KENYA BANKERS ECONOMIC BULLETIN

VOLUME TWO 2012

A report prepared by:

The Centre for Research on Financial Markets and Policy

KENYA BANKERS ASSOCIATION

One Industry. Transforming Kenya.

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About this Report

This report reviews the performance of Kenya's economy during the first half of 2012 and the emerging trends during the third quarter of 2012. The report covers production trends in the real sector, government fiscal operations, financial sector developments, public debt; inflation, interest rates; balance of payments; exchange rate; foreign exchange reserves; activity at the Nairobi Stock Exchange; budget analysis, commentary on Kenya Credit Information Sharing Initiative (KCISI), banking sector performance, and the East African Community Monetary Union.

About the Centre for Research on Financial Markets and Policy

The Centre for Research on Financial Markets and Policy was established by the Kenya Bankers Association in 2012 to offer an array of research, commentary, and dialogue regarding critical policy matters that impact on financial markets in Kenya. The Centre sponsors original research, provides thoughtful commentary, and hosts dialogues and conferences involving scholars and practitioners on key financial market issues. Through these activities, the Centre acts as a platform for intellectual engagement and dialogue between financial market experts, the banking sector and the policy makers in Kenya. It therefore contributes to an informed discussion that influences critical financial market debates and policies.

Kenya Bankers Economic Bulletin

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From the CEO's desk

It is our honour to bring to you, Volume 2 of 2012, of the Kenya Bankers Economic Bulletin which covers the first half of 2012. The Bulletin is prepared under the Kenya Bankers Association's Centre for Research on Financial Markets and Policy. The Centre offers a number of resources to the financial industry – primarily in the banking sector- including opinions on macroeconomic trends in Kenya and beyond, policy analysis as well as sponsored research. In its research activities, the Centre is currently collaborating with researchers from the Central Bank of Kenya, the Kenya School of Monetary Studies, Strathmore Business School, Kenyatta University, Egerton University, The International Monetary Fund and the Kenya Institute for Public Policy Research and Analysis. Through rigorous and objective research, the Centre, this year, hopes to come up with measures to address constraints to credit access and reduce the cost of credit in Kenya.

This bulletin is hopefully beneficial to stakeholders in the financial sector who need quick numbers for decision making or analysis. We will be very delighted to get any feedback and suggestions on the contents of the bulletin in order to benefit you more.

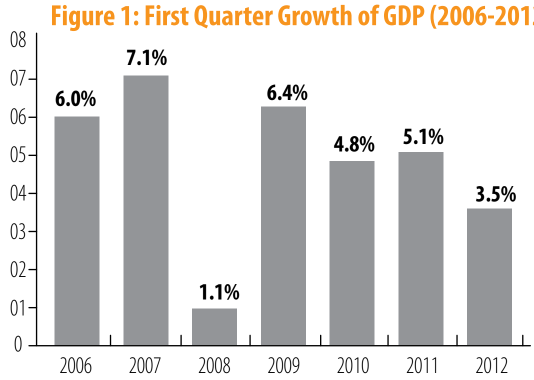
– Habil Olaka,
CEO, Kenya Bankers Association

Growth of Gross Domestic Product (GDP)

Economic growth statistics released by the Kenya National Bureau of Statistics in May 2012 showed that the economy grew by 4.4 percent in 2011, which was slower than the revised growth of 5.8 percent achieved in 2010. The Gross Domestic Product (GDP) for the first quarter of 2012 grew by 3.5 percent, a 1.6 percent fall, compared to a 5.1 percent growth in the same quarter in 2011. The fall in growth is mainly attributed to the slowdown in domestic demand following the tightening of credit as lending rates increased due to monetary policy tightening. Over the same period, there was rapid depreciation of the exchange rates which pushed up general prices. Price increases resulted from increase in oil prices and other imported inputs which were passed on to the consumers of domestically produced final products. As at June 2012, the overall inflation rate had dropped to 10.05 percent from a high of 19.72 percent recorded in November 2011. As a result of the drop in inflation, lending rates started to decline in tandem. Lending rates dropped from 20.34 percent in March 2012 to 20.12 percent in May 2012. The reduction in lending rates is expected to increase credit and investments leading to increased economic growth from the second half of 2012 and into 2013 if the momentum of the fall in lending rates is maintained.

Global oil prices also fell in the first half of 2012. Crude oil prices fell from USD 122.97 per barrel in March 2012 to USD 93.98 per barrel by June 2012. The effects of this drop are likely to be felt in the second half of 2012 since oil prices in Kenya are controlled by the Energy Regulatory Commission (ERC) and the ERC only reduced oil prices in mid July 2012. But the ERC is likely to be under pressure from the oil marketers to increase oil prices again since crude oil prices started to rise again from July 2012. The Euro Zone Crisis on the other hand continued to spread to other countries in the second quarter of 2012 with the latest victim being Spain with the Spanish government seeking and getting a bailout package from the European Union (EU). The EU agreed to grant Spain a loan of €100 billion ($125 billion) which the Spanish government planned to funnel to banks that need capital for bank re capitalization. Spain formally requested for the loan on June 25th 2012.

Figure 1: First Quarter Growth of GDP (2006-2012)



Source: KNBS

Agriculture

Reeling from the effects of drought in 2011, the agricultural sector continues to perform below its potential. The sector recorded a reduced growth in 2011 of 1.5 percent down from a growth of 6.4 percent (revised) in 2010. In the first quarter of 2012, the sector recorded a growth of 2.3 per cent. The performance was an improvement compared to 0.2 per cent growth in the first quarter of 2011. In the second quarter of 2012, the agricultural sector recorded a growth of 5.2 percent compared to a growth of 3.0 percent recorded in the same quarter in 2011.

Tea production was lower in the first half of 2012 with an average of 22,648 Metric Tonnes produced between January and May 2012 compared to average production of 29,162 Metric Tonnes in the same period in 2011. Tea prices in the first half of 2012 stood at an average of Kshs 249 per kg compared to Kshs 247.80 per kg in the same period in 2011. This represents a slight increase in tea prices in the first half of 2012 compared to the same period in 2011.

Figure 2: Tea Production and prices

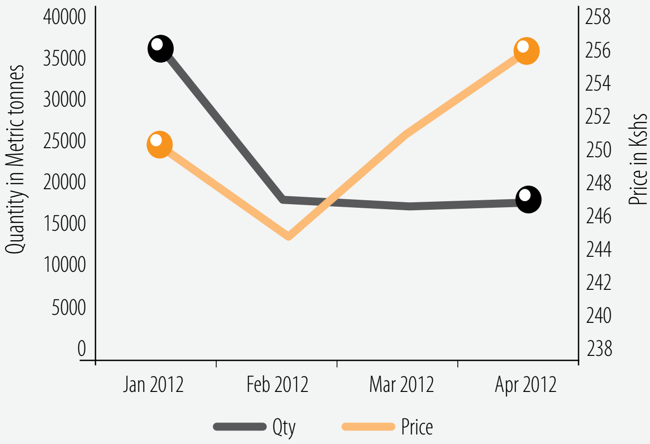
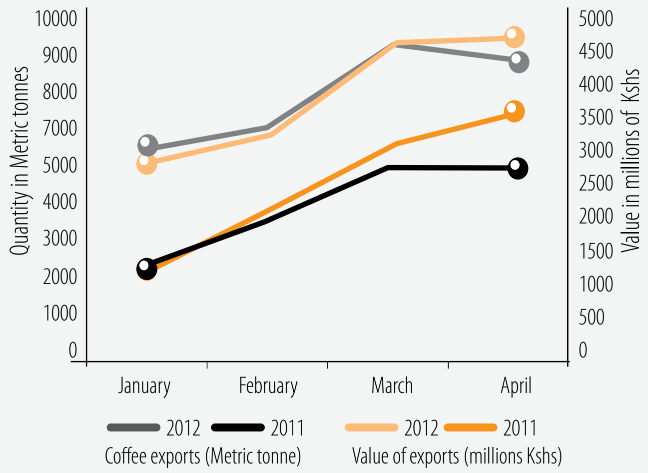
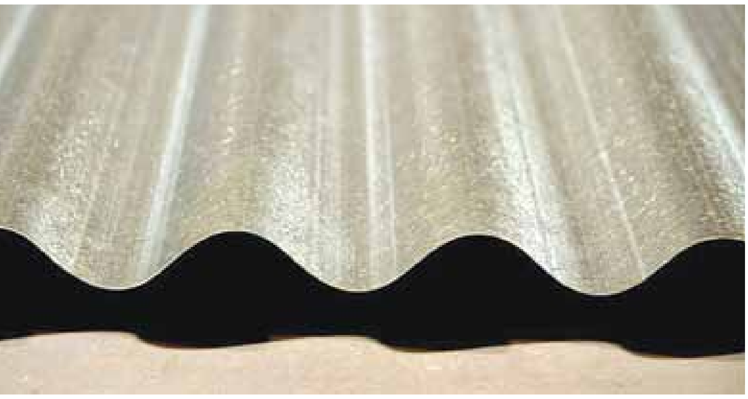


Figure 3: Coffee Exports (quantity and value) in 2011 and 2012



The quantity of coffee exported in the first four months of 2012 were on average higher compared to the quantity exported in the same months in 2011. Exports of coffee between January and April 2012 stood at an average of 4,111 MT compared to 3,695 MT exported in the first four months of 2011. The value of the coffee exported in the first four months of 2012 was also on average higher compared to the value of the coffee exported in the same period in 2011.



In the first four months of 2012, horticultural exports averaged at 18,168 MT compared to 19,624 MT in the same period in 2011. This represented a slight decrease in the quantity of horticultural exports. The value of those exports on the other hand went up from an average of Kshs 7386 Million between January and April 2012 to Kshs 7428 Million in the same period in 2012. In the first quarter of 2012, the volume of horticultural exports had decreased by 9.9 percent, from 55,050 metric tonnes in 2011 to 49,602 metric tonnes, although the value had slightly increased by 3.2 percent during the same period, from 22, 390 million shillings to 23, 100 million shillings. The volume of cut flowers exported in the first quarter increased by 6.8 percent to 29, 608 metric tonnes, up from 27, 732 metric tonnes in 2011, although fruits and vegetable export volumes declined 3.5 percent and 12.1 percent respectively. Similarly, the value of cut flowers increased 18.7 percent to Kshs. 17, 311 million up from Kshs. 14, 581 million in 2011.

Figure 4: Horticultural exports (quantity and value) in 2011 and 2012

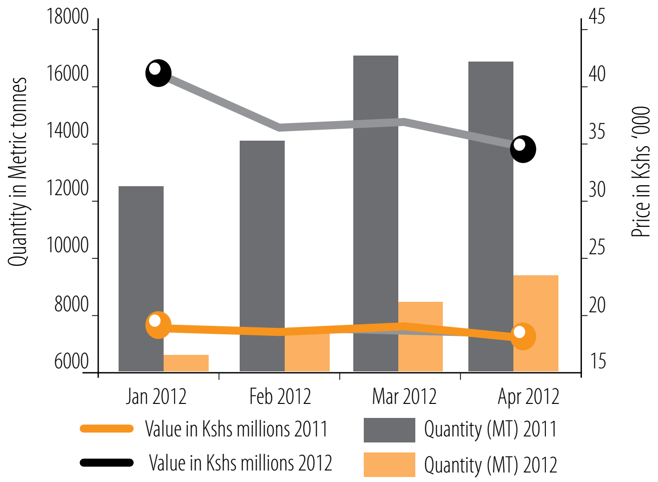
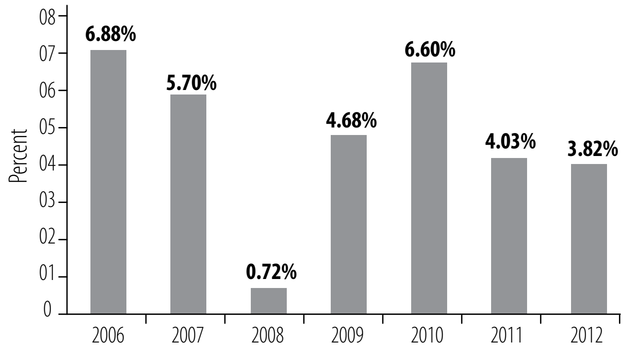


Figure 5: First Quarter Growth in Manufacturing ('06 -'12)



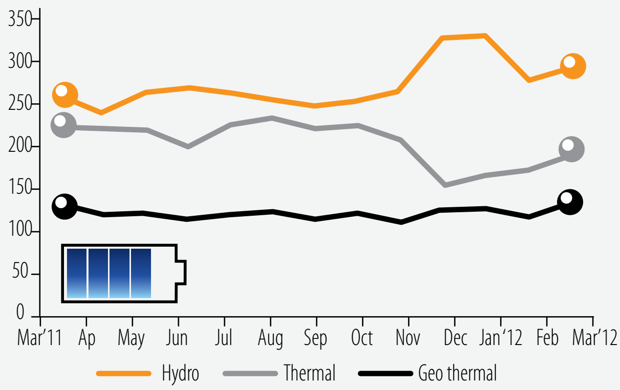
Manufacturing

Growth in the manufacturing sector remained relatively flat, registering a 0.2 percent decline and growing at 3.8 percent in the first quarter of 2012, compared to a 4.0 percent growth rate in the same quarter in 2011. This is the second consecutive year that manufacturing has declined in the first quarter, with increased pressure from imports from Asia and South Africa contributing to the slow growth rates. High energy costs, delays in processing VAT refunds and bottlenecks at customs clearance at East African Community gateways also hurt manufacturers. Nevertheless, efforts are being made to address the challenges faced in the in the implementation of the East African Community Common Market Protocol.

Energy

In the first three months of 2012 average petrol, diesel and kerosene prices for the first quarter of 2012 increased by 13.3 percent, 15.7 percent and 5.6 percent respectively to Kshs 112.4, 106.95 and 85.85 per litre respectively, up from Kshs. 99.22, 92.403 and 81.28 per litre respectively in the same period of 2011. High global oil prices, supply chain bottlenecks and high transportation costs in the high seas contributed to the price increase. The pricing formula used by the Energy Regulatory Commission did not result in significant reductions in average petroleum prices locally. Hydroelectric power generation dipped in February 2012 due to dry weather and low water levels, thus necessitating increased use of thermal power generation, which is more costly. Nevertheless, total electricity generation significantly improved in the first quarter of 2012, increasing by 202.4 percent to 1929.9 million KWh from 638.3 million

Figure 6: Electricity Generation by Source
March 2011 to March 2012



Source: KNBS

Building and Construction

The total value of building plans approved by the Nairobi City Council for the months of January and February decreased 17.6% in 2012, to Kshs 18255.8 million down from Kshs 22166.9 million in 2011. Nevertheless, the sector continued growing during the first quarter of 2012 albeit at a slower rate, despite the high cost of credit , with consumption of cement, a key indicator in the industry increasing 3.7% to 829,933 metric tonnes, from 800,175 metric tonnes in 2011 compared to a 19.9% increase during the same period in 2011, ..

Transport and Communications

The number of new vehicle registrations decreased significantly during the first quarter of 2012. The registrations decreased 23.3% from 51492 vehicles in the first quarter of 2011 to 39489 vehicles in during the same period 2012 compared to a 7.6% increase in 2011 High interest rates likely contributed to the decline in motor vehicle purchases since many vehicles are funded by loans. Motorcycles constituted the highest type of vehicle registered at 46.7%, although the number registered declined 37.3%. Motorcycles are an important means of transport, particularly in the rural areas and are also an important source of employment, especially for youth. The construction of the Southern Bypass commenced in March and is expected to provide a link to the airport and reduce traffic congestion on the busy Mombasa Highway.

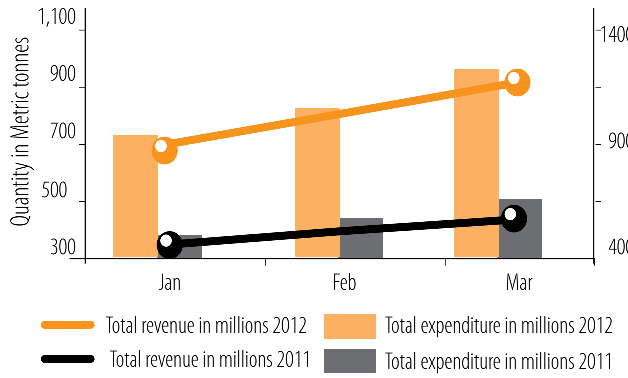
In the communications sub-sector, the government is stepping up efforts to facilitate migration from analogue to digital broadcasting.

Tourism

Visitor arrivals decreased marginally by 0.3% in the first quarter of 2012, at 312,258 visitors from, 313,105 visitors in 2011, compared to a 15.1% increase during the same period in 2011 from 271,916 visitors in 2010. The Eurozone debt crisis and security threats as a result of the military campaign in Somalia, among other reasons continue to affect tourist numbers. Despite increased surveillance and security checks in most public places, sporadic attacks threaten security of tourists and locals alike. There is need to improve the security approach and rely more on security intelligence and more sophisticated surveillance rather than the wands that are commonly in use at public places.

Figure 7: Growth of Tourist Arrivals in the First Quarters of 2011 and 2012

Figure 8: Total Government Revenues and Expenditures in



Financing of Government

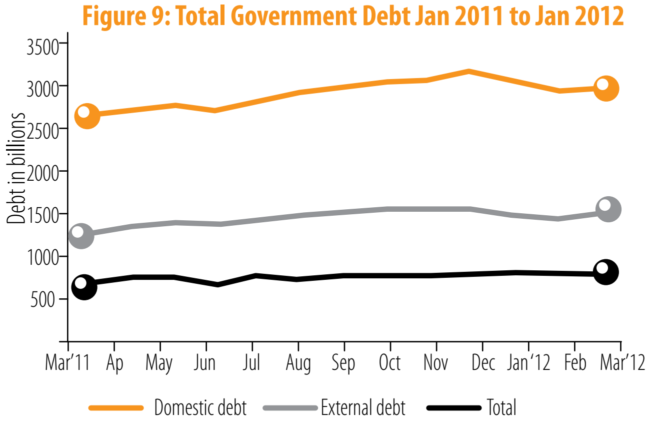
Total revenue at the end of the first quarter in 2012 was Kshs 630.639 billion, a 36% increase compared to the end of the same period in 2011, where it stood at Kshs 463.857 billion. Total tax receipts increased by 8.6 percent to Kshs 453.134 billion as of March 2012, up from Kshs 417.247 billion as of March 2011. This growth in tax revenues was however slower compared to the same period in 2011, when total tax receipts grew by 26.5 percent from Kshs 329.879 billion. Possible reasons for the slowdown in tax revenues include depressed GDP growth and consumption following increase in inflation and interest rates over the period as well as exchange rate depreciation over the period which caused receipts from import duties to decline. There is need to widen the tax base so as to reduce the tax burden on just a few registered businesses and those in formal employment.

Public Debt

The total tax revenues as at May 2012 stood at Kshs 573.2 (provisional) compared to Kshs 513.9 billion in the same period in 2011. The stock of domestic debt as at April 2012 stood at Kshs 896.4 billion. The total stock of public debt for the first quarter of 2012 (Jan to March 2012) on the other hand increased by 11.7 percent to Kshs 4600.54 billion, up from Kshs 4119.77 billion in the same period in 2011. This however represented , a 6.2 percent decrease in terms of Debt to GDP ratio, from 52.6 percent in 2011 to 46.4 percent in 2012. The decrease in the Debt to GDP ratio is partly caused by austerity measures being undertaken by the government. Japan and France were the biggest bilateral creditors. The World Bank's IDA was the biggest multilateral creditor, accounting for bilateral creditors, while the World Bank's 40.9 percent of the total government and guaranteed debt.

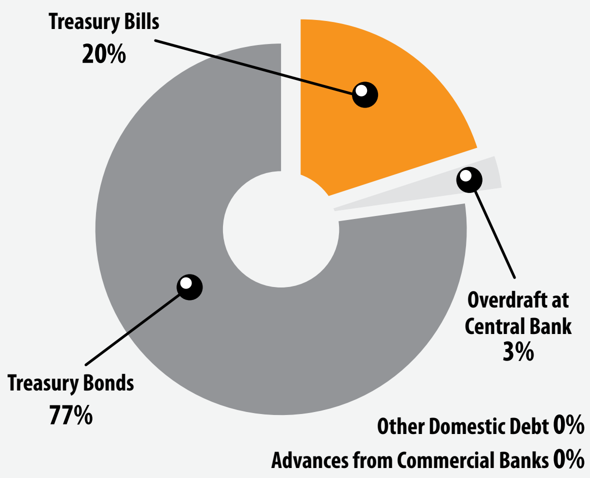
In terms of its composition, treasury bond holdings constitute 77 percent of the domestic debt. This is followed by Treasury bill holdings which constitute 20 percent of the domestic debt

Figure 9: Total Government Debt Jan 2011 to Jan 2012



Source: CBK

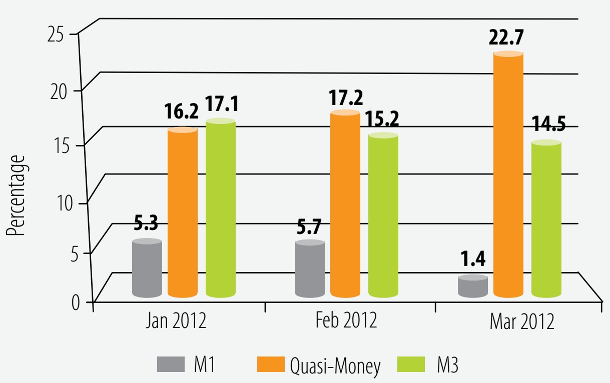
Figure 10: Composition of domestic Debt



Money and Credit

The total stock of money grew 13.5 percent in the first quarter of 2012. Growth of M1, Quasi-Money and M3 increased 4.1 percent 18.7 percent and 15.6 percent respectively. Although May and June figures are not yet available, as at April 2012, growth in domestic credit has remained unchanged. Total domestic credit increased 23.6 percent from Kshs. 1264.4 billion in 2011 to Kshs. 1557.3 billion, compared to a 23.16 percent increase in 2011, up from Kshs. 1022.8 billion in 2010. High lending rates contributed to the flat growth. in 2012. Growth of credit to the private sector declined to 24.2 percent in 2012, from 27.7 percent in 2011. The trade sector was the largest debtor to the banking system, borrowing Kshs. 202.3 billion. Private households came in second, borrowing Kshs. 164.4 billion.

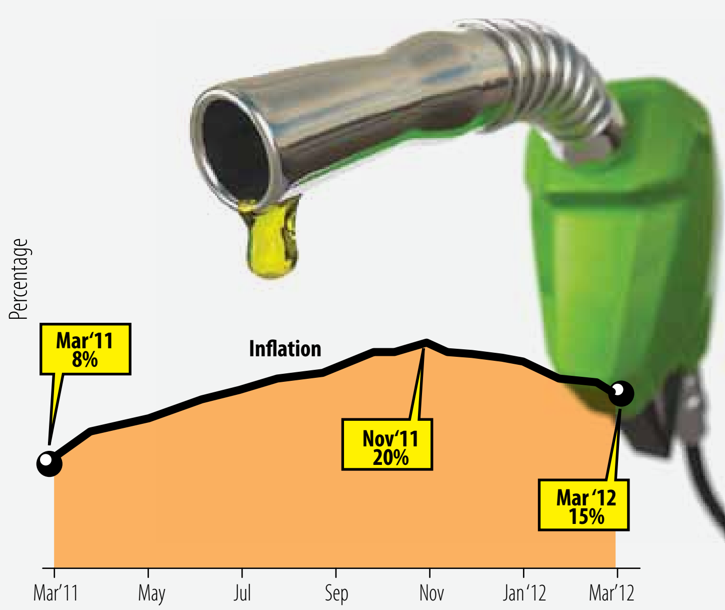
Figure 11: Growth in Money Supply Components; First Quarter of 2012



Inflation

Overall inflation continued its four month downward trend during the first quarter of 2012, after peaking at 19.42 percent during the fourth quarter of 2011. The March 2012 inflation rate stood at 15.61 percent, responding well to monetary policy tightening. Nevertheless, the rate was still below the single digit target set by the monetary authorities. Energy and food remained the biggest contributors to overall inflation, particularly petroleum, and maize.

Figure 12: Inflation Trends

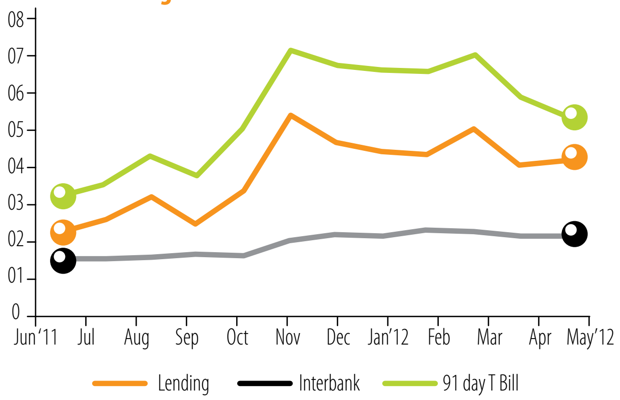


Source: KNBS

Interest Rates

The average 91-day Treasury bill yield rate for the first quarter increased by a whopping 644.3 percent to 19.4 percent in 2012, up from 2.6 percent during the same period in 2011 as effects of the rapid shilling depreciation and high inflation start to abate. The Central Bank Rate stayed steady at 18 percent despite pressure to reduce it following the steady decline in the inflation rate. Nevertheless, the Monetary Policy Committee agreed with some stakeholders who argued that it would be too soon to lower the rate, as this would have reversed the gains made in tackling inflation. Consequently, average commercial lending rates for the first quarter also increased 43.7 percent, from 13.9 percent in 2011 to 20.1 percent in 2012. There were attempts by the legislature to regulate interest rates through an amendment to the Finance Bill 2011. Had the amendments gone through, they would have had far-reaching consequences to the financial sector in the end might actually have exacerbated the

Figure 13: Trends interest Rates



high interest rate spread situation in the country. Overall, rates are unlikely to be substantially decreased in the near term as the monetary authorities target single digit inflation. Whereas the high interest rates have managed to reduce inflation, they have led to borrowing from the international markets where rates are substantially lower, and this might affect the country's balance of payments position.

Balance of Payments

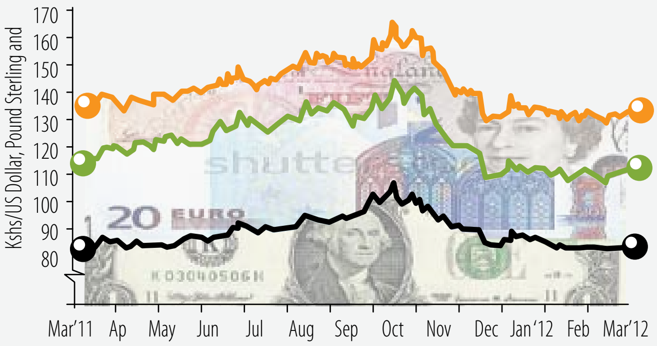
The current account deficit for the first quarter of 2012 increased to Kshs 81.116 billion, up from Kshs 76.440 billion during the same quarter in 2011. The continuing widening of the deficit can be attributed to increasing global oil prices, with Abu Dhabi prices averaging US$ 120.55 per barrel in the first quarter 2012, a 16.1 percent increase from 2011, when the average price was US$103.88 per barrel. Additionally, the value of horticulture, tea and coffee exports only marginally increased. Tourist arrivals remained relatively constant, decreasing by 0.3 percent in the first quarter of 2012, compared to 2011.

Gross reserves as of the end of first quarter of 2012 stood at Kshs 511.537 billion, a 13.3% increase from Kshs 452.169 billon, compared to a 12 percent increase in 2011, from Kshs 400.485 billion. Diaspora remittances increased 56 percent from Kshs. 16.157 billion in 2011 to 25.252 billion. This significant increase in remittances is despite the fact that growth in the US economy, the primary source of remittances grew at a meagre 1.9% in the first quarter of 2012.

Exchange Rate

The Kenya Shilling continued its appreciation against the major world currencies during the first quarter of 2012. The shilling averaged at Kshs, 84.12/US Dollar, Kshs 110.33/Euro and Kshs 132.16/Sterling Pound, compared to Kshs 93.90/US Dollar, Kshs 126.69/Euro, and Kshs 147.58/ Sterling Pound during the fourth quarter of 2011, The shilling stabilised although a high import bill, particularly petroleum continued to exert pressure on the local currency.

Figure 14: Movements in Exchange rates – March 2011 to March 2012

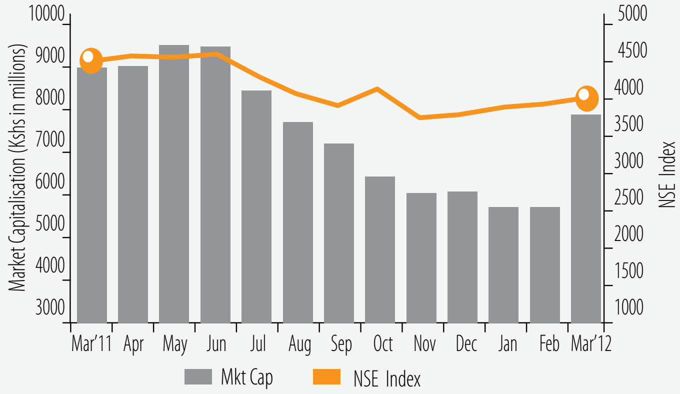


Source: CBK

Nairobi Stock Exchange

The Nairobi Stock Exchange market capitalisation declined in the months of January and February 2012, before increasing steeply by 82.8% in March to stand at Kshs 6386 million, up from Kshs 3493 million in February, Total market capitalisation for the first quarter of 2012 declined by 43.3% to Kshs 13.423 billion, down from Kshs 23.66 billion during the same period in 2011.

Figure 16: Activity at the Nairobi Securities Exchange



Source: KNBS

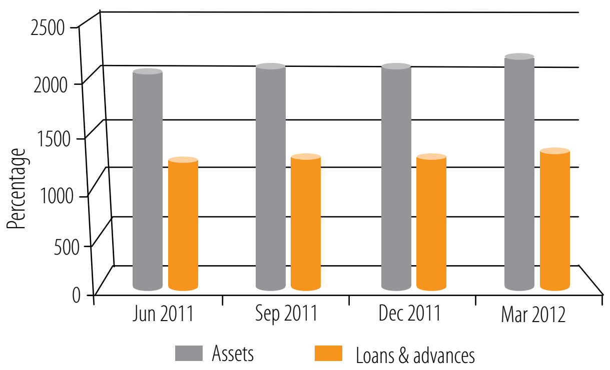
Banking Sector Performance

The Sector showed improved performance over the period between the second quarter of 2011 and first quarter of 2012. For instance the size of assets stood at Kshs. 2.1 Trillion Shillings loans & advances worth Kshs. 1.2 Trillion Shillings, while the deposit base was Kshs. 1.6 Trillion Shillings and profit before tax of Kshs. 24.7 billion as at 31st March 2012.

Assets and Loans

The banking sector assets increased by 10.5% from 1.9 Trillion Shillings in the quarter ending June 2011 to 2.1 Trillion Shillings in the quarter ending March 2012. The loans and advances on the other side increased from 1.1 Trillion Shillings to 1.24 Trillion Shillings giving a percentage increase of 12.73%

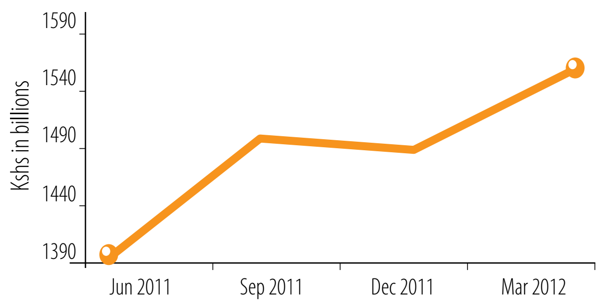
Figure 17: Total Assets and Loans June 2011 to March 2012



Deposits

Deposits act as the main source of funding for the banking sector. They increased by 11.43% from 1.4 Trillion Shillings in the second quarter of 2011 to 1.56 Trillion Shillings in the first quarter of 2012. This was attributed mainly by the increase in bank branches and bank account deposits. The bank branches increased by 6.53% from 1,102 branches during the June 2011 quarter to 1,174 branches during the March 2012 quarter. Over the same period the bank account deposits increased from 12,800,000 to 14,356,759.

Figure 18: Total Deposits June 2011 to March 2012



Total Capital and Shareholder Funds

Total Capital increased by 17 percent from 240.1 Billion shillings in June 2011 to 280.9 billion shillings in March 2012. At the same period shareholders' funds improved at a margin of 13.17 percent from 264.9 billion shillings to 299.8 billion shillings. On the other hand the core capital to total risk weighted Assets improved from 19 percent to 20.2 percent. In addition the total capital to total risk weighted Assets improved from 16.9 percent to 17.9 percent.

Figure 19: Total Capital and Shareholders funds June 2011 to March 2012

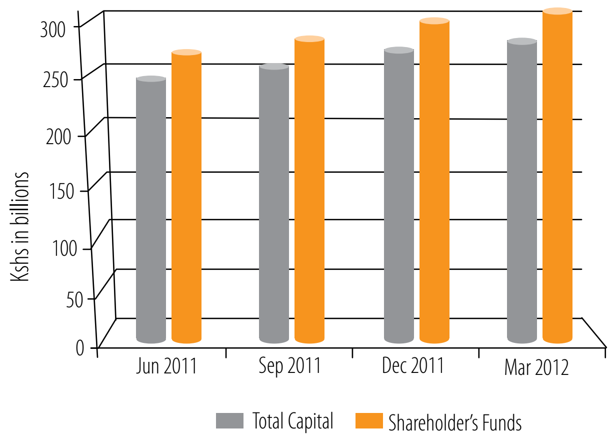
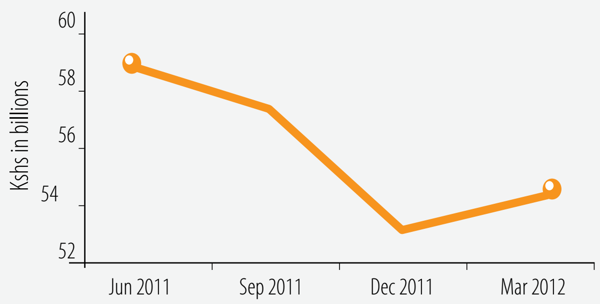


Figure 20: Gross Non-Performing Loans (NPLs)



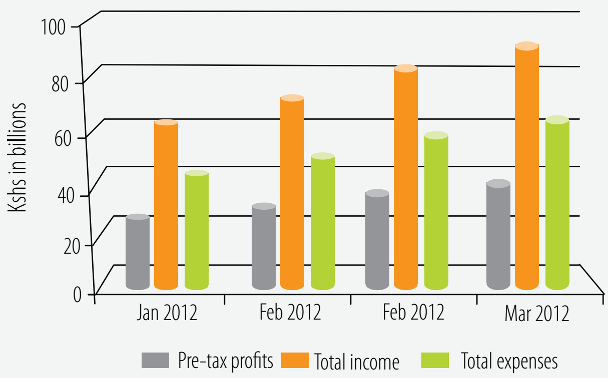
Gross Non-Performing Loans (NPLs)

During the first quarter of 2012 the sector recorded a stock of non-performing loans of 53.7 Billion Shillings which was a decline of 7.89 percent up from 58.3 Billion Shillings. The improvement could have been partly attributed to enhanced appraisal standards deployed by banks and partly by recoveries and write offs during the period.

Bank Profitability

During the 1st quarter of 2012, the sector registered Kshs. 24.7 billion pre-tax profits, which was an increase of 17.62 percent from Kshs 21.0 billion recorded in the quarter ending June 2011. Total income also stood at Kshs 88.4 billion from Kshs 56.2 billion as an increase by 57.3 percent. Total expenses on the other hand increased by 81.48 percent from Kshs 35.1 billion to Kshs 63.7 billion. Liquidity ratio decreased from 37.3% to 38.9% at a margin of 4.11 percent.

Figure 21: Bank Profitability



Feature

The East African Community Monetary Union

By Francis Ogula, KBA

The establishment of the proposed East African Monetary Union will be one of the last steps in realising the economic, social and political integration of the East African Community (EAC) member states namely Kenya, Burundi, Rwanda, Tanzania, and Uganda. This is expected to culminate in a political federation. Since the East African Community came into being in July 2000, precursors to the monetary union include establishment of the EAC Legislative Assembly and the EAC Court of Justice as the legislative and judicial arms of the Community respectively, and the EAC Customs Union and subsequently the EAC Common Market Protocol.

From the European Monetary Union experience, the requisite economic conditions for a viable monetary union include convergence of the economies; and economic and financial integration, allowing for unrestricted flow of goods, services, labour, capital and the like within the union. The proposed East African Community Monetary Union presents a myriad of opportunities for economic and financial integration and subsequently accelerated economic growth to member states. First, with an estimated combined population of about 141 million and a gross domestic product (GDP) of almost of 83 billion US Dollars, and relative homogeneity economically and geographically, the EAC Monetary Union will be a huge market for farmers, manufacturers, and traders while presenting consumers with more choices and variety; this will enhance efficiency and competition in production. Secondly, prices and costs across the bloc will be more easily compared without having to take into consideration currency conversion costs. A lot of research done suggests that indeed the East African Community is an optimal currency area, and thus at least from an economic perspective, suitable for a monetary union.

Possible challenges in the establishment and sustenance of the EAC monetary union may include the issue of internal exchange rate regime - the exchange rates of EAC members within the community and the external exchange rate regime - the exchange rate of the EAC as a whole vis-à-vis major world currencies. How the macroeconomic indicators such as interest rates, inflation, government debt are managed, with the goal of convergence will determine how soon a viable currency union can be commenced. Consequently, there will be a need to prudently manage and co-ordinate economic affairs as we target the value of the common currency taking into consideration the economic interests of the EAC as a whole, as well as those of individual member states.

The Central Banks of the five nations, as well as a yet to be established East African Central Bank, which will play an important role in managing the common currency , will need to co-ordinate their operations while at the same time ensuring that the individual countries do not lose out on the benefits of the monetary union.

Unfortunately, the Common Market Protocol is facing teething problems with most of the member states seeming unwilling to fully open up their markets for intra-regional trade and are using non-tariff barriers such as lengthy customs procedures and administrative procedures, sanitary and phytosanitary measures, among others to restrict free trade. There seems to be some apprehension towards opening up markets to intra-regional trade, particularly Tanzania, and this leads to retaliatory measures, which do not augur well for integration. Political goodwill is of paramount importance for the success of any union, thus lessons from the dissolution of the old EAC in 1977 need to be learnt and efforts made from the highest levels of government to ensure that any actions by government officials that go against the spirit and letter of the EAC Treaty are promptly addressed. The monetary union cannot be realised if governments are not fully committed to implementing the Common Market Protocol, including issuance of work permits, police roadblocks among others. Furthermore, there will be need to strictly adhere to common rules set by the member states without resorting to arm-twisting or nationalist rhetoric. So far, in all likelihood, the 2012 goal of adopting a common currency is highly unlikely. In addition, the lessons being learnt in the Eurozone crisis, where distressed countries such as Greece do not have sufficient monetary policy discretion to might have led to a rethink on the urgency of an EAC Monetary Union.

Nevertheless, it is better to miss deadlines rather than rushing into a monetary union without fully understanding and accepting the political and economic implication

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Francis Ogula is a Research Fellow, Centre for Research on Financial Markets and Policy, KBA.

Section B: Contribution from Member Banks

How does the Central Bank Rate (CBR) Affect Lending rates and inflation?

By Erastus K. Njoroge, Fina Bank

There are two distinct though not mutually exclusive ways to control inflation; through the use of monetary policy or through the use of fiscal policy. The use of monetary policy presumes that inflation is caused by excess of purchasing power. In other words, the cause of inflation is too much money chasing too few a good. As such, the objective in case of an increasing inflation is to reduce money in circulation and consequently, reduce consumer demand and inflation.

The Central bank of Kenya (CBK) uses the CBR to signal the direction of monetary policy. In case of high inflation, the CBK would increase the CBR. This triggers an increase in all the interest rates in the market including the treasury bill rates. An increase in T-Bill rates creates pressure on deposits rates to go up since T-bills are an alternative investment of funds. Because of the increase in deposits rates, which is the cost of funds to the banks, the lending rates offered by the banks on loans also increase. This reduces the uptake of loans, reducing consumption and inflation. Blaming banks for increasing their lending rates when the CBR increases therefore misses to recognize the link between the CBR and the lending rates.

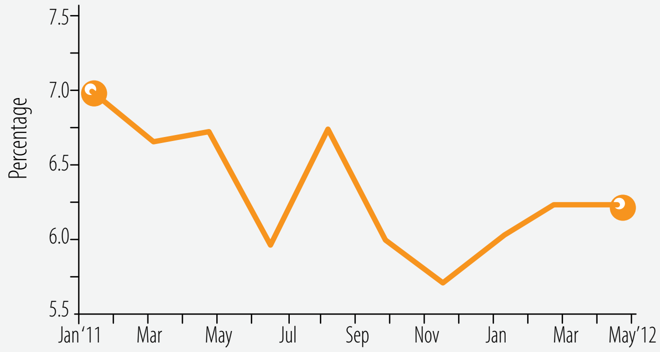
The central bank rate witnessed an unprecedented increase in late 2011 which pushed lending rates to the roof. The rate was adjusted to 16.5 percent in November 2011 from 11 percent. In December 2011, the Monetary Policy Committee (MPC) of the CBK again raised the CBR to 18 per cent in order to reduce inflation further and strengthen the local currency which was rapidly weakening. The CBR was retained at the high levels until July 2012 when it was slashed by 1500 basis points i.e 1.5% at the back of reduced inflation and stabilized exchange rate.

As a result of the rapid increase in the CBR, the lending rates also increased as shown in the figure below:

As can be seen from the figure below, interest rates were generally going up following the tight monetary policy stance of the CBK until about March 2012, when interest rates started to decline. This shows how monetary policy actions impact directly on other interest rates in the market.

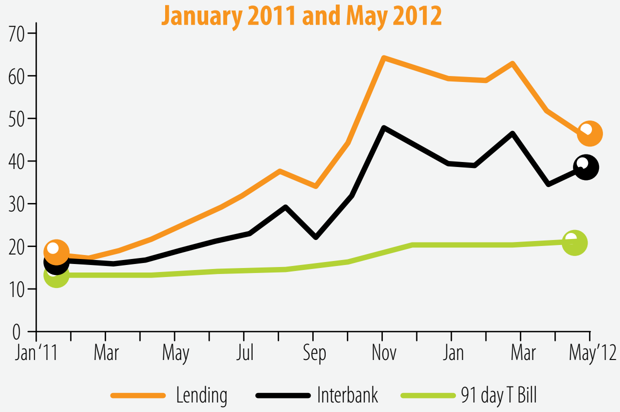
Erastus K. Njoroge, is an Analyst at Fina Bank Limited

Figure B1: CBR movements Jan 2010 – Nov 2011



Source: Central Bank

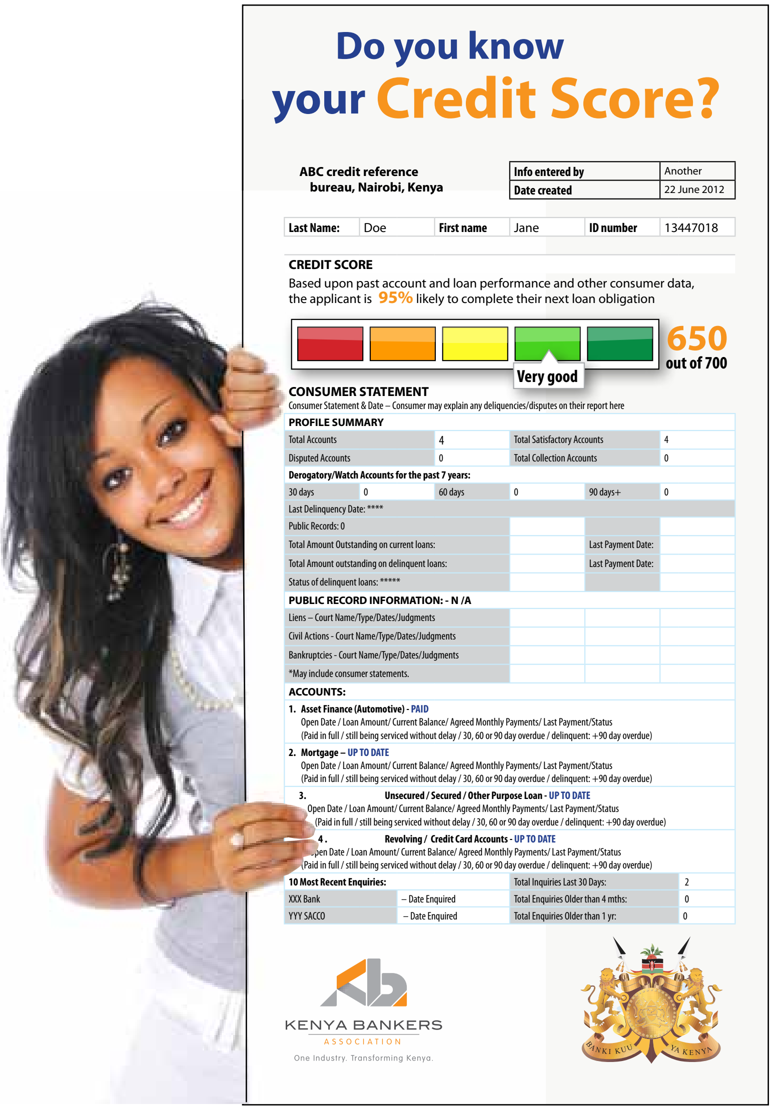
Figure B2: Movement in market interest rates between January 2011 and May 2012



Contribution from the Kenya Credit Information Sharing Initiative (KCISI)

Credit Referencing gaining ground in Kenya:

"Sharing of credit information can make an important contribution to the development of a country's financial system. Our vision is to develop a credit information sharing CIS mechanism for Kenya that will become an important aspect of financial infrastructure that enables lenders to improve risk assessment, and consumers obtain credit at competitive terms,"



By Jared Getenga,
Kenya Credit Information Sharing Initiative

Credit information sharing (CIS) has increasingly and steadily gained ground in Kenya's financial services market. The CIS project recently won a first runner up award under the Public Service Recognition and Awards Scheme (PSR&AS) of the Ministry of Public Service, under a category whose assessment focus was on the project's ability to save cost and time, its efficiency, the generation of competition, and its impact to the customer. This award was a good indicator that credit reports and credit scores have immense benefits to both lenders and borrowers.

Amongst these benefits is the ability of lenders to improve the way they assess and manage credit risk, and for borrowers to negotiate better credit terms with lenders. Armed with their credit reports, highly rated borrowers can negotiate for lower interest rates or even waiver of collateral. A good and credible credit history can be a substitute for tangible collateral. This is an avenue that many Kenyans with limited assets, can exploit to access loans from lenders. Moreover good repayment records in payment of utilities such as water, electricity, telephone, SACCO & university/education loans infer good reputation on a borrower's credit history, and help create "reputation collateral" for the underserved populace.

The economic impact of information sharing in consumer credit markets always points towards greater access to credit. Today only 2 million Kenyans (5% of the population) are able to access credit contrasted to over 80% of the population accessing credit in the developed world. Undoubtedly CIS can empower people to access credit and become more responsible over its use and repayment. The development of a sustainable CIS mechanism is indeed a key component of financial sector reforms for our economy.

It should be noted that such benefits can only be achieved when the entire credit market participates by sharing both negative and positive data (full file credit information) across sectors. Over the last two years, laws on CIS only mandated the sharing of negative credit information: thus only portraying the negative aspects of borrowers' trends on credit reports, which constitute only about 5% of the banking sector's entire loan book. In this regard, the Central Bank Act was amended in April 2012, mandating the sharing of positive credit information for banks. The law further authorized the participation of Deposit Taking Microfinance Institutions in banking sector CIS. The Minister for Finance, with the budget speech of 2012/2013, recommended the inclusion of SACCOs, credit-only MFIs and DFIs in the CIS. This is mainly due to the fact that credit providers outside the banking sector have for some time now, expressed great interest in their inclusion in CIS, given the mechanism's anticipated benefit to them, their customers and the economy as a whole.

Recent statistics on the uptake of credit reports by commercial banks and the Deposit Protection Fund have been quite encouraging, with an average of about 77,000 credit reports being accessed per month by banks and customers. This is bound to increase with the sharing of full file credit information.

Over the next few months, banks will be testing their systems in readiness for roll out on sharing performing loan data, as the Central Bank amends their regulations in line with the new laws. DTMs have also commenced preparations to share their data, in accordance with these amendments. The Higher Education Loans Board (HELB) have been submitting both positive and negative information on their borrowers to the CRBs, consequently enriching the bank database.

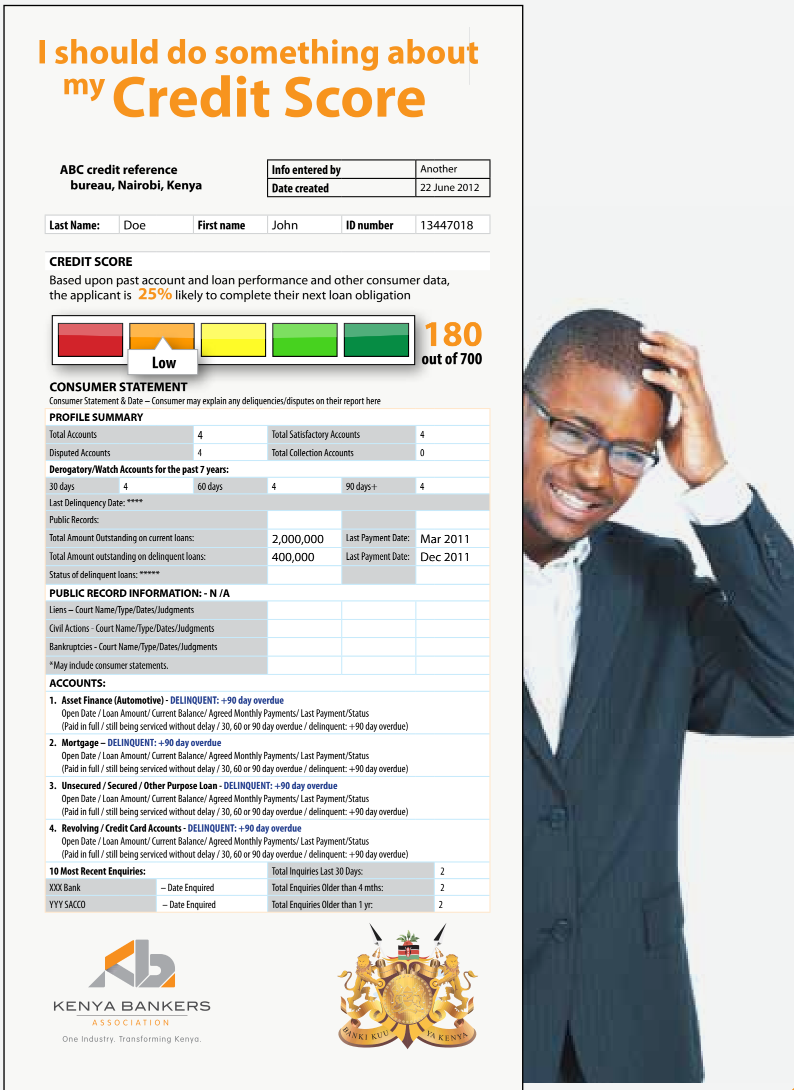
The Kenya Credit Information Sharing Initiative (KCISI) project office – based at the Kenya Bankers Association (KBA) – has been instrumental in co-ordinating the implementation of full file CIS amongst banks and non banks, with Phase II of the project looking to extend the mechanism to all credit providers in the country. In the midst of the project's accomplishments so far, however, a few challenges stand in the way.

First and most critical is that the current system is limited to commercial banks and Deposit Taking Microfinance Institutions only. Credit reports generated by such "segmented" systems give an incomplete and often misleading picture. "Comprehensive" systems, by contrast, allow a more complete credit profile of a consumer to be drawn. The use of non-financial data in credit files further offers the promise of a diversified information capital that will facilitate extension of reasonably-priced credit to those who have not previously accessed formal credit. Secondly, there is a challenge in ensuring that both lenders and borrowers are sufficiently sensitized on the merits of a robust CIS mechanism and are able to use it to their advantage. This calls for well thought out awareness campaigns and capacity building programs. It is particularly important that lenders develop skills that enable them apply credit management tools as effectively as possible so that low-risk customers are rewarded appropriately. Borrowers also ought to keep constant watch of their credit reports, and ensure that they are accurate and up to date, so that when necessary they can use them to exploit their due benefits.

Finally, the success of this process hinges on a robust legal framework that supports a full-file comprehensive data sharing mechanism. There's need to develop an effective legislation that addresses all aspects of credit bureau operations, data management and consumer protection.

Needless to say, the challenges in the current CIS system call for collective efforts by all stakeholders. In April 2012, a CIS Forum comprising of various credit providers was formally constituted to drive the agenda

Peter Gikang'a, Manager Bank Supervision Department, CBK, during a workshop on an Alternate Dispute Mechanism for CIS (August 21, 2012). PHOTO/KCISI



KBA and CBK officers: The Credit Information Sharing project won the 1st runners up award (Knowledge and informational Management catergory) under the Public Service Recognition & Awards Scheme of the Ministry of Public Service . PHOTO/KCISI

of establishing a comprehensive CIS regime for Kenya. It is anticipated that, through this Forum, credit providers will establish a "Kenya Credit Providers Association (KCPA)" to address the challenges outlined above and help achieve the desired results of developing a fully-fledged financial infrastructure for Kenya.

In brief, over the last six months, KCISI has achieved the following milestones, with financial support from KBA, Financial Sector Deepening (FSD) Kenya, Financial & Legal Sector Technical Assistance Project (FLSTAP), and USAID's FIRM:

By the end of 2012, the project anticipates a roll out of live data sharing amongst banks and deposit taking MFIs within the bank database, and further hopes to launch CIS amongst credit only MFIs.

Additional reporting by Patricia Musau, Communications Officer, Kenya Credit Information Sharing Initiative (KCISI)

DATE	ACHIEVEMENT
Jan - Feb 2012	Established a road map, Code of Conduct and a Consumer Protection Guide for full file (both positive and negative) credit information sharing amongst banks.
Feb 2012	Hosted a dinner forum, comprising of executive representatives of Kenya's credit providers, to share past successes on the CIS Project, identify opportunities for a broader collaboration between various market players, and open a new chapter that will propel the process into a more inclusive mechanism.
Mar – Apr 2012	Conducted a capacity review of all deposit taking MFIs and credit only MFIs who are members of the Association of Microfinance Institutions (AMFI). The review was carried out to establish the readiness of MFIs to participate efficiently in CIS.
Mar '12 to date	Commenced a review of Kenyan laws on CIS with the intention of comparing them with international standards and made proposals bringing Kenya's credit reporting system closer to global best practices.
Mar 2012 to date	Commenced a baseline survey to establish an understanding of stakeholder opinion on the CIS mechanism; its operations, products and benefits.
April 2012	Commenced the development of a Toolkit, to serve as a reference instrument that guides the varied aspects of CIS implementation, at sectoral level and at institutional levels.
April 2012	Amendments were made to the Central Bank Act to mandate positive information sharing amongst banks and include deposit taking MFIs in CIS, within the bank database.
April 2012	The CIS National Forum was formally constituted by various credit providers, with KCISI as its secretariat, to oversee the implementation of a robust CIS mechanism for Kenya.
June 2012	Developed a roadmap for MFIs to pilot data submissions
June 2012	Commissioned arbitrators to review the existing dispute resolution mechanisms in the interest of consumer protection.
June 2012	Commenced the development of a stakeholder directory of all credit providers in Kenya to enhance networking amongst credit providers and policy makers in Kenya.
June / July '12	Conducted a review on banks to determine their readiness to use full file credit reports

the contributors

Habil Olaka has served as CEO of the Kenya Bankers Association since 2010. Previously, he was the Director of Operations of the East African Development Bank (EADB). He holds a First Class Honours BSc degree in Electrical Engineering from the University of Nairobi and an MBA in Finance from the Manchester Business School (UK). He is a member of the Institute of the Certified Public Accountants of Kenya (ICPAK) and the CFA Institute.

Dr. Jacob Oduor is the Director of the Centre for Research on Financial Markets and Policy at KBA. Dr. Oduor has over ten years experience in macro-economic policy research and university teaching. He most recently served as Senior Analyst at Kenya Institute for Public Policy Research and Analysis (KIPPRA) and has served as lecturer of Econometrics and Statistics at Kenyatta University for over seven years.

He is published in international journals, including the Journal of Policy Modelling Ecomonic Modelling and Journal of Development Effectiveness. He holds a PhD in Economics from Bielefeld University (Germany) and a Master's degree in Economics from Kenyatta University.

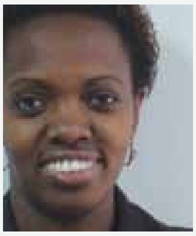
Lydia Mbura is a Research Fellow. She has experience in management, business analytics, corporate governance and ethics, and marketing. She has published a research paper on the "Effects of Logistics Outsourcing Strategies on Organisational Performance." in the International Journal of Business Management. She holds a Master's degree in Business Administration and Strategic Management from Jomo Kenyatta University of Agriculture and Technology of Nairobi; and a Bachelor of Commerce degree in Marketing from Kenyatta University.

Jared Getenga is the Project Manager, Kenya Credit Information Sharing Initiative (KCISI) on secondment from Central Bank of Kenya since August 2009. Operating under the auspices of KBA and CBK, KCISI is funded mainly by FSD Kenya and USAID (FIRM) for the development of a credit information sharing mechanism for banks and subsequently all credit providers in Kenya.

Before the secondment, Jared worked for 20 years with the Central Bank of Kenya (CBK) in Banking Supervision and in Deposit Protection as Statutory Manager and Liquidation Agent. Jared took two years' leave of absence from CBK to work with the Financial and Legal Sector Technical Assistance Project (FLSTAP) as Financial Sector Specialist. FLSTAP is a project funded by the World Bank IDA, DFID and GOK for purposes of coordinating technical assistance to strengthen Kenya's financial and legal sectors. He has a BCom and MBA from UON.

Francis Ogula is a Research Fellow. He has experience in banking and card services, primarily in the areas of credit, regulation, and operations. Other industry experience includes retail and security services. He holds a Master of Science in Finance degree from the University of London (UK); a Bachelor of Science in Computer Science from Catholic University of Eastern Africa; a Bachelor of Arts in Economics from Ohio State University (US); and a diploma in French studies.

Patricia Musau holds a Bachelor of Economics degree from the University of Nairobi, and has 9 years of experience managing Credit Risk Solutions and Debt Management Service for banks, having worked at the Kenya Bankers Association implementing the credit information sharing project under KCISI, as well as for two Credit Reference Bureaus - one of which is currently licensed by the Central Bank of Kenya. Patricia has also managed Finance and Administration roles for community based organizations funded by the Government of Kenya, UNICEF and Save the Children UK



Erastus Njoroge, works with Fina Bank as a Credit Analyst. He is a graduate of Mathematics and Economics from Kenyatta University. He is currently specializing in Financial Economics pursuing a Masters in Economics- Finance at Kenyatta University.

He has experience in Commercial banking, Investment bank, research and lecturing having lectured Economics and Statistics at Excel Institute of Professionals Thika, Thika technical Training institute and Reward Institute of Professionals.

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