stable, arising from a stable macroeconomic environment. Further, a low interest rate regime has a direct relationship with the quality of the banks' loan books, with expectations that non-performing loans will increase in a regime of high interest rates.

(b) Financial sector development. Cross-country studies show large interest spreads are associated with low levels of financial sector development. In general, spreads in East Asia and Pacific are lower than in Sub-Saharan Africa. And within Sub-Saharan Africa, the most advanced market (South Africa) exhibits small spread. As the financial sector grows, spreads narrow. The spreads in Low Income Countries (LICs) averaged 11.4% compared to 7.4% in Middle Income Countries (MICs) over 1990-2012 (Figure 9). Compared to the 1990s, spreads have also declined in Kenya.

Figure 9: Spreads in Low-Income and Middle-Income Countries



Source: World Bank, World Development Indicator. Missing LIC spreads were extrapolated.

(c) Industry-specific factors especially overhead costs. Kenya banks justify the high spreads as due to the difficult business environment they operate in (Oloo 2013). The main argument is that dispute resolutions take too long and is costly; while national infrastructure services (e.g. electricity) are expensive and unreliable. They also cite the high cost of attracting, training and maintaining human resources. Salaries and other forms of labour compensation make up a large part of their

overhead, as the scarcity of skilled financial sector workers leads to high turnover and compensation packages geared to retain scarce skills (World Bank 2013). Most banks estimate that salaries make up 50% of their overhead cost despite the fact that Kenya has a fairly well-developed pool of banking skills. Nevertheless, the largest portion of spreads is explained by profits in recent times (Table 9).

Table 9: Ex post Spread Decomposition in Kenya, %

	2009	2010	2011	2012
Profit	41.6	47.6	51.4	47.9
Bad loans provisions	7.9	8.6	3.6	4.3
Overhead costs	44.6	38.1	38.7	40.2
Reserves	5.9	5.7	6.3	7.7
Total	100	100	100	100

Source: World Bank (2013)

As seen in Table 9, overhead costs do play an important role in explaining the spreads in recent years in Kenya. Overhead costs have actually been going up since the macroeconomic disruptions in 2011. Given the large share of salaries in the overhead costs of the banking sector, increasing the supply of skilled labor to this sector should be a priority (World Bank 2013).

(d) *Bank-specific factors: Market structure.* Large banks have higher spreads than medium-size and small banks. The difference can be attributed to differences in the cost of raising capital. Small and poorly capitalized banks find it more difficult to raise funds. They have to offer higher deposit rates to attract funds and compensate for the perception that they are riskier than large, more liquid, better-capitalized banks, which are perceived to be “too big to fail”. Consequently, big banks are able to mobilize more deposits even at relatively low or near zero deposit rates while at the same time attracting large loan applications despite charging higher rates (World Bank 2013). In Kenya, the banking sector is characterized by an oligopolistic structure and market segmentation, in which the largest four banks control about two-fifths of the market, partly as a result of their reputation and customer loyalty, hence the need for increased competition and breaking the market dominance by a few players (Mwega 2011).

(e) *Bank specific factors: Lending risk premium.* The difference between market lending rates and short-term T-bill rates (Figure 7) can be interpreted as the risk premium, and reflect the market’s perception of risk. Over and above the actual risk perception, where information gaps on credit history or market conditions and other deficiencies in the financial infrastructure persist, banks are likely to price these deficiencies through a higher risk premium (World Bank 2013).

6 Prudential regulations in Kenya

In 1988, the Basel Committee issued the Basel I Accord which assesses banks capital adequacy requirements in the context of the credit risk they face and advocates risk-based supervision. Basel I therefore emphasized a set of minimum capital requirements for banks in order to address credit risk. In 2004, the Committee issued the Basel II Accord which contained further recommendations on banking laws and regulations. The Committee attempted to accomplish this by setting up rigorous risk and capital management requirements designed to ensure that a bank holds capital reserves appropriate to the risk the bank exposes itself to through its lending and investment practices. The Accord was to be implemented from 2007 by G10 countries, with more time given to developing countries, as they were yet to satisfy the prerequisites for the new accord. Basel II has three pillars: Pillar I on minimum capital requirements; Pillar II on the supervisory review process; and Pillar III on market discipline. In December 2010, the Committee announced proposals dubbed Basel III which are currently being reviewed for regulatory and supervisory suitability to financial systems (Kasekende et al. 2011). These proposals include the strengthening of capital adequacy and liquidity requirements as well as countercyclical macroprudential measures.

The CBK continues to regulate banks mainly based on Basel I but was in the process of formulating a policy position on Basel II implementation (KPMG 2012). New guidelines that came into force in January 2013 contain some features of Basel II and Basel III on capital adequacy requirements (Oloo 2013). Overall, Kenya has endeavoured to implement the Basel accords for ensuring financial stability of the country's financial sector. The Kenyan banking system has continued to record compliance with the minimum capital and liquidity prudential requirements. The prudential and financial stability indicators have shown that the financial sector is sound (Figure 10). All the banks have in the recent past met the four minimum capital requirements with respect to the (i) Minimum core capital of Ksh 250 million which was raised to Ksh 1 billion over 2008-12; (ii) Core Capital/Total Deposit Liabilities ratio (Minimum 8%); (iii) Core Capital / Total Risk Weighted Assets ratio (Minimum 8%) and Total Capital/ Total Risk Weighted Assets (Minimum 12%). In addition, the NPL/Assets ratio has decreased from a high of 22.6% in 2001 to a low of 4.3% in 2007, and of December 2013 averaged 5%, an indication that the banking systems asset quality has generally improved over time. As well, the ROA and ROE have generally shown an upward trend since 2002.

Based on the unaudited financial statements for 2012, almost all banks had met the enhanced minimum core capital requirement of Ksh 1 billion, according to CBK²¹. However, the final capital positions of the Kenyan banks will be determined once

²¹ Interview with CBK Governor in Oloo (2013).

the audited financial statements are submitted at the end of March 2013. This is however a minimum threshold and several banks already hold capital way above the minimum of Ksh 1 billion. The key determinant of capital for an institution is the needs of the market niche it serves.

One theory is that increased capital base is important for financial sector stability and may lead to cost reduction from economies of scale which may lead to lower lending rates. On the other hand, a further increase the capital requirement will only create more concentration, making the banking sector more oligopolistic. Gudmundsson et al. (2013) conclude that capital regulation improves the competition, performance and financial stability of Kenyan banks²². Implementation of the CBK's capital requirements for banks to build their core capital can therefore be expected to enhance financial sector stability and lead to cost reduction from economies of scale and ultimately lowering lending rates.

Figure 10: Selected prudential and financial stability indicators for the banking sector 2011 - 2013

	Dec-11	Dec-12	Dec-13	Statutory Requirement
Core capital to Total Risk Weighted Assets Ratio	18.0%	18.9%	19.5%	8.0%
Total Capital to Total Risk Weighted Assets Ratio	21.0%	21.9%	23.2%	12.0%
Core capital/Deposits	15.6%	16.3%	17.3%	8.0%
Liquidity Ratio	37.0%	41.9%	38.6%	20.0%
Gross Non-Performing loans to Gross Loans Ratio	4.4%	4.5%	5.0%	N/A
Return on Assets (ROA)	3.4%	3.8%	3.6%	NA
Return on Equity (ROE)	30.3%	34.2%	28.9%	NA

Source: Central Bank of Kenya

CBK has focused more on microprudential regulation which relates to factors that affect the stability of individual banks and less so on macroprudential regulation which relates to factors which affect the stability of the financial system as a whole. In the latter case, changes in the business cycles may influence the performance of banks, hence the Basel III proposal for countercyclical capital changes to provide the way forward for future macroprudential regulation, which should take into account the growth of credit and leverage as well as the mismatch in the maturity of assets and liabilities. Murinde (2012) however argues that review of macroprudential regulations should encompass the broader aspects of financial

²² They estimate the Lerner index and the Panzar and Rosse H-statistic as measures of competition and relate them to core capital. The panel estimates show the log of core capital is positive and significant while squared log of core capital is negative and significant. This implies that an increase in core capital reduces competition up to a point and then increases competition so that the benefits of increasing capital requirements on competitiveness are realized once consolidation in the banking sector takes place. They then use return on equity to capture bank performance and stability and the estimation results confirm a positive relationship supporting the evidence that capital regulation improves the performance of banks and financial stability.

services regulation, such as depositor protection or deposit insurance and the safety of the payments system which have received attention from CBK.

The regulatory toolkit in Kenya has also relied substantially on other variables such as structure of banking assets and liabilities such as restrictions on banks' large loan concentrations and foreign exchange exposure limits (Kasekende et al. 2011). As well, according to KPMG (2012), Kenya has a highly skilled workforce and the banking sector is able to secure banking staff with relevant training, and finance-related profession certification. In addition, the country has returning citizens with international professional experience to add to an already diverse talent pool. Capacity for implementing different regulations and supervision, such as lack of information and insufficient staff do not seem to be a major constraint. In a group of 11 SSA countries, Gottschalk (2013) finds Kenya to have the second largest number of supervisors (60), largest number of supervisors with more than ten years of experience (30) and the largest percentage of supervisors with a postgraduate degree (80), although the number of onsite supervisors by banks in the previous five years was comparatively low at 1.

Among other regulatory issues, Kenya has increasingly moved into universal banking reflected in increasing share of net commissions and fees in the banks' total income. The country now has banks that own insurance companies, others have set up insurance agencies to push forward their concept of bank-assurance; while others own stock brokerage firms. Hence there have been increased synergies between the banking, insurance and securities sectors with removal of regulatory barriers between the different segments of the financial sector. This poses regulatory challenges as different financial sector entities are subject to different regulatory regimes. Given the convergence and consolidation of the financial services, some players have called for the established of an overall services regulatory authority, as in UK (Mutuku 2008, Presidential Task Force on Parastatal Reforms in Kenya 2013).

According to the Central Bank, the convergence of financial services is a global phenomenon, with among its key drivers being the customer demands for a "one stop financial services super markets" and competition. This poses regulatory challenges as different financial sector entities are subject to different regulatory regimes. The Central Bank has adopted a consolidated supervision approach, which requires information sharing and coordination amongst the various regulators in the financial sector. This is consistent with Spratt (2013) who advocates for (i) a unified approach to supervision, with the central bank playing a dominant role; and (ii) a comprehensive approach that should utilize the already wider 'tool-kit' available to regulators.

7 Management of capital flows in Kenya

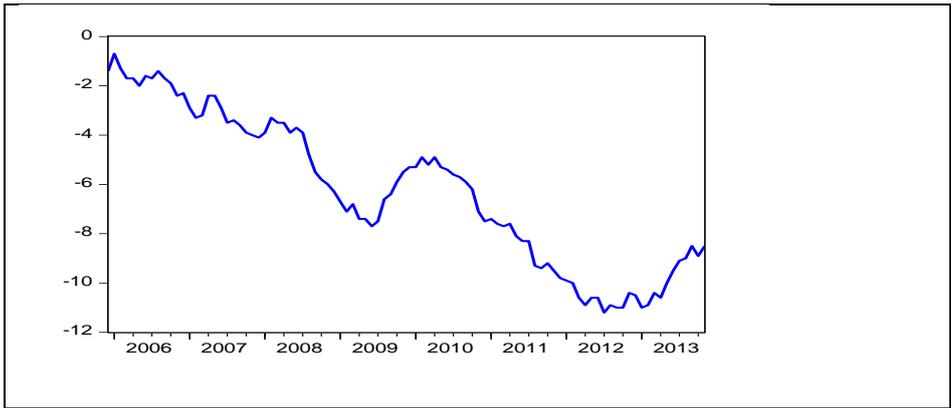
7.1 Evolution of current account deficit and net capital inflows in Kenya

Kenya has in the last decade experienced a large increase in the current account deficit (Figure 11). The current account recorded an average deficit of 1.75% of GDP in 2006, generally widening over the subsequent years. By 2012, the deficit had risen to an average of 10.6% of GDP. The deficit improved in 2013 from a peak of 11.0% of GDP in January 2013 to 8.5% of GDP in November 2013. The improvement in current account is attributed to normalisation of the import bill after the large amount of imports of equipment for infrastructure development and improvement in net receipts from services. As a result, the proportion of imports of goods and services financed by exports of goods and services increased to 62.9% in the first half of 2013 from an average of about 61.5% in the second half of 2012. Nonetheless, imports of machinery and other equipment continued to account for a higher proportion of the import bill at about 27.2%. These are essential for enhancing future productive capacity of the economy.

The high current account deficit would not be a major problem if it was financed by long-term capital inflows such as ODA and FDI. However the deficit is mainly financed by short-term net capital inflows, except in a few episodes when net long-term official flows dominate (Figure 12). Short-term capital flows have typically accounted for more than 50% of total financial flows. The easy reversibility of these inflows increases the risk of a ‘sudden stop’ as a shift in market sentiments creates a flight away from domestic assets (O’Connell et al. 2010). This could lead to depletion of reserves and sharp currency depreciations. While increased capital inflows are accompanied by a possible resurgence of growth and a marked accumulation of foreign exchange reserves, they have been accompanied by inflationary pressures, a real exchange rate appreciation and deterioration in the current account deficit (Maasa 2013). In Kenya net capital inflows depreciate the real exchange rate in the short-run and long-run (Mwega 2013).

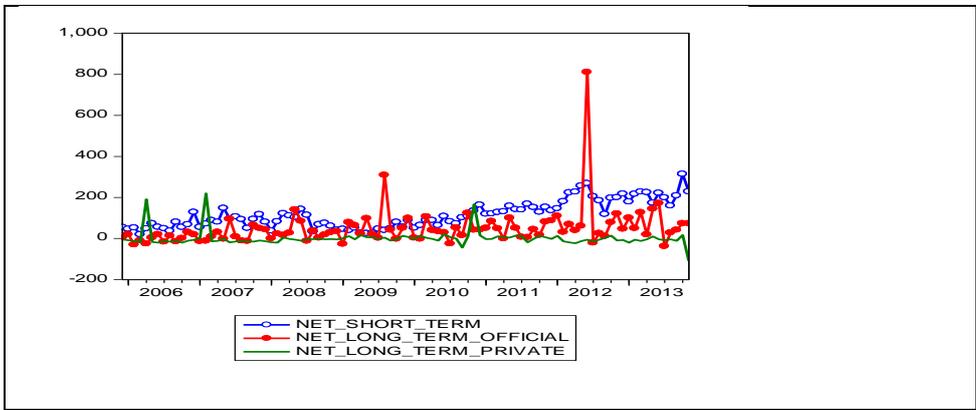
The CBK has not in the past collected information on foreign participation in the bonds market. However a Banking Circular No. 4 of 2013 was sent to all commercial banks on December 17, 2013, asking them to be providing monthly information on foreign investments in government securities. Table 10, on the other hand, shows the net foreign purchases in Kenya’s NSE as percentage of equity turnover over January 2009-December 2013. Net purchases averaged 14.7% of equity turnover and were negative in only a few months: January 2009 (-13%), May 2010 (-3%), April – June 2011 (-23% to -40%), December 2011 (-23%), February 2013 (-27%) and December 2013 (-6%).

Figure 11: 12-months cumulative current account deficit as % of GDP, December 2005-November 2013



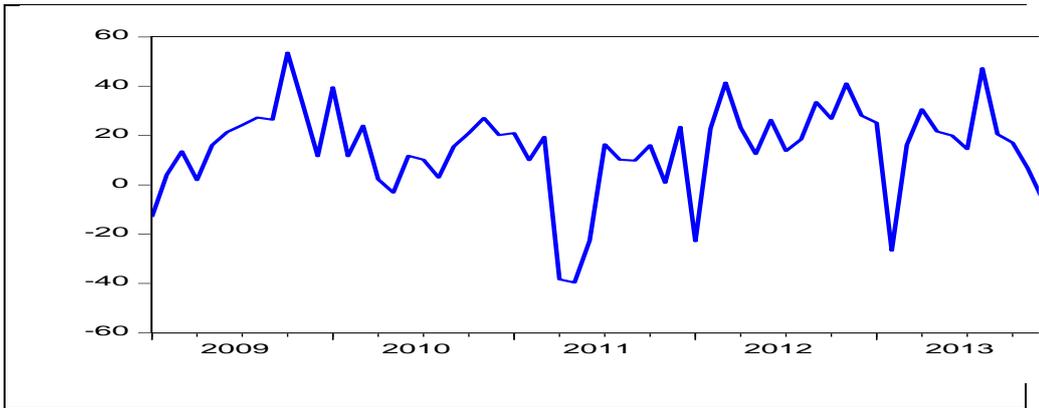
Source: Central Bank of Kenya

Figure 12: Net capital flows to Kenya, US\$ million, December 2005-November 2013



Source: Central Bank of Kenya

Table 10: Net Foreign Purchases as % Share of Equity Turnover in Kenya, January 2009-December 2013



Source: Central Bank of Kenya

7.2 ODA Flows

The other sources of finance are ODA and FDI²³. Mwega (2010) analyses the evolution of foreign aid to Kenya. Kenya is not a high aid-dependent economy. At its peak in 1989-90, net ODA inflows averaged 14.6% of the gross domestic income, declining to a low of 2.44% in 1999. There were thereafter increased net aid inflows which rose from 3.0% of GNI in 2002 to 7.4% of GNI in 2011 (Table 11). This was as a result of government increased borrowing to finance development projects on infrastructure as well as increased inflows of grants to support the government efforts in social sectors and humanitarian responses to droughts. The increase in foreign aid therefore reflected renewed donor confidence in the government resolve for proper management of the economy and situating adequate government measures against graft and corruption.

Table 11: Net ODA to Kenya, 2002-2011

Indicator Name	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Net ODA (% of GNI)	3.0	3.5	4.1	4.1	4.2	4.9	4.5	5.8	5.1	7.4
Net ODA (% of central government expense)	15.7	18.6	19.7	22.3	21.3	25.0	21.0	27.8	22.6	32.3
Net ODA (% of gross capital formation)	19.7	21.3	24.2	23.0	22.8	25.5	23.3	29.1	25.6	35.3
Net ODA per capita (current US\$)	11.9	15.4	19.0	21.2	25.8	35.1	35.2	44.6	39.8	59.1

Source: World Bank, World Development Indicators

One reaction to aid volatility has been reluctance by the government to factor in programme aid in the budget. The government has in the recent past excluded donor budgetary support from its annual budget strategy and beefed measures for local resource mobilization. Consequently, the country has substantially reduced aid-dependence, with government revenues having increased dramatically after the December 2002 elections. In the last two decades, tax revenues have increased both as a proportion of GDP and absolutely in US dollars terms, with acceleration since 2002. Tax revenue as a share of GDP increased from 17.3% in 2002 to 19.9% in 2011. In absolute terms, tax revenues almost tripled from US\$ 2.27 billion in 2002 to US\$ 6.69 billion in 2011.

While there have been concerns about public debt in the country, various indicators (Table 12) shows it is sustainable in the medium-term. The table shows the country is on the threshold with respect to the PV of the public sector debt to GDP ratio (40%) which increases from 39.3% in 2011 to 40.3% in 2012. However, it gradually decreases to 38.7% by 2014, and to about 25% by 2030. Given Kenya's historically strong revenue performance, the country remains well within the other two indicators.

Table 12: Public Debt Sustainability in Kenya

Indicator	2010	2011	2012	2013	2014	2015	2020	2030
PV of public sector debt to GDP ratio (40)	38.5	39.3	40.3	39.9	38.7	37.9	34.70	25.6
PV of public sector debt	156.5	154.2	156.1	151.5	145.6	147.8	140.4	106.1

²³ Remittances are already incorporated in the measurement of the current account deficit.

to revenue ratio (250)								
Debt service to revenue ratio (30)	25.5	21.9	24.5	23.5	21.6	21.5	20.0	15.5

Source: World Bank – IMF (2011)

7.3 FDI Flows

FDI has played a small (but increasing important) role in the Kenyan economy. Net FDI flows to Kenya have not only been highly volatile, they generally declined in the 1980s and 1990s despite the economic reforms that took place and the progress made in improving the business environment (Mwega and Ngugi, 2004). The investment wave of the 1980s dwindles in the 1990s as the institutions that had protected both the economy and body politic from arbitrary interventions were eroded (Phillips et al. 2001). The performance of FDI has improved since the 1990s and averaged US\$159.4 million in 2002-07. Net FDI increased to an average of 0.68% of GDP in this period. The data however show that the good performance was driven by a big jump of net FDI flows to the country in 2007. The jump was due to new investments by mobile phone companies (involving mergers and acquisitions of \$3 million) and accelerated offshore borrowing by private companies to finance electricity generation activities, which became necessary due to a drought that prevailed that year. FDI inflows averaged 0.3-0.98% of GDP in the country over 2008-2011. FDI inflows substantially declined in 2008 but improved over 2009-11. FDI inflows increased from US\$95.6 million in 2008 to US\$335.2 million in 2011. World Bank (2013) reports that Kenya received about US\$187.6 million in the year to June 2013, far below flows to Tanzania (US\$ 1,512.3 million) and Uganda (US\$ 1,817.1 million), mainly to their gas and oil industries²⁴. The report urges the country to improve its business climate to attract more FDI and promote economic growth. Esso (2010) for example finds a long-run relationship between FDI and growth in Kenya, with a one-way causality from the former to the latter. FDI is expected to scale up following the discovery of commercially viable oil deposits and rare minerals in the country.

Table 13: Net FDI inflows to Kenya, 2002-2011

Indicator Name	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
FDI, net inflows (% of GDP)	0.21	0.55	0.29	0.11	0.23	2.68	0.31	0.38	0.55	0.98
FDI, net inflows, US\$ million	27.6	81.7	46.1	21.2	50.7	729.0	95.6	116.3	178.1	335.2

Source: World Bank, World Development Indicators

In an empirical study, Mwega and Ngugi (2007) found the FDI ratio is mainly determined by a few fundamentals (in this case, the trading partners growth rate, terms of trade shocks; the external debt ratio and the quality of institutions). With the first two variables exogenous, the result suggests that investment promotion in Kenya requires actions such as reducing corruption (for example, changing government away from corrupt awards to insiders); rebuilding institutions; and enhancing the rule of law and order, with clear and transparent regulations, uniformly enforced (Phillips et al. 2001). Reducing the external debt overhang would also have a positive effect on FDI.

²⁴ At an average exchange rate of Ksh 85.3 per dollar in the year to June 2013.

7.4 Capital account regulation to avoid future currency or banking crises

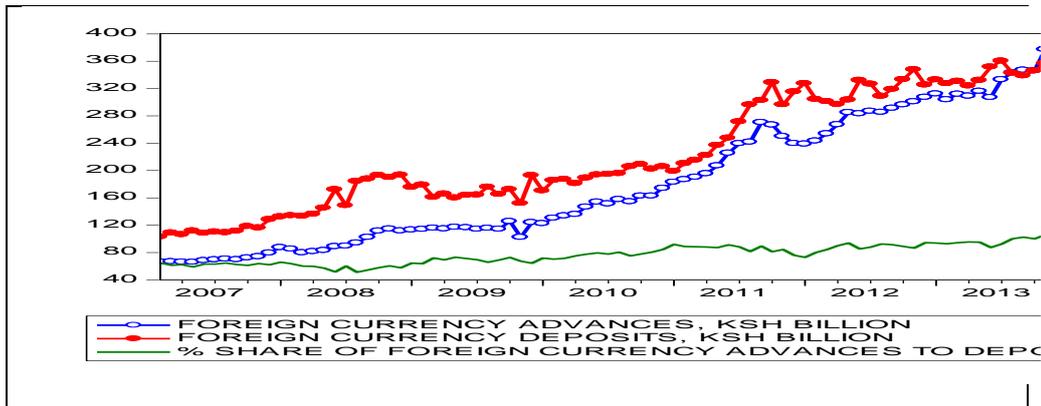
Management of the short-term capital flows in Kenya could be enhanced by some non-radical interventions such as building reserves (for example to the six months cover initially recommended by the East African Community) to guard against reversals. Some countries have implemented more radical policies such as the Tobin tax, asking such flows be in the country for a certain minimum period or revert to a crawling peg regime that would contain and lead to better management of both short-term capital flows and the exchange rate. According to O'Connell et al. (2010), the CBK is not yet in a trilemma which postulates that a country that operates an open capital account cannot peg the exchange rate and have an independent monetary policy at the same time. Given a combination of imperfect asset substitutability, prudential regulations and residual capital controls, CBK has scope to target inflation while also exerting some influence over the path of the nominal exchange rate in the short-run and perhaps for extended periods.

Besides monetary policy actions to neutralize the effects of the net capital on domestic liquidity, the CBK therefore mainly relies mainly on foreign exchange reserves to enhance the country's capacity to absorb shocks that impact the foreign exchange market. The statutory requirement is that the CBK endeavour to maintain foreign reserves equivalent to four months' import cover. The CBK does not participate in the foreign exchange market to defend a particular value of the Kenya shilling but may intervene to stabilize excess volatility in the exchange market. Following the volatility in the exchange rate in 2011, the CBK introduced various regulatory measures, through Prudential Guidelines of banks, to support the stability of the exchange rate. These included:

- Limiting the tenor of swaps and Kenya Shilling borrowing where offshore banks are involved to a tenor of not less than one year.
- Limiting the tenor of swaps between residents to not less than seven days.
- Reduction of the foreign exchange exposure ratio of core capital from 20% to 10%.
- Requiring that local banks obtain supporting documents for all transactions in the Nostro accounts of offshore banks.
- Suspension of the use of any Electronic Brokerage System by banks.

There are no explicit measures to regulate currency mismatches in lending to banks and companies, except indirectly through foreign currency exposure limits. As seen in Figure 13, while foreign currency advances and deposits have increased over time, their ratio has been fairly stable over 2007-2013. Neither are there counter-cyclical capital controls on inflows of short term capital flows to the country.

**Figure 13: Foreign Currency advances and deposits in Kenya,
January 2007 – December 2013**



Source: Central Bank of Kenya

8 Summary and conclusions

This case study investigates the potential tradeoff between regulation and stability of Kenya's financial sector, with a focus on the banking sector. The Terms of Reference for the research project identify six issues below that require investigation.

Section 2 is devoted to the size and growth of the financial sector. The paper first analyses the features and vision of development of the country as articulated in Kenya Vision 2030 and the Medium Term Plans (MTPs). The Vision identifies financial services as one of seven sectors that are the key drivers of the economy. It envisages the creation of “a vibrant and globally competitive financial sector that will create jobs and promote high levels of savings to finance Kenya's overall investment needs”.

Kenya's M2/GDP and private credit/ GDP ratios closely track those of low-income countries (LICs), but they are far below those of middle-income countries (MICs), with a clear divergence over time. With the country aspiring to MIC status by 2030, it apparently has a long way to go in building its financial sector. Granger causality tests show significant causality from financial intermediation to growth at 3 and 4 lags at the 5% level, with the other lags non-significant, supporting Kenya Vision 2030 designation of the financial sector as one of the drivers of growth in Kenya, at least in the short-run. On an annual basis, the financial sector growth has consistently outpaced the real GDP growth since 2009.

Section 3 discusses the role of the foreign, state-owned commercial banks and DFIs in the country. Kenya currently (in December 2013) has 43 banks, of which 14 banks have foreign ownership, accounting for 32.2% of net assets in 2012. The Central Bank also identifies 6 banks with state ownership accounting for 24.8.2% of net assets in 2012, with the government having majority ownership in three of these, which account for 4.2% of net total assets (Consolidated Bank; Development Bank of Kenya; and the National Bank of Kenya). The remaining 23 are local private banks, accounting for 43.0% of the banking sector's net assets. Kenya's banking system is therefore dominated by local private banks and foreign banks.

The foreign banks have done as well as local private banks with both having an average rate of return on assets of 4.6% over 2009-2012, ahead of banks with state ownership (3.7%) and state-owned banks (3.1%). The poor performance of the latter is attributed to poor legacy in the past of poor governance and massive interference by the state in their management. The same pattern is repeated in the other indicators. Foreign banks have on average done slightly better on the rate of return on core capital (46.3%) over 2009-2012 when compared to local private banks (44.6%), ahead of banks with state ownership (34.1% and 24.6%, respectively). They also have the lowest cost of funds (index of 3.2%), followed by banks with state ownership (index of 3.1% and 4.5%, respectively) and then local private banks (index 4.6%). Foreign banks are also the most efficient (with an

average score of 49.1%) slightly ahead of local private banks (score of 53.5%), with banks with state ownership the least efficient (scores of 60.4% and 65.1%, respectively). Finally, foreign banks have the least non-performing loans ratio (average 3.3% over 2009-2012), followed by local private banks (4.7%) and banks with state ownership (6.4% and 8.0%, respectively). It is therefore apparent that foreign banks largely behave and perform like local private banks, except that they have cheaper sources of finance due to their reputation capital. They are also quite diverse so that it is difficult to generalize their behaviour.

According to World Bank (2013), most foreign banks have dedicated units serving SMEs. There are however a few exceptions such as Citibank and, to a less extent, Standard that focus on corporate and high-end clients, and hence do not lend to SMEs. According to simulations from Oloo (2013) data, local private banks charge the lowest costs to SMEs, followed by foreign banks and then banks with state ownership.

In Kenya, some banks have expanded their branch networks in the region. Such banks pose an increasing challenge for regulators across Africa (Beck 2013). Central banks in Eastern African countries have signed a Memorandum of Understanding (MOU) to facilitate information sharing and supervisory co-operation for regional banking groups. The CBK has developed and implemented a consolidated supervision program for the effective oversight of banking groups. As part of efforts aimed at implementing consolidated supervision, it launched Prudential Guidelines on Consolidated Supervision and convened two Supervisory College meetings in 2012 and 2013 bringing together all Central Banks of the East African countries where Kenyan banks currently have operations. The East African Central Banks are also currently working to harmonize their banking sector supervisory rules and practices as a prerequisite for the envisaged East African Monetary Union (EAMU). One issue that appear critical in this increasing regulatory cooperation, based on the experience of European countries, is that there should be a focus on proper preparation for resolution. Non-binding MOUs and Colleges of Supervisors limited to information exchange are of limited use in times of bank failure.

In Kenya, DFIs play a small role in the economy. The five existing DFIs account for less than 1% of the assets of the banking sector and supplied only about 0.56% of the banking sector credit to the private sector. There however seems to be consensus that DFIs could play a significant role by providing long-term finance through targeted interventions for specific sectors or groups like SMEs, youth and women (CBK 2013). This is recognized under Vision 2030, where DFIs are expected to contribute towards enhanced financial access and investment goals. The Task Force on Parastatals Reform (2013) advocates consolidating DFIs under a Kenya Development Bank (KDB) with sufficient scale, scope and resources to place a catalytic role in Kenya's economic development by providing long-term finance and other financial and advisory, investment and advisory services. CBK (2013) as well calls for introduction of prudential regulation and supervision consistent with their mandate as done in several countries including Tanzania, Nigeria, China, Swaziland and Korea. As a result, Kenya would only customize the regulatory and supervisory frameworks to local circumstances.

Section 4 discusses financial inclusion in Kenya. Financial access surveys show that Kenya's financial inclusion landscape has undergone considerable change. The proportion of the adult population using different forms of formal financial services has increased from 27.4% in 2006, to 41.3% in 2009 and stood at 66.7% in 2013, amongst the highest in Africa. Overall, the proportion of the adult population totally excluded from financial services has declined from 39.3% in 2006 to 31.4% in 2009 and to 25.4% in 2013.

The massive increase in access to financial services in the country since 2006 is mainly due to enhanced usage of mobile money services from virtually 0% in 2006 to 28.4% in 2009 to 61.6% in 2013, making Kenya a global leader in the use of mobile phone platforms. Currently, the four mobile money services have close to 20 million customers, handling over US\$ 54.4 million worth of transactions per day. M-PESA however remains dominant with 82% of market share, Airtel Money 15%, YuCash 2% and Orange Money 1%.

Financial inclusion has varied with the socio-economic statuses of the population. According to FSDK (2013), financial exclusion in 2013 varied from 55.3% for the poorest 20% of the population to 5.7% for the wealthiest 20% of the population. As well, financial exclusion was highest for those without any education (60.7%) and lowest for those with tertiary education (1.8%). Women use of formal financial services has lagged behind that of men, but the gap substantially reduced between 2009 and 2013. As well, rural areas have lagged behind urban areas in access to financial services

The success of M-PESA in Kenya is often used to argue for a light-touch approach, where mobile banking was allowed to flourish (Spratt 2013). However, possible systemic and individual users' risks seem to require careful evaluation and monitoring. The CBK acknowledges that the technology used to deliver the mobile money services carries inherent threats, the main ones being operational risk, financial fraud and money laundering. However, prior to the launch of mobile banking services by the various companies, the CBK requires them to provide a detailed risk assessment, outlining all potential risks and satisfactory mitigating measures they have put in place. Precautionary measures have been put in place to ensure that the services do not infringe upon the banking services regulatory framework as provided for in the Banking Act. Following the enactment of the National Payments System Act in 2011, the CBK now has the oversight mandate, with all payment service providers including mobile phone service providers offering money transfer services falling under the CBK's regulatory framework.

Increased financial inclusion through financial innovations does not seem to have compromised financial stability. First, the stock of e-money is backed 100% by accounts held at commercial banks. The mobile money e-float is also a small proportion of the other monetary aggregates in terms of size for it to matter much for monetary policy. Weil et al. (2011) estimate the outstanding stock of M-PESA e-float at 1.6% of M0 and 0.4% of M1. Second, while there has been increased instability in monetary relationships post-2007, reflected in a decline in the income velocity of circulation and an increase in the money multiplier, undermining the conduct of monetary policy which assumes stable monetary relationships, stability seems to have been re-established since 2010. The instability was therefore a temporary phenomenon. The demand for money also shows stability post-2010 (Weil et al. 2011).

Section 5 is devoted to access and cost of credit in Kenya. Financial sector reforms have undoubtedly strengthened Kenya's banking sector in the last decade or so, in terms of product offerings and service quality, stability and profitability (Kamau 2009). The World Bank (2013) devotes itself to an analysis of banks lending to SMEs in Kenya. The report notes that although retail banking has improved markedly in Kenya in the last decade, access to credit for SMEs is still limited. Most of the surveyed SMEs cite the high cost of credit as the reason for cash flow challenges they face, leaving them with no recourse but to dig deeper into their personal savings or turn to family friends to raise funds for day to day operations. The report notes there is some evidence that Kenyan banks are actually ahead of their counterparts in Nigeria and South Africa in lending to SMEs. From field

surveys, about 17.4% of total bank lending goes to SMEs in Kenya, compared to only 5% in Nigeria, and 8% in South Africa. According to a survey reported in the World Bank (2013), involvement of Kenyan banks in the SME segment is growing, both in terms of size and the diversity of their approaches to the SME client relationship, with the encouragement of donors who provide bank-specific lines of credit and partial credit guarantees.. This has been driven by innovations specifically targeting this market. According to this survey, Kenyan banks tend to provide more working capital than investment loans.

On policy, the report recommends that tapping the full growth and job-creating potential of the SME sector will entail a move towards providing growth capital and not just working capital. Technical assistance could help bridge the distance between the demand for and the supply of private equity while improving the listability of SMEs on the special Growth Enterprise Market Segment (GEMS) could increase their access to equity finance.

One of the key criticisms of the Kenyan banking sector is that the cost of credit and the interest rate spread remains high (at an average of 10.02% over 2005-13). The spreads are on average relatively higher in Kenya than in, for example, Malaysia, Botswana, South Africa, Nigeria and Tanzania, but lower than in Uganda. Alongside high lending interest rates and wide spreads, the banking sector profits have increased over time. Profits before tax increased from about US\$ 70 million in 2002 to US\$ 1,256 million in 2012, an average growth rate of 38.7%, with income from interest on loans and advances accounting for 49.6% of total income during the period. The persistently high spreads and growing profitability of the industry have left it open to repeated criticisms of collusive price-setting behaviour, particularly for large banks (World Bank 2013, Oloo 2013). The Competition Commission has launched an investigation into possible collusion price-setting behaviour by commercial banks, while the National Treasury has set up a 15-member committee to probe these spreads.

There have been several studies of interest rate spreads in Kenya (Abdul et al. 2013, Were and Wambua 2013, World Bank 2013), which postulate that interest rate spreads reflect (i) macroeconomic factors; (ii) the state of financial sector development; (iii) industry-specific factors; and (iv) bank-specific factors which are discussed in the paper.

Kenya banks justify the high spreads as due to the difficult business environment they operate in (Oloo 2013). The main argument is that dispute resolutions take too long and are costly; while national infrastructure services (e.g. electricity) are expensive and unreliable. They also cite the high cost of attracting, training and maintaining human resources. Salaries and other forms of labour compensation make up a large part of their overhead, as the scarcity of skilled financial sector workers leads to high turnover and compensation packages geared to retain scarce skills (World Bank 2013). Most banks estimate that salaries make up 50% of their overhead cost despite the fact that Kenya has a fairly well-developed pool of banking skills. Given the large share of salaries in the overhead costs of the banking sector, increasing the supply of skilled labor to this sector should be a priority. Nevertheless, the largest portion of spreads is explained by profits in recent times (World Bank 2013).

Section 6 discusses prudential regulations in Kenya. The CBK continues to regulate banks based mainly on Basel I but was in the process of formulating a policy position on Basel II implementation (KPMG 2012). New guidelines that came into force in January 2013 however contain some features of Basel II and Basel III on capital adequacy requirements (Oloo 2013). Overall, Kenya has

endeavoured to implement the Basel accords for ensuring financial stability of the country's financial sector. The Kenyan banking system has continued to record compliance with the minimum capital and liquidity prudential requirements. All the banks have in the recent past met the four minimum capital requirements with respect to the (i) Minimum core capital of Ksh 250 million which was raised to Ksh 1 billion over 2008-12; (ii) Core Capital/Total Deposit Liabilities ratio (Minimum 8%); (iii) Core Capital / Total Risk Weighted Assets ratio (Minimum 8%) and Total Capital/ Total Risk Weighted Assets (Minimum 12%). In addition, the NPL/Assets ratio has decreased from a high of 22.6% in 2001 to a low of 4.3% in 2007, and of December 2013 averaged 5%, an indication that the banking systems asset quality has generally improved over time. As well, the ROA and ROE have generally shown an upward trend since 2002.

CBK has focused more on microprudential regulation which relates to factors that affect the stability of individual banks and less so on macroprudential regulation which relates to factors which affect the stability of the financial system as a whole. Basel III therefore proposes for countercyclical capital changes to provide the way forward for future macroprudential regulation, which should take into account the growth of credit and leverage as well as the mismatch in the maturity of assets and liabilities (Murinde 2012).

The regulatory toolkit in Kenya has also relied substantially on other variables such as structure of banking assets and liabilities such as restrictions on banks' large loan concentrations and foreign exchange exposure limits (Kasekende et al. 2011). As well, according to KPMG (2012), Kenya has a highly skilled workforce and the banking sector is able to secure banking staff with relevant training, and finance-related profession certification. In addition, the country has returning citizens with international professional experience to add to an already diverse talent pool. In a group of 11 SSA countries, Gottschalk (2013) finds Kenya to have the second largest number of supervisors (60), largest number of supervisors with more than ten years of experience (30); and the largest percentage of supervisors with a postgraduate degree (80), although the number of onsite supervisors by banks in the previous five years was comparatively low at 1.

*Finally, Section 7 discusses the management of capital flows in Kenya .*Kenya has in the last decade experienced a large increase in the current account deficit. The current account recorded an average deficit of 1.75% of GDP in 2006, generally widening over the subsequent years. By 2012, the deficit had risen to an average of 10.6% of GDP. The deficit improved in 2013 from a peak of 11.0% of GDP in January 2013 to 8.5% of GDP in November 2013. The high current account deficit has mainly been financed by short-term net capital inflows, which have typically accounted for more than 50% of total financial flows. The easy reversibility of these inflows increases the risk of a 'sudden stop' as a shift in market sentiments creates a flight away from domestic assets (O'Connell et al. 2010). This could lead to depletion of reserves and sharp currency depreciations.

The CBK has not in the past collected information on foreign participation in the bonds market. On the other hand, net purchases by foreigner in Kenya's NSE averaged 14.7% of equity turnover over 2005-2013 and were negative in only a few episodes: January 2009 (-13%), May 2010 (-3%), April – June 2011 (-23% to -40%), December 2011 (-23%), February 2013 (-27%) and December 2013 (-6%).

The other sources of finance are ODA and FDI which have only played a limited role, given they are relatively small and highly volatile. The World Bank urges the country to improve its business climate to attract more FDI and promote economic growth. Esso (2010) for example finds a long-run relationship between FDI and

growth in Kenya, with a one-way causality from the former to the latter. FDI is expected to scale up following the discovery of commercially viable oil deposits and rare minerals in the country. In an empirical study, Mweha and Ngugi (2007) found the FDI ratio is mainly determined by a few fundamentals (in this case, the trading partners growth rate, terms of trade shocks; the external debt ratio and the quality of institutions). The result suggests that FDI promotion in Kenya requires actions such as reducing corruption; rebuilding institutions; and enhancing the rule of law and order, with clear and transparent regulations, uniformly enforced (Phillips et al. 2001). Reducing the external debt overhang would also have a positive effect on FDI.

While there have been concerns about public debt in the country, various indicators shows it is sustainable in the medium-term. The country is on the threshold with respect to the PV of the public sector debt to GDP ratio (40%) which increases from 39.3% in 2011 to 40.3% in 2012. However, it gradually decreases to 38.7% by 2014, and to about 25% by 2030. Given Kenya's historically strong revenue performance, the country remains well within the other two indicators (World Bank – IMF 2011).

Management of the short-term capital flows in Kenya could be enhanced by some non-radical interventions such as building reserves to guard against reversals. Some countries have implemented more radical policies such as the Tobin tax, asking such flows be in the country for a certain minimum period or revert to a crawling peg regime that would contain and lead to better management of both short-term capital flows and the exchange rate. According to O'Connell et al. (2010), the CBK is not yet in a trilemma which postulates that a country that operates an open capital account cannot peg the exchange rate and have an independent monetary policy at the same time. Given a combination of imperfect asset substitutability, prudential regulations and residual capital controls, CBK has scope to target inflation while also exerting some influence over the path of the nominal exchange rate in the short-run and perhaps for extended periods.

There are no explicit measures to regulate currency mismatches in lending to banks and companies, except indirectly through foreign currency exposure limits. While foreign currency advances and deposits have increased over time, their ratio has been fairly stable over 2007-2013. Neither are there counter-cyclical capital controls on inflows of short term capital This case study investigates the potential tradeoff between regulation and stability of Kenya's financial sector, with a focus on the banking sector.

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