



KENYA BANKERS  
ASSOCIATION

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# POLICY BRIEF

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## Breaking the Doom Loop: Strengthening Financial Stability in Kenya's Banking Sector

### Executive Summary

Kenyan banks are heavily invested in government securities, with these holdings growing from 19% to over 30% of total assets between 2015 and 2022. While stabilizing government financing, these investments expose banks to systemic risks tied to fiscal health. This study identifies fiscal deficits, bond yields, and regulatory incentives as key drivers of sovereign debt demand. However, growing portfolio homogeneity amplifies systemic vulnerabilities, and increased government borrowing appears to crowd out private sector lending.

Using innovative network analysis, the study reveals heightened interconnectedness in banks' sovereign debt portfolios, increasing the risk of fiscal shocks cascading through the sector. To address these challenges, policymakers must prioritize reforms to promote diversification, strengthen oversight, and revise regulatory frameworks to mitigate systemic risks while sustaining economic growth.

### Context and Importance

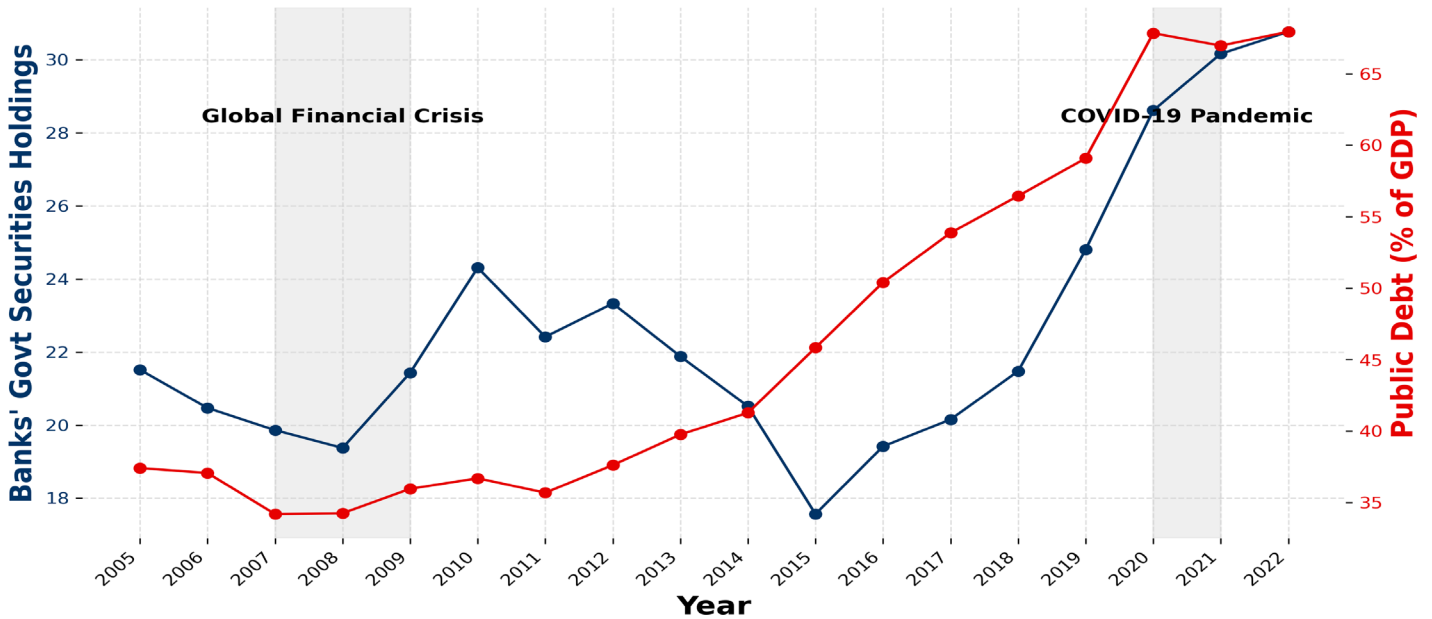
**T**he financial stability of a country often hinges on the complex interplay between its banking sector and sovereign debt. Banks worldwide hold government securities for their perceived safety and liquidity, yet these holdings can embed systemic risks, particularly in emerging markets like Kenya. This phenomenon is not new. The European debt crisis of 2010-2012 highlighted the 'doom loop,' a cycle where sovereign distress leads to bank instability and vice versa, as explained by Farhi and Tirole<sup>1</sup>. Such crises underscore the vulnerabilities created by excessive bank exposure to government debt, as even minor fiscal shocks can cascade into broader financial disruptions.

Kenyan banks have significantly increased their holdings of government securities, with these assets rising from 19% to over 30% of total bank assets between 2015 and 2022<sup>2</sup>. While this trend (see Figure 1) provides much-needed financing for the government, it has implications for financial stability and economic growth. The heavy reliance on domestic banks to absorb government debt stems from Kenya's limited external financing options and underdeveloped capital markets<sup>3</sup>.

The risks associated with this relationship are profound. When banks invest heavily in sovereign debt, their balance sheets become closely tied to fiscal health. Public debt in Kenya has risen sharply, from 45% to 68% of GDP over the same period (see Figure 1), raising concerns about debt sustainability<sup>4</sup>. In the event of a sovereign default or restructuring, these holdings could lose value, triggering widespread instability across the financial sector. This interconnectedness mirrors the collapse of Silicon Valley Bank in 2023, where losses on long-term government securities eroded confidence and led to a bank run<sup>5</sup>.

Authored By Rogers Ochenge, a Lecturer at the Department of Economic Theory of Kenyatta University and an adjunct lecturer at the Strathmore Institute of Mathematical Sciences. All correspondence to [rochenge@yahoo.co.uk](mailto:rochenge@yahoo.co.uk) and [rogers.ochenge@ku.ac.ke](mailto:rogers.ochenge@ku.ac.ke)

**Figure 1: Trends in Kenyan Banks' Sovereign Debt Holdings and Public Debt-to-GDP Ratio**



**Source:** Kenyan Treasury, CBK, and author's calculation

Moreover, the 'crowding out' effect presents another challenge. As banks allocate more resources to government securities, their capacity to lend to the private sector diminishes, constraining economic growth, job creation, and innovation. Studies by Altavilla et al.<sup>6</sup> and Gennaioli et al.<sup>7</sup> highlight how this development can stifle private credit expansion, particularly in emerging markets with constrained financial systems.

Kenya's banking sector also faces systemic risks from the growing homogeneity of sovereign debt portfolios. When banks hold similar assets, financial shocks affecting one institution can quickly spread throughout the system, amplifying the crisis. This lack of diversification was a critical factor during the European debt crisis, as observed by Acharya and Steffen<sup>8</sup>, and poses a comparable threat to Kenya's financial stability.

Understanding the drivers of sovereign debt demand—such as fiscal deficits, attractive bond yields, and regulatory incentives—and their systemic implications is critical for developing effective policies. Without proactive measures to address these risks, Kenya's financial system remains vulnerable to the same feedback loops that have destabilized economies elsewhere. This study aims to shed light on these dynamics and provide actionable insights to ensure a resilient banking sector that supports sustainable economic growth.

## Data and Methods

This study uses annual data from Kenyan commercial banks spanning 2005 to 2022 to analyze the factors driving their demand for government securities and the systemic risks associated with these investments. The analysis employs straightforward statistical techniques (i.e. panel data methods), focusing on the relationship between banks' sovereign debt holdings (as a percentage of total

assets) and key factors such as fiscal deficits, bond yields, capital adequacy ratios, and private sector lending. Additional variables, including GDP growth, bank profitability (ROA), and liquidity risks, are incorporated to capture broader economic and institutional influences.

To explore systemic risks, the study uses a novel network analysis approach,

which visualizes how interconnected banks are in their sovereign debt holdings. This method identifies patterns of similarity in investment portfolios and highlights which banks are most critical in spreading potential financial shocks. Inspired by lessons from the European debt crisis, the network graphs provide insights into how fiscal disturbances could cascade through Kenya's banking

sector, emphasizing the importance of diversification and risk management.

This combination of statistical analysis and network visualization offers a clear, practical framework for understanding the drivers of sovereign debt demand and its implications for financial stability. The approach ensures findings are accessible and actionable for policymakers and stakeholders.

## Results

This policy brief builds on the empirical findings of a study examining the factors driving Kenyan banks' sovereign debt holdings and the systemic risks they present. A key insight is the role of fiscal deficits, with banks stepping in during periods of fiscal stress to absorb increased government debt, a phenomenon known as "moral suasion." This aligns with global trends, particularly in emerging markets, where domestic financial institutions stabilize sovereign debt markets during economic uncertainty.

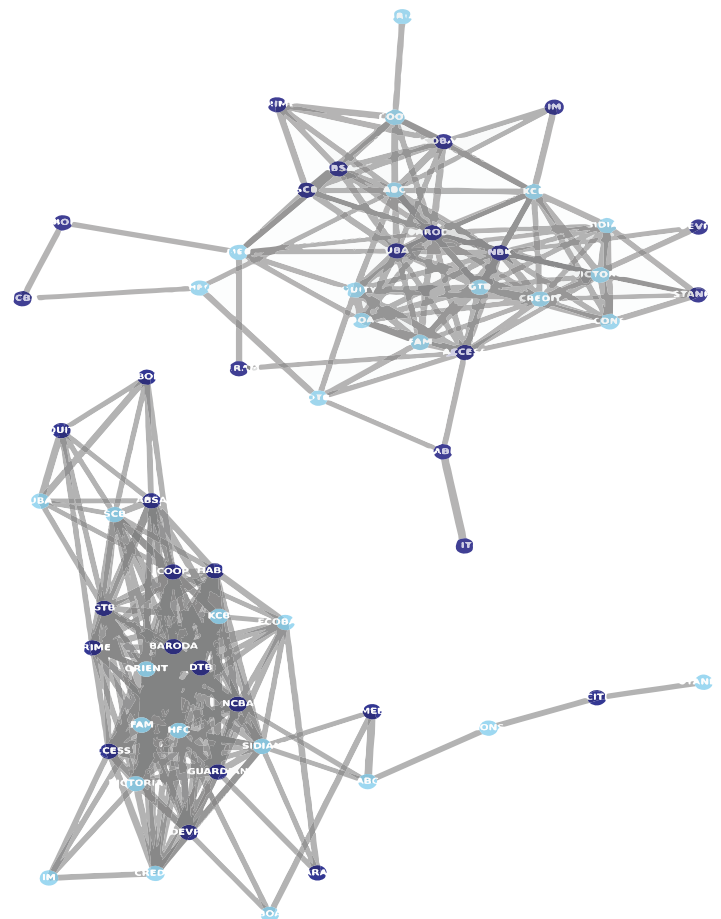
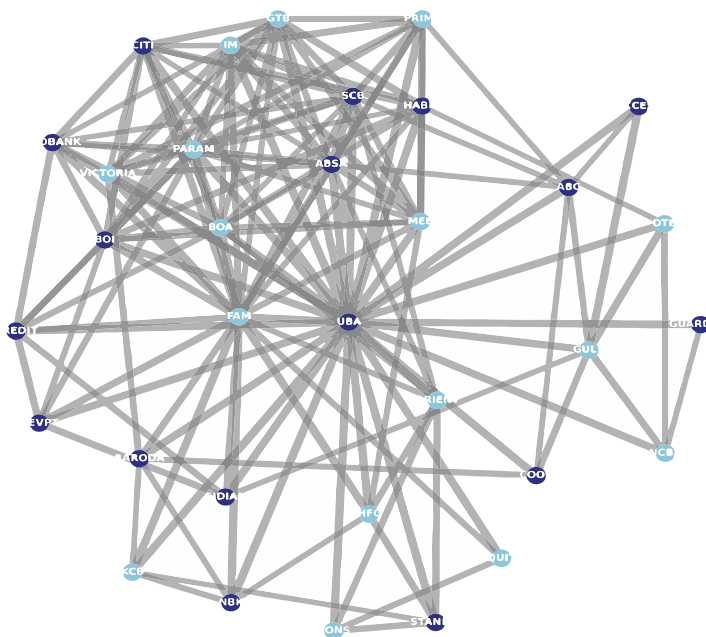
The findings also highlight the influence of bond yields, as higher returns on 5-year government securities attract banks seeking yield in a limited investment landscape. However, this reach-for-yield behavior competes with lending priorities. During periods of strong credit demand, banks shift resources to loans, reflecting a strategic balance between profitability and portfolio safety.

Regulatory frameworks further shape these decisions. The zero-risk weight of government bonds under capital adequacy rules incentivizes banks to hold sovereign debt, enhancing regulatory buffers. Yet, the negative relationship between past exposure and current holdings suggests

a cautious approach, with banks actively managing concentration risks to avoid over-reliance on government securities.

Network analysis reveals growing interconnectedness among banks' sovereign debt portfolios over time. Sparse connections in 2005-2010 reflect diversified strategies and lower systemic risks. However, the post-2010 periods show increased alignment, driven by shared economic pressures and regulatory environments, amplifying vulnerabilities. By 2017-2022, this alignment persists, indicating systemic risks remain elevated due to synchronized exposures.

These findings underscore the delicate balance Kenyan banks maintain between stabilizing sovereign debt markets and managing systemic risks. This study provides actionable insights to navigate the interconnected challenges of sovereign debt and financial stability.



## Conclusion and Policy Recommendations

This study explored the factors driving Kenyan banks' demand for government securities and the systemic risks associated with these holdings. Fiscal deficits, attractive bond yields, and capital adequacy requirements were found to significantly influence banks' sovereign debt investments. However, growing homogeneity in banks' portfolios heightens

systemic risk, and increased government borrowing appears to crowd out private sector lending. To address these challenges, targeted policy interventions are essential to ensure a resilient and growth-oriented banking sector. The study suggests the following actionable policy recommendations:

1. **Revise Capital Adequacy Rules:** Adjust regulatory frameworks to account for the risks of concentrated sovereign debt holdings. Introduce risk-weighted capital requirements for government securities to reflect their potential impact on systemic stability, especially during periods of fiscal distress. This approach would incentivize banks to diversify their portfolios while maintaining compliance with prudential standards.
2. **Incentivize Asset Diversification:** Encourage banks to diversify their investments by offering targeted tax incentives or reduced regulatory capital charges for non-sovereign assets. Promote alternative investment opportunities, such as corporate bonds or infrastructure financing, to mitigate systemic risks arising from portfolio homogeneity and reduce the crowding-out of private sector lending.
3. **Strengthen Supervisory Oversight:** Enhance monitoring of banks' sovereign debt exposures by integrating regular stress testing into supervisory practices. Develop early warning systems to identify vulnerabilities linked to fiscal shocks, enabling timely regulatory interventions. Prioritize transparent reporting of sovereign debt concentrations to improve risk management at both the institutional and systemic levels.

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### Kenya Bankers Association

13th Floor, International House, Mama Ngina Street  
P.O. Box 73100– 00200 NAIROBI  
Telephone: 254 20 2221704/2217757/2224014/5  
Cell: 0733 812770/0711 562910  
Fax: 254 20 2221792  
Email: [research@kba.co.ke](mailto:research@kba.co.ke)  
Website: [www.kba.co.ke](http://www.kba.co.ke)



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