Central Bank of Kenya

OCTOBER - DECEMBER 2018

CREDIT SURVEY

CENTRAL BANK OF KENYA COMMERCIAL BANKS' CREDIT OFFICER SURVEY OCTOBER - DECEMBER 2018

1.0 BACKGROUND

1.1 COMMERCIAL BANKS' CREDIT OFFICER SURVEY

Credit risk is the single largest factor affecting the soundness of financial institutions and the financial system as a whole. This results from lending being the principal business for banks. The ratio of gross loans to total assets for the quarter ended December 31, 2018 was 57.27 percent compared to 57.74 percent reported in the quarter ended September 30, 2018.

The Central Bank of Kenya (CBK) undertakes a quarterly Credit Officer Survey to identify the potential drivers of credit risk. The survey requires senior credit officers of banks to indicate their banks perception or actual position in the immediate past quarter and the subsequent quarter in terms of demand for credit, credit standards, interest rates, asset quality, credit recovery efforts, and impact of emerging developments on commercial banks' financial position and performance.

1.2 SURVEY METHODOLOGY

Senior Credit Officers[1] responsible for credit in all operating commercial banks complete the Credit Survey questionnaire. For the quarter ended December 2018, 39 operating commercial banks and 1 mortgage finance company participated in the Commercial Banks Credit Officer Survey.

The survey sought to establish the lending behavior in the banking sector in respect to all the eleven economic sectors. Questions were posed on demand for credit, standards for approving loans, interest rates, non-performing loans, the effect of capping of interest rates[2] on lending to Small and Medium sized Enterprises (SMEs), credit recovery efforts, and implementation of International Financial Reporting Standard (IFRS) 9 on Financial Instruments. The survey questions are generally phrased in terms of changes over the past three months or expected changes over the next three months.

[1] *These are officers involved in most of the credit decisions hence are able to provide reasonably accurate and complete responses from their banks perspective.*

[2] *The capping of interest rates came into effect on September 14, 2016.*

1.3 KENYAN BANKING SECTOR PERFORMANCE

The Kenyan Banking Sector recorded growth in the quarter ended December 31, 2018, compared to the quarter ended September 30, 2018. Some of the sector's performance indicators are as follows: -

- The aggregate balance sheet increased by 0.91 percent from Ksh.4.41 trillion in September 2018 to Ksh.4.45 trillion in December 2018. The increase was attributed to increased investment in local currency loans, balances at CBK and cash during the period.

- Gross loans increased by 1.18 percent from Ksh.2.54 trillion in September 2018 to Ksh.2.57 trillion in December 2018. The growth in gross loans was mainly due to increased advances in the Transport and Communication, Mining and Quarrying, and Tourism, Restaurant and Hotels sectors.

- Total deposits increased by 2.78 percent from Ksh.3.24 trillion in September 2018 to Ksh.3.33 trillion in December 2018. This was attributed to an increase in the amount of local currency deposits as a result of intensified deposit mobilizations by banks during the period.

- The ratio of gross non-performing loans to gross loans decreased from 12.52 percent in September 2018 to 12.03 percent in December 2018. The decrease in NPLs was mainly on account of repayments and recoveries during the quarter.

- The ratio of core capital to total risk-weighted assets increased from 16.15 percent in September 2018 to 17.23 percent in December 2018. The increase in core capital (10.23 percent) was higher than the increase in total risk weighted assets (3.34 percent). The total capital to total risk-weighted assets ratio also increased from 17.45 percent in September 2018 to 18.66 percent in December 2018. The core and total capital adequacy ratios were above the statutory minimums of 10.5 percent and 14.5 percent respectively.

- Core capital increased from Ksh.547.54 billion in September 2018 to Ksh.603.58 billion in December 2018. Total capital increased from Ksh.591.67 billion in September 2018 to Ksh.653.59 billion in December 2018.

- Profit before tax decreased by 4.77 percent to Ksh.37.15 billion in the quarter ended December 2018 from Ksh.39.01 billion in the quarter ended September 2018. Return on Assets increased marginally to 2.69 percent in December 2018 from 2.67 percent in September 2018. This is attributed to an increase in Total Assets during the period.

- Return on Equity decreased to 22.50 percent in December 2018 from 22.85 percent in September 2018. There was a higher increase in shareholders' funds (Ksh.56.65 million) compared to the decrease in profitability (Ksh.5.34 million) between the two periods.

- The average liquidity ratio in December 2018 was 48.60 percent. This was 0.62 percent higher than the liquidity level recorded in September 2018 (47.98 percent).

1.4 SUMMARY OF CREDIT OFFICER SURVEY FINDINGS

- **Demand for credit:** In the fourth quarter of 2018, the perceived demand for credit remained unchanged in nine economic sectors. Demand for credit in Trade and Personal/Household sectors increased. Internal financing, issuance of debt securities and equity are the main factors that contributed to the unchanged demand for credit.

- **Credit Standards[3]** remained unchanged in ten economic sectors in the fourth quarter of 2018 except in Real Estate sector where the credit standards were tightened.

- **Level of Interest Rates:** In the fourth quarter of 2018, 10 percent of the respondents indicated that their banks decreased their interest rates; whereas 90 percent of the respondents indicated that their banks held their interest rates constant.

- **Lending to Small and Medium-sized Enterprises (SMEs):** 51 percent of the commercial banks indicated that interest rate capping has positively affected their lending to SMEs whereas 49 percent of the respondents indicated that it had a negative effect.

- **Non-Performing Loans:** During the quarter under review, the respondents indicated that the level of NPLs remained unchanged in seven economic sectors. The level of NPLs in trade sector decreased whereas in the Transport and Communication and Real Estate sectors, the level of NPLs increased.

- **Expected Non-Performing Loans levels during the next quarter:** 42 percent of the respondents expect the level of NPLs to fall in the first quarter of 2019. This is attributed to enhanced recovery efforts being implemented by most banks. 26 percent of respondents expect NPLs to remain constant whereas 32 percent expect the levels to rise.

- **Credit Recovery Efforts:** For the quarter ended March 31, 2019, banks expect to intensify their credit recovery efforts in nine of the eleven economic sectors. The sectors whose credit recovery efforts are expected to remain unchanged are Mining and Quarrying, and Energy and Water sectors.

  The intensified recovery efforts are aimed at improving the overall quality of the asset portfolio. This is in line with the banks expectations of a conducive business environment during the first quarter of 2019.

- **International Financial Reporting Standard (IFRS) 9 on Financial Instruments:** Implementation of IFRS 9 has made the commercial banks to put more emphasis on secured lending, tighten their credit standards and enhance definitions of probabilities of default.

[3]*Credit standards are guidelines used by commercial banks in determining whether to extend a loan to an applicant.*

2.0 SURVEY FINDINGS

2.1 Demand for Credit

- In the fourth quarter of 2018, the perceived demand for credit remained unchanged in nine economic sectors. Demand for credit in Trade and Personal/ Household sectors increased since the level of credit uptake, during the festive season, was high in the two sectors.
- **Chart 1 and Table 1** below presents the trend in the demand for credit in the quarter.

Chart 1: Demand for Credit

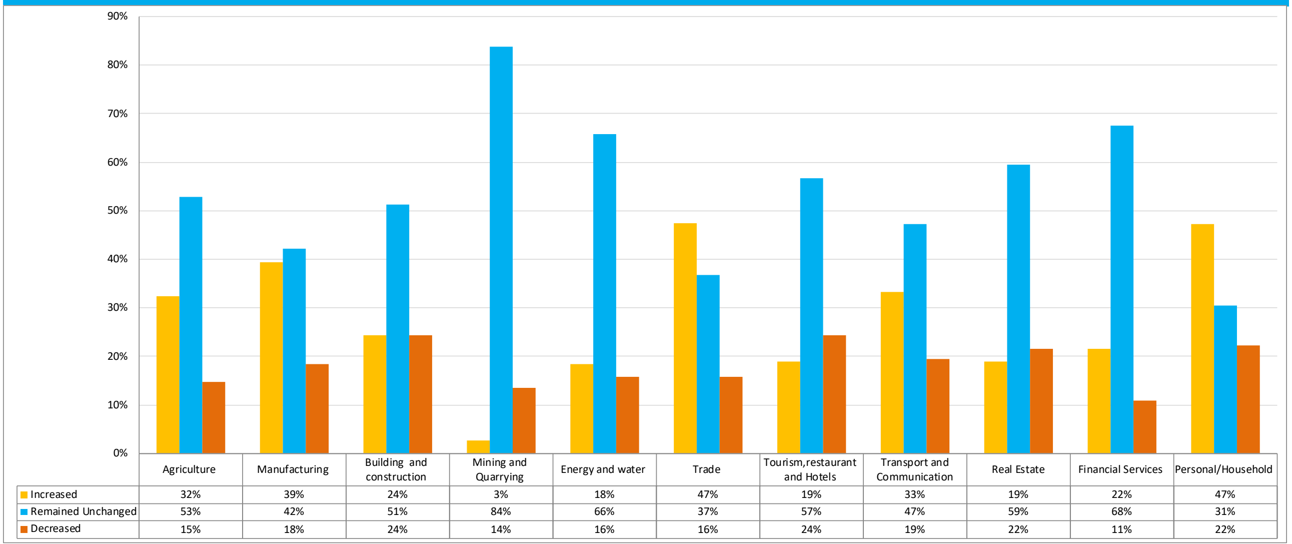


Table 1: Change in Demand for Credit

	September 2018			December 2018		
	Increased	Remained Unchanged	Decreased	Increased	Remained Unchanged	Decreased
Agriculture	24%	65%	11%	32%	53%	15%
Manufacturing	37%	50%	13%	39%	42%	18%
Building and Construction	36%	58%	6%	24%	51%	24%
Mining and Quarrying	11%	84%	5%	3%	84%	14%
Energy and Water	24%	63%	13%	18%	66%	16%
Trade	47%	42%	11%	47%	37%	16%
Tourism, Restaurant and Hotels	30%	62%	8%	19%	57%	24%
Transport and Communication	26%	63%	11%	33%	47%	19%
Real Estate	28%	58%	14%	19%	59%	22%
Financial Services	20%	69%	11%	22%	68%	11%
Personal/Household	38%	49%	14%	47%	31%	22%

2.2 Factors Affecting Demand for Credit

- In the quarter ended December 31, 2018, all factors affecting demand for credit did not have any impact on demand for credit as indicated in **Chart 2 and Table 2**
- Internal Financing, issuance of debt securities, retention of CBR and issuance of equity were cited as having had the least impact on the demand for credit during the quarter under review. This was reported by 86 percent, 81 percent, 78 percent and 78 percent of the respondents respectively.

Chart 2: Factors affecting Demand for Credit

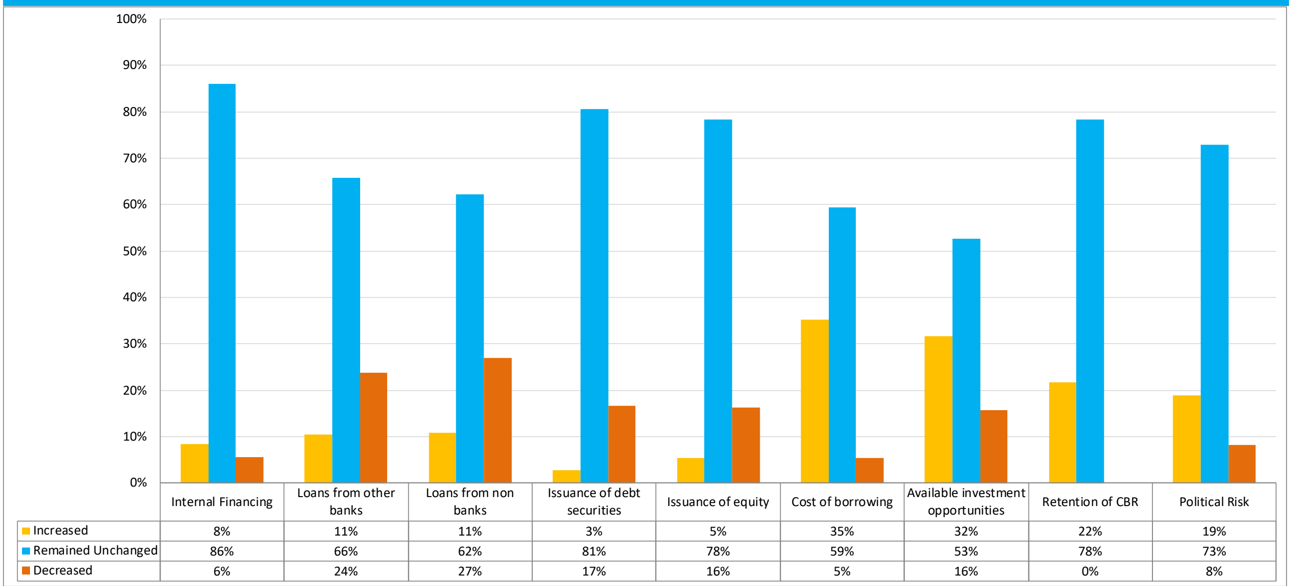


Table 2: Factors Affecting Demand for Credit

	September 2018			December 2018		
	Increased	Remained Unchanged	Decreased	Increased	Remained Unchanged	Decreased
Internal Financing	6%	91%	3%	8%	86%	6%
Loans from other banks	5%	76%	19%	11%	66%	24%
Loans from non-banks	3%	64%	33%	11%	62%	27%
Issuance of debt securities	3%	88%	9%	3%	81%	17%
Issuance of equity	3%	86%	11%	5%	78%	16%
Cost of borrowing	36%	61%	3%	35%	59%	5%
Available investment opportunities	19%	64%	17%	32%	53%	16%
Reduction of CBR	27%	73%	0%	22%	78%	0%
Political Risk	9%	71%	20%	19%	73%	8%

2.3 Credit Standards

- Credit Standards remained unchanged in ten economic sectors in the fourth quarter of 2018 except in Real Estate sector where the credit standards were tightened in order to reduce the level of NPLs in the sector. The other sectors that witnessed some tightening of credit standards were Building and Construction, and Transport and communication.
- This is presented in **Chart 3 and Table 3** below.

Chart 3: Credit Standards

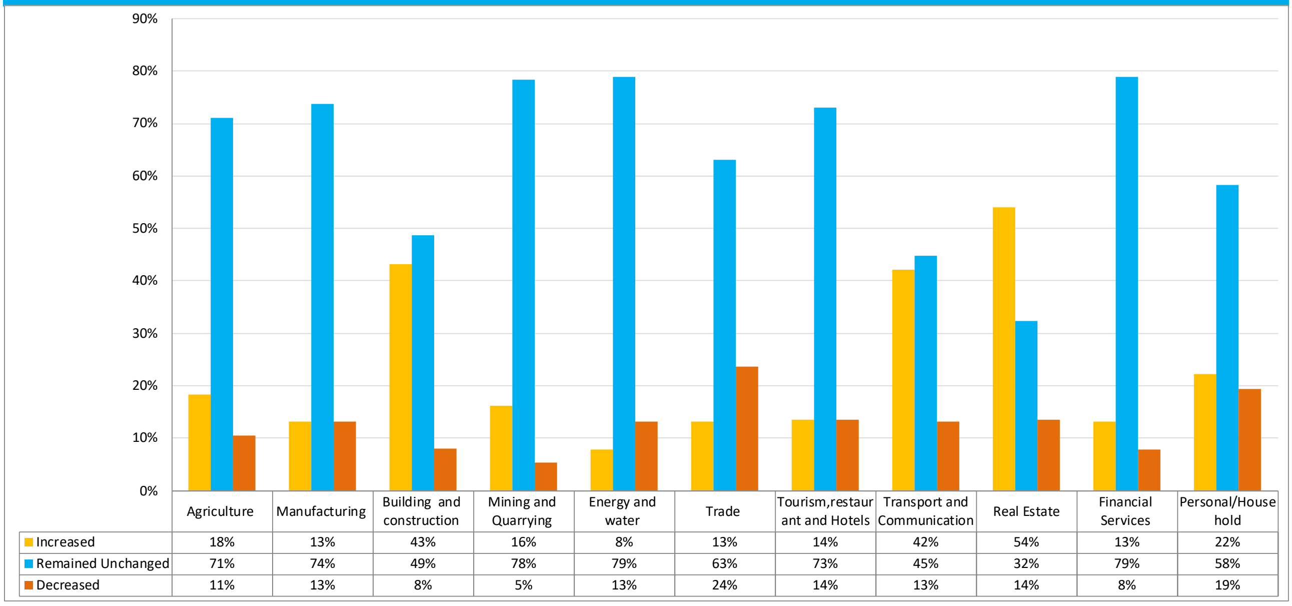


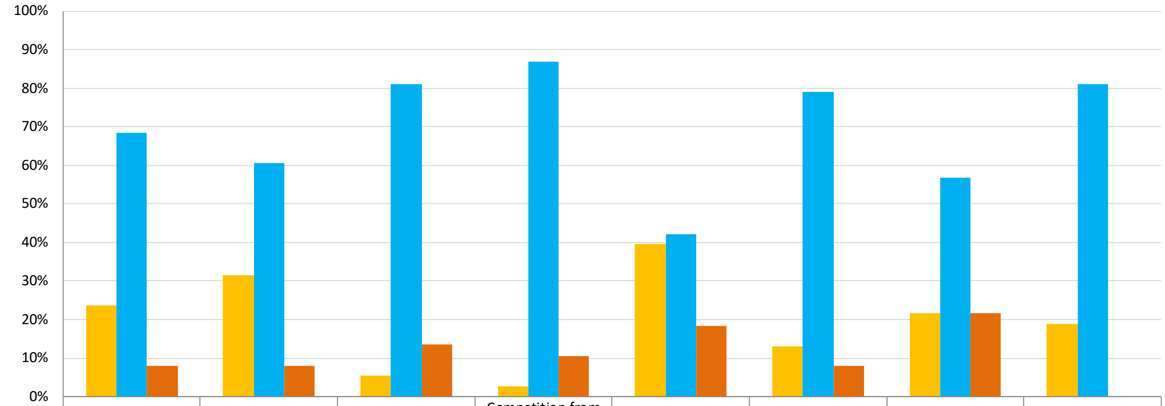
Table 3: Credit Standards for Loans to Various Economic Sectors

	September 2018			December 2018		
	Tightened	Remained Unchanged	Eased	Tightened	Remained Unchanged	Eased
Agriculture	8%	87%	5%	18%	71%	11%
Manufacturing	13%	76%	11%	13%	74%	13%
Building and Construction	38%	59%	3%	43%	49%	8%
Mining and Quarrying	11%	84%	5%	16%	78%	5%
Energy and Water	8%	87%	5%	8%	79%	13%
Trade	13%	71%	16%	13%	63%	24%
Tourism, Restaurant and Hotels	14%	78%	8%	14%	73%	14%
Transport and Communication	29%	63%	8%	42%	45%	13%
Real Estate	46%	51%	3%	54%	32%	14%
Financial Services	13%	82%	5%	13%	79%	8%
Personal/Household	24%	57%	19%	22%	58%	19%

2.4 Factors Affecting Credit Standards

- During the quarter ended December 2018, all eight factors had little or no impact on credit standards.
- Competition from Saccos, Microfinance banks and other Credit Providers are the major factors that made the commercial banks exercise caution in extending credit facilities.
- A comparison of the trend in the factors affecting the banks' credit standards are shown in **Chart 4 and Table 4.**

Chart 4: Factors affecting credit standards



	Bank's cost of funds & Balance sheet constraints	Constraints relating to Bank's capital position	Competition from other banks	Competition from DTMs, Saccos, & other Credit Providers	Expectations regarding general economic activity	Retention of CBR	Political Risk	Investment in Government Securities
Tightened	24%	32%	5%	3%	39%	13%	22%	19%
Remained unchanged	68%	61%	81%	87%	42%	79%	57%	81%
Eased	8%	8%	14%	11%	18%	8%	22%	0%

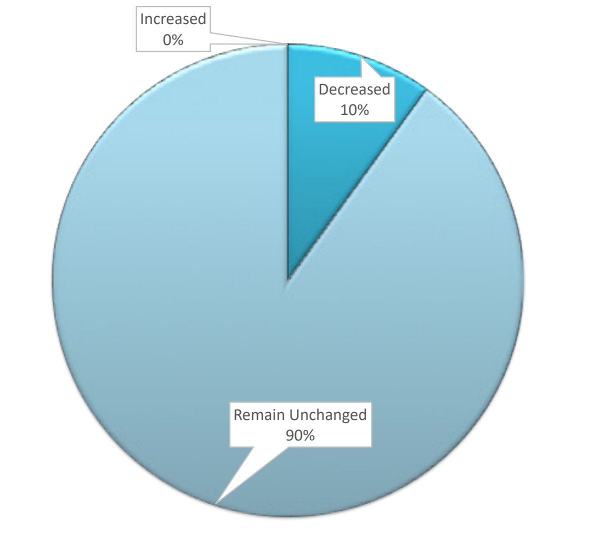
Table 4: Factors affecting credit standards

	September 2018			December 2018		
	Tightened	Remained Unchanged	Eased	Tightened	Remained Unchanged	Eased
Bank's cost of funds & Balance sheet constraints	21%	71%	8%	24%	68%	8%
Constraints relating to Bank's capital position	24%	68%	8%	32%	61%	8%
Competition from other banks	5%	84%	11%	5%	81%	14%
Competition from DTMs, Saccos, and other Credit Providers	3%	89%	8%	3%	87%	11%
Expectations regarding general economic activity	42%	42%	16%	39%	42%	18%
Reduction of Central Bank Rate (CBR)	11%	84%	5%	13%	79%	8%
Political Risk	27%	54%	19%	22%	57%	22%
Investment in Government Securities	21%	79%	0%	19%	81%	0%

2.5 Interest Rate Movements

- In the fourth quarter of 2018, 90 percent of the respondents indicated that their banks held their interest rates constant whereas 10 percent of the respondents indicated that their banks decreased their interest rates. This was as a result of retention of CBR at 9 percent during the quarter.
- The interest rate movements in the quarter under review are depicted in **Chart 5** below.

Chart 5: Interest Rate Movements



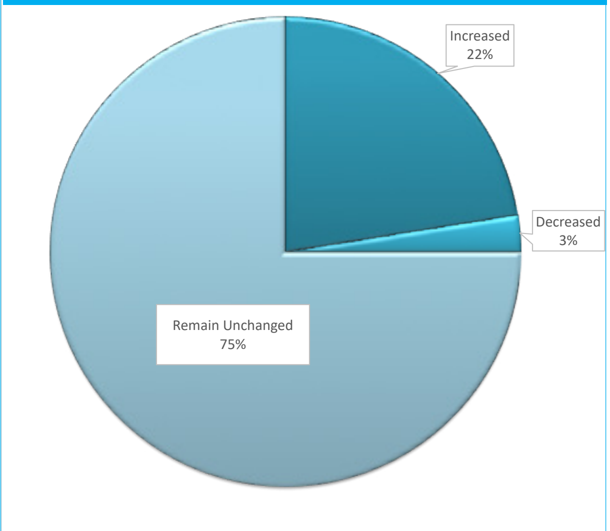
2.6 Capping of Interest Rates

- With the interest rate capping effective September 2016, the credit survey sought to find out the impact it had on demand for credit, lending to SMEs, actual credit granted over the quarter ended December 31, 2018 and the expectations of changes over the next three months.
- The survey also sought to find out how NPLs in the first quarter of 2019 will be affected by the interest rate capping.

2.6.1 Effect of Interest Rate Capping on Demand for Credit

- 75 percent of the respondents indicated that despite interest rate capping the demand for credit remained unchanged while 22 percent noted that demand for credit increased due to cheaper credit.
- 3 percent of the respondents noted that demand for credit decreased. This is depicted in **Chart 6** below.

Chart 6: Interest Rate Cap Effect on Demand for Credit over the past Quarter



2.6.2 Impact of Interest Rate Capping on Actual Credit Granted

- 74 percent of the respondents were of the view that interest rate capping had little or no effect on the actual credit granted. 18 percent of the respondents indicated that the actual credit granted decreased while 8 percent of the respondents indicated that the actual credit granted increased as depicted in **Chart 7.**

Chart 7: Interest Rate Cap Effect on Actual New Credit Granted

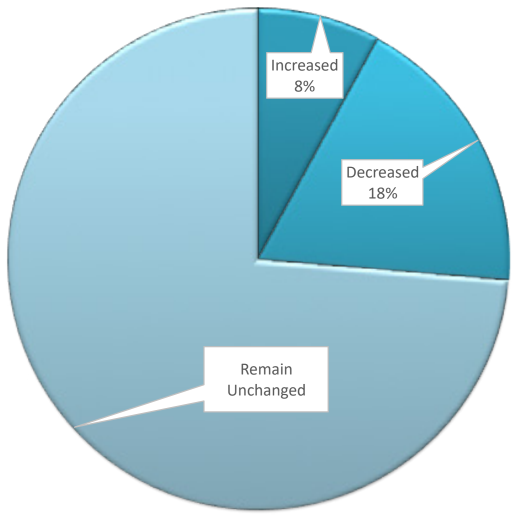
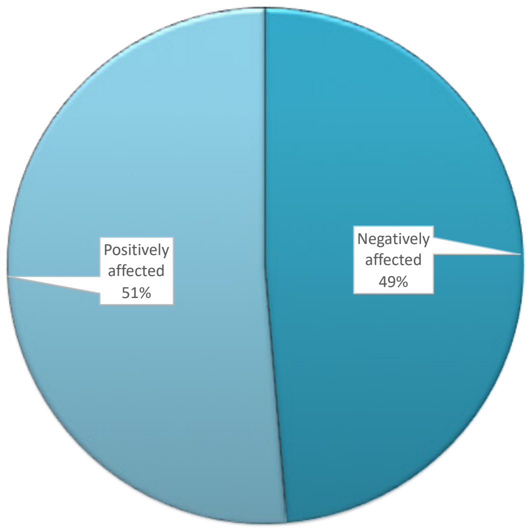


Chart 8: Effects of Interest Rate Capping to Lending to SMEs



2.6.3 Effect of Interest Rate Capping on Lending to SMEs over the past Quarter

- In the quarter ended December 31, 2018, 51 percent of the respondents indicated that interest rate capping had positively affected their lending to SMEs whereas 49 percent of the respondents indicated that it had a negative effect. This is in contrast to the quarter ended September 2018 where 51 percent of the respondents indicated that capping had negatively affected their lending to SMEs whereas 49 percent of the respondents indicated that it had a positive effect. This is indicated in **Chart 8.**

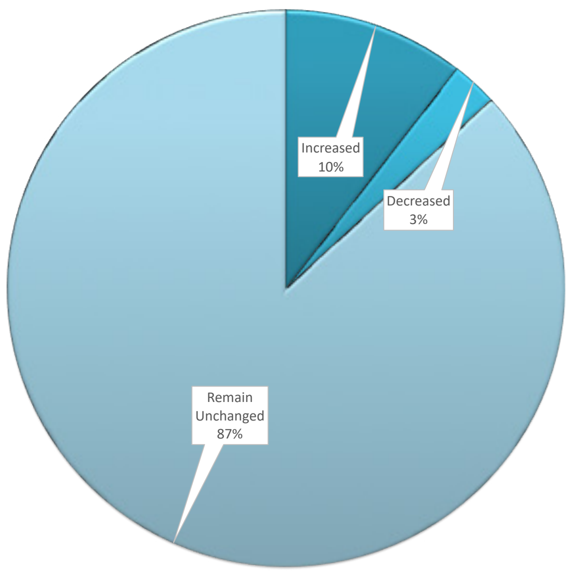
2.6.4 Interest Rate Cap Effect on Demand for Credit in First Quarter of 2019

- With regards to the expected demand for credit in the first quarter of 2019, 87 percent of the respondents anticipate that interest rate capping will have little or no impact on the demand for credit.

- However, 10 percent of the respondents felt that interest capping will lead to an increase in demand for credit.

- 3 percent of the respondents felt that the demand for credit will decrease. The expected movement on demand for credit in the third quarter is shown in **Chart 9.**

Chart 9: Interest Rate Cap Effect on Demand for Credit Over the Next Three Months

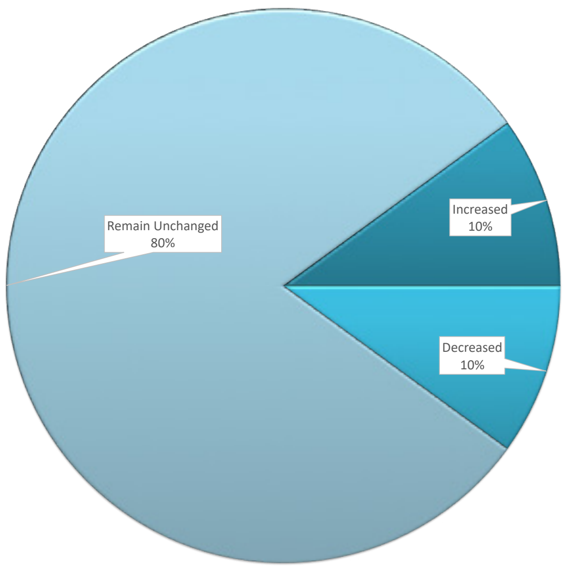


2.6.5 Effect of Interest Rate Capping on Actual New Credit over the first quarter of 2019

- In the first quarter of 2019, 80 percent of the respondents anticipate that the interest rate capping will have little or no impact on actual credit advanced. The respondents attributed this to tightened credit standards following the capping of interest rates.

- However, 10 percent felt that the new credit advanced would decrease. This was similar to the respondents who felt that credit advanced would increase. This is as indicated in **Chart 10**.

Chart 10: Interest rate cap effect on actual new credit granted over the next three months



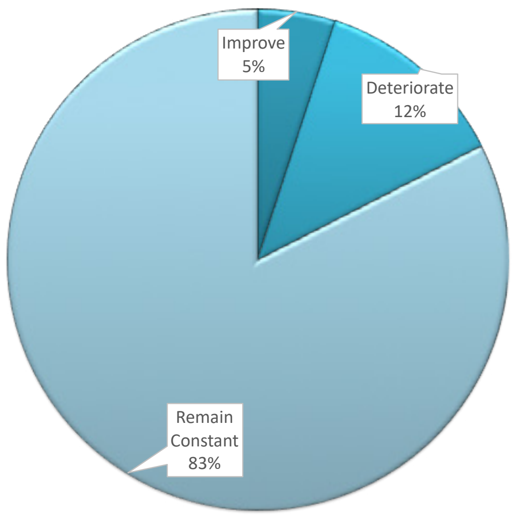
2.6.6 Expected Effect of Interest Rate Capping on the Level of NPLs

- In the first quarter of 2019, 83 percent of the respondents are of the view that the NPLs would remain constant since the pricing of the loans has no impact on repayment ability.

- 12 percent of the respondents indicated that NPLs would deteriorate.

- 5 percent of the respondents expect the capping of interest rates to have a positive impact on NPLs. Respondents have attributed this to the current favorable interest rates, which led to cheaper credit as indicated in **Chart 11** below.

Chart 11: Effect of interest rate capping on NPLs over the past quarter



2.7 Non-Performing Loans (NPLs)

2.7.1 Non - Performing Loans during the quarter ended December 31, 2018

- During the quarter under review, the respondents indicated that the levels of NPLs remained unchanged in seven economic sectors.

- The level of NPLs in Trade sector decreased whereas in Transport and Communication, and Real Estate sectors the level of NPLs increased.

- In Personal/Household sector there was an equal number of responses indicating that non-performing loans would rise and remain unchanged in the sector. This is depicted in **Chart 12** and **Table 5**.

Chart 12: Non-Performing Loans

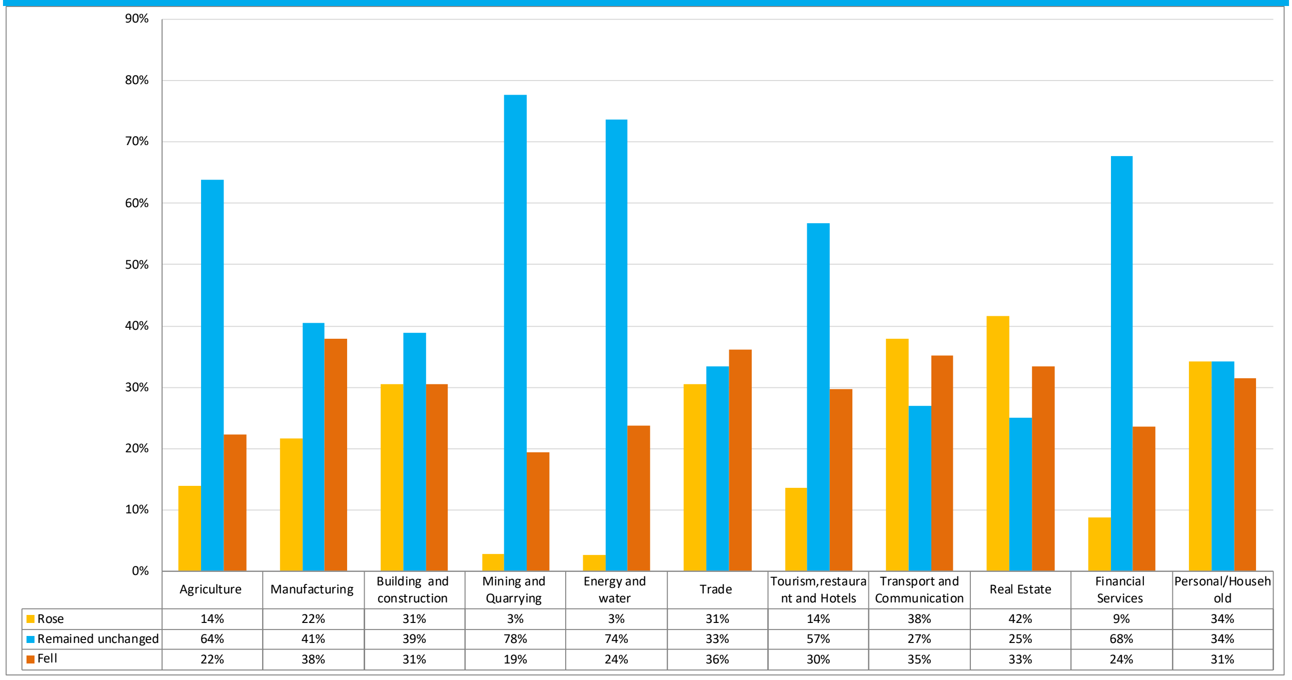


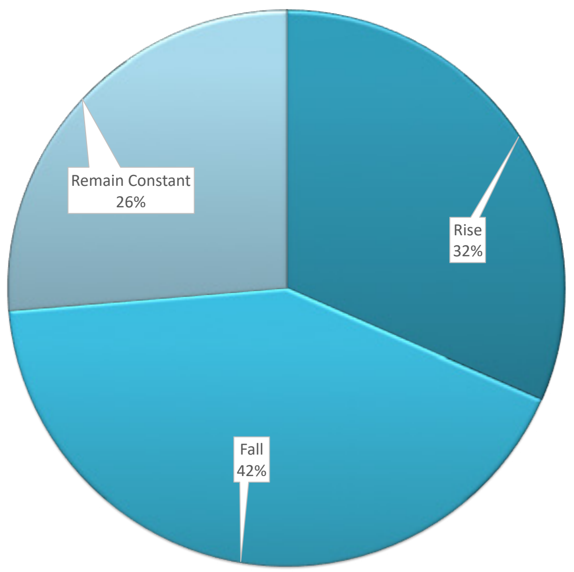
Table 5: Non Performing Loans Trend Per Economic Sector

	September 2018			December 2018		
	Rose	Remained Unchanged	Fell	Rose	Remained Unchanged	Fell
Agriculture	5%	76%	19%	14%	64%	22%
Manufacturing	18%	58%	24%	22%	41%	38%
Building and Construction	35%	41%	24%	31%	39%	31%
Mining and Quarrying	6%	83%	11%	3%	78%	19%
Energy and Water	5%	81%	14%	3%	74%	24%
Trade	30%	41%	30%	31%	33%	36%
Tourism, Restaurant and Hotels	6%	67%	28%	14%	57%	30%
Transport and Communication	30%	51%	19%	38%	27%	35%
Real Estate	39%	42%	19%	42%	25%	33%
Financial Services	8%	69%	22%	9%	68%	24%
Personal/Household	35%	46%	19%	34%	34%	31%

2.7.2 Expected Non Performing Loans Levels during the first quarter of 2019

- 42 percent of the respondents expect the level of NPLs to fall in the first quarter of 2019. This is attributed to enhanced recovery efforts being implemented by most banks. 24 percent of respondents expect NPLs to remain constant whereas 31 percent expect the levels to rise. This is depicted in **Chart 13.**

Chart 13: Expected movements of NPLs



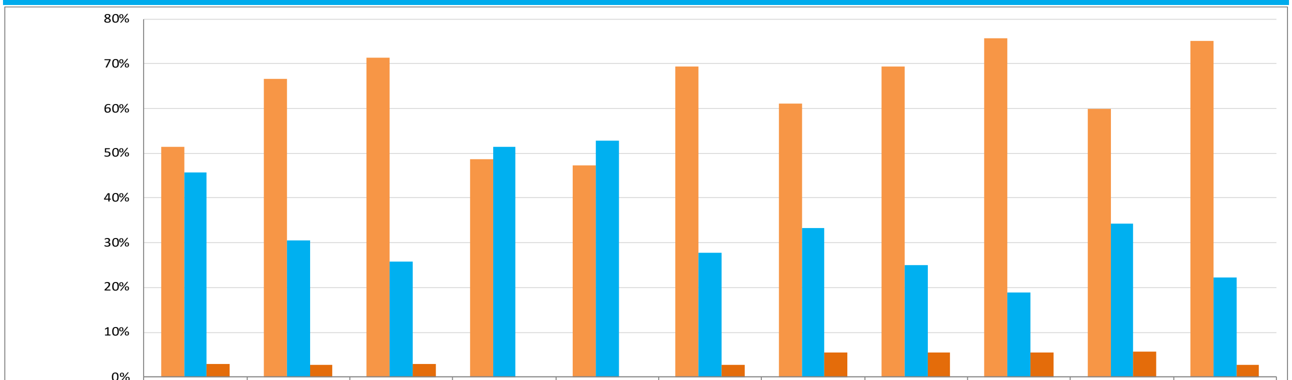
2.8 Credit Recovery Efforts in the first quarter of 2019

- For the quarter ended March 31, 2019, banks expect to intensify their credit recovery efforts in nine of the eleven economic sectors. The sectors whose Credit recovery efforts are expected to remain unchanged are Mining and Quarrying, and Energy and Water sectors since the level of bad debts in these sectors is low.

- The intensified recovery efforts are aimed at improving the overall quality of the asset portfolio. This is in line with the banks expectations of a conducive business environment during the first quarter of 2019.

- The responses on the expected credit recovery efforts by the banks are depicted in **Chart 14 and Table 6.**

Chart 14: Credit Recovery Efforts



	Agriculture	Manufacturing	Building and construction	Mining and Quarrying	Energy and water	Trade	Tourism,restaurant and Hotels	Transport and Communication	Real Estate	Financial Services	Personal/Household
Intensify	51%	67%	71%	49%	47%	69%	61%	69%	76%	60%	75%
Remain constant	46%	31%	26%	51%	53%	28%	33%	25%	19%	34%	22%
Ease	3%	3%	3%	0%	0%	3%	6%	6%	5%	6%	3%

Table 6: Credit Recovery Efforts

	September 2018			December 2018		
	Intensified	Remained Unchanged	Eased	Intensified	Remained Unchanged	Eased
Agriculture	56%	44%	0%	51%	46%	3%
Manufacturing	68%	32%	0%	67%	31%	3%
Building and Construction	75%	25%	0%	71%	26%	3%
Mining and Quarrying	46%	54%	0%	49%	51%	0%
Energy and Water	51%	49%	0%	47%	53%	0%
Trade	76%	24%	0%	69%	28%	3%
Tourism, Restaurant and Hotels	62%	35%	3%	61%	33%	6%
Transport & Communication	76%	22%	3%	69%	25%	6%
Real Estate	76%	24%	0%	76%	19%	5%
Financial Services	64%	33%	3%	60%	34%	6%
Personal/Household	78%	22%	0%	75%	22%	3%

2.9 International Financial Reporting Standard (IFRS) 9 on Financial Instruments

- The International Financial Reporting Standard (IFRS) 9 on Financial Instruments became effective from January 1, 2018. This standard replaced International Accounting Standard (IAS) 39, on Financial Instruments (Recognition and Measurement).

- The main objective of IFRS 9 is to provide users of financial statements with more useful information about an entity's expected credit losses on financial instruments.

- Institutions are required to recognize expected credit losses at all times and to update the amount of expected credit losses recognized at each reporting date to reflect changes in the credit risk of financial instruments.

- Following implementation of IFRS 9 beginning January 1, 2018, the Central Bank of Kenya sought to assess: -
  i. How the implementation of IFRS 9 has impacted the commercial banks' business model, credit risk appetite and model; and
  ii. The challenges the banks have experienced in the implementation of IFRS 9 and how they have mitigated the impact.

2.9.1 Impact of IFRS 9 on Credit Risk Appetite

- Most banks have prioritized lending to low risk ventures, adopted a tight credit appraisal, ensure the facilities are well secured and the banks have changed their lending policy to align them with IFRS 9.

2.9.2 Impact of IFRS 9 on Business Model

- There is more emphasis on secured lending given that provisioning levels would increase under IFRS 9. This would reduce the banks' credit risk appetite.

- Most of the respondents indicated that implementation of IFRS 9 resulted in banks tightening their credit standards.

- Probabilities of default have been better defined and greater requirements for security and less tolerance for adverse behaviour signals in the banks portfolios.

2.9.3 Challenges experienced in the Implementation of IFRS 9

- The respondents have highlighted the challenges they have experienced in implementing IFRS 9. Some of the cited challenges include:
    - Impact on their core capital adequacy.
    - Impact on their profitability.
    - Unavailability of reliable macroeconomic data and less historical data to rely on to prepare the models required for economic overlay and sector specific.
- As a mitigation measure, banks have indicated that they are currently exploring injection of additional capital, enhancing staff capacity through training as well as reviewing their policies and procedures. These are aimed at ensuring full compliance with IFRS 9.

LIST OF RESPONDENTS

1. African Banking Corporation Ltd.
2. Bank of Africa Kenya Ltd.
3. Bank of Baroda (K) Ltd.
4. Bank of India.
5. Barclays Bank of Kenya Ltd.
6. Citibank N.A Kenya.
7. Commercial Bank of Africa Ltd.
8. Consolidated Bank of Kenya Ltd.
9. Credit Bank Ltd.
10. Co-operative Bank of Kenya Ltd.
11. Development Bank of Kenya Ltd.
12. Diamond Trust Bank (K) Ltd.
13. DIB Bank Kenya Ltd.
14. Ecobank Kenya Ltd.
15. Equity Bank Ltd.
16. Family Bank Ltd.
17. Guaranty Trust Bank (Kenya) Ltd.
18. First Community Bank Ltd.
19. Guardian Bank Ltd.
20. Gulf African Bank Ltd.
21. Habib Bank A.G Zurich.
22. I & M Bank Ltd.
23. Jamii Bora Bank Ltd.
24. KCB Bank Kenya Ltd.
25. Middle East Bank (K) Ltd.
26. Mayfair Bank Ltd.
27. National Bank of Kenya Ltd.
28. NIC Bank Plc.
29. M Oriental Bank Ltd.
30. Paramount Bank Ltd.
31. Prime Bank Ltd.
32. Standard Chartered Bank (K) Ltd.
33. SBM Bank Kenya Ltd.
34. Spire Bank Ltd.
35. Sidian Bank Ltd.
36. Stanbic Bank Kenya Ltd.
37. Transnational Bank Ltd.
38. Victoria Commercial Bank Ltd.
39. UBA Kenya Bank Ltd.
40. HFC Ltd.

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