Patrick Njoroge: Strengthening Kenya's sovereign borrowing program – challenges and initiatives

Keynote speech by Dr Patrick Njoroge, Governor of the Central Bank of Kenya, at the Government Borrowers Forum, Paris, 3 May 2016.

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Honorable Minister, World Bank Vice President and Treasurer, Madame Commissioner, Excellencies, Distinguished Guests. Good morning! It is a great pleasure to speak before this distinguished group today. I would like to express my thanks to the organizers and our French hosts for their gracious hospitality.

This meeting brings together public sector representatives facing common challenges and opportunities relating to their public sector borrowing programs. It takes place at a crucial time, given the current state of the global recovery and the increased downside risks. In its communiqué three weeks ago, the IMFC noted that the global outlook had weakened and summarized the situation as follows: "*Although recent developments point to some improvements in sentiment, financial market volatility and risk aversion have risen […] Downside risks to the global economic outlook have increased since October, raising the possibility of a more generalized slowdown and a sudden pull-back of capital flows. […] Against this backdrop, it is important to buttress confidence in our policies.*"

Allow me to elaborate on how we are addressing these challenges, and the initiatives we are undertaking to strengthen our sovereign borrowing program. Like other central banks around the world, we are agents of the government with respect to its borrowing program, but we have lead some of the reforms in this area due to the close connection with other aspects of our mandate. I will conclude with a few words about the status of our banking sector.

Macroeconomic stability

In the second half of 2015, the Central Bank of Kenya moved decisively to deal with the emerging risks, particularly, rising inflation expectations and pressures in the foreign exchange market. This was against a backdrop of increased instability in the global financial markets, with uncertainty around the timing of the increase in U.S. interest rates, coupled with pressures from China's financial markets and the debt crisis in Greece. Significant stress was also observed in our domestic government securities market in August to October 2015, due to the tighter liquidity conditions and a perception of increased borrowing requirements. Market conditions stabilized and then improved towards the end of 2015 – inflation expectations are now better anchored, interest rates have fallen to normal levels, and the foreign exchange market has remained stable. Developments in the foreign exchange market are supported by a narrowing of the current account deficit with improved exports, strong diaspora remittances, and a lower oil import bill.

Turning to fiscal policy, Kenya's fiscal position is set to adjust gradually through a combination of lower expenditures and higher revenue collection. The fiscal deficit is targeted to narrow to 4.1 percent of GDP by 2018/19, from an estimated 8.0 percent of GDP in FY 2015/16. Public sector debt, having risen in the recent period to 53 percent of GDP in March 2016, remains sustainable.

This recent experience has underscored the importance of a strong macroeconomic framework, in addition to the following:

- ***Timely communication with the market players is essential.*** There are significant benefits in announcing a detailed advance borrowing plans by the government. We have also re-established a high-level *"Market Leaders Forum"* where representatives of the Central Bank, National Treasury, and the large commercial banks and custodial investors, discuss freely the government's domestic borrowing plans.

- ***Close policy coordination between the monetary and fiscal authorities*** is also important. This would minimize the risk of stress in the financial markets.
- ***Increased differentiation by investors of the economies where they invest is urged.*** Kenya has differentiated itself from other destination economies by pointing to the sources of its resilience – e.g., highly diversified exports and external markets, strong regional bias, low level of investment by foreigners in government securities (4 percent in March 2016) and equities (22 percent in March 2016). In addition, more granular assessments by investors of the destination economies would support their differentiated investment decisions.

There is a strong commitment to implement policies that sustain macroeconomic stability and to ensure availability of policy buffers to address adverse effects of global shocks. Nevertheless, the impact on Kenya of these external shocks is expected to be minimal due to the diversification of its export products and markets, and stable financial linkages. However, the shock of a potential U.K. exit from the European Union remains of great concern. Looking ahead, we expect that our level of foreign exchange reserves – currently equivalent to 5.0 months of import cover – and the new IMF precautionary arrangements amounting to US$1.5 billion, will provide adequate buffers against short-term shocks.

Strengthening the government borrowing program

Let me now highlight the significant steps that have been taken in recent years to expand and enhance the efficiency of the government borrowing program. Kenya is proud of the progress thus far, which has resulted in substantial growth in the size, depth, and liquidity of the government bond market. The accomplishments include:

- Lengthening the maturity profile of domestic debt and mitigating the refinancing risk.
- Successful issuance of 9 Infrastructure Bonds, raising domestically US$2.6billion over asix-year period, to help close the existing infrastructure gaps;
- Benchmark building by the re-opening of benchmark tenors, which has reduced bond fragmentation;
- A well-established and reliable yield curve that now extends to 26 years;
- The emergence of a vibrant secondary market, largely attributed to issuance of more liquid benchmark bonds, attractive infrastructure bonds and improvement in the trading infrastructure.

In addition to providing a reliable channel of financing the government's needs, Kenya's bond market has facilitated improvements in financial intermediation through better financial infrastructure, products, and services. It has also catalyzed the emergence of a local corporate bond market as an alternative to bank financing.

Let me also mention a number of other reforms that we are undertaking to further revamp the growth of the domestic debt market, including; launching of over-the-counter markets for government securities, introduction of electronic platforms for both primary and secondary markets, and launching of repo facilities and short selling.

An important question relates to how infrastructure investment can be supported, to become a key driver of long-term growth. Countries across Africa and the world are experiencing huge infrastructure gaps, and governments are grappling with the challenge of coming up with innovative solutions for the needed financing. To raise these resources, governments have engaged in direct borrowing from other governments, multilateral lenders, and the international market – e.g., by issuing Eurobonds, *Sukuk* and *Samurai* bonds. Kenya has issued tax-free infrastructure bonds, which have drawn both domestic and international investors. But these efforts fall short of the objective, and alternative sources of long-term funding need to be sought.

On the one hand, domestic banks would need to step up their participation, but this is constrained by legal and prudential limits on the proportion of banks' lending as a share of their core capital. Commercial banks would therefore need to enhance their capital base, to remain compliant with the regulatory requirements. On the other hand, external lenders are likely to be more concerned about the credit, liquidity and political risks that these projects would carry, given their size and long duration. It is therefore important that these projects have a clear and equitable contractual structure that optimally allocates project risks across participants. More innovative solutions to deal with these questions would be highly beneficial.

Mobile financial services revolution

A very exciting area of focus for Kenya and other similarly-situated countries is mobile financial services (MFS), where the Central Bank has played a critical role in promoting financial inclusion through the regulation of these services. Specifically, the CBK facilitated the rollout of innovative products driven by mobile phone technological platforms that are integrated with banking platforms. A pilot "test-and-learn approach" was adopted, allowing innovations while ensuring that necessary safeguards were in place to mitigate the potential risks. The CBK continues to engage with financial service providers and telecommunication companies as they seek to introduce innovative solutions or products in the market.

We have witnessed great success since 2007 when mobile money service providers begun to operate. These have allowed banks to avail their services more conveniently and cost effectively, which has not only revolutionized the delivery channels for financial services, but has also enhanced the satisfaction from utilizing financial services.

- ***Kenya has one of the fastest mobile phone service adoption rates in Africa***. As at December 2015, there were 37.7 million mobile phone subscribers (penetration of 88 percent). There were also 31.6 million mobile money service subscribers, and 143,946 mobile money agents.
- ***Mobile financial services have boosted financial inclusion,*** with 75.3 percent of the adult population now using formal financial services.
- ***The range of financial services accessible on mobile phones is increasing,*** with new innovations that reflect the benefits of a diversified financial system. Mobile payments account for over 80 percent of the volume of payment transactions, but 7.4 percent of the total value of transactions.

Ladies and gentlemen, we are proud of two related products that will soon be fully operational, through which public debt operations will leverage on the growth of mobile financial services.

The first is ***Treasury Mobile Direct (TMD),*** which was rolled out in November 2015. By offering a channel to access small denomination government securities through the mobile phone, this product leverages mobile-phone technology to improve the efficiency of the existing domestic debt issuance operations, in addition to increasing retail investors' participation in the primary auctions for government securities. The services that will be provided under TMD include information dissemination, account status inquiry, bidding for government securities, and payment/settlement through mobile money platforms. TMD will facilitate the growth of government securities by broadening significantly the investor base to retail investors.

The second product is ***M-Akiba***. This is a critical government initiative, which seeks to increase the public's participation in government securities through the existing mobile-phone money transfer services, and with a low minimum investment amount of US$30. The first *M-Akiba* infrastructure bond will be launched shortly as the necessary arrangements are in the final stages, and is expected to mobilize Ksh.5 billion (about US$50 million). Retail investors will be able to register, bid and pay for government securities through the existing mobile platforms. This will provide alternative investment options to retail investors who have long been poorly remunerated especially for their deposits held by banks.

These products will be transformational – in addition to promoting financial inclusion, they will facilitate a change in the population's savings culture, and ultimately lead to an increase in national savings. However, as the digital platforms continue to evolve, there are challenges and risks that need to be addressed. It is therefore important that countries continue to share experiences and strengthen partnerships based on best practices to address these challenges.

The state of the banking sector in Kenya

Finally, I would be remiss if I did not say a few words about the recent developments in our banking sector. In the main, concerns have been raised following the placing of three banks in receivership, since August 2015. We have underscored that the Central Bank's actions were necessitated by unique circumstances in each of these banks, and that these were carried out in the interest of the depositors, creditors, and the wider public interest. We have also indicated that the weaknesses revealed by these cases are not systemic and the banking sector remains strong and stable. The capital-adequacy ratio stood at 18.8 percent in March 2016, well above the statutory minimum of 14.5 percent. The average liquidity ratio rose to 39.8 percent in March 2016, above the statutory minimum of 20 percent and higher than 38.1 percent in December 2015.

Nevertheless, some challenges remain. For instance, interest rates spread remain very high: The spread between the average commercial banks' lending rate and deposit rate stood at 10.3 percent in March 2016.Poor liquidity management and distribution remains a key concern, for which remedial actions are being taken. Bank supervision is also being strengthened urgently. The Central Bank remains committed to fostering banking system stability and will continue to exercise its supervisory mandate in a fair and even-handed manner. Importantly, we have seized the opportunity occasioned by these events and ushered in ***"the new normal" in the banking sector,*** underpinned by the following:

- ***Greater transparency,*** which is supported by accurate data.
- ***Stronger governance,*** with clear demarcation of responsibilities, greater accountability, fair market conduct, and stronger supervision.
- ***Effective business models,*** aimed at strengthening the resilience of banks, reducing costs, and supporting innovation.

In closing, I wish to express our gratitude to the various institutions that have assisted Kenya achieve the significant growth and deepening of financial markets. Specifically, I wish to recognize; the World Bank, which has supported us through a range of projects, the IFC, the IMF, and local stakeholders who have contributed useful ideas for developing the domestic debt market.

I look forward to hearing of the experiences from other countries, and learning from your insights on how to resolve the issues raised.

Thank you.