I. INTRODUCTION

1. This Financial Sector Assessment (FSA) is based on the work of the joint IMF-World Bank missions that visited Kenya from July 15–24, 2003, and from September 30–October 15, 2003, in the context of the Financial Sector Assessment Program (FSAP). The principal objective of the missions was to assist the Kenyan authorities in assessing the development needs and opportunities for the financial sector and identifying potential vulnerabilities of financial institutions and markets to macroeconomic shocks, as well as the risks to macroeconomic stability from weaknesses and shortcomings in the financial sector. In this context, Kenya's compliance with the Basel Core Principles for Effective Banking Supervision (BCP); International Organization of Securities Commissions (IOSCO) Principles for Securities Regulation; and Corporate Insolvency and Creditor Rights Issues was formally assessed. A separate mission to assess Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT) took place in October/November 2003; the Report on Observance of Standards and Codes (ROSC) from that mission is included in the Financial Sector Assessment Program (FSAP) documentation.

1 The FSAP team comprised Patricia Brenner (Leader), Martin Čihák, and Julia Majaha-Jartby (all IMF/MFD); Inutu Lukonga (IMF/PDR); Arnold McIntyre (IMF/AFR); Michael Andrews (formerly IMF/MFD); Musa Ibrahim (Nigerian Deposit Insurance Agency); Michael Fuchs (Deputy, WB/AFTFS); Zeynep Kantur, Joselito Gallardo, Claire Grose, Gregorio Impavido, and Thordur Jonasson (all WB/OPD); Thorsten Beck and Inessa Love (WB/DECRG); Gordon Johnson (WB/LEGPS); and Megan Thomas (IMF/MFD, administrative assistant). The team was assisted in the field by the World Bank Country Director for Kenya, Makhtar Diop, and the IMF Resident Representative in Kenya, Samuel Itam.
II. **Overall Assessment and Key Recommendations**

2. Although the major elements of a well-developed financial system are in place in Kenya, the financial sector has been unable to reach its full potential in supporting the allocation of scarce economic resources and promoting strong economic growth. Kenya has a weak financial system that fails to deliver adequate credit to the private sector, especially for investment purposes, and to small- and medium-sized enterprises (SMEs) in particular. The government's role in strengthening the financial system should be focused on providing a robust legal and judicial framework, and strong supervision and regulation of financial institutions and markets, thereby promoting soundness and competition among all providers of financial services. Addressing the crucial development issues and increasing access to finance requires gaining strong consensus for sound strategies, pursuing a concerted program of reform action, building capacity within institutions, and sustaining attention to implementation.

A. **Increasing Access to Financial Services**

3. The major obstacles to developing the financial system, especially as regards access to finance by small- and medium-size enterprises, are the weak legal framework, lack of information on borrowers, and inefficient judiciary. The legal framework for property rights, insolvency, and creditor rights is fragmented, outmoded, and incomplete. The lack of accurate and reliable information about the borrowers' ability to pay reduces competition, increases credit risk and lending rates, and makes it difficult to reduce the dependence of banks' lending decisions on collateral. Inefficiencies and corruption in the court system delay court decisions and undermine property and creditor rights; these make lenders reluctant to lend and increase risk premia. Some of these problems are being addressed, most notably the dismissal of corrupt judges and expanded activity of the Commercial Court. However, the Commercial Court needs further strengthening by training competent judges, introducing modern administration and case management practices, reducing the granting of injunctions that interfere with creditor rights, and accelerating court decisions. Finally, there is an urgent need to strengthen the Companies Registry to enable the collection of timely and accurate financial data on companies and dissemination of this information to investors and creditors.

4. The high level of lending rates and interest rate spreads in Kenya reflect the high costs of lending and discourage financial intermediation. The high spreads are primarily the result of several major weaknesses of the financial system that have gone without important reform in recent years. These include: a very high proportion of non-performing loans (NPLs), mainly concentrated in the banks with significant public interest; relatively high banking costs owing to high overhead costs, outdated infrastructure, and the serious deficiencies in the legal framework and infrastructure outlined above; the presence of a number of weak banks that have been allowed to continue in operation; and poor regulatory governance and lack of transparency of financial sector supervision. The high intermediation margins are a rational reaction by banks to their operating environment; attempts to regulate interest rates, which resurface intermittently in Kenya, rather than improving the operating environment, would result in counter-productive effects.
5. A clear strategy for developing formal and informal institutions that provide financial services to segments of the Kenyan population underserved by commercial banks needs to be formulated; it should not include reviving failed development financial institutions (DFIs). A variety of financial institutions, including microfinance institutions (MFIs), savings and credit cooperative organizations (SACCOs), and the Kenya Post Office Savings Bank (KPOSB), offer deposit and lending services to economic and social segments of the population underserved by commercial banks. Two development banks and four DFIs, established in response to a lack of long-term financing and to meet sectoral policy objectives of the government, have been plagued by a high share of NPLs. Apart from the economic recession, poor institutional capacity and political interference help explain this poor performance. Any move to recapitalize the development institutions and renew lending not only could lead to a sizable contingent fiscal liability, but could also have significant adverse effects on the lending environment, by crowding out private providers of financial services. The authorities are encouraged to (i) undertake a thorough assessment of the current provision of financial services to underserved segments and the need for government intervention; and (ii) develop a strategy for development financing that minimizes the adverse effects on private financial intermediaries.

6. Reform of the pension system would help raise savings and develop long-term investment instruments. In the present system, key concerns relate to low coverage, poverty among old age retirees, the almost complete absence of longevity insurance, and the government's unfunded liabilities, currently estimated at about 25 percent of GDP. It is recommended that the authorities establish a policy committee to steer the pension reform debate.

B. The Role of the Government

7. The primary role of the government should be to provide a regulatory, supervisory, and legal framework that promotes soundness and competition in the financial system. All the major regulators of the financial system, except the Retirement Benefits Authority (RBA), have suffered from lack of independence from unconstructive government influence. Specifically, approval by the Minister for Finance has hitherto been required for dealing with problem banks, and for approving changes in banking and other charges (Section 44 of the Banking Act). The relative independence of the Capital Markets Authority (CMA) was recently compromised by bringing it within the ambit of the State Corporations Act. The Insurance Commission (IC) is directly part of the government, and is inadequately financed and staffed to perform supervision of insurance activities. In all sectors, there is a need for resolution/closing of insolvent, unprofitable or under funded institutions and companies.

8. Due to the detrimental effects of government involvement in the banking system — as reflected in the accumulation of considerable portfolios of non-performing loans — highest priority in the reform of the financial sector should be given to divesting the government's stakes in the banking sector. The government should take rapid steps to reach agreement on a time-bound plan for the divestiture of its remaining ownership stakes in
the banking system. Such reforms are already being discussed with the World Bank in the context of a pending Financial Sector Adjustment Credit.

9. An adequately funded and independent insurance authority also needs to be established to weed out the many weak companies that are impeding development of the insurance market. At the same time, a review of the Insurance Law and regulations is needed, aimed at strengthening the supervisory capacity of the insurance authority.

10. While the limited amount of private stocks and bonds partly reflects the paucity of companies strong enough to issue such instruments, improvements in regulation, supervision, disclosure standards, clearance and settlement structures, and investor protection would support capital market development. Enforcement of market rules and supervision of market participants need to be strengthened by making the supervisory authority operationally independent and providing it with more resources and training. To reduce the costs of transparency for listed companies, improving the companies’ regulation and disclosure through updating the Companies Act and strengthening of the Companies Registry would be required. Clearing and settlement of securities needs to be made more efficient to encourage trading in the market. Finally, investment compensation and guarantee funds need to be better managed.
Box 1. Key Recommended Actions

Access to financial services
- Modernize key commercial registries to provide access to current, accurate, and reliable information.
- Establish the legal basis for credit information-sharing among all financial service providers.
- Remove barriers to creation, registration, and enforcement of security, and integrate the land registry systems, including the removal of hidden liens and excessive registration costs.
- Reform and modernize insolvency procedures contained in the Companies and Bankruptcy Acts.
- Strengthen capacity in the Commercial Court to achieve efficient case administration, and promote training among judges. Expand the specialized Commercial Court to other regions, including Mombasa.

Regulatory governance
- Improve the supervision of financial markets and their participants by granting supervisory agencies and DPF the independence and resources they require to be able to carry out their functions effectively.
- Repeal Section 44 of the Banking Act and the Central Bank Amendment Act 2000.

Banking sector
- Divest the state’s stake in all commercial banks.
- Intervene in any weak bank that fails to develop and implement a time-bound recovery plan.
- Preserve the previous schedule for raising the minimum capital requirement for a bank to K Sh 500 million.

Payments and settlements systems
- Introduce to Parliament, as quickly as possible after a short consultation period, the National Payments Bill.
- Present the draft CBK/Kenya Bankers’ Association (KBA) payments system strategy paper for public consultation and move expeditiously to establishing a detailed, time-bound action plan for implementation.
- Adhere strictly to a T+3 settlement cycle and achieve Delivery versus Payment (DvP) for government securities by introducing Real Time Gross Settlement (RTGS) and strengthening the central depository under the CBK.
- Achieve T+5 and DvP settlements for private securities by making the Central Depository and Settlement Corporation (CDSC) operational and introducing RTGS.

Insurance and pensions
- De-license weak insurance companies unable to implement a time-bound remedial action plan.
- Review Insurance Law with a view to strengthening compliance with the standards of the International Association of Insurance Supervisors.
- Establish a pension policy committee to develop a strategy for the Kenyan pension system, including resolving the unfunded liabilities of the National Social Security Fund (NSSF), Civil Service Pension Scheme (CSPS), and quasi-governmental plans.

Other nonbank financial institutions (NBFIs)
- Move quickly to bring MFIs and SACCOs under regulatory oversight.
- Revise the Microfinance Bill to increase capital adequacy and asset quality standards for MFIs and narrowly define the geographical limits for community-based MFIs.
- Preserve the mandate of KPOSB in the provision of payment and deposit services, and limit investment by the KPOSB to government securities.
- Suspend lending by DFIs; future development financing to be done either through properly supervised financial institutions or in the form of grants rather than credit.

Capital markets
- Modernize the current Companies Act; strengthen the Registrar of Companies as the companies regulator; and establish clear coordination and division of responsibilities for the CMA and the Registrar.
III. MAIN FINDINGS

A. Reducing Interest Rate Spreads

11. **High lending rates and interest rate spreads are a reflection of the structural problems in the financial sector.** Interest rate spreads, margins, and overhead costs are higher than the worldwide average, although they are about the same or lower as those in Uganda and Tanzania (Table 1). The high interest spreads are a result of low intermediation efficiency and high costs, which in turn reflect: (i) the limited number of strong and reputable banks; (ii) deficiencies in the legal and institutional framework; (iii) the absence of information sharing on debtors; and (iv) the limited information available to bank customers.

<table>
<thead>
<tr>
<th>Country</th>
<th>Real Lending Rate</th>
<th>Real Deposit Rate</th>
<th>Spread</th>
<th>Margin</th>
</tr>
</thead>
<tbody>
<tr>
<td>Kenya</td>
<td>16.5</td>
<td>3.5</td>
<td>13.0</td>
<td>9.2</td>
</tr>
<tr>
<td>Uganda</td>
<td>19.4</td>
<td>5.9</td>
<td>13.5</td>
<td>12.7</td>
</tr>
<tr>
<td>Tanzania</td>
<td>12.0</td>
<td>-1.2</td>
<td>13.1</td>
<td>7.5</td>
</tr>
<tr>
<td>Sub-Saharan Africa</td>
<td>10.0</td>
<td>-1.5</td>
<td>11.5</td>
<td>8.1</td>
</tr>
<tr>
<td>World-wide average</td>
<td>8.9</td>
<td>0.9</td>
<td>8.0</td>
<td>5.5</td>
</tr>
</tbody>
</table>

Note: The interest spreads are the difference between deposit and lending rates. The net interest margin is the net interest revenue relative to total earning assets.


12. **High interest rate spreads reflect high risk and inefficiencies in the banking system.** Loan loss provisions and the profit margin, which reflects a premium on lending in a high-risk environment, make up nearly 50 percent of spreads. The “risk-component” of the spreads is related to weak property right protection, deficiencies in the judicial system, and lack of information sharing. Overhead costs constitute another 40 percent of spreads, and are driven by wage costs (generally about ½ of the overhead costs) and other costs (especially security, fraud, inefficient payment system, and regulatory burden).

13. **Addressing the underlying causes of high spreads is the surest way of bringing them down.** In contrast, administratively limiting lending rates would most likely result in counter-productive effects such as: (i) an increase in explicit or hidden charges to compensate for interest revenue; and (ii) credit rationing, both of which will have disproportional effects on credit to smaller borrowers. Administratively fixing deposit rates at a minimum level would, apart from the negative impact on banks’ soundness, most likely result in banks (i) raising minimum deposits; and (ii) charging additional fees to compensate for the higher cost. The cost of a deposit rate floor would be especially high in the current low interest rate environment. Finally, interest rates administratively set to reduce spreads would foster a trend towards short-term lending.

14. **An important reason for the high level of NPLs in the banking system is inadequate credit risk analysis in extending loans.** Lack of information on cash flow of borrowers means that prudent lending has to be based more often on collateral than on credit-
risk assessment or the profitability of potential investments. At the same time, difficulties in collecting on collateral because of the sometimes corrupt and highly inefficient judicial system impede collateral-based lending. Better reporting of financial information by companies, eliminating legal impediments to information sharing on borrowers, and the establishment of credit registries would enable more cash-flow-based lending. Improving the fixed asset registries and establishing a registry for movable collateral to increase access to loans for agriculture and small and medium enterprises can also contribute to more efficient lending.

15. **Competition would increase if there were more sound banks.** Several small banks are weak and undercapitalized. Therefore, knowledgeable customers prefer to bank with large foreign and state-owned banks. High loan losses and interest spreads of state-owned banks also undermine competitiveness in the system. Supervisors intervening rapidly into failing banks and government divestiture from state-owned banks with high loan losses would help foster competition in the market by creating stronger players.

16. **Greater transparency is needed both in banks and at policy level.** The information available to bank customers on banks’ interest rates and charges is limited. Uncertainty about future policy changes increases incentives for non-transparency and may reduce the effectiveness of policy changes. The authorities’ have started to publish a compendium of all bank interest rates and the most common charges and fees on a regular basis. This is a commendable step toward increasing transparency in the banking sector. At the same time, it would be useful to encourage the Banking Association and media to educate bank customers on their choices and options.

**B. Divesting the Government’s Ownership Stakes in the Banking Sector**

17. **As has been demonstrated in many other countries burdened with a legacy of state-influenced banking, divesting the government’s stake in these banks is the single most important contribution the authorities can make to strengthen the banking system.** As non-performing loans in Kenya are concentrated in the banks with state interest, restructuring banks and divesting government stakes in the banking sector will demonstrate the government’s commitment to fiscal responsibility and good governance, and help mobilize financial resources required to support higher rates of economic growth.

18. **Where possible the state’s stakes in banks should be divested as soon as possible, to provide a clear signal for the economic restructuring program.** This could take the form of the launching of a tender to divest the remaining government-influenced stake or – depending on the financial situation of the institutions in question – the government’s stake could be sold to development partners or private investors, failing which liquidation should be undertaken as expeditiously as possible so as to avoid the accumulation of new losses and resulting contingent liabilities.

19. **Close monitoring of the restructuring and divestiture process will be crucial, should the government prefer to undertake any restructuring of banks with state influence prior to divesting the government’s stake.** It will be crucial that the restructuring process, including preparation and implementation of stringent credit and other internal
controls designed to rationalize operations and the process of carving out of non-performing
assets, is closely monitored by the CBK and the Treasury. Furthermore any injection of new
capital should be made contingent on the completion of the divestiture of the government’s
remaining stake in its entirety to private investors unrelated to the government. In order to
ensure good governance of those banks to be divested by the government, the government is
considering targeting the sale of a defined portion of share to suitable domestic institutional
investors, thus avoiding dilution of governance, or sale to development-oriented strategic
investors.

20. The banking sector plays a central role in supporting the operations of Kenya’s
savings cooperatives, but has difficulty generating sufficient capital to meet their needs.
Despite recent efforts to restructure banking operations and strengthen bank capital to
support services provided to the cooperative sector, the cooperative shareholding structure
results in weak bank governance and has resulted in repeated calls for the injection of capital
to comply with regulatory minimums. The CBK is encouraged to work with the sector to
develop a governance restructuring plan that will facilitate the raising of additional capital
and markedly improve the quality of the governance of those banks which service this sub-
sector.

C. Improving the Credit Environment

21. Deficient property registration systems and inefficient enforcement systems
increase lending risk and the cost of borrowing. Although the underlying laws governing
creditors rights are based upon sound principles, the creation and enforcement of rights is
severely hampered by: (i) costs of taking security (stamp duty and legal fees); (ii) existence
of several disparate land registration systems; (iii) chaotic state of government registries; (iv)
expense of court proceedings, backlog of cases in the courts and erratic court decisions; (v)
difficulty of enforcing security over land in rural areas; (vi) absence of a movable assets
registry; and (vii) lack of a consolidated insolvency law with modern corporate recovery
alternatives. These factors contribute to uncertainty in debt recovery mechanisms and
underscore the need to update and harmonize security laws into a coherent and uniform
framework, especially in the area of land titling and transfers, and the taking of charges over
business assets.

22. Company and insolvency laws are outmoded and their administration is costly,
inefficient, and subject to abuse. In recent years, the courts have favored debtors over
creditors, readily granting injunctions with the result that enforcement can be delayed almost
indefinitely. A number of poor decisions have undermined creditors’ rights and constitute
binding precedence for other cases. The public perceives these decisions to be based on inept
training or in some instances corruption. The formal bankruptcy process is often shunned by
creditors in favor of contractual receivership, where businesses are rarely salvaged as going
concerns. Shortcomings in the formal regimes also render the informal process for corporate
workouts substantially ineffective.

23. Without accurate and reliable information, the price of lending rises. Many of the
registries are in serious need of modernization and maintenance. The Company Registry,
which plays a fundamental role to maintain confidence in commercial relationships, does not provide basic information; numerous files are missing; and even accessible files cannot be guaranteed to be current and reliable. Delays in registering charges and information are routine, as are delays in gaining access to that information. The registry has failed to pursue or enforce filing requirements or strike companies off the register when they fail to comply with statutory filing requirements.

24. **The Official Receivers Department is inadequately resourced and unable to deal with its moderate case load.** The registry is plagued by missing and outdated files, and the department apparently lacks the skills base to fulfill statutory obligations. In a number of instances, the Official Receiver has failed to protect funds realized from the liquidation of companies. In certain instances these funds have been poorly invested, or have been the subject of outright theft or conversion by those engaged by the office to collect or liquidate estate assets. The state of the Company Registry and the Official Receiver’s Department make them particularly vulnerable to abuse and corruption.

25. **Efforts are underway to address weak capacity and corruption in the courts.** Laws in Kenya have been inconsistently interpreted and enforced, due in part to poor decisions or corruption. Weaknesses in legal education are compounded by the dearth of continuing education and training for judges. In response to commercial distrust and shortcoming in procedures for resolving commercial disputes, a specialized commercial court was created in Nairobi, with good results. Plans are now underway to open a second commercial court in Mombasa. On the whole, the commercial court could be better resourced and would benefit from more effective case administration and management practices, such as through electronic recording of proceedings, rather than laborious handwritten note taking of the proceedings by judges.

26. **The government should seek prompt approval of the proposed amendment to the Banking Act to allow for information sharing among banks and the exchange of positive information among all financial institutions should be promoted.** Formal credit information sharing among financial institutions has been precluded until now by the confidentiality clause in the Banking Act. Amendments to the Banking Act are needed to allow for the establishment of credit reference bureaus, the exchange of information among institutions licensed under the Banking Act, and provide that the necessary regulations be issued by the MoF. Draft regulations which were prepared by the CBK prescribe the nature and the type of shared information, but provide only for the sharing of negative information (delays in repayment and defaults). Sharing of positive information will allow borrowers to build credit history. This will especially benefit small borrowers, as it will allow them to establish reputation with small loans and improve their chances to increase their borrowings as their business grows. In addition to information-sharing among institutions governed under the Banking Act, MFIs, building societies, leasing, hire purchase, and factoring companies should also be able to access a common information-sharing mechanism. Allowing all finance providers to share information on their borrowers would be beneficial for increasing competition.
D. Promoting Access to Financial Services

27. The large number of providers of micro and SME credit segments the market with adverse consequences for financial access and deepening. The providers of micro and SME finance operate in identified market niches. Lack of a comprehensive legal and regulatory framework and information sharing among different types of finance providers further contributes to segmentation. This impedes the smooth and rapid flows of funds across and through institutions, sectors and geographical regions, increases credit risk, and results in gaps in access to finance for small and particularly for growing middle-size companies – too large for microfinance and too small for banks.

28. The government should develop and secure consensus on a coherent national policy and strategy for micro and small business finance which clearly defines the respective roles of government, microfinance and SME finance stakeholders in providing and broadening access to basic financial services. Coordination among different regulators would improve transparency and would potentially reduce the segmentation among the different providers of financial services. The legislative and regulatory framework governing different classes of finance providers needs to be streamlined and clarified and should be consistent with the overall national policy and strategy for access and microfinance. The strategy should include all finance providers, including DFIs, and encourage private investment targeted to small business finance.

29. The main reason for lack of financial leasing is ambiguity and uncertainty about the legal and tax regimes that apply to leasing transactions. The Income Tax (Leasing) Rules, adopted in April 2002, provide confusing definitions of operational and finance leasing and conflict with the Income Tax Act on depreciation and expense allowances. Nonetheless, a number of financial institutions and specialized providers are actively researching the potential for entering the nascent market.

30. Future development financing should be done either through properly supervised financial institutions or in the form of grants rather than credit. Subsidized interest rates and non-repayment culture could have significant adverse effects on the competitive position of private providers of financial services, such as MFIs and small-business-oriented banks, with negative effects for sustainable financial development. The Government should develop a strategy for development financing that minimizes the adverse effects on private financial intermediaries.

31. KPOSB should retain its role as a safe repository for household savings and in providing payment services to households. KPOSB has the widest physical presence nationwide, has its own charter, and provides savings services (but not credit) to some 1.8 million customers. The operations of KPOSB consist mainly of collecting small deposits and investing in government securities. It is strongly recommended that KPOSB maintain its status and core mandate as a safe depository for household savings and money transfers by limiting investments solely to government securities. The bank should not diversify into retail lending because: (i) there is no obvious role or need for a new government-owned player, given the size and diversity of credit providers in the small business and microfinance
market; and (ii) the bank does not have nor can it easily acquire the required skills for credit assessment and lending operations.

E. Promoting the Development of Non-Bank Financial Institutions

32. **The insurance market needs to be consolidated.** The market is overpopulated, highly segmented and has a limited core of companies with adequate retention capacity and underwriting policies. Companies generally work with low loss ratios and high expense ratios. Under-reserving is a problem for many insurers, particularly those specializing in motor insurance due to the adoption of risky rebate policies. This is linked to low underwriting skills and poor market conduct among brokers. As a result, general insurance companies have been experiencing underwriting losses since 1997. It appears that companies generally compensate underwriting losses with investment income. However, with lower interest rates on treasury bills, companies are likely to face losses if they do not improve underwriting skills, reduce operating expenses, and consolidate.

33. **The Kenyan pension system does not provide adequate pension benefits and needs reforming.** The authorities should establish a policy committee to steer the pension reform debate so that reforms are implemented with a consistent vision for all plans. Major concerns relate to low coverage, poverty among old age retirees, the almost complete absence of longevity insurance, and the current unfunded liabilities, especially in NSSF, CSPS, and quasi-governmental pension plans. Poverty among old age retirees should be addressed by the introduction of a non means-tested social safety net or universal pension. Longevity insurance for the covered population could be addressed by converting NSSF into an actuarially balanced defined benefit scheme. Minimum funding levels for NSSF, CSPS, and quasi-governmental pension plans should be established and enforced while funding ratios for other occupational pension schemes should be improved. Eliminating incentives to withdraw lump sums from occupational pension plans (OPPs) would further contribute to provide access to longevity insurance.

34. **The need for reform of the Kenyan pension system is particularly acute due to the size of the government’s unfunded liabilities.** These are estimated at K Sh 238 billion for NSSF, CSPS and quasi-governmental OPPs. NSSF, CSPS, and the pension schemes of the Kenya Ports Authority, Teleposta, Kenya Railways Corporation, and Kenya Power & Lighting Company account for 90 percent of this estimate. Pre-funding of liabilities of CSPS should be promoted, while the government will have to make a policy decision on allocating the losses of NSSF. The Kenya Railways Corporation pension plan currently has a zero funding ratio and the refunding of this plan needs to be urgently addressed.

F. Supporting Capital Market Development

35. **Impediments on both the demand and supply side restrict capital market development in Kenya.** On the supply side, many of the family-controlled corporate groups are reluctant to meet the disclosure requirements of listed companies. The costs associated with listing also provide a disincentive. Improving the companies’ regulation and disclosure through updating the Companies Act and strengthening the Companies Registry would be required to reduce the costs of transparency for listed companies. Coordination between the
CMA and the Registrar of Companies should be established to ensure proper regulation of companies. On the demand side, while institutional investors demand both debt and equity securities, inefficiencies in the market, poor regulatory oversight, and inadequate corporate disclosure limit their willingness to invest.

36. **Investor protection is crucial to promote confidence in the market.** In addition to strengthening the regulation and supervision of the market and improving the clearance and settlement structures, it is important to ensure that the investment compensation and guarantee funds are well managed. The amount of funds in these schemes should be linked to the trading volume in the market, and the processes for the use of funds should be clearly defined. Careful attention to administration and investment strategies will ensure that these funds are available to meet investor claims when a market participant fails.

37. **It is also important to increase education at all levels for issuers, investors, financial intermediaries and regulators.** In addition to efforts already underway by the CMA and the NSE, industry organizations should play a key role in this undertaking. The Association of Kenyan Shareholders, the Association of Stock Brokers, the Association of Retirement Pension schemes, and the Association of Unit Trusts could take on important responsibilities in educating their members and improving standards for their respective sectors.

38. **Encouraging parastatals to issue bonds or shares through public offerings would help develop the market provided that the supervision of listed companies is strengthened.** Parastatals represent around 60 percent of the corporate sector in Kenya. Encouraging these companies to tap markets for their funding needs will not only create a supply of securities, but also provide a means for improving transparency and governance in these companies. Listing of more large issues would enhance liquidity and might also attract foreign investors. The caveat to this strategy is that the securities issued by parastatals, especially in the form of partial privatizations where the government retains majority ownership, will carry political and governance risk, limiting investor appetite in these securities. To lessen these investor concerns, good governance practices in these companies will be crucial.

39. **Creating a regional market in the East African Region would heavily depend on resolving the weaknesses and inefficiencies in the domestic markets.** While legal harmonization efforts among the authorities of Kenya, Tanzania, and Uganda are encouraging, it is crucial that all three countries first strengthen enforcement of market regulations, modernize the market infrastructures, and strengthen the financial intermediaries in the respective markets. Integration and harmonization among the three markets would facilitate the flow of demand for and supply of capital. However, given the scarce institutional capacity, it would be more desirable, at least in the first instance, to develop common structures, such as regulatory functions and back office facilities which offer considerable economies of scale.

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* The privatization process has halted awaiting the development of the new legal framework.
Banking supervision

40. Legal provisions of the Central Bank Amendment Act 2000 and Section 44 of the Banking Act that require prior approval of the Minister of Finance for changes in charges and fees, create uncertainty about the government's commitment to market-based financial intermediation. While the CBK has issued circulars to clarify that Section 44 will not be enforced, a subordinate legal instrument (CBK Circular) cannot change a law. Section 44 of the Banking Act and the Central Bank Amendment Act 2000 should be repealed to remove uncertainty in the market place.

41. The Bank Supervision Department (BSD) of the CBK has a well-designed off-site and on-site supervision program, which, however, often does not lead to corrective action. Demands of ad hoc assignments and requirements to deal with problem banks have strained the resources of the BSD, perhaps limiting the scope of off-site analysis and on-site examinations. More importantly, significant weaknesses identified through off-site analysis and on-site examinations frequently do not result in decisive supervisory action.

42. Failing banks have been allowed to stay open for too long. CBK has intervened in failing banks too late, with the result of (i) negative net worth and thus losses for uninsured creditors; and (ii) negative impact on borrower discipline and thus recovery of assets. For example, despite their continuous violation of capital requirements, two small banks were allowed to stay open for several years before being put under statutory management and liquidation, respectively.

43. Hitherto the most notable concern with the current Banking Act is the vesting of key powers to deal with problem banks, including removal of officers or directors, appointment of a statutory manager, or revocation of a license, in the Minister of Finance. Changes to the Banking Act were enacted in 2004 and going forward the CBK can be clearly held accountable for any future failure to deal promptly with identified problem banks once all supervisory powers are invested in it. Failing this – as has been demonstrated on a number of occasions – a prolonged period of inaction increases losses to depositors and other creditors once the bank is liquidated.

Deposit insurance and bank failure resolution

44. The DPF should be made more independent of the Minister of Finance. Representatives of the banking system are currently included on the DPF Board as is appropriate. However, although this has yet not been an issue, approval by the Minister of Finance of DPF board representatives and policies does open the door for political interference. The ability of the Minister of Finance to influence DPF decisions should be more narrowly prescribed, e.g., to matters having a significant fiscal impact.

45. The lender of last resort facility is not integrated into the overall financial safety net. While the Central Bank Act empowers the CBK to extend loans secured by government securities and for periods not exceeding six months to banks, it has on occasion provided
liquidity support for longer periods, and without the required security. There does not seem to be any formal consultation with the banking operations department concerning the extension of loans to banks that have been identified as weak by the supervision department.

46. **The current bank failure resolution is extremely inefficient.** In many cases, the CBK imposes statutory management on problem banks, rather than proceeding directly to liquidation. In most cases statutory management has been followed by liquidation. The sequence of statutory management and liquidation is inefficient, resulting in asset decay and delay for depositors in accessing their funds. Further, a thorough cost-benefit analysis should be done for past bank failure resolutions to maximize the DPF’s net recovery from failed bank liquidation. The outsourcing of debt collection to private agencies should be considered. The practice of limiting the interest rate on loans of failed banks to 15 percent should be discontinued, since it gives a disincentive for borrowers to agree to the sale of assets to a third party.

47. **The legal basis for a purchase and assumption operation should be created.** Such a procedure has two major advantages: first, the contagion risk is minimized since most depositors will not lose access to their accounts during resolution; second, performing assets will not leave the financial system and potential decay is avoided by keeping them out of the liquidation process. While DPF staff recognize that a purchase and assumption transaction would be more efficient than liquidation, legal impediments block the implementation of such a scheme.

**Insurance Sector and Pension Funds**

48. **The Insurance Act has important shortcomings and the Insurance Commission is not operationally independent and does not have adequate resources to carry out the effective supervision of the Insurance sector.** One and a half percent of direct premium income is paid to the Treasury while the budget of the Insurance Commission is only about 10 percent of collected fees. Staff salaries are much too low to attract supervisors with adequate skills. Financial reporting is too infrequent. Financial reports are submitted in hard copy only, and no computerized system is in place to conduct financial analysis. The limited number of inspectors does not allow the Commission to inspect all companies on an annual basis. The autonomy of the Commission in establishing prudential regulation seems to be undermined by the current governance structure.

49. **The Retirement Benefit Act complies with many international good practices and the Retirement Benefit Authority is staffed with highly qualified individuals.** The Authority has ongoing initiatives to train trustees, increase public education, and promote good market practices. However, the lack of a cohort mortality table for Kenya severely compromises the supervision of demographic assumptions. Retirement product rules need tightening to discourage the withdrawal of lump sums from defined benefit schemes at early retirement or from defined contribution schemes. The use of phased withdrawals and annuity products should be promoted.
Nonbank Financial Institutions

50. The government is seeking to bolster the microfinance sector, and has presented new legislation to Parliament that will, inter alia, provide for better supervisory oversight while avoiding over-regulation and overtaxing the capacity of the CBK. The sub-sector of the microfinance industry addressed by the proposed law covers MFIs with assets of an estimated K Sh 3.8 billion. The FSAP team provided detailed comments on the bill. Among the key recommendations were to: (i) place large SACCOs under similar prudential supervision as envisaged for MFIs; (ii) clearly define permitted and prohibited business; (iii) specify geographical limits for community-based deposit-taking MFIs; and (iv) specify higher capital adequacy standards and prudential standards for asset quality and liquidity management appropriate for MFIs.

51. The large SACCOs need to be moved quickly under regulatory oversight because they are virtually banks providing savings and loans to members as well as non-members. The 20 largest urban and rural SACCOs have memberships ranging from 5,000 to 85,000 and significant savings deposit business from non-members. As their operations are substantively similar to micro-banking, this category of SACCOs, especially those with Front Office Service Areas, should be required to register and be licensed under appropriate legislation—either under the Microfinance Act suitably amended to include large SACCOs or separate legislation—thereby obliging them to be prudentially supervised by the CBK, making their regulatory status more similar to that of banks.

Capital Markets

52. The legal framework for the capital markets has largely been put in place, but the enforcement of market rules and supervision of market participants remain weak. The CMA should be granted the operational independence and resources to be able to build the capacity to respond to the regulatory challenges in the market. Under the oversight of the CMA the Nairobi Stock Exchange (NSE) should be required to undertake its self-regulatory functions in monitoring the activities of its members and the market.

53. Currently, neither CMA nor NSE carry out any market surveillance activities to detect market misconduct such as manipulation, front running, ramping, cornering, or insider dealing. The regulators and the exchange need to be trained on how these market abuses occur and the ways in which they can carry out surveillance over the market to identify them and take enforcement action against violators.

H. Payment and Settlement Systems

54. The current payment system is largely based on manual and paper-based arrangements, and is associated with systemic risks while also hampering development of the financial system. The CBK has engaged in a National Payment System project which has resulted in the preparation of a draft framework and strategy paper that embraces the development and introduction of the RTGS and outlines key reform issues in the development of efficient and effective payment, clearing and settlement systems by 2005.
55. The efficient functioning of payment systems in Kenya is hindered by the inadequate legal framework, the lack of efficient payment instruments and long cycles for clearing and settlement. A number of decisions and actions need to be taken in preparation for the launching of modern payment and efficient settlement systems, including (i) accelerating the adoption of the revisions to the Central Bank Act to strengthen the authority and oversight responsibility for the CBK for the payment system; (ii) introducing, as quickly as possible, and after a short consultation period, the National Payments Law to provide for the efficient oversight of systemically important payment system; (iii) presenting the draft CBK/KBA payments system strategy paper for public consultation and developing a detailed, time-bound action plan for its implementation; (iv) working toward the implementation of RTGS; (v) strengthening the National Payments Division of the CBK to assume the full implementation responsibilities for the reforms in this sector.

56. Inefficiencies in the clearing and settlement of securities discourage trading and increase risks in the market. Government securities are settled through the paperless Central Depository System (CDS) account with the CBK while equity securities are cleared manually and settled at the NSE. The settlement cycle is typically T+5 for equities, and T+3 for bonds. However, the cycle for the actual delivery of the funds and securities are frequently extended to T+14, resulting in increased credit and settlement risks.

57. Implementation of the Central Depository and Settlement Corporation (CDSC) will be an important step in addressing the weaknesses in the clearance and settlement of private securities. However, in order for the CDSC to be operational, several important steps need to be taken, including (i) completion of the legal and regulatory framework including the CMA and NSE operational rules; (ii) development of systems within the CDSC to identify and mitigate operational, credit, and settlement risks; (iii) education of all market participants, including the registrars, on their roles and responsibilities within the context of the new settlement and clearance system, and (iv) determination that all settlement participants have the technical and risk management capability in place to be able to link with the CDSC. There should be a realistic transition period for the immobilization of securities, during which the two systems will run in parallel. Introduction of the automated clearing and settlement systems prior to these steps being taken could be disruptive to the market, creating uncertainties and further discouraging trading.