

TECHNICAL SUPPORT MISSION ON INTERNATIONAL CREDIT RATINGS REPUBLIC OF KENYA



Report No. G&SR-CRA02/2022

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1. ABOUT THE REPORT

In line with Decision Assembly/AU/Dec.631(XXVII) of the 28th Ordinary Session of the African Union (AU) Assembly of Heads of State and Government, the African Peer Review Mechanism (APRM), an autonomous entity of the AU, supports Member States to improve their international credit ratings. As part of the mechanisms of support, the APRM undertakes technical support missions (hereafter called "mission") to countries to assess the challenges faced in engaging international credit rating agencies (ICRAs), in reviews and in implementing review recommendations. The mission's further aim is to identify key success factors and good practices that could lead to positive rating outcomes, for the purposes of peer-learning and experience sharing with other countries. This report thus makes recommendations for implementation by relevant stakeholders in Kenya.

2. CONSULTATION PROCESS IN KENYA

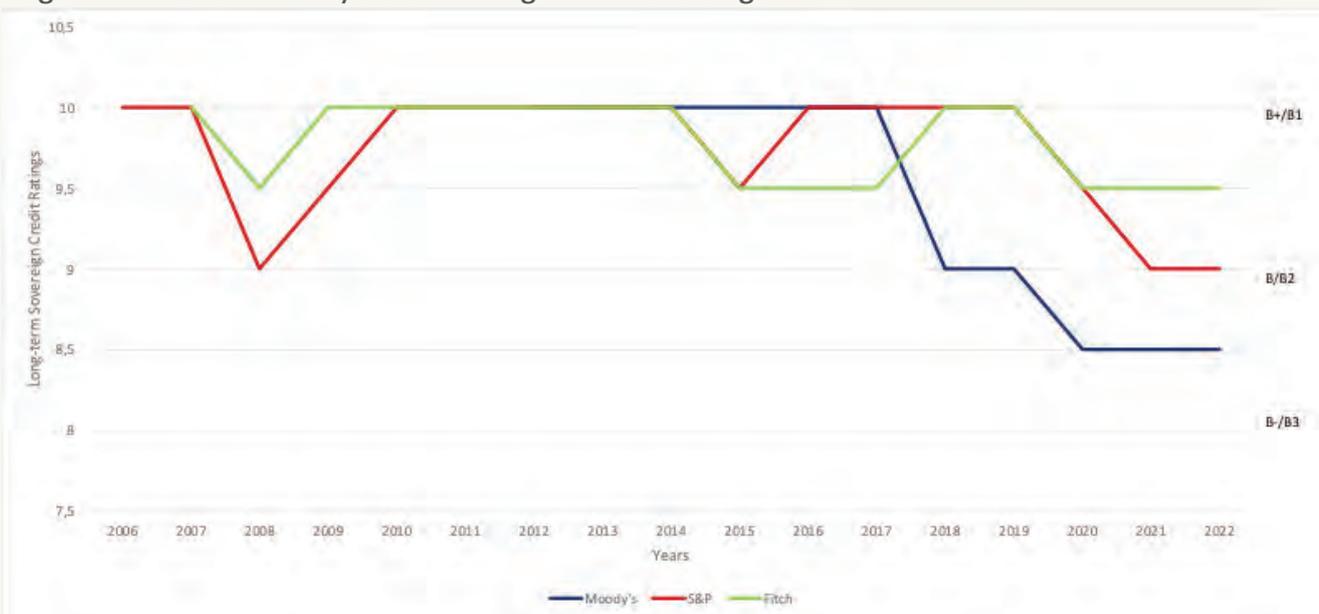
The APRM technical support mission team undertook a series of consultations with a variety of stakeholders in the Republic of Kenya from

the 25th of November to 3rd of December 2021. The mission team held meetings with representatives from the National Treasury, Central Bank of Kenya (CBK), Capital Markets Authority, Office of the IMF representative in Kenya, Representatives of banking sector, Kenya National Chamber of Commerce and Industry amongst other stakeholders.

3. INTERNATIONAL CREDIT RATINGS IN KENYA

Kenya first received a B+ sovereign credit rating from Standard & Poor's (S&P) and Fitch in 2006, and 2007, respectively. It was assigned a B+ equivalent of B1 rating by Moody's in 2012, which is the only rating agency to upgrade Kenya's sovereign rating to B2 in 2018. The sovereign credit ratings for Kenya have been relatively stable, currently standing at B (stable), B+ (negative) and B2 (negative) by S&P, Fitch and Moody's, respectively. Figure 1 below shows the historical trend of Kenya's sovereign credit ratings since 2006 when S&P first assigned the country a rating.

Figure 1: Trend of Kenya's Sovereign Credit ratings



Data from Tradingeconomics.com

4. BACKGROUND OF THE KEY RISK FACTORS

In 2020, Kenya's annual GDP growth fell by 5.2% to -3.2%¹ as the economy decelerated as a result of the Covid-19 pandemic. The sovereign rating downgrades, the fall in fiscal revenue combined with increased public spending drove public debt to surge to 72% of GDP² in 2020 from 61% in 2019. Despite the effects of the Covid-19 pandemic, the country has remained resilient, being downgraded only by S&P Global from B+ (negative) to B (stable) on 5 March 2021. The following risk factors in Kenya are identified by the three international credit rating agencies during the year 2021;

- i. High debt and interest burden that is posing financing risks and is driven by slow implementation of fiscal consolidation. The debt service to tax revenue ratio has increased from 17.5% in 2014 to 50% in 2021.
- ii. The country continues to face liquidity risk which is driven by high gross financing needs.
- iii. Slim revenue base because of the ineffective tax collection systems and tax measures.
- iv. Increased fiscal risk arising from budget

support and contingent liabilities driven by deteriorating financial performance in large state-owned enterprises (SOEs).

- v. Potential policy uncertainty posed by the elections in 2022 which could disrupt the ongoing sectoral reforms under the country's 'Big 4' agenda, damage business confidence and undermine growth.
- vi. Institutional and governance weaknesses compromising fiscal policy effectiveness leading to deterioration in fiscal metrics.
- vii. Expected increase in the country's exposure to environmental risks posed by climate events on the economy and government finances.
- viii. Exposure to social tensions caused by high levels of poverty, health and safety risks, high unemployment rates, and limited access to basic services.
- ix. Governance exposure due to weak fiscal policy effectiveness, high levels of corruption and weak rule of law.

5. FINDINGS OF THE TECHNICAL SUPPORT MISSION

The mission finds that the Government of Kenya currently do not have contracts with any of the

1 <https://data.worldbank.org/indicator/NY.GDPMKTP.KD.ZG?locations=KE>

2 <https://www.afdb.org/en/countries-east-africa-kenya/kenya-economic-outlook>

3 ICRA's after its contracts with Fitch Ratings and S&P Global expired. This means the rating agencies are issuing unsolicited ratings, which have not been requested by the government. There are a number of downsides to unsolicited ratings. First, the rating agencies do not consult adequately with government representatives during the review process. This means they do not gain an adequate understanding of the sovereign risk exposures and the government's strategy in addressing the downside risk factors. Second, the lack of an agreement with the Government of Kenya opens the door to rating agencies to use unfavourable ratings as a credible 'threat', forcing countries into contracts. Third, because there is no any written protocol or guideline on how unsolicited ratings should be conducted, they are likely to result in low ratings. Given the influence that ICRA's have on the international financial markets, the government can have no choice to ignore an unsolicited rating.

5.1 Capacity to engage ICRA's

The mission further finds that the National Treasury has minimum capacity to engage ICRA's on matters of fiscal developments, especially during the off-rating calendar periods. This is mainly because of lack of human capital, hence the National Treasury has neither dedicated team nor a focal person to provide requisite information to both investors and ICRA's when necessary. Instead, an adhoc team is assembled towards the rating review dates, who are normally overwhelmed with other deliverables under their responsibilities. The mission thus noted that the lack of capacity at the National Treasury could be the cause of delays in provision and verification of information requests by ICRA's. Hence, a number of rating decisions may have gone against the country either under the assumption that the National Treasury was non-cooperative or as a result of inadequate preparation by the National Treasury's adhoc country liaison team.

It is critical for the National Treasury in coordination with other key stakeholders to prepare review meetings, be consistent on government policy position, issue communiques, engage investors on public media platforms and reach out to ICRA's to avert possible speculations, especially

when there are significant fiscal developments. It is critical for the National Treasury to dedicate credit rating liaison team of experts - who have enough clout – to be able to comprehensively engage rating analysts and convince them on some perceived risk factors whose threats are usually inaccurately overstated. This would save the Government of Kenya a significant amount of financial resources that could be unnecessary lost through inflated debt service costs driven by negative rating action.

On the other hand, the CBK complements the National Treasury in addressing the capacity challenges with a dedicated team of key contacts at a very senior level, under the guidance of the office of the Deputy Governor, which engages ICRA's on matters of monetary policy. Despite the CBK's strong team that proactively engage ICRA's through quarterly meetings to discuss monetary developments in Kenya, developing a national strategy for dealing with ICRA's need to be led by the National Treasury. A clear national strategy is necessary to guide all stakeholders in their responses on issues raised by ICRA's in previous reviews and how relevant government departments and agencies are addressing them. It is crucial for governments to have on-going internal engagements in the National Treasury, in collaboration with the Central Bank to deliberate on risk exposures highlighted by rating agencies and develop strategies to mitigate them.

It was clear from consultation that, investors and other stakeholders are more concerned with consistent and timely publication of reliable economic data, which is the basis for investor sentiments, a key input to credit ratings determination. In cases where there are delays in publication of important economic information, the mission noted that, the information vacuum sends downside signals to investors, hence stakeholders value communication from the National Treasury and CBK explaining on the delays. However, to enhance communication and data provision, Kenya's National Treasury has significantly increased transparency on reporting government debt and other fiscal data through various reports, such as the External Public Debt Register³, Debt and Borrowing Policy⁴, Medium

3 <https://www.treasury.go.ke/external-public-debt-register/>

4 <https://www.treasury.go.ke/debt-borrowing-policy/>

Term Debt Management Strategy⁵, Development Partner Funding⁶ and Monthly Debt Bulletin⁷, Annual Debt Management Reports⁸, which are all accessible on the National Treasury website⁹. The Monthly Debt Bulletin, which commenced in January 2021, discloses detailed information on total nominal public and publicly guaranteed debt, debt service costs, debt structure (domestic and external), debt composition (by currency and creditors category).

5.2 Implementing ICRA review recommendations

The mission further noted that Kenya has advanced in improving public procurement transparency under the Public Procurement and Asset Disposal Regulations (2020)¹⁰, which requires all procurement contracts to be published and publicized within fourteen days after signing the contract. The regulations also provide guidance and elaborate procedures for the establishment and use of e-procurement systems and a central online portal by the Public Procurement Regulatory Authority, which has improved efficiency in procurement processes and reduced corruption. The mission was further informed during consultations that, to strengthen fiscal transparency and accountability in the use of public resources, the government is implementing comprehensive audits of all public spending, along with disclosure of beneficial ownership information of companies that are awarded procurement contracts.

With regards to addressing the fiscal challenges highlighted by ICRA in their most recent ratings reviews, the Government of Kenya has advanced in its implementation of fiscal measures to broaden the revenue base and reduce the fiscal deficit. Contrary to the general public sentiment¹¹ that the country's borrowing position is over-exposed towards external foreign currency debt, Kenya's external debt stock is 32.7% of GDP compared to 31.2% of GDP in domestic debt stock. Kenya's total nominal public and publicly guaranteed debt has decreased from 65.8% of GDP in April 2021, when the country received the IMF facility, to 63.9% of GDP in December 2021, and the bulk of the country's external

debt is largely multilateral and bilateral, which constitutes 67% of the of the total external debt composition. Borrowing through international sovereign bonds accounts for only 19% of the country's external debt and approximately 70% of the government bonds have an average of 9-year maturity profile, which reduced rollover needs. The mission notes that, due to the structure of its debt composition, Kenya's external exposure is significantly minimum as the risk of capital flight is low. In addition, the government has strong commitment to reducing debt vulnerabilities as the economy recovers from the impact of Covid-19 pandemic, forecasting a 6.4% GDP growth in 2021.

The Government of Kenya is also leveraging on its relatively large and diversified economy as a unique fundamental economic strength to drive the economy into recovery. The economy's high growth potential, which provides some absorption capacity to economic shocks, is supported by a relatively deep domestic financial market. The government has also been able to achieve the fiscal consolidation targets set as part of the International Monetary Fund (IMF)'s Extended Credit Facility (ECF) and the Extended Fund Facility (EFF) program, which advanced US\$2.34 billion in April 2021, a 3-year financing package to support Covid-19 response and to reduce debt vulnerabilities while safeguarding resources to protect vulnerable groups. From consultations, the mission noted that the IMF's EFF/ECF has yielded the majority of the intended results on reducing debt vulnerabilities through a multi-year fiscal consolidation effort centred on raising tax revenues and tightly controlling spending. In the first half of FY2021/22, Kenya Revenue Authority (KRA) posted a 5.12% surplus in tax revenue collection. The Kenyan authorities have shown strong commitment to their reform agenda.

To address the fiscal vulnerabilities, the government is implementing measures to broaden the revenue base, improve revenue collection and reduce the fiscal deficit. This has been undertaken through reinstating pandemic-related tax cuts, ending value-added tax

5 <https://www.treasury.go.ke/medium-term-debt-management-strategy/>

6 <https://www.treasury.go.ke/kenya-external-resources-policy/>

7 <https://www.treasury.go.ke/monthly-bulletins/>

8 <https://www.treasury.go.ke/annual-debt-management-reports/>

9 <https://www.treasury.go.ke/public-debt-management/>

10 <http://ppra.go.ke/download/the-public-procurement-and-asset-disposal-regulations-2020/>

11 <https://www.youtube.com/watch?v=BdLhli2NjV8>

(VAT) exemptions and tightening tax collection processes. In the height of the Covid-19 pandemic, income tax rate for top individual earners and corporations was reduced from 30% to 25% to support consumption by individuals and investments by firms, VAT was cut from 16% to 14% to protect low income earners. Over time, the government intends to reduce the fiscal deficit further by reducing recurring expenditure while aiming to prioritize key infrastructure projects, before undertaking further measures to broaden the tax base over the next 3 years. The Kenya Revenue Authority is implementing technological tax compliance surveillance systems, which has seen a significant level of tax compliance and helped it to surpass its collection targets.

Although there are plans to address the fiscal risk posed by SOEs through privatisation and robust restructuring strategies, fiscal vulnerabilities from bailouts and contingent liabilities will remain, at least, in the medium term. The mission noted from consultations that there is a gradual effort to strengthen the system for oversight and use the information to identify areas of weaknesses to develop a well-managed SOEs sector. The National Treasury however needs to develop capacity to analyse the volumes of data from SOEs businesses. Despite these challenges, the mission was informed that the funding support to SOEs is in line with Parliamentary Budget approvals and there are no unplanned expenditures.

With regards to uncertainty on policy continuity cited by ICRAAs, the mission finds that the risk of policy uncertainty posed by the 2022 general elections is significantly minimum given that two leading presidential candidates have strong links to the current government and were key in development of the existing policy. In addition, there is less likelihood of violence in 2022 elections given the electoral reforms, the key institutions established by the 2010 Constitution and well-established channels to resolve electoral disputes. This is contrary to the observations by S&P and Fitch that the upcoming presidential election will likely disrupt the reform agenda, damage business confidence and undermine growth. The probability of political dispute is therefore minimum due to an anticipated moderate level of political contestation, increase in political tolerance and a shift from ethnicised

politics. The government has also fast-tracked the implementation of the reform agenda and support the administration of political processes to ensure smooth political transition, maintenance of business confidence and economic growth. In addition, past experience has shown that elections in Kenya have not resulted in major fiscal or monetary policy shift.

The blanket classification of 'weak rule of law' in Kenya raised by ICRAAs is unjustified, especially given that the 2010 Constitution of Kenya provides a very strong foundation for protection of human and property rights. The mission noted a number of landmark cases that proves Kenya has a significantly strong rule of law, amongst these is the ruling by the Kenya's High Court against the government's plan to impose a minimum tax on corporate sales, which was declared unconstitutional and against the 'principles of business operation'. The private sector has also significantly influenced the government on the strategy to expand its tax base through supporting new businesses, taxing the technology sector, enhancing transparency and harmonising tax policies to increase voluntary compliance.

5.3 Regulation of ICRAAs in Kenya

The Capital Markets Authority (CMA) of Kenya is responsible for the licensing and regulation of domestic Credit Rating Agencies operating in Kenya, under the Capital Markets Act 487A of 2017 to ensure the proper conduct of that business. However, the mission was informed that only 5 local rating agencies are licensed by the CMA under the Act; Augusto & Company Limited (Headquartered in Nigeria), Metropol Corporation Limited, Global Credit Rating Company (headquartered in Mauritius), Care Ratings Africa (headquartered in Mauritius) and A.M Best Rating Services Limited (based in United Kingdom). In Kenya, it is currently not mandatory for ICRAAs to be licensed locally for them to be able to issue ratings in the country. The mission further noted that Kenya does not have a credit rating services legislation which regulates, amongst other things, the independence, objectivity, integrity and quality of ratings issued by credit rating agencies and the rating process as a whole. Since ICRAAs do not need to be registered or licensed locally, there is a legislative gap in regulating the ratings in Kenya. A credit rating services legislation would provide the foundation to enhancing the

credibility and confidence in credit ratings.

In addition to a credit rating services legislation, it is necessary for the regulatory authority to often provide further guidance through Rules and Guidelines to enhance effective regulation in line with international requirements of regulating credit rating agencies. Closing this regulatory gap will be instrumental in pushing the rating agencies and their analysts to have more physical presence in the country and to have a better understanding

of the local risk environment. The mission notes that, as in other African countries, a number of risk factors in the ICRAs' models such as the Risk of Banking Sector Credit, which is more inclined towards assessing banks' exposure to mortgage lending, is highly insignificant in Kenya. It is thus important for Government of Kenya to join other African countries and international organisations calling for ratings to be adaptable to Africa's risk context.

6. RECOMMENDATIONS

The APRM recommends the following to the Government of Kenya;

- i. **Institutionalise a framework for Country ICRA Liaison Teams** – This among others involves designating fulltime position(s) of a credit rating liaison personnel(s) in the National Treasury who are senior level expert(s) as key contacts, whose primary role will be to facilitate periodic engagements between the government and ICRAs [The National Treasury];
- ii. **Public Information on Relevant Performance Indicators** - In addition to having periodic meetings, proactively reach out to ICRAs, issue media statements, engage investors on public media platforms providing the same with verifiable information on the state and performance of key economic sectors, fiscal discipline and debt management to avert possible speculations, especially when there are key macroeconomic events [The National Treasury];
- iii. **Regularise Periodic Engagement of ICRAs** - At the beginning of each ratings calendar year, the rating liaison team needs to engage ICRAs on the theme of their rating review visits, discussion topics and industry experts they want to interview in order to coordinate with representatives of key institutions in public and private sector for consistency and coherence in communicating government's position on policy matters [The National Treasury, Central

Bank of Kenya];

- iv. **Designate an Information Clearing House** - Respond to information requests by ICRAs in a timely manner, verify factual correctness of media queries that may impact investors' sentiments [The National Treasury, Central Bank of Kenya];
- v. **Develop a Comprehensive National Strategy for Engagement with ICRAs** – This will guide the government on specific focus areas to improve credit ratings, mechanisms for periodic monitoring of sovereign risk exposures and all stakeholders on how they respond to issues raised by ICRAs in previous reviews and how relevant government departments and agencies are addressing them [The National Treasury];
- vi. **Enhance legislation** – Enact legislation on Credit Rating Services to ensure that regulation of international credit rating agencies is 'at least at par with international requirements' and in line with the G20 requirement of regulated and accountable credit rating agencies at a global level.
- vii. **Issue Rules and Guidelines** – The CMA, which may be responsible for enforcing the Credit Rating Services legislation, should be mandated to issue Rules and Guidelines to provide additional guidance and ensure uniform implementation of the Credit Rating Services legislation [National Assembly, Capital Markets Authority].



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