KENYA BANKERS ECONOMIC BULLETIN

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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 third quarter of 2012 and the emerging trends during the fourth 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; and banking sector performance.

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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In this Issue

This bulletin can also be downloaded from: **www.kba.co.ke**

From the CEO's Desk

Since the last edition of the Kenya Bankers Economic Bulletin, we have witnessed substantial developments within the banking sector and across industries as highlighted in this edition. Possibly the most compelling being the effects of monetary and fiscal policy on the country's inflation which declined from a high of 19.7 percent in November 2011 to slightly over 6 percent in August 2012.

In addition to discussing the macroeconomic environment in relation to the various sectors, we discuss the KBA's efforts to enhance efficiency within the banking sector through the automation of the cheque clearing process. This seemingly subtle change is often overlooked; but when we appreciate the journey -- which KBA embarked on in 1996 to modernise payments via cutting-edge technology (at the time it was the introduction of Magnetic Ink Character Recognition) to today when banks process payments through high capacity Wide Area Network links -- it is then that you realise business and trade are moving that much quicker, causing positive developments in the economy that much faster.

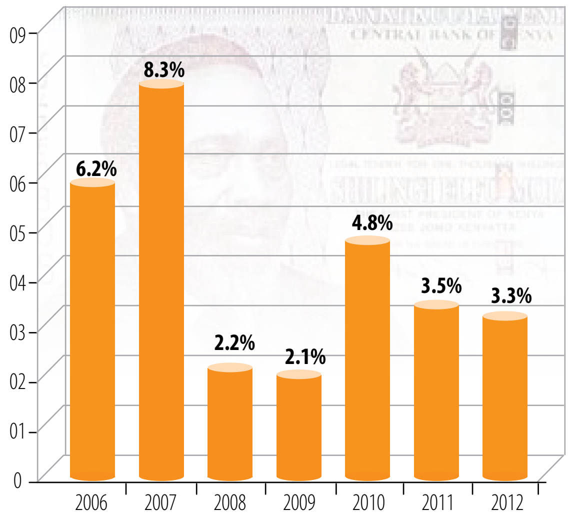
We hope you will find new and helpful information covered in this edition. We always welcome your feedback and comments via email to research@kba.co.ke.

– Habil Olaka
CEO, Kenya Bankers Association

Growth of Gross Domestic Product (GDP)

The Kenya National Bureau of Statistics (KNBS) estimated that the Kenyan economy grew by 3.3 percent in the second quarter of 2012 down from a growth of 3.5 percent in the first quarter of 2012. This is also lower than the 4.1 percent recorded in the second quarter of 2011. The slowdown in the second quarter of 2012 could be attributed to the spillover effects of the slowdown witnessed in the first quarter of 2012 and the last two quarters of 2011. Even though monetary policy eased in the second quarter of 2012 and domestic credit expanded, expansion in output following the expansion in credit would take time. Following the slowdown in economic performance in the first two quarters of 2012, growth forecasts for 2012 which had been projected at 5.2 percent will not possibly be realized. Performance of the economy in the last two quarters of 2012 is however expected to be better than the first two quarters of 2012 given the loose monetary policy stance taken by the Central bank of Kenya (CBK) in the second quarter of 2012. Figure 1 below shows the second quarter performance of the economy.

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



Source: KNBS

Agriculture

Growth in the agricultural sector slowed down in the second quarter of 2012 to 1.6 percent from 4.2 percent recorded in the second quarter of 2011. Some of the factors that contributed to the slowdown include delayed onset of the long rains in most parts of the country and frost that affected tea producing areas. Production of tea for instance declined by 8.1 percent in the second quarter of 2012 to stand at 85.7 thousand metric tonnes compared to 93.3 thousand metric tonnes recorded in the second quarter of 2011. The European debt crisis also contributed to an extent as export demand from the European countries declined. The third quarter of 2012 started with a depressed performance of the tea sub-sector. Provisional figures show that tea production for July 2012 decreased marginally by 0.39 percent to 24,306 metric tonnes, down from 24,401 metric tonnes (MT) in July 2011. Monthly export volumes of tea for the month of July decreased by 16.6 percent to 28,054.4 MT in 2012, down from 33,629 MT in 2011, with the value of the exports for the same month decreasing 15.7 percent, from Kshs 9,266 million in 2011 to Kshs 7,812 million in 2012. This trend shows the continued difficulty experienced by the sub-sector.

Figure 2: Second Quarter Tea Exports (value) 2007–2012

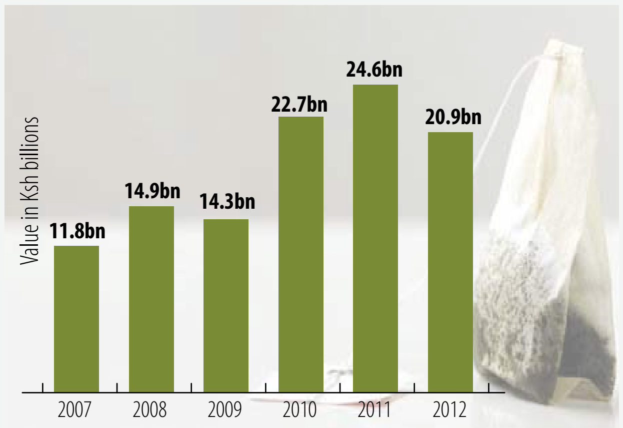
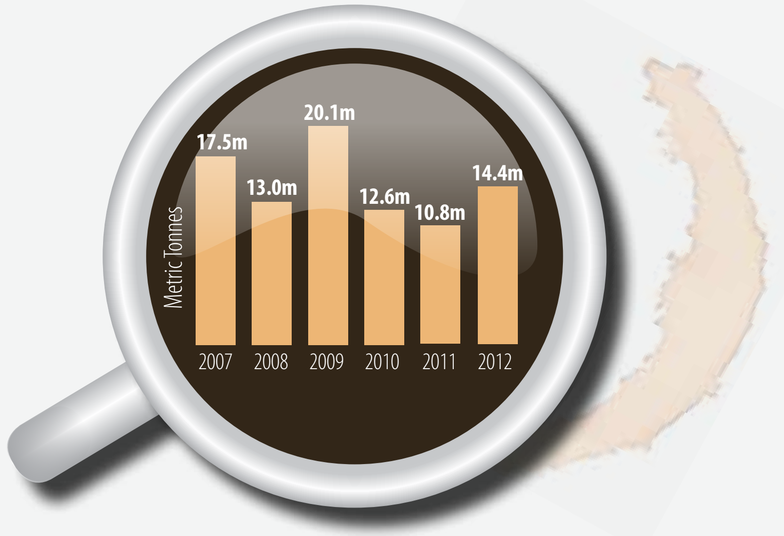
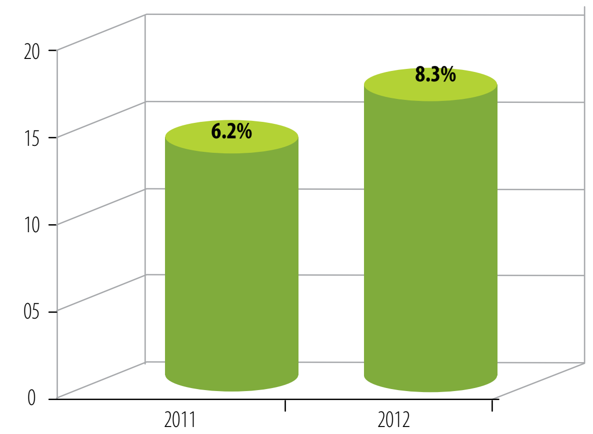


Figure 3: Second Quarter Coffee Exports (value) 2007–2012



Performance of the coffee sub-sector in the third quarter of 2012 however started on a positive note. Even though the volume of coffee sales at the Nairobi Coffee Exchange decreased 6 percent in July 2012 to 3,107 MT, compared to 3,305 MT in 2011, coffee export volumes doubled in July 2012 to 5727.3 MT, up from 2857.2 MT in July 2011. The value of exports for the same month also increased but by a lesser margin, at 37.08 percent, to Kshs 2396.9 million, up from Kshs 1748.5 million in 2011. This is due to a drop in world coffee prices, which, for "other mild Arabica", fell by an average of 32 percent in July and August 2012 to 182.64 US cents per pound, compared to 269.23 US cents per pound in 2011.

Figure 4: Horticultural exports Volume July2011 /2012



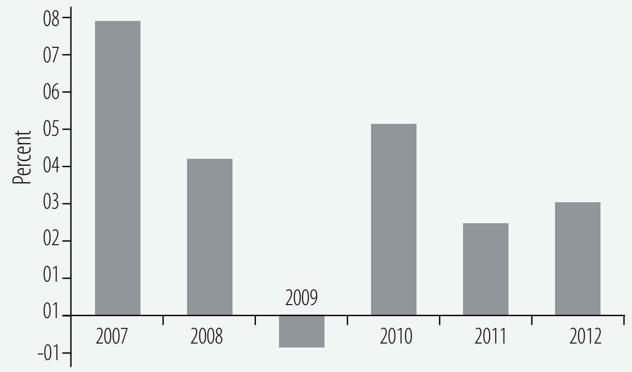
Source: KNBS

Horticultural exports in the first month of the third quarter showed a marked improvement in both volumes and value. The quantity exported increased by 21 percent to 18,655 MT, from 15,420 MT in July 2011. The value of the exports for the same period almost doubled, increasing by 47.2 percent from Kshs 5,530.9 million in 2011 to Ksh 8,139 million in 2012. The figures above show the performance of tea, coffee and horticulture sub-sectors in the second quarter of 2012. Data for the whole of the third quarter was not yet available at the time of writing this report.

The quantity of coffee exported in the first four months of 2012 was 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 5: Second Quarter Growth in Manufacturing (2007 – 2012)



Manufacturing

In the second quarter of 2012, the manufacturing sector recorded a growth of 3.0 per cent compared to 2.5 per cent in the same period in 2011. This represented an expansion of 0.5 percent and was mainly driven by growth in the manufacture of food and beverages which grew by 7.7 per cent during the period. Growth in all other manufacturing, including cement production, assembly of motor vehicles, manufacture of textiles clothing and footwear grew by only 1.0 percent while production of milk, maize meal and soft drinks recorded declines in the same period.

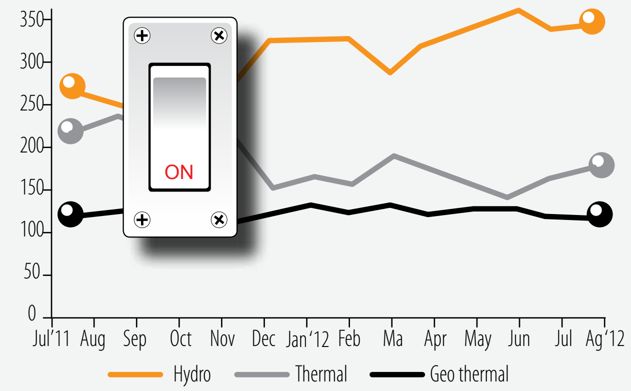
The third quarter of 2012 started with a mixed outcome for different sub-sectors of manufacturing. In the month of July 2012, production of assembled vehicles increased by 8.8 percent, to 570 units, up from 524 units in 2011. Domestic production of sugar in July 2012 on the other hand increased by 60.7 percent to 41,607 MT, compared to 25,884 MT in July 2011. Increased processing capacity and stiff competition for matured cane contributed to the increase. Soft drink production in the same period declined by 22.5 percent in July 2012 to stand at 22.073 million litres, compared to 28.478 thousand litres in the same month in 2011. Export of industrial supplies in July 2012 increased only marginally, by 4 percent, to Kshs12,657.50 million, up from Kshs 12,457.00 million in July 2011

Energy

In the second quarter of 2012, Electricity generation recorded a growth of 13.0 percent up from a contraction of 3.2 percent recorded in the second quarter of 2011. Better rainfall contributed to the expansion as hydro electricity generation increased. Hydro and geothermal electricity generation expanded by 21.9 per cent and 6.4 per cent respectively, while thermal generation contracted by 25.5 per cent in the same period. In the third quarter of 2012, energy prices were generally increasing. In July

2012, the average super petrol, automotive diesel and kerosene prices increased by 5 percent, 7 percent and 12 percent respectively to Kshs 116.32, 107.39, and 87.28 per litre respectively, up from Kshs 110.39, 100.29, and 77.81 per litre respectively. The average increase was approximately double the global crude oil price increases, with Murban Adnoc crude oil prices increasing by 4.5 percent. Global oil demand is projected by the International Energy Agency to increase by to 89.8 Millions of Barrels per Day (MB/D) and 90.6 (MB/D) for 2012 and 2013 respectively.

Figure 6: Electricity Generation by Source
July 2011 to August 2012



Source: KNBS

Building and Construction

Growth in the building and construction industry slowed down to 1.4 percent in the second quarter of 2012 compared to a growth of 5.4 percent in the second quarter of 2011. This was mainly attributed to the tight monetary policy that was put in place towards the end of 2011 and which continued to impact on the sector beyond 2011. However the trends in the third quarter of 2012 already show signs of recovery of the sector. Consumption of cement, a key indicator of activity in the construction industry increased by 18.4 percent to 348,031 metric tonnes in July 2012, up from 293,914 metric tonnes in 2011. This is higher than the 7.43 percent increase recorded in July 2011. This is occasioned by the easing of inflationary expectations and monetary policy with resultant decline in lending rates.

Transport and Communications

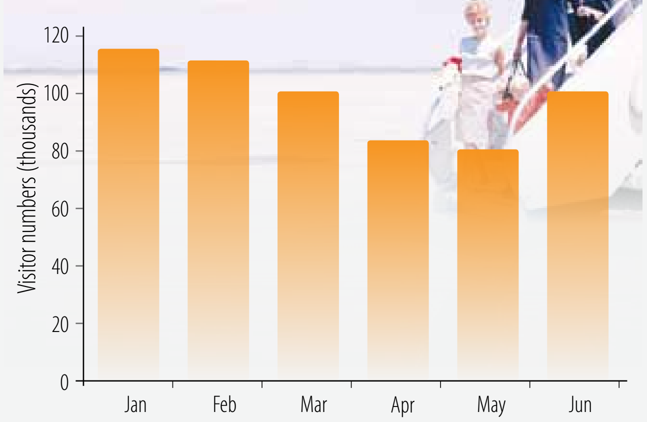
Statistics for the first two months of the third quarter show an improvement in the performance of the transport and communications sector but at a slower pace compared to the same period in 2011. The total number of new vehicle registrations for July 2012 for instance increased by 4.3 percent to 39,547 units, up from 37,925 units for the same period in 2011. This represents a slowdown from the 24.6 percent growth recorded in 2011, up from 30,437 units in 2010. Notable shifts include a decrease in the number of minibuses registered by 30 percent, from 40 units in 2011 to 28 in 2012, and a 40 percent increase in the number of trailers registered, from 501 in 2011 to 714 in 2012. Growth in the sector is expected to accelerate with the signing of an agreement between the Government of Kenya and the World Bank to develop a light rail system and expand Uhuru Highway.

Total mobile subscriptions increased by 17.5 percent to 29,430,072 subscriptions as at June 2012, up from 25, 048,774 subscriptions as at the same period in 2011. Total internet subscriptions on the other hand increased 81.7 percent for the same period from 4,258,287 subscriptions in 2011 to 7,738,882 subscriptions in 2012. Increased browsing speeds, access to internet-enabled phones and more affordable internet bundles contributed to the increase in subscriptions.

Tourism

Although total third quarter visitor arrivals data is not yet available, the tourism sector likely suffered a setback due to insecurity at the Kenyan coast. Near simultaneous unrest following the death of a prominent cleric in Mombasa as well as clashes in the Tana Delta led to travel warnings from Western countries against travel to the Coast. This is against the backdrop of the sporadic terrorist attacks and additional foiled attacks witnessed in the country. In addition, the infrastructure to the country's famed game reserves is in very poor state making travel to the reserves very difficult and costly for the tourists. The Eurozone crisis, although being contained, and the slow economic recovery in the USA, the major sources of overseas visitors in Kenya, continue to dampen growth in the industry. On a more positive note, the London Olympic games in July and August presented an opportunity for the country to market itself to the world. Major stakeholders in the tourism sector including the Brand Kenya Board, the Kenya Tourism Board, Kenya Investment Authority, Kenya Wildlife Service, National Museums of Kenya among other institutions marketed the country at the "Kenya House" targeting the millions of visitors in London. Total visitor arrivals through our international airports for the first half of 2012 through July decreased by 2.2 percent, to 676, 855 visitors, down from 692, 053 visitors in the same period in 2011.

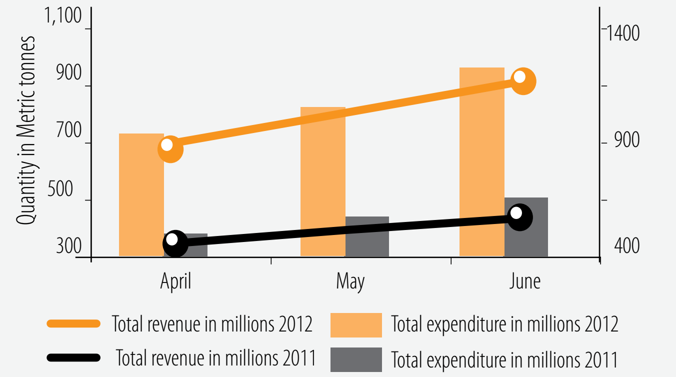
Figure 7: Visitor arrivals through Jomo Kenyatta & Moi International Airports – Jan - Jun 2012



Financing of Government

Provisional figures indicate that total government revenue and grants as at June 2012 increased 8.1 percent to Kshs 734.43 billion, up from Kshs 679.5 billion in 2011. Nevertheless, total expenditure grew faster than revenues; growing 12.1 percent, to Kshs 915.89 billion as at June 2012, up from Kshs 817.1 billion at the same period in 2011. The budget deficit thus grew by 31.9 percent, from Kshs -137.6 billion as at June 2011, to Kshs -181.5 billion as at the same period in 2012. The gap was filled through domestic borrowing of Ksh 73.6 billion domestically and Kshs 99.4 billion externally. The Government has however taken steps to reduce expenditure as part of fiscal discipline measures. Recurrent expenditure, total interest and other expenditure grew 9.9, 19.7, and 7.3 percent respectively as at June 2012, compared to 11.9, 21.7, and 8.1 percent growth as at the same period in 2011. Development expenditure on the other hand increased 17.5 percent as at June 2012, compared to an 18.5 percent increase as at June 2011. The increase in strikes as worker agitate for improved salaries is however a threat to maintaining fiscal discipline in government and keeping the budget deficit small. Wage increases are likely to increase unbudgeted expenditures which will either mean cut backs on development expenditures or increase in taxes. Both of these measures would have negative impacts on aggregate consumption and economic growth as people's disposable income is reduced by tax.

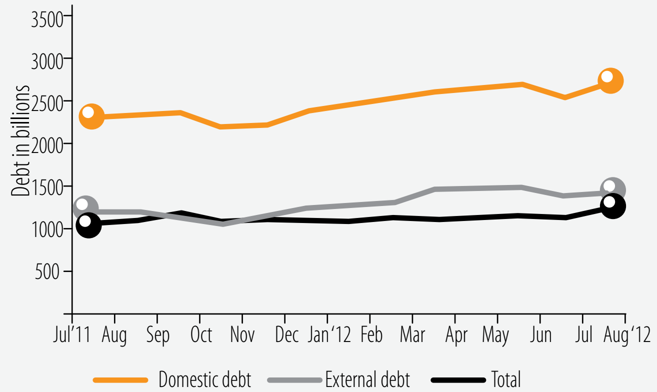
Figure 8: Total Government Revenues and Expenditures in 2012



Public Debt

Total debt at the end of the first half of 2012 was Kshs 1,633.38 billion at 49.4 percent of GDP, compared to Kshs 1,487.11 billion standing at 53.8 percent of GDP in 2011 . The increase in debt over the period is attributed to disbursements from the International Syndicated Bank Loan. This was an increase of 9.8 percent in nominal terms. External debt rose by Ksh 53.51 billion to stand at Ksh 774.55 billion, while domestic debt declined by Ksh 30.03 billion to stand at Ksh 858.83 billion in June 2012. The World Bank remained the country's largest multilateral creditor, accounting for 37.5 percent of the total external debt, while Japan was the biggest bilateral creditor.

Figure 9: Total Government Debt July 2011 to July 2012



Source: CBK

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

Fostering Objectivity in Banking & Financial Services

Kenya Bankers Association holds its inaugural research conference in Nairobi

The conference was an indicator of KBA's renewed commitment to closer engagement with stakeholders for the benefit of the industry as well as the banking public. Our goal is to set and shape the agenda towards a more vibrant and sustainable banking sector. Towards this end, we collaborated with researchers from the Central Bank of Kenya, the Kenya School of Monetary Studies, Strathmore Business School, Kenyatta University, Egerton University, International Monetary Fund and the Kenya Institute for Public Policy Research and Analysis (KIPPRA). Through rigorous and objective research, the KBA Centre for Research on Financial Markets and Policy hopes to come up with measures to address constraints to credit access and reduce the cost of credit in Kenya. KBA is planning to hold the conference on an annual basis.

LEFT: Dr. Freshia Waweru, from Strathmore University.

RIGHT: The Authors, CBK Director's and KBA officials pose for a group photo with the Governor

BELOW RIGHT: Nuru Mugambi of KBA gives a vote of thanks during the closing session.

CBK Governor, Professor Njuguna Ndung'u making the Key note speech and officially opening the conference.

LEFT: Dr. Jacob Oduor of KBA gives his welcome remarks.

ABOVE: Habil Olaka, CEO KBA gives his opening Speech.

LEFT: Participants from US listen to the presentations.

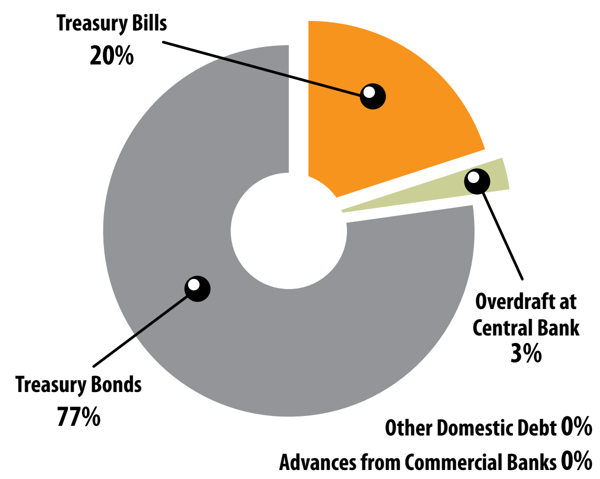
Nicholas Korir, Director of research at KSMS (Kenya School of Monetary Studies), CBK makes a comment during the discussion.

Dr. Lydia Ndirangu makes a presentation on Agency Banking.

From left: Habil Olaka (CEO, KBA), James Macharia (CEO, NIC Bank), Nasim Devji (CEO, DTB) and Prof. Njuguna Ndung'u (Governor CBK) catching-up during tea break.

Delegates listening to presentations.

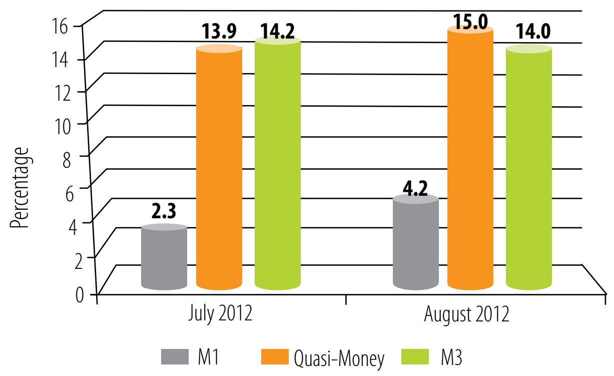
Figure 10: Composition of domestic Debt



Money and Credit

Money supply in the economy grew by 14 percent as at the end of August 2012, compared to August 2011. Growth of M1 and M2 increased by 4.2 and 15 percent respectively. Although third quarter figures are not yet available, total domestic credit at the end of the first half stood at Kshs 1550.52 billion, a 15.3 percent increase from Kshs 1344.23 billion in June 2011, compared to a 23.7 percent increase in 2011, up from Kshs 1,086.75 billion in June 2010. High interest rates contributed to the slowdown in the growth of credit. Growth of credit to the private sector was the largest contributor to the total growth, increasing by 18 percent to Kshs1258.01 billion, up from Kshs 1066.42 billion in 2011, compared to a 31.8 percent increase in 2011, up from Kshs 809.06 billion in 2010. The trade sector was the largest debtor to the banking system, borrowing Kshs 170.3 billion. Private households came in second, borrowing Kshs 152.6 billion.

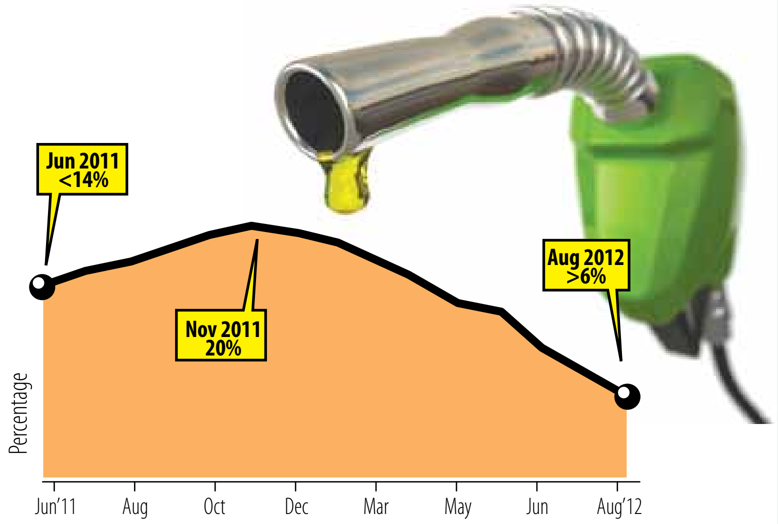
Figure 11: Growth in Money Supply Components; Third Quarter of 2012



Inflation

Overall inflation continued its decline into the third quarter of 2012. In July, the country registered single digit inflation for the first time since March 2011 to stand at 7.74 percent in July, 6.1 percent in August and 5.32 in September. The drop in inflation was attributed in part to the impact of the tight monetary policy stance taken by the CBK which started in September 2011 and in part to the increase in rainfall which increased food production and led to a fall in food prices. Food and fuel costs, traditionally the biggest contributors to overall inflation, significantly reduced at the end of September 2012, contributing 2.91 and 7.67 percent respectively to the overall inflation, compared to 24.37 and 14.09 percent respectively for the same period in 2011.

Figure 12: Inflation Trends (June 2011 –August 2012)

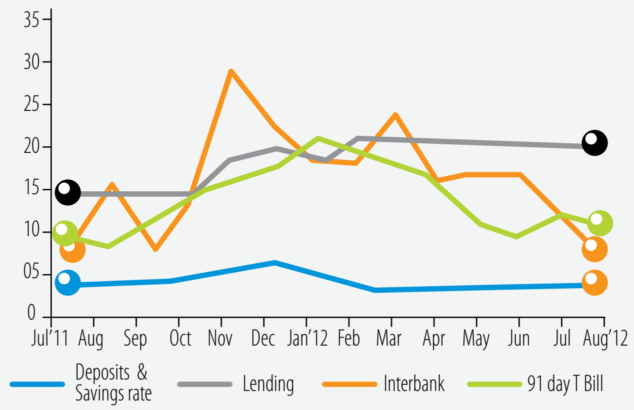


Source: KNBS

Interest Rates

Treasury bill rates continued their downward trend following monetary policy easing adopted in July 2012. The average 91-day Treasury bill yield rate for the months of July and August increased 25.6 percent to 11.4 percent in 2012, up from 9.1 percent for the same period in 2011. In July 2012, The MPC reduced its benchmark CBR for the first time since September 2011. The CBR was lowered to 16.5 percent in July, and subsequently to 13.0 percent in September. The average weighted rate on commercial bank loans and advances for July and August decreased by 61 basis points to 20.09 percent, down from 20.2 percent in the second quarter of 2012 and had reached 20.13 percent in August 2012.

Figure 13: Trends interest Rates (July 2011 – August 2012)



Balance of Payments

The overall Balance of Payments position improved to a surplus of US$ 646 million as at June 2012, compared to a deficit of US$ 55.13 million as at June 2011. The current account deficit decreased 12.4 percent to US$ 313.28 million as at June 2012, from a deficit of US$ 357.57 million as at June 2011. The strengthening of the Kenya Shilling contributed to the slight improvement in the current account position. Nevertheless, the current account deficit still pose challenges for the BoP position and needs to be trimmed down by improving competitiveness of Kenya's exports and exploring untapped export markets, particularly in Asian and South American. The value of foreign exchange reserves as at July 2012 increased 34.8 percent to US$ 7075.35 million, compared to US$ 5248.75 million as at the same month in 2011.

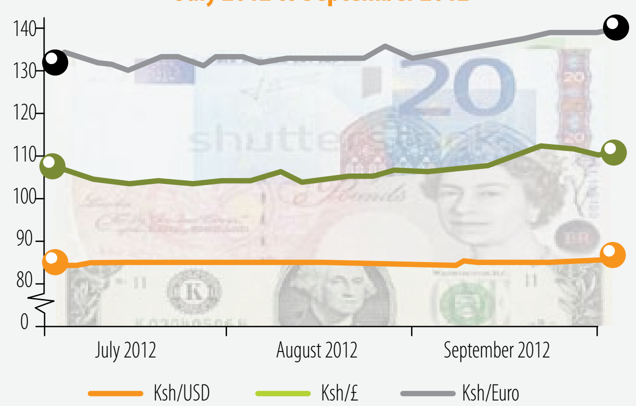
In July, India was Kenya's major source of imports, exporting into the country Kshs 21,938.60 million worth, followed by China and the UAE, which exported Kshs 15,473.93 million and 14,358.03 million

respectively into the country. Non-food industrial supplies constituted the highest percentage of the imports at 28.2 percent, valued at Kshs 34,842.5 million. Diaspora remittances in July increased 27.4 percent to US$ 92.7 million in 2012, from US$72.7 million in the same month in 2011 on the strength of the improving economic environment in the US and Europe.

Exchange Rate

The Kenya Shilling exchanged at an average of Kshs 84.5, 106.4, and 134.5 against the US Dollar, Euro and Sterling Pound respectively for the third quarter of 2012, compared to an average of Kshs 95.6, 134.7, and 153.8 per US Dollar, Euro and Sterling Pound respectively for the same period in 2011. The shilling appreciation is not surprising, given that the shilling had dramatically depreciated in the third quarter of 2011 into the fourth quarter.

Figure 14: Movements in Exchange Rates – July 2012 to September 2012



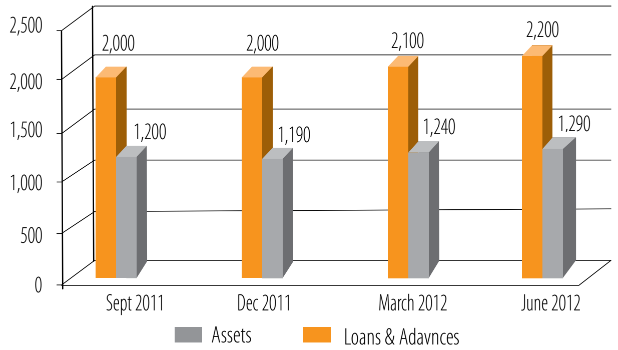
Banking Sector Performance

The Kenyan Banking Sector sustained a development path with the size of assets standing at Kshs 2.2 trillion, loans & advances worth Kshs 1.29 trillion, while the deposit base was Kshs 1.66 trillion and profit before tax of Kshs 53.2 billion as at 30th June 2012. During the same period, the number of bank customer deposit and loan accounts stood at 14,893,628 and 2,051,658 respectively.

Assets and Loans

The banking sector's assets increased by 4.8 percent from Kshs 2.1 trillion in March 2012 to Kshs 2.2 trillion in June 2012. The major components of the balance sheet were loans and advances, government securities and placements, which accounted for 56.6 percent, 19.5 percent and 7.3 percent of total assets respectively. The sector's gross loans and advances increased from Kshs 1.24 trillion in March 2012 to Kshs 1.29 trillion in June 2012, which translated to a growth of 4.0 percent.

Figure 17: Value of Total Assets and Loans September 2011 to June 2012

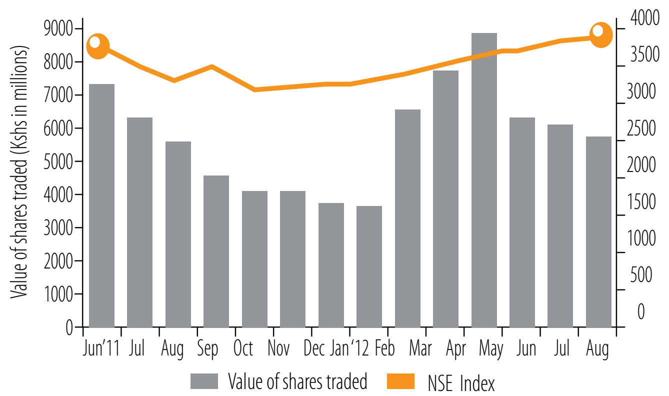


Source: CBK

Nairobi Securities Exchange

The total value of shares traded at the Nairobi Securities Exchange for the months of July and August in 2012 decreased 11.5 percent to Kshs 11,719 million, down from Kshs 13,241 million during the same period in 2011. The average NSE-20 Shares Index for the same period in 2012 however, increased 6.9 percent to 3849, up from 3602 in 2011. The impending general elections, which historically have seen the markets perform below par may leave particularly foreign investors cautious, going into the fourth quarter, despite the fact that the foreign investors have been the major driving force in the third quarter performance.

Figure 16: Activity at the Nairobi Securities Exchange

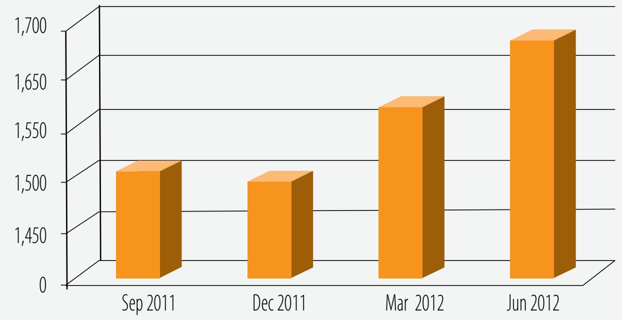


Source: KNBS

Deposits

Deposits, which form the main source of funding for the banking sector, accounted for 75.5 percent of total funding liabilities. The deposit base grew by 6.4 percent from Kshs 1.56 trillion in March 2012 to Kshs 1.66 trillion in June 2012 mainly due to branch expansion, remittances and receipts from exports. The number of bank branches stood at 1,196 in June 2012, an increase of 22 from the 1,174 branches registered in March 2012. Similarly, the number of bank deposit accounts increased from 14.36 million in March 2012 to 14.89 million in June 2012 representing a growth of 0.53 million accounts or 3.7 percent.

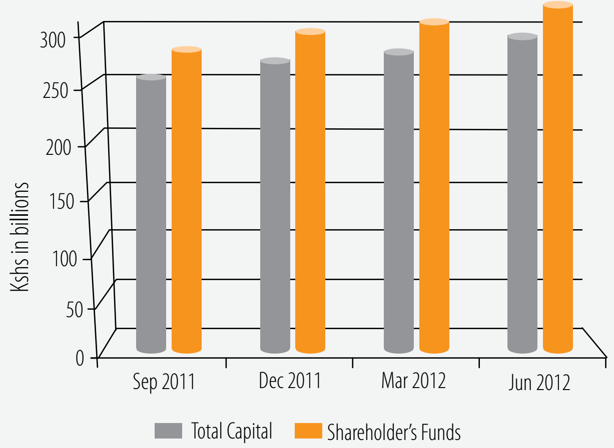
Figure 18: Value of Total Deposits Sep 2011 to June 2012



Total Capital and Shareholder Funds

The banking sector registered improved capital levels in June 2012 with total capital growing by 4.8 percent from Kshs 280.9 billion in March 2012 to Kshs 294.3 billion in June 2012. This growth is mainly attributed to the requirements by the CBK that all banks build-up their core capital towards the Kshs 1 billion mark by December 2012. Shareholders' funds on the other hand increased by 5.1 percent from Kshs 299.8 billion in March 2012 to Kshs 315.1 billion in June 2012. Similarly, the ratio of total capital to total risk-weighted assets increased from 20.2 percent in March 2012 to 20.3 percent in June 2012 while core capital to total risk weighted assets decreased from 17.9 percent to 17.7 percent over the same period.

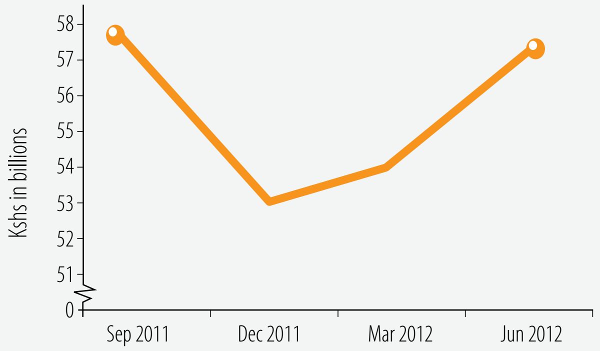
Figure 19: Total Capital and Shareholder funds September 2011 to June 2012



Gross Non-Performing Loans (NPLs)

The stock of gross non-performing loans (NPLs) increased by 7.1 percent from Kshs 53.7 billion in March 2012 to Kshs 57.5 billion in June 2012. Accordingly, the ratio of gross NPLs to gross loans increased from 4.3 percent in March 2012 to 4.5 percent in June 2012.

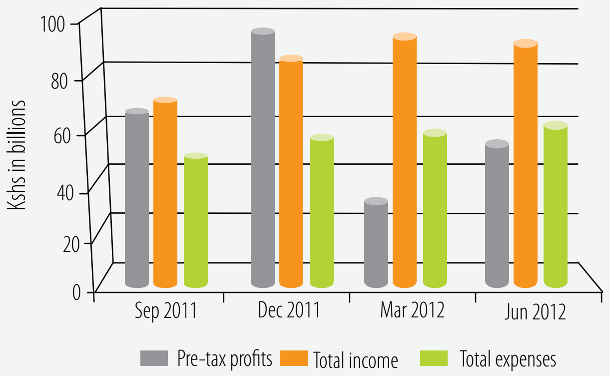
Figure 20: Gross Non-Performing Loans (NPLs)



Bank Profitability

The banking sector profit before tax for the quarter ended June 2012 increased by 15.4 percent from Kshs 24.7 billion in March 2012 to Kshs 28.5 billion in June 2012. However, total income stood at Kshs 88.0 billion in the second quarter being a marginal decline of 0.5 percent from Kshs 88.4 billion registered in the first quarter of 2012, whilst total expenses declined by 6.4 percent from Kshs 63.7 billion in the March 2012 quarter to Kshs 59.6 billion in the June 2012 quarter. On an annual basis, the profitability of the sector increased by 30.4 percent to Kshs 53.2 billion from the Kshs 40.8 billion registered in June 2011.

Figure 21: Bank Profitability



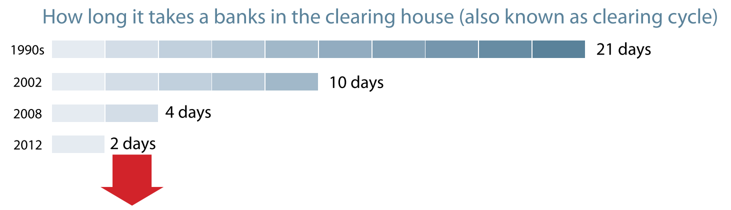
KENYA BANKERS ASSOCIATION

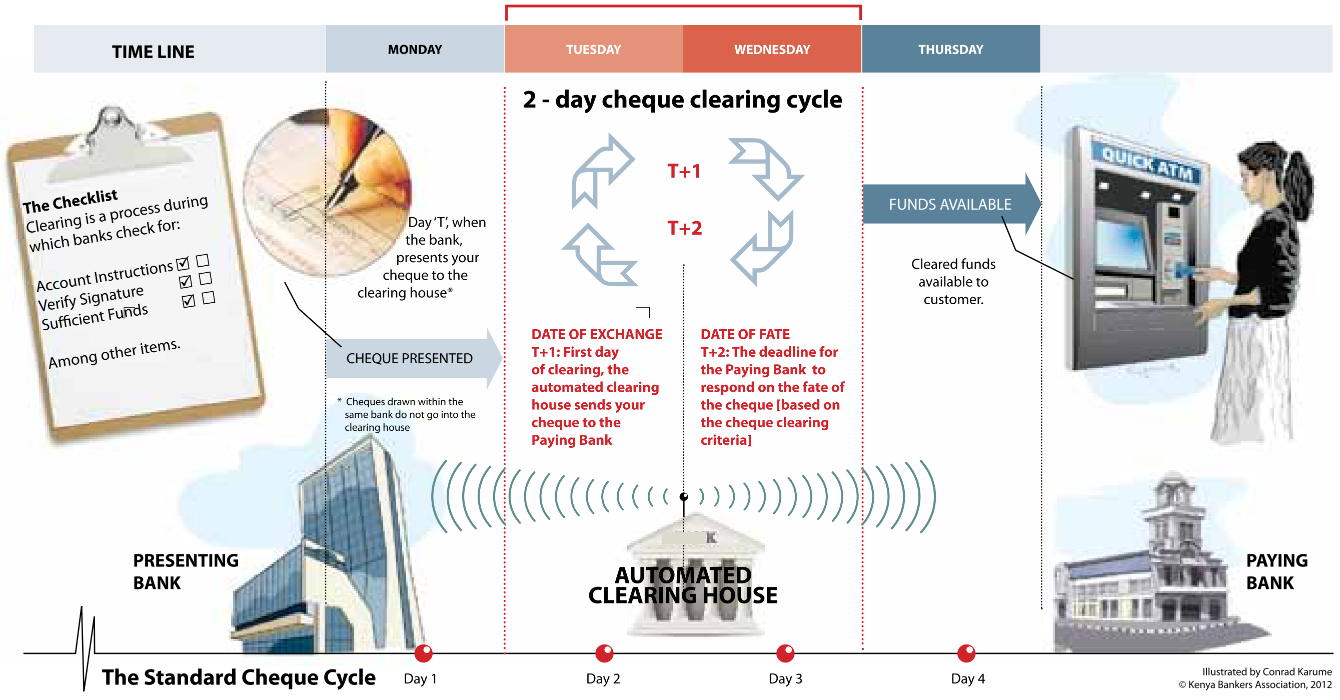
A typical Cheque Truncation process

Cheque clearing is the process between banks that takes place at the Clearing House. Kenya Bankers Association (KBA) owns the Clearing House and works with the Central Bank of Kenya (CBK) to operate it.

Through the use of technology, cheque clearing is now image-based. This has drastically improved the time from a high of 21 days to today when it takes banks just 2 days in the Clearing House.

Why does it take longer than 2 days to access the funds?
The cycle starts when a bank receives a cheque. If the cheque is from another bank, the Presenting Bank sends it to the Paying Bank via the Clearing House (see illustration). The cycle ends when payment is made (or the cheque is returned). The full cycle, including the 2 day clearing (T+1 and T+2) should be factored in estimating when funds would be available.





The Cheque Truncation Project

By Fidelis Muia,
Director, Technical Services, KBA

The Cheque Truncation project is a culmination of a dream for the Kenya Bankers Association. The long journey to this project started with the Automation of the Manual Clearing House in 1996 when the Association introduced the Magnetic Ink Character Recognition (MICR) system and the Electronic Journal system. This had the impact of reducing the Clearing times countrywide from ten working days to four days within the urban towns and ten working days from twenty one for remote towns.

The liberalization of the Telecommunications sector brought great improvements in the communication infrastructure and is the backbone on which this project rides. All Commercial banks participating in this project are connected to high capacity Wide Area Network links to facilitate the transmission of cheque images and Data to and from the Clearing House. This greatly speeds up the clearing process and introduces opportunities for greater efficiencies and savings on costs, primarily the cost of transporting cheques from branches countrywide to Nairobi overnight. Other savings are derived from the reduced clearing times and a safer clearing system from reduced fraud incidents.

New Clearing Cycle

A major deliverable of the project was to reduce the time it takes for a cheque to clear, also known as the clearing cycle. The cycle was four days within towns in Nairobi and upcountry and ten days for remote towns. It was intended that this will reduce to two working days in both urban and remote towns.

The new clearing cycle, (known as T+2 in banking terms) means that the paying bank has two (2) days to determine the fate of a cheque presented for payment at the Automated Clearing House. Previously the old clearing cycle gave the paying bank three (3) days to determine the fate of a cheque.

This cycle is applicable across the whole country, effectively making Kenya one clearing zone.

EXAMPLE :

Monday Day 0 - Collecting bank receives cheque(s) from Customers
Tuesday Day 1 - Date of exchange at Automated Clearing House
Wednesday Day 2 - Latest day of return/advise unpaid.
Thursday Day 3 - Customer Gets Value

The major benefit of the new clearing Cycle to the economy is the reduction of the cycle by a day. This ensures that the customer gets their money faster, increasing the availability of funds in the system. Another added benefit accruing from the collapsing of the clearing zones is that customers no longer pay clearing commissions for upcountry cheques. This was a significant savings to customers who originally had to pay for cheques collected upcountry and in remote towns. Standardizing the clearing zone also had the effect of instilling certainty of the clearing system.

Other Benefits of the Project

We have seen a reduction in the number of cheque frauds, as a result of the enhanced security features of the new redesigned cheque books.

As a result of the faster processing times, a number of banks have extended the hours that customers have to deposit cheques and transact at the branch.

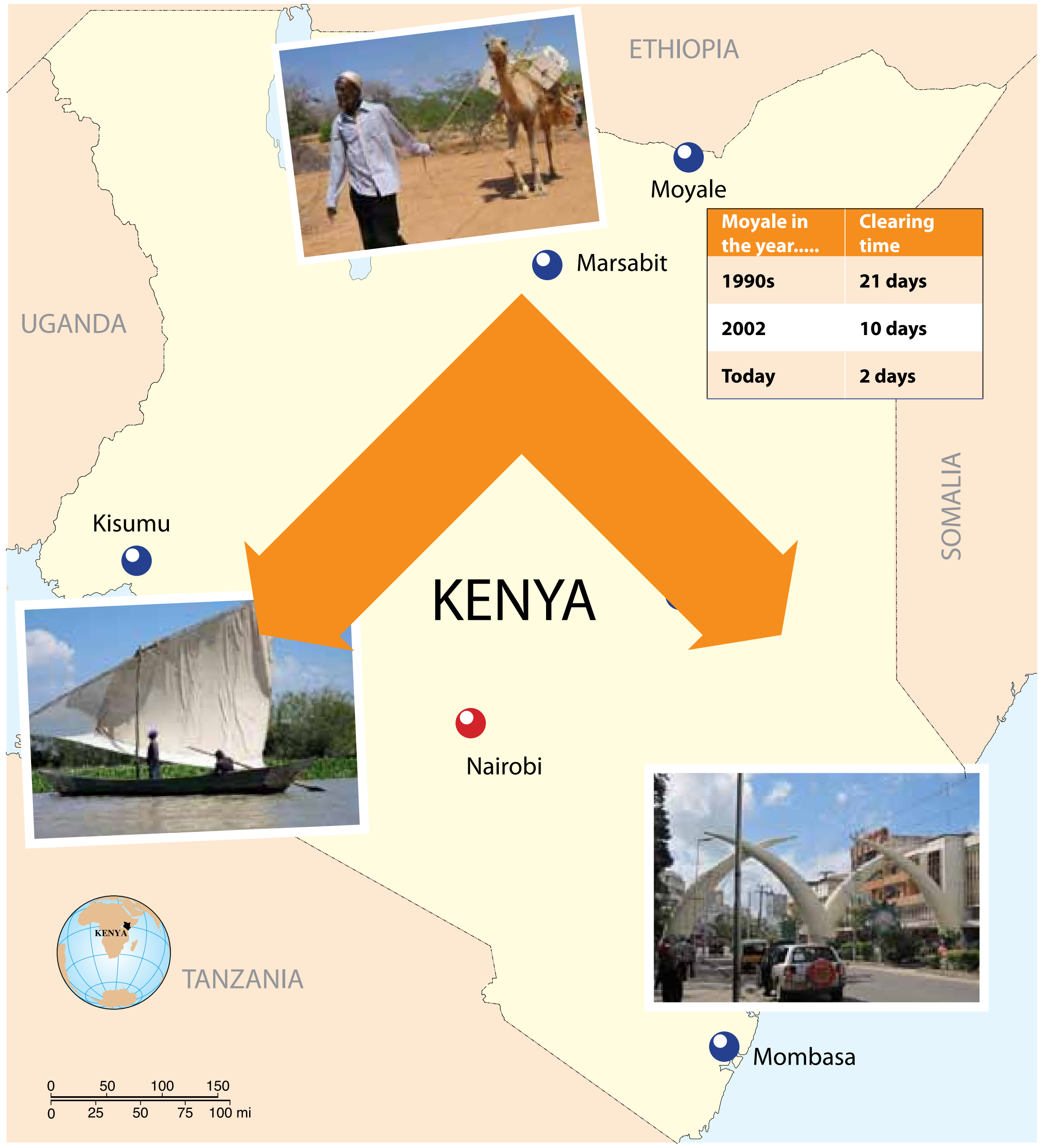
We hope to reduce the clearing period further by one day, making the clearing cycle T+1 where cheques will clear within one working day. This would mean that a customer who deposits a cheque on Monday will have the money in his/her account on Wednesday. This is the most advanced clearing process anywhere in the world and will make the Automated Clearing House a world-class system.

Volumes in the Automated Clearing House

In July 2011 and 2012 the Automated Clearing House processed the following items:

	July 2011		July 2012	
Items	Number of Transactions	Value of transactions (Kshs)	Number of Transactions	Value of transactions (Kshs)
Debits (Cheques)	1,541,320	169,019,997.75	1,666,533	189,697, 852,153.55
Electronic Funds Transfer Credits	728,575	28,229,905,193.90	765, 057	33,179,751,126.65

KENYA IS NOW 1 CLEARING ZONE



Moyale in the year.....	Clearing time
1990s	21 days
2002	10 days
Today	2 days

KENYA BANKERS ASSOCIATION
One Industry. Transforming Kenya.

The Cheque Truncation System

AN INITIATIVE OF THE KENYA BANKERS ASSOCIATION AND THE CENTRAL BANK OF KENYA

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Fidelis M. Muia is the Director, Technical Services , Kenya Bankers Association. Fidelis has been in the I.T industry since the late 1980's working as a software developer .

He has a vast experience in Insurance and Banking, having worked for Alico (Now Chartis) and Barclays Bank of Kenya. He has been involved in the Banking Industry modernization since the introduction of the MICR, the introduction of the Real Time Gross Settlement System, the Credit Information Sharing Initiative and lately the Cheque Truncation Project .

At the KBA Fidelis is involved in the industry initiatives to improve the technology platforms from an industry level and represents the Banking industry in the National Payments Steering Committee which is mandated to develop and implement the National Payments infrastructure.

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