The role and mission of Bank Supervision Department

The role of the Bank Supervision Department is to promote a sound and stable market-based banking system in Kenya by fostering liquidity and solvency of banking institutions, ensuring efficiency in banking operations and encouraging high standards of customer service. To realize this objective, the Department focuses its activities on enforcing the requirements of the Banking Act, the Building Societies Act and prudential regulations. The Department has also been engaged in developing appropriate regulatory and supervisory framework for micro finance institutions.

The Department conducts both on-site examinations and off-site surveillance of banking and non-bank financial institutions to ensure they attain and sustain minimum specified performance benchmarks on capital, assets, management, earnings and liquidity. It also undertakes examination of forex bureaus to ensure adherence to the Central Bank of Kenya (CBK) operational guidelines.

In the pursuit of its role, the Department's approach will continue to be guided by market-driven principles that underlie all activities and decisions. It will strive to uphold professionalism, integrity and impartiality in the conduct of supervisory functions. In its relationships with other key players in the financial services industry, the Department will continue to promote a consultative approach by building mutual trust and open communication.

The Bank Supervision Annual Report is prepared by
the Central Bank of Kenya and is available on the Internet:
http://www.centralbank.go.ke

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Message From The Governor

The year 2002 was a momentous one for the country. The country elected a new government, following national general elections held at the end of the year. The new government, led by His Excellency President Mwai Kibaki, took over at the end of 2002 and brought with it numerous changes in most spheres of leadership. At the Central Bank of Kenya, Mr. Nahashon N. Nyagah resigned and I was subsequently appointed Governor on March 4, 2003. Mr. Jones M. Nzomo took over as the Director of Bank Supervision Department, replacing Mr. John Murugu.

The performance of the banking sector declined in terms of pre-tax profits from Ksh 8.9bn in 2001 to Ksh 5.8bn in 2002. This decline is attributed to slowdown in economic performance that was occasioned by uncertainties regarding the outcome of the country's general elections, the high cost of doing business, reduced level of domestic savings and investor confidence and continued withholding of external financing by the international development partners. Although non-performing loans remain the biggest challenge, the banking sector is adequately capitalized in terms of capital held against risks inherent in the asset portfolio.

The economic slump adversely affected the performance of businesses including the banking sector, savings and investments. As a result, gross domestic product (GDP) expanded by 1.1% compared with 1.2% the previous year. The current economic reforms initiated by the new government are, however, expected to reverse the economic decline and the GDP growth is projected to accelerate to 1.9% in 2003 and to exceed 5% over the medium term.

The Central Bank of Kenya will continue to play its role in complementing Government efforts to revive the economy through implementation of appropriate reforms in the banking sector. Banking laws and prudential regulations will be reviewed and harmonized with international standards and practices to strengthen the supervisory function of the Central Bank of Kenya. In addition, the Central Bank of Kenya will continue to emphasize good corporate governance practices in the banking industry in order to, *inter alia*, minimise the number and cost of bank failures. The Central Bank of Kenya will be firm and insist on full compliance by all licensed institutions with the existing laws and regulations. There has been a notable improvement in the level of compliance by banking institutions.

Initiatives aimed at eliminating anti-money laundering and financing of terrorism activities continues to be a major concern for the country. The Minister for Finance gazetted the National Task Force (NTF) on anti-money laundering in April 2003 and mandated it to finalize the policy and legal framework to combat money laundering and financing of terrorism. The Government also published the Suppression of Terrorism Bill that is due for debate in Parliament.

The Central Bank of Kenya, in consultation with the Minister for Finance, has developed a Micro-Finance Bill which, on its enactment, will provide a legal and regulatory framework that will streamline the operations of micro-finance institutions and integrate them into the formal financial system.

I look forward towards the continued support of the banking sector in providing the cooperation needed to achieve the objectives of the Government in creating an appropriate infrastructure for conducting banking business and a conducive macroeconomic environment that will spur and sustain economic growth.

ANDREW MULLEI

NOVEMBER 2003

Chapter 1

Developments in the Local Banking Industry

1.1 Changes in the number of institutions and branch network

Number of institutions decreased due to mergers and take-over...

The total number of banking institutions and building societies decreased during the year from 55 as at end of 2001 to 52 as at the beginning of 2003. The reduction was due to two mergers involving four banking institutions and a take-over of one institution by another.

There were 54[1] operational institutions as at the end of the year out of which 45 were commercial banks, 3 non-bank financial institutions (NBFIs), 2 mortgage finance companies (MFCs) and 4 building societies. These institutions included 6 locally incorporated foreign owned institutions and 4 branches of foreign owned institutions. The Government of Kenya has shareholding in 5 commercial banks and 2 NBFIs. Two locally incorporated banks had 4 operational branches outside the country: 3 in Tanzania and 1 in Uganda. One bank owns a subsidiary in Malawi. One bank has an associate in Tanzania with a 20% shareholding. As shown in Table 1, the total branches decreased from 494 at the end of 2001 to 486 at the end of 2002. This was mainly as a result of the branch rationalization undertaken by some institutions in the sector.

....number of branches decreased due to branch rationalization

TABLE 1: BRANCH NETWORK OF THE BANKING INDUSTRY - 5 YEAR TREND

PROVINCE	2002	2001	2000	1999	1998
CENTRAL	69	69	65	79	114
COAST	70	69	71	80	77
EASTERN	34	35	31	36	60
NAIROBI	186	192	179	189	199
N. EASTERN	4	4	4	5	5
NYANZA	38	40	39	46	70
RIFT VALLEY	67	67	61	75	139
WESTERN	18	18	15	20	28
TOTAL	486	494	465	530	692

[1] This number includes Biashara Bank Ltd, which merged with Investments and Mortgages Bank Ltd, and Bank of India Finance Ltd, which merged with Bank of India. Both mergers were effective December 31, 2002.

1.2 Institutions under restructuring

Restructuring of City Finance Bank Ltd and The Delphis Bank Ltd continued in 2002. Both banks are operating under schemes of arrangement prepared in accordance with section 207 of the Companies Act. The schemes were prepared with two major objectives of converting sufficient deposit-related and sundry liabilities into share capital and eliminate the existing deficit in net assets and meet the minimum capital requirements and to repay the outstanding deposit-related and sundry liabilities in installments from recovery of loans and any profits generated.

City Finance Bank Ltd re-opened in April 2000 under a scheme of arrangement. The Scheme, which runs until December 31, 2003, provided for the conversion of a substantial portion of deposits into share capital with the residual balance to be repaid in installments over the currency of the Scheme. The restructuring of the bank has largely been successful and entailed the installation of a new board of directors and rationalization of the bank's operations. So far the bank has met its obligations under the Scheme.

The Delphis Bank re-opened its doors in December 2002 under a scheme of arrangement

The Delphis Bank Ltd re-opened in December 2002, under a scheme of arrangement, which called for the re-capitalization of the bank by the conversion of a substantial portion of eligible deposits into equity and cash injection of fresh capital. The restructuring model, though similar to the one used by City Finance Bank Ltd, was an improvement since there was actual cash injection to boost the bank's liquidity and provide funds for working capital. A new board of directors and management team was put in place and the Central Bank is monitoring progress. Through strict enforcement of banking laws and regulations, the Central Bank is making every effort to ensure that bank failures are minimised.

1.3 Foreign exchange bureaus

1.3.1 Licensing of forex bureaus

Review of moratorium on licensing of forex bureaus held in abeyance pending legislation of anti-money laundering and suppression of terrorism

In an effort to increase competition and minimise exchange rate margins, licensing of foreign exchange bureaus started in 1995. However, since June 1998, there has been a moratorium on licensing of forex bureaus, which was due to end by December 31, 2001. Following the September 11, 2001 terrorist attack in New York, the moratorium was again extended until further notice due to concerns that some bureaus may be easy conduits for financing of terrorist activities.

There was no evidence from our inspection findings that forex bureaus are involved in aiding money-laundering activities and financing of terrorism. That notwithstanding, modalities are in place to monitor forex bureau transactions above US$ 5,000 as required under section 3.8 of the Forex Bureau Guidelines. The Department continues to monitor operations of the bureaus to guard against the likelihood of their use in financing terrorism and money laundering activities.

There were 48 operating forex bureaus. Out of these, 40 were located in Nairobi, 4 in Mombasa and 1 each in Nakuru, Kisumu, Eldoret and Malindi. Weekly average transactions by bureaus increased from Ksh 1.2bn in 2001 to Ksh 1.4bn in 2002, while their foreign exchange transactions as at the end of 2002 accounted for 1.2% of the total foreign exchange transactions.

1.3.2 Financial performance of forex bureaus

During the year under review, the Central Bank inspected all the forex bureaus and highlighted various weaknesses in internal control, management and violation of Forex Bureau Guidelines. Several recommendations have also been made, as well as directions to individual bureaus for corrective action to improve their profitability and sustainability. The consolidated financial position based on the audited accounts as at December 31, 2002 was as follows:

- Total assets were Ksh 669m compared with Ksh 650m as at December 31, 2001;
- Total shareholders funds were Ksh 419m, an increase from Ksh 342m as at December 31, 2001. This was partly attributed to an increase in profitability of the bureaus during the year; and
- Profit before tax increased from Ksh 35m in 2001 to Ksh 38m as at December 31, 2002, an increase of 8.5%.

1.4 Developments in information technology

1.4.1 Impact of information technology in the banking industry

The banking industry has continued to embrace changes in information technology geared towards improved customer service and cost reduction. The new and dynamic systems have led to faster and efficient processing of bulky transactions and other processes leading to reduced unit costs. The level of competitiveness has increased significantly among banks, especially in the areas of service delivery and product development including Internet and telephone banking.

Industry has continued to embrace changes in IT to reduce operational costs and improve quality of customer care......

The manual processing of tasks has been greatly reduced or eliminated, freeing employees to more productive roles in their institutions. An increasing number of banks have introduced branchless banking, where branches are inter linked and customers can access their accounts from any outlet in the entire branch network. Where branches are not considered necessary, they have been closed and Automated Teller Machines (ATMs) installed to serve their customers.

... shared ATMs under the KENSWITCH project are expected to be rolled out to customers

The big five banks have continued to install new ATMs in new locations. During the year under review, Stanbic Bank introduced ATMs and received good response from its retail customers. The KENSWITCH project, a shared ATM project by a number of small banks, is already in the pilot stage. A few ATMs have already been installed in the premises of some member banks. On a test basis, the machines are currently being used by members of staff only and no hitches have been reported. They are expected to be rolled out to other customers soon.

The use of Very Small Aperture Technology (VSAT) and leased lines has facilitated faster and reliable transmission of data between institutions and the Central Bank, thereby increasing the efficiency levels in the industry.

1.4.2 Electronic transmission of data to the Central Bank

The electronic system for data transmission has been successfully installed in all institutions. A parallel run with the current manual system has been going on since September 2000. The delay in going live with the new system has been occasioned by the slowness of some institutions in adopting the system and the logistics of revising the KBA BankConnect to cater for non-clearing house institutions.

1.4.3 Banking Supervision Application (BSA) regional project

Electronic system for data transmission has been successfully installed in all institutions

The Banking Supervision Application (BSA) software is a joint project of the Eastern and Southern African (ESAF) Banking Supervision Group and the Central Banks within the Southern Africa Development Community (SADC). This software has been specially designed for bank supervision operations within the region. The software development and testing has now reached the final stages. The Central Bank of Kenya is a participant in this initiative.

The software is designed to improve the core processes of Bank Supervision including creating and maintaining supervisory data, licensing banks, conducting on-site and off-site supervision, taking enforcement actions and performing risk monitoring. When fully operational, the software is expected to improve management of data, internal workflows and harmonize supervisory practices within the region. The application will initially be deployed as a pilot project in Mozambique, and adopted later in other countries within the region.

1.5 Mergers and conversions

Central Bank has continued to encourage mergers of small and medium sized banks.....

During the year under review, the Central Bank continued to encourage the small and medium sized banks to merge in order to take advantage of the synergies accruing from a stronger capital base. In the year 2002 the Minister for Finance approved the merger of 6 institutions as follows:

- Bank of India Ltd merged with Bank of India Finance effective December 31, 2002, to form Bank of India Ltd;
- With effect from September 30, 2002, Co-operative Bank of Kenya also merged with Co-operative Merchant Bank to form Co-operative Bank of Kenya; and
- Investments & Mortgages Bank merged with Biashara Bank, effective December 31, 2002, to form Investments & Mortgages Bank Ltd.

... Building Societies Act has been amended to allow building societies to merge with institutions licensed under the Banking Act

Section 55A of the Building Societies Act was amended to provide for the building societies intending to convert to or merge with institutions. It removed the many legal hurdles in the transfer of assets and liabilities to the resulting institution. So far no building society has taken advantage of these amendments. Central Bank will, however, continue to encourage mergers and conversions.

1.6 Employment and human resource development

1.6.1 Employment levels

There has been a reduction in employment levels ....

Employment levels in the banking industry have maintained a continuous downward trend in the past six years. This reduction has largely been attributed to the downsizing in most institutions due to the continued economic downturn in the country as well as mergers that took place in the course of the year. As shown in the table below, total staff complement decreased by 4.3% from 11,854 in December 2001 to 11,340 in December 2002.

TABLE 2: EMPLOYMENT IN THE BANKING INDUSTRY

	2002		2001	
CATEGORY	NO.	%	NO.	%
MANAGEMENT	3,104	27.4	3,208	27.1
SUPERVISORY & SEC. HEADS	2,276	20.1	2,109	17.8
CLERKS & SECRETARIAL STAFF	5,032	44.4	5,329	45.0
OTHER CATEGORIES	928	8.2	1,208	10.2
TOTAL	11,340	100.0	11,854	100.0

Reduction in employment levels was experienced in all categories except among Supervisors and Section Heads. The highest reduction of 23.2% was recorded among other categories below the clerical/secretarial level. Employment in the management category had the least decline of 3.2%.

1.6.2 Human resource development

... training is necessary to equip employees with necessary skills and knowledge to face emerging challenges

The banking environment is dynamic and employees have to be continuously trained to equip them with the necessary knowledge and skills to face the challenges associated with the rapidly changing banking operating environment. This takes various forms and will differ from one banking institution to the other. Most institutions have drawn up elaborate training policies designed to identify their staff training needs.

The few institutions with training schools have continued to use their facilities to train their staff and update them on new developments in banking. Kenya School of Monetary Studies (KSMS), which is owned and managed by the Central Bank of Kenya, has continued to offer training courses particularly to employees from other institutions that do not have their own training facilities.

Sponsorship of staff to overseas courses has become increasingly common with the introduction of new products, particularly those that are available in developed markets. In addition, the international banks in the sector have been seconding their staff to branches in other markets to get hands-on experience on new products they launch.

The Bank Supervision Department is aware that, to be effective in discharging its role, its members of staff should be kept abreast with all the new developments in the banking industry. To this end, staff from the department have been exposed to these developments through continuous training. This has been achieved through a combination of local and overseas courses. Besides, over the last few years, Bank Supervision staff have also participated in joint inspections in the region, thus exposing them to new inspection methods.

1.7 Customer care and social responsibility

There has been increased focus by banking institutions on customer care to withstand competition...

Banking institutions have continued to focus on customer care in order to retain existing customers, while at the same time attracting new ones from the competition. Some of them have also increased their involvement in community projects in a bid to create awareness of their presence. Some of the measures taken to enhance customer care and social responsibility include:

- Setting up customer service desks to handle customer issues;
- Installation of suggestion boxes to receive queries and complaints from customers;
- Installation of ATMs at convenient places, to enable customers have easy access to their accounts; and
- Sponsorship of or direct participation in community projects.

... most customer complaints relate to charges levied by banking institutions

However, customers continue to raise a number of complaints regarding services offered by banking institutions. One of the most critical complaints relates to charges levied for various services offered. The public perception is that institutions are overcharging their customers. This view is strengthened by the super profits reported by some of them at a time when other companies with similar capital outlays are reporting modest profits. In addition, some of the institutions have increased their minimum balances required to operate an account, forcing out small savers. Another concern relates to the closure of branches, particularly in the rural areas. Customers from these areas are forced to travel long distances in search of banking services albeit at an additional cost.

1.8 Developments in bank supervision

The banking supervision process continued to be carried out, both on the basis of on-site as well as off-site surveillance. The most notable improvement in effective supervision was enforcing of compliance by the banking institutions. The reduced inspection cycle continued to be enforced while implementation of risk focused supervision continued. There was a marked improvement in the timeliness and accuracy of off-site data submitted to the Central Bank and electronic data transfer improved during the year under review. Implementation of risk-based supervision was enforced but the banking industry, and specifically the small banks, was being sensitized on the need to have formal and documented risk management frameworks in place.

1.8.1 Off-site surveillance

The off-site surveillance consists of two divisions, namely, Financial Analysis and Policy Divisions. The two divisions perform complementary roles within the Department. The primary responsibility of Financial Analysis Division is collection, processing and analysis of data to determine the financial soundness and identify early warning signals in individual institutions and in the entire banking system. On the other hand, Policy Division is charged with the responsibility of dealing with policy matters, updating banking legislation and regulations as well as processing of various approvals. In the pursuit of objectives for year 2002, the following developments took place in the off-site surveillance function:

- Banking institutions started electronic submission of returns to the Central Bank, beginning with a parallel run in September 2002, ultimately enhancing efficiency and security of data transfer between banking institutions and the Central Bank;

Frequency of publication of financial statements and disclosures was increased to quarterly intervals....

- Frequency of publication of financial statements and disclosures was increased from annual to quarterly intervals with effect from June 2002 to provide more data to all stakeholders for more informed decision-making;
- Building Societies were formally required to submit their audited balance sheets, loans classification and profit and loss accounts for incorporation in global financial reports;
- The rating system was revised to incorporate "Management" rating and some requirements of International Accounting Standards;
- The Department held Tripartite meetings for the year 2002 financial statements for all institutions and in consultation with ICPAK, is considering accounting issues that arose from those meetings;
- Drafting of prudential regulations for building societies was commenced; and
- Review of all prudential regulations for banking institutions was initiated.

1.8.2 On-site inspection

Following the adoption of risk-focused examination process, the Department continued to build capacity in terms of skills in risk-focused supervision by exposing examiners to relevant training. As part of sensitizing the banking sector about Basle II Capital Accord, banking institutions will be required to have formal and documented risk management frameworks. Over the years, inspection reports have highlighted the key issues in the banking sector. However, the number of weaknesses and frequency of occurrence in the sector have reduced significantly over time. Notable improvements were observed in the following areas:

... the number and frequency of weaknesses in the sector have reduced significantly.

Credit risk management

There has been a significant improvement in credit risk management in the sector. Both the board and the management of institutions have undertaken commendable steps in addressing serious credit risk management issues that had hitherto led to the high non-performing loans. Elaborate credit policies have been developed and are being adhered to, which have led to the drastic reduction of credit administration weaknesses noted during the routine on-site inspections.

Governance

Most institutions have made commendable efforts in enhancing corporate governance. This has been achieved through constitution of quality boards that meet regularly and discuss substantive matters. The management of the institutions have also generally improved except in a few institutions where desirable corporate culture has not been fully embraced. A few institutions still have weaknesses in corporate governance with respect to the quality and diversity of the boards and management. The Central Bank is closely monitoring these institutions in their effort to overcome these weaknesses.

Corporate culture has improved in most institutions

Compliance with Legislation and Prudential Regulations

There has been substantial improvement in compliance with the provisions of the Banking Act, Building Societies Act and Prudential Regulations with only a few banks not in compliance. Non-compliant institutions will be subjected to monetary penalties and other sanctions as provided for in the legislation and prudential regulations.

There has been a remarked improvement in compliance with legislation and prudential regulations by banking institutions

Appreciation of oversight function

Banking institutions now appreciate the inspection work carried out by the Department as this supplements both their internal and external auditors in testing internal control systems. Some institutions have requested for a review of implementation of Central Bank recommendations even before their next

... Inspection scope has been expanded to include review of litigation cases and directors declaration confirming non-existence of parallel banking ....

scheduled inspection. This is a clear departure from the early days when institutions used to dread inspections.

The following achievements were realized in the area of on-site inspection during the year under review.

- The examination process was expanded to include review of litigation cases relating to non-performing loans;
- The Central Banks from the three East African countries continued to conduct joint inspections to harmonize inspection methods and procedures in the region;
- During the year, there was a marked improvement in the accuracy of returns submitted to the Central Bank as evidenced by the reduction of exceptions noted; and
- Directors of banking institutions are now required to sign a declaration confirming non-existence of parallel banking in their institutions.

1.9 Future outlook

Focus of the Department is to complement Government efforts to revive the economy

The Bank Supervision Department will focus on the following issues in 2003:

- Play an active role in complementing the Government's efforts to revive the economy by ensuring that the financial sector in general, and the banking sector in particular, is sound and stable;
- Actively support the Government's war against corruption and play a more central role in the development of standards of best practice in the banking industry, including setting of standards and monitoring compliance on matters relating to money laundering;
- Embark on sensitizing the banking industry on the proposed approach to measuring Capital adequacy, as soon as the final version of the New Capital Accord is agreed upon, to ensure that the sector is prepared to adopt it by the set implementation date;
- Continue training technical staff in order to strengthen the regulatory function to bring it at par with international standards; and
- Liaise with the Ministry of Finance to facilitate granting of operational autonomy to the Central Bank for more effective supervision of the sector.

Chapter 2

Performance of the Banking Sector

2.1 Recent economic developments

2.1.1 Growth in GDP

The real Gross Domestic Product (GDP) expanded by 1.4% in the year to June, 2003 compared with 0.7% over a similar period, June 2002. The improved economic performance over the period was attributed to increased investor confidence and favourable weather conditions. The agricultural sector, which acounts for 24% of GDP grew by 1.3% compared with 0.7% in the period to June 2002. The manufacturing sector similarly expanded by 1.2% compared with 1.2% in the twelve months to June, 2002.

2.1.2 Economic prospects

The slowdown in economic performance in 2002 is expected to reverse in 2003 and thereafter, following the bold reform measures currently being implemented by the new government. The reform measures, particularly on corruption and bad governance, are already providing positive signals to both local and foreign investors. The source of optimism for enhanced growth also includes the expected reduction in the cost of doing business due to the strong commitment by the new government to address issues of poor infrastructure. Additional impetus for growth will accrue from the resumption of external financial support expected in the year 2003 that is expected to unlock financial support from other multilateral and bilateral donors.

Economic performance expected to improve in reference to economic reform measures underway....

The country's growth momentum is projected to accelerate to 1.9% in 2003, and thereafter to exceed 5% per annum over the medium term. The government has embarked on a strong and comprehensive reform programme aimed at restoring efficiency in public sector management. Similarly, increased access to external markets following the reduction of restrictive trade practices by Kenya's major trading partners is also expected to boost economic activity particularly in the manufacturing sector.

2.1.3 Inflation

Inflation was confined within the 5% target in the year to June 2003 following the sustained implementation of prudent monetary policy and the stability in the shilling exchange rate. However, during the last quarter of the year, an

.... inflation was maintained within the 5% target

upward trend in prices emerged as a result of both the temporary increase in the prices of basic food items and increase in the cost of fuel and power. The temporary increase in household expenditures during the December festive season and the election period also contributed to the modest increase in inflation.

The overall 12-month inflation increased to 4.1% in December 2002 from 2.7% in November 2002. The overall average annual inflation also rose to 2.0% in December 2002 from 1.8% in November. The underlying 12-month inflation increased to 2.7% from 1.9% in November, while the underlying average annual inflation declined to 2.9% from 3.1% over the same period.

2.1.4 Money supply

10% increase in broad money supply reflected an increase in both net foreign assets and domestic assets

Growth in all money supply aggregates accelerated in the year to June 2003, relative to the growth in the year to June 2002. Broad money supply, M3X, consisting of currency in circulation, private sector holdings of shilling denominated deposits with banks and residents' foreign currency deposits increased by 10.9% to Ksh 419bn during the period compared with 7.0% target growth in the year to June 2003, which was Ksh 404.9bn. The expansion in broad money supply, that is the intermediate money supply target for monetary policy, over the year to June 2003 reflected an increase in both net foreign and domestic assets of the banking system. The increase in net foreign assets in the year was due to build up in foreign assets of both banking institutions and Central Bank of Kenya. Similarly the increase in the net domestic assets reflected expansion of credit to the government by both the Central Bank of Kenya and banking institutions.

2.1.5 Reserve money

Reserve Money (RM), which comprises deposits of banking institutions at the Central Bank and currency in circulation, increased by 11.2% to Ksh 85.5bn in the twelve months' period to June 2002. This was higher than both the 6.6% target growth and actual growth in the previous year. The expansion in RM was due to a rise in currency in circulation and in the banking institutions' deposits at the Central Bank of Kenya. The deposits of non-bank financial institutions at the Central Bank however declined.

2.1.6 Interest rates

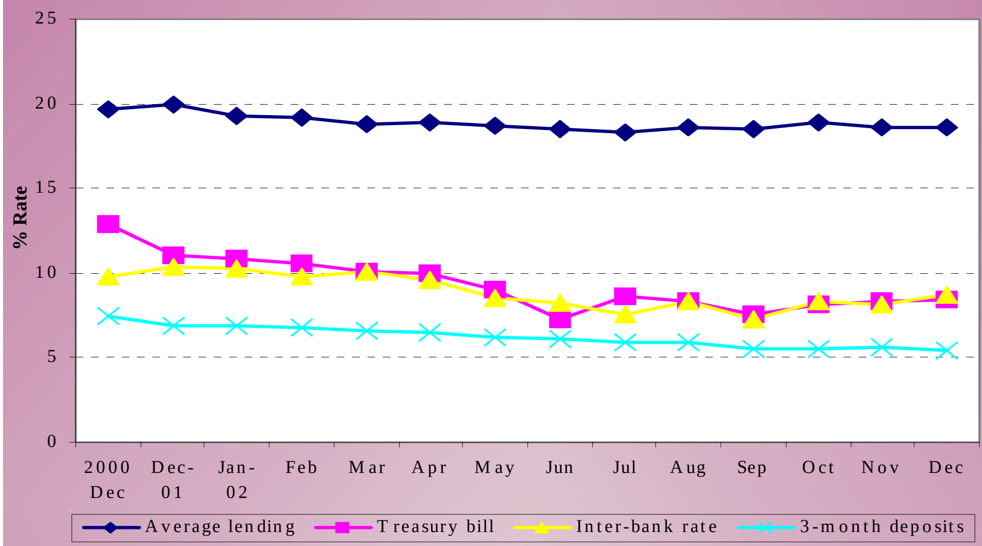
Interest rates movements between July 2002 and June 2003 were mixed as follows:

- The 91-day Treasury bill rate fell from 7.3% in June 2002 to less than 3% in June 2003;

There has been a general decline in interest rates

- The inter-bank rate declined from 8.2% in June 2002 to 1.6% in June 2003, indicating increased liquidity in the overnight market;
- The average lending rates fell from 19.3% in January 2002 to 18.5% in June 2002 and even slightly further to 14.9% in June 2003.
- The three-months average deposit rate declined to 5.4% in December 2002 from 6.9% in January 2002.

CHART 1: SHORT TERM INTEREST RATES - 2002



Source: Central Bank of Kenya

TABLE 3: INTEREST RATES (%) - 2002

	2002					2001	2000
FACILITY	Jan	Mar	Jun	Sep	Dec	Dec	Dec
Overdraft	19.3	18.8	18.5	18.5	18.6	20.0	19.7
Treasury Bill	10.9	10.1	7.3	7.6	8.4	11.0	12.9
Inter-bank	10.3	10.1	8.2	7.3	8.7	10.4	9.8
3-Months Deposit	6.9	6.6	6.1	5.5	5.4	6.9	7.5

Source: Central Bank of Kenya

2.1.7 Exchange rates

The Kenya shilling strengthened against the US Dollar, but weakened against the Sterling Pound and the Euro to exchange at an average of Ksh 73.7, Ksh 122.5 and Ksh 86.1, respectively, in the year to June 2003. Against the Japanese Yen and the South African Rand, the shilling, however, gained by

The Kenya shilling remained relatively stable against major hard currencies

2.8% to trade at Ksh 62.9 per 100 Japanese Yen and Ksh 7.5 per Rand. The shilling also strengthened against regional currencies to exchange at Tsh 12.3 compared with Tsh11.6 in the year to December 2001, and against the Uganda shilling at Ush 22.8 in the year to December 2002 compared with Ush 22.0 in the previous year.

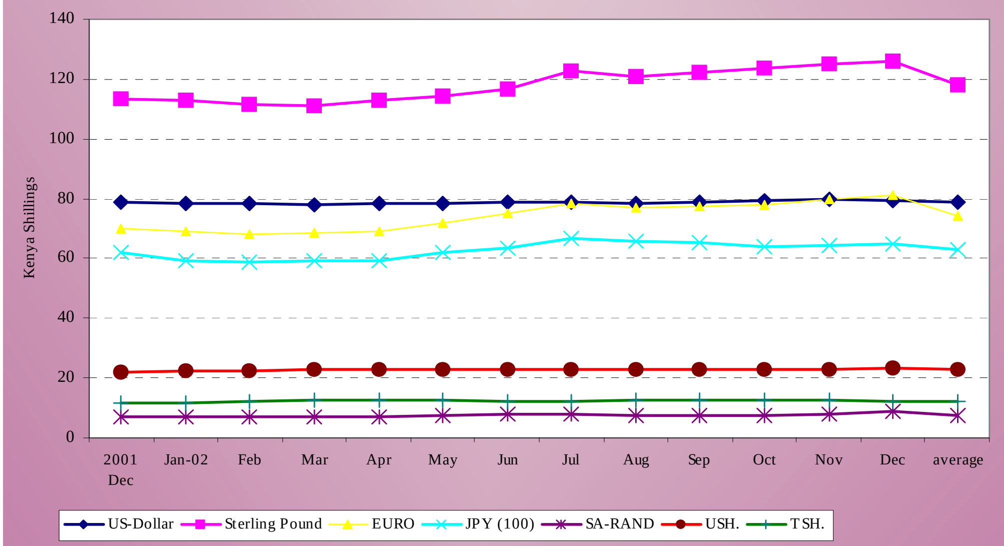
On a monthly basis, the shilling remained stable against the US dollar, trading at an average of Ksh79.5 in December 2002. However, it weakened against the Sterling Pound and the Euro but gained against the Japanese Yen. The stability of the shilling against the US dollar in December 2002 was attributed to subdued corporate demand for foreign exchange and higher inflows mainly from tea exports.

TABLE 4: SHILLING EXCHANGE RATES -2002

	2002						
MONTH	Jan	Mar	Jun	Sep	Dec	Avg	Dec. 2001
USD	78.6	78.1	78.7	78.8	79.5	78.7	78.7
GBP	112.8	111.1	116.6	122.5	126.1	118.3	113.2
EURO	69.3	68.5	75.1	77.3	81.0	74.4	70.2
JPY (100)	59.3	59.5	63.7	65.2	65.1	62.8	61.9
SA-RAND	6.8	6.8	7.8	7.4	8.9	7.5	6.9
Uganda shilling	22.2	22.7	22.9	22.9	23.2	22.8	22.0
Tanzania shilling	11.8	12.4	12.2	12.4	12.3	12.3	11.6

Source: Economic Survey, 2002

CHART 2: SHILLING EXCHANGE RATES - 2002



2.2 Overview of banking sector performance

Unlike the previous period 2000/01 when the banking sectors' total assets contracted by 2.2%, total assets increased by 7% to Ksh 456.7bn in December 2002 from Ksh 425.0bn in December 2001. Net Loans, which accounted for 49% of total assets, increased by Ksh 8.1bn to Ksh 222.8bn in December 2002 from Ksh 214.7bn in December 2001. This increase was mainly on account of additional lending to transport & communication, finance & insurance and private households.

Total assets in the sector increased by 7% as a result of Ksh 8.1bn increase in net loans....

Banks continued to shift their investments towards government securities at the expense of lending activities due to economic recession. During the period under review, government securities held by banks increased by 8.3% to Ksh 100.5bn in December 2002 from Ksh 92.8bn in December 2001, and accounted for 22% of total assets.

Due to the country's economic downturn, the sector's performance deteriorated compared with year 2001. Profits before tax declined by 35% from Ksh 8.9bn in 2001 to Ksh 5.8bn in 2002. The deterioration in the levels of profits was mainly attributed to two factors:

... however, pre-tax profits declined by 35% due to a decline in interest income and increase in operating expenses....

- A fall in interest income due to the general drop in interest rates and increased investments in lower yielding government securities;
- Increase in operating expenses especially bad debts charge and higher staff costs in year 2002 compared with 2001.

Capitalisation of the sector as measured by total capital (core and supplementary capital) stood at Ksh 53.3bn as at December 2002 down from Ksh 53.6bn in December 2001. Average total capital to total risk weighted assets ratio for the sector declined to 17.0% from 17.3% in 2001, but was above the prudential requirement of 12%.

... total capital declined marginally by 0.6% due to losses posted by some institutions

2.3 Structure of the balance sheet

2.3.1 Analysis of assets

Level and trend

Total assets of the banking system increased by Ksh 32bn from Ksh 425bn in December 2001 to Ksh 457bn as at end of December 2002. This was largely as a result of the rise in deposits by Ksh 28bn during the period under review and the reopening of Delphis Bank Ltd on December 5, 2002.

Loans remain the major asset component despite the decline in their share....

Composition and changes in assets

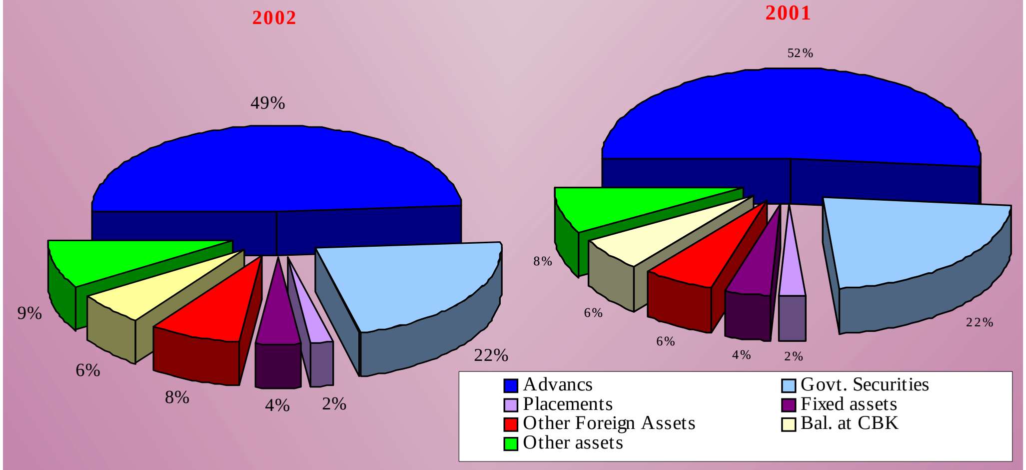
The major asset component continued to be loans that stood at Ksh 298bn (gross) in the period under review compared with Ksh 281bn as at December 2001. Net loans at the level of Ksh 222bn accounted for 49% of the sector's total net assets; compared with 51% in the previous year. The other significant item is government securities that accounted for 22%. Although other foreign assets accounted for only 8% of total assets, there was a significant increase of Ksh 10bn during the year. This growth calls for increased emphasis in foreign exchange risk management.

TABLE 5: BALANCE SHEET MOVEMENTS - ASSETS

Ksh'million'

	2002		2001		2000		1999	
Assets	**Amount**	**%**	**Amount**	**%**	**Amount**	**%**	**Amount**	**%**
Cash	10,358	2%	8,943	2%	9,754	2%	7,208	2%
Balances at CBK	25,896	6%	26,511	6%	26,119	6%	29,359	7%
Placements	9,930	2%	10,016	2%	14,536	3%	17,765	4%
Government Securities	100,458	22%	92,781	22%	71,923	17%	67,928	16%
Investments	5,576	1%	4,986	1%	3,815	1%	4,423	1%
Domestic Loans	183,084	40%	178,435	42%	192,563	44%	223,760	54%
Foreign Loans	39,690	9%	36,248	9%	33,736	8%	5,856	1%
Other Foreign Assets	36,152	8%	25,762	6%	35,043	8%	21,320	5%
Fixed assets (Net)	16,864	4%	18,608	4%	18,652	4%	18,655	4%
Other assets	28,683	6%	22,673	5%	28,397	7%	21,592	5%
Total assets	**456,691**	**100%**	**424,963**	**100%**	**434,538**	**100%**	**417,866**	**100%**

CHART 3: GLOBAL BALANCE SHEET



Source: Economic Survey, 2002

It is noted from Table 5 and Chart 3 above that there has been a general decline in the proportion of loans in banks' balance sheets. With the anticipated upturn in the country's economic performance, this trend is expected to reverse, thus enhancing the intermediary role of banking institutions.

Credit distribution to the private sector

Credit to most sectors increased in the period under review compared with a decline in the previous year. The major increase was in lending to private households and to the Transport and Communications sub-sectors. The

... renewed emphasis on personal loans has increased lending to private households....

TABLE 6: SECTORAL DISTRIBUTION OF CREDIT

SECTOR	2002 Credit Amt Ksh bn	2002 Credit % of Total	2002 Contribution to GDP Amt Ksh bn	2002 Contribution to GDP % of Total	2001 Credit Amt Ksh bn	2001 Credit % of Total	2001 Contribution to GDP Amt Ksh bn	2001 Contribution to GDP % of Total	Annual Change Credit Amt Ksh bn	Annual Change GDP Amt Ksh bn
1 Agriculture	24.9	10.0	25.5	28.2	22.9	9.7	25.2	28.7	2.0	0.3
2 Manufacturing	50.6	20.4	13.7	15.2	49.9	21.1	13.6	15.5	0.7	0.1
3 Trade & Hotels	41.5	16.7	13.3	14.7	46.8	19.8	13.2	15.0	-5.3	0.1
4 Finance, Insurance, Real Estate & Bus. Serv.	66.3	26.7	11.2	12.4	63.5	26.8	11.1	12.6	2.8	0.1
5 Transport & Communications	16.7	6.7	6.6	7.3	9.9	4.2	6.5	7.4	6.8	0.1
6 Building & Construction	20.0	8.1	2.6	2.9	20.1	8.5	2.5	2.8	-0.1	0.1
7 Private households	18.1	7.3	3.1	3.4	10.2	4.3	3.1	3.5	7.9	0
8 Other Services	10.2	4.1	14.3	15.8	13.6	5.7	12.6	14.4	-3.4	1.7
9 Total	248.3	100.0	90.3	100.0	236.9	100.0	87.8	100.0	11.4	2.5

CHART 4.1: CREDIT DISTRIBUTION - PRIVATE SECTOR

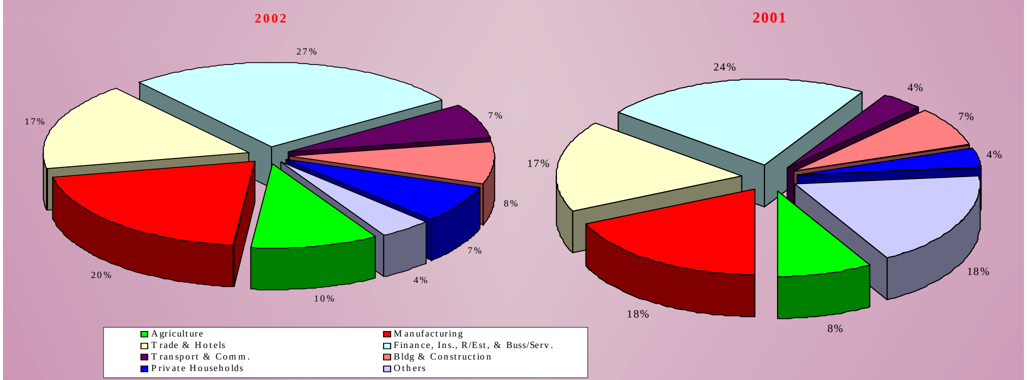
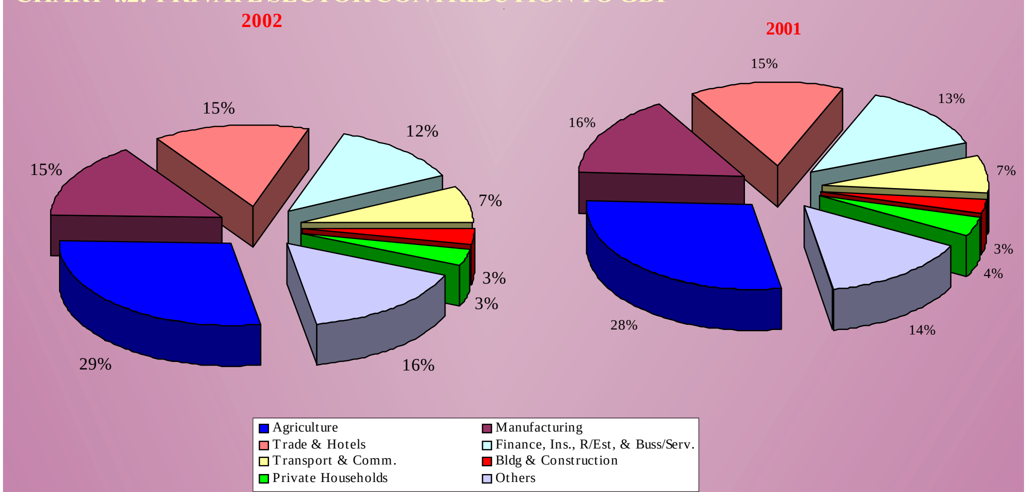


CHART 4.2: PRIVATE SECTOR CONTRIBUTION TO GDP



Source: Economic Survey, 2002

increased lending to private households rose from renewed emphasis on personal loans by the major banks in the industry.

... while the agricultural sector, which contributes 20% to GDP, received 10% of total credit

In terms of contribution to Gross Domestic Product (GDP), agricultural sector, which is the backbone of the country's economy, received Ksh 25bn or 10% of total credit to the private sector, yet it contributed 25.5% of GDP. On the other hand, the financial services sub-sector consumed the highest proportion of private sector credit, but only contributed 11% of GDP. This imbalance is attributed to perceived credit risks in the agricultural sub-sector.

2.3.2 Analysis of liabilities

Level and trend

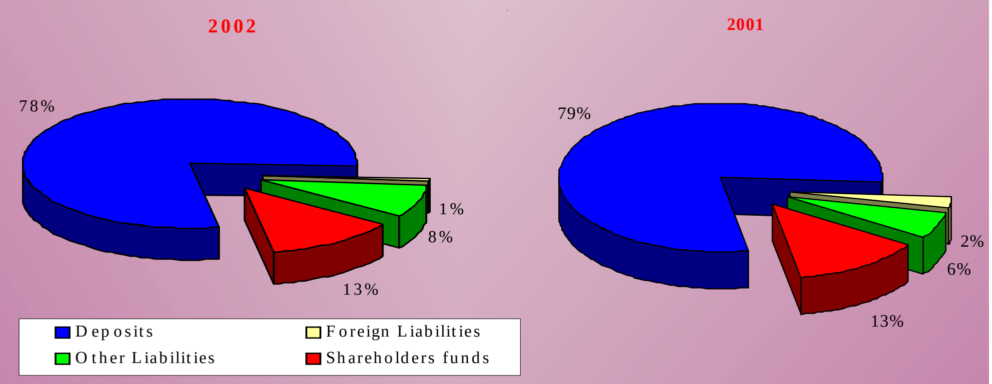
Total liabilities stood at Ksh 404bn, an increase of 10% from Ksh 368bn as at December 31, 2001. This increase was mainly due to the rise in deposit liabilities that went up by 8% from Ksh 333bn to Ksh 361bn in the period under review.

TABLE 7: BALANCE SHEET MOVEMENTS - LIABILITIES

Ksh'million'

	2002		2001		2000		1999	
	Amount	%	Amount	%	Amount	%	Amount	%
Liabilities								
Local Currency Deposits	304,026	67%	283,591	67%	326,703	75%	305,862	73%
Foreign Currency deposits	56,616	12%	48,977	12%	N/A	N/A	N/A	N/A
Accrued Interest	1,945	0%	3,035	1%	3,797	1%	5,206	1%
Foreign Liabilities	5,994	1%	7,730	2%	9,386	2%	21,925	5%
Other Liabilities	35,208	8%	25,097	6%	38,831	9%	37,721	9%
Total Liabilities	**403,789**	**88%**	**368,430**	**87%**	**378,717**	**87%**	**370,714**	**89%**
Net Assets / Liabilities	**52,900**	**12%**	**56,533**	**13%**	**57,072**	**13%**	**47,152**	**11%**
Capital & Reserves								
Paid-up Assigned Capital	30,088	7%	30,569	7%	42,344	10%	27,361	7%
Reserves	20,562	5%	20,389	5%	10,742	2%	19,791	5%
P & L Account	2,250	0%	5,575	1%	3,986	1%	-	0%
Total Shareholders Funds	**52,900**	**12%**	**56,533**	**13%**	**57,072**	**13%**	**47,152**	**11%**

CHART 5: GLOBAL BALANCE SHEET MOVEMENTS - LIABILITIES



Source: Economic Survey, 2002

Composition and changes in liabilities

Deposit liabilities continued to be the primary source of funding in the banking sector, and hence their safety remains the principal focus of Bank Supervision Department. There was a notable decline in foreign liabilities during the year, which was mainly attributed to maturing foreign lines of credit that were not being renewed.

Despite decline in foreign liabilities, customer deposits continued to be the single largest source of funds

Analysis of deposits by source and type

The analysis of deposits by source and type is as shown in Table 8.

TABLE 8: DEPOSITS BY SOURCE AND TYPE

Ksh 'million'

				2002			
	Source / Type	Demand	Call	Time	Savings	Total	%
1	Government	4,081	262	463	47	4,853	1
2	Parastatals	10,061	1,301	8,921	59	20,342	6
3	Banking Institutions	1,498	908	2,043	15	4,464	1
4	Co-operative Soc./ Insu.Co.'s	3,924	574	6,552	2,320	13,370	4
5	Private Enterprise	40,133	7,866	22,508	7,071	77,578	23
6	Non-profit Institutions & Indivi.	61,513	11,317	69,509	72,702	215,041	64
	TOTALS	#####	22,228	109,996	82,214	335,648	100
	Percentage of Total	36	7	33	24	100	
				2001			
	Source / Type	Demand	Call	Time	Savings	Total	%
1	Government	3,920	80	1,180	45	5,225	2
2	Parastatals	10,171	2,388	11,829	78	24,466	8
3	Banking Institutions	1,891	424	3,559	127	6,001	2
4	Co-operative Soc./ Insu.Co.'s	4,300	993	5,639	1,771	12,703	4
5	Private Enterprise	36,317	9,087	21,492	7,568	74,464	23
6	Non-profit Institutions & Indivi.	51,620	12,772	68,809	67,653	200,854	62
	TOTALS	#####	25,744	112,508	77,242	323,713	100
	Percentage of Total	32	8	34	23	96	

NB: * Excludes accrued interest on deposits, inter - bank balances and balances on foregn currency accounts for non-residents

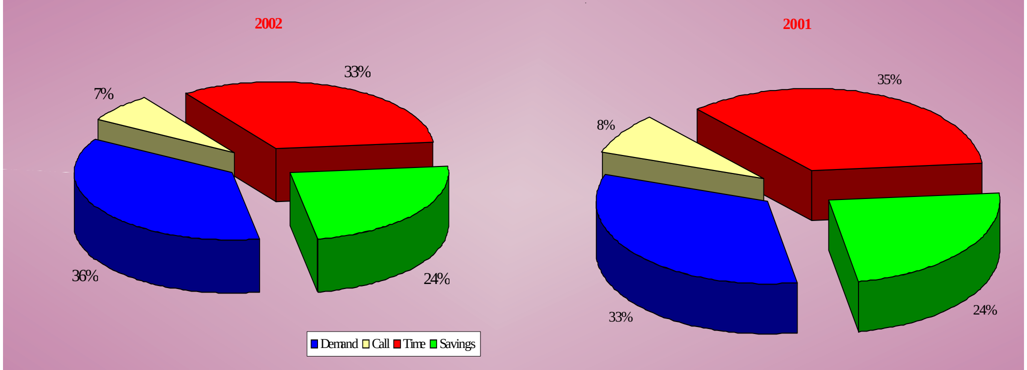
Non-profit institutions and individuals continued to be highest source of deposits. Deposits from this source stood at Ksh 215bn and accounted for 64% of total deposits. Government and parastatal deposits declined by Ksh 4.5bn indicating a shift in practice on investment of surplus funds. There was a marked increase in demand and savings deposits and a concurrent decline in time and call deposits during the year. This is attributed to the unattractive interest rates offered on term deposits. As shown in Appendix III, average cost of deposits fell from 5.7% in 2001 to 4.5% in 2002.

Non-profit making institutions and individuals continue to be the highest source of deposits

2.3.3 Capital and reserves

Capital and reserves for the sector stood at Ksh 52.9bn, having declined by Ksh 3.6bn from Ksh 56.5bn as at December 2001. This decline is attributed to significant losses made by one institution and dividend payouts from previous year's profits.

CHART 6: DEPOSITS BY SOURCE & TYPE



Source: Economic Survey, 2002

2.4 Structure of profit and loss account

2.4.1 Overview

Pre-tax profits declined due to poor economic performance, increased operating expenses and decline in the Treasury bill rate....

The performance of the banking sector in terms of profitability declined. Pre-tax profits declined by 35% from Ksh 8.9bn in 2001 to Ksh 5.8bn in 2002. The decline in profitability in the banking sector is attributed to the following factors:

- Poor performance of the economy that saw bad debt charge increase by Ksh 3.3bn from Ksh 7.7bn in 2001 to Ksh 11.0bn in 2002;
- Increase in staff and other restructuring costs as institutions continued with their staff and branch rationalization and other restructuring processes; and
- Decline in Treasury bill rate from 11% in December 2001 to 8.4% in December 2002 and lending rates from 20% to 18.6% over the same period due to high liquidity in the market and depressed economy.

Out of 49 institutions that were in operation, 42 made an aggregate profit of Ksh10.5bn while the remaining 7 made an aggregate loss of Ksh 4.7bn. The profitability of the sector is given in Appendix VI.

2.4.2 Income

.... despite its decline in contribution to income, interest income on loans remain the biggest source of income....

Total income of the banking industry increased marginally by 1.3% from Ksh 61.4bn in 2001 to Ksh 62.2bn in 2002 as shown in Appendix III. Interest on loans remained the major source of income although its contribution to total income declined from 49% in 2001 to 45% in 2002. The decline in interest income from loans is explained by poor performance of the economy, which resulted in high level of interest being suspended. Interest from government securities increased from Ksh 10.6bn in 2001 to Ksh 11.5bn in

2002. The contribution of interest income from government securities increased from 17% in 2001 to 18% in 2002.

... while contribution of fees and commission to total income has increased to 34%

Income from other sources, including fees and commissions, foreign exchange gains and other interest income increased from Ksh 18.7bn in 2001 to Ksh 21.2bn in 2002. Its contribution to total income increased from 31% in 2001 to 34% in 2002. This is a reflection of a deliberate move by banking institutions to shift away from traditional sources of income to more innovative fee and commission-based services. This move has been prompted by poor performance of the economy and declining lending rates.

2.4.3 Expenses

Salaries and wages expenses now exceed interest paid on deposits

Total expenses increased from Ksh 52.6bn in 2001 to Ksh 56.4bn in 2002. This year, salaries and wages have now exceeded interest expense on deposits. Staff costs increased from Ksh 13.5bn in 2001 to Ksh 15.7bn in 2002 and accounted for 29% of total expenses as compared with 26% in 2001. The main reason for the increase was restructuring costs incurred by some banks in their staff rationalisation programs.

Interest expense dropped from Ksh 16.7bn in 2001 to Ksh 13.9bn. Interest on deposits accounted for 22% of total expenses having declined from 30% in the 2001. The decline in interest on deposits was due to lower interest rates offered by banking institutions. As a percentage of total income, interest expense fell from 27% in 2001 to 23%. Provisions for bad and doubtful debts as a percentage of total income increased from 12.6% in 2001 to 17.7%, as shown in Table 9 below.

TABLE 9: INCOME AND EXPENDITURE ITEMS AS A PERCENTAGE OF INCOME

Income	2002 *%	2001 *%	2000 *%	1999 *%	1998 *%
Interest on advances	45.4	49.2	52.5	59.4	64.6
Interest on government securities	18.3	17.2	14.9	13.0	14.1
Interest on placements	2.1	3.1	4.9	3.9	4.3
Other income	34.2	30.5	27.7	23.7	17.0
Total Income	100.0	100.0	100.0	100.0	100.0
Expenses					
Interest expenses	22.7	27.3	29.1	29.9	47.2
Bad debts charge	17.7	12.6	20.2	23.4	15.1
Salaries and wages	25.2	21.9	22.6	21.3	15.0
Other expenses	25.0	23.8	23.9	25.2	17.9
Total expenses	90.6	85.6	95.8	99.8	95.2
Profit before tax	9.4	14.4	4.2	0.2	4.8

Income and expenditure items as a percentage of total income.

CHART 7.1: INCOME AS A PERCENTAGE OF TOTAL INCOME

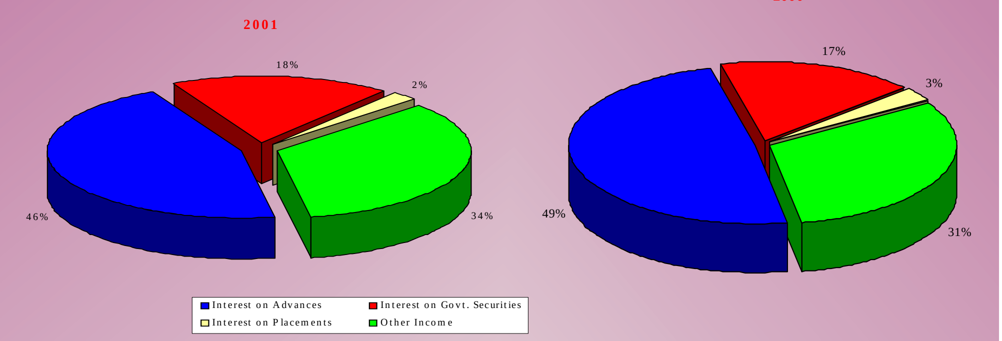
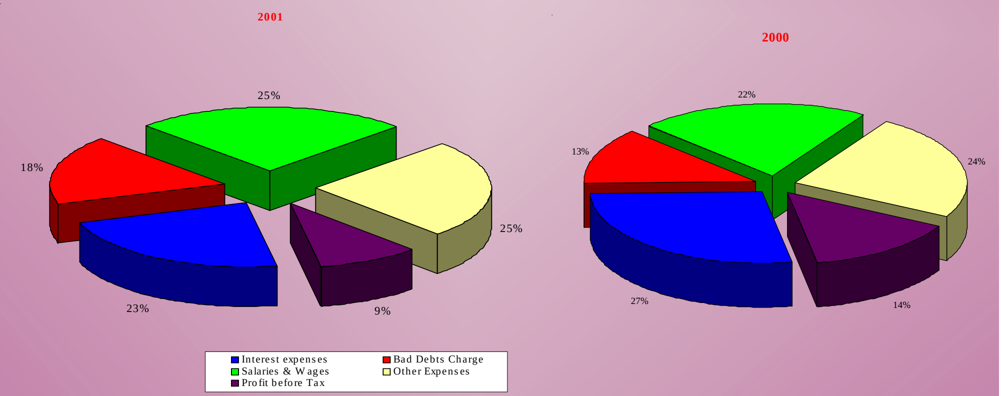


CHART 7.2: EXPENSES AS A PERCENTAGE OF TOTAL INCOME



Source: Economic Survey, 2002

2.5 Market share

69% of the banking system's net assets are controlled by 7 banks in peer group I

The banking system consisted of 45 commercial banks and 5 non-bank financial institutions (NBFIs). These institutions were grouped into 5 peer groups on the basis of net assets as shown in Tables 10 and 11.

TABLE 10: BANKS RANKING BY ASSETS AND DEPOSITS AS AT DECEMBER 2002

Peer Group	Asset Range Ksh' bn	Number of Institutions	Net Assets Ksh' bn	Market Share	Deposits Ksh' bn	Market Share	Pre-Tax Profits Ksh' bn	Pre-Tax Profits Market Share
1	Over 10	7	305.3	69.4%	245.5	70.7%	4,537.1	80.6%
2	5-10	7	51.5	11.7%	40.2	11.6%	1,040.6	18.5%
3	3-5	13	51.7	11.7%	42.2	12.1%	841.0	14.9%
4	1-3	15	29.0	6.6%	18.0	5.2%	- 775.6	-13.8%
5	0-1	3	2.3	0.5%	1.2	0.3%	- 13.5	-0.2%
GRAND TOTAL		45	439.8	100.0%	347.0	100.0%	5,629.6	100.0%

Source: Published Audited Accounts

The 7 banks in Peer Group 1 with a total asset base of Ksh 305bn accounted for 69% of the banks' total assets. These banks contributed 81% of the banks' total pre-tax profits. The remaining 38 banks, with a net asset base of Ksh 135bn, accounted for 31% of the banks' total assets and contributed 19% of the banks' pre-tax profits.

In terms of deposits, the 7 banks in Peer Group 1 accounted for 71% of total deposit liabilities, whereas the remaining 38 banks held only 29% of the deposits.

TABLE 11: NBFIs RANKING BY ASSETS AND DEPOSITS AS AT DECEMBER 2002

Peer Group	Asset Range Ksh' bn	Number of Institutions	Net Assets Ksh' bn	Market Share	Deposits Ksh' bn	Market Share	Pre-Tax Profits Ksh' bn	Pre-Tax Profits Market Share
1	Over 10	1	10.4	61.7%	9.0	65.9%	94.7	61.6%
2	5-10	0	0.0	0.0%	0.0	0.0%	0.0	0.0%
3	3-5	1	3.7	22.0%	2.8	20.3%	-62.0	-40.3%
4	1-3	1	2.4	14.5%	1.9	13.8%	84.3	54.8%
5	Less than 1	2	0.3	1.8%	0.0	0.1%	36.7	23.9%
GRAND TOTAL		5	16.9	100.0%	13.6	100.0%	153.7	100.0%

Source: Published Audited Accounts

With respect to NBFIs there was only one institution in Peer Group 1 with net asset base of Ksh 10.4bn. This institution controlled 62% of the total net assets, 66% of the deposits and contributed 62% of pre-tax profits by NBFIs.

Banking system is oligopolistic in structure ....

The structure of the banking system in Kenya can be described as oligopolistic as it is dominated by only 7 banks and 1 mortgage finance company in Peer Group 1. Out of the 7 banks in the Peer Group, 2 contributed 102% of the total banks' pre-tax profits with one bank making a loss of Ksh 3.2bn that accounted for negative 57% of the aggregate pre-tax profits and losses. The two banks have a combined market share of 34%, 32%, 35% and 29%, respectively, in terms of net assets, loans, deposits and capital plus reserves. The skewed distribution in pre-tax profits is attributed to the fact that 3 out of 7 banks in Peer Group 1 have very high levels of NPLs that have impaired their profitability. The 3 banks' aggregate NPLs accounted for 63% of the banks' total non-performing loans. Details of the market share are shown in Appendix IV.

2.6 Year-end performance rating

Banking sector performance is assessed in terms of several prudential ratios. The current rating system is based on an internationally recognized system called CAMEL, an acronym for Capital adequacy (C), Asset quality (A), Management (M), Earnings (E) and Liquidity (L).

A description of the CAMEL measurements used for analysis is as follows:

- Capital adequacy is determined using a ratio of Total Capital to Total Risk Weighted Assets;
- Asset quality is determined using a ratio of NPLs to Gross Loans;
- Management is evaluated in terms of compliance with good corporate governance principles;
- Earnings is determined using a ratio of Profit Before Tax to Gross assets, including contingent items; and
- Liquidity is determined using a ratio of Net Liquid Assets to Net Deposit Liabilities.

An overall (composite) rating is worked out using all the above parameters. Each institution is then rated and categorized as follows:

Strong (1) - Good performance in all parameters.

Satisfactory (2) - Good performance in most parameters.

Fair (3) - Average performance.

Marginal (4) - Below average performance in some of the parameters.

Unsatisfactory (5) - Poor performance in most parameters and violates minimum statutory requirements.

... overall performance of the sector remained fair

The overall rating in 2002 remained Fair as in 2001. The number of institutions rated unsatisfactory declined from four in 2001 to one in 2002 as shown in Table 12 below.

TABLE 12: YEAR END OVERALL PERFORMANCE RATINGS - BANKS AND NBFIs

	2002			2001		
CATEGORY	Number of Institutions	Net Assets Ksh bn	%	Number of Institutions	Net Assets Ksh bn	%
STRONG	6	21.3	4.7	8	19.7	4.6
SATISFACTORY	25	247.3	54.1	21	242.5	57.1
FAIR	11	83.9	18.4	14	54.4	12.8
MARGINAL	7	103.5	22.7	4	78.1	18.4
UNSATISFACTORY	1	0.8	0.2	4	30.3	7.1
TOTALS	50	456.7	100.0	51	425.0	100.0
OVERALL		FAIR			FAIR	

Source: Published Audited Accounts

2.6.1 Capital Adequacy

Capital provides a cushion to depositors and creditors against losses likely to arise from banking operations and uncollectable loans. Its adequacy is evaluated in terms of:

- Absolute minimum core capital required to be maintained by all institutions licensed under the Banking Act. As at the end of year 2002 the minimum amount was Ksh 350m for banks and mortgage finance companies and Ksh 262.5m for NBFIs;
- Minimum ratio of core capital to deposits at8%;
- Minimum ratio of core capital to risk weighted assets ratio is 8%; and
- Minimum total capital (core and supplementary) to risk weighted assets ratio at 12%.

Institutions rated unsatisfactory did not constitute a significant proportion of the sector, as they had a market share of only 0.5% in terms of net assets. In addition, the number of institutions in this category declined from eight in 2001 to four, as shown in Table 13 below.

institutions with capital rated "unsatisfactory" control only 0.5% of the sector's assets

TABLE13: YEAR END CAPITAL ADEQUACY RATING - BANKS AND NBFIS (AUDITED)

	2002			2001		
Performance Category	Number of Institutions	Net Assets Ksh bn	%	Number of Institutions	Net Assets Ksh bn	%
STRONG	33	128.6	28.2	33	123.4	29.0
SATISFACTORY	4	42.1	9.2	5	131.2	30.9
FAIR	5	190.0	41.6	4	126.3	29.7
MARGINAL	3	92.5	20.2	1	11.6	2.7
UNSATISFACTORY	5	3.5	0.8	8	32.5	7.6
TOTALS	50	456.7	100.0	51	425.0	100.0
OVERALL RATING	SATISFACTORY			SATISFACTORY		

Source: Published Audited Accounts

2.6.2 Asset quality

Overall asset quality

Asset quality rating for the industry improved to marginal from unsatisfactory in 2001 as seen in Table 14 below.

TABLE 14: YEAR END ASSET QUALITY RATINGS - BANKS AND NBFIs

Performance Category	2002 Number of Institutions	2002 Net Assets Ksh bn	2002 Net Assets %	2001 Number of Institutions	2001 Net Assets Ksh bn	2001 Net Assets %
STRONG	16	87.1	19.1	14	64.7	15.2
SATISFACTORY	10	187.8	41.1	9	171.6	40.4
FAIR	9	82.6	18.1	10	55.0	12.9
MARGINAL	5	15.5	3.4	7	38.0	8.9
UNSATISFACTORY	10	83.8	18.3	11	95.7	22.5
TOTALS	50	456.7	100.0	51	425.0	100.0
OVERALL RATING		MARGINAL			UNSATISFACTORY	

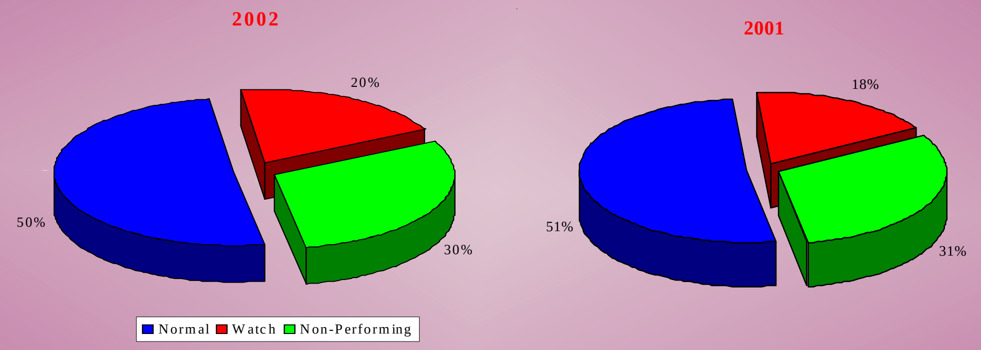
** Total NPLs exclude interest in suspense*

The table shows that 10 institutions, whose asset quality was rated unsatisfactory, controlled only 18% of the sector's net assets, a decline from 11 institutions that controlled 23% of the sector's net assets in 2001.

... NPLs also increased by 5%

The stock of NPLs in the sector increased to Ksh 77.0bn in December 2002 from Ksh 73.6bn in the previous year. As shown in Appendix VIII, although the level of NPLs increased, the banking institutions cushioned themselves against potential losses by making specific provisions of Ksh 33.1bn for the NPLs. The estimated realisable value of securities of Ksh 42.6bn together with provisions held, left a net exposure of Ksh 1.3bn, which the sector may have to provide for in future.

CHART 8: RISK CLASSIFICATION OF LOANS



Source: Economic Survey, 2002

2.6.3 Management

Over the past years, the Department was using CAEL to rate institutions in the sector, leaving out the management (M) component. Owing to the importance of management in determining the overall performance of the sector, the rating of management was implemented during the year after a period of trial runs, thus leading to a complete CAMEL rating. Only 3 institutions were rated strong as shown in Table 15 below. In arriving at the management rating, the following corporate governance issues were considered:

Management rating was incorporated in the "CAMEL" rating owing to its importance in determining the overall performance of institutions

- Shareholders' effectiveness is electing an effective board of directors;
- Board of directors and senior management oversight;
- Adequacy of policies and procedures;
- Risk monitoring and management information systems;
- Implementation of Central Bank inspection recommendations;
- Adequacy of internal controls; and
- Other CAMEL ratings.

TABLE 15: MANAGEMENT RATINGS - BANKS & NBFIs

	2002		
Performance Category	Number of Institutions	Net Assets Ksh bn	%
STRONG	3	101.5	22.2
SATISFACTORY	22	184.4	40.4
FAIR	19	162.2	35.5
MARGINAL	4	6.5	1.4
UNSATISFACTORY	2	2.1	0.4
TOTALS	50	456.7	100.0

*NB: * Comparative figures for year 2001 not available*

Source: Central Bank of Kenya, On-site Inspection Reports

2.6.4 Earnings

The earnings rating remained fair as in 2001 despite the decline in the sector's pre-tax profits. Institutions whose earnings are rated strong increased from 7 to 10 while those rated unsatisfactory declined from 10 to 8 as shown in Table 16 below.

Earnings rating remained "fair" despite decline in pre-tax profits....

.... while liquidity rating remains "strong"

2.6.5 Liquidity

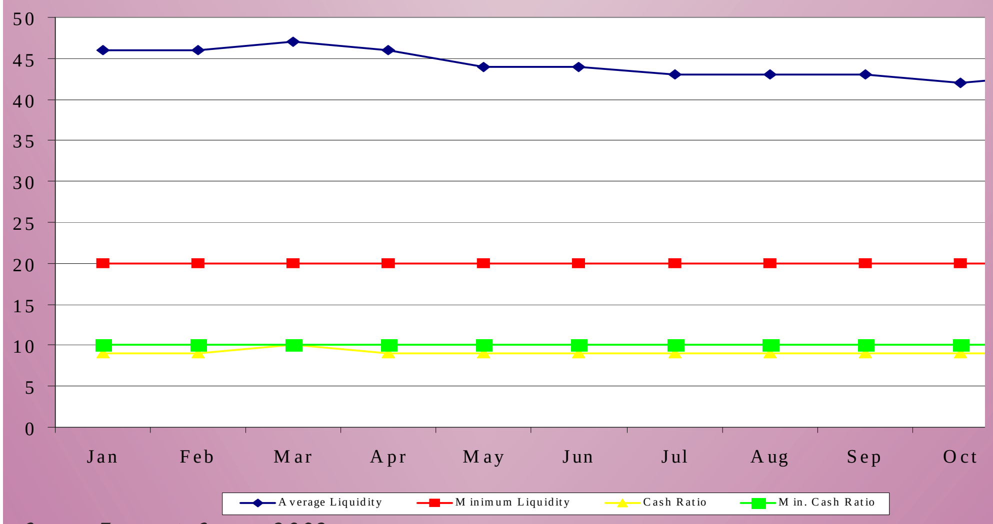
The overall liquidity at an average of 43.8% was rated strong as in 2001. Majority of institutions were rated strong as shown in Table 17 below. The high liquidity position in the sector was due to the fact that banks have continued to keep a relatively high proportion of their assets in government securities.

TABLE 16: YEAR END EARNINGS RATINGS - BANKS AND NBFIs

	2002			2001		
Performance Category	Number of Institutions	Net Assets Ksh bn	%	Number of Institutions	Net Assets Ksh bn	%
STRONG	10	75.6	16.6	7	140.0	32.9
SATISFACTORY	3	17.8	3.9	11	51.0	12.0
FAIR	17	155.4	34.0	10	52.9	12.4
MARGINAL	11	108.0	23.6	13	103.2	24.3
UNSATISFACTORY	9	100.0	21.9	10	77.9	18.3
TOTALS	50	456.7	100.0	51	425.0	100.0
OVERALL RATING	MARGINAL			FAIR		

Source: Published Audited Accounts

CHART 9: LIQUIDITY & CASH RATIOS - 2002



Source: Economic Survey, 2002

Chapter 3

Developments Related To Banking Legislation

3.1 Overview

Effective supervision and regulation of the banking sector requires that the applicable legal framework be regularly updated. The Bank Supervision Department facilitates amendments of the pertinent laws and regulations, in order to ensure that the applicable legislation and regulation remain in line with the latest international developments and standards. Over the last few years, extensive amendments have been made to the Banking Act and Building Societies Act, to strengthen the supervisory function of the Central Bank.

Effective supervision requires regular update of legal framework to conform with the ever-changing business and economic environment ....

3.2 Amendments to legislation during the year

The Finance Act 2002 revised the Building Societies Act (Cap. 489) by amending section 55A to enable building societies interested in converting to, or merging with, institutions licensed under the Banking Act to do so, without the many legal hurdles that societies faced in the transfer of their assets and liabilities to the resulting institution.

.... powers to approve transfer of building societies business to a company are now vested in the Minister for Finance.

The Building Societies Act was further amended by relinquishing the powers of the Registrar of Societies relating to the provisions of section 55A. As a result, the powers to approve transfer of building societies business to a company are now vested in the Minister for Finance.

There were no amendments made to the Banking Act (Cap. 488) in the year 2002.

3.3 Regulations and circulars issued by the Central Bank of Kenya

3.3.1 Publication of quarterly un-audited financial statements

Institutions licensed under the Banking Act and the Building Societies Act were required to publish their quarterly un-audited financial statements with effect from June 30, 2002. This regulation will ensure that stakeholders have more frequent access to financial information on individual institutions.

3.3.2 Banking circulars

During the year under review, the Department issued circulars as detailed in Appendix 10.

3.4 Proposed changes in legislation

3.4.1 Supervisory autonomy of the Central Bank

A number of operational functions of the Central Bank of Kenya still require the Minister's involvement

The Basel Core Principles for Effective Banking Supervision recommend that supervisory authorities be fully independent in the discharge of their functions. For this reason, many countries across the world have granted their Central Banks powers to regulate and supervise the financial sector without reference to the Ministry for Finance. Both Bank of Tanzania and Bank of Uganda have the full supervisory authority and Kenya has been requested to consider implementation, as part of the harmonization process of banking laws within the East African region. In Kenya, various sections of the Banking Act require the Minister's involvement in a number of operational functions relating to the banking sector. In order to enhance autonomy of the Central Bank, it is anticipated sections of the Banking Act will require amendment to enable the Minister cede the relevant powers to the Central Bank.

3.4.2 Use of the term "bank"

The Banking Act currently prohibits the use of the term bank by entities other than those licensed under the Act. It has been proposed that section 3 (1) of the Banking Act be amended to allow investment banks licensed by the Capital Markets Authority (CMA) to use the term "bank".

3.4.3 Operations of the Deposit Protection Fund Board (DPFB)

A number of amendments to the Banking Act were proposed for purposes of enhancing the effectiveness of the DPFB in the discharge of its duties. These related to its ability to wind up institutions promptly, efficient discharge of litigations, and ability to borrow from the Central Bank.

Chapter 4

Current Supervisory Issues

4.1 International Financial Reporting Standards

4.1.1 Overview

International Financial Reporting Standards (IFRS) have been widely adopted globally, due to the recognised need to harmonize financial reporting internationally. In Kenya, the Institute of Certified Public Accountants of Kenya (ICPAK) issued a circular in 1998 advising its members to start adopting IFRS from the financial year commencing on or after January 1, 2000. Early adoption was, however, encouraged.

IFRS have been widely adopted in recognition of the need to harmonize financial reporting and comparison

In 1998, the banking sector in Kenya started adopting IFRS although the level of compliance was minimal. However, with more consultations taking place between ICPAK and the Central Bank, tremendous progress in the level of compliance has been achieved.

The importance of adoption of IFRS in the banking sector is that:

- Institutions are required to disclose more information in their published financial statements, which leads to enhanced market discipline; and
- They facilitate accurate and transparent financial statements that are consistent and comparable across borders.

4.1.2 Highlights on IFRS 39: Financial instruments, recognition and measurement

During the year 2002, institutions continued adopting IFRS 39 in their reporting. The level of compliance with this standard, which establishes principles for recognition, measuring and disclosing information about financial assets and liabilities was higher compared to the year 2001. This was due to clarifications made by ICPAK, through Technical Guideline No. 2 of 2002.

There was increased compliance with IFRS 39

4.1.3 Highlights on IFRS 17: Accounting for leasehold land

In the past, institutions, just like other entities, were grouping leasehold land together with buildings in the balance sheet. The practice was that land was not being depreciated. The Standard requires that all leasehold land which was previously classified as finance lease be separated from the buildings and be disclosed at cost in the balance sheet as prepaid operating lease rentals to be amortised over the period of the lease. Previously, leasehold land was accounted for under IFRS 16 on property and equipment.

Highlights on IFRS 40: Accounting for Investment Property

The Standard prescribes the accounting treatment for investment property and related disclosure requirements. It became effective for financial statements covering periods beginning on or after January 1, 2001.

Investment property under IFRS 40 is defined as property (land or a building or both) held to earn rentals or for capital appreciation or both. Investment property does not include property held for use in production, administration purposes or for sale in the ordinary course of business. The Standard replaced the previous requirements of IFRS 25; Accounting for Investments, which allowed enterprises to choose from among a variety of accounting treatments for investment property.

Despite IFRS 40, institutions have to comply with legal and prudential reguirements

The effect of the Standard is to separate property held for investment purposes from the general classification of property, plant and equipment and resultant effect on financial and regulatory ratios. Institutions will need to ensure compliance with provisions of section 12(c) of the Banking Act, which limits the extent of investments held by institutions. In addition, the prudential limit of restricting revaluation reserves included in core capital to 25% after approval from the Central Bank will continue to apply, as per Prudential Regulation No. CBK/RG/01.

4.1.4 Initiatives by the Central Bank to enhance compliance with IFRS

The main initiatives being taken by the Central Bank to encourage compliance with IFRS include:

- Holding of tripartite meetings between banks, external auditors and the Central Bank to discuss the financial statements before they are published;
- Issuing of new regulations and circulars and revision of existing ones to ensure compliance; and
- Making disclosures of some items mandatory.

4.2 Implementation of Basel Core Principles (BCP) for Effective Banking Supervision

The Basel Committee for Banking Supervision (BCBS) developed 25 Basel Core Principles for Effective Banking Supervision (BCP) in 1997 to provide the basic framework required to supervise the banking sector. The Committee possesses no formal supervisory authority, and therefore the recommendations were never intended to have legal force but they nevertheless provide statements and guidelines of best practice applicable in general to the banking industry all over the world.

4.2.1 Progress on implementation

The IMF and the World Bank had by end of 2001 conducted BCP compliance assessments of 60 countries using the Methodology developed by the BCBS. By the end of 2002, Kenya had not been subjected to this independent assessment, and the Department therefore continued to rely on its self-assessment tests. However, Kenya will be subject to the BCP compliance assessment in the forthcoming FSAP scheduled for 2003.

Department has continued to rely on self-assessment tests and continues to identify weaknesses that hinder full implementation of BCP

During the year under review full compliance had not been achieved in the following core principles:

- **Core Principle 1(2)** - although the rules and objectives of the supervisory authority are well spelt out in the Kenyan legislation, and powers to grant/withdraw licenses and enforce rules and regulations and to share information are in place, the only exception is that the supervisor lacks legal operational independence.

- **Core Principle 5** - requires that criteria for reviewing a bank's major acquisitions or investments be in place. In Kenya, the Banking Act limits new acquisitions and investments in relation to core capital, but the Central Bank does not grant approval for acquisition.

- **Core Principle 8** - requires that banks establish and adhere to adequate policies for evaluating the quality of assets and adequacy of loan loss provisions. In order to minimize the likelihood of under-provisioning in the industry, the provisioning guideline is continuously being revised.

- **Core Principle 11** - this calls for the existence of adequate policies and procedures in banks for identifying, monitoring and controlling country risk and maintaining reserves against such risks. Many institutions are not active in international lending and investment activities. Currently, there is no requirement for maintaining reserves against country risks.

- **Core Principle 12** - requires accurate measurement, monitoring and controlling market risk and maintaining reserves against such risks. Currently, there is no requirement to maintain reserves against market risks.

- **Core Principle 13** - requires existence of comprehensive risk management processes in banks to identify, measure, monitor and control all other material risks and, where appropriate, to hold capital against these risks. Most banks have adequate risk management frameworks but there is no requirement to hold capital against these risks.

- **Core Principle 15** - relates to adoption of policies by banks to prevent money laundering. The existing systems are not comprehensive but efforts have been initiated to put in place comprehensive legislation.

- **Core Principle 18** - that off-site analysis of prudential reports and submission of statistical returns from banks be done on a solo and consolidated basis. Not many of our institutions have subsidiaries in non-banking fields, hence consolidated supervision and analysis have not been adopted.

- **Core Principle 20** - relates to supervision of banking groups on consolidated basis. Only a few complex banking groups exist in Kenya, hence the need for consolidated supervision is not compelling at the moment.

- **Core Principle 22** - requires that timely remedial measures be taken against institutions for non-compliance. Though there are adequate legal powers in place, corrective action has not always been prompt.

Although there are adequate legal powers in place, corrective action has not always been prompt

- **Core Principle 23** - requires that supervisors should practise global consolidated supervision over internationally active banking organizations. Global consolidated supervision has not been implemented because there are only a few banks with foreign presence whose operations have not been considered significant.

- **Core Principle 24** - calls for the establishment of contact and information exchange with various other involved supervisors, primarily host country supervisory authorities. Few banks have significant foreign presence hence information is only obtained on a case-by-case basis.

The Department continues identifying weaknesses in the national systems mitigating against full implementation, with a view to attaining full compliance in future.

4.3 Corporate governance in the financial sector

Corporate governance is now a topic of considerable interest to a large and expanding cross-section of the banking community. It is obviously of fundamental importance to the Central Bank, in its capacity as supervisor of the banking system. As indicated in the last annual report, the Bank has undertaken several measures to enhance corporate governance in the banking sector with effective legal and regulatory framework being put in place. During the year, banking institutions and building societies were required to publish their quarterly un-audited financial statements with effect from 30th June, 2002. This is to ensure regular, timely comprehensive, meaningful and reliable financial disclosures of an institution's affairs.

Although the Central Bank can institute certain measures to strengthen corporate governance, there are a few basic principles to which the Bank attach considerable importance and which only banking institutions themselves can institute:

- the importance of directors having a sound understanding of their institution's business, the nature of its risks and its strategic direction.
- the ultimate responsibility for ensuring that an institution's risks are being properly identified, monitored and controlled lies with the board of directors.
- a fundamental need for directors to be scrupulous in ensuring that, individually and collectively, potential conflicts or interest are avoided or at least managed in ways that do not compromise the interests of the institution.

These kinds of principles feature strongly in the Central Bank's approach to the supervision of banks.

4.3.1 Strengthening corporate governance in the financial sector

Sound corporate governance is essential to the well being of an individual institution and its stakeholders, particularly its shareholders and depositors. The financial difficulties and, in some cases, ultimate demise of many institutions have been substantially attributable to weak corporate governance. But sound corporate governance is not just a vital factor at the level of the individual institution. It is also a critical ingredient in maintaining a sound financial system. And that is why the Central Bank is placing greater emphasis on the role that corporate governance can play in promoting financial stability.

Financial health and stability of the financial system depends on corporate governance

In the financial system, corporate governance is one of the key factors that determine the health of the system and its ability to survive economic shocks. The health of the financial system much depends on the underlying soundness of its individual components and the connections between them such as the banks, the non-bank financial institutions and the payment systems. In turn, their soundness largely depends on their capacity to identify, measure, monitor and control their risks. The role of the Central Bank in strengthening corporate governance in the financial sector is therefore to review governance policies and implement appropriate reforms, such as:

- Effective structures that encourage banking institutions to have well-developed and enforced risk management systems that promote identification, monitoring and management of all material business risks;
- Well designed and enforced law, which specifies the duties and obligations of directors, the rights of shareholders and other stakeholders, disclosure and audit requirements, mechanisms for the enforcement of the law, and penalties for non-compliance;
- Strengthening market discipline on banking institutions in order to promote sound corporate governance and risk management so that prudently managed institutions are rewarded by the market and mismanaged ones take market discipline; and
- Ensure strict enforcement of banking legislation and prudential regulations.

The Central Bank supports the efforts of the Centre for Corporate Governance (CCG) and the Capital Markets Authority (CMA) in promoting effective corporate governance. The Bank takes cognisance of the fact that during the period under review, the CMA issued Corporate Governance Guidelines, 2002, while the Institute of Directors was established to rally the corporate leadership in the country into a body that advocates and fosters director professionalism and, in so doing, raise corporate governance standards to world-class levels. In addition, the Kenyan Shareholders' Association was registered in June 2002 with the aim of creating awareness of the need for good corporate governance, and to monitor and evaluate the extent, to which organizations in Kenya embark and implement good corporate governance practices and to assess the impact that this has on providing nation capacity competitiveness and efficiency.

4.3.2 Action plan for corporate governance

Central Bank has made good progress in implementing principles as set out in the checklist and in reviewing its prudential regulations to be in line with current trends in corporate governance

The Commonwealth corporate governance working-group was formed in 2000 to promote effective corporate governance in the financial sector. At a conference held in Nairobi in October/November 2000, the group set out a checklist of the policy issues that are relevant to assessing the effectiveness of corporate governance in the financial sector. The Central Bank has made considerable progress in implementing the principles as set out in the checklist. So far, about 80% of the checklist has been implemented. However, some issues remain outstanding, but shall be considered for implementation in the future following:

- Legal obligation that directors confirm the solvency of their institutions before distribution of dividends;
- Disclosures of financial and risk related information in respect of the institutions and the group;
- Disclosure of the bank's credit rating;
- Linking of deposit insurance to stringent requirements with respect to financial disclosure, corporate governance and risk management;
- Institutions to conduct periodic external assessment of own corporate governance arrangements;
- Directors to undertake professional training and courses on corporate governance before appointment as directors; and
- Requirement that institutions periodically change their auditors to enhance independence of auditors.

The Central Bank shall continue to hold seminars and workshops for directors and senior management in the banking sector. In addition, it will continue to be an active member of the Commonwealth Secretariat in promoting corporate governance issues.

4.4 International and regional cooperation

4.4.1 East and Southern Africa banking supervisors group (ESAF)

International and regional cooperation is being pursued to harmonize banking supervision philosophies and practices in member countries

ESAF is one of the several international and regional banking supervisory groups whose formation has been promoted by the Basel Committee on Banking Supervision as part of its outreach efforts. In pursuit of one of its objectives, i.e. harmonization of banking supervision philosophies and practices among member countries, staff from Kenya participated in the following ESAF activities:

- EASF workshop on the New Capital Accord in Kampala, Uganda in May 2002, facilitated by the Financial Stability Institute (FSI);
- ESAF Intermediate Course in Pretoria, South Africa in July/August, 2002;
- ESAF Heads of Supervision workshop and 12th AGM in Cape Town, South Africa in September 2002; and
- ESAF/FSI workshop in Livingstone, Zambia in October/November, 2002.

These workshops were found useful in achieving a better understanding of supervisory issues facing the region.

4.4.2 COMESA

During the 7th COMESA meeting of the Committee of Central Bank Governors held between April 5 and 7, 2002 in Swaziland, Governors agreed on harmonization of bank supervision and regulation for COMESA region. Efforts are underway to establish a framework for harmonization of regulatory and supervisory practices in the region.

4.4.3 Monetary Affairs Committee

Bank Supervisors from the three East African countries continued to pursue their common objective of strengthening the banking sector within the region and working towards harmonization of supervisory and regulatory practices for the banking sectors.

Two regional meetings were held during the year, namely, the Monetary Affairs Technical Committee Workshop (MATC) in March 2002 and the Governors' meeting of April/May 2002. The MATC workshop reviewed the New Basel Capital Accord and concerns relating to recognition of collateral in provisioning for bad and doubtful debts. The Governor's meeting made various resolutions aimed at ensuring convergence of supervisory/regulatory practices in line with the integration process in the East African Community.

4.5 Anti-money laundering and combating the financing of terrorism

The anti-money laundering and combating of financing of terrorism continue to be important national priorities. To minimize the possible consequences of anti-money laundering and terrorism, the Government has initiated some programs including development of a legal framework to combat money laundering.

4.6 Non-performing loans (NPLs)

4.6.1 Level and trend

NPLs continue to be a problem in the banking sector

The problem of NPLs in the banking sector continues to persist. The stock of NPLs in the sector increased in absolute terms to Ksh 75.7bn, but fell in relative terms to 29.7% of total loans, compared with Ksh 73.6bn or 30.1% of total loans in the previous year. As shown in Appendix VIII, although the level of NPLs increased, banking institutions cushioned themselves against the bad loans by making specific provisions of Ksh 31.3bn. In addition, institutions held securities worth Ksh 42.6bn resulting in a net exposure of only Ksh 1.8bn. Six institutions with public sector interest had an NPLs to total loans ratio of 60%, while the ratio for the other 43 institutions was only 18%.

The concentration of NPLs is high in the following 3 categories of institutions:

- Where shareholding is predominantly by the Government and the co-operative movement (public sector banks);
- Restructured and reopened banks institutions; and
- Distressed banks.

4.7 Lending rates and bank charges

Kenya's relatively high lending interest rates and bank charges have been a topical issue over the years. The business and political fraternity continue to debate these issues extensively and the consequences of the problem to the growth of the economy. Despite a decline in the average lending rate from 20% in December 2001 to 18% in December 2002, these rates are still considered relatively high. The high lending rates have adversely affected the business sector, causing default and hence the high level of NPLs in the sector. In order to mitigate against the declining interest rates and the interest foregone on NPLs, institutions have tended to increase charges on other services offered to customers. This is evidenced by an increase of Ksh 2.2bn in non-funded income during the year (see Appendix III).

4.8 Developments in the micro finance sector

4.8.1 Overview

The micro finance sector has continued to grow and most programmes have focused on group lending

Micro finance continues to be an important tool for poverty alleviation and the provision of financial services to the financial sector of the economy. Many micro finance institutions (MFIs), Savings and Credit Co-operatives (SACCOs) and other formal financial institutions, such as commercial banks and building societies are increasingly being engaged in financing of micro and small enterprises, including households. Many group lending programs are well established and account for most of the lending in the micro and small sector. These programs are continuing to grow, as the demand for micro lending and related services is still much greater than the supply, hence the need to facilitate orderly expansion of the sector to cater for the increasing demand.

4.8.2 Supervision and regulation of micro finance institutions

Regulation of MFIs is complicated by the fact that MFIs operate under different legal structures

The dialogue and consultations on developing appropriate regulatory framework for micro finance institutions, especially those that intend to take deposits, continued in the year. In October 2002, the Minister for Finance directed the Central Bank to initiate formation of a taskforce to co-ordinate the initiative of developing appropriate regulatory framework for the micro finance sector, especially micro finance institutions (MFIs), savings & credit cooperatives societies (SACCOs) and the Kenya Post Office Saving Bank (KPOSB). The Minister noted that the framework for strengthening regulation and supervision of SACCOs and KPOSB need to be considered as well.

Members of the Task Force were drawn from Treasury, Ministry of Co-operative Development (then Ministry of Agriculture and Rural Development), The Co-operative Bank of Kenya, K-REP Bank, KPOSB, Kenya Union of Savings and Credit Co-operatives (KUSCCO), The Associations of Micro finance Institutions of Kenya (AMFI), Central Bank of Kenya, Kenya National Federations of Co-operatives (KNFC), Kenya Rural Savings and Credit Union (KERUSCU), Capital Markets Authority (CMA) and Nairobi Stock Exchange (NSE).

Task force working on development of regulatory framework for MFIs has presented its recommendations to the Minister

The task force presented their recommendations to the Minister in February 2003 proposing regulation and supervision of micro finance institutions on a three tier basis. The first tier of micro finance institutions would be the informally constituted MFIs like rotating savings and credit associations (ROSCAs), club pools, financial services associations should not be regulated by an external agency. Donors, commercial banks and government agencies from which they obtain funds or that support them should carry out due diligence and make informed decisions about them.

The second tier institutions would be the formally constituted credit-only MFIs that do not accept deposits from the general public but accept cash collateral tied to loan contracts could be regulated and supervised by a self-regulatory (umbrella) body like Association of Micro finance Institutions (AMFI). The proposed legislation could empower AMFI to enforce compliance with its laid down regulations while the t.hird tier would constitute formally constituted deposit-taking MFIs. A Micro Finance Act be enacted to empower the Central Bank of Kenya to license, regulate and supervise formally constituted micro finance institutions intending to take deposits from the general public.

The SACCO system is mutual membership organisations. It involves pooling voluntary savings from members in the form of shares and on lending the same to members. In Kenya, like in many other countries, shares are not withdrawable and are issued as security for loans to members. There are over 3,800 SACCOs in Kenya with over 1.5 million members. Significant number of rural SACCOs have fully retail banking services commonly referred to as front office services (FOSAs).

Although the Cooperative Societies Act is being amended to give the commissioners power to establish a regulatory agency for SACCOs, the Task Force felt that more specific legislation needs to be put in place, especially to regulate near-banking operations of SACCOs, that is FOSAs. On Kenya Post Office Savings Bank (KPSOB), the task force recommended that it should be regulated and supervised by the Central Bank of Kenya after it has been capitalized, restructured and made to operate under the proposed Micro-Finance Act. Presently, the KPOSB is under its own Act and the Act would therefore need to be comprehensively reviewed.

4.9 Challenges in the banking sector

4.9.1 Low interest rate regime

Declining interest rates are forcing banking institutions to look for alternative sources of income...

Traditionally institutions in the local market have relied on interest income on loans and government securities as their major source of income. In the last few years, there has been a shift to government securities owing to lack of borrowers due to the depressed state of the economy. In the last one-year, the Treasury bill rates have been falling dramatically, thus compelling institutions to look for alternative sources of income to meet their operational costs and report profits for their shareholders. Some of these sources, especially increased fees and commissions have placed them on a collision course with the public. In an attempt to reduce their costs, some institutions have initiated restructuring programs that include staff retrenchment and rationalisation of their branch network. These measures have met resistance from the general public and trade unions.

4.9.2 Recovery of non-performing loans

Lengthy court processes in realization of collaterals has hampered timely realization of securities.

The challenge is therefore on banking institutions to move away from security based lending

Recovery of NPLs has remained the biggest challenge in the banking industry due to the lengthy court process that has impaired realisation of securities in good time. These delays have led to loss of income that would have been earned from the proceeds of the securities.

Public sector banks have NPLs, which were given without adequate documentations and these are proving difficult to collect. The challenge is now on the institutions to move away from security based lending and the new Government to clean up the court system to speed up realisation of securities.

4.9.3 Customer awareness

Due to increased customer awareness and availability of choice in the sector, some institutions have increasingly faced challenges in maintaining their customers. In order to counter this, they have been forced to invest in modern information systems to enable them offer better quality services. Greater use of more highly automated technology has transformed risks from manual processing errors to system failure risks as greater reliance is placed on globally integrated systems. Growth of e-commerce brings with it potential risks of internal and external frauds.

4.9.4 Derivative products

Internationally active institutions have moved into new products including financial derivatives in response to international customer demands. There is limited information and understanding on these products amongst staff in the sector. In an attempt to equip the staff with the relevant skills pertaining to these products, institutions have invested in staff training, bringing in additional costs.

Chapter 5

The New Basel Capital Accord

5.1 Background

New Capital Accord will be implemented by the beginning of 2007....

Capital provides a cushion for any losses arising from banking business risks. The measure of its adequacy is therefore important in assessing the safety and soundness of an institution in particular and the sector in general. In an attempt to correct the weaknesses of the 1988 Capital Accord, the Basel Committee on Banking Supervision has proposed a new capital framework - The New Basel Capital Accord or Basel II. Capital assessments have been changing over time. The New Accord is set to be finalised by the end of 2003 and member countries are expected to implement it at the beginning of 2007.

The path towards achievement of consensus on the final document has been long. In October 2002, the Basel Committee launched the final survey (QIS3), in order to obtain from banks worldwide additional feedback on the appropriateness of the New Capital Accord. The results of this comprehensive field test were reviewed and were used to provide inputs for modifications before release of the revised package in 2003.

5.2 Salient features of the New Accord

5.2.1 New dimensions

.... clearly defined disclosure will allow scrutiny of banks by market participants

The New Accord has, in addition to the minimum capital requirements, introduced two new dimensions, namely, supervisory review process and market discipline. Institutions will play a greater role in enhancing the supervisory work by developing their own capital adequacy assessment models. Guidance has been provided on clearly-defined disclosure of capital structure, risk exposures and capital adequacy. This is expected to allow market participants to assess critical information on banks.

5.2.2 Flexibility

The New Accord not only aligns capital requirements to the underlying risks, but also provides institutions and supervisors with a range of options of assessing capital.

Improved measurement analysis and treatment of credit risk....

5.2.3 Improved methodology

There is substantial improvement in the measurement, analysis and treatment of the credit risk, particularly in terms of credit risk mitigants and the nature of statistical inputs used in the capital requirement computation.

5.2.4 Operational risk

Greater emphasis has been laid on the role of operational risk in determining the extent of capital base requirement. In addition, more scientific, objective, and flexible approaches have been introduced in the measurement, analysis and treatment of operational risk.

5.2.5 Treatment of securitisation

The New Accord identifies various classes of securitisation exposures and sets standards for assigning risk weights to those classes.

5.2.6 Capital allocation

In the New Accord, emphasis is laid on the future view of asset portfolio, capital structure, and securities by detailing risk weighting, stress testing, and future predictions. Capital allocation process will be based on risk exposure disclosures by the market participants thus allowing them to make choices according to their perception of the future.

5.2.7 Challenges

The implementation of the Accord will face the following challenges:

- The New Accord places emphasis on the institution's own internal controls and management processes in assessing their risk profiles. However, institutions in various parts of the world are still faced by varying shortfalls in terms of availability of resources and development of market structures;

- The Accord is more complex, making it more difficult to comprehend and apply;

- The Accord requires data accumulation to quantify loss experiences arising from various risks over a period of between 2 to 5 years before it can be applied;

.... institutions will face the challenge of developing internal models

- Institutions will face the challenge of developing internal models, which are capable of providing outputs that are comparable and consistent across borrowers of various classes and time horizons. This requires them to modify their training strategies and methods, which may also be supplemented by skills outsourcing where necessary;

- Since the quality and computation of data to determine capital allocation process in each institution will vary widely, it would be a great challenge to the regulators to validate the quality, accuracy, measurements, transparency and integrity of the data;

- The New Accord presupposes existence of external rating agencies. These agencies will either have to be established within Kenya, or be set up as local branches of overseas establishments, if the standardized approach is to be implemented; and

- It will require more flexible skills for the regulator to identify early warning signs of weak institutions in order to take prompt action due to the use of institutions own internal information and methods to assess their risk levels.

Harmonised regional approach for implementation of the New Capital Accord to be pursued

In order to determine the most appropriate and harmonized regional approach on the implementation of the New Capital Accord, the member countries of the East and Southern Africa Bank Supervisors Group (ESAF) have resolved to adopt a unified and relevant approach that would be applicable to this part of the world. The outcome of ESAF's consultations will help guide implementation of the Accord in Kenya's banking sector. ESAF is an outreach arm of the Basel Committee on Banking Supervision and will therefore ensure international acceptance of approaches being adopted by regulators within the region.

In addition, the Monetary Affairs Committee of the East African Community, consisting of the Governors of the three East African central banks, has resolved to ensure a harmonized approach to implementation of the New Capital Accord within the three East African countries.

ORGANIZATION STRUCTURE OF BANK SUPERVISION DEPARTMENT

DIRECTOR*
Mr. John K. Murugu

DEPUTY DIRECTOR**
Mr. Jackson M. Kitili

INSPECTION DIVISION
Mr. F.P.K. Pere

FUNCTIONS

Carries out on-site inspections to:

1. Evaluate the financial condition of banking institutions.
2. Appraise the quality and competence of management.
3. Review adequacy of the system of internal controls.
4. Confirm compliance with Banking Banking Act, Prudential Regulations and other relevant laws.
5. Identify weak and problematic areas and make recommendations for corrective action.
6. Verify the accuracy of the prudential returns and other information submitted to the Central Bank.

FINANCIAL ANALYSIS DIVISION
Mr. W. Nyagaka

FUNCTIONS

DATA BANK

1. Collects statutory returns and captures information on electronic database.
2. Data processing and production of reports for analysis.

ANALYSIS

3. Analyses off-site reports.
4. Design and development of reports.
5. Coordinates matters pertaining to institutions under statutory management.
6. Conducts follow-up on inspections.
7. Coordinates training for the Department.
8. Prepares and monitors departmental budget.

POLICY DIVISION
Mr. P. K. Muhindi

FUNCTIONS

1. Formulates new and reviews existing legislation and prudential regulations.
2. Processes applications for renewal of annual licenses, new places of business, relocations and closure of places of business.
3. Liaises with the regional and international organisations on banking supervisions, such as ESAF and Basle Committee.
4. Liaises with domestic financial intermediaries and regulations e.g. RBA, KRA, insurance agencies, etc.
5. Carries out technical studies on current supervisory issues.
6. Analyses and advises on new products/instruments.
7. Processes approvals of external auditors, shareholders and appointed directors.
8. Handles general correspondence with banking institutions, building societies and other external parties.
9. Conducts follow-up on inspections.
10. Handles departmental registry and maintains technical library.

MICRO FINANCE DIVISION
Mr. G. O. Omino

FUNCTIONS

1. Development of micro finance legislation and prudential guidelines.
2. Processes applications for new and renewal of annual licenses for forex bureaus.
3. Conducts inspection of forex bureaus.
4. Processes approval of appointment of principal officers of forex bureaus.
5. Analyses returns submitted by forex bureaus.
6. Handles matters relating to CMA, Reference Bureaus, Credit Rating Agencies and SACCOs.
7. Analyses returns submitted by forex bureaus/micro finance institutions.
8. Liaises with the Centre for Corporate Governance (CCG), the CMA, NSE and others on corporate governance matters.

* With effect from March 2003, **Mr. Jones M. Nzomo** was appointed the new Director, Bank Supervision, taking over from Mr. Murugu.

** With effect from March 2003, **Mrs. Linah C. Soi** was appointed Deputy Director, Bank Supervision, in-charge of **Inspection Division**, while Mr. Jackson M. Kitili remains in-charge of Financial Analysis, Policy and Micro Finance Divisions.

BANKING SECTOR BALANCE SHEET ANALYSIS
as at December 2002 and December 2001

Figures in Ksh million

	DECEMBER 2002 (Audited)				DECEMBER 2001 (Audited)			
	BANKS	**NBFIs**	**TOTAL**	**%**	**BANKS**	**NBFIs**	**TOTAL**	**%**
A. ASSETS								
1. Cash	10,298	60	10,358	2%	8,833	110	8,943	2%
2. Balances at CBK	25,723	173	25,896	6%	26,355	156	26,511	6%
3. Placements	8,408	1,522	9,930	2%	7,925	2,091	10,016	2%
4. Government Securities	97,736	2,722	100,458	22%	90,057	2,724	92,781	22%
5. Investments	5,490	86	5,576	1%	4,880	106	4,986	1%
6. Advances(net)	172,169	10,915	183,084	40%	166,677	11,758	178,435	42%
7. Foreign Loans	39,665	25	39,690	9%	36,248	0	36,248	9%
7.(b) Other foreign Assets	35,916	236	36,152	8%	25,751	11	25,762	6%
8. Fixed Assets(Net)	16,353	511	16,864	4%	17,939	669	18,608	4%
9. Other Assets	28,063	620	28,683	6%	22,064	609	22,673	5%
10. Total Assets	**439,821**	**16,870**	**456,691**	**100%**	**406,729**	**18,234**	**424,963**	**100%**
B. LIABILITIES								
11. Local Currency Deposits	290,404	13,622	304,026	67%	268,712	14,879	283,591	67%
12. Foreign Currency Deposits	56,616	0	56,616	12%	48,977	0	48,977	12%
13. Accrued Interest	1,802	143	1,945	0%	2,880	155	3,035	1%
14. Foreign Liabilities	5,977	17	5,994	1%	7,697	33	7,730	2%
15. Other Liabilities	34,482	728	35,210	8%	24,427	670	25,097	6%
16. Total Liabilities	**389,281**	**14,510**	**403,791**	**88%**	**352,693**	**15,737**	**368,430**	**87%**
17. Net Assets/(Liabilities)	**50,540**	**2,360**	**52,900**	**12%**	**54,036**	**2,497**	**56,533**	**13%**
C. CAPITAL & RESERVES								
18. Paid up/Assigned Capital	28,358	1,730	30,088	7%	28,894	1,675	30,569	**7%**
19. Shareholders Loans/Grants	0	0	0	0%	8,204	0	8,204	**2%**
20. Reserves	20,182	380	20,562	5%	11,584	601	12,185	**3%**
21. P & L Account	2,000	250	2,250	0%	5,354	221	5,575	**1%**
22. Total Shareholders' Funds	**50,540**	**2,360**	**52,900**	**12%**	**54,036**	**2,497**	**56,533**	**13%**
23. Contingent Liabilities	74,374	11	74,385		75,160	60	75,220	
24. Gross Loans	280,813	17,515	298,328		264,331	16,386	280,717	
25. Total Loans	245,610	12,711	258,321		231,655	13,321	244,976	
26. Gross Non-Performing Loans	106,002	11,018	117,020		100,225	9,133	109,358	
27. Total Non-performing loans	70,799	6,214	77,013		67,549	6,068	73,617	
28. Interest in suspense	35,203	4,804	40,007		32,676	3,065	35,741	
29. Specific Provisions	31,434	1,706	33,140		26,263	1,491	27,754	
30. General Provisions	2,342	65	2,407		2,467	72	2,539	
31. Total Provisions	33,776	1,771	35,547		28,730	1,563	30,293	
32. Gross Provisions	68,979	6,575	75,554		61,406	4,628	66,034	
33. Accum. Depreciation	12,671	408	13,079		12,104	1397	13,501	
34. Core Capital	42,045	2,178	44,223		42,647	2,235	44,882	
35. Total Capital	**50,919**	**2,352**	**53,271**		**51,217**	**2,410**	**53,627**	
36. Total Risk Weighted Assets	**300,020**	**12,529**	**312,549**		**295,545**	**13,585**	**309,130**	
D. PERFORMANCE INDICATORS								
37. Capital/Deposits Ratio	14.5%	17.1%	14.6%		16.9%	16.6%	16.8%	
38. Capital/Assets Ratio (Unweighted)	9.8%	14.0%	10.0%		11.2%	13.6%	11.3%	
39. Core Capital/TRWA	14.0%	17.4%	14.1%		14.4%	16.5%	14.5%	
40. Total Capital/TRWA	17.0%	18.8%	17.0%		17.3%	17.7%	17.3%	
41. Core Capital/Total Depoists	12.1%	16.0%	12.3%		13.4%	15.0%	13.5%	
42. Liquidity Ratio	43.9%	31.1%	43.4%		45.5%	30.3%	45.2%	
43. Gross Prov/Gross Non-perf Loans	65.1%	59.7%	64.6%		61.3%	50.7%	60.4%	
44. Gross Non-perf.Adv/Gross Loans	37.7%	62.9%	39.2%		37.9%	55.7%	39.0%	
45. Total NPLs/Total Loans (27/25)	28.8%	48.9%	29.8%		29.2%	45.6%	30.1%	
46. (Total NPLs-S/Prov.)/Net Loans	18.6%	41.2%	19.7%		20.3%	38.9%	21.4%	
47. Gross Loans/Deposits Ratio	80.5%	127.2%	82.3%		82.5%	109.0%	83.6%	
48. Gross Provisions/Gross Loans	24.6%	37.5%	25.3%		23.2%	28.2%	23.5%	
49. Total Provisions/Total Loans	13.8%	13.9%	13.8%		12.4%	11.7%	12.4%	
50. Total NPL's/Total Assets	16.1%	36.8%	16.9%		16.6%	33.3%	17.3%	

BANKING SECTOR PROFIT AND LOSS ANALYSIS
as at December 2002 and December 2001

Figures in Ksh million

	DECEMBER 2002 (Audited)				DECEMBER 2001 (Audited)			
	BANKS	NBFIs	TOTAL	%	BANKS	NBFIs	TOTAL	%
A. INCOME								
1. Interest on Advances	26,378	1,824	28,202	45%	28,370	1,851	30,221	49%
2. Interest on Placement	1,159	122	1,281	2%	1,668	239	1,907	3%
3. Interest on Govt. Securities	11,154	306	11,460	18%	10,266	317	10,583	17%
4. Foreign Exc. Gain/(Loss)	3,318	0	3,318	5%	2,909	(1)	2,908	5%
5. Other Interest Income	550	2	552	1%	735	0	735	1%
6. Other Income	17,100	267	17,367	28%	14,853	220	15,073	25%
7. Total	59,659	2,521	62,180	100%	58,801	2,626	61,427	100%
B. EXPENSES								
8. Interest on Deposits	11,607	943	12,550	20%	14,347	1,305	15,652	30%
9. Other Interest Expenses	1,537	9	1,546	2%	1,083	10	1,093	2%
10. Occupancy Costs	1,834	73	1,907	3%	2,131	72	2,203	4%
11. Director's Emoluments	325	5	330	1%	383	5	388	1%
12. Bad Debts Charge	10,609	425	11,034	18%	7,501	245	7,746	15%
13. Salaries & Wages	15,147	547	15,694	25%	12,950	508	13,458	26%
14. Other Expenses	12,970	365	13,335	21%	11,467	563	12,030	23%
15. Total	54,029	2,367	56,396	91%	49,862	2,708	52,570	100%
16. Profit Before Tax	5,630	154	5,784		8,939	(82)	8,857	
17. No. of Employees	10,884	426	11,310		11,465	385	11,850	
C. PERFORMANCE INDICATORS								
18. Yield on Earning Assets	11.9%	11.2%	11.8%		13.0%	12.2%	12.9%	
19. Cost of Funding Earning Assets	3.7%	4.7%	3.7%		4.6%	6.7%	4.7%	
20. Interest Margin on Earning Assets	8.2%	6.5%	8.1%		8.4%	5.5%	8.3%	
21. Yield on Advances	10.7%	11.6%	10.7%		14.0%	12.5%	12.1%	
22. Cost of Deposits	4.4%	7.0%	4.5%		5.6%	8.8%	5.7%	
23. Return on Assets(Including Contingents)	1.0%	0.7%	1.0%		1.7%	-0.4%	1.6%	
24. Return on Shareholders Funds	11.1%	6.5%	10.9%		16.5%	-3.3%	15.7%	
25. Overhead to Earnings	68.5%	56.1%	68.0%		58.6%	53.0%	58.3%	
D. RATINGS								
Capital Adequacy	2.00	2.00	2.00		2.00	2.00	2.00	
Asset Quality	4.00	5.00	4.00		5.00	5.00	5.00	
Earnings	3.00	4.00	4.00		3.00	5.00	3.00	
Liquidity	1.00	2.00	1.00		1.00	2.00	1.00	
Composite Score	2.50	3.25	2.75		2.75	3.50	2.75	
Performance Category	Fair	Fair	Fair		Fair	Marginal	Fair	

MARKET SHARE (NET ASSETS, NET ADVANCES, DEPOSITS, CAPITAL & PROFITS) DECEMBER 2002

No	Name of Institution	Total Net Assets	Market Share	Net Advances	Market Share	Total Deposits	Market Share	Capitals & Reserves	Market Share	Pre-tax Profit	Market Share
1	Barclays Bank of Kenya Ltd	86,027	19.6%	50,165	23.7%	68,924	19.9%	9,989	19.8%	2,518	44.7%
2	Standard Chartered Bank Ltd	61,736	14.0%	16,660	7.9%	52,315	15.1%	4,667	9.2%	3,217	57.2%
3	Kenya Commercial Bank Ltd	56,844	12.9%	27,590	13.0%	47,623	13.7%	4,316	8.5%	-3,199	-56.8%
4	Citibank, N.A.	30,191	6.9%	11,208	5.3%	24,598	7.1%	4,067	8.0%	1,159	20.6%
5	Co-operative Bank of Kenya	28,994	6.6%	17,897	8.4%	22,125	6.4%	1,794	3.5%	102	1.8%
6	National Bank of Kenya Ltd	25,205	5.7%	19,392	9.2%	15,710	4.5%	1,917	3.8%	390	6.9%
7	Commercial Bank of Africa	16,345	3.7%	4,763	2.2%	14,185	4.1%	1,568	3.1%	351	6.2%
8	CFC Bank Limited	9,610	2.2%	6,154	2.9%	7,393	2.1%	1,507	3.0%	187	3.3%
9	National Industrial Credit Bank	9,329	2.1%	4,704	2.2%	6,457	1.9%	2,498	4.9%	340	6.0%
10	Stanbic Bank Kenya Limited	7,977	1.8%	2,839	1.3%	6,390	1.8%	649	1.3%	35	0.6%
11	Investment & Mortgages Bank	7,176	1.6%	3,351	1.6%	5,942	1.7%	1,093	2.2%	109	1.9%
12	Diamond Trust Bank Kenya	6,164	1.4%	2,696	1.3%	4,710	1.4%	1,051	2.1%	107	1.9%
13	First American Bank Limited	5,943	1.4%	2,979	1.4%	4,658	1.3%	1,199	2.4%	191	3.4%
14	Fina Bank Limited	5,342	1.2%	2,607	1.2%	4,636	1.3%	554	1.1%	73	1.3%
15	Bank of Baroda	4,998	1.1%	1,469	0.7%	4,415	1.3%	415	0.8%	41	0.7%
16	Credit Agricole Indosuez	4,695	1.1%	1,925	0.9%	3,613	1.0%	752	1.5%	45	0.8%
17	Bank of India	4,667	1.1%	1,044	0.5%	3,801	1.1%	774	1.5%	63	1.1%
18	Imperial Bank Limited	4,181	1.0%	2,586	1.2%	3,354	1.0%	617	1.2%	187	3.3%
19	Giro Commercial Bank	4,101	0.9%	2,620	1.2%	3,515	1.0%	397	0.8%	33	0.6%
20	Guardian Bank	4,011	0.9%	2,317	1.1%	3,211	0.9%	663	1.3%	64	1.1%
21	Akiba Bank Ltd	3,979	0.9%	3,017	1.4%	3,062	0.9%	620	1.2%	19	0.3%
22	Middle East Bank of Kenya	3,923	0.9%	1,253	0.6%	3,049	0.9%	687	1.4%	60	1.1%
23	Habib AG Zurich	3,806	0.9%	697	0.3%	3,124	0.9%	375	0.7%	82	1.5%
24	Prime Bank Limited	3,763	0.9%	1,927	0.9%	2,966	0.9%	543	1.1%	71	1.3%
25	African Banking Corporation	3,386	0.8%	1,583	0.7%	2,868	0.8%	382	0.8%	44	0.8%
26	Victoria Commercial Bank Ltd	3,102	0.7%	1,325	0.6%	2,576	0.7%	479	0.9%	22	0.4%
27	Habib Bank Limited	3,043	0.7%	744	0.4%	2,597	0.7%	373	0.7%	110	1.9%
28	Consolidated Bank of Kenya	2,707	0.6%	1,026	0.5%	1,794	0.5%	624	1.2%	77	1.4%
29	Southern Credit Banking Corp.	2,684	0.6%	1,499	0.7%	2,092	0.6%	433	0.9%	14	0.2%
30	Development Bank of Kenya	2,643	0.6%	1,385	0.7%	714	0.2%	809	1.6%	39	0.7%
31	Biashara Bank of Kenya Ltd	2,582	0.6%	768	0.4%	2,111	0.6%	396	0.8%	52	0.9%
32	Equatorial Commercial Bank	2,498	0.6%	1,004	0.5%	1,979	0.6%	416	0.8%	65	1.2%
33	Delphis Bank Limited	2,266	0.5%	1,013	0.5%	254	0.1%	824	1.6%	-277	-4.9%
34	Charterhouse Bank Limited	1,886	0.4%	947	0.4%	1,409	0.4%	401	0.8%	105	1.9%
35	Credit Bank Limited	1,795	0.4%	666	0.3%	1,361	0.4%	370	0.7%	31	0.5%
36	Transnational Bank Limited	1,705	0.4%	904	0.4%	912	0.3%	715	1.4%	122	2.2%
37	K-REP BANK	1,674	0.4%	1,163	0.5%	821	0.2%	609	1.2%	86	1.5%
38	Industrial Development Bank	1,626	0.4%	1,218	0.6%	190	0.1%	355	0.7%	-98	-1.7%
39	Euro Bank Limited	1,291	0.3%	1,224	0.6%	1,780	0.5%	-980	-1.9%	-1,071	-19.0%
40	Paramount-Universal Bank	1,262	0.3%	710	0.3%	957	0.3%	280	0.6%	9	0.2%
41	Fidelity Commercial Bank	1,180	0.3%	682	0.3%	897	0.3%	248	0.5%	22	0.4%
42	Chase Bank Limited	1,162	0.3%	676	0.3%	744	0.2%	366	0.7%	47	0.8%
43	City Finance Bank	815	0.2%	448	0.2%	51	0.0%	396	0.8%	15	0.3%
44	Daima Bank Limited	759	0.2%	537	0.3%	708	0.2%	28	0.1%	-1	0.0%
45	Dubai Bank Limited	750	0.2%	454	0.2%	429	0.1%	306	0.6%	-28	-0.5%
	TOTAL	**439,823**	**100.0%**	**211,836**	**100.0%**	**347,020**	**100.0%**	**50,542**	**100.0%**	**5,630**	**100.0%**
	NBFI's / MFC's										
1	Housing Finance Co. of Kenya	10,403	61.7%	7,694	70.3%	8,975	65.9%	950	40.3%	95	61.7%
2	Savings & Loan	3,713	22.0%	2,030	18.6%	2,761	20.3%	614	26.0%	-59	-38.4%
3	Prime Capital & Credit	2,444	14.5%	1,190	10.9%	1,877	13.8%	504	21.4%	81	52.8%
4	Bank of India Finance	229	1.4%	0	0.0%	0	0.0%	229	9.7%	42	27.3%
5	Devna Finance	80	0.5%	25	0.2%	9	0.1%	63	2.7%	-5	-3.4%
	TOTAL	**16,869**	**100.0%**	**10,939**	**100.0%**	**13,622**	**100.0%**	**2,360**	**100.0%**	**153**	**100.0%**
	GRAND TOTAL	**456,692**		**222,775**		**360,642**		**52,902**		**5,783**	

Source: Published Audited Accounts

NON-PERFORMING LOANS & PROVISIONS - DECEMBER 2002

Figures in Ksh million

		1	2	3	4	5
No.	**Banks**	**Non-Performing Loans (NPLs)**	**Specific Provisions**	**Total Loans**	**NPLs/Total Loans**	**Specific Prov./NPLs**
					(1/3) %	**(2/1) %**
1	Kenya Commercial Bank Ltd.	20,175	8,395	36,175	55.8%	41.6%
2	National Bank of Kenya Ltd.	14,897	8,986	28,593	52.1%	60.3%
3	Co-operative Bank of Kenya Ltd.	8,778	4,520	22,596	38.8%	51.5%
4	Barclays Bank of Kenya Ltd.	7,925	1,914	52,829	15.0%	24.1%
5	Delphis Bank Ltd.	1,991	1,140	2,173	91.6%	57.2%
6	Euro Bank Limited	1,633	1,419	2,646	61.7%	86.9%
7	Standard Chartered Bank Ltd.	1,399	232	17,048	8.2%	16.6%
8	Guardian Bank Ltd.	1,202	114	2,449	49.1%	9.5%
9	National Industrial Credit Bank Ltd.	947	600	5,381	17.6%	63.4%
10	Akiba Bank Ltd.	891	237	3,277	27.2%	26.6%
11	First American Bank Ltd.	841	284	3,289	25.6%	33.8%
12	Giro Commercial Bank Ltd.	741	132	2,773	26.7%	17.8%
13	Consolidated Bank of Kenya Ltd.	711	451	1,487	47.8%	63.4%
14	Development Bank of Kenya Ltd.	708	394	1,791	39.5%	55.7%
15	Investment & Mortgages Bank Ltd.	583	135	3,519	16.6%	23.2%
16	Industrial Development Bank Ltd.	567	115	1,344	42.2%	20.2%
17	Commercial Bank of Africa Ltd.	525	160	4,975	10.6%	30.5%
18	Southern Credit Banking Corp. Ltd.	516	157	1,669	30.9%	30.4%
19	Daima Bank Ltd.	450	112	651	69.2%	24.9%
20	Fina Bank Ltd.	442	143	2,776	15.9%	32.4%
21	Transnational Bank Ltd.	418	121	1,039	40.2%	28.9%
22	Middle East Bank of Kenya Ltd.	406	51	1,313	30.9%	12.5%
23	Paramount-Universal Bank Ltd.	361	101	816	44.2%	27.9%
24	CFC Bank Ltd.	354	98	6,312	5.6%	27.8%
25	Citibank, N.A.	348	225	11,554	3.0%	64.6%
26	Stanbic Bank Kenya Ltd.	316	50	2,919	10.8%	15.9%
27	City Finance Bank Ltd.	265	34	484	54.7%	12.7%
28	Bank of Baroda Ltd.	258	51	1,533	16.8%	19.7%
29	Victoria Commercial Bank Ltd.	258	77	1,414	18.2%	30.1%
30	Imperial Bank Ltd.	235	175	2,812	8.4%	74.4%
31	Fidelity Commercial Bank Ltd.	228	87	776	29.4%	38.3%
32	Prime Bank Ltd.	194	87	2,032	9.6%	44.6%
33	Credit Agricole Indosuez	172	173	2,136	8.1%	100.5%
34	Diamond Trust Bank Kenya Ltd.	161	58	2,780	5.8%	36.1%
35	African Banking Corporation Ltd.	152	46	1,644	9.2%	30.5%
36	Equatorial Commercial Bank Ltd.	149	66	1,080	13.8%	44.1%
37	Credit Bank Ltd.	139	19	693	20.1%	13.8%
38	Charterhouse Bank Ltd.	128	70	1,027	12.5%	55.1%
39	Dubai Bank Ltd.	92	51	510	18.0%	55.4%
40	Bank of India Ltd.	82	26	1,081	7.6%	32.2%
41	Habib Bank Ltd.	73	66	819	8.9%	90.1%
42	Habib AG Zurich	56	36	740	7.6%	64.5%
43	K-Rep Bank Ltd.	18	10	1,185	1.5%	57.3%
44	Biashara Bank of Kenya Ltd.	13	12	787	1.7%	92.3%
45	Chase Bank Ltd.	1	1	684	0.1%	100.0%
	SUB-TOTAL	**70,800**	**31,433**	**245,610**	**28.8%**	**44.4%**
	NBFI'S					
1	Housing Fin. Co. of Kenya Ltd.	5,314	1,357	9,089	58.5%	25.5%
2	Savings and Loan (K) Ltd.	735	286	2,333	31.5%	38.9%
3	Prime Capital & Credit Ltd.	165	63	1,263	13.1%	38.2%
4	Bank of India Finance Ltd.	0	0	-	-	0.0%
5	Devna Finance Ltd.	0	0	26	0.0%	0.0%
	SUB-TOTAL	**6,214**	**1,706**	**12,711**	**48.9%**	**27.5%**
	GRAND TOTAL	**77,013**	**33,139**	**258,321**	**29.8%**	**43.0**
	Adjust: Rounding Error	**-**	**1**	**-**	**-**	**-**
	GRAND TOTAL	**77,013**	**33,140**	**258,321**	**29.8%**	**43.0**

NB: - Specific provisions exclude general provision

- NPLS & Total Loans exclude interest in suspense (columns 1 & 3)

PROFITABILITY OF BANKING INSTITUTIONS FOR THE YEAR 2002

Figures in Ksh million

NO	BANKS	1 PROFIT BEFORE TAX	2 RETURN ON ASSETS: Total Assets & Contingencies	3 RETURN ON ASSETS: Return on Assets (1/2) %	4 RETURN ON EQUITY: Shareholders Equity	5 RETURN ON EQUITY: Return on Equity (1/4) %
1	Standard Chartered Bank Ltd	3,217	74,495	4.3%	4,667	68.9
2	Barclays Bank of Kenya Ltd	2,518	105,378	2.4%	9,989	25.2
3	Citibank, N.A.	1,159	36,108	3.2%	4,067	28.5
4	National Bank of Kenya Ltd	390	53,618	0.7%	1,917	20.4
5	Commercial Bank of Africa Ltd.	351	19,617	1.8%	1,568	22.4
6	National Industrial Credit Bank Ltd.	340	10,826	3.1%	2,498	13.6
7	First American Bank Ltd.	191	8,138	2.3%	1,199	15.9
8	Imperial Bank Ltd.	187	5,285	3.5%	617	30.4
9	CFC Bank Ltd.	187	12,674	1.5%	1,507	12.4
10	Transnational Bank Ltd.	122	3,075	4.0%	715	17.1
11	Habib Bank Ltd.	110	3,561	3.1%	373	29.4
12	Investment & Mortgages Bank Ltd.	109	9,416	1.2%	1,093	10.0
13	Diamond Trust Bank Kenya Ltd.	107	6,942	1.5%	1,051	10.1
14	Charterhouse Bank Ltd.	105	2,511	4.2%	401	26.2
15	Co-operative Bank of Kenya Ltd.	102	41,810	0.2%	1,794	5.7
16	K-Rep Bank Ltd.	86	1,736	5.0%	609	14.2
17	Habib AG Zurich	82	4,345	1.9%	375	21.8
18	Consolidated Bank of Kenya ltd.	77	4,160	1.9%	624	12.4
19	Fina Bank Ltd.	73	6,622	1.1%	554	13.1
20	Prime Bank Ltd.	71	4,767	1.5%	543	13.2
21	Equatorial Commercial Bank Ltd.	65	2,965	2.2%	416	15.7
22	Guardian Bank Ltd.	64	5,205	1.2%	663	9.7
23	Bank of India	63	5,122	1.2%	774	8.2
24	Middle East Bank of Kenya Ltd.	60	5,021	1.2%	687	8.7
25	Biashara Bank of Kenya Ltd	52	3,062	1.7%	396	13.1
26	Chase Bank Ltd.	47	1,401	3.4%	366	12.9
27	Credit Agricole Indosuez	45	6,532	0.7%	752	5.9
28	African Banking Corporation Ltd.	44	4,065	1.1%	382	11.6
29	Bank of Baroda	41	5,604	0.7%	415	9.9
30	Development Bank of Kenya Ltd.	39	3,463	1.1%	809	4.9
31	Stanbic Bank Kenya Ltd.	35	9,704	0.4%	649	5.4
32	Giro Commercial Bank Ltd.	33	5,239	0.6%	397	8.3
33	Credit Bank Ltd.	31	2,133	1.4%	370	8.3
34	Fidelity Commercial Bank Ltd.	22	1,454	1.5%	248	9.0
35	Victoria Commercial Bank Ltd	22	3,738	0.6%	479	4.6
36	Akiba Bank Ltd	19	5,158	0.4%	620	3.0
37	City Finance Bank Ltd.	15	933	1.6%	396	3.9
38	Southern Credit Banking Corp. Ltd.	14	3,517	0.4%	433	3.2
39	Paramount-Universal Bank Ltd.	9	1,715	0.5%	280	3.4
40	Daima Bank Ltd.	-1	1,318	-0.1%	28	(3.2)
41	Dubai Bank Ltd.	-28	980	-2.8%	306	(9.1)
42	Industrial Development Bank Ltd.	-98	2,011	-4.9%	355	(27.7)
43	Delphis Bank Ltd.	-277	4,222	-6.6%	824	(33.6)
44	Euro Bank Limited	-1,071	3,820	-28.0%	-980	109.3
45	Kenya Commercial Bank Ltd	-3,199	92,382	-3.5%	4,316	(74.1)
	SUB-TOTAL	**5,630**	**595,847**	**0.9%**	**50,542**	11.1
	NBFI'S					
1	Housing Fin. Co. of Kenya Ltd.	95	16,381	0.6%	950	0.1
2	Prime Capital & Credit Ltd.	84	2,786	3.0%	504	0.2
3	Bank of India Finance Ltd.	42	229	18.3%	269	0.2
4	Devna Finance Ltd.	-5	80	-6.5%	63	(0.1)
5	Savings and Loan (K) Ltd.	-62	4,386	-1.4%	614	(0.1)
	SUB-TOTAL	**154**	**23,862**	**0.6%**	**2,400**	**0.1**
	GRAND TOTAL	**5,783**	**619,709.26**	**0.9%**	**52,942.00**	**0.1**

Source: Published Audited Accounts

CORE CAPITAL AND RISK WEIGHTED ASSETS - DECEMBER, 2002

Figures in Ksh million

	Institution	Core Capital	Total Capital	Overall risk weighted assets	Core capital to risk weighted assets ratio	Total capital to risk weighted assets ratio
1	Barclays Bank of Kenya Ltd	8,732	8,789	64,880	13.5%	13.5%
2	Kenya Commercial Bank Ltd	4,316	4,506	43,306	10.0%	10.4%
3	Standard Chartered Bank Ltd	4,397	4,429	36,225	12.1%	12.2%
4	Co-operative Bank of Kenya Ltd	1,975	3,819	19,954	9.9%	19.1%
5	Citibank, N.A.	3,799	3,799	26,083	14.6%	14.6%
6	National Industrial Credit Bank Ltd	2,308	2,419	5,970	38.7%	40.5%
7	National Bank of Kenya Ltd	-4,132	1,989	17,660	-23.4%	11.3%
8	CFC Bank Ltd	1,846	1,906	8,810	21.0%	21.6%
9	Commercial Bank of Africa Ltd	1,404	1,471	6,184	22.7%	23.8%
10	First American Bank Ltd	1,199	1,199	4,016	29.9%	29.9%
11	Investment & Mortgages Bank Ltd	1,093	1,093	5,264	20.8%	20.8%
12	Diamond Trust Bank Kenya Ltd	984	992	3,353	29.3%	29.6%
13	Delphis Bank Ltd	812	832	1,543	52.6%	53.9%
14	Credit Agricole Indosuez	752	790	2,732	27.5%	28.9%
15	Trans-National Bank Ltd	715	729	1,656	43.2%	44.0%
16	Development Bank of Kenya Ltd	726	726	1,832	39.6%	39.6%
17	Middle East Bank of Kenya Ltd	697	706	2,057	33.9%	34.3%
18	Imperial Bank Ltd	617	669	2,756	22.4%	24.3%
19	Guardian Bank Ltd	663	663	2,370	28.0%	28.0%
20	Stanbic Bank Kenya Ltd	641	641	5,260	12.2%	12.2%
21	K-Rep Bank ltd	609	621	1,302	46.8%	47.7%
22	Akiba Bank Ltd	581	605	3,782	15.4%	16.0%
23	Fina Bank Ltd	548	574	3,602	15.2%	15.9%
24	Prime Bank Ltd	533	552	2,868	18.6%	19.2%
25	Bank of India	482	502	1,030	46.8%	48.8%
26	Victoria Commercial Bank Ltd	479	491	1,214	39.5%	40.4%
27	Consolidated Bank of Kenya Ltd	396	453	1,877	21.1%	24.1%
28	Southern Credit Banking Corp. Ltd	421	436	1,892	22.3%	23.1%
29	Giro Commercial Bank Ltd	397	417	2,723	14.6%	15.3%
30	Equatorial Commercial Bank Ltd	416	416	1,169	35.5%	35.5%
31	Bank of Baroda (K) Ltd	415	415	1,743	23.8%	23.8%
32	Biashara Bank of Kenya Ltd	396	404	1,312	30.2%	30.8%
33	Charterhouse Bank Ltd	401	401	1,523	26.3%	26.3%
34	African Banking Corporation Ltd	382	397	1,798	21.2%	22.1%
35	City Finance Bank Ltd	396	396	622	63.6%	63.6%
36	Credit Bank Ltd	370	378	730	50.7%	51.8%
37	Habib Bank Ltd	373	373	691	53.9%	53.9%
38	Habib AG Zurich	371	371	1,070	34.7%	34.7%
39	Chase Bank Ltd	366	366	693	52.8%	52.8%
40	Dubai Bank Ltd	306	306	539	56.7%	56.7%
41	Industrial Development Bank Ltd	302	302	1,403	21.5%	21.5%
42	Paramount-Universal Bank Ltd	274	280	762	36.0%	36.8%
43	Fidelity Commercial Bank Ltd	241	247	781	30.8%	31.6%
44	Daima Bank Ltd	28	28	695	4.0%	4.0%
45	Euro Bank Limited	-980	-978	2,285	-42.9%	-42.8%
	Sub-Total	**42,045**	**50,919**	**300,020**	14.0%	17.0%
	NON-BANK FINANCIAL INSTITUTIONS					
1	Housing Fin. Co. of Kenya Ltd	831	923	8,728	9.5%	10.6%
2	Savings and Loan (K) Ltd	553	623	2,453	22.5%	25.4%
3	Prime Capital & Credit Ltd	502	512	1,192	42.1%	42.9%
4	Bank of India Finance (K) Ltd	239	239	85	280.4%	280.4%
5	Devna Finance Ltd.	52	55	71	73.5%	77.5%
	Sub-Total	**2,178**	**2,352**	**12,529**	17.4%	18.8%
	GRAND TOTAL	**44,223**	**53,272**	**312,549**	14.1%	17.0%

NB: Ranked in terms of Total Capital

Appendix VIII

NON-PERFORMING LOANS AND PROVISIONS.

No.	Item	2002	2001	Growth
1	Normal	130,475	127,725	2%
2	Watch	50,834	43,634	17%
3	Substandard Accounts	11,975	15,376	-22%
4	Doubtful Accounts	34,026	33,680	1%
5	Loss Accounts	31,011	24,561	26%
6	Total Loans (1+2+3+4+5)	258,321	244,976	5%
7	Interest Suspended	40,007	35,741	12%
8	Total NPLs (3+4+5)	77,012	73,617	5%
9	Specific Provisions Held	33,140	27,754	19%
10	Net NPLs (8-9)	43,872	45,863	-4%
11	Value of Securities (estimated)	42,561	36,187	18%
12	Net Exposure (10-11)	1,311	9,676	-86%
13	Gross Loans (6+7)	298,328	280,717	6%
14	General Provisions	2,407	2,539	-5%
15	Net Loans (6-9-14)	222,774	214,683	4%
16	Gross Provisions (7+9+14)	75,554	66,034	14%
17	Total Provisions (9+14)	35,547	30,293	17%
18	Total NPLs / Total Loans (8/6)	30%	30%	
19	Net NPLs/Net Loans (10/15)	20%	21%	
20	Total Provisions/Total Loans (17/6)	14%	12%	
21	Net Exposure/Total Loans(12/6)	0.5%	3.9%	

NB: Normal & Loss A/C balances for 2001 have been re-stated