

AFRICA RISK CONSULTING

Kenya Monthly Briefing August 2016

Kenya Summary 9 August 2016

Parliament passes Banking Act (Amendment) Bill 2015 in the face of opposition from the government, Central Bank of Kenya (CBK) and Kenya Bankers Association (KBA). The legislation caps commercial bank lending rates at 400 basis points above the CBK benchmark rate. The International Monetary Fund (IMF) warns of the possible risk of undisclosed government debt, and calls for greater transparency in public private partnerships (PPPs). Kenya Airways Ltd records a full-year loss to March of 26.2 billion Kenyan shillings (KSh) (\$258m).

Parliament passes Banking Act 2015

Despite government opposition, parliament on 28 July unanimously approved the **Banking Act (Amendment) Bill 2015**.¹ The approval was unexpected as both treasury cabinet secretary **Henry Rotich** and **Central Bank of Kenya (CBK)** governor **Patrick Njoroge** oppose the legislation.² The amendment caps the commercial bank lending rate at 400 basis points above the CBK benchmark central bank rate.³ The CBK on 25 July held its benchmark rate at 10.5%.

*"This implies that under the proposed law banks will charge up to 14.5% interest rate per annum, which is far below market rates that are as high as 27%."*⁴

The CBK has repeatedly called on banks to lower commercial lending rates but opposes a cap.⁵

*"Even the CBK has admitted that current interest rates are high and loans are not easily accessible even to the most productive sectors of the economy. Small and mid-size enterprises are some of the borrowers who find it difficult to access credit and the high interest rates are cited as the biggest hurdle to home ownership. Kenya has a dismal 20,000 mortgages yet annual demand for housing stands at 50,000 units."*⁶

Banks claim that the elevated rates they charge are necessary due to the difficulty of obtaining detailed 'know your customer' credit reference information.⁷

*"Consumer lobby groups have also accused banks of only sharing information on bad borrowers and keeping information on their prime customers private. Withholding information on good customers denies these customers access to alternative lenders who can offer better rates."*⁸

Banking analysts forecast that the cap will encourage the CBK to cut the benchmark rate at its monetary policy committee meetings scheduled for September and November (see below).⁹ The Banking Act amendment additionally sets the minimum rate for bank deposits at 70% of the CBK

¹ Capital FM, 27 Jul 2016.

² Capital FM, 27 Jul 2016.

³ Capital FM, 27 Jul 2016.

⁴ Source, banking journalist, Nairobi

⁵ Capital FM, 27 Jul 2016.

⁶ Source, banking journalist, Nairobi

⁷ Reuters, 28 Jul 2016.

⁸ Source, banking journalist, Nairobi

⁹ The Star, 1 Aug 2016.

benchmark rate.¹⁰ CEOs of commercial banks are personally liable for implementing the legislation, facing financial sanctions of up to \$10,000 and imprisonment for contraventions.¹¹

Both the CBK and the **Kenya Bankers Association (KBA)** have warned that both provisions will encourage commercial banks to adopt more conservative lending strategies, making it harder for small and medium enterprises to obtain formal sector credit.¹² The KBA has warned that borrowers will increasingly turn to foreign currency-denominated loans to avoid the cap, thereby increasing pressure on the Kenyan shilling.¹³ The CBK has warned that the cap will increase the risk of inefficiencies in the credit market and monetary policy implementation.¹⁴ The CBK is increasing its banking sector regulation due to concerns about insider lending, non-performing loans, inadequate credit securities, liquidity problems and poor corporate management.¹⁵

“There is some truth to the lenders’ and the regulator’s concerns. The proposed law comes less than a year before the general elections and Kenyan members of parliament have gained notoriety for defaulting loans.”¹⁶

There is uncertainty about whether a cap will lower the cost of credit, especially as it will have limited impact on the high levels of government domestic borrowing that have kept prices high.

“The proposed bill does not address the main reasons that make the cost of borrowing exorbitantly high. It ignores the role that the central government plays especially with regard to government borrowing. The government’s rapacious appetite for borrowing has in the past pushed interest rates on the 91-Day Treasury Bill to as high as 20%. The high rate on government paper resulted in depositors asking for equally high rates on their deposits, especially pensions, investment firms and high net worth individuals.”¹⁷

Banking sector confidence remains low after the CBK placed **Imperial Bank Ltd, Dubai Bank Kenya Ltd** and **Chase Bank Kenya Ltd** into receivership between October 2015 and April 2016 (see previous *ARC Briefing* for Kenya). This has further increased the cost of credit as smaller banks have raised interest on customer deposits to avoid withdrawals by large customers.¹⁸ Kenyan banks tend to run their own automatic teller machine (ATM) infrastructure; this increases operational costs, which the banks pass on to consumers.

President **Uhuru Kenyatta** (2013-present) still has to approve the amendment bill. It is uncertain whether Kenyatta will assent to the bill.

*“On the one hand the powerful KBA lobby group and even the CBK are in strong opposition to the Bill. Additionally, the Kenyatta family owns **Commercial Bank of Africa Group**, one of the largest banks in **East Africa**, which begs the question whether the president would sign into law a Bill that will hurt his family’s interests?”¹⁹*

Regardless of the bill’s future, the CBK will probably cut rates before the end of the year as inflation remains within its target band and external vulnerabilities ease. The CBK statement announcing the rate retention indicated that the monetary policy committee believes that low inflation will persist due to moderate demand pressures and relative currency stability.²⁰ Despite inflation accelerating from 5% in May to 5.8% in June, it remains within the CBK’s 2.5-7% target range. The currency

¹⁰ Capital FM, 27 Jul 2016.

¹¹ Capital FM, 27 Jul 2016.

¹² Capital FM, 27 Jul 2016.

¹³ Capital FM, 27 Jul 2016.

¹⁴ Bloomberg, 28 Jul 2016.

¹⁵ Source, senior lawyer, Nairobi

¹⁶ Source, banking journalist, Nairobi

¹⁷ Source, banking journalist, Nairobi

¹⁸ Source, banking journalist, Nairobi

¹⁹ Source, banking journalist, Nairobi

²⁰ www.centralbanknews.info

stability is improving Kenya's balance of payments, with the current account deficit projected to continue to narrow on weak energy imports and strengthened exports. This will allow the CBK to gradually loosen monetary policy.²¹ The CBK statement appeared to justify rather than halt the loosening cycle, citing temporary threats to the economy including 'Brexit', the **United Kingdom (UK)** referendum to leave the **European Union**.²²

IMF warns of undisclosed debt linked to public private partnerships

The **International Monetary Fund (IMF)** has warned of the possible risk of undisclosed government debt.²³ Undisclosed debt may lead to a reassessment of Kenya's creditworthiness. The undisclosed debt takes the form of 313 billion Kenyan shillings (KSh) (\$3.8 billion) guarantees for power purchase agreements (PPAs) between **Kenya Power** and independent power producers.²⁴ The IMF noted that there was no public information for the guarantees, which are not accounted for in public financial documents.²⁵ **World Bank** partial risk guarantees underwrite the PPAs but are time bound, expiring after an unspecified number of months. The IMF warned that the risk from the undisclosed PPAs is that they,

"... involve an obligation for a minimum demand or revenue guarantee ('take' or 'pay') supported by government letters of support".²⁶

The IMF called for additional disclosure about the PPA contracts to more accurately assess Kenya's debt stock. Kenya Power signed the relevant 12 PPAs between 1996 and 2013, notably before the **Public Private Partnership Act 2013** increased transparency over public private partnerships (PPPs).²⁷ The IMF warned that failure to disclose contract terms for future PPP agreements will add to contingent liabilities, and called on the Kenyan government to introduce a PPP assessment framework.²⁸

PPP projects have a mixed track record in Kenya. The government has typically looked to development finance institutes for debt financing for strategic greenfield transport infrastructure projects. **Chinese** credit lines have also financed much of this infrastructure development. The pipeline of infrastructure projects suggests this is changing and sources of financing are diversifying. Better-capitalised local pension funds, private capital and commercial financing inflows into infrastructure projects are increasing.²⁹ Commercial financing is increasingly attracted to the infrastructure sector.³⁰ **South Africa**-based **Standard Bank** and its Kenya-based unit **CfC Stanbic** are particularly active in financing infrastructure projects.³¹

Investors looking for PPP opportunities, however, report a number of challenges:³²

- The government prefers the use of donor funding or public resources for infrastructure, only turning to the private sector if these are unavailable, or for less attractive projects;
- Opaque decision making in tendering and financing of infrastructure projects, and a lack of transparency over the acquisition of project rights;
- Concerns over bankability and cost recovery, due to political sensitivities around the tariffs charged for the provision of infrastructure services;

²¹ www.centralbanknews.info

²² www.centralbanknews.info

²³ Business Daily, 14 Jul 2016.

²⁴ Business Daily, 14 Jul 2016.

²⁵ Business Daily, 14 Jul 2016.

²⁶ Business Daily, 14 Jul 2016.

²⁷ Business Daily, 14 Jul 2016.

²⁸ Business Daily, 14 Jul 2016.

²⁹ Oxford Analytica, 2016

³⁰ Cambridge Economic Policy Associates, Aug 2015.

³¹ Cambridge Economic Policy Associates, Aug 2015.

³² Cambridge Economic Policy Associates, Aug 2015.

- The absence of credible project developers;
- A lack of capacity in the central government's **PPP Unit**.

Additionally, large-scale projects are vulnerable to disputes over land-grabbing, and local politicians who have sought to benefit, with investors reporting demands for illegal payments, equity stakes, or contracts or jobs for relatives.³³

Despite PPP challenges, Kenyatta has improved Kenya's investment environment with tangible results. **Ernst & Young** on 29 July published data showing that with regard to inward foreign direct investment (FDI) in 2015, Kenya recorded 95 projects, a 53.2% increase on 62 in 2014.³⁴ Kenya was the second largest FDI recipient after South Africa. UK- and **India**-based investors were the largest source of FDI in Kenya.³⁵ The majority of FDI in Kenya was channelled into technology, media and telecommunications (TMT) and real estate, hospitality and construction (RHC).³⁶ Ernst & Young warned that Kenya's current account deficit and increased debt levels are downside risks to growth.³⁷ The survey also showed that Kenya in 2015 became the largest source of intra-African FDI projects.³⁸ The majority of Kenyan intra-African FDI projects are concentrated in the **East African Community (EAC)**.³⁹ A total of 36 FDI projects in Africa originated in Kenya, a 140% increase on 2014.⁴⁰ South Africa was the second largest source of intra-African FDI with 33 projects.⁴¹ Kenyan FDI projects were valued at KSh100 billion (\$986m) compared to South African projects, which were worth KSh200 billion (\$1.97 billion).⁴² The majority of FDI projects that originated in Kenya focused on financial and business services.⁴³

Kenya Airways records \$258m loss

Nairobi Securities Exchange-listed national carrier **Kenya Airways Ltd** on 21 July announced a full-year loss to March of KSh26.2 billion (\$258m).⁴⁴ The loss is a boost for **Ethiopian Airlines**, which has long vied with Kenya Airways for supremacy in East Africa. Ethiopian Airlines has its hub in **Addis Ababa**, a much more efficient airport than **Jomo Kenyatta International Airport**. The loss is the result of dollar appreciation and fuel price volatility. The after-tax result compares to a KSh25.7 billion (\$253.7) full-year loss to March 2015. Gross profit increased 42%, the operating loss decreased 75% to KSh4.1 billion (\$40.4m), and revenue increased 5%.⁴⁵ However, Kenya Airways recorded KSh9.7 billion (\$95.7m) foreign exchange losses.⁴⁶ Finance costs increased approximately 50% to KSh7 billion (\$69.1m).⁴⁷ Kenya Airways lost approximately \$50m in a fuel hedging exercise against oil price vacillations.⁴⁸ Kenya Airways is in the middle of a government-backed **PJT Partners Inc**-advised '**Operation Pride**' turnaround plan. Kenya Airways plans to retrench 600 employees, decrease the size of its fleet by a third, and sell some of its real estate holdings.⁴⁹ Kenya Airways in February 2016 sold two aircraft to **United States**-based **Omni Air International**, and subleased an additional five

³³ Source, journalist, Nairobi

³⁴ East African, 29 Jul 2016.

³⁵ East African, 29 Jul 2016.

³⁶ East African, 29 Jul 2016.

³⁷ East African, 29 Jul 2016.

³⁸ East African, 29 Jul 2016.

³⁹ East African, 29 Jul 2016.

⁴⁰ East African, 29 Jul 2016.

⁴¹ East African, 29 Jul 2016.

⁴² East African, 29 Jul 2016.

⁴³ East African, 29 Jul 2016.

⁴⁴ Capital FM, 21 Jul 2016.

⁴⁵ Reuters, 21 Jul 2016.

⁴⁶ Reuters, 21 Jul 2016.

⁴⁷ Capital FM, 21 Jul 2016.

⁴⁸ Capital FM, 21 Jul 2016.

⁴⁹ Capital FM, 21 Jul 2016.

aircraft.⁵⁰ Kenya Airways additionally sold a landing slot at **London Heathrow (UK)**. In 2015 Kenya Airways secured \$200m bridge financing from **African Export-Import bank (Afreximbank)**, which the government backs through an on-lending agreement. On the same day Kenya Airways released its results, Rotich said that private equity investors are considering investments in the airline.⁵¹

Implications

Industry opposition may derail the Banking Act Amendment Bill. Even if enacted, it is unlikely to significantly decrease interest rates, which will persist as the government looks to domestic markets rather than more expensive international markets. The pressure on smaller banks is likely to result in a series of mergers and acquisitions as bigger competitors seek to acquire their business.

The IMF warning about undeclared government debt is a reminder that the appreciation of the dollar is increasing the expense of maintaining Kenya's external debt holdings. However, the \$1.5 billion IMF stand-by arrangement agreed in March 2016 reduces the risk of a potential default. Kenya's PPP framework is nascent and underdeveloped. While the regulatory and institutional framework has improved since the PPP Act, principles of transparency and accountability remain underdeveloped, raising concerns about ensuring competitive and fair tendering processes free of political interference.

The commercial context is difficult for the aviation companies due to currency fluctuations and fuel price volatility. African airlines including Kenya Airways are likely to struggle commercially in 2016. However, Kenya Airways' improved passenger and sales numbers, despite operating fewer aircraft, suggest it is on a broadly positive trajectory. Uncertainty around the 8 August 2017 general election may, however, deter tourist arrivals.

⁵⁰ Capital FM, 21 Jul 2016.

⁵¹ Citizen TV, 21 Jul 2016.

About Africa Risk Consulting:

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