KENYA NATIONAL ASSEMBLY

Tenth Parliament – Fourth Session

REPORT OF THE PARLIAMENTARY SELECT COMMITTEE ON THE DECLINE OF THE KENYA SHILLING AGAINST FOREIGN CURRENCIES

Clerk's Chambers
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TABLE OF CONTENTS

PREFACE vii

SUMMARY OF FINDINGS x

SUMMARY OF RECOMMENDATIONS xiv

ACKNOWLEDGEMENT xix

CHAPTER ONE 1

1.0 INTRODUCTION 1

CHAPTER TWO 3

SUBMISSIONS TO THE SELECT COMMITTEE 3

2.0 GOVERNMENT INSTITUTIONS AND AGENCIES 3

2.1 Central Bank of Kenya (CBK) 3

Submissions 3

Observations 9

Recommendations 11

2.2 Ministry Of Finance 13

Submissions 13

Observations 14

Conclusion and Recommendations 15

2.3 Kenya Revenue Authority 15

Submissions 15

Observations 16

2.4 Taskforce on the Decline of the Kenya Shilling (0ffice of the Prime Minister) 17

Submission 17

Observations 18

Recommendation 19

2.5 Energy Regulatory Commission (ERC) 19

Submission 19

Observation 20

2.6 Capital Markets Authority (CMA) 20

Submission 20

Observations 21

Recommendations 22

2.7 Kenya Tourism Board ... 23
Submission ... 23
Observations ... 23
2.8 Kenya Ports Authority (KPA) ... 24
Submissions ... 24
Observations ... 24
2.9 Kenya Institute for Public Policy Research and Analysis (KIPPRA) ... 25
Submission ... 25
Observation ... 26
2.10 Export Promotion Council (EPC) ... 26
Submission ... 26
Observation ... 27
2.11 Kenya Investment Authority (KenInvest) ... 27
Submission ... 27
2.12 School of Economics, University of Nairobi ... 28
Submissions ... 28
Observations ... 29
3.0 COMMERCIAL BANKS ... 29
3.1 Equity Bank Limited ... 29
Submissions ... 29
Observations ... 32
Recommendation ... 32
3.2 Kenya Commercial Bank Limited ... 33
Submission ... 33
Observation ... 33
3.3 Cooperative Bank of Kenya Limited ... 34
Submission ... 34
Observation ... 35
Recommendations ... 36
3.4 CitiBank limited ... 37
Submission ... 37
Observations ... 37
Recommendations ... 38

3.5 Family Bank Limited 38
Submission 38
Observation 40
Recommendations 41
3.6 Barclays Bank of Kenya Limited 41
Submission 41
Observations 42
3.7 CFC Stanbic Bank 42
Submission 42
Observations 43
Recommendations 44
3.8 Housing Finance Company Kenya Limited 44
Submission 44
Observation 45
3.9 Standard Chartered Bank Ltd 45
Submission 45
Observations 46
Recommendation 47
3.10 Kenya Bankers Association 47
Submission 47
4.0 SUBMISSIONS BY ECONOMIC EXPERTS 48
4.1 Dr. David Ndii 48
Submission 48
Observation 49
Recommendations 49
4.2 Micah Cheserem – Former Governor of the CBK 49
Submission 49
Observations 51
Recommendations 51
4.3 Dr. Thomas Kibua – Former CBK Deputy Governor 51
Submission 51
Observations 53
Recommendations 54

5.0 OTHER STAKEHOLDERS 54
5.1 Foreign Exchange Dealers Association 54
Submission 54
Observations 56
Recommendations 56
5.2 Kenya Private Sector Alliance (KEPSA) 57
Submissions 57
Observations 59
Recommendation 59
5.3 Consumers Federation of Kenya 59
Submissions 59
5.4 Institute of Economic Affairs (IEA) 60
Submissions 60
6.0 POLICY RESPONSES 61
CHAPTER FOUR 64
COMMITTEE FINDINGS AND RECOMMENDATIONS 64
7.0 FINDINGS 64
7.3 RECOMMENDATIONS 70
TABLES........76
Table 1: Foreign Exchange Holdings by Commercial Banks by September 2011........76
Table 2: Commercial Bank Borrowings from CBK and Profits, 2010-2011........77
FIGURES........78
Figure 1: Five Banks with Largest Foreign Exchange Holdings by September 2011........78
Figure 2: CBK Discount Window and Interbank Rate........79
Figure 3: Commercial Banks Net Foreign Exchange Assets........80
Proposed Amendments........81
ANNEX........85
Annex 1: Minutes of the Committee Sittings
Annex 2: CBK Regulatory Interventions: Banking Circulars/Letters
Annex 3: Foreign Exchange Holding by Banks: Quarter Ending September 2011
Annex 4: Submission by Ministry of Finance
Annex 5: Submission by High Level Committee formed by the Prime Minister
Annex 6: Report of the High Level Committee formed by the Prime Minister
Annex 7: Submission by Capital Markets Authority
Annex 8: Submission by Equity Bank
Annex 9: Submission by KCB
Annex 10: Submission by Cooperative Bank

Annex 11: Rejoinder by Kenya Cooperative Coffee Exporters
Annex 12: Central Bank of Kenya's letter to Family Bank
Annex 13: Submission by Barclays Bank of Kenya
Annex 14: Submission by CFC Stanbic Bank
Annex 15: Submission by Kenya Bankers Association
Annex 16: Submission by Micah Cheserem
Annex 17: Submission by Kenya Private Sector Alliance
Annex 18: Submission by Parliamentary Budget Office

PREFACE

Mr. Speaker Sir,

1.1 On Wednesday, November 16th 2011, following a Motion in the House by the Hon Adan Keynan, M.P. The House resolved to establish a Parliamentary Select Committee on the decline of the Kenya Shilling against other currencies.

1.2 Mandate of the Select Committee –

1.2.1 The mandate of the Select Committee as per the resolution was:-

i) To comprehensively investigate and inquire into the causes of drastic and steady decline of the Kenya shilling against foreign currencies;
ii) To make recommendations on the way forward.

1.3 Consequently, the Committee was required to submit a report to the House within 60 days. The Committee subsequently sought extension for thirty days which was graciously granted by the House.

1.4 Motion Setting Up the Select Committee and its Composition

THAT, aware that Kenya is the East Africa's biggest economy and regional economic hub, noting that Kenya is facing a spike in inflation and her currency has plummeted to its weakest level and is now recorded as the continent's worst performer this year despite being fairly stable for the last four decades, concerned that the Central Bank of Kenya has maintained a *"watch and see attitude"* and has publicly admitted that it could not control the currency slip citing that some commercial Banks are hoarding foreign currencies and has asserted that the problem may persist for another six months, considering that the Task Force established by the Rt. Hon. Prime Minister to help

stabilize the shilling, the efforts by the Monetary Policy Committee and the interventions by Treasury have not succeeded in addressing the situation, aware that this depreciation trend has made many Kenyans and foreign investors incur massive losses and the cost of transacting business unduly expensive, this House resolves to constitute a Select Committee to comprehensively investigate the cause(s) of the drastic and steady decline of the Kenya Shilling against the foreign currencies and make recommendations on the way forward and that the Committee shall comprise the following and shall table its report within sixty days of its appointment.

1) Hon. AdanKeynan, M.P. – Chairperson
2) Hon. Rachel Shebesh, M.P. – Vice Chairperson
3) Hon. ShakeelShabbir, M.P.
4) Hon. Charles Kilonzo, M.P.
5) Hon. Benjamin Langat, M.P.
6) Hon. Peter Kiilu, M.P.
7) Hon. Moses Lesonet, M.P.
8) Hon. Emilio Kathuri, M.P.
9) Hon. Benedict Gunda, M.P.
10) Hon. ShakilaAbdalla, M.P.
11) Hon. NtoithaM'Mithiaru, M.P.
12) Hon. Martin Ogindo, M.P.
13) Hon. Yusuf Chanzu, M.P.
14) Hon. (Dr.) Erastus Mureithi, M.P.
15) Hon. Abdul Bahari, M.P.
16) Hon. Adan Bare Duale, M.P.
17) Hon. JakoyoMidiwo, M. P.
18) Hon. Chris Okemo, M. P.
19) Hon. (Prof.) Philip Kaloki, M. P.

1.5 Meetings

1.5.1 The committee set out to achieve its mandate by holding a series of meetings both internal and with stakeholders comprising of institutions, individualsand experts in the industry. In total, the Committee convened twenty seven (27) sittings with the relevant Government agents and other stakeholders in the financial sector.

1.6 Submissions to the Committee

1.6.1 The Select Committee received both oral and written submissions from 30 stakeholders in the industry. These comprised of the following:-

(i) Government Agencies

- Central Bank of Kenya
- Ministry of Finance
- Parliamentary Budget Office, Kenya National Assembly
- Kenya Revenue Authority
- Taskforce on the Decline of the Kenya Shilling (0ffice of the Prime Minister)
- Energy Regulatory Commission
- Capital Markets Authority
- Kenya Tourism Board
- Kenya Ports Authority
- Kenya Institute for Public Policy Research and Analysis (KIPPRA)
- Export Promotion Council (EPC)
- Kenya Investment Authority (KenInvest)
- School of Economics, University of Nairobi

(ii) Commercial Banks

- Equity Bank Limited
- Kenya Commercial Bank Limited
- Cooperative Bankof Kenya Limited
- CitiBankLimited

- Family Bank Limited
- Barclays Bankof Kenya Limited
- CFC Stanbic Bank
- Housing Finance Company Kenya Limited
- Standard Chartered Bank Ltd
- Kenya Bankers Association

(iii) Economic Experts

- Dr. David Ndii - Economist
- Mr. Micah Cheserem – Former Governor of the CBK
- Dr. Thomas Kibua - Former Deputy Governor of the CBK

(iv) Other Stakeholders

- Foreign Exchange Dealers Association
- Kenya Private Sector Alliance (KEPSA)
- Consumers Federation of Kenya
- Institute of Economic Affairs (IEA)

Note: National Security and Intelligence Service (NSIS) and Commercial Bank of Africa were sent letters of invitation but did not appear.

SUMMARY OF FINDINGS

2.1 The Committee received a range of the causes of the fall of the Kenya shilling which the committee divides into economic, human and institutional failures. The economic causes such as the wide current account deficit, Euro crisis, large import bill of non-essential commodities, the Arab Spring, are still in place even after the shilling recovered its value in December 2011. The Committee therefore zeroed on institutional and human failures. These factors include policy indecisiveness and inaction of the CBK which has capacity to stop the slide, speculative activities of some Banks and individuals, and inaction by the Ministry of Finance which also has powers in law to intervene if CBK cannot act. These factors are outlined as follows:

2.1.1 Policy indecisiveness and inaction of the Central Bank of Kenya (CBK) - The Committee finds the following acts as directly linked to the slide of the shilling:

(i) Creating opportunities for arbitrage
(ii) Failure to detect and arrest speculative activities
(iii) Unclear Communication to financial markets
(iv) Ineffectiveness of the Monetary Policy Committee (MPC)
(v) Inadequate policy responses
(vi) Belated intervention by the CBK

2.1.2 Governor of the CBK - The Committee finds that the CBK Governor:

(i) Did not react in good time to the problem of sharp decline of the shilling which triggered a panic and fertile ground for hoarding in foreign currencies and speculation.
(ii) Kept CBK Discount Window interest rates below the interbank rate and Treasury bill rates that encouraged the commercial Banks to by-pass the interbank market to borrow from the Discount Window.
(iii) Allowed communication breakdown between the CBK and the Banks.
(iv) The Governor played down the gravity of the problem to the extent that in various instances and forums, he was quoted saying that he would not intervene in the foreign exchange market.
(v) Being less candid enough with information to Kenyans and even to this Select Committee. For instance, the Governor claimed publicly that some Banks, which he refused to name, were responsible for arbitrage and hoarding of foreign currencies.
(vi) Overseeing the rise of the CBR rate to 18%, hence occasioning Kenyans heavy interest rate payments.

(vii) Is squarely responsible for creating the opportunity for Banks and individuals to make quick money through speculation and hoarding.

(viii) His announcement and release of CBK circular to bypass the Banking system and deal directly with buyers or sellers of foreign exchange, although reversed, was in complete disregard of the financial structures and could have opened opportunities for rationing of foreign exchange, occasioned parallel markets to thrive.

2.1.3 Arbitrage by commercial Banks - Various financial players, including commercial Banks participated in arbitrage. Although this is not illegal and is a common business practice, the Committee observed that Banks exploited loopholes in the financial market to borrow funds from the CBK through the Discount Window and used the funds to profit from foreign exchange trading or to buy Government securities.

2.1.4 Commercial Banks with increased foreign exchange trading activity - Three Banks namely; CFC Stanbic Bank, Standard Chartered Bank, and Citibank were reported to have had increased foreign exchange trading activity. CBK wrote to them seeking explanation and clarification.

2.1.5 Suspension of specific financial institutions from participating in the interbank market or foreign exchange market - the Governor reported that CFC Stanbic Bank had flouted the guidelines issued on October 13, 2011 regarding the tenor of foreign currency swaps. The Bank was suspended from participating in the swap market for 30 days and was also penalized Ksh. 1 million in line with the Banking Act (Section 2(a) of Legislation No. 77 of 1999: The Banking (Penalties) (Amendment) Regulations 1999).

2.1.6 **Commercial Bank Foreign Exchanging holdings** - The committee finds that 12 major Banks held 87.7% of total foreign assets by September 2011.

2.1.7 **Conflict of Interest** –The Committee finds that top management and board members in some Banking institutions hold board positions in key public policy organs which are tasked with major development projects in the country. This is a source of disaffection and suspicion among Banks which feel undue advantage is gained by such Bank executives. For instance, the CEO of Equity Bank chairs the Vision 2030 board which in the Committee's opinion and that of other Banking institutions provides undue advantage on present and future information about inflow of funds towards infrastructure development. Similarly, the chairman of Equity Bank chairs the National Oil Corporation.

2.1.8 **Kenya Bankers Association** – The Committee found that the interaction between the regulator and KBA, which is an interest group for profit seeking Banks, was inappropriate in free markets. This opens up opportunities for collusion, arbitrage and speculation in foreign currencies.

2.1.9 **Inaction by the Ministry of Finance** – The ministry of finance failed to exercise the provisions of the Central Bank Act (Cap 491 section 4c) and take a proactive role to tame the decline of the shilling.

2.1.10 Poor working relationship existed between the CBK and commercial Banks.

2.1.11 Failure by the fiscal and the monetary policy organs of the Government to take timely corrective measures to arrest the slide of the shilling against major currencies.

2.1.12 Capital Flight - The country suffered capital flight during the period when the Kenya shilling was depreciating. The uncertainties about the unpredictable exchange rate of the Kenya shilling fuelled negative expectations about the economy and key macroeconomic variables.

2.1.13 Global economic crisis– The Committee finds factors external to the domestic economy may have played a role in the decline of the shilling. These include Euro zone debt crisis, US debt crisis, and Political events in the Middle East and North Africa. However, since these conditions still persist, the committee considers them not to have been the main causes for the drastic depreciation of the shilling.

SUMMARY OF RECOMMENDATIONS

3.1 On the basis of the above findings, the Committee has drawn a range of recommendations which will ensure that future crisis such as the sharp depreciation of the shilling is not replicated. The Committees' recommendations span both economic and institutional changes as follows:

3.1.1 Monetary Policy

(i) **Governor of the CBK** –The Committee finds the Governor's conduct and behavior incompatible with the holder of the office of Governor of the Central Bank of Kenya and therefore recommend:

- The Governor takes responsibility for allowing the sharp decline of the shilling.
- The Governor steps aside to pave way for thorough investigations
- That the President should constitute a Tribunal to investigate the Governor's conduct, incapability and incompetence to perform the functions of the office as per the provisions of the CBK Act Cap 491 section 14 (2)(f) and 14(3).

(ii) **Productive communication between CBK and financial market players** - the Committee recommends that CBK should design a framework of engaging with foreign exchange market players within the confines of the financial market laws and regulations.

(iii) **Coherence of monetary policy** - The Committee found that the CBK may have been overenthusiastic about economic stimulus and also maintained the low interest rate regime for far too long, and therefore recommends that the CBK should maintain a coherent monetary policy at all times with a focus on price stability.

(iv) **Early warning mechanism** - CBK should put in place thresholds or trigger values for which the foreign exchange should fluctuate in times of extreme crisis and at which the CBK would move in to restore stability.

(v) **Strengthen reserve position of the CBK** - That the Government and CBK should take adequate steps to boost the reserve position to at least the 4 months of import cover to strengthen its ability to respond to market volatility.

(vi) **Enforcement of the In-Duplum Rule** – Section 44A of the Banking Act needs to be enforced and further amended to apply to all loans – both performing and non-performing.

3.1.2 Legal Amendments

3.1.2.1 Suggested amendments to the CBK Act should target, but are not restricted, to the following:

(i) Position of Chair and Deputy Chair of the CBK Board– Amendment to the Central Bank Act (CAP 491 section 11 (1)(a)(b)) to provide that the CBK Governor and the Deputy Governor

cannot chair the Board of Directors of CBK which is expected to review his performance in achieving the CBK core mandates.

(ii) **Appointment of the Governor and Deputy Governor** - That the CBK Governor and Deputy Governor be recruited through a transparent and competitive process.

(iii) **Oversight over CBK**–Introduction of an amendment to the CBK Act to provide that the CBK Governor appears on a quarterly basis before a relevant Parliamentary Committee of the National Assembly to expound on monetary policy and other actions related to the discharge of the CBK core mandate of price stability and financial stability.

(iv) **Autonomy of the CBK** – Strengthen the autonomy of the two arms of CBK namely, the Bank supervision/financial markets on one hand and monetary policy arm on the other.

(v) **Sanctions** - Introduction of amendment to the CBK Act to provide for punitive sanctions on the Management of the Central Bank for gross failure in attainment of important monetary policy objectives or failure which occasions the country huge losses.

(vi) **The Monetary Policy Committee** – Amendment to section 4(d) of the CBK Act to provide for an extra member to the MPC of a CBK staff responsible for Bank supervision.

(vii) **Conflict of interest**– That senior managers and board members of Banks should not hold positions in Government policy organs or Government commissions with direct impact on financial and monetary policies.

3.1.3 Supervisory Oversight of Financial Institutions

(i) CBK should develop tools to efficiently monitor financial markets – Particularly find tools to quickly deal with the adverse effects of innovations in foreign exchange trades such as the Electronic Brokerage System, foreign exchange swaps and carry trades.

(ii) That the CBK should increase the speed and responsiveness to market developments to deal with rapidly changing financial market behavior.

(iii) Independent forensic audit - That;

- Ethics and Anti-Corruption Commission and the Auditor General's office to carry out an independent forensic audit on the operations and transactions of the Discount Window and foreign exchange trading of twelve Banks which had the largest foreign exchange holdings by September 2011.
- The CMA to conduct a comprehensive investigation of the NSE to determine suspect capital inflows and outflows from the Bourse and report to parliament within 90 days from the date of adoption of this report by the House.

(iv) Review of Internal Processes - That CBK carries out an internal audit of what went wrong in monetary operations and Bank supervision with a view to rectifying the problem.

(v) Banking Penalties Regulations –Amendments be made to the CBK Act and the Banking Act in order to revise and enhance the penalties which may be imposed for breach of CBK Regulations to levels proportionate of the value to the Bank of the malpractice at that particular time. Since the current amount of penalty, Ksh. 1 million is too lenient, the Committee recommends a more deterrent penalty of 50% of the amount involved or Ksh. 20 million whichever is greater (regulation 2 of the Banking (penalties) Regulations, 1999).

3.1.4 Fiscal Policy

(i) Reduction of the current account deficit through exports promotion.

(ii) Placing tariffs and non-tariff barriers on non-essential imports - the Ministry of Finance should explore ways through the regional trading arrangements to increase tariffs on non-essential commodities so as to reduce the import bill.

(iii) Exercise of powers provided under the law – That the Ministry of Finance should not hesitate to take policy measures if the CBK grossly deviates from its monetary policy statement.

(iv) Strong Macroeconomic Fundamentals - The Committee finds the CBK and the Treasury lacking in strong Macroeconomic fundamentals in the form of policy. Both institutions appear to have been overenthusiastic about economic stimulus. The CBK also maintained the low interest rate regime for far too long. The CBK should therefore maintain a coherent monetary policy at all times with a focus on price stability.

(v) Coordination between the Monetary and Fiscal Policy Institutions - The Committee recommends effective policy coordination between the fiscal and monetary authorities/agencies.

7.3.6 Finally, the current interest rates of slightly over 30% charged by banks are unrealistic, harmful and untenable. Therefore, the Government, CBK and financial market players should put in place deliberate mechanisms to reduce the interest rate to affordable rates within three (3) months of adoption of this report by the House.

ACKNOWLEDGEMENT

Mr. Speaker Sir,

4.1 The foregoing is a summary of the Select Committee report on the drastic decline of the Kenya Shilling against other Foreign Currencies. The Committee Observations, Findings and Recommendations are the outcome of the insightful submissions made to the Committee by various stakeholders in the Financial Markets, Government Agencies and distinguished experts in the economic discipline. I take this opportunity to thank them most sincerely.

4.2 May I, on behalf of the Committee extend our gratitude for the invaluable support accorded to the Committee by the Parliamentary Service Commission and the Office of the Clerk of the National Assembly towards executing the Committee's mandate. Further, I wish to assure this House that the observations and findings contained in the report were unanimously agreed upon by Members of the Select Committee.

4.3 Finally, Mr. Speaker, It is my pleasant duty and privilege, on behalf of the Select Committee on the decline of the Kenya Shilling against foreign currencies, to present this report to the House for adoption pursuant to Standing Order 181.

SIGNED……………………………………………

HON. ADAN KEYNAN, M.P.
CHAIRPERSON

DATE: ………………………………………………

The Report was countersigned by the following Members of the Committee:-

1) Hon. Adan Keynan, M.P. – Chairperson
2) Hon. Rachel Shebesh, M.P. – Vice Chairperson
3) Hon. Benjamin Langat, M.P.
4) Hon. Peter Kiilu, M.P.
5) Hon. Moses Lesonet, M.P.
6) Hon. Emilio Kathuri, M.P.
7) Hon. Shakila Abdalla, M.P.
8) Hon. Ntoitha M'Mithiaru, M.P.
9) Hon. Martin Ogindo, M.P.
10) Hon. Yusuf Chanzu, M.P.
11) Hon. (Dr.) Erastus Mureithi, M.P.
12) Hon. Adan Bare Duale, M.P.
13) Hon. Jakoyo Midiwo, M. P.

<u>CHAPTER ONE</u>

1.0 INTRODUCTION

1.1 The Kenya shilling had been stable for nearly a decade, hardly breaching Ksh. 80 to the US dollar since 2003. However, the shilling depreciated sharply in 2011 to levels seen in the height of the Goldenberg scandal in the 1990's. By mid-October 2011, the Kenyan shilling had depreciated sharply against major currencies, hitting a historic low of Ksh.107 against the US dollar.

1.2 The combined effects of rising inflation and a weakening shilling presented a toxic risk to Kenya's economy not seen since the 2008 electoral disturbances. Indeed, these problems drastically increased the cost of living and made life unbearable for majority of Kenyans, including posing a real risk of economic slump and a rise in poverty levels as well as the number of Kenyans that were predisposed to eminent poverty due to decline in purchasing power. This was a cause of concern amoung citizens and their elected representatives.

1.3 As a result, the House formed the Select Committee to investigate the rapid decline of the Kenya shilling. Drawing from the Motion, there was concern that the Central Bank of Kenya had maintained a *"watch and see attitude"* and had publicly admitted that it could not control the currency slip citing that some commercial Banks were holding foreign currencies and that the problem may persist for another six months.

1.3 The Members were also concerned that effort by a Task Force established by the Rt. Hon. Prime Minister to help stabilize the shilling, the interventions by the Monetary Policy Committee, and the interventions by Treasury had not borne fruit.

1.4 The pressure for the Central Bank of Kenya to intervene persisted throughout the year, but it was only in October 2011 that CBK

increased the Central Bank Rate (CBR) to 11 percent. On November 1, 2011 the CBK further raised the CBR rate to 16.5 percent and again to 18 percent in December. This has contributed to high lending rates, some as high as 32% that are threatening to turn middle class majority of Kenyans into paupers.

1.5 The Committee in its sittings particularly explored the causes of the drastic fall of the Kenya shilling throughout 2011 but with specific reference to the most turbulent period: September to October 2011. The Committee also sought to identify any policy failure or inaction among key institutions such as the CBK, or any fraudulent and speculative activities of CommercialBanks or other institutions.

1.7 The Committee held sittings to investigate the reasons for the fall of the Kenya shilling with various institutions and stakeholders among them, the CBK, Ministry of Finance, Task force at Office of the Prime Minister, Capital Markets Authority, Kenya Bankers Association, eight Commercial Banks, Academic and Research Institutions, former Governor of Central Bank and several economic experts.

1.8 These factors are explored below including synthesis of findings and presentations from various witnesses who appeared beforethe Committee. Specific recommendations are also put forth toaddress the policy failures and other factors and to ensure that this economic disaster does not recur again.

CHAPTER TWO

SUBMISSIONS TO THE SELECT COMMITTEE

2.0 GOVERNMENT INSTITUTIONS AND AGENCIES

2.1 Central Bank of Kenya (CBK)

Submissions

2.1.1 The CBK Governor presented to the Committee the key causes for the fall of the shilling. Among these factors include the following: rising inflationary pressures, rising fuel prices in over 10 months period at a price above US$ 100, very high fuel import bill that rose from 19.2 percent in January 2011 to 31 percent in August 2011, huge current account deficit of about 12 percent to the GDP, Eurozone and US debt problems that contributed to instability in international foreign currencies. The fall of the shilling was also attributed to prolonged drought resulting in food shortages and hence high food import bill (during this time, sugar became an extremely important/expensive import commodity), and high private sector credit.

2.1.2 The Central Bank singled out the current account deficit as one of the primary factors driving the fall of the shilling. For example, for the month of September 2011 alone, the difference between imports and exports stood at US$ 576.7 million, while in November 2011, this difference amounted to US$ 693 million. Indeed, exports have been financing only 51 % of imports which means that the country was losing foreign exchange at an alarming rate. This is a fundamental problem with the economy which requires strong export policies (see other submissions and recommendations). The CBK also blamed the fall of the shilling on the strengthening of the US dollar internationally following the Eurozone debt crisis.

2.1.3 Further, the Governor in his presentation argued that since Kenya is a small open economy (with open capital account and floating or

flexible exchange rate) any major international shocks could have a direct effect on the exchange rate and domestic prices. Apart from the problem with high import bill relative to exports (large current account deficit), the exchange rate is also affected by changes in prices in Kenya's trading partners, the size of Kenya's official foreign exchange reserves, and the country risk profile. According to the CBK, countries such as South Africa, Tanzania and Uganda also experienced steep depreciation of their currencies in the period April to September 2011. Most countries around the world intervened to address the fall of their currencies, but the effectiveness of this was constrained by the level of foreign exchange reserves available.

2.1.4 With regard to the pertinent issues requested from the CBK, such as whether the Bank had made any ad hoc visits to commercial Banks during the time of exchange rate crisis, or whether the Bankhad sent any warning letters to Banks regarding their foreign exchange trading activities, or whether the CBK had taken any supervisory interventions such as suspension from the interbank market or any other measures, the CBK clarified the following:

(i) **The use of the Discount Window**: The CBK had issued circular to curtail the capacity of Banks to borrow from the Discount Window for speculation. The CBK issued circulars specifying the frequency and amounts that could be borrowed from the Window. The Banking Circular No. 5 of June 29, 2011 set the Discount Window rate at 8% (above the CBR rate) and announced stiff penalties for Banks using the Window to trade in the interbank market. Further, operations in the interbank and foreign exchange dealings were checked before commercial Banks could access this borrowing.**(see annex 2).**

(ii) **Regulatory actions and visits to financial institutions**: the CBK made regular audits of all Banks involved in foreign exchange dealings particularly relating to their use of the Electronic Brokerage System

which the CBK believed could cause arbitrage opportunities. The visits found that commercial Banks had substantial amounts of foreign exchange assets and that the demand for foreign currencies by importers of food and oil were causing speculation on the price of foreign currencies.

(iii) **Warning Letters related to trade in foreign exchange, use of the Discount Window and Participation in the Interbank Market**: the CBK clarified that there were no warning letters issued, but there were letters sent to various Banks requesting clarification and explanations on various issues in accordance with Section 33F of the Central Bank of Kenya Act. In addition all circulars and any changes to guidelines relating to foreign exchange trading, the use of the Discount Window and participation in the interbank market were duly communicated to all commercial Banks. Letters requesting explanations were issued to three Banks that handle large foreign exchange reserves and that had increased foreign exchange activity. Information provided by the Governor shows that the three top Banks by September 2011 controlled 42.2% of total foreign assets in the Banking system (approximately Ksh. 174.5 billion). The Governor reported that adequate explanations were provided by the Banks during the visits.

(iv) **Banks that had high foreign exchange trading activity**: The Governor provided the names of the Banks that had increased foreign exchange activity. But, as noted in above bullet, these Banks provided adequate explanations during the visits **(see annex 3).**

(v) **Suspension of specific financial institutions from participating in the interbank market or foreign exchange market**: The Governor reported that one Bank had flouted the Guidelines issued on October 13, 2011 regarding the tenor of foreign currency swaps. The Bank was suspended from participating in the swap market for 30 days and was also penalized Ksh. 1 million in line with the

Banking Act (Section 2(a) of Legislation No. 77 of 1999: The Banking (Penalties) (Amendment) Regulations 1999).

(vi) **Other Regulatory Interventions by the CBK:** to deal with the problem of the exchange rate the MPC held a special meeting and thereafter held monthly meetings to deal with the currency crisis. The CBK also suspended the use of Electronic Brokerage System by Banks, limited the tenor of foreign currency swaps where offshore Banks were involved to not less than one year, and limited the tenor of swaps between residents to a period not less than seven days. Apart from reducing the foreign exchange exposure ratio from 20 to 10% (through a letter to Chief Executive Officers of commercial Banks on 13th October 2011), the CBK also required Banks to obtain supporting documents for all transactions in the Nostro accounts of offshore Banks.

2.1.5 To respond to the developing problem of the exchange rate, the CBK made various policy measures in form of circular issuance to the Banks, changes in the guidelines and changes to prudential regulations. The CBK uses various instruments to control the behavior of and capacity of commercial Banks to adjust their portfolios (for example to curtail harmful adjustments of portfolio). Normally, the usual deals in foreign exchange are done on behalf clients, and others are done on the basis of a Banks analysis or expectations of the movements in the exchange rate given the knowledge of when they expect the clients will require or provide the foreign exchange. For example the Banks could temporarily hold foreign exchange if they expect it to depreciate further, or to avoid losses. Commercial Banks adjust their foreign exchange portfolios relative to their holdings of assets denominated in Kenya shilling depending on market conditions and liquidity conditions. This is standard market behavior in competitive foreign exchange market and is followed up in the recommendations (supervisory operations, etc).

2.1.6 To curtail volatility in the foreign exchange markets the CBK uses or used instruments that include, the cash reserve requirements, foreign exchange exposure limits, guidelines on tenor limiting hedging, access to foreign exchange facilities, and liquidity management through the open market operations. The CBK Governor also provided information about policy responses that the Bank had taken to address the fall of the shilling (and also to reduce inflationary pressures). These responses include:

(i) Tightened monetary policy; on 5th October 2011, the CBK raised CBR to 11%. On 1st November 2011, the CBR was further raised 16.5% and the cash reserve ratio was also increased to 5.25% from 4.75% effective from 15th December 2011. In December 2011, the CBK further increased the CBR rate to 18%**(see annex 2).**
(ii) The CBK also introduced guidelines on foreign exchange exposure and trading. For example, the CBK reduced commercial Banks foreign exchange exposure from 20% to 10% to control trading in foreign exchange.
(iii) The CBK also made sales of foreign exchange. But, sales of foreign exchange reserves by the CBK were complemented by other measures in stabilizing the exchange rate. The sales were limited by the amount of foreign exchange reserves available to the CBK.

2.1.7 It can be noted that on this, changes to the cash reserve requirements to 5.75%, the rise in the CBR rate to peak at 18%, and changes in the foreign exchange exposure limits have forced Banks to adjust their portfolios. These adjustments may include dumping of foreign exchange denominated assets (thus occasioning the strengthening of the shilling), shift from treasury bonds and bills to interbank lending or to foreign exchange credit lines among others. For example, some Banks hold significant cash surpluses to profit from the interbank market.

2.1.8 With regard to the Discount Window of the CBK, the Governor said that commercial Banks come to the CBK as a lender of last resort especially when the interbank market rates are high. High interbank interest rates often indicate tight liquidity especially following the increase in the CBR rate to 18 percent and the cash ratio from 4.75% in May 2011 to 5.25% in November 2011. The increase in the CBR rate increased the lending rates of interest in the country. In response to the negative effect of the increase of the CBR rate the Central Bank has met with the Kenya Bankers Association on the interest rates charged to existing loans and agreed on restructuring the loans in consultation with the borrowers.

2.1.9 The CBK Governor also reported that the Government had committed to review its budgeted expenditures to cut down on non-priority area. This was expected to support the tight monetary policy pursued by CBK. The Governor reiterated that the priority was to bring inflation and inflationary expectations under control and also to protect the economic growth base. The CBK would also seek to build up foreign exchange reserves as buffer, but its interventions in the foreign exchange market will only be done to dampen volatility of the exchange rate. The Governor also said that interactions with market players will be sustained to enhance the effectiveness of the transmission mechanism of monetary policy and policy actions.

2.1.10The Governor however refuted claims that the CBK favours certain Banks in the country arguing that the Discount Window was open to all Banks. He also refuted the allegation that he did not do much to arrest the fall of the shilling. He explained that the CBK needed to assess the market before taking any action since some of the market activities or financial products were new. The Governor also defended his competence in running the CBK.

Observations

2.1.11 Tracking CBKs response to the exchange rate and inflationary pressures throughout the year could provide a hint on what may have gone wrong. The CBK firstly increased the CBR on March 23, 2011 from 5.75% to 6% and was revised again to 6.25% on 4th June, 2011. The CBR rate was not reviewed again until September 15th, but this was raised to only 7%. Thus, though the Kenya shilling was rapidly losing value and inflation was rising, the CBK still kept the CBR fairly flat for about 9 months.

2.1.12 During this time, the CBK was implementing other measuresincluding interventions on the Discount Window and interbankmarket. The significant raise in the CBR rate came through the Circular of October 6, 2011: raising the CBR from 7% to 11%. Further adjustments came in November 2, 2011 when the CBR was raised to 16.5% (cash reserve ratio was also increased to 5.25% from 4.75% to be effective in December 2011), and again in December 2, 2011 when the CBR rate was increased to 18%.

2.1.13 Regardingthe use of the Discount Window, the CBK corrected the mismatch between the CBR and Window rate on 29 June, 2011 when the Window rate was raised to 8%. However, through the Banking Circular No. 6 of 11th July, 2011 the CBK reviewed the Discount Window downwards from 8% to 6.25%, though there were additional restrictions on the use of Window such as barring Banks that were lending in the interbank market from accessing the Window the same day. This could have effectively sealed the loophole where Banks were borrowing at a low rate through the Window and lending at a higher rate in the interbank market. Successive review of the Window rate and guidelines for accessing it indicate continued adverse use of the window by Banks (arbitrage).

2.1.14 The Committee can infer that in fact Banks were using the Discount Window to lend in the interbank market the same day or the next day

since the Banking Circular No. 8 of August 12, 2011 sought to curtail this practice. Also, the revised formula of the Window rate which would ensure the rate was higher than the interbank rate plus a penalty sought to dissuade Banks from using the difference in the Window and interbank lending rate for profit. Also, eligibility to access the Discount Window funds was also determined by the Banks trading behavior in the foreign exchange markets. Further, measures to strengthen and to close the opportunity for arbitrage created by the mismatch among major short term interest rates were issued in successive circulars.

2.1.15 What we note from these two observations is that the mismatch between the Discount Window and the interbanklending rate, and the low rates available through the Discount Window created opportunities for arbitrage by Banks, which when the funds were used in the trading in foreign exchange created further volatility in the exchange rate. This particularly took place from about May 2011 to about September 2011. This was significant since these activities worsened the direction of exchange rate expectations: further worsening the slide of the Kenya shilling. The Committee notes that lack of quick action to close these opportunities could have caused this. The problem of the exchange rate could have been addressed to a great extent through a rise in the CBR as early as June 2011 and also the placement of stringent penalties for the abuse of the Discount Window.

2.1.16 The mitigating factor is that the movements in the exchange rate could have been in other ways fueled by the rising inflation and external factors (such as movements of short term capital due to the Euro crisis). The CBK Governor however noted that the CBK needed to act on the basis of analysis of unfolding developments, so the Bank did not act as fast as the situation may have required.

2.1.17 The Committee notes that the CBK ACT (CAP 491), Section 10 provides that the Board of Directors whose Chairman is the Governor of CBK should (a) "keeping under constant review the performance of the Governor in discharging the responsibility of that office; (e) keeping under constant review the performance of the Governor in ensuring that the Bank achieves its objectives. The Committee observes that the Board of Directors, for which the Chairman is the Governor, cannot effectively review the performance of the Governor. Also, the Committee noted the two roles of the CBK: price stability and the regulation of the financial sector. Are these roles complementary under the same institution or do best international practices indicate the need to separate these two roles?

Recommendations

2.1.18 The Committee concurs with some of the reasons for the fall of the shilling last year given by the CBK (and also other witnesses) such as Euro- zone crisis, US debt crisis, North Africa political turmoil, and world oil prices among others. That the reasons advanced remained fairly the same even after November 2011, when the shilling started to strengthen is a strong pointer that internal dynamics played a role in the decline of the shilling and that had certain aspects of the Banks behavior been addressed, the depreciation of the shilling would have been less violent. The Committee therefore isolated three factors as the primary drivers of the sudden fall of the shilling particularly between May 2011 and October 2011:

(i) The abuse of the Discount Window and related trades in foreign exchange;

(ii) Overuse of various foreign exchange trade tools such as Electronic Brokerage System, currency swaps, and carry trades (most of them within legal limits); and,

(iii) The delay in CBK to detect the problem and respond adequately in a timely manner.

2.1.19 Regarding the overuse of various financial innovations to make profits at the expense of the exchange rate, it is noted that this is in financially developed markets quite part of standard market behavior. Given that Kenya's financial sector is quite sophisticated, and given that Kenya'sholds an open capital account and floating exchange rate, and given the inter-linkages of the Global financial markets. It would be hard to roll back progress in financial innovations in foreign exchange or scale down the level of liberalization. It is therefore the Committees primary assessment that the CBK needs to develop tools or abilities to properly and efficiently monitor the financial markets, particularly find tools to quickly deal with the adverse effects of innovations in foreign exchange trades such as the Electronic Brokerage System, swaps and carry trades.

2.1.20The CBK should therefore urgently develop or strengthencapacity to monitor the financial markets so as to redress any sharp deviations from the normal market trading. The CBK needs to increase the speed and responsiveness to market developments and also to strengthen response to control rapidly changing market behavior in a way without curbing the normal operations of the markets. In addition, the CBK should put in place a reasonable threshold or trigger point at which the CBK could take action if the shilling depreciates or appreciates by a certain margin. The Committee also suggests the need to share this information with an active oversight institution during times of crisis. Penalties for non-adherence to prudential and other supervisory regulations and guidelines should be enhanced including custodial sentences and or stiffer monetary penalties among others.

2.1.21As noted in the Committee observations, the abuse of the Discount Window could have been prevented if action was taken in a timely manner. In order to uncover any wrong doing relating to the use of the Discount Window during the period March 2011 to October 2011, the Committee further recommends a forensic audit of Banks books during the period when there was massive abuse of the Discount

Window. This should be instituted if the Banks breached any regulations at the time and if the required penalties were not applied.

2.1.22Though not directly apparent, some of the problems associated with the fall of the shilling and the lethargic response by the CBK could be related to the operations of the CBK. The Committee therefore recommends a review of the structure and operations of the CBK with a view to making the institution more efficient and responsive to monetary crisis.

2.1.23In addition, the CBK Act should be amended to provide that the CBK Governor cannot chair the Board of Directors of CBK which is expected to review the office holder's performance in achieving the objectives of this critical institution. The Committee also recommends a review of the structure of the CBK so as to strengthen the roles of maintaining price stability and the role of regulating the financial sector. Noting that the financial markets are quite critical in the transmission of monetary policy and performance of exchange rate, the Committee recommends having adequate representation from the Bank supervisory arm of the CBK in the Monetary Policy Committee. The Committee therefore proposes amendment of CBK Act to provide for an extra member to the MPC of a CBK staff responsible for Bank supervision.

2.2 Ministry of Finance

Submissions

2.2.1 The Ministry of Finance attributed the decline in the value of the shilling to external factors such as rise of crude oil prices, higher import bill due to increased spending in infrastructure such as energy and also due to internal factors. In response to the exchange rate crisis the Ministry took the following steps:

(i) Sent circulars to all Government departments to reduce unnecessary expenditure such as those on foreign travel and furniture. Savingsamounting to about Ksh. 5 billion were made due to these measures alone.

(ii) Reducing the budget deficit by 1 percent in themacroeconomic framework.

(iii) Sought and received an extension of the Extended Credit Facility (EFC) from IMF. The country has accessed amounts exceeding USD 300 million since early 2011, under the three year ECF program (see annex 4).

2.2.2 In addition, Treasury participated in meetings with the CBK, commercial Banks, the Kenya Bankers Association, and a Task force in the Office of the Prime Minister on the issue of the exchange rate and to help manage expectations.

Observations

2.2.3 The Committee noted that the Ministry of Finance seemed unaware that it could legally intervene and take over monetary policy through the cabinet if it felt that CBK had failed or had pursued unsuitable policies or had deviated substantially from the Monetary Policy Statement. This was through the Central Bank of Kenya Act Cap 491 4(c)2).

2.2.4 The crisis of the shilling and the time lapse in instituting interventions points at some disconnect between the monetary and fiscal policy actions. The Committee notes that the monetary policy actions were not immediately backed by corresponding fiscal actions to stem the shilling decline. Fiscal spending restrictions were not forthcoming at the height of the crisis.

Conclusion and Recommendations

2.2.5 The Committee is of the view that the Ministry of Finance could have played more active role to help stabilize the Kenya shilling. Also, it is apparent that little has been done to address the chronic low export earnings relative to the import bill. More importantly, was the observation that the Ministry of Finance has the powers in the Central Bank Act to take over monetary policy making through the cabinet if the CBK shows inability or unwillingness to pursue the intended monetary policies under the Monetary Policy Statement. To help address the shortcomings in the fiscal side the Ministry of Finance should make policies to reduce the current account deficit. Secondly, the Ministry of Finance should familiarize itself with the CBK act and draw possible grounds for interventions in monetary policy decision making and execution.

2.3 Kenya Revenue Authority

Submissions

2.3.1 The Committee met with the Kenya Revenue Authority, on 8th December 2011. The Committee was informed as follows:

(i) During the period July to November 2011, KRA collected Kshs 266.7 billion (of which Kshs 252.2 billion was exchequer revenue) compared to Kshs 237 billion in a similar period of FY 2010/2011.

(ii) Petroleum taxes recorded a growth rate of 1.2 % in the period July – November 2011, compared to a similar period in 2010/11.

(iii) During the period July to November 2011 indirect taxes registered a decline of 3.4% compared to a similar period in 2010/11. Principal under performers were VAT, Domestic Excise and Excise on air time.

(iv) Since September 2009, the shilling had been depreciating against the major currencies and particularly the dollar. This affected the FOB value eventually influencing volumes purchased for importation to Kenya.

(v) The imports and exports volumes over 2011 to the end of November grew by 11.1% and 14.6% respectively.
(vi) The taxpayers who heavily depend on imported raw materials or products and services were caused to increase the cost of production. This mostly resulted in reduced sales revenues and VAT collections.
(vii) Banks may have realized foreign exchange gains which impacted positively on their profitability.
(viii) The Central Bank measure to minimize exchange rate volatility through increased Bank rate caused Banks to increase their lending rate which may have resulted in bad debts due to defaults, reduced borrowing, which in the long run would impact their profitability.
(ix) The weakening shilling piled pressure on sales of used cars whose orders dropped by 18.2% in the third quarter, thus raising the cost of used cars.

Observations

2.3.1 From the interaction with the Kenya Revenue Authority, the Committee observed the following:

(i) The poor performance in petroleum taxes was attributed to the rising prices of oil in the world oil markets which undermined import volumes and depreciation of the shilling against other major currencies.
(ii) The decline in VAT was largely attributed to the rolling back of withholding VAT which allowed for the VAT to be withheld and remitted directly. VAT was also impacted on by the exchange rate which by raising import values increased the deductions on import VAT. Excise duty on domestic products was affected by a drop in production quantities which could not be attributed to the exchange rate movements. Excise duty on airtime poor performance was a result of the price war in the telecommunications.

(iii) The value of growth in the imports and exports volumes over 2011 was primarily driven by the depreciation of the currency and unit price of imports. But, the weakening shilling denied the economy the benefits of the ongoing fall in global crude prices, despite the fall in the international oil markets.

(iv) The depreciating shilling resulted in higher revenue outrun as importers paid more shillings for foreign currencies. There was however a decline in volume of imports as was shown by Import Declaration Fees and in addition, the high inflationary environment and the exchange rate gains were eroded by inflationary pressure.

(v) Companies who heavily depend on imported raw materials increased the cost of production thus impacting negatively on domestic taxes.

(vi) Those tax payers with loans denominated in foreign currency incurred foreign exchange losses which affected profitability. When businessmen suffer exchange rate losses these are deductible expenses which undermine corporation taxes.

(vii) The key requirement for revenue performance is stability of key economic parameters so that business does not adopt a wait and see attitude with respect to investment and expenditure.

2.4 Taskforce onthe Decline ofthe Kenya Shilling (0ffice ofthe Prime Minister)

Submission

2.4.1 The taskforce had been set up by the Prime Minister to investigate the causes of the decline after it was evident that measures being undertaken by the CBK and the Treasury were not bearing fruit. It was comprised of Dr. Edward Sambili, Mr. M. Isihakai, Dr. Chris Kiptoo, Mr. MugoKibati, Mr. Gerald Nyaoma, Mr. HabilOlaka, Mr. Anthony Weru and Mr. A.K.M. Kilele.

2.4.1 The Committee met with the Taskforce on the Decline of the Kenya Shilling, on 25th January 2012. The Committee was informed that the causes of the fall of the Kenya shilling were as follows:

(i) Deterioration of current account: the rise in the current account has been gradual and sustained reaching a peak of about 11.9 % of GDP by July, 2011, thus exerting considerable pressure on the exchange rate. The widening of the current account emanates from a growing gap between exports and imports of merchandise goods. This mainly reflects the impact of higher prices for oil and chemicals imports.

(ii) Domestic demand driven by private sector credit expansion as well as increase in public investment in 2010/11 also increased pressure on the current account. Also, credit that grew at about 32% had grown faster than average for real estate, consumer durables and domestic trade components that are highly correlated with domestic demand. These developments have been reflected in the deterioration in the current account deficit.

(iii) Unrest in Arab States led to rise in oil prices and the import bill. High oil prices domestically also drove inflation in 2011.

(iv) The Euro zone debt crisis especially in Greece, Portugal and Spain also made investors (local and foreign) sell their securities (shares, bonds) to buy foreign currencies as a relatively safe haven.

(v) The depreciation of shilling was also driven by the sentiments of the financial markets rate - speculators may have read the market and taken the position that the shilling will weaken further thus raising demand for more foreign currency in order to make a profit.

(vi) Also, the response by the CBK was not clear and was inconsistent. The CBK's inefficiency in dealing with the problem at its onset could have been a major cause of the continued depreciation. There was no dialogue between the CBK and the commercial Banks yet the CBK is their regulator **(see annex 5).**

Observations

2.4.2 From the interaction with the Taskforce on the Decline of the Kenya Shilling, the Committee had the following observations:

(i) There should be more effective dialogue between the CBK and the private sector, more specifically the CBK and corporate player's in the foreign exchange market and Government. The Committee observed that credibility is of critical importance on the part of the regulator and that this credibility could be enhanced through engaging in more effective dialogue.
(ii) The Government should make efforts to increase spending capacity of its ministries so as to increase absorption of donor funds that in turn will help build foreign exchange reserves.
(iii) The CBK's announcement that it will sell foreign currencies directly to importers and bypassing Banks is a violation and disregard to financial structures.

Recommendation

2.4.3 The announcement and release of CBK circular to bypass the Banking system and deal directly with buyers or sellers of foreign exchange, although reversed, was in complete disregard of the financial structures. This could have opened opportunities for rationing of foreign exchange, occasioned parallel markets to thrive and creation of multiple currency practices. In addition, the capacity of the Governor was found wanting(see annex 6).

2.5 Energy Regulatory Commission (ERC)

Submission

2.5.1 The Committee met with the Energy Regulatory Commission, on 6th December 2011. The following are the key submissions from the Commission:

(i) The present high cost of fuel was being experienced globally since the international prices of crude oil had gone up. The increase was partly due to the political crisis in the Arab oil producing states like Libya. Since the imported petroleum products are paid for in US dollars, when the prices of fuel increased internationally,

Kenya had an increase in the import bill. This led to an increase demand for foreign currencies and could have escalated the decline of the Kenya shilling.

(ii) That there has been an increase in pump prices of 32.0% for super petrol, 30.7% for diesel and 25.1% for kerosene and these changes reflects the increases in the cost of products.

Observation

2.5.2 From the interaction with the ERC, the Committee observed that indeed external factors attributed to have caused the decline of the shilling still persisted and did not therefore contribute significantly to the decline of the shilling. The Committee however observes that the ERC pricing mechanism is a major concern within the economy since contributing to the high cost of oil 75% of the crude oil cost at source.

2.6 Capital Markets Authority (CMA)

Submission

2.6.1 The Committee met with the Capital Markets Authority, on 28th November 2011. The Committee was informed as follows:

(i) There was a decline in the stock market index depicting a decline in the capital gains of the companies listed in the stock market in Kenya. Quite a number of these companies heavily rely on imported goods and when the exchange rate increased, there was an increase in the cost of production. This reduced their potential profits.

(ii) Capital flight from the stock market caused by political uncertainties and ICC cases, and in the second round the rapid fall of the shilling could have been caused by subsequent investors dumping the shilling for the foreign currencies.

(iii) Though there was a high capital outflow, some of the money seems to be coming back since the total inflows from October 2010 to October 2011 net amount of Ksh5.1 billion.

(iv) In responding to questions by the Committee about insider dealings and foreign exchange hoarding, CMA affirmed that there were no cases of insider dealing that the Authority was investigating or aware of in relation to the depreciation of the Kenya Shilling. Further, there was no evidence that foreign exchange fluctuations were as a result of investments at the capital markets. There was no consistent indication of a link between the depreciation of the shilling and net foreign equity flows. At the point when the net outflow was highest (3.3bn), the Kenya shilling was at 85.70 to the USD. As the Shilling continued to depreciate, foreign equity flows did not move commensurately in the same direction.

(v) The market information did not show that the weak shilling increased foreign investor flows into the country. The correlation between the depreciation of the shilling and net foreign equity flows was weak, unpredictable and inconsistent. The equity market experienced net foreign equity portfolio outflows when the shilling was relatively stable. At the shilling weakest points, between August and November 2011 the equity market experienced positive (but not highest) foreign equity portfolio flows.

(vi) The weaker shilling had more significant impact on foreign investors (who are mostly institutions) whose asset valuation declined as a result of exchange rate losses and not local individual (retail) investors (see annex 7).

(vii) The depreciation of the shilling affected yields on already held bonds (by Diaspora or foreign investors who had to convert periodic returns from bond investment into their host country's currency) leading to lower returns and discouraging investment in fixed income securities.

Observations

2.6.2 From the interaction with the CMA, the Committee observed the depreciation of the Kenya shilling affected the cost structure of listed companies which rely on imports. Higher import costs affected their projected earnings which further triggered the fall in the price of the

listed shares. In addition, the decline of the shilling caused companies to postpone conducting Initial Public Offers (IPO) fearing under-subscription. Thus, the shilling decline was partly to blame for the drop in the NSE 20-share index. Also, ordinary retail investors may have sold their shares to cope with the high cost of living associated with the weak shilling and inflationary pressures.

2.6.3 Even though the capital markets are central in the financial sector and are highly exposed to fluctuations of the shilling and global financial events, the Committee found minimal interactions between this market segment with the CBK and Treasury regarding prevailing economic conditions and monetary policy. The huge erosion of investor wealth which could be associated with the shilling volatility should be of great interest to policy makers in the three institutions.

2.6.4 The CMA was not forthcoming withspecific information requested by the Committee and did not appreciate the role of parliament and section 125 of the constitution.

Recommendations

2.6.4 Owing to the importance of the capital markets in Kenya's development process, and as a source of affordable non-Bank capital for listed companies, the Committee recommends the need for the Ministry of Finance, CMA and CBK to consult regularly regarding unfolding economic conditions and ways to redress them so as to secure investor wealth.

2.6.5 Amend Capital Market Authority Actto provide that the CMA chief executive briefs a relevant Parliamentary Committee of National Assembly on a quarterly basis.

2.6.6 The CMA to conduct a comprehensive investigation of the NSE to determine the institutions involved in huge capital inflows and outflows from the equity market.

2.7 Kenya Tourism Board

Submission

2.7.1 The Committee met with the Kenya Tourism Board, on 6th December 2011. The Committee was informed that the causes of the fall of the Kenya shilling were as follows:

(i) Widening current account deficit due to a high oil import bill and increased importation of infrastructure for development.

(ii) The shilling's depreciation also could have been caused by the global economic volatility attributed to the Euro zone sovereign debt crisis and currency speculation activities within the foreign exchange market.

Observations

2.7.2 From the interaction with the Kenya Tourism Board, the Committee observed the following:

(i) Though the rapid decline in the shilling hurt the aggregate economy, the depreciation was beneficial to both foreign tourists and the tourism sector since foreign tourist products are priced in foreign currency and this means that local destinations and Kenyan products were viewed as affordable in terms of direct expenditure. There was increased revenue once the hoteliers, tour operators and airlines converted the currencies into shillings.

(ii) There were negative effects also in the sector since domestic tourism had reduced revenue margins. The high domestic rates reduced the appeal for domestic tourism in leisure, business and conferencing as individuals and organizations shifted adjusted their spending priorities to cope with the high inflation rates.

(iii) The CBK's monetary policy actions measures in the foreign exchange market helped restore confidence in the market and stabilized the shilling.

2.8 Kenya Ports Authority (KPA)

Submissions

2.8.1 The Committee met with the Kenya Ports Authority, on 8th December 2011. The Committee was informed as follows:

(i) The amount of imports coming through the port of Mombasa has been on the rise. Port traffic was heavily skewed in favour of imports, a trend that had been growing from year 2001. This share was 84% imports and 14.5% exports in 2011.

(ii) There was a slight decline in the in imports as the shilling became weaker. This was because the imports became expensive as the shilling weakened and the cost of importation increased since they are paid in foreign currency. This could have increased the demand for foreign currencies in the market.

(iii) The country has been importing a lot of grains as depicted by a steady rise in volume of grain imports over the years. This shows that the country has been depending a lot on imported food.

(iv) To cushion Kenyans against the effects of the decline of the shilling, Kenya Ports Authority provided 24/7 port operations to ensure that cargo do not incur charges, maintained the same charges as per the tariff effective 1st of February 2008 with minor amendments, removed scanning verification charges, contracted eight CFSs that helped to decongest the Port and facilitate cargo movement.

(v) The Authority hoped to upgrade the port to an E-port by 2012 and also submitted proposals for development of additional port capacity. The Authority's recurrent expenditures such as fuel for equipment and maintenance of spare parts that are purchased oversees were also affected.

Observations

2.8.2 From the interaction with the Kenya Ports Authority, the Committee observed the following:

(i) There is a relationship between currency fluctuation and the volumes of imports. Notably, the weakening of the shilling led to a marginal drop in imports, but overall the demand for imports has remained high. This implies it is not possible to reduce the import bill through currency depreciation; rather the Government needs to put in place tariff and non-tariff barriers to deal with the problem of huge imports.

2.9 Kenya Institute for Public Policy Research and Analysis (KIPPRA)

Submission

2.9.1 The Committee met with KIPPRA on 1st December 2011. The Committee was informed that the causes of the fall of the Kenya shilling were as follows:

(i) Large current account deficit due to fast growth in import payments relative to slow growth in export receipts. This put pressure on the shilling to depreciate.
(ii) Government introduced a fiscal stimulus package in 2009 causing Government expenditure to rise rapidly. The budget deficit also increased showing that the Government was relying more on CBK's advances and by September 2011, the CBK's overdraft facility stood at 25.4 Billion. Increased spending by the Government may have played a big part in the depreciation of the shilling.
(iii) Monetary expansionary since 2008 is related to fast growth in private sector credit which caused inflationary pressures in the economy. This indirectly contributed to the fall of the shilling.
(iv) The Europe debt crisis forced jittery investors to shift from Euro to dollar denominated assets. This caused the dollar to appreciate against other currencies including the Kenya shilling.
(v) CBKs announcement that it would sell foreign currencies directly to importers caused panic in the market.

(vi) When the shilling started falling, individuals and Banks could have taken speculative positions so as to benefit from the declining shilling through hoarding of foreign currencies. This could have escalated the decline of the shilling.

Observation

2.9.1 From the interaction with KIPPRA, the Committee observed the need to closely monitor fiscal policy so as to reduce expenditure on non-essential and non-priority items in the short-term. Loose monetary policy was a major catalyst of the fall of the shilling and so it should be tightened to reign on inflation and excess money in the economy. In addition, the problem of the wide current account deficit was structural; hence the need to change Kenya's production structure towards increased export production.

2.10Export Promotion Council (EPC)

Submission

2.10.1The Committee met with EPC on 6th December 2011. The Committee was informed that the causes of the fall of the Kenya shilling were as follows:

(i) Limited export product range and reduced foreign exchange inflows. This has reduced the national capacity to cover the import bill from the exports proceeds and also constrained the capacity of the treasury and CBK to employ effective monetary and fiscal policies that will ensure a stable exchange rate.

(ii) Uncertainty over the Arab spring in the Middle East and North Africa states caused a rise in oil prices, which resulted in a larger import bill.

(iii) Kenya had been in a heated political environment for the better part of 2011 with the upcoming elections and the ICC trials debate. This has made investors who anticipate election violence to take off causing capital flight.

(iv) Speculation by importers so as to get favorable forward purchases in the wake of a depreciating shilling.

(v) The oscillating shilling created an uncertain environment for production and other structural issues. It was conducive for planning for production. This has negatively impacted on long term investments and also induced capital flight.

2.10.2 The EPC also informed the Committee that the weak shilling had a positive impact on exports earnings. But this advantage has not been fully felt in the market since the Kenya exports raw products with limited valued addition. Kenya lacks high value capital products.

Observation

2.10.3 From the interaction with EPC, the Committee noted that the Government had not created adequate domestic business environment that can lead to rapid export growth. This is causing capital flight and disinvestment by foreign investors. Since increased fuel prices contribute to the fall of the shilling, the Government should invest in alternative energy resources.

2.11 Kenya Investment Authority (KenInvest)

Submission

2.11.1 The Committee met with KenInvest on 14th December 2011. The Committee was informed as follows:

(i) There have been unsteady Foreign Direct Investment (FDI) inflows to the country over the recent years. Though this is a major source of financial and technological resource to the country, no agency has been mandated to record the FDI inflows in Kenya making their role undocumented.

(ii) The ease of doing business in Kenya has deteriorated with Kenya being ranked 109 for the year 2012. This affects FDI directly since investors want to be assured of security, conducive business

environment and most importantly minimal bureaucracy and corruption.

(iii) The cost of doing business in Kenya is also worrying since some of the essential services like energy are very expensive and unreliable. The Government should provide the necessary infrastructure and services so as to encourage foreign investors to come invest in the country.

(iv) Many foreign investors are unable to startup businesses in Kenya due inability to access land. The Government should create land Banks in each and every county specifically for investors.

2.12 School of Economics, University of Nairobi

Submissions

2.12.1 The Committee met with the School of Economics, on 1st December 2011. The Committee was informed that the causes of the decline of the shilling were as follows:

(i) Lack of clear monetary policies. CBK Governor intervened from the demand side ignoring the supply side.

(ii) The Central Bank of Kenya should have predicted possible failure and act fast but there was some laxity on the part of CBK.

(iii) Market distortions. The level of exchange rate is determined by the forces of demand and supply of foreign currency. Under normal circumstances, there should not be a sharp rise in the exchange rate. Something else, therefore, may have caused the sharp decline of the shilling.

(iv) The international forces like Euro crisis and the Arab spring may have been a driver at the onset but could not warrant the sharp decline of the shilling.

(v) Pressures from the increased import bill could have contributed to the fall of the shilling. There had been an increase in importation of commodities that should not ordinarily be imported like foodstuff.

2.12.2 The School of economics further furnished the Committee with the following information:

(i) The intervention measures taken by CBK will have serious impact on the growth of the economy as people will not have money to invest although the inflation will be tamed in the short run.
(ii) Long term borrowing for development is likely to lead to undue expectation by the public. The Government will have to make substantial borrowing to meet those expectations.

Observations

2.12.3 The Committee observed that the primary causes of the depreciation of the Kenya shilling exchange rate were economic and also market distortions due to ineffective intervention and monitoring in the foreign exchange markets.

3.0 COMMERCIAL BANKS

3.1 Equity Bank Limited

Submissions

3.1.1 On the causes of the decline of the shilling, Equity Managing Director blamed it on: large oil import bill (oil constitutes 25 percent of imports), prolonged low interest rates which were used to import construction materials and overt consumption, large and growing middle class with a taste for imported goods, heavy infrastructure investments in the country, panic buying by importers, sell-off of shares by foreign investors at the Nairobi Stock Exchange, among other factors. He attributed the recovery of the shilling to the CBKs decision to raise the CBR rate to 18 percent, but also blamed this for current high lending rates and interbank lending rates. Equity Bank is one of the most capitalized Banks.

3.1.2 During their submissions to the Select Committee, Equity Bank Managing Director responded to the questions raised by the Committee regarding its participation in the interbank market, the Discount Window of the CBK, and whether the Bank had received any warning letters or other interventions from the CBK. The Managing Director reported the following regarding those issues:

(i) That Equity Bank had not received any warning letters regarding its foreign exchange trading activities, the use of the Discount Window, or participation in the interbank lending market
(ii) The Bank had also not been suspended from participating in the foreign exchange market, the use of the Discount Window, and participation in the interbank lending market,
(iii) Equally, the Bank had not received any *ad hoc* visits from the CBK regarding the same matters and had not been subject to other regulatory interventions from the CBK.

3.1.3 The Bank further presented information and data showing the level of the Bank's participation in foreign exchange trading and foreign exchange exposure. Notably, the Bank argued that its foreign currency operations were negligible relative to the national foreign exchange reserves or the monthly import bill, which means that the Bank has limited capacity to influence the exchange rate. Between January 2011 and September 2011, the Equities Bank reserves ranged between US$ 16.22 million to US$ 49.98 million. Its reserves were about 0.01 percent of the reserves held by the CBK for the period January 2011 to September 2011. Foreign exchange trading income of the Bank had risen from Kshs 208 million in March 2011 to Ksh. 508 million in September 2011, but its proportion to the total operating income remained at about 3 percent during the same period. Even though Equity Bank is one of the largest Banks in terms of assets, the Bankreiterated that it was not a major player in the foreign exchange trading relative to other Banks whose foreign exchange trading could

represent 10 to 30 percent of their total operating incomes**(see annex 8)**.

3.1.4 Responding to a question about foreign exchange trading for clients, the Bank argued that it does not participate in deal transactions, did not hold any major client accounts in foreign exchange, and therefore had not noticed any unusual fluctuations in foreign exchange trading volumes. The Bank however clarified that it held foreign exchange denominated funds (equivalent to Ksh. 14 billion) lent to Equity by several international institutions (for example the International Finance Corporation) at low interest rates for on-lending to local institutions involved in infrastructure developments. In fact Equity had extended foreign exchange denominated loans to a few institutions, such as US$ 70 million to the KPLC. Transactions regarding these funds have minimal impact in weakening the shilling exchange rate since the funds are not exchanged to Kenya shillings, instead these funds would help strengthen the shilling.

3.1.5 The Managing Director refuted claims that he had in any way participated in any Government policy or given opinion to the CBK regarding the fall of the Kenya shilling. Instead, the Managing Director said that being the Chair of the Vision 2030, he often expressed his opinions regarding Kenya's development. He pointed out that his participation in this initiative could not give Equity undue advantage or influence in Government contracts since much of the information on Vision 2030 programmes is in the public domain, and further that his role in this initiative was not for profit but to be of service to the country.

3.1.6 The Bank also discounted the view that it was favoured in the awarding of Government contracts or Government funds to the Youth for example. Indeed, the Bank clarified that though it had received Ksh. 400 million from the Government for on-lending to target

groups such as the youth, it had always multiplied the amount it lends under this program (as required under the arrangement)at a low rate.

Observations

3.1.8 It was however apparent that the Managing Director of Equity Bank, owing to his prominent role in financial services sector both locally and internationally, was closely associated with the Vision 2030, a Government Policy program with substantial impact on the direction of Government spending priorities. It is felt that sitting in such a commission could provide grounds for conflict of interest or cause disaffection among other Banks. It is therefore difficult to remove the tag that Equity Bank is favoured by the Government or is privileged if the CEO continues to advise Government through the Vision 2030 secretariat.

3.1.9 That despite the submission asserting that the Bank was a net lender to the interbank market, the Bank went to the Discount Window 14 times in 2010 and slightly over 50 times in 2011 (annex of Equity Bank) this is a contradiction to the claim that the Bank is a net lender and against the reasons for resorting to the window. The Bank borrowed from the Discount Window in excess of the stipulated guidelines of twice a week. It is evident that the Bank borrowed funds from the Discount Window despite its submission that it had not. The Bank was therefore not candid in its information to the Committee.

Recommendation

3.1.10From the foregoing, it is recommended that senior Banking officials in the country should be excluded from directly sitting in Government policy Committees or Government commissions to avoid conflict of interest, or to cause disaffection among other Banks.

3.2 Kenya Commercial Bank Limited

Submission

3.2.1 The Committee met with the management of Kenya Commercial Bank (KCB) on 14th December 2011. The Committee was informed that the causes of the fall of the Kenya shilling were as follows:

(i) Political crisis in the Middle East and North Africa (MENA) countries resulted in a spike in the prices of oil internationally. Kenya's consumption of oil remained unchanged so the spike created a strain on the balance of payment and foreign currency requirements to pay for oil imports.
(ii) The crisis in Egypt disrupted the tea auction since Egypt buys 30% of Kenya's tea thus reducing the foreign exchange to Kenya.
(iii) There was a sell-off in the equities market globally and especially affecting emerging and frontier markets. Foreign investors also sold-off their shares at the NSE thereby putting more pressure on the Kenya shilling as the investors bought foreign currency.
(iv) The CBKs reduction of the CBR rate early 2011 to 5.75% may have increased credit expansion and increased demand for imported goods.
(v) Drought in Kenya had an effect on food and hydroelectricity production. So the country had to import food and more oil for power production increasing demand for foreign currency **(see annex 9)**.

Observation

3.2.2 Upon interrogation of the KCB management, the Committee made the following observations:

(i) That the CBK's intervention in the market was long overdue
(ii) There was capital flight in the economy and this could have been an additional cause of the decline of the Kenya shilling
(iii) The Bankdenied involvement in any speculation stating that it participates in the foreign exchange market according to rules and regulations in place.

(iv) The Bank has always held capital in foreign assets at below the maximum limit of the CBK even before the regulator revised the limit downwards.

3.3 Cooperative Bankof Kenya Limited

Submission

3.3.1 The Committee met with the management of Cooperative Bank of Kenya on two occasions, 14th December 2011 and 25th January 2012. In the meetings, the Committee was informed that the some of the causes of the fall of the Kenya shilling include the presence of a wide current account deficit, building of reserves by CBK, and servicing of external debts. The reasons for the wide current account deficit were:

(i) Large and growing imports bill due to: high dependency on oil imports whose international prices are unstable, increased importation of second hand cars which have caused an increase in fuel consumption, importation of foodstuff due to drought, importation of non-essential commodities, increased importation of machinery and equipment for ongoing constructions, among others.

(ii) Stagnant supply of foreign currency due to the following:reduced earnings from sale of tea, coffee, horticulture due to the financial crisis in the European Union and political instability in the MENA region which are our main trading partners; and, reduced remittances from the Diaspora.

3.3.2 In the presentations, Cooperative Bank proposed the following to the Committee that could help in mitigating the problem of the depreciation of the shilling:

(i) The country should develop initiatives to mitigate the import bill in the following areas:

- Encourage more fruitful local production of food and use it to enhance strategic food reserves
- Develop Government policies to hinder importation of non-essential commodities and mass importation of second hand cars
- Enhance Government investments in renewable energy**(see annex 10)**.

Observation

3.3.3 The Committee instructed the Bank to furnish information on a number of interactions the Bank had with the CBK during the period when the shilling was in a crisis and the shareholding of the Bank. The committee established the following from the Cooperative Bank management:

(i) That the Bank did not receive any warning letters from the CBK regarding their foreign exchange trading, use of the Discount Window of the CBK and participation in the interbank market.

(ii) The Bank was not suspended from the foreign exchange market, Discount Window of the CBK and participation in the interbank lending market.

(iii) The Bank received a team of two CBK staff who carried out an onsite review of their foreign exchange trading activities but the Bank did not receive a formal report of the review.

(iv) That the Bank has a total of 13 directors who holds 4% shareholding in the Bank; 7 of the directors were elected by the cooperative holding society, 2 are elected by the ordinary share holders, 1 is the commissioner of cooperatives, 1 is the representative of the Permanent Secretary in charge of Treasury and 1 is the Managing Director of Cooperative Bank of Kenya.

(v) The Bank stated that there was no staff sacked during the period of June to December 2011. The only staff that left during the period retired voluntarily.

(vi) That the Kenya Cooperative Coffee Exporters Ltd is not owned by Cooperative Bank though some of the export company's

directors were also directors in the Cooperative Bank board. These directors were elected by the coffee farmers who are shareholders in both companies **(see annex 11)**.

(vii) It was further observed that this company is owned whole by cooperative farmers and so there is no evidence to connect them with any malpractices related to foreign exchange trading.

(viii) The Bank admitted to have seconded two of its staff to the Kenya Cooperative Coffee Exporters Ltd for technical support in administration of the Company.

(ix) The Co-operative holding society held 65% of the total shares of the Bank while the remaining 35% shares are held by investors through the Nairobi Stock Exchange. Of the 35% shares held by investors at the NSE, 4% are held by the Bank directors. The Committee noted that the information was publicly available.

(x) That some of the directors of the Bank sold their shares of the Bank in the NSE including the MD of Cooperative Bank who had sold one third of his shares in the Bank(approximately worth Kshs.320 Million in the course of the year 2011). However, these sales were not related to the volatilities of Kenya's shilling exchange rate.

(xi) That the Bank operates on a foreign currency limit of approximately 3.5% against a foreign exchange exposure limit of 20% (10 % after review of foreign exchange exposure limits).

Recommendations

3.3.4 Based on the submissions by the Cooperative Bank management, and the fact that the Bank maintains a very low foreign exchange exposure, the Committee found no information to show that the Bank had committed any malpractices regarding trading in foreign exchange.

3.4 CitiBank limited

Submission

3.4.1 The Committee met with the management of CitiBank on 19th December 2011. The management team of the Bank outlined before the Committee the causes of the fall of the Kenya shilling as follows:

(i) Perceptions about Kenya's forthcoming elections and rising political activity may have caused jitters in the foreign exchange market.

(ii) The global economy was also in turmoil andpassing through uncertain times. There was a steady increase in the demand of foreign currencies.

(iii) The loose monetary policy was a major cause since the interest rates were extremely low and the inflation rate was high making it unattractive to hold assets in shillings, hence the huge demand for foreign currencies.

(iv) Strong economic growth and fiscal spending continued to suck in imports, widening the current account deficits.

(v) The depreciation was accelerated by a sharp rise in inflation in early 2011 caused by poor rains against a background of rising food prices and fuel prices.

(vi) When the shilling started to weaken, modest speculative flows increased the pace for depreciation as the CBK seemed not to have an appetite to intervene in the market.

Observations

3.4.2 From the interaction with the management of Citi Bank, the Committee observed the following:

(i) That the CBK's delayed intervention could have been a major contributing factor of the sharp depreciation of the shilling.

(ii) The Bank's foreign exchange trading was questionable since it received 2 letters from CBK for inspection and the CBK made four

(4) unscheduled visits to the Bank upon which the regulator inspected the foreign exchange trading by the Bank.

(iii) The Bank did not access the interbank lending window during the period of the fall of the shilling since it was liquid enough.

Recommendations

3.4.3 The Committee observes that the Bank had increased amount of trading in foreign exchange, probably well within the legal limits(at that time, the foreign exchange exposure limitwas 20% of core capital) at the time. However, the Committee recommends that the CBK should increase its monitoring tools to ensure that excessive trading in foreign exchange does not affect the general stability of the shilling.

3.5 Family Bank Limited

Submission

3.5.1 The Committee met with the management of Family Bank on 14th December 2011 and 25th January 2012. The Committee was informed that the causes of the fall of the Kenya shilling were as follows:

(i) That the core problem facing the economy was supply side inflation. The Bank observed that Kenya's population has been rising while local production of essential goods can hardly match the demand, leading to rising imports. The export earnings from the country also cannot support the needed imports thus creating a current account deficit. This causes an increase demand for foreign currencies.

(ii) High dependency on rain-fed agriculture also affects availability of food locally making the country resort to importation. The country's export market is dominated by agricultural produce and a shift in the rain pattern affects production. Increased import of food increases demand for foreign currency.

(iii) The slow action by the Government and specifically the CBK could also have been a caused since it failed to arrest the inflation problem early enough.

3.5.2 To address the problem of the shilling exchange rate, the Bank proposes the following:

(i) The country should manage its food security situation by developing agricultural policies to encourage irrigation agriculture and modernized agricultural practices. Also agricultural lands should be protected and housing projects be directed deliberately towards semi-arid areas unsuitable for agriculture.

(ii) The country should also invest in renewable energy and reduce overreliance of rainfall relied hydroelectricity and the expensive thermal energy.

(iii) The country should also learn from the Euro zone on the effects of uncontrolled debt since Kenya presently has a huge debt and is paying a lot in interest. This is consuming quite a chunk of the foreign currency.

(iv) The Bank also noted that the exchange rate still remains vulnerable to depreciation until the primary drivers of the depreciation such as huge current account deficit are addressed.

3.5.3 On whether the Bank had received any warning letters, ad hoc visits by the CBK, suspension from the interbank market, or had been subject of other regulatory interventions, the Management of Family Bank clarified the following:

(i) There were unscheduled visits to the Bank by CBK officials who came to review their foreign exchange trading activities but no formal report was presented to Family Bank concerning the visit. The Bank reported to have no problem with its ratios **(see annex 12)**.

(ii) That the Bank went to the CBK Discount Window three times in a week, against the maximum 2 times stipulated in the new CBK guidelines, thus inviting steeper or punitive interest rates on such borrowing. The Bank used the window due to prevailing liquidity problems in the Banking system following CBKs measure to raise the CBR.

(iii) With regard to the foregoing, the Bank noted that it was not easy for small local Banks to obtain funds from the interbankBank market during the time of the liquidity crunch since they did not have credit lines with the Banks with liquidity. Hence, the Banks went to the CBK which is a lender of last resort.

(iv) The larger Banks and those with excess liquidity often mark credit lines with other Banks on the basis of risk management practices among other policies. Thus, the interbank market is not essentially a purely fair market.

(v) The Bank also noted that small local Banks faced very expensive branch network, maintained a larger customer base, and therefore faced higher operating costs.

Observation

3.5.4 The Committee noted that the interbank market was not working efficiently particularly after the liquidity problems that followed the spike in the CBR rate in November to December 2011. Specifically, the market is far from perfect: small Banks face expensive borrowing in the interbankmarket and when those funds are unavailable, the only option is to go to the CBK Discount Windowfor funds at punitive interest rates. The Committee notes that Banks cannot at times obtain credit from the Banks with liquidity if they do not maintain credit lines. The larger Banks and those with excess liquidity often mark credit lines with other Banks on the basis of risk management practices among other policies. The Committee also observes that the seamless and efficient operation of the interbank market and the Discount Window are critical for the stability of the financial sector and the

transmission of monetary policy decisions. What then can be done to make the market more flexible and efficient?

3.5.5 The Committee observes that the management of FamilyBank was quite candid and honest with the Committee regarding most of the issues sought.

Recommendations

3.5.6 The CBK should use necessary tools and work with Banks to improve the operations of the interbank market so as to insure against unnecessary liquidity problems and unnecessarily high interest rates.

3.6 Barclays Bank of Kenya Limited

Submission

3.6.1 The Committee met with the management of Barclays Bank of Kenya on 14th December 2011. The Committee was informed that the causes of the fall of the Kenya shilling were as follows:

(i) Kenya is a net importer, that is, Kenyans consume a lot of imported goods. Excessive imports of goods coupled with an increase in global prices of commodities like oil piled more pressure on the local currency to depreciate.
(ii) Drought and sporadic rainfall in early 2011 saw a reduction in food production and increased importation of food commodities. This increased the current account deficit.
(iii) Due to the debt problems and slow growth in the European Union and US, foreign investors sold off shares at the NSE to address shortfalls in their incomes in their home countries. This caused a heavy demand for foreign currencies.

3.6.2 From the interaction with the management of Barclays Bank of Kenya, the Committee observed the following:

(i) The Bank did not undertake any speculative trading positions. All currency purchased and sales were supported by underlying customer orders.

(ii) The Bank's foreign currency levels were between US$230 million and US$340 million during the year 2011, but generally showed an increasing trend though there was a slight peak during the month of March and July **(see annex 13)**.

(iii) The response by the CBK to increase the CBR rate to 11% and eventually 16.5% caused the Banks to increase their base lending rate. This has made the cost of borrowing high.

Observations

3.6.3 The Committee observed that Barclays Bank is one of the largest holders of foreign currency, holding foreign currency in excess of Ksh. 26 billion. However, the Committee found no evidence of any trading malpractices by the Bank.

3.7 CFC Stanbic Bank

Submission

3.7.1 The Committee met with the management of CFC Stanbic Bank on 16thDecember 2011. The Committee was informed that the causes of the fall of the Kenya shilling were as follows:

(i) Huge import bill and low exports due to massive importation of machinery and equipment to the country for infrastructural development increased the demand for foreign currency. Drought also led to increased food imports but decreased exports of agricultural produce. Other factors that affected the export markets include: the Arab uprising in the Middle East which is a major export destination for Kenyan tea, and Europe debt crisis which is a major destination for Kenyan horticulture and floriculture market.

(ii) With the shilling weakening, importers panicked and bought foreign currencies in advance to facilitate for their future importation while individuals and Banks with speculative tendencies held on to their foreign currencies with the aim of making profit from the situation.

(iii) The increase in the international price of fuel could have been a cause since Kenya is a net importer of fuel and the demand did not decrease even with an increase in prices.

3.7.2 The Bank representatives observed that Kenya lacked a clear institution to regulate the foreign exchange trading market and the Kenyan foreign exchange trading was done on a supply and demand basis. Once the shilling had shown signs of weakening, speculative behavior set in, acting as the major catalyst of the depreciation given that Kenyan foreign exchange trading is an open system.

3.7.3 Following queries by the Committee, the Bank admitted to have received unscheduled visits from the CBK to inspect its foreign exchange trading. The CBK found out that the Bank had flouted some regulations and the Bank was suspended from the interbank exchange window **(see annex 14)**.

Observations

3.7.4 CFC Stanbic Bank is one of the Banks with large foreign exchange holdings which mean that it had significant impact in the foreign exchange market. From information available, the Banks trading appear to have been within the required limits until the CBK placed new guidelines on foreign currency swaps. The Bank suffered suspension from the interbank market for 30 days and was fined Ksh. 1 million for flouting a new guideline issued by the CBK on 13th October, 2011 on the tenor of foreign currency swaps.

3.7.5 The Committee notes that since the interbank market is regulated by Kenya Bankers Association, there is no adequate intervention to

control abuse of market power by big players. Also, the penalty for flouting regulatory guidelines is very light relative to the potential economic cost of the malpractice. The penalties could be enhanced.

Recommendations

3.7.6 The Committee is of the view that Banks could have made a lot of money from foreign trading which also contributed to the fall of the shilling. Given that part of this trading is within legal limits, the Committee recommends the reduction of opportunities for such trading through CBK monitoring and also enhancement of penalties for flouting the regulations. The monetary penalty on breach of a regulation should be proportionate to the value to the Bank of the malpractice at the given time. In the wake of the magnitude of the fall in value of the shilling, the Kshs. 1 million penalty on the Bank could be only a very small fraction of the gains made by this Bank.Therefore, the penalty should be revised upwards to be commensurate of the value to the Bank of the malpractice.

3.8 Housing Finance Company Kenya Limited

Submission

3.8.1 The Committee met with the management of Housing Finance Company Limited, on 14th December 2011. The Committee was informed as follows:

(i) The weak shilling affects the housing sector due to high cost of imported construction materials. Kenya imports raw material and equipment for construction in the housing sector and the weakening of the shilling caused these imports to be costly.

(ii) Remittances from the Diaspora helped offset reduced investment in housing associated with the weakening shilling.

(iii) The Managing Director also regretted that the irregularly acquired titles in places such as Syokimau and other parts of the country

could increase default rates in future. About two clients had their houses demolished in Eastleigh area of Nairobi.

Observation

3.8.2 The Committee observed that as a result of the increasing in CBR rate to 18%, Banks arbitrarily increased their lending rates on existing loans to between 24% and 32%.Further insider knowledge played a part during the period of the crisis with Banks raising the interest rates way before the rise in the CBR rate.

3.9 Standard Chartered Bank Ltd

Submission

3.9.1 The Committee met with the management of Standard Chartered Bank on 6th February 2012. The Committee was informed that the causes of the fall of the Kenya shilling were as follows:

i) Macroeconomic instability in both the local and global economy. The international economy was facing tough times while internally, the country was facing a high inflation regime, a wide current account deficit, and increasing budget deficit.

ii) The fall of the Kenya shilling was preceded by a period of low interest rates caused by an expansionary monetary policy. High liquidity in the financial sector contributed to cheap credit that fueled domestic consumption. A bigger proportion of the borrowing was used to finance consumer demand rather than corporate investments. Part of consumer spending was geared towards imported goods which further worsened the difference between exports and imports and the current account deficit. Thus, the growth in domestic credit did not therefore fully lead to increased production in the country.

iii) Uncertainties about the direction of the Kenya shilling exchange rate caused widespread panic among market players such as importers and exporters. The expectations were that the shilling

could slide further, and this caused exporters to hold their foreign currencies positions while importers bought foreign currencies to cushion their planned future importation. The importers could have even borrowed from the Banks due to the cheap credit so as to buy the foreign currencies.

3.9.2 On whether the Bank had received any warning letters, ad hoc visits by the CBK, suspension from the interbank market, or had been subject of other regulatory interventions, the Management of Standard Chartered Bank clarified the following:

(i) That the Bank did not receive any warning letters from the CBK regarding their involvement in the foreign exchange market, the CBK's discount lending window or the interbank window.
(ii) That the Bank did not borrow from the Discount Window at the time that Banks were accused of involvement in arbitrage. The Bank further clarified that it was never involved in arbitrage.
(iii) The Bank was never suspended from participating in the interbank market or the CBK's Discount Window.
(iv) The Bank did not receive any ad hoc visits from the CBK regarding its participation in the foreign exchange market during the period when the shilling was depreciating.
(v) The Bank only holds foreign exchange on behalf of its clients and not for foreign exchange trading purposes or speculation. Thus, the buildup of the foreign exchange balances was due to individual customer holdings of foreign currencies.

Observations

3.9.2 From the interaction with the management of Standard Chartered Bank, the Committee observed that maintaining of an expansionary monetary stance with the inflation rate going up could have been a major cause of the fall of the Kenya shilling. The CBK interest rate at some point was as low as 6 percent when inflation was 10 percent. This situation would definitely encourage arbitrage.

3.9.3 Though the Bank in its submissions before the Committee denied that it had received letters and ad hoc visits by the CBK, evidently the correspondence between the CBK and Standard Chartered Bankdemonstrates that the Bank was one of those inspected by the CBK.Correspondence between the CBK and the Bank revealed that CBK officials visited the Bank to carry out related investigations. Clearly the Bank was not honest with information.

Recommendation

3.9.4 The Commercial Banks took advantage of the frequent upward revision of the CBR rate and increased their lending rates without proper cause and notification thus hurting the borrowers. This should be reduced to preempt an eminent rise in default rate.**(see annex 15)**.

3.10 Kenya Bankers Association

Submission

3.10.1The Committee met with the CEO, Kenya Bankers Association, on 15th December 2011. The Committee was informed that the causes of the fall of the Kenya shilling were as follows:

(i) There was an increase in the world fuel price and since Kenya is a net exporter, this worsened the current account deficit.
(ii) The Euro zone debt crisis worsened the situation with the capital flight by investors to US dollars which was deemed to be a safe haven. This made the dollar appreciate against most currencies.
(iii) The private sector credit had risen faster than economic activity implying that credit expansion was financing more of consumption than productive economic activities. This exerted inflationary pressures from the demand side which needs to be contained by monetary policy.
(iv) The depreciation was further worsened importers and exporters who went into panic buying of foreign currencies for their future

needs in anticipation of a weakened shilling. Speculators also came into the market creating a shortage of foreign currencies.

4.0 SUBMISSIONS BY ECONOMIC EXPERTS

4.1 Dr. David Ndii

Submission

4.1.1 The Committee met with Dr. David Ndii on 8th December 2011. The Committee was informed that the causes of the fall of the Kenya shilling were as follows:

(i) The instability of the shilling had two drivers, the underlying causes and the trigger. The underlying causes were to do with fiscal and monetary policies and the trigger was the Euro zone crisis.

(ii) The pressure on the shilling could be traced back to the fiscal stimulus packages announced after multiple economic shocks namely, post-elections violence, drought and global financial crisis in 2008/09 financial year. The fiscal stimulus was rolled out in the 2009/10 and 2010/11 budgets.

(iii) The CBK also supported a monetary stimulus by creating an accommodative monetary stance similar to that of monetary authorities all over the world. The benchmark 91-day Treasury bill rate was driven downwards from 7% in November 2009 to a low of 1.6% in July 2010, and kept below 3% until the middle of 2011.

(iv) The stimulus, both fiscal and monetary, enabled importation of capital and consumer goods, in effect causing the widening of the trade deficit. The widening trade deficit and excessive cheap credit created an opportunity to speculate against the shilling.

Observation

4.1.2 From the interaction with Dr. David Ndii, the Committee observed the following:

(i) The fiscal stimulus programme should have been rolled back in 2010/2011 since it was evident that the economy was more resilient to shocks and the country had been recovering strongly.

(ii) The monetary stimulus was imprudent since the Banking sector was strong and stable. The CBK should have waited to see the impact of the fiscal stimulus first before acting to expand money supply.

Recommendations

4.1.3 The Committee finds that the CBKmay have been overenthusiastic about economic stimulus and also maintained the low interest rate regime for far too long. The Committee therefore recommends that the CBK should maintain a coherent monetary policy at all times with a focus on price stability. This is the key objective of the CBK. Other goals should be secondary.

4.2 Micah Cheserem – Former Governor of the CBK

Submission

4.2.1 The Committee met with Mr. Cheserem on 6th December 2011. The Committee was informed that the causes of the fall of the Kenya shilling were as follows:

(i) There was a deteriorating current account deficit. This was due to food shortages and fuel price increases that caused increased importation and a surge in the demand of foreign currencies.

(ii) The move by the CBK to purchase foreign currencies from the market to strengthen its foreign exchange reserves when the shilling had already started deteriorating created a window for speculators to start hoarding the foreign currencies.

(iii) The pronouncement by the CBK that it would not intervene in the market worsened speculative activity and the shillings continued with its free fall.
(iv) Purchase and repatriation of foreign currencies by foreign and local investors since the Treasury bills had very low interest rates compared to overseas interest rates.

4.2.2 From the interaction with Mr. Cheserem, the Committee observed the following:

(i) The CBK could only be responsible for managing underlying causes which are subject to monetary policy while all other causes are outside the control of the CBK.
(ii) The CBK had capable economists yet it allowed an expansionary regime of money supply to persist for long.
(iii) The CBK's move to mop up liquidity then pump it in again within a short time sent mixed reactions to the public.

(iv) The CBK's public pronouncement of its intentions to intervene or not in the market sent mixed signals to the players in the market**(see annex 16)**.

4.2.3 On his part Mr. Cheserem suggested the following measures for consideration to address the problem of the exchange rate:

(i) The CBK should maintain a high but not too excessive CBR rate that would not damage the economy.
(ii) The Government should put austerity measures to reduce borrowing from the market. This will ease the interest rates.
(iii) The CBK Governor and Deputy Governor should be appointed through a competitive process.
(iv) The CBK should be required to appear before an appropriate Parliamentary Committee on a regular basis to explain the performance of their two core mandates of price stability and financial stability of the Banking system.

Observations

4.2.4 As a former CBK Governor, Mr. Cheserem submissions were quite useful. Firstly, the Committee notes the importance of strengthening the operational structure of the CBK including the need to recruit the top officials such as the Governor and Deputy Governor competitively. More important is the need to ensure that the management of CBK is answerable to the Kenyan public not only through the executive but also through an appropriate parliamentary Committee.

Recommendations

4.2.5 From the foregoing, and to strengthen the governance of the CBK, the Committee recommends that the CBK Governor and Deputy Governor be recruited through a competitive process. The Committee also recommends that the CBK Act should also be amended to provide the CBK Governor appears before a relevant Parliamentary Committee of the National Assembly on a regular basis to explain the performance of CBK concerning the core mandates of price stability and financial stability. In addition, there ought to be put in place a mechanism that guarantees oversight over the CBK by a parliamentary Committee.

4.2.6 Amend the law to review and restructure the composition, selection process and qualifications of members of the Monetary Policy Committee.

4.3 Dr. Thomas Kibua – Former CBK Deputy Governor

Submission

4.3.1 The Committee met with Dr. Kibua on 1st December 2011. The Committee was informed that the causes of the fall of the Kenya shilling were as follows:

(i) The world economic situation was deteriorating with America and the Euro zone both in a debt crisis. The Middle East and North Africa countries were having political instability. Since most of these countries are trading partners with Kenya, there was a drop in the earnings from export causing a current account deficit.

(ii) The country was facing supply constraints; inadequate food supply and rising fuel prices. This increased the import bill creating a current account deficit.

(iii) The actions of the Government in 2011 were equivalent to fiscal indiscipline. The economic stimulus programme, women development fund and youth development fund had become unproductive since the money spent was not equal to the output. This money found its way to consumption rather than development.

(iv) The CBK had created an environment of weak monetary policy, creating excess liquidity, rise in credit to the private sector, and inflation. This money increased inflation and could have been used for speculation. With the drop in the interest rates, many Kenyan decided to transfer their money into foreign currencies with the aim of speculating since the returns would be more lucrative than investing it. This even caused divesture since people needed their money in foreign currencies. Speculative activities of individuals andBanks made them to hoard foreign currencies with anticipation that prices would go up.

(v) There had been heightened political temperatures with the coming of an election year and the ICC cases debate. Investors were divesting and foreigners were withdrawing their stakes in shares at the Nairobi Stock Market.

(vi) There was a drop in the inflows from export and remittances from the Diaspora. Many of the external investors felt Kenya was unstable.

(vii) The actions and omission from the CBK were a clear cause of the problem. The CBK should ensure that the market is stable. Once the CBK sent mixed signals in the market, speculators positioned

themselves to take advantage of the reactions. The CBK also did not engage the commercial Banks early enough but it tried to compete with them yet it should be their regulator, not competitor.

4.3.2 From the interaction with Dr. Kibua, the Committee had the following recommendations to address of the Kenya shilling:

(i) Legislation should be put in place to discourage conspicuous consumption like importation of non-essential goods and basic commodities available locally.
(ii) Fiscal discipline: The Treasury should develop good macroeconomic financial programs to guide the economy. There should be value for money from all Government expenditures. The Government should prioritize public projects in a manner in which the economy doesn't overheat.
(iii) The CBK should be in control of the financial market as a regulator. Since there is a clear problem of cartels in the market, the CBK should address this through its Bank supervision department.
(iv) The CBK should be clear with its stand and should not send mixed signals in the market. The CBK should be up-to-date with the market operations of the Banking industry since its timely interventions could save the country from a similar economic downturn.
(v) The independence of central Bank should be upheld and the institution should know its responsibility and the consequence of not undertaking its duties diligently. The Government should stop frequent interferences with its CBKs operations.

Observations

4.3.3 The Committee notes that the CBK may have lost control of the financial markets during the time of the exchange rate crisis and was not up-to-date with the market operations of the Banking industry

which could have slowed down its response to the crisis. While the independence of the CBK is paramount, the CBK should execute its mandates effectively and there should be sanctions for failure to do so effectively.

Recommendations

4.3.4 From this observation, the Committee recommends that an external organization carries out an internal audit of what went wrong in monetary operations and Bank supervision with a view to rectifying the problem. The Committee also proposes amendments to the CBK Act to provide for punitive measures on the Management of the Bank for gross failure in attainment of important monetary policy objectives or failure which occasions the country huge losses.

5.0 OTHER STAKEHOLDERS

5.1 Foreign Exchange Dealers Association

Submission

5.1.1 The Committee met with a representative of the Foreign Exchange Dealers Association, on 15th December 2011. The Committee was informed that the causes of the fall of the Kenya shilling were as follows:

(i) The ICC decision on the "Ocampo six" led to uncertainty on Kenya's political climate and any foreign investor started divesting and taking up foreign currencies as a safe haven increasing the demand for foreign currency.

(ii) The drought that hit parts of the country affected export produces like tea and coffee causing a reduction in their production. This reduced the country's exports while import bill was rising widening balance of payment. This, compounded by the fact that one of Kenya's major tea export market, Egypt, was

in a political crisis significantly reduced the income from tea exports.

(iii) The turmoil in North Africa and the Middle East caused uncertainty in the international oil market. Prices had risen to over $100 per barrel. IMF World Economic Outlook forecasts for 2011 were $85.50 per barrel. Oil imports constitute over 25 per cent of Kenya's current account. Thus the increase in prices increased the import bill directly.

(iv) The NSE had lost 446 points since January 2011 —about 10 per cent. The foreign component of this directly affects the demand and supply of US dollars, which directly affects the USD/KES price.

(v) Speculative behaviour may have been responsible for the problem with shilling, but speculation is standard market behaviours in domestic and international markets. Like in the case of NSE stock trading, dealers in foreign exchange are in the market to trade and speculate since this is the way they make money.

(vi) With all the fundamentals causing jitters in the foreign exchange market, the CBK failed to acknowledge the facts and instead dismissed them as short term in nature or supply side shocks.

(vii) Treasury implemented the Economic Stimulus Programme (ESP) while the Central Bank implemented an accommodative monetary policy. The CBK reduced the CRR and the CBR so as to encourage Banks to lower their lending rates and make credit cheap. This policy made the market liquid, making it possible for the Treasury bills and Treasury bonds interest rates to fall drastically and making it easy for the Government to borrow. The interest rates were below inflation rates. The Government started undertaking massive development projects and there was need to import major construction materials. Furthermore, the country was facing drought and it embarked on importation of food. The cheap credit went intoimportation of second hand

vehicles, non-essential goods and basic foodstuff. All this added to a growing import bill.

5.1.2 In its sittings the Committee also heard from the Foreign Exchange Dealers Association that:

(i) That the long-term structural problems in Kenya's economy, including the ratio of exports to imports, high cost of crude oil in the past ten months besides drought had sparked inflation and also the depreciation of the local currency.
(ii) The built up of the Central Bank foreign currency reserves, mainly from actual purchases of USD from the market, from 2008 to early 2011 reduced the amount of foreign currency in the market.
(iii) When the crisis was at its onset, the signals from the CBK to the market were creating more confusion in the market. For example, its failure to intervene caused panic buying by importers and increased speculation. The Central Bank did not inject its foreign currencies to the market early enough.

Observations

5.1.2 The Committee notes that while foreign exchange trading and taking positions within legal limits is not illegal, the CBK should be in a position at operational level to devise tools and regulations and guidelines to ensure stability in the foreign exchange market and to curb excessive trades that may drastically affect the direction of the shilling.

Recommendations

5.1.3 The Committee recommends that the CBK should focus on ensuring the efficient operation of the foreign exchange market and respond in a timely manner to major fluctuations in the exchange rate. The guidelines to curb unusual and illegal trades should be deterrent.

5.2 Kenya Private Sector Alliance (KEPSA)

Submissions

5.2.1 The Committee met with the Kenya Private Sector Alliance, on 8th December 2011. The Committee was informed as follows:

(i) It is important to have an improved and efficient infrastructure to the growth of the economy. There is a need to have policy guidelines on how the projects towards infrastructural development are implemented. There should be a mechanism to look into the mega projects and their execution processes.

(ii) That the cost of running the Government is too high putting pressure on the scarce resources. The overall budget is widening due to both an increase in the development and recurrent expenditures. The revenue collected is not growing enough to counter the recurrent expenditure and there is need for reforms to manage it. With the enactment of the constitution and the implementation of the Vision 2030, there has been increased development expenditure so as to deliver the required conducive environment to the Kenyans. This is in the backdrop of a not so good performing revenue collection. So the Government has to resort to borrowing both from the internally and externally increasing the public debt and the amount of interest to be paid.

(iii) The increased cost of goods in partly caused by inefficiency in production which is then passed on to the consumer.

(iv) There is need to harmonize companies involved in energy supply and target tariffs to avoid competition in the energy sector.

(v) The Central Bank of Kenya Governor chairs the MPC as the policy making organ and he is also the implementer. The nomination of the members of the MPC is also shrouded in secrecy hence bringing in the suspicion.

(vi) Foreign funded project are not fully paid for and the Government has to buy foreign currencies to pay for its part. In light of the

increase in the number of such projects, this raises the demand for the foreign currencies hence pushing inflation further up.

(vii) The Central Bank should have a working relationship with Banks and other foreignexchange dealers in order to share information. Competition in the foreign exchange markets and other money markets should be encouraged so as to limit cartels.

(viii) Government projects should be sub-let to local contractors to reduce the demand for foreign currency. Any foreign contractor should work in conjunction with local contractors so as to enhance knowledge transfer.

(ix) The Government should identify what can be imported for the projects and what should be produced locally. That is, need to look at the ratio of inflow and outflow in the projects. Some machinery from local companies should be used to avoid using foreign currencies to import machinery which are locally available. Since most of the development is in preparation for the devolved Government, this should be effected in phases for cost efficiency and to maintain stability.

(x) Energy cost is an issue in the country and should be addressed effectively. The efficiency of Kenya pipeline as well as the entire supply chain should be improved to cut on energy cost. The harnessing of coal should be fast-tracked to enhance development of power in a different way. It should also be fast-tracked so as to cut on the energy costs incurred through importation.

(xi) Infrastructure efficiency and capacities should be improved by giving incentives to companies whose vehicles reduce congestion on the roads, such as double-decker buses.

(xii) The education sector should set up standards of education to be able to supply the region with skills needed for efficiency as well as enable Kenyans acquire international contracts as a way of earning foreign currency.

(xiii) The Kenya Tourist Board should promote education tourism to boost the economy.

(xiv) That the import storage facility in Mombasa needs to be commissioned to cut on the additional costs imports incur at the store.

(xv) An independent Commission to monitor Central Bank should be formed.

Observations

5.2.2 The interaction with the Kenya Private Sector Alliance,outlines many public policy issues of broader economic interest than the issue of Kenya shilling. The Committeemainly observes the need for accountability in Government and coordination of economic policy making with other agencies so as to have a uniform way to deal with and to avoid economic crisis such as that of the fall of the Kenya shilling.

5.2.3 The Committee also noted the need to divide the roles of CBKpolicy making and oversight of the Banking industry. Currently the nomination and appointment to the MPC is shrouded in secrecy. This suggests the need to give some level of autonomy to the Bank supervision wing of the CBK. Additionally, the selection and composition of the MPC should be open or competitive so as to strengthen the role of monetary policy making and accountability **(see annex 17)**.

Recommendation

5.2.3 To improve the effectiveness of CBK the Committee recommends that a review of the CBK structure be done to suit the viability of increasing the autonomy of the CBK policy making organ and the oversight or supervision of the Banking system.

5.3 Consumers Federation of Kenya

Submissions

5.3.1 The Committee met with the Consumer Federation of Kenya, on 6th December 2011. The Committee was informed as follows:

(i) Owing to the devaluation of the Shilling against major currencies, the cost of living of Kenyans has sky rocked and consumers are not able to access basic needs due to the high cost of commodities.
(ii) Imports have become expensive making them unaffordable.

5.4 Institute of Economic Affairs (IEA)

Submissions

5.4.1 The Committee met with the Institute of Economic Affairs, on 1st December 2011. The Committee was informed as follows:

(i) A rise in interest rates tends to contract the economy by appreciating the currency and reducing net exports. On the other hand a decline in interest rates tends to expand the economy by depreciating the currency and raising net exports.
(ii) Fiscal policies often affect interest rates and international capital flows to Kenya. For example, fiscal expansion pushes up interest rates. At higher interest rates, Kenyan securities become more attractive to foreign investor, which appreciates the shilling.
(iii) Contradictory monetary policy reduces aggregate demand, which lowers both real GDP and prices. A monetary contraction raises interest rates; hence a tighter monetary policy attracts foreign capital into Kenya in search of higher rates of returns. The exchange rate therefore rises.
(iv) Kenyan exports were dampened due to the euro zone crisis since Europe is a big consumer of Kenyan products
(v) The Institute recommended the tightening of monetary policy.

6.0 POLICY RESPONSES

6.1 The signs that the Kenya shilling exchange was facing sustained fall due to the current account imbalances and rising inflation was apparent as early 2011. Nevertheless, the CBK still resisted calls to intervene instead, the Monetary Policy Committee of the Central Bank of Kenya maintained the CBR rate flat (minimal changes were made in May to July 2011) unchanged from February 2011 to September 2011 despite the fact that both inflation and depreciation of the Kenya shilling was rising at alarming rates. Clearly, there was a major policy lapse given that policy action from the CBK should have come as early as March 2011. Various belated measures were, however, implemented by the CBK and the Ministry of Finance to stem the fall of the shilling.

6.2 The Ministry of Finance took the following steps to deal with the fall of the Kenya shilling:

(i) The Ministry of Finance for example sent circulars to all Government departments to reduce unnecessary expenditure such as those on foreign travel and furniture. These were meant to address Governments demand for foreign exchange and also to curb inflationary pressures. Treasury reported that it had made savings amounting to about Ksh. 5 billion owing to these measures alone.

(ii) The Ministry of Finance also reported that the Government had changed its macroeconomic framework to reduce the amount of budget deficit by 1 percent by end of 2012.

(iii) The Ministry also sought and received an extension of the Extended Credit Facility (EFC) from IMF. Given that the fall of shilling was largely driven by balance of payments problems, the Governmentsought support from the IMF under the Extended Credit Facility to shore up the local currency and ensure that the country's balance of payments remained stable. The country has since accessed amounts exceeding USD 300 million since early

2011, and could access additional funds under the three year ECF program.

(iv) Treasury's action to curb non-essential imports could do something to address the huge import bill, but this needed permission from EAC partner states to change any tariffs on imported products.

(v) In addition, CBK, Treasury, Banks or their representatives, the Kenya Bankers Association, and a Task force in OPM held various consultations which improved communication between CBK and Banks and also helped coordinate the response and also manage expectations.

6.2 The CBK responded to the early problem of arbitrage by increasing restrictions on the use of the Discount Window. It is believed that Banks were using the Discount Window to access funds to invest in the Government securities instead of using their dollar holdings. This therefore reduced dollars available in the foreign exchange markets. Following are the primary responses that the CBK took:

(i) The CBK injected US$ 118.25 million in the market between July and November 22, 2011. Given that the Bankalso bought foreign currency from the markets amounting to USD 95. 8 million, the net injection was small and could not have reversed the direction of the Kenya shilling. The intervention through the sale of foreign exchange was limited by the amount of reserves available in Kenya.

(ii) The CBK also reacted by lowering the foreign exchange exposure limit of Commercial Banks from 20% to 10%: This measure served to make foreign currency more readily available and therefore cheaper (in relation to Kenya shilling) by forcing Banks to hold less foreign currency assets, which also reduces foreign currency dealings and speculation.

(iii) Successive increments in the CBR rate and the Cash reserve ratio to reduce money supply: The most significant policy response

came in October 2011 when the CBK raised the CBR to 11 percent. Early the next month, the CBK again raised the CBR to 16.5 percent, resulting in sharp strengthening of the shilling from the peak Ksh. 107 to the US dollar to Ksh. 90.31 to the US dollar by end of November 2011. In December 2011, the rate was raised to 18 percent causing further strengthening of the Kenya shilling.

(iv) Through various regulatory interventions, circulars, moral suasion, among other approaches (see Section 4.1 on the Central Bank of Kenya).

6.3 While some of the measures such as the sale of foreign exchange and interventions to reduce Government spending were largely inadequate, some of these measures, due to their sheer magnitude ended up hurting the same Kenyans they were supposed to protect. Primarily, the shock increase in the CBR to 16.5 % and further to 18 percent lend to a sharp rise of lending interest rate in the Banks and contraction of credit to the private sector. Many commercial Banks have adjusted their base rates from an average of 15 percent to about 24 percent. For some Banks, actual lending rates are about 30 percent. Business people and consumers are finding these rates exorbitant, and without an alternative source of money, businesses either postpone investments.

6.4 Ultimately, high interest rates will cause a fall in economic growth, worsen the unemployment situation and increase poverty. The increase of CBR has also contributed to reduced subscription of Government securities since Banks find it more profitable and prudent to lend to each other through interbank lending or overnight lending than investing in T- bills and T-bonds,

CHAPTER FOUR

COMMITTEE FINDINGS AND RECOMMENDATIONS

7.0 FINDINGS

7.1 The Committees sittings were quite fruitful and helpful in isolating the primary drivers of the drastic depreciation of the Kenya shilling. The Committee received diverse submissions and explanations of the possible causes of the drastic decline of the shilling which it divided into economic, human and institutional failures. The economic causes such as the wide current account deficit, Euro crisis, large import bill of non-essential commodities, the Arab Spring, are still in place even after the shilling recovered its value since December 2011. The Committee therefore zeroed on institutional and human failures. These factors include policy indecisiveness and inaction of the CBK, speculative activities of some Banks and individuals, and inaction by the Ministry of Finance.

7.2 The Committee's findings on the cause of the sharp decline of the shilling are as follows;

7.2.1 **Policy indecisiveness and inaction of the Central Bank of Kenya (CBK)** - The Committee finds the following acts as directly linked to the slide of the shilling:

(i) **Creatingopportunities for arbitrage -** Failure by the CBK to detect and close in time the gap between the interest rate on Discount Window of the CBK, the rate on the interbank lending market and rates on Treasury bills and bonds. The Committee is convinced that commercial Banks exploited this loophole for monetary gains. The problem of the exchange rate could have been addressed to a great extent through a rise in the CBR as early as June 2011 and also the placement of stringent penalties on the abuse of the Discount Window.

(ii) **Failure to detect and arrest speculative activities -** The Committee also found that the CBK failed to detect and arrest speculative activities of the financial market players through several financial instruments that fueled the sharp volatility and sudden fall of the shilling in 2011. This is related to weak monitoring and surveillance of financial markets.

(iii) **Unclear Communication to financial markets -** The Committee felt that CBKs communication strategy was ineffective during part of the year, and this may have created conditions for further speculative activities or unresponsiveness of market players to CBK's policy signals. Indeed, the signals from the CBK to the market and failure to intervene were creating more confusion in the market sparking panic buying by importers and increased speculation backed by series of circulars issued by CBK.

(iv) **Ineffectiveness of the Monetary Policy Committee (MPC) -**The buildup to the decline of the shilling was evident as early as January 2011, but the CBK through the MPC failed to discern the signals and stem the crisis before it reached its peak The Committee observes there is ineffectiveness on the part of the MPC, especially its failure to meet regularly, its composition, and its inadequate response to the shilling's decline as one of the problem that worsened the situation last year.

(v) **Inadequate policy responses** – The Committee finds that policy responses were either inadequate or came in too late. Slow reaction of by the Central Bank of Kenya to the problem made exchange rate problem spiral out of control. Tracking CBKs response to the exchange rate and inflationary pressures throughout the year provides a hint on what went wrong. The CBK firstly increased the CBR on March 23, 2011 from 5.75% to 6% which was revised again to 6.25% on 4th June, 2011. The CBR rate was not reviewed again until September 15th 2011 but

this was raised to only 7% despite the fact that the Kenya shilling was rapidly losing value and inflation was rising. The CBK kept the CBR fairly flat for about 9 months.

(vi) **Belated intervention by the CBK**– CBKs response through hiking the CBR rate to 18% was too drastic and costly to the economy.This has forced the Banks to hike their lending rate to more than 30 percent for new and old loans. Kenyansare now at risk of becoming paupers due to high interest rate payments.

7.2.2 Governor of the CBK - The Committee finds that the CBK Governor:

(i) Did not react in good time to the problem of sharp decline of the shilling which triggered a panic and fertile ground for hoarding in foreign currencies and speculation. This was corroborated by several commercial Banks, the Taskforce, all the economic experts and other organizations.

(ii) Kept CBK Discount Windowinterest rates below the interbank rate and Treasury bill rates that encouraged the commercial Banks to by-pass the interbank market to borrow from the Discount Window.

(iii) Allowed communication breakdown between the CBK and the Banks.

(iv) The Governor played down the gravity of the problem to the extent that in various instances he was quoted in the media saying that he would not intervene in the foreign exchange market.

(v) Being less candid with information. For instance, the Governor claimed public in the media that some Banks, which he refused to name, were responsible for arbitrage and hoarding of foreign currencies. The Governor was therefore not candid enough and honest to the Kenyans and even to this Select Committee.

(vi) Overseeing the rise of the CBR rate to 18%, hence occasioning Kenyans heavy interest rate payments.

(vii) The Committee is of the view that the Governor is squarely responsible for creating the opportunity for Banks and individuals to make quick money.

(viii) His announcement and release of CBK circular to bypass the Banking system and deal directly with buyers or sellers of foreign exchange, although reversed, was in complete disregard of the financial structures. This could have opened opportunities for rationing of foreign exchange, occasioned parallel markets to thrive and creation of multiple currency practices **(see annex 5)**.

7.2.3 **Arbitrage by commercial Banks -** Various financial players, including commercial Banks participated in arbitrage. Although this is not illegal and is a common business practice, the Committee observed that Banks exploited loopholes in the financial market to borrow funds from the CBK through the Discount Window and used the funds to profit from foreign exchange trading or to buy Government securities. The Committee can infer that in fact Banks were using the Discount Window to lend in the interbank market the same day or the next day since the Banking Circular No. 5 of June 29, 2011, Banking Circular No. 6 of July 11, 2011, and Banking Circular No. 8 of August 12, 2011 sought to curtail this practice. The Committee also found that Kenya Bankers Association, in a meeting with CBK, had expressed concern about the small Discount Window rate relative to the interbank market rates which was opening up opportunities for arbitrage.

7.2.4 **Commercial Banks with increased foreign exchange trading activity** - Three Banks namely; CFC StanbicBank, Standard Chartered Bank, and CitiBank were reported to have had increased foreign exchange trading activity. CBK wrote to them seeking explanation. **(see annex 18)**.

7.2.5 **Suspension of specific financial institutions from participating in the interbank market or foreign exchange market** - the Governor reported that CFC StanbicBank had flouted the guidelines issued on October 13,

2011 regarding the tenor of foreign currency swaps. The Bank was suspended from participating in the swap market for 30 days and was also penalized Ksh. 1 million in line with the Banking Act (Section 2(a) of Legislation No. 77 of 1999: The Banking (Penalties) (Amendment) Regulations 1999).

7.2.6 **Commercial Bank Foreign Exchanging holdings**- The Committee finds that 12 major Banks held 87.7% of total foreign assets by September 2011 (see annex 3).

7.2.7 Conflict of Interest–the Committee finds that top management and board members in some Banking institutions hold board positions in key public policy organs which are tasked with major development projects in the country. This is a source of disaffection among Banks which feel undue advantage is gained by such Bank executives. For instance, the CEO of Equity Bank chairs the Vision 2030 board which in the Committee's and other Banking institutions provides undue advantage on present and future information about inflow of funds towards infrastructure development.Similarly, the chairman of Equity Bank chairs the National OilCorporation.

7.2.8 **Kenya Bankers Association** – The Committee found that Kenya Bankers Association (KBA) discussed the problem of monetary policy in a meeting with CBK. The Committee found that the interactions between the regulator and KBA, which is an interest group for profit seeking Banks, was inappropriate in free markets. This opens up opportunities for collusion, arbitrage and speculation in foreign currencies.

7.2.9 **Inaction by the Ministry of Finance** – The Ministry of Finance failed to exercise the provisions of the Central Bank Act (Cap 491 section 4c) and take a proactive role to tame the decline of the shilling. Under the law, Treasury can intervene (take over monetary policy) upon

approval by the Cabinet for a period of 6 months if the CBK shows inability or unwillingness to pursue the intended monetary policies.

7.2.10 **Working relationshipbetween the CBK and commercial Banks-** the poor relationship between these financial players necessitated the formation of a taskforce in the office of the Prime Minister. However, this did little to arrest the direction of the Kenya shilling.

7.2.11 **Failure by the fiscal and the monetary policy organs of the Government**- to take timely corrective measures to arrest the slide of the shilling against major currencies.The Committee finds that the CBK was far too slow to react to the problem of the shilling which triggered a panic and fertile ground for hoarding in foreign currencies and speculation.

7.2.12 **Capital Flight -**The country suffered capital flight during the period when the Kenya shilling was depreciating. The uncertainties about the unpredictable exchange rate of the Kenya shilling fuelled negative expectations about the economy and key macroeconomic variables. The fall of the NSE 20 share index from 4464.9 points in January 2010 to 3120.88 in December 2011 was partly associated with the increased activity among foreign investors at the stock market. The capital market authority failed to share with the Committee the magnitude of capital flight from the NSE and major actors involved.

7.2.13 **Global economiccrisis**– The Committee finds factors external to the domestic economy to have played a role in the decline of the shilling.These include Eurozone debt crisis, US debt crisis, and Political events in the Middle East and North Africa. However, since these conditions still persist, the Committee considers them not have been the main causes for the drastic depreciation of the shilling.

7.3 RECOMMENDATIONS

7.3.1 On the basis of the above findings, the Committee has drawn a range of recommendations which will ensure that future crisis such as the sharp depreciation of the shilling in 2011 is not replicated. The Committees' recommendations span both economic and institutional changes as follows:

7.3.2 Monetary Policy

(i) **Governor of the CBK** –Failures attributable to the CBK during the period of the decline of the shilling, and the Governors own conduct bordering on incompetence created panic and fertile ground forBanks and individuals to make quick money.The Committee finds the Governor's conduct and behavior incompatible with the holder of the office of Governor of the Central Bank of Kenya and therefore recommend:

- The Governor takes responsibility for allowing the sharp decline of the shilling.
- The Governor steps aside to pave way for thorough investigation.
- That the President should constitute a Tribunal to investigate the Governor's conduct, incapability, connivance and incompetence to perform the functions of the office as per the provisions of the CBK Act Cap 491 section 14 (2)(f) and 14(3).

(ii) **Productive communication between CBK and financial market players** - the Committee recommends that CBK should design a framework of engaging with foreign exchange market players within the confines of the financial market laws and regulations.

(iii) **Coherence of monetary policy** - The Committee found that the CBK may have been overenthusiastic about economic stimulus and also maintained the low interest rate regime for far too long.

The Committee therefore recommends that the CBK should maintain a coherent monetary policy at all times with a focus on price stability.

(iv) **Early warning mechanism** - CBK should put in place thresholds or trigger values for which the foreign exchange should fluctuate in times of extreme crisis and at which the CBK would move in to restore stability.

(v) **Strengthen Reserve Position of the CBK** - The Committee recommends that the Government should take adequate steps to boost the reserve position to at least the 4 months of import cover to strengthen its ability to respond to market volatility.

(vi) **Enforcement of the In-Duplum Rule** – The In-Duplum rule as provided under section 44A of the Banking Act needs to be enforced.In addition, the Act needs to be amended to apply to all loans – both performing and non-performing.

7.3.3 Legal Amendments

Suggested amendments to the CBK Act can target, but are not restricted to the following:

(i) Position of Chair and deputy Chair of the CBK Board - The Central Bank Act (CAP 491 section 11 (1)(a)(b)) should be amended to provide that the CBK Governor and the Deputy Governor cannot chair the Board of Directors which is expected to review his performance in achieving the CBK core mandates.

(ii) Appointment of the Governor and Deputy Governor - The Committee recommends that the CBK Governor and Deputy Governor be recruited through a competitive process.

(iii) **Oversight over CBK** - The Committee also recommends that the CBK Act should be amended to provide that the CBK Governor appears on a quarterly basis before a relevant parliamentary Committee of the National Assembly to expound on monetary policy and other actions related to the discharge of the CBK core mandate of price stability and financial stability.

(iv) **Autonomy of the CBK**–Strengthen the autonomy of the two arms of CBK namely, the Banksupervision/financial markets on one hand and monetary policy arm on the other.

(v) **Sanctions** - To provide for punitive sanctions on the Management of the Bank for gross failure in attainment of important monetary policy objectives or failure which occasions the country huge losses, the Committee recommends the introduction of amendment to the CBK Act.

(vi) **The Monetary Policy Committee** – To include the input of supervisory arm of CBK in monetary policy decision making, the Committee proposes amendment of CBK Act to provide for an extra member to the MPC of a CBK staff responsible for Bank supervision. The performance of the MPC during the crisis and in particular the handling of the sharp depreciation of the shilling was found to be wanting. The Committee recommends a reconstitution of the current MPC to reflect the requisite expertise that will inform the monetary policy direction in the country.

(vii) **Conflict of interest**–To provide for a fair and level playing field in the Banking sector and to avoid conflict of interest, the Committee recommendsthat senior managers and board members of Banks should not hold positions in Government policy organs or Government commissions with direct impact on financial and monetary policies.

7.3.4 Supervisory Oversight of Financial Institutions

(i) **Tools to efficiently monitor financial markets -** CBK needs to develop tools to properly and efficiently monitor the financial markets, particularly find tools to quickly deal with the adverse effects of innovations in foreign exchange trades such as the Electronic Brokerage System, foreign exchange swaps and carry trades.

(ii) **Responsiveness to market developments** - The CBK should increase the speed and responsiveness to market developments to deal with rapidly changing financial market behavior.

(iii) **Independent forensic audit** - Possible speculation and abnormal trading in foreign exchange could have been prevented if action was taken in a timely manner. The Committee also recommends

- Ethics and Anti-Corruption Commission (EACC) and the Auditor General's office to carry out an independent forensic audit on the operations and transactions of the Discount Window and foreign exchange trading of twelve Banks which had the largest foreign exchange holdings by September 2011. **(see annex 3)**.

- The CMA to conduct a comprehensive investigation of the NSE to determine whether there were institutions that involved in suspect capital inflows and outflows from the bourse and report to parliament within 90 days from the date of adoption of this report by the House.

(iv) **Review of internal processes** - The Committee recommends that the CBK carries out an internal audit of what went wrong in monetary operations and Bank supervision with a view to rectifying the problem.

(v) **Banking penalties regulations** – The Committee recommends amendments be made to the CBK Act and the Banking Act in order to revise and enhance the penalties which may be imposed for breach of CBK regulations. Such penalties should be proportionate of the value to the Bank of the malpractice at that particular time. The Committee found the amount of penalty, Ksh. 1 million too lenient and therefore recommends a more deterrent penalty of 50% of the amount involved or Ksh. 20 million whichever is greater (regulation 2 of the Banking (penalties) Regulations, 1999).

7.3.5 Fiscal Policy

(i) **Reduction of the current account deficit through exports promotion.**

(ii) **Placing tariffs and non-tariff barriers on non-essential imports** - To reduce the import bill, the Ministry of Finance should explore ways through the regional trading arrangements to increase tariffs on non-essential commodities.

(iii) **Exercise of powers provided under the law** - The Committee recommends that the Ministry of Finance should not hesitate to take policy measures if the CBK grossly deviates from its monetary policy statement.

(iv) **Strong macroeconomic fundamentals** - The Committee finds the CBK and the Treasury lacking in strong macroeconomic fundamentals in the form of policy. Both institutions appear to have been overenthusiastic about economic stimulus. The CBK also maintained the low interest rate regime for far too long. The Committee therefore recommends that the CBK should maintain a coherent monetary policy at all times with a focus on price stability.

(v) **Coordination between the monetary and fiscal policy institutions** -The effectiveness of the monetary policy in a country must be matched with an equally effective fiscal policy, particularly so when dealing with a crisis of the magnitude the decline in value of the shilling. Fiscal spending remained high before some austerity measures were issued. The Committee recommends effective policy coordination between the fiscal and monetary authorities/agencies.

7.3.6 Finally, the current interest rates of slightly over 30% charged by banks are unrealistic, harmful and untenable. Therefore, the Government, CBK and financial market players should put in place deliberate mechanisms to reduce the interest rate to affordable rates within three (3) months of adoption of this report by the House.

Table 1: Foreign Exchange Holdings by Select Commercial Banks by September 2011

Bank	Total Holdings (Ksh '000)	Bank Holdings as Percent of Total Industry Holdings	Cumulative Percentage
CfC Stanbic Bank (K) Ltd	70,425,709	17.0%	17.0%
Kenya Commercial Bank Ltd	57,476,699	13.9%	30.9%
Standard Chartered Bank (K) Ltd	46,561,144	11.3%	42.2%
Citibank N. A. Kenya	29,179,720	7.1%	49.2%
Barclays Bank of Kenya Ltd	26,562,409	6.4%	55.6%
Commercial Bank of Kenya Ltd	26,086,714	6.3%	61.9%
I&M Bank Ltd	23,252,309	5.6%	67.6%
Diamond Trust (K) Bank Ltd	22,094,803	5.3%	72.9%
NIC Bank Ltd	20,295,571	4.9%	77.8%
Equity Bank Ltd	15,372,270	3.7%	81.5%
Co-Operative Bank of Kenya Ltd	13,355,225	3.2%	84.8%
Bank of Africa (K) Ltd	12,081,122	2.9%	87.7%

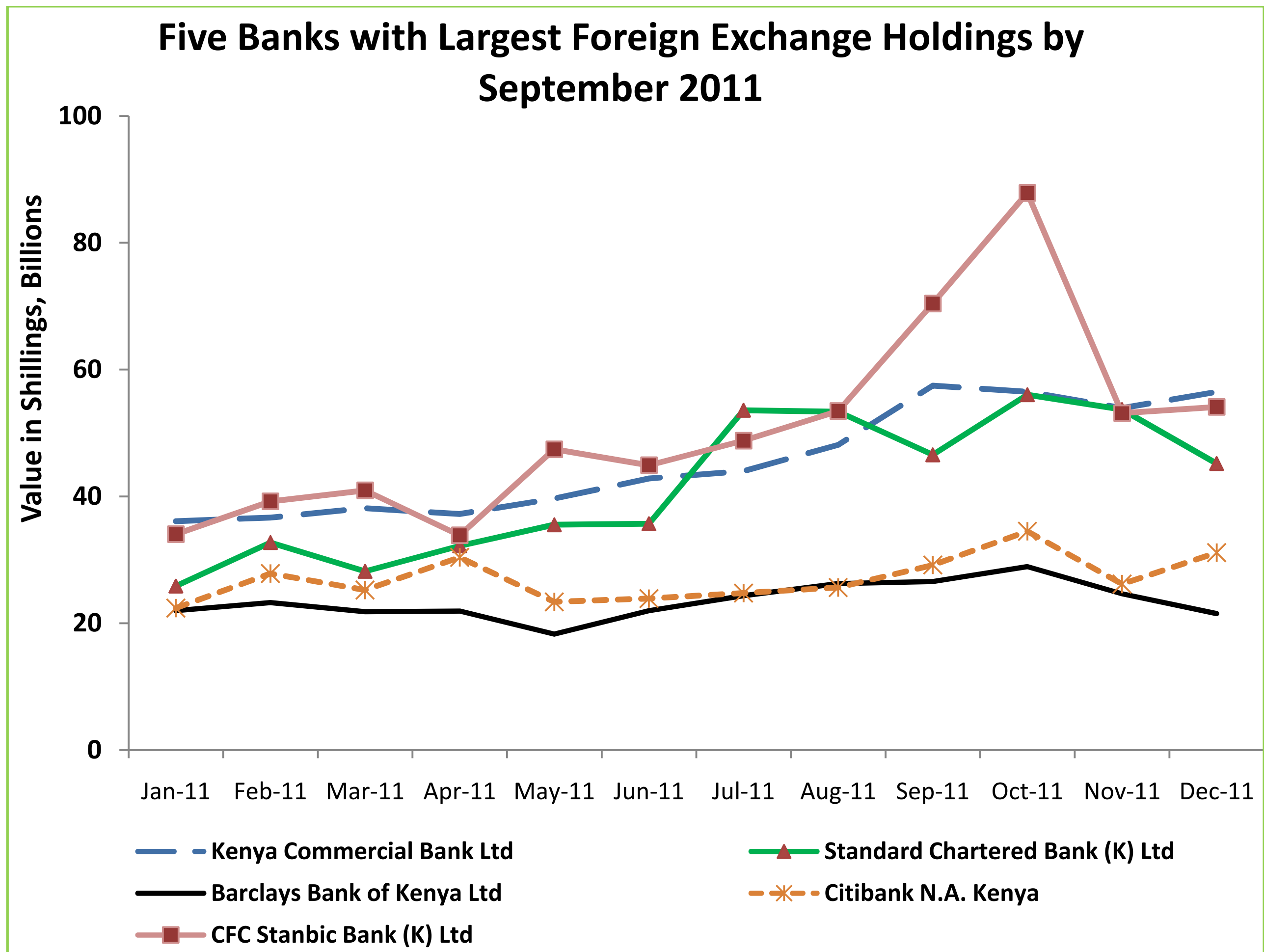
Source: Central Bank of Kenya

Table 2: Commercial Banks Borrowing from CBK and Profits, 2010-2011

Banks	Central Bank Window Borrowing (Ksh. Billions)		Profit before tax (Ksh. Billions)	
	2010	2011	2010	2011
Kenya Commercial Bank Ltd	0.960	148.420	6.500	9.100
Standard Chartered Bank (K) Ltd	1.170	7.555	6.185	5.492
Barclays Bank of Kenya Ltd	2.329	146.555	7.015	8.867
Commercial Bank of Africa Ltd	0	3.150	--	--
Cooperative Bank of Kenya Ltd	2.296	186.481	4.302	5.544
Citibank N.A Kenya	0.700	0	--	--
Bank of Africa (K) Ltd	1.280	23.768	--	--
CfC Stanbic Bank (K) Ltd	0.701	1.920	1.506	2.378
NIC Bank Ltd	0	3.980	2.004	2.577
I&M Bank Ltd	0.012	22.744	--	--
Diamond Trust Bank (K) Ltd	0	2.280	2.351	3.110
Equity Bank Ltd	1.664	53.336	6.464	8.246

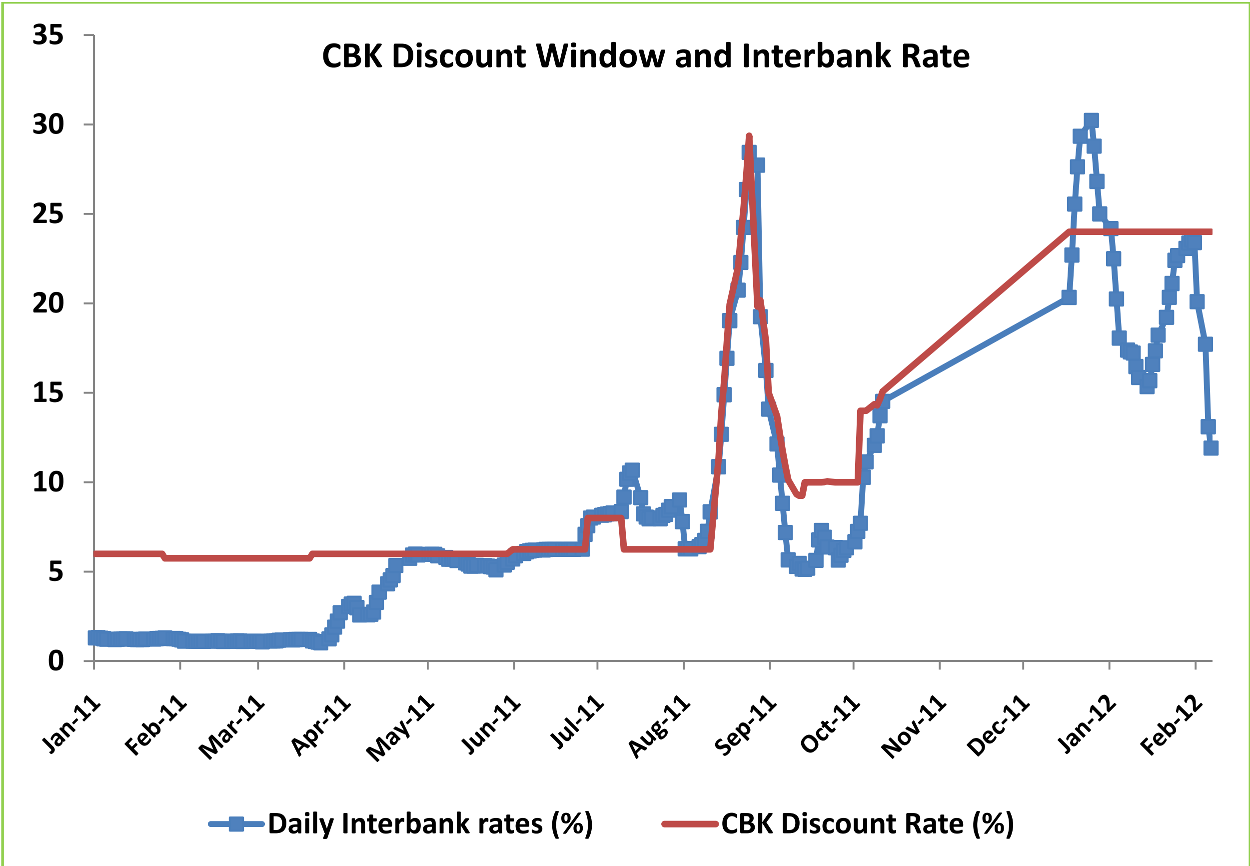
Source: CBK data, Financial Statements of listed banks

Figure 1



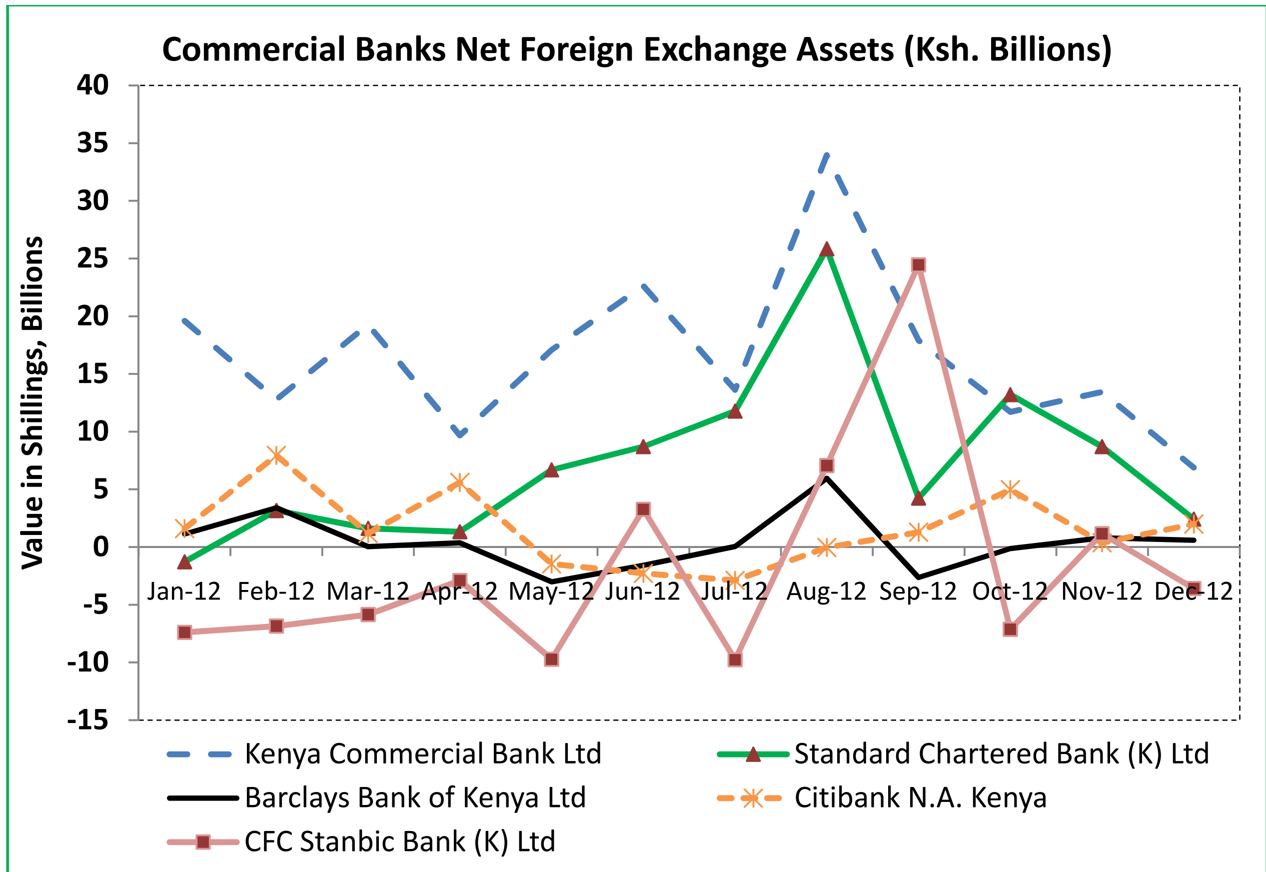
Source of data: Central Bank of Kenya

Figure 2



Source of data: Central Bank of Kenya

Figure 3



Source of data: Central Bank of Kenya

Insertion of new section 12A in Cap. 485A.

1. The Capital Markets Act is amended by inserting the following new section immediately after section 12—

Report to committee of National Assembly.

12A. The Authority shall, on a quarterly basis, appear before the relevant committee of the National Assembly to expound on its mandate under this Act.

Deletion of section 44A of Cap. 488.

2. The Banking Act is amended by deleting section 44A and substituting therefor the following new section—

Limit on interest recovered on loans.

44A. (1) An institution shall be limited in what it may recover from a debtor with respect to a loan to the maximum amount under subsection (2).

(2) The maximum amount referred to in subsection (1) is the sum of the following—

(a) the principal owing;

(b) interest, in accordance with the contract between the debtor

and the institution, not exceeding the principal owing; and

(c) expenses incurred in the recovery of any amounts owed by the debtor.

(3) This section shall not apply to limit any interest under a court order accruing after the order is made.

(4) In this section—

(a) "debtor" includes a person who becomes indebted to an institution because of a guarantee made with respect to the repayment of an amount owed by another person; and

(b) "loan" includes any advance, credit facility, financial guarantee or any other liability incurred on behalf of any person.

(5) This section shall apply with respect to loans made before this section comes into operation.

Insertion of

3. The Banking Act is amended by

new section 49A in Cap. 488.

inserting the following new section immediately after section 49—

Penalty for non-compliance with Central Bank directions.

49A. Any institution or other person who fails or refuses to comply with any directions given by the Central Bank under the Act shall be liable to a penalty of twenty million shillings or, if the directions relate to monetary transactions, a penalty equivalent to fifty per cent of the amount of money transacted.

Amendment of section 4D of Cap. 491.

4. Section 4D of the Central Bank of Kenya Act is amended—

(a) in subsection (2), by deleting the word "two" appearing in paragraph (c) and substituting therefor the word "three";

(b) in subsection (2A), by—

(i) deleting the word "two" and substituting therefor the word "three";

(ii) inserting the following new paragraph immediately after paragraph (b)—

"(c) one shall be a person with executive responsibility within the Bank for supervision of banks.";

(c) in subsection (6), by deleting the word "six" appearing immediately before the word "months" and substituting therefor the word "three".

Amendment of section 11 of Cap. 491.

5. Section 11 of the Central Bank of Kenya Act is amended—

(a) in subsection (1), by deleting the words "who shall be the chairman" appearing in paragraph (a);

(b) by inserting the following new subsection immediately after section (1)—

"(1A) The chairman of the Board, who shall be a person who is qualified in economics or finance, shall be appointed by the President."

(c) in subsection (2), by inserting the words "through a competitive process" immediately after the word "President".

Insertion of new section 4E in Cap. 491.

6. The Central Bank of Kenya Act is amended by inserting the following new section immediately after section 4D—

Report to committee of National Assembly.

4E. The Governor shall, on a quarterly basis, appear before the relevant committee of the National Assembly to expound on the monetary policy formulated by the Bank, and to report on other actions related to the mandate of the Bank.