

DEVELOPMENTS IN THE KENYAN BANKING SECTOR FOR THE QUARTER ENDED 30TH JUNE 2012

A. OVERVIEW OF THE BANKING SECTOR PERFORMANCE

For the quarter ended June 30, 2012, the sector comprised 43 commercial banks, 1 mortgage finance company, 6 deposit taking microfinance institutions, 5 representative offices of foreign banks, 115 foreign exchange bureaus and 2 credit reference bureaus.

The Kenyan Banking Sector continued on a growth trajectory with the size of assets standing at Ksh. 2.2 trillion, loans & advances worth Ksh. 1.3 trillion, while the deposit base was Ksh. 1.7 trillion and profit before tax of Ksh. 53.2 billion as at 30th June 2012. During the same period, the number of bank customer deposit and loan accounts stood at 14,893,628 and 2,051,658 respectively.

Stress tests conducted by the Central Bank indicated that the sector remains sound and resilient. It is noteworthy that the financial sector is developing and deepening faster than the overall economy. It grew by 9.0% in 2010 and 7.8% in 2011 while the economy grew by 5.8% and 4.4% in 2010 and 2011 respectively. This has been driven by financial infrastructure that has enabled financial inclusion. The growth of micro deposit accounts (accounts with average balances of Ksh 100,000 and below) has been a critical contributor to the development and deepening of the banking sector. These accounts have increased from about 2.14 million in 2005 to 14.0 million in June 2012. The number of loan accounts remains low at just over 2 million and will need to increase substantially to catalyse reduced unit costs of loans. In this regard, the Central Bank will continue to work with Government and the banking sector to implement reforms geared towards reducing the cost of credit to increase the number of Kenyans able to access credit.

Structure of the Balance Sheet

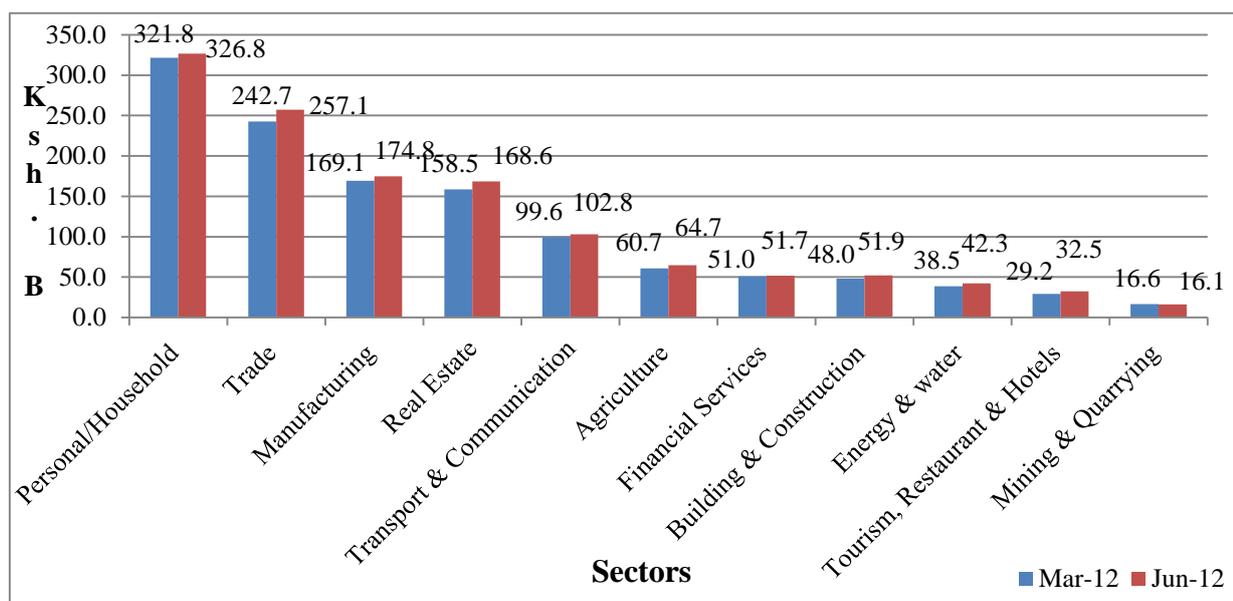
i) Assets

The banking sector's aggregate balance sheet expanded by 4.8 percent from Ksh. 2.1 trillion in March 2012 to Ksh. 2.2 trillion in June 2012. The major components of the balance sheet were loans and advances, government securities and placements, which accounted for 56.6 percent, 19.5 percent and 7.3 percent of total assets respectively.

ii) Loans and Advances

The sector's gross loans and advances increased from Ksh. 1.24 trillion in March 2012 to Ksh. 1.29 trillion in June 2012, which translated to a growth of 4.0 percent. The growth, which stood at Ksh. 53.6 billion, was in 10 sectors as shown in Chart 1 with Mining and Quarrying sector registering a marginal decline of Ksh. 0.5 billion occasioned by higher repayments than the new loans advanced to the sector during the period.

Chart 1: Sectoral Distribution of Loans (March 2012 Vs June 2012)



iii) Deposit Liabilities

Deposits, which form the main source of funding for the banking sector, accounted for 75.5 percent of total funding liabilities. The deposit base grew by 6.4 percent from Ksh. 1.56 trillion in March 2012 to Ksh. 1.66 trillion in June 2012 mainly due to branch expansion, remittances and receipts from exports.

The number of bank branches stood at 1,196 an increase of 22 from the 1,174 branches registered in March 2012. Similarly, the number of bank deposit accounts increased from 14.36 million in March 2012 to 14.89 million in June 2012 representing a growth of 0.53 million accounts or 3.7 percent.

iv) Capital and Reserves

The banking sector registered improved capital levels in June 2012 with total capital growing by 4.8 percent from Ksh. 280.9 billion in March 2012 to Ksh. 294.3 billion in June 2012, whereas shareholders' funds increased by 5.1 percent from Ksh. 299.8 billion in March 2012 to Ksh. 315.1 billion in June 2012. Similarly, the ratio of total capital to total risk-weighted assets increased from 20.2 percent in March 2012 to 20.3 percent in June 2012 while core capital to total risk weighted assets decreased from 17.9 percent to 17.7 percent over the same period.

Other Banking Sector Performance Indicators

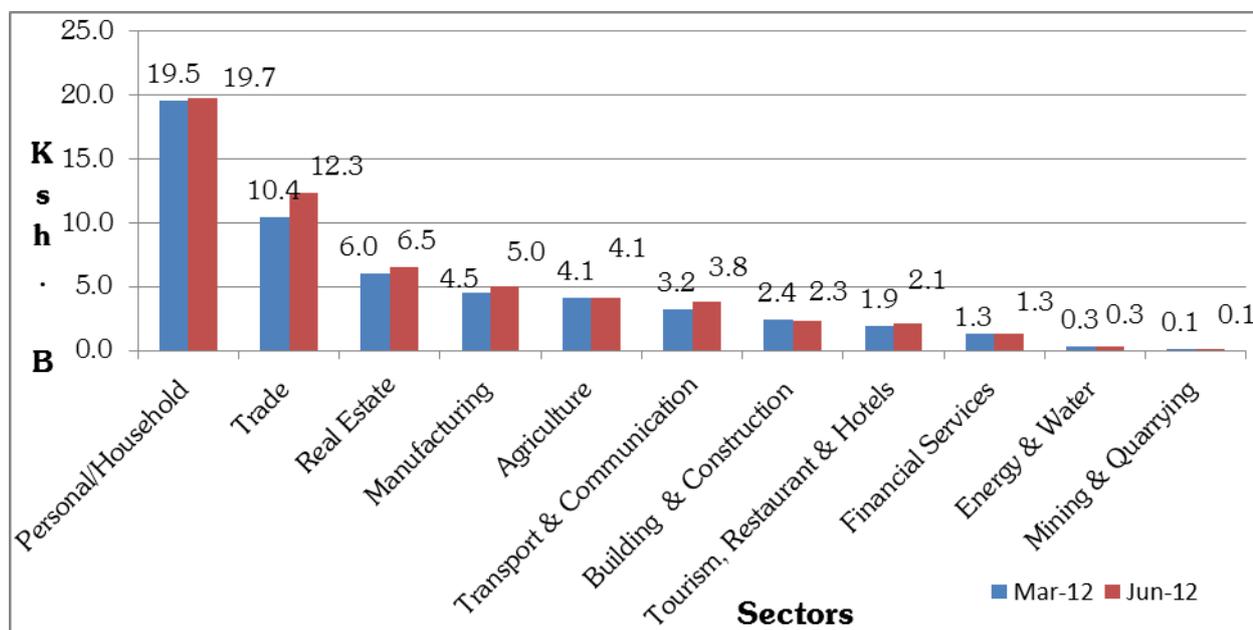
i) Assets Quality

The stock of gross non-performing loans (NPLs) increased by 7.1 percent from Ksh. 53.7 billion in March 2012 to Ksh. 57.5 billion in June 2012. Accordingly, the ratio of gross NPLs to gross loans increased from 4.3 percent in March 2012 to 4.5 percent in June 2012. However, the quality of assets, measured as a proportion of net non-performing loans (Gross non-performing loans less provisions and interest in suspense) to gross loans improved from 1.4 percent to 0.8 percent over the same period.

During the period under review, 6 out of 11 sectors registered increase in NPLs by Ksh. 3.8 billion with Building and Construction being the only sector that registered a decline

as shown in Chart 2. The high lending interest rates regime contributed to the increase in NPLs. However, banks continue to deploy enhanced appraisal standards to mitigate credit risk and the Central Bank is closely monitoring the trend.

Chart 2: Sectoral Distribution of NPLs (March 2012 Vs June 2012)



The credit risk environment in Kenyan banks has improved substantially in recent years. The Kenyan banking sector emerged from a high non-performing loans environment in the 80's, 90's and early 2000's. This was partly attributable to weak credit risk management, weak corporate governance and non-performing government related debt. Due to the strengthened legal and regulatory environment, credit standards have been enhanced and government related and other legacy non-performing debt has been resolved. The introduction of the credit information sharing mechanism in 2010 has further strengthened credit appraisal standards. The generally enhanced economic environment since 2003 has also seen a faster growth in new lending compared to the rate of loans becoming non performing.

ii) Profitability

The banking sector profit before tax for the quarter ended June 2012 increased by 15.4 percent from Ksh. 24.7 billion in March 2012 to Ksh. 28.5 billion in June 2012. However, total income stood at Ksh. 88.0 billion in the second quarter being a marginal decline of 0.5 percent from Ksh. 88.4 billion registered in the first quarter of 2012. Whilst total expenses declined by 6.4 percent from Ksh. 63.7 billion in the March 2012 quarter to Ksh. 59.6 billion in the June 2012 quarter. On an annual basis, the profitability of the sector increased by 30.4 percent to Ksh. 53.2 billion from the Ksh. 40.8 billion registered in June 2011.

Interest on loans and advances, fees and commissions and government securities, which are the major sources of income accounted for 62 percent, 17 percent and 13 percent of total income respectively. On the other hand, interest on deposits, staff costs and other expenses were the key components of expenses, accounting for 42 percent, 24 percent and 20 percent respectively.

It is important to note that the Central Bank requires banks to maintain adequate provisions for non-performing loans before declaring profits or dividends. To enforce this, the Central Bank relies on both off-site and on-site surveillance. Offsite surveillance is based on periodic returns from banks which enables the Central Bank to assess the loan portfolio quality of individual banks. This is supplemented by onsite surveillance which involves visits to banks to review individual loan facilities and identify any additional loan provisions required. Banks are required to effect any additional provisions identified by the Central Bank before declaring profits or dividends.

iii) Liquidity of the Banking Sector

For the period ended June 2012, average liquid assets amounted to Ksh. 599.0 billion while total liquid liabilities stood at Ksh. 1,571.1 billion, resulting to an average liquidity ratio of 38.1 percent, against 37.3 percent registered in March 2012, and above the minimum statutory limit of 20 percent. The gross loans to deposits ratio decreased from 79.5 percent in March 2012 to 77.8 percent in June 2012 an indication of a slow-down in credit growth in relation to the increase in deposits mobilization.

B. BANKING SECTOR POLICY DEVELOPMENTS

i) Credit Reference Bureaus

The Credit Information Sharing (CIS) mechanism which was launched in July 2010, continues to be used by both commercial banks and individuals. The number of credit reports requested by institutions stood at 1,774,185 in June 2012 up from 1,542,988 reports in March 2012, representing an increase of 15.0 percent or 231,197 reports. Over the same period, the number of reports requested by customers increased from 7,603 to 10,032 reports.

The introduction of the credit information sharing mechanism has further strengthened credit appraisal standards. Banks have now incorporated credit reference reports in the credit risk appraisal. It is also expected that credit referencing will go a long way in inculcating credit discipline in borrowers.

ii) Agency Banking

As at 30th June 2012, there were 10 commercial banks that had contracted 12,054 active agents facilitating over 18.7 million transactions valued at Ksh. 93.1 billion. This was an increase from 8 banks that had contracted 10,006 active agents facilitating over 13 million transactions valued at Ksh. 64.8 billion in March 2012.

iii) Deposit Taking Microfinance Institutions

As at 30th June 2012, 6 Deposit Taking Microfinance Institutions (DTMs) were in operation and had gross loans worth Ksh. 17.9 billion compared to Ksh. 17.2 billion registered in March 2012 thus translating to a growth of 4.1 percent. Similarly, the deposits base stood at Ksh. 12.3 billion representing a growth of 22.0 percent from Ksh. 10.8 billion in March 2012. The long-term borrowings by DTMs increased from Ksh. 6.8 billion in March 2012 to Ksh. 9.2 billion in June 2012. The number of DTMs deposit accounts and loan accounts stood at 1.6 million and 0.5 million respectively in June 2012 compared to

1.5 million deposit accounts and 0.48 million loans accounts registered at end of March 2012.

iv) Authorization of a Representative Office of a Foreign Bank in Kenya

On 29th June 2012, the Central Bank granted authority to Bank of China Limited to open a Representative Office in Kenya. Bank of China Limited becomes the fifth foreign bank to be authorized by the Central Bank to establish a Representative office in Kenya.

Under the Banking Act, a representative office of a foreign bank in Kenya is not permitted to engage in banking business as defined in the Act but can only engage in marketing and liaison roles in connection with the activities of its parent bank and affiliates.

Banking Sector 2012 Outlook

The banking sector is expected to sustain its growth momentum on the backdrop of declining inflation, stabilization of the Kenya shilling and downward revision of lending interest rates. The Central Bank is also conducting a comprehensive review of the banking sector legal and regulatory framework. The revised prudential and risk management guidelines to be issued in the second half of 2012 are intended to address emerging risks and ensure the continued stability and integrity of the sector as the number of Kenyans included in the banking sector continues to grow rapidly. The enhanced regulatory framework will strengthen corporate governance and risk management frameworks to deal with cross border risks as Kenyan banks expand regionally. The new framework will also enable banks to boost their liquidity management, loans management and enhance their resilience to withstand macro-economic shocks. The capital management framework will be strengthened to ensure banks hold adequate capital in relation to their risk profile and have adequate buffers to ride out periodic macro-economic shocks.