CENTRAL BANK OF KENYA (CBK)
CREDIT OFFICER SURVEY JULY - SEPTEMBER 2016

Key findings:

- The perceived demand for credit remained unchanged in eight of the eleven economic sectors in quarter 3 (Q3) of 2016.
- Credit standards remained unchanged in seven out of the eleven economic sectors in Q3 of 2016.
- In Q3, the downward movement of interest rates is mainly attributed to the capping of interest rates that came into effect on 14th September 2016 and the reduction of the Central Bank Rate (CBR) rate to 10.0%.
- Banks expect the level of NPLs to remain unchanged in Q4 of 2016 in ten of the eleven economic sectors.
- Banks predict credit recovery efforts will be intensified in nine out of the eleven sectors by allocation of more resources on monitoring and recovery of loans as well as use of external parties in the recovery process.

1.1 CREDIT OFFICER SURVEY

The Credit Officer Survey is conducted quarterly by the Central Bank of Kenya in order to identify the potential drivers of credit risk. Credit risk is the single largest factor affecting the soundness of financial institutions and the financial system as a whole. Lending is also the principal business for banks. The ratio of total loans to total assets for the quarter ended 30th September 2016 was 59.17%; a decrease of 1.99% from 61.16% reported in June 2016.

1.2 SURVEY METHODOLOGY

The Credit Officer Survey is addressed to senior credit officers of commercial banks and one mortgage finance company. In the current survey, all 40 operational commercial banks and 1 mortgage finance company participated in the survey. Charterhouse Bank Ltd and Imperial Bank Ltd were excluded from the survey.

The survey seeks to establish the lending behavior in the banking sector and targets eleven economic sectors. For all eleven economic sectors, questions are asked on credit standards for approving loans, demand for credit, interest rates, non-performing loans and credit recovery efforts.

The survey questions are generally phrased in terms of changes over the past three months (in this case in the third quarter of 2016) or expectations of changes over the next three months (i.e. in the fourth quarter of 2016).

This survey also included some questions regarding the effect of capping of interest rates that came into effect on 14th September 2016.

1.3 KENYAN BANKING SECTOR PERFORMANCE

The Kenyan Banking Sector recorded growth in the quarter ended 30th September 2016, compared to the quarter ended 30th June 2016. Some of the sector's performance indicators are as follows:

- The aggregate balance sheet increased by 2.91% from Kshs 3.67 trillion in June

2016 to Kshs 3.78 trillion in September 2016.

- Gross loans increased by 0.44% from Kshs 2.27 trillion in June 2016 to Kshs 2.28 trillion in September 2016.
- The ratio of gross non-performing loans to gross loans increased from 8.4% in June 2016 to 9.1% in September 2016. The increase in gross non-performing loans was mainly attributable to challenges in the business environment that led to cashflow constraints for borrowers.
- The ratio of core capital to total risk-weighted assets increased slightly from 16.25% as at June 2016 to 16.32% as at September 2016. The total capital to total risk weighted assets increased marginally from 18.96% in June 2016 to 19.0% in September 2016. The capital adequacy ratios remained above the statutory minimum of 10.5% and 14.5% respectively.
- Return on Assets decreased to 3.3% in September 2016 from 4.2% in June 2016.
- Return on Equity decreased to 27% in September 2016 from 33.8% in June 2016.
- The Average Liquidity Ratio increased to 42.9% in September 2016 from 40.4% in June 2016.

2.0 SURVEY FINDINGS

2.1 Demand for Credit

- Demand for credit remained unchanged in eight of eleven economic sectors in Q3 of 2016. The economic sectors were led by Mining and Quarrying (74%), Financial Services (65%), Tourism Restaurant and Hotels (63%), Energy and Water (63%) and Agriculture (63%), Building and Transport (46%) and Manufacturing (44%).
- The Q3 survey indicated that perceived demand for credit increased in three economic sectors compared to the four sectors in Q2 of 2016. This was led by Trade, Personal/Household and Real Estate sectors with 48%, 43% and 40% of the respondents reporting increased demand for credit. This could be attributed to favorable macroeconomic environment and reduced cost of borrowing.

Chart 1 and **Table 1** below present the trend in the demand for credit in the quarter

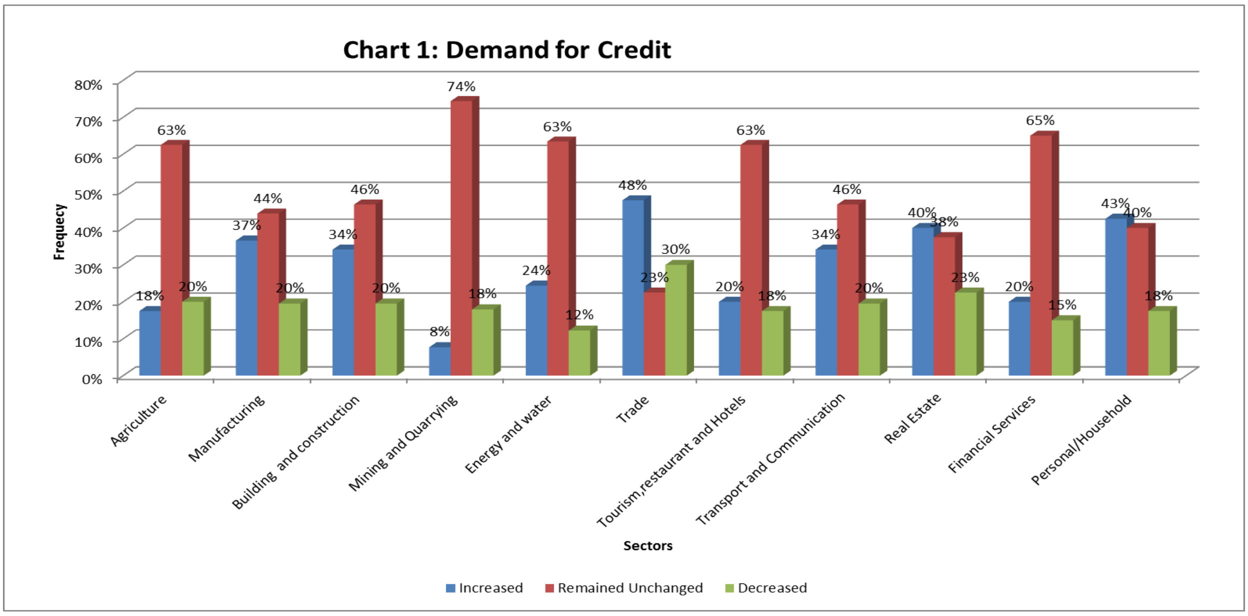


Table 1: Change in Demand for Credit

	September 2016			June 2016		
	Increased	**Remained Unchanged**	**Decreased**	**Increased**	**Remained Unchanged**	**Decreased**
Agriculture	18%	63%	20%	35%	35%	35%
Manufacturing	37%	44%	20%	38%	38%	38%
Building & Construction	34%	46%	20%	44%	44%	44%
Mining and Quarrying	8%	74%	18%	15%	15%	15%
Energy and Water	24%	63%	12%	30%	30%	30%
Trade	48%	23%	30%	56%	56%	56%
Tourism, Restaurant and Hotels	20%	63%	18%	20%	20%	20%
Transport and Communication	34%	46%	20%	28%	28%	28%
Real Estate	40%	38%	23%	35%	35%	35%
Financial Services	20%	65%	15%	28%	28%	28%
Personal/Household	43%	40%	18%	38%	38%	38%

2.2 Factors affecting demand for credit

- In Q3 of 2016, factors affecting demand for credit generally remained unchanged for eight economic sectors.
- Issuance of equity, issuance of debt securities, internal financing, loans from non-banks, political risk, retention of KBRR, loans from other banks and

available investment opportunities were cited as having had the least influence on the demand for credit during the quarter under review. This was reported by 95%, 92%, 92%, 85%, 80%, 74%, 73% and 63% of the respondents respectively.

- As compared to Q2 of 2016, reduction of CBR and cost of borrowing were cited in Q3 of 2016 as the factors that positively increased the demand for credit. Given that the effect of reduction of Central Bank Rate from 10.5 % to 10.0% effective 20th September 2016 will be felt in Q4 of 2016. The envisaged reduction of the lending rates will subsequently result in increased appetite for credit from the customers.

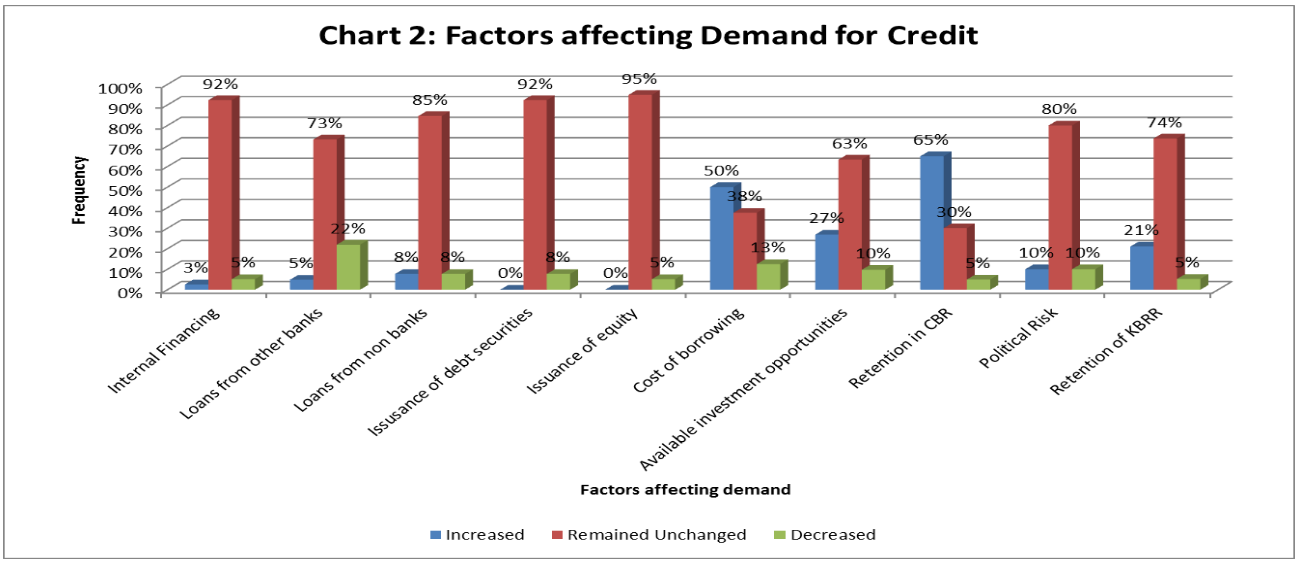


Table 2: Factors affecting Demand for credit

	September 2016			June 2016		
	Increased	**Remained Unchanged**	**Decreased**	**Increased**	**Remained Unchanged**	**Decreased**
Internal Financing	3%	92%	5%	5%	5%	5%
Loans from other banks	5%	73%	22%	10%	10%	10%
Loans from non-banks	8%	85%	8%	3%	3%	3%
Issuance of debt securities	0%	92%	8%	0%	0%	0%
Issuance of equity	0%	95%	5%	0%	0%	0%
Cost of borrowing	50%	38%	13%	5%	5%	5%
Available investment opportunities	27%	63%	10%	24%	24%	24%
Reduction in CBR	65%	30%	5%	13%	13%	13%
Political Risk	10%	80%	10%	3%	3%	3%
Retention of KBRR	21%	74%	5%	5%	5%	5%

2.3 Credit Standards

- Seven out of the eleven economic sectors attracted unchanged credit standards in Q3 of 2016. These are Mining and Quarrying (73%), Energy and Water (66%), Agriculture (63%), Financial Services (60%) Manufacturing (59%), Tourism, Restaurant and Hotels (55%), and Trade (49%).
- However in comparison to Q2 of 2016, Credit standards in Q3 of 2016 :-

i. Tightened in seven economic sectors (Energy, Trade, Transport Personal/Household, Manufacturing Financial Services and Agriculture economic sectors).

ii. Remained unchanged in three economic sectors (Building and Construction, Mining and Quarrying and Real Estate economic sectors).

iii. Eased in the Tourism, Restaurant and Hotels sector.

These responses are presented in **Chart 3 and Table 3** below:

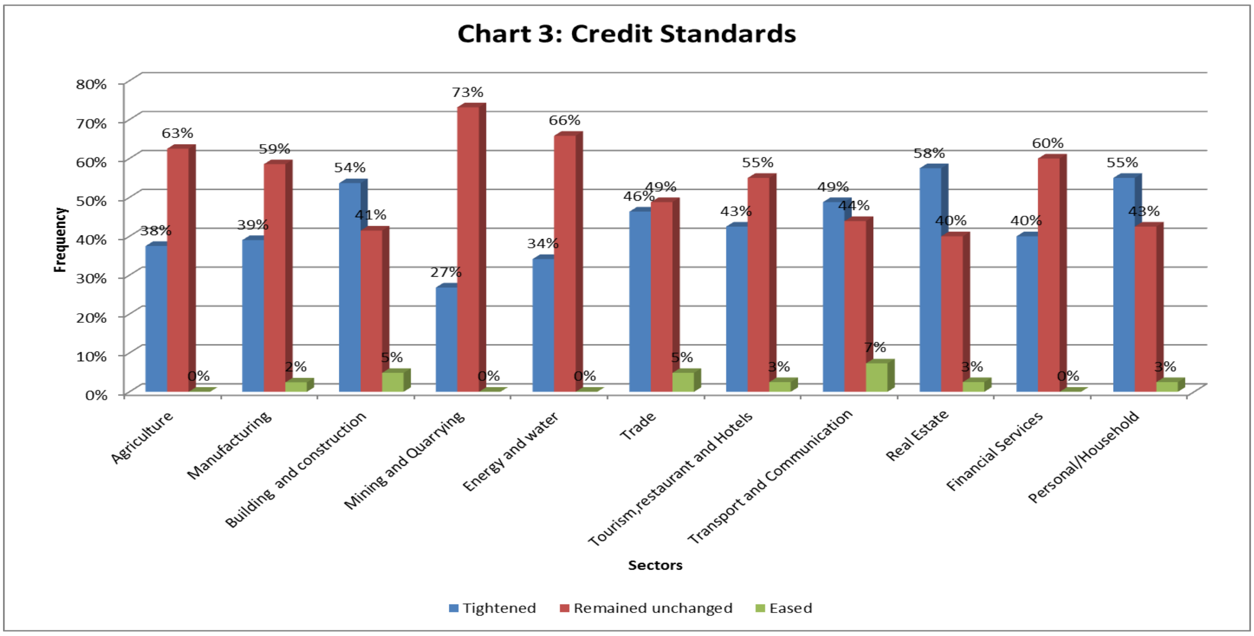


Table 3: Credit Standards for Loans to Various Economic Sectors

	September 2016			June 2016		
	Tightened	Remained Unchanged	Eased	Tightened	Remained Unchanged	Eased
Agriculture	38%	63%	0%	35%	65%	0%
Manufacturing	39%	59%	2%	25%	73%	3%
Building & Construction	54%	41%	5%	61%	37%	2%
Mining and Quarrying	27%	73%	0%	28%	73%	0%
Energy and Water	34%	66%	0%	15%	83%	3%
Trade	46%	49%	5%	29%	61%	10%
Tourism, Restaurant and Hotels	43%	55%	3%	43%	58%	0%
Transport and Communication	49%	44%	7%	39%	56%	5%
Real Estate	58%	40%	3%	63%	33%	5%
Financial Services	40%	60%	0%	25%	73%	3%
Personal/Household	55%	43%	3%	35%	55%	10%

2.4 Factors affecting credit standards

- In the quarter ended 30th September 2016, most of the factors that influence changes on credit standards had little impact.
- As a response to the operating environment, interest rate capping and accompanying effect on the cost of funds and balance sheet constraints, the banks have tightened credit standards.
- In comparison to Q2 of 2016, more banks cited Reduction of CBR (32%), Retention of KBRR (16%), Bank's Costs of Funds & Balance Sheet constraints (7%) and expectations regarding general economic activity (5%) as factors that contributed to their tightening of credit standards.

A comparison of the trend in the factors affecting the banks' credit standards are shown in **Chart 4** and **Table 4** below.

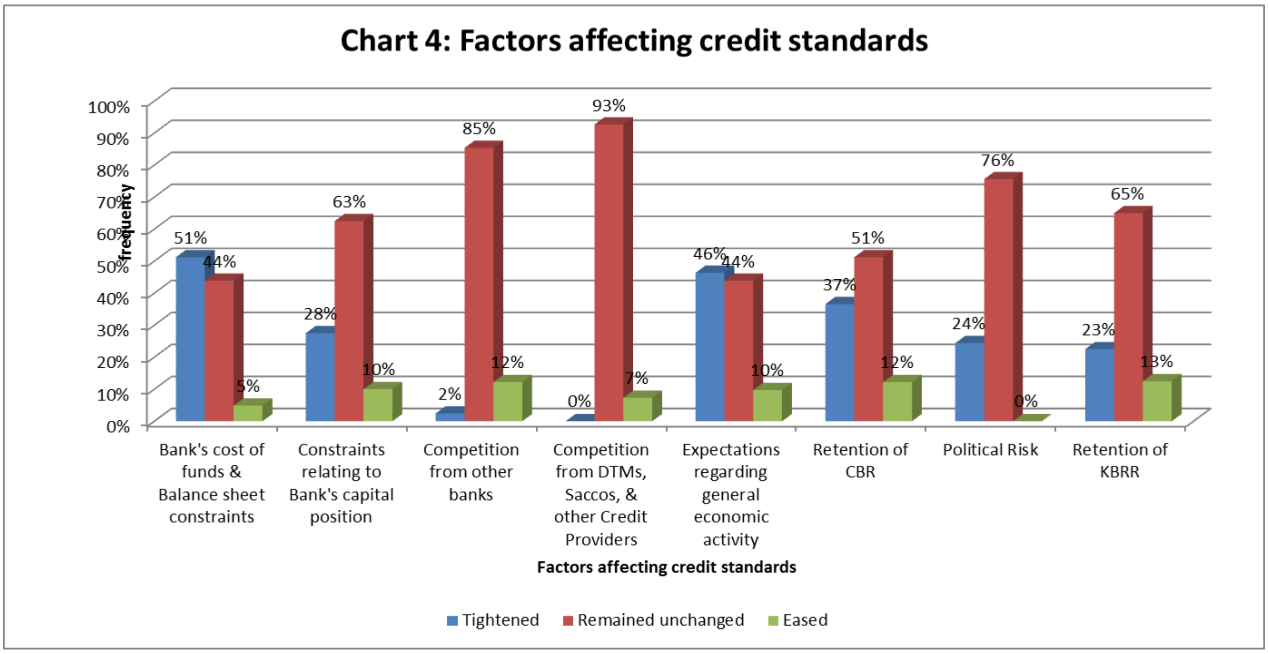
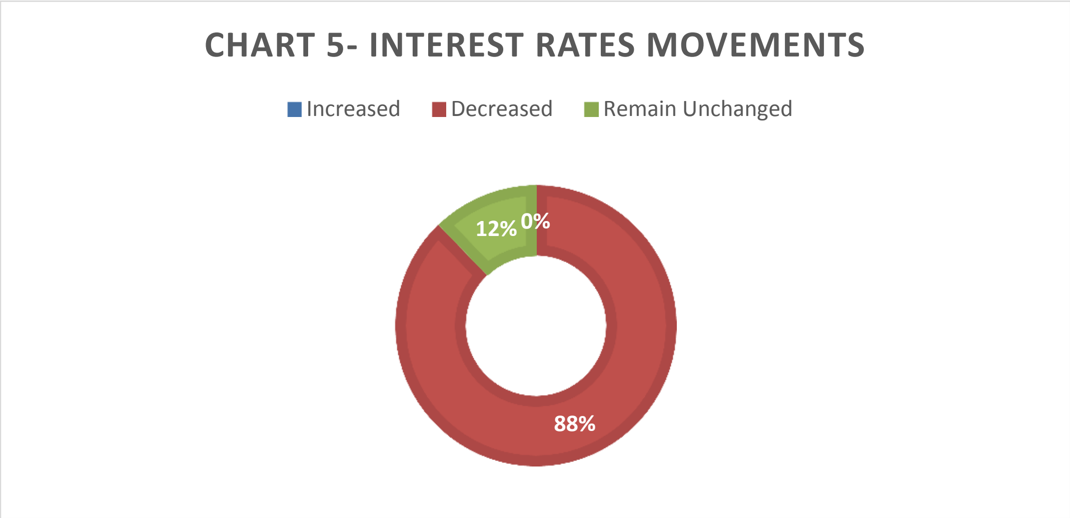


Table 4: Impact of factors affecting credit standards

	September 2016			June 2016		
	Tightened	**Remained Unchanged**	**Eased**	**Tightened**	**Remained Unchanged**	**Eased**
Bank's cost of funds & Balance sheet constraints	51%	44%	5%	44%	54%	2%
Constraints relating to Bank's capital position	28%	63%	10%	38%	55%	8%
Competition from other banks	2%	85%	12%	7%	73%	20%
Competition from DTMs, Saccos, & other Credit Providers	0%	93%	7%	5%	83%	12%
Expectations regarding general economic activity	46%	44%	10%	44%	51%	5%
Reduction of Central Bank Rate (CBR)	37%	51%	12%	5%	90%	5%
Political Risk	24%	76%	0%	29%	71%	0%
Retention of KBRR	23%	65%	13%	7%	93%	0%

2.5 Interest rates movements

The movement of interest rates is mainly attributed to the capping of interest rates that came into effect in September 2016, CBK's retention of the KBRR and the reduction of the CBR rate to 10%. The observations made in the quarter under review depicted in **Charts 5** below.



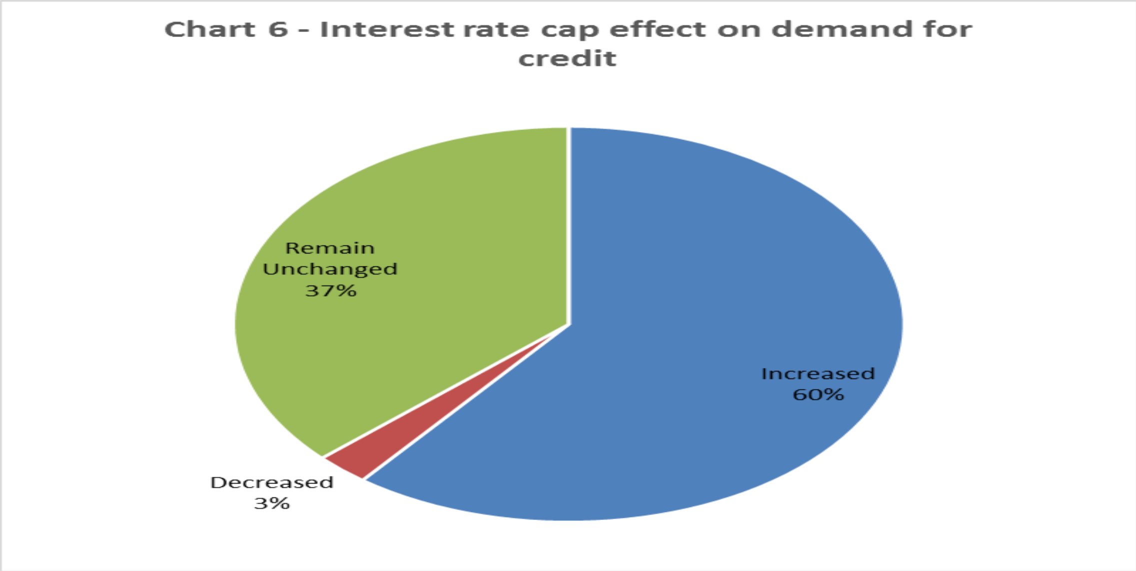
12% of the banks held their interest rates constant, 88% of the banks reduced their interest rates while none of the banks reported increase in interest rates.

2.6 Capping of interest rates

With the interest rate capping that came into effect on 14th September 2016, the credit survey sought to find out the impact it had on demand for credit, actual new credit granted over the period to 30th September 2016 and the expectations of changes over the next three months. Further, the survey also sought to find out how NPLs in Q4 of 2016 will be affected by the interest rate capping. These anticipated changes are analysed below.

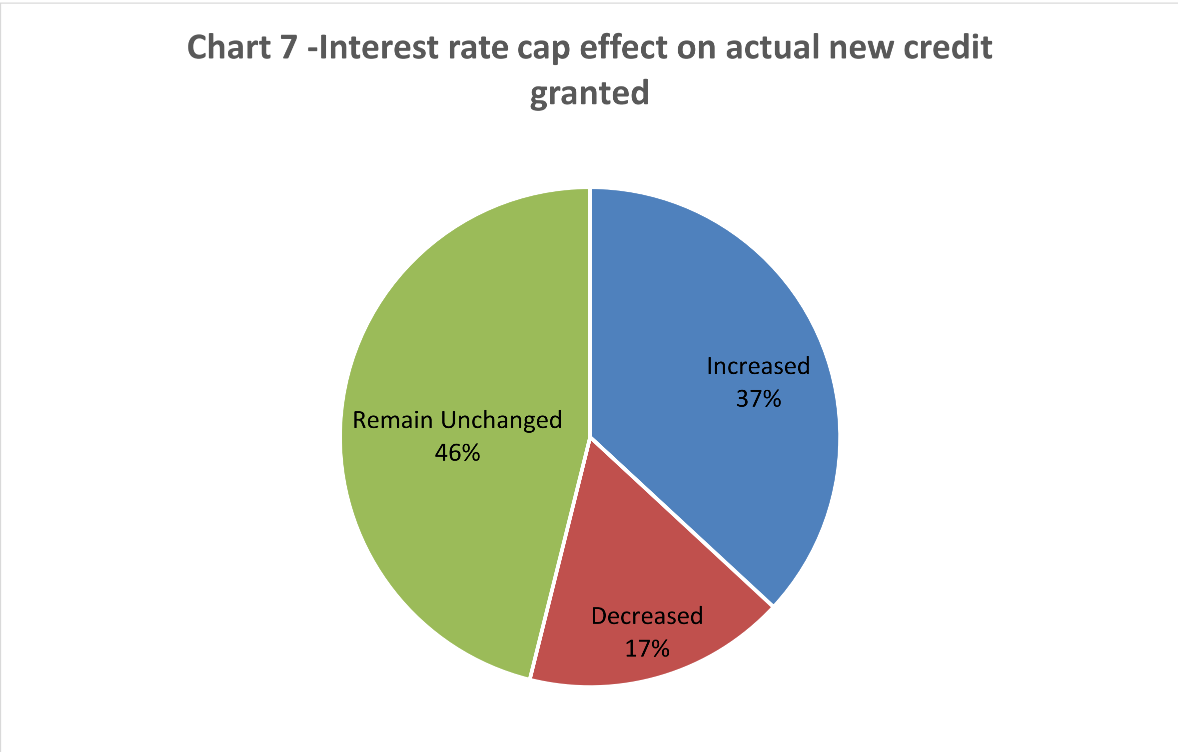
2.6.1 Effect of interest rate capping on demand for credit

Interest rate capping led to increased demand for credit as indicated by 60% of the respondents. 37% of the respondents felt that the demand for credit remained unchanged while 3% felt that the demand decreased as depicted in **chart 6** below.



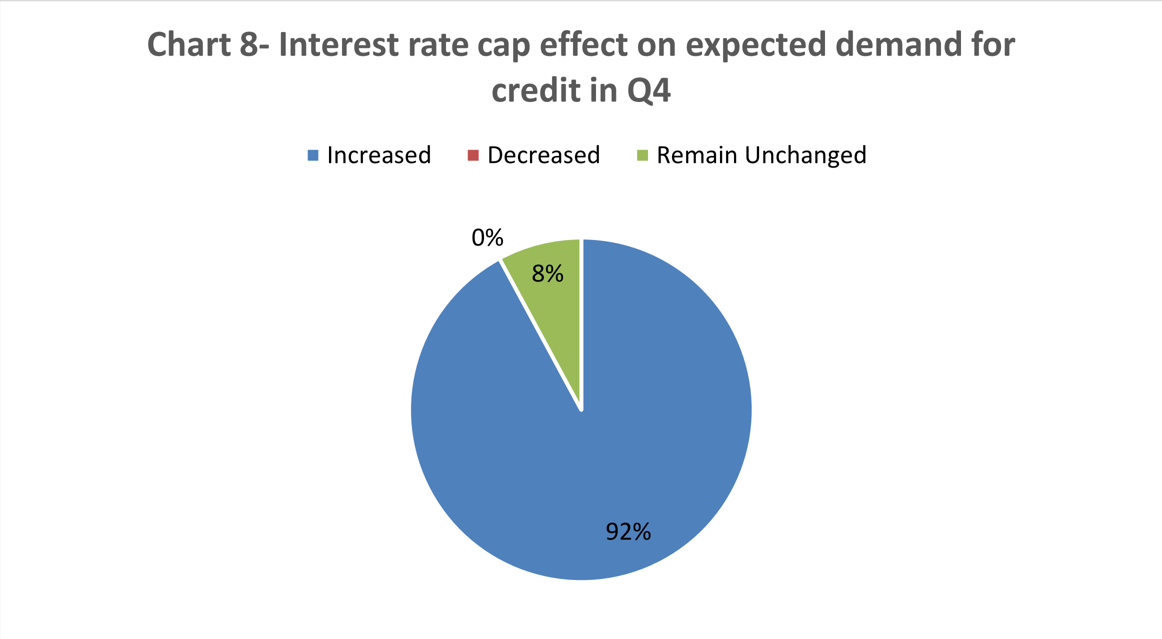
2.6.2 Effect of interest rate capping on actual new credit granted

46% of the respondents indicated interest rate capping had little effect on the actual new credit granted, 37% felt that actual new credit increased while 17% felt that the actual credit decreased as depicted in **chart 7** below. This depicts a situation of mixed reactions as the commercial banks take the wait and see aproach on how the capping of interest rates will impact the market.



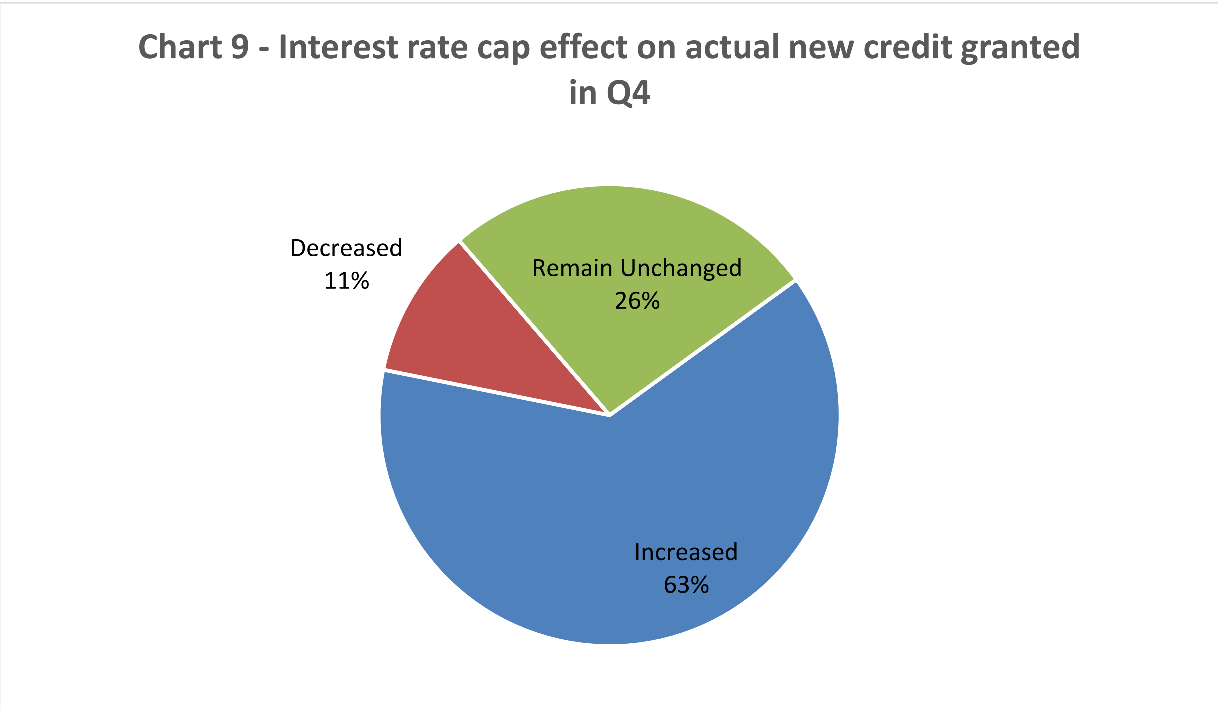
2.6.3 Effect of interest rate capping on expected demand for credit in Q4

Going forward, 92% of the respondents felt that interest capping will increase demand for credit while 8% felt that the demand will not change as per **chart 8** below.



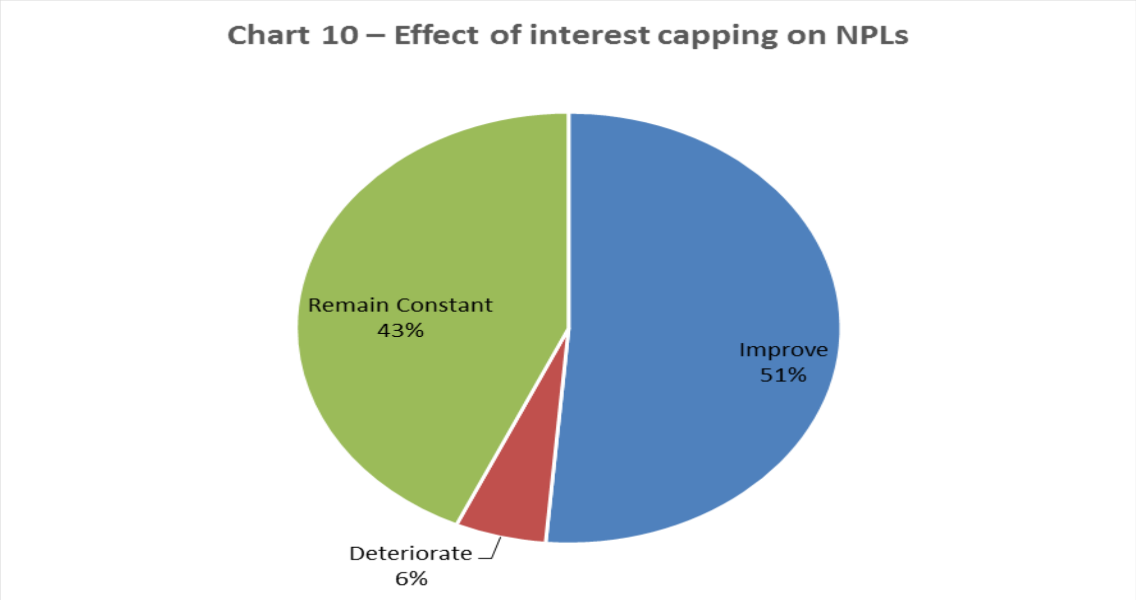
2.6.4 Interest rate cap effect on actual new credit granted in Q4

With regards to demand for new credit in Q4, interest rate capping will result to an increase in actual new credit granted as indicated by 63% of the respondents. 26% of the respondents felt that the demand will remain unchanged while 11% felt that the demand will decrease as per **chart 9** below.



2.6.5 Effect of interest rate capping on the level on NPLs

In Q4 of 2016, 51% of the respondents expect that the capping of interest rates will have a positive impact on NPLs, 6% felt that NPLs will deteriorate while 43% felt that the NPLs will not change as per **chart 10** below. This mixed reaction may be due to the fact that the capping of interest rates is still in the early stages.



2.5 Non-Performing Loans (NPLs)

Banks expect the level of NPLs to remain unchanged in Q4 of 2016 in ten out of the eleven economic sectors as depicted in **Chart 11** below.

- In the June 2016 Credit Survey, the credit officers of commercial banks forecasted a drop of NPLs in ten out of eleven economic sectors in Q3 of 2016. However, actual NPLs in Q3 of 2016 indicate that NPLs increased in eight economic sectors and decreased in 4 economic sectors.
- Though most of the banks expect the level of NPLs to remain unchanged in Q4 of 2016, there was a significant increase in the number of respondents that foresee a drop in NPLs in the Trade, Personal/Household, Mining and Quarrying, Agriculture, Manufacturing, Tourism, Transport Building and Construction and Financial Services sectors. These were 17%, 15%, 14%, 12%, 12%, 10%, 9%, 4% and 2% increase in the number of respondents respectively as compared to the quarter ended June 2016.
- Most of the respondents predicted that the drop in NPLs is attributed to the reduced CBR rate to 10% and the capping of interest rates effected in September 2016. This has resulted to better repayment ability since the loans have become affordable.
- The decrease expected in the Household/Personal and Agriculture sectors could be attributed to better liquidity from tea and coffee proceeds and the anticipated general improvement in the business environment which are likely to increase cash flows and reduce default position.
- The last quarter of 2016 is usually the high season for Tourism, Hotels and Restaurant sector which is expected to experience better cash flows.

Chart 11 and **Table 5** below indicate respondents' expectations on NPL trend in Q4 of 2016.

Chart 11: Non-Performing Loans

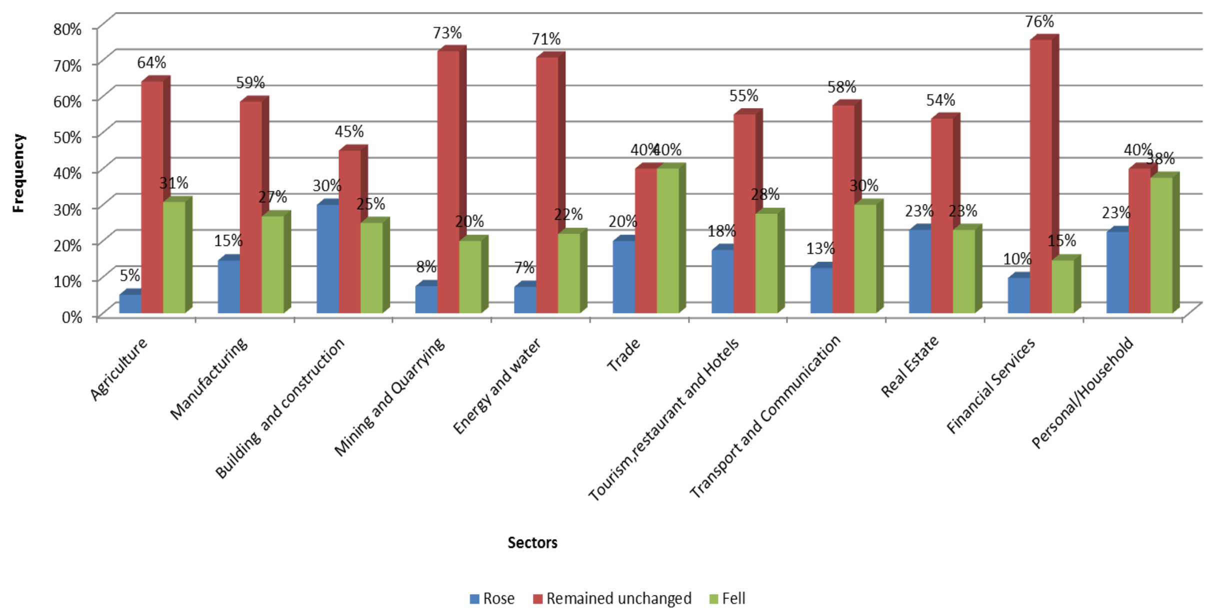


Table 5: Non Performing Loans Expectation Trend Per Economic Sector

	September 2016			June 2016		
	Rose	**Remained Unchanged**	**Fell**	**Rose**	**Remained Unchanged**	**Fell**
Agriculture	5%	64%	31%	8%	73%	19%
Manufacturing	15%	59%	27%	18%	67%	15%
Building & construction	30%	45%	25%	37%	42%	21%
Mining and Quarrying	8%	73%	20%	8%	86%	6%
Energy and water	7%	71%	22%	8%	82%	11%
Trade	20%	40%	40%	28%	49%	23%
Tourism, Restaurant & Hotels	18%	55%	28%	13%	70%	18%
Transport & Communication	13%	58%	30%	26%	54%	21%
Real Estate	23%	54%	23%	33%	40%	28%
Financial Services	10%	76%	15%	13%	74%	13%
Personal/Household	23%	40%	38%	38%	40%	23%

2.6 Credit Recovery Efforts

For the quarter ending 31st December 2016, banks predict that credit recovery efforts will be intensified in nine out of the eleven sectors. The banks intend to allocate more resources on monitoring and recovery of loans as well as use of external parties in the recovery process. The intensified credit recovery efforts will be in the:

i. Tourism and Agriculture sectors, which experience seasonal fluctuations of cash flows, banks intend to intensify recovery efforts so as to collect amounts due during the peak season in the fourth quarter.

ii. Personal/Household sector, banks expect that due to the end of the year festivities characterized by increased consumer spending, borrowers may be constrained in servicing their facilities over the next 3 months.

iii. Transport and Communication aims at tapping into the positive returns in Transport and Communication sectors arising from increased tourists arrivals to Kenya during the festive peak season.

iv. Building and Construction sector aims at enhancing collections from delayed contractor payments expected to be paid in the fourth quarter.

The responses on the expected credit recovery efforts by the banks during the quarter ending 31st December 2016 are depicted in **Chart 12** and **Table 6** below.

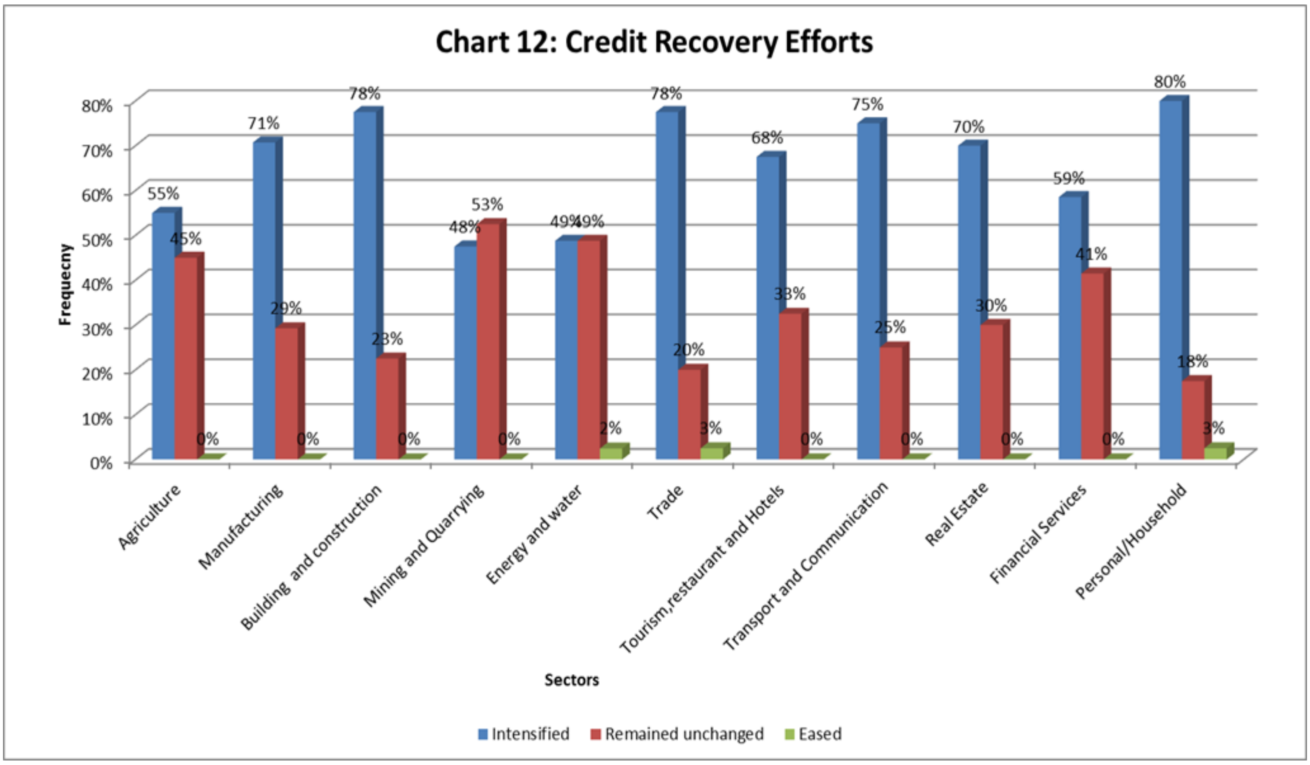


Table 6: Credit Recovery Efforts

	September 2016			June 2016		
	Intensified	**Remained Unchanged**	**Eased**	**Intensified**	**Remained Unchanged**	**Eased**
Agriculture	55%	45%	0%	58%	42%	0%
Manufacturing	71%	29%	0%	67%	33%	0%
Building & construction	78%	23%	0%	74%	23%	3%
Mining and Quarrying	48%	53%	0%	45%	55%	0%
Energy and water	49%	49%	2%	48%	53%	0%
Trade	78%	20%	3%	82%	18%	0%
Tourism, Restaurant & Hotels	68%	33%	0%	62%	38%	0%
Transport & Communication	75%	25%	0%	79%	18%	3%
Real Estate	70%	30%	0%	69%	31%	0%
Financial Services	59%	41%	0%	50%	50%	0%
Personal/Household	80%	18%	3%	85%	15%	0%