REPUBLIC OF KENYA

MINISTRY OF FINANCE

ANNUAL PUBLIC DEBT MANAGEMENT REPORT

JULY 2010 – JUNE 2011

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DECEMBER 2011

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Foreword

Public borrowing and the level of public debt has been consistent with the overall fiscal framework aimed at ensuring macro-economic stability over the medium term.

Over the last three years, public debt has risen by 40 percent from Ksh 1,059 billion in June 2009 to Ksh 1,487 billion in June 2011. In nominal terms, public debt to GDP increased from 46 percent of GDP to 54 percent of GDP during the three year period. Much of this increase was occasioned by severe drought and depreciation of the Kenya Shilling. The Government policy is to bring the public debt level from the current level of 54 percent of GDP to 45 percent of GDP in the medium term. However, Debt Sustainability studies done by the IMF/World Bank show that the public debt is still sustainable.

The fact that the bulk of the much needed funding was raised domestically is a pointer to the depth and resilience of the domestic debt market. This is a result of consistent reforms that have been undertaken by the Government in the last few years. I look forward to this reform momentum being maintained to make Kenya's domestic market comparable to those of emerging markets.

Public borrowing has been consistent with the overall fiscal framework aimed at ensuring macro-economic stability. It is anchored on the projections in the official documents including the Budget Policy Statement and the Budget Outlook Paper. The borrowing is further informed by a formal Medium Term Debt Strategy (MTDS) which is tabled in Parliament during the presentation of the Budget Estimates. The MTDS tool evaluates cost and risks of various scenarios to reach an optimal strategy that is implemented in the course of the year. The 2011 MTDS was prepared and tabled in Parliament in June 2011 to guide borrowing in the financial year 2011/12.

However, since the formulation of the 2011/12 Budget in June 2011 and the time of publishing this Report, the economic environment has changed significantly. High inflation stemming from higher food and fuel prices, and deteriorating global economic conditions, has weakened the prospects for faster economic expansion. In addition, rising inflationary expectations have placed pressures on the Shilling exchange rate weakening it to unprecedented lows. To address these issues, the Government has taken several remedial measures including tightening of monetary policy by the Central Bank of Kenya which has resulted in rising domestic interest rates in both the money markets and in the auctions for government securities.

Under these circumstances, the implementation of the budget so far in the financial year has proved challenging: Revenues have fallen behind target, domestic borrowing has been constrained by the under subscription of Treasury Bills and Bonds in the auction market for government securities. On the expenditure side, we are facing additional spending pressures to support the implementation of the new Constitution, cushion the vulnerable households from the impact of the drought and higher food and fuel prices, as well as dealing with security operations along our borders. In addition, the weakening of the Shilling exchange rate against major currencies has increased repayment of external debt in Shilling terms and government expenditure on import of goods and services.

In light of the above developments, it is imperative that we continue to ensure that the Government lives within its means while safeguarding macroeconomic stability.

Overall, realising that borrowing is not always an enviable option and as we embark on implementing the new Constitution, it is of paramount importance to ensure prudent borrowing. The constitution provides on how the National and County Governments can borrow. The Public Finance Management Legislation which is under preparation will come up with provisions and guidelines of how this will be achieved.

HON. UHURU KENYATTA, EGH, MP
DEPUTY PRIME MINISTER AND MINISTER FOR FINANCE
DECEMBER 2011

Acknowledgement

The 2010/11 Annual Public Debt Management Report prepared by the Ministry of Finance presents the major developments in Kenya's public debt management.

Prudent public debt management is critical for all economies and more so for developing countries where strong institutions are often lacking. In 2003, Kenya faced challenges relating to debt management which made the Government embark on a five year reform program to strengthen Debt Management. This has borne fruit since we now have a Debt Management Department in the Ministry of Finance which is the focal point of all matters on public debt management. The production of an Annual Public Debt Management Report is one of the deliverables of the department and is aimed at disseminating information on public debt during the relevant period. This Report for 2010/11 is the fifth since its preparation was revived in 2006.

The implementation of the new constitution will necessitate review of institutional framework and the Debt Management Department will be affected. Part of the reforms is the transition to a Debt Management Office (DMO) as provided in the Public Financial Management Bill. The existing department has a core team that has been trained in relevant skills. Continued capacity building will be critical in nurturing skills required in the new dispensation so that the DMO is able to deliver on the expanded mandate of ensuring prudent borrowing by both the Central and County Governments.

I wish to recognize the role played by the Debt Management Department, Ministry of Finance who coordinated the production of this Report. My sincere gratitude is to the core team involved in its production, namely: John Murugu (Director), Charles Kairu, Felister Kivisi, Livingstone Bumbe, Stella Osoro, Racheal Njoroge, Benard Gibet, Dennis Okungu, Robert Osudi, George Kariuki and Faith Njau, all from the Debt Management Department; Joseph Kiarie from DGIPE and Leonard Thotho from the Central Bank of Kenya.

JOSEPH K. KINYUA, CBS
PERMANENT SECRETARY/TREASURY
DECEMBER 2011

List of Abbreviations

ADB	African Development Bank
ADF	African Development Fund
A-I-A	Appropriation in Aid
ATM	Average Time to Maturity
BoP	Balance of Payments
BIS	Bank for International Settlement
CBK	Central Bank of Kenya
CBR	Central Bank Rate
CCN	City Council of Nairobi
CDS	Central Depository System
CMA	Capital Markets Authority
COMSEC	Commonwealth Secretariat
CPIA	Country Policy and Institutional Assessment
CRR	Cash Ratio Requirement
CS-DRMS	Commonwealth Secretariat Debt Recording and Management System
CSD	Central Securities Depository
DGIPE	Department of Government Investment and Public Enterprises
DMD	Debt Management Department
DMO	Debt Management Office
DSA	Debt Sustainability Analysis
DSF	Debt Sustainability Framework
DX	Domestic Currency
ECB	European Central Bank
EEC	European Economic Commission
EIB	European Investment Bank
ERD	External Resources Department
EUROSTAT	European Union Statistical Agency
FLSTAP	Financial and Legal Sector Technical Assistance Project
FX	Foreign Currency
FXD	Fixed Discounted Treasury Bonds
GDP	Gross Domestic Product
GoK	Government of Kenya
GSMM	Government Securities Market Makers
HIPC	Highly Indebted Poor Countries
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IFB	Infrastructure Bond
IFC	International Finance Corporation
IMF	International Monetary Fund
JPY	Japanese Yen
KACC	Kenya Anti-Corruption Commission
KBC	Kenya Broadcasting Corporation
KenGen	Kenya Electricity Generating Company
MEFMI	Macroeconomic and Financial Management Institute of Eastern and Southern Africa
MLF	Market Leaders' Forum
MODM	Monetary Operations and Debt Management Department
MOF	Ministry of Finance
MT	Medium Term
MTEF	Medium Term Expenditure Framework
NBFI	Non Bank Financial Institution
NPV	Net Present Value
NSE	Nairobi Securities Exchange
NSSF	National Social Security Fund
ODA	Official Development Assistance
OECD	Organization for Economic Co-operation and Development
OTC	Over the Counter
PA	Payment Advice
PD	Primary Dealers
PFMB	Public Financial Management Bill
PMG	Pay Master General
PPG	Public and Publicly Guaranteed
PV	Present Value
PwC	PricewaterhouseCoopers
QEBR	Quarterly Economic and Budgetary Review
SDB	Savings Development Bond
SDR	Special Drawing Rights
SFX	Restructuring Treasury Bonds
ST	Short Term
SWIFT	Society for Worldwide Interbank Financial Telecommunication
TDS	Total Debt Service
TARDA	Tana and Athi River Development Authority
TEDS	Total External Debt Service
UK	United Kingdom
UNCTAD	United Nations Conference on Trade & Development
USA	United States of America
USD	US Dollar
WB	World Bank
WPDM	OECD Working Party on Debt Management
ZC	Zero Coupon Rate Bonds

Executive Summary

The overall objective of the Government debt management policy is to meet the Central Government's financing needs at the lowest possible long term borrowing cost with a prudent degree of risk. Additionally, it aims at facilitating Government's access to financial markets as well as supporting development of a well functioning vibrant domestic debt market.

The Government is committed to pursuing prudent debt management strategies to ensure that public debt remains within sustainability thresholds. In the medium term, the Government plans to lower the level of public and publicly guaranteed debt to 45 percent of GDP. This will require reduction in the overall fiscal deficit from over 6 percent to below 5 percent, as well as adherence to prudent debt management. The Government debt management strategy is outlined in the 2011 Medium Term Debt Strategy (MTDS) published in June 2011. The MTDS is subject to annual updates.

Public and publicly guaranteed debt increased from Ksh 1,229,406 million or 51.0 percent of GDP in June 2009/10 to Ksh 1,487,110 million or 53.9 percent of GDP in June 2010/11. External debt rose from Ksh 569,138 million or 23.6 percent of GDP to Ksh 722,888 million or 26.2 percent of GDP over the period under review. Similarly, domestic debt rose from Ksh 660,268 million in 2009/10 to Ksh 764,222 million in 2010/11. As a percentage of GDP, domestic debt increased marginally from 27.4 percent to 27.7 percent. This rise in nominal domestic debt stock is attributed largely to a deliberate strategy to increase domestic borrowing to finance the budget deficit.

During the period under review, the share of domestic debt declined by 2.5 percentage points from 53.7 percent to 51.2 percent while external debt rose from 46.3 percent to 48.8 percent of total debt. The external portfolio indicates that the debt is mainly owed to multilateral and bilateral creditors at 61.0 percent and 35.5 percent, respectively. On domestic debt, the ratio of Treasury Bonds to Treasury Bills was 82:18.

The overall debt service increased by 21.7 percent from Ksh 80,992 million (16.0 percent of ordinary revenue) in 2009/10 to Ksh 98,552 million (16.2 percent of ordinary revenue) in 2010/11. During the period, interest payments on domestic debt increased significantly by 22.9 percent to Ksh 70,497 million while external debt service rose by 18.8 percent to Ksh 28,055 million. The sharp increase in the overall debt service was attributed to the rapid growth of domestic debt and the depreciation of the Kenya Shilling.

Over the period under review, average interest rates on Government securities rose significantly with the 91-day Treasury Bill standing at 8.95 percent in June 2011 from 2.98 percent in June 2010. Market yield rates on Benchmark Bonds also took an upward shift especially at the short end of the yield curve. By period end, the market yield of the 2-year Treasury Bond rose by 666 basis points to stand at 10.92 percent while the 20-year Treasury Bond rose by 133 basis points to 11.27 percent.

The Government's external debt strategy remained unchanged: new external loans are contracted on highly concessional terms to minimise interest rate cost. The average interest rate and grace period on new external loans contracted in financial year 2010/11 was 0.8 percent and 8.1 years, respectively. This profile, together with the long maturity of 26.6 years yields an average grant element of 69.8 percent for new external loans. On the other hand, reflecting on the success of lengthening the maturity of domestic debt to minimise refinancing risk, the average maturity profile of outstanding domestic debt increased from 4.6 years to 5.8 years over the period under review.

Total disbursement of external project loans and budget support increased from Ksh 39,582 million in June 2010 to Ksh 59,678 million in June 2011. The amount disbursed under project loans, Ksh 28,390 million remained below the annual projected target of Ksh 58,000 million at end June 2011. The dismal performance in disbursement of funds under project loans is due to low absorption capacity of project funds. To enhance the absorption capacity, the Ministry of Finance in liaison with development partners is formulating strategies and an action plan in the draft Kenya External Resources Policy to improve aid and development effectiveness for consideration and implementation by the stakeholders. The Ministry has also adopted a computerized system, Electronic Project Management Information System (e-Promis) for monitoring the implementation of all development projects.

The Guarantee (Loans) Act, Laws of Kenya, Cap 461 provides the legal framework for issuance of Government loan guarantees to public entities. To minimize contingent liabilities to the Central Government and ensure prudent borrowing, public enterprises are required to seek prior approval from their respective management boards, parent ministries and the Ministry of Finance before contracting any direct or guaranteed loans.

Establishing better institutional processes and ensuring transparency in on-lending operations and monitoring of contingent liabilities are expected to contribute positively towards the management of costs and risks in the Government debt portfolio. In this regard, the Ministry of Finance is making efforts to ensure on-lent loans and contingent liabilities are well managed.

The outlook in the medium term indicates that gross public debt is projected to increase in nominal terms from Ksh 1,487,110 million in June 2011 to Ksh 2,044,315 million in June 2015. Real GDP is projected to grow at an average rate of 5.8 percent while debt to GDP ratio is expected to decline from 54 percent to 45 percent over the medium term.

Although overall debt service in nominal terms is projected to increase by almost 48 percent in the medium term, the debt burden indicators will remain within sustainable levels. Total debt service is projected to increase from Ksh 98,552 million (16.3 percent of revenue) in 2010/11 to Ksh 110,281 million (15.5 percent of revenue) in 2011/12 and to Ksh 145,994 million (14.2 percent of revenue) in 2014/15. Nearly 60 percent of the increase in debt service is attributed to domestic interest.

Information on public debt is available on the Treasury website www.treasury.go.ke, which hosts the Annual Public Debt Management Report, the Monthly Debt Bulletin and the Quarterly Economic and Budgetary Review (QEBR). The Central Bank's website www.centralbank.go.ke hosts the Monthly Economic Review and Weekly Bulletin.

Introduction

The Fiscal Year 2010/11 Annual Public Debt Management Report presents the major developments in Kenya's public debt management activities during the financial year ended June 2011. The Report is organised under the following chapters:

1. Financing of Budget Deficit
2. Domestic Debt
3. External Debt
4. Publicly Guaranteed Debt
5. On-Lent Loans and Contingent Liabilities
6. Disputed External Commercial Debt
7. Debt Strategy and Debt Sustainability
8. OECD Public Debt Management Partnership
9. Reforms in Public Debt Management
10. Outlook for the Medium Term

1. FINANCING OF BUDGET DEFICIT

1.1 Financing of the Deficit

The 2010/11 Central Government budget deficit (including grants) of Ksh 188 billion or 6.8 percent of GDP was to be financed partly through net foreign financing of Ksh 82.7 billion (3.0 percent of GDP). The remaining Ksh 105.3 billion was to be financed through net domestic borrowing (3.8 percent of GDP) inclusive of Infrastructure Bonds amounting to Ksh 31.6 billion. No privatization proceeds were expected.

A review of the actual budget outturn resulted in a revised deficit of Ksh 137.8 billion. This deficit was 4.3 percent of GDP and was financed through net foreign financing of Ksh 28.4 billion (1.0 percent of GDP), and net domestic borrowing of Ksh 109.4 billion (3.3 percent of GDP).

1.2 Total Public Debt

Kenya's public and publicly guaranteed debt increased from Ksh 1,229,406 million or 51.0 percent of GDP in June 2010 to Ksh 1,487,110 million or 53.9 percent of GDP in June 2011 as indicated in Table 1.1. Domestic debt rose from Ksh 660,268 million or 27.4 percent of GDP to Ksh 764,222 million or 27.7 percent of GDP over the period under review. Similarly, external debt rose from Ksh 569,138 million in 2010 to Ksh 722,888 million in 2011. As a percentage of GDP, external debt increased from 23.6 percent to 26.2 percent over the period. The significant rise in domestic debt stock is attributed largely to an increase in domestic financing from 3.8 percent to 4.6 percent of GDP to offset reduced foreign financing and shortfalls in revenue collection.

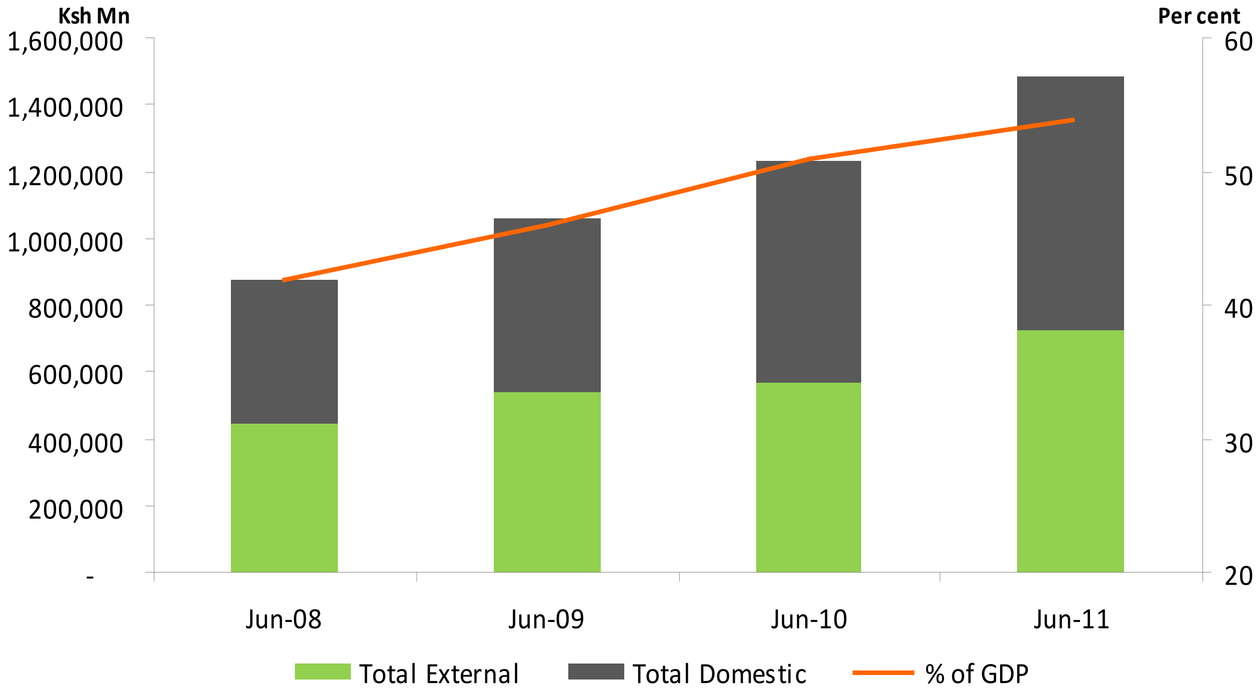
During the period under review, the share of domestic debt declined from 53.7 percent to 51.2 percent as shown in Table 1.1 while external debt increased from 46.3 percent to 48.8 percent of total debt. The increase in external debt is due to the weakening of the Kenya shilling against major world currencies. The external debt portfolio as at end-June 2011indicates that the debt is mainly owed to multilateral and bilateral creditors at 61.0 percent and 35.5 percent respectively. On domestic debt, the ratio of Treasury Bonds to Treasury Bills was 82:18 at end-June 2011.

Table 1.1: Public and Publicly Guaranteed Debt, Ksh Million

	June 2008	June 2009	June 2010	June 2011	Change 2010/11
DOMESTIC (Gross)					
Banks					
Central Bank	35,548	40,061	50,215	39,691	(10,524)
Commercial Banks	192,934	250,717	351,579	384,640	33,061
Sub-total	228,482	290,778	401,794	424,331	22,537
Non-banks					
Non-bank Financial Institutions	11,177	3,651	2,956	10,013	7,057
Other Non-bank Sources	190,953	224,078	255,518	329,878	74,360
Sub-total	**202,130**	**227,729**	**258,474**	**339,891**	**81,417**
Total Domestic	**430,612**	**518,507**	**660,268**	**764,222**	**103,954**
As a % of GDP	20.7	22.5	27.4	27.7	
As a % of total debt	49.3	48.9	53.7	51.2	
EXTERNAL					
Central Government					
Bilateral	127,786	152,985	159,687	215,035	55,348
Multilateral	268,223	327,633	348,647	436,838	88,191
Commercial Creditors	18,543	23,837	20,458	25,041	4,583
Sub-Total	**414,552**	**504,455**	**528,792**	**676,914**	**148,122**
Guaranteed					
Bilateral	25,415	32,948	36,660	41,930	5,270
Multilateral	2,911	3,472	3,686	4,044	358
Sub-Total	**28,327**	**36,420**	**40,346**	**45,974**	**5,628**
Total External	**442,878**	**540,875**	**569,138**	**722,888**	**153,750**
As a % of GDP	21.2	23.4	23.6	26.2	
As a % of total debt	50.7	51.1	46.3	48.8	
GRAND TOTAL	**873,490**	**1,059,382**	**1,229,406**	**1,487,110**	**257,704**
As a % of GDP	41.9	45.9	51.0	53.9	
Memorandum item					
GDP	2,085,152	2,307,700	2,409,600	2,761,500	

Source: Treasury and Central Bank of Kenya

Chart 1.1: Trend in Public and Publicly Guaranteed Debt Stock, Ksh Million



Source: Treasury and Central Bank of Kenya

As illustrated in Chart 1.1, public and publicly guaranteed debt has grown steadily in the past three years with nominal stock to GDP surpassing the 50 percent mark in June 2011, raising sustainability concerns. In the medium term, the Government plans to lower the level of public and publicly guaranteed debt to 45 percent of GDP.

1.3 Debt Service

Total Debt Service (TDS) on Kenya's Central Government debt increased by 21.7 percent from Ksh 80,992 million in 2009/10 to Ksh 98,552 million in 2010/11 as shown in Table 1.2. Interest payments on both domestic and external debt increased substantially. Domestic and external debt service increased from Ksh 57,381 million to Ksh 70,497 million and from Ksh 23,611 million to Ksh 28,055 million respectively. The rise in debt service was attributed to increased borrowing from the domestic market and depreciation of the Kenyan shilling.

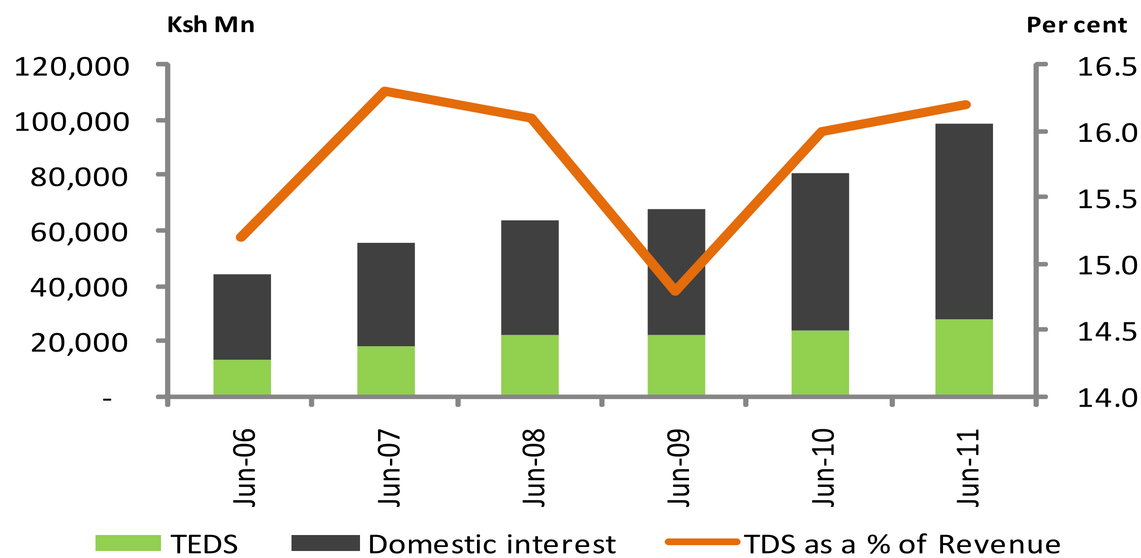
As a proportion of total debt service, the external component remained relatively unchanged at 28.5 percent in 2010/11 while the domestic portion increased from 70.8 percent to 71.5 percent. Total External Debt Service (TEDS) as a percentage of export earnings declined from 5.9 percent to 5.5 percent over the same period.

Table 1.2: Debt Service on Kenya's Central Government Debt, Ksh Million

	June 2006	June 2007	June 2008	June 2009	June 2010	June 2011	Change 2010/11
External Principal	9,230	13,884	15,815	16,013	17,373	21,020	3,647
External Interest	3,645	4,433	5,961	5,632	6,238	7,035	797
TEDS	**12,875**	**18,317**	**21,776**	**21,645**	**23,611**	**28,055**	**4,444**
TEDS as a % of TDS	29.1	33.2	34.0	32.0	29.2	28.5	(0.7)
Domestic Interest	**31,445**	**36,860**	**42,181**	**45,949**	**57,381**	**70,497**	**13,116**
Dom Interest as a % of TDS	70.9	66.8	66.0	68.0	70.8	71.5	0.7
TDS	**44,320**	**55,177**	**63,957**	**67,594**	**80,992**	**98,552**	**17,560**
Ordinary Revenue	291,064	338,509	396,489	456,000	507,500	609,223	101,723
Export Earnings (goods only)	228,181	261,626	298,239	358,136	400,024	511,577	111,553
TDS as a % of Revenue	15.2	16.3	16.1	14.8	16.0	16.2	0.2
TEDS as a % of Exports	5.6	7.0	7.3	6.7	5.9	5.5	(0.4)

Source: Treasury and Central Bank of Kenya

Chart 1.2: Kenya's Central Government Debt Service, Ksh Million



Source: Treasury and Central Bank of Kenya

The structure of Central Government debt service remained relatively unchanged with a large share being domestic component as illustrated in Chart 1.2. On average, total debt service as a percent of revenue has been relatively stable except during 2009 when there was a low interest rate regime.

1.4 Cost/Risk Characteristics of Public Debt

Arising from the Government external debt strategy of contracting external loans on highly concessional terms to minimise interest rate cost, the average interest rate and grace period on new external loans contracted in financial year 2010/11 was 0.8 percent and 8.1 years, respectively. This profile, together with the long maturity of 26.6 years yields an average grant element of 69.8 percent for new external loans.

On the other hand, reflecting the success of lengthening the maturity of domestic debt to minimise refinancing risk, the average maturity profile of outstanding Government domestic debt has increased from 4.6 years in June 2010 to 5.8 years in June 2011.

2. DOMESTIC DEBT

2.1 Total Domestic Debt

Government domestic debt consists of stock of Government securities which comprises Treasury Bills and Treasury Bonds, Long-Term Stocks, Government Overdraft at Central Bank of Kenya and Pre-1997 Government Debt. During the Financial year 2010/11, the Government raised Ksh 109,387 million through borrowing from the domestic market by sale of Treasury Bills, Treasury Bonds and Infrastructure Bonds. Under the Government borrowing plan, the level of Government Overdraft was to be maintained at zero by end June 2011.

As shown in Table 2.1, on a net basis, the outstanding stock of domestic debt rose by Ksh 103,954 million (15.7 percent growth) in 2010/11 to stand at Ksh 764,222 million in June 2011 compared to Ksh 660,268 million in June 2010. This increase was mainly attributed to an increase by Ksh 147,046 million in the stock of Treasury Bonds. The increase in domestic debt was partly offset by a decline in the stock of Treasury Bills of Ksh 31,889 million and a repayment of Ksh 555 million of the Pre-1997 Government Debt.

Table 2.1: Domestic Debt Stock, Ksh Million

Instrument	June 2010		June 2011		Change
	Amount	%	Amount	%	
Total Stock of Domestic Debt (A+B)	**660,268**	**100.0**	**764,222**	**100**	**103,954**
A. Government Securities(1-4)	**640,080**	**96.9**	**753,929**	**98.7**	**113,849**
1.Treasury Bills (excluding Repo bills)	**158,494**	**24.0**	**126,605**	**16.6**	**(31,889)**
Banking Institutions	133,797	20.3	87,736	11.5	(46,061)
Others	24,697	3.7	38,869	5.1	14,172
2.Treasury Bonds	**448,615**	**67.9**	**595,661**	**77.9**	**147,046**
Banking Institutions	217,562	32.9	294,206	38.5	76,644
Others	231,053	35.0	301,455	39.4	70,402
3. Long Term Stocks	**753**	**0.1**	**0**	**0.0**	**(753)**
Banking Institutions	0.0	0.0	0	0.0	0.0
Others	753	0.1	0	0.0	(753)
4. Pre-1997 Government Debt	**32,218**	**4.9**	**31,663**	**4.1**	**(555)**
B. Others:[1]	**20,188**	**3.1**	**10,293**	**1.3**	**(9,895)**
of which CBK Overdraft	17,649	2.7	7,571	1.0	10,078)

Source: Central Bank of Kenya

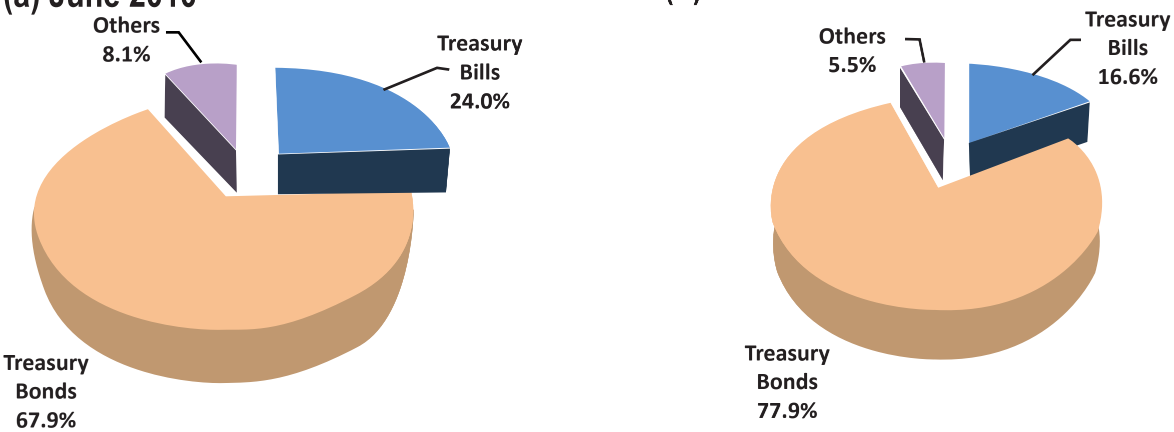
1. Others consist of CBK Overdraft to GoK, cleared items awaiting transfer to PMG, commercial bank advances and Tax Reserve Certificates.

2.2 Domestic Debt by Instrument

The stock of outstanding Treasury Bonds increased by 32.8 percent from Ksh 448,615 million in June 2010 to Ksh 595,661 million in June 2011 while Treasury Bills decreased by 20.1 percent from Ksh 158,494 million to Ksh 126,605 million over the same period as shown in Table 2.1. Consequently, the proportion of Treasury Bonds in total domestic debt increased from 67.9 percent to 77.9 percent while Treasury Bills declined from 24.0 percent to 16.6 percent during the period as shown in Charts 2.1(a) and 2.1(b). Under the domestic debt borrowing strategy, the Government sought to achieve and maintain the ratio of Treasury Bills and Treasury Bonds at 25:75. The Government Long Term Stock was cleared during the year. The proportion of Pre-1997 CBK advances to Government dropped from 4.9 percent to 4.1 percent due to a net repayment of Ksh 555 million made during the fiscal year 2010/11.

Chart 2.1: Domestic Debt by Instrument

(a) June 2010 (b) June 2011



Source: Treasury and Central Bank of Kenya

2.3 Domestic Debt by Holder

Table 2.2 shows that commercial banks continue to hold the largest share of domestic debt at 50.3 percent down from 53.2 percent in June 2010. In the same period, the share of domestic debt held by non-bank investors increased from 38.7 percent in June 2010 to 43.2 percent in June 2011.

Table 2.2: Domestic Debt by Holder, Ksh Million

Holder	June 2010 Amount	%	June 2011 Amount	%	Change
Banks	**401,794**	***60.8***	**424,331**	***55.5***	**22,537**
o/w Central Bank	50,215	*7.6*	39,691	*5.2*	(10,524)
Commercial Banks	351,579	*53.2*	384,640	*50.3*	33,061
Non-Banks	**258,474**	***39.2***	**339,891**	***44.5***	**81,417**
o/w Non-Bank Financial Institutions	2,956	*0.5*	10,013	*1.3*	7,057
Other Non-Bank Sources	255,518	*38.7*	329,878	*43.2*	74,360
Total	**660,268**	***100***	**764,222**	***100***	**103,954**

Source: Central Bank of Kenya

2.4 Treasury Bills and Bonds by Tenor

Treasury Bills accounted for 17.5 percent of outstanding Government securities held as at end June 2011, down from 26.1 percent as at end June 2010 (Table 2.3). The trend in Treasury Bills holdings indicates investor preference for the 91-day security.

Outstanding Treasury Bonds with a maturity range of 1 year to 5 years amounted to Ksh 187,563 million (26.0 percent) of total Government securities while those with a maturity range of between 6 and 9 years stood at Ksh 135,502 million (18.8 percent). Treasury Bonds with a maturity profile of 10 years and above amounted to Ksh 272,596 million (37.7 percent). This maturity distribution indicates a large concentration of Government securities holding at the short to medium segment of the yield curve. However, there has been a gradual shift as the proportion of longer dated Bonds in the portfolio increased to 37.7 percent in June 2011 from 32.2 percent in June 2010. This development has contributed to the successful establishment of a stable yield curve for Government securities, largely attributed to the continued implementation of the Benchmark Bonds program.

2.4.1 Benchmark Bond Program

The implementation of the Benchmark Bonds initiative begun by Government in September 2007 to address illiquidity in the domestic bond market continued in the financial year 2010/11. The program involves issuance and reopening of Treasury Bonds of 2, 5, 10, 15, 20, and 25 year maturities. The program is also aimed at strengthening the Government securities market by promoting secondary trading and improving liquidity around the Benchmark Bonds. In addition, the program seeks to lengthen maturity of domestic debt in order to minimize rollover risk.

Reflecting on the success of the Benchmark Bonds program, the average maturity profile of outstanding Government securities increased from 0.5 years in June 2001 to 5.8 years in June 2011. In the period under review, the ratio of Treasury Bonds to Treasury Bills was 82:18 which is in line with the debt management strategy of lengthening the average time to maturity of domestic debt. In addition, there has been improved liquidity both at the primary and the secondary market for bonds. As shown in Table 2.3 and Charts 2.2(a) and 2.2(b), Benchmark Bonds account for the largest share of outstanding Treasury Bonds with over 60 percent as at end June 2011. Turnover of bonds traded at the Nairobi Securities Exchange (NSE) rose from Ksh 337,300 million in 2009/10 to Ksh 454,150 million in 2010/11. Riding on the success of the Benchmark Bonds program, a total of seventeen (17) corporate bonds have been listed and are trading at the NSE.

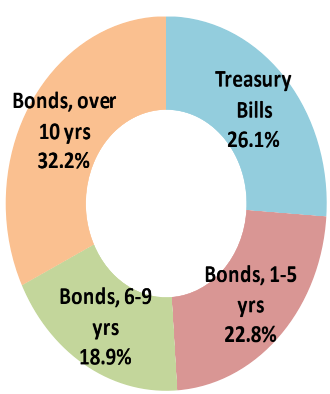
Table 2.3: Outstanding Treasury Bills and Bonds by Tenor, Ksh Million

Security Type	June 2010		June 2011		Change	
	Amount	(%) of total	Amount	(%) of total	Amount	(%) of total
Treasury Bills (Days)						
91	23,663	3.9	69,135	9.6	45,472	5.7
182	85,337	14.1	22,528	3.1	(62,809)	(11.0)
364	49,494	8.2	34,942	4.8	(14,552)	(3.4)
Sub totals	**158,494**	**26.1**	**126,605**	**17.5**	**31,889**	**(8.6)**
Treasury Bonds (Years)						
2	46,577	7.7	73,012	10.1	26,435	2.4
3	1,781	0.3	0	0.0	(1,781)	(0.3)
4	3,384	0.6	0	0.0	(3,384)	(0.6)
5	86,582	14.3	114,551	15.9	27,969	1.6
Sub totals	**138,324**	**22.8**	**187,563**	**26.0**	**49,239**	**3.2**
6	48,986	8.1	60,661	8.4	11,675	0.3
7	21,353	3.5	24,296	3.4	2,943	(0.1)
8	26,721	4.4	22,813	3.2	(3,908)	(1.2)
9	17,760	2.9	27,732	3.8	9,972	0.9
Sub totals	**114,820**	**18.9**	**135,502**	**18.8**	**20,682**	**(0.2)**
10	69,090	11.4	91,391	12.7	22,301	1.3
11	4,031	0.7	4,031	0.6	0.0	(0.1)
12	33,051	5.4	33,051	4.6	0.0	(0.8)
15	61,929	10.2	75,443	10.4	13,514	0.2
20	20,361	3.4	29,727	4.1	9,366	0.7
25	7,008	1.2	20,193	2.8	13,185	1.6
30	0	0.0	18,760	2.6	18,760	2.6
Sub total	**195,470**	**32.2**	**272,596**	**37.7**	**77,126**	**5.5**
Grand Total	**607,109**		**722,266**		**115,1587**	

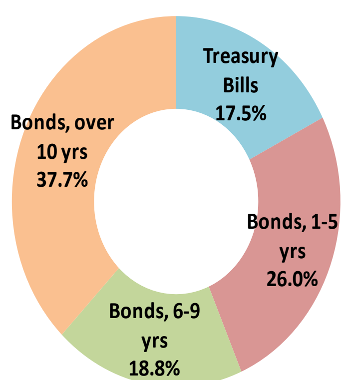
Source: Central Bank of Kenya

Chart 2.2: Outstanding Government Securities

(a) June 2010



b) June 2011



Source: Central Bank of Kenya

2.5 Infrastructure Bonds (IFBs) Program

In recognition of the role played by infrastructure in economic development, the Government embarked on the issuance of Infrastructure Bonds in February 2009 to mobilise resources to finance specific projects in roads, energy and water sectors (See Appendix 9).

To date, a total of Ksh 82 billion has been raised through the sale of four (4) IFBs as reflected in Table 2.4. In financial year 2011/12, sector-specific IFBs worth Ksh 35.9 billion will be issued to finance various infrastructure projects across the country.

Table 2.4: Performance of Infrastructure Bond (IFB) at Primary Market Auction

Issue No./Tenor	Date of Issue	Offer Amount (Ksh Mn)	Bids Received FV (Ksh Mn)	Successful Bids (Ksh Mn)	Coupon Rate (%)	Successful Average Rate (%)
IFB 1/2009/12	23-02-09	18,500	26,884	18,568	12.500	13.505
IFB 2/2009/12	07-12-09	18,500	44,121	18,417	12.000	12.537
IFB 1/2010/8	01-03-10	14,500	35,273	16,264	9.750	9.579
IFB 2/2010/9	30-08-10	31,600	37,362	30,590	6.000	7.293

Source: Central Bank of Kenya

2.6 Treasury Bills by Holder

The stock of Treasury Bills decreased by 20.1 percent from Ksh 158,494 million in June 2010 to Ksh 126,605 million in June 2011 (Table 2.5). The proportion held by Commercial Banks decreased from Ksh 137,497 million (86.8 percent) in June 2010 to Ksh 87,736 million (69.3 percent) in June 2011. Insurance companies and Parastatals also scaled down their holdings to 3.9 percent and 0.3 percent respectively, while Pension funds increased their holdings to 19.8 percent respectively during the period under review.

Table 2.5: Outstanding Treasury Bills, Ksh Million

Holders	June 2010		June 2011	
	Amount	%	Amount	%
Commercial Banks	137,497	*86.8*	87,736	*69.3*
NBFIs	212	*0.2*	546	*0.4*
Insurance companies	8,757	*5.5*	4,931	*3.9*
Parastatals	1,961	*1.2*	410	*0.3*
Pensions Funds (including NSSF)	4,647	*2.9*	25,077	*19.8*
Others	5,420	*3.4*	7,905	*6.2*
Total [2]	**158,494**	***100***	**126,605**	***100.0***

Source: Central Bank of Kenya

2.7 Treasury Bonds by Holder

Outstanding Treasury Bonds increased from Ksh 448,615 million in June 2010 to Ksh 595,661 million in June 2011 as shown in Table 2.6. Commercial Banks continue to hold the highest share of Treasury Bonds. However, holdings by Parastatals declined to 0.3 percent in June 2011 from 3.8 percent in June 2010, while holdings in the 'others' category which includes

2. Excludes repurchase order (Repo) bills for monetary policy

individual investors recorded an increase from 1.3 percent to 4.9 percent during the period under review.

Table 2.6: Outstanding Treasury Bonds, Ksh Million

Holders	June 2010		June 2011	
	Amount	%	Amount	%
Commercial Banks	217,562	48.5	294,206	49.4
NBFIs	9,832	2.2	9,467	1.6
Insurance Companies	54,642	12.2	73,349	12.3
Parastatals	17,123	3.8	1,958	0.3
Pensions Funds (including NSSF)	143,799	32.0	187,392	31.5
Others	5,657	1.3	29,189	4.9
Total	**448,615**	**100**	**595,661**	**100**

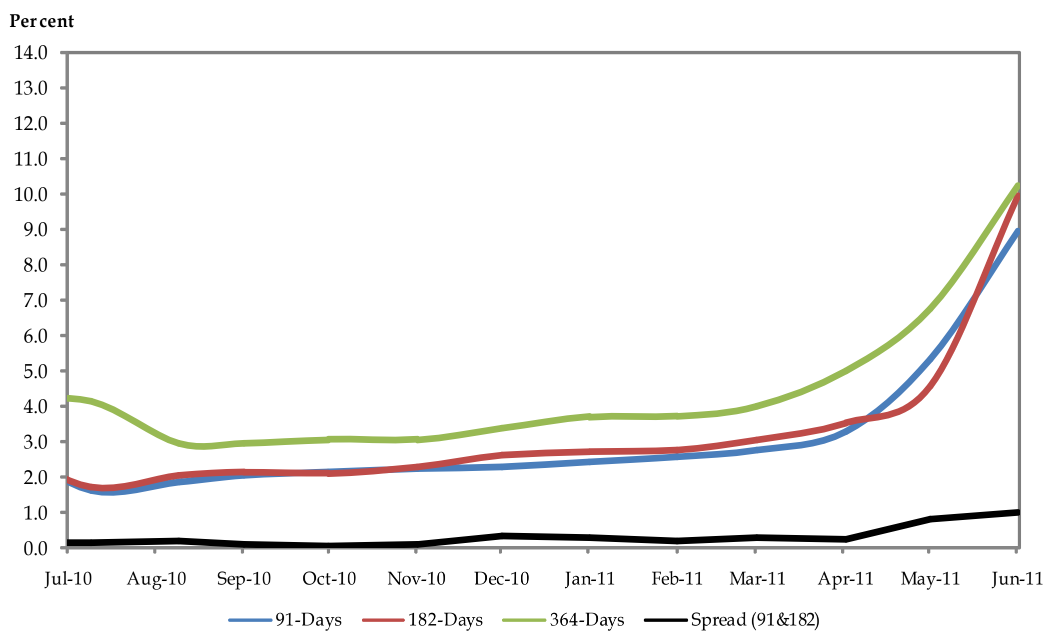
Source: Central Bank of Kenya

2.8 Average Interest Rates on Government Securities

Average interest rates for Treasury Bills increased during the period under review. The 91-day Treasury Bill rate rose by 597 basis points from 2.98 percent in June 2010 to 8.95 percent in June 2011. Likewise, average interest rate for the 182-day Treasury Bill rose by 707 basis points from 2.86 percent to 9.93 percent during the period (Chart 2.3). The 364-day Treasury Bill which is issued bi-monthly also rose by 611 basis points from 4.14 percent in June 2010 to 10.25 percent in June 2011.

Average interest rates on the 91-day and 182-day Treasury Bills continue to act as benchmark rates in the money markets. Changes to these rates cause adjustments to both commercial banks' deposit and lending rates, pricing of tradable debt securities and structure of investment portfolio.

Chart 2.3: Interest Rates on Treasury Bills, July 2010 - June 2011



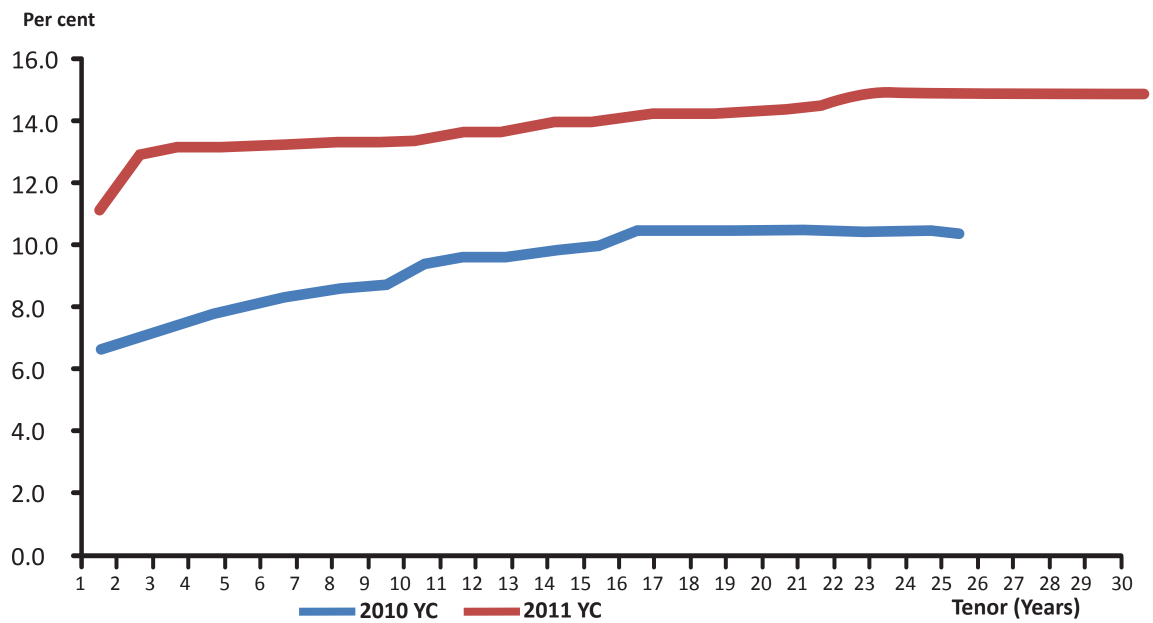
Source: Central Bank of Kenya

2.9 Government Securities Yield Curve

As shown in Chart 2.4, the Government securities trading yield curve shows an ascending shape indicating that the yields rise as maturity lengthens. The yield curve reflects the risk premium associated with the uncertainty about the future rate of inflation and the risk this poses to the future value of cash flows.

The development of the yield curve has been boosted by the successful implementation of the Benchmark Bonds program and enhanced liquidity in the secondary market for Government Bonds. This has also lowered rollover risk associated with short term debt.

Chart 2.4: Government of Kenya Securities Yield Curve, June 2011



Source: Central Bank of Kenya

2.10 Domestic Interest Payments

As shown in Table 2.7, Government expenditure on interest and other charges on domestic debt during the fiscal year 2010/11 amounted to Ksh 70,497 million, a 22.9 percent increase from 2009/10. Domestic interest as a proportion of revenue, expenditure and GDP increased over the period largely due to increased domestic borrowing and a higher proportion of long term Bonds in the portfolio. Interest payments on Treasury Bills declined by 9.7 percent to Ksh 7,369 million, while a significant increase of 29.4 percent was observed in interest payments on Treasury Bonds, which is consistent with the increase in bond holdings.

Table 2.7: Domestic Interest Payments and Ratios

Type of Debt	Interest (Ksh Million)		Percentage Change
	2009/10	2010/11	
Treasury Bills	8,156	7,369	(9.7)
Treasury Bonds	44,934	58,162	29.4
CBK Commission	3,000	3,000	0.0
Pre - 1997 Debt	993	1,171	17.9
Others	298	795	166.8
Total	**57,381**	**70,497**	**22.9**
Ratios (%)			
Domestic Interest/Revenue	11.3	11.6	0.3
Domestic Interest/Expenditure	7.9	8.7	0.8
Domestic Interest/GDP	2.4	2.6	0.2
Domestic Interest/Total Interest	90.2	90.9	0.7

Source: Treasury and Central Bank of Kenya

3. EXTERNAL DEBT

3.1 Legal Framework

Public external debt refers to debt owed by the Central Government to non residents.

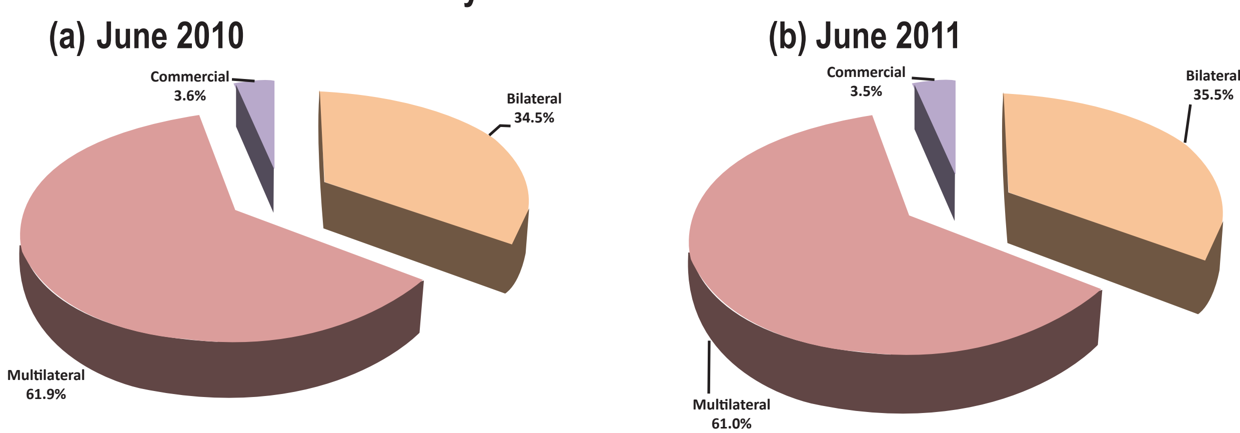
The External Loans Act, Cap 422, Laws of Kenya, provides the legal framework for Central Government borrowing while the Guarantee (Loans) Act Cap 461, Laws of Kenya provides the legal framework for issuance of Government loan guarantees to public entities. The Public Finance Management Legislation, under preparation will provide a consolidated framework for public borrowing.

3.2 Total External Debt

Total public and publicly guaranteed external debt increased from Ksh 569,138 million in June 2010 to Ksh 722,888 million in June 2011 due to both the depreciation of the Kenya Shilling and an increase in net loan disbursements. In US Dollar terms, external debt increased by USD 1,096.5 million to USD 8,044.3 million at end June 2011. As a percentage of GDP, external debt increased marginally by 2.6 percent to 26.2 percent. (See Table 1.1 and Appendix 4(b)).

At the beginning of the financial year 2010/11, Kenya's external debt portfolio shows that the debt was mainly owed to multilateral (61.9 percent) and bilateral (34.5 percent) creditors with a small proportion owed to commercial creditors (3.6 percent) as shown in Chart 3.1(a). This structure remained relatively unchanged over the period under review as demonstrated in Chart 3.1(b). Multilateral debt decreased by 0.9 percent to 61.0 percent in June 2011, whereas bilateral debt increased slightly from 34.5 percent to 35.5 percent over the same period. Commercial debt remained relatively unchanged.

Chart 3.1: External Debt stock by Broad Creditors

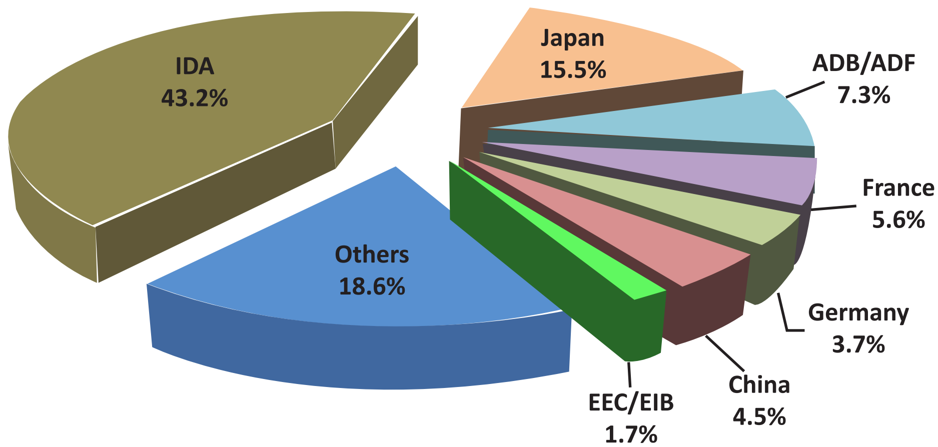


Source: Treasury

3.3 External Debt by Major Creditors

Further examination of the external debt portfolio reveals that the World Bank (IDA) is the leading creditor (43.2 percent of total external debt), followed by Japan (15.5 percent) and African Development Bank Group (7.3 percent). Other notable creditors to Kenya are France, Germany, China and the European Union/European Investment Bank as shown in Chart 3.2.

Chart 3.2: External Debt by Major Creditors, June 2011

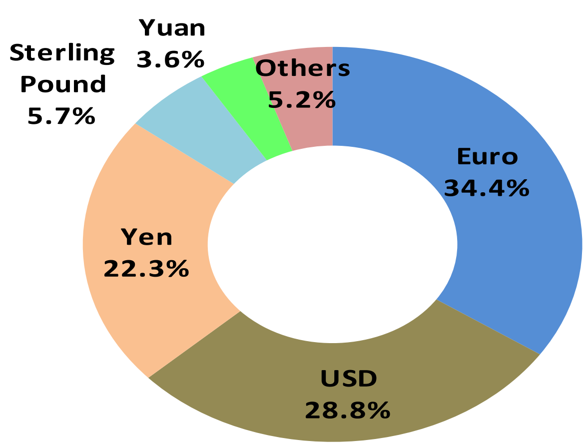


Source: Treasury

3.4 Currency Structure of External Debt

Chart 3.3 shows that external debt is mainly denominated in Euro, US Dollar and Yen. Although a diverse currency structure mitigates against exchange rate risk on the country's external debt, the currency mix is not as a result of a deliberate debt management strategy but more a reflection of source of external loans.

Chart 3.3: External Debt by Currency, June 2011

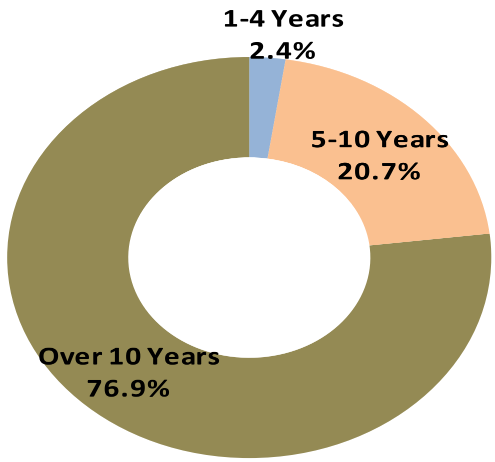


Source: Treasury

3.5 Maturity Structure

Overall, the country's external debt is long term. As at the end of June 2011, the proportion of external debt with remaining maturities of more than 10 years was 76.9 percent. Only 2.4 percent of the debt had maturity of less than 4 years: a reflection of negligible default risk (Chart 3.4). This profile shows that a large stock of external debt is scheduled for full retirement in the distant future.

Chart 3.4: External Debt by Remaining Maturity, June 2011



Source: Treasury

3.6 Average Terms of New External Loan Commitments

Arising from the Government external debt strategy of contracting external loans from both multilateral and bilateral sources on concessional or "soft" terms, average interest rate and grace period on new external loan commitments as at the end of June 2011 was 0.8 percent and 8.1 years respectively. This profile, together with the long maturity of 26.6 years yields an average grant element of 69.8 percent. Table 3.1 shows that during the period under review, there was a softening of borrowing terms with the grant element rising by 16.5 percentage points at end June 2011.

Table 3.1: Average Terms of Loan Commitments

	June 2010	June 2011
Average Maturity (yrs)	31.7	26.6 ▼
Grace Period (yrs)	7.2	8.1 ▲
Average Interest Rate (%)	1.3	0.8 ▼
Grant Element (%)	53.3	69.8 ▲

Source: Treasury

3.7 External Debt Service

Total external debt service on Central Government debt increased from Ksh 23,611 million in 2009/10 to Ksh 28,055 million in 2010/11 as shown in Table 3.2. Principal repayments increased from Ksh 17,373 million in June 2010 to Ksh 21,020 million in June 2011 while interest payments increased from Ksh 6,238 million to Ksh 7,035 million during the period. In the year under review, external debt service was split 47:53 between multilateral and bilateral creditors. No commercial debt was repaid during the year as the entire category of this debt relates to disputed suppliers' credit.

Table 3.2: External Debt Service on Central Government Debt by Creditor, Ksh Million

Payments	Multilateral		Bilateral		Commercial		Total	
	June 2010	June 2011	June 2010	June 2011	June 2010	June 2011	June 2010	June 2011
Principal	8,976	10,062	8,397	10,958	-	-	17,373	21,020
Interest	2,872	3,189	3,366	3,846	-	-	6,238	7,035
Total	**11,848**	**13,251**	**11,763**	**14,804**	**-**	**-**	**23,611**	**28,055**

Source: Treasury

3.8 Disbursements of External Loans

Total disbursement of external project loans and budget support increased from Ksh 39,582 million in June 2010 to Ksh 59,678 million in June 2011 as shown in Table 3.3. However, the amount disbursed under project loans, Ksh 28,390 million remained below the annual projected target of Ksh 58,000 million at end June 2011. The dismal performance in disbursement of funds was due to low absorption capacity of project funds. To enhance the absorption capacity, the Ministry of Finance has formulated strategies and an action plan in the draft Kenya External Resources Policy on how to improve aid and development effectiveness for consideration and implementation by the stakeholders. The Ministry is also implementing a computerized system, Electronic Project Management Information System (e-Promis) for monitoring the implementation of all development projects.

Table 3.3: External Loans Disbursements, Ksh Million

	June 2010		June 2011	
	Amount	%	Amount	%
Project Cash Loans	10,155	25.7	28,390	47.6
Project A-I-A	29,427	74.3	31,288	52.4
Total	**39,582**	**100.0**	**59,678**	**100**

Source: Treasury

4. PUBLICLY GUARANTEED DEBT

4.1 Legal Framework

Publicly guaranteed debt refers to the debt owed by the country's public entities to both foreign and local creditors but guaranteed by Central Government. The debts may be denominated in domestic or foreign currency.

The Guarantee (Loans) Act, Laws of Kenya, Cap 461 provides the legal framework for issuance of Government loan guarantees to public entities. The ceiling for guaranteed debt is Ksh 80 billion which is subject to review by Parliament through a Sessional Paper by the Minister for Finance. To minimize contingent liabilities to the Central Government and ensure prudent borrowing, public enterprises are required to seek prior approval from their respective management boards, parent ministries and the Ministry of Finance before contracting any direct or guaranteed loans.

The Constitution of Kenya 2010 provides that the County Governments can borrow only with the Central Government guarantee. The Public Finance Management Legislation under which all borrowing laws will be consolidated will come up with provisions and guidelines of how this will be achieved.

Table 4.1: Publicly Guaranteed Debts, Ksh Million

Organization	Year Loan Contracted	Purpose of Loan	Creditor	Loan Balance		Change
				June 2010	June 2011	
City Council of Nairobi	1985	Umoja II Housing Project	USA	348.2	305.5	(42.7)
Kenya Broadcasting Corporation	1989	KBC Modernization Project	Japan	6,268.6	6,722.2	453.6
Telkom Kenya Ltd	1990	Purchase of Microwave Telephone System	Canada	376.8	404.4	27.6
Tana and Athi River Development Authority	1990	Tana Delta Irrigation Project	Japan	2,717.4	2,950.5	233.1
East African Portland Cement	1990	Cement Plant Rehabilitation Project	Japan	3,378.0	3,667.7	289.7
KenGen Ltd	1995	Mombasa Diesel Generating Power Project	Japan	5,899.1	6,642.3	743.2
	1997	Sondu Miriu Hydropower Project	Japan	5,472.5	6,224.8	752.3
	2004	Sondu Miriu Hydropower Project II	Japan	9,758.9	11,773.2	2,014.3
	2007	Sondu Miriu Hydropower Project – Sang'oro Power Plant	Japan	1,620.7	3,238.2	1,617.5
Kenya Ports Authority	2007	Mombasa Port Modernization Project	Japan	819.5	1.2	(818.3)
Kenya Railways	2008	Kenya Railways Concessioning	IDA	3,686.3	4,043.9	357.6
Kenya Farmers Association	2005	Revival of KFA	Local banks	Unutilized	Unutilized	
National Cereals & Produce Board (GSM-102)[3]	2009	Importation of maize under GSM-102	USA	Unutilized	Unutilized	
TOTAL				**40,346.0**	**45,973.8**	**5,627.9**

Source: Treasury

4.2 Stock of Guaranteed Debt

As shown in Table 4.1, outstanding Government guaranteed debt increased by Ksh 5,627.9 million to Ksh 45,973.8 million in June 2011 from Ksh 40,346.0 million in June 2010. The increase was mainly attributed to depreciation of the Kenya Shilling against the Japanese Yen, in which the bulk of the guaranteed debt is denominated and partly due to new disbursements for KenGen – Sondu Miriu Hydropower Project and Kenya Ports Authority - Mombasa Port Modernization Project.

Table 4.2: Payments by the Government on Guaranteed Debt in 2010/11, Ksh Million

Borrower	Quarter I		Quarter II		Quarter III		Quarter IV		Cumulative June 2011	
	Projected	Actual	Projected	Actual	Projected	Actual	Projected	Actual	Projected	Actual
CCN	35.9	-	-	37.2	37.1	37.7	-	-	73.0	74.9
TARDA	159.3	-	-	176.2	234.1	193.6	-	-	393.4	369.8
KBC	-	-	399.5	450.3	-	-	424.2	514.2	823.7	964.5
TOTAL	**195.2**	**-**	**399.5**	**663.7**	**271.2**	**231.3**	**424.2**	**514.2**	**1,290.1**	**1,409.2**

Source: Treasury

3. GSM-102: USA Export Credit Guarantee Program

4.3 Payments by the Government on Publicly Guaranteed Debt

During the period under review, the Government as a guarantor spent Ksh 1,409.2 million to service guaranteed debts owed by public enterprises in financial distress. As shown in Table 4.2, these public enterprises included City Council of Nairobi, Tana and Athi River Development Authority and Kenya Broadcasting Corporation. Due to delays in internal payment processes in the fourth quarter of 2009/10, the projected amount of Ksh 424.28 million remained outstanding as at end June 2010 but was eventually paid in July 2010 after the end of the 2009/10 Financial year.

4.4 Cumulative GoK Payments of Guaranteed Debt

As shown in Table 4.3, the net cumulative repayments of guaranteed debt by the Government on behalf of public enterprises for the last ten years between 1991 and June 2011 stood at Ksh 27,525.8 million. The top net debtors to the Central Government under publicly guaranteed debt are Kenya Broadcasting Corporation (Ksh 7,440.0 million), Nzoia Sugar Company (Ksh 6,127.8 million), City Council of Nairobi (Ksh 3,859.1 million) and Tana and Athi River Development Authority (Ksh 2,658.2 million), all four accounting for over 90 percent of un-reimbursed balances.

Table 4.3: Cumulative Central Government Payments of Guaranteed Debt, Ksh Million, 1991-2010/11

	Parastatals	Principal	Interest	Total	Reimbursement to GoK by Parastatals	Balance
1	Kenya Broadcasting Corporation	4,582.5	2,901.5	7,484.0	44.0	7,440.0
2	Nzoia Sugar Company	4,605.8	1,523.5	6,129.3	1.5	6,127.8
3	City Council of Nairobi	1,828.9	2,154.9	3,983.8	124.7	3,859.1
4	Tana and Athi River Development Authority	1,681.0	977.5	2,658.5	0.3	2,658.2
5	Industrial and Commercial Development Corporation	484.9	181.4	666.3	-	666.3
6	Kenya Railways	1,151.0	203.9	1,354.9	715.1	639.8
7	East Africa Sugar Industries Muhoroni	226.7	75.8	302.5	-	302.5
8	Development Finance Company of Kenya	92.4	39.9	132.3	45.0	87.3
9	KenGen	1,487.4	1,156.5	2,643.9	2,609.7	34.2
10	Tana and Athi River Development Company	1,001.3	1,154.3	2,155.6	2,148.4	7.2
11	Kenya Fiber Corporation	-	14.7	14.7	-	14.7
	TOTAL	**17,141.9**	**10,383.9**	**27,525.8**	**5,688.7**	**21,837.1**

Source: Treasury

5. ON-LENT LOANS AND CONTINGENT LIABILITIES

5.1 Background

Government on-lending is an arrangement where Central Government normally through the Ministry of Finance contracts loans from either external or domestic sources and lends it to a state owned enterprise or institution. In certain circumstances, Central Government may use tax revenue as a source of loan funds. The rationale for this lending arrangement is three-fold:

i. The state-owned enterprise or institution does not have a strong balance sheet to attract funding from external or domestic sources on competitive terms;
ii. The project to be financed is a social welfare enhancing investment that would efficiently be executed by a state-owned enterprise or institution on behalf of the Government;
iii. The state-owned enterprise is of strategic nature to the country.

Depending on the source of borrowing, the Central Government would record a debt (liability) and a corresponding domestic claim (asset) in its portfolio. Borrowing by state-owned entities with or without Government guarantees constitutes potential contingent liability to the Government. In the event of default on on-lent loans and guaranteed or non-guaranteed loans, Central Government will bear the cost of the debt.

Effective Government on-lending is now recognized as an important debt management function. Significant arrears or defaults in the on-lent portfolio can severely constrain efficient debt management, and would ultimately impact on fiscal sustainability. Establishing better institutional processes and ensuring transparency in on-lending operations and monitoring of contingent liabilities are expected to contribute positively towards the management of costs and risks in government debt portfolio.

In an attempt to automate loan records, the Commonwealth Secretariat Debt Recording and Management System (CS-DRMS) was installed in 1988 in the Department of Government Investments and Public Enterprises (DGIPE), Ministry of Finance. CS-DRMS is basically an external and domestic debt management package but has been adopted to manage both on-lent and direct loans managed by DGIPE. DGIPE has designed a customized manual ledger for capturing the loan accounts. To date, the manual ledgers and CS-DRMS exist side by side.

5.2 On-Lent Loan Portfolio

Table 5.1 shows that the total on-lent loan portfolio amounted to Ksh 94,938.3 million as at June 2011, out of which outstanding loans, arrears and accrued interest stood at Ksh 46,666.0 million, Ksh 14,781.1 million and Ksh 33,491.2 million, respectively. Over 90 percent of the loan portfolio is non-performing due to poor financial performance of borrowers.

Table 5.1: Status of On-Lent Loans Portfolio as at June 2011, Ksh Million

Ministry/Sector	June 2010 (Ksh Million)	June 2011 (Ksh Million)			
	Outstanding loans	Outstanding loans	Principal Arrears	Accrued interest	Total
Local Government	7,635.0	7,729.4	4,843.8	10,715.6	23,288.8
Transport	5,636.4	5,636.4	2,405.0	13,017.0	21,058.4
Energy	12,268.3	15,112.5	3,354.8	4,192.7	22,660.0
Agriculture	5,635.5	6,076.6	3,456.9	3,715.1	13,248.6
Water and Irrigation	9,070.9	9,121.2	-	1,255.6	10,376.8
Trade	1,096.2	1,235.9	128.8	3.9	1,368.6
Environment & Natural Resources	593.0	634.8	399.9	1.1	1,035.8
Finance	411.2	554.9	34.5	5.5	594.9
Others[4]	529.6	564.3	157.4	584.7	1,306.4
Total	**42,876.1**	**46,666.0**	**14,781.1**	**33,491.2**	**94,938.3**

Source: Treasury

During the period under review, the outstanding on-lent loans excluding arrears and interest increased by Kshs 3,789.9 million from Ksh 42,876.1 million to Ksh 46,666.0 million. This increase is attributed to new loans on-lent to the water, transport and agriculture sectors.

5.3 Receipts From On-Lent and Direct Loans

As shown in Table 5.2, principal receipts by GoK amounted to Ksh 1,159.9 million during 2010/11 against a projection of Ksh 942.7 million. Over the same period, Ksh 794.4 million was collected as interest receipts against a projection of Ksh 628.9 billion. Total collections therefore translate to 124 percent performance of the portfolio.

Table 5.2 Principal and Loan Interest Receipts, 2010/11, Ksh Million

Organization	Principal Receipts	Interest Receipts	Total
KenGen	821.6	470.9	1,292.5
Kenya Power and Lighting Company	141.2	35.9	177.1
Agro Chemical and Food Company Ltd	0.0	150.0	150.0
Uchumi Supermarkets	81.4	38.6	120.0
Nyeri Water and Sewerage	50.4	27.4	77.8
Kenya Airports Authority	0.0	47.1	47.1
New Kenya Cooperative Creameries	22.0	2.5	24.5
Cooperative Bank of Kenya	11.0	7.4	18.4
K -Rep Bank	11.8	5.1	16.9
Equity Bank	11.0	1.3	12.3
Agricultural Finance Corporation	7.5	0.0	7.5
Moi University	0.0	6.6	6.6
Agricultural Settlement Fund	1.9	1.3	3.2
Kenya Meat Commission	0.0	0.3	0.3
Agricultural Society of Kenya	0.1	0.1	0.2
Total	**1,159.9**	**794.4**	**1,954.3**

Source: Treasury

4. Others include: - Tourism, Education and Land

5.4 Contingent Liabilities

Potentially large and unreported contingent liabilities have been identified as posing additional risk to the sustainability of public debt. In this regard, a comprehensive financial review/study was commissioned in 2007 by the Government to establish the extent of contingent liabilities in twenty five (25) state corporations. The review established that the identified corporations have actual liabilities adding up to Ksh 63.8 billion and contingent liabilities estimated at Ksh 22.1 billion. Subsequently, this review would be extended to other state corporations. With the implementation of a devolved system of Government, the extent of contingent liabilities is expected to increase as liabilities of County Governments are taken into account.

6. DISPUTED EXTERNAL COMMERCIAL DEBT

6.1 Background

Kenya's external commercial debt estimated at Kshs 25,041million or 1.7 percent of total public debt at end June 2011 is in arrears. In August 2004, the Government suspended payments pending verification of the amount due on each of the eleven (11) suppliers' credit contracts which constitute external commercial debt. Soon after the suspension, the Controller and Auditor General undertook a special audit on eighteen (18) suppliers' credit contracts as follows:

1. Eleven (11) contracts that are in dispute;
2. Three (3) contracts though fully paid by the Government, relate to projects in dispute as under (1) above; and
3. Four (4) contracts in which the creditors voluntarily returned all funds paid by the Government.

In four (4) of the eleven (11) suppliers' credit contracts in dispute, the creditors sought legal re-dress in courts or arbitrations in UK, The Hague and Switzerland for breach of contract. In response, the Government engaged reputable and experienced international law firms to represent its interest.

In February 2005, the Kenya Anti-Corruption Commission (KACC) began investigations on these contracts. Although some progress has been made, the pace has been slowed down by court orders that have prohibited KACC from carrying out investigations in some areas.

6.2 Audits on External Commercial Debts

The Controller and Auditor General's Special Audit Report was tabled in Parliament in May 2006. The findings indicated that procurement laws and regulations were violated in the contracting process, that the projects were overpriced and in most cases, no credit was extended by the creditors. The Report recommended that professional valuation of works, goods and services be carried out to determine value for money.

In January 2007, the Ministry of Finance contracted PricewaterhouseCoopers (PwC) to conduct forensic audit and valuation. PwC submitted the forensic audit and valuation report on 31st July 2007. The PwC Report established that those contracts were procured in an irregular manner and that the pricing, financing, and other terms of the contract do not reflect terms obtained on arms length commercial transactions.

Specifically, the PwC Report cited:

i. Significant overpricing
ii. Financing charged in excess of the financing that was needed
iii. Under-delivery of supplies provided under the contracts

iv. Serious contraventions of Kenya public expenditure law
v. Circumstantial evidence that these contracts were corruptly procured

As a precautionary measure, the Government sought to eliminate financial risk exposure on Promissory Notes issued under seven (7) contracts. The Minister for Finance, in consultation with the Attorney General, issued a Caveat Emptor in December 2007 informing all parties that the underlying contracts were fraudulent and hence the Promissory Notes were illegal and the Government would not honour them. The Caveat Emptor was circulated to banks worldwide through SWIFT and placed in the local dailies.

6.3 Government Position on Existing Commercial Debts

The Government is committed to resolving the dispute on the outstanding external commercial debts on the basis of fair value received by the Government on each contract as determined by independent valuers and based on legal advice. On the other hand, the Government will take legal measures to recover from the suppliers any payments over and above the fair value received. One of the 11 projects in dispute, Project Nexus has been successfully resolved and negotiations are on-going in the Oceanographic Vessel project. Two Cabinet Memoranda are awaiting submission to the Cabinet to seek approval on resolution of the remaining projects.

6.4 Lessons Learnt from External Commercial Debt

Some key lessons have been learnt on this matter referred to by the media as the "Anglo Leasing" scandal. First, weak institutional arrangement of public debt management undermined accountability and transparency in the contracting, disbursement and payment processing of external loans. To address this weakness, the Government embarked on a comprehensive public debt management reform program to set up a fully functional Debt Management Department at the Ministry of Finance responsible for all matters relating to public debt. Second, inadequate public financial management system weakens budget formulation and implementation. This partly explains payment of suppliers' credit contracts against under-deliveries. Public Financial Management Reforms have been undertaken to strengthen the budget, accounting and control systems in Central Government. Third, weak legal framework on public procurement that permitted single sourcing on account of national security concerns. Whereas restricted tendering system or single sourcing is not wrong per se, it can be subject to abuse in absence of robust framework of checks and balances. This matter has to a large extent been addressed in the Public Procurement and Disposal Act 2005.

Finally, lack of formal debt policy and strategy that guides debt management operations created fiscal risk through high cost borrowing to finance non-priority expenditures. As a remedial measure, the Government has prepared a Medium Term Debt Strategy (MTDS) that indicates the sources, amount and loans of preferred borrowing to finance the budget deficit taking into account both cost, risk and debt sustainability. Specifically, external commercial borrowing will be contracted transparently from reputable financial institutions or through issuance of an International Sovereign Bond.

7. DEBT STRATEGY AND DEBT SUSTAINABILITY

7.1 Background

Since 2009, the Ministry of Finance has been preparing the Medium Term Debt Strategy (MTDS) which outlines the government borrowing policy by evaluating the cost and risk characteristics of both the existing public debt portfolio and alterative borrowing mix. In addition, the strategy incorporates initiatives to develop a vibrant domestic debt market.

The 2011 MTDS outlines the Government preferred strategy to guide debt management operations in FY2011/12.

The government has over the years sought to maximize concessional external borrowing. This source of financing has been dwindling due to creditors lending on hardened terms. The government has also taken into account the interest cost and rollover risk associated with accumulation of domestic debt. While the government is increasingly facing limited financing options, the MTDS remains a key tool to achieving its objectives.

Kenya is currently implementing an economic and financial program supported by a three-year Extended Credit Facility (ECF) arrangement with the International Monetary Fund. The program is designed to help rebuild Kenya's international reserves by supporting the conditions for sustainable growth while preserving macroeconomic stability. The program's main objectives are: i) to raise real GDP to 7 percent, with an increased reliance on domestic private savings and investment consistent with a decline in the external current account deficit to about 5 percent of GDP; ii) bring the public debt to GDP ratio to below 45 percent over the medium term; and iii) bring inflation to 5 percent in the medium term..

A summary of the 2011 MTDS is presented in Box 1 and section 7.2.

Box 1: 2011 MEDIUM TERM DEBT MANAGEMENT STRATEGY (MTDS)

I. Alternative Borrowing Strategies

The 2011 MTDS evaluated the following five (5) possible debt financing strategies (See Table 1 below):

1. Strategy 1 (S1. 2010 MTDS). In view of the challenges arising from absorption of external concessional borrowing, this strategy assumes 25 percent of gross financing needs would be external while domestic borrowing would amount to 75 percent.
2. Strategy 2 (S2. More external borrowing). This strategy assumes that 30 percent of the gross financing needs would be met by external borrowing, on both semi-concessional and concessional credit terms, and 70 percent from the domestic market.
3. Strategy 3 (S3. Medium term domestic debt). This strategy assumes external and domestic borrowing in the same proportion as in S1 (25 percent external and 75 percent domestic), with more domestic debt issued at 5- and 10- year maturities, in line with market needs and cost reduction.
4. Strategy 4 (S4. More domestic borrowing). This strategy assumes domestic borrowing would amount to 80 percent while 20 percent of the gross financing needs would be met by external borrowing, from both semi-concessional and concessional creditors.
5. Strategy 5 (S5. International Sovereign Bond (ISB)). Under this strategy, the Government would issue an international bond as an alternative to increasing domestic borrowing.

Table 1: Alternative Debt Management Strategies

Envisaged New debt	2010 MTDS S1	More external debt S2	Medium term domestic debt S3	More domestic debt S4	ISB S5
Domestic	75%	70%	75%	80%	65%
1-year	8%	8%	8%	8%	3%
2-year	11%	12%	11%	12%	7%
5-year	19%	16%	22%	19%	13%
10-year	19%	18%	17%	20%	13%
15-year	9%	8%	9%	12%	10%
20-year	9%	8%	8%	9%	20%
External	25%	30%	25%	20%	35%
Semi-concessional	8%	7%	5%	5%	8%
Concessional	17%	20%	17%	13%	13%
5-Yr Syndicate	0%	3%	3%	3%	3%
10-yr ISB	0%	0%	0%	0%	11%

II. 2011 MTDS

After analyzing the five strategies and carrying out simulations, Strategy S2 was identified as the optimal strategy. The strategy entails:

i. 70% net domestic financing and 30% external financing;
ii. The domestic borrowing will be on medium term basis;
iii. External borrowing will comprise of 20% on concessional terms, 7% on semi concessional terms while 3% will be contracted as a syndicated bank loan;
iv. There will be no issuance of the Euro bond during the year as developments in the international markets are monitored.

7.2 Cost and risk characteristic of existing debt portfolio

The 2011 MTDS envisaged growth of public debt stock as at June 2011 to reach Kshs 1,347 billion or 49 percent of GDP in nominal terms. However at end June 2011, the stock of public debt stood at 1,487 billion or 54 percent of GDP as shown in Table 7.1. This reflects the desire of the Government to reduce reliance on external sources in light of their volatility.

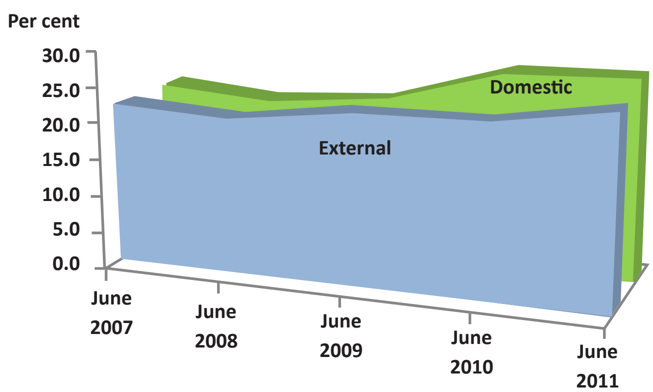
Table 7.1: External and Domestic Debt, End June 2011

	USD Billion	Ksh Billion	Percent of GDP	Share of total debt	Weighted avg. interest rate
External debt	8.0	722.9	26.2	48.8	0.8
Domestic debt	8.5	764.2	27.7	51.2	12.4
Total debt	**16.5**	**1,487.1**	**53.9**	**100.0**	**6.8**

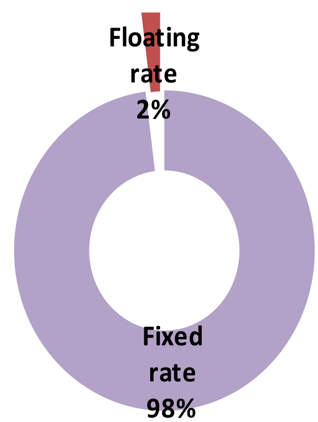
Source: Treasury and Central Bank of Kenya

Chart 7.1 Evolution and composition of total public debt

(a) Total public debt in percentage of GDP



(b) Interest rate composition, June 2011



Source: Treasury and Central Bank of Kenya

Table 7.2 summarizes the relevant considerations arising from the current debt portfolio that influence the 2011 MTDS. Appendix 5 also summarizes macro-risks and implications for the MTDS.

Table 7.2: Cost and Risk Considerations of Debt Portfolio, End June 2011

Characteristics of Existing Portfolio	Ex ante Risks	Ex ante Cost
Currency composition (FX = 43%; DX = 57%)		
External, mostly concessional	Exchange rate risk	Low
Domestic	No exchange rate risk	High
Maturity profile (ATM = 8.7 years)		
External, mostly concessional (ATM = 11.7 years)	Low refinancing risk	Low
Domestic (ATM = 5.8 years)	Medium refinancing risk	High
Interest rate composition (Fix = 98%; Float = 2%)	Low interest rate risk	Low

Source: Treasury

7.3 Sources of finance

7.3.1 External Sources of Financing

Official Sources

External debt will be contracted from mainly multilateral and bilateral sources. IDA, ADB/AfDB and EEC/EIB are the main multilateral creditors while Japan, France and Germany are the main bilateral creditors.

Commercial Sources

Kenya's commercial debt constitutes about 4 percent of total public external debt. All Commercial debt is in dispute. The Government potential to access international capital market remains, particularly given the general recovery in international market conditions.

7.3.2 Domestic Sources of Financing

The investor base remains dominated by the domestic banking sector, which represent about 50 percent of the investor base. Pension funds and insurance companies are the next most significant investor group. In order to create liquidity and establish a credible yield curve in the domestic debt market, the Government identified benchmark instruments.

7.4 Baseline assumptions for 2011 MTDS

7.4.1 Macroeconomic Assumptions

i. Growth in real GDP has continued to improve with output expanding faster that projected. In 2010/11, real GDP growth rate was 5.4 percent and is expected to gradually reach 6.5 percent in 2013/14.
ii. The 2011 MTDS projected that the overall budget deficit (including grants) will decline from 5.9 percent of GDP in FY 2010/11 to 3.7 percent of GDP in FY 2013/14.
iii. Inflation is expected to remain at around 6 percent, and the exchange rates to remain stable.
iv. Balance of Payments is expected to return to surplus from FY2010/11 due to improvements in exports, remittances and FDI compared to 2009/10.
v. Gross international reserves are assumed to reach the East African Community (EAC) target of 4 months of imports by FY 2013/14.

7.4.2 External Borrowing Assumptions

i. Concessional external loans are priced at a fixed rate of 0.75 percent, with a 40-year tenor and a 10-year grace period.
ii. Semi-concessional loans are assumed to be contracted from official creditors or export credit agencies. These loans have a fixed interest rate of 2.5 percent, a maturity of 20 years including a 5-year grace period.
iii. Non-concessional financing including guarantees assumed at USD 700 million for the

year 2011/12.

iv. Accessing the international capital market is priced off the assumed effective yield curve, based on the underlying forward US Treasury yield curves plus an assumed credit spread. The international sovereign bond would have a maturity of 10 years, with a bullet repayment and a credit spread of 450 basis points.

v. The net external borrowing for financial year 2011/12 is 1.9 percent of GDP and expected to rise to 2.5 percent of GDP in the financial year 2013/14.

7.4.3 Domestic Borrowing Assumptions

i. Borrowing will be through Treasury Bills and Benchmark Treasury Bonds at the ratio of 30:70 to ensure the maturity structure of the existing portfolio is lengthened to minimize refinancing risk and build liquidity.

ii. Net domestic borrowing for financial year 2011/12 is 3.5 percent of GDP and is expected to fall to 1.2 percent of GDP in the financial year 2013/14.

In the financial year 2011/12, borrowing limit is set at 5.4 percent of GDP and expected to decline to 3.7% of GDP in 2013/14.

7.5 Debt Sustainability

Kenya conducted a Debt Sustainability Analysis in 2011 under the joint World Bank-IMF Debt Sustainability Framework (DSF). The DSF concluded that the debt sustainability indicators have deteriorated slightly reflecting a projected faster debt accumulation over the medium term. However, Kenya remains at low risk of external debt distress (See Appendices 6 and 7). Debt Sustainability is assessed in relation to policy-dependent debt burden thresholds. Kenya is classified as a “medium performer” in terms of quality of its policies and institutions as measured by a three year average of Kenya’s score on the World Bank’s Country Policy and Institutional Assessment (CPIA) index.

In Table 7.3, a worst case scenario is simulated where a “borrowing shock” scenario is presented which assumes a Government borrowing equivalent to 10 percent of GDP in FY 2011/12. The results indicate that in the medium term (by FY 2013/14), the debt burden indicators will breach one debt sustainability benchmark, the Net Present Value of Debt as a percentage of GDP (NPV of Debt/GDP).

Table 7.3: Sensitivity Analysis for Key Indicators of Public Debt

	Benchmark	2011	*Impact of 10% of GDP increase in borrowing in 2011 on debt indicators in 2014*
NPV of debt as % of: -			
GDP	40	39	48
Revenue	250	154	180
Debt service as % of: -			
Revenue	30	22	26

**Source: Treasury*

7.6 Implementing the 2011 MTDS

To support the development of a MTDS, reforms to improve the enabling environment will be implemented in the following areas:

i. The Government will determine a borrowing plan to accompany the 2011 MTDS and meet the financing requirement for the coming fiscal year. The Government will communicate it to the market participants.
ii. If the risk parameters in 2011 MTDS result in a significant deviation from the outturn, the strategy will be reviewed and revised.
iii. To support the debt management strategy, the Government will develop a robust legal framework.
iv. The Government will increasingly monitor the contingent liabilities as they have implication on debt sustainability.
v. Continued collaboration with partners, such as the US Treasury, the World Bank, IFC, MEFMI and Commonwealth Secretariat will be encouraged in developing the Government and corporate bond markets and capacity building in debt management.

In conclusion, the 2011 MTDS complements the debt sustainability framework which is concerned with long-term sustainability of debt. Caution is however warranted to ensure the favourable public debt situation persists over the medium term. Larger recourse to domestic debt financing could further increase the domestic interest rates undermining the favourable debt situation. Recourse to non-concessional external financing could also prove difficult and may increase the risk of debt distress. The borrowing envisaged under the 2011 MTDS will be undertaken with caution taking these factors into account.

Box 2: Sovereign Credit Ratings

As a requirement to access the international capital markets, sovereign rating is imperative. This rating is important not only because some of the largest issuer in the international capital markets are national governments, but also because these assessments affect the ratings assigned to borrowers of the same nationality. Kenya has been rated B+ by two renowned international rating agencies: Standard and Poor's (S&P) and Fitch Ratings Limited.

Table 7.3 Rating Criteria for Long Term Debt

Investment - Grade Ratings		
Interpretation	Moody's	S & P/Fitch
Highest quality	Aaa	AAA
High quality	Aa1 Aa2 Aa3	AA+ AA AA-
Strong payment capacity	A1 A2 A3	A+ A A-
Adequate payment capacity	Baa1 Baa2 Baa3	BBB+ BBB BBB-
Speculative - Grade Ratings		
Likely to fulfill obligation, ongoing uncertain	Ba1 Ba2 Ba3	BB+ BB BB-
High risk obligations	B1 B2 B3	B+ B B-

8. OECD PUBLIC DEBT MANAGEMENT PARTNERSHIP

8.1 Background

The OECD Working Party on Debt Management (WPDM) was set up in 1979 as a special working group of the OECD's Committee on Financial Markets. The mandate of the WPDM was to serve as a policy forum for senior government debt managers from OECD Member countries to exchange their views, experiences and policies in the field of government debt management and government securities markets.

In 1990, WPDM initiated a policy dialogue with transition countries and emerging markets, including the Annual OECD/World Bank/IMF Global Bond Market Forum, the Annual OECD Global Public Debt Management Forum, and the OECD Forum on African Public Debt Management and Government Securities Markets.

8.2 OECD Forum on African Public Debt Management

Following the Annual OECD Global Forum on Public Debt Management, the first OECD forum on African Public Debt Management was held in Amsterdam, in December 2006. This Forum has become a regular annual event bringing together senior debt managers from OECD countries and Africa enabling frank and open discussions about latest technical developments, comparing good practice and sharing experiences.

Four key issues have been identified as affecting debt management in Africa:

i. Data quality;
ii. Resourcing;
iii. The macroeconomic framework; and
iv. The absence of high level drivers for change.

Following up on the above issues, the IMF announced that it was actively seeking to enhance its surveillance of debt management identifying the following four short- and medium-term priorities:

i. A risk orientated approach which should start with the use of a robust debt sustainability framework which takes into account domestic debt and contingent liabilities,
ii. The continued improvement in debt data and debt management systems,
iii. Development and implementation of a medium term debt strategy, and
iv. Establishment of a debt management function which is risk orientated.

As at June, 2011, OECD had conducted five (5) Global Forums on African Public Debt Management and four (4) regional Workshops on African Debt Management and Bond Markets. The regional workshops are jointly organized by OECD and South African authorities. The first OECD Regional Workshop on African Debt Management and Bond Markets was held in Johannesburg, in April 2007.

8.3 African Public Debt Management and Government Securities Markets

The project on African Public Debt Management and Government Securities Markets involves forum meetings for policy makers to prepare and execute sound debt management strategies and develop local-currency bond markets.

The project has enhanced awareness of public debt management and government bond markets in Africa across multiple audiences. These activities take on greater importance as many countries take advantage of debt reduction initiatives and seek to avoid falling back into positions of unsustainable debt.

Working relationships have been established and are being maintained with various international organisations such as the IMF, World Bank, COMSEC and MEFMI. In this way, the project acts as a platform for implicitly co-ordinating the different and complementary activities of the various agencies in the area of public debt management and government bond markets.

8.4 African Central Government Debt Statistical Year Book

The first issue of the Statistical Yearbook on African Central Government Debt, compiled by OECD provides comprehensive and consistent information on African central government debt instruments. Individual country data is presented in a comprehensive standard framework to facilitate country comparison. This initiative has created a new database that complements and supports other internationally acknowledged publications. The first publication in 2009 benefited from the following countries: Angola, Cameroon, Kenya, Madagascar, Malawi, Morocco, Mozambique, Namibia, Nigeria, South Africa, Tanzania, Tunisia, Uganda and Zambia. The second edition in 2010 had three additional countries; Gabon, Mauritius and Sierra Leone. 31 countries are expected to participate in the publication of the third edition of the Statistical Yearbook in 2011.

8.5 OECD Centre for African Public Debt Management

The centre was launched in June 2011 and is aimed at encouraging cooperation, not only amongst African debt managers, but also other stakeholders, such as securities exchanges and other financial institutions in working towards sound practices, in order to create stronger securities markets and developing the necessary infrastructure in Africa. The centre will be housed at the Development Bank of South Africa (DBSA), in Midrand, South Africa.

The centre will mainly focus on:

i. Promoting policy dialogue among Africa Debt Managers;
ii. Drafting and publishing an African bond market monitor and compiling debt data and statistics;

iii. Sharing practices in public debt management and the development of bond markets;
iv. Engaging in capacity building programs to enhance the skills level of debt managers in Africa; and
v. Promoting cooperation of the centre with other multilateral, regional and financial institutions in respect of complementary projects and activities.

Kenya's public debt management functions and practices are bound to benefit greatly from the activities to be undertaken by the centre.

9. REFORMS IN PUBLIC DEBT MANAGEMENT

9.1 Introduction

To address structural weaknesses in public debt management, Treasury and the Central Bank of Kenya (CBK) have been implementing certain reforms supported by the Financial and Legal Sector Technical Assistance Project (FLSTAP) and the Public Financial Management Reforms (PFMR) project.

The objective is to transform the Debt Management Department (DMD) to a Debt Management Office (DMO) at the Ministry of Finance anchored on an effective staff retention framework to effectively perform public debt management functions in accordance with best practice. The CBK will spearhead reforms in the domestic debt markets to deepen the investor base, promote secondary market trading and support development of a reliable yield curve for Government securities. Under the new institutional arrangement, debt management operations will be guided by both appropriate legal framework and Medium Term Debt Strategy (MTDS).

9.2 Reforms at the Ministry of Finance

9.2.1 Achievements

9.2.1.1 Consolidation of Debt Management functions

i. DMD Organization Structure set up with clearly defined functions. This will be complemented by the envisaged establishment of a Debt Management Office.
ii. Staffing and staff training at DMD has been enhanced.
iii. Annual DMD Work Plans developed, implemented, monitored and evaluated.
iv. DMD Service Charter developed.

9.2.1.2 Strengthening Back Office Operations

i. New CS-DRMS 2000+ software installed and upgraded periodically.
ii. Updated and validated external debt data in the CS-DRMS database.
iii. Use of CS-DRMS 2000+ in Back office operations, debt service forecasts for the annual Budget and other debt statistics.
iv. Computerization of external debt service Payment Advice (PA) through an in-house developed system. This process was previously done manually, resulting to delays, inaccuracies and subsequent accumulation of arrears and resultant penalty payments.
v. Strengthened Back Office payment and settlement operations.
vi. Developed Back Office operations manual.
vii. Activated the Fibre Optic link between the Treasury and CBK to facilitate electronic data transmission.

9.2.1.3 Strengthening of Front and Middle Office Operations

i. Active participation in domestic and external borrowing strategy, design and implementation.
ii. Increased and accurate dissemination of debt information through Weekly Domestic Borrowing Bulletin, Monthly Debt Bulletin, Quarterly Economic and Budget Review (QEBR), Annual Public Debt Management Report and other ad hoc reports.
iii. Developed Front and Middle Office operations manuals.

9.2.1.4 Development of a Medium Term Debt Strategy (MTDS). In June 2011, the Government published the third debt strategy, the 2011 Medium Term Debt Strategy.

9.2.2 Challenges

i. Resource constraint to support capacity building in debt management.
ii. Staffing constraints and staff retention (high staff turnover) at DMO and County levels.
iii. Delays in receiving technical assistance under donor funded programs.
iv. Sustaining debt management capacity at National and County level.

9.2.3 Future Reforms

The Treasury through DMD plans to implement the following reforms to further strengthen public debt management:

i. Strengthen staffing and staff retention policy for the DMO.
ii. Execute the Agency Agreement between the Treasury and CBK.
iii. Ensure sustainable capacity to design and implement Medium Term Debt Strategy.
iv. Prepare the Public Finance Management Regulations on debt management.
v. Assist County Government strengthen debt management units.

9.3 Reforms at the Central Bank of Kenya

9.3.1 Achievements

i. Continued implementation of the Government Securities Market Makers (GSMMs) initiative as a first phase of the Primary Dealers (PD) framework.
ii. On the legal framework, Internal Loans Act amendments finalised as part of input to the Public Financial Management (PFM) Bill.
iii. Continued support for longer maturity profile of domestic debt with the issuance of the longest bonds of 25 and 30 years in the region during the period under review. Average maturity of domestic debt has improved to 5.8 years as at June 2011 from 0.5 years in June 2001.
iv. In expanding the range of financial products available to the market under product diversification initiative, the CBK in February 2011 successfully issued the first ever 30 year Savings Development Bond (SDB) as a retail product to instil a saving culture in

the populace. Product diversification in the period under review also included unique packaging of features of bonds with incentives to both the issuer and the investors.

v. During the financial year and building on the success of the Infrastructure Bonds (IFBs) program since 2009, the CBK successfully issued a single IFB worth Kshs 31.6 million which was oversubscribed, indicating strong support for infrastructure development by public and the market.

vi. The Bank continued to support securities market awareness and information dissemination initiatives mainly through the Market Leaders Forum (MLF), marketing and promotions in mass media, modernized customer care desk at CBK and in its website www.centralbank.go.ke.

vii. The CBK began the bond consolidation strategy aimed at smoothening the maturity profile of bonds, addressing bonds fragmentation and market illiquidity through Benchmark Bonds. The successful implementation of this program has been very useful in supporting uptake of bonds at the primary market, enhancing liquidity at the secondary market and development of the yield curve.

9.3.2 Challenges

i. Meeting domestic government borrowing targets particularly during unfavorable market conditions.

ii. Changeover from manual to automated auction process.

9.3.3 Future Reforms

i. Fully implement the GSMM program as a first phase in the PD framework.

ii. On the legal framework, CBK will continue to participate in the formulation of the PFM legislation to guide public debt management and support secondary market development.

iii. Implement an online platform for CBK Central Depository System (CDS) account opening, bidding and auction information dissemination to enhance efficiency at the primary market for Government securities. The Bank in conjunction with the Treasury and World Bank (WB) also intends to finalise the implementation of the Treasury Mobile Direct Programme to enable sale of Government Securities through mobile phones, thus deepening investor base particularly the retail segment.

iv. In liaison with MOF, CMA and other stakeholders, oversee the establishment of Over the Counter (OTC) trading platform for government securities.

v. Continue implementation of the Benchmark Bonds program through consolidation strategies and bond reopening. (See Appendix 8).

vi. Introduce more innovative products such as bonds targeting Kenyan Diaspora citizens and securities with post-auction offers through Tap sales.

10. OUTLOOK FOR THE MEDIUM TERM

10.1 Public Debt Stock in the Medium Term

As shown in Table 10.1, overall public debt is projected to increase in nominal terms from Ksh 1,487,110 million in June 2011 to Ksh 1,547,424 million in June 2012 and rise to Ksh 2,044,315 million in June 2015. However, as a proportion of GDP, public debt in nominal terms is projected to decline from 53.9 percent of GDP in June 2011 to 48.6 percent of GDP in June 2012 and to decline further to 45.6 percent in June 2015.

External debt is projected to rise from Ksh 722,888 million in June 2011 (26.2 percent of GDP) to Ksh 760,976 million (23.9 percent of GDP) in June 2012 and to Ksh 1,118,757 million (25.0 percent of GDP) in June 2015. Similarly, domestic debt is projected to increase from Ksh 764,222 million (27.7 percent of GDP) in June 2011 to Ksh 786,448 million (24.7 percent of GDP) in June 2012 and rise to Ksh 925,558 million (20.6 percent of GDP) in June 2015.

Table 10.1: Projected Public Debt Stock, Ksh Million

	2010/11*	2011/12	2012/13	2013/14	2014/15
External Debt	722,888	760,976	882,894	990,717	1,118,757
% of GDP	26.2%	23.9%	24.6%	24.7%	25.0%
Domestic Debt	764,222	786,448	832,648	882,420	925,558
% of GDP	27.7%	24.7%	23.2%	22.0%	20.6%
Total Public Debt	**1,487,110**	**1,547,424**	**1,715,542**	**1,873,137**	**2,044,315**
% of GDP	53.9%	48.6%	47.8%	46.7%	45.6%
Memoranda Items					
Nominal GDP	2,761,500	3,184,100	3,588,700	4,011,500	4,483,500
Ordinary Revenue	605,820	713,700	814,500	920,600	1,031,100

Source: Treasury

** Provisional*

10.2 Debt Service in the Medium Term

Table 10.2 shows that although in nominal terms overall debt service is projected to increase by 48 percent in the medium term, as a ratio to GDP, the debt burden indicators will be within sustainable levels. Total debt service is projected to decline from 15.5 percent of revenue in 2011/12 to 15.3 percent of revenue in 2012/13 and decline further to 14.2 percent of revenue in 2014/15. Nearly 60 percent of the increase in debt service is attributed to domestic interest.

Domestic interest is projected to increase from Ksh 76,558 million in 2011/12 to Ksh 86,129 million and Ksh 98,644 million in 2012/13 and 2014/15, respectively. However, as a percentage of revenue, domestic interest will remain at an average of 10 percent in the medium term. On the other hand, interest on external debt is projected to increase from Ksh 8,251 million in 2011/12 to Ksh 9,980 million in 2012/13 and rise further to Ksh 15,899 million in 2014/15, an average 1.4 percent of revenue over the period.

Annual principal repayments on external debt is projected to increase from Ksh 25,472 million in 2011/12 to Ksh 28,712 million in 2012/13 and to Ksh 31,451 million in 2014/15 or an annual average of 3.3 percent of revenue.

Table 10.2: Central Government Projected Debt Service, Ksh million

	2010/11	2011/12	2012/13	2013/14	2014/15
Domestic Interest	70,497	76,558	86,129	88,253	98,644
% of Revenue	11.6%	10.7%	10.6%	9.6%	9.6%
External Interest	7,035	8,251	9,980	13,681	15,899
% of Revenue	1.2%	1.2%	1.2%	1.5%	1.5%
Total Interest	77,532	84,809	96,109	101,934	114,543
% of Revenue	12.8%	11.9%	11.8%	11.1%	11.1%
External Principal Repayments	21,020	25,472	28,712	28,077	31,451
% of Revenue	3.5%	3.6%	3.5%	3.0%	3.1%
Total Debt service	**98,552**	**110,281**	**124,821**	**130,011**	**145,994**
% of Revenue	**16.3%**	**15.5%**	**15.3%**	**14.1%**	**14.2%**

Source: Treasury

GLOSSARY

- **Bond Conversion**
  This is a strategy where the outstanding volume of the bond is redeemed or converted into another or a new one with longer maturity provided the holders of such a portion are agreeable.

- **Bond Reopening**
  This involves opening up or offering the same paper to the primary market on a date other than its original issue date with a view to increasing its outstanding amounts and or expanding the original offer amounts.

- **Bond Switching**
  This a strategy in which a portion of an existing bond is switched through an auction process into another existing bond preferably of longer maturity or a new one to build the volume of the benchmark issue.

- **Concessionality**
  A measure of the softness of a credit reflecting the benefit to the borrower compared to a loan at market rate. Technically, it is calculated as the difference between the nominal value and the present value of the debt service as of the date of disbursement, calculated at a discount rate applicable to the currency of the transaction and expressed as a percentage of the nominal value.

- **Debt Relief**
  Agreements by creditors to lessen the debt burden of debtor countries by either rescheduling interest and principal payments falling due over a specified time period, sometimes on concessional basis, or by partially or fully cancelling debt service payments falling due in a specified period of time.

- **Debt Rescheduling**
  A form of debt re-organization in which payments of principal and/or interest previously due at a specified time are deferred for repayment on a new schedule following negotiations between the creditor and debtor.

- **Debt Service**
  The amount of funds necessary for or used in the payment of interest or amortization charges of a debt.

- **Debt Sustainability**
  Sustainable debt is the level of debt which allows a debtor country to meet its current and future debt service obligations in full, without recourse to further debt relief or

rescheduling, avoiding accumulation of arrears, while allowing an acceptable level of economic growth.

- **Debt Sustainability Analysis**
  Conducted in the context of medium-term scenarios. These scenarios are numerical evaluations that take account of expectations of the behaviour of economic variables and other factors to determine the conditions under which debt and other indicators would stabilize at reasonable levels, the major risks to the economy, and the need and scope for policy adjustment. In these analysis, macroeconomic uncertainties, such as the outlook for the current account, and policy uncertainties, such as for fiscal policy, tend to dominate the medium term outlook.

- **Disbursement**
  The actual international transfer of financial resources or of goods or services by the lender to the borrower.

- **Domestic Borrowing**
  Government borrowing through issuance of Government securities and direct borrowing from the Central Bank.

- **Export Credit**
  Loans for the purpose of trade and which are not represented by a negotiable instrument. They may be extended by the official or the private sector. If extended by the private sector, they may be supported by official guarantees.

- **External Borrowing**
  Government borrowing from both official (Government or Government agencies) and private institutions domiciled outside the country.

- **Government Securities**
  Financial instruments used by the Government to raise funds from the primary market.

- **Grant Element**
  It measures the concessionality of a loan, in the form of the present value of an interest rate below the market rate over the life of a loan.

- **London Club**
  An international group of private commercial banks whose credits are not covered by government guarantees or insurance. The group is designed to provide a common approach to rescheduling of such debts owed by debtor countries.

- **Monetary Policy**
  The management of money supply by the Central Bank in an economy to achieve desired economic conditions such as the overall level of prices.

- **Present Value**
  The present value (PV) of debt is a measure that takes into account the degree of concessionality. It is defined as the sum of all future debt-service obligations (interest and principal) on existing debt, discounted at the appropriate market rate. Whenever the interest rate on a loan is lower than the market rate, the resulting PV of debt is smaller than its face value.

- **Official Development Assistance**
  Loans from official development agencies to countries received by the public sector, for promotion of economic development and welfare as the main objective and, extended at concessional financial terms (with minimum grant element of 25 percent). Loans and credits for military purposes are excluded in this definition.

- **Paris Club**
  The Paris Club is an ad-hoc gathering of creditor Governments, chaired by high ranking official of the French Treasury, which meets for the purpose of rescheduling debts. The Paris Club is open to all creditor governments that are willing to adhere to its unwritten rules and practices and that have claims against a debtor country seeking rescheduling. Debtor countries must have strong adjustment programs supported by the upper credit tranche IMF arrangements before being considered for debt relief.

- **Primary Market**
  A market in which initial issue of financial instruments is made.

- **Public Debt**
  Outstanding financial liabilities of the Government arising from past borrowing. It includes Government guaranteed debts to State Corporations and Local Authorities.

- **Public Domestic Debt**
  Part of the overall debt owed by the Government to creditors domiciled in the economy. The debt includes money owed to commercial banks, non-bank financial institutions and individuals.

- **Public External Debt**
  Part of the overall debt owed by the Government to creditors domiciled outside the economy. The debt includes money owed to private commercial banks, other governments, or international financial institutions such as the IMF and World Bank.

- **Secondary Market**
  A market for already issued financial instruments.

- **Suppliers' Credit**
  An arrangement under which a supplier or exporter agrees to allow the customer to defer payment under a sales contract.

- **Tap sale**
  Ongoing issuance in the same series.

- **Treasury Bills**
  Short term debt instruments currently with maturities of 91, 182 and 364 days issued by the Treasury. In Kenya, this instrument is issued by the Treasury through the CBK.

- **Treasury Bonds**
  Medium to long-term term debt instruments issued by the Treasury. In Kenya, this instrument is issued by the Treasury through the CBK.

- **Yield Curve**
  Relationship between the interest rate and maturity of securities. A rising yield curve, that is, where interest rated for short-term securities are lower than interest rates for long-term securities, is called normal. A falling yield curve is described as inverted.

APPENDICES

Appendix 1: Outstanding Government Securities by Tenor, Ksh Million

Tenor	June 2002	June 2003	June 2004	June 2005	June 2006	June 2007	June 2008	June 2009	June 2010	June 2011
91-DAY	61,420	48,186	29,500	42,761	37,632	22,017	17,980	23,523	23,663	69,135
182-DAY	20,630	30,558	33,439	29,177	57,144	72,405	58,313	93,271	85,337	22,528
364-DAY									49,494	34,942
1-YEAR	15,258	14,593	9,343	30,953	1,000	8,728	13,191	14,789	-	0.0
1.5 YEAR	3,999	-	-	-	-	-	-	-	-	0.0
2-YEAR	33,117	44,214	28,237	24,686	39,738	37,652	31,747	45,206	46,577	73,012
3-YEAR	31,846	40,973	44,817	27,898	31,225	31,174	26,663	12,798	1,781	0.0
4-YEAR	9,800	20,187	26,520	26,160	26,287	19,281	16,539	12,914	3,384	0.0
5-YEAR	9,336	18,003	23,086	22,740	28,391	28,787	43,511	52,787	86,582	114,551
6-YEAR	2,982	11,800	17,909	20,434	33,105	48,333	47,589	38,769	48,986	60,661
7-YEAR		2,801	8,558	10,330	13,566	15,884	24,154	24,153	21,353	24,296
8-YEAR	-	3,907	11,969	11,969	15,287	17,944	17,944	17,944	26,721	22,813
9-YEAR	-	2,368	9,555	9,555	12,615	12,615	12,615	12,615	17,760	27,732
10-YEAR	-	2,705	8,634	8,634	17,113	22,113	34,415	44,415	69,090	91,391
11-YEAR	-	-	-	-	-	4,031	4,031	4,031	4,031	4,031
12-YEAR	-	-	-	-	-	8,766	8,766	28,494	33,051	33,051
15-YEAR	-	-	-	-	-	16,892	32,114	42,303	61,929	75,443
20-YEAR	-	-	-	-	-	-	1,912	9,526	20,361	29,727
25-YEAR	-	-	-	-	-	-	-	-	7,008	20,193
30-YEAR	-	-	-	-	-	-	-	-	-	18,760
TOTAL	**188,388**	**240,295**	**251,567**	**265,297**	**313,103**	**366,622**	**391,484**	**477,538**	**607,109**	**722,266**

Source: Treasury and Central Bank of Kenya

Appendix 2: Treasury Bonds Issues, July 2010 - June 2011, Order by Issue Date

Issue no	Tenure (Years)	Amount at face value (Ksh Million)	Amount at cost (Ksh Million)	Issue date	Maturity date
FXD 1/2010/25	25	13,184,350,000.00	15,029,468,782.50	26/07/2010	28/05/2035
IFB 2/2010/9	6	14,200,000,000.00	13,163,182,863.25	30/08/2010	22/08/2016
IFB 2/2010/9	7	8,700,000,000.00	8,114,919,636.45	30/08/2010	21/08/2017
IFB 2/2010/9	9	9,971,550,000.00	9,306,922,044.30	30/08/2010	19/08/2019
FXD 3/2010/2	2	12,740,950,000.00	12,769,633,077.00	27/09/2010	24/09/2012
FXD 1/2010/10	10	13,847,900,000.00	14,462,477,148.00	01/11/2010	19/10/2020
FXD 2/2010/5	5	11,968,750,000.00	11,970,146,450.00	29/11/2010	23/11/2015
FXD 4/2010/2	2	8,946,200,000.00	8,946,606,136.00	27/12/2010	24/12/2012
FXD 2/2010/15	15	7,329,350,000.00	6,316,191,993.00	27/12/2010	08/12/2025
FXD 1/2011/5	5	10,810,200,000.00	10,810,797,632.00	31/01/2011	25/01/2016
FXD 2/2010/10*	10	1,111,650,000.00	1,085,650,371.00	31/01/2011	19/10/2020
FXD 1/2011/2	2	14,226,500,000.00	14,227,019,335.00	28/02/2011	25/02/2013
SDB 1/2011/30	30	8,718,100,000.00	8,097,583,053.00	28/02/2011	21/01/2041
FXD 1/2011/5	5	11,272,900,000.00	11,023,156,280.00	28/03/2011	25/01/2016
SDB 1/2011/30*	30	10,041,550,000.00	9,033,178,376.50	28/03/2011	21/01/2041
FXD 2/2011/2	2	1,438,900,000.00	1,438,973,695.00	25/04/2011	22/04/2013
FXD 2/2010/15*	15	6,183,750,000.00	4,782,536,624.00	25/04/2011	08/12/2025
FXD 2/2011/2	2	7,034,500,000.00	6,684,489,432.50	30/05/2011	22/04/2013
FXD 1/2010/10*	10	7,341,550,000.00	5,894,844,502.00	30/05/2011	19/10/2020
FXD 1/2011/20	20	8,138,500,000.00	5,984,553,392.50	30/05/2011	05/05/2031
FXD 2/2011/2	2	7,322,000,000.00	6,836,123,753.00	27/06/2011	22/04/2013
FXD 2/2011/5	5	1,723,400,000.00	1,399,844,682.80	27/06/2011	23/11/2015
FXD 1/2011/20	20	1,227,300,000.00	870,315,400.45	27/06/2011	05/05/2031
Total		**197,479,850,000.00**	**188,248,614,660.95**		

Source: Central Bank of Kenya

**Reopened Bonds*

Appendix 3: Government Securities Market Yields for June 2011

Tenor		Current Market Yield (%)	Last issue average rate (%)	Dated	Last issue coupon rate (%)	Tenor Differential
91-days	0.25	8.995	7.942	13.06.2011	-	-
182-days	0.5	9.906	5.444	06.06.2011	-	0.911
364-days	1	10.249	10.249	13.06.2011	-	0.343
1 year	1	10.317	4.138	14.06.10	-	0.068
2 year	2	10.917	7.439	25.04.11	4.586	0.600
3 year	3	11.719	9.696	25.09.06	8.250	0.802
4 year	4	8.407	9.438	26.02.07	11.000	-3.312
5 year	5	10.778	8.501	28.03.2011	6.671	2.371
6 year	6	10.226	11.288	30.04.07	11.500	-0.553
7 year	7	9.673	10.325	26.07.07	9.750	-0.553
8 year	8	9.120	9.579	01.03.10	9.750	-0.553
9 year	9	8.663	13.599	24.04.06	13.500	-0.457
10 year	10	8.458	9.683	31.01.11	9.307	-0.205
11 Year	11	8.242	14.308	25.09.06	13.750	-0.216
12 Year	12	8.975	12.537	07.12.09	12.000	0.733
13 Year	13	8.217	-	-	-	-0.758
14 Year	14	7.938	-	-	-	-0.280
15 Year	15	8.447	12.388	25.04.10	9.000	0.509
18 Year	20	11.269	13.691	28.12.09	13.750	2.822
20 Year	20	13.974	13.974	30.05.11	10.000	2.705
25 Year	25	14.396	9.839	26.07.10	11.250	3.128
30 Year	30	14.035	13.520	28.03.11	12.000	-0.361

Source: Central Bank of Kenya

Appendix 4(a): Public and Publicly Guaranteed External Debt by Creditor, Ksh Million

CREDITOR	June 2004	June 2005	June 2006	June 2007	June 2008	June 2009	June 2010	June 2011
1. BILATERAL								
AUSTRIA	2,664	2,468	2,437	3,031	3,252	2,217	1,814	2,018
BELGIUM	5,693	5,188	5,247	4,625	4,750	7,078	6,775	9,037
CANADA	2,322	1,297	1,267	1,470	1,400	1,585	1,609	1,676
DENMARK	2,521	2,365	2,392	2,144	2,336	2,354	2,291	2,775
FINLAND	215	134	160	118	120	129	119	132
FRANCE	18,416	18,106	18,643	18,886	22,903	28,103	28,173	40,347
GERMANY	11,236	12,941	13,910	13,479	15,764	16,441	16,235	26,670
ITALY	9,129	7,182	8,741	7,151	6,344	5,750	4,347	4,388
JAPAN	85,353	84,469	79,464	66,167	72,845	90,839	98,847	111,842
NETHERLANDS	4,103	2,208	2,752	2,367	2,318	2,140	1,877	3,012
UK	2,863	2,818	2,705	2,628	2,458	2,354	2,128	2,328
USA	5,821	6,057	5,842	5,206	4,863	5,669	5,729	5,901
CHINA	2,306	2,486	2,398	3,132	4,024	11,821	14,385	32,453
OTHERS	10,273	9,949	8,918	11,300	9,823	9,453	12,018	14,386
TOTAL	**162,914**	**157,669**	**154,877**	**141,706**	**153,200**	**185,933**	**196,347**	**256,965**
2. MULTILATERAL								
ADB/ADF	25,366	23,560	25,837	23,630	30,134	32,651	41,000	52,645
EEC/EIB	10,178	8,468	13,335	10,248	11,235	11,063	10,498	12,497
IBRD	111	38	-	-	-	-	-	-
IDA/IFAD	216,366	210,311	204,306	190,877	209,545	246,485	260,108	319,268
IMF	8,270	12,641	11,409	13,703	17,548	35,125	34,110	47,582
OTHERS	367	655	663	1,801	2,673	5,781	6,617	8,890
TOTAL	**260,658**	**255,764**	**255,550**	**240,259**	**271,135**	**331,105**	**352,333**	**440,882**
3.COMMERCIAL BANKS	**2,912**	**1,776**	**1,274**	**574**	**-**	**-**	**-**	**-**
4.EXPORT CREDIT	**16,674**	**19,244**	**19,536**	**18,427**	**18,543**	**23,837**	**20,458**	**25,041**
GRAND TOTAL	**443,157**	**434,453**	**431,237**	**400,966**	**442,878**	**540,875**	**569,138**	**722,888**

Source: Treasury

Appendix 4(b): Public and Publicly Guaranteed External Debt by Creditor, USD Million

CREDITOR	June 2004	June 2005	June 2006	June 2007	June 2008	June 2009	June 2010	June 2011
1. BILATERAL								
AUSTRIA	33.5	32.4	33.0	45.6	50.3	28.7	22.1	22.5
BELGIUM	71.6	68.0	71.0	69.6	73.4	91.7	82.7	100.6
CANADA	29.2	17.0	17.2	22.2	21.6	20.5	19.6	14.2
DENMARK	31.7	31.0	32.4	32.3	36.1	30.5	28.0	35.4
FINLAND	2.7	1.8	2.2	1.8	1.9	1.7	1.5	1.5
FRANCE	231.6	237.3	252.3	277.8	354.0	364.2	343.9	449.0
GERMANY	141.3	169.6	188.3	198.1	243.7	213.1	198.2	296.8
ITALY	114.8	94.1	118.3	107.6	98.1	74.5	53.1	48.8
JAPAN	1,073.4	1,109.5	1,075.6	1,006.0	1,126.0	1,177.3	1,206.7	1,244.6
NETHERLANDS	51.6	28.9	37.3	35.6	35.8	27.7	22.9	33.5
UK	36.0	36.9	36.6	39.6	38.0	30.5	26.0	25.9
USA	73.2	79.4	79.1	70.9	75.1	73.5	69.9	65.7
CHINA	29.0	32.1	32.5	46.9	62.2	153.2	175.6	361.1
OTHERS	129.0	130.9	120.7	117.7	151.9	122.7	146.7	160.08
TOTAL	**2,048.9**	**2,069.0**	**2,096.3**	**2,071.5**	**2,368.1**	**2,409.8**	**2,396.9**	**2,859.5**
2. MULTILATERAL								
ADB/ADF	319.0	310.0	349.7	353.1	465.8	423.2	500.5	585.8
EEC/EIB	128.0	111.0	180.5	150.4	173.7	143.4	128.2	139.1
IBRD	1.4	0.5	-	-	-	-	-	-
IDA/IFAD	2,721.0	2,757.0	2,765.4	2,867.7	3,239.0	3,194.5	3,175.3	3,552.8
IMF	104.0	165.7	154.4	206.9	271.2	244.6	416.4	529.5
OTHERS	4.8	6.0	9.0	32.7	41.3	74.9	80.8	98.9
TOTAL	**3,278.2**	**3,350.2**	**3,459.0**	**3,610.8**	**4,191.0**	**4,080.6**	**4,301.2**	**4,906.1**
3.COMMERCIAL BANKS	**36.6**	**23.3**	**17.2**	**4.3**	**-**	**-**	**-**	**-**
4.EXPORT CREDIT	**209.7**	**252.3**	**264.4**	**271.0**	**286.6**	**286.6**	**249.7**	**278.7**
GRAND TOTAL	**5,573.4**	**5,694.8**	**5,837.0**	**5,957.6**	**6,845.7**	**6,777.0**	**6,947.8**	**8,044.3**

Source: Treasury

Appendix 5: Macro-Risks and Implications for the Medium Term Debt Strategy

Implications for Debt Strategy Preferences				
Macroeconomic Factors	**Impact**	**Target source**	**Currency**	**Other comments**
Balance of Payment Risks				
Terms of trade shock	Exchange rate	Domestic	DX	Improve market capacity
FDI/Private capital flow volatility	Exchange rate	Domestic	DX	Improve market capacity
Remittance dependence	Exchange rate	Domestic	DX	Improve market capacity
Tourism receipts dependence	Exchange rate	Domestic	DX	Improve market capacity
Low foreign exchange reserves	Exchange rate		FX	Diversify trading partners
Fiscal Risks				
Potential volatility (revenues)	Expenditure volatility	Market	DX/FX	Create fiscal space, prioritize expenditure and improve efficiency
Capital spending aid dependent	Growth volatility		DX/FX	Improve relationship with donors, improve absorptive capacity and implementation efficiency
Contingent liabilities	Debt level increase	Market	DX/FX	Create fiscal space and strengthen overall PFM framework
Monetary Risks				
High inflation	Impede market development, higher interest costs			
Negative real interest rate	Impact real money investors and deposit growth			Increase credibility of monetary policy, improve monetary operational framework and monetary transmission mechanism to reduce inflation premium
Natural Disasters				
Natural Disasters	Growth volatility	Market	DX/FX	Diversify economy and explore the possibility of commodity hedge

Source: Treasury, 2011 MTDS

Appendix 6: Kenya Public Sector Debt Sustainability Framework, Baseline Scenario 2008-2031
(In percent of GDP, unless otherwise indicated)

	Actual			Average 5/	Standard Deviation 5/	Estimate	Projections					2011-16 Average			2017-31 Average
	2008	2009	2010			2011	2012	2013	2014	2015	2016		2021	2031	
Public sector debt 1/	41.3	42.7	45.7			47.5	47.5	46.7	45.0	43.8	43.1		39.0	28.1	
o/w foreign-currency denominated	23.7	22.9	22.9			25.9	25.9	25.9	25.2	24.6	23.5		19.3	10.2	
Change in public sector debt	2.1	1.4	3.0			1.8	0.0	-0.8	-1.8	-1.2	-0.7		-0.9	-1.0	
Identified debt-creating flows	2.1	-0.6	3.2			1.0	-2.2	-1.2	-1.8	-1.7	-1.2		-0.7	0.5	
Primary deficit	2.1	3.1	2.8	1.0	1.9	2.5	2.3	1.9	1.2	1.0	1.5	1.8	1.4	1.9	1.6
Revenues and grants	23.2	22.8	24.6			25.5	25.8	26.3	26.6	25.7	25.0		24.7	24.1	
of which: grants	1.1	0.9	0.8			1.0	1.3	1.4	1.5	1.0	0.7		0.5	0.2	
Primary (non-interest) expenditure	25.4	25.8	27.4			28.0	28.1	28.2	27.8	26.7	26.4		26.1	26.1	
Automatic debt – dynamics	1.7	-3.7	0.3			-1.5	-4.6	-3.1	-3.0	-2.8	-2.7		-2.1	-1.5	
Contribution from interest - rate/ growth differential	-1.2	-1.4	-0.7			-3.2	-3.0	-2.1	-2.0	-1.9	-2.0		-1.5	-1.1	
of which: contribution from average real interest rate	-0.6	-0.3	1.5			-1.0	-0.5	0.6	0.8	0.8	0.7		0.7	0.5	
of which: contribution from real GDP growth	-0.6	-1.1	-2.2			-2.2	-2.5	-2.7	-2.8	-2.7	-2.7		-2.3	-1.7	
Contribution from real exchange rate depreciation	2.9	-2.3	1.0			1.7	1.6	-1.0	-1.0	-0.8	-0.7		…	…	
Other identified debt-creating flows	-1.8	0.1	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Privatization receipts (negative)	-1.8	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	

	Actual			Average 5/	Standard Deviation 5/	Estimate	Projections					2011-16 Average			2017-31 Average
	2008	2009	2010			2011	2012	2013	2014	2015	2016		2021	2031	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Debt relief (HIPC and other)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Other (specify, e.g. bank recapitalization	0.1	0.1	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Residual, including asset changes	0.0	2.0	-0.2			0.8	2.3	0.4	0.0	0.5	0.5		-0.2	-1.5	
Other Sustainability indicators															
PV of public sector debt	…	…	38.5			39.3	40.3	39.9	38.7	37.9	37.6		34.7	25.6	
o/w foreign-currency denominated	…	…	15.8			17.7	18.7	19.1	18.9	18.7	18.0		15.0	7.7	
o/w external	…	…	15.8			17.7	18.7	19.1	18.9	18.7	18.0		15.0	7.7	
PV of contingent liabilities (not included in public sector debt)	…	…	…			…	…	…	…	…	…		…	…	
Gross financing need 2/	11.4	17.6	14.8			15.2	15.4	15.1	13.8	13.2	13.2		13.0	11.9	
PV of public sector debt-to-revenue and grants ratio (in percent)	…	…	156.5			154.2	156.2	151.5	145.6	147.8	150.5		140.4	106.1	
PV of public sector debt-to-revenue ratio (in percent)	…	…	161.6			160.5	164.3	160.0	154.2	153.6	154.5		143.3	107.1	
o/w external 3/	…	…	66.1			72.2	76.2	76.6	75.4	75.8	74.0		62.0	32.3	
Debt service-to-revenue and grants ratio (in percent) 4/	18.4	41.7	25.5			21.9	24.5	23.5	21.6	21.5	21.1		20.0	15.5	
Debt service-to-revenue ratio (in percent) 4/	19.4	43.3	26.4			22.8	25.8	24.8	22.9	22.3	21.7		20.4	15.6	

	Actual			Average 5/	Standard Deviation 5/	Estimate	Projections					2011-16 Average			2017-31 Average
	2008	2009	2010			2011	2012	2013	2014	2015	2016		2021	2031	
Primary deficit that stabilizes the debt-to-GDP ratio	0.1	1.7	-0.1			0.7	2.3	2.7	3.0	2.2	2.2		2.4	3.0	
Key macroeconomic and fiscal assumptions														1.1	
Real GDP growth (in percent)	1.5	2.6	5.6	4.2	2.2	5.0	5.6	6.0	6.4	6.4	6.5	6.0	6.1	6.1	6.1
Average nominal interest rate on forex debt (in percent)	1.5	0.5	1.0	1.4	1.0	1.0	1.3	1.5	1.7	1.9	2.0	1.6	2.4	2.1	2.2
Average real interest rate on domestic debt (in percent)	-1.7	0.0	8.4	2.2	3.1	-3.6	-2.5	1.8	3.2	3.3	3.3	0.9	3.1	2.7	3.1
Real exchange rate depreciation (in percent, + indicates depreciation)	14.1	-10.3	4.8	-2.5	7.9	7.9	…	…	…	…	…	…	…	…	…
Inflation rate (GDP deflator, in percent)	11.9	10.9	2.2	5.9	3.7	12.1	12.3	7.1	5.6	5.2	5.0	7.9	5.0	5.0	5.0
Growth of real primary spending (deflated by GDP deflator, in prevent)	0.1	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.0	0.0	0.0	0.1	0.1	0.1	0.1
Grant element of new external borrowing (in percent)	…	…	…	…	…	35.4	9.3	18.3	14.9	17.2	17.0	18.7	22.3	24.7	…

Sources: Country Authorities and staff estimates and projections.

1/ Public debt refers to net debt of the central government and parastatals.

2/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period.

3/ Revenues excluding grants.

4/ Debt service is defined as the sum of interest and amortization of medium and long-term debt.

5/ Historical averages and standard deviations are generally derived over the past 10 years, subject to availability.

Appendix 7: Kenya Sensitivity analysis for Key Indicators of Public Debt 2011 – 2031

	Projections							
	2011	2012	2013	2014	2015	2016	2021	2031
PV of Debt-to-GDP Ratio								
Baseline	39	40	40	39	38	38	35	26
A. Alternative scenarios								
A.1 Real GDP growth and primary balance are at historical averages	39	40	40	40	40	40	40	30
A.2 Primary balance is unchanged from 2011	39	41	41	42	42	43	45	39
A.3 Permanently lower GDP growth 1/	39	41	41	41	41	41	44	47
B. Bound tests								
B.1 Real GDP growth is at historical average minus one standard deviations in 2012-2013	39	43	46	47	48	49	52	50
B.2 Primary balance is at historical average minus one standard deviations in 2012-2013	39	41	42	41	41	40	38	29
B.3 Combination of B1-B2 using one half standard deviation shocks	39	41	42	43	43	44	46	43
B.4 One-time 30 percent real depreciation in 2012	39	48	47	46	45	44	41	31
B.5 10 percent of GDP increase in other debt-creating flows in 2012	39	50	49	48	47	46	42	32
PV of Debt-to-Revenue Ratio 2/								
Baseline	154	156	151	146	148	151	140	106
A. Alternative scenarios								
A.1 Real GDP growth and primary balance are at historical averages	154	155	151	149	156	161	162	122
A.2 Primary balance is unchanged from 2011	154	158	157	157	165	173	181	162
A.3 Permanently lower GDP growth 1/	154	159	157	154	159	166	176	195
B. Bound tests								
B.1 Real GDP growth is at historical average minus one standard deviations in 2012-2013	154	166	175	175	185	196	212	209

	Projections							
	2011	2012	2013	2014	2015	2016	2021	2031
B.2 Primary balance is at historical average minus one standard deviations in 2012-2013	154	160	160	155	158	162	154	121
B.3 Combination of B1-B2 using one half standard deviation shocks	154	160	160	160	168	177	188	179
B.4 One-time 30 percent real depreciation in 2012	154	185	179	172	174	177	165	130
B.5 10 percent of GDP increase in other debt-creating flows in 2012	154	193	187	180	183	186	171	131
Debt Service-to-Revenue Ratio 2/								
Baseline	22	25	23	22	21	21	20	15
A. Alternative scenarios								
A.1 Real GDP growth and primary balance are at historical averages	22	25	24	22	22	22	22	17
A.2 Primary balance is unchanged from 2011	22	25	24	22	22	22	22	20
A.3 Permanently lower GDP growth 1/	22	25	24	22	22	22	23	24
B. Bound tests								
B.1 Real GDP growth is at historical average minus one standard deviations in 2012-2013	22	25	25	24	25	25	27	26
B.2 Primary balance is at historical average minus one standard deviations in 2012-2013	22	25	24	22	22	22	20	16
B.3 Combination of B1-B2 using one half standard deviation shocks	22	25	25	22	23	23	24	22
B.4 One-time 30 percent real depreciation in 2011	22	25	25	24	24	24	23	19
B.5 10 percent of GDP increase in other debt-creating flows in 2011	22	25	26	26	26	25	22	17

Sources: Country Authorities and staff estimates and projections.

1/ Assumes that real GDP growth is at baseline minus one standard deviation divided by the square root of the length of the projection period.

2/ Revenues are defined inclusive of grants.

Appendix 8: Government Securities Issuance Program Development Implementation Plan Agreed Upon Between the Government and World Bank Market Mission

Issue/question	Action/recommendation	ST/ MT
1. Issuance program development		
Define target size for benchmarks	Determine size of benchmark taking account of size of MOF overdraft, liquidity buffers and whether the same principle should apply to short and long securities	ST
Define key maturities for benchmarks	Determine the key maturities taking into account that not all long maturities are necessary, check if 3, 5, 10, and 25y are sufficient.	ST
How long should a bond remain a benchmark?	More flexibility for longer tenors • 2 year +/- 0.5 years • 5 year and 10 year +/-1 year • 25 years +/- 2 years	ST
Determine if long-short coupons pose problems for investors	Issuing in broken maturities, e.g. 2 1/2 years requires first coupon to be short	ST
Decide the minimum size of a non-benchmark and create "rump" stock concept	The minimum size should be Ksh 10 billion and those bonds could either be targeted by OTC buybacks or conversion offers	ST
Distinguish between on-the-run benchmarks, off-the-run benchmarks, non-liquid bonds posed for buybacks and rump stock	Decide and announce	ST
Decide upon conversion formula	Dirty price for source and destination stock is intuitive and simple to apply	ST
Create an internal yield curve model for pricing rump stock	Use a combination of primary market and secondary market prices	ST
Announce a list of outstanding bonds, clarifying their status into on-the-run, off-the-run and rump stock	Announcement of program	ST
Does the MTDS address benchmark bonds and what are the measures to monitoring and quantifying refinancing risk	Update MTDS, set up monitor key debt ratios	ST
Define announcements prior to buybacks (how many days prior to operation)	Define and announce, e.g. 7-days. This should give professional intermediaries sufficient time to contact investors.	ST
Launch liability management program for small illiquid issues (see matrix for preconditions)	Use regular Tbond auctions as reference, after which fixed dirty/dirty conversion offers can be extended	ST
The CBK/TRE should identify whether "rump" stock is primarily in bank hold-to-maturity portfolios and what are the implications of that	Survey banks of holdings of government securities portfolios by each series	ST

Issue/question	Action/recommendation	ST/ MT
Use Tbills for pre-financing when necessary	Build sufficient flexibility into Tbill amounts and announce that additional amounts raised are for pre-financing. Amounts up to Ksh 10 billion should be sufficient	MT
A key issue for the success of the benchmark program will be adequate presentation of information material pitched at intermediaries and investors	Sufficient time and detail needs to be invested in this activity	ST
Terms and conditions of buybacks need to be defined and should encompass both auctions, post auction conversion offers and OTC	Prepare procedures manual terms and conditions	ST
2. Clarifications to ensure successful launch of Issuance program		
Systems, such as electronic auction system and the internal system at the CBK should cope with the 3 types of buybacks	Adequately prepare IT system	MT
Retirement process for securities bought back, including accounting, paper statements needs to be clear	Adequately prepare for accounting and preparation of reports	ST
A large share of government securities held by banks is in a hold-to-maturity portfolio that may prevent participation in bond exchanges	Check whether bonds be transferred from HTM portfolio to trading portfolio	ST
The Budget Act may contain a gross borrowing requirement that can restrict issuance of source bonds in liability management operations	Check whether the Budget Act contains any such restrictions	ST
Does the Budget Act restrict contracting of new debt (increased indebtedness in nominal terms) as a result of buying back above par	Clarify that budget act allows for reopening, buybacks and contracting of new debt for debt management operations. This should also include permission to increase debt servicing costs (accounting for premium when buying back above par)	ST
Is it possible to issue debt for the purpose to re-deposit (increase the liquidity position)	Clarify whether new debt may be issued for the purpose of re-deposit, i.e. to improve the liquidity position)	ST
Should there be fixed price conversion offers, following auctions of benchmark securities, targeting destination stock in similar maturities?	Decide upon initial approach	ST
Are buybacks restricted by CMA Act?	Investigate whether CMA must approve buybacks prior to them taking place	ST
Are buybacks restricted by Internal Loans Act?	Analyze Internal Loans Act	ST
Can bonds purchased by the MOF/CBK legally be retired?	Analyze Internal Loans Act and other relevant Acts	ST

Issue/question	Action/recommendation	ST/ MT
Can CBK act as Agent for the MOF in buybacks as it can for regular sell auctions?	Analyze Central Bank Act and Budget Act, update Agency Agreement and clarify who makes decisions on buyback pricing	ST
Presenting a conversion offer may in fact create a market price for rump securities that were previously illiquid, forcing their revaluation (for those investors subject to mark-to-market requirements)	Coordinate with regulator (Banking and CMA) to understand whether conversion offers trigger mark-to-market revaluations	ST
3. Primary market operational issues		
The CBK should actively monitor performance of its auction participants to better assess their abilities	Introduce a performance evaluation scheme and prepare league tables, initially internal	ST
The settlement cycle in auctions is overly long	Increase efficiency by shortening settlement cycle	ST
There is limited pre-trade transparency since auction calendars are not published	Publish auction calendars: For Tbills dates and maturities (gradually introduce amounts a few days prior); and for Tbonds dates for the year, maturities quarterly and amounts a few -days prior)	ST
The auction rules require physical bids to the CBK's tender box and auction processing is time consuming and has resulted in announcement delays	Streamline auction process and implement electronic bidding in auctions	ST/ MT?
Target amounts in auctions should become flexible for the CBK given unpredictable demand	Assess to introduce target amounts for each auction with 15% flexibility around midpoint. How important is this one in relation to others?	ST
Auction operations and participation of non-professional investors should be segregated from the competitive auction.	Create a special non-competitive facility outside of the normal auction process	ST
As benchmark bonds foster liquidity and enable more cost efficient funding, issuance should be channeled into benchmark bonds whenever possible	Reduce reliance on non-standard instruments such as savings and infrastructure bonds	MT
The use of commissions in the auction are only linked to volume but could be made more effective	Link commissions to: volume, maturities and bids made on behalf of customers	MT
4. Secondary market and Custody/settlement		
The de facto OTC market is not covered by the relevant set of operational parameters and price reporting rules	Define trading rules and clarify the supervision for a professional OTC market	MT
	Define how transactions in the OTC market are reported	MT

Issue/question	Action/recommendation	ST/ MT
Horizontal repos have been implemented but are not actively used by market participants such as banks and non-banks	Upgrade repo markets (e.g. re-hypothecation of collateral, clarify accounting treatment, taxation) framework for non-bank institutions	MT
The dual CSD structure should be revisited as only one CSD is necessary	Strategic and policy decision over a single or dual CSD structure: CBK and CDSC	MT
Depending on the outcomes of whether to have 1 or 2 CSDs	Introduce higher degree of automation of CBK's CSD and changes in some conceptual design: pre-blocking before trading, improved access and services to non-banks	MT
Depending on the outcomes of whether to have 1 or 2 CSDs	CDSC requires settlement of cash at CBK, bilateral settlement cycle, elimination of pre-trade blocking of securities.	MT
Trading before settlement in primary market is not reported until the auction is settled	Trade reporting system needs to accept registration of trades prior to settlement	MT
Government securities are not available to buyers on the date of trade and can thus not be used for repos or resold	Eliminate securities pre-deposit before trading rule	MT
The CBK's CSD does not allow custodians to see query their securities accounts balances and must rely on day-old printed statements	Daily reporting of securities accounts balances	MT

Source: World Bank Domestic Market Mission, 2010/11

Appendix 9: Projects Financed by Proceeds of Infrastructure Bonds

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