

# ALIGNING KENYA'S FINANCIAL SYSTEM WITH INCLUSIVE GREEN GROWTH



## SUMMARY: ALIGNING KENYA'S FINANCIAL SYSTEM WITH INCLUSIVE GREEN GROWTH

This summary paper explores the state of green investment in Kenya, and the role of the financial sector and potential financial policy innovations that could increase the flow of domestic green investment. This paper is part of a broader analysis on scaling domestic sustainable finance in Kenya and is being led by the International Finance Corporation and UNEP's Inquiry into the Design of a Sustainable Financial System. The IFC, as the largest global development institution focused exclusively on the private sector in developing countries, has been utilizing its investment and advisory services to develop local financial markets and leverage the private sector to advance innovative and viable solutions to ensure environmental and social sustainability. The UNEP Inquiry was set up to advance policy options to deliver a step change in the global financial system's effectiveness in mobilizing capital towards a green and inclusive economy, through including producing country specific policy reports.

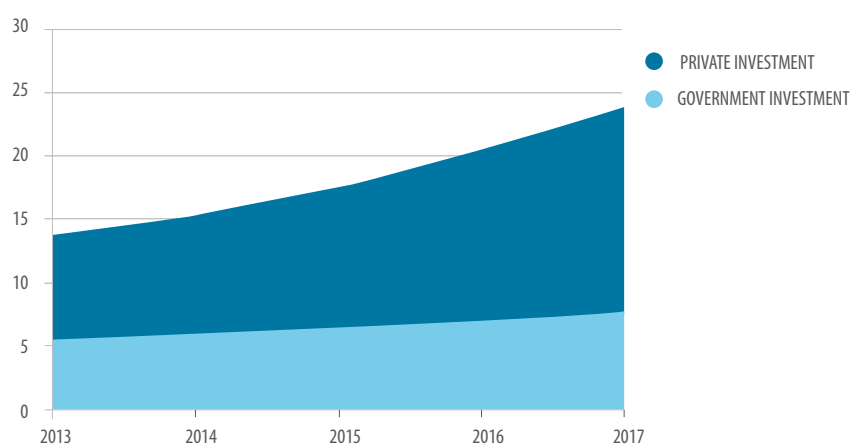
Kenya's development master plan 'Vision 2030' sets out its aspiration to become a middle-income country by 2030, aiming to increase annual GDP growth rates from around six to ten percent. 'Integral to this is its vision of developing a 'just and cohesive society enjoying equitable social development in a clean and secure environment'.

Responding to climate change and other environmental challenges is a core part of enabling the success and stability of Kenya's economy. Roughly 42 percent of the country's GDP is derived from natural resource sectors, such as agriculture, mining, forestry, fishing and tourism. The success of these industries, as well as those exploiting new-found sources of energy, depend significantly on whether they are able to respond effectively to environmental challenges and risks, including adapting to climate change and addressing conflict over land and water resources.

### INVESTMENT NEED

Kenya's aspiration for sustainable growth and development is premised on a growth in investment – with the government targeting a rise of investment from 24.7 percent of GDP in 2013/14 to 30.9 percent of GDP by 2017/18. The bulk of the increase in overall investment level is expected to be financed by the private sector.

INVESTMENT TARGETED BY SECOND MEDIUM TERM PLAN (US \$ BILLIONS)



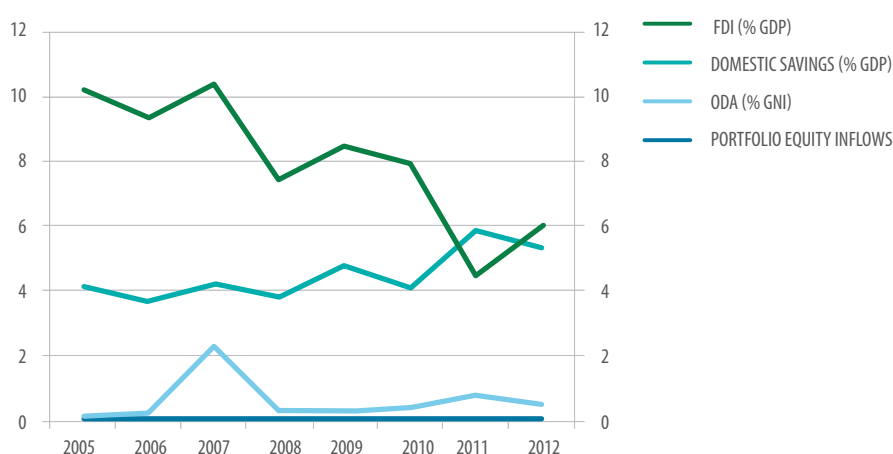
Source: Based on targets in Second Medium Term Plan, and World Development Indicators.

Overall the medium-term plan envisages some US\$58 billion of private investment between 2013 and 2017, all of which would need to be sensitive to environmental challenges. The Government estimates that some KES 1 trillion (US\$13 billion) needs to be invested by the public and private sectors in relation to climate change mitigation and adaptation specifically in this period alone.<sup>2</sup> More broadly, as outlined in Annex 1, climate change entails risks and potential opportunities for many of Kenya’s key economic sectors.

Expanding and modernising Kenya’s infrastructure is a critical priority. The government has allocated about 20 percent of its budget to energy and transport infrastructure<sup>3</sup>, but it identifies a further infrastructure funding gap of about US\$2-3 billion per year over the next 10 years.<sup>4</sup> Mobilising private capital for infrastructure is therefore critical, and the Public Private Partnership (PPP) Act No. 15 of 2013 established a new legal framework enabling PPPs in infrastructure to be pursued.

## SOURCES OF CAPITAL

INVESTMENT TARGETED BY SECOND MEDIUM TERM PLAN (US \$ BILLIONS)



Source: World Development Indicators, World Bank.

The Vision 2030 plan seeks to mobilise additional and more effective investment via a higher domestic savings rate, expected to rise from 17% of GDP in 2006 to 30% in 2012, with around a third of this financed externally through remittances from Kenyans abroad, foreign investment and overseas development assistance (ODA), and the rest by a significant rise in domestic savings.

Domestic savings are seen as crucial, because Kenya’s low rate of domestic saving suggests the potential for growth, and domestic investors have a more long-term outlook and may not be as vulnerable to. However, in practice, domestic savings have in fact fallen to around 6% of GDP by 2013.<sup>5</sup>

While government investment is envisaged to stay at 8-10%, there is a shift to fund more of via international capital markets and less through domestic borrowing. The government successfully issued Infrastructure Bonds with significant uptake in 2008, 2009 and 2012 at a total value of KES90bn (US\$1bn). In 2014 the government followed this and launched its first Eurobond raising US\$2 billion for flagship projects in Transport, Energy and Agriculture.

## THE FINANCIAL SECTOR

Vision 2030’s sees the financial services sector becoming a vibrant and globally competitive financial sector that will create jobs and promote a higher savings rate in the country. The financial sector should play a particular role in mobilizing and allocating domestic bank and pension savings towards sustainable development in Kenya.

The financial sector in Kenya has grown significantly and become highly integrated in the overall economy, regionally and internationally. It comprises of the banking, capital markets, insurance industry, pension industry, safety nets and resolution institutions like the Kenya Deposit Insurance Corporation, financial markets infrastructure (e.g. the Nairobi Securities Exchange, stock brokers and rating agencies); and Savings and Credit Cooperatives sub-sectors. Its regulators are the Retirement Benefits Authority, the Insurance Regulatory Authority, the Capital Markets Authority, the Central Bank and the Savings and Credit Societies Regulatory Authority, although work is underway to create a Financial Services Super regulator. Total value of assets held by banks, pensions, insurance and credit cooperatives accounted for 108 percent of GDP in 2013, up from 96 percent of total assets excluding capital markets in 2012. Total value of equity market capitalization amounted to 51 percent of GDP in 2013.<sup>6</sup>

#### SHARE OF FINANCIAL SECTOR TO GDP

GDP/Sub-sector assets	2012		2013	
	KES million	Share of GDP	KES million	Share of GDP
Nominal GDP	3,403,547	N/A	3,797,988	N/A
Banking Assets	2,330,335	68.47%	2,703,394	71.18%
Pension Assets	548,700	16.12%	696,680	18.34%
Insurance Assets	311,000	9.14%	366,252	9.64%
Saccos Assets	93,765	2.75%	335,437	8.83%
<b>Total</b>	<b>3,283,800</b>	<b>96.48%</b>	<b>4,101,763</b>	<b>108.00%</b>
Equities Market Capitalization	1,272,002	37.37%	1,920,719	50.57%

Source: Central Bank of Kenya, Financial Stability Report 2013.

Banking dominates the financial sector, accounting for 71 percent of total assets excluding capital markets; however pension funds have expanded significantly and are an important investor in government securities. Kenya's pension sector is highly fragmented with over 1,200 registered pension funds, the majority with an asset base of less than KES5 billion (US\$55 million).

The financial sector is expected to grow rapidly over the years ahead, supported in part by a fast-growing pension and insurance asset base. Sustainable investment provides substantial new opportunities for the sector.

## DEVELOPMENTS IN GREEN FINANCE

The linkage between Kenya's environmental challenges and opportunities for green growth, and the effectiveness of its financial system in allocating capital is not widely recognized. For example it is not addressed in Vision 2030, and while the Central Bank considers erratic weather as a potential stress on the economy it does not consider this in any depth in its Financial Stability Report.

Nevertheless there are examples of emerging recognition and leadership in the financial sector seeking to integrate a better understanding of sustainability factors into financial decision-making:

- **The Kenya Bankers Association launched the Sustainable Finance Initiative** in 2014 to explore opportunities for industry alignment while building industry wide capacity in the area of environmental and social risk management.

- **CFC Stanbic and Cooperative Bank are providing green credit lines worth KES 3.3 billion for energy and resource efficiency projects and green mortgage products**, with funding provided by the African Development Bank.
- **Commercial Bank** in partnership with Safaricom provided a KES 860 million (US\$10million) syndicated loan facility to M-KOPA, a renewable energy start-up which provides solar home systems on credit to customers with little formal credit history or collateral.
- **A few pension funds have begun investing directly in green infrastructure** (including the Local Authorities Pension Trust (LapTrust).
- **The Capital Market Authority draft Code of Corporate Governance Practice released in 2014 includes guidance on including Environmental, Social and Governance (ESG)** in responsibilities and reporting. Kenya Commercial Bank and Safaricom have been the first to publish integrated reports as recommended by the code.
- **The Nairobi Securities Exchange (NSE) in 2013 launched the Growth Enterprise Market Segment (GEMS) to enable small and medium sized firms to raise funds from the capital markets.**
- **The Nairobi Securities Exchange Diversity Series aiming to increase diversity on company boards.**

While these initiatives indicate emergent interest and recognition of the importance of sustainability factors for investment, in practice domestic investment in the green economy has, to date, been limited. Investments with participation by the domestic financial sector include amongst others the Olkaria geothermal project and the Lake Turkana wind project.

## BARRIERS TO INCLUSIVE GREEN INVESTMENT

A series of interviews was carried out with representatives from across the investment value chain to explore the barriers to greater integration of environmental considerations into investment decisions, and to the mobilization of capital through the financial system towards Kenya's sustainable development needs.

The main barriers that were identified through the interview process can be categorized as:

### Structural

- **Short-term investment horizon** prevailing at all levels of the investment value chain. Short-term finance-only focus on behalf of bank's boards, trustees and fund managers do not allow for long-term considerations, such as environmental and social sustainability, to be factored into investment and strategic planning. The only factor that is measured is short term financial success. Economic value creation over the longer-term is not recognized and more importantly not rewarded by any of the stakeholders.
- **Fragmentation of the market:** The fragmentation of the pensions market doesn't allow for economies of scale, and time and effort invested in product development and thought leadership.
- **Incentive structures:** Pension fund trustees are price driven especially in the large parastatal funds (government owned sector) as they are elected by the members on a renewable three

year basis. The basis for re-election is driven by financial results during their terms in post. Services providers are therefore also rewarded for low fees and quarterly out-performance, and not for long-term sustainable investments.

- ⦿ **Preference for traditional assets:** The move to “Defined Contribution Funds” from “Defined Benefits” and the regulatory change that allows members to cash-out when they switch employers is driving a business model that emphasizes short-term financial returns among the pension funds. This has significant negative implications to any asset class with a long-term horizon and a short-term negative cash-flow model (such as infrastructure and Private Equity investment). The system rewards investments in safe and traditional assets (government bonds and listed equities).
- ⦿ **Short-term focus of medium tier banks:** Although the large Kenyan banks are emerging as leaders of the domestic sustainable finance agenda, there is still a gap in the medium tier and family bank segment of the market which is still driven by short-term financial returns.
- ⦿ **Lack of definitions, ESG data and analysis:** The structural issues are resulting in long-term sustainability factors not being considered. The consequent lack of demand from investors means that there is limited reporting and analysis of ESG data. This also means that there are no common definitions of terms such as green and inclusive investment.

### Lack of suitable investment vehicles

- ⦿ **Project risks:** In Kenya, there is potentially a green infrastructure pipeline that presents opportunities for local commercial banks and institutional investors to participate if investments are structured correctly upfront, this includes attaining an acceptable level of risk. For banks, global regulatory changes (Basel III) require banks to put up increasing amounts of security for long-term projects and are reducing their acceptance for risk and consequently the amount of capital that can be allocated to infrastructure and PE.
- ⦿ **Lack of pipeline information:** Lack of a centralized and well-coordinated overview of the green inclusive investment categories by economic and social sector, and project size was reported as an area of improvement that could help drive asset flows.
- ⦿ **Sub-optimal quality of the pipeline** was cited as an area where collective efforts could help increase the number and quality of the underlying pipeline (it should be noted that the infrastructure bonds issued in Kenya to date do not have income streams associated with the underlying asset and cash flows for the bonds are paid directly out of government tax revenues).
- ⦿ **Competition with familiar “safer” investments** such as government bonds (which have recently also offered higher yields) coupled with perceived and real higher risk of underlying green investments (both for infrastructure and PE).

### Limited Policy and Regulatory Incentives

- ⦿ **Kenya has limited policy and regulatory incentives** that drive investment towards a sustainable finance model. Even though a number of high-level policy papers confirm the government’s commitment to green and inclusive growth, the integration of such issues into sector specific implementation plans is still work in progress.
- ⦿ **Absence of minimum ESG regulation in the financial sector:** Some of the interviewed leaders in this space expressed a need for minimum regulation to kick-start a change. Vision 2030 and

the Medium Term Plan both include several initiatives intended to drive the green growth agenda, but efforts are not coordinated and as a result the issue ends up not being prioritized in the sectoral long-term strategies.

- ⦿ **Nascent ESG Guidelines for listed companies:** The Capital Markets Authority draft Corporate Governance Code 2014 does incorporate environmental, social and governance factors as relevant for impacting the “triple bottom line” and suggests companies should report on their performance in these areas, in addition to financial performance. But it is early days and companies have limited experience in terms of such reporting.
- ⦿ **No sustainability/integrated reporting requirement for listed companies:** Integrated Reporting for listed companies on the Nairobi Stock Exchange is at present voluntary. Making Integrated Reporting a listing requirement will ensure a minimum degree of disclosure on the material ESG issues (risks and opportunities) that will have an impact on the largest companies in Kenya.
- ⦿ **Real sector regulatory enforcement:** There are also potential challenges with enforcement of environmental and worker health and safety regulations in the real-sector, which creates a weak link when investors rely on reported compliance.

### Other barriers to investment

- ⦿ **Lack of public awareness:** Lack of public awareness/information/reporting on potential opportunities available to the public, such as energy efficient light bulbs or payment plans on home solar systems, means limited demand and hinders the development of green growth industries. A unique feature of the Kenyan pension fund AGMs, which are a strong latent driver, is public and active participation by members in the AGMs. There is some emerging interest and questions posed in relation to developmental investments, such as low income housing; however knowledge about the benefits of green and inclusive investment is not yet widespread.
- ⦿ **Lack of reporting by media** on environmental and social issues in general results from the lack of knowledge on behalf of financial journalists on sustainability issues.
- ⦿ **Lack of investment-ready green growth companies:** Taking the “green industry” (i.e. beyond green infrastructure) to scale in Kenya is a challenge which will require massive financial support for R&D, including grant funding<sup>7</sup>. This is a fundamental barrier and even if it is not directly within the control of the financial sector, there are ways that the financial sector could support the development of green growth SME and industry pipelines. However this is unlikely to happen until the financial sector itself has reached a certain level of consensus and re-structuring internally, to allow for that engagement and support to occur.

### POTENTIAL SOLUTIONS

These are the combined result of the research process and ideas put forward in the interviews. These ideas are intended as conversations starters and not prescriptive options.

#### Address structural issues

- ⦿ **Regulatory provisions to encourage a long-term investment horizon and ESG integration:** The financial sector in Kenya has traditionally shown market driven leadership which has subsequently been supported by enabling policy and regulatory changes. The financial sector and the regulator could collectively promote a more long-term investment horizon by establishing such policies.

- ⦿ **Incentives for consolidation of the market** such as aggregated mandates and pooled investment vehicles. Stricter minimum requirements for service providers.
- ⦿ **Raise awareness** and integrate long-term sustainability concepts in the training curriculum in particular for trustees and banking professionals as they are key drivers in the investment value chain. (For banks this is already happening under the Sustainable Finance Initiative).
- ⦿ **Develop the business case** to show the impacts of environmental and social risks on investments; accounting bodies and investment analysts are well placed to initiate work on quantification of the business case and externalities. The Capital Markets Authority, the Nairobi Securities Exchange, companies and analysts all have a potential impact on the quality of ESG data that is produced.
- ⦿ **Company – investor dialogue:** Engage in dialogue to raise awareness among both listed companies and investors around strategic ESG risks and opportunities. The NSE Diversity Series is an example of using the process of dialogue to establish industry codes.
- ⦿ **Public awareness:** In order for many of the suggested step changes to be effective, there is also great need for increased public awareness and better media reporting on the relevance of ESG issues. This would include pension plan member education. Some efforts are already underway with KCB supporting journalist training. Sensitization campaigns at a national level will also help give legitimacy to green growth businesses.

## Develop investment vehicles

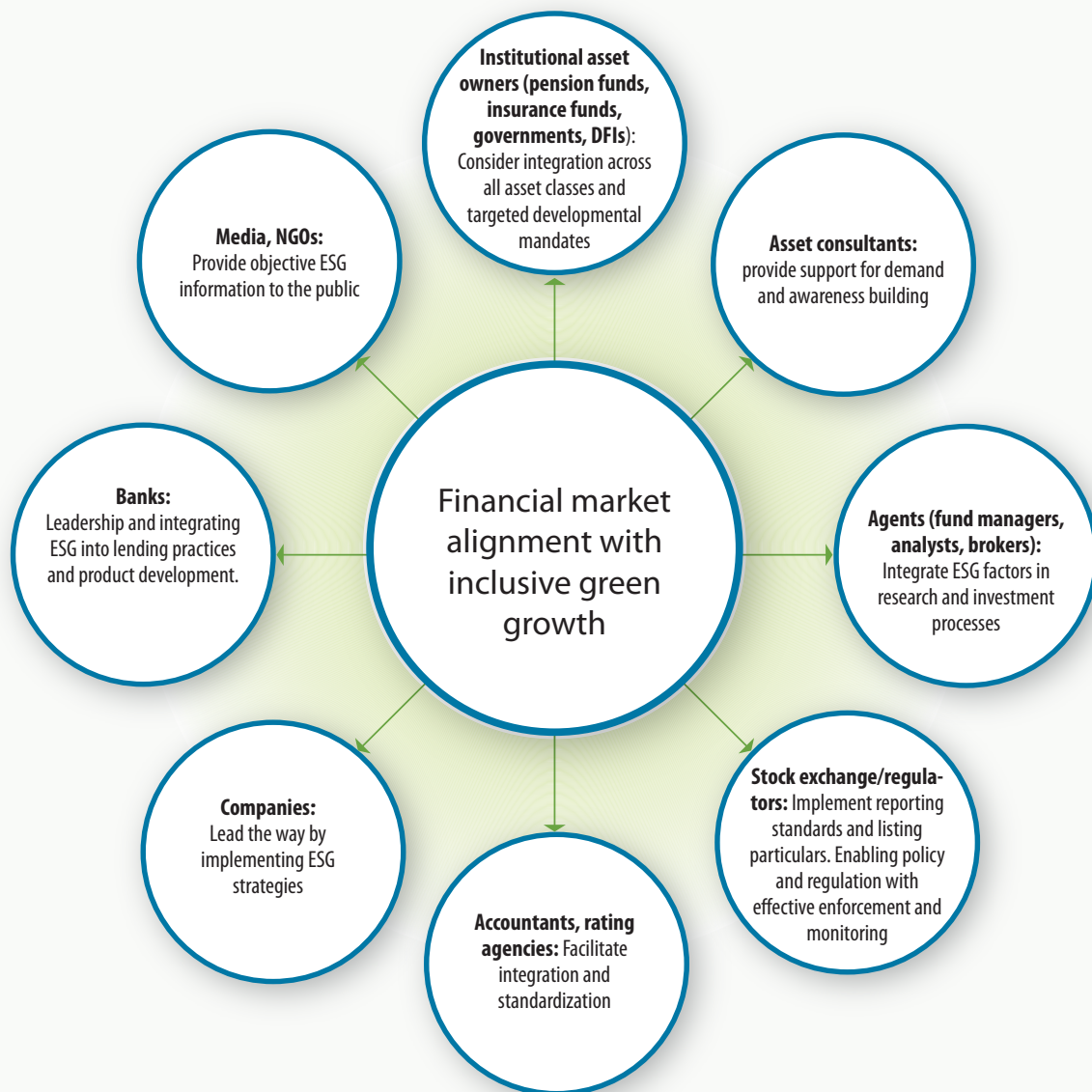
There are a range of investment vehicles that may be suitable for inclusive green investments. Some examples with relevance to the Kenyan market could include:

- ⦿ **Collective Investment Schemes (CIS)** for Institutional Investors in the green investment space would reduce risks to the investor through diversification and enable them to invest in smaller projects.
- ⦿ **Green bonds** potentially combine an attractive investment proposition with an opportunity to support inclusive green growth projects. Bond issuances can be tailored to the needs of diverse financial market players and support a range of corporate as well as government projects in this space. Bonds can be issued by municipal or federal government, as well as private sector entities.
- ⦿ **Risk guarantee instruments** can de-risk investments in infrastructure and Private Equity, with the use of international funding. Examples include risk guarantee products deployed by the African Development Bank and World Bank to successfully enable private sector participation in infrastructure projects.
- ⦿ **Private Equity funds:** private equity funds may be another appropriate vehicle in the green inclusive space given their relatively low risk-aversion and their interest in exploring new sectors in the real economy.
- ⦿ **Regional pooled vehicles:** Should the underlying investable portfolio in Kenya prove to be too small to develop products of substantial size, investing in a range of regional infrastructure funds/bonds could provide an alternative approach. This also allows for investment in cross-country infrastructure such as transport and for the risks to be mitigated by exposure to a range of projects through a diversified infrastructure fund.



- **Green REITs:** Although at this point there are not enough low income housing or green design buildings to form Green/Inclusive REITs, it could present a viable future option given the fast growing real-estate sector and the huge need for development of cost efficient low-income housing. A phased approach to this could be to start engaging with developers at the design stage so that cost-efficient green designs can be incorporated.
- **Green pipeline task-force:** Addressing sub-optimal pipeline information through stakeholder collaboration to identify the full size and scope of green growth/infrastructure projects and the best funding options for both the short and the long-term. Potential participants in such a task force could include government, investors (short-term and long-term), project developers and business incubators.

**ILLUSTRATION: POTENTIAL CHANGES ACROSS INVESTMENT VALUE CHAIN TO ACHIEVE ALIGNMENT BETWEEN FINANCIAL MARKETS AND INCLUSIVE GREEN GROWTH.**



## Policy and regulation, standards and codes

- ⦿ **Cohesive market-wide policy:** The ongoing creation of a financial services “Super-Regulator” may be an opportune time to integrate long-term thinking and ESG considerations into public policy, regulation and standards at its outset. Experience from Kenya and other markets shows the importance of linking new policy measures to issues that resonate with constituents, such as long-term economic growth, job creation, human health, sustainable pensions and increasing levels of savings. Effective monitoring and enforcement mechanisms are also critical for success.
- ⦿ **Elevate climate change and inclusive green growth** into the Vision 2030 second medium-term priority areas for the financial sector.
- ⦿ **ESG and Developmental Mandates:** Investigate the potential to establish a minimum (as opposed to maximum limit) ESG allocation or Developmental Mandate in the pension investment policy guidelines. In other markets such as South Africa and Namibia this has aimed to spur investment in infrastructure and SME funds.
- ⦿ **Broadening the concept of Governance:** The scope of the newly drafted Good Governance Code 2014 could be broadened to further cover environmental, social risk management. This could also include a requirement that all listed companies produce an (integrated) sustainability report, as this will ensure a minimum degree of disclosure across all listed companies.
- ⦿ **Tax incentives** will be critical to drive investments from both Institutional Investors and Private Investors. There are already tax incentives for capital market investment instruments and it is likely that green investment vehicles would qualify for the same tax incentives. Much needed adjustment to the feed-in-tariff for wind energy was highlighted by some interviewees.

### QUESTIONS FOR CONSIDERATION

Experience in other countries has shown that collaboration amongst key stakeholders, as represented by participants in this project’s convening process, can be successful in addressing these barriers and opportunities. In taking this discussion forward, below are potential questions to consider:

1. **What** are the key goals for a sustainable financial system in Kenya across banking, capital markets and investment?
2. **What** are the barriers to scaling up positive innovations from market practitioners and policymakers?
3. **Are** there existing initiatives that can be scaled up?
4. **How** do we build the necessary leadership to deliver the required transformation?

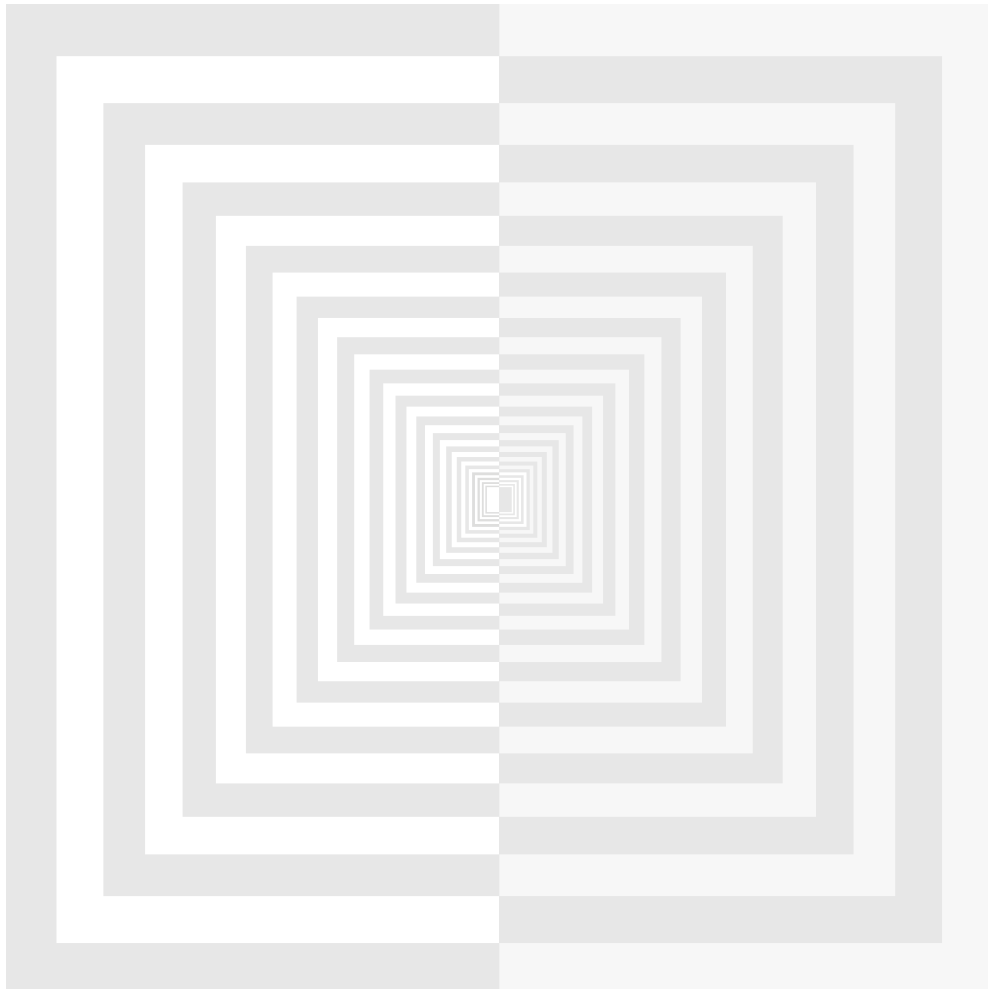
### ENDNOTES

- 1 *Vision 2030*
- 2 *National Climate Change Action Plan.*
- 3 *Budget Statement for the fiscal year 2012/2013 and 2013/2014, National Treasury*
- 4 *Sanga, B. (2015) Private sector to finance 57 infrastructure projects <http://www.standardmedia.co.ke/article/2000148388/private-sector-to-finance-57-infrastructure-projects>.*
- 5 *World Development Indicators*
- 6 *Central Bank of Kenya (2013) KENYA FINANCIAL SECTOR STABILITY REPORT.*
- 7 *Interview with African Development Bank.*

## ANNEX 1: CLIMATE-CHANGE RISKS AND INVESTMENT OPPORTUNITIES

Sector	Climate-change risks	Green growth innovation/investment opportunities
<b>Agriculture, forestry, fisheries</b>	High dependence on rain-fed subsistence agriculture; declining production due to erratic rainfall, soil erosion, and increased evapotranspiration	<ul style="list-style-type: none"> <li>Climate-smart agriculture and agroforestry technology (e.g. drought-tolerant crops, water harvesting, efficient irrigation systems and integrated soil fertility management)</li> <li>Restoration of forests on degraded lands</li> </ul>
<b>Trade and industry (e.g. cement)</b>	Reliance on infrastructure and services (water, energy and transport); vulnerability to disruption from droughts and heavy rains	<ul style="list-style-type: none"> <li>Cleaner technologies and resource-efficient processes</li> <li>Industrial-scale cogeneration using biogas produced from agricultural residues</li> </ul>
<b>Tourism</b>	Dependence on environmental resources (e.g. wildlife)	<ul style="list-style-type: none"> <li>Eco-tourism</li> <li>Low-carbon tourism infrastructure</li> </ul>
<b>Energy</b>	Reliance on increasingly unreliable large-scale hydroelectricity	<ul style="list-style-type: none"> <li>Geothermal power generation</li> <li>Off-grid clean energy solutions</li> <li>Strategic multipurpose dams</li> <li>Renewables (wind, solar and biogas)</li> <li>Solar water heater distribution and maintenance</li> </ul>
<b>Transport</b>	Destruction of transport infrastructure due to extreme weather	<ul style="list-style-type: none"> <li>Green transport infrastructure (rail networks, a mass transit system for Greater Nairobi)</li> <li>Bioethanol blending and biodiesel use</li> <li>Urban transport management skills</li> <li>Technological innovation to make infrastructure “climate proof” (e.g. a rail network that can withstand high temperatures)</li> </ul>
<b>Waste management</b>		<ul style="list-style-type: none"> <li>Modern waste management facilities, e.g. use of methane and landfill gas, recycling facilities</li> </ul>
<b>Water and sanitation</b>	Increased water scarcity	<ul style="list-style-type: none"> <li>Water-efficient technologies</li> <li>Improved water resource management (better sewage systems, irrigation and drainage)</li> <li>Flood mitigation schemes</li> <li>Use of water filters (reduces demand for firewood to boil water, slowing deforestation)</li> </ul>
<b>Telecoms/ICT</b>	Destruction of telecoms infrastructure	<ul style="list-style-type: none"> <li>Climate-proof telecoms infrastructure</li> <li>Renewable energy-powered base stations</li> </ul>
<b>Financial sector</b>	Reduced returns of investment portfolios over the long term	<ul style="list-style-type: none"> <li>New product development (weather risk insurance, micro insurance, energy-efficiency lending and green mortgage products)</li> </ul>
<b>Property</b>	Destruction of and damage to property	<ul style="list-style-type: none"> <li>Upgrading of building codes to include climate resilience and green building concepts</li> <li>Green buildings</li> <li>Low-income housing</li> </ul>
<b>Extractive industries</b>	Reliance on water and energy; pollution; exposure of sensitive infrastructure (e.g. pipelines) to extreme weather	<ul style="list-style-type: none"> <li>Climate-proof, resource-efficient extraction technologies</li> </ul>

Source: Table compiled based on information in the National Climate Change Action Plan 2012, the Climate Change Framework Policy 2014 and the Scaling up Renewable Energy Program (SREP) Investment Plan for Kenya 2011.



## ALIGNING KENYA'S FINANCIAL SYSTEM WITH INCLUSIVE GREEN GROWTH



### **Inquiry:** Design of a Sustainable Financial System

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