KENYA BANKERS
ASSOCIATION

STATE OF THE BANKING INDUSTRY REPORT 2023

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CENTRE FOR RESEARCH ON

FINANCIAL MARKETS AND POLICY®

STATE OF THE BANKING INDUSTRY REPORT 2023

The Centre for Research on Financial Markets and Policy® was established by the Kenya Bankers Association in 2012 to offer an array of research, commentary, and dialogue regarding critical policy matters that impact on financial markets in Kenya. The Centre sponsors original research, provides thoughtful commentary, and hosts dialogues and conferences involving scholars and practitioners on key financial market issues. Through these activities, the Centre acts as a platform for intellectual engagement and dialogue between financial market experts, the banking sector and the policy makers in Kenya. It therefore contributes to an informed discussion that influences critical financial market debates and policies.

ABOUT THIS REPORT

The *State of the Banking Industry (SBI) Report* is an annual publication of the *Kenya Bankers Association Centre for Research on Financial Markets and Policy®* aimed at contributing to the understanding of the Kenyan banking industry. The report is motivated by the fact that various stakeholders seeking perspective on the Kenyan banking industry engage various sources, including market analysts, banks, the Kenya Bankers Association (KBA) Secretariat, the Central Bank of Kenya (CBK) and other financial sector players and regulators. The breadth of views in this report is underpinned by the respective institution's analytical work, making the report reflective of the diversity of analyses.

The Kenya Bankers Association Centre for Research on Financial Markets and Policy® has compiled a database of financials at the bank-level spanning over one and half decades. Together with other secondary data whose source is duly acknowledged, the database underpins the analyses in this report. The financial database, indicated as KBA data in the report, is based on published financial statements by banks up to December 31, 2022.

The report's analysis is undertaken at industry level as well as in the three-Tier bank clusters – Large, Medium, and Small. It also draws on the background work that is published under the Kenya Bankers Association *Working Paper Series* and other relevant published work as cited in the report and links provided as appropriate.

This issue of the *SBI Report* has benefited from discussions, comments and suggestions from banks, analysts, and academic researchers. However, the analysis and inferences are entirely those of the report's authors and should not be attributed to those who commented on it, the KBA General Body, and Governing Council.

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FOREWORD

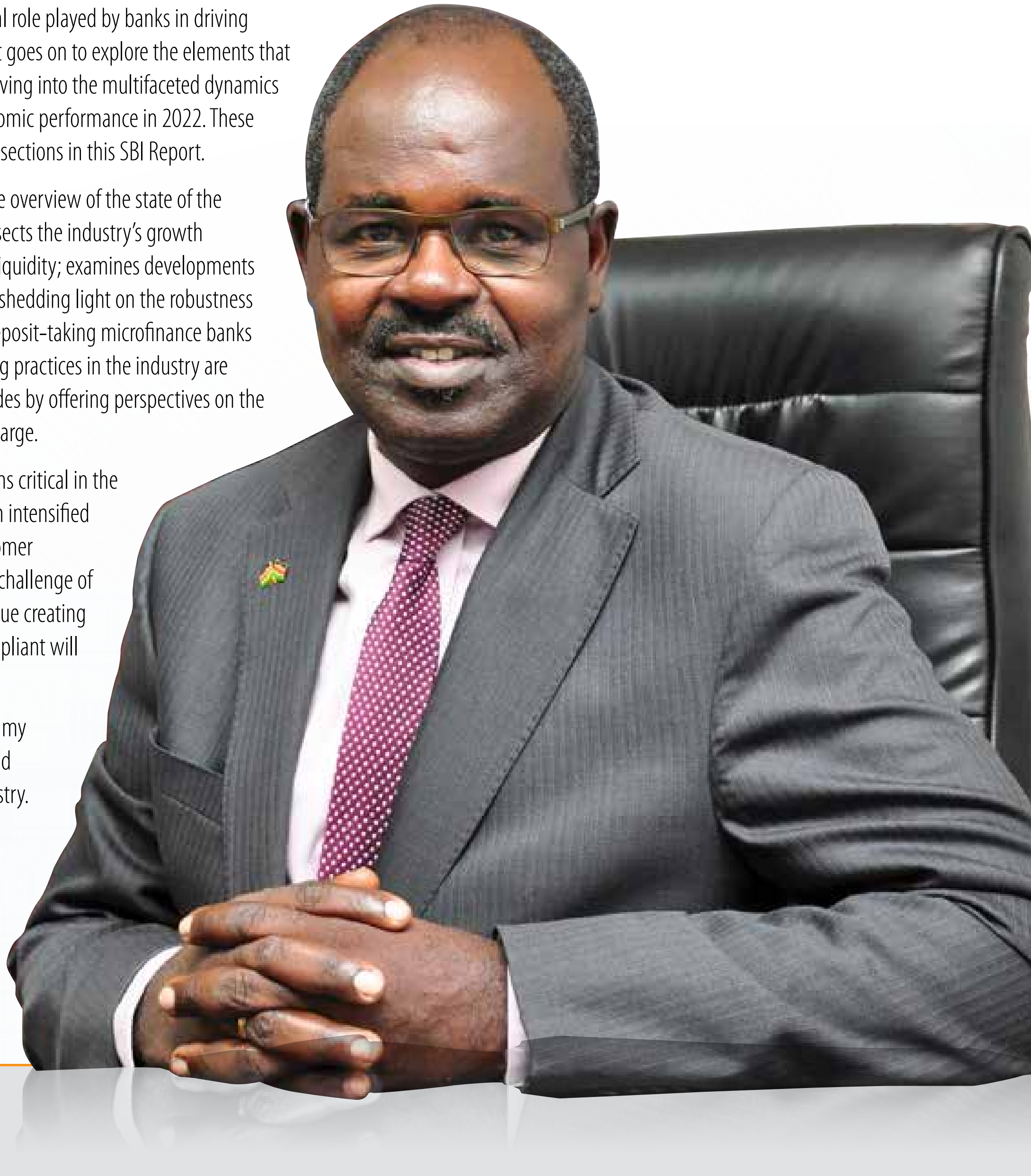
The fifth edition of the State of the Banking Industry (SBI) Report by the Kenya Bankers Association sheds light on diverse factors that influenced Kenya's economic growth path in 2022. The report highlights the economy's resilience in the face of both global and domestic shocks.

Moreover, the report underscores the pivotal role played by banks in driving economic activities across various sectors. It goes on to explore the elements that contributed to the economy's resilience, delving into the multifaceted dynamics of the banking sector that shaped the economic performance in 2022. These insights are presented across seven distinct sections in this SBI Report.

The initial section provides a comprehensive overview of the state of the economy. Subsequently, the SBI Report dissects the industry's growth indicators, including assets, liabilities, and liquidity; examines developments in asset quality and financial performance, shedding light on the robustness of the banking sector. The significance of deposit-taking microfinance banks and the embodiment of sustainable banking practices in the industry are also highlighted. Finally, the Report concludes by offering perspectives on the Outlook for the sector and the economy at large.

The pursuit of operational excellence remains critical in the banking sector. As such, navigating through intensified market competition and ever-shifting customer expectations, the industry faces the crucial challenge of continuously re-engineering itself to continue creating value in the economy while remaining compliant will all the regulatory requirements.

As you delve into the depths of this Report, my sincere aspiration is that you gain a profound understanding of the Kenyan banking industry.



Dr. Habil Olaka,
Chief Executive Officer

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ABBREVIATIONS

CAR	Capital Adequacy Ratio
CBK	Central Bank of Kenya
CIR	Cost-to-Income Ratio
CoF	Cost of Funding
DEG	German Development Finance Institution
DLR	Deposit-to-Liability Ratio
EAC	East African Community
FMO	Dutch Entrepreneurial Development Bank
GDP	Gross Domestic Product
HHI	Herfindahl-Hirschman Index
IMF	International Monetary Fund
IOS	Apple Operating System
KBA	Kenya Bankers Association
KSL	Kenya Sign Language
LDR	Loan-to-Deposit Ratio
LLR	Loan Loss Provisions
MFB	Micro Finance Bank
MSME	Micro, Small and Medium sized Entrprises
NIR	Net Interest Margin
NPL	Non-performing Loan
PMI	Purchasing Managers' Index™
PWD	Persons with Disability
ROA	Return on Assets
ROE	Return on Equity
SFI	Sustainable Finance Initiative
TRWA	Total Risk-Weighted Assets

ATM with keys for visually impaired customers

EXECUTIVE SUMMARY

- Kenya's macroeconomic environment proved resilient in 2022 despite shocks from both the global and domestic economy; to grow at 4.8 percent compared to 7.6 percent in 2021. This reflected a rebalancing effect of a stronger growth in services and industry as agriculture remained depressed. On the policy front, inflationary challenges at both global and domestic front triggered monetary policy tightening; that consequently pushed up interest rates and cost of Government borrowing. Besides taming inflationary pressures, the other policy priority was reducing debt vulnerabilities in the economy. Against this backdrop, and as highlighted in this State of the Banking Industry Report, the focus is on evolution of the banking industry in 2022.
- There were two critical regulatory developments that shaped the outcomes of the credit market in 2022. First, was the enhanced approvals of banks' risk-based credit pricing models by the Central Bank of Kenya that continued to support bank's ability to price credit appropriately. As at end 2022, twenty-eight banks (comprising of 4 Tier I; 7 Tier II; and 17 Tier III) out of 39 banks - representing 53.2% of total industry assets - had received approvals of their risk -based pricing models. Second, was the rollout of the Credit Repair Framework in November 2022 for the financial institutions, targeted at addressing the digital non-performing loans and improving credit records of borrowers at the credit reference bureaus (CRBs).
- Other developments during the year saw the banking sector assets (that account for about 47.1 percent of GDP) grow by 8.2 percent to Kshs. 6.5 trillion from Kshs.6.0 trillion in 20210, driven mainly by growth in loans and advances and investments in government securities that together accounted for 79.7 percent of the total assets. Changes in asset structure continued to reflect portfolio adjustments driven by the operating environment, individual bank's strategy in dealing with emerging challenges in the credit market as well as their risk appetite.
- Credit growth in 2022 was strong, reaching double-digit levels owing to the recovery in private sector activity. While this was evidently divergent across bank tiers, the observed private-sector lending was largely underpinned by dynamics in credit uptake by the key sectors of the economy, their inherent risk developments,

and embedded projections on their performance against other macroeconomic developments and risks.

- Analyses of banking sector concentration reveals reflect an increase in concentration; a reversal in trend that characterized the period 2019-2021. On the assets side of the balance sheet, banking sector concentration slightly increased in 2022 in terms of assets, with the top-10 banks accounting for 84.9 percent of the assets up from 77.8 percent in 2021. However, the concentration depicted in the banking sector did not threaten competition levels, with the Herfindahl-Hirschman Index (HHI) at 909.40 at end of 2022.
- The banking system deposits – the main liability component - maintained its strong growth trajectory, growing by 13.1 percent in 2022, thereby enhancing liquidity in the system and outpacing the growth in gross loans. Consequently, this partly led to increased liquidity in the banking system, with the deposit-to-liability ratio rising marginally to 70.8 percent from 70.3 percent in 2021; indicating the sector's continued reliance on wholesale funding to cut costs on the liability side of the balance sheet.
- The industry asset quality in 2022 improved slightly, reflecting a stronger growth in performing loans. The industry ratio of gross Non-Performing Loans (NPLs) to gross loans declined to 13.7 percent from 14.4 percent at end 2021; as the growth in loans outpaced the growth in NPLs . However, notable divergences across bank tiers were evident, that were mirrored in the provisions for expected credit losses. Even with the improved overall asset quality, the industry continued to increase its loan loss provisions to cover expected credit losses. In 2022, the banking sector's loan loss provisions rose by 16.2 percent to Kshs. 68.8 billion compared to Kshs. 59.2 billion in 2021; indicating banking sector's commitment to sustaining stability.
- Banking industry capitalization in 2022 remained strong; well above statutory minimum limits. The industry's total and core capital adequacy ratios were strong at 19.0 percent and 16.3 (marginally lower than 19.5 percent and 16.5 percent in 2021) but well above 14.5 percent and 10.5 percent statutory minimum limits, respectively. The strong capitalization levels allowed the industry to whether economic shocks that increased credit risk.

Picture Credit: Chris Njoroge/CBK

- The industry financial performance in 2022 was robust, driven by a stronger increase in total operating incomes than the total operating costs; thus, mirroring a decline in the cost to income ratio. Total operating incomes grew by 17.7 percent during the period, pushed up by a 93.6 percent rise in foreign exchange gains, as incomes from loans and investments in government securities remained steady on their growth trajectory. This increase amidst a slower (13.4 percent) growth in total operating costs, implied an improvement in the efficiency levels in the industry, with industry cost to income ratio to 56.7 percent in 2022 down from 58.4 percent in 2021. Consequently, the industry's net interest margin improved to 6.8 percent during the year up from 6.5 percent in 2021.
- The industry's total pre-tax profits rose by 23.0 percent in 2022, as average return on assets and return on equity edged up to 3.7 percent and 26.5 percent, respectively in 2022, up from 3.3 percent and 22.1 percent in 2021. The improved profitability reflected continued recovery of the economy from the depressing effects of the pandemic.
- The industry made significant strides in embracing sustainable finance practices; strongly appreciating that business goals needed to simultaneously deliver enhanced benefits for Profit, People and Planet. The industry pursued capacity building to support the adoption of sustainable banking practices. As at end 2022, over 44 thousand banking sector staff had undergone training on sustainability, with over 27 thousand (slightly over 60 percent of total banking sector staff) completing seven mandatory modules relevant for their job roles. Other activities included promoting inclusivity for persons with disability and financial literacy for SMEs as a key component in enabling access to finance.
- Analyses of developments in deposit-taking microfinance banks (MFBs) show that in 2022, they experienced a 4.8 percent reduction in total assets, reaching Kshs. 70.4 billion, accompanied by a 1.9 percent decrease in net loans and advances to Kshs. 39.3 billion. Their asset structure was stable, with net advances to customers accounting for 55.9 percent of the total assets, while short-term deposits, investments in government securities and cash/bank balances accounting for 15.8, 7.0 and 2.5 percent, respectively. Asset quality declined, reflected by a 14.5 percent NPL ratio deterioration and a lower coverage ratio of 2.3 percent. Liabilities and customer deposits decreased by 4.9 percent and 7.8 percent, respectively.
- The MFB's total income contracted to Kshs. 13.2 billion, while expenses increased to Kshs. 13.1 billion, majorly attributable to staff costs and deposit-related fees which accounted for 27.9 percent and 25 percent, respectively, of total expenses. Even so, efficiency improved, with the cost-to-income ratio dropping to 61.7 percent in 2022. Marginal profitability growth was evident, as pre-tax profits were up by 11.7 percent, resulting in higher return on equity (11.2 percent) and return on assets (1.4 percent), relative to the previous year. Despite increased competition indicated by declining Herfindahl-Hirschman Indices, a few major players still held 97 percent of total industry assets. Liquidity and capital adequacy remained strong, with an 81 percent aggregate liquidity position and a 16 percent capital adequacy ratio.
- The outlook of the banking sector appears strong underpinned by adequate capitalization and liquidity levels, the continuing banking sector's robust approach to treatment of asset quality deterioration and continued implementation of efficient and resilient business models. Nonetheless, the sector is keen to monitor the evolution of some emerging risks, from rising inflationary pressure, concerns of public debt sustainability, fragile economic recovery, and volatilities in both global financial markets.
- On the journey to sustainable banking, the sector is projected to sustain its drive in embracing sustainable finance practices as a critical driver of positive transformation in Kenya's banking industry. Banks have embraced a great responsibility to refine their approach and business models to meet the very present needs of all the stakeholders for their long-term viability and to support sustainable economic development.

Chapter 1:

INTRODUCTION

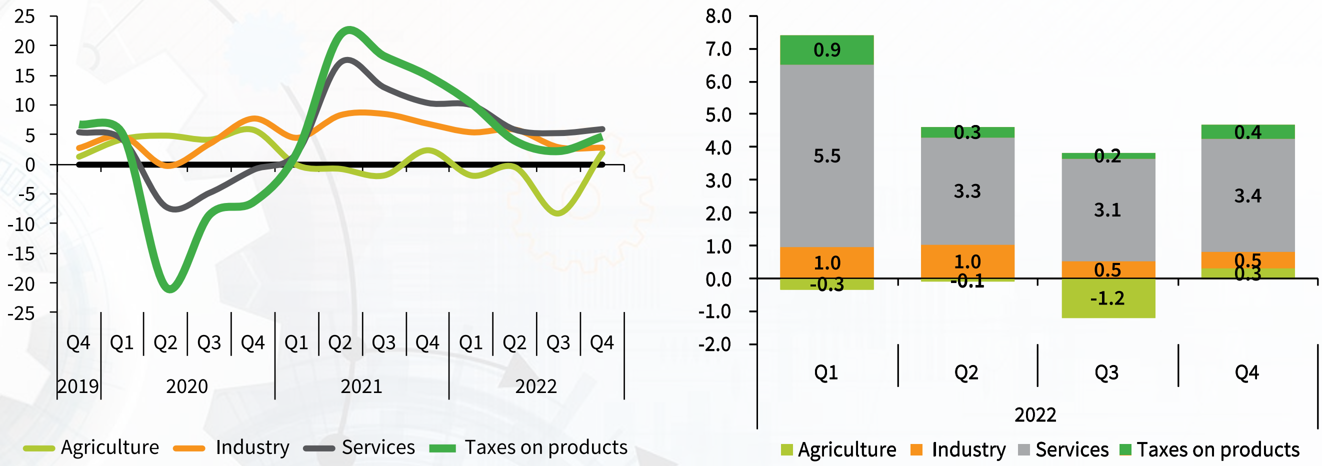
Kenya's macroeconomic environment proved resilient in 2022 despite shocks it experienced to grow at 4.8 percent compared to 7.6 percent a year earlier (Figure 1), reflecting a rebalancing effect of services and industry versus the agriculture sector. Several sectoral developments and mixed performances explain the resilience of the economy. First, the services sector continued to support growth despite reflecting a modest growth of 7.0 percent compared to 9.8 percent in 2021.

During the same period, the industrial sector grew by 3.9 percent, almost half of the growth of 7.5 percent recorded in 2021, as manufacturing activity decelerated to 2.7 percent compared to 7.3 percent in 2021. The contribution of agriculture, the backbone of the Kenyan economy, was negative through all the quarters in 2022 with the sector's overall performance depicting a stronger contraction by 1.6 percent compared with a contraction of 0.4 percent in 2021, due to adverse weather conditions experienced across the breadbasket regions of the country.

Figure 1: Economic Growth Rose to Above Pre-Pandemic Levels

1a. Overall growth supported by resilience in the services sector…

1b. Agriculture sector's contraction sustained through 2022...



Source: KBA, CBK & KNBS

> The Central Bank of Kenya, as well as other monetary authorities across the region shifted to aggressive monetary policy tightening in the second half of 2022, to tame rising inflationary pressures and inbuilt inflationary expectations.

Monetary policy stance during 2022 was tight as inflationary pressures and outcomes remained elevated and significantly above the government's target range. Headline inflation edged upwards to peak towards the end of 2022, driven by food and food prices as core inflation largely remained steady though on an upward trajectory. The Central Bank of Kenya, as well as other monetary authorities across the region shifted to aggressive monetary policy tightening in the second half of 2022, to tame rising inflationary pressures and inbuilt inflationary expectations. The interplay between economic and monetary policy developments had implications on the credit market dynamics. Overall, private sector credit double-digit growth momentum continued to be sustained, albeit with some moderation; a reflection partly of the transmission of monetary policy tightening stance. Overall, total banking sector credit to the private sector grew by 12.5% in the 12 months to December 2022 with the stock of credit growing to Kshs. 3,433.5 billion by end December 2022 (**Figure 2**). The double-digit growth trajectory owed to strong uptake of credit to mining and quarrying (whose credit grew by 31.40%), transport and communication (23.48%), agriculture (22.36%), manufacturing (13.78%), business services (13.68%), consumer durables (12.87%), trade (11.38%), building and construction (8.2%) among other sectors. Growth in bank lending was achieved without any detrimental impact on the asset quality, as non-performing loan ratio declined to 13.1 percent in December 2022 from 14.1% in 2021, reflecting an improvement in banking sector's efforts to generate good quality loan book.

Figure 2: Private Sector Credit Dynamics

Double-digit growth in credit to the private Sector is sustained albeit at a decelerating pace...

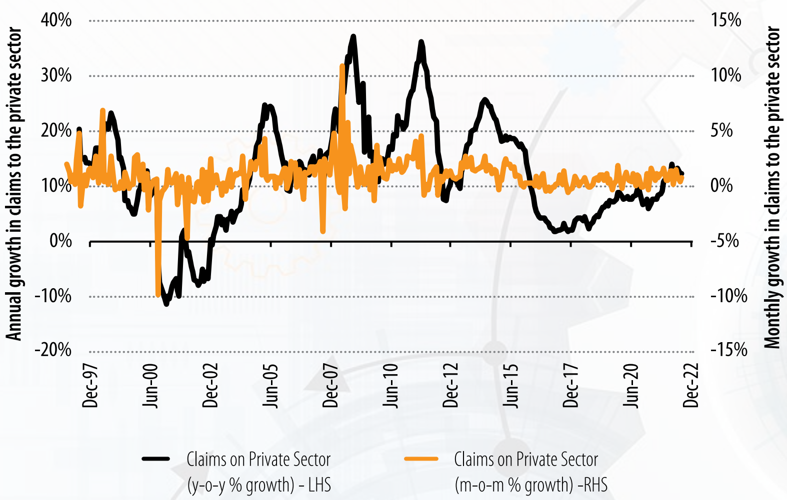
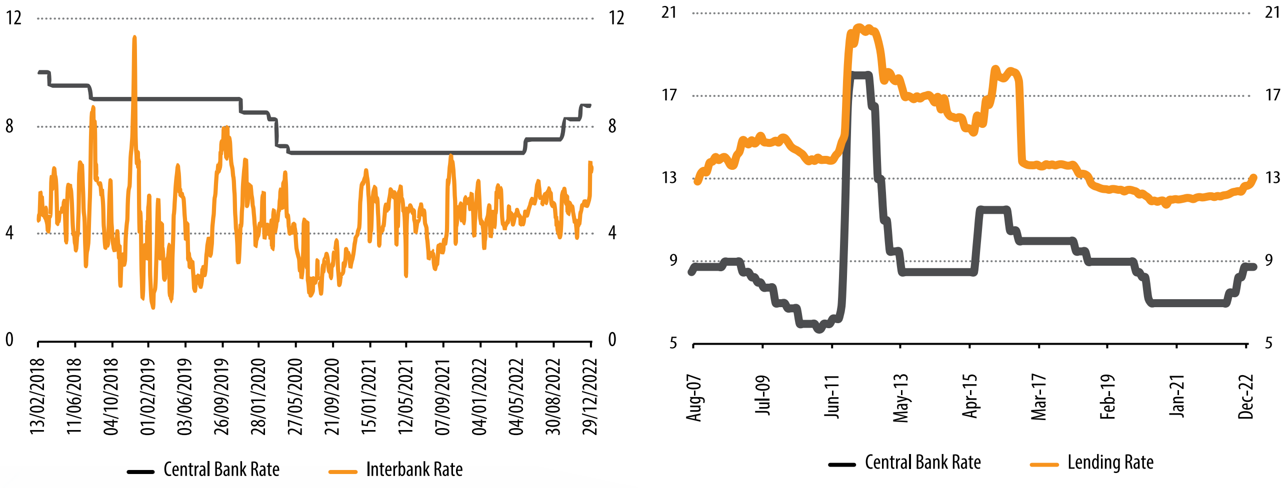


Figure 3: Trends in policy rate, interbank rates, and lending rates

3a. Interbank rates mirrors the trends in CBR.....

3b. Lending rates responding to strong signals of CBR hikes ...



Source: CBK

During the period, there was divergence in the domestic interest rates. As the Central Bank Rate (CBR) was adjusted upwards, the overnight interbank rate edged upwards as yields on government securities rose steadily. However, the banking sector loan rates remained largely sticky (**Figure 3**). This reflected slow transmission of monetary policy signals and banking sector loan portfolio rebalancing skewed towards high-yielding assets. Given the inherent lags in monetary policy transmission, the impact of the decisive strong upward adjustments in the CBR, particularly in the second half of 2022, was projected to have a stronger impact on credit markets and economic activity from the end of 2022 going forward.

On the fiscal policy front, policy priorities considerably shifted from short-term support to the economy to reducing debt vulnerabilities over the medium term. However, slower economic growth risks and realities threatened the fiscal consolidation path. On the revenue side, tax collection increased, supported by robust indirect and custom taxes. However, spending pressures intensified particularly in FY 2022/23 owing to the fuel subsidies imposed between July and August, the introduction of a maize flour subsidy in July, drought emergency interventions, and the launch of plans to support agricultural production through fertilizer subsidies in the last quarter of 2022. Going forward, the financing of the budget deficit was undertaken largely through the domestic issuance of bonds and concessional and commercial external financing. As at end of 2022 and looking into the medium term, fiscal consolidation to reduce debt vulnerabilities was likely to be achieved by raising the revenue-to-GDP ratio to above pre-COVID-19 levels to create space for growth-enhancing investments and priority social spending.

Regulatory developments shaped the outcomes of credit to the private sector. There were enhanced approvals of banks' risk-based credit pricing models by the Central Bank of Kenya that continued to support bank's ability to price credit appropriately. As at end 2022, twenty-eight banks (comprising of 4 Tier I; 7 Tier II; and 17 Tier III) out of 39 banks - representing 53.2% of total industry assets - had received approvals of their risk -based pricing models. Overall, a faster transition of the industry to risk-based pricing of loans is expected to boost credit supply and uptake by the private sector in the near to medium term.

Other notable policy developments that impacted on the credit market included the rollout of the Credit Repair Framework in November 2022 for the financial institutions, targeted at addressing the digital non-performing loans[1] and improve credit records of borrowers at the credit reference

bureaus (CRBs). According to the CBK, the framework aimed at enabling over 4.2 million mobile phone digital borrowers, adversely listed with CRBs, to repair their credit standing, and the total value of the outstanding facilities amounted to Ksh.30 billion (or approximately 0.8 percent of the gross banking sector loan portfolio at end October 2022). Under the Framework – that was expected to last for 6 months- financial institutions were required to grant mobile borrowers affected by the COVID-19 pandemic a discount (haircut) of at least 50 percent of the non-performing mobile loans (of less than 30 days maturity) that were outstanding as at the end of October. In addition, financial institutions were expected to enter into a repayment agreement with borrowers for the repayment of the outstanding balance during the period of framework implementation.

This report reflects the interplay between the state of the economy, the broader macroeconomic policy and the regulatory environment. In 2022, the state of the Kenyan banking industry sector was shaped by both monetary and fiscal policy developments that influenced the state of the economy overall as well as sectoral performances. The above background provides the setting upon which the state of the banking industry in 2022 is outlined. It provides the underpinning context for understanding the interaction between the market players, the regulatory requirements, customer, and shareholder expectations, and how the interactions fed into banks' financial performance. In essence, financial performance by whichever measure is seen as a consequence of the interactive process.

1 https://www.centralbank.go.ke/uploads/press_releases/318500544_Press%20Release%20-%20Credit%20Repair%20Framework.pdf

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Chapter 2:

INDUSTRY GROWTH

2.1 Banking System Total Assets

The banking system's total assets continued to grow, by 8.2 percent to Kshs. 6.5 trillion in 2022 from Kshs. 6.0 trillion in 2021 (Figure 4). Across bank Tiers, while all groups registered growth in assets, the magnitudes varied, reflecting heterogeneities across bank tiers. As total assets of large banks grew by 9.1 percent in 2022 to Ksh.4.9 trillion from Ksh.4.5 trillion in 2021, the assets of medium-sized banks grew by 7.6% to Ksh.1.4 trillion from 1.3 trillion over the period. Small-sized bank's assets however contracted by 6.7 % in 2022 reversing previous growth gains achieved since 2018; declining to Ksh.210.5 billion from Ksh.225.70 billion in 2021.

Figure 4: Banking System Total Assets

Figure 4a: Total Assets, Annual (Ksh. Billion)

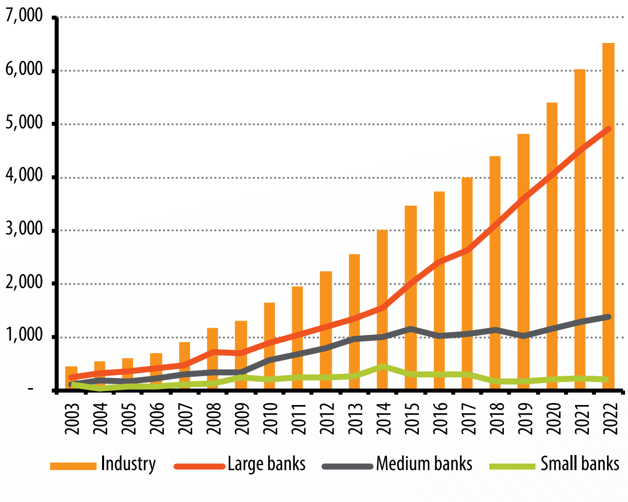
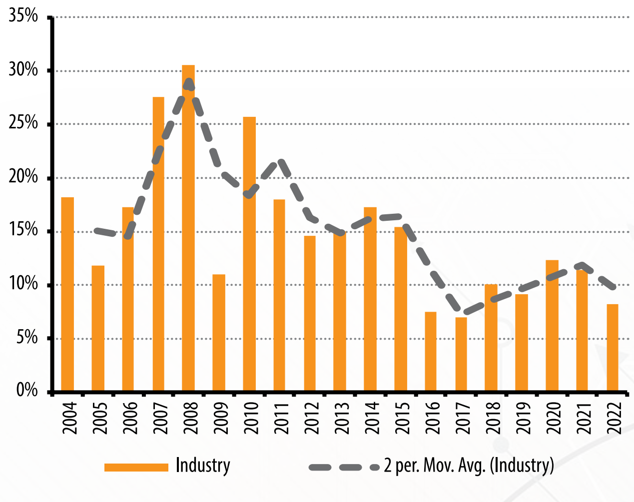


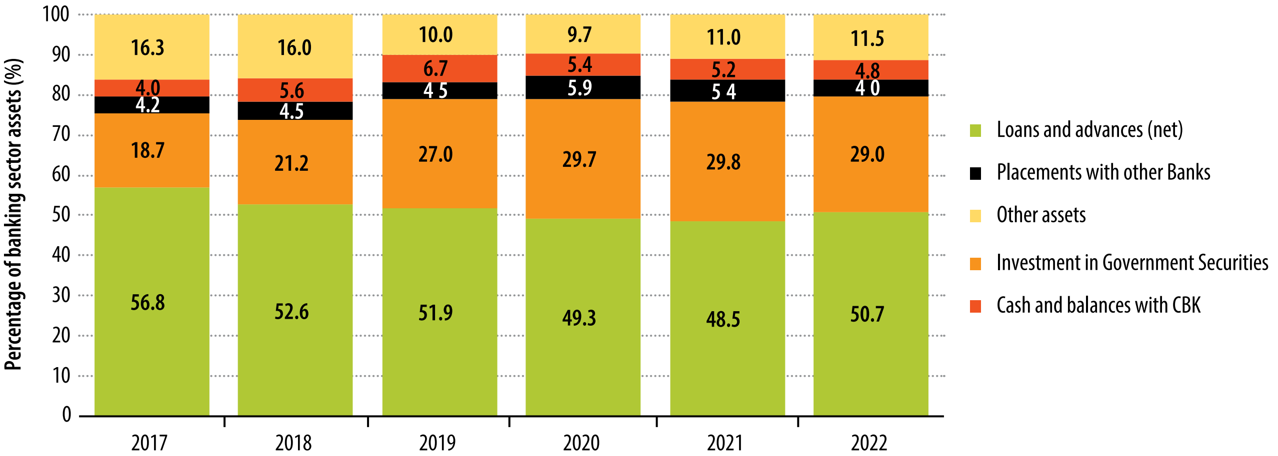
Figure 4b. Disaggregated Assets across Banks (%)



Source: KBA

An examination of the asset structure of the banking sector in 2022 reveals some notable changes (**Figure 5**). While loans and advances continued to dominate the asset structure, in 2022 accounting for 50.7 percent of the total industry assets compared to 48.5 percent in 2021. This reflected a portfolio shift out of investment in government securities (that accounted for 29.0 percent of total assets, slightly lower than the 2021 levels when it stood at 29.8 percent), and holdings of cash and balances with the CBK (that declined to 4.8 percent in 2022 from 5.2 percent in 2021). Similarly, interbank placements also contracted to 4.0 percent in 2022 from 5.4 percent in 2021. Changes in asset structure that reflected portfolio adjustments were driven by the operating environment, individual bank's strategy in dealing with emerging challenges in the credit market as well as their risk appetite.

Figure 5: **Disaggregated Asset Structure of the Kenyan Banking System**

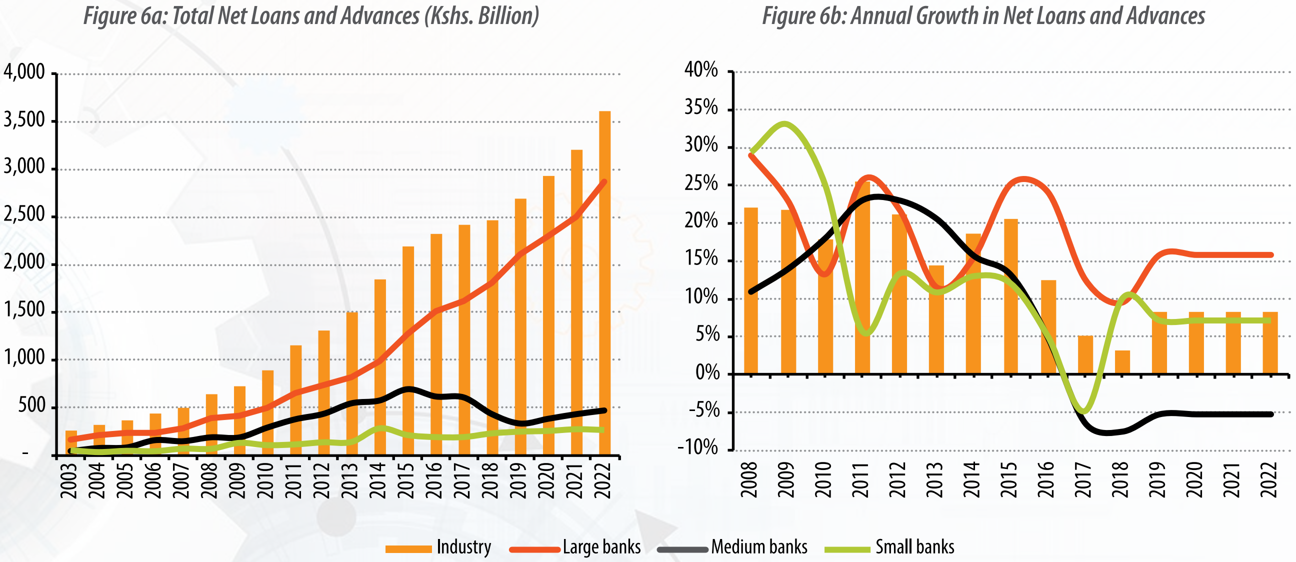


Source: KBA

2.2 Banking System Loans and Advances

Credit growth was stronger and reached double-digit levels owing to the reinvigoration of private sector activity. In 2022, loans and advances grew by 12.5 percent to Kshs. 3.6 trillion in 2022 from Kshs. 3.2 trillion in 2021 (**Figure 6**). Across the banks, divergences in the evolution of loans and advances were evident. Lending by medium (tier 2) banks grew by 9.1 percent in 2022 to Kshs. 472 billion from Kshs. 432.5 billion in 2021 while that of large (tier 1) banks expanded by 14.7 percent to Kshs. 2.8 trillion from Kshs. 2.5 trillion over the period. In contrast, lending by small (tier 3) banks declined by 2.9 percent to Kshs. 264.2 billion in 2022 from Kshs. 271.98 billion in 2021, reflecting net repayments of loans to the small banks.

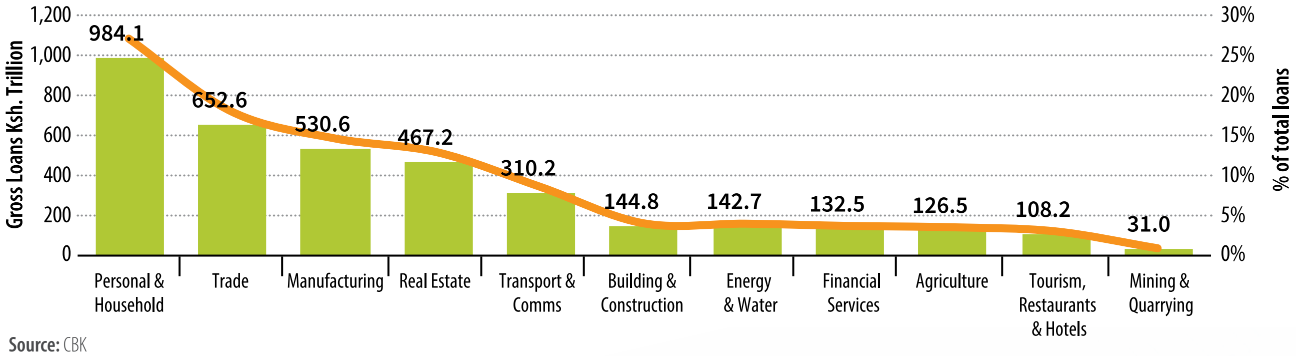
Figure 6: **Banking System Loans and Advances**



Source: KBA

The observed private-sector lending was underpinned by dynamics in credit uptake by the sectors of the economy, their ensuing risk dynamics and projected performance of each. Strong credit growth was absorbed by four main sectors: personal/household (that accounted for 27.1% of total credit to private sector), trade (18%), manufacturing (14.6%), and real estate (12.9%), cumulatively accounting for 72.6 percent of the total industry loan book (**Figure 7**). As such, the evolution of these sectors' risk profile had a strong impact on the overall performance of the industry loan book during the period.

Figure 7: Banking System Sectoral Loan Distribution as at December 2022



Source: CBK

2.3 Banking System Deposits

Deposits in 2022 continued to grow outpacing credit growth, reflecting the industry efforts in mobilizing more deposits in support of enhancing liquidity position. Total deposits in the banking sector expanded by 13.1 percent in 2022, (outpacing the credit growth which stood at 12.5 percent), to Kshs. 5.1 trillion from Kshs. 4.6 trillion as at end of 2021 (**Figure 8**). Despite this notable overall growth, changes were evidently varied across bank categories. Large bank's deposits grew by 12.8 percent in 2022 compared to 10.6 percent growth in 2021, as deposits in medium size banks expanded by 17.2 percent relative to 12.0 percent in 2021. The deposits growth in large and medium banks partly reflected movements of funds from the smaller banks; whose deposit mobilization efforts bore a modest growth of 7.0 percent down from 8.8 percent in 2021.

Figure 8: Banking System Deposits

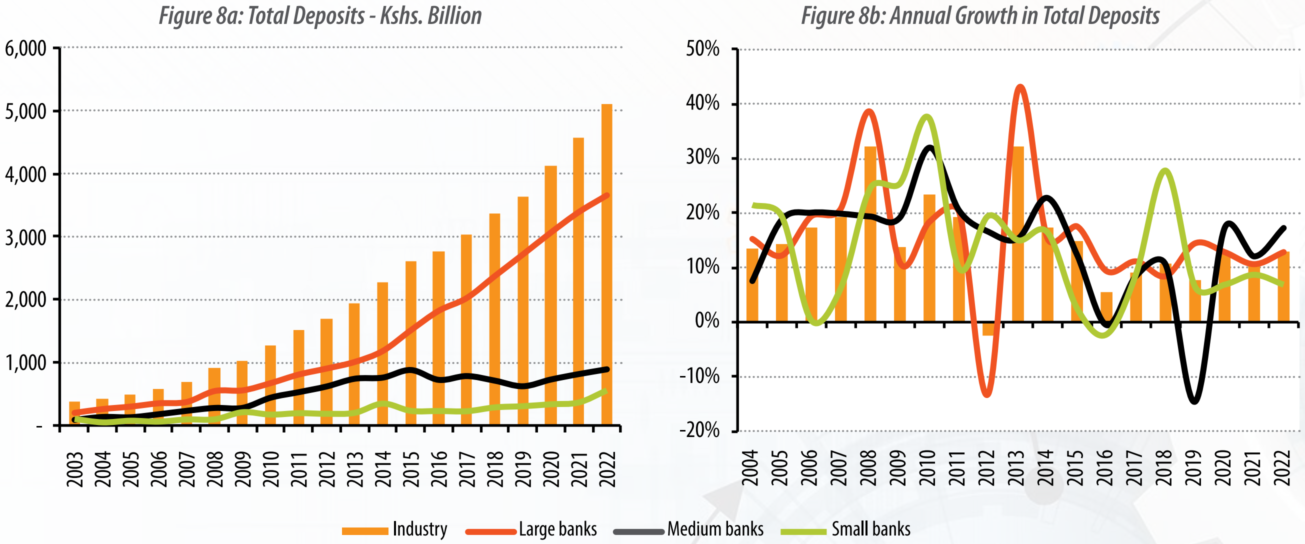
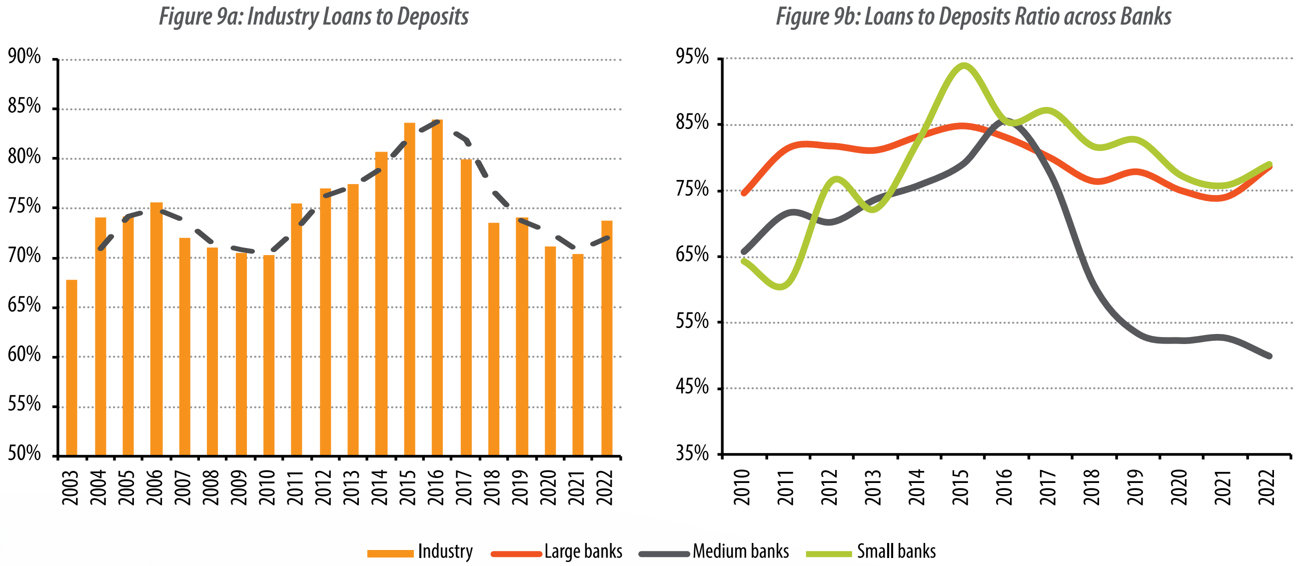


Figure 9: **Banking System Loan-to-Deposit Ratio**



Source: KBA

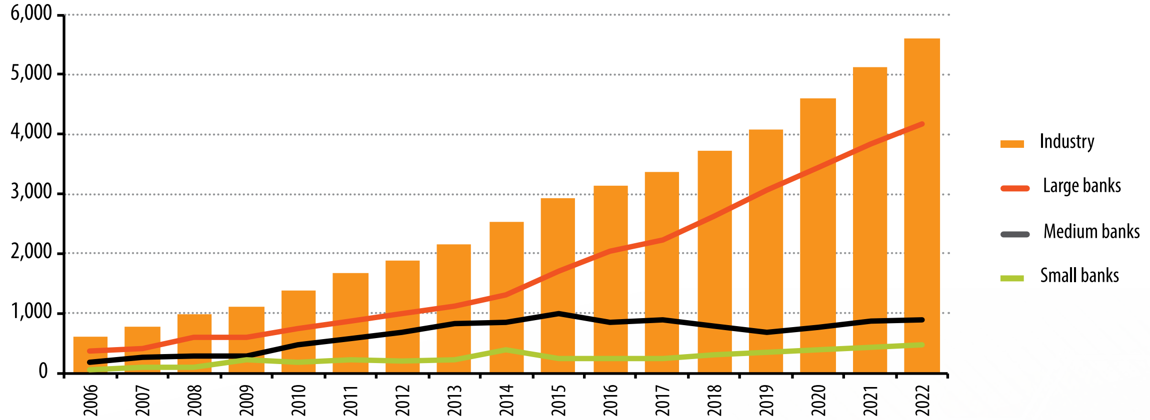
2.4 Banking System Loan-to-Deposit Ratio

The banking sector liquidity remained ample in 2022, supported by the robust growth in deposits. Relative to the loans extended - a measure of structural liquidity profile - the industry loan-to-deposit ratio (LDR) edged upwards to 73.7 percent in 2022 from 70.3 percent in 2021 (**Figure 9a**). Across banks, the loan-to-deposit ratio among small banks stood at 78.9 percent in 2022 from 75.7 percent in 2021. While the loan-to-deposit ratio of medium size banks in 2022 stood at 50.0 percent (compared to 52.8 percent in 2021), that of large banks rose to 78.7 percent in 2022 from 74.0 percent a year earlier (**Figure 9b**). Large banks 'ability to generate more loans out of a stock of deposits reflects their ability to benefit from economies of scale in deposits held, the mix between demand and term deposits and strong capitalization levels that enabled banks to absorb any increases in credit risk in the market. The sustained tightening of monetary policy in 2022, going forward, is likely to further lead to compositional changes in the structure of deposits, increased competition for liquidity, and moderation in credit supply.

2.5 Banking System Liabilities

The banking system's total liabilities, reflecting the evolution of deposits, grew by 9.2 percent in 2022 to Kshs. 5.6 trillion; slower than 11.5 percent growth in 2021. Similarly, the evolution of total liabilities mirrored some differences across banks, most notably contracting for the small (tier 3) banks. As total liabilities for the aggregate, small banks increased by 9.7 percent to Kshs. 466 billion percent in 2022, the liabilities for the large banks expanded by 8.9 percent to Kshs. 4.2 trillion as those of the medium size banks also edged upwards by 4.1 percent to Kshs. 901 billion over the same period (**Figure 10**).

Figure 10: Banking System Liabilities

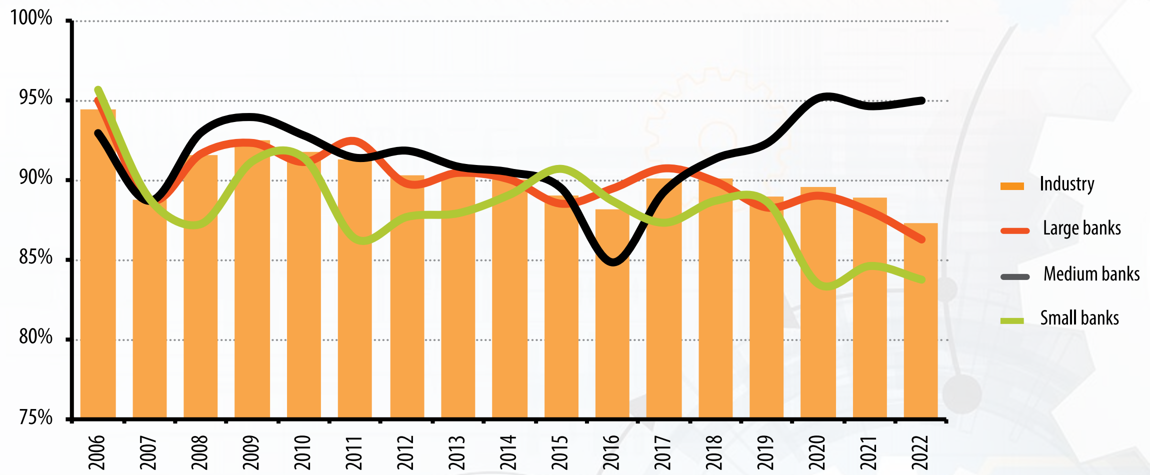


Source: KBA

2.6 Banking System Deposit-to-Liability Ratio

The banking sector's liability profile is primarily driven by domestic deposits. In total, deposits accounted for 87.3 percent of total liabilities in 2022; a slight decline in the proportion from 89.9 percent in 2021 (**Figure 11**). This share has remained relatively constant since 2008, oscillating around 90 percent. Across banks, the evolution of the deposit-to-liability ratio while mirroring industry trends since 2018 remained elevated among medium size banks reflecting this category's increasing reliance on deposits for liquidity purposes.

Figure 11:Banking System Deposit-to-Liability Ratio



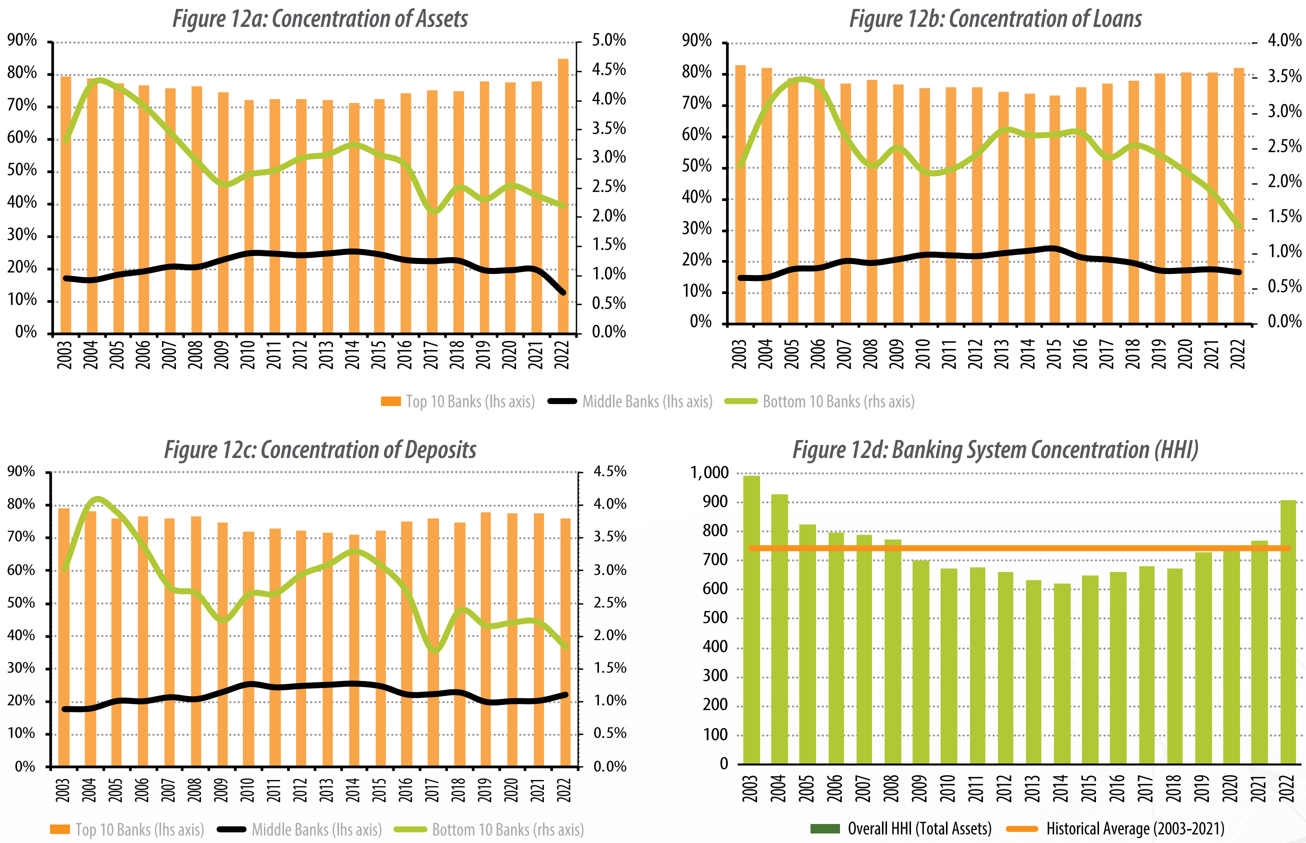
2.7 Banking Sector Market Structure

Kenya's financial sector activity continues to be driven by the banking sector, whose assets as a ratio of GDP stands at about 50 percent. As at end 2022, the sector's assets as a ratio of GDP stood at 47.1 percent compared to 49.7 percent in 2021 and 50.6 percent in 2020. This reflects the credit book that stood at 26.3 percent of GDP in 2022 and 26.9 percent in 2021. On the liability side, deposits to GDP ratio of the banking sector declined to 33.8 percent in 2022, down from 36.7 percent in 2021.

A further look at the banking sector, especially from a concentration perspective, reveals a modest uptick in concentration; a reversal in trend that characterized the period 2019-2021. On the assets side of the balance sheet, banking sector concentration slightly increased in 2022, with the top-10 banks accounting for 84.9 percent of the assets up from 77.8 percent in 2021 (**Figure 12a**). A similar pattern is mirrored in total loan book concentration where the top-10 banks accounted for 82.0 percent of the total industry loan book compared to 80.6 percent in 2021 and 80.7 percent in 2020 (**Figure 12b**). On the liability side, a reversal in the concentration is evident with the top-10 bank's total deposits accounting for 76.0 percent of the industry deposits in 2022 down from 77.4 percent in 2021 and 77.6 percent in 2020 (**Figure 12c**). Measured by the Herfindahl-Hirschman Index (HHI)[2], the concentration of the industry based on total assets rose to 909.40 in 2022 from 767.31 in 2021 from 736.20 in 2020 (**Figure 12d**). In spite of the significant rise in the HHI index, it is noteworthy that it remains below the 1,500-mark suggesting that the Kenyan banking sector remains sufficiently competitive. The changes in market power over time reflect competition dynamics in the industry and by extension the efficiency gains in the intermediation process.

2. The Herfindahl-Hirschman Index (HHI) -attributed to the U.S Department of Justice - is a measure of the level and trend of concentration in a particular market. The HHI is calculated by squaring each entity's market share (relative to the total market), and summing the values attained. The U.S. Department of Justice considers a market with an HHI of less than 1,500 to be a competitive marketplace, an HHI of 1,500 to 2,500 to be a moderately concentrated marketplace, and an HHI of 2,500 or greater to be a highly concentrated marketplace.

Figure 12: Banking Sector Market Structure



Source: KBA

Chapter 3:

ASSET QUALITY

3.1 Asset Quality

The industry asset quality improved in 2022, reflecting a stronger growth in performing loans. Notably, the stock of non-performing loans (NPLs) in 2022 rose to Kshs. 493.7 billion from Kshs. 460.5 in 2021.

However, the industry's NPLs ratio to total loans declined to 13.7 percent in 2022 from 14.4 percent in 2021 (**Figure 13a**). Heterogeneities across bank tiers were evident, as Tier 3 banks reflected significantly higher (and increasing) NPL ratios than the Tier 2 and Tier 1 banks[3]. Among large banks, the NPL ratio increased marginally to 13.0 percent in 2022 from 12.9 percent as medium banks and small banks' NPL ratios declined to 15.4 percent in 2022 and 18.5 percent in 2022, from 17.7 percent and 22.4 percent in 2021, respectively (**Figure 13b**). The evolution of NPLs in the industry and across bank Tiers reflected the unsynchronized recoveries of the economic sectors from the effects of the pandemic and banks' risk appetites.

Figure 13: Banking System Gross Non-Performing Loans to Gross Loans

Figure 13a: Gross NPLs to Gross Loans

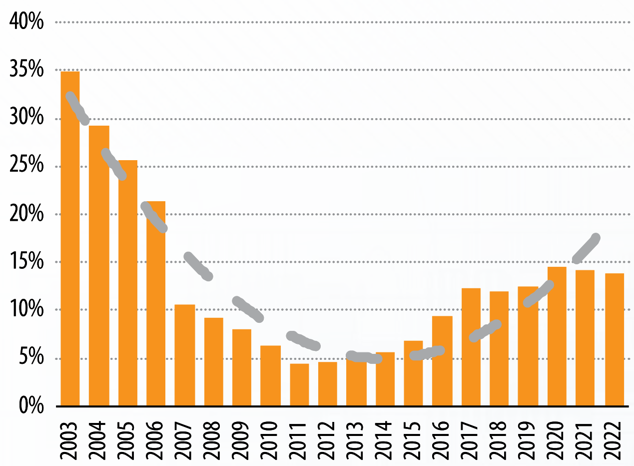
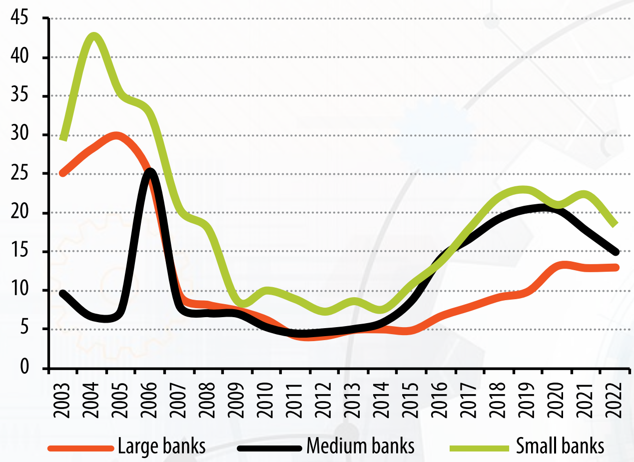


Figure 13b: Gross NPLs to Gross Loans Ratio across bank tiers

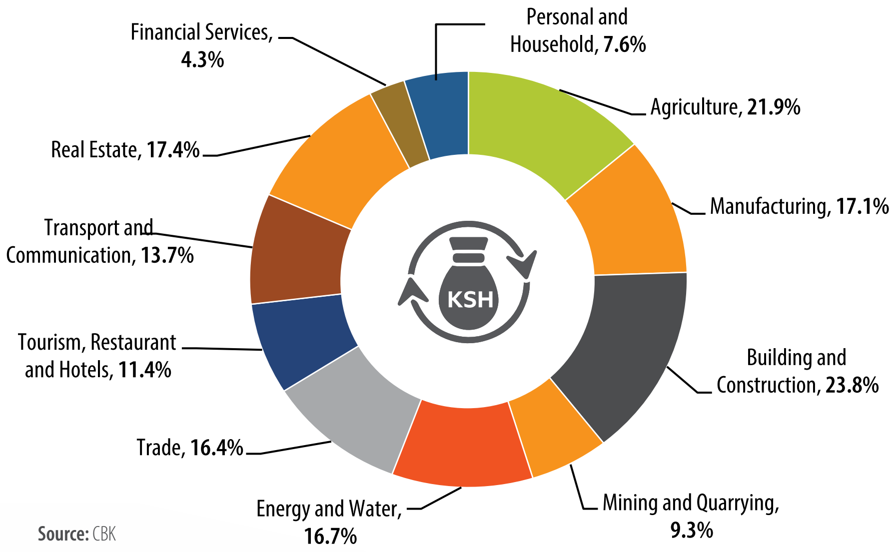


Source: KBA

3. Smaller banks have traditionally had higher NPL ratios across the years.

As **Figure 14** shows, the bulk of the asset quality deterioration in 2022 was registered in building and construction (whose NPL ratio stood at 23.8 %), agriculture (21.9%), real estate (17.4%), manufacturing (17.1%), energy and water (16.7%), trade (16.4%), transport and communication (13.7%), tourism, restaurant, and hotels (11.4%), personal and household (7.6%) and financial services (4.3%).

Figure 14: Banking System Sectoral Asset Quality in 2022

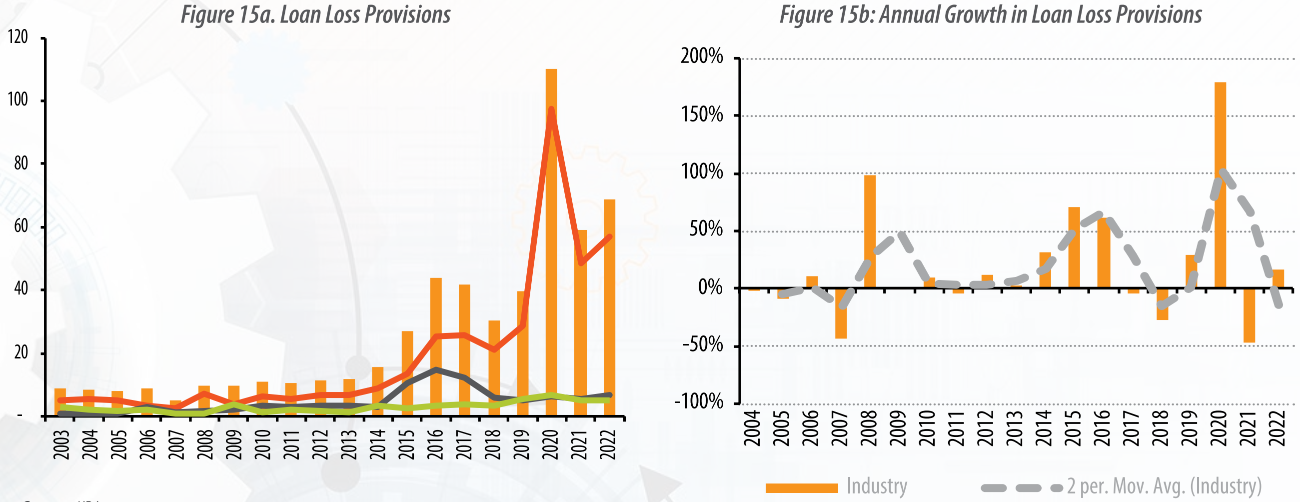


Source: CBK

3.2 Loan Loss Provisions

As asset quality improved, the industry continued to increase its loan loss provisions to cover expected credit losses. In 2022, the banking sector's loan loss provisions rose by 16.2 percent to Kshs. 68.8 billion compared to Kshs. 59.2 billion in 2021 (**Figure 15**), the bulk of which made by large size banks. Across bank tiers, the increase in loan loss provisions was driven by medium banks whose provisions grew by 26.6 percent (to stand at Kshs. 6.8 billion in 2022 from Kshs. 5.4 billion), followed by provisions by large banks that increased by 16.7 percent (to stand at Kshs. 56.8 billion in 2022 from Kshs. 48.6 billion in 2021). Provisions by small banks remained largely unchanged from levels reported for 2021, growing by a marginal 0.2 percent in 2022 to stand at Kshs. 5.3 billion.

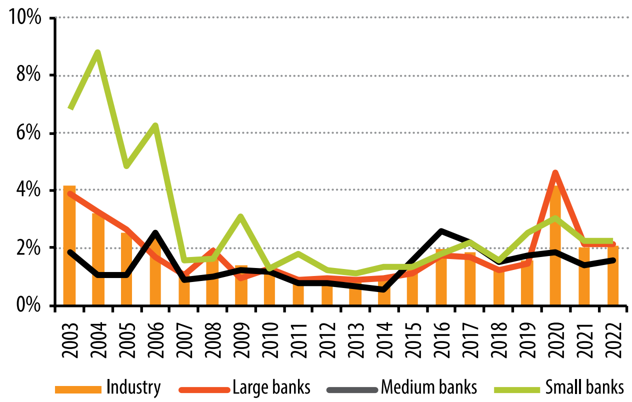
Figure 15: Banking System Loan Loss Provisions



Source: KBA

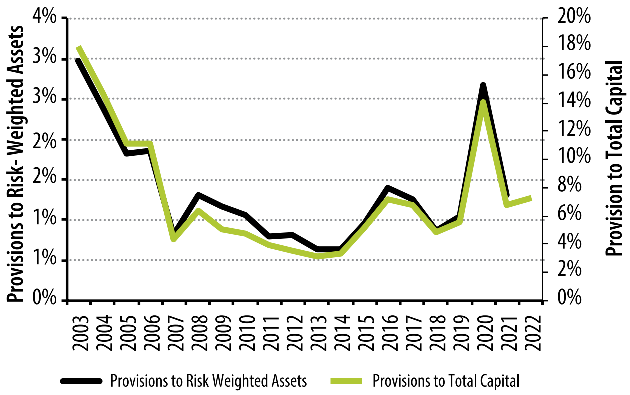
Figure 16: Banking System's Coverage Ratio

Figure 16a: Provisions to Total Loans



Source: KBA

Figure 16b: Loan Loss Provisions to Total Risk Weighted Assets and Total Capital



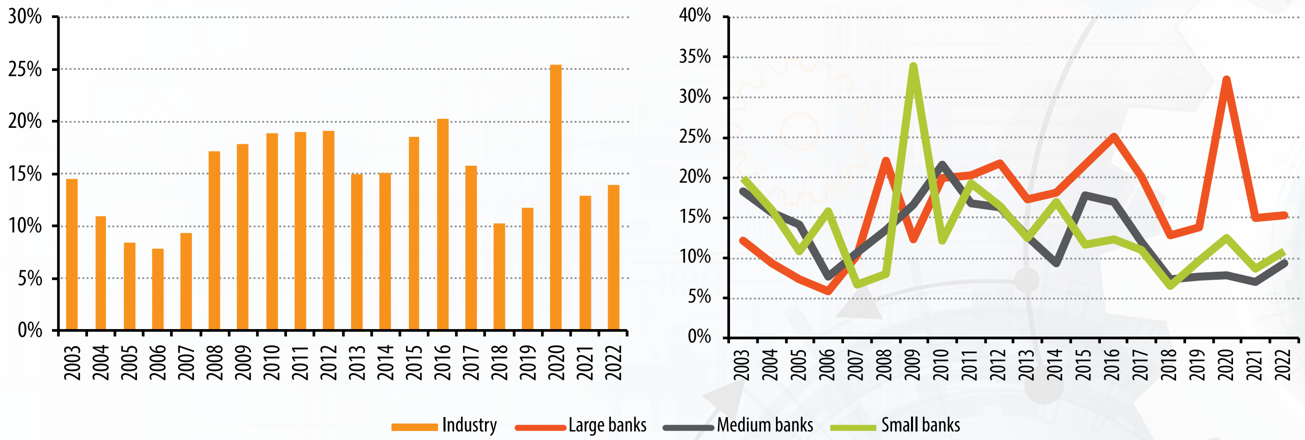
The banking sector coverage ratio in 2022 improved, indicating the fact that provisioning broadly kept pace with the evolution of credit risk. In particular, the ratio of loan loss provisions to net loans and advances increased marginally in 2022 both at the industry and across the three bank Tier categories, albeit at varied magnitudes. The coverage ratio at the industry level in 2022 stood at 2.1 percent, disaggregated to 2.1 percent for Tier 1, 1.6 percent for Tier 2 and 2.2 percent for tier 3 (**Figure 16a**). As a proportion of total risk-weighted assets, provisions in 2022 rose to 1.4 percent compared to 1.3 percent in 2021 (**Figure 16b**). For Tier 1 banks, the ratio stood at 1.4 percent, as that of Tier 2 and Tier 3 banks respectively stood at 1.0 percent and 1.7 percent. During the same period, as total provisions rose marginally, its ratio to total capital also increased to 7.2 percent in 2022 from 6.8 percent in 2021 (**Figure 16b**). Across banks, the ratio of total provisions to total bank capital stood respectively at 7.7 percent, 4.4 percent, and 8.5 percent for large, medium, and small banks respectively, reflecting low exposures to credit losses relative to capital base.

The ratio of loan loss provisions to gross non-performing loans also rose but remained below the pandemic levels, reflecting recoveries from the peak effects of the pandemic (**Figure 17**). At the industry-level, the ratio stood at

Figure 17: Banking System's Provisions to Non-Performing Loans Ratio

Figure 17a: Total Industry Provisions to NPLs Ratio

Figure 17b: Provisions to NPLs



Source: KBA

Table 1: Capital Adequacy

	2016	2017	2018	2019	2020	2021	2022	Minimum CAR (%)
Core Capital/ TRWA (%)	16.9	16.4	16.6	16.6	16.6	16.5	16.3	10.5
Total Capital/ TRWA (%)	19.5	18.7	18.0	18.8	19.0	19.5	19.0	14.5
Core Capital/ Total deposits (%)	19.0	18.1	17.3	17.4	16.7	16.4	16.0	8.0

Notes: TRWA: Total-Risk-Weighted-Assets; CAR: Capital Adequacy Ratios

Source: KBA

13.9 percent in 2022 up from 12.9 percent in 2021. A similar trend was also reflected across the bank categories, with tier 1, tier 2 and tier 3 banks' ratio rising to 15.2 percent, 9.3 percent and 10.8 percent in 2022, respectively from 15 percent, 7.0 percent and 8.6 percent in 2021.

3.3 Capital Adequacy

The industry on average maintained adequate capital buffers well above minimum statutory regulatory requirements. In 2022, the ratio of total capital to risk-weighted assets edged slightly downwards to 19.0 percent from 19.5 percent in 2021 against a statutory regulatory minimum of 14.5 percent. Similarly, and against a statutory minimum of 10.5 percent, the ratio of core capital to total risk weighted assets remained stood at 16.3 percent in 2022; a slight moderation from 16.5 percent in 2021. As a ratio of total deposits, core capital in 2022 stood at 16.0 percent, slightly below 16.4 percent reported for 2021, well-above the 8 percent minimum statutory capital requirements (**Table 1**). Strong capital positions for the industry enabled the sector to carry the emerging credit risks without compromising on its stability.

Chapter 4:

FINANCIAL PERFORMANCE

4.1 Operating Incomes

The banking sector's total operating income in 2022 sustained its growth trajectory, rising by 17.7 percent to Kshs. 740.4 billion from Kshs. 628.5 billion in 2021 (**Figure 18a**). Underlying this robust growth was a 93.6 percent rise in foreign exchange gains, compared with a 9.2 percent growth in 2021. Other income sources included interest on placements and bank balances, which grew by 23.5 percent in 2022 and interest on government securities that expanded by 18.6 percent in 2022. Interest on loans also grew by double digits, at 11.8 percent in 2022 from 8.0 percent in 2021. Fees and commissions income during the period recorded a modest 8.5 percent comparable to 8.1 percent in 2021. The divergent increases in income reflected portfolio shifts triggered by macroeconomic developments that shaped government borrowing, developments in the foreign exchange market and policy measures taken to tame inflationary pressures that pushed up interest rates.

The structure of contribution of the various sub-components of operating income, however, remained unchanged (**Figure 18b**). As interest income from loans accounted for 45.1 percent of the total operating income, interest on government securities accounted for 28.0 percent.

There was a notable increase in the share of foreign exchange earnings in total operating income, reflecting the global and domestic developments that triggered a sustained exchange rate depreciation through the period. The dynamics in total operating income contributions generally reflected banks' investment strategies amidst uncertainty caused by the pandemic, a trade-off between credit and liquidity, and portfolio realignments to mitigate elevated private sector credit risk and take advantage of emerging opportunities.

Figure 18: Banking System Operating Incomes

Figure 18a: Total Operating income (Kshs. Billion) and Annual Growth

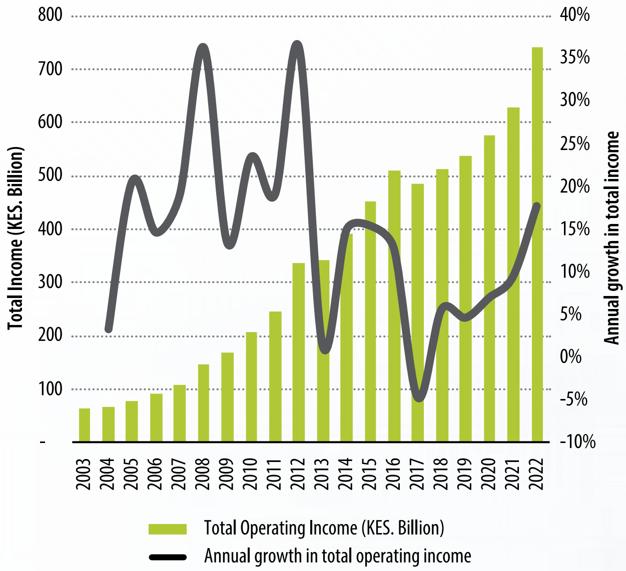
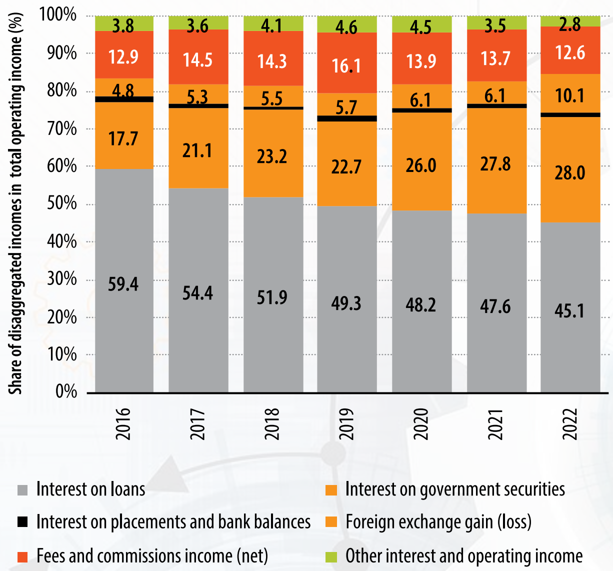


Figure 18b: Share of disaggregated Incomes in total operating income



Source: KBA

Figure 19: Banking System Operating Costs

Figure 19a: Total Operating Costs (Kshs. Billion) and Annual Growth

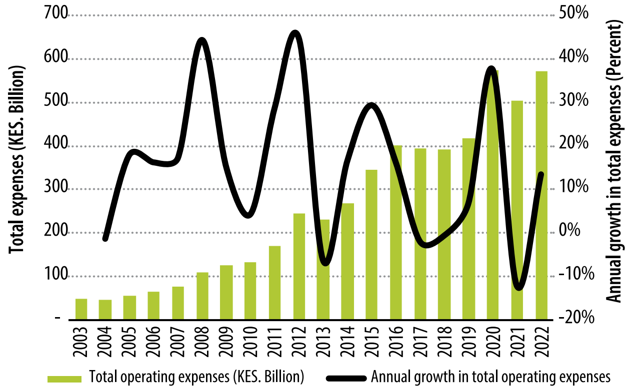
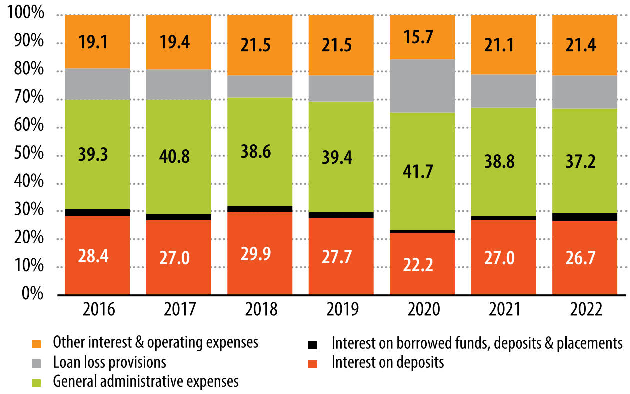


Figure 19b: Share of Disaggregated Costs in Total Operating Costs



Source: KBA

4.2 Operating Costs

The banking sector's operating costs rose in tandem with increased operating incomes, driven by interest expenses and general administrative costs (Figure 19a). Total operating costs rose by 13.4 percent (to Kshs. 571.9 billion) in 2022 driven by a rise in interest expenses on borrowed funds, deposits and placements which more-than doubled in the year, rising by 118.3 percent, and a 38.3 percent increase in the general administrative costs. Interest expenses on deposits grew by 12.3 percent during the period under review (to Kshs. 153.0 billion from Kshs. 136.3 billion in 2021), mirroring the rising market interest rates. Other interest and operating expenses rose by 12.3 percent during the period. Administrative expenses and interest expenses remained the main cost components of bank costs, respectively accounting for 37.2 percent and 26.7 percent of banks' costs in 2022 (**Figure 19b**).

Other interest and operating expenses' share in total costs stood at 21.4 percent as loan loss provision accounted for 12.0 percent during the period 2022; slightly higher than 11.7 percent in 2021, while the share interest expenses on borrowed funds, deposits, and interbank placements remained modest, rising to 2.6 percent in 2022 from 1.3 percent in 2021.

4.3 Cost-to-Income Ratio

Banks' aggregate cost-to-income[4], a proxy of efficiency, improved with costs absorbing 56.7 percent of the incomes in 2022 compared to 58.4 percent in 2021 (Figure 20a). The efficiency levels improved though at varied levels across bank categories, with Tier 1 banks depicting the lowest cost-to-income (CIR) ratios at 54 percent in 2022 when compared to tier 2 and tier 3's 60 percent and 87 percent, respectively (**Figure 20b**). This reflects tier 1 banks' size advantage in

Figure 20: Banking Sector Cost-to-Income Ratio

Figure 20a: Industry Cost-to-Income Ratio

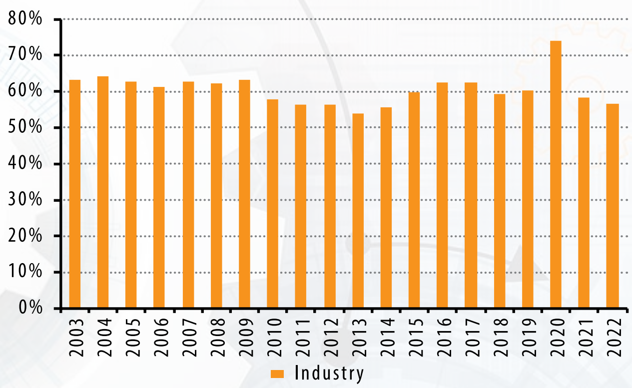
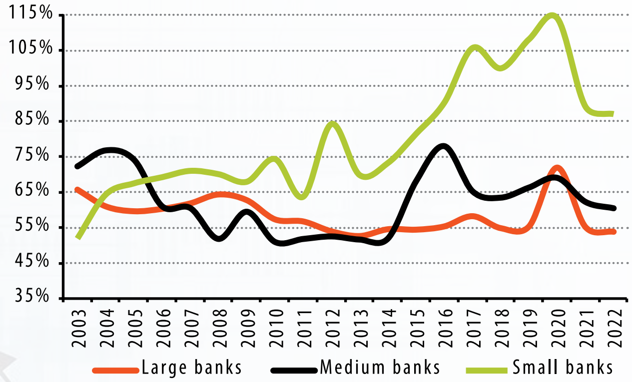


Figure 20b: Industry Cost-to-Income Ratio Across Bank Tiers



Source: KBA

4. This is obtained by dividing a bank's operating costs to its total revenue. A relatively high ratio shows cost inefficiencies.

their ability to leverage on economies of scale in the provision of banking services. Besides size, the observed divergent patterns in cost to income ratios partly reflect the differences across banks in business models as well as institutional structures.

4.4 Net Interest Margin

Analyses of the banking sector's net interest margin showed an improvement in 2022, albeit marginally, reflecting a reversal in the downtrend registered since 2016. Net interest margins, one of the measures that reflect competitiveness dynamics, was on the rise between 2003 and 2013. However, post-2014 it begun shrinking, partly reflecting the increasing competition within the industry. In 2022, however, the average net interest margin edged up to 6.8 percent from 6.5 percent in 2021.

Across banks, however, net interest margins varied considerably; rising to 7.2 percent in 2022 (from 6.9 percent in 2021) among large banks, to 5.6 percent (from 5.3 percent) for the medium size banks, but declining marginally for the smaller banks to 5.2 percent from 5.3 percent a year earlier (**Figure 21**) .

Figure 21: Banking Sector Net Interest Margin

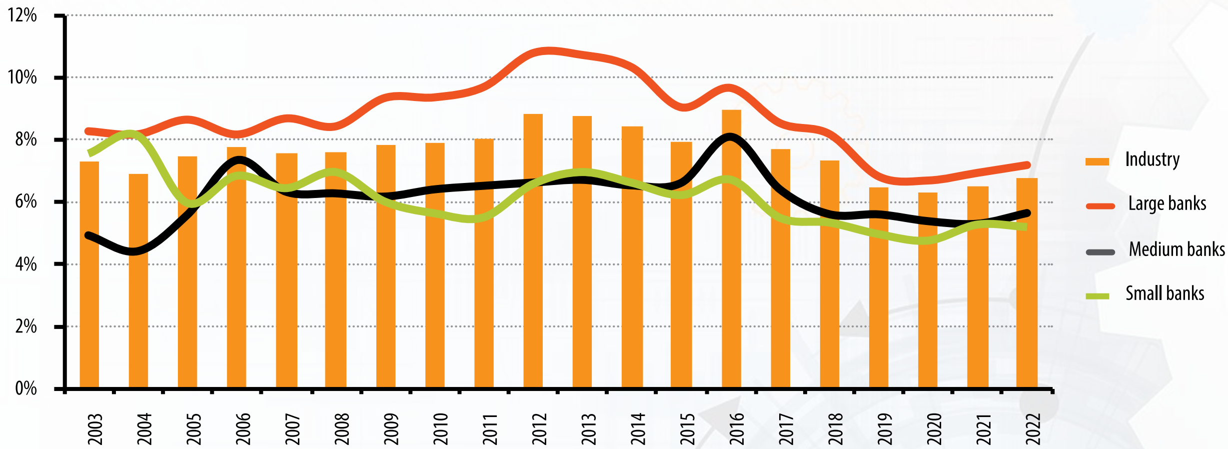
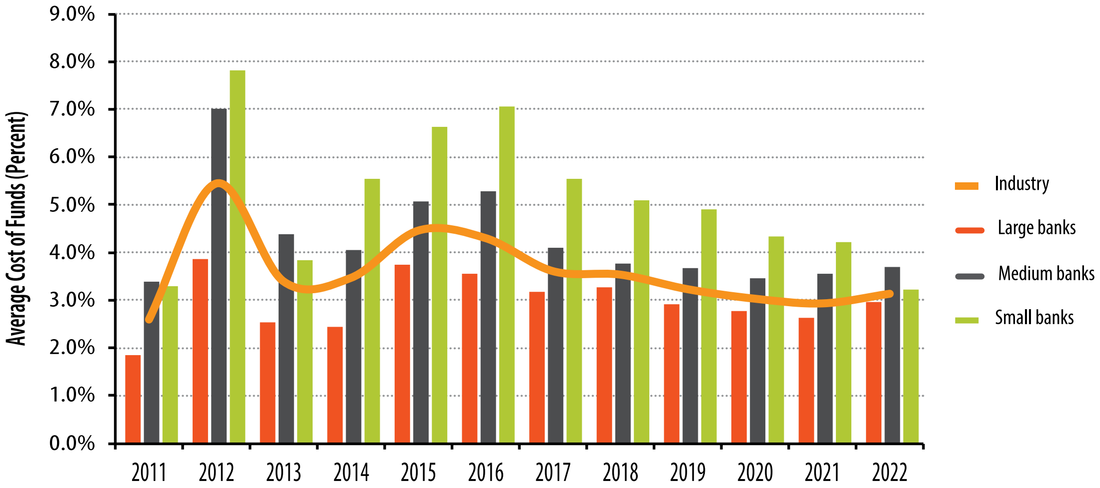


Figure 22: **Banking System Cost of Funding**



4.5 Cost of Funding

The average banking sector's average funding costs rose marginally, reflected across all bank categories, driven by tightening monetary conditions in the economy. In 2022, the average industry cost of funds rose to 3.1 percent from 2.9 percent in 2021, reversing the trend decline recorded since 2018. Large banks posted a notable increase in the cost of funds, to 3.0 percent in 2022 from 2.6 percent in 2021; a development that is attributable to their ability to take advantage of economies of scale particularly via three perspectives[5].

First, they are more diversified and thus perceived as safer havens during periods of economic uncertainty. Second, unlike small-sized banks, they can take advantage of their spread to mobilize more retail and wholesale deposits at more attractive rates often unaffordable to other smaller banks, and third, they onboarded an elevated average NPL ratio, which positively correlates with higher funding costs[6]. For small banks, even with the highest average funding costs, there has been a notable trend decline in the average funding costs and the differential between the industry average and their funding costs has been narrowing as the banks increasingly become more competitive.

4.6 Profitability

The industry's total pre-tax profits rose by 23.0 percent to Kshs. 241.52 billion in 2022 from Kshs. 196.44 billion in 2021 (Figure 23). Across banks, the largest increase in pre-tax profits was among small banks where the pre-tax profits almost doubled (88.1 percent increase) to Kshs. 4.2 billion in 2022 from Kshs. 2.2 billion in 2021 followed by medium bank's profits whose profits grew by 24.0 percent to Kshs. 29.25 billion. Pre-tax profits for the large banks during the period edged up steadily by 22.0 percent to Kshs. 208.1 billion in 2022.

At an industry level, these developments translated to an average return on assets (ROA) of 3.7 percent in 2022 up from 3.3 percent in 2021, and an average return on equity (ROE) of 26.5 percent in 2022 compared to 22.1 percent in 2021. The return on assets and equity also varied across banks. Large banks in 2022 posted 30.6 percent average ROE and 4.2 percent average ROA, while ROE and ROA for the medium and small banks, respectively stood at 18.6 percent and 2.1 percent for medium banks, and 5.6 percent and 1.98 percent for the small banks in 2022.

5. Smaller banks continue to have significantly higher cost of funding than medium and large banks. The cost of funds for small banks stood at 4.15 percent in 2021, while that of medium-sized banks at 3.6 percent, both above the industry average. Large bank's cost of funding in 2021 stood at 2.6 percent, which is below the industry average.

6. The transmission channel is such that a higher NPL ratio calls for more provisioning in tandem with the increased balance sheet riskiness. As a result of the deteriorating quality of a bank's portfolio investors would be seeking higher returns and this leads to an elevated funding costs for a bank.

Figure 23: Banking Industry Profitability

Figure 23a: Profit before Tax (Kshs. billions)

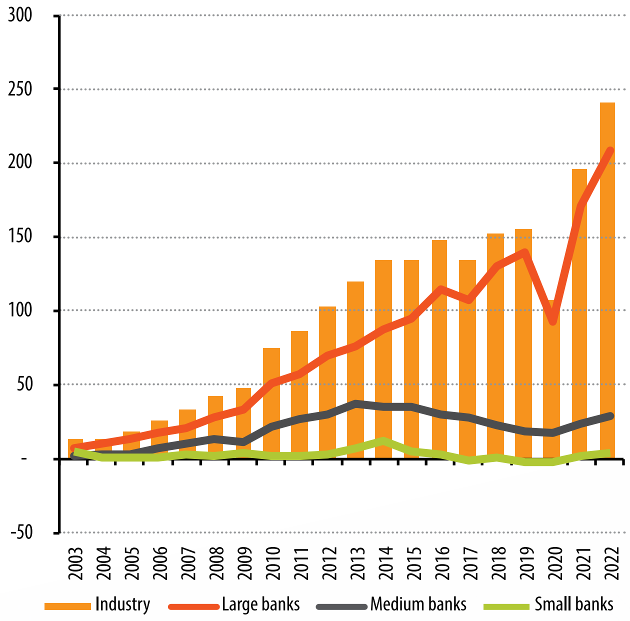


Figure 23b: Annual growth in Profit before Tax (%)

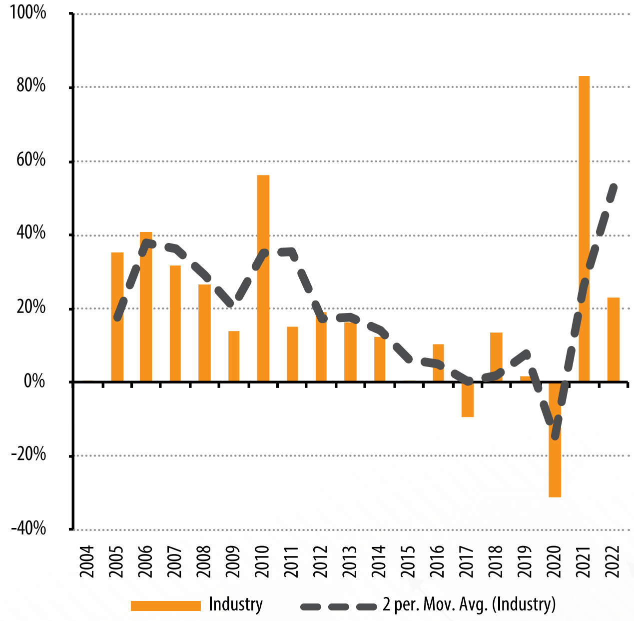


Figure 23c: Bank Return on Equity (ROE)

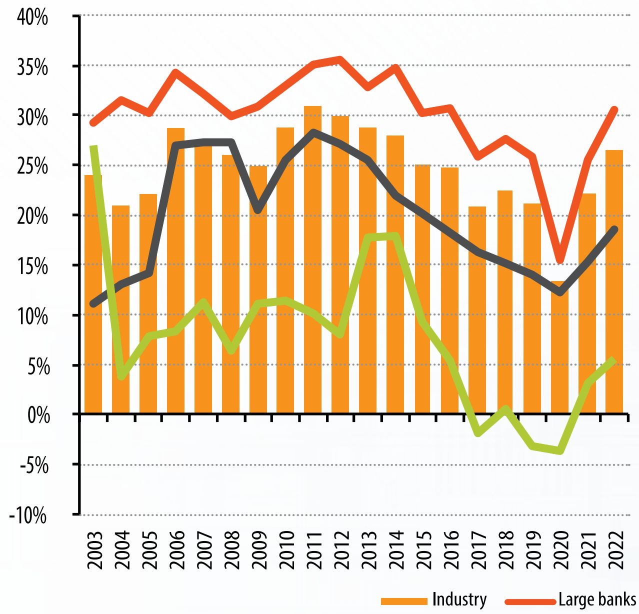
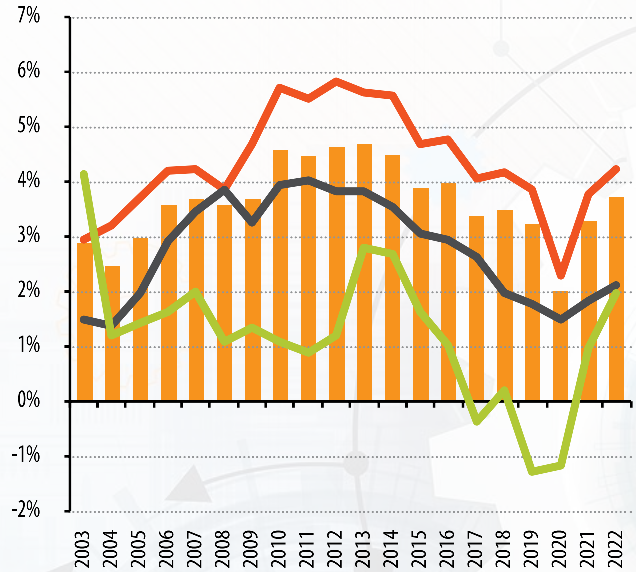


Figure 23d: Bank Return on Assets (ROA)



Chapter 5:

PERFORMANCE OF DEPOSIT TAKING MICRO-FINANCE BANKS (MFBs)

5.1 MFB's assets, composition, and growth

Assets of deposit-taking microfinance banks continued to moderate. In 2022, the total assets of deposit-taking microfinance banks contracted further by 4.8 percent to Kshs. 70.4 billion from Kshs. 74.0 billion in 2021 (Figure 24a). This was driven by a contraction in the net loans and advances to customers by 1.9 percent to Kshs. 39.3 billion from Kshs. 40.1 billion in 2021 (**Figure 24b**).

Figure 24: MFB's assets, and asset growth

Figure 24a: MFBs Total Assets, Annual (Kshs. Billion)

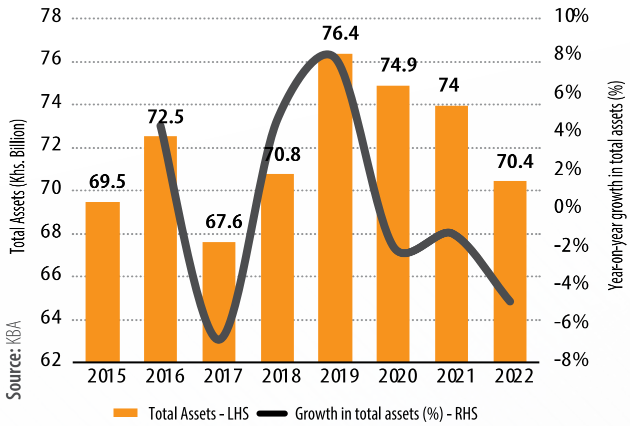
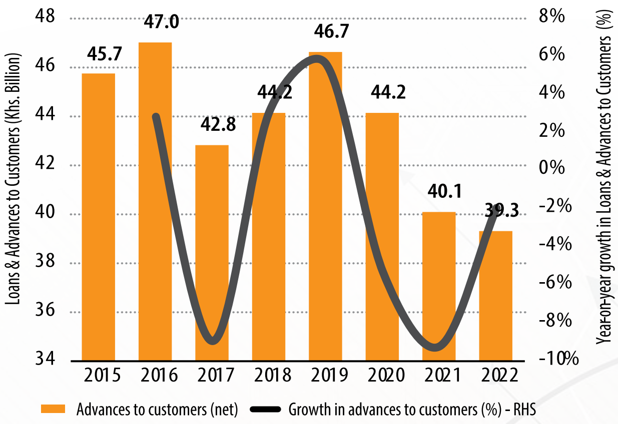


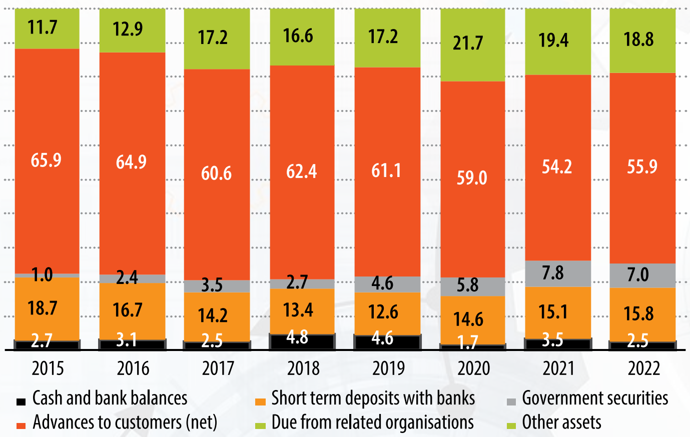
Figure 24b: MFBs Net Loans to Customers, Annual (Kshs. Billion)



The asset structure of the deposit-taking microfinance banks remained stable (**Figure 25**), with net advances to customers accounting for 55.9 percent of the total assets. Short-term deposits accounted for 15.8 percent, while investment in government securities and cash and bank balances accounted for 7.0 percent, and 2.5 percent, respectively.

> The total assets of deposit-taking microfinance banks contracted further by 4.8 percent to Kshs. 70.4 billion from Kshs. 74.0 billion in 2021.

Figure 25: Dynamics of MFB's Asset Composition (%)

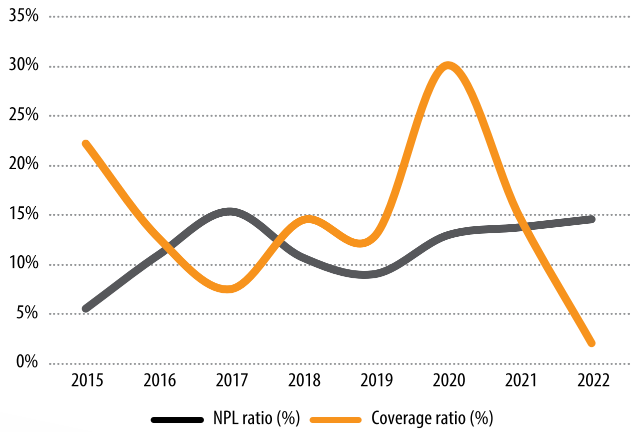


Source: KBA

5.2 MFB's Asset Quality Dynamics

Asset quality of deposit taking microfinance banks continued to deteriorate, as the coverage ratio also edged further downwards. The quality of the credit portfolio deteriorated further to 14.5 percent in 2022 from 13.7 percent in 2021. Consequently, the coverage ratio – that is, provision for loan impairment as a proportion of net NPLs – declined to 2.3 percent as at 2022, from 14.8 percent as at 2021 (**Figure 26**).

Figure 26: Asset Quality of Deposit-Taking MFBs, 2015-2022



Source: KBA

5.3 MFB's liabilities, composition, and growth

The sector's total liabilities continued to edge downwards. The total liabilities dropped to Kshs. 62 billion in 2022 from Kshs. 65 billion in 2022, representing a 4.9 percent year-on-year contraction (**Figure 27a**). A similar trajectory is evident for customer deposits, which also edged further downwards to Kshs. 46.5 billion in 2022 from Kshs. 50.4 billion in 2021, thus registering a 7.8 percent reduction (**Figure 27b**).

Figure 27: MFB's liabilities, composition, and growth

Figure 27a: Total Liabilities *Figure 27b: Customers deposits*

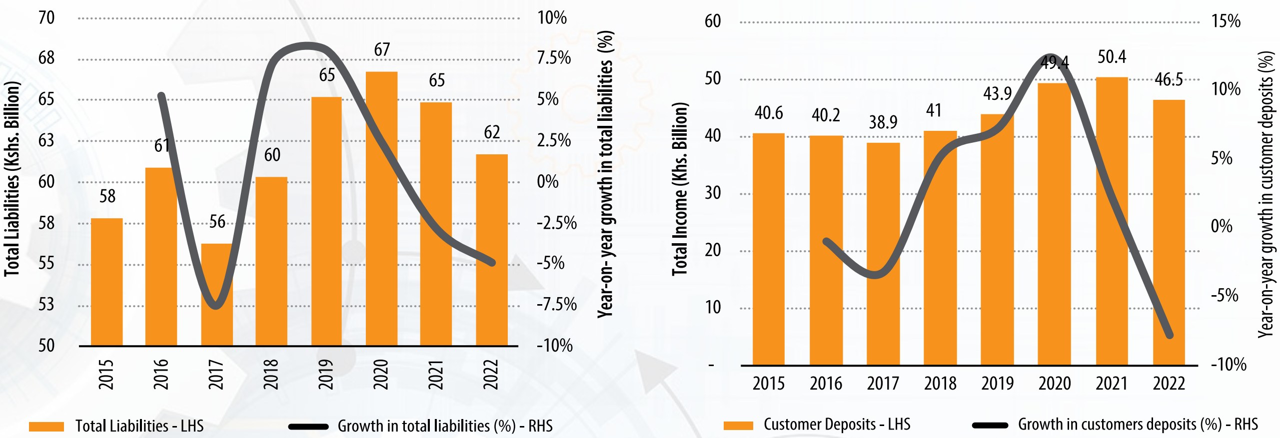
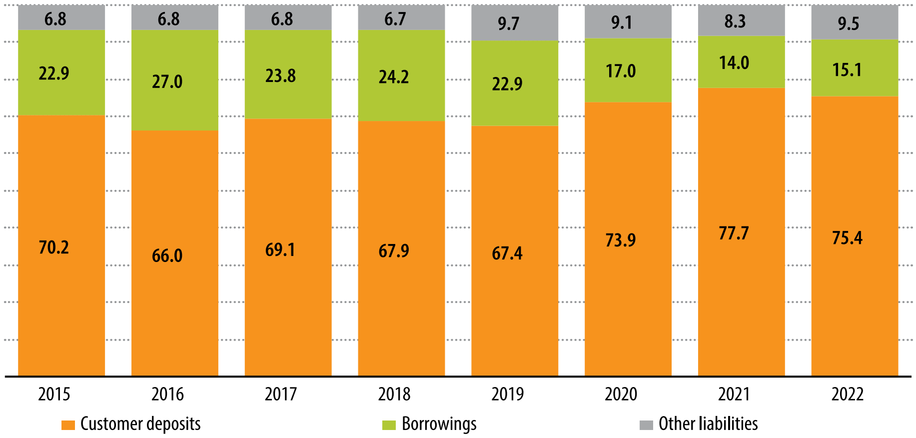


Figure 28: **MFB's liability structure (%)**



Similarly, the liability structure remained stable. The customer deposits – the deposits-to-liabilities ratio - remained dominant at 75.4 percent of the total liabilities, while borrowing and other liabilities accounted for 15.1 percent, and 9.5 percent, respectively (**Figure 28**).

5.4 MFB's income, growth, and composition

Total incomes of the sector declined marginally. In 2022, total income contracted by 1.6 percent to Kshs. 13.2 billion compared to a 2.3 percent growth registered as at end of 2021 (**Figure 29a**). In 2022, the income structure remained relatively stable, as interest on loan portfolio accounted for 70.7 percent of the total incomes, fees and commissions accounted for 8.5 percent, income from investment in government securities accounted for 4.5 percent, while deposits and balances with banks and other financial institutions accounted for 4.2 percent (**Figure 29b**).

Figure 29: **MFB's incomes, composition, and growth**

Figure 29a: Total Incomes

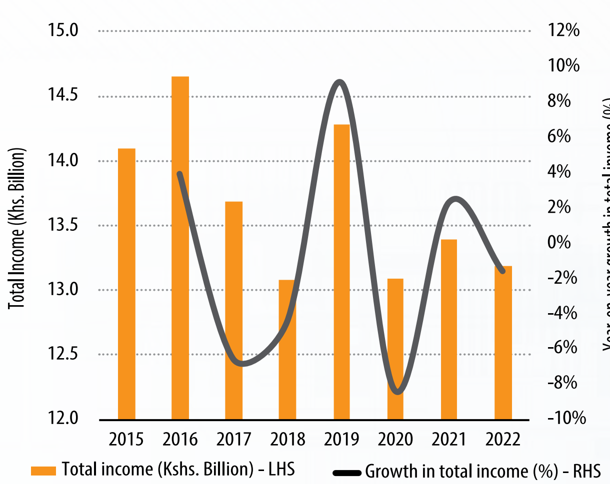
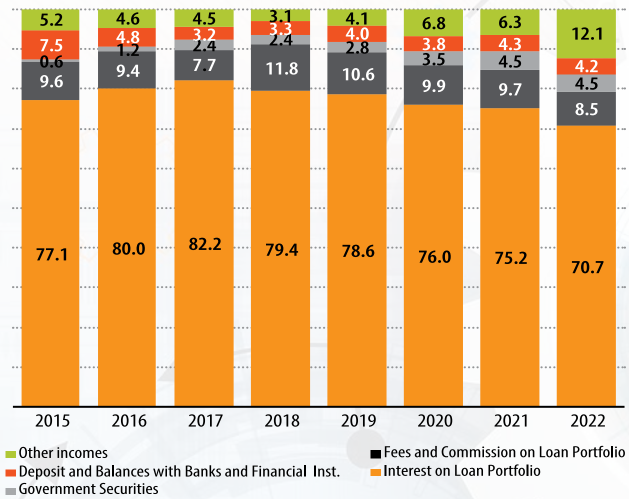


Figure 29b: Income Structure

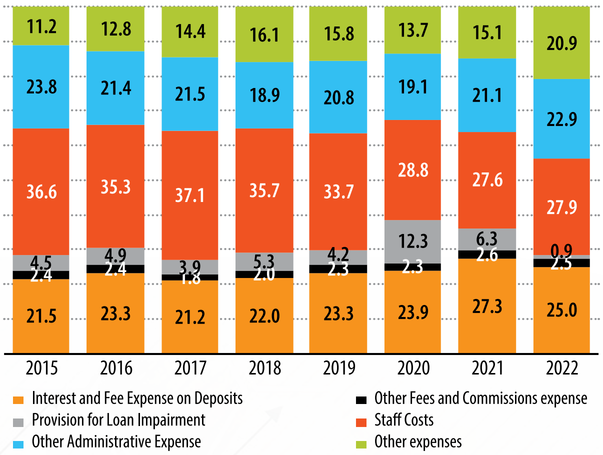


Source: KBA

5.5 MFB's total expenses

Total expenses edged upwards, albeit marginally from Kshs. 12.9 billion in 2021 to Kshs. 13.1 billion in 2022, representing a 1.4 percent year-on-year growth. An examination of the structure of expenses reveals that staff costs at 27.9 percent of total expenses is the most dominant, followed by interest expenses on deposits at 25 percent (**Figure 30**).

Figure 30: MFB's expenses, composition, and growth (%)

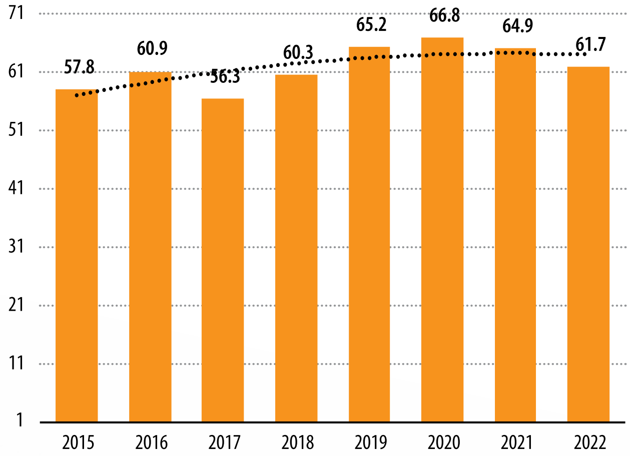


Source: KBA

5.6 MFBs Cost-to-income ratio

The efficiency, measured by the cost-to-income ratio of the deposit taking microfinance banks gradually been improving since 2020. In 2022, the cost-to-income ratio for the microfinance sector declined to 61.7 percent compared to 64.9 percent in 2021 (**Figure 31**).

Figure 31: Cost-to-Income ratio of Deposit-Taking MFBs



Source: KBA

5.7 MFBs Profitability Dynamics

Profitability of the microfinance banks has increased, albeit marginally. Profits before tax increased to Kshs. 0.98 billion in 2022, a 11.7 percent increase compared to Kshs. 0.88 billion in 2021 (**Figure 32a**). Consequently, the return on equity (ROE) went up to 11.2 percent during the period 2022, from 9.6 percent for 2021, while the return on assets (ROA) also edged upwards to 1.4 percent in 2022 compared to 1.2 percent in 2021 (**Figure 32b**).

Figure 32: Profitability dynamics of Deposit-Taking MFBs

Figure 32a: MFBs Profit before Tax (PBT)

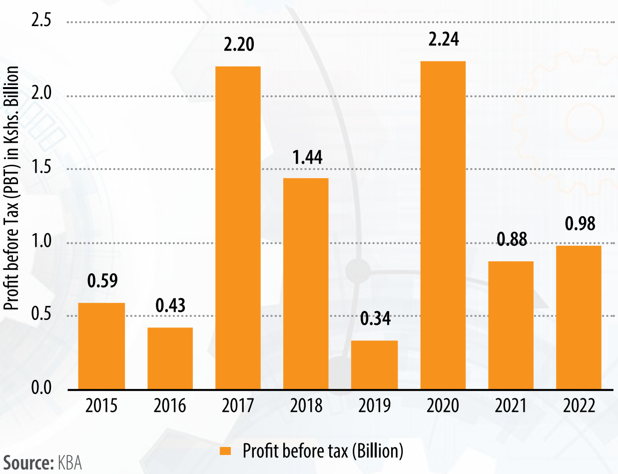
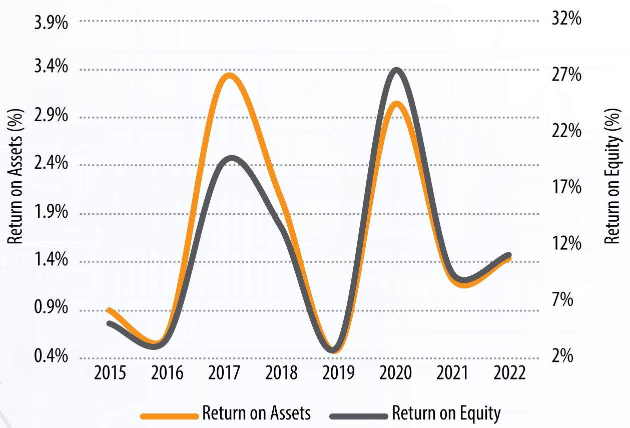


Figure 32b: MFBs Return on Assets and Equity



Source: KBA

Figure 33: Market Structure of Deposit-Taking MFB

Figure 33a: MFBs Herfindahl - Hirschman Index (HHI) on Assets

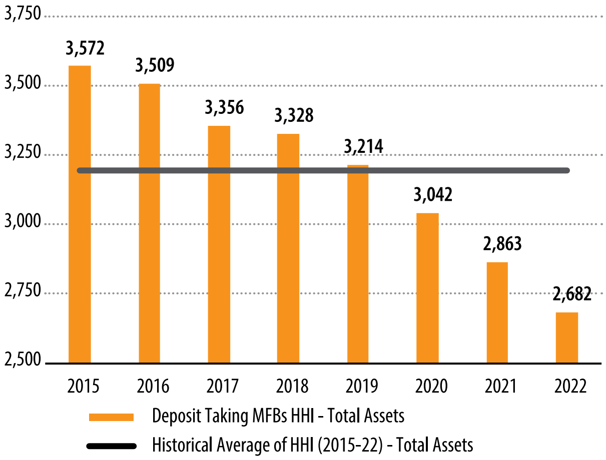
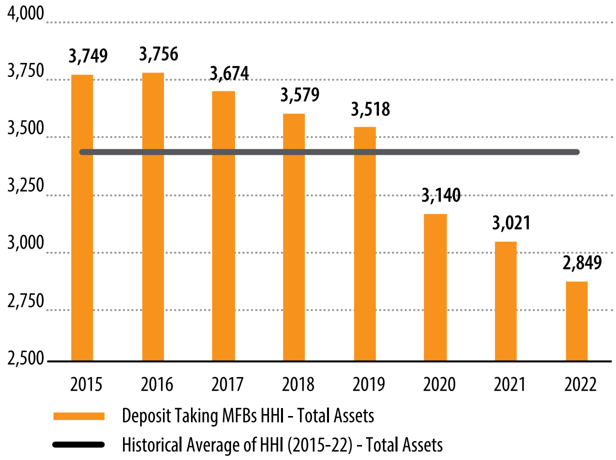


Figure 33b: MFBs Herfindahl - Hirschman Index (HHI) on Loans



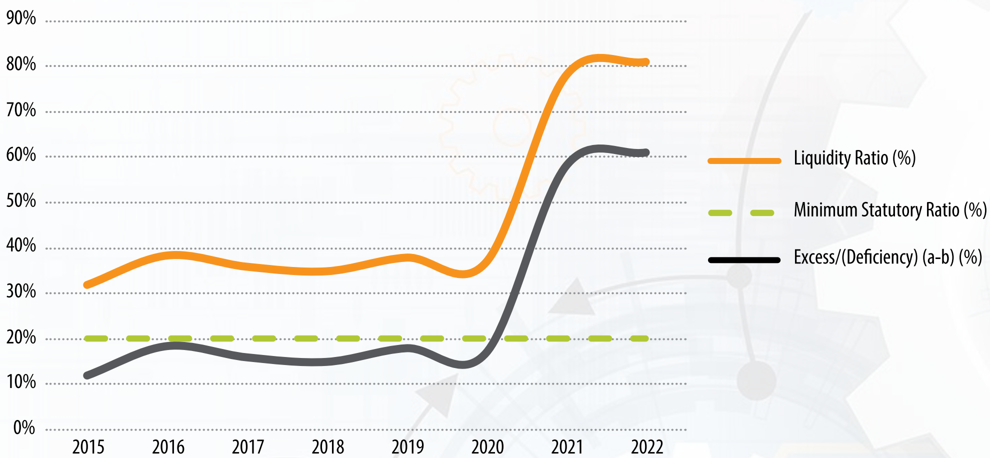
5.8 MFBs Market Structure Dynamics

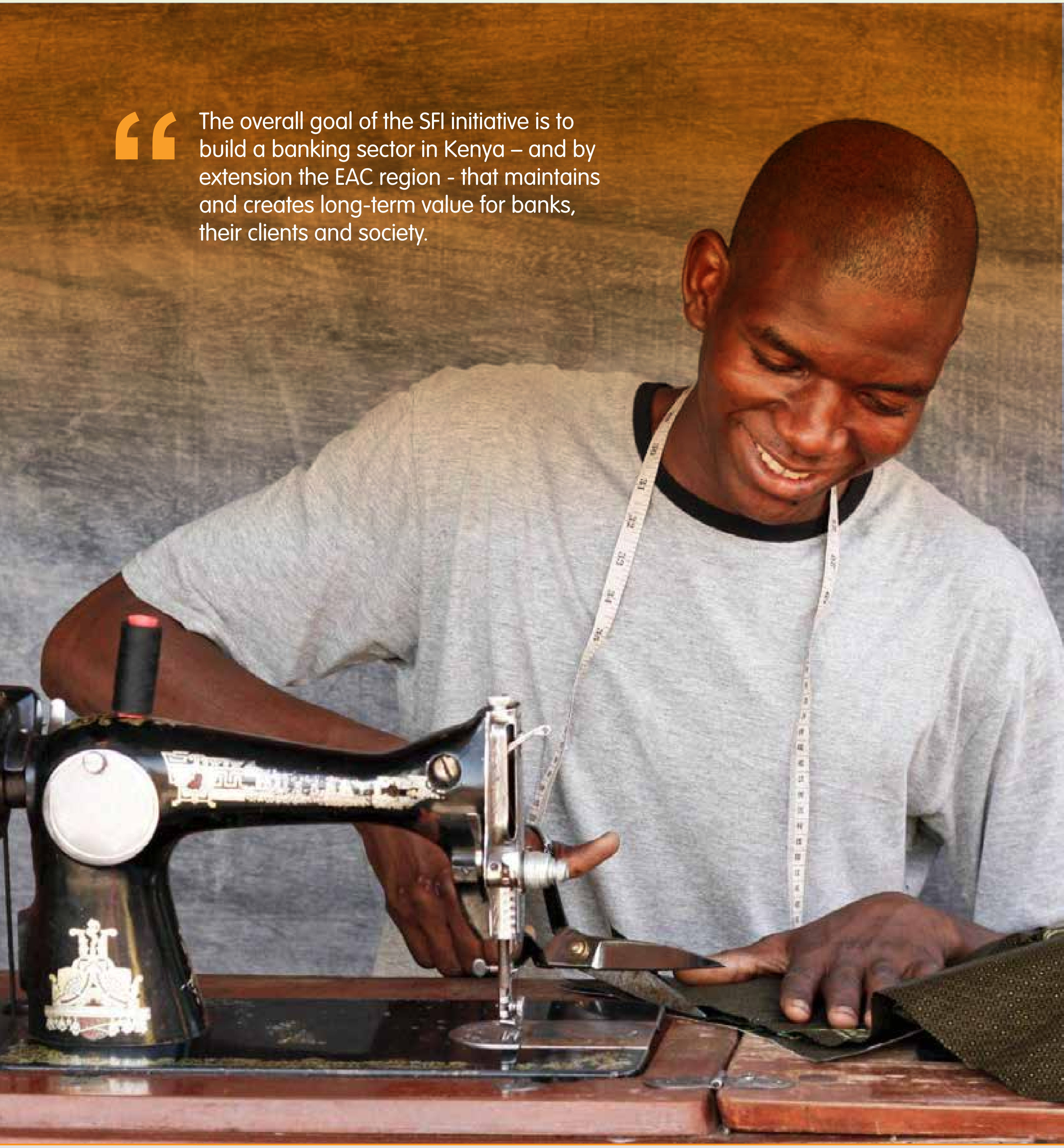
Structure of the deposit-taking financial sector continues to improve. The sector's Herfindahl-Hirschman Index (HHI), based on total assets declined to 2,682 in 2022 from 2,863 in 2021 and has consistently been on a downtrend since 2015, suggesting an increase in competitiveness (**Figure 33a**). Similarly, the index based on total loans and advances has also been on a declining trend mirroring the evolution of total assets with the HHI standing at 2,849 in 2022 from 3,021 in 2021 (**Figure 33b**). However, the sector continues to be dominated by a few players with the top largest MFBs accounting for 97 percent of the total industry assets.

5.9 MFB's Liquidity and Capital Positions

The deposit taking MFB's have high levels of liquid assets and the liquidity positions continue to remain adequate with significant buffer positions. The aggregate liquidity position of deposit taking MFBs, stayed well above the regulatory threshold of 20 percent, at 81 percent in 2022 from 78 percent in 2021, indicating the system's limited exposure to potential short-term outflows of funds (**Figure 34**). Similarly, the capital position of the sector remained robust and capital buffers high. The aggregate capital adequacy ratio (CAR) of the sector was well above the regulatory limit, standing at 16 percent as at end- 2022, against a minimum statutory requirement of 12 percent.

Figure 34: Liquidity Position of Deposit-Taking MFBs





> “The overall goal of the SFI initiative is to build a banking sector in Kenya – and by extension the EAC region - that maintains and creates long-term value for banks, their clients and society.

Chapter 6:

DEVELOPMENTS IN SUSTAINABLE BANKING PRACTICES

During the year under review, investor interest in Environmental, Social Governance (ESG) factors continued to drive corporates – including banks - to shift towards more sustainable development practices. Beyond investor interest and regulatory requirements globally, financiers continued to appreciate the fact that embedding ESG principles is an essential strategy to safeguard long-term business success. Kenya's banking industry players are making significant strides in re-orienting their business priorities from purely pursuing profits to being more socially and environmentally conscious. Banks are appreciating that their business goals need to simultaneously deliver enhanced benefits for Profit, People and Planet.

To help the industry achieve this pursuit, KBA in September 2013 developed and rolled out the Sustainable Finance Initiative (SFI); a set of universal principles (The SFI Guiding Principles) that direct banks in balancing their immediate business goals with the economy's future priorities and socio-environmental concerns. The SFI Guiding Principles in Kenya (available in detail on *https://sfi.kba.co.ke/*) are the first, industry-led sustainable finance guidelines in Africa and provide guidance in the areas of environmental and social credit policy, appraisal and risk assessment, and product innovation, and aim to provide critically needed capacity building on these topics for the sector.

The overall goal of the SFI initiative is to build a banking sector in Kenya – and by extension the EAC region - that maintains and creates long-term value for banks, their clients and society. In so doing, the sector is demonstrating that aside from its role in deepening financial inclusion, it is also concerned with other emerging challenges such as climate change, resource scarcity, environmental degradation and social exclusion that have the potential to undermine sustainable economic growth. Critical focus of the initiative has been the need to build capacity of the industry to trigger stronger adoption of sustainable finance practices, driving inclusivity particularly for people living with disabilities and promoting financial literacy to support stronger access to finance particularly by SMEs. Below is an account of the developments along these focus areas.

6.1 Building Capacity of the Industry to Adopt Sustainable Finance Practices

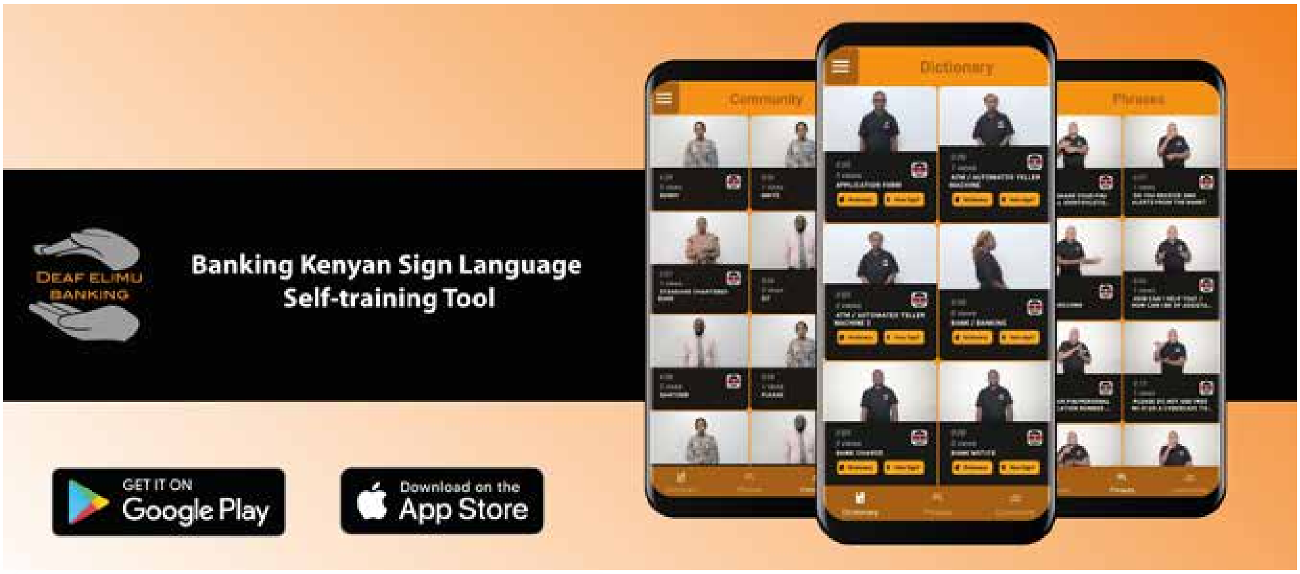
To ensure that the banking industry is well equipped to implement the industry-wide adopted SFI Guiding principles, the Association developed an e-learning platform in 2015. With the funding support from the FMO (Dutch Entrepreneurial Development Bank) and DEG (German Investment Corporation), a comprehensive curriculum was developed to deepen bank staffs' understanding of the importance of creating long-term value for their clients, firm, environment, and the economy. Since its launch, and by end 2022, over forty-four thousand bank staff have undergone training, with over 27 thousand (slightly over 60 percent of total banking sector staff) completing seven mandatory modules offered under the SFI e-learning platform relevant for their job roles.

6.2 Driving Inclusivity for Persons with Disability

In an effort to realize the SFI Guiding Principle on growth through inclusivity and innovation, in December 2021, KBA unveiled the Deaf eLimu Banking Application platform.[7] A first of its kind innovation in the region, the App helps bank staff undergo Kenyan Sign Language (KSL) training to break the communication barrier between them and their deaf customers. The development of the App (supported by both Android and iOS) was inspired by recommendations from a case study that culminated in the publication of a Digital Accessibility Report by KBA in 2020. Ultimately, the App seeks to support efforts towards the promotion of financial inclusion of Deaf bank customers.

KBA as at end 2022, had compiled a consolidated industry wide roadmap based on individual accessibility plans submitted by banks on a voluntary basis. So far, thirty-one member banks have developed their roadmaps, with the initiative targeting to have all banks develop their roadmaps for the inclusion of PWD clients by December 2024.

7. The launch was presided over by the Central Bank of Kenya Governor, Dr. Patrick Njoroge.



6.3 PWD Highlights:

- KBA developed a harmonized roadmap to guide banks on their accessibility journey.
- KBA launched the Deaf elimu Banking App in a forum attended by CBK Governor. The App is now available on both Android and iOS.
- KBA developed a database of Kenyan Sign Language and PWD Etiquette to support bank's capacity building initiatives.
- KBA convened a workshop attended by both the trainers and banks HR teams to synergize on the KSL and etiquette training model.

6.4 Financial Literacy a Key Component in Enabling Access to Finance

A key consideration towards enabling a robust financial system, hinges on the back of having a financially enlightened consumer. Banks have invested considerably in financial literacy programs to empower MSMEs to run their businesses optimally. One such initiative is the Inuka Enterprise Program driven by KBA on behalf of the industry. The capacity building program is carefully designed to de-risk MSMEs to enhance their ability to access bank finance. It is deployed through face-to-face training and an e-learning platform. As at end 2022, over Kshs. 3.2 billion had been issued as loans by the industry through the program, and slightly sixty-five thousand MSMEs drawn from all the 47 counties in Kenya trained under the Inuka program's curriculum.

Chapter 7:

OUTLOOK

The year 2023 looks to be a challenging year for the global economy, with global growth decelerating as the effects of monetary tightening and the war in Ukraine continuing to weigh on economic recoveries and activity. Persistent inflationary pressures, and recent financial sector volatilities particularly in advanced markets continue to inject additional uncertainty into an already complex economic landscape.

Kenya's real GDP growth in 2023 is expected to slow on lower global growth and continued drought conditions in some parts of the country. Even so, the domestic economy is expected to maintain its recent momentum due to growth in the agriculture industry and a thriving services sector.

The outlook remains clouded by several interconnected risks, that include persistent inflationary pressures, the effects of tighter monetary policy conditions on credit flows and by extension economic activity, the tax laws in the Finance Act 2023, sustained depreciation of the Kenya Shilling versus the major currencies, and concerns of debt sustainability amidst upcoming external debt maturities.

Going forward, the balance of risks for the trajectory of inflation in the short to medium term remains biased to the upside, owing to the expected coming into effect of the new fuel tax laws contained in the Finance Act 2023, the protracted geopolitical tensions and their impact on food and fuel prices, and the softening global growth. In addition, the transmission of the monetary policy tightening stance particularly adopted from the second half of 2022 and augmented progressively, is likely to be felt stronger in 2023 through a deceleration in credit flows, and slower economic activity.

Furthermore, the sustained depreciation of the Kenyan shilling against the US dollar – occasioned by relatively wider current account deficit and monetary policy tightening in advanced economies, shall continue to exert pressure on inflation, may moderate importation of capital goods and thus potentially dampening economic performance. Concerns of debt sustainability will require a stronger commitment to fiscal consolidation path- to partly resolve inflationary pressures. This may, however, be tempered by rising interest rates in the market driven by the tightening monetary policy conditions, and the pressing need by the government to resolve pending bills and expenditures targeted at the vulnerable segments of the population.

Given the elevated level of private sector credit risk and the expected macroeconomic slowdown in 2023, this is likely to push banks to increase their exposure to lower risk weighted, less-risky government securities, tapering the private-sector credit loan growth improvements registered so far. Moreover, the expectations of economic growth slow down, and a sustained depreciation of the Kenyan shilling may further deteriorate credit risk and banking sector asset-quality deterioration, thus exerting pressure on banks to make additional loan loss provisions. Nonetheless, the banking sector is expected to 'weather the storm' with adequate capitalization and liquidity levels.

On the journey to sustainable banking, the sector is projected to sustain its drive in embracing sustainable finance practices as a critical driver of positive transformation in Kenya's banking industry. Banks have embraced a great responsibility to refine their approach and business models to meet the very present needs of all the stakeholders for their long-term viability and sustainable economic development.

"Basi Go, Electric buses designed for Kenya: Investor interest in Environmental, Social Governance (ESG) factors continued to drive corporates – including banks - to shift towards more sustainable development practices.

Picture Credit: Basi-Go Ltd

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