STATE OF THE BANKING INDUSTRY REPORT 2022

PREPARED BY: KBA CENTRE FOR RESEARCH ON FINANCIAL MARKETS AND POLICY®

July 2022

STATE OF THE BANKING INDUSTRY REPORT 2022

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.

The entire content of this publication is protected by copyright laws. Reproduction in part or whole requires express written consent from the publisher.

© Kenya Bankers Association, 2022

ABOUT THIS REPORT

The State of the Banking Industry (SBI) Report is an annual publication of the *Kenya Bankers Association Centre for Research on Financial Markets and Policy®* aimed at contributing to the understanding of the Kenyan banking industry. The report is motivated by the fact that various stakeholders seeking perspective on the Kenyan banking industry engage various sources, including market analysts, banks, the Kenya Bankers Association (KBA) Secretariat, the Central Bank of Kenya (CBK) and other financial sector players and regulators. The breadth of views in this report is underpinned by the respective institution's analytical work, making the report reflective of the diversity of analyses.

The *Kenya Bankers Association Centre for Research on Financial Markets and Policy®* has compiled a database of financials at the bank-level spanning over one and half decades. Together with other secondary data whose source is duly acknowledged, the database buttresses this report's analysis. The financial database, indicated as KBA data in the report, is based on published financial statements by banks up to December 31, 2021.

The *report's* analysis is undertaken at industry level as well as in the three-tier bank clusters – tier 1, tier 2, and tier 3. It also draws on the background work that is published under the *Kenya Bankers Association Working Paper Series* and other relevant published work as cited in the report and links provided as appropriate.

This issue of the *SBI Report* has benefited from discussions, comments and suggestions from banks, analysts, and academic researchers. However, the analysis and inferences are entirely those of the report's authors and should not be attributed to those who commented on it, the KBA General Body, and Governing Council.

This version of *SBI Report* is available in full on the KBA's website, www.kba.co.ke. Inquiries about the content of the report and its accompanying files can be shared by sending a request to research@kba.co.ke.

Authors:

Dr. Samuel Tiriongo;
Director, Research and Policy.

Kiplangat Josea;
Senior Research and Policy Officer.

Hillary Mulindi;
Research, Policy, and Knowledge Management Officer.

Pic/ zac wolff - unsplash

FOREWORD

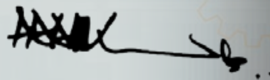
It is my pleasure to present to you our Fourth issue of the *Kenya Bankers Association's State of the Banking Industry (SBI) Report*. As highlighted in the SBI report, there is continued focus on the impact of COVID-19 pandemic on the banking industry even with some notable recovery in the economy and the evolution of the banking sector given its central role in driving all other sectors' economic activities.

As the *report* presents, the impact of the pandemic and the recovery patterns varied from sector to another, exposing the heterogeneities across sectors. At the same time, the banking sector depicted unprecedented resilience to post strong and adequate liquidity and sufficient capital positions that allowed it to support other sectors with significant loan restructures and continued loan extension.

This *report* is organized along Seven broad areas. After the background, the report discusses the notable industry growth in terms of assets, liabilities, and liquidity conditions. Second, it covers developments in capital adequacy and asset quality. Third covers a number of areas. It outlines the banking sector's responses to mitigate the adverse effects of the pandemic; characterizes the industry performance; reviews the asset quality developments; the financial performance of the industry as well as public debt developments. The report also reviews developments in the market structure before providing a perspective on the banking sector outlook amidst the existing uncertainty created by the pandemic.

Amidst the protracted pandemic, and the consequent uncertainty, the banking sector players continue to review and enhance their business models seeking to leverage on frameworks that promise efficiency gains, particularly through adoption of innovations. Cognizant of the growing competition in the market, increasing sophistication of customer expectations, as well the dynamism in the regulatory environment, the overarching challenge to the industry is to continue investing resources in remaining at the frontier of both regulatory and customer expectations.

It is my hope that this report enriches your understanding of the Kenyan banking industry, especially with regards to its interactions with the various economic agents and sector amidst the uncertainty created by the pandemic.



Dr. Habil Olaka,
Chief Executive Officer

TABLE OF CONTENTS

ABOUT THIS REPORT i
FOREWORD iii
LIST OF FIGURES AND TABLES vi
ABBREVIATIONS vii
EXECUTIVE SUMMARY viii

Chapter 1
INTRODUCTION 1

Chapter 2:
INDUSTRY GROWTH 3
2.1 Banking System Total Assets 3
2.2 Banking System Loans and Advances 4
2.3 Banking System Deposits 5
2.4 Banking System Loan-to-Deposit Ratio 6
2.5 Banking System Liabilities 6
2.6 Banking System Deposit-to-Liability Ratio 7

Chapter 3
PUBLIC DEBT DEVELOPMENTS 8

Chapter 4
ASSET QUALITY 11
4.1 Asset quality 11
4.2. Loan Loss Provisions 13
4.3 Capital adequacy 15

Chapter 5
FINANCIAL PERFORMANCE 16
5.1. Operating Incomes 16
5.2. Operating Costs 17
5.3. Cost-to-Income Ratio 18
5.4. Net Interest Margin 20
5.5. Cost of Funding 21
5.6 Profitability 22
5.7 Comparative analysis of bank and non-bank financial performance 24

Chapter 6
BANKING SECTOR MARKET STRUCTURE 25

CHAPTER 7
OUTLOOK 28

APPENDICES 30

PIC/ mika baumeister-unsplash

Tacken
Zaster
Kohle
Moneten
PLUS

LIST OF FIGURES AND TABLES

List of Figures

Figure 1: Economic growth rose to above pre-pandemic levels 1
Figure 2: Private Sector Credit dynamics and interest rate developments 2
Figure 3: Banking System Total Assets 3
Figure 4: Disaggregated Asset Structure of the Kenyan Banking System 4
Figure 5: Banking System Loans and Advances 4
Figure 6: Banking System Sectoral Loan Distribution 5
Figure 7: Banking System Deposits 5
Figure 8: Banking System Loan-to-Deposit Ratio 6
Figure 9: Banking System Liabilities 7
Figure 10: Banking System Deposit-to-Liability Ratio 7
Figure 11: Public Debt Dynamics and Banking Sector Holdings of Government Debt 8
Figure 12: Banks' Exposure to Sovereign debt Relative to Total Capital 9
Figure 13: Bank's sovereign exposure and balance sheet dynamics 9
Figure 14: Banking System Gross Non-Performing Loans 11
Figure 15: Banking System Gross Non-Performing Loans to Gross Loans 12
Figure 16: Banking System Sectoral Asset Quality in 2021 12
Figure 17: Asset Quality and Growth in Net Lending Nexus 13
Figure 18: Banking System Loan Loss Provisions 13
Figure 19: Banking System's Coverage Ratio 14
Figure 20: Banking System's Provisions to Non-Performing Loans Ratio 15
Figure 21: Banking System Operating Incomes 16
Figure 22: Banking System Operating Costs 18
Figure 23: Banking Sector Cost-to-Income Ratio 18
Figure 24: Cost-to-Income Ratio and Bank Balance Sheet Dynamics 19
Figure 25: Banking Sector Net Interest Margin and Interest Rate Developments 20
Figure 26: Net Interest Margin, Bank Size and Capital Adequacy Nexus 20
Figure 27: Banking System Cost of Funding 21
Figure 28: Banking System Profitability 22
Figure 29: Banking System Profitability and Bank Balance Sheet Dynamics Nexus 23
Figure 30: Bank and Nonbank Return on Investment Trend 24
Figure 31: Banking Sector Market Structure 24

List of Tables

Table 1: Capital adequacy ratios 13

ABBREVIATIONS

CAK	Competition Authority of Kenya
CAR	Capital Adequacy Ratio
CBK	Central Bank of Kenya
CIR	Cost-to-Income Ratio
CoF	Cost of Funding
DLR	Deposit-to-Liability Ratio
GDP	Gross Domestic Product
HHI	Herfindahl-Hirschman Index
IMF	International Monetary Fund
LDR	Loan-to-Deposit Ratio
LLR	Loan Loss Provisions
NIR	Net Interest Margin
NPL	Non-performing Loan
PMI	Purchasing Managers' Index™
ROA	Return on Assets
ROE	Return on Equity
TRWA	Total Risk-Weighted Assets

EXECUTIVE SUMMARY

- The domestic economy despite depicting some notable recovery in 2021 faced uncertainty arising from delayed full containment of the pandemic, elevated credit risk, rising inflationary pressure and headwinds from disruptions in global economic out-turn. Against this backdrop, and as highlighted in this State of the Banking Industry Report, the focus is on evolution of the banking industry in 2021.
- Two regulatory developments shaped the outcomes of the credit market in 2021. First, was the rollout of the risk-based pricing frameworks. As at end 2021, six banks had received approvals of their lending models accounting for 20.0 percent of the industry private sector loan portfolio. Second, was the suspension of listing of negative credit information in October 2021 (backdated to September 2020) which restricted credit information sharing and constrained lending.
- During the year, the banking sector total assets expanded by 11.4 percent to Kshs. 6.0 trillion from Kshs.5.4 trillion in 2020, driven mainly by growth in investments in government securities and private sector gross loans that together accounted for 78.3 percent of the total assets. The notable changes in asset structure reflected portfolio adjustments during the period aligned to the modifications in the operating environment and individual banks' strategies.
- The banking system deposits maintained a strong growth trajectory, growing by 12.2 percent to Ksh 4.6 trillion in 2021. The deposits buildup during the year outpaced the growth in gross loans. This partly led to increased liquidity in the banking system, with the deposit-to-liability ratio rising marginally to 89.9 percent from 89.6 percent in 2020 and indicated the sector's strong reliance on wholesale funding to cut costs on the liability side of the balance sheet.
- The industry asset quality in 2021 improved slightly, with the ratio of gross Non-Performing Loans (NPLs) to gross loans declining to 14.1 percent from 14.5 percent at end 2020, reflecting a slower growth in NPLs than the growth in gross loans. The reported growth in NPLs was attributed to the continued adverse effects of the pandemic on households and firms' incomes, that saw NPLs grow to Ksh. 460 billion up from Kshs. 436 billion as at end 2020. As credit risk eased, the provisioning for expected loan losses contracted by 46.5 percent-compared with 47.5 percent increase in 2020 - to Kshs. 58.7 billion down from Ksh 110.3 billion in 2020. These provisions covered 2.0 percent of net loans and advances and absorbed 12.9 percent of NPLs in 2021 compared to 3.8 percent and 25.7 percent in 2020, respectively.
- Banking industry capitalization in 2021 was resilient, depicting adequate capitalization well above statutory limits. The industry's total and core capital adequacy ratio were strong respectively at 19.5 percent and 16.5 percent in 2021 compared to 19.0 percent and 16.6 percent in 2020; both above the statutory respective minimum requirements of 14.5 percent and 10.5 percent. This was supported by an increase in the capital which outpaced the growth in total risk-weighted assets during the period.

A ship berthed at the Lamu Sea port

- The industry financial performance in 2021 was robust, reflecting a sustained growth in total operating incomes and a decline in operating costs; causing a decline in the cost to income ratio. The industry's net interest margin improved to 6.5 percent during the year up from 6.3 percent in 2020.
- Overall profitability of the banking sector recovered in 2021, as average return on assets and return on equity edged up to 3.3 percent and 22.1 percent , compared to 2.0 percent and 13.3 percent in 2020, respectively. The improved profitability reflected recovery of the economy from the depressing effects of the pandemic. A comparative analysis of the banking sector's ROA and ROE against non-bank firms' shows that the banking sector profitability reflects moderate profitability.
- Analyses of tax contribution of the banking sector shows that the sector contributed Kshs. 49.48 billion in 2021 up from Kshs. 43.73 billion in 2020, largely reflecting the recovery from the depressing effects of the pandemic on incomes. While this represents a 13.15 percent increase in the tax contribution, it highlights the extent to which the sector contributed to the national tax basket, shouldering an implicit tax rate of 32.6 percent in the year.
- The competitiveness of the banking industry market structure in 2021 remained largely unchanged, partly underpinning the sector's resilience to shocks. The banking system concentration in assets, loans and deposits that had been declining since 2003, moderated in the last five years, even with the recent mergers and acquisitions by top banks as they pursued the benefits of economies of scale.
- The outlook of the banking sector appears strong underpinned by adequate capitalization and liquidity levels, the continuing banking sector's robust approach to treatment of asset quality deterioration and continued implementation of efficient and resilient business models. Nonetheless, the sector is keen to monitor the evolution of some emerging risks, from rising inflationary pressure, concerns of public debt sustainability, fragile economic recovery, and volatilities in both global and domestic financial markets.

> **"The recovery of the economy continues to face heightened uncertainty associated with the delayed full containment of the pandemic**

The sector is keen to monitor the evolution of some emerging risks, from rising inflationary pressure, concerns of public debt sustainability, fragile economic recovery, and volatilities in both global and domestic financial markets.

Chapter 1

INTRODUCTION

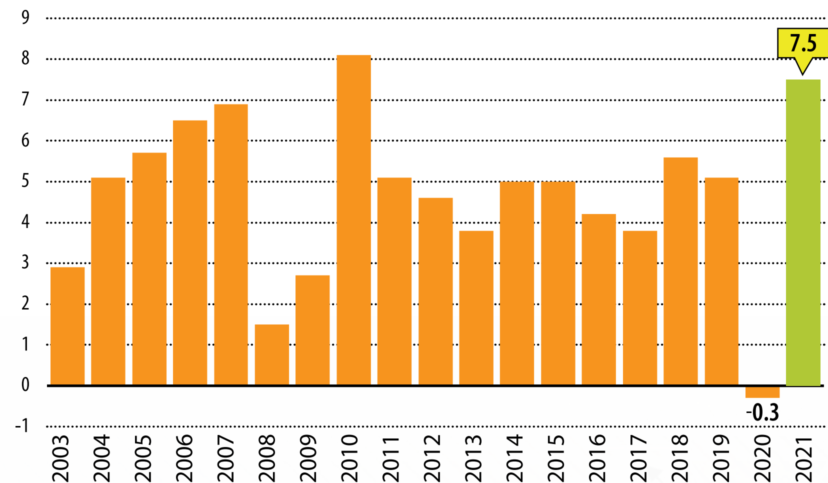
The state of the Kenyan banking industry reflects the interplay between the state of the economy, the broader macroeconomic policy and regulatory environment. In 2021, the banking industry sector was shaped by the following developments:

First, a notable recovery in domestic economic activity by margins beyond pre-pandemic levels (**Figure 1**). Kenya's GDP rose by 7.5 percent, after contracting by 0.3 percent in 2020. During the first quarter of 2021, the economy grew by 2.7 percent, a rate that steadily increased to 11.0 percent in the second quarter. The momentum, however, began to dissipate in the second half of 2021 with the economy growing by 9.3 percent in the third quarter[1] and 7.4 percent in the fourth quarter. Overall, the observed strong rebound in growth in 2021 was driven mainly by the recoveries in the industrial activity and services sector anchored on the prompt and supportive policy measures deployed to mitigate the adverse effects of the pandemic. On the downside, agricultural activity contracted by 0.2 percent in 2021 following relatively unfavorable weather conditions during the first half of the year.

1 This was driven by a broad-based recovery in services – particularly transport & storage, education, accommodation & food services, and trade – and industrial activity (mainly construction and manufacturing).

Figure 1: Real GDP Growth 2003 -2021

In 2021, the economy rebounded strongly with growth exceeding pre-pandemic levels



Source: KBA

The recovery of the economy continues to face heightened uncertainty associated with the delayed full containment of the pandemic and elevated credit risk. As a result, the mix between government and private sector-led growth will determine the outcome going forward. This is particularly important with the announced fiscal consolidation that the Government adopted in 2021 that led to the shrinking of Kenya's fiscal deficit to 3.9 percent of GDP cumulatively by the third quarter of FY2021/22 from 4.4 percent over a similar period a year earlier. The deficit by end of the financial year is expected to stand at 6.2 percent of GDP, to be financed through net external financing equivalent to 2.0 percent of GDP and net domestic financing equivalent to 4.2 percent of GDP[2]. With elevated private sector credit risk, banking sector rebalancing of holdings of sovereign debt and extending private sector loans has risen significantly.

Two, regulatory developments have shaped the outcomes of the credit to the private sector. The rollout of risk-based pricing framework while notable remains low and continued to shape the private sector credit trajectory. As a share of total industry assets, 29.6 percent (representing six banks) of banks since 2020 have transitioned to a risk-based pricing environment accounting for 20.0 percent of the industry loan portfolio as at the end of 2021, reflecting a slow transition to risk-based pricing. Other notable policy developments that impacted on the credit market included the suspension of listing of negative credit information in 2021[3] (backdated to

2 However, as observed by the World Bank (2022) "fiscal consolidation faces rising challenges and risks, including from the increased spending pressures from measures to contain the economic impact of the war in Ukraine, potential election-related fiscal slippages, and the prospect of more expensive financing costs on the back of tighter global financial conditions."

September 2020) which restricted credit information sharing and constrained lending, more so, in credit appraisal and decision making due to the existing information asymmetry between borrowers and financial institutions.

As evident in **Figure 2a**, private sector credit growth in 2021 remained in the positive territory but continued to be trapped in single digit notwithstanding the CBK's accommodative monetary policy stance adopted through the period. As such challenges in the pricing of credit continued to constrain lending even beyond the repeal of interest rate caps in November 2019[4]. However, private sector credit growth rose to 8.6percent in December 2021; the highest growth registered since March 2021, supported by strong growth in credit to consumer durables (15.0%), transport and communication sector (14.3%), manufacturing (13.1%), business services (9.5%) and trade (8.5%) sectors.

During the period, divergent paths characterised domestic interest rates; the yield on loans remained sticky while yields on government securities was on the rise (**Figure 2b**), impairing effective monetary policy transmission as portfolio rebalancing was skewed towards high-yielding assets. In this regard, fast-tracking the transition to risk-based pricing of loans would support an effective transmission of monetary policy signals, and revamp private sector credit growth.

The above background provides the setting upon which the state of the banking industry in 2021 is outlined. It provides the underpinning context for understanding the interaction between the market players, the regulatory requirements, customer, and shareholder expectations, and how the interactions feed into banks' financial performance.

Figure 2: Private Sector Credit dynamics and interest rate developments

Figure 2a: Growth in claims to the private sector remains muted

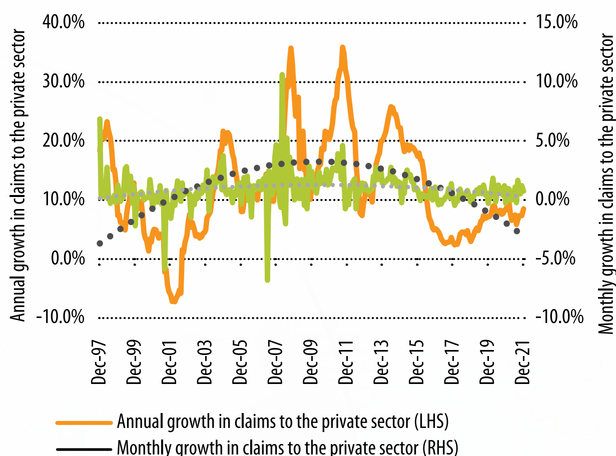
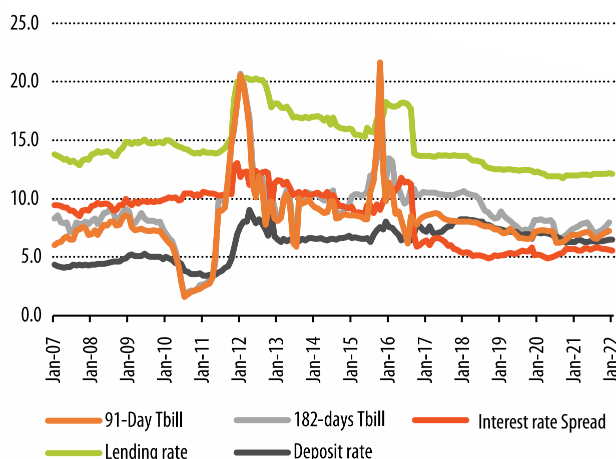


Figure 2b: Interest rate dynamics: A divergent course; yield on loans sticky, while yields on government securities on the rise.



Source: CBK

3 *https://www.centralbank.go.ke/uploads/press_releases/566112348_Presspercent20Releasepercent20-percent20Suspensionpercent20ofpercent20Thepercent20 Listingpercent20ofpercent20Negativepercent20Creditpercent20Informationpercent20forpercent20Borrowers.pdf*

4 Slow rollout and adoption of risk-based pricing and suspension of negative listing, have seen private sector credit growth trapped at single-digits growth levels

Chapter 2

INDUSTRY GROWTH

2.1 Banking System Total Assets

The banking system's total assets continued to grow, by 11.4 percent to Kshs. 6.0 trillion in 2021 from Kshs. 5.4 trillion in 2020 (Figure 3). Across bank tiers, while all groups registering growth, the magnitudes varied. tier 1 bank's assets in 2021 grew 11.8 percent to 4.5 trillion from 4.0 trillion in 2020, as the assets for the tier 2 and tier 3 rose by 11.3 percent and 6.1 percent to 1.3 trillion and Kshs. 226.8 billion in 2021 from 1.2 trillion and Kshs. 213.8 in 2020, respectively.

Figure 3: Banking System Total Assets

Figure 3a: Total Assets, Annual (Ksh. Billion)

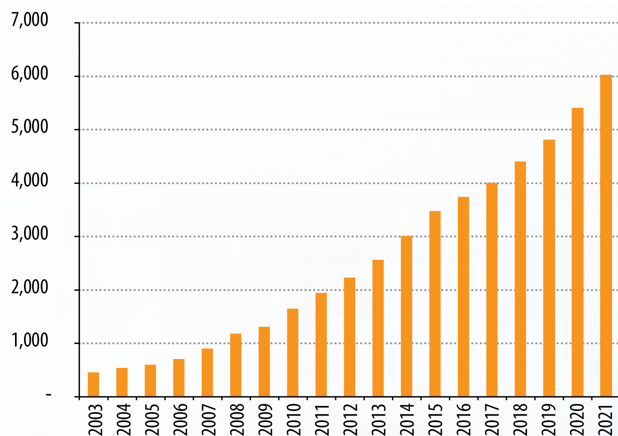
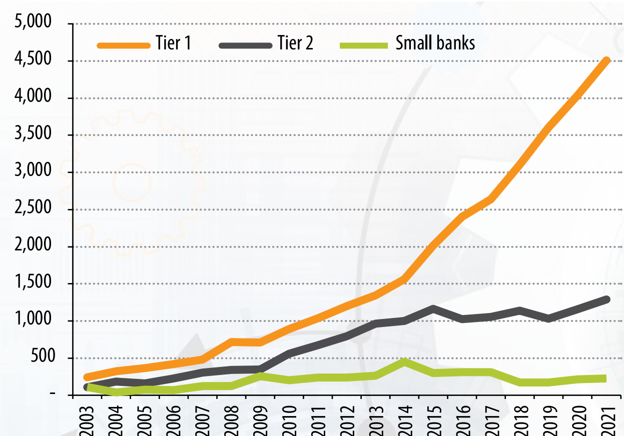
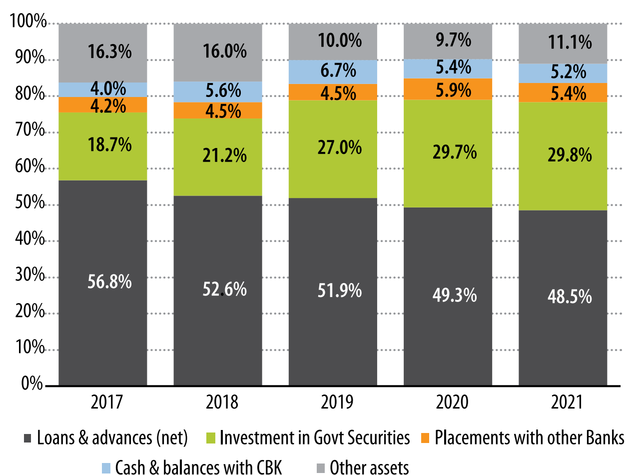


Figure 3b. Disaggregated Assets across Banks (Ksh. Billion)



Source: KBA

Figure 4: Disaggregated Asset Structure of the Kenyan Banking System



An examination of the asset structure of the banking sector in 2021 reveals some notable changes (**Figure 4**). Changes in asset structure reflect portfolio adjustments driven by the operating environment and individual bank's strategy in dealing with emerging challenges in the credit market as well as their risk appetite. First, loans and advances continued to dominate the asset structure, in 2021 accounting for 48.5 percent of total assets slightly below 49.3 percent in 2020. Investment in government securities took the second largest share of total assets, representing 29.8 percent of the total assets in 2021 (compared with 29.7 percent in 2020). Other relatively smaller components included interbank placements and holdings of cash and balances with the CBK, that respectively accounted for 5.4 percent and 5.2 percent of total assets in 2021, with minimal changes from their 2020 levels. All other assets aggregated accounted for 11.1 percent of the total assets in 2021 compared to 9.7 percent in 2020.

2.2 Banking System Loans and Advances

While the growth of loans and advances continued to pick momentum, it remained trapped within the single-digit levels, growing by 9.3 percent in 2021 to Kshs. 3.2 trillion from Kshs. 2.9 trillion in 2020 (**Figure 5**). The large size tier (1) banks continued to drive growth in industry loans and advances as growth in loans and advances of medium (tier 2) and small size (tier 3) banks remained modest over the period. Net loans and advances for the tier 1 banks expanded by 9.2 percent to Kshs. 2.5 trillion from Kshs. 2.3 trillion in 2020, as loans by the tier 2 and tier 3 banks grew by 12.9 percent and 5.0 percent, respectively.

Figure 5: Banking System Loans and Advances

Figure 5a: Total Net Loans and Advances (Ksh. Billion)

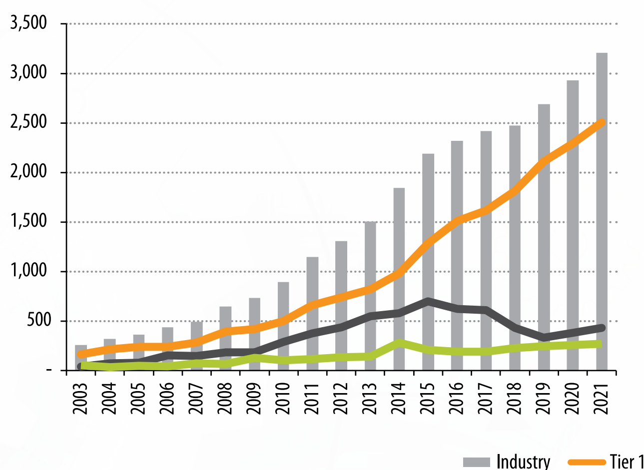
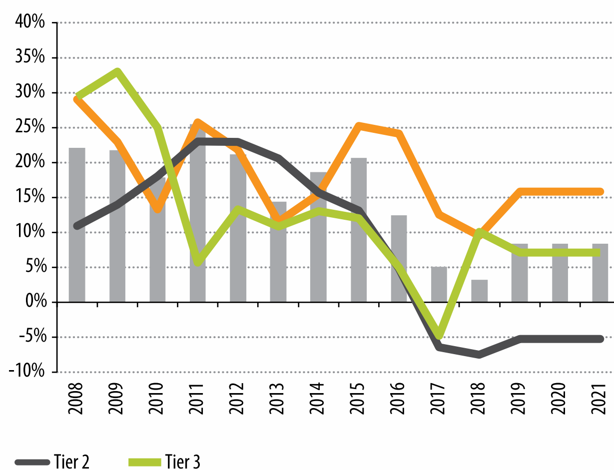


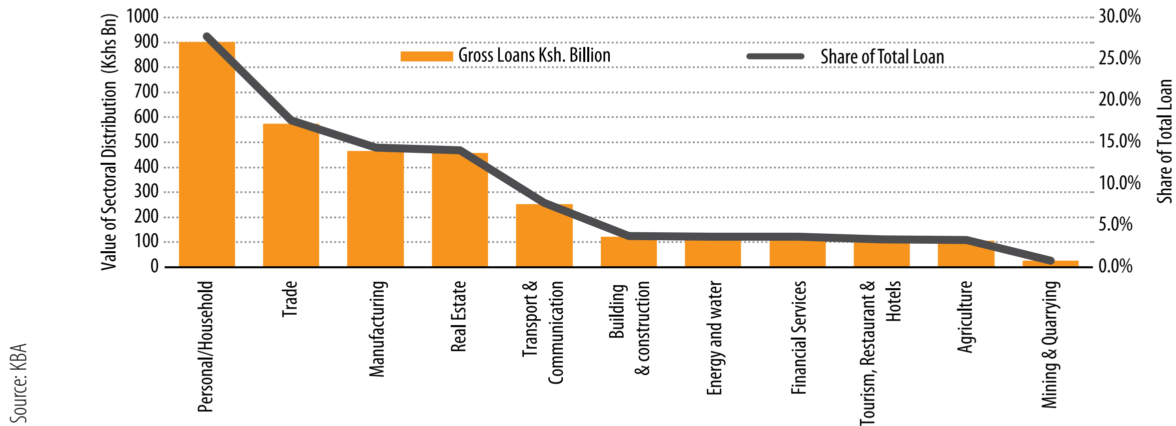
Figure 5b: Annual Growth in Net Loans and Advances



Industry Tier 1 Tier 2 Tier 3

Source: KBA

Figure 6: Banking System Sectoral Loan Distribution



At an industry level, and in terms of sectoral distribution, the private sector loans are concentrated in four sectors, which include personal/household (27.7%), trade (17.6%), manufacturing (14.3%), and real estate (14.1%), all accounting for 73.8 percent of the total industry loan book (**Figure 6**). As such, the evolution of these sectors' risk profile would have a stronger impact on the overall performance of the industry loan book.

2.3 Banking System Deposits

Deposits in 2021 continued to grow outpacing credit growth. Total deposits of the banking sector grew by 10.9 percent, to stand at Kshs. 4.6 trillion by end 2021 from Kshs. 4.1 trillion in 2020 (**Figure 7**). Despite this notable growth, within bank categories, the growth was varied with large and medium banks registering double digits growth. Deposit growth was characterised by marginal contraction. Among Tier II banks, deposits grew at 12.0 percent in 2021 compared to 17.2 percent in 2020. Tier I deposit grew at 10.6 percent in 2021 compared to 12.8 percent in 2020. Among Tier III banks, deposits grew at 10.7 percent in 2021 compared to 7.0 percent in 2020.

Figure 7: Banking System Deposits

Figure 7a: Total Deposits - KES Billion

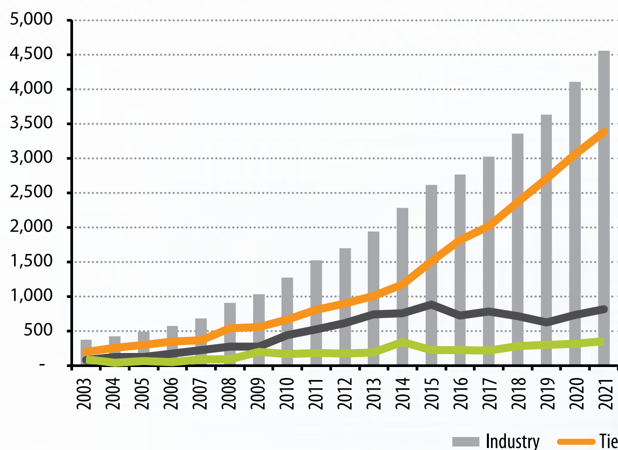


Figure 7b: Annual Growth in Total Deposits

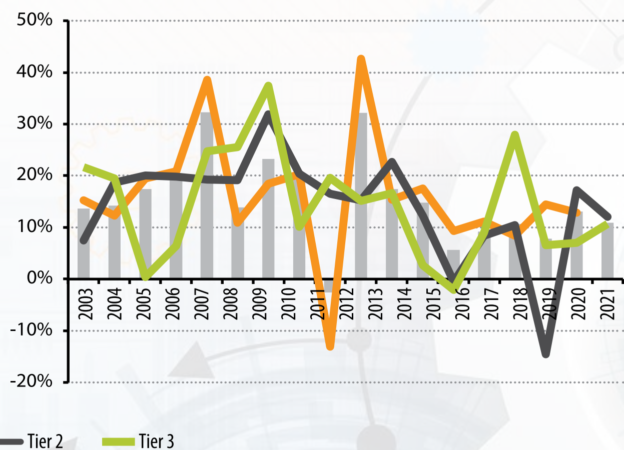


Figure 8: Banking System Loan-to-Deposit Ratio

Figure 8a: Loans to Deposits Ratio

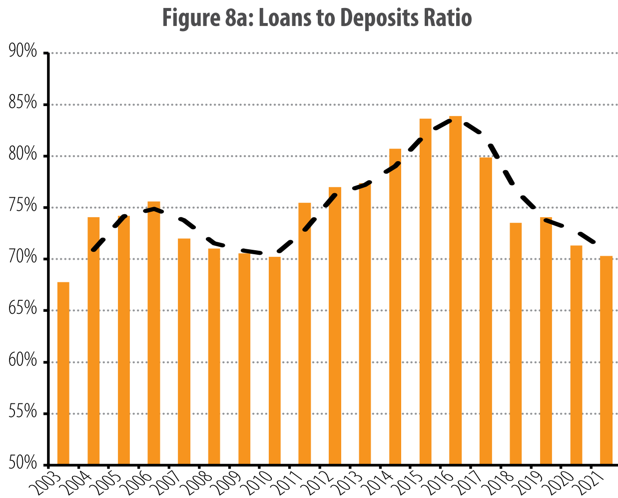
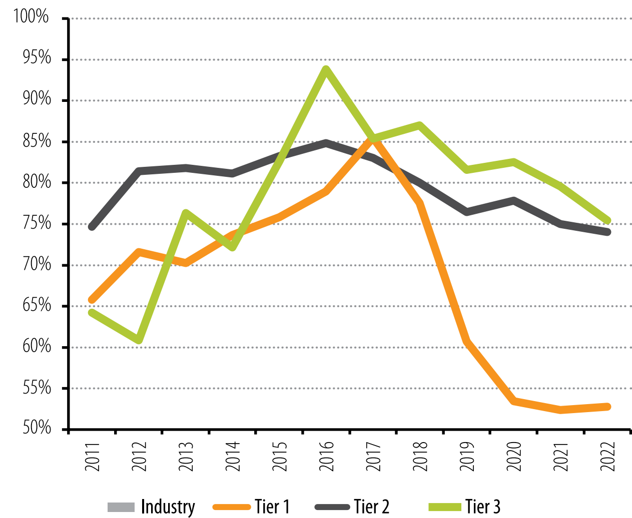


Figure 8b: Loans to Deposits Ratio across Banks



Source: KBA

2.4 Banking System Loan-to-Deposit Ratio

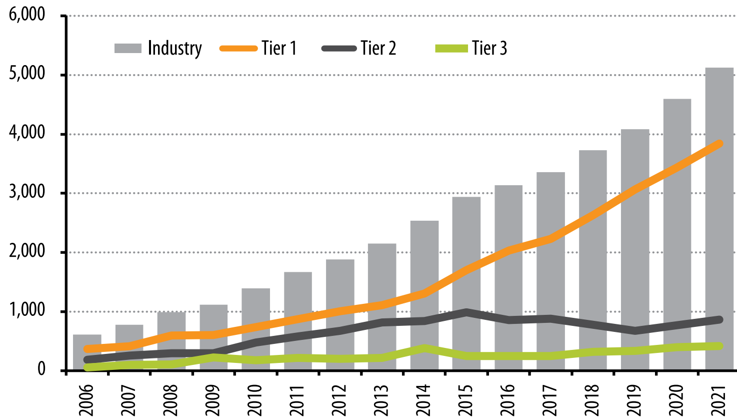
The system's structural liquidity, as measured by the loan-to-deposit ratio, continued to decline, and evolve variedly across bank tiers. Bank's loan-to-deposit ratio in 2021 stood at 70.3 percent compared to 71.2 percent in 2020 (**Figure 8a**), reflecting a faster growth in deposits – which grew by 10.6 percent - relative to the net loans and advances, which grew by 9.3 percent. The loan-to-deposit ratio remained the highest among tier 3 banks, albeit also mirroring the industry's downward trend. In 2021, tier 3 bank's loan-to-deposit ratio stood at 75.4 percent compared to 77.2 percent in 2020 and 82.6 percent in 2019. Further, loan-to-deposit ratio of tier 1 and tier 2 banks in 2021 stood at 74.0 percent and 52.8 percent, respectively, both trending downwards (**Figure 8b**).

> **Sustained trend growth in deposits outpacing loan growth**

2.5 Banking System Liabilities

The banking system's total liabilities, reflecting largely the evolution of deposits, grew by 11.5 percent in 2021 to Kshs. 5.1 trillion from Kshs. 4.6 trillion in 2020. Similarly, the evolution of total liabilities mirrored some differences across bank tiers. For instance, among tier 1 banks, the liabilities expanded by 11.9 percent to Kshs. 3.8 trillion in 2021 as liabilities for the tier 2 banks edged upwards by 12.6 percent to Kshs. 865.7 billion in 2021. The liabilities for the tier 3 banks grew by 5.6 percent to Kshs. 417.7 billion percent in 2021 (**Figure 9**).

Figure 9: Banking System Liabilities

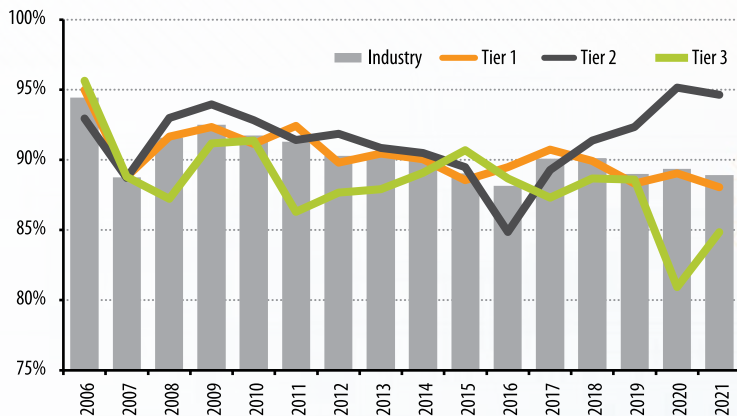


Source: KBA

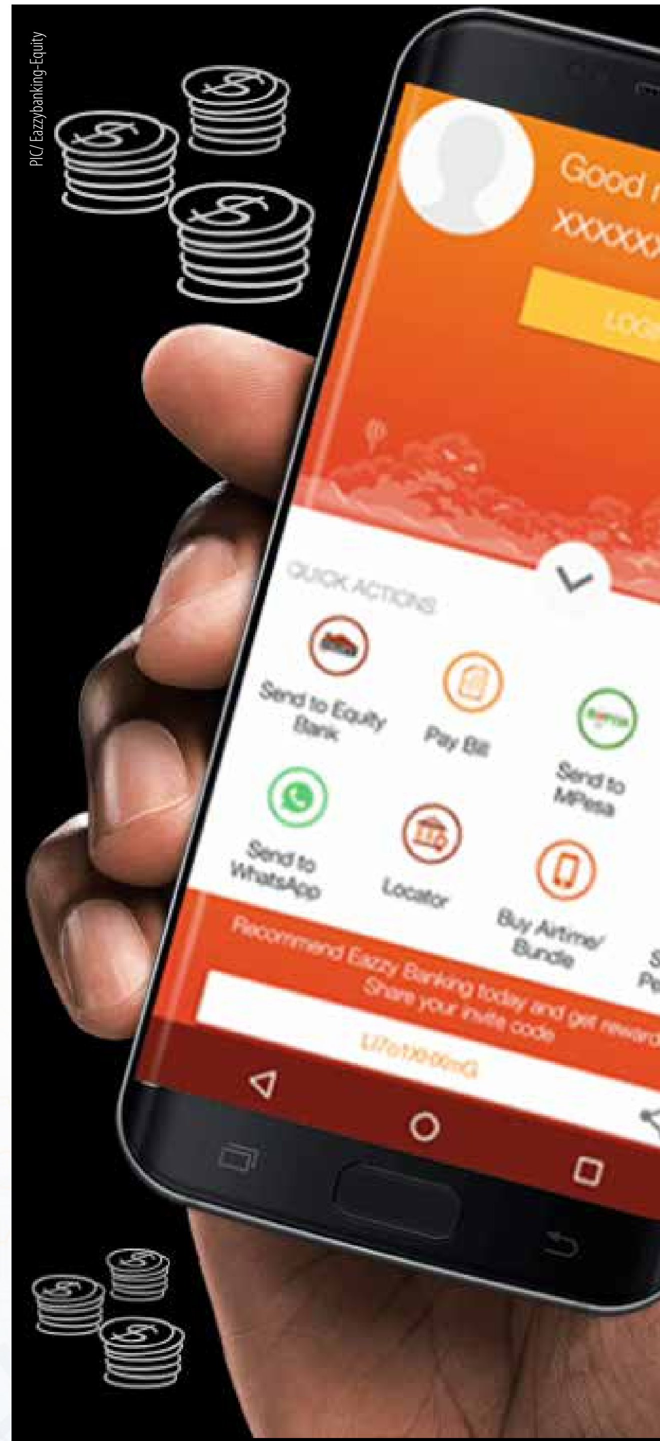
2.6 Banking System Deposit-to-Liability Ratio

Focusing on the liability side of the bank balance sheet, the deposit-to-liability ratio contracted marginally in 2021, to 88.9 percent from 89.4 percent in 2020, and depicted mixed trends across bank tiers (**Figure 10**). Across bank tiers, the evolution of the deposit-to-liability ratio while mirroring industry trends remained elevated among tier 2 banks at 94.6 percent compared to 95.2 percent in 2020. Among tier 1 banks, the ratio also declined to 88.1 percent from 89.0 percent in 2020. However, among tier 3 banks, the ratio edged upwards to 84.9 percent in 2021 from 83.5 percent in 2019 on account of a more than proportionate increase in total liabilities than in total deposits.

Figure 10: Banking System Deposit-to-Liability Ratio



Source: KBA



PIC/ Eazzybanking-Equity

Chapter 3:

PUBLIC DEBT DEVELOPMENTS

The stock of public debt continued to build up to stand at Kshs. 8.2 trillion in 2021 (Figure 11a). Amidst uncertainty and slack in economic performance, the banking sector balance sheet adjustments emerged, and notable was portfolio rebalancing towards government securities as banks sought for higher yield. Similarly, the shift of bank's portfolio owed to the perceived safety of more liquid public assets during the COVID-19 pandemic.

Banks' holdings of local currency government debt in 2021 increased significantly as a share of their assets. **Figure 11b** shows the trends of bank's domestic sovereign debt exposure since 2018; highlighting the fact that from 2020, the share of government securities held by banks has remained above the historical average since 2005. While this reflects a portfolio establishment in government debt, it mirrors the elevated private sector credit risk. In particular, 32.4 percent of government securities as of December 2021 was held by the banking system compared to 32.6 percent recorded in 2020.

Figure 11:Public Debt Dynamics and Banking Sector Holdings of Government Debt

Figure 11a. Public Debt, 2011–21
Public debt has surged ...

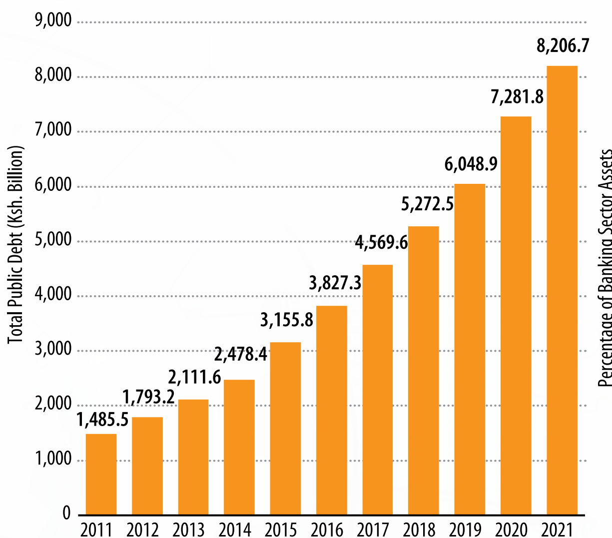
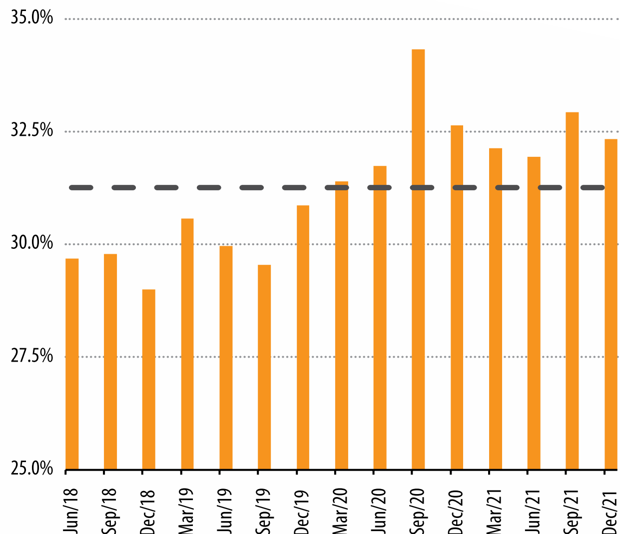
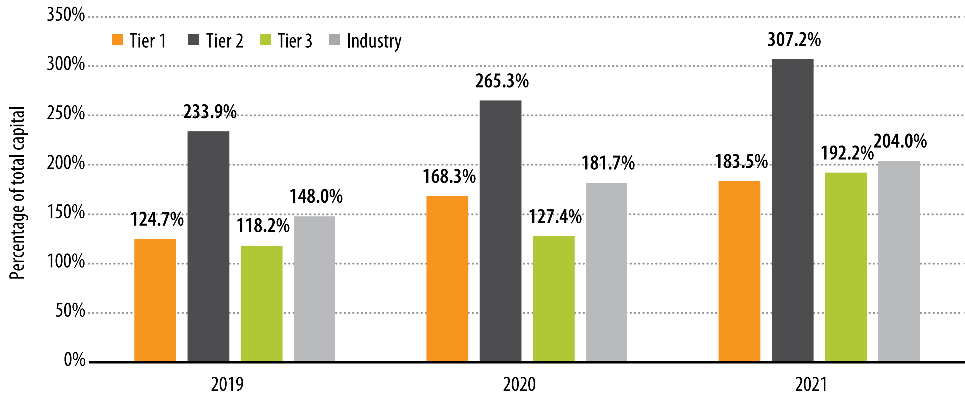


Figure 11b. Banks' Domestic Sovereign Debt Exposure, 2005–21
... the share of government securities held by banks increased during the pandemic, and reached historic highs



Source: CBK

Figure 12: Banks' Exposure to Sovereign debt Relative to Total Capital



As a share of total capital, bank's investment in government securities rose to 204 percent in 2021 compared to 181.7 percent in 2020 and 148.0 percent in 2019. The increase in the ratios was evident across all bank tiers, with tier 2 banks depicting the highest ratios (**Figure 12**), while the 2021 growth reflects increased exposure to sovereign risks, concerns included the fact that any delays in fiscal consolidation would have adverse implication on private-sector credit recovery and increase bank-sovereign linkages.

Evidently, as **Figure 13a** shows, banks with higher capital buffers also tend to invest more in government securities; a pattern that was more evident in tier 3 banks. The motive of holding government securities is varied and well documented in the literature. For instance, and as shown in **Figure 13b**, banks hold government securities to support their liquidity management as the higher the loan-to-deposit ratio, the lower is the year-on-year changes in the ratio of government securities to total assets.

Figure 13: Bank's sovereign exposure and balance sheet dynamics

Figure 13a: Capital Regulatory Buffers and Banks' Holdings of Government Securities, 2021

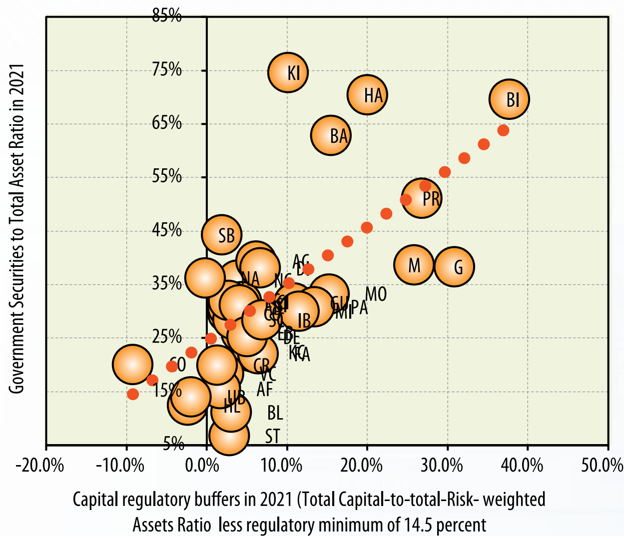
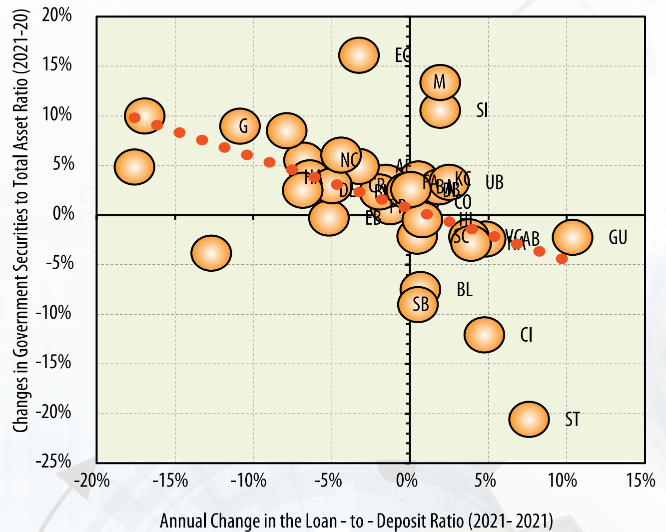


Figure 13b: Change in the Ratio of Bank's holdings of Government Securities to Total Assets versus Change in the Ratio of Loans to Deposits, 2020-21 (Percent)



I&M
jeecalih-unsplash

Chapter 4:

ASSET QUALITY

4.1 Asset Quality

The stock of non-performing loans (NPL) in the banking system continued to edge upwards during the period, to approximately Kshs. 460 billion from Kshs. 436 billion in 2020 (Figure 14). The distribution of the NPLs by volume, however, remained non-homogenous across the banking system. Among tier 1 banks, the rate of growth of gross NPLs in 2021 was 7.1 percent to stand at Kshs. 323.20 billion as the NPLs among tier 3 banks grew by 5.5 percent to Kshs. 57.78 billion in 2021. However, the volume of NPLs held by tier 2 banks contracted by 2.3 percent. The evolution of NPLs in the industry and across bank tiers reflected an elevated credit risk as the economy continued to suffer the devastating effects of the pandemic on firms and households' incomes and the measures applied by individual banks to mitigate any further deterioration of their credit portfolios.

Figure 14: Banking System Gross Non-Performing Loans

Figure 14a: Gross Non-Performing Loans (Ksh. Billion)

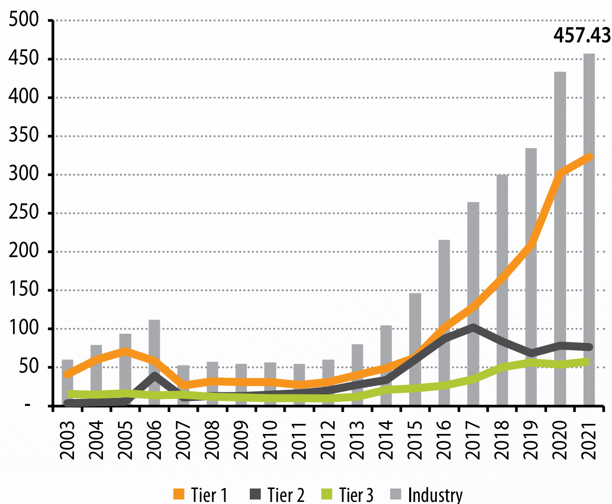
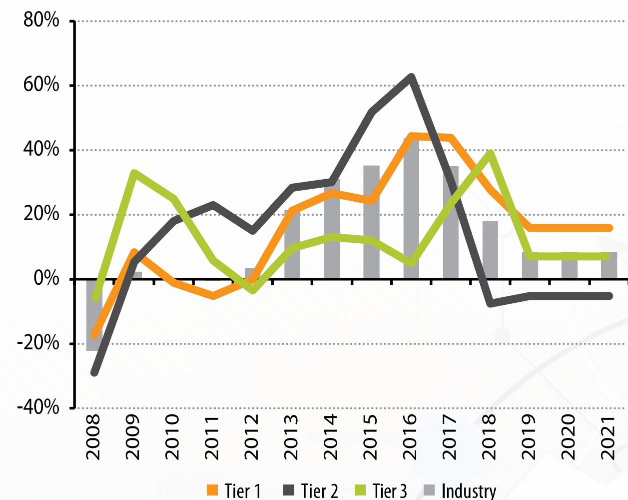


Figure 14b: Annual Growth in NPLs (Percent)



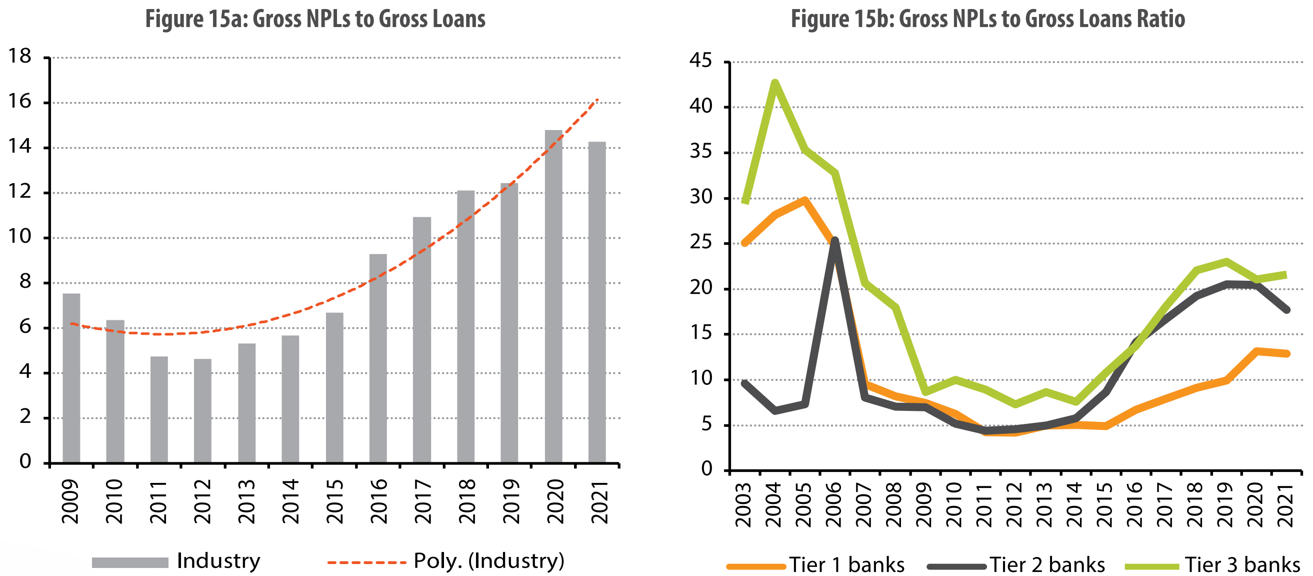
Source: KBA

The asset quality improved marginally in 2021 as the economy recovered from the effects of the pandemic that peaked in 2020. By end 2021, the gross NPLs ratio to gross loans stood at 14.1 percent, down from 14.5 percent at the end of 2020 (**Figure 15**). This reflected a larger quantum decline in growth of gross NPLs than the increase in gross loans.

Heterogeneities across bank tiers were evident, as tier 3 banks reflected significantly higher (and growing) NPL ratios than the tier 2 and tier 1 banks[5]. Notably, tier 3 bank's NPL ratio edged upwards while that of medium and large banks continued to register improvements in 2021. In particular, the NPL ratio among tier 3 banks rose to 21.6 percent in 2021 from 21.1 percent in 2020 while that of tier 2 and tier 1 banks declined to 17.7 percent and 12.9 percent, respectively in 2021, from 20.4 percent and 13.2 percent in 2020.

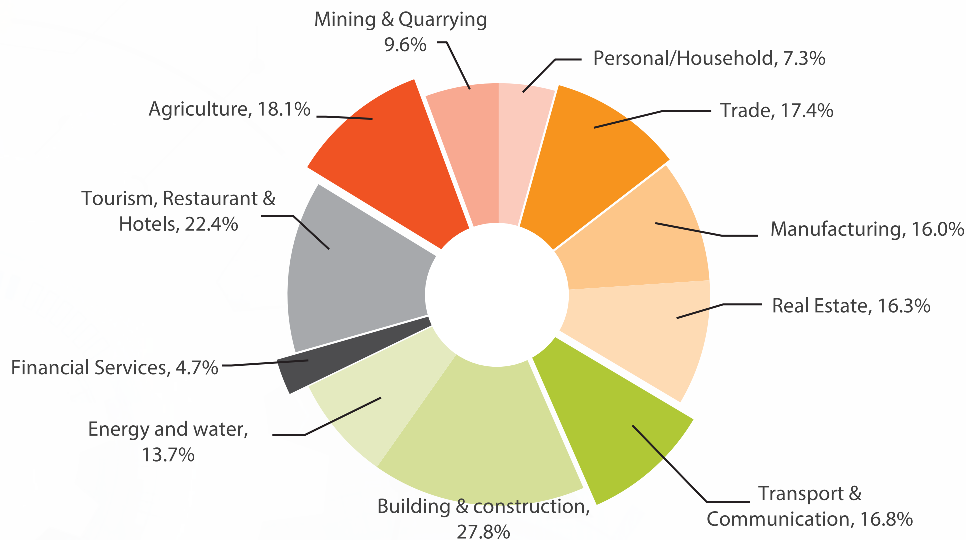
5 Tier 3 banks have traditionally had higher NPL ratios across the years.

Figure15: Banking System Gross Non-Performing Loans to Gross Loans



Source: KBA

Figure16: Banking System Sectoral Asset Quality in 2021

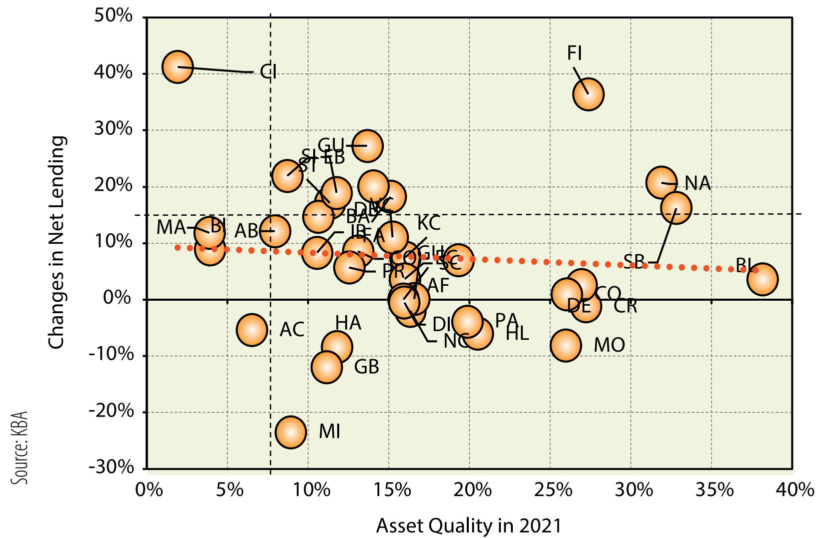


Source: CBK

As **Figure 16** shows, the bulk of the asset quality deterioration was registered in building and construction (27.8 %), tourism, restaurant, and hotels (22.4%), manufacturing (18.1%), trade (17.4%), transport and communication (16.8%) real estate (16.3%), and manufacturing (16.0%). Other sectors' asset quality remained better than the industry average of 14.1 percent (for instance energy and water (13.7%), mining and quarrying (9.6 %), personal/household (7.3%), and financial services (4.7 %)).

The state and evolution of the NPLs reveals the extent to which market uncertainty has filtered into the risk attitude of banks, and consequently the adjustments they are making regarding loan portfolio growth, adherence to regulatory requirements as well as shareholder expectations. The elevated NPLs triggers increased risk averseness and a decline in net lending, albeit the relationship being moderate (**Figure 17).** This observation is aligned to recent studies [e.g., Raunig, et al. (2017)[6]] that empirically determine that banks reduce loan supply in times of higher uncertainty, causing households and firms to cut back on their investments and consumption.

Figure17: Asset Quality and Growth in Net Lending Nexus



4.2 Loan Loss Provisions

With an elevated credit risk, banks made provisions for expected credit losses sufficient to offset this risk. Banking sector loan loss provisions contracted sizably in 2021 compared to 2020 but remained higher than the pre-pandemic levels. In 2021, the loan loss provisions stood at Kshs. 58.97 billion compared to Kshs. 110.30 billion in 2020 (**Figure 18**) representing a 46.5 percent contraction on an annual basis, mainly driven by tier 1 banks, as provisions among tier 2 and 3 banks changed modestly. The rate of contraction among tier 1 banks was 50.1 percent, while among medium and small banks stood at 13.2 percent and 25.8 percent, respectively. Provisions made in 2020 were released, reflecting the impact of economic recovery that implied lower expected credit losses than anticipated in 2020.

Figure 18: Banking System Loan Loss Provisions

Figure 18a. Loan Loss Provisions

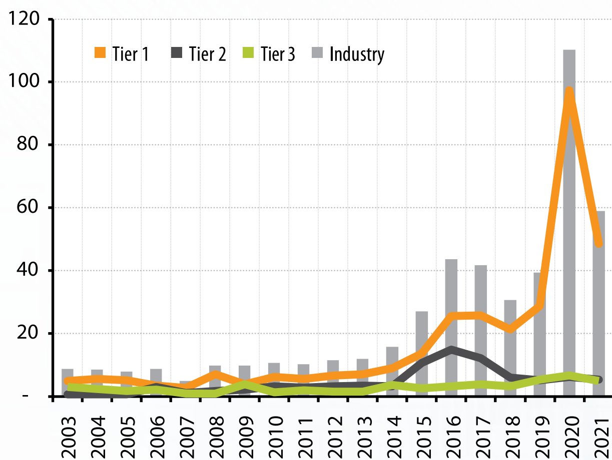
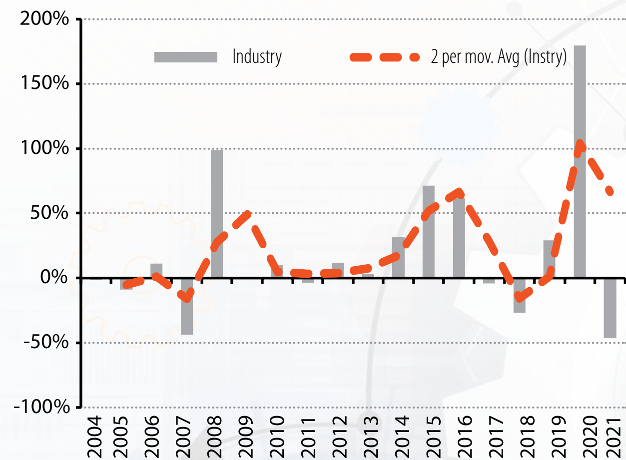


Figure 18b: Annual Growth in Loan Loss Provisions



6 Raunig, B., Scharler, J., and Sindermann, F. (2017) "Do Banks Lend Less in Uncertain Times?", *Economica*, Volume 84 (36) pp. 682 -711. (See the working paper version is here: https://www.econstor.eu/bitstream/10419/101084/1/780100263.pdf)

Banking sector coverage ratio in 2021 improved, indicating the fact that provisioning broadly kept pace with the evolution of credit risk. In particular, the ratio of loan loss provisions to net loans and advances declined in 2021 both at the industry and across the three bank tier categories, albeit at varied magnitudes.

The coverage ratio at the industry level in 2021 stood at 2.0 percent, 2.1 percent both for the tier 1 and tier 3 banks and 1.4 percent for tier 2 banks (**Figure 19a**). As a proportion of total risk-weighted assets, provisions in 2021 stood at 1.3 percent compared to 2.7 percent in 2020; with the decline mainly driven by a quantum drop in provisions (**Figure 19b**). For tier 1 banks, the ratio of total provisions to total risk-weighted assets stood at 1.3 percent, as tier 2 and tier 3 banks respectively reflected 0.9 percent and 1.5 percent. As total provisions declined drastically, its ratio to total capital also dropped to 6.7 percent in 2021 from 14.0 percent in 2020 (**Figure 19b**). Across banks, the ratio of total provisions to total bank capital stood at 7.2 percent, 3.8 percent, and 7.9 percent for tier 1, tier 2 and tier 3 banks, respectively.

Figure19: Banking System's Coverage Ratio

Figure 19a: Provisions to Total Loans

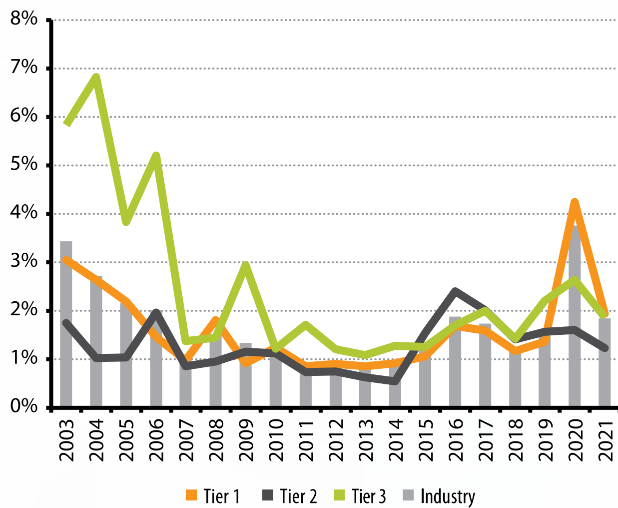
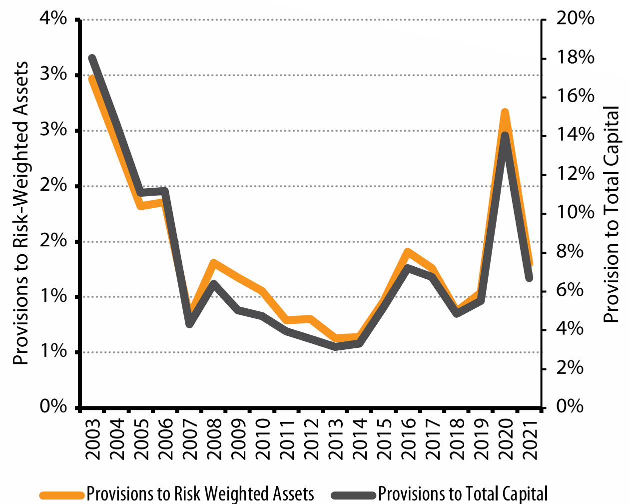


Figure 19b: Loan Loss Provisions to Total Risk Weighted Assets and Total Capital



Source: KBA

Figure 20: Banking System's Provisions to Non-Performing Loans Ratio

Figure 20a: Provisions to NPLs

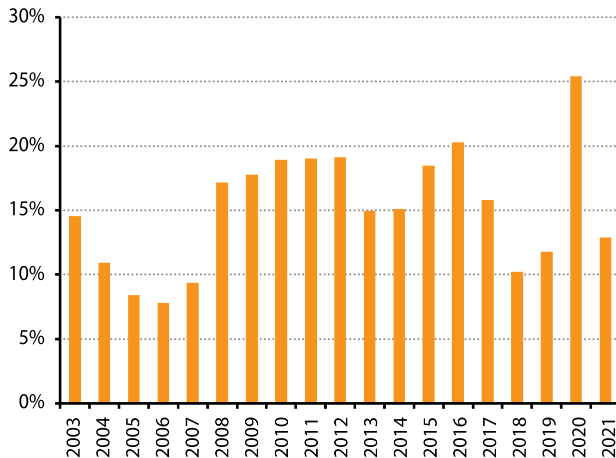
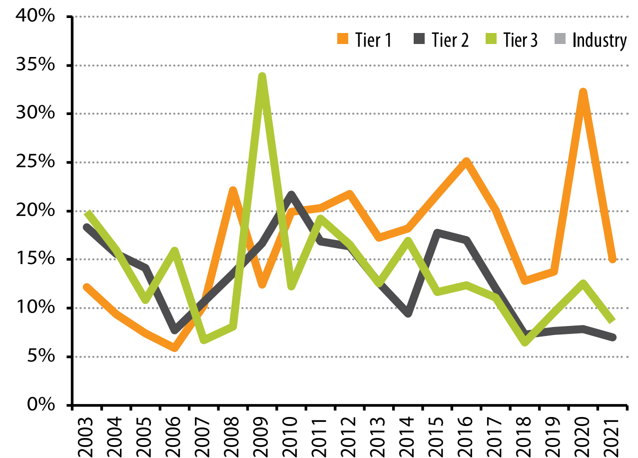


Figure 20b: Provisions to NPLs



Source: KBA

The ratio of loan loss provisions to gross non-performing loans, albeit reflecting a decline in 2021, remained higher than the pre-pandemic levels (**Figure 20**). At the industry-level, the ratio stood at 12.9 percent in 2021, about half of 25.4 percent recorded in 2020. A similar trend is also reflected across the bank categories, with tier 1 banks' ratio declining by more than half to stand at 15 percent in 2021 from 32.3 percent in 2020. For the tier 2 and tier 3 banks, their respective ratios of the provisions to gross NPLs depicted mixed trends, respectively contracting to 7.0 percent and 8.6 percent in 2021 from 7.9 percent and 12.5 percent in 2020.

4.3 Capital Adequacy

The banking sector continued to depict resilience in 2021 against the protracted challenges presented by COVID-19 pandemic on economic activities. Capitalization of the banking sector remained strong and well above minimum statutory regulatory requirements, despite the deterioration in credit risk. In 2021, the ratio of total capital to risk-weighted assets rose to 19.5 percent from 19.0 percent in 2020 against a statutory regulatory minimum of 14.5 percent (**Table 1**). Similarly, the ratio of core capital to total risk weighted assets remained above statutory minimum of 10.5 percent, largely unchanged, at 16.5 percent in 2021 compared to 16.6 percent in 2020. As a ratio of total deposits, core capital in 2021 stood at 16.4 percent slightly below 16.7 percent in 2020, even though it was well-above the 8 percent minimum statutory capital requirements.

Table 1: Capital Adequacy Ratios

	2016	2017	2018	2019	2020	2021	Minimum Capital Adequacy Ratios (percent)
Core Capital/ TRWA (percent)	16.9	16.4	16.6	16.6	16.6	16.5	10.5
Total Capital/ TRWA (percent)	19.5	18.7	18.0	18.8	19.0	19.5	14.5
Core Capital/ Total Deposits (percent)	19.0	18.1	17.3	17.4	16.7	16.4	8.0

Notes: TRWA: Total-Risk-Weighted-Assets; CAR: Capital Adequacy Ratios

Source: KBA

Chapter 5:

FINANCIAL PERFORMANCE

5.1 Operating Incomes

Banking sector total operating income sustained its growth in 2021, marginally rising by 9.4 percent to Kshs. 628.5 billion from Kshs. 574.7 billion in 2020 (Figure 21a). The overall income growth reflected differentiated contribution by the various income sources, with interest income dominating at 47.6 percent of the total operating income, followed by interest from investments in government securities that contributed 27.8 percent.

The third contributor to operating income was fees and commission incomes which accounted for 13.7 percent as foreign exchange gains accounted for 6.1 percent of operating income. Other interest and operating income accounted for 3.5 percent of operating income. The dynamics in total operating income contributions reflected banks investment strategies amidst uncertainty caused by the pandemic, a tradeoff between credit and liquidity, and portfolio realignments to mitigate elevated private sector credit risk.

beks-uzyzobh-unsplash

Figure 21: Banking System Operating Incomes

Figure 21a: Total Operating income (Kes. Billion) and Annual Growth

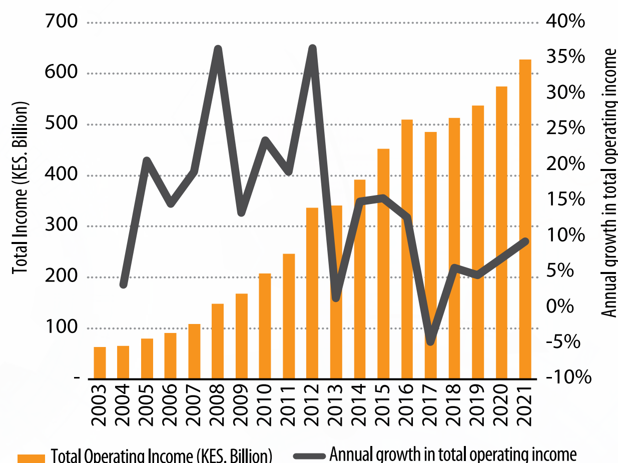
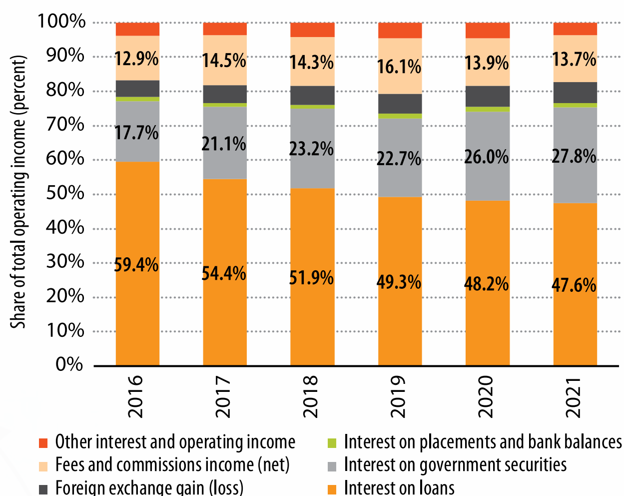


Figure 21b: Share of Disaggregated Incomes in Total Operating Income



In terms of volumes, as interest income rose to Kshs. 298.87 billion in 2021 from Kshs. 276.93 billion in 2020 registering a 7.9 percent year-on-year growth, interest from investments in government securities rose to Kshs. 174.63 billion from Kshs. 149.24 billion in 2020. This represented a 17.0 percent annual growth; the highest growth registered in comparison with other sources of operating income. Incomes from fees and commissions registered an annual growth of 8.1 percent from Kshs. 79.7 billion in 2020 to Kshs. 86.2 billion in 2021, reversing the contraction recorded in 2020. Foreign exchange gains grew at 9.3 percent to Kshs. 38.6 billion from Kshs. 35.3 billion in 2020. This growth was, however, lower than the 14.7 percent annual growth recorded in 2020. Other interest and operating income contracted to Kshs. 22.3 billion in 2021 from Kshs. 25.9 billion in 2020.

5.2 Operating Costs

Operating costs declined (Figure 22) as banks deployed cost rationalisation measures supporting bank income recovery. Overall, banking sector total operating expenses contracted by 12.6 percent to Kshs. 502.34 billion in 2021 from Kshs. 574.58 billion in 2020 on account of cost containment efforts by the sector amidst the effects of COVID-19 pandemic. A significant driver in the cost reduction was the decline in loan loss provisions which contracted by 18.7 percent to Kshs. 58.97 billion in 2021 from 110.30 billion in 2020. In addition, interest expenses on borrowed funds, deposits and interbank placements also contracted by 5.7 percent to Kshs. 6.6 billion in 2021 from 7.1 billion in 2020. Similarly, the general administrative expenses also contracted by 2.0 percent in 2021 to Kshs. 194.77 billion. However, other components of interest income; namely interest on deposits and other interest and operating expenses, edged upwards, albeit at a rate lower than the 2020 levels for the former and higher for the latter. Interest expenses on deposits grew by 6.8 percent to Kshs. 135.96 billion in 2021 compared to Kshs. 127.27 billion in 2020.

Figure 22: Banking System Operating Costs

Figure 22a: Total Operating Costs (Kes. Billion) and Annual Growth

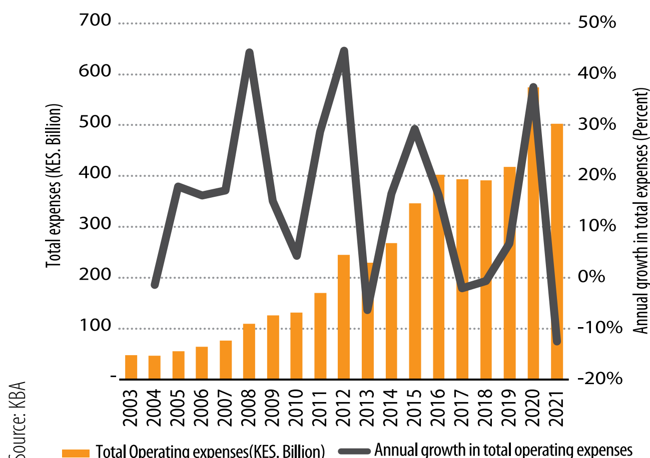
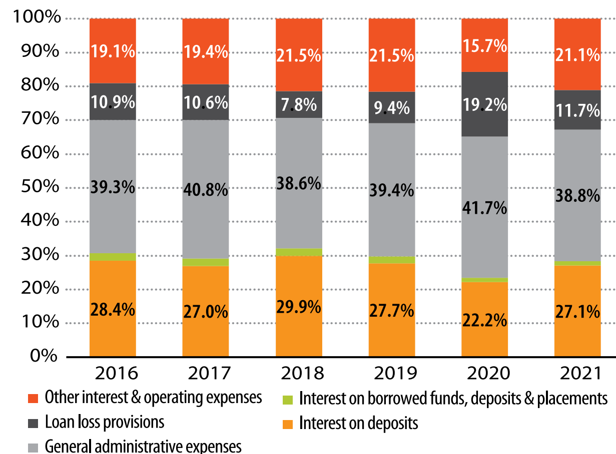


Figure 22b: Share of Disaggregated Costs in Total Operating Costs



Source: KBA

Administrative expenses and interest expenses are the two main cost components of bank costs, respectively accounting for 38.8 percent and 27.1 percent of banks' costs as at the end of 2021 (**Figure 22b**). Loan loss provision's share of operating expenses stood at 11.7 percent in 2021, lower than 19.2 percent in 2020, while other interest and operating expenses stood at 21.1 percent of operating expenses. Interest expenses on borrowed funds, deposits, and interbank placements as a share of operating expenses remained largely unchanged between 2020 and 2021.

5.3 Cost-to-Income Ratio

Banks' aggregate cost-to-income ratio[7], a proxy of a bank's efficiency, improved with costs absorbing 58.1 percent of the incomes in 2021 compared to 74.1 percent in 2020 (Figure 23a). The efficiency levels varied widely across bank tiers with tier 1 banks depicting low cost-to-income (CIR) ratios at 55 percent in 2021 (down from 72 percent in 2020) relative to the tier 2 and tier 3 banks (**Figure 23b**). This

Figure 23: Banking Sector Cost-to-Income Ratio

Figure 23a: Industry Cost-to-Income Ratio

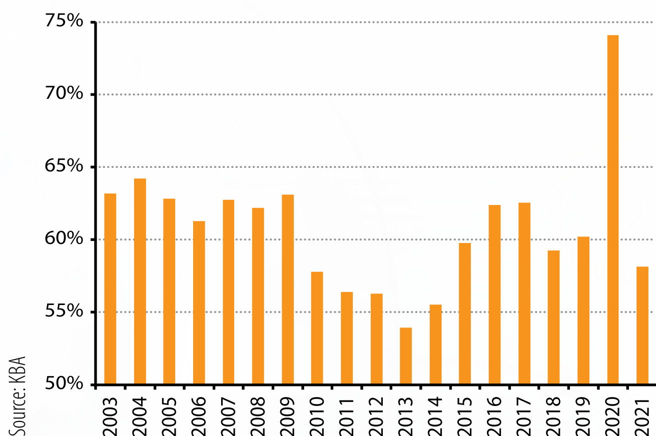
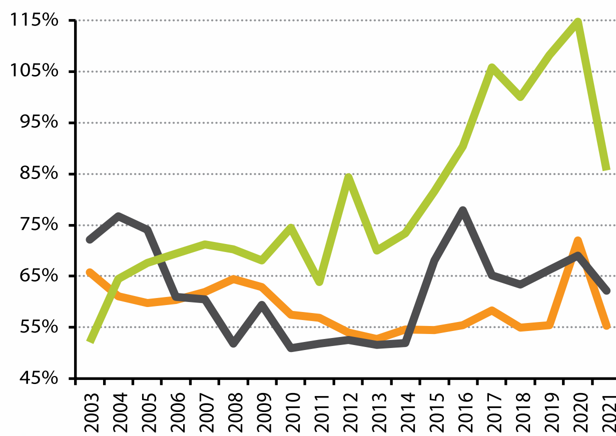


Figure 23b: Cost-to-Income Ratio Across Banks



Source: KBA

7 This is obtained by dividing a bank's operating costs to its total revenue. A relatively high ratio shows cost inefficiencies

reflects the size advantage that tier 1 banks have leveraging on their ability to enjoy economies of scale in the provision of banking services. Nonetheless, there was a notable improvement in the efficiency for the tier 3 banks as their CIR declined to 86 percent during the year from 115 percent in 2020. Similarly, the CIR for the tier 2 banks declined to 62 percent in 2021 from 69 percent in 2020. The observed divergent pattern partly reflects the differences in the business models as well as institutional differences.

Figure 24: Cost-to-Income Ratio and Bank Balance Sheet Dynamics

Figure 24a: Correlation between Cost-to-Income Ratio and Bank Size

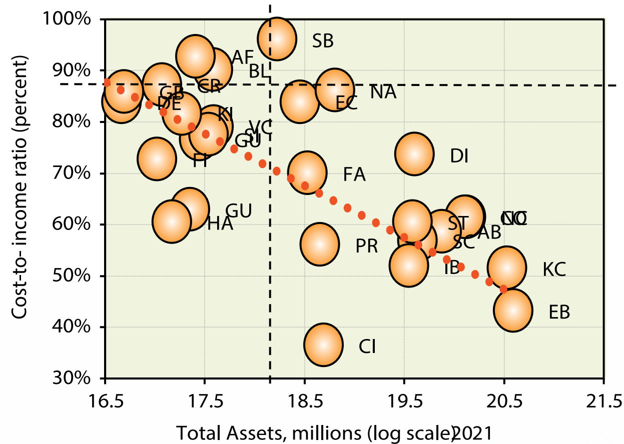


Figure 24b: Correlation between Cost-to-Income Ratio and Net Interest Margin

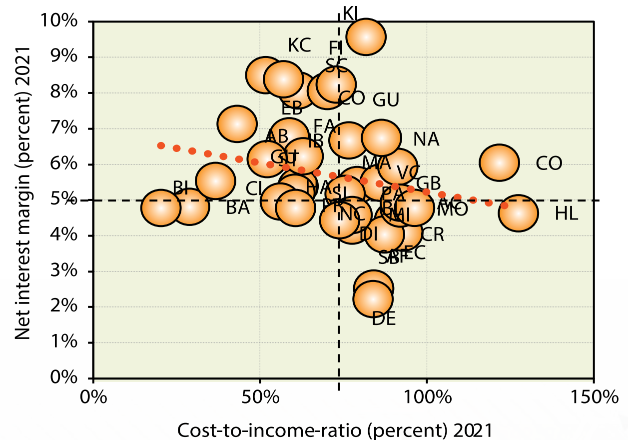


Figure 24c: Correlation between Cost-to-Income Ratio and Cost of Funding

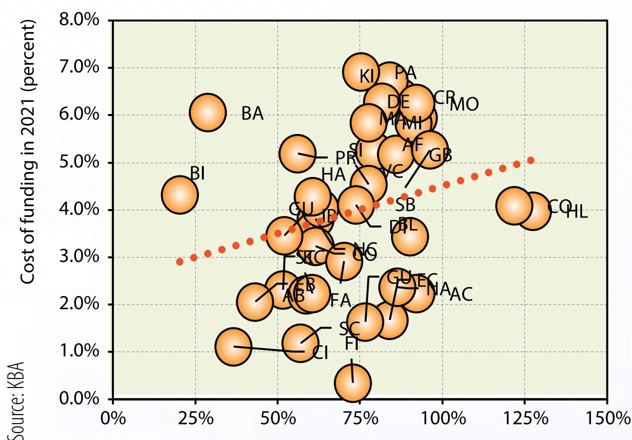
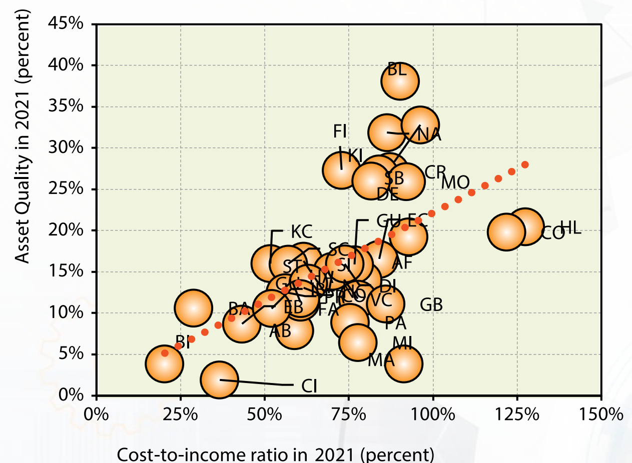


Figure 24d: Correlation between Cost-to-Income Ratio and Asset Quality



Evidently, CIR is inversely related to bank size (**Figure 24a**). Larger banks tend to be more cost-efficient than smaller ones because of their capacity to spread overheads over a large revenue or asset base. In addition, the fact that on average larger banks tend to operate closer to the production frontier; they have costs incurred over and above the minimum cost necessary to sustain output at a certain level. The implication of a higher CIR is a depressed net interest margin (**Figure 24b**) and associated with a higher cost of funding (**Figure 24c**). In addition, banks with a higher cost-to-income ratio also tend to register a higher NPL ratio (**Figure 24d**).

Figure 25: Banking Sector Net Interest Margin and Interest Rate Developments

Figure 25a: Bank Net Interest Margin

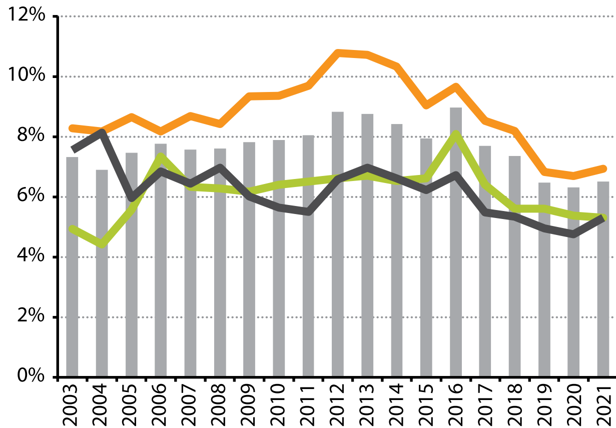
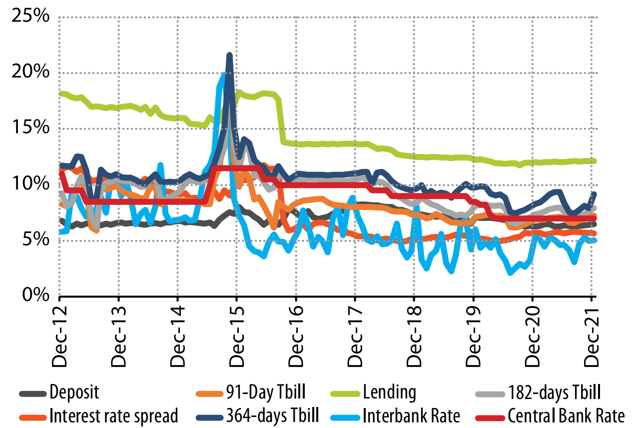


Figure 25b: Evolution of Key Interest Rates, 2012-2021



5.4 Net Interest Margin

Analyses of the banking sector's net interest margin showed an improvement in 2021, albeit marginally but reflecting a notable reversal in the downtrend registered since 2016. Net interest margins was on the rise between 2003 and 2013. However, post-2014 it has been shrinking, partly reflecting the increasing competition within the industry. In 2021, however, the net interest margin edged up to 6.5 percent from 6.3 percent in 2020 (**Figure 25a**).

Across banks, net interest margins varied considerably, with tier 3 banks recording the highest improvements in 2021 (Figure 25a). Driving the observed industry's net interest margin is the evolution of the short-term interest rates which rose during the period (Figure 25b). Based on a two-way comparative analysis, it is observed that the larger the bank the higher the interest margins (Figure 26), but the relationship between net interest margins and total-capital-to-risk-weighted assets is weak.

Figure 26: Net Interest Margin, Bank Size and Capital Adequacy Nexus

Figure 26a: Correlation between Net Interest Margin and Bank Size

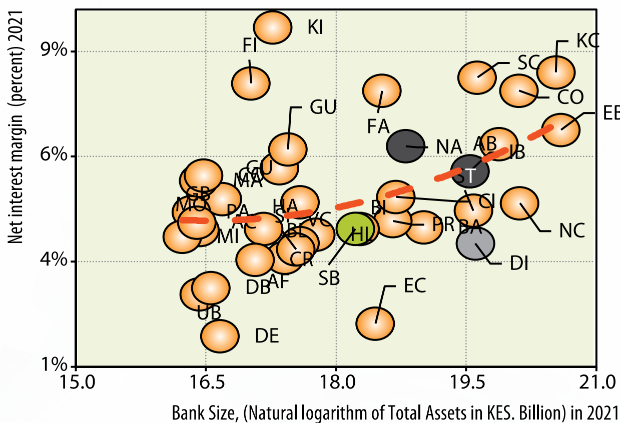
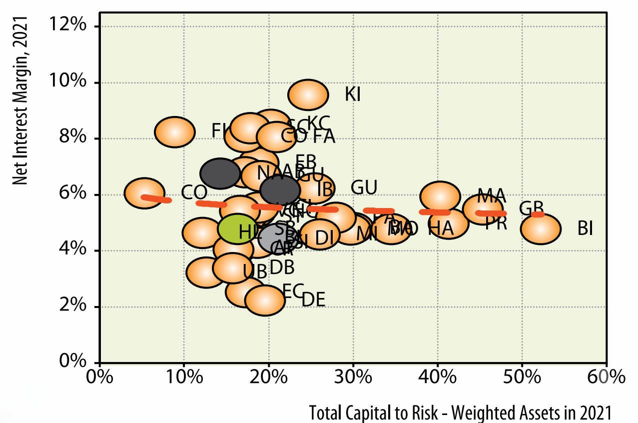
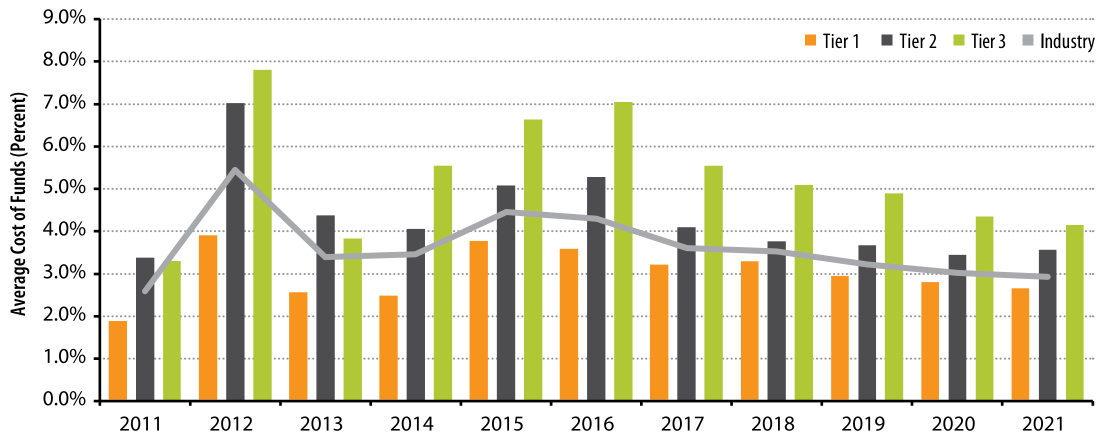


Figure 26b: Correlation between Net Interest Margin and Total Capital to Risk-Weighted Assets



Source: KBA

Figure 27: Banking System Cost of Funding



5.5 Cost of Funding

The average banking sector average funding costs continued to decline, though marginally, to 2.9 percent in 2021 from 3.0 percent in 2020 and 3.2 percent in 2019 (Figure 27). Tier 1 banks led the pack having been able to lower the marginal cost of funding[8] to below industry average, when compared to the tier 2 and tier 3 banks; a feature attributable to their ability to take advantage of economies of scale particularly via three perspectives[9]. First, they are more diversified and thus perceived as safer havens. Second, unlike smaller banks, they can take advantage of their spread to mobilize more retail deposits that are often cheaper than wholesale deposits, making them more cost-efficient, and third, they have lower average NPL ratio, which positively correlates with lower funding costs[10].

For tier 3 banks, even with the highest average funding costs, the differential between the industry average and their funding costs has been narrowing.

Credit/ namiri digital bank africa

8 This is the cost of raising an additional unit of funding.

9 Tier 3 banks continue to have significantly higher cost of funding than tier 2 and tier1 banks. The cost of funds for Tier 3 banks stood at 4.15 percent in 2021, while that of tier 2 banks at 3.6 percent, both above the industry average. Tier 1 bank's cost of funding in 2021 stood at 2.6 percent, which is below the industry average.

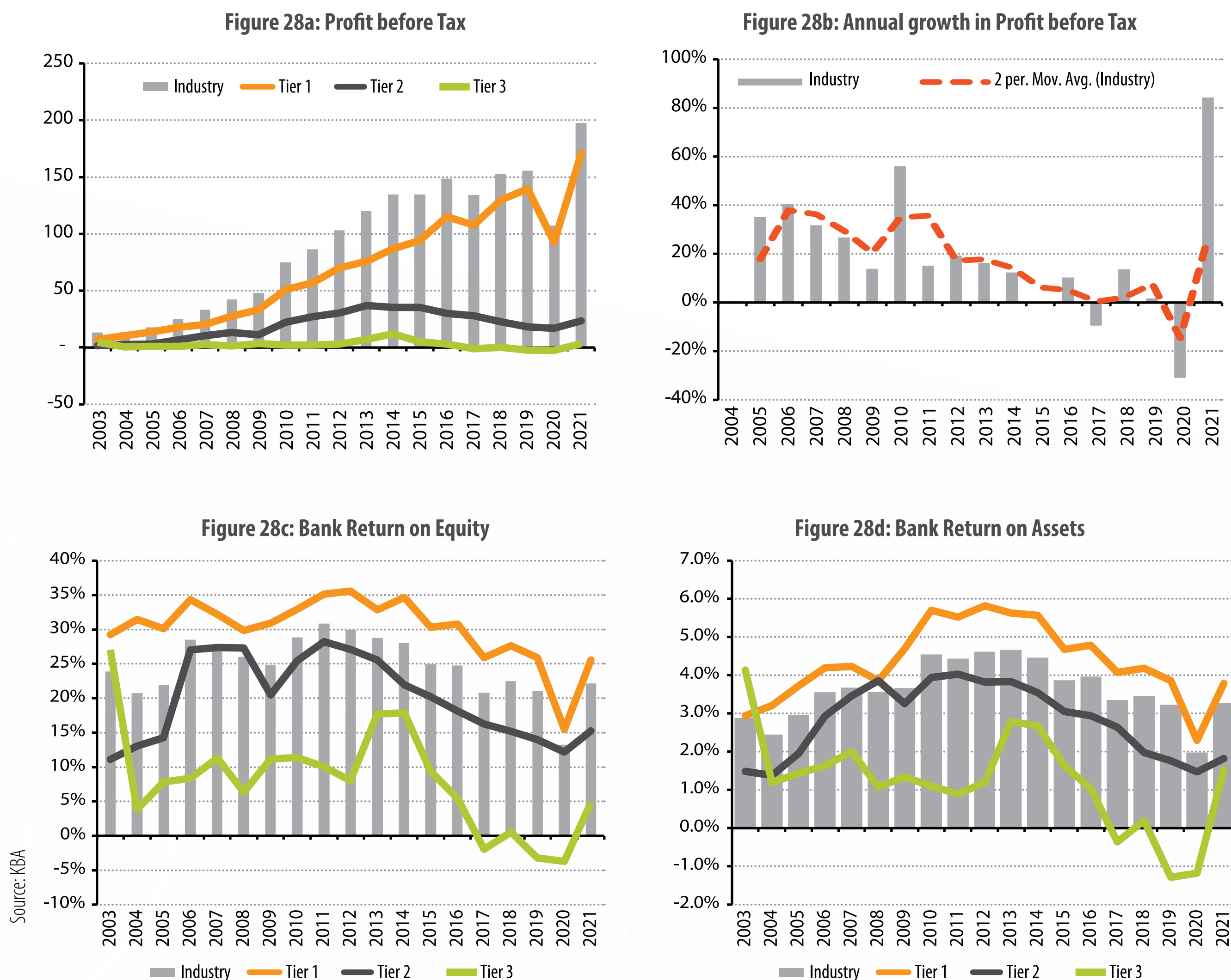
10 The transmission channel is such that a higher NPL ratio calls for more provisioning in tandem with the increased balance sheet riskiness. As a result of the deteriorating quality of a bank's portfolio investors would be seeking higher returns and this leads to an elevated funding costs for a bank.

5.6 Profitability

The industry's pre-tax profits rose by 84.3 percent to Kshs. 197.7 billion in 2021 from Kshs. 107.3 billion in 2020 (Figure 28). This translated to an average return on assets (ROA) of 3.28 percent compared to 1.98 percent in 2020, and an average return on equity (ROE) of 22.1 percent in 2021 up from 13.3 percent in 2020. Disaggregating the pre-tax profits, tier 1 bank's pre-tax profits almost doubled from Kshs. 92.67 billion in 2020 to Kshs. 170.6 billion in 2021, as the pre-tax profits of tier 2 banks rose from 17.12 billion in 2020 to Kshs. 23.58 billion in 2021. Similarly, tier 3 bank's pre-tax profit rose to Kshs. 3.48 billion in 2021 from Kshs. 2.51 billion in 2020.

Tier 1 banks in 2021 posted 25.6 percent average ROE and 3.79 percent average ROA, while medium banks reported 25.5 percent and 1.83 percent, respectively. The ROE for tier 1 and tier 2 banks was much higher than for the tier 3 banks which stood at 4.83 percent in 2021, even when the latter's ROA was comparable at 1.53 percent over the same period.

Figure 28: Banking System Profitability



Banking system profitability has recovered on account of lower impairment provisioning, which returned to pre-pandemic levels, a recovery in net interest margins (NIMs) driven by a decline in bank funding costs, and improved asset quality. Across bank sizes, profitability (measured by ROA and ROE) was highest among tier 1 banks in 2021 (**Figures 29a & Figure 29b**); an observation that supports the view that larger operations allow banks to exploit economies of scale, thereby enhancing their profitability. Further, efficient banks - that is, those with lower cost-to-income ratios - have a higher ROA and ROE than less efficient banks (**Figure 29c & Figure 29d**).

Figure 29: Banking System Profitability and Bank Balance Sheet Dynamics Nexus

Figure 29a: Correlation between Bank Size and Return on Assets

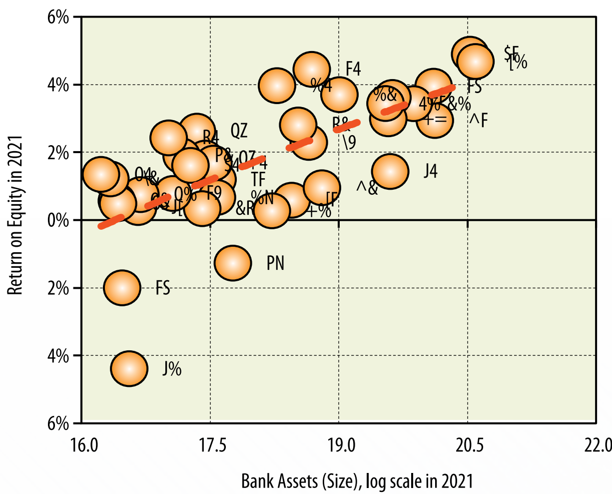


Figure 29b: Correlation between Bank Size and Return on Equity

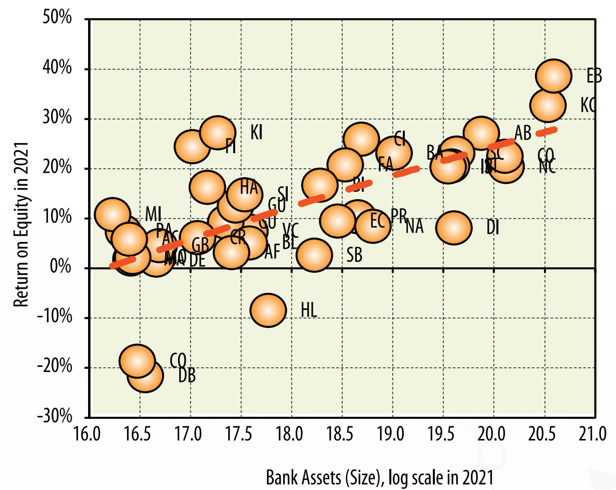


Figure 29c: Correlation between Efficiency and Return on Assets

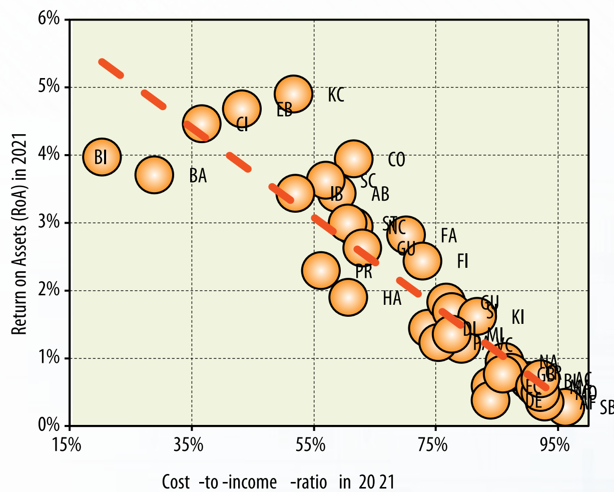
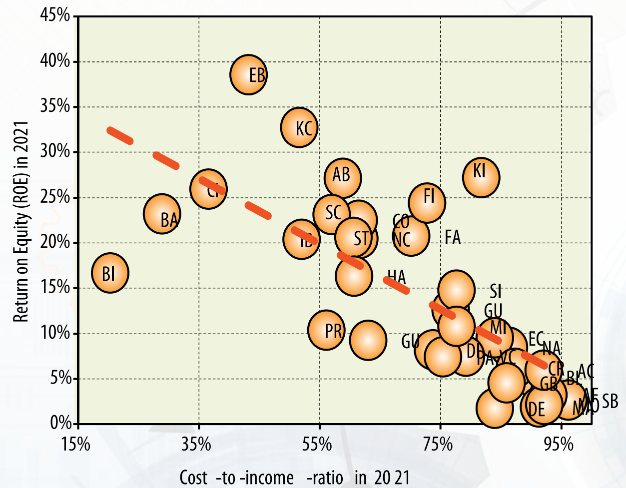


Figure 29d: Correlation between Efficiency and Return on Equity



Source: KBA

5.7 Comparative analysis of bank and non-bank financial performance

Sectoral heterogeneity in performance is evident, with both return on assets and return on equity of the banking sector lagging behind that of firms in other sectors. The banking sector's performance, measured by the average return on assets (ROA), that stood at 3.3 percent in 2021, was the fourth highest return after telecommunication sector (29.8%), manufacturing and allied (10.6%), and investment services (6.6%) (**Figure 30a**). With respect to the average return on equity, the average return on equity of banks was the second highest at 22.1 percent after the telecommunication sector which registered a return on equity of 50.3 percent in 2021 (**Figure 30b)**. Based on these emerging trends, the banking sector profitability when paraded alongside other sectors' performances was moderate, reflective of normal profit levels.

Figure 30: Bank and non-bank return on investment trends

Figure 30a: Banking Sector and Non-Banking Sector Return on Assets

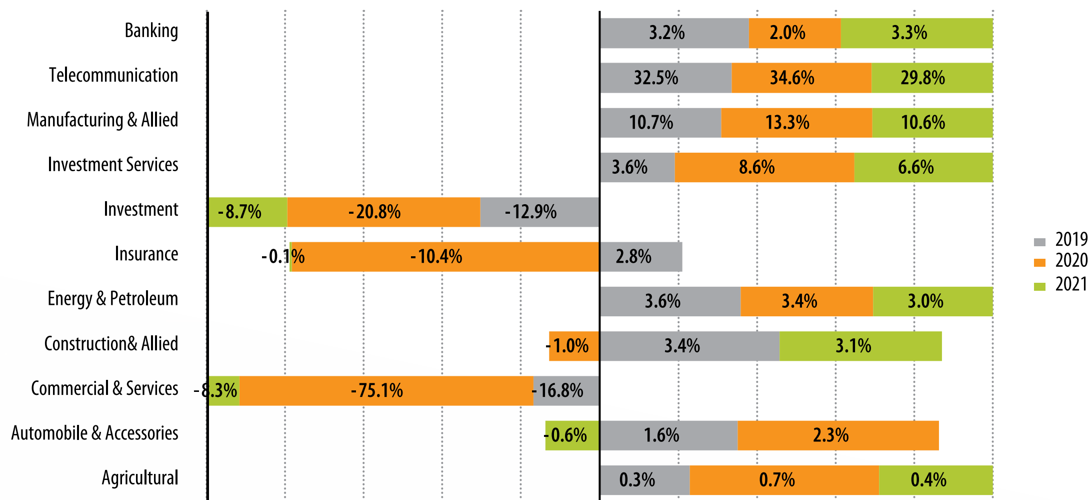
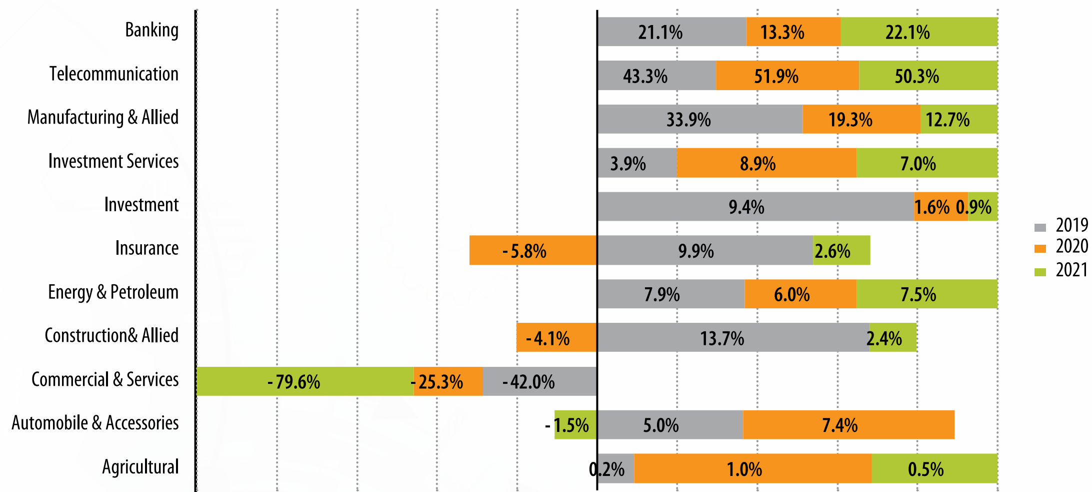


Figure 30b: Banking Sector and Non-Banking Sector Return on Equity



Source: NSE and KBA

Chapter 6:

BANKING SECTOR MARKET STRUCTURE

As at end 2021, the banking industry assets as a ratio of GDP stood at 49.0 percent, and the industry's deposits to GDP ratio was 36.2 percent[11]; cementing the importance of the banking industry in the economy. As such, the assessment of the banking sector market structure remains critical, as noted by a study commissioned by the Competition Authority of Kenya (CAK) in 2014[12]. Since then, there has been a continuous need to monitor the market structure, and dynamics of the interest rate spreads to ascertain whether any changes are driven by market power of some banks.

Across bank tiers, tier 1 banks' assets to GDP ratio stood at 48.0 percent, while tier 2 and tier 3 banks' assets-to-GDP stood at 10.3 percent and 5.8 percent, respectively. In terms of deposits, large banks took the highest share of deposits, at 36.1 percent of GDP, while medium and small banks' deposits were 8.2 percent and 4.2 percent, respectively. While the overall banking industry appeared to be dominated by large banks, measures of concentration across key bank lending and deposit markets point to gradually decreasing levels of market concentration, supported by increasing digitization of financial services. For instance, the bank concentration, and in this case reveals that the extent of concentration of the banking sector edged downward, a trend observed since 2017.

On the assets-side of the balance sheet, bank concentration declined. For instance, in 2021 the top 10 banks accounted for 75.3 percent of the

11 IHS Markit Kenya Banking Sector Forecast Tables (May 2022). *https://connect.ihsmarkit.com/master-viewer/show/phoenix/2398083?connectPath=Search&searchSessionId=49793959-215d-4b44-b213-54c3c25c2ac9* [data available on request]

12 CAK (2014), "*Kenyan banking sector study*", October. *[https://www.cak.go.ke/sites/default/files/Bankingpercent20Sectorpercent20Phasepercent20Ipercent20Marketpercent20Inquiry-min.pdf]*

Pic/ jason denk-unsplash

industry assets compared to 77.8 percent in 2020 and 77.7 percent in 2019 **(Figure 31a)**. In terms of loan concentration, the top 10 banks accounted for 77.7 percent of the total industry loans and advances in 2021 in contrast to 80.8 percent in 2019 and 80.7 percent in 2019 **(Figure 31b)**.

On the liability side of the balance sheet, the concentration of deposits reveals a similar trend observed in the asset-side. For instance, in 2021 the top 10 banks' deposits accounted for 75.3 percent of the industry's deposits down from 77.5 percent in 2020 and 78.6 percent in 2019 **(Figure 31c)**. However, whereas the industry's concentration, measured by the Herfindahl-Hirschman Index (HHI)[13] rose to 767.31 in 2021 from 736.20 in 2020 **(Figure 31d),** it stood below the 1,000 mark an indication that the Kenyan banking sector remained sufficiently competitive.

Recent studies by the KBA Centre for Research on Financial Markets and Policy® revisit the subject of market structure[14] with the analytical anchor

Figure 31:Banking Sector Market Structure

Figure 31a: Concentration of Assets

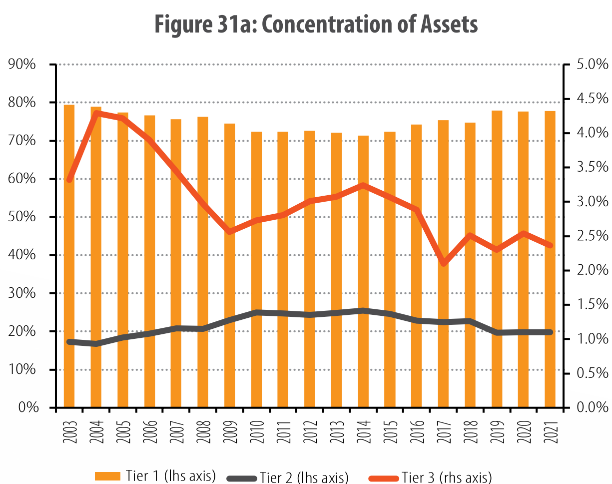


Figure 31b: Concentration of Loans

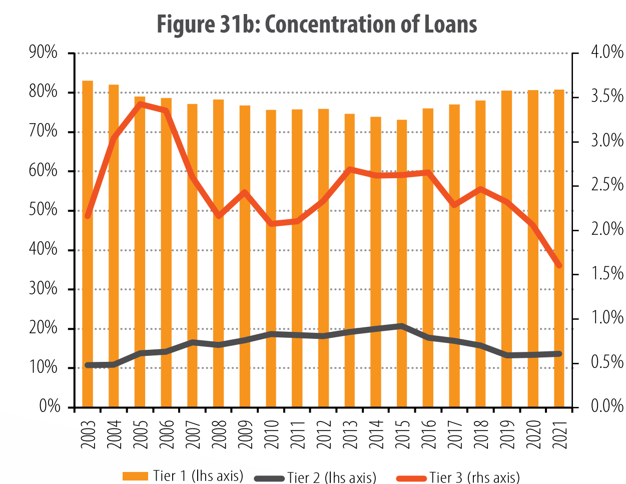


Figure 31c: Concentration of Deposits

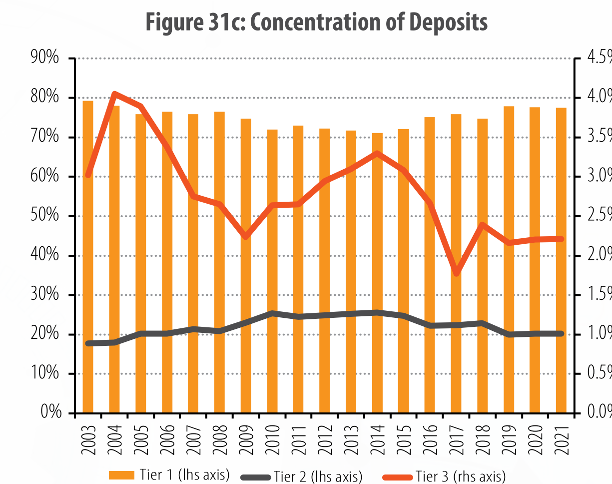
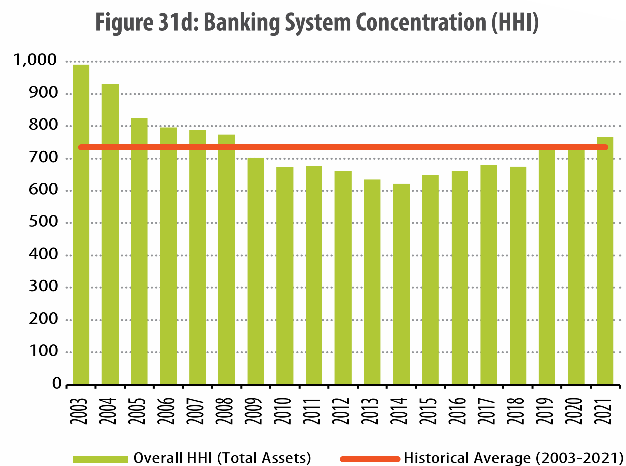


Figure 31d: Banking System Concentration (HHI)



13 The Herfindahl-Hirschman Index (HHI) is a measure of the level and trend of concentration in a particular market. The HHI is calculated by squaring each entity's market share (relative to the total market), and summing the values attained. A higher index represents a more concentrated, or less competitive lending market. A decrease indicates the opposite.

being the three measures of competition, namely: (i) market structure and performance; (ii) regulatory indicators of entry barriers and restriction of bank activities; (iii) empirical measures that gauge the response of output to changes in input prices. A two-level assessment of these three measures is undertaken. The first level provides a quick assessment that seeks to debunk the popular debate that the economy has too many banks based on either a simple numerical count or the per capita number of banks.

There is a long-established argument of the tenuous relationship between the extent of market concentration and competition (see, for instance, Neave, 1989[15]). We content though that an understanding of the trends in market concentration provides a good entry point into a more in-depth empirical assessment of what the structure means for intermediation efficiency in Kenya. But competition is not an end in itself. As Kiemo and Kamau (2020)[16] establish, banks have scope to optimize their scale of operations to shift towards increasing returns to scale, as well as gain from improving their efficiency. The changes in market power over time, the study asserts, seems to favour efficiency and competition gains in the industry. Based on the foregoing, market power doesn't come at the expense of competition. The competitive gains arising thereof have enhanced the pursuit for efficiency. Ultimately, the market-driven change in structure is increasingly supporting the improvement in the Kenyan banking system's intermediation efficiency.

14 See highlights here: *https://www.kba.co.ke/*

15 Nathan, A. and Neave, E.H. (1989). "Competition and contestability in Canada's financial system: empirical results". *Canadian Journal of Economics*. Vol. 22(3), pp. 576-594. *[https://www.jstor.org/stable/pdf/135541.pdf?casa_token=QSRGRnCwa2YAAAAA:I3FbFDujIgGBq27oREkR3_bRuA5Myt5MY67Vqi1zL-FUy_q4lfzWWYsB1P-Jb87xZPLR8h8Xz_xvxo7cbl2OJ02aqr_Ad3vozIj8SjcuY8JJLU0_4g]*

16 Kiemo, S. and Kamau A. (2020), "Banking Sector Competition and Intermediation Efficiency in Kenya", KBA Centre for Research on Financial Markets and Policy® *Working Paper Series No 39(WPS/04/20)*, May. [*https://www.kba.co.ke/downloads/WPS-42-2020.pdf*]

Chapter 7

OUTLOOK

Going forward, GDP growth both at global and domestic economies is expected to moderate in 2022 amidst elevated risk levels[19] associated with the ongoing Russia-Ukraine war. According to the IMF (2022), global growth is projected to slow from an estimated 6.1 percent in 2021 to 3.6 percent in 2022 and 2023[18].

The domestic economic growth is projected at 5.7 percent in 2022, and 5.3 percent in 2023[19]. The spillovers of a weak global economy on the domestic economy are also imminent through several channels, including weak export growth, reduced business confidence, heightened investor uncertainty, and capital outflows from emerging markets as financial conditions tighten. The strong domestic economic recovery registered in 2021 is expected to moderate in 2022 due to poor weather conditions in the first quarter particularly in the bread-basket regions, the depressing effects of higher oil and other imported commodity prices on manufacturing and other heavily energy-dependent sectors. Further, the domestic economic recovery in 2022 faces new headwinds from the domestic political risks, and spillovers of the heightened geopolitical tensions.

Evidently, some of the risks have materialized in the local economy. At the start of the second quarter of 2022, a notable slowdown in economic activity is depicted by the composite Purchasing Managers' Index™ (PMI)[20] that fell below the 50-mark in May to 48.2 for the second time in 2022 from 49.5 in April[21]. Inflation driven by higher food and fuel prices edged up to 7.1 percent in May from 6.5percent in April; maintaining an upward trajectory since December 2021. Inflation is likely to remain elevated in 2022, hitting households' purchasing power and constraining consumption growth. As a mitigation seeking to tame inflationary pressure, the Central Bank of Kenya (CBK) in May 2022, tightened its monetary policy stance, raising the Central Bank Rate (CBR) by 50 basis points to 7.5 percent; the effecrs of which are expected to be transmitted in the near term. In addition, the presidential election in August 2022 adds considerable uncertainty, which could dampen private consumption and investment even further.

GDP growth both at global and domestic economies is expected to moderate in 2022 amidst elevated risk levels associated with the ongoing Russia-Ukraine war.

17 IMF Staff Statement on the Economic Impact of War in Ukraine https://www.imf.org/en/News/Articles/2022/03/05/pr2261-imf-staff-statement-on-the-economic-impact-of-war-in-ukraine?utm_medium=email&utm_source=govdelivery

18 IMF (2022). World Economic Outlook (WEO), April 2022: War Sets Back The Global Recovery. https://www.imf.org/en/Publications/WEO/Issues/2022/04/19/world-economic-outlook-april-2022

19 IMF (2022). Sub-Sahara Africa (SSA) Regional Economic Outlook (REO), April 2022: A New Shock and Little Room to Maneuver. https://www.imf.org/-/media/Files/Publications/REO/AFR/2022/April/English/text.ashx

20 The composite Purchasing Managers' Index (PMI) is published by Stanbic Bank monthly and measures changes in economic activity and business conditions between two successive months. An index measure above 50.0 signals an improvement in business conditions and below 50 reflects a deterioration. The PMI is generated from a survey of firms in the manufacturing sector.

21 Reflecting a decline in economic activity that was associated with marked increases in input prices, fuel costs and other living expenses. Forward-looking, the PMI report shows that business confidence in April dropped to a record low for the second successive month amid concerns over rapid price inflation and reduced client spending.

Kenyan imports from Russia and Ukraine

On the fiscal side, fiscal consolidation may not be realizable with potential slowdown in economic activity amidst government expenditure pressures. There is a reported effort to address debt vulnerabilities through a gradual fiscal consolidation targeting enhanced revenue mobilization, expenditure rationalization and prudent management of public debt. Consequently, the fiscal deficit is projected to decline from 8.2 percent of GDP in the Financial Year 2021/2022 to 3.9 percent by end 2024/2025. There are, however, some downside risks to the realization of these targets, including the constrained transmission of monetary policy (given the slow growth in private sector credit) - that would call for fiscal policy to provide the much-needed reprieve. In addition, the evident slowdown in economic activity may depress government revenues and require additional borrowing given the growing expenditure demands to finance contracted infrastructure projects and the post-Covid recovery strategy. Moreover, there are evident challenges in offshore borrowing with the tightening of financial market and borrowing conditions in the global markets following the tightening of monetary policy in most developed markets. As a result, the tight fiscal finances will likely increase banks' exposure to sovereign risks as discussed in Chapter 3.

The Kenyan banking sector is strong with liquidity levels in the system high and almost three times the minimum requirements. However, the prevailing elevated credit risk, coupled with the rising inflationary outcomes and expectations, implies that credit growth is at risk of being constrained further. The ongoing challenge that has kept banks' lending rate somewhat unchanged is associated largely to the lenders' inability to effectively price risk amidst the elevated credit risk-with the ratio of gross non-performing loans to gross loans edging up to 14.1 percent in April from 13.1 percent by the end of 2021[22]. The existing slow approvals and implementation of risk-based pricing frameworks by banks continue to constrain lending by the industry as banks are not adequately able to effectively accommodate risk in credit pricing. Overall, loan growth is anticipated to be muted in the near term amid rising impairments which is likely to keep banks cautious regarding lending to the private sector[23].

Going forward, any efforts to boost credit extension to the private sector, and support the fragile economic recovery, requires as a necessary and sufficient condition, a stronger shift in the pricing conditions/frameworks to allow effective pricing of risk. This will provide an incentive for banks to price-in risk and unlock credit to the private sector.

22 May 20222 CBK Monetary Policy Press Release *https://www.centralbank.go.ke/uploads/mpc_press_release/649158074_MPCpercent20Presspercent20Releasepercent20-percent20Meetingpercent20ofpercent20Maypercent2030percent202022.pdf*

23 IHS Markit Banking risk April highlights and May 2022 outlook. *https://connect.ihsmarkit.com/master-viewer/show/phoenix/4357144?connectPath=Search&searchSessionId=49793959-215d-4b44-b213-54c3c25c2ac9* [commentary also available on request]

APPENDICES

1. BALANCE SHEET	2016	2017	2018	2019	2020	2021
Total Assets	3,739.2	4,002.7	4,407.6	4,810.0	5,405.7	6,024.5
Total Liabilities	3,137.7	3,358.6	3,730.0	4,081.1	4,598.3	5,125.0
Net Assets (Shareholders' Fund)	599.0	644.2	678.0	737.3	807.5	893.3
Total Deposits	2,766.4	3,026.4	3,361.4	3,631.8	4,119.4	4,556.6
Loans and Advances to customers (net of provision)	2,206.4	2,272.7	2,318.1	2,495.4	2,663.7	2,921.7

2. PROFIT AND LOSS ACCOUNT	2016	2017	2018	2019	2020	2021
2.1. INCOME						
Interest on loans and advances	303.4	264.7	266.4	265.1	276.9	298.9
Interest on government securities	90.4	102.8	119.0	122.0	149.2	174.6
Interest on placements and bank balances	6.7	4.8	5.3	8.5	7.6	8.0
Other Interest income	2.9	1.4	1.5	1.2	1.7	1.3
Total interest income	403.5	373.7	381.0	396.7	435.4	482.8
Net interest income	264.5	245.3	253.9	259.2	289.3	328.6
Foreign exchange gain (loss)	24.6	25.9	28.1	30.7	35.3	38.5
Fees and commissions income (net)	65.7	70.6	73.4	86.4	79.7	86.2
Total net operating income	358.3	357.9	375.3	399.8	428.7	475.7
Disclosures						
Gross Non-performing loans	215.5	264.5	299.6	334.3	433.7	457.4
Total Provisions	78.7	101.2	115.7	134.3	198.1	212.4
Core Capital	525.7	546.6	582.4	631.2	686.7	749.0
Supplementary Capital	89.3	75.1	50.4	82.8	99.6	133.9
Total Capital	605.3	620.7	631.7	714.0	786.2	882.6
Total risk weighted assets	3,107.6	3,323.8	3,509.1	3,798.3	4,136.3	4,527.1
Selected Performance Ratios (%)						
Total liabilities/ Total Assets	83.9%	83.9%	84.6%	84.8%	85.1%	85.1%
Shareholders' funds/ Total assets	16.0%	16.1%	15.4%	15.3%	14.9%	14.8%
Net interest margin	9.0%	7.7%	7.4%	6.5%	6.3%	6.5%
Net Loans and advances/ Total assets	59.0%	56.8%	52.6%	51.9%	49.3%	48.5%
Total deposits/ Total Liabilities	88.2%	90.1%	90.1%	89.0%	89.6%	88.9%
Loan-to-Deposit Ratio	83.9%	79.9%	73.5%	74.1%	71.2%	70.3%
Return on Assets (ROA)	4.0%	3.4%	3.5%	3.2%	2.0%	3.3%
Return on Equity (ROE)	24.8%	20.8%	22.5%	21.1%	13.3%	22.1%
Cost of Funds	4.3%	3.6%	3.5%	3.2%	3.0%	2.9%
Cost Income Ratio (CIR)	62.4%	62.5%	59.3%	60.2%	74.1%	58.1%
Bank Z-Score	27.7	27.0	26.1	25.7	23.5	25.1

Source: KBA Financial Database

th
Anniversary
1962-2022

KENYA BANKERS
ASSOCIATION

Kenya Bankers Association
13th Floor, International House, Mama Ngina Street
P.O. Box 73100– 00200 NAIROBI
Telephone: 254 20 2221704/2217757/2224014/5
Cell: 0733 812770/ 0711 562910
Fax: 254 20 2221792
Email: research@kba.co.ke
Website: www.kba.co.ke