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9/3/2023

REPUBLIC OF KENYA

THE NATIONAL ASSEMBLY

THIRTEENTH PARLIAMENT (SECOND SESSION)

SELECT COMMITTEE ON PUBLIC DEBT AND PRIVATIZATION

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REPORT ON THE 2023 MEDIUM TERM DEBT MANAGEMENT STRATEGY

MARCH 2023

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List of Acronyms and Abbreviations

ATR	Average Time to Refixing
ATM	Average Time to Maturity
BPS	Budget Policy Statement
CBK	Central Bank of Kenya
CBR	Central Bank Rate
CFS	Consolidated Fund Services
DCC	Debt Carrying Capacity
DSA	Debt Sustainability Analysis
IMF	International Monetary Fund
MTDS	Medium Term Debt Management Strategy
OCOB	Office of the Controller of Budget
OAG	Office of the Auditor General
PV	Present Value
PPG	Public and Publicly Guaranteed

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CHAIRPERSON'S FOREWORD

The 2023 Medium Term Debt Management Strategy (MTDS) was submitted to Parliament on Wednesday 15th February 2023 pursuant to Section 33(1) of the Public Finance Management Act, 2012 and standing order 232A of the National Assembly Standing Orders. In line with standing order 232A(3), the 2023 MTDS was committed to the Public Debt and Privatization Committee to examine and make recommendations for approval by the House. I am happy to inform this House that the committee has adequately fulfilled its mandate. It is therefore my honour and privilege to present to this House, the committee's report on the 2023 Medium Term Debt Management Strategy.

The Medium Term Debt Management Strategy provides the strategies and initiatives that will be undertaken by the National Treasury in FY 2023/2024 to meet the fiscal deficits for the period FY2023/24 – 2025/26 as proposed in the 2023 Budget Policy Statement. For FY 2023/24, the fiscal deficit is estimated at Ksh.720.1 billion with expenditure estimated at 3,663.1 billion and revenue estimated at 2,894.9 billion.

The 2023 MTDS has been prepared at a time when the global economic outlook remains uncertain due to ongoing geo-political tensions, lingering effects of the Covid-19 pandemic, supply chain disruptions, projected global economic slowdown and global inflationary pressures which has led to rising interest rates thereby tightening the international capital markets and reducing the government's access to long-term funding. Domestically, the government seeks to revive the economy through the bottom-up economic transformation agenda which targets investments in key priority programmes geared towards economic turnaround even as fiscal consolidation is pursued in order to limit borrowing and debt accumulation. Furthermore, high inflation domestically has led to high interest rates and this may limit the government government's capacity to adequately undertake liability management operations on its debt portfolio.

To this extent, the 2023 MTDS has considered four alternative funding strategies taking into account inherent costs and risks of the existing public debt portfolio. It proposes a balanced domestic-external financing strategy which envisages 50 percent net domestic borrowing and 50% net external borrowing. Under this strategy, the government expects to maximize concessional and semi-concessional borrowing while rolling over commercial debt from external sources; and to lengthen maturity and deepen the domestic markets through issuance of medium to long term debt securities under the benchmark bond programme.

The MTDS further provides that changes in global economic and market conditions may necessitate deviation from the optimal strategy.

Examination of The 2023 Medium Term Debt Management Strategy

In reviewing the 2023 MTDS, the Committee held productive deliberations with key stakeholders and received their submissions. These include the Office of the Controller of

Budget, the Office of the Auditor General and the Central Bank of Kenya. The committee also held discussions with the National Treasury before the report was finalized.

Further, in line with Article 201(a) of the Constitution, the committee undertook public participation on the MTDS. This was done through request for memoranda which was submitted to the committee for consideration. The recommendations arising from these deliberations have been incorporated into this report.

Once approved, the 2023 MTDS is expected to inform the country's borrowing strategy in the coming financial year and over the medium term.

Key Recommendations

Arising from these consultative engagements, the Committee has made the following recommendations:

a) Policy recommendations

1) **That,** any borrowing undertaken by the National Treasury in FY 2023/24 should not exceed the Ksh. 10 trillion approved debt ceiling set by Parliament.
2) **That,** to enhance liquidity management and help reduce unnecessary short-term domestic borrowing occasioned by governments inability to access surplus funds held in numerous Ministries, Departments and Agencies (MDAs) bank accounts, the National Treasury spearheads the integration of MDA banking arrangements into a **single treasury account** system as provided for in Section 28(2) of the PFM Act and the PFM regulations. This should be submitted to Parliament within six months.
3) **That,** as indicated in our report on the Consolidated Fund Services (CFS) expenditures for supplementary estimates No. 1 of FY 2022/23, the National Treasury should within six months, table regulations for the establishment of a sinking fund dedicated to public debt servicing as provided for under Section 50(8) of the PFM Act, 2012.
4) **That,** in order to safeguard against shocks with regard to external interest payments, the National Treasury adopts hedging mechanisms on foreign exchange risks and/or negotiating lending agreements in Kenya shillings.
5) **That,** the National Treasury undertakes a review of all undisbursed loans amounting to Ksh. 1.179 trillion and submits to the National Assembly within one month, a report with information on terms, status, reasons for non-disbursement and proposals on any loans that can be cancelled to save spending on commitment fees.
6) **That,** in adherence to the Accra Agenda for Action 2018, donor support MUST be aligned to the country's budget cycle to facilitate proper planning by the implementing agencies and reduce occurrence of undisbursed loans.

7) **That,** within two months, the National Treasury submits to this House, a strategy for resolution of non-performing loans linked to various State Owned Enterprises (SoEs) including Kenya Airways.
8) **That,** the Office of the Auditor General expedites the audit of project loans under the water sector and the Ksh. 9.9 billion loan borrowed on behalf of KPLC and submits this report to the House within the next two months.
9) **That,** in the next budget cycle, the National Treasury aligns the borrowing strategy proposed in the Budget Policy Statement with the borrowing strategy in the MTDS in order to ensure credibility of the government's planning documents.
10) **That,** in the next budget cycle, the National Treasury undertakes public participation on the MTDS in line with Article 201 of the constitution.
11) **That,** going forward, the MTDS should live up to its expectation as a medium term document by showing consistency in proposed debt management strategies including deficit financing on a three year rolling framework, from one MTDS to another.
12) **That,** the National Treasury undertakes a sensitivity analysis on the 2023 MTDS and submits to this House, within two weeks, a contingency plan on measures to be undertaken in the event of revenue shortfalls or underperformance of loans.

b) Financial recommendations

1) **That,** the fiscal deficit target for the medium term is approved and set at no more than 4.4% of GDP for FY 2023/24; 3.9% of GDP for FY 2024/25, and 3.6% of GDP for FY 2025/26 in line with the fiscal consolidation path.
2) **That,** the country's borrowing strategy is approved at 50 percent net external borrowing and 50 percent net domestic borrowing as contained in the 2023 Medium Term Debt Management Strategy.
3) **That,** any deviation from the approved borrowing strategy will require the approval of the National Assembly.

Stock of domestic and foreign public debt including guarantees

Further, pursuant to standing order 232A(5)(a), information on the stock of foreign public debt is hereby attached in the first Schedule; and information on the stock of domestic public and publicly guaranteed debt is attached in the second Schedule.

Acknowledgements

The Committee thanks the Office of the Speaker, the Office of the Clerk of the National Assembly and the Parliamentary Budget Office for the support extended in fulfilling its mandate of reviewing the 2023 Medium Term Debt Management Strategy. Sincere gratitude is also extended to the National Treasury, the Office of the Controller of Budget, the Office of the Auditor General and the Central Bank of Kenya, for honouring the invitation and

providing critical information in the process of reviewing the MTDS. The Committee is also grateful to the public who took their time to review the MTDS and submit their recommendations.

Finally, the committee would like to appreciate the Parliamentary Budget Office and the Directorate of Appropriations, Audit, and other Select Committees for the extensive technical assistance provided in the review of the 2023 MTDS and the finalization of this report.

It is therefore my pleasant undertaking, on behalf of the Public Debt and Privatization Committee, to table this report to this House and recommend it for adoption.

SIGNED

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HON. ABDI SHURIE, MP.
CHAIRPERSON, PUBLIC DEBT & PRIVATIZATION COMMITTEE

9th March 2023
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DATE

THE NATIONAL ASSEMBLY
PAPERS LAID
DATE: 09 MAR 2023 DAY:
TABLED BY:
CLERK-AT THE-TABLE:

THE NATIONAL ASSEMBLY
PAPERS LAID
DATE: 09 MAR 2023 DAY: THURSDAY
TABLED BY: Chairperson, Public Debt & Privatization Committee Hon. Abdi Shurie
CLERK-AT THE-TABLE: Joyce Lemerelle

I. PREFACE

1.1.Establishment and Mandate of the Committee

The powers of each House of Parliament to establish committees and to make standing orders for the orderly conduct of its proceedings are provided for under Article 124 of the Constitution of Kenya, 2010. For critical oversight over matters relating to public debt and debt guarantees, public-private partnerships and privatization of national assets, standing order 207A establishes the Public Debt and Privatization Committee with specific mandates among which is to:

i. Oversight public debt and guarantees, pursuant to Article 214 of the Constitution
ii. Examine matters relating to debt guarantees by the National government;
iii. Oversight Consolidated Fund Services excluding audited accounts;
iv. Examine reports on the status of the economy in respect of the public debt;
v. Oversight public-private partnership programmes by the national government in respect of the public debt; and
vi. Oversight privatization of national assets

This committee is therefore mandated, among other functions, to examine the medium-term debt management strategy and propose recommendations to the House for adoption.

1.2.Membership of the Committee

The Public Debt and Privatization Committee as currently constituted, comprises of the following honourable members: -

CHAIRPERSON
Hon. Abdi Shurie, M.P.
Balambala Constituency
Jubilee Party

VICE-CHAIRPERSON
Hon. (Dr.) Makali Mulu M.P
Kitui Central
Wiper Party

Hon. Junet, Mohamed S.N. CBS. M.P
Suna East Constituency
ODM Party

Hon. Mohamed, Abdikadir Hussein, M.P
Lagdera Constituency
ODM Party

Hon. Omboko Milemba M.P
Emuhaya Constituency
ANC Party

Hon. Suleka, H. Harun. M.P
Nominated
UDM Party

Hon. (Dr.) Irene Kasalu M.P
Kitui County
Wiper Party

Hon. Chege Njuguna M.P
Kandara Constituency
UDA Party

Hon. Kwenya, Thuku Zachary, M.P
Kinangop Constituency

Hon. Abdi Ali Abdi, M.P
Ijara Constituency

Jubilee Party

Hon. Kipkoros, Joseph Makilap M.P
Baringo North Constituency
UDA Party

Hon. Aden Daud, EBS, M.P
Wajir East Constituency
Jubilee Party

Hon. (Dr.) Daniel Manduku, M.P
Nyaribari Masaba Constituency
ODM Party

NAP-K

Hon. Letipila, Dominic Eli, M.P
Samburu North Constituency
UDA Party

Hon. Kirwa, Abraham Kipsang, M.P
Mosop Constituency
UDA Party

1.3.Committee Secretariat

In the preparation of this report, the committee was facilitated by the following staff:

Mr. Chacha Machage
Fiscal Analyst I/ Lead Clerk

Mr. Fridah Ngari
Media Relations Officer III

Ms. Yasmin Hassan
Assistant Serjeant-at-Arms

Mr. Job Mugalavai
Fiscal Analyst III/ Assistant Clerk

Mr. Eugene Luteshi
Audio Officer III

Ms. Florence Mbuthi
Protocol Officer III

1.4.Parliamentary Budget Office

The Committee also received technical support from the following staff of the Parliamentary Budget Office:

Dr. Martin Masinde
Ag. Director, Parliamentary Budget Office (PBO)

Mr. Robert Nyaga
Ag. Senior Deputy Director, Parliamentary Budget Office (PBO)

Ms. Millicent Makina
Fiscal Analyst I

Ms. Julie Mwithiga
Fiscal Analyst I

Mr. Joseph Lekisima
Fiscal Analyst III

II. REVIEW OF THE 2023 MEDIUM TERM DEBT MANAGEMENT STRATEGY

2.1.Introduction

1. The Medium-term Debt Management Strategy (MTDS) is a framework that was developed by the World Bank and the IMF to guide countries in debt management decisions and operations. It links the country's borrowing with macroeconomic policy and outlines how the government intends to borrow and manage its debt in order to minimize costs and risks while meeting financing needs.
2. The 2023 Medium-term Debt Management Strategy was developed in accordance with article 201 of the Constitution which calls for transparency and accountability in public finance matters. The article also provides that the burdens and benefits of the use of resources and public borrowing should be equitably distributed between present and future generations. Additionally, section 62 of the Public Finance Management (PFM) Act, 2012, sets out the country's debt management objectives as follows: -
    a) Minimize the cost of public debt management and borrowing over the long-term taking account of risk.
    b) Promote the development of domestic market institutions for government debt securities.
    c) Ensure the sharing of the benefits and costs of public debt between the current and future generations.
3. In line with Section 33 of the PFM Act, the MTDS should contain the following information:-
    a) the total stock of debt as at the date of the statement;
    b) the sources of loans made to the national government and the nature of guarantees given by the national government;
    c) the principal risks associated with those loans and guarantees;
    d) the assumptions underlying the debt management strategy; and,
    e) Analysis of the sustainability of the amount of debt, both actual and potential.

2.2.Public debt stock and debt ceiling

4. As at December 2022, the total debt stock amounted to Kshs 9.15 trillion; comprising of Kshs. 4.47 trillion domestic debt and Kshs. 4.67 trillion external debt. Given the estimated fiscal deficit of Ksh. 833 billion for FY 2022/23, it is projected that by June 2023, the total debt stock will amount to Ksh. 9.42 trillion.
5. In June 2022, Parliament set a debt limit of Ksh. 10 trillion to enable the government to fully finance the FY 2022/23 budget without breaching the debt limit. However, from the available statistics, if the FY 2022/23 fiscal deficit of Ksh. 833.9 billion is fully funded through borrowing, then the borrowing space available for the next financial year is less than Ksh. 587 billion. This is against a projected fiscal deficit of Kshs. 720.1 billion in FY 2023/24.
6. Changes in the composition and structure of public debt as a result of its expansion have also altered the costs and risks associated with the debt portfolio. Currently, the ratio of domestic to external debt is equal at 50:50, and costs have risen over time. To illustrate,

total debt service expenditure has experienced a tenfold increase over the past decade to reach to Ksh. 917.7 billion (47.9% of revenues) in June 2022, up from Ksh. 98.5 billion (16.2% of revenues) in June 2011. This increase in debt service costs is largely accounted for by an increase in domestic debt interest. As at June 2022, domestic debt service accounted for 67% of all debt service costs, while external debt service accounted for 34%.

7. To slow down debt accumulation, the government proposes to implement a fiscal consolidation strategy targeted at reducing the fiscal deficit to 3% of GDP by FY 2026/27. This is to be achieved by ensuring that revenue projections do not exceed the average revenue growth in the previous three years; that expenditure growth is limited to 75% of revenue growth; and that there is budget neutrality, that is, new programs are funded by releasing resources from another project that is completed or closed. Under this strategy, the budget deficit is expected to reduce from 5.7% in FY 2022/23 to 4.4% in FY 2023/24 and even further to 3.6% in FY 2026/27.

2.3. Review of Previous Medium-term Debt Management Strategies

8. A review of the previous borrowing strategies indicates that the government has frequently deviated from the approved borrowing strategy in recent times. Since 2019, the MTDS target for gross external financing has not been met thereby necessitating increased domestic borrowing beyond the MTDS target. Failure to comply with the approved borrowing mix of domestic and external debt presents a risk to the achievement of debt management objectives as set out in the medium-term debt management strategy.
9. It is worth noting that the domestic debt portfolio has consistently displayed the highest vulnerability due to its higher interest rates, shorter average time to maturity (ATM) and higher portion of debt servicing costs. As a result of deviation from the approved borrowing mix, domestic debt risk indicators have progressively worsened, making it more costly and elevating domestic debt related risk. It is crucial therefore, that the medium-term debt management strategy is strictly adhered to in order to accomplish the desired results.
10. For FY 2022/23, the Medium-Term Debt Management Strategy envisaged a net borrowing mix of 32:68 in external and domestic loans respectively. This is despite the obvious costs and risks associated with domestic debt. Thus it is expected that by end of FY 2022/23, the stock of domestic debt will have increased even further, along with attendant costs and risks.

2.4. The Borrowing Strategy for FY 2023/24

11. The national government considered four alternative strategies to finance the fiscal deficit for FY 2023/24 and ultimately proposed a balanced domestic-external financing strategy targeting a 50:50 ratio of net domestic and net external borrowing.
12. This proposed borrowing strategy is based on a number of macroeconomic assumptions outlined in the Budget Policy Statement (BPS). These include a GDP growth projection of 6.1 percent and inflation of 5.8 percent in 2023/24. Further, revenue is projected at Ksh.

2,894.9 billion and expenditure at Ksh. 3,663.1 billion; translating to a projected fiscal deficit of Ksh. 720.1 billion. Thus, the proposed 50:50 strategy will translate to borrowing of Ksh. 360 billion each for both domestic and external loans.

13. It is important to note that in the preparation of the 2023 MTDS, a Sensitivity Analysis was not undertaken with regard to economic and revenue performance. As such, the strategy does not provide any corrective measures to be undertaken in case of a failure of an assumption such as revenue shortfalls or underperformance of loans. This therefore indicates that should downside risks to economic growth and revenue performance materialize, liquidity constraints will adversely affect budget implementation.

2.5.Potential Sources of Financing

14. The 2023 MTDS indicates that domestic debt financing will be met through issuance of treasury bills and bonds, Kenya shilling syndicated debt, foreign currency denominated domestic bond, private placement among others. Further, the government seeks to reengineer the issuance of the M-Akiba bond to provide accessible alternative investment opportunities for the informal sector. Other interventions are targeted at the non-bank financial institutions such as pension, insurance and mutual funds with plans to initiate new financial products such as post retirement and contributory pension schemes, diversified asset classes, private equity and venture capital.
15. With regard to external financing, the government will prioritize concessional financing from multilateral financial institutions and bilateral lenders. Plans are also underway to explore issuance of green and blue bonds to finance climate related or environmental sustainability projects as part of instrument diversification.

2.6.Risks and costs associated with the current stock of debt

16. As at December 2022, Kenya's Present Value (PV) of public debt was at 60 percent of GDP of which the domestic debt was 33.2 percent of GDP and external debt was 26.8 percent of GDP. The scope of the MTDS covers outstanding debt of Ksh. 8,907.7 billion comprising of domestic debt of Ksh. 4,400.5 billion and external debt of Ksh. 4,509.2 billion. The costs and risks associated with debt are with regard to interest rate payments, refinancing and exchange rate exposure.
17. With regard to interest rate risk, domestic debt portrays higher vulnerability than external debt. Notably, a reduction in the average time to refixing (ATR) of domestic debt from 8.6 years as at June 2022 to 8.1 years as at December 2022 indicates an escalation of the interest rate risk. On the other hand, the average time to refixing (ATR) of external debt has been increasing from June 2018 to December 2022 signalling a reduction in interest rate risk on external debt. Statistics available as at December 2022 also indicates that total interest payments as a percentage of GDP was at 5.3 percent comprising of 3.9 percent for domestic debt and 1.4 percent for external debt. Interest rate payment for domestic debt is almost triple the level paid on external debt even though their respective stocks are the

same. This reflects the high cost of domestic debt due to high interest rates and shallow domestic debt market attracting minimal capital inflows.

18. In terms of refinancing risk, debt maturing in 1 year (for total stock of public debt) declined from 15.5% to 11.7% between December 2020 and December 2022. This shows an overall improvement in the debt profile and reduced refinancing risk which is critical for cash flow management. However, with the payment of the Eurobond issued in 2014 falling due in FY 2023/24, there is significant refinancing risk given the tight global financial conditions. Further bullet payments on Kenya Eurobonds are expected in FY 2026/27 and FY 2027/28.
19. With regard to exchange rate risk, as at December 2022, 49 percent of total public debt was in foreign currencies and thus exposed to foreign exchange rate volatility risk. In terms of composition, 68% of the debt was denominated in the United States Dollars (USD) followed by the Euro and Yen at 19.8% and 4.2% respectively. Given that the external debt stock is predominantly denominated in United States dollar, sustained appreciation of the USD against the local currency signals an elevation of the exchange rate risk.

2.7.Public Debt Sustainability Analysis (DSA)

20. The public debt sustainability framework assesses a country's debt portfolio and projects total debt to examine the inherent vulnerabilities against set thresholds and determine the country's debt carrying capacity. It is noted that Kenya's debt carrying capacity was downgraded in 2019 from strong to medium with a high risk of debt distress.
21. The recent debt sustainability analysis shows that the country has breached 3 ratios out of the 7 debt sustainability indicators. These are PV of debt to GDP Ratio; PV of Public & Publicly guaranteed external debt to exports; and Public and publicly guaranteed external debt service to exports. Further, it is projected that the country will breach the Public and Publicly Guaranteed (PPG) debt service to revenue ratio in 2024. This indicates that the country is at high risk of debt distress.

2.8.Macroeconomic framework underpinning the 2023 MTDS

22. The 2023 MTDS is anchored on macroeconomic assumptions outlined in the 2023 Budget Policy Statement (BPS). These include a growth projection of 6.1 percent over the medium term supported by private sector growth, recovery in agriculture, labour market recovery, improved consumer confidence and resilient remittances. Further, it is expected that implementation of the government's priority programmes through the Bottom-up Economic Transformation Agenda Strategy geared will result in economic turnaround and inclusive growth.
23. Inflation is projected to ease in the near term due to muted demand pressures and policy interventions and is estimated at 5.8 percent in 2023/24. Other key macro variables include interest rates which have increased in the recent past owing to an increase in the CBR rate but are expected to stabilize in the coming months; and the exchange rate which has

declined significantly owing to an increase in the USA Federal Reserve policy rate but is expected to improve going forward.

24. There are risks to this outlook which primarily emanate globally from ongoing geopolitical tensions, global inflation pressures and supply chain disruptions. Domestically, continued drought conditions pose the greatest risk to inflation and economic growth outlook.

III. SUBMISSIONS FROM KEY STAKEHOLDERS

i. Office of the Controller of Budget (OCOB)

The Office of the controller of budget made the following submissions to the committee:

25. **Public debt stock:** The public debt stock recorded an 11.8 percent growth from Ksh. 8.21 trillion as at 30th December 2021 to Ksh. 9.17 trillion as at 31st December 2022. This was attributed to new loans acquired as well as the effect of a depressed shilling against major currencies.
26. **Receipts from borrowing:** there is a high likelihood that the government may not realize the planned borrowing to implement the budget. Between July 2022 and January 2023, cumulative borrowing realized from domestic and external sources was Ksh. 497.48 billion, forming 35.8 percent of the annual estimates of Ksh. 1.39 trillion.
27. **Debt service cost:** debt service is highest in 2023 coupled with spikes in 2024. This is primarily attributed to maturing short-term government securities and maturities of international sovereign bonds. Additionally, in the past three years, the country's debt carrying capacity has been downgraded from strong to medium while the risk of debt distress has moved from moderate to high. The debt service to revenue ratio of 37.9 percent of the total revenue is above the International Monetary Fund (IMF) recommended threshold of 18 percent for medium Debt Carrying Capacity (DCC) countries. High debt service cost has constrained fiscal space.
28. **Commitment fees on undisbursed loans:** In the first half of 2022/2023, the National Treasury paid commitment fees of Ksh. 680.03 million on undisbursed loans. These payments can be avoided if implementing agencies are fully prepared to execute their programmes.
29. **Overdraft facility:** the overdraft limit for FY 2022/23 was raised to Ksh. 80 billion from Ksh. 75 billion in FY 2021/22 and is charged an interest rate of Ksh. 7% per annum on the outstanding amount at the end of each month. In the period July to December 2022, the total charge on the overdraft facility was Ksh. 2.04 billion.

Issues in public debt management

30. **Interest rate risk:** interest rate risk is higher on domestic debt than external debt since the rates are market determined. It is also likely to rise further if the Central Bank of Kenya (CBK) increases its Central Bank Rate (CBR) rate to curb inflation.

31. **Exchange rate fluctuation:** approximately 50 percent of Kenya's debt is denominated in foreign currencies with a high proportion denominated in US dollars. The Kenya shilling has depreciated significantly against the US dollar due to rising interest rates in the USA. Kenya is also a net importer of goods and services which means higher forex outflows, further depreciating the Kenya shilling.
32. **Liquidity constraints:** investor preference locally has been on short term bills to avoid duration risk carried by bonds. A shorter maturity period for loans means increased debt servicing at higher rates expected sooner, thereby piling more pressure on revenue growth as a large chunk of revenue collected goes to debt servicing. Given that debt payment is a first charge on the Consolidated Fund, more revenue is spent on debt payment at the expense of recurrent and development expenditure. This liquidity shortage for critical government expenditures will adversely impact economic growth. A longer repayment period will ease the refinancing pressure and improve the country's liquidity position.
33. **Liquidity risk:** some of the cash call-up for the Treasury bonds have not been funded on time. Furthermore, the National Treasury has failed to disburse funds towards monthly and lumpsum pensions payment in a timely manner. The government has also failed to raise adequate funds through Treasury Bills and Bonds and the M-Akiba bond.
34. **Proposed securitization of pending bills:** this presents a dilemma; on one hand it will solve the problem of pending bills and on the other hand it will increase the debt stock repayment.
35. **Borrowing by county governments:** County governments have been making local arrangements with commercial banks to get short-term borrowing at a cost which isn't budgeted for.
36. Currently many of the loan repayments cannot be traced to existing projects.

37. **The Office of the Controller of Budget proposed the following recommendations:**
    (a) **Establishment of a sinking fund**: this will enable the country to contribute to the fund in the years leading up to debt maturity in order to soften the hardship when the debt falls due.
    (b) **Fiscal consolidation**: the budget deficit should be reduced in order to slow down debt accumulation.
    (c) **Loan disbursements**: Loan disbursements should be enhanced in order to curtail annual commitment fees.
    (d) **Regular review of costs and risks** emanating from domestic and external debt in order to balance these risks.
    (e) **Regular progress reports on capital projects financed through debt** in order to enhance oversight.
    (f) All borrowing by the county governments should be guaranteed by the National Treasury.

ii. Office of the Auditor General (OAG)

38. Whereas the Office of the Auditor General could not substantively critique the proposed 2023 MTDS on account of section 42 of the Public Audit Act, 2015 which bars the office from questioning the merits of government's policy objectives, **they submitted the following concerns**:

39. On the increasing public debt stock, it was indicated that over the past five years, the outstanding amount of public debt has increased by Ksh. 3,677,533,114,275 (77 percent increase); from Ksh. 801,416,851,482 in FY 2017/18 to Ksh. 8, 478,949,965,757 in FY 2021/22. The outstanding amount as at FY 2021/22 represents 84.8 percent of the approved maximum ceiling of Ksh. 10,000,000,000,000. Further, by FY 2021/22, public debt expenditure accounted for 87% of total CFS expenditure.

40. **Audit issues on public debt:** audits undertaken by the Auditor-General reveal the following concerns:
    a) There are no specific financial statements prepared to show the country's debt position. Consequently, it isn't possible to ascertain the amount redeemed and current value; and therefore validity, of the public debt expenditure.
    b) There is non-disclosure of all GoK guaranteed obligations in the statement of obligations guaranteed by the government of Kenya. There is also non-disclosure of loans and overdrafts, if any, held by other national and county government entities. Further, other government liabilities or obligations such as pending bills/ accounts payable and pension areas are not fully disclosed.
    c) The government continues to pay commitment fees incurred on undrawn amounts in respect of loans signed between the national government and foreign lenders. In FY 2021/22, a total of Ksh. 1,486,813,083 was paid as commitment fees for undrawn amounts.
    d) The cost of domestic debt has become more expensive than the cost of external borrowings. In the FY ended 30 June 2022, interest debt on internal debt stood at 76% of the total finance costs, including loan interest. This is three times the cost of external debt which stood at 24% of the total finance costs.
    e) There are dormant/ non-performing loans where the recipients have defaulted on the repayment obligations. This has exposed the government to risks of legal suits that may lead to punitive penalties and subsequent loss of public resources. As at June 2022, the portfolio of non-performing loans was at Ksh. 218.8 billion.
    f) Debt servicing is prone to foreign exchange loss exposure on payment of external debt.

The Office of the Auditor General proposed the following recommendations:

41. As the overall supervisor of MDAs, the National Treasury should ensure that programmes and projects are ready for execution before committing the government to loan agreements. Key stakeholders should also be involved during pre-loaning stages to enable them recognize the significance of some of the processes and the importance of adhering to the agreed loan conditions.

42. The National Treasury should put in place measures to guard against the excessive internal borrowings which may have a negative impact on the country's interest rates, inflation rates and may lead to crowding out of private investors due to reduced loanable funds in the market.
43. The government should consider hedging mechanisms on foreign exchange risks to reduce the risks associated with exchange rate fluctuations between the Kenya shilling and lenders' currencies.
44. To reduce risks and costs of existing stock of debt, the following conditions should be enforced before signing new external debt:
    i. Acquisition of land and compensation
    ii. Relocation of utilities
    iii. Timely disbursement of counterpart funding
    iv. Updating and proper design studies and feasibility studies
    v. Establishment of debt sinking fund to be used for debt repayment in order to address foreign exchange rate fluctuations, variation of prices and increasing interest rates.
    vi. Use solid negotiation strategies that do not lead to large concessions.
    vii. Signing of new loans should be based on public need as opposed to supply driven projects.
    viii. Non-drawn loans in the debt portfolio to be restructured or cancelled.

iii. The Central Bank of Kenya (CBK)

The central bank of Kenya gave the following submissions to the committee:

45. **Macroeconomic assumptions:** The 2023 MTDS is based on the assumption that over the medium term, the economy will recover with stable macroeconomic variables, revenue collections will improve, and fiscal balance will decline.
46. **Feasibility of proposed strategy:** The preferred financing strategy of borrowing 50% from domestic and 50% from external sources is feasible as it provides flexibility to the national government to adjust domestic or external borrowing depending on market conditions. Further, the improved borrowing terms reflect a strategy to maximize concessional and semi-concessional loans.
47. **Expected outcomes of the preferred strategy:** Improved outcomes are expected in the cost and risk of debt. This is in terms of reduced refinancing risks, lower debt to GDP ratio and lengthening of time to maturity. Indeed as at end of 2026, under the preferred strategy, the following indicators are expected to perform as follows:
    a) Nominal debt as a percent of GDP is expected decline from the current 67 percent to 59.8 percent;
    b) Present value of debt as a percent of GDP is expected to improve from the current 60 percent to 53.1 percent;
    c) Interest payment as a percent of GDP is expected to decline from the current 5.3 percent to 4.4 percent; and

d) Implied interest rate is projected to increase from 7.6 percent in 2022 to 7.9 percent as at end of 2026.

48. **The government's fiscal consolidation path** is expected to bring the debt down gradually; with the deficit as a percent of GDP estimated at 3.6 percent and the total debt PV as a percent of GDP estimated at 52.5% by end of 2027. The MTDS is aligned to ongoing fiscal consolidation measures aimed at reducing fiscal deficits and lowering debt costs.
49. **Soundness of the 2023 MTDS**: MTDS objectives are consistent with the key priorities of domestic debt management. Despite the current vulnerabilities, public debt will remain sustainable.
50. The proposed plan by the national government to diversify the investor base and explore new sources of financing such as green and blue bonds is a welcome move.

The CBK indicated that it has made the following contributions to domestic debt market development:

51. **Modernization of market infrastructure:** the Dhow CSD system which is scheduled to go live in March 2023 will enhance efficiency of domestic debt operations, improve market liquidity, promote capital market growth and position the country as the preferred financial hub in the region.
52. **Automation of access to government securities:** the CBK rolled out TMD in February 2002, a digital channel for retail investors to access government securities through mobile phones. Also, an internet/mobile banking platform is expected to be launched later in the year to facilitate access to government loans by individual investors, institutional investors and persons in the diaspora. This should expand the investor base and address low bids for government domestic issuance.
53. **Sustained market engagement and stakeholder collaboration:** there is enhanced coordination with the national treasury on debt and market development initiatives including debt reprofiling through switch operations. Further, market engagement through the Bond Market Forum (BMF) initiative started back in 2001 has been instrumental in developing one of the fastest growing markets in Africa.

iv. The National Treasury and Economic Planning

The National Treasury gave the following submissions to the committee:

54. The stock of public and publicly guaranteed debt grew from Ksh. 8.03 trillion (61.6% of GDP in PV terms) by end of December 2021 to Ksh. 9.14 trillion (60% of GDP in PV terms) as at end of December 2022. This comprises Ksh. 4.67 trillion in external debt and Ksh. 4.47 trillion domestic debt. Public debt stock remains sustainable but with a high risk of debt distress and a medium debt carrying capacity.
55. External debt comprises of Ksh. 2.21 trillion multilateral debts (47%); Ksh. 1.21 trillion bilateral debts (26%) of which China accounts for 67%; and Ksh. 1.25 trillion commercial

debt (27%) with the Eurobond accounting for 87 billion (19%). Low export growth has increased external debt vulnerability.

56. Domestic debt comprises Ksh.3.71 trillion Treasury bonds (84%); Ksh. 67 billion Treasury bills (14%); and Ksh. 9 billion others – mainly overdraft from the Central Bank of Kenya (CBK).
57. In FY 2023/24, net foreign financing will be through commercial borrowing (Ksh.270 billion); programme loans (Ksh. 65 billion); and project loans & A-i-A (Ksh. 239 billion).
58. The National Treasury projects a decline in the present value of debt as a percentage of GDP from 60 percent in 2023/24 to 53.1 percent in FY 2025/26. This will be achieved through following a fiscal consolidation path as outlined in the 2023 BPS.
59. The National Treasury has initiated a process of amending the debt ceiling from a numerical number of Ksh. 10 trillion to a debt anchor of 55 percent of debt to GDP in present value terms. This will be submitted to parliament for approval after public participation to enable the National Treasury to fully finance the budget deficit in FY 2023/24.
60. The ratio of total debt maturing in one year as a share of GDP has been gradually declining over time, thus reducing the refinancing and resettlement risk. It is worth noting however that the redemption profile is characterized by large maturities of external debt in 2024 and 2028 which increases the refinancing and resettlement risk.
61. There are expected bullet payments for Kenya Eurobonds that will fall due in 2023/24 (Ksh.254.16 billion maturing); 2026/27 (Ksh. 114.37 billion maturing); and 2027/28 Ksh. 127.08 billion maturing). The National Treasury has indicated that it will undertake liability management operations targeting the 2024 Eurobond maturity to smoothen the maturity structure of public debt over the medium term. Establishment of a sinking fund is another way of managing debt maturities.
62. The proposed strategy of 50:50 domestic to external is preferred due to the flexibility to adjust depending on evolving domestic and international market conditions. Further, the government intends to maximize use of concessional borrowing as opposed to commercial debt.
63. The deficit financing mix of 50 percent each from external and domestic sources aims to achieve the following:
    a) Minimizing of Interest payments as a ratio of GDP and the implied percentage interest costs are projected to be minimized in the medium term by maximizing use of concessional sources and reducing use of commercial borrowing from external sources;
    b) Minimizing refinancing risks by lengthening the total portfolio Average Time to Maturity through issuance of longer tenor debt instruments and use of concessional debt whose terms include longer maturities;
    c) Maximizing the use of fixed interest rate debt in order to minimize interest risks in terms of average time to refixing;
    d) Promote the development of the domestic debt market through issuance of more medium to long tenor instruments as the main source of domestic financing; and

e) The strategy may be adjusted towards either external or domestic borrowing targets depending on prevailing market conditions.

64. The national government is currently implementing the following reforms to develop the domestic market:
    a) Facilitation of an electronic bond and bills auction;
    b) Implementation of a new Central Securities Depository (CSD) to enhance market infrastructure;
    c) Separation of the retail and wholesale markets;
    d) Annual publishing of the Issuance calendar;
    e) Re-energizing and enhancing the effectiveness of a horizontal repo market and the securities lending and short-selling for key market participants; and
    f) Strengthening monthly stakeholders meeting and feedback.

65. Public debt sustainability is projected to improve as a result of reforms under the ongoing Extended Fund Facility/Extended Credit Facility (EFF/ECF) supported by the IMF which embeds implementation of the proposed fiscal consolidation strategies for macroeconomic stability over the medium term. To pursue debt sustainability, the government will optimize use of concessional external funding sources, lengthen the maturity profile of public debt through issuance of medium to long dated bonds and deepening the domestic debt market to be able to finance more of the budget deficits and reduce reliance on external sources.

v. Public participation

66. In line with article 201 of the Constitution, the committee undertook public participation on the 2023 Medium-term Debt Management Strategy through request for memoranda from the public. The period provided was seven days as from February 18th 2023, and the advertisements were placed on the Daily Nation and The Standard newspapers.
67. Notable contributions were received from the Institute of Public Finance as well as from Mr. Bernard Muchere, a Fraud Risk Management Consultant.
68. The submissions touched on key concerns with regard to the country's debt management over the years, notably the huge variance in choice of debt strategies from year to year, the difficulty in accessing external financing especially on concessional terms, the implications of deviation from the fiscal consolidation path and the proposed debt anchor. There were also audit concerns particularly with regard to how much debt has been spent vis-à-vis what was approved and various submissions were made to mitigate risks in public debt management.

(Received memoranda are in Annex 6.)

IV. COMMITTEE OBSERVATIONS AND FINDINGS

69. **Arising from the above deliberations, the committee made the following observations:**

i) The fiscal deficit for FY 2022/23 is estimated at Ksh. 833.8 billion and that of FY 2023/24 is estimated at Ksh. 720.1 billion. If the government fully funds the 2022/23 fiscal deficit through borrowing, it will lead to a breach of the Ksh. 10 trillion debt ceiling in FY 2023/24 as the available fiscal space will be Ksh. 587 billion only.

ii) The National Treasury's proposal to amend the debt ceiling from the numerical number of Ksh. 10 trillion to a debt anchor of 55 percent of GDP in present value terms could reduce transparency in debt oversight due to monitoring challenges. Further, current statistics indicate that the present value of debt as a percentage of GDP is at 60 percent which is already in breach of the proposed 55 percent. The committee is cautious that unless fiscal consolidation is undertaken aggressively, the debt anchor may not be achieved.

iii) The proposed borrowing ratio in the 2023 Budget Policy Statement (BPS) is 72 percent domestic and 28 percent external borrowing which differs from the proposed ratio in the 2023 MTDS of 50 percent domestic and 50 percent external borrowing. The committee is concerned that there appears to be a disconnect in policy formulation and the proposed debt management objectives.

iv) The country is at a high risk of debt distress as demonstrated by a breach of 3 of the 7 debt sustainability indicators and an expected breach of a fourth indicator, the PPG debt service to revenue ratio, in FY 2023/24. Indeed, the most recent credit rating for Kenya undertaken by Standard and Poor downgraded Kenya's rating to B with a negative outlook. Deterioration of the credit rating will have an adverse impact on the country's borrowing costs.

v) Continued depreciation of the Kenya shilling against the US dollar has significantly worsened the country's debt position. Data availed to the committee indicates that in FY 2021/22, Ksh. 5.4 billion was paid in debt service as a result of exchange rate fluctuation and another Ksh. 3.4 billion was incurred in the first half of FY 2022/23. It is further estimated that by end of the current FY 2022/23, this sum will exceed Kshs. 6 billion. The committee is concerned that this will significantly strain the foreign exchange reserves, thereby rendering the Kenya shilling even more vulnerable to external shocks.

vi) High inflation poses a significant risk to domestic borrowing. This is because higher inflation trends may require CBK intervention through increasing the central bank rate (CBR) which would cause a further increase in interest rates. The committee notes that domestic debt service is the largest component of debt service expenses. As such, increased domestic borrowing against a background of higher interest rates will significantly increase debt payment expenses. Conversely, tight global financial conditions due to a surge in global inflation continue to limit the country's access to external financing and this may push the country towards domestic borrowing.

vii) The government is incurring significant losses through the payment of commitment fees on undisbursed loans. Data availed to the committee puts this loss at Ksh. 680.03 million in the first half of FY 2022/23. The total amount of undisbursed loans is at Ksh. 1.179 trillion. The committee notes that there is a lack of preparedness by some implementing agencies to execute programmes funded through loans within reasonable timeframes which has led to slow drawdown of the loans.

viii) MDAs keep multiple bank accounts with commercial banks and this has denied the national government access to these funds. The committee noted that because of this scenario, with regard to domestic borrowing, the national government is borrowing its own money through commercial banks where some government institutions hold deposits. This is costly to the government.

ix) The expected reduction in fiscal deficit and consequently debt accumulation is contingent on the success of the fiscal consolidation program. The committee notes with concern that given the expenditure pressures emanating from the government's economic transformation agenda, welfare spending, wage demands as well as the likelihood of revenue underperformance, the fiscal deficit target may not be achieved and this may lead to higher borrowing.

x) The 2023 MTDS has not addressed non-performing loans to state corporations and their impact on the fiscal framework. The committee noted that there were significant challenges with regard to debt guaranteed for Kenya Airways (Ksh.88.3 billion) and the KPLC (Ksh.9.9 billion). The loan to Kenya Airways is in default and government is currently servicing the debt. With regard to the debt guaranteed for KPLC, information availed to the committee is that the KPLC is unaware of the existence of this loan raising questions on the purpose and application of the loan.

xi) There isn't enough details on certain project loans and the progress and performance of the projects which the loans were supposed to finance. The committee will await the audit by the auditor general to address any discrepancies in the earmarking of loans to their respective projects.

xii) The international sovereign bond of USD 2 billion issued in 2014 is falling due in FY 2023/24. The committee is concerned that the proposed strategy to refinance it through commercial borrowing contradicts the policy intentions of the National Treasury to favour concessional and semi-concessional borrowing over commercial debt in order to reduce external borrowing costs.

xiii) The proposal to establish a sinking fund in order to mitigate against high debt repayments has taken too long to be implemented.

xiv) The National Treasury appears not to have undertaken public participation on the 2023 MTDS contrary to article 201 of the constitution. Information on public participation should include newspaper notices, details of submissions received and the National Treasury's response.

xv) The MTDS does not show consistency from one year to another. There are glaring changes in the proposed borrowing ratios from one MTDS to another. This indicates lack of stability in the country's debt management strategy which should be undertaken from a medium term perspective.

xvi) Sensitivity analysis with regard to economic and revenue performance has not been undertaken on the 2023 MTDS. As such, the strategy does not provide any corrective measures that will be undertaken in case there are revenue shortfalls or underperformance of loans. If this is not addressed now and should the risks to economic growth and revenue performance materialize, liquidity constraints will adversely affect budget implementation.

V. COMMITTEE RECOMMENDATIONS

70. **In view of the foregoing, the committee has made the following recommendations:**

Policy recommendations

i. **That**, any borrowing undertaken by the National Treasury in FY 2023/24 should not exceed the Ksh. 10 trillion approved debt ceiling set by Parliament.

ii. **That**, to enhance liquidity management and help reduce unnecessary short-term domestic borrowing occasioned by governments inability to access surplus funds held in numerous Ministries, Departments and Agencies (MDAs) bank accounts, the National Treasury spearheads the integration of MDA banking arrangements into a **single treasury account** system as provided for in Section 28(2) of the PFM Act and the PFM regulations. This should be submitted to Parliament within six months.

iii. **That**, as indicated in our report on the Consolidated Fund Services (CFS) expenditures for supplementary estimates No. 1 of FY 2022/23, the National Treasury should within six months, table regulations for the establishment of a sinking fund dedicated to public debt servicing as provided for under Section 50(8) of the PFM Act, 2012.

iv. **That,** in order to safeguard against shocks with regard to external interest payments, the National Treasury adopts hedging mechanisms on foreign exchange risks and/or negotiating lending agreements in Kenya shillings.

v. **That,** the National Treasury undertakes a review of all undisbursed loans amounting to Ksh. 1.179 trillion and submits to the National Assembly within one month, a report with information on terms, status, reasons for non-disbursement and proposals on any loans that can be cancelled to save spending on commitment fees.

vi. **That,** in adherence to the Accra Agenda for Action 2018, donor support MUST be aligned to the country's budget cycle to facilitate proper planning by the implementing agencies and reduce occurrence of undisbursed loans.

vii. **That,** within two months, the National Treasury submits to this House, a strategy for resolution of non-performing loans linked to various State Owned Enterprises (SoEs) including Kenya Airways.

viii. **That,** the Office of the Auditor General expedites the audit of project loans under the water sector and the Ksh. 9.9 billion loan borrowed on behalf of KPLC and submits this report to the House within the next two months.

ix. **That,** in the next budget cycle, the National Treasury aligns the borrowing strategy proposed in the Budget Policy Statement with the borrowing strategy in the MTDS in order to ensure credibility of the government's planning documents.

x. **That,** in the next budget cycle, the National Treasury undertakes public participation on the MTDS in line with Article 201 of the constitution.

xi. **That,** going forward, the MTDS should live up to its expectation as a medium term document by showing consistency in proposed debt management strategies including deficit financing on a three year rolling framework, from one MTDS to another.

xii. **That,** the National Treasury undertakes a sensitivity analysis on the 2023 MTDS and submits to this House, within two weeks, a contingency plan on measures to be undertaken in the event of revenue shortfalls or underperformance of loans.

Financial recommendations

71. **The committee further recommends that this House resolves as follows:**

i. **That,** the fiscal deficit target for the medium term is approved and set at no more than 4.4% of GDP for FY 2023/24; 3.9% of GDP for FY 2024/25, and 3.6% of GDP for FY 2025/26 in line with the fiscal consolidation path.

ii. **That,** the country's borrowing strategy is approved at 50 percent net external borrowing and 50 percent net domestic borrowing as contained in the 2023 Medium Term Debt Management Strategy.

iii. **That,** any deviation from the approved borrowing strategy will require the approval of the National Assembly.

Stock of domestic and foreign public debt including guarantees

72. Further, pursuant to standing order 232A(5)(a), information on the stock of foreign public debt is hereby attached in the first Schedule; and information on the stock of domestic public and publicly guaranteed debt is attached in the second Schedule.

SIGNED

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HON. ABDI SHURIE, MP.

CHAIRPERSON, PUBLIC DEBT & PRIVATIZATION COMMITTEE

9th MARCH 2023

DATE

THE NATIONAL ASSEMBLY

DATE: 09 MAR 2023 DAY: THURSDAY

TABLED BY: Chairperson, Public Debt and Privatization Committee Hon. Abdi Shurie

CLERK-AT THE-TABLE: Joyce Lemerelle