Njuguna Ndung'u: Recent economic developments and policy direction for the banking sector

Keynote address of Prof Njuguna Ndung'u, Governor of the Central Bank of Kenya, at the Kenya Institute of Bankers Annual Dinner, Nairobi, 23 November 2007.

*   *   *

Chairman, Kenya Institute of Bankers
Distinguished Members of the Council
Management and Members of the Kenya Institute of Bankers
Distinguished Guests
Ladies and Gentlemen

It is my great pleasure to be with you this evening at this auspicious occasion which celebrates an important annual event for the Kenyan Banking Fraternity. I therefore thank the officials of Kenya Institute of Bankers for inviting me to this annual dinner and for according me the privilege of addressing this distinguished audience.

This Annual event gives us a unique opportunity to meet, share experiences, reflect on the achievements we have made in the banking sector during the year, the missed opportunities and the challenges we face going forward.

At the outset, Ladies and Gentlemen, I would like to recognize the important role that KIB has played in capacity building within Kenya's banking and financial sector. During my opening remarks at the 7th East African Banking School hosted by KIB earlier in the year, I did mention that capacity constraints would halt the sector's vibrancy. I am happy to learn that a good number of staff in most commercial banks have gone through the Institute's training and have contributed to the improvement of banking and professional standards in the industry.

The country achieved several milestones in 2007. Economic performance during the year was tremendous with real GDP growing by 7.1 percent in the second quarter of the year compared with 5.8 percent in 2006. **Growth begets growth – that is one of my conclusions in some of my research works**. This growth was supported by improved performance in the manufacturing, tourism, transport and communications, and of course the financial services sectors. The good performance is expected to continue supported by continued stable macroeconomic environment, increased investments in infrastructure facilities in the 2007/2008 financial year, and consolidation of financial sector to mobilize development finance, regional economic integration and increased investments in both public and private sector. As we continue to solve the underlying constraints.

One of the major successes in the banking sector has been the expansion of branch network of the key banking institutions in Kenya. However, we have not yet exhausted the opportunities to increase access to financial services by a majority of the population, and our target is to be a regional hub for banking and financial services and the economy to be completely monetized.

During the year, the National Economic and Social Council developed a vision for Kenya. Vision 2030 seeks to transform Kenya into a globally competitive middle-income country with a high quality of life by the year 2030. To realize this vision, the Kenyan economy requires a sustained annual growth of 10% during this period. This will require maximum contribution of each and every key sector of the economy, including the banking and financial sector. The banking and financial sector, for instance, is expected to increase the savings rates to 30% of GDP which will be achieved by increasing bank deposits and increasing the pool of funds through reforms of the pension industry and the capital markets. This may require transformation of banking institutions into larger, stronger banks with attractive savings products and extension of credit referencing services. The insurance services sector will also require reforms to make the players stronger and able to support a larger economy.

Ladies and Gentlemen: One of my objectives when I joined the Central Bank as Governor this year, was to oversee an effective monetary policy that is consistent with the development agenda of the country and the development of an appropriate financial sector in which you play a key role.

During the year, the Central Bank pursued a monetary policy designed to support economic growth projections of the economy, contain underlying inflation at below 5%, and refine monetary policy operating procedures to enhance the efficiency of the monetary policy instruments. These developments have worked, but there are challenges on the inflation front brought about by the external shocks arising from increasing pass through effect of oil prices and sometimes domestic food prices.

The monetary policy also facilitated adequate credit expansion to the private sector which grew by 15% on average over the last 3 years.

Short term interest rates remained stable with a gradual upward trend in 2007, and are expected to continue to remain stable in the medium term on account of continued Government commitment to fiscal discipline, inflation expectations anchored on continued low and stable underlying inflation and an independent monetary policy guaranteed by a flexible exchange rate.

Interest rate spreads also narrowed from 9.4% in January 2007 to 8.5% by September 2007. I wish to commend the banks for their effort in reducing the lending rates though we believe we can still do more to bring the spread to much lower levels. Perhaps we will have time to share our survey and analytical results on factors sustaining large spreads in Kenya.

A challenge for us all – deposits have remained low and most of the time negative in real terms. This is not a good way to attract savings.

Let me touch on Banking Sector Development: The banking sector recorded strong growth in the year to September 2007 against a backdrop of buoyant economic conditions. The highlights of the sector's performance in the year to September 2007 were as follows:

- The sector's total assets expanded by 20 percent while deposit liabilities increased by 18 percent during the period. The increase in the deposit base was attributed to aggressive marketing campaigns for new deposits by some institutions and rapid expansion of branch network of banking institutions. The banking sector remained well capitalised with capital and reserves increasing by 22 per cent as a result of fresh capital injection and retention of profits.
- As at September 2007 gross Non-Performing Loans declined to 12.7% of total loans compared with 22.7% in 2006. The sharp reduction in the level of non-performing loans was attributed mainly to write-offs against provisions held and recoveries by some of the banks during the period under review. Additionally, the resolution of non performing assets by the Government in one of the leading banking institutions contributed greatly to this reduction in NPLs.
- Pre-tax profit for the nine months period ending September 2007 increased by 36.4 per cent to stand at Ksh 26.6 billion compared with Ksh 19.5 billion in September 2006. The improved profitability was attributed to an increase in interest income on loans and advances, government securities and non-funded income, all attributable to the vibrancy in the sector.

Mr. Chairman, allow me to commend your members for the excellent performance in the banking sector. On our part, we remain committed to fostering a stable market based financial system as mandated by law. We will continue to develop and enforce a legal and regulatory framework that fosters a safe, efficient and accessible financial system. You will agree with me that a sound financial system is indeed a catalyst for the high economic growth that the country needs to move to new development frontiers.

Let me also salute the commercial banks for the various innovative niche products introduced during the year. It is only through such new products that we can counter the "negative innovation" that saw the proliferation of pyramid schemes in 2007. At the CBK, we are consulting with other market players including the banking sector with a view to conducting sensitization and awareness programmes to enlighten Kenyans about these unscrupulous schemes. **One conclusion we have arrived at in CBK is that once barriers to entry and transaction costs of maintaining bank accounts are solved, the downstream market will be vibrant and lucrative thereby improving financial access**.

The Banking landscape has become very dynamic. During the year Central Bank licensed two fully fledged Sharia compliant Banks, First Community Bank and Gulf African Bank. These banks are expected to introduce novel Sharia compliant products adding to the existing variety in the sector. We believe this is in tandem with national aspirations of developing Kenya into a premier financial services hub in the region with a variety of competitive products on offer.

Ladies and Gentlemen: I will spend the next few minutes to highlight the various initiatives undertaken in the course of 2007 in order to enhance the legal and regulatory framework for the sector.

The comprehensive review of the Banking Act that commenced in 2006 was completed in May this year, and the revised Draft submitted to the Minister of Finance in June. The draft is currently being reviewed by the Attorney General and will be put to another round of stakeholder consultations before publication and tabling in Parliament. The overarching objective of the review was to align the Act to best practice as stipulated by the Basel Committee on Banking Supervision and to take into account emerging issues in the sector.

Ladies and Gentlemen: the lack of credit information sharing has in the past been a contributory factor to the high levels of non performing loans in the sector. Furthermore, banks have tended to rely more on physical rather than on "personal" collateral in their lending decisions. Following the enactment of the Finance Act, 2006 that made the sharing of information on non-performing loans compulsory, the Central Bank in partnership with the sector formulated regulations on Credit Reference Bureaus. The regulations which are currently under review by the Attorney General will provide the framework for the licensing and oversight of Credit Reference Bureaus by the Central Bank. **Credit Information Sharing will reduce the incidence of non-performing loans and enhance access to credit by individuals in the informal sector and Small and Medium Enterprises who can rely on "personal" collateral, or other innovative forms of collateral that the market may develop**.

A sound legal and regulatory framework for money laundering prevention and control is critical to safeguarding the integrity of the Kenyan financial system. In this regard, the Proceeds of Crime and Money Laundering Prevention Bill was tabled in Parliament in May 2007. The Bill has since lapsed, but we anticipate it will be retabled in Parliament in the coming year. On our part, we will continue enforcing without exception, the Guideline on Proceeds of Crime and Money Laundering (Prevention) to deter the use of the Kenyan banking system for money laundering purposes.

A survey released early this year indicated that 38% of Kenyans lack access to financial services. This population has been kept away from banks due to fear of costs and barriers to entry. Once the income side is solved through economic growth and an enabling legal and regulatory framework for Microfinance Institutions is created, it is our strong belief that this will go a long way in pushing forward the "**Kenyan access to financial services frontier**". As you will recall, the Microfinance Act was assented to in December 2006 and the regulations to operationalise the Act are currently under review by the Attorney General. Once gazetted, the regulations will provide the Central Bank with a platform to license and oversee Microfinance Institutions. **This means more players and more flexibility and competitiveness within the financial sector**.

Ladies and Gentlemen: It would be remiss of me not to address the current "buzz word" in supervisory circles, "Basel II". As you are aware, the Basel Committee issued the Basel II Capital Framework in June 2004. Basel II was ready for implementation among the Committee's 13 member countries from the end of 2006. It is, however, widely acknowledged that Basel II will only be implemented in emerging economies such as Kenya at a later date as they put the requisite supervisory infrastructure in place. This position was indeed adopted by the Central Banks of Kenya, Uganda and Tanzania in 2005.

Since then, we have focused on putting in place the requisite supervisory infrastructure as I have alluded to in my remarks this evening. I am delighted that we have made substantial progress towards this end. Accordingly, we commenced in September, a consultative process with the Banking Sector that will lead to the formulation of a policy position on implementation of Basel II in Kenya in the course of 2008.

The financial sector will be facilitated to play a pivotal role in achieving these objectives through reforms aimed at achieving:

- STABILITY in the sector to ensure that all banks and financial institutions taking deposits safely handle the public's savings and ensure that the chances of financial crises are minimized.
- Greater EFFICIENCY in the delivery of financial services to ensure that the costs of services become increasingly affordable and that the range and quality of services better caters to the needs of both savers and investing businesses.
- Improved ACCESS to financial services and products for a much larger population of Kenyans.

Let me reiterate that a consultative approach will be followed to ensure that the best interests of the banking sector and national development aspirations are taken into account in formulating the policy position.

The Payments System has undergone active modernization that began in 1998 to develop a world-class payment system to ensure: increased efficiency and effectiveness of the clearing and settlement; provision of a variety of instruments and mechanisms for an integrated, modern and technologically sound payment system for transfer of funds between transacting parties; reduction and containment of systemic and other payment related risks; reduction of settlement cycles; enhanced access to financial services and promotion of Kenya as a competitive regional and international financial center.

Given the importance of payment and settlement systems in the economy, the Central Bank, with the support of Kenya Bankers Association, implemented a Real Time Gross Settlement system two years ago going by the acronym KEPSS (Kenya Electronic Payment Settlement System). The Central Bank is happy with the way that the Banking Sector adapted to its usage especially for inter-bank payments. I commend the banking fraternity for this co-operation. The total value of transactions processed through the system increased by 71.4% from Kshs 496.3 billion in August 2005 to the current level of Kshs 850.7 billion. A commercial bank survey conducted in July 2007 indicated that 75.1 percent of the users were corporate while 24.9 percent were individuals.

Central Bank is, however, convinced that this system's usage for third party payments can still be enhanced and accordingly, the Bank is seeking your support in achieving this objective by way of pricing the service competitively among other contributions. The Bank has also initiated action in a number of areas namely: linking the Central Government and Kenya Revenue Authority to KEPSS and capping the value of payments processed through the clearing house in order to reduce systemic risk associated with the large value payments while at the same time increasing the number of transactions processed on a RTGS basis.

Turning to the retail payment sector, the Central Bank has observed increased use of plastic money or payment cards and the use of mobile phones to transfer money in Kenya. In a recent survey carried out by the Central Bank, **ATMs in Kenya grew from 648 in June 2006 to 844 in June 2007**. The mobile phone as a means of transferring money was introduced early in the year and is recording rapid increase in usage especially for rural to urban funds transfers. This phenomenal growth is evidence of the modernization and innovations taking place in payments in the country. In order to facilitate this growth further, banking institutions are encouraged to expand access to the rural areas without ignoring the fact that enhanced reliability of these new technologies is equally important.

The above developments notwithstanding, Central Bank recognizes the fact that a sound legal framework plays a crucial role in the proper functioning of payment and settlement systems and the financial sector as a whole. To this end, a proposed National Payment Systems Bill, 2007 has been forwarded to the Attorney General's office where it is undergoing final drafting to reinforce the existing general legal infrastructure that affects payment systems. The law will provide a legislative framework for governing the operations of national payment systems and payment instruments in Kenya when enacted. It is important that legislation takes place when the infrastructure is in place and the players are prepared. It is our hope that this will be realized by end of the first quarter of next year.

In closing, let me underline the Central Bank's commitment to partnership with the banking industry in facilitating the development of a sound banking system with highly trained professionals that would improve the standards and mobilize the substantial resources required for our country's development.

Finally, Ladies and Gentlemen, as we head towards the festive season, I take this opportunity to wish each and every one of you a Merry Christmas, a peaceful electioneering period and a prosperous New Year. Thank you.