CENTRAL BANK OF KENYA

1998

BANK SUPERVISION ANNUAL REPORT

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 preparation of prudential guidelines on the intepretation 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.

KENYA'S BANK SUPERVISION ANNUAL REPORT

Kenya's Bank Supervision Annual Report, prepared by the Central Bank of Kenya, starting with the December 1997 edition, are available on the Internet at address: **http://www.centralbank.go.ke**

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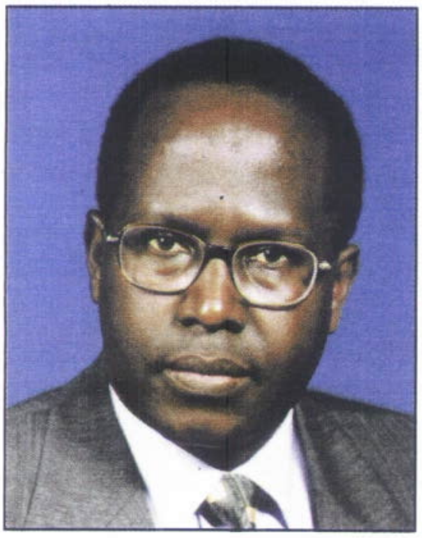


The Kenyan banking system underwent considerable turbulence during 1998 which culminated in placement of five banks under statutory management. The crisis was precipitated by imprudent practices by the banks, including reckless lending, mismanagement, and heavy borrowing by insiders. In response, and to avert future crises, the Central Bank has taken a range of measures and the Banking Act was amended to empower the Central Bank to, inter alia, levy penalties for failure to comply with prudential requirements. Despite the problems however, the performance of the banking sector was still fair.

During the year, measures were taken to ensure that Bearer Certificates of Deposit are systematically phased out from the banking system and institutions were given upto end of 1999. This action was taken since these instruments were observed to be volatile in nature and were being used for money laundering and other malpractices.

During the last two years, we have sensitised our banking institutions of the Year 2000 date change since it is a matter of business survival and not merely a technological issue. Good progress has been made and full compliance is expected well before the year-end.

The financial needs of the informal sector which forms a significant segment of Kenya's economy cannot be ignored. In this connection, the Central Bank will continue to liaise with the relevant government departments and other stakeholders to promote orderly development of micro-finance institutions.

Banking today has become a global affair and our institutions should not lag behind developments in other parts of the world. We need to pay greater attention to the payment system with a view to enhancing the operational efficiency, reliability, speed and timeliness of transactions. Banking institutions should also embrace prudent banking practices, good corporate governance and greater disclosure.

In conclusion, I would like to thank the banking industry as a whole for the cooperation accorded to the Central Bank during 1998. 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 enter the next millennium.

MICAH CHESEREM
June, 1999

CHAPTER 1

RECENT DEVELOPMENTS IN THE LOCAL BANKING INDUSTRY

1.1 Overview

During the second half of 1998, the Kenyan banking sector underwent turbulence, which culminated in four small and one medium size banks being placed under statutory management. The fourth largest bank experienced a deposit run leading to liquidity problems.

The audited results indicated that profits of the sector dropped by 55% from the previous year. This was largely due to higher provisioning for increased level of non-performing loans. Although there was deterioration from the previous year, the performance of the sector was still fair.

In an effort to, inter alia, expand the capital base, two banks merged while two nonbank financial institutions converted to commercial banks. The forex bureau sector which started operating in 1995 expanded and continued to attract more investors. In order to enhance corporate governance, the Central Bank conducted seminars for bank directors and internal auditors while the industry continued to adopt various developments in information technology particularly to improve customer service.

1.2 Institutions and Branch Development

As at the end of December 1998, the total number of banking institutions totalled 73 out of which 53 were operational banks, 14 were nonbank financial institutions (NBFIs), 2 were mortgage finance companies (MFCs) and 4 were building societies. Two new institutions were licensed during the year under review but as at the end of 1998 they had not become operational. The number of locally owned banks with branches and subsidiaries outside the country remained at four with seven branches located; one in Malawi, three in Tanzania, two in Uganda and one in Pakistan. Branch expansion for banks continued to be more pronounced in the main urban areas, notably Nairobi, Mombasa and Kisumu. On a province basis, Rift Valley continued to follow Nairobi with the most number of bank branches (Table 1.1).

TABLE1.1: BRANCH NETWORK OF THE BANKING INDUSTRY

PROVINCE	BANKS		NBFI's		MFC's		TOTALS	
	1997	1998	1997	1998	1997	1998	1997	1998
CENTRAL	95	96	1	1	3	3	99	100
COAST	80	81	3	3	2	2	85	86
EASTERN	59	59	0	0	1	1	60	60
NAIROBI	162	170	17	13	8	8	187	191
N.EASTERN	5	5	0	0	0	0	5	5
NYANZA	64	65	2	2	2	2	68	69
RIFT VALLEY	132	132	2	2	4	4	138	138
WESTERN	27	27	0	0	1	1	28	28
TOTAL	**624**	**635**	**25**	**21**	**21**	**21**	**670**	**677**

Source:Bank Supervision Dept.

1.3 Foreign Exchange Bureaus

Following the foreign exchange liberalization and in order to increase competition in the foreign exchange markets, foreign exchange bureaus were introduced in 1995. However, the bureaus were only to engage in foreign exchange spot transactions. At the time, 28 bureaus were licensed by the Central Bank of Kenya and as at the end of 1998, 45 foreign exchange bureaus had been licenced and were operational. In terms of distribution, 27 bureaus are located in Nairobi and its environs, 6 in the coastal region, and one each in Nakuru, Kisumu and Eldoret respectively. The weekly average transactions by bureaus have increased over the years from US$7.4 million in 1996 to US$ 12.9 million in 1998 while foreign exchange transactions by bureaus as at the end of 1998 accounted for 2.5% of the total foreign exchange transactions.

1.4 Institutions Under Liquidation/Receivership/CBK Management.

Despite the instability recorded in the banking sector towards the end of 1998, the total number of institutions under liquidation remained at 30 as in the previous year while the same 17 institutions remained under Deposit Protection Board (DPFB), 7 under Consolidated Bank Limited, 4 under official receiver, 1 under voluntary liquidation and 1 was wound up by court. During 1998, 5 banks were placed under statutory management. The main reasons for the bank failures during the year were:

High level of non-performing loans caused by poor lending practices which were compounded by mismanagement and outright frauds.

- Conflict of interest in those cases where shareholders participate in the day-to-day management of their banks.

- Difficulties faced by banks in the recovery of non-performing loans through judiciary.

- Some loans to nonviable projects appear to have been advanced on official influence.

- Insider lending to directors and their associates for nonviable investments.

- Undercapitalization for some banking institutions.

- Over-investment in the speculative property market which is currently experiencing dramatic drop in prices.

In an effort to stabilize the banking system the following measures are being undertaken:

- increased capitalization by raising the minimum paid-up capital requirements for institutions.

- the Government progressively divesting from the banking system.

- efforts are also being undertaken by the Government to improve the judiciary by providing adequate court facilities, computerization, appointment of additional judges and other necessary improvements in order to uplift the efficiency of the court process.

- encouraging small banks to merge so as to enjoy economies of scale.

- tightening of banking regulations. In particular the following conditions will apply for the reopening of any institution that is now under statutory management:

  - no previous director shall be permitted to sit on the Board of the reopened bank.

  - the previous Chief Executives and the majority of the senior managers will not be employed in any reopened bank.

  - no shareholder shall be permitted to participate in the management of the reopened bank except as a non-executive director.

- new directors shall not be allowed to borrow from the institution.

1.5 Employment in the Banking Industry

The banking sector recorded a 5% decrease in staff in 1998 mainly through staff reduction schemes associated with computerisation and other technological applications compounded by the redundancies in institutions that were placed under statutory management. Staff reductions were more pronounced in the clerical, secretarial and subordinate categories (Table 1.2). The industry, with increased adoption of contemporary information technology, has experienced a rapid change in skills requirement which has necessitated retraining of existing staff.

TABLE 1. 2: EMPLOYMENT IN THE BANKING INDUSTRY*

	1997				1998				**Under	Grand	
CATEGORY	BANKS	NBFI's	TOTAL	%	BANKS	NBFI's	TOTAL	%	Statutory Mgt.	Total	%
MANAGEMENT	2,964	228	3,192	20	3,205	221	3,426	23	137	3,563	23
SUPERVISORY/SEC.HEAD	1,646	149	1,795	11	1,438	137	1,575	10	33	1,608	10
CLERKS & SECR. STAFF	8,390	464	8,854	54	7,656	320	7,976	53	113	8,089	53
OTHER CATEGORIES	2,195	188	2,383	15	1,878	168	2,046	14	64	2,110	14
GRAND TOTAL	**15,195**	**1,029**	**16,224**	**100**	**14,177**	**846**	**15,023**	**100**	**347**	**15,370**	**100**

* Excludes Central Bank of Kenya

Source: Bank Supervision Department

1.6 Developments in Information Technology

Banking institutions continued to adopt new advancements in information technology designed to improve management and services rendered to customers like money transfers, cheque clearing and internal banking operations. The Magnetic Ink Character Recognition (MICR) technology was adopted during 1997 while development of national electronic clearing system is yet to be finalised.

In an effort to enhance customer service some banks made good progress in the automation of their teller services (ATMs) with a number of them placing their teller machines in strategic places in Nairobi and at major towns in the country. Reflecting a marked progress, some ATMs were made to access services from other local banks through recognized credit cards.

1.7 Customer Service

The instability of the banking sector translated into a marked decline in depositor confidence in the small banking institutions. As a result, there was an increased number of not only new account holders moving to the large established banks but also those from the small banks. In an effort to maintain good customer service, banks continued to adopt additional measures designed to improve customer service by upgrading personnel skills, provision of adequate banking space, extending banking hours, controlling queues and reorganizing their internal operations. The Central Bank of Kenya continued to liaise with banking institutions on the issue of customer care and on-site customer service inspections were carried out as part of on-site inspection exercise.

1.8 Training and Human Resource Development

In order to adequately adapt to changes in the banking industry, banking institutions made considerable progress in retraining their staff. Many institutions continued to take advantage of facilities at the Kenya School of Monetary Studies to retrain their staff in such areas as economics, banking, finance, management as well as professional courses in information technology.

CHAPTER 2

CURRENT SUPERVISORY ISSUES

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 Millennium Bug continued to be the central regulatory and supervision concerns during the year.

2.1 Corporate Governance

The necessity for efficient and effective corporate governance was once again underscored by the placement of five banks under Statutory Management. In all cases the management was found to have engaged in reckless lending, mismanagement and heavy borrowing by insiders. In some of the banks, the Executive Chairmen made crucial decisions without consultation with other board members while weak internal controls and lack of proper internal audit function created a fertile ground for extensive and systematic malpractices in these institutions.

In an effort to improve corporate governance, the Central Bank organized a seminar for directors and another one for Internal Auditors of banks during the year under review. To enhance harmonization of supervision in the East African subregion, and share experience of board management, the resource persons were drawn from all the three central banks and board members of local commercial banks.

2.2 Progress In Implementation Of Core Principles For Effective Banking Supervision

Central Bank continued its efforts to bring the quality of bank supervision to international standards through implementation of the principles propagated by the Basle Committee on banking supervision.

Below is a summary statement of the 25 core principles and the status of their implementation.

Preconditions For Effective Banking Supervision

1. *An effective system of banking supervision will have clear responsibilities and objectives. It should possess operational independence and adequate resources. A suitable legal framework is also necessary. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.*

The Supervision Department of the Central Bank of Kenya has clear responsibilities and objectives. The legal framework is set out in the Banking Act. Measures are being taken to ensure operational autonomy. The legal framework is also being reviewed to facilitate information sharing between supervisors while at the same time protecting the confidentiality of such information.

Licensing And Structure

2. *Banking institutions should be licensed and their activities as banks must be clearly defined. The use of the word "**bank**" in names should be controlled as far as possible.*

Use of the name "**bank**" or "**finance**" is restricted and has to be approved by the Minister of Finance

3. *The licensing authority must have the rights to set criteria and reject applications for establishments that do not meet the standards set. In case of a foreign bank, the prior consent of its home country supervisor should be obtained.*

These requirements are strictly followed by the Ministry of Finance and Central Bank.

4. *Banking supervisors must have the authority to review and reject any proposals to transfer significant ownership or controlling interests in existing banks to other parties.*

All mergers of banking institutions have to be approved by the Minister while proposals to restrict transfers of ownership are being considered for inclusion in the Banking Act.

5. *Banking supervisors must have the authority to establish criteria for reviewing major acquisitions or investments by a bank and ensuring that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.*

Total equity investment is limited to 25% of capital and unimpaired reserves while acquisition of land is also restricted.

Prudential Regulations And Requirements

6. *Banking supervisors must set minimum capital requirements and must define the components of capital, bearing in mind a bank's ability to absorb losses.*

A minimum ratio of 7.5% has to be maintained between capital plus unimpaired reserves and deposits/ weighted assets and off-balance sheet items. The risk weights are being reviewed while the Banking Act is being amended to cater for the Basle Capital Accord. These ratios are being revised upwards while the minimum capital in absolute terms is being increased.

7. *Banking supervisors must evaluate bank's policies, practices and procedures in granting loans and making investments.*

Independent evaluation of these policies and procedures is done during on-site inspections.

8. *Banking supervisors must be satisfied that banks establish and adhere to adequate policies, practices and procedures for evaluating the quality of assets and the adequacy of loan loss provisions and reserves.*

The Central Bank has put in place guidelines for evaluating the quality of assets and adequacy of provisions for bad and doubtful assets. Banking institutions are also required by law to only declare dividends after adequate provisions are made.

9. *Banking supervisors must be satisfied that banks have management information systems that enable management to identify credit concentrations and must set prudential limits to restrict bank exposures to single borrowers or groups of related borrowers.*

Lending to single borrower or groups of related borrowers is restricted to 25% of capital and unimpaired reserves.

10. *Banking supervisors must have in place requirements that banks lend to related companies and individuals on an arm's length basis and that appropriate steps are taken to control or mitigate the risks.*

All connected insider lending must be fully secured. Lending to a single insider is limited to 25% of paid-up capital while aggregate lending to all insiders combined should not exceed 100% of paid-up capital. Loans to directors need to be sanctioned by the full board of directors and reported to Central Bank.

11. *Banking supervisors must be satisfied that banks have adequate policies and procedures for identifying, monitoring and controlling country risk and transfer risk in their international lending and investment activities.*

Procedures for identifying, monitoring and control of country and transfer risks are yet to be formulated.

12. *Banking supervisors must be satisfied that banks have in place systems that accurately measure, monitor and adequately control market risks.*

The on-site examiners evaluate the extent to which banks address various types of risks.

13. *Banking supervisors must be satisfied that banks have in place comprehensive risk management process to identify, measure, monitor and control all other material risks.*

Banks are required to have effective management to address all risks. However, only in advances are there guidelines on provisioning.

14. *Banking supervisors must determine that banks have in place internal controls that are adequate for the nature and scale for their business. Appropriate independent internal or external audit functions should also be in place.*

These important aspects are examined by the Central Bank during on-site surveillance.

15. *Banking supervisors must determine that banks have adequate* policies, practices and procedures in place, that promote high ethical and professional standards in the financial sector and prevent the bank being used by criminal elements.

The Central Bank has a programme on customer service. A programme on money laundering inspection is also under preparation but legal framework would also be necessary.

Methods Of On-Going Banking Supervision

16. *An effective banking supervisory system should consist of some form of both on-site and off-site supervision.*

The Central Bank Supervision Department has both on-site and off-site supervision teams.

17. *Banking supervisors must have regular contact with bank management and thorough understanding of the institution's operations.*

This is done through correspondence, prudential returns and on-site inspection

18. *Banking supervisors must have a means of collecting, reviewing and analyzing prudential reports and statistical returns from banks on a solo and consolidated basis.*

Presently, returns are reviewed on solo basis. However, measures are being taken for consolidated analysis of prudential reports and statistical returns.

19. *Banking supervisors must have a means of independent validation of supervisory information either through on-site examinations or use of external auditors.*

This is being done through on-site inspection and audit reports.

20. *An essential element of banking supervision is the ability of the supervisors to supervise the banking organization on a consolidated basis.*

Legal framework for consolidated supervision to include entities which are not licensed under the Banking Act is under review.

Formal Powers Of Supervision

21. *Banking supervisors must be satisfied that each bank maintains adequate records that enable the supervisor to obtain a true and fair view of the financial condition of the bank and that the financial statements are published regularly.*

Audited accounts have to be submitted to Central Bank and prescribed formats published in a national newspaper within three months of the financial year end.

22. *Banking Supervisors must have at their disposal adequate supervisory measures to bring about corrective action when banks are being run in an imprudent manner.*

In Kenya, the Central Bank has powers to take corrective measures by advising, appointing statutory managers, imposing penalties, issuing cease and desist orders or removal and suspension of officers.

Cross-Border Supervision

23. *Banking supervisors must practise global consolidated supervision.*

The Banking Act is being reviewed to ensure that information from related entitites is obtained.

24. *A key component of consolidated supervision is establishing contact and information exchange with the various other supervisors involved, primarily host country supervisory authorities.*

The Banking Act is being amended to allow sharing of information with other Supervisory Authorities.

25. *Banking supervisors must require the local operations of foreign banks to be conducted to the same high standards as are required of domestic institutions and must have powers to share information needed by the home country supervisors of those banks for the purpose of carrying out consolidated supervision.*

The Central Bank requirements are applicable to all banks whether local or foreign. The legal powers to share information with home supervisors are being reviewed.

2.3 Harmonisation of Bank Supervision and Regulation in East Africa.

Reflecting the continued East African Cooperation, several measures were undertaken to harmonize banking supervision and regulation within the East African subregion. The main measures which have been adopted in the recent past for implementation by the East African Central Bank Governors included: joint supervision; sharing of inspection programmes and supervision materials; cross-border and consolidated supervision; formation of commercial courts; introduction of common criteria for approval and vetting of directors and senior management of banking institutions by Central banks; encouragement of establishment of credit rating agencies; holding of seminars and workshops for directors, external and internal auditors; issuing regulations governing the conduct of external auditors; and encouraging micro finance institutions by putting in place an appropriate legal framework.

To enhance debt recovery by not only operational banks but also institutions under liquidation, commercial courts were built at Uajiri House and appropriate measures are being taken to enhance their effectiveness by inter alia assigning more judges and magistrates. Already prior approval and vetting of directors and senior management of banking institutions by Central Bank is a requirement before their appointment.

In order to assist commercial banks in their credit risk assessment, the Central Bank has been encouraging the formation of independent credit reference bureaus and agencies through private initiative. The first credit reference bureau was officially launched in February 1999. The bureau collects and disseminates creditor data from many sectors with special emphasis on the banking sector.

However, no credit rating agency has been established although several foreign based ones have expressed interest to have a presence in Kenya.

2.4 The Year 2000 Millennium Bug

The Year 2000 Problem is of major concern in the banking sector where date-related transactions are prevalent. For this reason and in order to sensitise the sector concerning the date change problem, the Central Bank organised a workshop with all commercial banks in 1998 to map out a strategy of achieving compliance in good time. The deadline set for all banking institutions to be Year 2000 Compliant was 31st December, 1998 but only 72% of the sector reported having achieved full compliance. The deadline was extended to April, 1999 when 92% reported having achieved full compliance. It is expected that the remaining 8% will be compliant well before the year-end and Central Bank will closely monitor the progress.

2.5 Other Areas of Supervisory Concern

- Legislation to deal with issues of confidentiality of information given to Credit Rating and Credit Reference agencies.
- High level of non-performing loans.
- High level of insider loans.
- Banks under Statutory Management.
- Enforcement actions to be taken on institutions that fail to comply with the Banking Act and Central Bank of Kenya Act.

CHAPTER 3

DEVELOPMENTS IN BANKING REGULATION

3.1 Overview

The Banking Act was amended and the Central Bank is now able under the powers of the Act to closely monitor the activities of the banks and levy monetary penalties and fines to enforce corrective actions. The following amendments to the Banking Act were passed by Parliament in 1998:

3.1.1 Directors/Insider Loans

Insider and connected lending to directors and their related companies has been a major problem in many institutions and a key cause of bank failures. In order to instil strict discipline in sanctioning of directors loans, the following amendments to the Banking Act have now been put in place.

- Loans to directors, must be made on terms similar to those extended to other customers and must be approved by the full Board. The Central bank shall be notified of the same within seven-days of the approval.

- A director of an institution who defaults in repayment of any advance or loan made to him by the institution for three consecutive months shall forthwith be disqualified from holding office.

- Total insider loans and advances as well as non-performing loans shall be disclosed and published for public information.

- The Central Bank may, in case of non-performing advance, loan, or credit facility to a director of an institution, direct the removal of such director from the board of directors of the institution and may direct the suspension of any other officer or employee of the institution who sanctioned the advance, loan or credit facility.

3.1.2 Administrative Sanctions

With the amendment of section 33 and insertion of 33(A) into the Banking Act the Central Bank has now powers to:

- Advise and direct the operations of an institution along sound banking practices.
- Restrict, suspend or prohibit the payment of dividends by an institution.

- Direct the suspension or removal of any officer involved in contravening the Act, from the service of the institution.
- Require the institution to constitute its board of directors.
- Withhold branch or other corporate approvals with respect to an institution.

3.1.3 Minimum Capital Requirements

To enhance the ability to bear risk and absorb losses when they arise, the capital requirements for both local and foreign incorporated institutions have now been harmonized. The minimum paid-up/assigned capital for banks, and mortgage finance companies has been set at two hundred million shillings by the end of 1999 while that of non banks financial institutions will be shs.150m.

In view of the importance of capital, there are proposals to further increase the capital requirements within the next three years. Banks will be required to increase their capital at the rate of shs.100m per year to reach shs.500m while the corresponding increase for NBFI's will be shs.75m per year to reach shs.375m by year 2002. However, institutions entering the industry for the first time will be required to raise a minimum of shs.500m in case of banks and mortgage finance companies and shs. 375m for financial institutions.

3.1.4 Monetary Penalties

Following amendments in the Banking act, and after the Minister gazettes the regulations, the Central Bank will be able to levy money penalties with respect to non-compliance with prudential regulations.

3.2 Regulations and guidelines by Central Bank

3.2.1 Loan Classification and Provisioning

To ensure that institutions reflect the true state of their financial position, and asset quality in particular, revised prudential guidelines on provision for bad and doubtful debts were issued. The institutions are now required to report to Central Bank of Kenya on a quarterly basis the loan classification and provisioning. This is a major departure from the past where reporting was annual.

3.2.2 **Disclosure Requirements**

Increased disclosure of financial information plays a key role in ensuring financial discipline. In this light, Central Bank issued Banking Circular No.1 of 1999 which requires that all institutions disclose for publication with effect from Financial Year ended 1998 the following information:

- Total non-performing loans.
- Provisions for bad & doubtful debts.
- Total advances to shareholders, directors employees and associates.
- Letters of credit, guarantees, acceptances.
- Other contingent liabilities and
- Total contingent liabilities.

The level of disclosure will be progressively increased in future.

3.3 **Directives and Circulars**

The Central Bank issued a total of 27 circulars and directives in 1998. Matters relating to bank supervision included, organising Year 2000 date change workshop for all commercial banks, update on issues of "Debit" and "Credit" cards, the winding down of Bearer Certificates of Deposit by December 1999 and minimum conditions for reopening troubled banks.

3.4 **Liquidation by Deposit Protection Fund Board**

To enhance efficiency of performance and speed of liquidation, the Banking Act was amended to enable the liquidator to among others things assign the assets or liabilities of an institution to third parties for the benefit of the creditors and depositors of the institution.

CHAPTER 4:

PERFORMANCE OF THE BANKING SECTOR

4.1 Overview

Arising from the instability that hit the banking sector during the year the overall performance was rated fair, a drop from the satisfactory rating in 1997. The profitability of the sector dropped by 55% from the level of 1997. This was attributed to the high provisions for the increased non-performing loans. Capital levels and liquidity were also adversely affected during the year under review.

4.2 Structure of the Balance Sheet

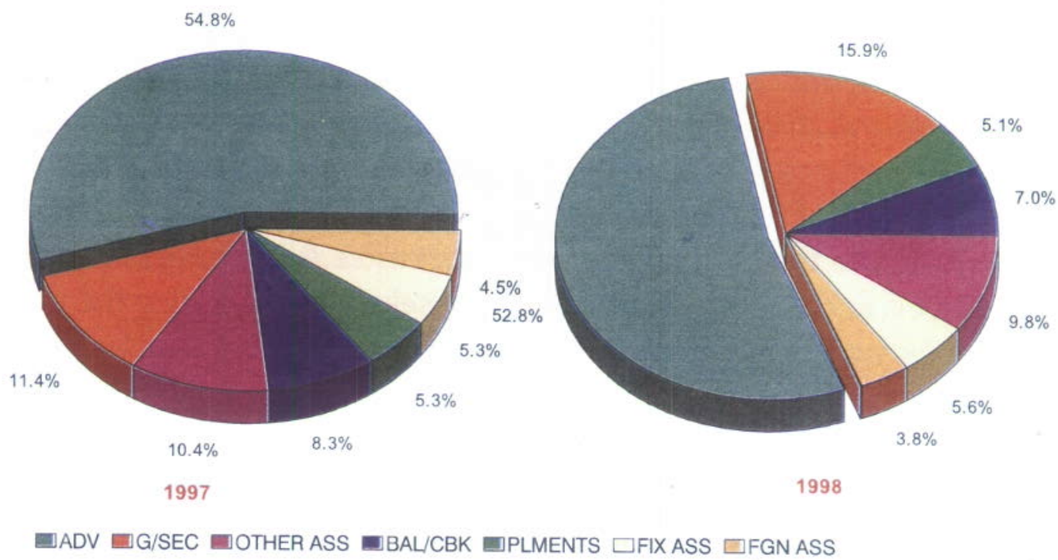
4.2.1 Composition of Assets

Total assets of the banking system at shs.436bn as at the end of December, 1998 was 6% higher than the level recorded at the end of December, 1997 (Appendix 1). Aggregate assets for the five institutions under statutory management at shs.15bn formed 3.5% of total assets of the banking sector. In terms of composition, loans and advances continued to constitute the major component of assets. However, net total loans and advances stood at shs.230bn or 53% of total assets and were 2 percentage points below the share of 55% recorded in 1997 (Chart 4.1). Other major assets were Government securities which at shs.70bn were 16% of total assets while mainly due to reduction of cash ratio requirements, the respective share for balances at the Central Bank fell by one percentage point to 7%. Placements with other banking institutions as at the end of 1998 stood at shs. 22bn and accounted for 5% of total assets (Chart 4.1).

GLOBAL BALANCE SHEET

COMPOSITION ANALYSIS (ASSETS)

CHART 4.1

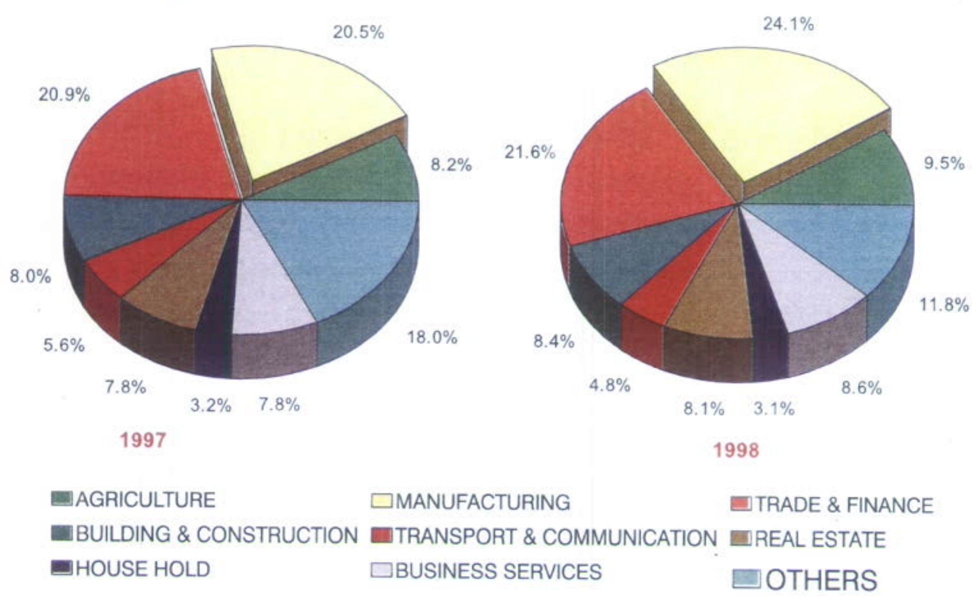


As in the previous year, the distribution of credit to the private sector was dominated by the manufacturing sector which formed 24% of the total credit to the private sector compared to 21% in 1997. The proportion of total private sector credit to trade and finance recorded a 1.0 percentage point increase to 22% during 1998 (Chart 4.2).

CREDIT DISTRIBUTION

PRIVATE SECTOR

CHART 4.2



Bank Supervision Department

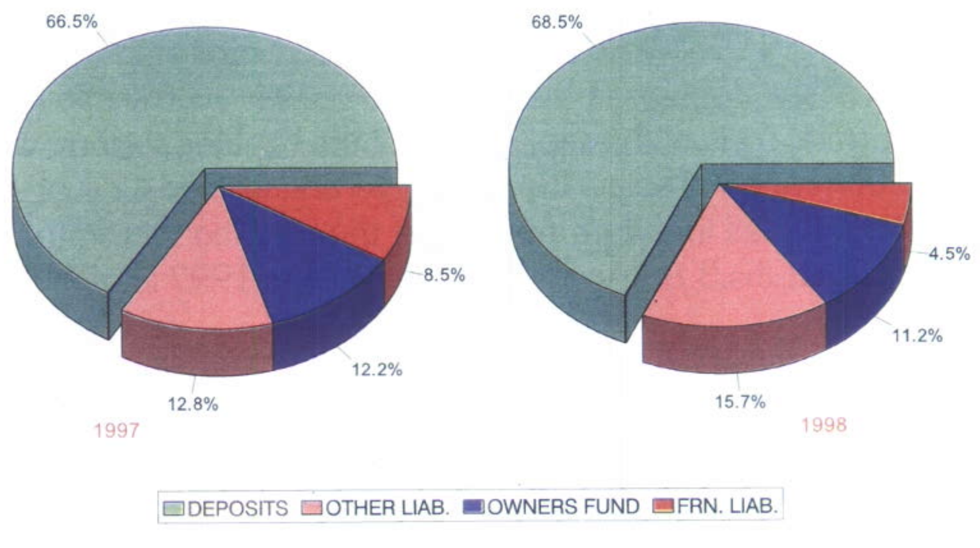
4.2.2. **Liabilities**

Total labilities stood at shs.388bn and were 8% above the level recorded in 1997. Aggregate liabilities for the five institutions under statutory management at shs.17bn formed 4% of total liabilities of the banking sector. Total deposits excluding accrued interest which stood at shs.299bn, were 10% above the 1997 level and continued to form the largest share of total liabilities. Including accrued interest, deposits constituted 70% of total liabilities and shareholders' funds compared to 67% recorded in 1997 while the share of foreign labilities fell from 8% in 1997 to 5% as at December, 1998 (Chart 4.3).

GLOBAL BALANCE SHEET

COMPOSITION ANALYSIS (LIABILITIES)

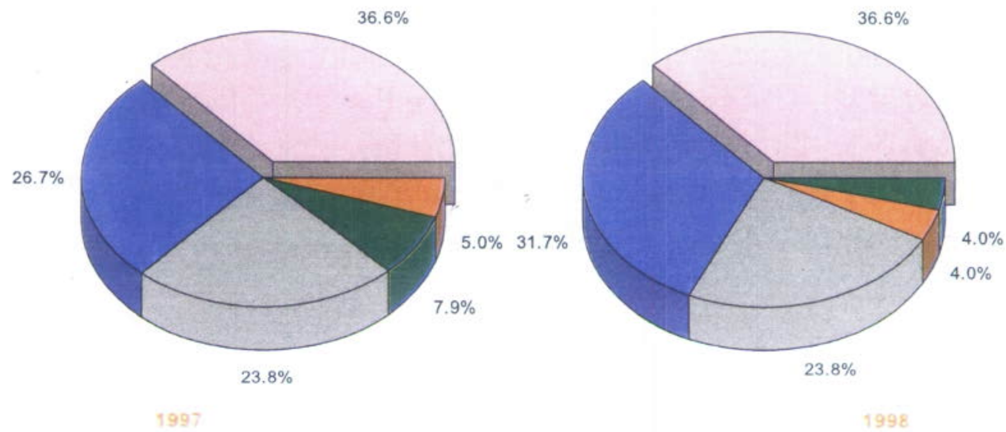
CHART 4.3



During the year, the structure of deposit composition changed slightly with the share of demand and call deposits increasing by 5 percentage points to 32% in 1998 while the share of 3-months deposits remained unchanged at 37%. Following the policy to phase out Bearer Certificates of Deposits by the end of 1999, their proportion of total liabilities fell from 8% at end 1997 to 4% at end 1998 (Chart 4.4).

COMMERCIAL BANKS ANALYSIS OF DEPOSITS

CHART 4.4



4.2.3 Capital and Reserves

Total capital base [shareholders' funds] of the banking industry at shs.49bn as at the end of 1998 was 2% below the level recorded in 1997. Paid-up/assigned capital at shs.25bn as at the end of 1998 was 13.6% above the 1997 level and formed 51% of the capital base of the banking system, while reserves at shs.20bn were 7% below the 1997 level and formed 42% of the capital base. Reflecting a fall in the profitability of the banking sector, the profit and loss balances, at shs.3.8bn were 37.5% below the 1997 level.

4.3 Structure of profit and loss account

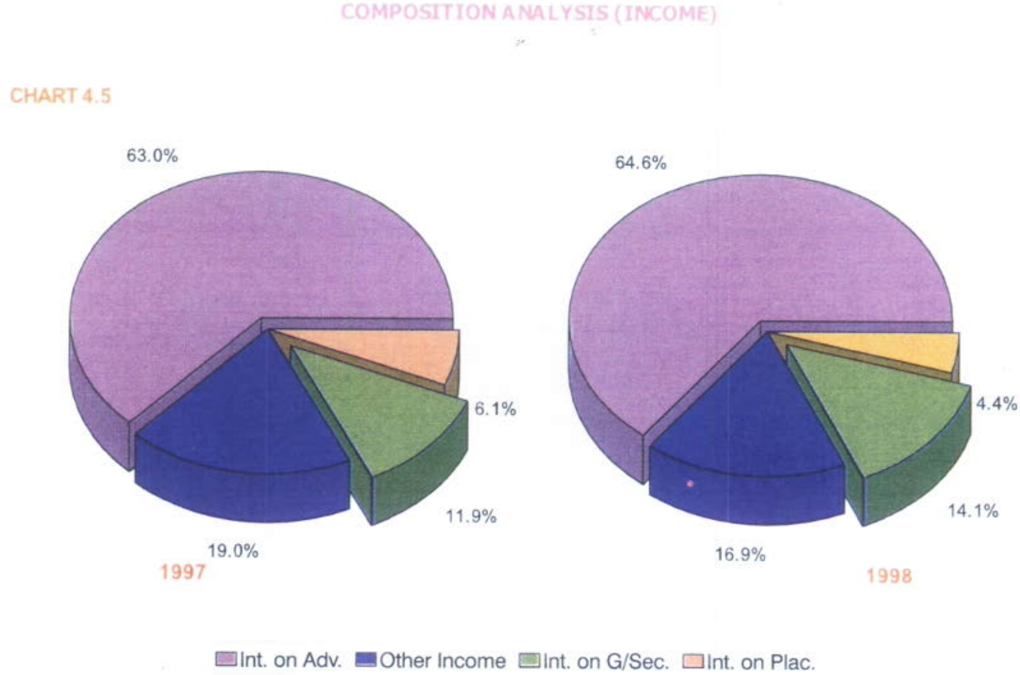
4.3.1 Profitability

Profits in the banking sector declined by 55%. Aggregate profits before taxation stood at shs.7bn compared to shs.16bn recorded in 1997. The fall was attributed mainly to increased provisioning for non-performing loans and the losses recorded by the five institutions under statutory management. The bad debts charge increased by 135% from shs.4.6 billion in 1997 to shs.10.9 billion in 1998 (Appendix II).

4.3.2 Income

There was a slowdown in the growth of total income from 13% in 1997 to 8% in 1998. The composition of income was dominated by income on advances to the private sector which formed 65% of the total income. The interest earnings on advances at shs.59 billion in the year was 10% above the level recorded in 1997. The second major source of income for banks was interest on Government securities (Treasury instruments) which at shs.13bn in 1998 was 27% above the level recorded in 1997. Foreign exchange income after increasing to shs.4.6bn in 1997 fell to shs.3.6bn in 1998 (Chart 4.5).

GLOBAL PROFIT AND LOSS ANALYSIS



4.3.3 Expenses

Total expenses in the sector grew from shs.68bn in 1997 to shs.84bn in 1998. Interest on deposits stood at shs.43bn in 1998 and formed 51% of total expenses. Salaries and wages at shs.14bn in 1998 constituted 16% of total expenses while bad debts charges at shs.11bn was 13% of the total expenses.

4.4 Market Share

Banking business in 1998 continued to be dominated by a few banks with 9 banks controlling 70% of the market share of total net assets and 69% of total deposits. Distribution among the NBFIs was more skewed with the top 2 financial institutions controlling 57% of the market share in terms of total net assets and 63% in terms of deposits. The banking crisis during the later part of 1998 caused some flight of deposits from small and medium banking institutions which exarcebated the skewdness of market shares in favour of the relatively large banks (Table 4.1 and Table 4.1 (b).

TABLE 4.1(A): BANKS RANKING BY ASSETS AND DEPOSITS AS AT DECEMBER, 1998

PEER GROUP RANGE Shs' .billion	NUMBER OF INSTITUTIONS	NET ASSETS Shs' billion	MARKET SHARE %	DEPOSITS Shs' billion	MARKET SHARE %
Over 10	9	282	70	185	69
5-10	6	37	9	23	9
3-5	8	32	8	22	8
1-3	20	43	11	31	12
0-1	10	8	2	6	2
GRAND TOTAL	53	402	100	267	100

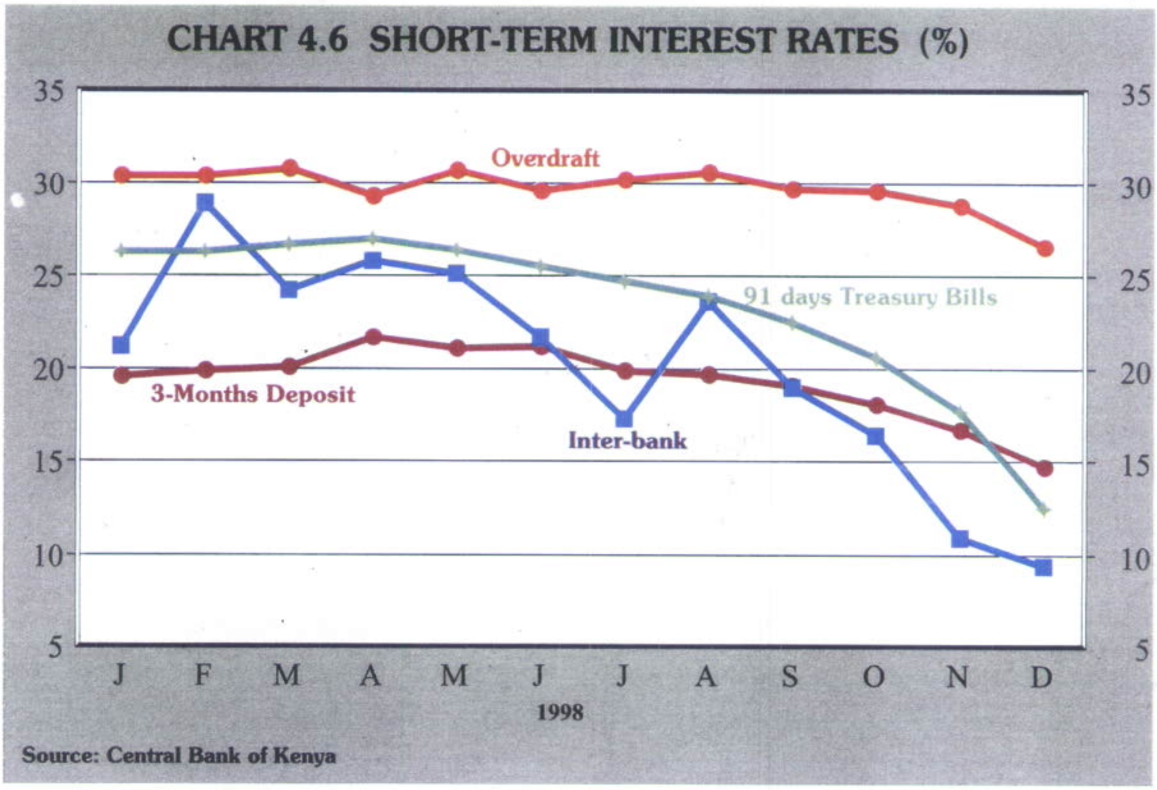
TABLE 4.1B: NBFI's RANKING BY ASSETS AND DEPOSITS AS AT DECEMBER, 1998

PEER GROUP RANGE Shs' billion	NUMBER OF INSTITUTIONS	NET ASSETS Shs' billion	MARKET SHARE %	DEPOSITS Shs' billion	MARKET SHARE %
Over 10	1	13	37	10	46
5-10	1	7	20	4	17
3-5	2	8	23	5	20
1-3	2	3	10	1	6
0-1	10	4	11	2	11
GRAND TOTAL	16	35	100	22	100

4.5 Interest and Exchange Rates

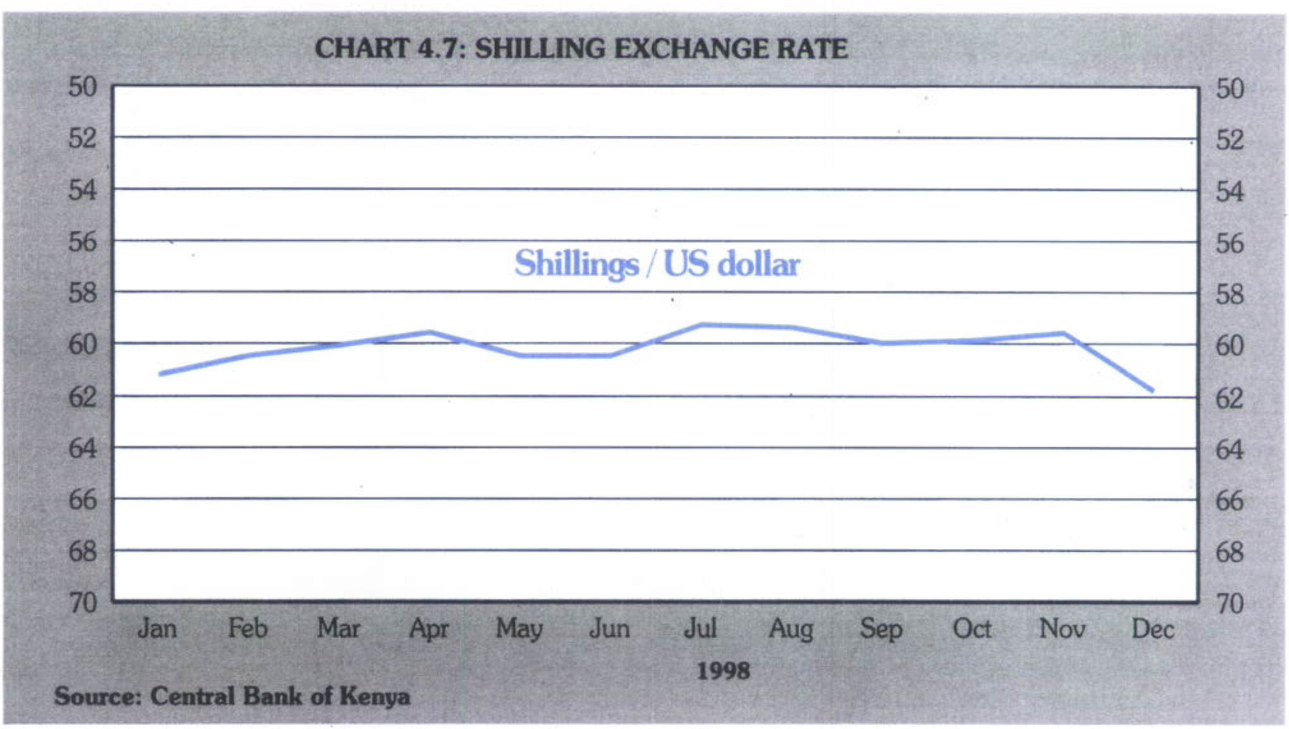
Interest Rates

There was a general decline in all categories of interest rates in the year to December, 1998. Overdraft and interbank lending rates fell by 3.8 and 9.3 percentage points respectively. During the period, Treasury bill rate, three-months deposit rate and savings rates also fell by 13.9, 5.5 and 1.8 percentage points respectively (Chart 4.6). The fall in interest rates was attributed to availability of surplus funds in the money market as a result of gradual decline in cash ratio requirements. There was also relatively low demand for bank loans by both public and private sector as a result of slow down in economic activities.



Exchange Rates

The shilling exchange rate held steadily against the US Dollar during the year to December 1998. The shilling strengthened steadily to exchange at Kshs.60 to one US Dollar at the end of the first quarter of 1998 before depreciating slightly by 3 percent to exchange at shs.61.8 per US Dollar. The weakening of the shilling was explained by the increase in liquidity which led to general decline in interest rates (Chart 4.7).



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). Institutions are rated on a five tier system as shown below:

Strong	- Excellent performance in all the parameters.
Satisfactory	- Good performance in most of the parameters.
Fair	- Average performance and meets minimum statutory requirements.
Marginal	- Below average performance in some of the parameters.
Unsatisfactory	- Poor performance in most of the parameters and violates minimum statutory requirements.

On this basis and inclusive of banks under statutory management, the overall performance of the banking sector was rated fair compared to satisfactory rating in 1997. There were 32 banks in strong and satisfactory categories accounting for 56% of the market in terms of assets compared to 32 banks with 70% of assets in 1997. On the other hand, banks rated fair and below accounted for 44% of assets in 1998, an increase from the 30% in 1997 (Table 4.2(A).)

TABLE 4.2(A): YEAR END OVERALL PERFORMANCE RATINGS- BANKS*

PERFORMANCE CATEGORY	NUMBER OF INSTITUTIONS	NET ASSETS Shs' billion	%	NO. OF INST.**	NET ASSETS Shs' billion	%
STRONG	8	39	10	11	123	30
SATISFACTORY	24	224	60	21	103	26
FAIR & BELOW	21	114	30	21	176	44
TOTALS	53	377	100	53	402	100

* Based on audited accounts

** Includes institutions under statutory management

Source: Bank Supervision Department

TABLE 4.2(B): YEAR END OVERALL PERFORMANCE RATINGS - NBFIs*

PERFORMANCE CATEGORY	NUMBER OF INSTITUTIONS	NET ASSETS Shs' billion	%	NUMBER OF INSTITUTIONS	NET ASSETS Shs' billion	%
STRONG	4	13	39	5	6	17
SATISFACTORY	5	3	9	4	9	26
FAIR & BELOW	8	17	52	7	20	57
TOTALS	17	33	100	16	35	100

* Based on audited accounts

In the case of NBFI's, nine institutions in the strong and satisfactory categories had 43% of net assets compared to 9 institutions with 48% of assets in 1997. Seven institutions rated fair and below accounted for 57% of assets, compared to 8 institutions accounting for 52% of assets in 1997 (Table 4.2(B).

4.6.1 **Capital Adequacy**

The importance of capital in the soundness of the banking system cannot be overemphasised. Capital represents the shareholders stake in an institution and cushions the institution against losses that may arise from various risks. It is against this background that institutions are required to steadily increase their capital base to reach shs.500m for banks and shs.375 for NBFI's by Year 2002.

TABLE 4.3: YEAR END CAPITAL ADEQUACY: BANKS & NBFI's

	1997			1998		
PERFORMANCE CATEGORY	NUMBER OF INSTITUTIONS	NET ASSETS Shs' billion	%	NUMBER OF INSTITUTIONS	NET ASSETS Shs' billion	%
STRONG	34	190	46	38	254	58
SATISFACTORY	23	180	44	22	132	30
FAIR & BELOW	13	40	10	9	50	11
TOTALS	70	410	100	69	436	100

The basis of rating capital was the proportion of capital to deposit liabilities (gearing ratio). Based on this criteria, there were 60 institutions accounting for 88% of the market in terms of net assets rated strong and satisfactory. This was a slight deterioration from the rating in 1997 when 57 institutions with 90% were in the two categories (Table 4.3).

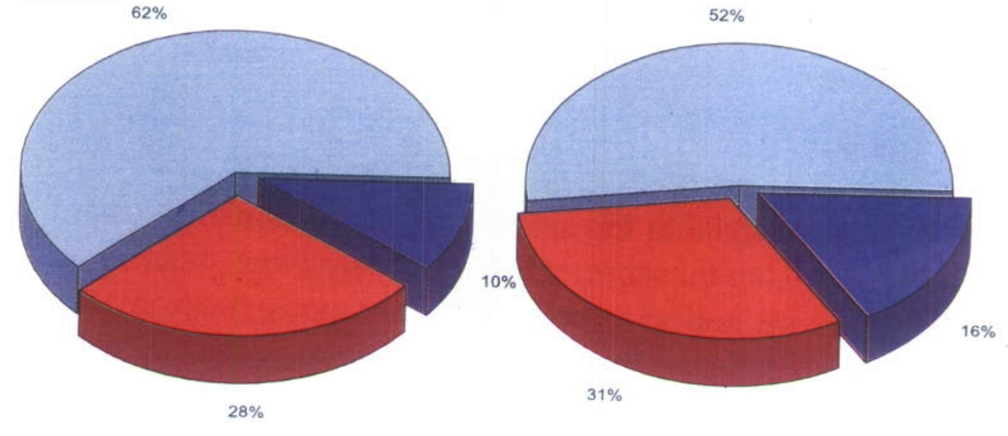
4.6.2 **Asset Quality**

Loans and advances continued to form the largest share of total assets for banking institutions. The level of non-performing loans in the banking sector remained high and as at December, 1998 stood at shs.83bn compared to shs.69bn in 1997. Non-performing loans as a proportion of total loans was 31% in December 1998 compared to 28% in 1997 (Chart 4.4).

COMMERCIAL BANKS AND NBFI's

RISK CLASSIFICATION FOR ADVANCES

CHART 4.8



To comply with much stricter requirements from Central Bank, the level of provisions for bad debts increased by 65% from shs.23 billion in 1997 to shs.38 billion in 1998. In the rating of institutions, the amount of provisions made were taken into account. It is for this reason that the quality of assets improved from unsatisfactory rating in 1997 to marginal rating in 1998. It is observed that in 1998 the institutions in the strong and satisfactory categories were 34 accounting for 39% of the market in terms of net assets while in 1997 there were 30 institutions with 21% in net assets in the two categories (Table 4.4).

The poor asset quality over the last few years has been attributed to inter-alia imprudent management of credit risk by some banking institutions, high interest rates on loans and advances which made borrowers unable to pay loans, the general decline in economic activity which was further compounded by the El-nino rains and the bomb blast.

TABLE 4.4: YEAR END ASSET QUALITY: BANKS AND NBFI's

	1997			1998		
PERFORMANCE CATEGORY	NUMBER OF INSTITUTIONS	NET ASSETS Shs' billion	%	NUMBER OF INSTITUTIONS	NET ASSETS Shs' billion	%
STRONG	20	57	14	24	65	15
SATISFACTORY	10	30	7	10	103	24
FAIR & BELOW	40	323	79	35	268	61
TOTALS	70	410	100	69	436	100

4.6.3 **Earnings**

In 1998, profitability of the banking sector dropped substantially. Return on assets declined from 4% in 1997 to 1.5% in 1998 and the profitability was therefore rated fair compared to strong in 1997. In the strong and satisfactory categories were only 30 institutions with 55% of total assets compared to 30 institutions with 62% of assets in 1997. On the other hand, 39 institutions with 45% of assets had profitability rating of fair and below compared to 40 institutions with 37% of assets in 1997. Despite the reduced profits and the lower rating, it should be noted that the institutions reported more realistic results in 1998 relative to past periods (Table 4.5).

TABLE 4.5: YEAR END EARNINGS: BANKS AND NBFI's

	1997			1998		
PERFORMANCE CATEGORY	NUMBER OF INSTITUTIONS	NET ASSETS Shs' billion	%	NUMBER OF INSTITUTIONS	NET ASSETS Shs' billion	%
STRONG	23	246	60	20	200	46
SATISFACTORY	7	14	3	10	38	9
FAIR & BELOW	40	150	37	39	198	45
TOTALS	70	410	100	69	436	100

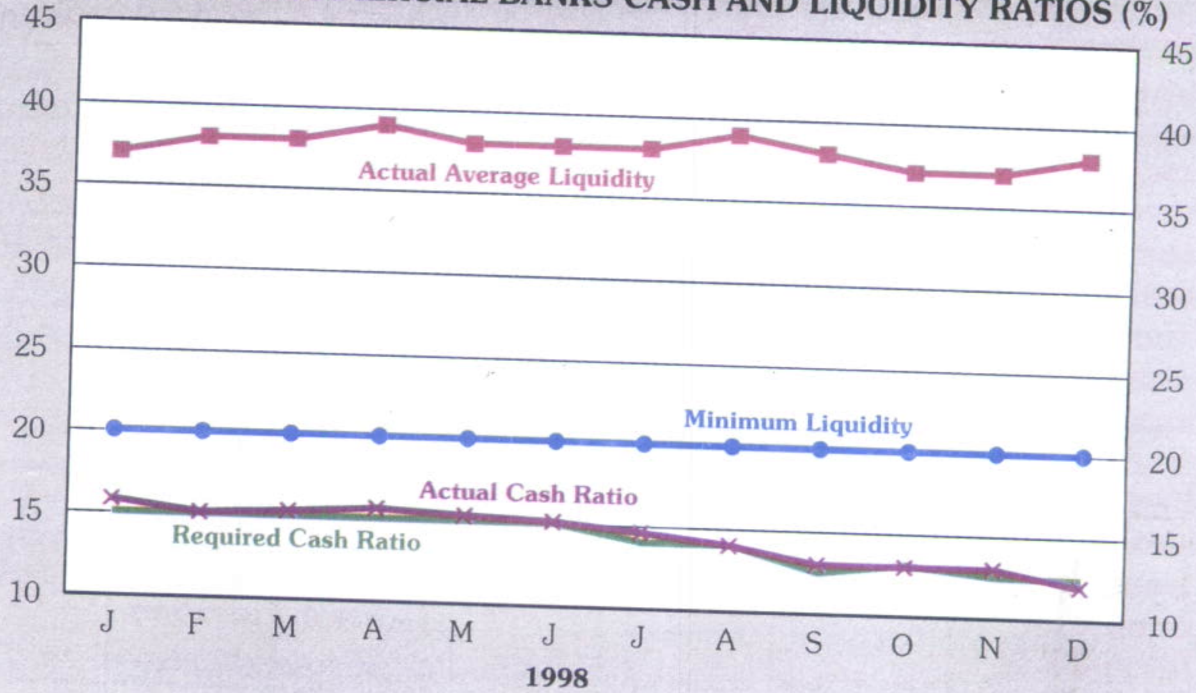
4.6.4 **Liquidity**

The average liquidity of the banking system as measured by the ratio of net liquid assets to total deposits, was 38% as at end of 1998 which was above the minimum statutory level of 20% and was rated strong. This was the same average level recorded as at the end of the year 1997. However, some deterioration in liquidity is observed in 1998 compared to 1997. 20 institutions with 36% of net assets had liquidity rating of fair and below compared to 15 institutions with 20% of net assets in 1997 (Table 4.6 and Chart 4.9).

TABLE 4.6: YEAR END LIQUIDITY: BANKS AND NBFI's

	1997			1998		
PERFORMANCE CATEGORY	NUMBER OF INSTITUTIONS	NET ASSETS Shs' billion	%	NUMBER OF INSTITUTIONS	NET ASSETS Shs' billion	%
STRONG	46	212	52	39	225	52
SATISFACTORY	9	92	22	10	54	12
FAIR & BELOW	15	106	26	20	157	36
TOTALS	70	410	100	69	436	100

CHART 4.9: COMMERCIAL BANKS CASH AND LIQUIDITY RATIOS (%)



BANKING SECTOR GLOBAL BALANCE SHEET ANALYSIS AS AT DECEMBER, 1997 AND DECEMBER, 1998

Figures in Kshs. million	AUDITED							
	Banks 31.12.98	MGT** 31.12.98	NBFIs 31.12.98	Total 31.12.98	% 31.12.98	Total 31.12.97	% 31.12.97	Growth %
A. ASSETS								
1. Cash	5,784	13	54	5,851	1	7,017	2	-16.6
2. Balances at CBK	29,448	153	999	30,600	7	34,066	8	-10.2
3. Placements	15,726	384	6,134	22,244	5	21,770	5	2.2
4. Government Securities	67,046	498	1,970	69,514	16	46,961	11	48.0
5. Investments	3,583	150	179	3,912	1	4,460	1	-12.3
6. Advances(net)	187,286	11,889	22,965	222,140	51	205,599	50	8.0
7(a). Foreign Loans	8,164	0	0	8,164	2	19,307	5	-57.7
7(b). Other foreign Assets	16,332	463	7	16,802	4	18,298	4	-8.2
8. Fixed Assets	21,511	1,344	1,489	24,344	6	21,661	5	12.4
9. Other Assets	31,474	383	1,010	32,866	8	31,256	8	5.2
10. Total Assets	**386,353**	**15,277**	**34,806**	**436,436**	**100**	**410,395**	**100**	**6.3**
B. LIABILITIES								
11. Deposits *	263,612	13,023	22,443	299,078	69	273,221	67	9.5
12. Accrued Interest	5,961	1,022	560	7,542	2	7,053	2	6.9
13. Foreign Liabilities	19,284	12	543	19,839	5	34,869	8	-43.1
14. Other Liabilities	51,692	2,493	6,876	61,061	14	45,475	11	34.3
15. Total Liabilities	**340,549**	**16,549**	**30,422**	**387,520**	**89**	**360,618**	**88**	**7.5**
16. Net Assets/(Liabilities)	**45,804**	**(1,272)**	**4,384**	**48,916**	**11**	**49,776**	**12**	**-1.7**
C. CAPITAL & RESERVES								
17. Paid up/Assigned Capital	21,040	1,477	2,216	24,732	6	21,769	5	13.6
18. Reserves	21,093	(2,749)	2,025	20,369	5	21,906	5	-7.0
19. P & L Account	3,671	0	143	3,814	1	6,101	1	-37.5
20. Total Shareholders' Funds	**45,804**	**(1,272)**	**4,384**	**48,916**	**11**	**49,776**	**12**	**-1.7**
21. Contingent Liabilities	53,339	1,248	279	54,866		52,067		
22. Non-performing Advances	58,939	9,043	15,504	83,485		69,001		
23. Loan Loss Provisions	26,646	4,455	7,175	38,276		23,265		
23. Other Non-performing Assets								
D. PERFORMANCE INDICATORS (%)								
Capital/Deposits Ratio	16	-9	19	15		16		
Capital/Assets Ratio (Unweighted)	10	-8	12	10		11		
Liquidity Ratio	40	6	34	38		38		
Loan Loss Prov/Non-perf Adv Ratio	45	49	46	46		34		
Non-perf.Adv/Total Adv Ratio	27	55	51	31		28		
Advances/Deposits Ratio	77	116	128	82		79		

* Includes Interbank deposits

** Institutions under statutory management

BANKING SECTOR GLOBAL PROFIT AND LOSS ANALYSIS AS AT DECEMBER, 1997 AND DECEMBER, 1998

Figures in Kshs. million	AUDITED						
	Banks 31.12.98	MGT** 31.12.98	NBFIs 31.12.98	Total 31.12.98	% Total 31.12.98	Total 31.12.97	% Total 31.12.97
A. INCOME							
1. Interest on Advances	49,256	4,783	4,934	58,973	65%	53,378	63%
2. Interest on Placement	3,056	51	870	3,978	4%	5,136	6%
3. Interest on Govt. Securities	12,082	119	674	12,875	14%	10,118	12%
4. Foreign Exc. Gain/(Loss)	3,450	89	33	3,572	4%	4,605	5%
5. Other Interest Income	808	18	47	873	1%	1,213	1%
6. Other Income	10,334	278	385	10,997	12%	10,297	12%
7. Total	**78,985**	5,338	6,944	91,268	100%	84,746	100%
B. EXPENSES							
8. Interest on Deposits	35,405	3,751	3,942	43,097	51%	38,869	57%
9. Other Interest Expenses	1,562	142	314	2,018	2%	1,818	3%
10. Occupancy Costs	1,845	81	99	2,026	2%	1,790	3%
11. Director's Emoluments	421	14	20	455	1%	300	0%
12. Bad Debts Charge	7,390	2,960	526	10,876	13%	4,630	7%
13. Salaries & Wages	12,588	473	639	13,700	16%	11,456	17%
14. Other Expenses	10,513	833	488	11,834	14%	9,623	14%
15. Total	**69,724**	8,253	6,028	84,006	100%	68,487	100%
16. Profit Before Tax	**9,261**	(2,915)	916	7,262		16,259	
C. PERFORMANCE INDICATORS							
Yield on Earning Assets	22%	29%	17%	22%		25%	
Cost of Funding Earning Assets	12%	22%	11%	12%		14%	
Interest Margin on Earning Assets	10%	7%	6%	10%		11%	
Yield on Advances	22%	29%	16%	22%		24%	
Cost of Deposits	13%	29%	17%	14%		13%	
Return on Assets(Including Contingents)	2%	-18%	3%	1.5%		4%	
Return on Shareholders Funds	20%	229%	21%	15%		34%	
Overhead to Earnings	41%	82%	26%	43%		33%	

FUTURE OUTLOOK

The future goals of Bank 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 intemediaries not under Banking Act are also regulated. It will also evaluate ways in which the micro finance sector can be regulated and integrated into the banking system.

- Work closely with various stakeholders in restructuring of institutions under statutory management.