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Commercial Banks and Economic Infrastructure PPP Projects in Kenya: Experience and Prospects

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By Paul Kamau*

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Abstract

Infrastructure is an umbrella term for many activities which are referred to as 'social overhead capital' has made many private sector operators shy off from them. This has not been the exception for the banking industry in Kenya. In fact, evidence shows that most of the financing of such infrastructure in Kenya has been through the Exchequer, Roads Maintenance Levy Fund (RMLF), multilateral financial institutions such as the World Bank; the African Development Bank, and donor countries. This paper aims at examining whether commercial banks can benefit from the PPP market in light of evolving opportunities for PPP financing. The broad objective is to explore several aspects of potential benefits that could trigger, improve or diversify the activities of banks in Kenya related to PPP financing. Specifically, the study aimed at finding (a) roles that commercial banks can play; (b) some specifics of the procedure for PPP financing by the banks; (c) trends in participation of banks as lead arrangers on the global PPP market; and (d) presence of international banks in existing PPP projects in Kenya. The paper provides valuable insight to commercial banks as potential financiers of PPP projects in Kenya, as well as provision of financial services.

In Kenya opportunities provided by the legal/regulatory framework for public-private partnerships (PPP) are evolving but remain rather novel. The public sector has also not made much headway in accomplishing substantial PPP while private sector stakeholders, including commercial banks are still not actively involved. Commercials Banks, most frequently provide advisory services, and banking services but not financing of PPP projects. With the changing terrains in ownership, financing, operation and management of economic infrastructure in Kenya resulting from the adoption of

PPP approach, the Kenyan banking industry has a role to play besides that of credit provision. There is scarcity of knowledge in terms of how the banking industry has been involved in the PPP architecture in Kenya.

This study focuses on the road infrastructure. This is because road transport is an enabling industry for almost all other sectors in the Kenyan economy and is critical to the movement and flow of raw materials and finished goods along the agricultural, manufacturing, trade and tourism value chains. In addition, road transport is one of the most widely used modes of transport in Kenya. Road transport has received substantial resources for construction, rehabilitation and maintenance over the past decade and has seen increased role of private industry through PPP, but banks seem to shy away. The findings indicate that most banks have limited participation in the road PPP projects in Kenya. Out of the 71 PPP pipelines currently underway, none of the commercial banks indicated as having participated in any activity. Knowledge about the PPP and opportunities provided for the banking industry seems to be low. Those respondents with knowledge of the annuity programme argued that the financing model was too complicated that it could lead to increased non-performing loans. The paper recommends that there should be more consultative meetings between the banks and the governments in order to promote the partcipation of commercial banks in infrastructure investments. The KBA has to play even a bigger role in mediating between the banking industry and the PPP projects so that banks can commit more resources towards roads PPP projects.

Key Words: *Annuity Financing, Infrastructure, Public Private Partnership*

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Acronyms & abbreviations

AICAD	Africa Infrastructure Country Diagnostic
AfDB	African Development Bank
COMESA	Common Market for Eastern and Southern Africa
DAC	Development Assistance Committee
DFID	Department for International Development
ERS	Economic Recovery Strategy
GDP	Gross Domestic Product
GoK	Government of Kenya
JKIA	Jomo Kenyatta International Airport
KBA	Kenya Bankers Association
PPP	Public Private Partnership
PPPU	Public Private Partnership Unit
KeNHA	Kenya National Highways Authority
KeRRA	Kenya Rural Roads Authority
KURA	Kenya Urban Roads Authority
MSEs	Micro and Small Enterprises
MOTI	Ministry of Transport and Infrastructure
MTEF	Medium Term Expenditure Framework
SSA	Sub-Saharan Africa
UNDP	United Nations Development Program

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Introduction

1.1 Background

There is growing evidence in literature that shows that economic infrastructure plays a critical role in economic growth and development (World Bank 1994, AfDB 2013, Biau et al 2008). Arguably, good infrastructure raises productivity, lowers production costs, and enhances competiveness leading to more effective delivery of service.

Moreover, economic infrastructure can deliver major benefits in economic growth, poverty alleviation and environmental sustainability. Some estimates indicate that a one percent increase in the stock of infrastructure is associated with a one percent increase in gross domestic product (GDP). As countries develop, the need to increase not only the quantity but also the quality of infrastructure in order to support changing patterns of demand.

The World Bank (1994) defines economic infrastructure as services accruing from public utilities (power, telecommunications, piped water supply, sanitation and sewerage, solid waste collection and disposal and piped gas) and public works (roads, railway networks, sea transport, air transport, major dams, and canals for irrigation and drainage). It also includes other transport sectors – urban and interurban railways, urban transport, ports and water ways, and airports (World Bank 1994 p.2). In other reports, infrastructure is defined as adequate electrical power, access roads, water and sewerage, security of tenure of premises, telecommunications and worksites. The provision of these economic infrastructure (including roads, power, rail, sea and airports) and services such as water, health and sanitation is a key mandate of governments the world over. These public goods are a fundamental prerequisite for economic growth and development.

Fiscal constraints experienced by countries, however, have resulted in the development of new and innovative approaches to the provision and financing of economic infrastructure and services, gradually supplementing the traditional role of government as the primary provider of such infrastructure and services. In recent years, there has been a revolution in thinking about who should be responsible for providing infrastructure stocks and services, and how these services should be delivered to the users. Out of this revolution, involvement of the private sector in management, financing, or ownership through Public-Private Partnership (PPP) frameworks has been critical in ensuring commercial orientation in infrastructure. This has also lessened the financial burden to the governments which previously had to finance all infrastructural projects. According to World Bank (1994) governments in developing countries owned, operated, and financed nearly all infrastructure, primarily because its production characteristics and the public interest involved were thought to require monopoly- and hence government-provision.

In Kenya, investment in infrastructure, outside of telecommunications, is largely driven by the public sector. Currently, the third largest allocation of public funds goes to physical infrastructure, after non-discretionary and education industry expenditures. However, a lack of financial capacity for large scale infrastructural projects has resulted in an intention by the government to fund those projects set out in the Vision 2030 predominantly through PPPs which presents a significant opportunity for private sector investors in Kenya.

Therefore, the adoption of a Public-Private Partnership (PPP) framework reflects the Government's desire to improve the quality, quantity, cost-effectiveness and timely provision of much needed economic infrastructure and services in the country. The private sector provision of economic infrastructure and services has the potential to offer enhanced value for money and enables the Government to use the private sector's delivery and project completion expertise and capability for the benefit of the people. Since 1996, Kenya has attracted private investments into the country's economic infrastructure sectors including telecommunications, energy, transport, water and sewerage. These investments have demonstrated both the commitments of the Government to PPPs and the interest by private investors, lenders and operators in these sectors. The legal, policy and regulatory environment for PPPs were enhanced following the enactment of the PPP Act of 2013 (Kenya, 2013). This has enabled infrastructure investments in most sectors of the economy with gains expected to spill over to economic growth.

There are many reasons why Kenya has been keen on the PPP approach to financing economic infrastructure. First and foremost, there is increased demand for quality and affordable services from the citizens. Secondly, there is need to reduce the financing gaps for infrastructure which has been estimated at about US$ 40 billion over the next ten years. Thirdly, there is need to provide new sources of investment capital for required infrastructure projects by reducing government sovereign borrowing and associated risks. Finally, it is the need to utilize efficiencies of the private

sector in running public services so as to increase their impact on development.

1.2 Objectives

This paper was designed broadly to document the involvement of the commercial banks in the provision of economic infrastructure in Kenya through PPP architecture. To achieve this, the specific objectives were:-

i. Examine how the PPP Act stipulates the role of the banking industry the infrastructural PPP project

ii. Examine how different banks in Kenya have been involved in the PPP architecture in Kenya

iii. Assess commercial banks' commitment to financing road transport PPP projects in Kenya over the last five years.

iv. Suggest policies for enhancing the banking industry participation in the infrastructure PPP projects

1.3 Methodology

The study utilized three main approaches namely survey, desk study and key informant interviews. A survey using a standard questionnaire was administered among bank managers to get their views on bank's role and commitments in financing PPP. This was conducted in July – August 2015. Twenty-two (22) commercial banks in peer-one and peer-two were interviewed so as to provide information on opportunities and challenges in financing roads PPP projects. Out of these 22 commercial banks 15 responded to the survey questionnaires. The data was analysed using descriptive statistics.

With regard to the desk study, various documents were reviewed in order to obtain valuable information on the subject of infrastructure PPPs in developing countries. Other issues that were examined included, legal framework, financing models and credit commitments by the commercial banks in Kenya. Data on commercial banks credit commitments to the infrastructural PPP projects was also analyzed.

Key informant interviews with diverse stakeholders and institutions dealing with PPP issues in Kenya were conducted. Information from key informant was used to corroborate survey findings and also the desk study.

Fieldwork for the study was conducted between July and August 2015, with most of the fieldwork conducted in Nairobi where most of the banks have their headquarters. Most of the respondents in the survey were the CEO/MD or the investment managers. Authorisation to conduct the survey was sought from the NACOSTI. In addition, KBA introduced the study among the commercials banks which was truly helpful.

Literature Review

2.1 Defining Public-Private Partnerships (PPPs)

There is no single definition of PPPs, but broadly it refers to long-term contractual agreement between the public and private sector agencies, specifically targeted towards financing, designing, implementing, and operating infrastructure facilities and services that were traditionally provided by the public sector. Under a PPP contract, the Government remains responsible and accountable to its citizens for service quality, price certainty, and cost-effectiveness.

A PPP is an arrangement between a public body or contracting authority and a private sector body in which the private party undertakes to perform a public function, or to provide a service on behalf of the contracting authority and receives compensation for it through user fees, government payment or a combination of both (Kamau, 2014, Kenya, 2013, World Bank 2013). PPPs are largely collaborations between the public and private sectors in which the public sector (includes the government, government bodies and agencies) gives authority to a private sector partner to design, implement and manage projects on their behalf. In exchange for the service, the private party receives compensation from the public fund or charges fees or both from users or consumers of the project.

The term Public Private Partnership (PPP) is sort of an "umbrella notion" covering a broad range of agreements between public institutions and the private sector, aimed at operating public infrastructures or delivering public services. According to LaRocque (2006:3), "contracting involves a government agency entering into an agreement with a private provider to procure a service, or a bundle of education services, in exchange for regular payments". Literature suggests that PPP means a contract concluded between the contracting authority and a project company under which the

project company is entrusted to undertake a project.

In Kenya, the Vision 2030 (2008 – 2030) which aims to transform Kenya into a middle income country by 2030 emphasizes the need for PPP in the development and management of public sector projects. Through the PPPs, the government is able to reduce the funding gap and also produce an accelerated and larger pipeline of infrastructure investments, and catching up with the infrastructure deficit in the country approximately US$ 2 to 3 billion/ year. Through PPPs, government is able to utilize efficiencies of private sector to increase the efficiency of public services. Finally, PPPs increase the business opportunities for the domestic market.

2.2 Why Focus on Public-Private Partnerships (PPPs)?

The concept of using private capital to provide public facilities is very old, in 18th and early 19th century Britain, groups of local magnates formed turnpike trusts which borrowed money from private investors to repair roads, these debts were repaid by charging toll or user fees a type of PPP that later came to be known as concessions (Yescombe, 2007). Concessions are most suitable for naturally monopolistic infrastructure sectors and were common in the 18th and 19th century in the construction of railways, waterways and other public infrastructure. PPP projects have been successfully developed in a wide range of industries, including both competitive infrastructure sectors such as public road transport sector and natural monopolistic sectors such as rail and air transport sectors.

The power purchase agreement developed in the USA is the template for the modern day PPP. Under this model, the project company does not take usage risks but only the risk of completing the project in time and within agreed costs. A financing technique in this model is the project finance which provides the high ratio of long term debt financing required for such projects.

The Public Finance Initiative (PFI) was announced by the British government in 1992 “in order to engage the private industry in the design, build, finance and operation of public infrastructure, with the aim of delivering good quality and well maintained assets that provided value for money for the taxpayer” (HM Treasury 2012). PFI was developed along the lines of concessions – where instead of user fees, the model introduced the concept of payment by the public authority. The private industry investor is paid by the public authority for the work done to required specification, as well as the provision of services such as maintenance, cleaning and catering. PPPs today are based on the concessions and PFI model.

A PPP project will naturally involve financing from various sources through equity and/or debt or project finance. Equity contributions are funds invested in the project company which comprise it's share capital and other shareholder funds. Equity contributions bear the highest risk and therefore potentially

receive the highest return on investment (Kamau, 2014; Odiege et al 2013). Financing through debt can be undertaken from many sources, including commercial lenders, export credit agencies, bilateral or multilateral organisations, bondholders (such as institutional investors) and sometimes the host country government. The source of debt will have an important influence on the nature of the debt provided. Unlike equity contributions, debt contributions have the highest priority amongst the invested funds. Project Finance, a common, and often most efficient, financing arrangements for PPP projects is also known as "limited recourse" or "non-recourse" financing. Project financing normally takes the form of limited recourse lending to a specially created project vehicle which has the right to carry out the construction and operation of the project. Limited recourse means that the lenders look only to the assets and revenues of the project for repayment of debt and interest; and not to the shareholders (Delmon 2010).

Controversy, criticism and conflict exist over PPPs. The profit-making objective of the private industry comes into play and proponents argue that this motivates them to seek cost savings at the expense of quality services, against the public's well-being; and the involvement of private industry in public services results in loss of jobs for public employees. In contrast, proponents contend that the profit motive of the private industry leads to improved level of service via cost effective solutions as the private industry can become more accountable to the public through well-designed PPPs, which provide the public industry sufficient control over the works and services being provided by the private industry, while allowing the management skills, technologies and financial resources of the private industry to come into play.

The decision to adopt PPP must be political, first. The government must consider the political and social implications of PPP and whether there is sufficient political will to implement PPP. Consideration needs to be given to the institutional, legal and regulatory context - the extent to which government institutions have the needed skills and resources, the financial and commercial markets have needed capacity and appetite, and laws and regulations encourage or enable PPP – and whether changes need to be made to the institutional, legal and regulatory climate in order to provide the right context for PPP (Kamau P. 2014). Once these basic issues have been addressed, those designing the PPP solutions available to policymakers must consider the most commercially and financially viable and appropriate structures.

In order for more PPPs to emerge in Africa, countries need to improve their business environment. At present serious constraints exist in many African countries ranging from: inadequate legal and regulatory framework for PPPs; inadequate technical skills to manage PPP programmes and projects; unfavourable investors' perception of country risk profile, Africa's limited role in global trade and investment, small market size, limited infrastructure and limited financial markets.

2.3 PPPs in the Infrastructure Industry

Public infrastructure and it's funding is an issue that occupies the development agenda of both the developed and developing economies. For both, there are apparent deficits in financing for both infrastructural construction and maintenance. While providing services and infrastructure through purchasing is a core public industry function, PPPs offer options to undertake infrastructure projects in which some (or all) of the up-front capital is provided by the private industry. Access to this private industry finance allows increased investment in public infrastructure, as compared to raising or budgeting additional funds (IISD 2013). It is for this reason, that governments worldwide have involved the private industry in providing infrastructure for energy generation and distribution, transport, telecommunications and water.

Infrastructure investment is generally delivered through large up-front capital intensive projects during the construction phase, with relatively smaller operational costs. Roads or Railway systems, for example, are expensive to design and build; however, once their construction is complete they portend significantly lower operating and maintenance costs.

Infrastructure assets provide limited flexibility compared to other commercial activity. They must physically fit into, and interconnect with, the existing array of utilities and networks (electrical lines, drainage pipes, water networks among others) in order to be functional. Not only that, but infrastructure development projects themselves must integrate into regional or national development plans. Furthermore, it is not likely that infrastructure can be easily converted to another use, meaning that infrastructure investment is generally defined by investment into single-purpose assets (IISD 2013; Kamau P. 2014). Some of these investments are natural monopolies, e.g. a water treatment plant, road or rail network etc. The inherent certainty of demand for the services and returns creates confidence for investors and lenders.

PPPs are not easy to apply in infrastructural projects due to their complexity in contractual arrangements and the high level of uncertainty that arises from the long-term concession period. To ensure the success of the PPP projects, both the government and the concessionaire must be competent to implement the partnerships. In addition, the project risks should be properly allocated between participants and a sound financial plan should be secured (Kwak et al. 2012).

Although the term infrastructure is wide including roads, public works, railway, air, water transport, energy, and housing, this paper focuses on road transport. This is because road transport is an enabling industry for almost all other sectors in the Kenyan economy and it is critical to the movement and flow of raw materials and finished goods along the agricultural, manufacturing, trade and tourism value chains. In addition, road transport is one of the most widely used modes of transport in Kenya. In any case, road transport has received substantial resources for construction, rehabilitation and maintenance over the past decade and has seen increased role of private industry through PPPs.

2.4 Role of Commercial Banks in PPPs

There has been substantial increase in private capital flows in the developing world since 1990 following economic and financial market liberalization. This created some hope that the private industry would be the next provider of investment in infrastructure and public utilities in poor countries. However, financial in flows in most of the developing countries started sobering after sometime. For instance, as a result of the Asian financial crisis of 1997, private investors, major commercial banks and international organizations retreated from these economies. This withdrawal was amplified by the weakening of the global infrastructure industry leading to the decline in international sources by at least 50%.

However, at their peak in 1997, they were just 3.6% of total new international bond, loan, and equity issuance (World Bank 2004). It is clear today that international private capital flows are not going to bridge the huge investment gap in poor countries' infrastructure needs. In Sub-Saharan Africa annual investment needs in infrastructure are estimated at approximately USD 22 billion, while total annual spending is about USD 10 billion (World Bank 2010). As a result, Sub Saharan African governments have tried to get new sources of financing infrastructure especially with dwindling exchequer funds. One such source is the banking industry.

Yescombe (2010) argues that financing PPP projects by one or several banks operating in the same country in which the project is located is a rather favorable form of finding capital to meet the project needs. The most significant potential benefits that would be realized in case of financing PPP projects by domestic banks are: complete avoidance of risk; synergy in the activities of PPP projects' implementation due to the fact that domestic banks are most familiar with the business conditions in the local environment.

In setting up a PPP arrangement, a selected private partner is in charge of negotiating all contractual arrangements concerning the project, signing the contract and closing the financial structure. Often times the public partner is without relevant expertise and experience and would normally hire financial advisors. Financial advisory services are provided by banks which have specialized knowledge about a certain markets. Investment banks may only arrange the financing, but may not provide lending to the project. In other cases, banks may form consulting companies, specialized in project finance and/or financial advisory services. The responsibility of a bank as a financial advisor covers several segments including: tender preparation; feasibility study of the project; risk analysis; economic optimisation, legal and tax structure advice among others. The typical approach in arranging loans in PPP projects is to assign one or several banks the role of lead manager, which would be the underwriter of debt, placing it on the financial market. The lead manager is often referred to as arranger or lead arranger.

2.5 Trends in Banks' Participation in Infrastructure PPPs in Sub-Saharan Africa

The importance of economic infrastructure has been increasingly emphasised during the last Decade; driven by the recognition of it's crucial role in economic development and poverty reduction, as evident particularly in Sub Saharan Africa. Importantly, the global scene has witnessed a buoyant financing interplay with the existence of loans for projects financed by project finance techniques (including PPP projects). Despite global economic disturbances, in 2011 SSA markets recorded a total amount of extended loans of USD 213,487.00 billion, through 615 projects with a financial closure, in 54 countries in the world (Banks and Bank Systems, Volume 9, Issue 1, 2014). As early as 2001, project finance lenders, commercial banks recorded a whopping share of 82% in the private debt market; banks were especially active in project finance. Among the donors, the World Bank Group was the largest, with disbursements amounting to roughly to about a quarter of the total ODF for infrastructure by donors reported. This was followed by Japan, the EU Institutions, AfDB and the IADB. Overall, multilateral donors,[1] including the EU Institutions, provided 62% of total financing for infrastructure in 2011, with bilateral donors providing 38%. While emerging economies such as the People's Republic of China and India are also providing significant levels of financing for infrastructure, these amounts are not included, as they do not report to the DAC. However, according to estimates, the two economies provided nearly USD 2.1 billion for infrastructure in 2011 through south-south co-operation (Development Initiatives, 2013). Nevertheless, in the late 2000s, the global economic crisis caused some extremely significant changes at the global level in banks specialized to conduct lead arranger's operations (Banks and Bank Systems, Volume 9, Issue 1, 2014).

The World Bank's Africa Infrastructure Country Diagnostic (AICD) study on infrastructure in Africa estimates that Sub-Saharan Africa needs to spend US$93 billion a year on infrastructure, of which only US$ 45 billion is already being met through existing sources such as government spending, user charges, private industry investment, and other external sources, creating an annual total funding gap of US$ 48 billion.[2] Accordingly, there is a trend in allowing private participation through PPPs for infrastructure development projects, with the aim of overcoming that financial deficit and promoting development of areas with underutilized potential.

The financing gap for infrastructure requires further mobilisation of resources, which is unlikely to be provided either by the donor community, given tightening budgets, or by developing country

1 Multilateral donors are the World Bank, AfDB, The EU, a DAC member with its own sources of financing and budgetary authority, is also included here, although it has a sui generis legal nature.

2 ESTACHE, Antonio and ACARES, Universitélibre de Bruxelles - Africa's Infrastructure Challenges and Opportunities; IMF; March 2006; p 6-9, 65-86

governments who are constrained by affordability and sustainable debt levels. In this context, trying to leverage more private finance becomes an important avenue for infrastructure financing, especially given the private industry's ability to innovate and use resources efficiently.

In Kenya, the AICD report estimates that, to address the country's infrastructure deficit will require sustained expenditures of approximately US $4 billion per year (20% of GDP) over the next decade. To meet this objective, the Government of Kenya (GOK) has been looking at alternatives aimed at raising additional finance, adopting low-cost technologies, while prioritizing infrastructure investments. In this context, the Government of Kenya (GOK) has made infrastructure development through Public Private Partnerships (PPPs) a priority as a mechanism that can help it address the major infrastructure gaps in the country. The government has over the past been committed to improving and strengthening the environment for private sector participation in the country (Kenya, 2003 –ERS). In the effort to improve the PPP investment climate, a number of deliberate initiatives have been undertaken by the government. These include:

- Adoption of a PPP Policy to articulate the government's commitment to PPPs and to provide a basis for the enactment of a PPP Law;
- Gazettment of the PPP Act 2013 on 8th February 2013;
- Establishment of PPP Unit; and
- Development of PPP Regulations for both the National and County governments.

The Kenyan government is confident that through the PPP modality, the private sector can offer a dynamic and efficient way to deliver and manage public infrastructure. These efforts are geared towards achieving Vision 2030, Kenya's long-term development strategy, so that future generations can gain from the benefits of modern services, improved living standards, and reduced poverty.

2.6 PPPs in the Kenyan Context - Towards Vision 2030

The Kenya Vision 2030, which is the country's development blueprint covering the period 2008 to 2030 aims to transform Kenya into a newly industrialising, "middle-income country, providing high quality life to all its citizens by the year 2030. The Vision aspires for a country firmly interconnected through a network of roads, railways, ports, airports, water and sanitation facilities, and telecommunications (Government of Kenya, 2007).

Overall there is increased demand for quality and affordable transport, water and sewerage, telecommunications, power, social services services from citizens. The Kenyan Government has set out to reduce the funding gap for infrastructure estimated at US$ 40 billion over the next 8 years; provide a new

source of investment capital for required infrastructure projects reduce Government sovereign borrowings and associated risks and drive the creation of local long term funding market; utilize efficiencies of private industry in running public services while at the same time expanding the economy and stimulating job creation and increasing the quality of public services to the Kenyan citizen.

2.7 PPPs in Kenya

Kenya has worked hard to attract private investments by strengthening it's PPP, legal and regulatory framework. Actions since 2009 in PPs include:

- Etablishment of an institutional framework through regulations issued under the Public Procurement Disposal Regulations of 2009;
- A review of Kenya's legal and regulatory framework which recommended the enactment of a PPP Law to address identified gaps, inconsistencies, conflicts and overlaps in 2010;
- The approval of a PPP Policy Statement by the Government of Kenya in 2010;
- An agreement with the World Bank in December 2012, where the Government of Kenya received a credit from the World Bank for the Infrastructure Finance and Public Private Partnership (IFPPP) Project, with an overall objective of increasing private industry investment in the Kenyan infrastructure market and to improve the enabling environment so as to generate a pipeline of bankable PPP projects; and
- The PPP Bill approved by the Kenyan Parliament in December 2012, which received Presidential Assent on 14th January 2013. This resulted in the Public Private Partnership Act, No. 15 of 2013, published in the Kenya Gazette supplement No. 27 of 25th January 2013. Consequently the PPP Act came into effect on 8th February 2013.

However, there exist challenges in the implementation of the PPP Act 2013. These challenges include:

- The short-term institutional capacity of the National Treasury PPP Unit to provide feasibility oversight of an ambitious pipeline of projects that have been identified by the national government.
- The institutional capacity of government institutions (other than the Treasury) to establish the required PPP nodes (in-house PPP units) that will work closely with the Treasury to ensure that PPP projects are feasible, sustainable, and meets the expectations for "Value for Money"
- The institutional challenges created by the recent devolution and decentralization of PPP

"autonomous" PPP authority to the 47 county governments.

- Inadequate experience of Kenyan financial institutions regarding domestic Private Industry funding of local PPP projects.
- Limited knowledge among developers and other stakeholders in the Kenyan construction industry about PPPs.
- Ongoing revisions needed to beef up the 2013 PPP Act in regards to transparent procurement procedures – specifically those regulating unsolicited PPP procurements.

In addressing the above challenges a number of corrective actions have been proposed and adopted. These include:

- Securing the resources to build institutional capacity (from both the Government of Kenya and foreign donors)
- Identifying those who should be trained to support initiatives so that proposed PPP projects are not smothered by bureaucratic red-tape
- Finding ways to encourage collaboration between government agencies, the National Treasury, and county government
- Educating government decision makers and politicians about PPPs and related procurement guidelines so that expectations can be tempered when it comes to unrealistic expectations about the use of PPPs, and Finding ways to educate the Kenyan Private Industry about what PPPs are really about.

2.8 Current infrastructure PPPs in Kenya

There are various PPP projects which are at different stages of operation. What emerges from our analysis is that demand for PPP project has been on a steady rise partly due to the implementation of devolved governments and also the commitment by the national government to provide public infrastructure. Broadly, PPP projects can be classified as either on-going or pipeline projects.

The PPP Unit has the mandate to apprise the stakeholders on the status and progress of the countries PPP pipeline. The most recent updated list of PPP projects in Kenya is dated May 2014 and contains about 58 PPP projects which cut across different economic sectors (Kamau, P.K. 2014, PPP Unit 2015). The full list of all PPP projects is appended in Annex 1. In this section, we briefly discuss some of these PPP projects especially those in the infrastructure road sector.

Table 1: Kenya Selected PPP as at June 2015

Project Name	Description	Contracting Authority	Status
2nd Nyali Bridge	The proposed project seeks to apply PPP arrangement for development of a 2nd Nyali Bridge connecting the Mombasa Island with the North mainland	KURA	Feasibility study by the TA
Dualling of Mombasa – Nairobi Highway	The proposed project seeks to apply a PPP arrangement for the upgrading, capacity expansion and subsequent operation and maintenance of the heavily trafficked 485 km Mombasa – Nairobi Highway (A109)	KeNHA	Feasibility study by the TA
O&M of Nairobi Thika Road	The proposed project under an operation and maintenance (Q&M) PPP scheme, whereby the private party, to be awarded through competitive bidding process, is to operate and maintain the eight lane 50 KM superhighway	KeNHA	Feasibility study by the TA
O&M of Nairobi Southern Bypass	Upon the completion of 28.6 km dual carriage bypass, the proposed project under Q&M PPP arrangements shall be awarded to a private party to operate and maintain the road.	KeNHA	Feasibility study by the TA
Dualling of Nairobi – Nakuru Road	The project is envisaged to apply a PPP arrangement for the development and operation of the 157 km Nairobi-Nakuru Road (A104)	KeNHA	Feasibility study by the TA
Phase 1 of Roads Annuity Programme	The GOK has adopted an ambitious plan to develop and rehabilitate 10,000 km of the road network within the next five (5) years. The 3,000 km phase 1 of the programme adopts a 'Finance-Design-Build-Maintain-Transfer' PPP scheme. In return the private developer is compensated via fixed and performance related periodical payments (annuity) by GOK from public funds	MOTI-KeNHA, KURA & KERRA	Approval of Tender Evaluation
Mombasa 2nd Container Terminal Phase II & III	The project consists of construction of a new container terminal with a total area of 100 hectares and capacity to handle 1.2 million TEU per annum. It is funded by Japan Bank for International Development in three phases.	KPA	Tender Prequal-ification

Table 1: Kenya Selected PPP as at June 2015

Project Name	Description	Contracting Authority	Status
Kisumu Sea Port	Development of Kisumu Port into a modern commercial lake port to serve the growing trade in the EAC region	KPA	Feasibility study by the TA
Development of the Shimoni Port	Shimoni located in South Coast is considered to be the best positioned, as a result of its good nautical access, for tourism development purposes and continuation of existing trade on PPP basis. The private party is expected to inject additional funds to support the infrastructure development and play a key role in the operation of the port.	KPA	Development of ToRs for TA services
Conversation of Berth 11-14 into Container terminals	The project entails infrastructural modification to berths 11 to 14 to support loadings from modern container handling equipment and procurement of handling equipment. The project is estimated to cost USD 120 million, while construction and equipping of the berths will take approximately 2 years.	KPA	Project Proposal
Lamu Port Development Project	The development of Lamu Port will also include the construction of port associated infrastructure such as Causeway, port access road, railway yard, water and electricity supply, port building and other port related services. Lamu Port is expected to have a total of 32 Berths, with each Berth having an estimated quay length of 400m and a draft of between 17.5m to 18m. The Port has an estimated total investment of US$ 5Billion with an Internal Economic Rate of Return of 23.4%.	KPA	Project Proposal
Multi-Storey Terminal at Likoni	Development of a multi-storey terminal on 1.6Ha in Mombasa to provide a modern ferry terminal, parking, bus terminal as well as a variety of commercial services to maximize revenue potential of the site.	KFSL	Feasibility study by the TA

Source: PPP Unit, June 2015

Of the twelve projects listed in Table 1, six of them are in the road sector, which signifies the commitment of the government in collaborating with the private sector in the provision of road network system in Kenya. It is worth noting that roads PPP projects appear to be at advanced stage of implementation compared to those in other subsectors. The most recent and perhaps the most ambitious road project by the government is the road annuity programme whose phase one is at the tendering stage. As discussed elsewhere in the paper, this is a Kshs. 300 million project which aims at increasing the paved road network by 10,000 kilometres by the year 2017. It is a project where commercial banks appear to have a special opportunity for PPP investments.

In addition to providing the list of PPP projects in Kenya, the PPP Unit whose mandate is to provide overall coordination, promotion, and oversight of the implementation of the PPP program in Kenya, has developed a sectoral analysis of investment opportunities. Table 2 below provides this information. It is clear that most of the investment opportunities exist in the energy sector followed by the roads sub-sector at US$ 19,808 million and US$ 9,000 million, respectively. Therefore these two areas therefore provide important opportunities for PPP projects and where the banking industry can play a key role.

Table 2: Opportunities for Infrastructure Investments 2012-2020

	Industry	Amount (Us$ Million)
1	Energy (power and others)	19,808
2	Ports	4,800
3	Roads	9,000
4	Water and sanitation	4,567
5	Railways	7,248
6	Airports	906
7	Tourism	2,050
8	ICT	7,850
9	Local Government	2,000
10	Housing	2,901
11	Public Works	1,000

Table 2: Opportunities for Infrastructure Investments 2012-2020

	Industry	Amount (Us$ Million)
12	Lamu Port Corridor	3,723
	Total Needs	**62,176**
	Available Resources (GoK – 2012 - 2020)	**25,000**
	Funding Annual Gap	**37,176**

Source: PPP Unit (2012)

According to PPP Unit (2015), infrastructure investment opportunities in Kenya for the period 2012-2020 are estimated at US$ 62,176 of which available resources are approximately US$ 25,000 leaving an annual funding gap of US$ 37,176 which can be bridged through PPP projects. The energy sector takes the lion share of this investment at US$ 19,808 followed by road whose investment potential is US$ 9,000. This further reinforces the importance of the road subsector in Kenya.

2.9 The Road Infrastructure in Kenya

The physical infrastructure sector consists of Roads; Public Works; Transport; Energy; and Housing Sub-Sectors. In the long term development blue print "The Kenya Vision 2030", infrastructure development has been recognized as an enabler for sustained development of the economy and particularly for the six key sectors namely; Tourism, Business Process Outsourcing (BPO), Wholesale and Retail, Manufacturing, Financial Services and Agriculture and Livestock identified under the economic pillar (Kenya 2008, 2011). Transport is particularly important in the Vision 2030 because reliable and efficient road, rail, air, and water transport infrastructure facilitate smooth and faster movement of goods and services, in turn boosting trade within and across Kenyan borders (Kenya- Economic Survey, 2015). It is also vital in facilitating economic growth and sustainable development. The government has therefore over time intensified efforts aimed at improving transport infrastructure.

The transport sub-sector in Kenya encompasses a transport system comprising of the following modes: road, rail, air and maritime transport. The sub-sector is crucial in the promotion of socio-economic activities and development through effective, efficient and reliable transport system that promotes rapid and sustained development in terms of national, regional and international integration, trade facilitation, poverty reduction and improvement of welfare of the citizenry (Kenya 2011, Kidenda 2014). In the Vision 2030, the transport sub-sector is identified as a key

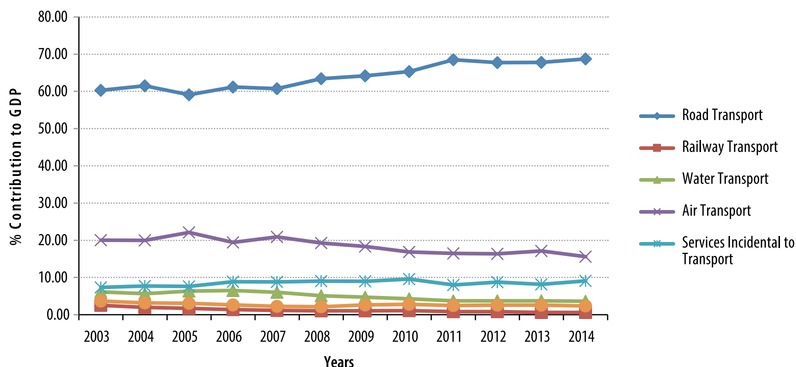
pillar expected to play a pivotal role in steering Kenya's economy towards a middle income level by facilitating mobility of people, goods and services.

The road sub-sector is the most important in terms of output generation given that it is the most widely used mode of transport in the country. For 2003 to 2014 period the sub-sector contributed the highest share of output, on average 64.04% (Figure 1). This contribution rose from 60.23% in 2003 to 68.73% in 2014 making it the most significant subsector in the transport sector. The general trend of road transport is a clear growth over time. The second major transport subsector is air transport whose value of output for the same period was 18.54%, followed by water transport with an average contribution of 4.97% and then pipeline at 2.70%. Last is the railway whose average contribution is mere 1.24% during the period 2003-2014 (see Figure 1).

As at independence, Kenya's road network was 45,000 kilometres of which only 2,000 kilometres was paved (4.4%). In 2014, the road network was approximately 161,000, with only 14,100 kilometres (8.8%)being paved.[3] Given the contribution of road transport in the economy and a marginal growth of 242 kilometres per year for the past 50 years, there has been an urgent need to invest in road infrastructure. Out of the total road network, only 11% is classified as in good condition, with 33% being fair and 56% being in poor condition. This clearly demonstrates the need for serious investments in the road sector. The government has committed to fund road construction in the recent past not only from the exchequer and donor funds but also from private sector. One of the most recent efforts by the government is the construction of 10,000 KM of roads within the period 2013-2017, a commitment by the Jubilee Government. This has been rated as

3 This includes the classified, urban and rural roads as well as roads in the National Parks and Reserves.

Figure 1: Transport Share Value of Output 2003 -2014 (%)



Source: Computed from Economic Survey (Various Issues)

one of the most ambitious and transformative plan to expand road network in Kenya since independence. In addition, it is a plan that tries to bring together public and private sectors in the road network expansion.

In terms of policy the roads sector is guided by the Sessional Paper No. 5 of 2006 on the *"Development and Management of the Road Sub-Sector for Sustainable Economic Growth'*; the Public Road and Tolls Act (CAP 407) of 2007, and the Roads Act 2007. Among the institutions responsible for roads construction, rehabilitation and maintenance include the Kenya National Highways Authority (KeNHA), Kenya Rural Roads Authority (KeRRA): Kenya Urban Roads Authority (KURA); and the the Kenya Roads Board. Others include the Mechanical and Transport Department, Materials Testing and Research Department, and the Kenya Institute of Highways and Building Technology (KIHBT). According to the Roads Act 2007, KeNHA is responsible for the development and maintenance of class A, B and C roads. KeRRA is responsible for all rural and small town roads of Class D and below including Forest Roads, Special Purpose Roads and unclassified roads. KURA is responsible for management and maintenance of all roads within cities and major municipalities. The Kenya Roads Board established by Kenya Roads Board Act 1999 is responsible for funding maintenance of all roads including approval of maintenance work programmes, technical and financial audits of works funded by the Board. Section 22 of the Roads Act 2007 empowers the Roads agencies to enter into any arrangement with a state corporation or other entity which is likely to promote/secure the provision, or improved provision, of any service/facilities, and for the payment, collection or apportionment of any tolls, rates, charges. Through the recent policy and institutional development in the roads subsector, the stage seems to have been set for public–private partnership (PPP) particularly in the bridging the finance-gap.

Inadequate road network expansion in the past has been attributed to insufficient funding (funding gap). According to some estimates, Kenya's infrastructure funding-gap is estimated at US$ 2.1 billion (Kshs. 180 billion) annually for the next ten years. For the roads, the financing gap is estimated at US$ 44 million (Ksh. 40 billion) per year. The major financing source of road construction, rehabilitation and maintenance is the exchequer, donors, and the Roads Maintenance Levy Fund (RMLF). In the routine and periodic maintenance, the optimal annual finance requirement is Kshs. 40 billions, while the RMLF realises approximately Kshs. 25 billion annually, leaving a gap of Kshs. 15 billion (Kidenda, 2015).

Therefore, Kenya has unveiled a new financing model for road construction and reviewed it's design standards and construction methodologies, which forms part of a new strategy for the East African country. Under this new plan Kenya is planning to upgrade 10,000km of road, with these links featuring asphalt surfacing; the work being carried out over the

next five years at a cost of US$2.8 billion. Despite the country grappling with a backlog of road maintenance works requiring $4.3 billion, the Kenyan Government has moved ahead with the new plan, commonly called the Annuity financing programme.

This will nearly double the number of Kenya's asphalt surfaced roads from the current 14,000km, an equivalent of 8.8% of the 161,451km of classified roads, to 24,000km by the end of 2017. "Under this Annuity programme, the plan is to complete 2,000 km of small roads within 2014/2015 financial year. This will be followed by 3,000km in 2015/2016, made up of 80% small roads, and 20% highways. In (the) 2016/2017 financial year, complete 5,000km, 80% of which will be small roads and 20% highways." With only 8.8% of the current road network (161,000 KM) being paved 50 years after independence, has triggered the government to embark on a massive road project dubbed the Annuity Financing Framework. Kenya will be the first country in Africa to use this model. Under this programme, the government will let private companies build roads and maintain them for a period. Initially, private companies will have to use their own funds or borrow from banks at lower rates than usual due to a guarantee by the government. In exchange, contractors will be collecting a cheque every year from the government, allowing them to pay off the debt and keep the balance. The road PPPs can be turned into more innovative schemes by introducing road concessioning, promoting build-operate-transfer models and also the fund-rehabilitate-maintain-transfer scheme. In the year 2014, the government was able to raise a 12 year infrastructure bond worth US$ 168 million to finance the road network expansion, as well as to provide funds for other projects. There are therefore many ways through which the banking industry (private sector) can be involved in the financing of roads infrastructure.[4]

2.10 Structure of Commercial Bank Industry in Kenya

The banking system in Kenya consists of the Central Bank of Kenya, Commercial Banks, Mortgage Finance Companies, Microfinance Banks (MFBs), Credit Reference Bureaus (CRBs), Money Remittance Providers (MRPs) and Foreign Exchange (forex). It has a pyramidal structure with the Central Bank at the apex and commercial banks in the second tire. Other financial institutions form different tiers which are part of the pyramid.

As at 31st December 2014, the banking sector comprised of the Central Bank of Kenya, as the regulatory authority, 43 commercial banks, 1 mortgage finance company, 9 Microfinance Banks (MFBs), 2 Credit Reference Bureaus (CRBs), 13 Money Remittance Providers (MRPs) and 87 Foreign

4 As already mentioned, the Kenya Commercial Bank and the Co-operative Bank of Kenya have contributed Kshs 40 billion and Kshs. 8 billion, respectively towards the Kshs. 300 billion for the road annuity programme.

Table 3: Ownership and Asset Base of Commercial Banks

				(Ksh. Millions)
Ownership	Number	% of Total	Total Net Assets	% of Total
Local Public Commercial Banks	3	7.00	154,896	5
Local Private Commercial Banks	27	62.80	2,061,517	64
Foreign Commercial Banks	13	30.20	982,983	31
Total	**43**	**100.00**	**3,199,396**	**100**

Source: CBK 2014

Exchange (forex) Bureaus (Central Bank of Kenya 2014). Out of the 44 banking institutions, 30 were locally owned banks comprised 3 with public shareholding and 27 privately owned while 14 were foreign owned. The 9 MFBs, 2 CRBs, 13 MRPs and 87 forex bureaus are all privately owned. Of the 14 foreign owned banking institutions, 10 are locally incorporated subsidiaries of foreign banks and 4 are branches of foreign incorporated banks. Further, 11 of the 44 banking institutions are listed on the Nairobi Securities Exchange.

The banking industry is dominated by local private banks in terms of numbers, and net assets as indicated in Table 3. The total net assets in the banking industry as at 31st December 2014 stood at Kshs. 3.2 trillion, of which 64% was from local private commercial banks. A total of 13 commercial banks were foreign owned and accounted for 31% of the industry's assets (CBK, 2014).

Commercial banks in Kenya are further classified into three peer groups using weighted composite index that comprises net assets, customer deposits, capital and reserves, number of deposit accounts and number of loan accounts.[5] This classification is also used to determine the market share of commercial banks as shown in Table 4. For the period ending 31st December 2014, there were 6 large banks with a market share of 49.9%, 16 medium banks with a market share of 41.7% and 21 small banks with a market share of 8.4% (CBK, 2014).

5 According to the CBK (2014: P 6), a bank with a weighted composite index of 5 per cent and above is classified as a large bank. A medium bank has a weighted composite index of between 1 and less than 5; while a small bank has a weighted composite index of less than 1 per cent.

Table 4: Commercial Banks Market Share Analysis

Peer Group	Number	Weighted Market share (%)	Total Net Assets (Kshs. Mn)	Customer Deposits (Kshs. Mn)	Capital & Reserves (Kshs. Mn)
Large	6	49.90	1, 561, 262	1,136,299	251,667
Medium	16	41.70	1,367, 559	953,598	209,348
Small	21	8.40	270,576	202,301	40,718
Total	43	100.00	3,199,397	2,292,198	501,733

Source: CBK 2014

The Banking sector has continued to grow in terms of inclusiveness, efficiency and stability on the backdrop of legal, regulatory and supervisory reforms and initiatives. According to CBK (2014), this growth supports the government's efforts for a vibrant and competitive financial sector in Vision 2030. Some of the developments in the sector included increased convergence of banking and mobile phone platforms; introduction of a transparent credit pricing framework (Kenya Banks' Reference Rate- KBRR); operationalization of the Credit Reference Bureau Regulations 2013; harmonization of credit information sharing (CIS) and impressive increase in the volume of banking business transacted through agents (CBK, 2014:26). Following the rebasing of Kenya's economy in November 2014, the economy grew by 5.3% in 2014 compared to 5.7% in 2013 and 4.5% in 2012. This growth has meant increased demand for financial products offered by the banking sector. The economic outlook 2015 has been predicted to be positive largely driven by the on-going public sector investment in transport, energy and irrigation, ICT and Financial infrastructure, which are expected to ease supply side bottlenecks, reduce production, reduce intermediation costs and stabilize output.

Generally, the banking sector registered enhanced performance during the year ended December 2014. The sector recorded a 12.2% growth in pre-tax profits during the year. Both the total net assets and total deposits held by commercial banks recorded growth rates of 18.4%. The sector also recorded strong capitalization levels as a result of retention of profits and additional capital injection. However, asset quality registered a decline with the non-performing loans (NPLs) ratio increasing from 5.2% in December 2013 to 5.6% in December 2014 (CBK, 2014).

Findings

3.1 The Public Private Partnership Act, No. 15 of 2013 and the Role of the Banking Industry in the Infrastructural PPP Project

The PPP Act (2013) was assented into law on 14th January, 2013 and commenced operation on the 8th February, 2013. It provides an institutional and regulatory framework for public private partnerships in Kenya. The PPP act will regulate the process of engaging private parties and the manner in which public private partnerships are conducted so as to ensure the provision of high quality facilities and services.

It also provides a comprehensive framework for carrying out public private partnerships and seeks to replace the existing regulations which are considered to be largely inadequate. Further, the Act aids in providing legal capacity for public bodies to enter into PPP contracts; creating more certainty and investor confidence; addressing legal gaps and removing conflicts and overlaps in the law; providing specific procedures of selection and contracting of more suitable PPP mechanisms; ensuring that investor selection is done in a transparent, fair and competitive manner; overcoming procedural, legal impediments and difficulties that would have been faced by the government to implement public private partnership procurement; introducing of funding into Kenyan legislative framework for procurement.

The Public Private Partnership Unit (PPPU) is established under Section 8 of the Public Private Partnership (PPP) Act, 2013 as a Special Purpose Unit within the National Treasury of the Government of Kenya (GOK). The PPP Unit's focus is to serve as the secretariat and technical arm of the PPP Committee, which is mandated with assessing and approving PPP projects in the country.[6] In accordance

6 See Kamau P. K. (2014) for more details on the role of PPP Unit and legal PPP infrastructure

with Section 14 of the PPP Act 2013, the functions of the PPP Unit are to serve as a resource centre on matters relating to PPP, conduct civic education to promote awareness and understanding amongst stakeholders; rate, compile and maintain an inventory of PPP projects; ensure adherence to management process of PPP projects by all parties; assist contracting authorities where necessary to design, identify, select, prioritise, appraise, evaluate and negotiate projects; and monitor contingent liabilities and accounting and budgetary issues related to public private partnerships with the relevant offices within the State department responsible for finance.[7]

Although the PPA Act (2013) is not explicit on the role of the banking industry, it creates several opportunities for Investors – including commercial banks, these include: risk mitigation(Letters of Support, Guarantees (Demand/Traffic Guarantee), subsidies; Inflation and interest rate indexation; Performance monitoring mechanisms; Direct Agreement and step-in rights to Lenders – (which favours commercial banks); compensation for termination/ extra-ordinary events/ direct impact of change, Laws/political event; establishment of a Viability Gap Fund to support economically viable projects which may not be financially viable without Government support and a clear, transparent, fair and competitive process for PPPs, covering Project identification, selection, prioritization, preparation, appraisal, procurement, approvals and procurement of project Advisors.

7 For more details of the functions of the PPP Unit, see Article 14 page 321 of the PPP Act 2013 (Kenya, 2013).

The PPP Act also provides that a clear institutional framework for development and approval of PPP projects – Cabinet, PPP Committee, PPP Secretariat is in place contracting Authorities and the role of Treasury in fiscal risk management and Contingent Liabilities is spelt out (Kamau S. 2014; Kamau P. 2014). It promises that the government will prepare bankable projects before going to the market and the guaranteed use of Privately Initiated Investment Proposals (unsolicited) method of procurement when there is urgent need for continuity and where there is intellectual innovation.

3.2 Enhancing the Banking Industry's Participation in the Infrastructure PPP Projects in Kenya

The role of the banks would be both to provide a source of finance for bonds, financing for PPP projects through private industry contractors and for enabling GoK and development partners to access the rural poor through their networks. The possibilities that are open in the Kenyan context in terms of financing PPP projects, along with the level of banking industry's development, provide rather positive prospects for a more intensive presence of PPP projects in this market. Research indicates that commercial banks can use various forms of benefits through know-how, same policy and procedures, experience sharing, expertise, easier insight into the country/region specific, culture familiarity; Indirect impact, due to their know-how, syndication, diversity of services and competition.

To attract investors, Kenya must continue developing and sustaining a sound legal, regulatory, and institutional PPP framework which inspires investor confidence. This will of necessity include high standards of public and corporate governance, flexible labour markets, transparency, and the rule of law, including protection of property and contractual rights, essential for attracting the participation of the private industry in all sectors of the economy, including infrastructure.

Of worthwhile importance, PPP processes should be free of corruption and subject to appropriate levels of accountability, while public authorities should take effective measures to ensure the integrity and accountability of all partners and should establish procedures to deter, detect, and sanction corruption. Likewise, the process for awarding PPP contracts should be competitive and should guarantee procedural fairness, no discrimination, and transparency.

Public authorities can increase the popularity of PPPs by encouraging informed debate on the role and impact of these partnerships, consulting stakeholders and the public about the use of PPPs, putting in place an effective communications and awareness strategy, and creating a rigorous evaluation program.

A follow-through integrated and coherent infrastructure development plan must be put in place with inbuilt capacity to identify, prioritize, and develop projects which are bankable and attractive to private investors. There will be need for open, competitive and transparent procurement processes which ensure, and are seen to ensure value for money.

The Kenyan Government can promote commercial banks investment in infrastructure by treating local and foreign providers equally, providing investment incentives, and ensuring a supportive and efficient environment for investors. Investment promotion agencies can support investment in infrastructure by promoting this important area as a priority investment industry.

In order to ensure that long-term local currency financing is sustained, there needs to be development and expansion of local and regional pension fund and life insurance markets and the development and expansion of local and regional bond trading markets to facilitate PPP bond liquidity. Government also needs to ensure the development of tenor extension and refinancing guarantee products to backstop lenders who are tenor-constraint insurance companies.

Some of the fiscal policies that should be considered in enhancing commercial banks participation include: deepening of domestic financial market; lengthening the Government yield curve and developing a more liquid Government Bond market;[8] developing regulatory regime for securitization instruments to enable participation of pension funds and insurance

8 Pension Firms – The pension industry has a particular role as a major potential investor in bonds and also in infrastructure that it buys from either the contractor or government once it has been built/refurbished leasing it back to an operator

companies in PPP; explore possibilities of a long term infrastructure fund/financial intermediary lending facilities; enhance guarantee instruments to mobilise private financing for infrastructure development; and provide appropriate avenues for entry and exit in PPP projects.

Regarding the guarantee instruments, the World Bank guarantees are available to all countries eligible for borrowing from the International Bank for Reconstruction and Development (IBRD) or the International Development Association (IDA). The World Bank through its guarantee instruments helps accelerate growth in developing countries by mobilizing private financing for infrastructure development and other projects of national importance. By covering government performance risks that the market is unable to absorb or mitigate, the World Bank's guarantee mobilizes new sources of financing at reduced financing costs and extended maturities, thereby enabling commercial/private lenders to invest in projects in developing countries (World Bank, 2011). Guarantees can mitigate a variety of critical sovereign risks and effectively attract long-term commercial financing in sectors such as power, water, transport, telecom, oil and gas, and mining. Guarantees can also enhance private industry interest in participating in privatizations and public private partnerships (PPPs). This can help Kenyan governments access the international financial markets.

3.3 Commercial Banks in Kenya Commitments in Financing Road Transport PPP Projects

In the context of declining interest rates and commercial banks' average lending rates between 2013 and 2014, the appetite for loans seems to have increased significantly. For example, Central Bank Rate (CBR) was retained at 8.5% in 2014 to continue anchoring inflationary expectations and ensure price stability. The weighted average interbank interest rate declined from 8.89% in December 2013 to 6.91% in December 2014 due to improved liquidity in the money market, supported by net redemptions of government securities and Government payments. It is worth noting that this stability has somewhat been distorted in 2015.

Therefore we examine how loans and advances were distributed among different economic sectors in 2014. According to the CBK (2014:32), substantial share of banking sector loans and advances were extended to personal/households, followed by trade, real estate and manufacturing sectors which collectively accounted for 72.7% of gross loans. Similarly, 83.6% of loan accounts were in personal/household sector which accounted for 26 % of the banking credit and 25% of the non-performing loans (NPLs). Trade, real estate, and manufacturing accounted for 46.1% of the sector's credit and 46.5% of the NPLs.

Table 5: Sectoral Distribution of Loan Accounts, Gross Loans, and NPLs – December 2014

Sectors	No. of Loan Accounts	% of Total	Gross Loans (Kshs. Mn)	% of Total	Gross NPLs (Kshs. Mn)
Agriculture	127,518	2.9	80,195	4.1	4,670
Manufacturing	18,395	0.4	236,962	12.2	10,215
Building & Construction	17,785	0.4	84,559	4.4	9,722
Mining & Quarrying	3,266	0.1	18,783	1.0	1,117
Energy and Water	7,516	0.2	88,692	4.6	1,073
Trade	426,236	9.8	375,525	19.3	27,552
Tourism, Restaurant & Hotels	11,978	0.3	34,249	1.8	2,578
Transport & Communication	44,868	1.0	150,488	7.8	9,507
Real Estate	34,919	0.8	282,396	14.6	12,662
Financial Services	19,359	0.4	72,612	3.7	1,726
Personal/Households	3,635,560	83.6	516,320	26.6	27,478
Total	**4,349,400**	**100.0**	**1,940,781**	**100.0**	**108,300**

Source: CBK 2014

The transport and communication sector received a comparatively low share of the banking sector's loans and advances estimated at 1% of the accounts and 7.8% of total gross loans. The NPLs in this sector accounted for 9.2% of gross NPLs. Of the loans advanced to this sector in 2014, NPLs accounted for 6.3%, compared to 5.3%, 5.8% and 6.5% in personal/household, agriculture and trade sectors, respectively. One can therefore argue that transport and communication sector is considered a risky sector to advance credit.

While the banking sector's net assets increased by 18.3% between 2013 and 2014, and the gross loans and advances by 22.9%, the lag effects of high interest rate regime in 2012/2013 and subdued economic performance witnessed in the 2014 impacted negatively on the quality of loans and advances. As a result, non-performing loans (NPLs) increased by 32.4% to Kshs. 108.3 billion in 2014 from 81.8 billion in 2013. This could be attributed to the banking sector's concentration in personal/household credit with comparative high risk of repayment.

Further analysis of the loans and advances by the banking sector in 2014, shows that 88% of loans were considered normal; 6.6% were classified as watch, 1.4% substandard, 2.8% doubtful and 1.3% as loss (bad debts). On a positive note, loans and advances in the normal risk category increased by 23.2% between 2013 and 2014 from Kshs. 1,385.7 billion to 1,707.8 billion. This according to the CBK (2014) was occasioned by the increased demand for credit from various economic sectors in 2014. However, compared to 2013, the doubtful and loss loans and advances increased from 3.6% to 4.1% an indication of high risk element in lending by the banking sector.

The PPP in the road transport involves the private sector taking full control and responsibility for delivery of roads. This would ideally include financing, designing, construction, maintenance and operation of the road. The recovery of initial investments under this programme would be through Toll proceeds or user fees. So far viable roads which have been constructed, upgraded and improved under PPPs include the Northern Corridor, the Nairobi-Thika Superhighway; and the Southern Bypass. Our objective here was to find out if any of the commercial banks in Kenya were involved in any way to support these PPP projects by way of credit financing.

With regard to the funding of road transport PPP projects by the banking sector, we did not find that evidence of commercial banks involvement. It is not clear if credit advanced to the transport and communication sector could have included financing of PPP projects because data is highly aggregated. Lack of data in this could imply two things (1) the banking sector has not funded any of the transport PPP projects, or (2) data relating to this credit is not well captured. We are inclined to think of the former given the low level of credit to the transport sector.

In order to shed some light in this issue, a survey among banks in the large and medium size categories was carried out (see Table 3). The banks in these two categories accounted for 91.6% of the market share in 2014. The survey was carried out using a standard questionnaire administered using face-to-face interviews with investment managers in each of the 22 banks. The ownership structure of these banks varied significantly ranging from private to public owned, locally incorporated to foreign owned, and those with high government involvement.

Preliminary results indicate that most commercial banks have not been involved in the funding of PPP projects in Kenya. Bank officials generally indicated that the road transport sector was considered high risk and therefore banks were shying off from advancing credit to this sector. Secondly, our respondents argued that demand from other sectors of the economy was high and loan performance generally impressive. In other cases, respondents indicated that individual bank's policies did not prioritise road transport in terms of credit financing. As such bank credit departments were constrained in financing this sector.

The second financing model of road transport in Kenya is the 'road annuity concessions' which was recently unveiled by the government. This model perceived to be one of the ambitious infrastructural plans to be witnessed since independence will see 10,000 KM of roads across the country being upgraded to tarmac in a period of five years. The Roads Annuity Concessions Financing model, largely borrowed from India, is a system where contractors will undertake construction of roads and then be paid after assessment of sections by the government. They will have responsibility to design, build and maintain roads for up to eight years Sourcing for loans from banks by the contractors is guaranteed by the treasury.[9] This model involves engagement of a private entity to finance, design, construct and maintain a road based on agreed periodical payments by the government (Kidenda, 2014). This model has been selected for roads that are not viable for conventional Tolling PPPs.

So far, available evidence shows that only two commercials -the Kenya Commercial Bank and the Co-operative Bank of Kenya have contributed Kshs. 48 billion of the Kshs. 300 billion required for the project.[10] From our survey, other banks appear to be reluctant to commit fund to this annuity programme. Respondents argue that the financing model is quite complicated and may lead to banks losing money in the long run hence the adoption of wait and see approach. It appears from our survey that commercial banks do not see this model of funding as lucrative as perhaps envisioned by the government. This appears to cast doubt into preparedness of the private sector in up taking public transport projects under either PPP or Annuity fund.

Most banks (60%) in our sample felt that the PPP Act was very protective of the public sector entities but was exposing private sector actors to risks. Given the nature of investments that commercial banks would undertake in the road construction, most banks felt that the risks were too high, yet there were other viable investment opportunities. The banking sector felt that they were not well integrated in developing the PPP

9 Under the Annuity Financing model, contractors will access loans guaranteed by the state from banks, enabling them to design, construct and maintain the roads. Treasury will then repay the loans in equal installments (annuity) over the period of eight years, starting from the time the road section is completed.

10 KCB Allocated Kshs. 40 billion while Co-operative Bank committed Kshs. 8 billion towards the Road Annuity Financing programme. See Daily Nation 13 March 2015 page 16

Act which meant that their interests may not have been well captured. One approach that commercial banks could participate in the road financing architecture was through consortium. However, this was challenging because of the limited formular for sharing the profit realised from the venture. By the nature of investment in the road infrastructure, very few banks in Kenya could marshal resources to undertaken such investments. In the absence of clear cushioning of the private sector actors and lack of a credible profit sharing framework most banks were shying off from these kind of ventures.

The PPP Act according to the respondents was silent on the issue of unsolicited bids. Although Article 61 acknowledges that ideas about a PPP project can be floated by a private sector entity, the procedure for engaging a private entity must be subjected to competitive bidding. As such commercials banks are not keen to float new ideas to government agency for fear of not being compensated appropriately when the idea is translated to project.

To commercial banks, there were other more efficient avenues for investment which were more certain and predictable than in government infrastructure financing. For example, banks were keen in investing in the treasury bills and bonds which were more certain and maturity was binding. At the time of this survey, the treasury bills rate was between 20% and 24%, making it one of the most avenue of investment. In contrast, the deposit interest rate at that time was between 14% and 16%. As such there are no incentives for commercials banks to invest in the infrastructure.

3.4 Involvement of Commercial Banks in the Infrastructural PPP Architecture in Kenya

Besides participation in the road transport PPP projects, we were interested in finding out if commercial banks were involved in financing PPP projects in other sectors. Again there is scanty of information relating to Banks involvement in PPP projects in Kenya. We relied on an exploratory survey from banks to find out the level of engagement.

The survey findings indicate low levels of commercial banks' participation in the PPP architecture. As in the road transport, respondents indicated that financing of public projects under PPP required huge amount of money and was too complicated for their respective banks to participate in financing. There was a feeling among the respondents that channelling huge amount of credit to PPP projects would crowd out credit to other sectors. It appears that banks were keen on conventional credit channels especially to household and individual sector.

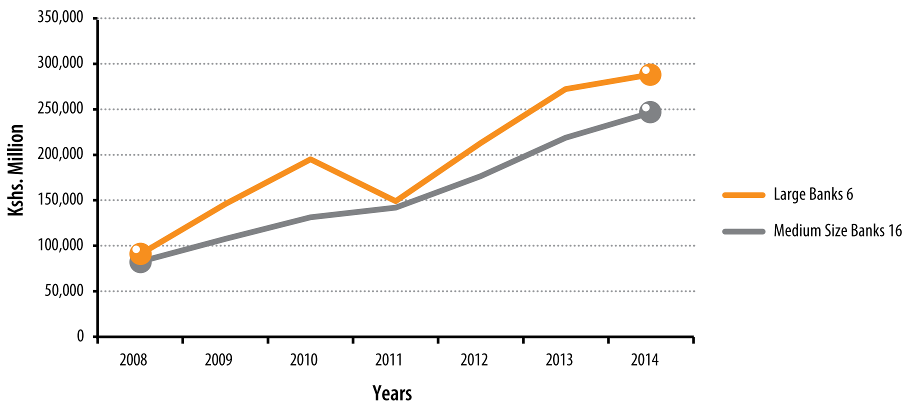
The knowledge on PPP Act 2013 seems to low among the respondents included in the survey. A good number of respondents indicated that they did not know much about the PPP Act and its effect on the

banking sector. This illuminates the need for more awareness creation by the PPP Unit in sensitizing the banking sector as well as members of public about the role of PPPs in the development process.

Analysis of investments by commercial banks in government securities shows an upward trend. Looking at the 6 large scale banks (Peer 1) the total investment in government securities increased from Kshs. 90 billion in 2008 to 288 billion in 2014. For the 16 medium size banks (Peer 2), investments in the same increased from Kshs. 82 billion in 2008 to 247 billion in 2014. This implies that the leading 22 commercial banks in Kenya investments in government securities increased from Kshs. 172 billion to Kshs. 535 billion between 2008 and 2014. This demonstrates that commercial banks have the capacity to invest in public – private partnerships if the framework is well designed. To most of these banks it is the risk which is associated with road infrastructure that deters them from engaging in PPPs. There is need to reformulate the PPP framework so that commercial banks perceived risk is lowered.

There was a sharp decline in investment by the large banks between 2010 and 2011, which could be associated with the spillover effects of the 2007/2008 global financial crisis to the emerging economies. From the experience of the crisis the collapse of large entities such as the Lemma Brothers was a clear justification that there is no entity which is too large to overcome such crisis. As such the big banks being

Figure 2: Commercial Banks Investment in Government Securities



Source: Computed from Economic Survey (Various Issues)

more exposed than small banks started to cut down on their investments to avoid such risks at the time.

Commercial banks cited delays in payment by the government as one of the most determent factors in their participation in the road infrastructural investment. It therefore becomes increasingly risky to do business with the government.

Conclusion

4.1 Summary of Findings

The physical infrastructure sector consists of roads; public works; transport; energy; and housing sub-Sectors. In the new long term development blue print for the country "The Kenya Vision 2030", infrastructure development has been recognized as an enabler for sustained development of the economy. The report recognizes that development of infrastructure is critical for socio-economic transformation. Road transport infrastructure is no doubt an important element of the infrastructure sector in Kenya.

Given the funding gaps in financing infrastructure project, the Kenyan government has developed an elaborate programme for strengthening public –private partnerships in the provision of these infrastructure services. In spite of the opportunities created by the new legal framework of PPP, participation by the private sector especially the banking industry has been extremely low. The analysis of banks participation shows that most of the banks operating in Kenya still perceive PPP in the road infrastructure as risky venture and would rather channel their investments into other areas whereby perceived risks are comparatively low. Evidence from the banking industry loan performance appear to support this because most of the non-performing loans in 2014 were in road construction sector, whereby analysts cited delayed payments by the government as the main factor in non-performing loans (NPL).

Infrastructure and especially transportation projects are structurally exposed to the risk of demand. This is also called market risk, and is irrespective of the sub-industry (roads, ports, airports, aviation, and railways) involved. Certainly, below-estimates demand may be the result of errors in project preparation for example, defective cost-benefits analysis, inaccurate traffic projections, unaffordable tariffs

or may derive from unfavourable government action, external factors, among others. Demand/traffic risk can be mitigated in several ways, including: off-take agreements; availability payments; minimum traffic guarantees, and good visibility over other transport infrastructures. Realistically, demand/traffic risk is often unavoidable. Commercial banks should as need be, conduct their own traffic projections to be in a good position to assess this risk involved in financing PPP projects.

Close working relations with the government creates an enabling environment and opens opportunities that the commercial banks can easily tap into. These opportunities will not be fathomed if commercial banks do not work with the government. This relationship is also key for the sustainability of PPP transport programmes. Likewise, measures and regulations by the government and by the Central Bank should be tailored in a way that stimulates the interest of commercial banks in the PPP arena.

4.2 Policy Recommendations

The road infrastructure remains the most widely used mode of transport in Kenya given it's crucial role in movement and flow of raw materials and finished goods along the agricultural, manufacturing, trade and tourism value chains. It therefore has a significant role to play towards the Vision 2030 goals and economic development (World Bank 1994).

In the past decade, the Road transport has received substantial resources for construction, rehabilitation and maintenance which has seen increased role of private industry through PPP. Apparently the banking industry seems to shy away from participating in road PPP projects due to perceived high risks. The enactment of the PPP Act in 2013 seems not to have changed much in terms of commercial banks' perception about the PPP projects. There is strong evidence that the banking industry has a capacity and potential to play a more active role in financing road PPP projects.

From the study findings, a number of key policy recomendations with regard to enhancing commercial banks' participation in PPP projects are postulated. These include:

- Review of the PPP Act inorder to harmonise the interests of the public and private sector actors.
- Creation of awareness among stakeholders about the road PPP projects in Kenya.
- Sensitization of the banking sector on both the PPP and the Road Annuity Financing model.
- Enhancing a close working relationships between PPP unit and the banking industry inorder to develop alternative financing models for the road sub-sector in Kenya while strengthening the existing ones.

- Setting up of infrastructure departments within commercial banks that can engage with the government and play a leading role in enhancing banks participation in PPP projects.

6. Review of the PPP framework to make it more accomodative of commercial banks' concerns in managing the projects under PPP.

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