PROJECT INFORMATION DOCUMENT (PID)
APPRAISAL STAGE

Report No.: PIDA21042

Project Name	Financial Sector Support Project (P151816)
Region	AFRICA
Country	Kenya
Sector(s)	General finance sector (100%)
Theme(s)	Other Financial Sector Development (100%)
Lending Instrument	Investment Project Financing
Project ID	P151816
Borrower(s)	Republic of KENYA
Implementing Agency	Department of Economic Affairs, National Treasury
Environmental Category	C-Not Required
Date PID Prepared/Updated	30-Jan-2015
Date PID Approved/Disclosed	10-Mar-2015
Estimated Date of Appraisal Completion	20-Feb-2015
Estimated Date of Board Approval	30-Apr-2015
Appraisal Review Decision (from Decision Note)	

I. Project Context

Country Context

1. Kenya's economy is estimated to have grown at a rate of 5.4 percent in 2014 despite the slowdown in the services sector due to security concerns. This growth was effected in a sound macroeconomic environment where both inflation and exchange rates remained stable. Kenya's recent economic performance is in line with its regional peers. Average growth between 2010 and 2013 was 6.2 percent, which compared favorably with the average for other countries in Sub-Saharan Africa (5.4 percent). In its immediate neighborhood, the East African Community (EAC), Rwanda grew at 7.1 percent, Tanzania at 6.7 percent, Uganda at 5.4 percent and Burundi at 4.1 percent, over the same period.

2. There is a general consensus that despite the resilience it has shown in recent times Kenya's current growth trajectory is unlikely to realize the goals of Vision 2030 – the Government of Kenya's (GoK) strategic plan to "create a globally competitive and prosperous nation with a high quality of life by 2030". The Economic Pillar of Vision 2030 envisages that the Kenyan economy will grow at a sustained rate of at least 10 percent annually beginning in 2012. Given the growing size of Kenya's young population, every year that this "takeoff" is delayed creates a backlog of unemployment that builds social unrest. Kenya is now at the juncture where transformational

changes in a few priority sectors are needed to shift it to a higher growth path and consolidate its status as a lower middle-income country.

3. Before the slowdown last year the services sector in Kenya has consistently exhibited higher than average growth. In fact, the recent service sector slowdown was largely concentrated in the tourism sector. Other services such as finance and insurance, retail trade and ICT continued to grow faster than other sectors. Finance and insurance grew at 9.1 percent in 2014.

4. Despite this, businesses continue to cite finance as one of the chief constraints to their growth, and domestic resource mobilization - especially of long term funding - remains below target levels. The cost of credit is one of the main reasons businesses, especially SMEs rely on family and friends for financing. Moreover, as Kenya is poised to consolidate its middle-income status the needs of the real economy to fill the vast infrastructure gap and onshore the gains from the incipient natural resources economy pose new challenges for the financial sector.

Sectoral and institutional Context

Stability, Outreach, and Efficiency

5. The Kenyan financial sector is the third largest in sub-Saharan Africa (SSA) and has been relatively stable through recent slowdowns and shocks, both domestic and global. It is comprised of (i) a large banking sector that has leveraged its gains in resilience and growth to establish a notable sub-regional presence, (ii) a relatively well developed securities market (third in terms of capitalization in SSA), and (iii) a relatively large pensions and growing insurance sector. This has been the result of concerted efforts on the part of the GoK and an entrepreneurial private financial sector.

6. The financial sector continues to be dominated by the banking sector; banking assets stood at about 60 percent of GDP. The banking sector has strengthened substantially over the last decade. It has been resilient to domestic shocks (post-election violence in 2008 and subsequent lower economic growth) and international shocks (global financial crisis and the rising prices of food and fuels in particular). In fact, the ratio of gross non-performing loans (NPLs) to gross loans was at 5.2 percent in 2013 compared to 30 percent in 2003. The improvements in banking sector stability are a major achievement compared to 2003 when the high level of NPLs, mainly a result of loans extended by state-owned banks, presented a risk to the system. Concerted efforts since 2000 to reform the banking sector, introduce professional management practices, liberalize interest rates, and replace direct controls on lending with open market operations made it possible for Kenyan banks to leverage the resulting gains to venture abroad.

7. Kenya’s banking sector has been undergoing rapid structural change over the last decade. Cross-industry and cross-border integration, have contributed to greater interconnectedness of financial systems, both nationally and internationally. Financial innovation is creating a more complex financial system, in terms of the intricacy of financial instruments, the diversity of activities, and the concomitant mobility of risks. These structural changes have raised the possibility of adverse consequences of financial instability on economic performance affecting both Kenya and – through the banking and trade linkages – the wider East Africa region. The CBK has made important strides in updating and strengthening the legal and regulatory frameworks for banking supervision but the evolving the structure continues to create new challenges from a

prudential perspective.

8. Technological innovations and the emergence of financial institutions and initiatives that target traditionally underserved segments of the market have expanded the reach of the financial sector. The expansion of retail banks into lower-income markets and regulation of MFIs has led to an expansion in deposit accounts, branches and agents. At the same time, financial institutions started leveraging off the developments in information and communications technologies (ICT) by introducing agency banking, facilitated by the introduction of regulation to permit the use of agents. Between 2010 and September 2013, a total of 21,816 agents were licensed, lowering the costs of providing financial services in sparsely populated areas and increasing outreach. Over the same period the Savings and Credit Cooperative (SACCO) sector has become increasingly formalized, facilitated by the establishment of the SACCO Societies Regulatory Authority (SASRA) in 2008.

9. Mobile phone based payments have dramatically changed the landscape of retail payments and transfers. Introduced by Safaricom’s M-Pesa, the customer base of mobile money transfer services stood at 23.75 million customers at end June 2013. The number of mobile money transactions amounted to 643.1 million at year end June 2013 with a total volume of Ksh 1,689.04 billion. Correspondingly, the total number of agents increased to 103,165 by end of June 2013 from 61,313 in June 2012.

10. While outreach has substantially increased, the interest rate spread in the banking sector remains high. The interest rate spread has averaged 10.42 percent over the period from 2000 to 2010. In January 2014, the spread was at 10.48 percent – marginally above the long-term average. The recent rise in the interest rate spread can partly be attributed to the rise in short-term interest rates (Central Bank Rate, Interbank Rate and 91 day T-Bill rate) from mid-2011 until mid-2012 as part of monetary tightening during this period, but is also evidence of a structural problem. To facilitate lower interest rate spreads, inter alia, information asymmetries and risks need to be ameliorated by expanding information available at credit bureaus (to include positive information as well as information from non-bank financial institutions and commercial entities such as shops and utilities), improving the land and companies registries and titling, and improving the process of taking and realizing collateral. Other factors affecting spreads include the effective competition in the Kenyan banking sector, the stability of the benchmark rates in the government paper market, and the availability of alternative savings instruments.

Long term financing

11. The Kenyan capital market is the largest in East Africa and third in terms of capitalization in SSA, after South Africa and Nigeria. The capital market is dominated by equities and government bonds. A total of 60 companies are listed on the Nairobi Securities Exchange (NSE) with a total market capitalization of over Ksh 1.9 trillion at the end of 2013. The 10 largest listed companies, the majority of which are commercial banks, account for over 70 percent of market capitalization. The outstanding government bond market represents about 26 percent of GDP. The non-government bond market remains underdeveloped (though growing at a fast pace).

12. An automated bond-trading platform has been introduced linking the NSE and CBK, which has contributed to an increase in government bond trading. However, volumes are well below their potential and a reliable government bond yield curve still needs to be developed. The market structure and infrastructure remain inadequate and the hybrid bond market structure, which would

facilitate Over the Counter Trading of bonds alongside exchange based trading, is yet to be operationalized. The repo market, a foundation for the bond market, is not functioning well and the sale/buy back market, has recently been beset by scandals, in which investors lost money.

13. A number of key gaps and market weaknesses exist in the capital market including limited number and size of new equity and debt issuance and limited diversity of capital markets products and services amid increasing appetite for investment, especially from institutional and foreign investors. A strengthened policy and regulatory environment and market infrastructure are required to support market development, efficiency and integrity. There is also clear need to focus on corporate governance and strengthening supervision.

14. The Kenyan insurance sector is underdeveloped (especially with regards to the penetration ratios) but has a relatively large number of companies. The industry has 45 insurance companies, 2 re-insurance companies, 154 insurance brokers, and 4205 insurance agents. The industry is regulated and supervised by the Insurance Regulatory Authority (IRA), established in 2007. Gross premium income was at Ksh 131 billion at the end of 2013 (66 percent falling under general and 34 percent under life insurance business) compared to Ksh 56 billion in 2008. The primary business line for insurance companies in Kenya is motor insurance, a frequent phenomenon in developing markets given that Motor Third Party Liability (MTPL) is often mandatory. Insurance penetration (total premiums to GDP) stood at 3.77 percent of GDP at end 2013, which is low given the large number of insurance companies.

15. Low per-capita incomes, instances of fraud, and weak supervision are some of the deterrents to the development of the insurance market. The GoK has three main goals for the insurance sector: a) promote consumer education and protection, b) promote an inclusive, competitive and stable insurance industry, and c) offer quality customer service.

16. The Kenyan pensions system manages assets of about 17 percent of GDP. The Retirement Benefits Authority (RBA) has regulated and supervised the industry since 2000, using risk-based supervision. Pension funds are established on a trust basis with governing bodies made up of members and sponsor representatives and are licensed by the regulator. Most are now defined contribution (DC) funds, with defined benefit (DB) schemes being largely closed to new members. The RBA also licenses the industries service providers - with 16 fund managers, 12 custodians, and 26 registered external administrators currently operating in the country. Total pension fund assets as of December 2013 amounted to KSh 633.5 billion, with the National Social Security Fund (NSSF) accounti ng for 21 percent.

17. The pension system in Kenya consist of a three pillar system, where the first pillar delivers universal pension of a very low amount aimed at poverty eradication via the means tested Older Persons Cash Transfer (OPCT). The second is a mandatory contributive pillar based on a defined benefit scheme managed by the NSSF, while the third is a voluntary pillar, formed by occupational and individual pension schemes. Outside the OPCT which is being gradually extended, the overall coverage of the system is low. The currently unfunded Civil Service Pension Scheme (CSPS) covers 450,000 civil servants, with the NSSF covering 1.3 million formal, private sector workers on a mandatory basis. The approximately 1,200 occupational pensions have around 400,000 members. Overall, coverage has remained at around 15 percent of the labor force, with more than 80 percent of the workforce in the informal sector having no social security or pension coverage.

Rationale for continued support

18. World Bank support to financial sector development in Kenya over the last decade was delivered largely, but not entirely, under the umbrella of the Financial and Legal Sector Technical Assistance project (FLSTAP). FLSTAP was approved in October 2004 as a technical assistance loan with an IDA credit of USD 18 million and DFID co-financing of USD 10 million. The overall development objective (PDO) of the project was to create a sound financial system and strengthened legal framework and judicial capacity that would ensure broad access to financial and related legal services. When the Project closed in March 2013 almost all of the PDO indicators have been achieved and in some cases even exceeded expectations.

19. The new operation will build on the gains realized through FLSTAP. It will take into account the progress made on the stability and access front by the financial sector over the duration of the project and the evolving needs of the financial and real sector. The Project will support the Kenyan authorities in further developing regulatory and supervisory frameworks that continue to be effective in mitigating the new risks associated with the financial sector's rapid development, deepening and expansion across sectors and across borders. It will support the upgrade of the supervisory, regulatory and institutional framework to keep pace with more complex markets and products with the overall objective of cementing stability.

20. In addition, Kenya's financial sector is also now at the stage where it would benefit from a more targeted approach that supports solutions to specific constraints that curtail the growth and job creation potential of the Kenyan private sector. These constraints include:
(a) availability of "affordable" credit to businesses especially SMEs
(b) scarcity of term finance to address Kenya's development needs

21. Many factors underpin the current interest rate structure, including (i) returns on risk-free govt. paper, (ii) competition in the banking structure, (iii) risk pricing and credit information gaps, (iv) gaps in the collateral systems, (v) gaps in consumer protection and dispute resolution frameworks, etc. For the GoK this is a priority issue and the recommendations of the Inter-institutional Interest Rate Committee touch on these areas. The CBK's Monetary Policy Committee introduced (June 2014) the Kenya Bank' Reference Rate in a bid to introduce more transparency in the way that banks price their products.

22. Since bank financing still dominates in Kenya and bank s tend to rely primarily on deposits as their source of funds there is a general shortage of long-term funds for infrastructure, mortgages, etc. Reforms are needed on the supply side because even as the liquidity position of institutional investors (pensions, insurance companies) has improved these funds are not necessarily finding their way to the market. On the demand side, the agenda includes supporting a wider array of instruments and issuers.

II. Proposed Development Objectives

The project's development objective is to strengthen the legal, regulatory and institutional environment for improved financial stability, access to and provision of affordable and long term financing.

III. Project Description

Component Name

Component 1: Strengthening Institutions

Comments (optional)

This component will focus on the overarching reform, modernization, and capacity support to the financial sector institutional framework. This component will deliver technical assistance to the various beneficiaries, mostly in the form of consultancies, to design roadmaps and action plans, and implementation support to realize the planned reforms. It will also support the upgrade of IT systems and deliver capacity support to ensure a more effective functioning of the financial architecture.

Component Name

Component 2: Enabling Efficient Financial Intermediation

Comments (optional)

This component will move forward the financial inclusion agenda in Kenya with a focus on strengthening and making more transparent the pricing of financial intermediation (savings and lending) so that more businesses and individuals have access to affordable financial products.

Component Name

Component 3: Mobilizing LongTerm Finance

Comments (optional)

This component will focus on strengthening the demand for and supply of long-term funds so that Kenya's growing development finance needs for long-term projects in infrastructure, housing, etc. can be met.

Component Name

Component 4: Supporting Project Management

Comments (optional)

Funds will be allocated for the purposes of project management.

Component Name

Contingency

Comments (optional)

IV. Financing *(in USD Million)*

Total Project Cost:	37.00	Total Bank Financing:	37.00
Financing Gap:	0.00		

For Loans/Credits/Others	Amount
BORROWER/RECIPIENT	0.00
International Development Association (IDA)	37.00
Total	37.00

V. Implementation

VI. Safeguard Policies (including public consultation)

Safeguard Policies Triggered by the Project	Yes	No

Environmental Assessment OP/BP 4.01		×
Natural Habitats OP/BP 4.04		×
Forests OP/BP 4.36		×
Pest Management OP 4.09		×
Physical Cultural Resources OP/BP 4.11		×
Indigenous Peoples OP/BP 4.10		×
Involuntary Resettlement OP/BP 4.12		×
Safety of Dams OP/BP 4.37		×
Projects on International Waterways OP/BP 7.50		×
Projects in Disputed Areas OP/BP 7.60		×

Comments (optional)

VII. Contact point

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