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GOVERNOR'S MESSAGE



In the banking sector, the year started with lifting of moratorium on licensing of new banking institutions which had been in force since 1993. To prevent recurrence of instability in the banking industry that occurred in 1993, stringent licensing criteria were put in place covering inter alia requirements for enhanced capital requirements and that bank management are "fit and proper".

Technological developments continued with further expansion of credit cards and automated teller machines (ATMs). Progress was also made in the implementation of Magnetic Ink Character Recognition (MICR) project.

In line with the spirit of East African Cooperation, the three Central Banks initiated the harmonization of supervisory laws and practices. This entails convergence in banking laws and prudential regulations, joint inspections and exchange of supervisory information.

The performance of the banking sector was generally satisfactory. There are however some areas of concern and the Banking Act will be amended to address them.

Though the formal sector is relatively developed, it is apparent that the financial needs of the informal sector have not been well addressed. In view of the importance of this sector, it is important that strategies of ensuring its orderly development be devised. Therefore, the Central Bank will liaise with the various stakeholders associated with microfinance to evaluate how the sector can be assisted in terms of registration, regulation and integration into the formal banking sector.

In conclusion, I would like to thank the banking industry as a whole for the cooperation accorded to the Central Bank of Kenya during 1997. We look forward to continuation of the same spirit to ensure efficiency and stability of the financial system for the benefit of our economy as we approach the next millennium.

MICAH CHESEREM
JUNE, 1998

RECENT DEVELOPMENTS IN THE LOCAL BANKING INDUSTRY

1.1 OVERVIEW

The overall performance of the banking sector was satisfactory during 1997. Banking activities remained buoyant as institutions maintained relatively high levels of profitability and liquidity. Conversion of non-bank financial institutions to banks continued while one institution was placed under liquidation, one local bank extended its operations across the border and the forex bureau sector attracted more investors. The Central Bank conducted seminars for bank directors to enhance corporate governance, while the banking industry adopted various developments in information technology designed to improve customer service.

1.2 INSTITUTIONS AND BRANCH DEVELOPMENT

As at the end of December 1997, the total number of institutions stood at 74, out of which 53 were banks, 17 non-bank financial institutions (NBFIs) including 2 mortgage finance companies (MFCs) and 4 building societies. During the year under review, one local bank extended its operations to Tanzania, increasing the number of locally owned banks with branches/subsidiaries outside the country to four with seven branches located; one in Malawi, three in Tanzania, two in Uganda and one in Pakistan. There was a marked expansion in branch network of banks due to general expansion and conversions of non bank financial institutions (NBFI's) to banks (Table 1.1).

TABLE 1.1: BRANCH NETWORK OF THE BANKING INDUSTRY

PROVINCE	BANKS		NBFI's		MFC's		TOTALS	
	1996	1997	1996	1997	1996	1997	1996	1997
CENTRAL	81	95	2	1	3	3	86	99
COAST	82	80	4	3	2	2	88	85
EASTERN	47	59	-	-	1	1	48	60
NAIROBI	150	162	21	17	6	8	177	187
N. EASTERN	5	5	-	-	-	-	5	5
NYANZA	54	64	2	2	2	2	58	68
RIFT VALLEY	95	132	2	2	4	4	101	138
WESTERN	24	27	-	-	1	1	25	28
TOTAL	538	624	31	25	19	21	588	670

Source: Bank Supervision Department

1.3 FOREIGN EXCHANGE BUREAUS

The number of forex bureaus increased from the 31 in 1996 to 37 in 1997. Nineteen new applicants were issued with Conditional Letters of Intent and were preparing their premises in readiness for licensing.

1.4 INSTITUTIONS UNDER LIQUIDATION/RECEIVERSHIP/CBK MANAGEMENT

The number of failed and restructured institutions between 1984 and 1997 rose to thirty after Ari Bank Corporation Limited was placed under liquidation during the year. Seventeen institutions were under Deposit Protection Fund Board (DPFB), 7 under Consolidated Bank, 4 under the Official Receiver, one under voluntary liquidation and one was wound up by the court.

1.5 EMPLOYMENT IN THE BANKING INDUSTRY

The banking sector recorded a 21% reduction in staff through retrenchment and other adjustment schemes. The reductions were necessitated by computerization and other technological applications. The highest reductions were at clerical, secretarial and subordinate levels. There was a change in personnel and skills requirements of the industry necessitating retraining of both existing and new staff (Table 1.2).

TABLE 1.2: EMPLOYMENT IN THE BANKING INDUSTRY *

Category	1996				1997			
	Banks	NBFIs	Total	%	Banks	NBFIs	Total	%
Management	2,930	254	3,184	19	2,715	206	2,921	22
Supervisory/Section Heads	1,504	204	1,708	10	1,584	132	1,716	13
Clerks & Secretarial Staff	8,940	597	9,537	57	6,098	411	6,509	50
Other Categories	2,074	194	2,268	14	1,848	155	2,003	15
Grand Total	15,448	1,249	16,697	100	12,245	904	13,149	100

* Excludes Central Bank

Source: Bank Supervision Department

1.6 DEVELOPMENTS IN INFORMATION TECHNOLOGY

The banking industry continued to adopt new developments in information technology designed to improve customer service in the form of money transfers, cheque clearing systems and internal banking operations.

Another significant development in 1997 was the adoption of the Magnetic Ink Character Recognition (MICR) technology. This will vastly improve security through elimination of cheque substitution, faster cheque processing and accuracy in data processing. It will also ultimately facilitate development of a national electronic clearing system.

The implementation of this technology started in January, 1996, when a number of banks started circulating the new design of MICR cheques and developing MICR system to automate the clearing of cheques. The next phase which is expected to be operational by late 1998 will cover credit and other forms of electronic transfers.

A number of credit and debit cards were introduced in 1997 for both local and international transactions and have made a breakthrough in the local market. Banks and a number of non-bank financial institutions also continued to recognise foreign based cards that have no local franchise.

A few banks made considerable progress in the automation of their teller services (ATMs) in 1997. This development has greatly enhanced customer service. Arrangements are underway for sharing of ATMs among institutions with the objective of minimising costs.

1.7 CUSTOMER SERVICE

Due to the increased competition by banks under the liberalised financial environment, the quest for quality services by customers has taken centre stage. Complaints from customers have been mainly on the following:

- Poor customer relations.
- Lack of disclosure of charges and rates offered on different types of services.
- Long cheque clearing period.
- Congestion and long queues.
- High minimum amounts for opening new accounts.

Most banks have put in place measures that are largely aimed at addressing issues that have been raised by customers. These include:

- Well trained customer service personnel to accord personalised service,
- Provision of clean, spacious banking halls manned by competent staff,
- Availing suggestion boxes which are conspicuously placed,
- Controlling queues by use of barriers,
- Displaying bank charges conspicuously,
- Provision of flexible counter services.

The Central Bank of Kenya has also continued to liaise with banking institutions on the issue of quality of customer service and has organised seminars on customer care. It has also introduced customer service program in its on-site inspections. Further, technological advancement in areas of automated teller machines has made it possible for customers to have easier access to their accounts.

1.8 TRAINING AND HUMAN RESOURCE DEVELOPMENT

The Kenya School of Monetary Studies continued to offer training programmes geared towards capacity building to prepare the financial sector face future challenges. The training is mainly in the fields of economics, banking, finance, development of managerial skills, as well as professional courses leading to the award of various diplomas in banking and information technology. The school is also planning to introduce postgraduate programmes in the same areas of study. During 1997, its first year of operation, over 2,500 persons enrolled in various disciplines.

CURRENT SUPERVISORY ISSUES

During the year under review, the most important regulatory and supervisory issues were corporate governance, implementation of the Basle Core Principles for effective banking supervision, harmonisation of bank supervision in the East African sub-region and the Year 2000 problem - Millennium Bug.

2.1 CORPORATE GOVERNANCE

Prudent corporate governance has become more important as new technologies, product innovation and the size and speed of financial transactions, have changed the nature of financial markets. Further, globalisation of markets has also increased the vulnerability of both domestic and international financial systems to potential shocks and possible bank failures. Responsibility for bank's corporate governance lies with the Board of Directors and Management, External Auditors, Audit Committees of the Non-Executive Board Members and the Supervisory Authority.

The Board of Directors have the responsibility for the level of risk taken by their banks and are responsible for appreciating risks and ensuring that management is taking steps to identify, measure, monitor and control risks. The degree of soundness of a bank will depend largely upon the policy decisions of the Board, the integrity and competence of its members, the interest it takes in the corporate affairs, the choice of personnel for managing the bank at different levels and the general control it exercises in ensuring that the policies are carried out in an effective manner.

During the year under review, the Central Bank conducted semi-annual seminars for directors in order to sensitise them on their responsibilities. The vetting of directors to ensure they are "fit and proper" was introduced.

Senior management assumes the responsibility of managing the day-to-day affairs of the bank by, implementing policies and objectives established by the Board of Directors and employing, training and retaining qualified staff. The senior management team must also ensure that the bank is operating in compliance with the banking laws and regulations and the prudential guidelines and directives as periodically issued by the Central Bank. The team is however bound to experience difficulties unless the appropriate systems such as internal controls are in place and functioning well so that the operation and administration of the institution can be effectively accomplished.

Internal Auditor's main focus is the compliance with the Board's policies including accounting systems and operational efficiency. Historically, the internal control function, has been a mechanism for reducing instances of fraud, misappropriation and errors. However, it has now become more encompassing, addressing all the various risks faced by banking organisations. Therefore, a sound internal control mechanism is critical to a bank's ability to meet its set goals and objectives and maintenance of its financial viability. In recognition of the importance of the internal audit function, the Central Bank organises workshops for internal auditors of banking institutions.

All banks and non-bank financial institutions were encouraged to establish Audit Committees during the year. **An Audit Committee** should be made up of at least three non-executive members of the Board of Directors. Its role is to provide assistance to the Board in fulfilling its responsibility to existing and potential shareholders and the business community relating to accounting, reporting practices and the quality and integrity of the financial reports of the institution. It is the responsibility of the Audit Committee to maintain free and open avenues of communication between the directors, the external auditors, the internal auditors, and the executive management of the institution. The committee assists the bank in adapting to the changing financial and economic environment. It also enables directors to acquire financial and accounting skills and enhances corporate image and accountability.

The role of the **external auditor** is to evaluate the bank's policy and risk management systems. The Banking Act and the Central Bank of Kenya Prudential Guidelines set out the duties of External Auditors in relation to the supervisory authority. Central Bank continued to liaise closely with the Banking Committee of the Institute of Certified Public Accountants of Kenya (ICPAK) in matters relating to auditing and accounting in the banking industry.

2.2 CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

Background

In 1997, the Basle Committee on Banking Supervision circulated a set of 25 core principles for effective banking supervision with a view to assessing the status of implementation by member countries. The committee whose secretariat is based at the Bank of International Settlements, Basle, Switzerland, was formed in 1975 by central bank governors of the G-10 countries. It now encompasses non-G-10 countries divided into sub-regional groupings. Kenya belongs to the Eastern and Southern African Sub-Group (ESAF) whose secretariat is currently based at the Bank of Zambia.

The Basle core principles are the minimum guidelines for effective banking supervision and supervisory authorities are therefore required to adapt them to suit local environment.

Evaluation of the progress made in implementation of the relevant core principles in Kenya is satisfactory. However, there are a few outstanding areas which will be addressed after the necessary legal framework is put in place.

Implementation of the core principles calls for extensive reporting requirements to the supervisory authorities by banking institutions. The reports are necessary and in line with international requirements. It is expected that with adoption of modern technology by all banks, the data and reports will be transmitted to the Central Bank electronically.

Below is a summarised statement of the 25 core principles.

Preconditions for Effective Banking Supervision

1. An effective system of banking supervision will have clear responsibilities and objectives; operational independence; adequate resources; suitable legal framework and arrangement for sharing information with other supervisors.

Licensing and Structure

2. The activities of institutions that are licensed and subject to supervision as banks must be clearly defined and the use of the word “bank” should be controlled as far as possible.
3. The licensing authority must set criteria and standards for licensing. These include banking organization’s ownership structure, directors and senior management, its operating plan and internal controls and projected financial condition including its capital base. Where the proposed owner or parent organization is a foreign bank, the prior consent of its home country supervisor should be obtained.
4. Banking supervisors must have the authority to approve significant ownership transfers and any controlling interests in existing banks to other parties.

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5. Banking supervisors should have authority to approve major acquisitions or investments by a bank and ensure that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.

Prudential regulations and requirements

6. Banking supervisors must set minimum capital requirements for banks and must define the respective components of capital.
7. Banking supervisors must have independence in evaluating bank's policies, practices and procedures for granting loans and investments and also performance of the loan and investment portfolios.
8. Banking supervisors must ensure that banks have adequate policies, practices and procedures for evaluating the quality of assets and the adequacy of loan loss provisions and reserves.
9. Banking supervisors must set prudential limits to restrict bank exposures to single borrowers or groups of related borrowers.
10. Banking supervisors must ensure that lending by banks to insiders is at arms length and is well monitored and that steps are taken to control or mitigate the risks.
11. Banking supervisors must ensure that banks have adequate policies for identifying, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and also maintaining adequate reserves against such risks.
12. Banking supervisors should set limits and /or specific capital charge on market risk exposures and banks should have adequate measures to monitor and control market risks.
13. Banking supervisors must ensure that banks have a comprehensive risk management process to identify, measure, monitor and control all other

material risks and, where appropriate, to hold capital against these risks.

14. Banks must have adequate internal controls and appropriate independent internal or external audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.
15. Banks should have adequate policies to promote high ethical and professional standards in the financial sector and prevent the bank being used, intentionally or unintentionally, by criminal elements.

Methods of On-going Banking Supervision

16. An effective banking supervisory system should consist of both on-site and off-site supervision.
17. Banking supervisors must have regular contact with bank management and thorough understanding of the institution's operations.
18. Banking supervisors must have a means of collecting, reviewing and analysing prudential reports and statistical returns from banks on a solo and consolidated basis.
19. Banking supervisors must have independence in validation of supervisory information either through on-site examinations or use of external auditors.
20. Bank supervisors should have the ability to supervise the banking organisation on a consolidated basis.

Information Requirements

21. Banking supervisors must ensure that banks maintain adequate records and that they publish on a regular basis financial statements that fairly reflect their conditions.

Formal Powers of Supervision

22. Banking Supervisors must have measures to bring about corrective action when banks fail to meet prudential and regulatory requirements.

Cross-border Banking

23. Banking supervisors must practise global consolidated supervision, adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by banking organizations worldwide, primarily at their foreign branches, joint ventures and subsidiaries.
24. For effective global consolidated supervision, banking supervisors must maintain contacts and information exchange with other supervisors and more important the host country supervisory authorities.
25. Banking supervisors must ensure a uniform supervision standard for both domestic and foreign institutions and must have powers to share information needed by the home country supervisors for the purpose of carrying out consolidated supervision.

2.3 HARMONISATION OF BANK SUPERVISION AND REGULATION IN EAST AFRICA.

As part of the East African cooperation, arrangements initiated in 1997 are at an advanced stage to harmonise banking supervision and regulation within the sub-region. In this regard, during the periodic East African Central Bank Governors' meetings, the following measures have been adopted for implementation within the sub-region.

- Practise joint supervision.
- Share inspection programmes and supervision materials.
- Practise cross border and consolidated supervision.
- Encourage formation of commercial courts.
- Introduce prior approval and vetting of directors and senior management of banking institutions by Central Banks.

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- Encourage establishment of credit rating agencies.
 - Continue to hold seminars and workshops for directors, external and internal auditors.
 - Issue regulations governing the conduct of external auditors and supervisors.
 - Encourage microfinance institutions by putting in place appropriate legal framework.

2.4 THE YEAR 2000 PROBLEM: THE MILLENNIUM BUG

In the Banking sector, the Y2000 problem poses significant challenges because of heavy reliance on automation in the management of information. However, the Basle Committee on Banking Supervision has taken the initiative to assist banks to move towards Y2000 compliance. One such initiative was circulating a questionnaire to supervisory authorities to sensitise banking institutions within their respective jurisdictions on the year 2000 problem.

In Kenya, a variety of measures have been taken to ensure that banks will be Y2000 compliant by December 1998. These include:

- Sending the Basle committee questionnaire in October 1997 to all banking institutions to assess their awareness and preparedness.
- Requiring Banking institutions to submit quarterly reports on progress made on the Year 2000 compliance.
- Verifying during on-site examinations progress made towards compliance.
- Holding workshops with all banking institutions to evaluate progress made.

2.5 OTHER AREAS OF SUPERVISORY CONCERN

- Non compliance with the Banking Act and Prudential Regulations.
- High level of non-performing loans.
- Self serving practices by directors and insiders.
- High interest rates.
- Lack of credit rating agency services.
- Regulation of other financial intermediaries.

DEVELOPMENTS IN BANKING REGULATION

3.1 OVERVIEW

During 1997, the ability of the Central Bank to foster a stable and sound financial system was hampered by a number of weaknesses in the banking laws and regulations. Several changes are therefore being undertaken in the legislation and regulations of banking activities.

3.2 PROPOSED AMENDMENTS TO THE BANKING ACT.

The proposed amendments to the Banking Act are enumerated below:

3.2.1 Directors/Insider Loans

The issue of insider loans is a major problem in the Banking industry. Out of 30 bank failures between 1984 and 1997, eighty seven percent were due to insider abuse. Todate, the current restrictions on insider loans are not adequate. The following measures are being considered for inclusion in the Banking Act in order to instil discipline in the sanctioning of directors' loans, ensure **their** performance and enable Central Bank to take swift and decisive action to address any abuses by directors.

- Loans and credit facilities to directors and senior management to be approved by the full board of directors and reported to the Central Bank.
- Lending to directors to be in the regular course of business and on similar terms to those offered to other customers.
- Appropriate penalties be imposed on the Board if there are any irregularities with the directors' loans. This will include immediate disqualification of the affected director.

3.2.2 Provisions For Bad And Doubtful Debts

Despite non-performing loans being high, banking institutions in Kenya have for the last few years posted very high profits. In order to ensure that adequate provisions are maintained, the Central Bank has made proposals for penalties on institutions that fail to comply with the requirements of provisioning. This will ensure stability of the sector and avoid crisis like the recent one experienced in South East Asia.

3.2.3 Powers to Issue Cease and Desist Orders

The level of compliance with Banking Act and Prudential Guidelines has been low over the years resulting to simple matters developing into chronic problems which eventually impair the soundness of an institution. This is because the Central Bank relies largely on moral suasion to ensure compliance. To overcome this difficulty, the Central Bank should be empowered to issue Cease and Desist orders on observed unsound practices. Institutions will have to comply with these orders within a specific period failing which penalties will be imposed.

3.2.4 Powers To Issue Administrative Sanctions

Since the enforcement of current penalties provided for in the Banking Act involves protracted legal process, the Central Bank is handicapped in compelling banking institutions to address shortcomings noted by external auditors and Central Bank inspectors. Measures are being undertaken to empower Central Bank to issue administrative directives/sanctions where examiners' or auditors' reports show that management is conducting business of an institution in a manner likely to prejudice the interest of the institution or the depositors or the general public.

3.2.5 Regulations And Guidelines By Central Bank

A number of prudential guidelines issued by the Central Bank currently lack force of the law. To enable the Central Bank have flexibility in dealing with operations in the banking industry, it should be empowered to make regulations and prescribe prudential guidelines which have legal force.

3.2.6 Liquidation By Deposit Protection Fund Board

In discharging its duties as the liquidator, the Deposit Protection Fund Board relies on the provisions of part VI of the Companies Act. These provisions in some areas do not cater for specific requirements for liquidating banking institutions. To address these problems, and to ensure that Deposit Protection Fund Board carries out its functions as liquidator of banking institutions more effectively, several amendments are being proposed. Among them are the right of assignment of assets and liabilities of an institution and/or customer. This will enable the liquidator to sell branches and assets of institutions under liquidation.

3.2.7 Minimum Capital Requirements

To create a level playing field between foreign and locally incorporated institutions, measures are being taken to harmonise the capital requirements for all institutions.

3.3 REGULATIONS OF OTHER FINANCIAL SERVICES AND INSTITUTIONS

A number of organisations involved in financial intermediation do not fall under Central Bank Supervision thus affecting its ability to foster a stable financial system. This calls for appropriate legislation to ensure that they are properly regulated and that they do not adversely affect the country's financial system.

Micro-Enterprises (also popularly known as “Jua Kali”) form a major segment of the informal sector in Kenya. The financial needs of the informal sector however have not been well addressed. Due to the important role played by micro-finance institutions in terms of credit extension to the informal sector, the Central Bank will liaise with various stakeholders with a view to creating an enabling environment for micro-finance institutions. This will include review of the legal framework to ensure they are regulated or they become integrated into the existing banking system.

3.4 DIRECTIVES AND CIRCULARS

The Central Bank issued a total of 38 circulars and directives in 1997. Matters touching directly on bank supervision included circulars on lifting of the moratorium on new banking licences, publication of financial information, harmonisation of expiry date of licences, increase in minimum capital requirements, disclosure in the profit and loss statement, licensing procedures, Year 2000 compliance and bank holidays.

PERFORMANCE OF THE BANKING SECTOR

4.1 OVERVIEW

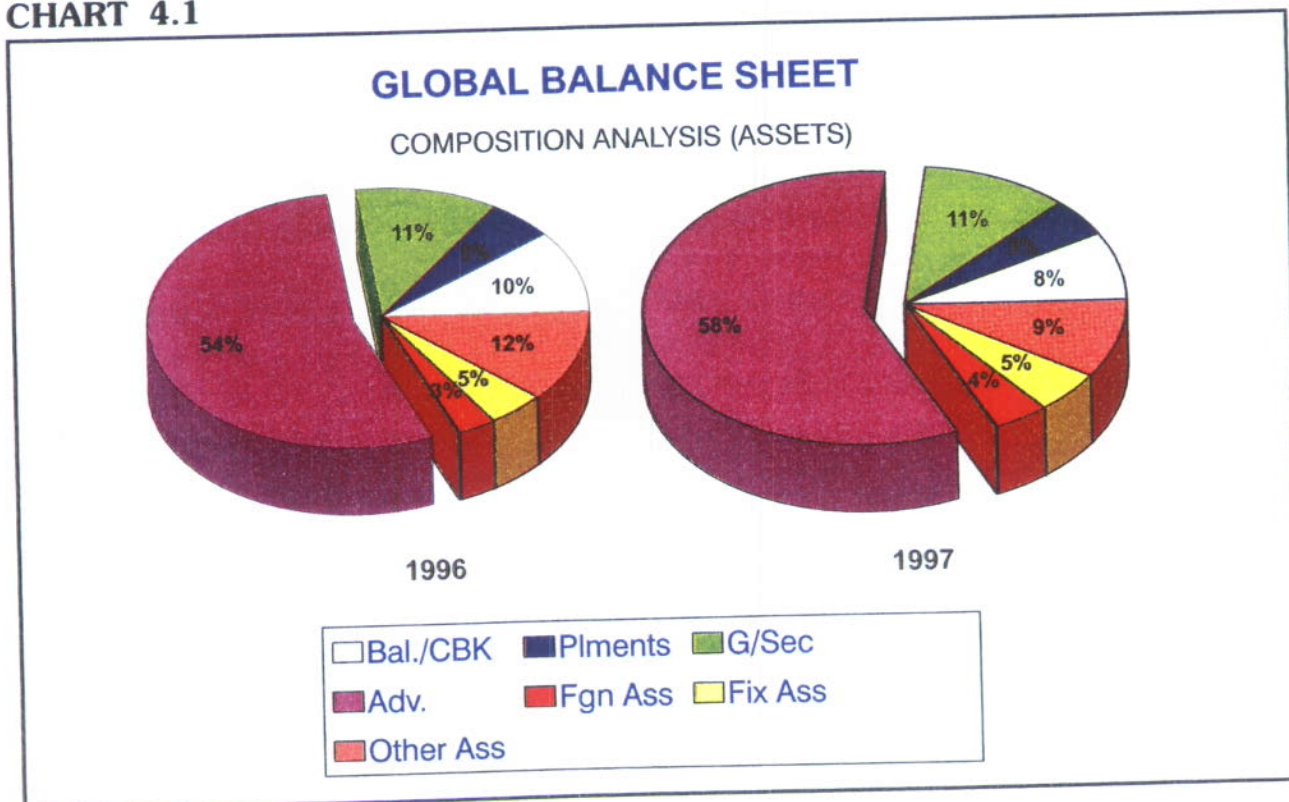
The overall performance of the banking sector in 1997 was rated satisfactory. Growth of total assets and liabilities of the sector slowed down compared to the previous year. Capitalisation and liquidity remained strong during the year. The proportion of non-performing advances to total advances increased but due to inadequate provisions for non-performing advances by some institutions, profitability of the sector remained high.

4.2 STRUCTURE OF THE BALANCE SHEET

4.2.1 Composition of Assets

Total assets of the banking industry at shs 439 bn at the end of December 1997 was 11% above the level recorded at the end of December 1996 (Appendix I). In terms of composition, advances at 58% of the total assets continued to constitute the major component. Other major assets were holdings of Government securities (11%), balances at the Central Bank (8%) and interbank placements at 5% (Chart 4.1).

CHART 4.1



Source: Bank Supervision Department

CHART 4.2

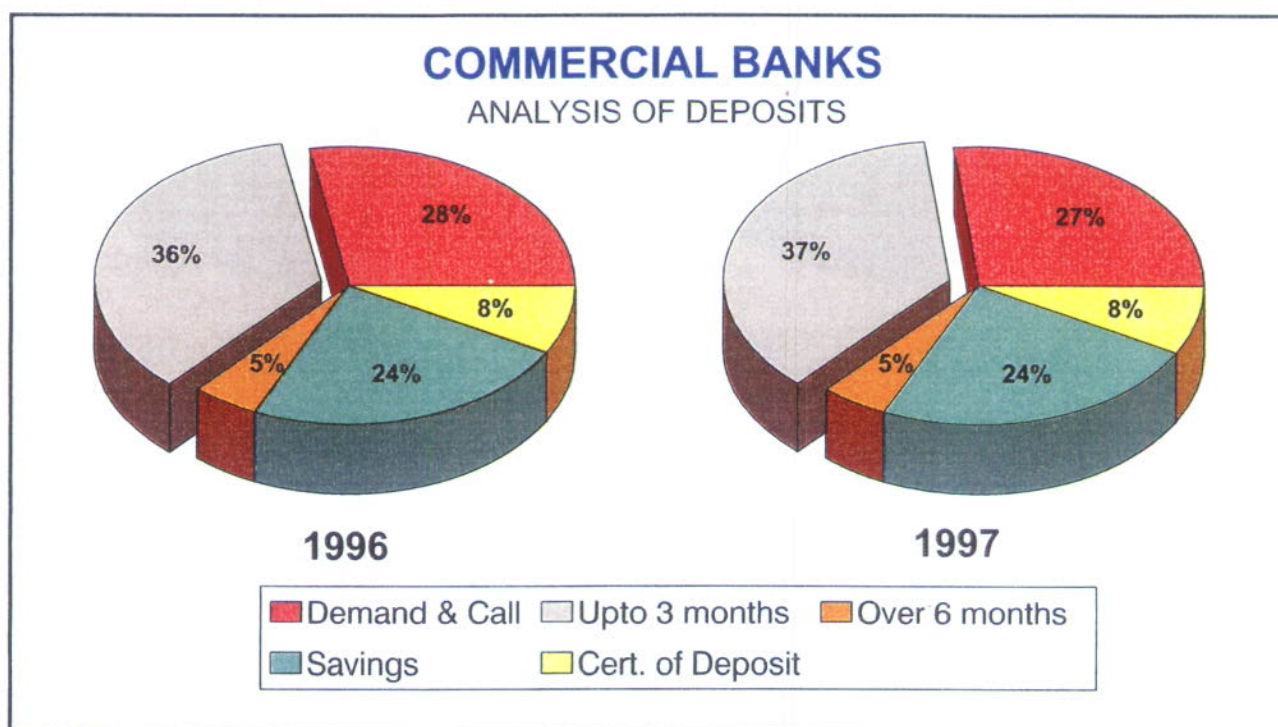


4.2.2 Liabilities

CHART 4.3



The structure of deposit composition did not vary significantly from the previous year. The 3-months deposits continued to be the major component at 37% of total deposits. Other deposit types were savings 24%, demand and call 27%, certificates of deposits 8% and over 6 months deposits 5% (Chart 4.4).



Source: Bank Supervision Department

4.2.3 Capital and Reserves

Total capital and reserves (shareholders' funds) of the banking industry at shs 57bn on 31st December 1997 was 18% above the level recorded in 1996. Paid up/ assigned capital at shs 21bn at the end of 1997 increased by 6.4% above the level recorded in 1996. Reserves, also at shs 21bn, were 39% above the 1996 level. The Profit and loss account balance increased by 11% to Shs. 15 bn in 1997.

4.3 STRUCTURE OF PROFIT AND LOSS ACCOUNT

4.3.1 Profitability

Aggregate profits before tax of the banking system rose by 8.4% to shs 18.8bn during 1997 compared to an increase of 13.7% during 1996. Return on assets (including contingent liabilities) remained unchanged at 4% in 1997 while return on shareholders' funds declined from 36% in 1996 to 33% in 1997 (Appendix II).

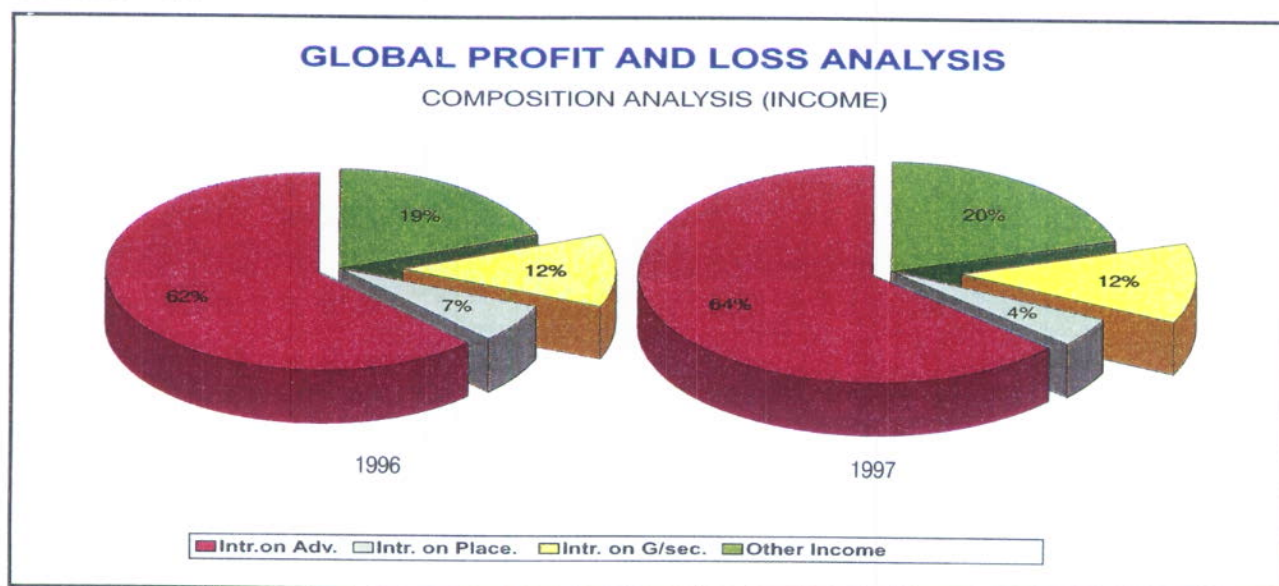
4.3.2 Income

Total income grew by 13% in 1997 compared to 27% in 1996. Interest on loans continued to be the major source of income for the banking industry. The other major sources of income were interest on Government securities and interbank placements (Appendix I and Chart 4.5).

4.3.3 Expenses

Total expenses of the banking system rose by 15% to shs 68bn in 1997 compared to an increase of 31% during 1996. Interest on deposits continued to be the major expense. Other major expenses were salaries and wages and other expenses.

CHART 4.5



Source: Bank Supervision Department

4.4 MARKET SHARE

Banking business in 1997 continued to be dominated by a few banks. Seven banks controlled 62% of the market share in terms of total net assets and deposits, while the other 46 banks took 38% (Table 4.1).

Due to conversion of a number of non bank financial institutions to banks, the share of NBFIs' assets in the banking system has continued to decline from 13% in 1996 to 8.5% in 1997. During 1997, four NBFIs, with assets in excess of shs 500m took 68% of the total assets of NBFIs while the other thirteen took 32% of the market share, reflecting a relatively skewed distribution.

TABLE 4.1

COMMERCIAL BANKS' MARKET SHARE BY NET ASSETS AND DEPOSITS AND BY PEER GROUPS AS AT DECEMBER 1997.

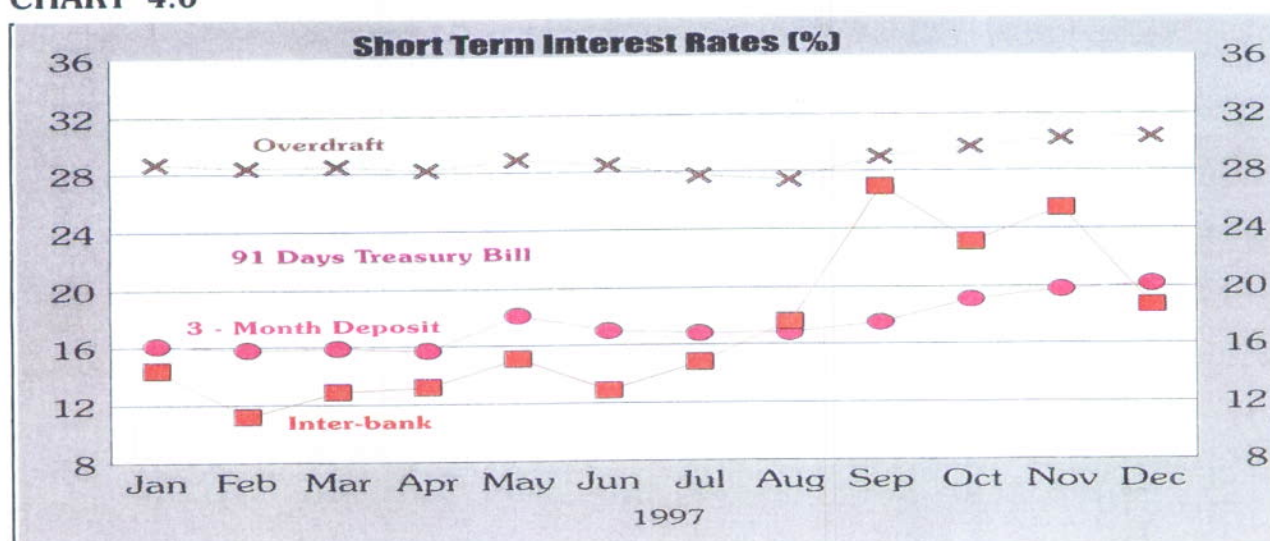
PEER GROUP RANGE	NO. OF INST.	NET ASSETS	MARKET SHARE	DEPOSITS	MARKET SHARE
Shs'millions		Shs'billions	%	Shs'billions	%
OVER 10000	7	234	61.7	158	61.7
5000 - 10000	10	68	17.9	41	16.0
3000 - 5000	7	27	7.1	18	7.0
1000 - 3000	22	45	11.9	35	13.7
0 - 1000	7	5	1.3	4	1.6
GRAND-TOTAL	53	379	100.0	256	100.0

Source: Bank Supervision Department

4.5 INTEREST AND EXCHANGE RATES

There was an upward trend in the movement of major short term interest rates during 1997. Overdraft rates, treasury bill rates, inter bank rates and 3 months deposit rates increased by 1.5, 4.8, 2.7 and 4.2 percentage points to 30.4%, 26.4%, 18.7% and 20.2% respectively during the year (Chart 4.6).

CHART 4.6

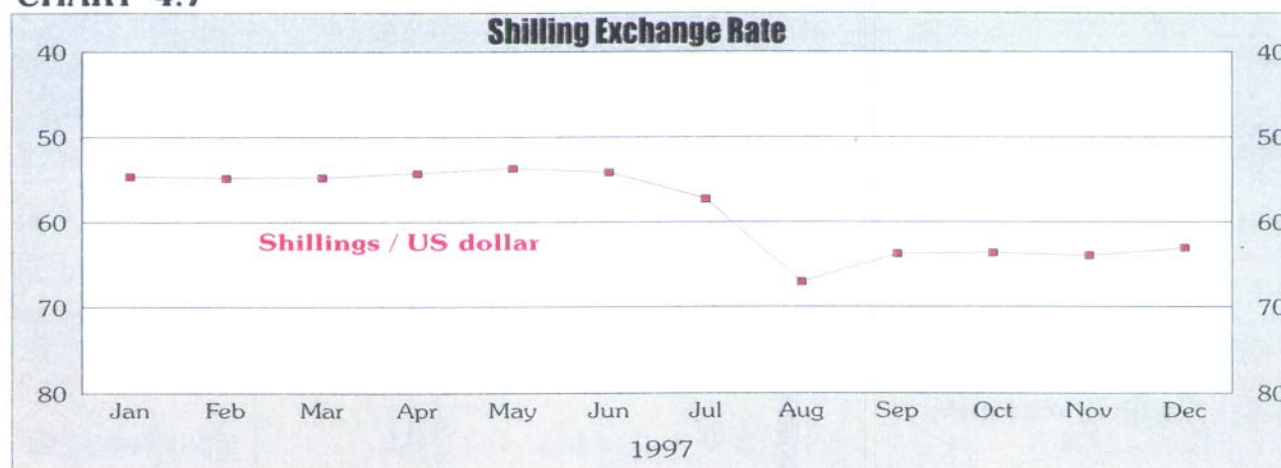


Source: Bank Supervision Department

The savings deposit rate however dropped by 1.5% percentage points to 9.7%. Most commercial banks and NBFIs maintained a base lending rate of at least 2 percentage points above the prevailing Treasury bill rates. On average, interest rates for loans and advances of 1 to 3 years maturity were between 26%-32% for banking institutions. Banks maintained an average spread of 11% between deposit and lending rates.

The shilling exchange rate weakened during 1997 against major currencies partly as a result of heavy short term capital outflows and anticipated changes in domestic inflation (Chart 4.7).

CHART 4.7



Source: Bank Supervision Department

4.6 YEAR END OVERALL PERFORMANCE RATING

Performance rating of banks and NBFI's continued to be on the basis of capital adequacy, asset quality, earnings and liquidity (CAEL). Based on this, the overall performance of the banking sector during 1997 was satisfactory. As at end of 1997, seven banks and 4 NBFI's with combined total assets representing 24% of total banking system assets were rated strong. Twenty two banks and 4 NBFI's holding 43% of total assets were rated satisfactory. Other 24 banks and 9 NBFI's with assets representing 33% of the total banking system assets were rated fair and below (Table 4.2(a) and 4.2(b))

TABLE 4.2 (a)
YEAR END OVERALL PERFORMANCE RATING - BANKS

Performance Category	1996			1997		
	No. of Banks	Market Share Total Assets		No. of Banks	Market Share Total Assets	
		shs'bn	%		shs'bn	%
Strong	9	94	28.1	7	103	26.1
Satisfactory	28	160	47.9	22	173	43.8
Fair and below	13	80	24.0	24	119	30.1
Total	50	334	100.0	53	395	100.0

TABLE 4.2 (b)

YEAR END OVERALL PERFORMANCE RATING - NBFI's

Performance Category	1996			1997		
	No. of NBFI's	Market Share Total Assets		No. of NBFI's	Market Share Total Assets	
		shs'bn	%		shs'bn	%
Strong	1	3	4.8	4	3	6.8
Satisfactory	9	32	51.6	4	16	36.4
Fair and below	11	27	43.5	9	25	56.8
Total	21	62	100.0	17	44	100.0

4.6.1 Capital Adequacy

Capital represents the shareholders' stake in an institution and is the main resource that is readily available to cushion the institution against losses that may arise from various risks. Based on the proportion of capital to total deposit liabilities (gearing ratio), which is one of the capital measurements, the capital in the banking industry was rated strong. However, if adequate provision for bad and doubtful assets had been made, the rating would have been lower. Eighteen banks and 8 NBFI's were rated strong, 28 banks and 5 NBFI's were rated satisfactory while 7 banks and 4 NBFI's were rated fair and below.

4.6.2 Asset Quality

The proportion of non-performing loans and advances at shs 52bn was 21% of total advances (Appendix I and Chart 4.8). Asset quality for the sector was therefore rated unsatisfactory. Fourteen banks and 5 NBFIs with assets representing 30.7% of the banking system assets were rated strong, while 8 banks and one NBFI, representing 32.1% of total banking system assets were rated satisfactory. The other 31 banks and 11 NBFI's representing 37.2% of total banking system assets were rated fair and below (Table 4.3). The deterioration in asset quality over the last few years has been caused partly by management failure to address credit risk, and the general decline in economic performance.

Table 4.3:

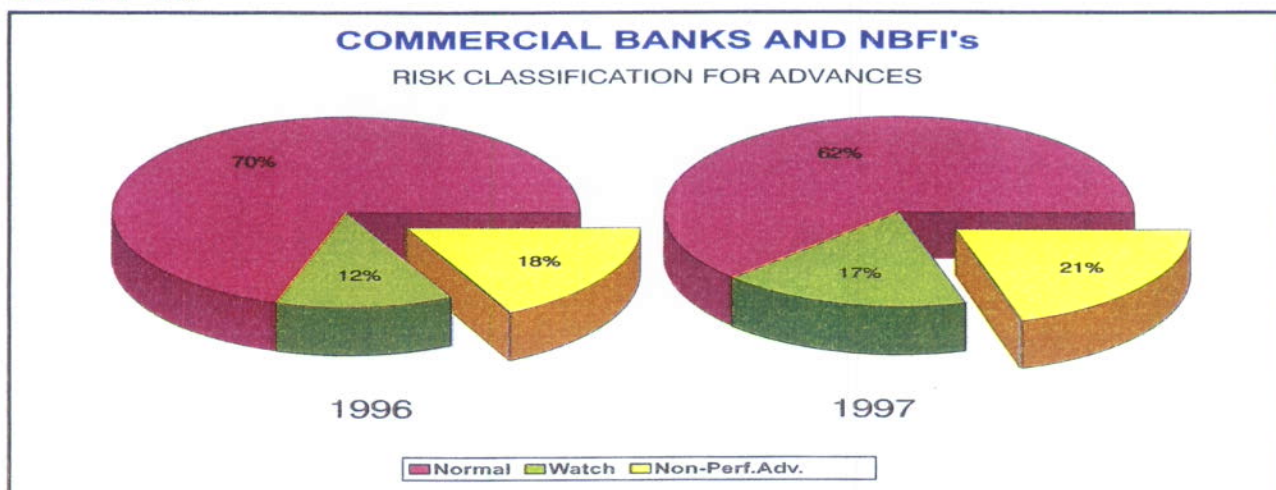
YEAR END PERFORMANCE RATING - BANKS & NBFI's

Asset Quality

Performance Category	1996			1997		
		Market Share Net Assets			Market Share Net Assets	
	No. of Inst.	shs'bn	%	No. of Inst.	shs'bn	%
Strong	20	128	33.8	19	127	30.7
Satisfactory	10	34	9.0	9	133	32.1
Fair & below	41	217	57.3	42	154	37.2
Total	71	379	100.0	70	414	100.0

Source: Bank Supervision Department

CHART 4.8



Source: Bank Supervision Department

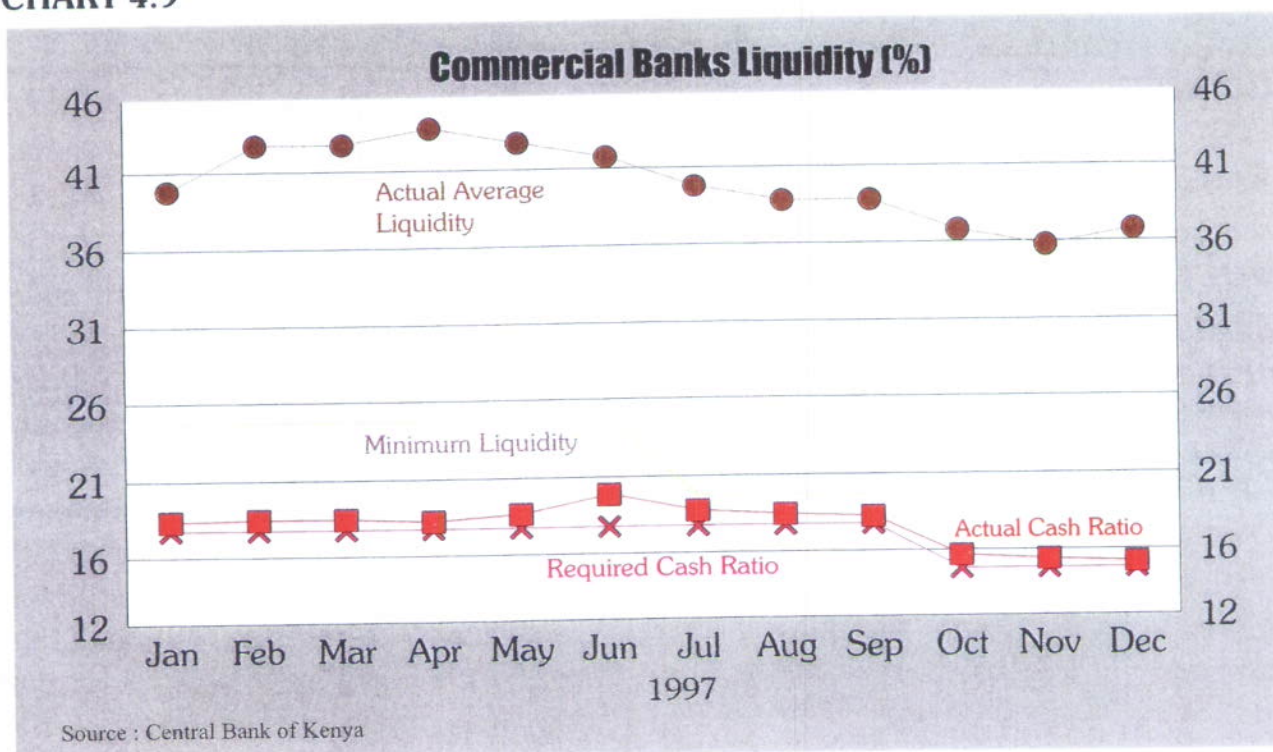
4.6.3 Earnings

Despite the unsatisfactory performance in asset quality, profitability of the banking sector was rated strong. Earnings by 21 banks and 6 NBFI's were rated strong 7 banks and one NBFI had a satisfactory rating while 25 banks and 10 NBFI's had earnings rated fair and below. High profitability was however associated with inadequate provisions for bad and doubtful assets.

4.6.4 Liquidity

The average liquidity of the banking system as measured by the ratio of net liquid assets to total deposits, was 37% which was above the minimum required level of 20%, and was rated strong. Liquidity of 35 banks and 12 NBFI's was rated strong, 8 banks and one NBFI had their liquidity rated satisfactory, while that of 10 banks and 4 NBFI's was rated fair and below (Chart 4.9).

CHART 4.9



APPENDICES

**BANKING SECTOR GLOBAL BALANCE SHEET ANALYSIS AS
AT DEC. 1996 AND DECEMBER 1997.**

Appendix I

Figures in Kshs. million

	31 December 1997				31 December 1996		Growth
	Banks	NBFIs	Total	%	Total	%	'96/'97
A. ASSETS							
1. Cash	6,963	29	6,992	1.6	6,007	1.5	16.4
2. Balances at CBK	32,801	1,387	34,188	7.8	41,163	10.4	-16.9
3. Placements	15,388	4,864	20,252	4.6	20,953	5.3	-3.3
4. Government Securities	43,541	3,594	47,134	10.7	44,035	11.1	7.0
5. Investments	3,868	131	3,999	0.9	5,685	1.4	-29.7
6. Advances(gross)	221,159	31,738	252,897	57.6	213,734	54.0	18.3
7. Other foreign Assets	17,753	9	17,762	4.0	11,785	3.0	50.7
8. Fixed Assets	20,776	1,365	22,142	5.0	18,421	4.7	20.2
9. Other Assets	32,867	957	33,824	7.7	33,878	8.6	-0.2
10. Total Assets	395,115	44,074	439,190	100.0	395,661	100.0	11.0
B. LIABILITIES							
11. Deposits	250,144	21,545	271,689	61.9	256,624	64.9	5.9
12. Accrued Interest	5,929	794	6,723	1.5	6,893	1.7	-2.5
13. Foreign Liabilities	34,033	1,084	35,117	8.0	25,438	6.4	38.0
14. Other Liabilities	52,580	15,776	68,356	15.6	58,127	14.7	17.6
15. Total Liabilities	342,686	39,199	381,885	87.0	347,082	87.7	10.0
16. Net Assets/(Liabilities)	52,429	4,875	57,304	13.0	48,579	12.3	18.0
C. CAPITAL & RESERVES							
17. Paid up/Assigned Capital	18,975	2,048	21,023	4.8	19,762	5.0	6.4
18. Reserves	20,068	907	20,975	4.8	15,077	3.8	39.1
19. P & L Account	13,385	1,920	15,305	3.5	13,741	3.5	11.4
20. Total Shareholders' Funds	52,429	4,875	57,303	13.0	48,580	12.3	18.0
21. Contingent Liabilities	27,701	100	27,801		25,408		
22. Non-performing Advances	39,111	12,751	51,862		37,901		
23. Loan Loss Provisions	16,260	8,840	25,100		17,436		
D. PERFORMANCE INDICATORS							
Capital/Deposits Ratio	18%	21%	18%		17%		
Capital/Assets Ratio (Unweighted)	12%	11%	12%		12%		
Liquidity Ratio	37%	38%	37%		41%		
Loan Loss Prov/Non-perf Adv Ratio	42%	69%	48%		46%		
Non-perf. Adv/Total Adv Ratio	18%	40%	21%		18%		
Advances/Deposits Ratio	76%	135%	81%		74%		

NB : Due to rounding of figures, total percentages may not always add upto 100.

**BANKING SECTOR GLOBAL PROFIT AND LOSS ANALYSIS AS
AT DEC. 1996 AND DECEMBER 1997.**

Appendix II

Figures in Kshs. million

	31 December 1997				31 December 1996		Growth
	Banks	NBFIs	Total	%	Total	%	'96/'97
A. INCOME							
1. Interest on Advances	49,876	5,317	55,193	63.6	47,927	62.5	15.2
2. Interest on Placements	2,995	904	3,899	4.5	5,035	6.6	-22.6
3. Interest on Govt. Securities	9,507	746	10,254	11.8	9,140	11.9	12.2
4. Foreign Exc. Gain/(Loss)	4,555	(9)	4,546	5.2	1,964	2.6	131.5
5. Other Interest Income	1,614	370	1,984	2.3	2,675	3.5	-25.8
6. Other Income	10,388	549	10,937	12.6	9,912	12.9	10.3
7. Total	78,936	7,877	86,813	100.0	76,653	100.0	13.3
B. EXPENSES							
8. Interest on Deposits	34,709	4,215	38,924	57.3	34,708	58.5	12.1
9. Other Interest Expenses	1,817	438	2,255	3.3	1,476	2.5	52.8
10. Occupancy Costs	1,711	111	1,823	2.7	1,823	3.1	-0.0
11. Director's Emoluments	175	22	197	0.3	151	0.3	30.5
12. Bad Debts Charge	2,642	624	3,266	4.8	2,409	4.1	35.6
13. Salaries & Wages	11,170	548	11,718	17.2	10,442	17.6	12.2
14. Other Expenses	9,287	515	9,802	14.4	8,282	14.0	18.4
15. Total	61,511	6,473	67,984	100.0	59,291	100.0	14.7
16. Profit Before Tax	17,425	1,404	18,829		17,362		8.4
C. PERFORMANCE INDICATORS							
Yield on Earning Assets	24%	15%	22%		22%		
Cost of Funding Earning Assets	13%	9%	12%		12%		
Interest Margin on Earning Assets	11%	5%	10%		10%		
Yield on Advances	23%	17%	22%		22%		
Cost of Deposits	12%	19%	13%		12%		
Return on Assets(Including Contingencies)	4%	3%	4%		4%		
Return on Shareholders Funds	33%	29%	33%		36%		
Overhead to Earnings	32%	23%	31%		30%		

ROLE OF BANK SUPERVISION DEPARTMENT

The role of the Bank Supervision Department is to promote a sound and stable banking system in Kenya. To realise this objective, the department focuses its activities on enforcing the requirements of the Banking Act and prudential regulations, fostering liquidity and solvency of banking institutions, ensuring efficiency in banking operations and encouraging high standards of customer service.

The department conducts both on-site examinations and off-site surveillance of banking institutions to ensure they attain and sustain minimum specified performance standards regarding capital, assets, management, earnings and liquidity.

Other key functions of the department include revision of the banking legislation and drafting of prudential guidelines on the interpretation and application of the banking laws. It also updates the industry on worldwide developments in banking. Routine operations include appraisals of applications for banking licences for new institutions as well as new branches of existing institutions, annual renewal of the banking licences, approval of external auditors and inspection of new premises for banking institutions.

FUTURE OUTLOOK

The future goals of Banking Supervision Department are:

- Working closely with the banking institutions to enhance corporate governance. It will also strive to improve the level of compliance of legal and prudential requirements by banking institutions.
- To strengthen its supervisory capacity and skills in order to cope with the challenges of the banking industry which is becoming increasingly sophisticated.
- Taking necessary measures to ensure implementation of the remaining requirements of the Basle Committee's core principles for effective banking supervision.
- To work closely with the three East African Central Banks to harmonise banking legislation and supervisory practices within the region.
- To ensure stability of the financial sector, initiate measures to ensure other financial intermediaries not under Banking Act are also regulated. It will also evaluate ways in which the microfinance sector can be regulated and integrated into the banking system.