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The Monetary and Banking Situation in Kenya

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1. The monetary situation in Kenya

The year 2015 has been a difficult one for the Kenyan economy, characterised by:

- Rising interest rates;
- A significant decline in the equities market;
- Lower than expected revenues;
- Widening current account deficit (even with reduced crude oil prices);
- A weakening of the Kenyan Shilling against hard currencies; and
- The failure of two private banks – now under receivership - within four months.

These factors have led to:

- The World Bank growth estimates which were initially 6% and 6.6% for 2015 and 2016, being revised down to 5.4% and 5.7% respectively;
- The Nairobi Securities Exchange loosing 26% of its value in dollar terms year to date; and
- The increase of key interest rates from low teens to the low twenties – which is usually a sign of crisis in Kenyan markets.

In this paper, we discuss the various factors at play, and offer a view of the future based on Kenya's fundamental economic strengths. Our summary view is that the Kenyan markets continue to face many challenges, but that the majority of investors' positions will continue to perform well in the long term as the underlying fundamentals of the Kenyan economy have not changed, if the investors can remain patient and hold their nerve.

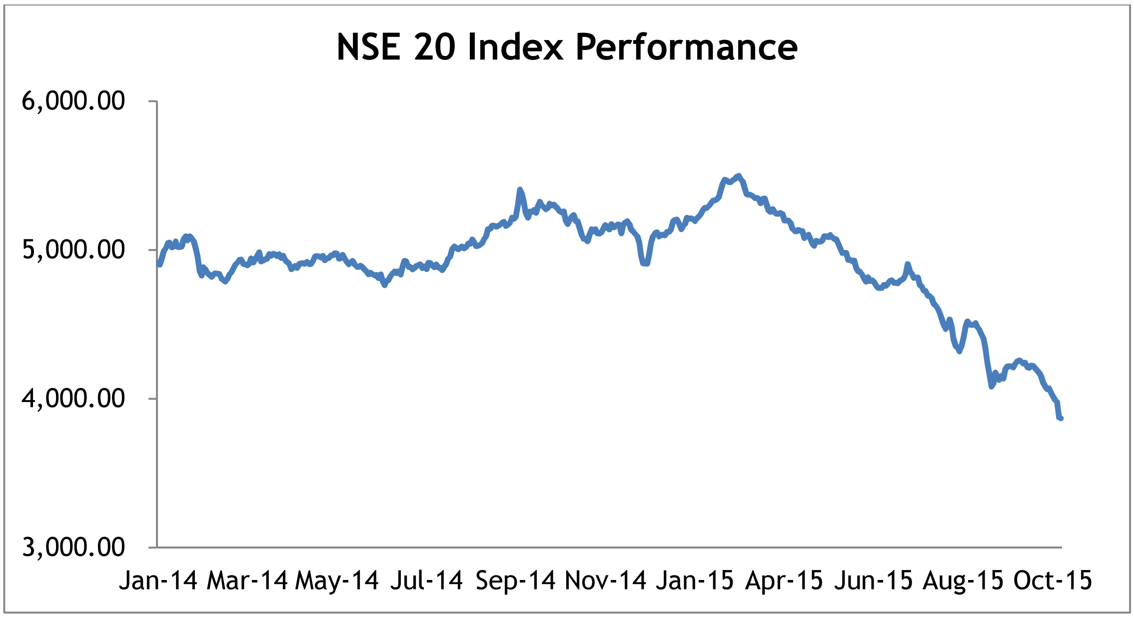
The Nairobi Securities Exchange

The Nairobi Securities Exchange has this year lost 26% of its value in USD terms. This declining equities market is not unique to Kenya and is being experienced in many developing markets. At a global level, this can be attributed to a weak global growth, driven by deceleration in emerging markets, particularly China, fears of a Greek default and a U.S. interest rate hike that was expected in September 2015.

As is common in Kenya, what began as a softening in markets following quite a sustained bull run (between January 2013 and March 2015, the NSE showed a 53% gain) turned into significant period of selling as investors quickly exited off equities. As one of the more liquid African stock markets, the NSE suffers when international investors seek to quickly rebalance portfolios. The lively retail market tends to follow suit, and the result can be seen.

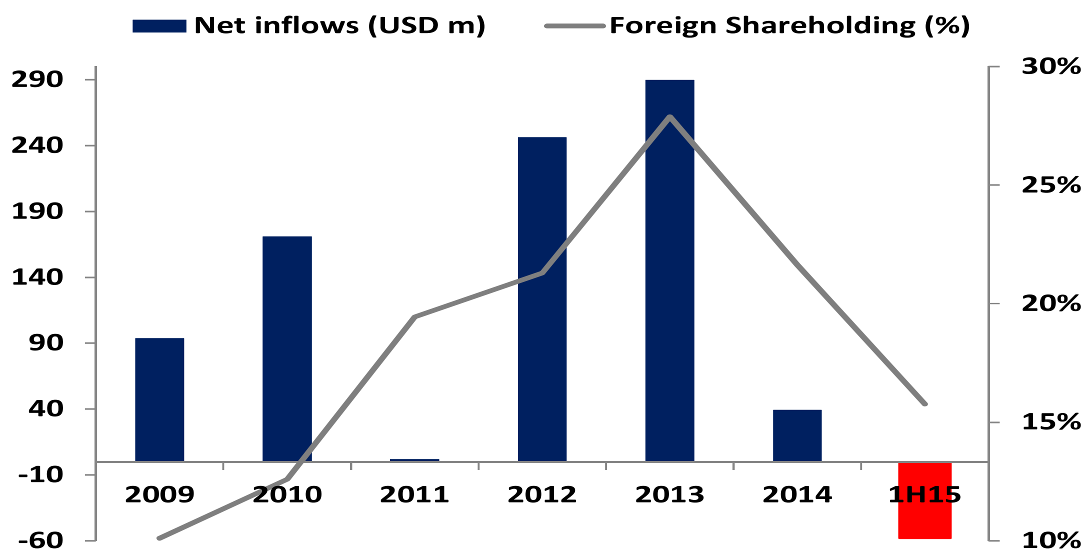
It can also be argued that, with T-Bills now offering 22% yield, any investor who stays in equities has to be a 'long-term believer' The Interest rate cycle has shifted asset allocation with a bias to short term fixed income, where the returns in Kenya are in upper teens and lower 20's

The graph below shows the NSE performance for the last 21 months to 15th October 2015:



Source: Nairobi Securities Exchange, Fusion Analysis

The graph below shows the increased sell off by the foreign investors at the NSE

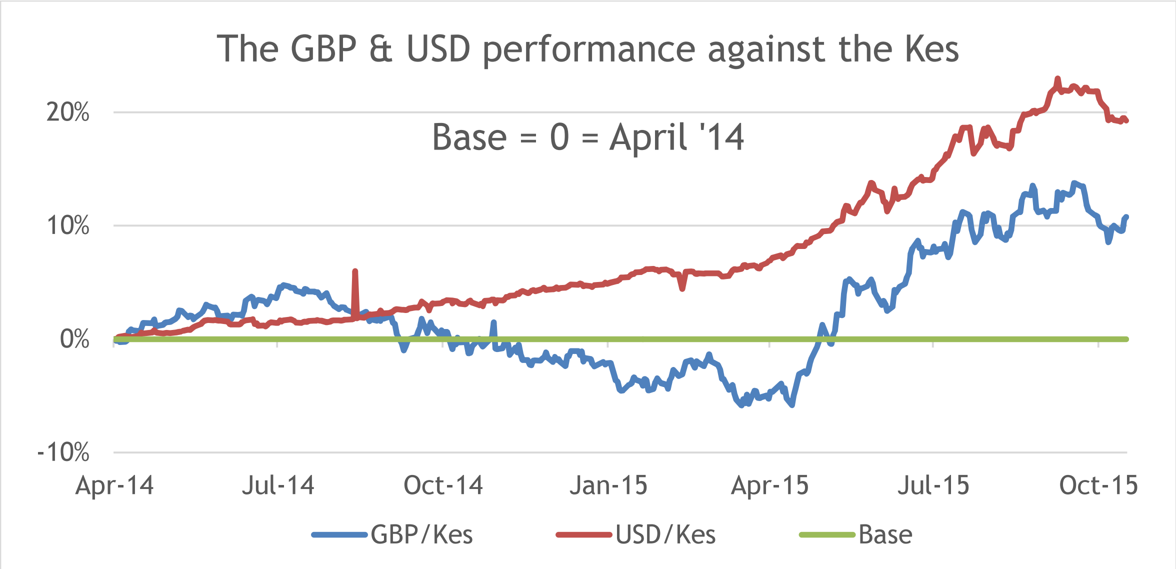


Source: Nairobi Securities Exchange

The Kenya shilling performance

The Kenya shilling has weakened to levels last seen four years ago due to both internal and external factors. This weakening of local currencies over the last 6 months has been witnessed in almost all the countries in Sub Saharan Africa.

The graph below shows the GBP and USD performance against the shilling



Source: Central Bank of Kenya

From the graph above, it is evident that both the USD and GBP have been strengthening against the Kenya shilling especially the latter part of 2015.

Domestically, the delay in appointing the Central Bank Governor - which led to policy uncertainty – and the huge current account deficit led by reduced inflows are some of the factors that have contributed to the weakening of the Shilling.

Internationally, the expectation that the US Reserve Bank would raise its key interest rates for the first time since June 2006 led to investors' flight from emerging markets to markets considered safe like the US.

On top of this, the country is currently importing large amounts of materials for some of its large infrastructural projects (e.g. the construction of Kenya's first rift valley standard gauge railway line) further widening the current account deficit.

The graph below shows the trend in the current account:

Source: Central Bank of Kenya

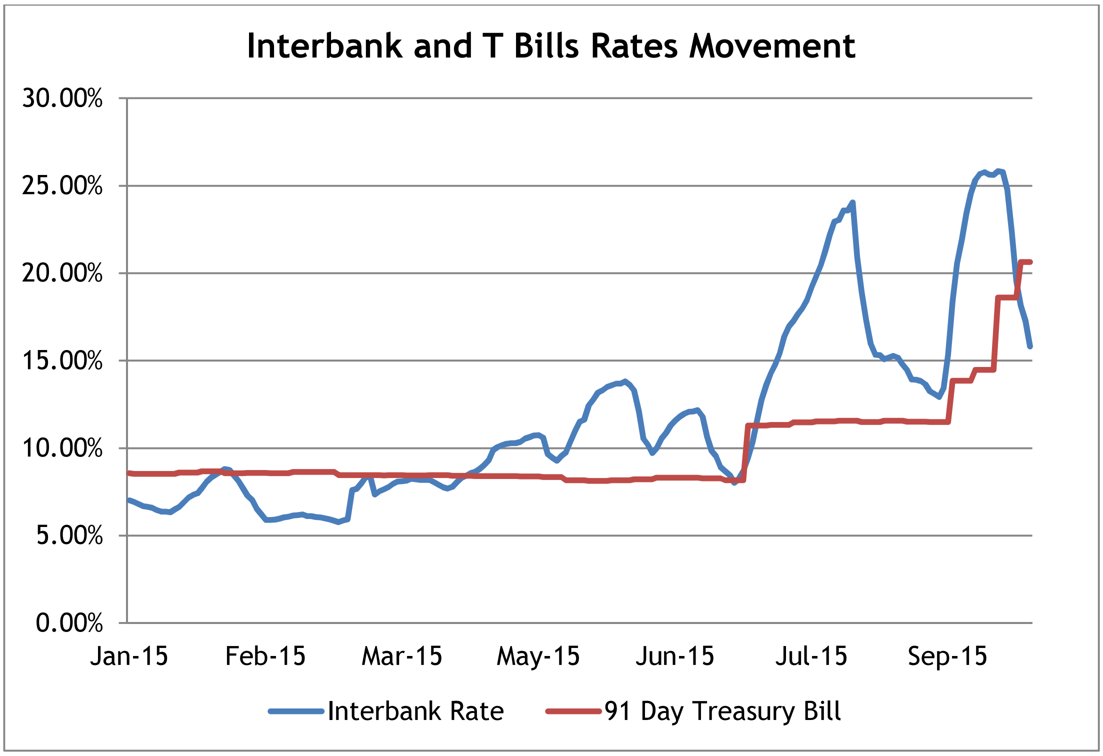
As shown in the graph above, the current account has continued to widen with increased imports bills.

More recently, the Central Bank has applied a number of measures to contain the shilling, including raising of its key interest rates and constant mopping of liquidity. The Monetary Policy Committee raised the key Central Bank Rate from 8.5% in May to 10% in June and finally to the current rate of 11.50% in July 2015. These measures are also expected to reduce consumption and inflationary pressure brought about by expensive imports.

Interest rates heading north

The Monetary policy tightening and tight liquidity have forced short term interest rates, which have averaged single digit and lower teens in the last three year, to the upper teens and lower twenties. Rates have been rising gradually from July 2015 to the current levels of lower twenties as the Central Bank moved to mop up liquidity to battle the weakening shilling

The graph below shows the interbank and Treasury Bills rates trend in the last ten months.



Source: Central Bank of Kenya

At these high interest rates level and low liquidity, it is expected that the Government will continue to crowd out the private sector. The high interest rates may also lead to an increase in non-performing loans within the banking sector in the near future.

On a positive note, this environment has presented our investors with great opportunities in money market where our positions are earning yields in excess of 22% in local currency.

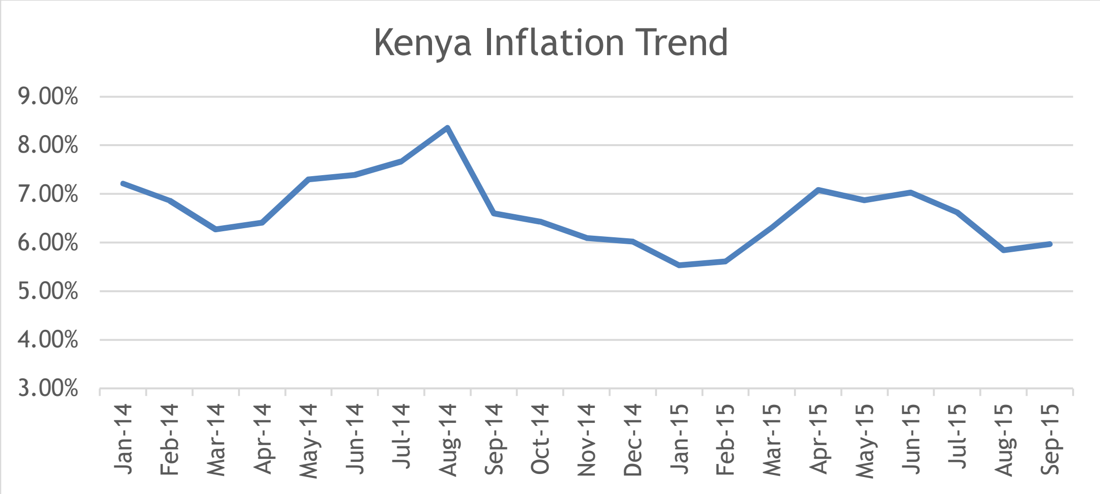
Going forward, we expect the regulator's monetary policy efforts to curb the volatility of the shilling causing it to stabilise. In addition, the government has secured a KS 67 Billion (USD 688 Million) loan facility from IMF for use in curbing exogenous domestic or external shocks.

These conditions remind us of 2011, when the Kenyan shilling fell to 0.0094 against the USD and 0.0060 against Sterling (USD against the KS was 106 and GBP to the KS was 166), and the CBK responded by raising short term interest rates to 18%. This then led to the currency rebounding, appreciating back to 0.0118 against the USD and 0.0076 against Sterling (USD to the KS 84.74 and GBP to the KS 131) by the year end. Investors who rode this cycle by buying shillings at a low price and then benefiting from both high interest rates and the appreciation, made a handsome return indeed - however, it required some nerve, and belief in the fundamentals of the economy.

Inflation

Kenya's inflation has been relatively stable, with monthly inflation being maintained at single digits. The current low global crude oil prices are expected to continue providing reprieve to inflation, and especially if the food prices rise.

The graph below shows the inflation trend in the last twenty one months



Source: Kenya national Bureau of Statistics

As shown on the graph, the highest rate was at 8.36% in August 2014 and since then the rate has been generally in a downward trend.

It is projected that the headline inflation is likely to average 6.62% in the year 2016. The only risk that is foreseeable is if the projected El Nino rains this quarter will be severe. Kenya being an agriculture dependent economy remains vulnerable to El Niño's. In case of excess rain, this will diminish crop yields and carries a risk of flooding on lowlands and flood-prone areas. This was a significant aspect of the 1997/98 El Niño, when floods devastated infrastructure and harvests.

The only other risk we foresee that is likely to push the inflation up is the Kenya shilling, if it is not contained - and with Kenya being a net importer - there is a likelihood that the shilling will exert an upward pressure on imported inflation.

2. The Kenya Banking Sector

As at 30th September 2015, the Kenyan banking sector – regulated by the Central Bank of Kenya 'CBK' – was comprised of 44 banking institutions (43 commercial banks and one mortgage finance institution). These banks held total assets worth KS Billions 3,199 (USD 32 Billion) and had outstanding Loans/advances worth KS Billions 1,531 (USD 15Billion).

Historical development in the Kenyan Banking Sector

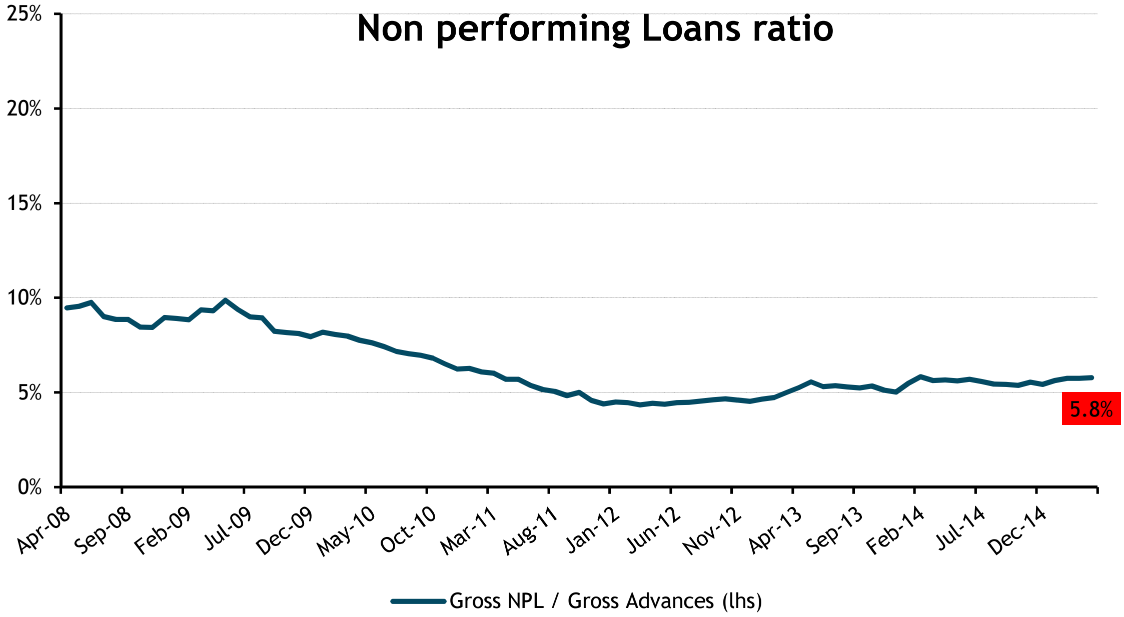
The banking sector has been significantly modernised and strengthened since the 1980s and 1990s when it faced problems of under-capitalisation, high levels of non-performing loans, weak corporate governance, and inadequate competition (amongst other issues). Following the banking crisis of the mid 1980s, Kenya established a deposit protection fund Board to manage the deposit insurance fund and carry out the liquidation of insolvent institutions once they were closed by the CBK. The Board has since been converted into an independent entity, the Kenya Deposit Insurance Corporation (KDIC), under an independent Act of Parliament.

In 1998 the CBK enhanced capital requirements and raised the gearing ratio from 5% to 7.5% in order to prevent other crises in the banking sector. Further, effective as of January 2008, the minimum capital requirement for commercial banks was increased from Ksh 250 million (USD 2.5M) to Ksh1 billion (USD 10M) in a graduated, staggered manner over four years. Revised prudential and risk management guidelines were issued by the CBK in November 2012. These reforms, adopted over the past few decades, have substantially improved the stability and efficiency of the Kenyan banking system.

Today, Kenyan banks are generally well-capitalised with an overall capital adequacy ratio of 20% (December 2014), considerably higher than the 12% required by the prudential guidelines.

Asset Quality in the banking Sector

Following the period of liberalisation in the 1980s and 1990s, and in particular after the economic crisis in the mid-1990s, there was a peak in Non-performing loans (NPLs) in the banking sector rising to a high of 33.6% in 2001 - mostly due to the NPLs accumulated by a few Government-owned and Government-influenced banks. Post 2001, the share of NPLs to total loans gradually declined. The level of NPLs started increasing again after 2011, mostly as a result of higher interest rates introduced as a response to a period of macroeconomic instability.



Recent adverse development in the banking sector

After many years of stability, the Banking sector has recently witnessed two adverse development incidents (defined as events which caused short periods of panic in the Kenya's financial sector). This year has seen the collapse and liquidation of one bank, Dubai Bank Kenya Limited (August 2015) and placement under statutory management of another bank, Imperial Bank Limited (October 2015). As the collapse of and subsequent liquidation of Dubai Bank was due to mismanagement, it did not have much of an affect the banking sector. In addition, Dubai bank was relatively small with a net asset of KS 3.5 Billion (USD 34 Million) and a market share of 0.1%.

The placement of Imperial Bank Limited under statutory management however has led to some panic in the banking sector. Imperial Bank is a mid-tier bank (ranked 17th) with a market share of 1.8% and an asset base of KS 70.33 Billion (USD 679 Million) (June 2015). On top of this (and again unlike Dubai bank) the placement of the bank under statutory management caught the market by surprise.

What went wrong with Imperial Bank Limited (in Receivership)?

Imperial Bank Limited is a public company incorporated in the Republic of Kenya in 1992. Initially incorporated as a private finance and securities company (Imperial Finance and Securities Company Limited), Imperial has since become a fully-fledged Kenyan commercial bank. In 2010, they established a subsidiary in Uganda - Imperial Bank (Uganda) Limited - which operates 26 branches in Kenya and 5 branches in Uganda and had a market share of 1.8% (Kenya) as of December 2014.

On 13th October 2015, the Central Bank of Kenya and the Bank of Uganda placed the operating units of Imperial Bank in their respective jurisdiction under statutory management for a maximum period of twelve (12) months after it was made aware, by the Imperial Bank board of directors, of inappropriate banking practices. While the regulator has not provided the exact details of the foregoing, only stating it was due to (amongst others irregularities and malpractices) the exposure of its depositors and creditors and the banking sector in general to financial fluctuations. The bank currently is not transacting any banking business except accepting loan repayments so as prevent a run on deposits.

Sadly, the bank had just completed a bond sale earlier this month, of KS 2 billion (USD 19 million) and was to begin trading on the Nairobi Securities Exchange on the same day it was suspended. The proposed listing has since been suspended. This suspension will definitely have an adverse effect on the Bond investors and also on other firms aspiring to raise debt from the public. It is to be noted that this year alone, several corporates have raised over KS 23 Billion (USD 0.2B) in corporate debts successfully from the markets.

Was the case of Imperial Bank a unique case?

Though the Central Bank action has caused some panic in the markets since the bank had deposit worth KS 58 Billion (USD564 Million), the regulator has promised to use all avenues at its disposal to ensure there is enough liquidity in the banking sector.

We believe that the Imperial Bank case is an isolated one and that its challenges does not present a systemic risk for the banking sector. We believe that Kenya's banking sector is safe and robust.

At Fusion, we were not in any way exposed to the happenings at Imperial Bank. The bank in the first place had not met our minimum threshold and therefore was not in our list of pre-approved counterparties.

Conclusion

The Kenyan economy continues to face many challenges both internally and externally. With these challenges, the economy has opportunely presented Fusion and her investors with an opportunity especially in the money markets in local currencies where the rates are in the twenties.

According to a World Bank Report (October 2015), the Kenya's economic growth could be the highest in sub Saharan Africa over the next 15 years. The bank says that the Kenya's growth should remain robust at around 6.2% until 2030, well above that of many other African economies who will suffer from China's economic slowdown and restructuring away from foreign investment and towards domestic consumption.

Our view, based on Kenya's fundamental economic strengths is that the issues the country is facing are temporary and that the country will come out of them in the short to medium term and that current investors' returns will continue to be robust in the long term as they are underpinned by the market fundamentals- if they can be patient and hold their nerve.

The placement of Imperial Bank under statutory management did not directly affect Fusion as we did not have an exposure with them either for deposit or having invested in their recently concluded Corporate Bond. At Fusion, we pay extra attention in selecting counterparties. We consider (among other factors): the counterparty stability, experience, size, exposure, management and governance. We have a list of pre-approved counterparties based on these factors which are regularly monitored. In addition, we only deal with Tier I and strong Tier II banks.

We believe the Kenyan banking sector is safe and robust and that the Imperial Bank limited issue is an isolated case and that its challenges does not present a systemic risk at all for the banking industry.