



KENYA

SELECTED ISSUES

October 2018

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KENYA

SELECTED ISSUES

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Approved By
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Glossary

CGT	-	Capital Gains Tax
CIT	-	Corporate Income Tax
DTT	-	Double Tax Treaty
EAC	-	East African Community
EBITDA	-	Earnings Before Interest, Tax, Depreciation and Amortization
EPZ	-	Export Processing Zone
FAD	-	Fiscal Affairs Department
FDI	-	Foreign Direct Investment
GDP	-	Gross Domestic Product
IMF	-	International Monetary Fund
ITA	-	Income Tax Act
KRA	-	Kenyan Revenue Authority
KSH	-	Kenya Shilling
LOB	-	Limitation of Benefits
MDTT	-	Multilateral Double Tax Treaty
MFN	-	Most Favored Nation
MLI	-	Multilateral Legal Instrument
MSMEs	-	Micro, Small, and Medium-Size Enterprises
OECD	-	Organization for Economic Cooperation and Development
OITI	-	Offshore Indirect Transfers of Interest
PIT	-	Personal Income Tax
SEZ	-	Special Economic Zone
SLC	-	Special License Company
TA	-	Technical Assistance
TFP	-	Total Factor Productivity
UN	-	United Nations
VAT	-	Value Added Tax

KENYA'S SUCCESS IN BOOSTING FINANCIAL INCLUSION¹

Kenya has been a regional and global leader in increasing financial inclusion over the past decade. Traditional bank deepening has helped, but new innovations in mobile technology have allowed a greater number of Kenyans to access financial services than would otherwise have been possible at this stage of development. Mobile technology has shifted perspectives on financial access as traditional banking channels have become just one of several means by which Kenyans can now transfer money, save, and borrow. Widespread mobile money usage has, in turn, helped to smooth consumption, reduce poverty, and boost growth in Kenya.

1. **Kenya's success in boosting financial inclusion over the past decade has attracted widespread attention.** Kenya's financial inclusion is high in terms of both access and types of financial services available. The World Bank's Financial Inclusion Index (World Bank, 2014a) shows financial inclusion in Kenya to be high relative to countries with similar levels of per capita income, education, mean age of women at marriage, and governance (Figure 1). In this paper, we first review Kenya's experience with financial inclusion—the scale on which it has taken place, the channels by which it has occurred, and the environment that enabled it to happen so rapidly, with an eye toward lessons for other countries at similar levels of development and financial depth. We then review recent analytical work to gain a sense of how these developments have positively impacted poverty reduction and growth in Kenya and how this might apply to other countries.

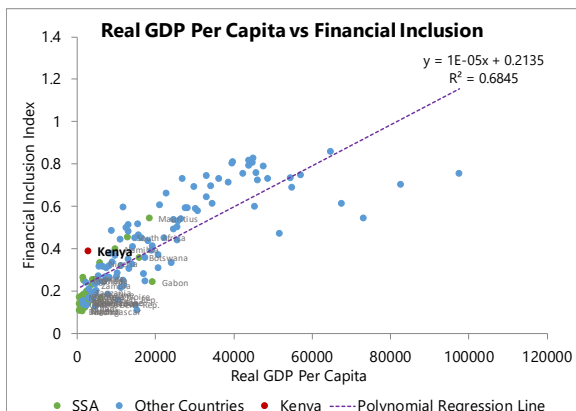
A. How Did Kenya Increase Financial Inclusion?

2. **Kenya's rapid financial inclusion has been supported by the expansion of traditional banking channels.** First, **local banks** were well integrated into low-income markets through various means. Financial access in Kenya stands out relative to other East African Community (EAC) countries in terms of the number of branches, deposit accounts, the number of ATMs, and the number of point of sale (POS) terminals (Figure 2). More importantly, firms of all sizes have had easy access to bank credit. Enterprise Surveys in 2007 and 2013 show that almost all firms have a checking or savings account, a bank loan, a line of credit, or overdraft facilities. Both working capital and fixed capital investment have been financed largely with retained earnings, but bank credit and suppliers' credit are also important sources. Past surveys have shown that the need for collateral is below the regional average and access to credit is generally not perceived as a major constraint (Figure 3); subsequent analysis suggests that this has further improved since the last survey.

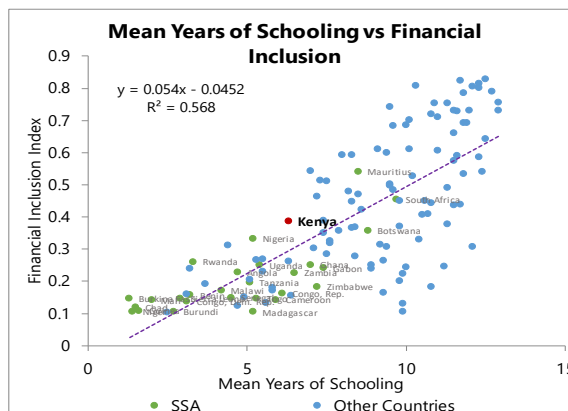
¹ Prepared by Armando Morales, Mika Saito, and Jason Weiss.

Figure 1. Kenya: Financial Inclusion and Socio-Economic Conditions

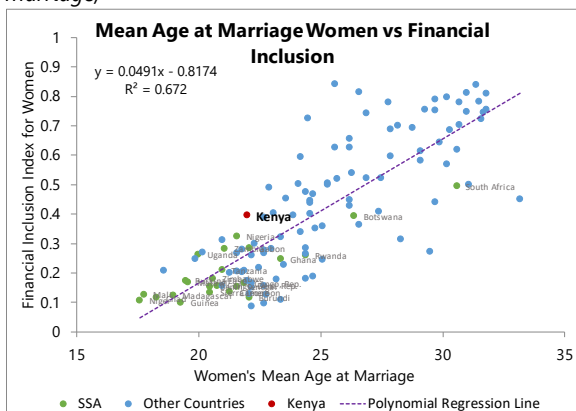
Kenya's level of financial inclusion is high relative to peer with similar per capita income ...



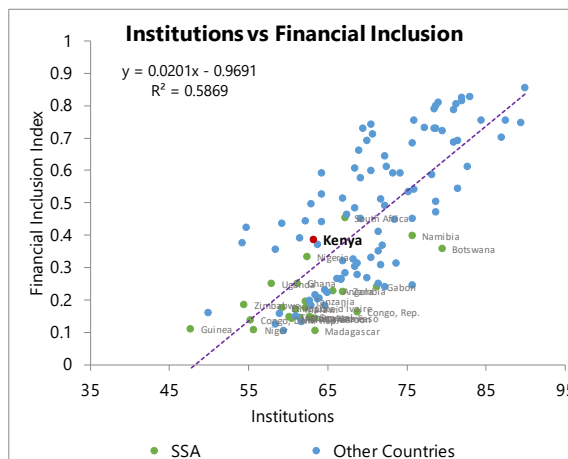
... relative to peers with similar level of education,



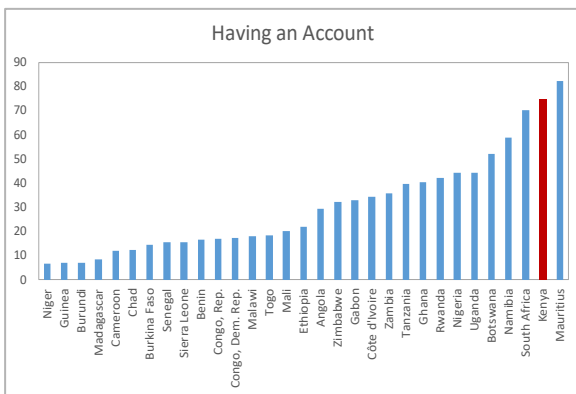
relative to peers with similar mean age of women at marriage,



and relative to peers with similar level of governance.



Kenya's financial inclusion is high in terms of not only access



... but also in terms of types of financial services

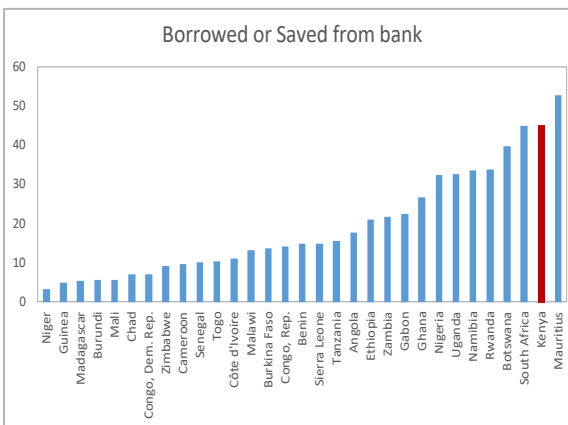
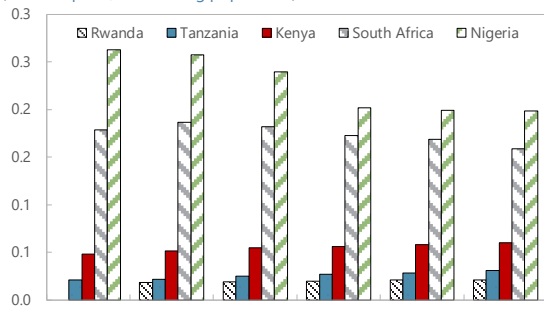


Figure 2. Kenya: Penetration of Local Banking Services, 2010–15

Kenya: Number of Branches, 2010-15

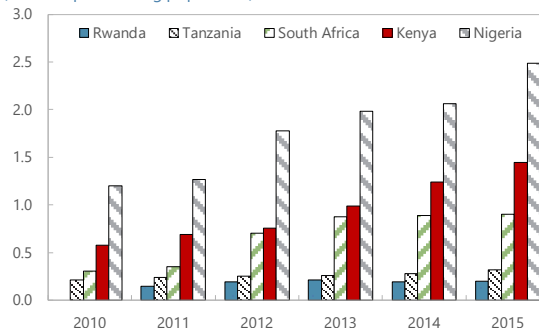
(Number per 1,000 working population)



Sources: Global Payment Systems Survey; National Payments System; and IMF staff calculations.

Kenya: Deposit Accounts, 2010-15

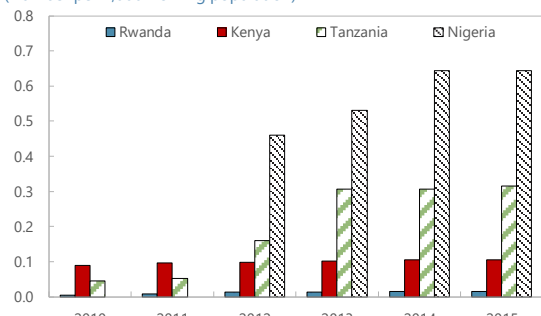
(Number per working population)



Sources: Global Payment Systems Survey; and IMF staff calculations.

Kenya: Number of ATMs, 2010-15

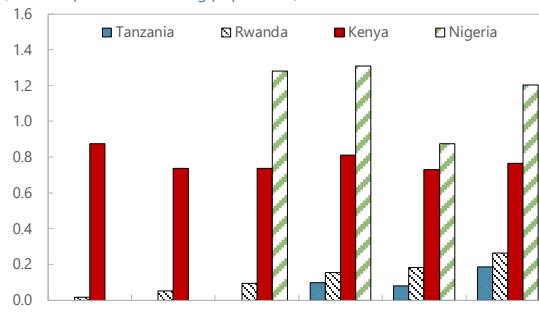
(Number per 1,000 working population)



Sources: Global Payment Systems Survey; National and Payments System; and IMF staff calculations.

Kenya: Number of Point of Sale (POS) Terminals, 2010-15

(Number per 1,000 working population)



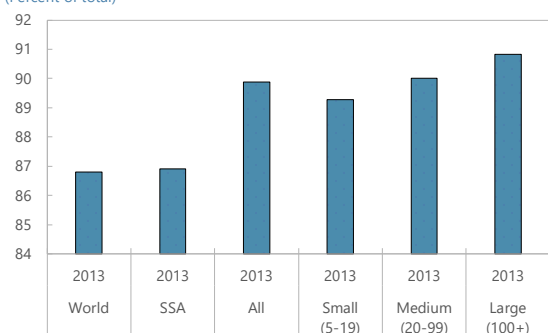
Sources: Global Payment Systems Survey; National Payments System; and IMF staff calculations.

Figure 3. Kenya: Access to Finance, 2007–13

Firms have had easy access to financial services

Kenya: Firms with a Bank Account, 2013

(Percent of total)

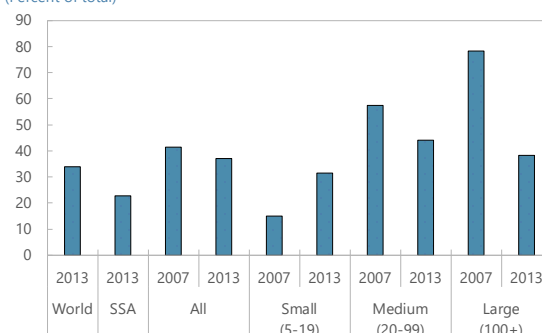


Sources: Enterprise Survey 2013; and IMF staff calculations.

Both in terms of savings and borrowing, with

Kenya: Firms with a Bank Loan/Line of Credit, 2013

(Percent of total)



Sources: Enterprise Survey 2013; and IMF staff calculations.

Less loan applications due to less needs

Kenya: Firms Not Needing a Loan, 2007-13

(Percent of total)

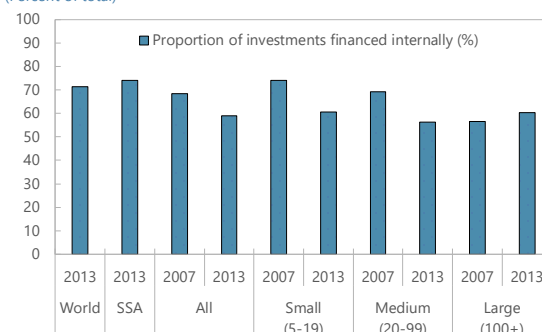


Sources: Enterprise Surveys 2007 and 2013; and IMF staff calculations.

Retained earnings are the main source of finance for investment

Kenya: Retained Earnings to Finance Investment, 2007-13

(Percent of total)

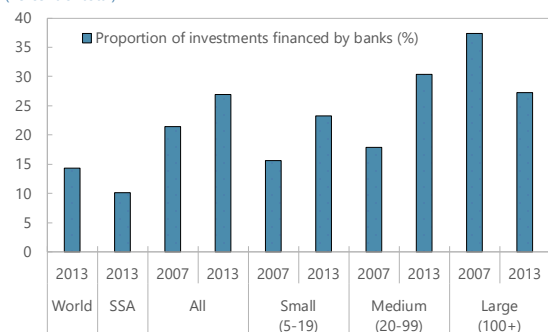


Sources: Enterprise Surveys 2007 and 2013; and IMF staff calculations.

But the use of bank credit and

Kenya: Bank Credit to Finance Investment, 2007-13

(Percent of total)

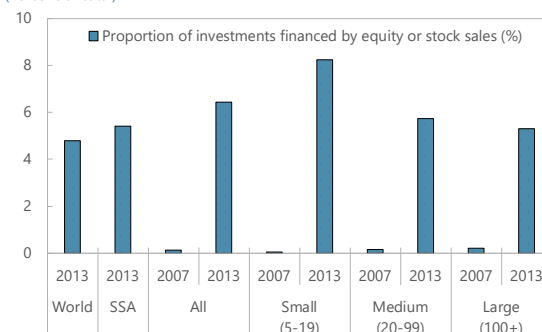


Sources: Enterprise Surveys 2007 and 2013; and IMF staff calculations.

other sources of finance increased.

Kenya: Equity to Finance Investment, 2007-13

(Percent of total)



Sources: Enterprise Surveys 2007 and 2013; and IMF staff calculations.

3. **The introduction of digital platforms has been a major factor in expanding financial inclusion.** Kenya is highly rated across a variety of forms of digital financial adoption (see Figure 4), including authorities' commitment, widespread adoption of mobile money services among traditionally underserved groups, and a broad range of mobile money services (Lewis et al., 2017).

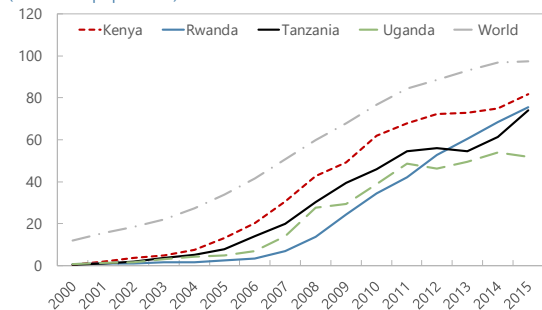
- Mobile-cellular phone subscriptions and subscriptions to **mobile transfer services** grew rapidly in Kenya as Safaricom began operations of M-Pesa in March 1, 2007. Safaricom almost immediately began partnerships with numerous companies in 2008,² including a partnership with Western Union that allowed M-Pesa users to receive money, initially from the United Kingdom and subsequently from more than 40 countries. The value of transfers grew rapidly, reaching Ksh 388 billion (about 12.2 percent of GDP) by 2010 (this figure had risen to Ksh 1,465 billion, or about 20.8 percent of GDP, by 2016). Internet usage has also grown rapidly (the share of the population using the internet is above the world average), but subscriptions for fixed broadband remain low.
- After an initial surge of subscriptions to transfer services, growth stabilized in line with nominal GDP growth, with mobile transfers remaining at about 20 percent of GDP since 2012. At the same time, **mobile commerce, banking, and cross-border remittances** saw rapid growth following the partnership of Safaricom with leading supermarkets in 2010. Safaricom continued to expand its partnership in 2011: the partnership with Lipa Karo allowed for school fees to be paid using M-Pesa, while its partnership with I&M Bank allowed transfers of money from M-PESA accounts into an international Visa Pre-Paid Card (known as M-Pesa PrePay Safari Card). The growth in mobile commerce took off after Safaricom partnered with Commercial Bank of Africa (CBA) to launch M-Shwari, a paperless banking service which allowed customers to (i) open and operate M-Shwari bank accounts via M-Pesa without visiting banks or filling out any forms; (ii) move money in and out of M-Shwari savings accounts to M-Pesa accounts at no charge; (iii) save money and earn interest; and (iv) access micro credit products (loans) of a minimum KSh 100 (about \$1.00) anytime, instantly. In 2015, Safaricom partnered with Vodacom Tanzania to allow M-Pesa customers to send and receive money to and from Tanzania. Other mobile bank accounts such as KCB M-Pesa (partnership with KCB Bank) and MCo-op Cash (partnership with Co-operative Bank of Kenya) began in 2015.
- **Mobile payments** have grown rapidly, dominating the volume of payments, but in terms of value, real time gross settlements (RTGS) remain the main method of payment in Kenya. By 2016, the total value of mobile services for the industry as a whole was Ksh 3.3 trillion (47 percent of GDP), of which person to person transfers were about a half, Ksh 1.7 trillion (25 percent of GDP). These values are much smaller than the value of RTGS, which was Ksh 26.2 trillion (372 percent of GDP) but are on par with the value of credit and debit card payments. Looking forward, mobile payments are expected to continue growing while cards will become less important. While values are still relatively low, the very large volumes suggest marked progress in financial inclusion in Kenya. The latest FinAccess Household Survey (2016) found that this is particularly true for women. Nevertheless, inclusion still skews toward those living in urban areas with relatively higher levels of education and income, suggesting that financial inclusion still has further to go in Kenya.

Figure 4. Kenya: A Rapid Growth of Mobile Platform, 2007–16

² Housing Finance (March 2008), Chevron Kenya Ltd (May 2008), PesaPoint (July 2008), PostBank (July 2008), Old Mutual Kenya (October 2008), Western Union (December 2008).

Mobile-cellular phone subscription grew rapidly since 2007 with Safaricom.

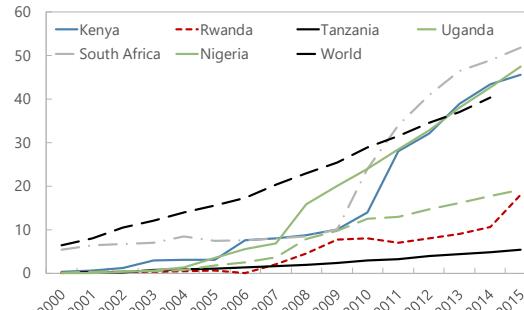
Kenya: Mobile-Cellular Phone Subscriptions, 2000-15
(Percent of population)



Sources: International Telecommunication Union; World Bank; and IMF staff calculations.

The use of internet has grown too,

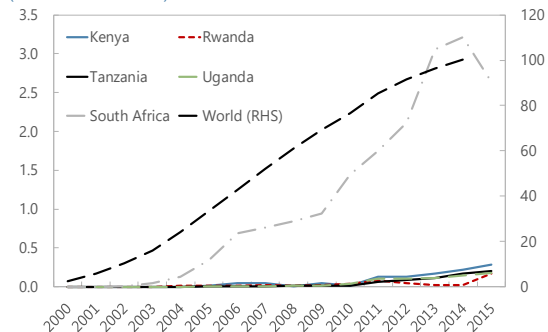
Kenya: Use of Internet, 2000-15
(Percent of population)



Sources: International Telecommunication Union; World Bank; and IMF staff calculations.

but the subscriptions for fixed broadband remained low.

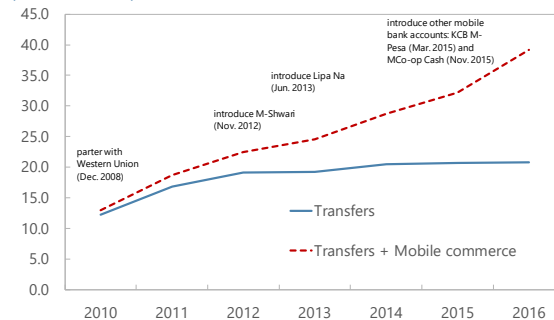
Kenya: Fixed Broadband Subscription, 2000-15
(Per 1000 inhabitants)



Sources: International Telecommunication Union; World Bank; and IMF staff calculations.

A surge of mobile commerce emerged since 2010.

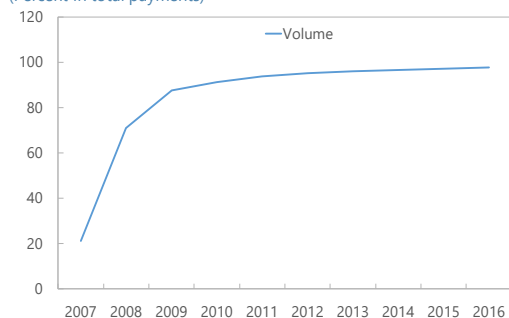
Kenya: Safaricom Mobile Services, 2010-16
(Percent of GDP)



Sources: Communications Authorities of Kenya; Safaricom; and IMF staff calculations.

Mobile payments have grown rapidly in volumes, but

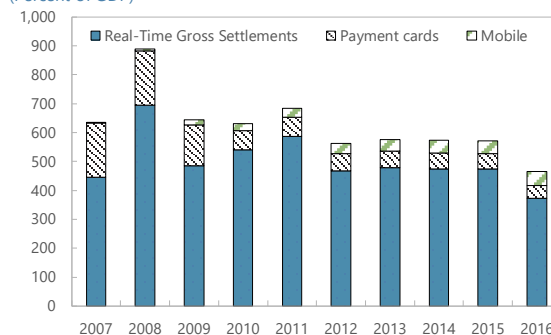
Kenya: Mobile Payments, 2007-16
(Percent in total payments)



Sources: Central Bank of Kenya; and IMF staff calculations. Total payments include real-time gross settlements (RTGS), card payments, and mobile payments.

Real time gross settlements (RTGS) remain the main method of payments in values.

Kenya: Types of Payments, 2007-16
(Percent of GDP)



Sources: Central Bank of Kenya; and IMF staff calculations.

4. **Mobile adoption appears to be developing in parallel with, and not in place of, traditional banking activity.**

- While mobile payments may be replacing credit card payments, mobile money usage overall appears complementary to traditional bank lending. The growth of bank lending to the private sector has slowed significantly since 2015, but this is likely due to other factors, such as bank closures in 2015–16 and the introduction of interest rate controls in 2016. Indeed, the 2016 FinAccess Household Survey suggests that Kenyans are increasingly using a portfolio of different types of financial services—traditional banking, mobile banking, and other forms—and not just one or the other. As such, mobile banking in Kenya has been a means to accelerate financial inclusion at a faster pace than conventional financial deepening would have allowed. Figure 5 shows that mobile transaction growth largely tracked credit growth over 2011–15. Mobile transaction growth continued through the bank credit slowdown. This suggests that mobile transactions could, potentially, act as a substitute during episodes when commercial banks are pulling back credit supply. At the same time, mobile transaction growth appears to be tied to broader economic activity, with a strong drop coinciding with the broader economic slowdown in Q2 and Q3 2017.
- Mobile activity does not appear to be meaningfully detracting from deposit growth, either: While deposit growth slowed somewhat in mid-2015, this also coincides with the bank failures; mobile transaction growth did not accelerate during this period (which might be expected if customers were taking money out of banks in favor of mobile accounts). Moreover, bank deposits still vastly outweigh mobile transactions.

5. **A favorable regulatory environment also contributed to greater financial inclusion.**

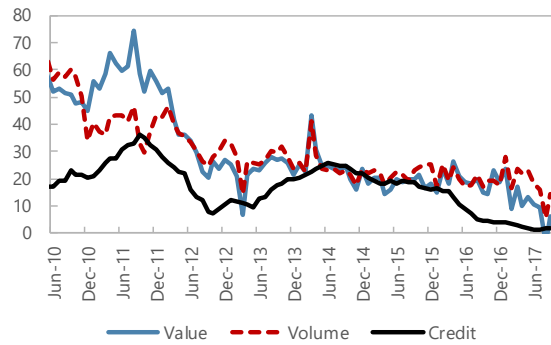
- Mobile network operators (MNOs) were well-placed to reach customers with affordable financial services due to their existing customer bases, marketing capabilities, physical distribution infrastructure (e.g., network agents), and experience with high-volume, low-value transactions (e.g., sale of airtime). Whether this translated into innovation in access depended on the regulatory stance. Kenya has allowed nonbanks to issue electronic money and hold matching value assets in pooled accounts in regulated banks, and the M-Pesa mobile platform there has thrived. Other regulators, such as in Brazil and Mongolia, have been reluctant to allow MNOs to take money in exchange for e-money due to concerns that prudential regulations covering these activities were not yet in place.
- Gutierrez and Singh (2013) show empirically that the regulatory environment matters. They find an enabling legal and regulatory framework to be strongly associated with higher usage of mobile banking for both the banked and unbanked, although supporting frameworks do not necessarily require detailed regulation of mobile banking industries. Key features of an enabling regulatory environment include: certainty (that regulations do not change frequently); openness (to allow new entrants and innovation); an e-contracting principle (to allow for electronic signatures); interoperability (to allow customers to easily switch between providers—e.g., mobile number portability). Gutierrez and Singh also find that a more concentrated banking system is associated with less use of mobile banking services

among the unbanked, possibly due to a lack of competition in key network industries, including banking and telecoms.

Figure 5. Kenya: Mobile Transactions, Credit, and Deposit Growth

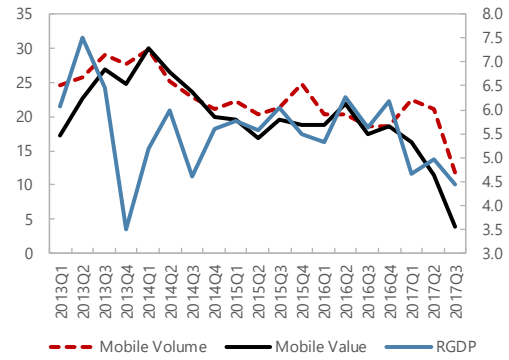
Mobile Transaction and Credit Growth

(y/y)



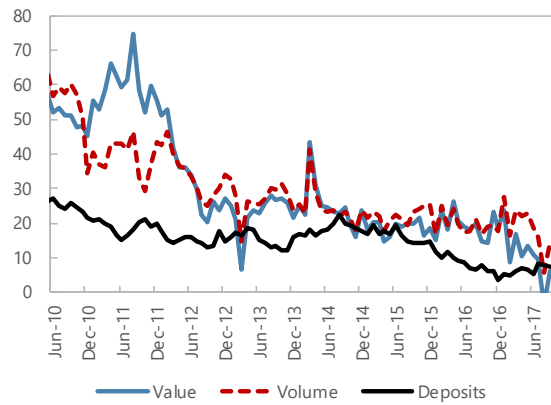
GDP v Mobile Transactions

(y/y)



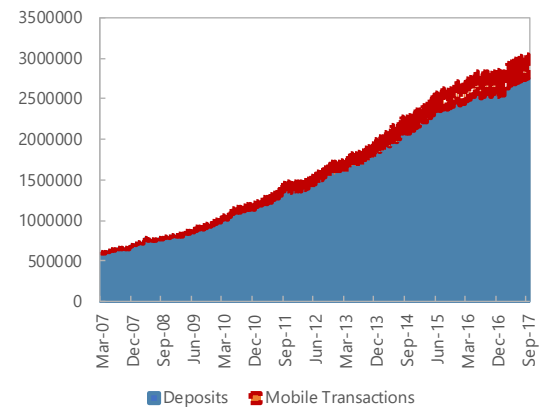
Mobile Transaction and Deposit Growth

(y/y)



Deposits and Mobile Transactions

(Ksh mn)



B. Measuring the Impact of Financial Inclusion on Growth in Kenya

6. **A wide range of literature highlights the positive impact that financial inclusion has on growth.** For example, Beck, Demirguc-Kunt, and Levine (2007) show that financial development disproportionately boosts the incomes of the poorest quintile of a population by reducing income inequality and increasing aggregate economic growth. More recently, Sahay et al. (2015) developed a broad-based financial development index (assessing financial depth, access, and efficiency) that confirmed the positive relationship between financial development and growth. While the benefits of financial deepening begin to diminish beyond a certain level of financial development (as measured by the financial development index) as financial stability becomes more of a concern, most emerging and developing economies, including Kenya, are currently strongly on the benefit side of the tradeoff. Moreover, the tradeoff only pertains to depth; financial access has a positive and linear relationship with growth. This is particularly relevant for Kenya where, as noted above, significantly increased access is not necessarily leading to large gains in deepening, given the low value of mobile transactions.

Growth via Consumption-Smoothing

7. **Financial inclusion helps boost growth through its effects on consumption smoothing and capital accumulation.** Mehrotra and Yetman (2015) show that in countries where households have easier access to instruments for saving and borrowing, aggregate consumption volatility is lower, especially when looking at measures of account ownership and saving at formal financial institutions. Similarly, Sahay et al. (2017) find that financial access allows firms to invest and households to smooth consumption, build capital, and guard against shocks. They also find that, in contrast to credit, other forms of financial access do not adversely affect financial stability and can be promoted until the growth effects fade. This is particularly relevant to Kenya, where much of the advance in financial access and inclusion has been related to non-credit financial services.

8. **A number of time-series data studies show that electronic payments raise growth by stimulating consumption.** Scipartners (2013) compute the penetration of electronic payments by the value of credit card and debit card payments as a share of private consumption for 62 developed and emerging economies for 2004–09 and compare it with per capita income. They find that a one-percentage point increase in electronic payment penetration is associated with a 0.03 percent increase in per capita GDP. Moody's Analytics (2010) looks at the impact of credit card penetration on consumption and growth. The study included 70 countries over 5 years, 2011–15. They found that a one-percentage point increase in card penetration (spending using cards as a percentage of overall consumer expenditures) led to an increase of 0.06 percent in real consumption on average (with 0.11 percent for emerging markets and 0.08 percent for advanced countries). Hasan, De Renzis, and Schmiedel (2013), using 27 European markets over the period 1995–2009, find that migration to efficient electronic retail payments stimulate the overall economy, consumption, and trade.

9. **The link between financial inclusion and growth appears to be particularly relevant in sub-Saharan Africa (SSA).** Deeper financial development is associated with higher economic growth in SSA (IMF 2016). And, per the growth-stability tradeoffs discussed above, most SSA

countries, including Kenya, are well below the inflection point at which rapid financial deepening becomes a financial stability concern.

10. **In Kenya, financial inclusion—and mobile money in particular—has enabled transactions and economic activity.** In an early empirical look at M-Pesa, Mbiti and Weil (2011) find a strong correlation between reported changes in transfer frequency and changes in the amount of money transferred. In other words, a positive relationship between M-Pesa adoption and the frequency of sending or receiving transfers (and so economic activity). They estimate that M-Pesa adoption accounted for nearly the entire increase in the frequency of transfers sent in Kenya over 2006–09. They also find a strong positive relationship between M-Pesa adoption and bank use, formal savings, and employment. Finally, they find a negative relationship with informal savings methods.

11. **Studies suggest that mobile money in Kenya has also helped to smooth consumption, reduce poverty, and mobilize savings.**

- Using data from a large panel household survey taken over three years in Kenya, Jack and Suri (2014) found that economic shocks reduced household consumption for non-users of mobile money by 7 percent, while mobile money users' consumption was unaffected. The better outcomes for mobile money users was linked to the greater remittances they received and their access to a greater number of sources sending these remittances. Mobile money has also increased household risk-sharing in Kenya by reducing the transaction cost of remittances: In the face of a shock, user households are more likely to receive remittances, to receive a larger number of remittance transactions, and to receive a larger total value of remittances than non-users. Users are 13 percent more likely to receive remittances, on average amounting to 6 to 10 percent of annual consumption over a six-month period. Jack and Suri (2014) estimate a related welfare benefit of 3 to 4 percent of income, with longer term welfare benefits possibly higher if the dynamics of poverty are driven by random reductions in consumption that lead to persistently low income. This was more evident for the bottom three quintiles of the income distribution, as richer households were able to smooth consumption without mobile services.
- In a follow-up study that used five rounds of household panel surveys, Jack and Suri (2016) found that consumption increased significantly in areas of Kenya where mobile money agent access increased, with the effect on female-headed households double that of the average. Increased agent access significantly reduced general and extreme poverty: The authors estimate that mobile money brought at least 194,000 Kenyan households out of extreme poverty and induced 185,000 women to move into business or retail as their main occupation by more efficiently allocating labor, savings, and risk.
- Along similar lines, a recent study (Cook and McKay, 2015) found that M-Shwari users, who are disproportionately urban and poor, use the platform as a line of credit, to save for short-term needs while increasing access in the future. The study also found that 79 percent of active depositors had borrowed money in the past 90 days to manage short-term cash flow needs.

- Likewise, Gurbuz (2017) found that M-Pesa users made Kenyan households 16 to 22 percent more likely to save for precautionary purposes. M-Pesa users' mean average self-reported monthly savings is equivalent to 15 to 21 percent of average monthly earnings, as a result of a reduced cost of remittances and its impact on savings. This should create the basis for greater investment and, ultimately, stronger growth. Ouma, Odonge, and Were (2017) also found that mobile financial services have a strong impact on the likelihood to save and the amount saved.

Growth via Corporate Credit Access

12. **Studies in recent years have focused on the positive impact of financial inclusion on growth in Kenya via firms' increased access to credit.** Greater access to finance can generate higher growth by reducing costs of corporate finance. Lower costs of entry, lower collateral requirements, and lower interest rate spreads can increase credit availability and corporate sector output. More efficient contracts also lead to a more efficient allocation of funds and so increase total factor productivity. For example, Dabla-Norris et al. (2015) focus on access to credit by small and medium-sized enterprises (SMEs). In the authors' general equilibrium model, financial inclusion is determined by structural features of the economy and three types of frictions: fixed costs of credit entry (participation costs), limited commitment, and asymmetric information (the costs incurred by banks to assess and monitor the creditworthiness of borrowers). The authors find that, for Kenya, reducing participation cost has the highest positive impact on GDP (increasing it by 0.67 percent), although this also increases inequality.³ Morales and Yang (forthcoming) further refine the Dabla-Norris model and calibrate it for Kenya for two years (2006 and 2013). They find that most of the financial inclusion policies introduced by the Kenyan authorities over 2006-13 lowered participation costs, making interregional transfers less costly and encouraging banks to penetrate the SME segment via agency banking and wider branch networks. They estimate that, in a scenario in which participation and monitoring costs are lower and loan-to-collateral ratios are higher, GDP and total factor productivity (TFP) would be 4.7 and 2.5 percent higher, respectively, although inequality would increase.

C. Concluding Remarks

13. **Kenya has become a regional and global leader in mobilizing new technologies to advance financial inclusion, poverty reduction, and growth.** The rapid progress of financial inclusion in Kenya has been a result of a friendly environment for the absorption of information technology, dynamic local banks, and open and stable regulations. Advances in financial inclusion over the past 10 years have allowed Kenyans to reap many of the benefits of financial access at a much faster pace than the typical cycle of financial deepening in low- and middle-income countries. This appears to have been achieved without negatively impacting conventional bank lending and

³ Other model-based country assessments have had similar results. For instance, Townsend and Ueda (2010) find that, in Thailand, financial deepening does not significantly increase contemporaneous growth but does generate welfare gains from improved production efficiency and consumption risk sharing. Greenwood, Sanchez, and Wang (2013) find that, for Taiwan and Uganda, increased financial sector efficiency leads funds to be reallocated to more productive firms, which in turn leads to falling interest rates and capital deepening. The authors find that Uganda could dramatically increase its output if it adopted more efficient financial practices.

deposit-taking activities or financial stability more broadly. Moreover, the impact of financial inclusion on poverty, growth, and welfare in Kenya has been significant. Mobile financial services have lowered the transaction cost of remittances, allowing Kenyan households to smooth consumption in the face of shocks and significantly reducing poverty. Finally, increased financial inclusion has increased access to credit for small businesses by lowering participation and transfer costs. In sum, improvements in financial inclusion have helped set the stage for continued broad-based and inclusive growth in Kenya.

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KENYA: IMPACT OF INTEREST RATE CONTROLS¹

The Kenyan Parliament adopted in September 2016 a law on interest rate controls. The lawmakers' objective was to reduce the cost of borrowing, expand access to financial services, and increase the return on savings. Since its introduction, however, the law seems to have had several unintended negative consequences. These include: (i) a sharp decline in bank credit to micro, small, and medium-sized firms; (ii) a disproportionate hit on lending activity and profitability of small banks; and (iii) reduced monetary policy signaling. These are assessed to have had a significant adverse impact on economic growth and financial inclusion. Such costs are expected to mount over time and, if controls are maintained for much longer, they could hurt financial stability. The staff recommends that the law on interest rate controls is abolished, or at least modified to avoid its adverse effects. Instead, the focus should be to accelerate and deepen the reforms underway that aim to increase competition in the financial sector and improve the functioning of the interbank market.

A. The Law on Interest Rate Controls

1. **A law on interest rates, which was sponsored by a group of lawmakers and received unanimous support from parliament, became effective in September 2016.** The law imposed: (i) a ceiling on lending rates by “banks or financial institutions” at 4 percent above a “reference rate”; and (ii) a floor on interest rates for time deposits, equal to 70 percent of the “reference rate.”² Similar attempts in the past to impose interest rate controls (in 2001 and 2011) had failed. The Central Bank of Kenya (CBK) issued a circular in September 2016 setting the policy rate (CBR) as the reference rate for the purposes of this law. When the law became effective, the CBR was 10.5 percent, implying a deposit rate floor of 7.35 percent and a lending rate cap of 14.5 percent.
2. **Most of the outstanding bank credit to the private sector, at the onset of the law, was above the implied ceiling on interest rates.** The Kenya Bankers Association (KBA) conducted a survey in August 2016, to which 28 of the 40 commercial banks responded. The responders accounted for about 73 percent of the banking sector in Kenya, and were representative across the various banking groups (small, medium, and large), covering at least 2/3 of banks in each group size. The highlights of the survey on bank lending to the private sector (Table 1) were as follows:
 - **On average, about 60 percent of outstanding loans were at interest rates above the cap.** The share was roughly uniform across different bank groups by size.
 - **The share of loans to micro, small and medium-sized enterprises (MSMEs) was significantly higher for small banks.** The overall share of banking sector loans to MSMEs was about 18 percent. However, the share for small banks (about 40 percent) was significantly higher than that of large banks (13 percent).
 - **The average lending rate to MSMEs was broadly uniform across bank groups.** This is somewhat surprising, as large banks have lower costs than small banks, yet charge similar interest rates. This may reflect the market power of the large banks.

¹ Prepared by Emre Alper, Benedict Clements, Niko Hobdari, and Rafel Moyà Porcel.

² The law does not apply on non-deposit taking microfinance institutions (MFIs), Savings Credit Cooperatives (SACCOs), microfinance banks, and mobile money-related financial transactions.

- **The share of consumer loans was higher for the large banks.** This possibly reflects the preference of large banks to provide low-risk, payroll-backed personal loans. Similar to the pattern on loans to MSMEs, rates for consumer loans were roughly uniform across banks of different size.

Table 1. Kenya: KBA Survey Results for Bank Loans to Private Sector

	SME loans		Consumer loans		Share of loans with int. over 14.5%
	Share	Avg. int.	Share	Avg. int.	
Bank Size					
Large	11%	19%	22%	18%	59%
Medium	21%	17%	13%	16%	65%
Small	39%	17%	8%	16%	55%
Average 1/	17%	18%	18%	17%	61%

Notes:

1/ Averages weighted by market share of each bank.

Source: Kenya Bankers Association.

3. **Small banks relied more heavily on interest-earning deposits and paid a higher interest rate at the time of the adoption of the law (Table 2).** This suggests lack of other funding sources for smaller banks to finance their lending operations. On average, the deposit rate floor affected over half of bank deposits, but only about one third of deposits in small banks.

Table 2. Kenya: KBA Survey Results on Bank Deposits

	Savings deposits		Share of deposits with interest less than 7.35%
	Share	Avg. int.	
Bank Size			
Large	57%	6.6%	55%
Medium	71%	7.0%	54%
Small	70%	8.4%	30%
Average 1/	63%	6.9%	53%

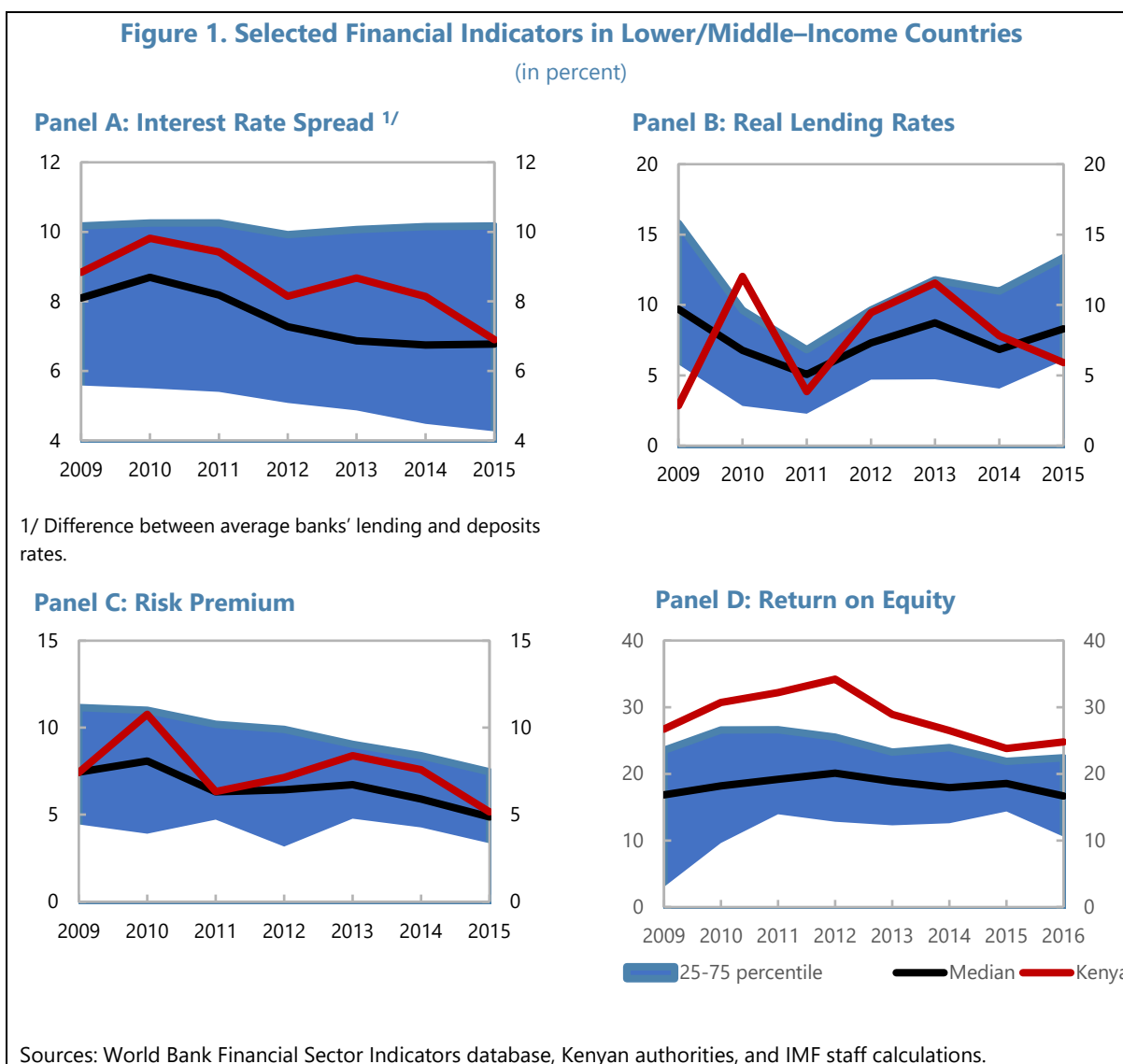
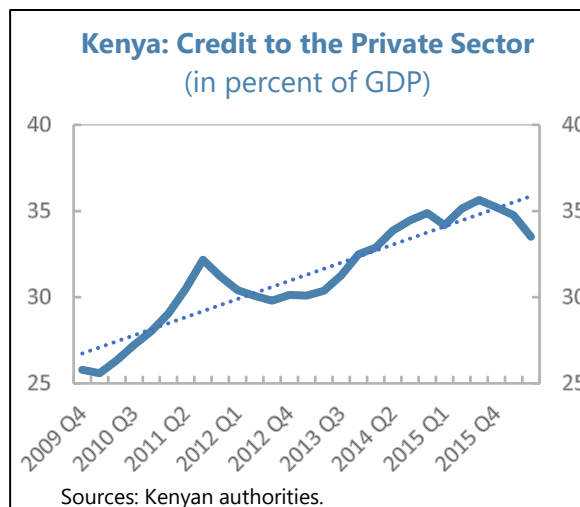
Notes:

1/ Averages weighted by market share of each bank.

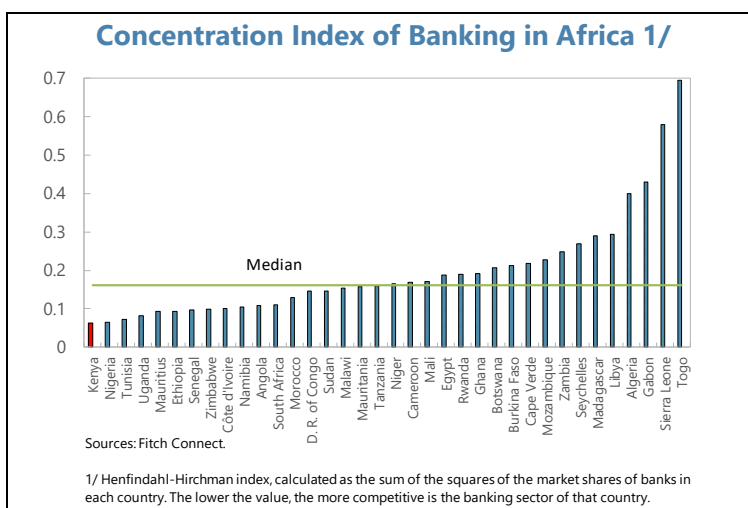
Source: Kenya Bankers Association.

4. **The lawmakers' objective for setting interest rate controls was to reduce the cost of lending, expand access to financial services, and increase the return on savings.** High lending rates were viewed as a source of excess profits for banks, and also as hurting the economy by stifling investment and putting borrowing out of reach for many consumers (e.g., for mortgages and consumer loans).

5. **At the onset of the interest rate controls, however, key indicators on the cost of credit were trending downwards and broadly aligned with Kenya's peers.** This included the spread between bank lending and deposit rates, real interest rates, and the spread of bank lending rates over treasury bill rates (Figure 1, panels A, B, and C). And despite concerns regarding high lending rates, credit to the private sector (as a share of GDP) had been on an upward trend in Kenya over the past decade (text figure). In addition, the profitability of Kenyan banks, as measured by the return on equity, was also trending downward in the run-up to the implementation of interest rate controls (Figure 1, panel D).



6. **In addition, the structure of Kenya's banking sector prior to the introduction of controls suggests a comparatively competitive system.** The level of concentration in Kenya's banking sector, as measured by the Herfindahl-Hirschman index (commonly used as an indicator of the amount of competition in an industry), was the lowest in Africa at the time interest rate controls were introduced in 2016 (text figure).



7. **An accounting decomposition exercise indicates that banks' intermediation spreads had declined significantly between 2002 and 2015 (prior to the implementation of the interest rate controls).** Using banks' balance sheets and income statements for 2014 and 2015, the average intermediation spread between effective deposit and lending rates is decomposed into (i) the interest paid to recover the interest costs of funds deposited as required reserves, (ii) loan loss provisions, (iii) operating costs allocated based on the share of

Decomposition of Interest Spreads: 2002 and 2015

Period	2002	2015
No. of banks	(43)	(40)
Interest earned on loans	18.3	15.3
Interest paid on customer deposits	3.4	7.0
Spread	14.9	8.3
Interest paid to cover required reserves	0.3	0.3
Loan loss provisions/ loans	2.5	1.5
Operating costs/loans	5.9	6.1
Pre-tax profit	6.2	0.4
<i>Memorandum items:</i>		
Return on assets (after tax)	1.4	1.6
Personnel costs (% of operational costs)	...	40.4

Sources: Central Bank of Kenya and IMF staff calculations.

Notes: Data for 2002 from Beck and Fuchs (2004). The decomposition is similar to Cihak and Podpiera (2005). Simple averages based on end period data for 2014-15. Asset size weighted averages would result in intermediation spread of 9.3 in 2015. Further details available at Alper and others (2018, forthcoming).

loans in total assets, and (iv) pretax profit margin on private sector lending.³ The average intermediation spread declined from 1490bps in 2002 to 830bps in 2015. In addition, while overhead costs—about 40 percent accounted for by personnel costs—is an important contributor to the intermediation spreads, the profit margin is not in 2015, a deviation from 2002.

B. International Experience with Interest Rate Controls

8. **Traditionally, caps on bank lending rates have been used by governments for both political and economic reasons, most commonly to provide support to a specific industry to address a perceived market failure.** Over the past several decades, however, interest rate controls have been relaxed in most countries, and now focus mainly on protecting vulnerable borrowers from

³ See for example Beck and Fuchs (2004) and Cihak and Podpiera (2005). Details on data definitions are available at Alper and others (2018, forthcoming).

predatory lending practices. There has been no country in recent memory that has imposed such a high floor on deposit interest rates.

9. **International experience suggests several potential problems with lending caps:**⁴

- **Reduced financial intermediation.** Loans to small borrowers (such as small farmers, MSMEs, and individuals) tend to be riskier and are costlier to manage. Banks are likely to offer less credit to these borrowers when interest rate caps are imposed. Instead, financial institutions reallocate their lending towards the government and large private borrowers.
- **More predatory lending.** As access to bank credit is curtailed, potential borrowers may be forced to turn to informal lenders that charge much higher rates and are not subject to supervision. This can lead to lower banking sector intermediation.
- **Reduced transparency.** Lenders may institute non-interest charges, such as fees, to compensate for lower income from interest rate ceilings. This makes it more complicated for customers to internalize the total cost of borrowing and more difficult to make well-informed borrowing decisions.
- **Elevated risks to financial stability.** Implementation of binding ceilings on lending rates and binding floors on deposit rates can adversely affect the viability of small and medium-sized banks, whose business model relies on attracting deposits at higher interest rates and lending to high cost/high return MSMEs.⁵ This, in turn, can have contagion effects and thus pose risks to overall financial stability.

10. **Specific examples of how these problems have manifested themselves in different countries include:**

- A **withdrawal of financial institutions from the poor or from specific segments of the market**, especially for small borrowers that have higher loan management costs for banks such as women and rural clients (e.g., in WAEMU countries, Bolivia, Colombia, the Dominican Republic, Ecuador, Haiti, Nicaragua, Peru, Poland, and Zambia);
- An **increase in average loan size**, reflecting lower access to small borrowers and larger loans to more established firms after the imposition of the caps (e.g., in Bolivia, Ecuador, South Africa, and Zambia);
- A **proliferation of fees and commissions** (e.g., Armenia, Nicaragua, South Africa, and Zambia);
- **Decreased diversity of products for low-income households** (e.g., France and Germany) and reduced bank competition (Italy); and
- An **increase in illegal lending** (such as in Japan and United States).

C. The Impact of Interest Rate Controls

⁴ See, for example, Campion and others (2010), Cottarelli and others (1986), Hawkins and Khalil (2015), Helms and Reille (2004), Heng (2015), and Maimbo and Gallegos (2014).

⁵ Microcredit costs are high because of the greater delivery costs of small-scale transactions that require face-to-face interaction. In effect, micro-finance institutions use personal contact as a substitute for formal collateral or credit bureaus (see Helms and Reille, 2004; Mbengue, 2013; and Rosenberg and others, 2013).

11. **A survey conducted by the CBK one year after the introduction of interest rate controls showed that controls have had an adverse impact through several channels.** A total of 32 banks participated in the survey, representing over 80 percent of the banking sector in Kenya, covering data through September 2017 (one year since the introduction of the controls). In summary, the survey results showed that there has been a sharp decline in bank credit to MSMEs since the introduction of the controls (especially in the trade and agriculture sectors), and lending activity and profitability of small banks have been disproportionately hit. In addition, as discussed below, the controls have reduced the effectiveness of monetary policy.

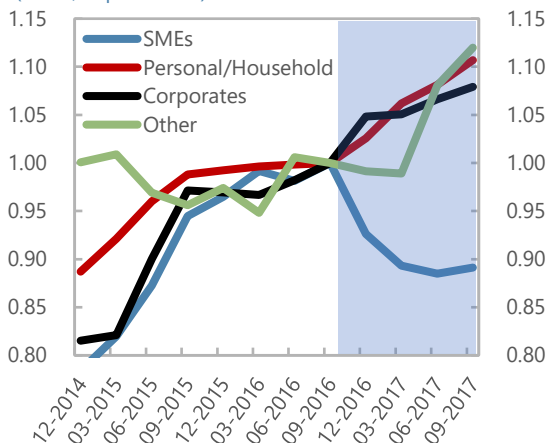
Credit Developments: Adverse Effects on MSMEs and Small Banks

12. **The lending caps have led to substantial changes in the lending behavior of banks:**
- **Collapse of bank credit to MSMEs.** The controls have taken a particular toll on lending to MSMEs, with the stock of credit to this segment dropping by around 10 percent in just one year (Figure 2, panel A). In contrast, lending to other types of borrowers (such as households or large corporates), continued to increase at a rate similar to the one prevailing before the introduction of the caps.
 - **Shrinking of the loan book of small banks.** The outstanding stock of credit of small banks declined by about 5 percent in the 12 months to September 2017 (Figure 2, panel B). Medium- and large-sized banks, on the other hand, have continued to achieve moderate credit growth. While the slowdown of credit started about a year before the introduction of lending caps, it was broadly shared across all bank groups. One explanation for why small banks have been disproportionately hit since the caps is their different business model: they rely more strongly on higher-risk/higher-return borrowers, such as MSMEs. With most of the lending to this segment at rates above lending caps (see Table 1), small banks seem to have restricted credit to these borrowers.
 - **A shift of credit towards the public sector.** Overall credit to the private sector has grown very slowly in nominal terms (growth of 2 percent y/y as of end-October 2017), resulting in a sharp decline in real terms and as a share of GDP. At the same time, lending to the public sector has increased sharply (growth of over 25 percent during the same period) helping finance a larger fiscal deficit (Figure 2, panel C).

Figure 2. Kenya: Selected Financial Indicators

Panel A. Credit Outstanding by Borrower

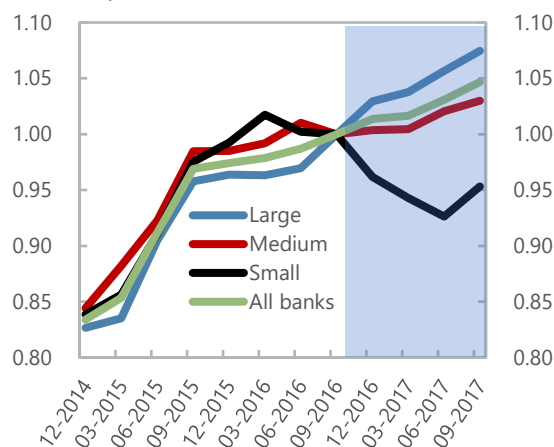
(index, Sep. 2016=1)



Source: Survey of Kenyan banks conducted by the CBK.

Panel B. Credit Outstanding by Bank Size

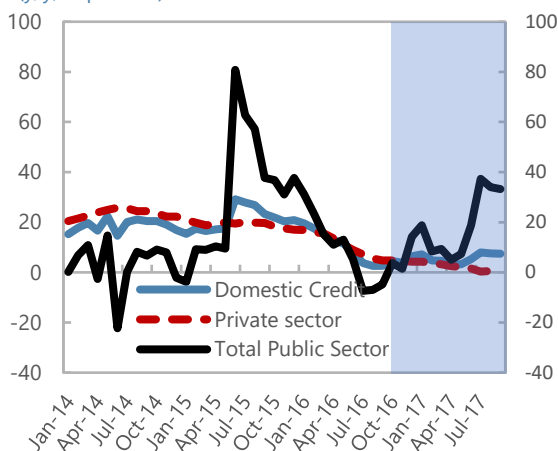
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Source: Survey of Kenyan banks conducted by the CBK.

Panel C. Credit Growth by Sector

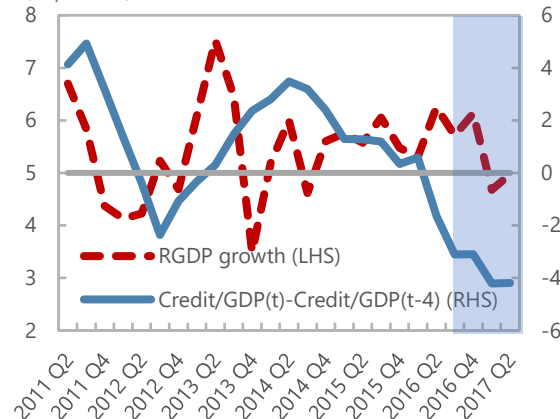
(y/y, in percent)



Source: Survey of Kenyan banks conducted by the CBK.

Panel D. Kenya: Growth and Credit Expansion

(in percent)



Source: Kenyan authorities and IMF staff calculations.

- A simple empirical analysis confirms the apparent structural break in relative credit to MSMEs and relative lending by small banks following the implementation of interest rate controls.** The results summarized in Table 3 show the significant trend reversal in relative credit extended to MSMEs and by small banks. The trend reversal in relative share of banks' lending to the public sector, however, is not statistically significant, even though it has the expected sign.

Table 3. Kenya: Bank Lending Following Interest Rate Controls

(quarterly, Dec. 2014 – Sep. 2017)

	Trend before controls 1/	Trend after controls 1/	Difference
Credits to MSMEs relative to corporate sector	0.23*	-0.59*	-0.82*
Small banks' credit relative to large banks' credit	0.02*	-0.23*	-0.25*
Public sector credit relative to private sector credit	0.49	0.80	0.30

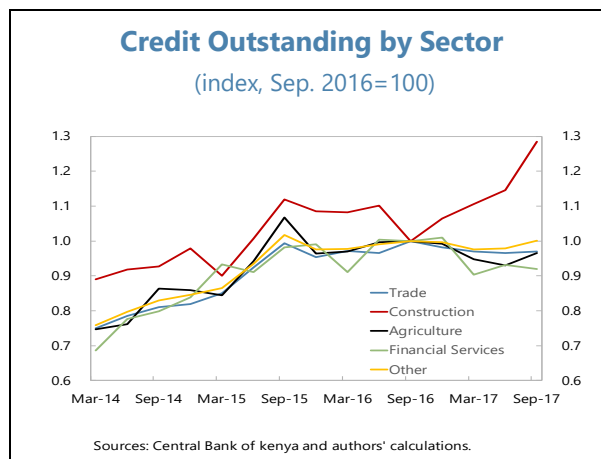
1/ Implementation starts in 2016Q4.

* Denotes significance at 1% level based on Newey-West standard errors.

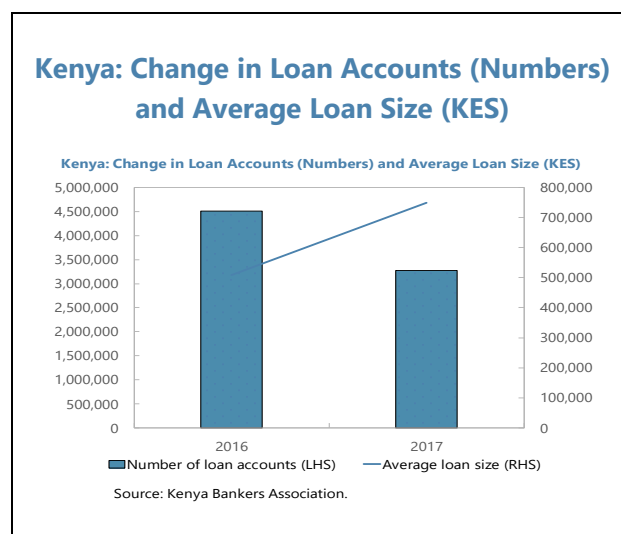
Sources: Central Bank of Kenya and IMF staff's calculations.

- **Across sectors, the reduction in private credit has affected mainly agriculture, trade and financial services.** The stock

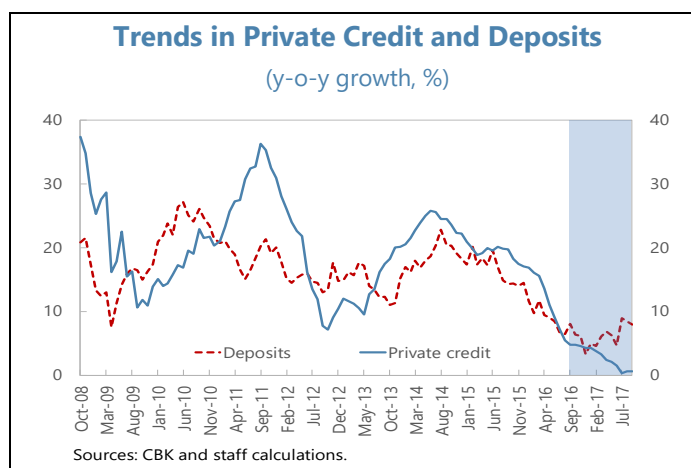
of credit to the trade sector—which is the second largest sector in terms of borrowing and accounts for about a fifth of total credit to the private sector—dropped by about 3 percent. Other small sectors, such as agriculture and financial services (which combined account for approximately 7 percent of outstanding bank credit) also experienced a decline. Meanwhile, credit to the construction sector continued to grow at a very rapid pace.



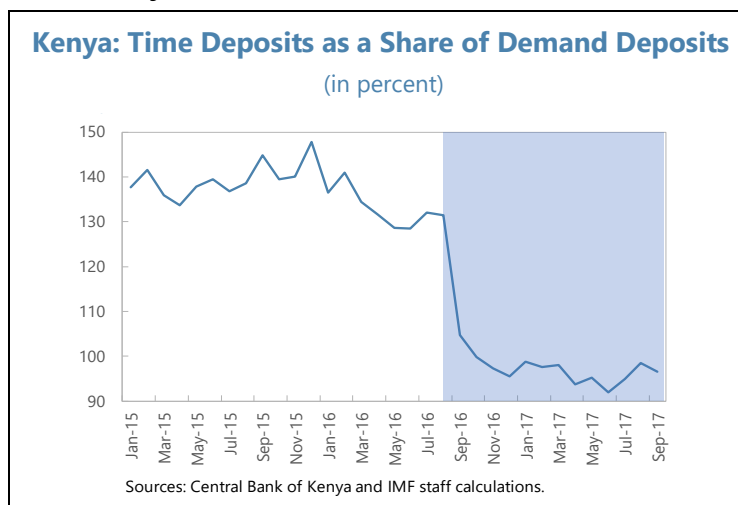
- **Adverse impact on financial inclusion.** The caps have contributed to a reduction in the number of borrowers since the introduction of the lending caps (by about 20 percent), whereas the average loan size has increased (text figure). There is no evidence that the high-risk borrowers that have been cut off by the banks have been able to find alternative sources of finance, as growth of lending by institutions that are not subject to interest caps (such as micro-finance institutions and SACCOS) has remained broadly unchanged. The number and value of mobile loans has continued to increase, but at a slower pace than before the introduction of the caps.



- Trends in the growth of bank credit and deposits have diverged since the introduction of interest rate controls.** Starting in mid-2014, both deposits and lending by banks began to decline. The two have generally comoved in recent years. But while deposits have staged a rebound since early 2017, credit to the private sector has remained broadly unchanged at about 2 percent y/y over the past several months.



- There has been a significant shift in deposits away from time and towards demand deposits, and a shortening of the maturity of new loans.** The floor on the interest rate for time deposits was intended to increase the return on savings. But it has prompted a sharp decline in time deposits (about 15 percent between September and December 2016), and a commensurate increase in demand deposits that are not remunerated (text figure). The average maturity of new loans has also declined due to the lending caps. A shorter maturity of deposits and loans increases financial stability risks and reduces incentives to borrow to finance investment, thus potentially reducing medium-term growth.

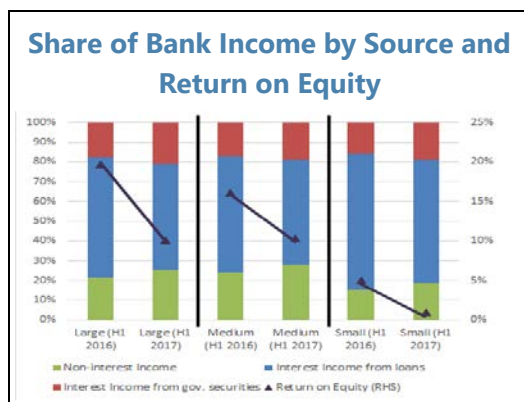


Bank Profitability: A Disproportionate Hit on Small Banks

13. **Banks have been forced to adjust to a new environment of smaller interest margins.** Bank profits are increasingly coming from fees and lending to the government, and less from interest income on private sector lending, reflecting a change in banks' strategies. In a situation where the lending rate has been capped at 14 percent over the past 12 months, investing in long-term government securities yields similar returns and has several additional advantages over lending to the private sector: (1) higher creditworthiness relative to average private borrowers; (2) no need for borrower screening; (3) no administrative costs for loan servicing; (4) no requirement for additional capital for nonperforming loans; and (5) ability to easily sell government securities in the market (a liquidity premium). The migration from lending to the private sector to investment in government securities is similar across the different bank groups. High government budget deficits

and borrowing requirements, together with the floor on deposit rates, have kept interest rates on government paper elevated, further aggravating the effect of the caps on private sector borrowing.

14. **Amid a deterioration of income and an increase in non-performing loans (NPLs), the return on equity (RoE) for banks has declined in the last twelve months.** While all three bank tiers have suffered significant drops in RoE, the controls have again been particularly damaging for the smaller banks. Their profits were already lower than for the other two groups before the controls. Since their introduction, the RoE of small banks fell from 5 percent in mid-2016 to 1 percent in mid-2017 (text figure).



15. **Many of these findings are also supported by the accounting decomposition exercise of intermediation**

spreads for 2017 (text table). Average

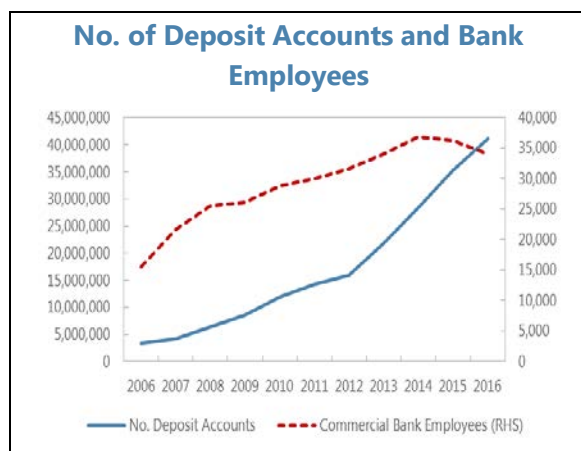
commercial banks' intermediation spreads decline from 830 basis points in 2015 to 660 basis points in 2017. The decline is broadly uniform between large and small size banks. While average effective

lending rates decline, contrary to the intention of the law, average deposit rates also declined with the shift from time deposits to demand deposits. Average operating costs remained broadly stable while average profit margins on private sector lending activities declined further and turned negative.

Size	Total		Large		Small	
	2015	2017	2015	2017	2015	2017
Period						
No. of banks	40	40	6	6	20	20
Interest earned on loans	15.3	11.8	13.7	11.6	14.8	11.6
Interest paid on customer deposits	7.0	5.2	3.6	3.1	7.7	5.9
Spread	8.3	6.6	10.0	8.5	7.1	5.7
Interest paid to cover required reserves	0.3	0.2	0.2	0.2	0.4	0.3
Loan loss provisions/ loans	1.5	2.0	1.5	1.8	1.5	2.2
Operating costs/loans	6.1	6.1	5.9	5.4	7.0	11.0
Pre-tax profit	0.4	-1.8	2.4	1.1	-1.8	-7.9
<i>Memorandum items:</i>						
Return on assets (after tax)	1.6	0.5	3.3	3.0	0.8	-2.1
Personnel costs (% of operational costs)	40.4	38.8	41.8	40.1	41.2	40.3

Sources: Central Bank of Kenya and IMF staff calculations.
The decomposition is similar to Cihak and Podpiero (2005).
Simple averages across banks are reported based on end-period data for 2014-2017. Further details are available at Alper and others (2018, forthcoming).

16. **Banks have made several adjustments of their business models to adapt to the new environment and reduce costs.** Commercial bank staff in 2016 was reduced by around 6 percent from a year earlier, accelerating a trend that started since 2015 (text figure). In parallel, banks have changed their customer relationship strategies, relying more on digital channels to reduce costs and overhead.

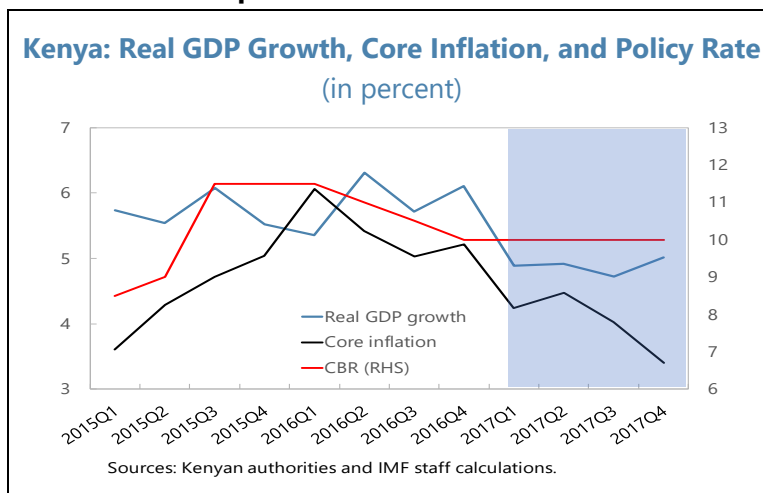


Reduced Monetary Policy Effectiveness

17. **The introduction of interest rate controls has constrained the ability of the CBK to adjust the policy rate in response to economic developments.** Prior to the introduction of

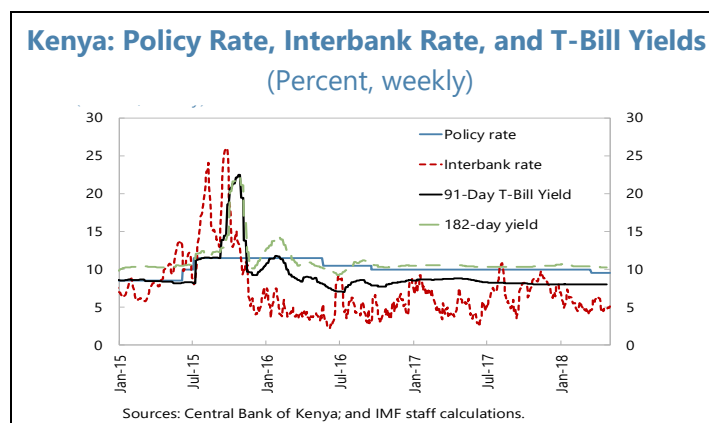
interest rate controls, the CBK had been changing the policy rate (CBR) with respect to developments in inflation and growth. Specifically, it increased the policy rate when core inflation moved above the mid-point of the inflation target range (5 ± 2.5 percent) and/or growth accelerated above potential, and lowered the policy rate when core inflation and growth moved in the opposite direction (text figure).

Since the introduction of the caps, however, until March 2018 the CBK kept the policy rate unchanged at 10 percent, despite lower growth and core inflation falling to $3\frac{1}{2}$ percent in October 2017. The concern was that a lower policy rate would ration a greater share of high risk/high return borrowers, exacerbating the credit constraints on this group of borrowers, thus ending up tightening (rather than loosening) credit conditions. In March 2018, the CBK changed the CBR for the first time since controls were introduced, cutting the rate by 50 bps to signal its accommodative stance, but in doing so noting the potential for perverse outcomes.



18. **Liquidity conditions have been looser in recent months than indicated by the policy rate.** Since the

introduction of the law on interest rate controls, the interbank interest rate has averaged about 6 percent (or 400 basis points lower than the policy rate). Excess liquidity has kept 91-day treasury bill rates between 150-250 basis points below the policy rate since September 2016. The interbank rate has also been very volatile during this period, ranging between 2.5 and 11 percent (text figure).



19. **The significant difference between the policy rate and interbank interest rate, as well as the high volatility of the latter, have undermined the signaling role of the policy rate.** The implementation of a forward-looking monetary policy framework requires that the central bank sets the policy rate to signal the stance of monetary policy, and intervene as necessary, to keep the interbank rate within a narrow corridor around the policy rate (Box 1). In the presence of interest rate controls, however, steps to realign the interbank and policy rates at the current juncture would likely result in premature tightening of monetary policy in Kenya.

Other Potential Adverse Effects of the Interest Rate Controls

20. In addition to the adverse effects from the new law on interest rate controls discussed above, there are other potential ones, for which there is either no information available, or it is too early for the controls to have a visible effect. These include:

Box 1. Policy Implementation in Forward-Looking Monetary Policy Frameworks

Central banks with forward-looking monetary policy frameworks use the policy rate to signal the stance of monetary policy. Such central banks actively steer liquidity conditions in the market either by relying on central bank standing facilities, or through open market operations (OMO), including FX interventions, to keep interbank rates (usually short-term) close to their policy rate (CBR) within a relatively narrow corridor.¹ Through the corridor, the central bank is able to generate a more effective policy signal as market rates closely track the CBR. In doing so, central banks influence both longer-term money market rates and the interest rates used by banks and other financial intermediaries in their transactions with the wider economy.

The rationale for the corridor is to encourage banks to manage their liquidity primarily in the interbank market rather than using the central bank as an intermediary. The width of the corridor is important: corridors that are too narrow or too wide tend to discourage interbank trading. This tends to dampen market and yield-curve development, weakening the transmission of interest-rate based monetary policy. In most countries, the corridor is within ± 200 basis points (Text Table).

Total Width	Countries	Type
50bps	Australia, Canada, Chile, Israel, Malaysia	Symmetrical
100bps	Egypt, New Zealand, Singapore, South Africa, Tunisia, Sweden, Switzerland, Thailand	Not all symmetrical
200bps	Bahrain, Jordan, Morocco, Oman, Czech Republic, pre-2007 ECB, Bank of England, Hungary, India, Korea	Mostly symmetrical
More than 200bps	Azerbaijan, Bolivia, Brazil, Ghana, Iraq, Poland, Qatar, Turkey, Uganda	

Source: IMF ISIMP database.

The way a corridor system is used by a central bank may vary depending on market and macroeconomic circumstances:

- **External conditions.** If surplus liquidity emerges (for example, if the central bank is buying FX to lean against exchange rate appreciation), it could allow short-term interbank rates to decrease to the floor of the corridor, as this will encourage market participants to invest in FX-denominated assets, and so help in leaning against appreciation. Conversely, if there is a shortage of liquidity (for example, if the central bank is selling FX to lean against exchange rate depreciation), the central bank could allow short-term interbank rates to increase to the ceiling of the corridor, as this will discourage demand for FX. In both cases, a change in short-term interbank rates would be engineered without any change to the CBR. Clear communication of such actions is required by the central bank to help the market interpret its policy signals.
- **Market segmentation and market stress.** Under conditions when there is increased segmentation in the interbank market, i.e., when “liquidity-rich” banks do not lend to banks facing liquidity shortages (e.g., due to increased perception of *counterparty risk*), the corridor width could be narrowed. Indeed, since 2007, advanced economy central banks reduced the width of the corridor temporarily to reduce the spread in short-term rates. Narrowing the corridor is a temporary policy response, but important for use during periods of financial stress and increased counterparty risk among banks.

¹ An interest rate corridor (“corridor”) is a system for guiding short-term market interest rates (IBR) towards the central bank target/policy rate (CBR).

- **Lower quality of bank services.** To deal with a squeeze in their profitability, smaller banks could be forced out of some markets, while larger banks may close marginal branches; both factors would reduce competition and the provision of banking services to the population.
- **Fiscal costs.** The decline in overall profitability of the banking sector has reduced corporate income tax receipts. In addition, any resolution of banks severely affected by the controls could imply some fiscal costs.
- **Greater dollarization.** To avoid the interest rate controls, banks may encourage foreign currency deposits and switch to foreign currency lending, which in turn would increase exchange rate risks for the financial system.⁶ Indeed, there is preliminary evidence that foreign currency deposits, which had been declining before the introduction of the caps, have started to grow.

D. Gauging the Impact of the Interest Rate Controls on Growth

21. **Several studies find that credit and economic growth are positively correlated and the direction of causation is from credit growth to economic growth.** Garcia-Escribano and Han (2015), for example, explore the contribution of credit growth (corporate, consumer, and housing credit) to output growth in emerging market economies. They find elasticities of GDP growth to private credit growth ranging from 0.02 for corporate credit, to 0.07 for consumer credit, and as high as 0.2 for housing credit.

22. **Estimations for Kenya suggest that the elasticity of GDP growth to credit growth is broadly similar to that in other studies on emerging market economies.** Specifically, we used quarterly data from 2000Q1 to 2016Q3 under three different specifications: a static specification, an autoregressive distributed lag specification, and a VAR specification. We include lending rates to proxy credit conditions as control variable in each specification. We also control for global liquidity conditions and risk aversion by including the three-month LIBOR rate in US\$ and the VIX index. We find that a 10-percentage point rise in private credit growth increases output growth by 0.6 to 1.8 percentage points, depending on the specification, in line with estimates from the literature.⁷

23. **The interest rate controls are estimated to have had a significant adverse impact on Kenya's economic growth.** Assessing the impact of interest rate controls on GDP growth is difficult to ascertain with precision. The first difficulty is that there is uncertainty on the effects of the controls on credit growth. The second difficulty is what elasticity to use for assessing the impact of credit growth on GDP growth: as discussed in the previous paragraph, our estimates range between 0.06 and 0.18 in Kenya.⁸ With credit growth at about 2 percent y/y as of end-October 2017, compared to an average growth of credit of about 20 percent between 2008–16, these estimated elasticities imply that the lower rate of credit growth has had an adverse impact on GDP growth of between $\frac{3}{4}$ – $2\frac{1}{4}$ percentage points. However, not all this difference can be attributed to the caps on

⁶ Deposits and loans dollarization have remained stable since the early 2000s in Kenya, currently considered as having a "medium" degree of dollarization. The share of foreign currency deposits in total deposits and foreign currency loans in total loans is about 20 percent. See Mecagni and others (2014).

⁷ Estimation results are available from the staff upon request.

⁸ Analysis done by the Central Bank of Kenya suggests a similar elasticity range (between 0.11 and 0.17) Central Bank of Kenya, 2018).

banks' lending rates, given that credit growth in Kenya had been slowing since mid-2014, well before the introduction of the interest rate controls.

- One way to separate the impact of the controls on credit is to look at the divergence in the growth of bank deposits and credit since the introduction of lending caps. As discussed earlier, credit growth has remained low in recent months, despite a rebound in bank deposits. In the past, the correlation between deposits and lending growth rates has been very high (about 0.9). Putting these two effects together, we assess that the impact of credit controls on growth under these assumptions over the past 12 months in the range of $\frac{1}{4}$ – $\frac{3}{4}$ percentage points.
- Another approach is to look at the decline in credit to MSMEs, which as discussed earlier is clearly related to interest rate controls. Specifically, credit to MSMEs, which accounted for about 17 percent of overall bank credit to the private sector in Kenya (Table 1), has declined by about 10 percent in the 12 months since the introduction of interest rate controls (Figure 2). This compares to a growth of about 5 percent y/y before the introduction of interest rate controls. Using the same range of elasticities of credit growth on GDP growth as above, a “normal” credit growth to MSMEs would have implied a higher GDP growth of about $\frac{1}{4}$ – $\frac{1}{2}$ percentage points on an annual basis.

Market-Friendly Measures to Lower Lending Rates and Spreads

24. **The level of lending rates by banks and interest rate spreads reflect both the financial market structure and macroeconomic conditions.** Regarding market structure, the degree of competition in the banking sector is especially important, with spreads an increasing function of the concentration of the banking sector. In this context, the decline in banks' profitability is likely to deter new investors in the sector. Interest rate spreads are also a reflection of the macroeconomic conditions prevailing in a country: the more stable the interest rates in the interbank market, the lower are banking spreads (Silva and Pirtouscheg, 2015).

25. **Thus, strengthening competition in Kenya's banking sector and stabilizing money market rates are a better alternative than interest rate controls for lowering bank lending rates and spreads.** Indeed, the Kenyan authorities are taking several steps that will strengthen consumer protection and help improve transparency and competition in the banking system. These include: (i) improving information from Credit Reference Bureaus, to allow banks to better identify the risk profile of borrowers and facilitate pricing of credit risks; (ii) strengthening consumer protection to avoid predatory lending behavior by banks; (iii) recent adoption of a law on movable collateral registry that will expand the collateral available against bank lending; (iv) increasing the transparency of pricing by banks of their products, such as the launch of a portal to inform the public on the total cost of various lending products by banks, and the effective interest rate on bank deposits; (v) supporting banks in strengthening their cybersecurity frameworks, aimed at protecting depositors and reducing banks' costs from data breaches; and (vi) working with banks towards improving their business models, including greater focus on customer service.

E. Concluding Remarks

26. **Kenya's interest rate controls are among the most drastic ever imposed.** Two aspects stand out. First, no country, at least to our knowledge, has imposed a floor on the interest rate for all

time deposits, the majority of which carried an interest rate below the established floor. Second, no country—at least in recent experience—has imposed a cap on lending rates that is as stringent as the one applied in Kenya. Over the past several decades, interest rate controls have been relaxed in most countries, and now focus mainly on protecting vulnerable borrowers from predatory lending practices. In contrast, about 60 percent of loans in Kenya at the time of the law on interest rate controls were above the cap set by the law.

27. **The law on interest rate controls has had several unintended and negative consequences.** The lawmakers' objective in adopting the new law on interest rate controls was to reduce the cost of lending, expand access to financial services, and increase the return on savings. However, since its introduction in September 2016 the law seems to have contributed to: (i) a sharp decline in bank credit to small- and medium-sized firms, especially in trade and agriculture; (ii) reduced financial inclusion; (iii) a disproportional hit on lending activity and the profitability of small banks; and (iv) reduced monetary policy effectiveness.

28. **The cost of these adverse effects is expected to mount over time, undermining the authorities' objectives for inclusive and sustained growth and for financial stability.** The adverse impact on GDP growth of interest rate controls is assessed to have been significant, at between $\frac{1}{4}$ and $\frac{3}{4}$ percentage points on an annual basis. Given the envisaged fiscal consolidation over the medium term, maintaining strong and inclusive economic growth will require a revival of credit growth, especially for MSMEs. While banks have sufficient buffers to weather the adverse impact of controls on their profitability, if maintained for much longer the controls could hurt financial stability. The authorities are thus advised to abolish the law on interest rate controls or significantly change them to avoid their adverse impact.

29. **International experience suggests that market-based solutions are a better way to achieve the objectives of the law on interest rate controls.** These include, in particular, steps to increase competition and transparency in the financial sector. To that end, the authorities are introducing several reforms consistent with international best practice. Such reforms would help achieve the objectives of the lawmakers without the distortions created by interest rate controls.

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MACRO-FINANCIAL LINKAGES BETWEEN CORPORATES AND THE FINANCIAL SECTOR IN KENYA¹

Kenya's non-financial corporate sector (NFCS) has expanded significantly in recent years, enabled by robust economic growth and benign financial conditions, including access to external debt. Corporate debt has, in turn, increased significantly. However, stress tests suggest that both the corporate and banking sectors are resilient to shocks, including under adverse and extreme scenarios.

1. **This paper assesses linkages between Kenya's Non-Financial Corporate Sector (NFCS) and the financial sector using firm-level data.** In light of the correlation observed between companies' earnings, capital expenditure, and bank credit, developments in the NFCS have significant macroeconomic implications. This study uses both national statistics as well as data from the annual financial report of the listed companies over the period 2000–16. Forty-four companies listed in the Kenyan Stock Exchange (NSE) were included in the latter sample.²
2. **The structure of the paper is as follows:** Section A summarizes the main macroeconomic developments in Kenya and their effects onto the NFCS at large; Section B studies a narrow group of listed corporates and compares the findings to those based on national statistics; Section C conducts three different stress test scenarios to evaluate corporate and banking sector resilience to shocks; and Section D presents the conclusions.

A. Macroeconomic Overview of NFCS

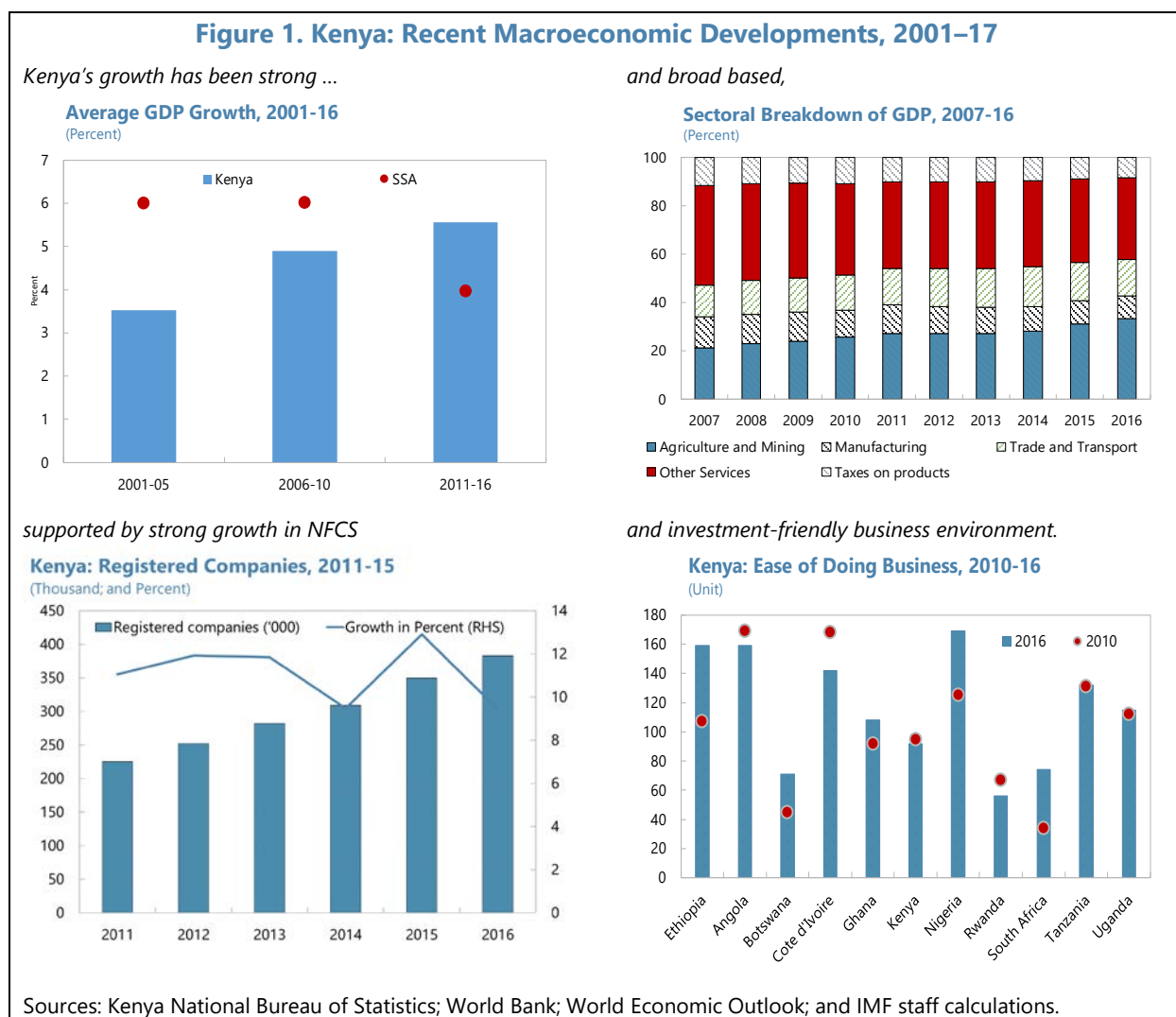
3. **Kenya is the largest economy in the region, with strong regional interlinkages in terms of investment and trade flows.** Compared to the rest of the Sub-Saharan Africa (SSA), Kenya's economy has enjoyed strong growth and is now outperforming the region (Figure 1, panel a). Average economic growth in Kenya was 6.0 percent in the period 2010–14 compared to 4.3 percent in SSA. Kenya's economic expansion has been broad-based (Figure 1, panel b), underpinned by a stable macro-environment and a vibrant private sector. Structural and regulatory reforms enacted in recent years have helped encourage both foreign and domestic investment.³
4. **Kenya has placed emphasis on private sector-led economic growth.** Kenya recognizes the corporate sector's crucial contribution to economic activity as it seeks to transform itself into a newly industrializing, middle-income country as envisaged in the Vision 2030 blueprint. The private sector is viewed as having an important role in expanding employment and reducing poverty.
5. **The corporate sector in Kenya has become a key driver of economic growth.** The sector has become more integrated in the region and beyond, creating opportunities but at the same time

¹ Prepared by James Maina, Rafel Moyà Porcel, Mika Saito, and Kevin Tuitoek.

² The National Treasury has an ownership stake in nine of the companies in the sample.

³ UNCTAD, 2012, "An Investment Guide to Kenya, Opportunities and Conditions" UNCTAD/DIAE/PCB/2012/2 (Geneva: United Nations Conference on Trade and Development).

heightening vulnerabilities. According to the Kenya National Bureau of Statistics (KNBS), the number of new companies registered increased at an average 11.2 percent between 2010 and 2016 (Figure 1, panel c). The bulk of these new registrations remain domestically-owned firms, although the registrations of foreign-owned companies are growing at a quicker pace. The rise in number of enterprises, especially from the Small and Medium Enterprises (SME) segment suggest that these firms are formalizing their operations. Consistent with this trend, there has been an improvement in the general investment environment in Kenya, as depicted by the World Bank's Doing Business ranking, which improved to 80th overall in the world in 2017 (from 90, 108 and 136 in 2016, 2015 and 2014, respectively; Figure 1, panel d).⁴



6. **Over the years, debt has increased in the NFCS, which facilitated the expansion of its assets.** The total debt of firms relative to GDP increased sharply from 2010 (Figure 2, panel a). The debt-to-GDP ratio increased from about 18 percent in 2010 to about 30 percent in 2015. The

⁴ World Bank, 2017, Doing Business 2017: Economic Profile 2017 Kenya (Washington: World Bank Group).

positive outlook for the firm growth, improved financial sector stability, and stable interest rates all facilitated the increase in debt.

7. **Commercial bank lending to the NFCS has expanded significantly as firms increased their borrowing and investment.** Favorable financial conditions and an accommodative monetary policy stance have been supportive of this expansion. A large part of domestic credit goes towards the NFCS, accounting for about 50 percent of total domestic credit extended in 2016. The domestic credit to the NFCS, as a percent of GDP, increased from 20.5 percent in 2010 to over 34 percent by 2016. Meanwhile, NFCS credit has grown at an average of about 20 percent since 2010. This has, in turn, increased the exposure of commercial banks to the sector, with inherent risks to the financial sector and the economy. Commercial, telecommunication, and investment sectors continue to receive the largest share of credit, followed by the construction sector (Figure 2, panel c).
8. **The share of foreign currency borrowing by NFCS has also risen over time as firms take advantage of lower international interest rates.** The share of foreign currency credit in total NFCS credit rose from about 24 percent in 2010 to about 31 percent in 2016 (Figure 2, panel d). Many firms borrowing in foreign currency have “natural hedges” of foreign exchange revenue streams. However, those that have limited or no protection against currency risk are likely to face a higher degree of credit and refinancing risk over the years.
9. **Higher external debt has raised exposure to global financial conditions.** Firms that are more leveraged are likely to face increased debt service costs with a rise in interest rates in international financial markets. In addition, currency depreciation associated with rising foreign interest rates may make it harder for these firms to service their foreign currency-denominated debts if they are not adequately hedged. Such distress in the corporate sector could be transmitted to the financial sector.
10. **The Kenyan Parliament adopted in September 2016 a law imposing interest rate controls.** The law established a ceiling on lending rates and a floor on interest rates for time deposits. While these new interest rate controls are likely to constrain the borrowing capacity of the corporate sector, the present paper figures and estimates refer to end of 2016 data. At that time, the effects of the new law were not yet noticeable. In addition, preliminary analysis suggests that most of the impact of the new law is borne by the SME sector, representing a small share of the total NFCS.⁵

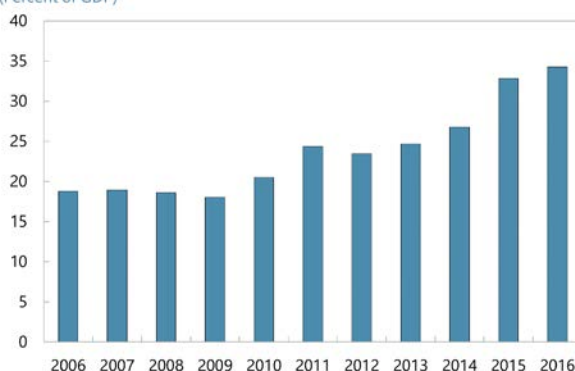
⁵ For a further discussion on the implications of the interest rate controls, see the Selected Issues Paper: “*Implications of New Interest Rate Controls*” by E. Alper, B. Clements, N. Hobdari, R. Moyà Porcel.

Figure 2. Kenya: Credit to NFCS Based on National Statistics, 2006–16

NFCS' debt as a share of GDP grew over time....

Kenya: NFCS Debt, 2006-16

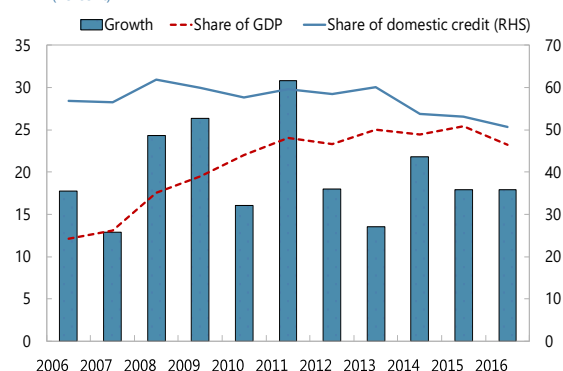
(Percent of GDP)



.... mostly being bank-financed

Bank Credit to NFCS, 2006-16

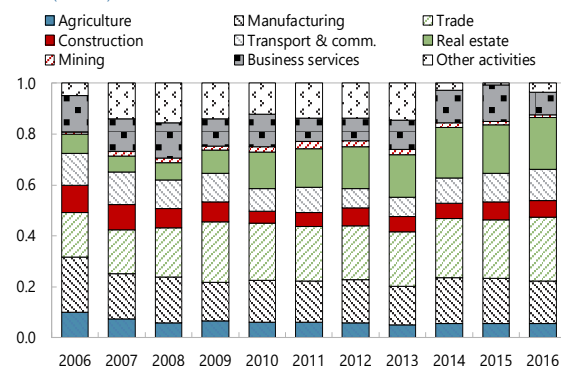
(Percent)



.... with real estate becoming a more important sector....

Sectoral Distribution of Credit, 2006-16

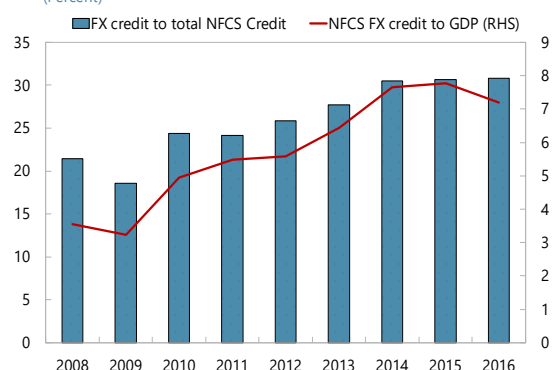
(Percent)



..... and foreign credit increasing.

Credit in Foreign Exchange, 2008-16

(Percent)



Sources: Central Bank of Kenya; and IMF staff calculations.

B. Performance Based on Firm-Level Data

11. **This section analyses a subsample of the NFCS in Kenya using publicly available data derived from the annual financial reports for companies listed in the Nairobi Securities Exchange (NSE).** The number of companies in this analysis varies over time as new firms get listed in the stock exchange while others get unregistered. The firm-level data are comprehensive and allow for more in-depth analysis of the NFCS across different sectors and over time. As our sample size varies, the analysis focuses on the use of performance ratios to facilitate comparison. The sample size for this study, while small, is representative of the large corporates in Kenya, and accounts for around 40 percent of total corporate debt outstanding.

Growth

12. **Firm-level data confirms that listed companies experienced strong asset growth, supporting the notion that the asset expansion allowed for increase in debt levels in the aggregate corporate sector (Section A).** The total assets of listed firms have been rising steadily

over time and have more than doubled since 2010 (Figure 3, panel a). The average firm size, measured by the assets, has increased at an annual pace of 15.8 percent since the year 2000. The past fifteen years has seen over a 600 percent increase in total assets, representing a Compound Average Growth Rate (CAGR) of 14 percent during the period. The electricity companies, with an average share of total assets of 36 percent, have been the dominated sector within the NFCS in Kenya, indicative of the increased public investment in this area of the economy.

13. **The granular dataset of listed firms shows that capital expenditure expanded at a rapid clip.** Listed NFCS maintained a positive capital expenditure trajectory with the ratio of capital expenditure to assets increasing from 5.6 percent in 2000 to about 13.7 percent in 2015 (Figure 3, panel b), but dropped to 8.5 percent in 2016. Similarly, capital expenditure to revenue ratio increased from 7.0 percent in 2000 to 20.8 percent in 2015, but dropped in 2016 to 13 percent. The drops in 2016 are mostly driven by reductions in capital expenditures in the airline and telecom sectors after large companies refocus or restructure activities. Firms also allocated more retained earnings for investment. The share of cash used in investment activities in total revenue increased from 7.4 percent in 2000 to 22.0 percent in 2015. The increase in investment occurred during the period that also witnessed a rise in leverage (see below), implying that the sector financed part of this investment through borrowing. The trend is a reflection of the favorable macroeconomic environment that facilitated borrowing.

Profitability

14. **Kenya's NFCS has registered relatively attractive profitability over the years, although it has declined recently.** The turnover ratio (defined as revenue over assets) has been declining since 2008, and so has profitability (see Figure 3, panels c and d). Return on equity (ROE) (= profit/equity) declined from 13.8 percent in 2000 to 9.4 percent in 2016. Return on assets (ROA) (= profit/assets), a measure of the efficiency with which firms utilize their assets, followed a similar decline from 7.7 percent in 2000 to 3.5 percent in 2016.

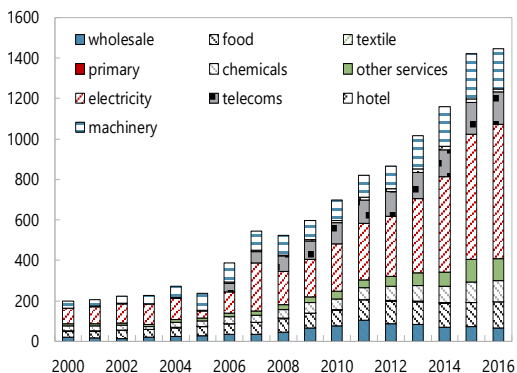
15. **The profitability of Kenya's NFCS still remains above that of peers.** ROE in Kenya was higher than that of selected regional economies and emerging market economies (Figure 3, panel e). Compared against other economic blocks, Kenya's profitability was also higher than average returns in emerging markets in Asia (10.0 percent), Latin America (9.3 percent) and Europe (10.1 percent). Profitability across sectors reveals a significant degree of heterogeneity, with telecoms and textiles being more profitable (Figure 3, panel f). The less profitable sectors include machinery and chemicals.

Figure 3. Kenya: Financial Health of Listed NFCS, 2000–16

The NFCS has expanded rapidly, ...

Asset Size of NFCS, 2000-16

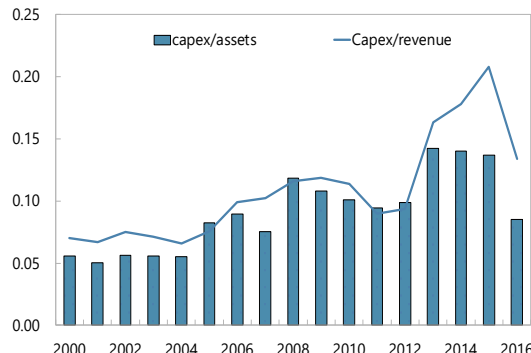
(Billion KShilling)



supported by a sustained level of capital expenditure.

Capital Expenditure, 2000-16

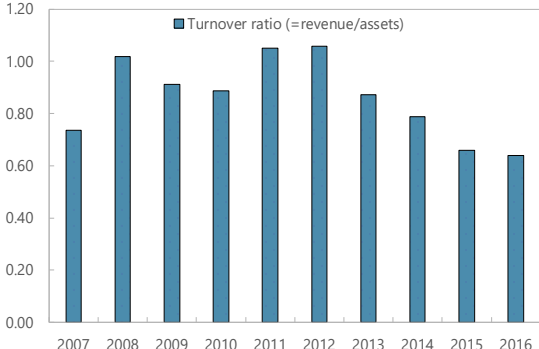
(Unit)



But the turnover ratio has been declining...

Corporate Sector Activity, 2007-16

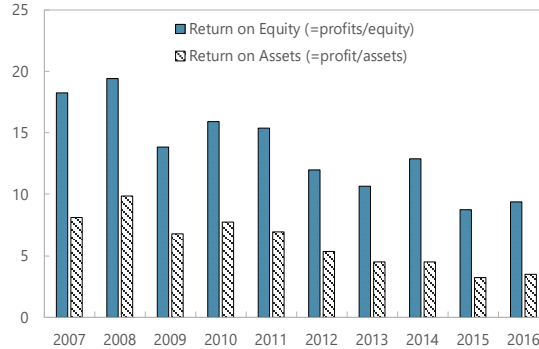
(Unit)



...and so has profitability.

Corporate Sector Profitability, 2007-16

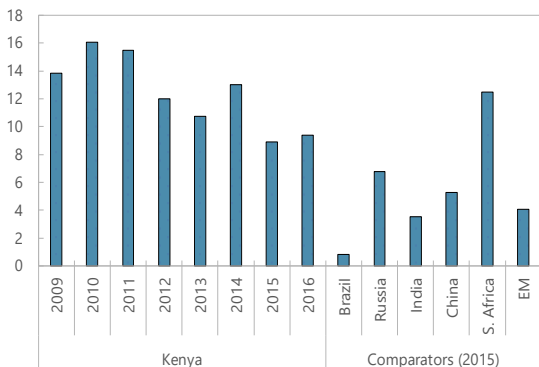
(Percent)



Profitability is still high relative to peers ...

Corporate Profitability Relative to Others, 2009-16

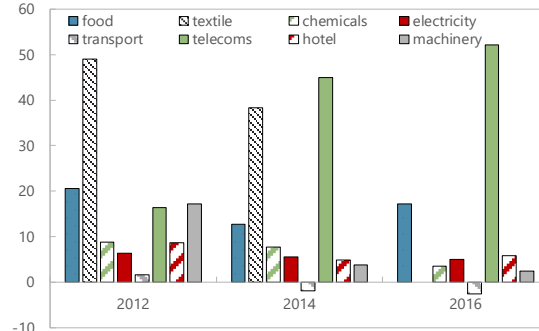
(Percent)



...and there are large variations cross sectors.

Return on Assets, Selected Sectors, 2012-16

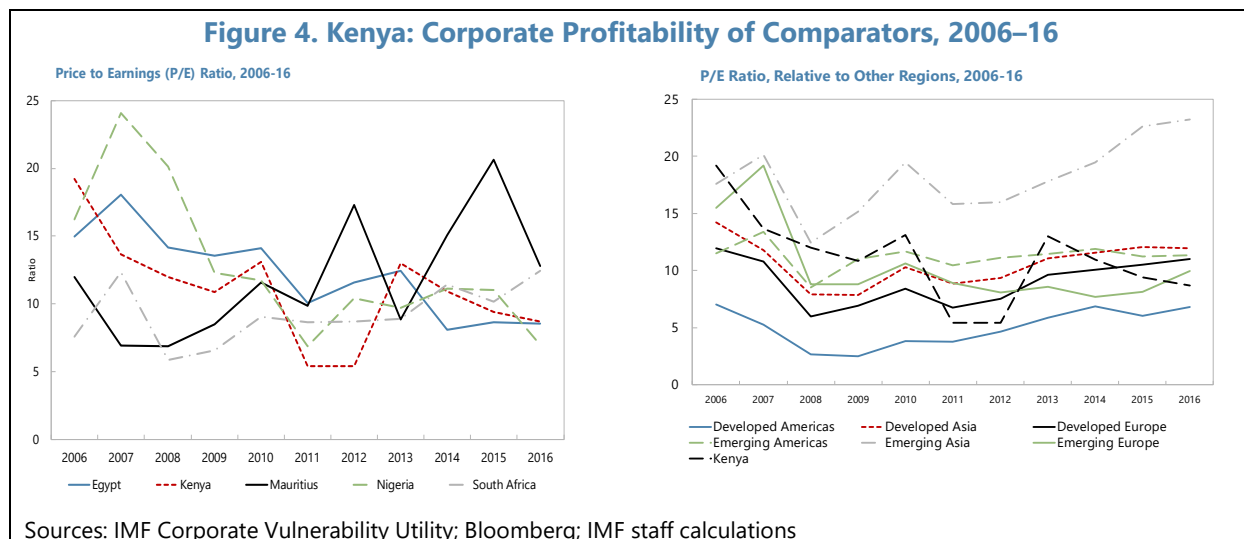
(Percent)



Sources: Annual reports of listed firms; Capital Market Authority; Worldscope; and IMF staff calculations.

16. **Kenya's Price to Earnings ratio (PE) indicates valuations in the same range as regional peers (Figure 4).** Compared with other African peers, Kenya's PE (8.7) in 2016 was higher than that of Egypt (8.6) and Nigeria (6.9), but lower than that of South Africa (12.5) and Mauritius (12.8). These

valuation levels across countries reflect, to some extent, the degree of development of financial markets in these countries.



Leverage

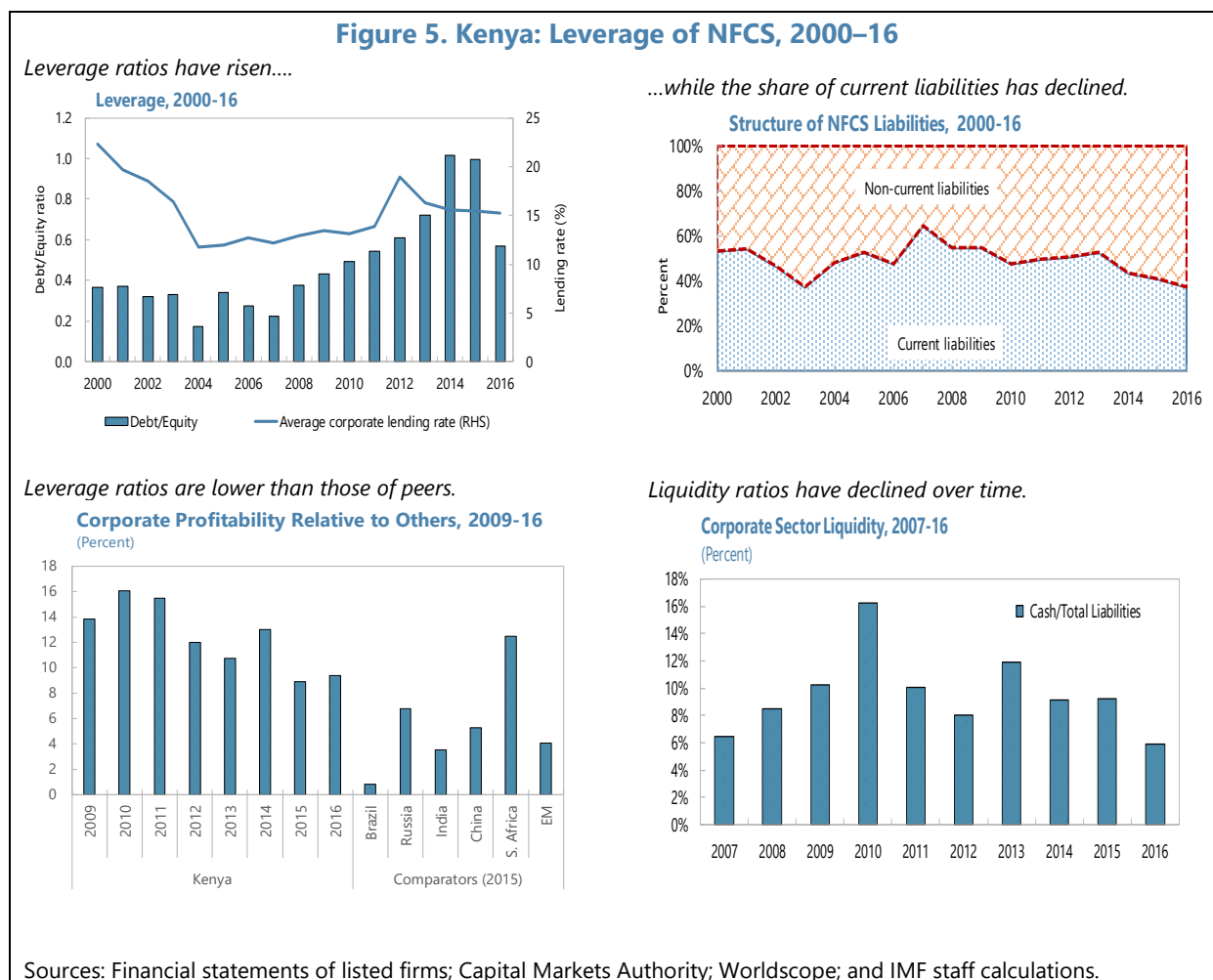
17. **Over the years, listed firms in Kenya have increased their leverage ratios.** The debt to equity ratio, used as the main measure of leverage, has increased consistently since 2007. This followed an extended period of deleveraging (Figure 5, panel a). The leverage ratio increased from about 23 percent in 2007 to about 100 percent in 2015. This rise in leverage was driven by the improved business environment. This resulted in better firm's performance (profitability), a positive outlook by firms, improved financial sector stability, and stable interest rates. In 2016, however, leverage dropped significantly to around 50 percent. Construction, sugar and mining have seen some companies in financial distress, reducing substantially their outstanding credit. Across sectors, most of the buildup in leverage was in the transport, energy, and manufacturing sectors. There are very low leverage ratios in agriculture and insurance.

18. **While total leverage shows the overall indebtedness of the listed NFCS has increased, the maturity structure of the debt has improved, reducing vulnerabilities.** The ratio of current liabilities to total liabilities has been on a downward trend in Kenya, with the ratio falling from 65 percent in 2007 to about 39 percent in 2016 (Figure 5, panel b). The low and declining proportion of short-term debt is a source of strength from a stability perspective (as it makes companies less vulnerable to shocks) and from a developmental perspective (as it demonstrates the ability to raise long-term financing to support investment and growth). Moreover, the level of leverage is lower than peers and emerging market economies (Figure 5, panel c).

Liquidity

19. **Kenya's NFCS has experienced a decline in liquidity ratios since 2010.** This development has improved the efficiency of liquidity management, but at the same time increases vulnerability to

shocks. Overall, the sector's cash to total liabilities ratio declined from a high of 16.2 percent in 2010 to about 6 percent by 2016 (Figure 5, panel d). The decline in liquidity corresponds to a period of lower turnover and profit reduction. It is important to note that liquidity requirements vary across the sectors and/or firms depending on the sector/firm—specific circumstances and nature of their business.

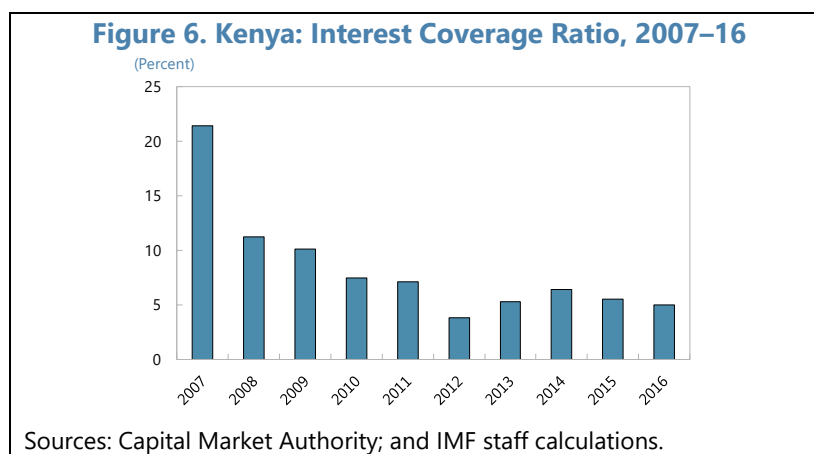


C. Stress-Testing the NFCS

Interest-Cover Ratio

20. **Kenya's NFCS remain relatively well cushioned against shocks.** The Interest Cover Ratio (ICR), defined as EBIT over interest expense, measures the debt servicing capacity of corporates and their ability to weather shocks. In 2016, the average ICR of the NFCS stood at 5.0, well above the threshold of 1.5. The increase in leverage over the years, coupled with reduced profitability, is reflected in a general decline of ICR of the NFCS. While the average ICR is useful for determining how vulnerable the corporate sector is as a whole, special attention should be given to the sectors and/or firms with very low ICR. An ICR below 1 indicates firm distress in covering interest payments

with their current earnings, and can signal the possibility that the firm may fall into arrears to their creditors. From this standpoint, the NFCS appears quite robust, as no sector in Kenya has an ICR below 1.



21. A corporate vulnerability stress test is conducted using the same approach as the April 2015 Global Financial Stability Report (GFSR)⁶:

- We use detailed firm level data for about 40 listed firms for the period 2009 to 2016 from Orbis and the companies' filings to the Kenyan Capital Markets Authority (CMA); the total debt captured in this sample is about \$7.7 billion (or around 40 percent of our estimate of total corporate debt outstanding).
- Of this, in 2016 \$3 billion (or 35 percent) is considered "debt-at-risk", i.e., the total debt of firms where their ICR is less than 1.5.⁷ The debt-at-risk is held by approximately 35 percent of the companies, suggesting no specific concentration in large or small corporates. There has been a progressive increase in the share of debt-at-risk from 2010 to 2016 (Figure 7).

22. The potential evolution of NFCS debt is assessed under baseline, adverse, and extreme scenarios. We apply a combination of shocks to the exchange rate, operating income, and interest expenses. Throughout this exercise, we assume that half of the revenues associated with the credit granted in foreign currency is naturally hedged by the corporates through their sale of goods and services in foreign currency. Under the baseline, we assume a marginal nominal depreciation of the exchange rate against the US dollar of 3 percent. The baseline scenario also includes an increase in EBIT of 15 percent, in line with the nominal GDP growth for 2016. In addition, a moderate increase in interest expenses of 10 percent is assumed, as the stock of debt for corporates goes up.

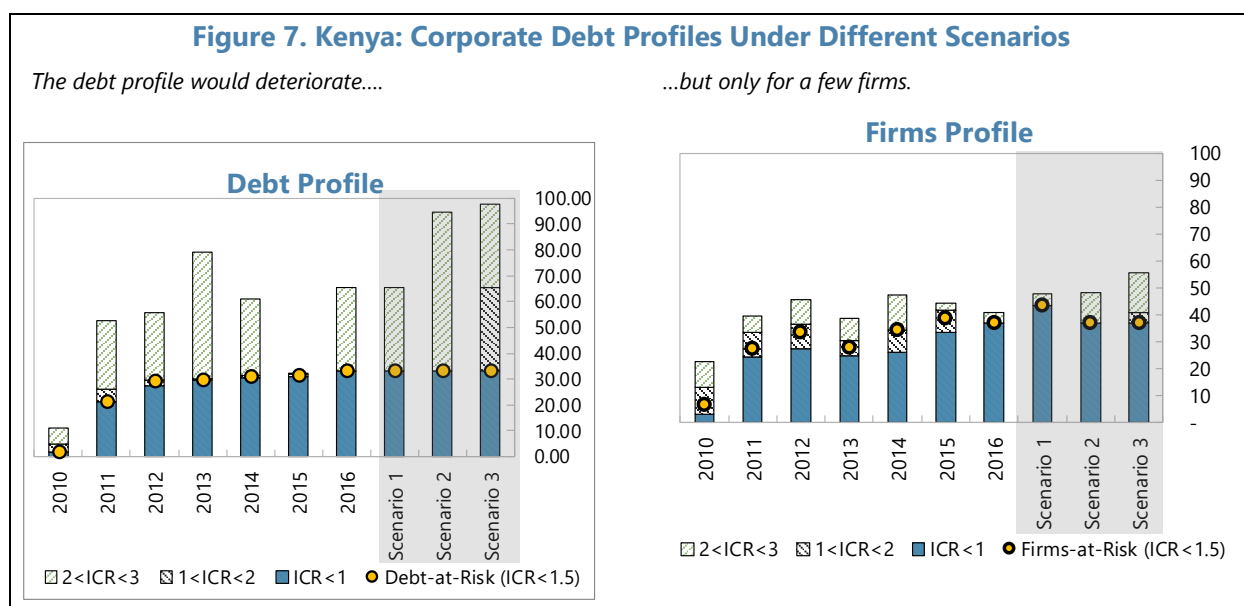
23. For the adverse and extreme scenarios, a combination of shocks to the exchange rate, operating income, and interest expense is applied. The adverse scenario consists of a foreign

⁶ International Monetary Fund, Global Financial Stability Report—Navigating Monetary Policy Challenges and Managing Risks (Washington, April 2015).

⁷ Chow, Julian T. S., 2015, "Stress Testing Corporate Balance Sheets in Emerging Economies", IMF Working Paper No. 15/216 (Washington: International Monetary Fund).

exchange depreciation of 20 percent, an additional 10 percent increase in interest expense, and unchanged operating income. In an environment where inflation is present, keeping nominal operating income unchanged results in a decline in real income. In the extreme scenario, we apply an exchange rate depreciation of 35 percent,⁸ unchanged operating income, and an additional 10 percent increase in the interest rate expense for corporates, bringing it to a 30 percent increase.⁹

24. **Under the adverse and extreme scenario, debt at risk remains low and ICR remains healthy.** While debt deteriorates in the adverse and the extreme scenarios, debt-at-risk (ICR lower than 1.5) remains stable. Companies with their debt-at-risk constitute around 40 percent of the universe and they remain broadly unchanged, despite the shocks in the different scenarios. The debt susceptible to being close to debt at risk (ICR between 1.5 and 3), however, increases markedly.



D. Potential Impact on the Banking Sector

25. **A deteriorating environment for corporates in Kenya would have a negative impact on the banking sector.** A number of assumptions are made to assess the potential impact of these scenarios on the banking sector. First, it is assumed that the banking sector holds the same proportion of debt-at-risk as our corporate sector sample. Second, a *probability of default* of 15 percent is assumed, based on Moody's estimated probability of default for companies with $ICR < 1.5$. Third, to assess the potential impact on capital, *loss given default* of 45 percent is assumed, based on the Basel II guidance on losses given default of 45 percent. Finally, it was assumed that

⁸ A currency depreciation against the U.S. dollar of 30 percent is similar to trends observed in the crisis in the late 1990s.

⁹ Chow (op. cit) points out that a 30 increase in borrowing costs was approximately the median increase in countries during the Global Financial Crisis.

banks' balance sheets would not be directly hit by Kenya Airways' debt, given the strategic importance of the company and the significant ownership share of the government.

26. **Under this set of assumptions, the size of non-performing loans and that of losses/needed capital injection are calculated.** Based on end-2016 figures, NPLs would increase to 12.3 percent in the baseline scenario, 12.9 percent in the adverse scenario, and 13.3 percent in the extreme scenario. Assuming a 100 percent risk weighting on these items, the capital adequacy ratios would decrease, but remain healthy at 18.1 percent in all three scenarios (Figure 8).

Table 1. Impact of the Stress Test Scenarios on the Banking Sector

	End 2016	Baseline	Adverse Scenario	Extreme Scenario
Current claims on private sector (Ksh Billion)	2,315	2,315	2,315	2,315
Implied increase in aggregate NPLs (Ksh Billions) 1/		75	87	98
Aggregate NPLs (Ksh Billions)	211	285.31	298	309
Implied NPL Ratio (percent)	9.1	12.3	12.9	13.3
Implied loss (Ksh billion)		128	134	139
Implied loss rate (percent)		5.5	5.8	6.0
Implied capital (N Billions)	3,493	3,364	3,359	3,354
Implied risk weighted assets (assume 100% risk weighting) (Ksh Billion)	18,693	18,565	18,559	18,554
Capital Adequacy Ratio (CAR) (%)	18.7	18.1	18.1	18.1
Impact on CAR (ppts)		-0.6	-0.6	-0.6

Sources: Financial Soundness Indicators; and IMF Staff estimates.

1/ Assuming banking sector holds the entire debt-at-risk in the sample, with a 15 percent probability of default. Debt-at-risk of Kenya Airways is excluded.

27. **The exercise suggests that bank capital is adequate to withstand these shocks.** To the extent that the government has a stake at some of the companies with debt-at-risk, however, distress in those companies would have implications for the public-sector balance sheet, as well as foreign reserves, depending on the currency composition of the debt-at-risk.

E. Conclusions

28. **Solid economic growth and benign financial conditions have allowed the Kenyan NFCS to expand remarkably.** Albeit weakening in recent years, the performance of Kenya's NFCS remains well above that of comparator countries. The results show that the NFCS has recorded tremendous growth over the years and enjoyed high profitability. A number of firms were able to tap foreign currency denominated debt to help fuel their expansion. The level of profitability, however, remains well above that of comparators, and debt ratios remains below those of peers.

29. **The Kenya NFCS and the banking sector show high robustness under different stress tests.** The different stress test scenarios conducted for large corporates find that corporate resilience—measured by the ICR—is solid and able to withstand the estimated shocks. In line with these findings, the banking sector also shows capacity to absorb these shocks. Under the adverse and extreme scenarios, the banking sector would experience an increase in NPLs, but would not see a severe deterioration of its level of capital.

INTERNATIONAL TAXATION ISSUES IN KENYA¹

The overall parameters of Kenya's current international tax regimen are quite sound, but several important steps could be taken to improve the regime. A transparent treaty policy using cost-benefit analysis to assess the need for a treaty is essential to the integrity of Kenya's treaty network. An "earnings stripping" rule could augment the current thin-capitalization rule to limit earning stripping via interest payment. There are also a number of improvements in transfer pricing policy that can be revenue enhancing.

A. Introduction and Overview

1. **The National Treasury requested that a team from the IMF Fiscal Affairs Department examine Kenya's overall system for the international taxation of business income, from the perspective of facilitating cross-border business and financial activity while appropriately protecting Kenya's tax base.** This assessment is timely, in light of rapidly increasing flows of inbound foreign direct investment into Kenya and the desire to attract more, including through entering into new double taxation agreements; the potential for increases in outbound investment from Kenya, particularly into other EAC countries; the world's current focus on combatting profit shifting and tax base erosion; and the proposed general reform and redrafting of the Kenyan Income Tax Act (ITA).
2. **The overall parameters of Kenya's current international tax regime are quite sound, but several important steps should be taken to improve the regime going forward.** This will be necessary to avoid the likely increase in leakage from the tax base that can be expected as a result of increasing cross-border inbound investment, and, particularly, from a widening treaty network constraining Kenyan taxation. Some positive reforms in the tax law have already been made over the last few years, noted in the report—but more can be done. The mission has not been able to quantify the impact of current issues, or of any possible changes, due to the unavailability to the mission of the necessary microdata. However, it is possible to identify from the legal framework itself several important areas of focus—which discussions with both the authorities at the National Treasury and KRA, as well as taxpayer representatives in the private sector, corroborate.
3. **The report next provides some quantitative context regarding the current tax and investment situation, then addresses the primary issues that the mission has identified.** These include: earnings stripping problems, especially through inter-group management/service fees and, potentially, interest payments; aspects of Kenya's double taxation treaties, particularly with regard to the more recent treaties and those not yet in effect, with observations regarding how the provisions of the new Multilateral Instrument (MLI) could affect Kenya's treaties; and transfer pricing issues.
4. **CIT represents a major revenue source for Kenya.** In 2015 CIT accounts for 4.08 percent of GDP and is the third most important tax in raising revenue following PIT (5.41 percent of GDP)

¹ Prepared by Victoria Perry, Li Liu, and Stephen Shay (FAD).

and VAT (5.02 percent of GDP). While the overall tax-to-GDP ratio has remained relatively stable since 2010, the share of CIT tax revenue in total tax revenue has increased.

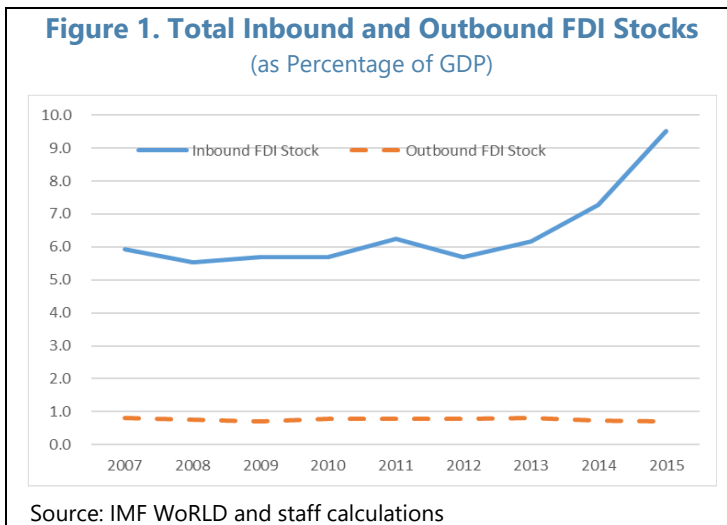
5. **Kenya's 30 percent corporate income tax rate is comparable with most EAC partner countries, and is slightly higher than South Africa (Table 1).** Its revenue yield is the highest among all the EAC countries, suggesting that the CIT in Kenya is relatively efficient in raising revenue within the EAC, as measured by the ratio of CIT revenue as a percentage of GDP to the standard CIT rate. However, its CIT efficiency ratio is seven percentage points lower than South Africa, despite that Kenya has a slightly higher CIT rate. This suggests that there is room for Kenya to benefit from improvement in its CIT regime, including in relation to cross-border tax issues, in order to enhance efficiency and revenue mobilization.

Table 1. Regional Corporate Income Taxes (2015)

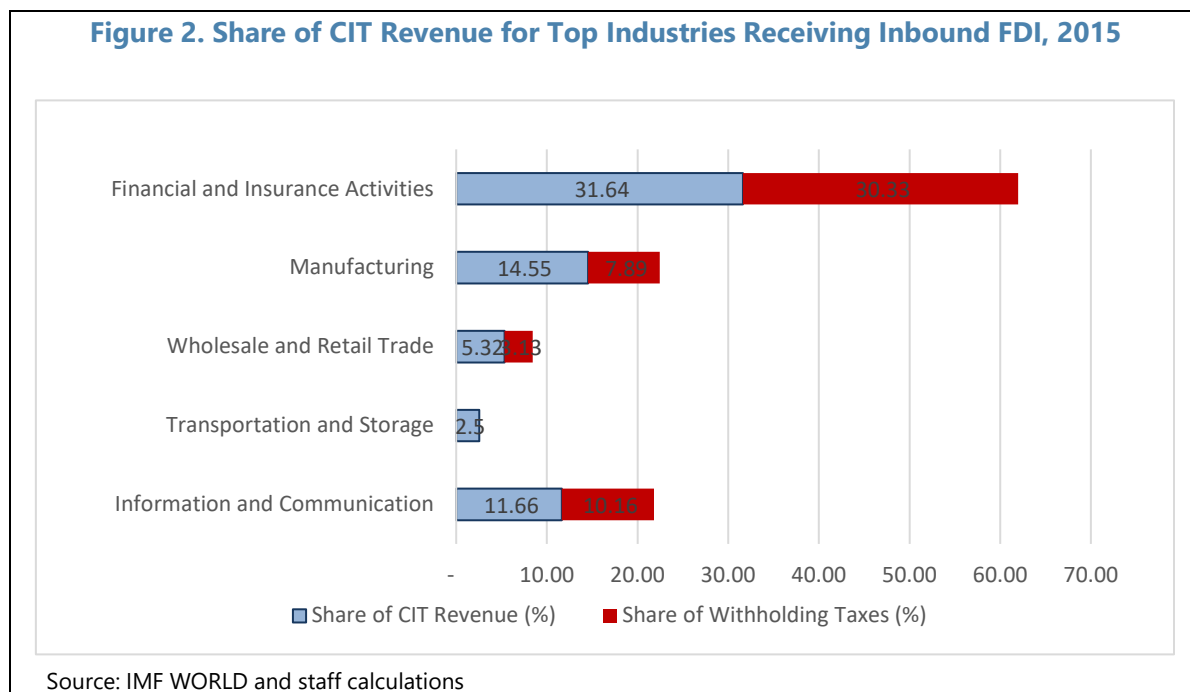
Country	Standard CIT Rate	Revenue as Percentage of GDP	Efficiency Ratio
Kenya	30	3.70	0.12
<i>Other EAC Countries:*</i>			
Burundi	35	2.27	0.06
Rwanda	30	1.41	0.05
Tanzania	30	1.49	0.05
Uganda	30	0.68	0.02
South Africa	28	5.35	0.19

* Source: IMF WORLD and staff calculation

6. **Kenya's international tax policy, in particular its treaty policy, should be informed by the structure of its FDI.** Kenya is a large net capital importer, and growth in its total inbound FDI stock is presently outpacing that in outbound FDI (Figure 1). Kenya is though envisioned to become the regional hub in attracting foreign direct investment into the rest of East Africa. It is therefore key to match the strategic economic development in Kenya with development in its international tax system.



7. **Financial and Insurance Activities, Telecom, and Manufacturing are the largest sectors for inbound FDI, accounting for more than half of total inbound FDI and generating substantial revenue for Kenya (Figure 2).** They are among the five largest sectors in terms of inbound FDI stocks, together with wholesale and retail trade and Transportation and Storage attracting close to 80 percent of total inbound FDI. The three sectors alone account for 57 percent of total inbound FDI. They are also the major sources of CIT revenue in Kenya, with financial and insurance generating around 34 percent of CIT and 27 percent of withholding tax revenue in 2014. Given their importance in revenue mobilization, these sectors would in particular benefit from addressing a number of issues including transfer pricing and earnings stripping that are relevant for taxation of cross-border incomes.



B. Tax Treaties

Introduction

8. **Double tax treaties (DTTs) are concluded to eliminate double taxation and to protect against the avoidance of taxation.** Double taxation arises if both residence country and source country claim taxing rights over the same income. DTTs contain provisions that allocate income between the contracting countries, whereby the source country typically gives up (part of) its taxing rights in exchange, it is hoped, for more FDI, lower investment costs, better access to patents and knowledge-based capital with positive spillovers, or nontax benefits.

9. **In situations where the bilateral economic relations are equal, meaning that both countries serve equally as source and residence country, the limitation of taxing rights will be relatively equally divided.** However, in bilateral relations where one country is characterized as predominantly the source country, the advantages received in exchange from the residence country become more important. Kenya is currently in this latter position with most of its treaty partners and should weigh the cost of lower WHT rates and restricted source taxation of business income against the benefits it receives in return.

10. **There is a need for a Government-wide policy and process regarding choice of treaty partners that preserves a central decision-making role for the Treasury.** Accordingly, the next section of the report addresses best practices in entering into treaties. Subsequent sections review the existing Kenyan treaty network, including treaties that are in the process of adoption, and address specific issues which expose the tax base to revenue loss or which might be modified to conform to current best practices. Specific issues considered include withholding tax rates, source taxation of technical services and offshore sales of interests in immovable property entities, and limitation of benefits provisions. Another section will consider issues raised by the EAC treaty that has not been signed by enough countries to enter into force. Finally, the report addresses opportunities and challenges presented by the opening for signature of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (also known as the Multilateral Legal Instrument (“MLI”).

Importance of a Tax Treaty Policy

Maintaining a Transparent Treaty Policy

11. **Kenya’s international tax policy is manifest in its tax law provisions (generally, the Income Tax Act (ITA)) governing taxation of non-residents (including international investors) on income derived from Kenya and of Kenyan residents on their foreign income.** Under ITA §41, a Kenyan DTT modifies domestic tax law. Accordingly, once entered into, Kenyan DTTs become an integral element of Kenya’s international tax policy. Negotiating DTTs effectively requires the development of a tax treaty policy that aligns DTTs with Kenya’s international tax policy.

12. **A country does not negotiate a DTT in isolation from other DTTs; each treaty negotiation should be understood as part of a country’s overall tax treaty program.** It is a best practice for a country to have an internal “model” DTT that makes its treaty policy transparent and becomes a basis from which to negotiate individual bilateral treaties. The draft East African

Community (EAC) Model treaty of November 11, 2016 (EAC Model Draft) is an excellent step toward such a model. Subsequent to that draft, the OECD released the text of the MLI. The EAC Model Draft should incorporate provisions addressed in the MLI as appropriate for Kenyan policy to conform to the most current best practices. Once a model treaty is developed, it is important to update it periodically to keep it up to date with current best practice.

Using Cost-Benefit Analysis to Assess the Need for a Treaty

13. **Recent thinking about treaties in developing countries has started to focus on the inefficiency of bilateral treaties generally—they are time consuming to negotiate, they absorb additional resources to administer (including processes for refunding treaty-based reclaims of withholding taxes), they tend to be based on one-sided investment flows and result in revenue loss.** Treaties are hard to terminate, even when termination provisions only require the customary six-month notice. Treaties also are hard to change and can stifle tax law reform in the international context. A statutory reform affecting cross-border business can be effectively negated by a single treaty provision.

14. **The inflexibility of treaties once adopted is particularly significant currently as the OECD and UN have proposed the most significant changes in international tax rules in decades and changes may be expected to continue in coming years.** Serious consideration should be given to whether a dramatic expansion of the tax treaty program is the highest and best use of GOK (especially Treasury and KRA) resources currently and over time. Policymakers should consider whether it is possible to achieve the same objectives as a DTT or DTT program through a mix of (i) unilateral measures in the laws governing taxation and investment, (ii) bilateral or multilateral tax information exchange agreements (TIEAs), and (iii) bilateral or multilateral investment protection agreements including sector specific instruments such as shipping and aircraft agreements.

15. **The decision to enter into each specific DTT should be based on an overall cost benefit analysis.** This requires balancing the tax revenue loss from treaty source taxation concessions against gains in the form of increased investment that leads to job creation and increased incomes for residents. The latter point is critical; increased investment is beneficial only to the extent it improves the quality of life of Kenya's residents, and that its benefits not accrue only to a nonresident investor.

16. **Kenyan administration costs.** The cost of administering a DTT program should not be underestimated. In addition to the significant time and cost of treaty negotiations, there are ongoing costs. Implementation of a tax treaty network may require adjustment at several levels, including changing forms and filing requirements for non-residents who claim treaty benefits (it is critical to vet non-resident claims for treaty eligibility). Further, to avoid inadvertent treaty disputes with taxpayers, internal treaty coordination mechanisms are required from local office level up to central policy administration.

17. **Kenyan revenue loss.** For a country such as Kenya that principally is a recipient of foreign investment, each DTT inevitably results in revenue loss. The extent of the revenue loss depends on

the specific terms of the DTT. In general, two broad factors affect the amount of revenue loss from a DTT. First, is the extent to which Kenya's right to tax nonresidents is reduced by a treaty. The key source taxation issues affected by treaties are (i) withholding tax reductions on interest, dividends and royalties, (ii) restricted net-based source taxation of business profits, including under many treaties fees for technical, professional and management services, and (iii) limits on taxation of capital gains, including from offshore sales of stock in companies (especially those holding resource and telecom assets).

18. **Taking the concession of source taxation just described as a given, the second factor affecting revenue loss is the extent that the treaty is susceptible to “treaty shopping” use by investors from a country other than the treaty partner.** While it is possible to employ anti-treaty shopping (or so-called limitation on benefit) provisions, the Fund's experience is that it often is possible to circumvent limitations with sophisticated planning or as a result of limited enforcement capacity. As a practical matter, each treaty should be viewed as a potential “treaty with the world.” It is therefore critical to preserve the right for Kenya in each tax treaty to prevent the abuse or misuse of the treaty.

19. **It is difficult to measure the exact amounts of revenue loss that result from a treaty program, but the magnitude can be material.** Moreover, revenue loss can increase over a long period of time as investors shift investments to the weakest treaty in a country's tax treaty network.

20. **Kenyan gains.** Balancing against inevitable revenue loss from a DTT are potential gains in the form of investment. Importantly, the only gains that should be counted are from investment that would not be made in the absence of a DTT. Before entering into a DTT it is best practice for a country to assess (i) what investment would come from the treaty partner country, (ii) whether the investment would occur without the presence of a DTT, and (iii) whether the investment could be encouraged by an instrument that does not involve the revenue loss of a DTT. It must be recognized that, if asked, investors routinely claim that a DTT is necessary for investment, but such claims should be scrutinized. Comments from the private sector indicate that treaties are not necessarily a material factor; today for example investments into Kenya are routinely routed through Mauritius where there is currently no treaty in force.²

21. **The tax administration advantages of a DTT (such as exchange of tax information and resolution of tax disputes) generally can be accomplished through entry into other agreements (such as a tax information exchange agreement) without the revenue loss accompanying a DTT.** Moreover, it is possible in theory to enter into a limited treaty that includes information exchange and a mutual agreement procedure to address investor concerns about resolving tax disputes. Finally, a bilateral investment treaty often is viewed as helpful to encourage investment, but its arbitration procedures need to be carefully drafted and monitored.

² According to the most recent FDI stock statistics by UNCTAD, the top 10 source countries for inward FDI are United Kingdom, United States, Belgium, China, France, South Africa, Switzerland, Netherlands, Germany, and Italy. The major destination countries for outward FDI are Uganda, Tanzania, Rwanda, France, South Africa, and Zambia. Among these countries, United States, Belgium, Switzerland, Netherlands, and Italy do not have a BTT with Kenya; the EAC internal treaty that includes Rwanda, Tanzania, and Uganda has not been signed yet.

22. **It is a best practice that the Treasury be the final agency arbiter of a recommendation to initiate DTT negotiations with a country.** Treasury should develop clear guidelines for determining when a DTT should be pursued and be charged with undertaking a cost benefit analysis.

Issues in Existing Kenyan Treaties

23. **Kenya has 11 treaties in force, with: Canada, Denmark, France, Germany, India (under renegotiation), Norway, Seychelles, South Africa, Sweden, United Kingdom, and Zambia.**

Under ITA § 41, the Minister (the Cabinet Secretary responsible for matters relating to finance) may by notice cause a treaty to be effective for Kenya, to be brought into force on completion of the requirements under the terms of the treaty.

24. **Kenya has a number of treaties that have been signed, but for which notice has not been given or the treaty partner has not completed the formalities for the treaty to enter into force.** These jurisdictions include China, Iran, Korea, Kuwait, Mauritius, the Netherlands, and Qatar. Kenya also has ongoing negotiations with several countries. Succeeding sections consider areas of potential revenue leakage in the current and proposed Kenyan treaty network.

Withholding Tax Rate Reductions

25. **In general, and with exceptions, Kenya's treaties provide modest reductions in withholding tax rates from the statutory rates (see Appendix Table A.1 for detailed rates).**

Thus, broadly speaking from this standpoint, there is limited risk of revenue loss from these withholding provisions, although viewed from a different perspective, a reduction from a 10 percent to a 5 percent withholding rate on dividends is a substantial percentage reduction. The DTT with the Seychelles limits dividend withholding to 5 percent. Signed treaties (not yet in force) that also have a 5 percent rate are those with Iran, Kuwait and the multilateral EAC treaty. The very old treaty with Zambia includes a zero rate of withholding on dividends, interest and royalties if the item of income is taxed in Zambia.³

26. **As an example of how leakage could occur, the Seychelles presents clear potential for treaty shopping advantage to be taken of the lower withholding tax rate.** A Seychelles Special License Company (SLC) is taxed in the Seychelles at a rate of 1.5 percent and an SLC's dividends, interest and royalties are exempt from Seychelles withholding. Accordingly, a Seychelles company has potential to be used as a conduit company. The Seychelles DTT withholding rates from Kenya are as low as any other Kenyan treaty (dividends 5 percent, interest 10 percent and royalties 10 percent) thus offering clear advantages over direct investment from a non-treaty country and

³ 2017 changes to the ITA provide zero rates of withholding on dividends paid to non-residents from companies or persons operating in special economic zones (SEZs); a rate of 5 percent is provided for royalties, interest, and management and professional fees so paid. It can be difficult to police this rule in regard to companies or related entities where part of their operations is within an SEZ and part is not. This therefore has the possibility to result in greater reductions in CIT revenue than would already occur under the literal terms of the provision.

even other treaty countries in many circumstances.⁴ The Seychelles DTT does not have a limitation on benefits provision to restrict treaty shopping by third country investors. The statutory anti-treaty shopping rule of ITA § 41(5) might apply, as considered below, -- though even an effective DTT would not justify a treaty that does not offer real advantages to Kenya. This example highlights the importance, in negotiating treaties, of learning about the law of the treaty partner. Since relatively little investment exists from Seychelles residents, and there is little possibility of double taxation under Seychelles domestic law, a cost benefit analysis in cases such as this example would be helpful.

27. **A different example of the challenges of managing a treaty program is raised by the 2007 treaty with France.** That treaty provides for a 10 percent withholding rate on dividends, but it also includes a most favored nation (MFN) clause in Article 28 that provides for an automatic reduction in rate if any later treaty with an OECD member allows for a rate on dividends, interest or royalties that is lower than the rate in the treaty with France. Among the treaties not yet in force, the treaty with the Netherlands provides for a zero percent withholding rate on dividends to a 10 percent corporate or pension fund shareholder if a full tax exemption is applicable to the dividends in the Netherlands.⁵ The Dutch treaty includes an anti-abuse paragraph in the article that limits availability of the withholding tax reduction relief if a main purpose was to obtain the reduced rate, but these kinds of principal purpose provisions are very difficult to enforce. Once the Dutch treaty enters into force, this same rate will apply under the French treaty (which also has an anti-abuse rule in the dividend article). As this illustrates, a general difficulty with MFN clauses is that they require continuous monitoring, but often are forgotten.

Fees for Technical, Management and Professional Services

28. **Under the ITA, the withholding rate on management or professional fees is 20 percent—designed to limit reduction in the Kenyan tax base through this means.** It is common practice for global groups to consolidate group service expenses and to charge them out to the group, often with a mark-up (that sometimes is “parked” in a low-tax intermediary jurisdiction). In discussions with KRA and private advisors, there appeared to be a consensus that use of technical services fees paid to nonresidents is one of if not the most substantial source of cross-border revenue leakage.⁶ Even where a reduced treaty withholding rate does not apply on such payment, the reduction of effective tax rate from a statutory 30 percent rate, by virtue of paying a deductible service fee, to the 20 percent statutory withholding rate saves 10 percentage points of tax for the taxpayer. But if a DTT can be used to further reduce the effective rate on management fees to a 10 percent rate, this base erosion tax planning can achieve 20 percentage points of tax savings.

⁴ On the positive side, the Seychelles treaty allows for 10 percent Kenya withholding tax on “management professional or technical fees,” which include payments for agency or contractual services, and preserves Kenyan taxation of gains on the sale of shares of a company that owns directly or indirectly principally immovable property.

⁵ Kenya—Netherlands Treaty, Art. 10(3) and Protocol, Art. XIII.

⁶ The mission was not able to verify this quantitatively given an absence of data availability.

29. **There also will be circumstances where treaties may be used to avoid withholding on these fees altogether.** As an example, under the treaty with Qatar, a Qatar Financial Center (QFC) company that is not subject to tax on income from outside Qatar could be used to charge out services fees. In the absence of a Kenyan permanent establishment, the fees would be exempt from Kenyan withholding tax under the business profits article. The Other Income article of the Qatar treaty does not include a UN-style paragraph 3 that would potentially allow source taxation, so there would be no ability to tax the income represented by these payments (subject only to satisfying a “main purpose” limitation of benefits provision, described above).

30. **To address the technical services issue, it is highly advisable to include a separate technical services article in future treaties that would at least preserve some level of taxation.** The Seychelles Treaty Article 13 is a good model. This approach is increasingly accepted internationally.

Offshore indirect transfers of Interest

31. **“Offshore Indirect Transfers of Interest” (OITIs) have become of increasing concern for the tax base of developing countries.** The issue is the possibility that by selling interests in important domestic assets indirectly (that is, by selling entities that own the assets rather than the assets themselves), capital gains taxation in the country where those underlying assets are located can be avoided. The central conceptual question raised by OITIs is that of how taxing rights should be allocated between the country where the underlying asset is located and others involved in the transaction. This relates to taxing power of developing countries, in their role as ‘sources’ of income, relative to advanced economies in their role as the ‘residence’ countries of the multinationals headquartered there. While this issue has come to the fore in the past, it has become of much greater importance in recent years.

32. **Analysis strongly favors a primary right to tax of the country in which the underlying immovable assets are located, with respect to capital gains realized by their indirect transfer offshore.** In equity terms, this mirrors the internationally generally recognized right in relation to direct transfers of such assets; in efficiency terms, it fosters neutrality between direct and indirect transfers, and importantly provides one way to tax location specific rents—such as those embodied in minerals and petroleum.

33. **Kenya’s domestic law has been recently amended so that it provides for taxation of such indirect transfers in the case of interests related to the exploitation of natural resources.**⁷ Remaining issues include, primarily, the potential negative impact of some of Kenya’s treaties on this right—notably and importantly, among them the signed treaties with Mauritius and Qatar; and consideration of whether the definition of covered interests (now embodied in the term “immovable property”) should be expanded.

34. **There is a fairly common—though not universal—practice for taxation of offshore transfers where the underlying asset is immovable property, defined to include minerals,**

⁷ See ITA section 3(2)(g); ITA Ninth Schedule section.

petroleum and rights and licenses thereto. The practice is embodied in the OECD and UN model tax conventions in Article 13(4), and this concept is what is now codified in the ITA. When more than 50 percent of the value of the asset being directly transferred is derived from immovable property in the source country, the right to tax capital gains (or losses) is, under treaties based on these models, allocated in full to that country; where between 20 and 50 percent of the value is so derived, the taxation is proportionate. It is critically important, however, to note that this important provision will only apply if the right to so tax indirect transfers is not limited in applicable tax treaties to the residence country (as opposed to allowed to Kenya, the source country). As noted, some of Kenya's treaties do allow the source country (Kenya) to impose tax on these offshore sales. In considering how to apply the provisions of the OECD Multilateral Instrument, this is one of the two most important items to add to existing treaties. The proposed revisions would include the needed language in all treaties where both bi-lateral parties agree to do so; Kenya should make sure that when the time comes, this step is taken—which only can be effective, however, to the extent that its negotiating partners will agree.

35. **Expanding somewhat the definition of immovable property also would be appropriate, though less critical.** Article 13(5) of the *UN* model extends the reach of offshore taxation beyond immovable property, allocating to the source country taxing rights to gain on the disposal of shares by a non-resident of that country arising on shares of any company resident in the source country. Interpretation of this provision is frequently that it extends only to shares *directly* held, however, in companies that are resident in the source country, making Article 13(5) rather easy to plan around. A different, more targeted, and perhaps more effective way to expand the reach of offshore transfers to indirect holdings beyond the resource sector would be to *extend the definition of immovable property to reach assets embodying location specific rents that are clearly linked to other national assets*—e.g., telecommunication licenses; rights to operate public power grids or water systems. From an economic standpoint, there is good justification for this. And these types of assets have been at the heart of some of the major disputes over such offshore taxation (e.g., the *Vodafone* case in India). Were this to be done, it would also be important to ensure that, as in the case of resource interests, the ITA itself provides a significant rate of tax on the gains so captured. At present, gains realized on the transfer of natural resource assets/shares are taxed at a rate of 20 percent of the net gain. All other capital gains realized by corporations on the transfer of capital assets, however, are taxed at a rate of only 5 percent. In order to give much effect to an expansion of the provision for offshore indirect transfers to additional important underlying assets, this rate should be equated to that for resource transfers.⁸

Limitation on Benefits Provisions

36. **It now is recognized as a best practice for a DTT to include a limitation of benefits (LOB) provision that restricts use of a DTT to entities that have a sufficient economic nexus with the residence country to justify the source country tax concessions given under the DTT.** This is particularly important for DTTs with countries whose tax systems either do not impose

⁸ In general, the current differential between corporate income, and capital gains realized by corporations—30 percent versus 5 percent—can be a source of tax reduction planning through arbitrage, whether international or domestic.

material income tax, such as Kuwait, Mauritius, Qatar, and the Seychelles, or whose tax systems offer a tax-efficient conduit for income from Kenya to a third country investor, such as the Netherlands and the United Kingdom.

37. **Kenya recently adopted a statutory LOB provision in ITA Section 41(5), which provides that a person that is resident of the other contracting state other than a listed company will be denied the benefit of an exemption, exclusion, or reduction of tax if fifty per cent or more of the “underlying ownership” of that person is held by an individual or individuals who are not residents of that other contracting state for the purposes of the agreement.** “Underlying ownership” is defined broadly to mean an interest in the person held directly, or indirectly through an interposed person or persons, by an individual or by a person not ultimately owned by an individual(s).⁹ Similarly, “interest in a person” is defined to include a share or other membership interest in a company, an interest in a partnership or trust, or any other ownership interest in a person.¹⁰

38. **It is not clear whether “ownership” is measured by vote alone or by vote or value.** To avoid a controversy whether a voting share could be manipulated, it would be wise to clarify that ownership is measured by vote or value, whichever is greater. There is some lack of clarity as to whether Section 41(5) applies to pre-effective date treaties, and this would have to be resolved by Kenyan lawyers. However, the language of the provision appears to support its application to all treaties.

39. **Section 41(5) is both over- and under inclusive.** It does not include a “base erosion” rule that would prevent use of an entity that satisfies the ownership test from streaming payments to an ineligible person. On the other hand, it also would preclude treaty benefits even if the entity in the treaty partner country carries on a substantial business in that country that is related or connected to the income earned in Kenya. The “simplified limitation on benefits” provision of the MLI includes a business nexus exception but does not include an anti-base erosion rule. The MLI also would allow the competent authority discretion to allow treaty benefits consistent with the purposes of the DTT.

40. **Section 41(5) is not a panacea that cures treaty shopping, but 41(5) is nonetheless an effective if somewhat overbroad defense against base erosion.** It will be very important for Kenya to include the MLI LOB provision in its requests for changes to existing treaties, in the MLI process. It would be advisable that Kenya adopt a DTT LOB rule for DTTs with genuine trading partners that would allow real investment to benefit from the treaty where there is sufficient legitimate economic connection between the Kenyan business and the treaty claimant.

EAC Treaties

41. **The EAC multilateral DTT (MDTT) signed in 2010 is intended to promote intra EAC trade and investment.** Because it does not include any LOB provision, it in theory could be used by any third country investor that establishes a company in one of the EAC countries. In general, it

⁹ Or by a person not ultimately owned by individuals, such as a government entity.

¹⁰ ITA Ninth Schedule section

appears that the laws of the EAC states would require payment of reasonably material tax in the event of conduit use of a member country entity, and that this is therefore at this point not too much of a danger. Nonetheless, internal domestic laws can change quickly, so it would be advisable that the EAC MDTT be updated with suitable LOB provisions before it is brought into force. Other provisions, which would conform the treaty to current best practices, such as including authorization for source country taxation of sales of immovable property companies, also should be added. This would seem to be a reasonable path to propose, since the treaty was now drafted some time ago, and best practices in these regards have—particularly within the last two years—moved forward. It would be good to bring the EAC treaty into force in line with current best practice.

Multilateral Legal Instrument (MLI)

42. **The MLI was made public at the end of November 2016 and opened for signature as of December 31, 2016.** It includes 18 articles that each would permit a party to the MLI to modify existing in force bilateral DTTs, *provided that the DTT partner agrees in each case to make the same modification.*¹¹

43. **The treaty modifications provided in the MLI range from the highly technical rules affecting hybrid mismatches in Part III, to the relatively unimportant change to treaty preambles in Article 6, to the much more important LOB provisions of Article 7, offshore sale of immovable property entities provision of Article 9 and mandatory binding arbitration rules¹² of Articles 18–26.** A signatory to the MLI must determine its position in respect of all of the provisions in relation to each of the signatories of in-force DTTs. This is a complex and time-consuming process. The MLI was signed on June 7, 2017, by about 70 countries, and as of January 24, 2018, there were 78 signatories. Kenya has not yet signed, but the convention remains open for additional signatories after that date, and accordingly, it is within the discretion of the GOK to decide whether and when to sign.

44. **The MLI offers Kenya an opportunity to add important provisions to in force treaties, particularly with respect to LOB provisions and taxation of offshore sales of immovable property entities.** These, and other changes, only will be effective, though, with the agreement of DTT partners to accept the changes—so the MLI cannot be viewed as a complete panacea for dealing with DTT revenue leakage. For example, many MLI signatories have reserved upon (ie., not adopted) the provisions of Article 9 of the MLI regarding offshore transfers, discussed above. Thus, even if Kenya were to sign at least some of its treaties will not be effectively amended in that particular regard.

45. **The process under the MLI for determining a country's positions involves at least the following steps:**

- Determine Kenya's position in respect of each substantive article of the MLI. Is the position proposed one that Kenya would like to adopt as part of its treaty policy?

¹¹ A handful of the provisions may be applied to one and not both of the DTT parties.

¹² Kenya provided a reservation to the ATAF Model Treaty provision on mandatory arbitration.

- With respect to each in force DTT, determine:
 - Whether Kenya would include the DTT within the ambit of the MLI as a Covered Agreement (this is discretionary with each country),
 - If so, determine how each substantive article would interact with the DTT in question so as to determine whether to accept application of the MLI rule or opt in to the MLI rule (as appropriate for that article) and/or what reservations if any are needed for Kenya in relation to the article, and
 - What notifications are necessary for each MLI article in relation to the DTT in question.

46. **In general, the substantive articles of the MLI would be favorable to Kenya, or at worst would do no harm.** The LOB and offshore immovable property entity provisions in particular would improve existing treaties—again, in the case of the latter, if DTT partners accept that provision. As discussed above, if the immovable property entity provision is not added to treaties then the statutory change added to the Ninth Schedule of the ITA to achieve these purposes will not be effective, as in any important cases structuring will take place through a DTT that does not include the requisite provision.

C. Transfer Pricing Issues

47. **Kenya faces substantial risks in cross-border revenue leakage from transfer pricing.** Suitable data was not available to quantify this risk. However, it is safe to say that the revenue challenge from transfer pricing issues in Kenya, as in most lower income countries, is large.

48. **The ITA provides an anti-avoidance rule that allows the KRA to adjust transfer prices between related resident and nonresident taxpayers.**¹³ The KRA introduced transfer pricing regulations in 2006, following a loss in the transfer pricing case of *Unilever Kenya Limited v. Commissioner of Income Tax*, in which the court upheld the taxpayer's use of a cost plus method under OECD Transfer Pricing Guidelines to support export sales to Unilever Uganda at a lower price than in domestic sales. The regulations establish a transfer pricing policy that determines an arm's length price. The regulations authorize the KRA to request documentation from the taxpayer evidencing how a transfer pricing method was used to arrive at an arm's length price.

49. **The issue of transfer pricing is not limited to cross-border cases, but can arise in domestic contexts as well.** The Export Processing Zone (EPZ) taxation rules in the Eleventh Schedule provide authority for applying the arm's length principle in dealings between related EPZ and non-EPZ companies. This is a good provision; the statute should be expanded to reach all related party dealings within Kenya, in which profit is shifted in order to reduce Kenyan tax.

50. **Changes to the transfer pricing enforcement strategy would focus more on risk-based analysis.** Both the KRA and tax advisors described transfer pricing enforcement in the past as consisting principally of the KRA requesting information regarding the taxpayer's pricing methodology and testing whether the method was followed. KRA reported that it is seeking to move away from using only such a "manual intervention" approach, and to redesign its process so that information is collected that will allow it better to use risk-based analytics to identify cases for

¹³ ITA section 18(3).

examination. KRA is designing an addition to the tax return disclosure tool that will provide front end focus on information regarding related party transactions. The existing corporate tax return already includes significant information that should permit some initial diagnoses of transfer pricing risk; KRA indicated that this is being done to a considerable extent.

51. **There are a number of improvements in transfer pricing policy that can be revenue enhancing.** First, it is highly advisable to shift away from using a taxpayer's articulated methodology as starting point for enforcement rather than using data to identify transactions that are targets of opportunity. Second, alternative methods, such as profit split, can also help assessing margins of the related counterparty in addition to one-sided methods. Obtaining this information will be facilitated by country-by-country reporting that should become available to Kenya once completion of procedures for the entry into force of the Mutual Administrative Assistance Convention takes place. Third, consideration could be given to use of dispute resolution mechanisms, including the use of streamlined final offer arbitration processes that have been successful elsewhere. This matter will merit further study, as there are various concerns involved.

D. Other Provisions of the ITA

Thin-Capitalization Rule

52. **The ITA already includes an anti-avoidance rule designed to prevent reduction of the tax base through artificially inflating deductible interest costs.** Kenya's rule was introduced in 2006¹⁴ and is in the form of a "thin-capitalization" rule, which restricts interest deductibility based upon the ratio of debt to equity in a company's capitalization. The current thin-capitalization rule has a 3:1 debt to equity ratio¹⁵—companies with ratios in excess of the 3:1 debt to equity ratio are not allowed to deduct interest costs proportional to the excess amount of debt.

¹⁴ ITA sections 4A (a), 16(2)(j) and 16(3)).

¹⁵ This ratio is 1.5:1 for resources companies.

53. **A very good feature of Kenya’s rule is that the restriction is based upon all debt, not just debt owed to a “related party” to the taxpayer.**¹⁶ While it is quite common to apply such rules only to related party borrowing, Kenya’s approach is much preferable—and not unique. Such rules targeting all debt are more effective in restricting excessive corporate borrowing; from an administrative standpoint, anti-abuse rules restricted to related party borrowing are easier to avoid through use of related party guarantees of third party debt and tax planning. Further, the approach of targeting all debt also focuses more generally on the risks for macroeconomic stability that excessive real leverage can cause, regardless of the source of the loans.¹⁷ The ratio of 3:1 is quite generous, however, requiring non-financial companies to hold only 25 percent equity

54. **One possibility for further strengthening Kenya’s international tax regime would be to augment the thin-capitalization rule with an “earnings stripping” rule.** This is the more modern approach—utilized for example by Germany, and recommended under the G20/OECD BEPS Action 4. This approach implements a “fixed ratio” rule that regardless of the debt to equity ratio, limits net interest deductions claimed by a company (or a group of businesses operating in the same country) to a fixed percentage of EBITDA. This ratio is normally set between 10 and 30 percent of applicable EBITDA with 30 percent being more generous. This type of rule avoids problems such as the need to define what constitutes debt (in a world with complex hybrid financing instruments) or to combat the charging of an excessively high interest rate on related party debt. The potential revenue impact of the earning-stripping rule would be easy to quantify, using comprehensive micro-level data for Kenya companies, including both private and publicly traded; this could be obtained from tax returns.

Controlled Foreign Company Rules

55. **As Kenya increasingly becomes a source of outbound investment into other countries, consideration should be given to adding to the ITA rules to prevent the avoidance of Kenyan taxation on portfolio investment income (dividends, gains, interest) from such investments.** These type of anti-avoidance rules are typically known as “controlled foreign company rules,” or the like. At this stage, this is not a critical consideration for Kenya. However, as a major overhaul of the ITA is undertaken, it would be wise to address issues such as this that will become of increasing concern in future.

E. Concluding Remarks

56. **The overall parameters of Kenya’s current international tax regime are quite sound, but several important steps could be taken to improve the regime going forward.** This will be necessary to avoid the likely increase in leakage from the tax base that can be expected as a result of increasing cross-border inbound investment, and from constraints on cross border taxation arising from a widening tax treaty network.

¹⁶ ITA section 16(2)(j)

¹⁷ International Monetary Fund, 2016, “Tax Policy, Leverage and Macroeconomic Stability, Policy Paper”, December, (Washington, D.C.)

57. **A transparent treaty policy that uses cost-benefit analysis to assess the need for a treaty is essential to preserve the integrity of Kenya’s treaty network.** To restrict revenue leakage through payment of inter-group technical, management and professional service fees, future treaties should include a separate technical services article (following the Seychelles Treaty Article 13 model). To limit incentives for treaty shopping, a limitation of benefits (LOB) provision restricting use of a DTT to entities that have a sufficient economic nexus to justify the source country tax concessions given up by Kenya should be included. If Kenya were to adopt the Multilateral Legal Instrument an LOB provision would be added to existing treaties. Many of Kenya’s treaties do not include the necessary provisions to make effective the relatively recent additions to the ITA designed to permit taxation of indirect offshore transfers of interest in Kenyan immovable assets. Finally, the EAC MDTT should be updated with suitable LOB provisions before it is brought into force. Other provisions, which would conform that treaty to current best practices, such as including authorization for source country taxation of sales of immovable property companies, also should be added.

58. **An “earnings stripping” rule could augment the current thin-capitalization rule to limit earning stripping via interest payment,** by implementing a “fixed ratio” rule that limits net interest deductions claimed by a company to a fixed percentage of earnings before interest, taxes and depreciation (EBITDA). This ratio is most typically set at (a generous) 30 percent of applicable EBITDA. This type of rule avoids problems such as the need to define what constitutes debt or to combat the charging of an excessively high interest rate on related party debt.

59. **There are also a number of improvements in transfer pricing policy that can be revenue enhancing,** starting with using risk-based analysis to identify cases that are targets for enforcement. Alternative methods, such as profit split, which can help assessing margins of the related party in addition to one-sided methods, should become available to Kenya once completion of procedures for the entry into force of the Mutual Administrative Assistance Convention takes place. Consideration could also be given to use of dispute resolution mechanisms, including the use of streamlined final offer arbitration processes that have been successful elsewhere. The draft Income Tax Bill has addressed some of these issues, for example by introducing the profit split method in the Eighth Schedule, but more improvements are needed in the longer term and would need to be implemented outside the scope of the income tax bill.

Appendix I. Summary of Kenya's WTH Rates

This appendix summarizes key withholding tax rates on dividends, interest, and royalties in Kenya's DTAs, including those that are ratified and currently in force (Table A.1. Section B), and those that are not yet in force (Table A.1 Section C). In comparison, Section A lists the statutory rates that apply to domestic payments. Data on the treaty tax rates is drawn primarily from the International Bureau of Fiscal Documentation (IBFD) tax treaties database, and has been updated whenever appropriate based on various meetings and discussions with colleagues at the Treasury and KRA.

	Dividends (%)		Interest (%) ^[1]	Royalties (%)
	Individuals, Companies	Qualifying Companies ^[2]		
Section A. Domestic Rates				
Companies:	10	10	15/25	20
Individuals:	10	n/a	15/25	20
Companies or Individuals in SEZs ^[3]	10	0	5	5
Section B. Treaty Rates with:				
Canada	25	15	15	15
Denmark	30	20	20	20
France	10 ^[4]	10	12	10
Germany	15	15	15	15
India	15	15	15	20
Norway	25	15	20	20
Seychelles	5	5	10	10
South Africa	10	10	10	10
Sweden	25	15	15	20
United Kingdom	15	15	15	15
Zambia	– ^[5]	–	15/25 ^[6]	20 ^[7]
Section C. Treaties Not in Force:				
EAC External (in draft)	No rate	No rate	No rate	
EAC Internal	5	5	10	10
Iran	5	5	10	10
Kuwait	5	5	10	10
Qatar	10	5	10	10
South Korea	1	8 (25 corp sh)	12	10
Mauritius	1	5	10	10
Netherlands	10 (KE)/15 (NL)	0 (10 corp sh or PF)	10 (0 PF)	10
<p>1. Many treaties provide for an exemption for certain types of interest, e.g. interest paid to public bodies and institutions or in relation to sales on credit. Such exemptions are not considered.</p> <p>2. The rate generally applies with respect to participations of at least 25 percent of capital or voting power, as the case may be.</p> <p>3. The reduced rate is introduced in 2017 and applies to dividends, interest and royalties paid to non-residents from companies or persons operating in Special Economic Zones (SEZs).</p> <p>4. A most favored nation clause may be applicable with respect to dividends, interest and royalties.</p> <p>5. No withholding tax is levied under the treaty if dividends are subject to tax in Zambia.</p> <p>6. Interest is exempt from tax in Zambia should it be subject to tax in Kenya. Otherwise, there is no reduction under the treaty and the domestic withholding tax rate is applicable.</p> <p>7. Royalties are exempt from tax in Zambia should they be subject to tax in Kenya. Otherwise, there is no reduction under the treaty and the domestic withholding tax rate is applicable.</p> <p>Source: IBFD 2016, 2017</p>				