Central Bank of Kenya

JULY - SEPTEMBER 2018

CREDIT SURVEY

CENTRAL BANK OF KENYA COMMERCIAL BANKS' CREDIT OFFICER SURVEY JULY - SEPTEMBER 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 is because lending is the principal business for banks. The ratio of gross loans to total assets for the quarter ended September 30, 2018 was 57.27 percent compared to 58.42 percent reported in the quarter ended June 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 September 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 September 30, 2018, compared to the quarter ended June 30, 2018. Some of the sector's performance indicators are as follows: -

- The aggregate balance sheet increased by 3.27 percent from Ksh.4.27 trillion in June 2018 to Ksh.4.41 trillion in September 2018. The increase was attributed to increased investment in government securities, balances at CBK and placements during the period.

- Gross loans increased by 1.84 percent from Ksh.2,492.69 billion in June 2018 to Ksh.2,538.68 billion in September 2018. The increase in gross loans was mainly due to major increase in demand for loans in the Personal/Household, Manufacturing, Trade and Real Estate sectors.

- Total deposits increased by 2.52 percent from Ksh.3.16 trillion in June 2018 to Ksh.3.24 trillion in September 2018. This was attributed to an increase in the amount of local currency deposits during the period as a result of intensified deposit mobilizations by banks during the period.

  - The ratio of gross non-performing loans to gross loans increased from 11.97 percent in June 2018 to 12.52 percent in September 2018. This was attributed to: -
  - a concluded takeover of a loan portfolio from a bank in receivership that was inactive, delayed payments by government agencies and private sector, and
  - low uptake in the property market.

- The ratio of core capital to total risk-weighted assets decreased from 16.55 percent in June 2018 to 16.15 percent as at September 2018. The increase in core capital (0.49 percent) was lower than the increase in total risk weighted assets (2.96 percent). The total capital to total risk-weighted assets ratio decreased from 17.97 percent in June 2018 to 17.45 percent in

September 2018. The core and total capital adequacy ratios remained above the statutory minimums of 10.5 percent and 14.5 percent respectively.

- Core capital increased from Ksh.544.87 billion in June 2018 to Ksh.547.54 billion in September 2018. Total capital decreased marginally from Ksh.591.81 billion in June 2018 to Ksh.591.67 billion in September 2018.

- Profit before tax increased by 9.84 percent to Ksh.15.06 billion in the quarter ended September 2018 from Ksh.13.71 billion in the quarter ended June 2018. Return on Assets decreased to 2.67 percent in September 2018 from 2.75 percent in June 2018. This was attributed to a higher increase in total assets (Ksh.148.03 million) as compared to the increase in profitability (Ksh.1.35 million).

- Return on Equity decreased to 22.85 percent in September 2018 from 23.73 percent in June 2018. There was a higher increase in shareholders' funds (Ksh.30.16 million) compared to the increase in profitability (Ksh.1.35 million) between the two periods.

- The average liquidity ratio in September 2018 was 47.98 percent the same level recorded in June 2018.

1.4 SUMMARY OF CREDIT OFFICER SURVEY FINDINGS

- **Demand for credit:** In the third quarter of 2018, the perceived demand for credit remained unchanged in ten sectors. However, demand for credit increased in the Trade sector with respondents attributing this to an increased demand for consumer goods and services.

- **Credit Standards[3]** remained unchanged in all economic sectors in the third quarter of 2018.

- Competition from Microfinance banks, Saccos, other credit providers, and other banks have made the commercial banks exercise caution in extending credit facilities to all sectors.

- **Level of Interest Rates:** In the third quarter of 2018, 74 percent of the respondents indicated that they decreased their interest rates; whereas 26 percent of the respondents indicated that their interest rates remained unchanged.

  It is worth noting that the reduction of the Central Bank Rate (CBR) to 9 percent from 9.5 percent on July 30, 2018 played a key role in the reduction of interest rates in the quarter.

- **Lending to Small and Medium-sized Enterprises (SMEs):** 51 percent of the respondents indicated that interest rate capping has negatively affected their lending to SMEs whereas 49 percent of the respondents indicated that they have experienced a positive effect on the same.

- **Non-Performing Loans:** During the quarter under review, the level of NPLs remained unchanged in all the eleven economic sectors. This was attributed to the effect of the challenging business environment in the third quarter of 2018.

- **Expected Non-Performing Loans levels during the next quarter:** Generally, the commercial banks expect a drop in the levels of NPLs in the fourth quarter of 2018 with 45 percent of the respondents indicating so. The expected drop in NPLs is attributed to the intensified recovery efforts implemented by most banks to recover Non-Performing Loans on the sectors with the highest levels.

- **Credit Recovery Efforts:** The banks expect to intensify their credit recovery efforts in ten of the eleven economic sectors. The sector whose credit recovery efforts are expected to remain unchanged is Mining and Quarrying sector.

  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 fourth quarter of 2018.

- **International Financial Reporting Standard (IFRS) 9 on Financial Instruments:**
  Implementation of IFRS 9 has made the commercial banks to focus on short term trade facilitation and a mix of short term secured facilities.

[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 third quarter of 2018, the perceived demand for credit remained unchanged in ten economic sectors. Demand for credit in Trade sector increased.
- Internal financing, isssuance of debt securities and equity are the major factors that had no impact on demand for credit.
- **Chart 1** and **Table 1** below present the trend in the demand for credit in the quarter.

Chart 1: Demand for Credit

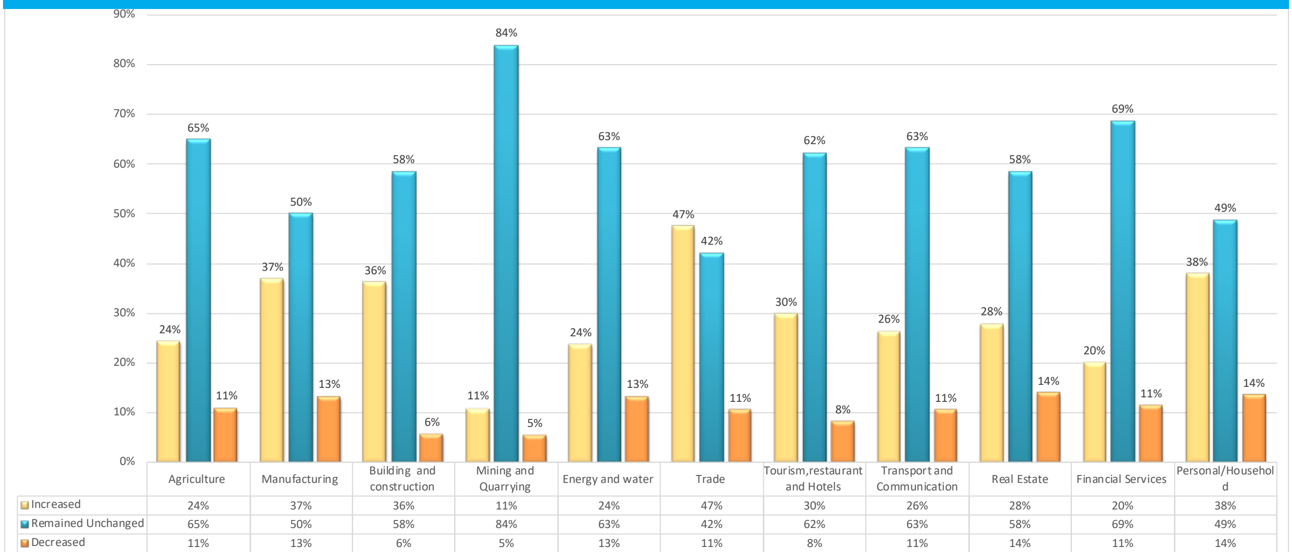


Table 1: Change in Demand for Credit

	June 2018			September 2018		
	Increased	Remained Unchanged	Decreased	Increased	Remained Unchanged	Decreased
Agriculture	26%	58%	16%	24%	65%	11%
Manufacturing	26%	62%	13%	37%	50%	13%
Building and Construction	32%	55%	13%	36%	58%	6%
Mining and Quarrying	8%	84%	8%	11%	84%	5%
Energy and Water	28%	62%	10%	24%	63%	13%
Trade	44%	44%	13%	47%	42%	11%
Tourism, Restaurant and Hotels	29%	58%	13%	30%	62%	8%
Transport and Communication	23%	56%	21%	26%	63%	11%
Real Estate	21%	58%	21%	28%	58%	14%
Financial Services	18%	71%	11%	20%	69%	11%
Personal/Household	32%	47%	21%	38%	49%	14%

2.2 Factors Affecting Demand for Credit

- In the quarter ended September 30, 2018, all the nine 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 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 91 percent, 88 percent and 86 percent of the respondents respectively.

- The impact of political risk and available investment opportunities on demand for credit decreased significantly between the two quarters.

Chart 1: Factors affecting Demand for Credit

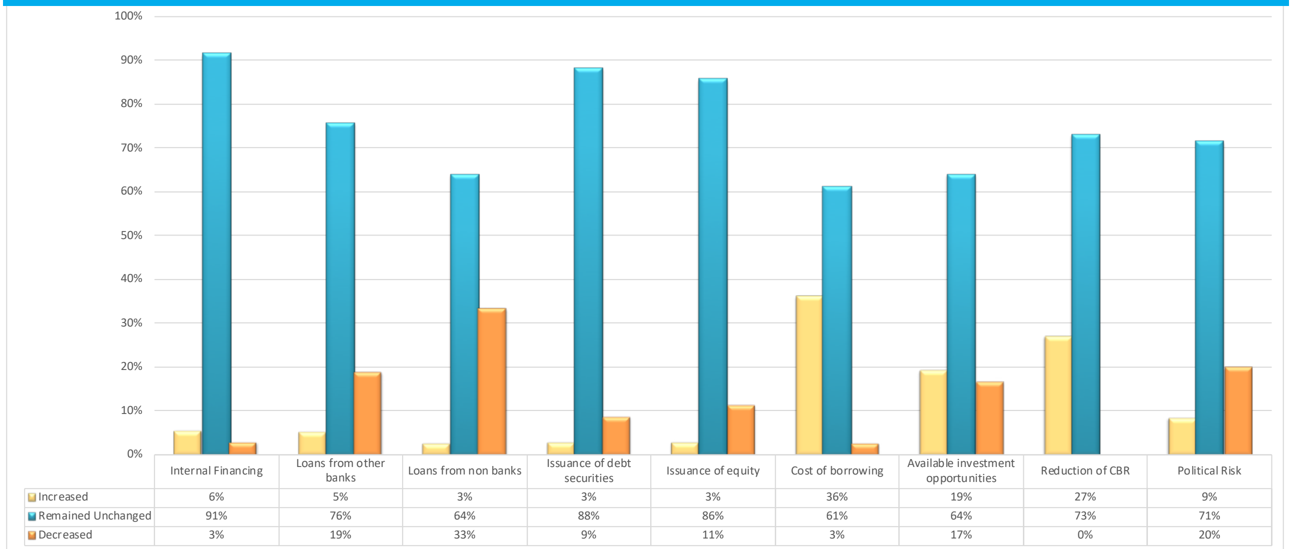


Table 2: Factors Affecting Demand for Credit

	June 2018			September 2018		
	Increased	Remained Unchanged	Decreased	Increased	Remained Unchanged	Decreased
Internal Financing	5%	84%	11%	6%	91%	3%
Loans from other banks	8%	72%	21%	5%	76%	19%
Loans from non-banks	3%	66%	32%	3%	64%	33%
Issuance of debt securities	3%	89%	8%	3%	88%	9%
Issuance of equity	5%	84%	11%	3%	86%	11%
Cost of borrowing	36%	59%	5%	36%	61%	3%
Available investment opportunities	32%	50%	18%	19%	64%	17%
Reduction of CBR	33%	64%	3%	27%	73%	0%
Political Risk	18%	50%	32%	9%	71%	20%

2.3 Credit Standards

Credit Standards remained unchanged in all economic sectors in the third quarter of 2018 unlike in the second quarter of 2018 where credit standards in ten sectors remained unchanged.

- These responses are presented in **Chart 3** and **Table 3.**

Chart 3: Credit Standards

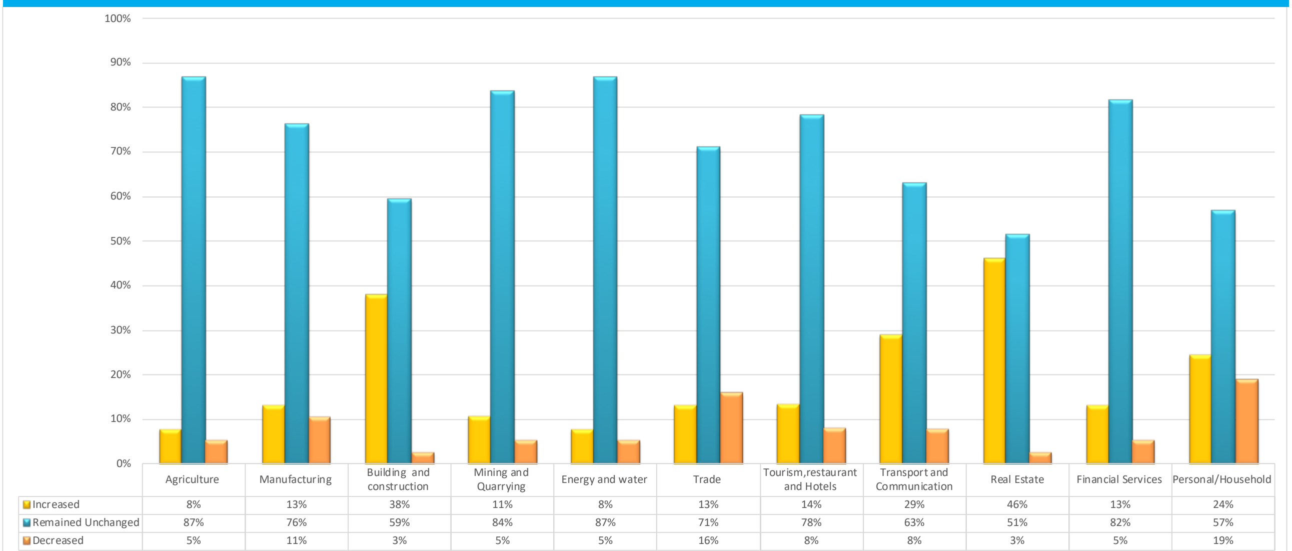


Table 3: Credit Standards for Loans to Various Economic Sectors

	June 2018			September 2018		
	Tightened	Remained Unchanged	Eased	Tightened	Remained Unchanged	Eased
Agriculture	23%	72%	5%	8%	87%	5%
Manufacturing	24%	68%	8%	13%	76%	11%
Building and Construction	39%	55%	5%	38%	59%	3%
Mining and Quarrying	16%	82%	3%	11%	84%	5%
Energy and Water	13%	85%	3%	8%	87%	5%
Trade	18%	69%	13%	13%	71%	16%
Tourism, Restaurant and Hotels	26%	68%	5%	14%	78%	8%
Transport and Communication	36%	56%	8%	29%	63%	8%
Real Estate	53%	42%	5%	46%	51%	3%
Financial Services	18%	77%	5%	13%	82%	5%
Personal/Household	30%	54%	16%	24%	57%	19%

2.4 Factors Affecting Credit Standards

- During the quarter ended September 2018, seven factors had little or no impact on credit standards. However, 42 percent of the respondents' indicated that expectations regarding general economic activity led to tightened credit standards. However, 42 percent of the respondents indicated that this had no impact.

- Competition from other banks, Saccos, Micro finance 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

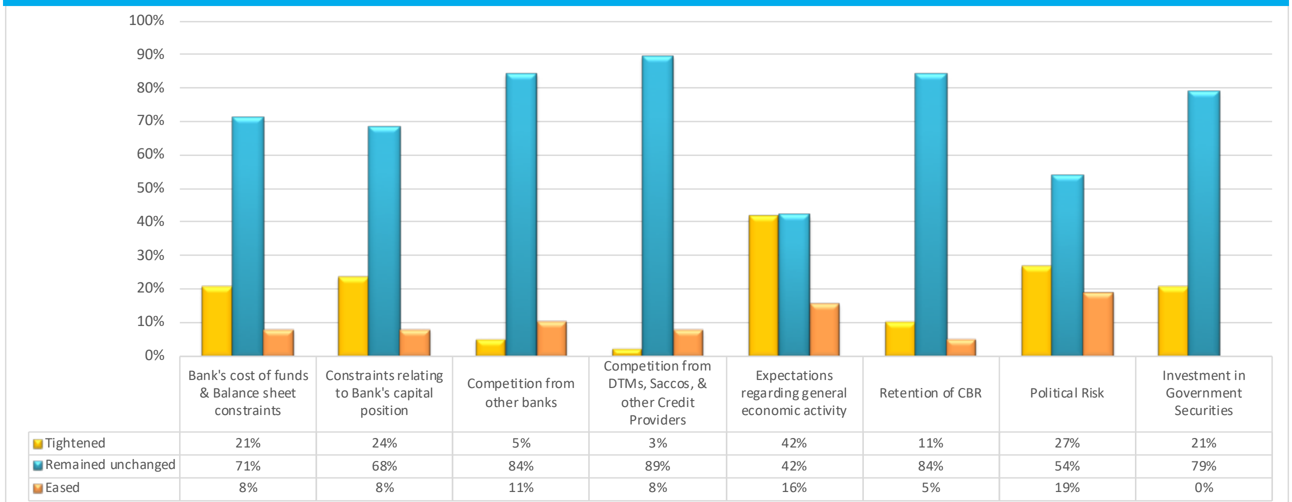


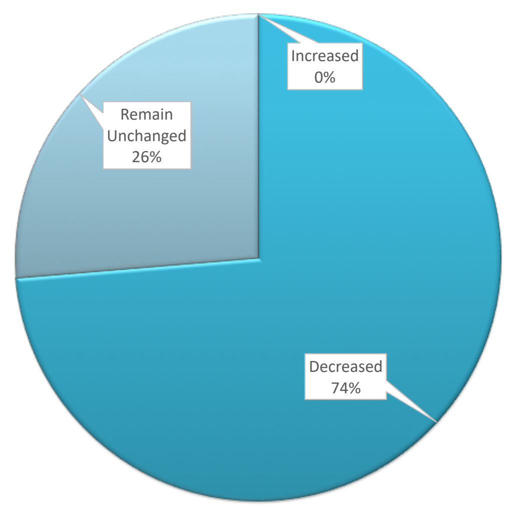
Table 4: Factors affecting credit standards

	June 2018			September 2018		
	Tightened	Remained Unchanged	Eased	Tightened	Remained Unchanged	Eased
Bank's cost of funds & Balance sheet constraints	26%	62%	13%	21%	71%	8%
Constraints relating to Bank's capital position	31%	64%	5%	24%	68%	8%
Competition from other banks	0%	92%	8%	5%	84%	11%
Competition from DTMs, Saccos, and other Credit Providers	3%	90%	8%	3%	89%	8%
Expectations regarding general economic activity	33%	44%	23%	42%	42%	16%
Reduction of Central Bank Rate (CBR)	10%	87%	3%	11%	84%	5%
Political Risk	33%	49%	18%	27%	54%	19%
Investment in Government Securities	23%	72%	5%	21%	79%	0%

2.5 Interest Rate Movements

- In the third quarter of 2018, 74 percent of the respondents indicated that their banks decreased their interest rates; whereas 26 percent of the respondents indicated that their banks held their interest rates constant.
- This is as a result of reduction in capped interest rates to 13.0 percent in July 30, 2018.
- The interest rate movements in the quarter under review are depicted in **Chart 5** below.

Chart 5: Interest Rate Movements



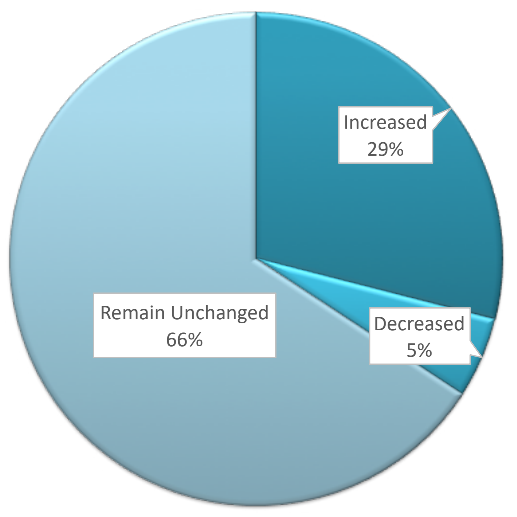
2.6 Capping of Interest Rates

- 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 September 30, 2018 and the expectations of changes over the next three months.
- The survey also sought to find out how NPLs in the fourth quarter of 2018 will be affected by the interest rate capping.

2.6.1 Effect of Interest Rate Capping on Demand for Credit

- 66 percent of the respondents indicated that despite interest rate capping the demand for credit remained unchanged while 29 percent noted that demand for credit increased who attributed this to cheaper credit.
- 5 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

- 58 percent of the respondents were of the view that interest rate capping had little or no effect on the actual credit granted. 34 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.**
- The decreased actual credit granted is as a result of the institutions inability to undertake risk based pricing in high risk segments as a result of capped interest.

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

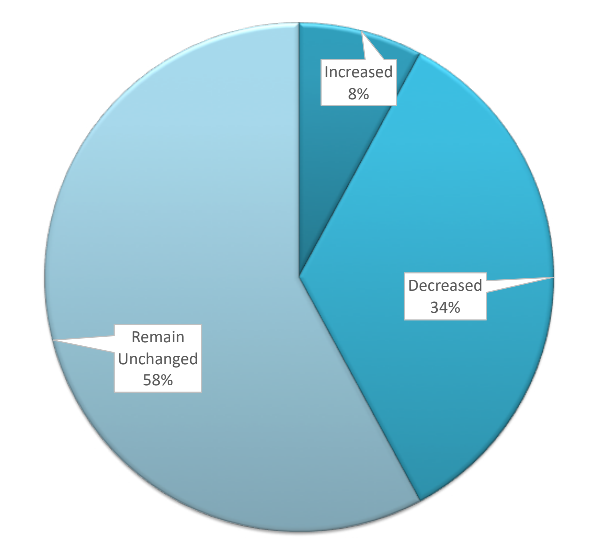
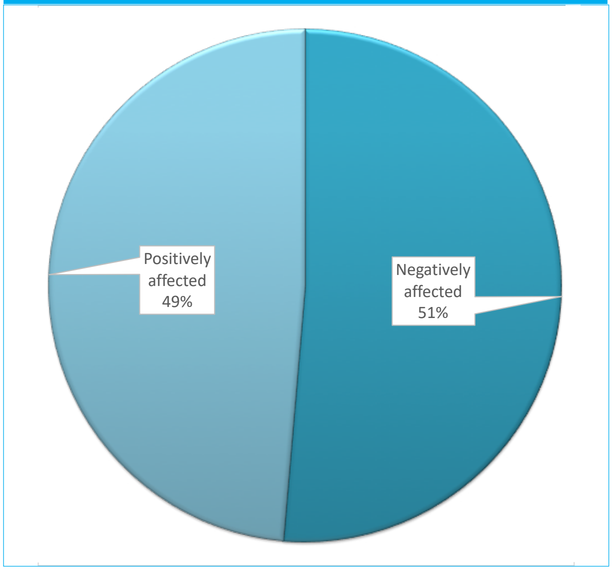


Chart 8: Effects of Interest Rate Capping to Lending to SMEs



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

- 51 percent of the commercial banks indicated that interest rate capping has 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.**

- Interest rate capping has compelled banks to increase their risk mitigation measures including the tightening of credit standards, which has led to the reduced credit facilities granted to SMEs.

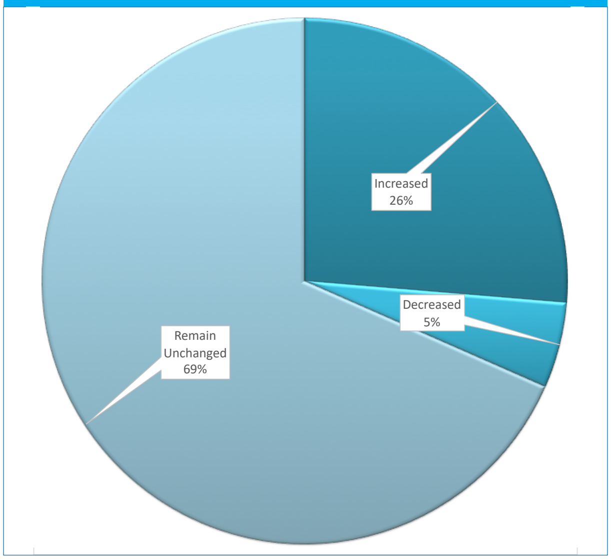
2.6.4 Interest Rate Cap Effect on Demand for Credit in Fourth Quarter of 2018

- With regards to the expected demand for credit in the fourth quarter of 2018, 69 percent of the respondents anticipate that interest rate capping will have little or no impact on the demand for credit. Most institutions indicate that interest rate capping has not significantly affect their lending strategies.

- However, 26 percent of the respondents felt that interest capping will lead to an increase in demand for credit.

- 5 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

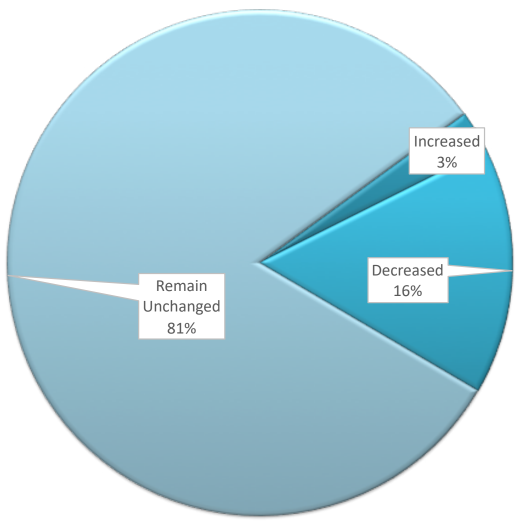


2.6.5 Effect of Interest Rate Capping on Actual New Credit over the fourth quarter of 2018

- In the fourth quarter of 2018, 81 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, 16 percent felt that the new credit advanced would decrease. This is as indicated in **Chart 10.**

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



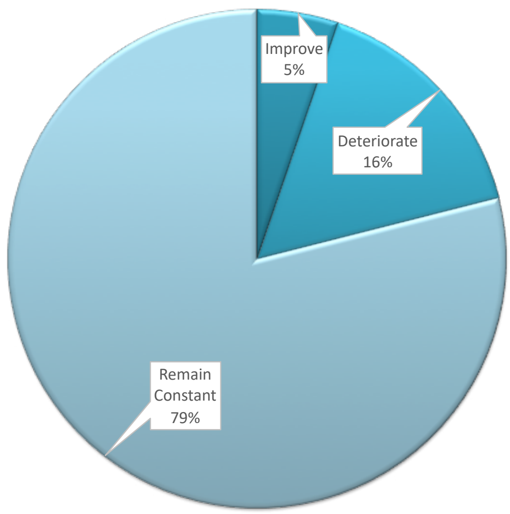
2.6.6 Expected Effect of Interest Rate Capping on the Level of NPLs

- In the fourth quarter of 2018, 79 percent of the respondents are of the view that the NPLs would not change since the pricing of the loans has no impact on repayment ability.

- 16 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 September 30, 2018

- During the quarter under review, the levels of NPLs remained unchanged in all the eleven economic sectors.
- The Mining and Quarrying, Energy and Water, Agriculture and Financial Services sectors had the most respondents indicating that the NPLs remained unchanged. This is similar to the previous quarter's responses.
- Several banks do not expect a major shift in macroeconomic environment whilst loans underwriting criteria will remain unchanged in the fourth quarter. This is depicted in **Chart 12** and **Table 5.**

Chart 12: Non-Performing Loans

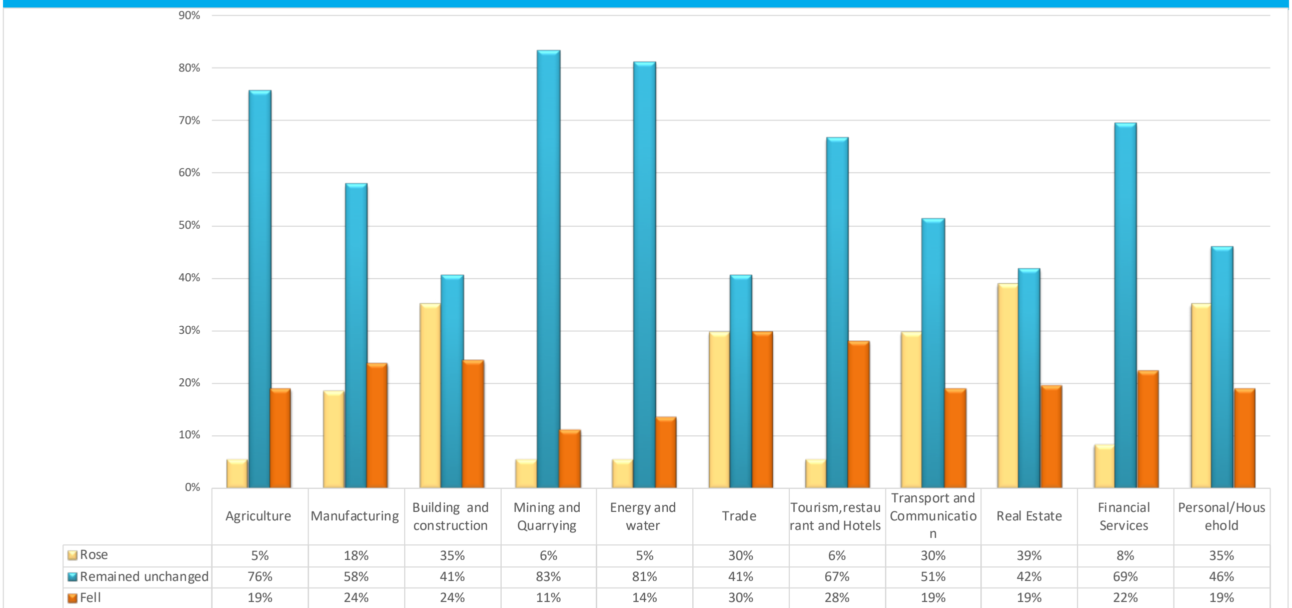


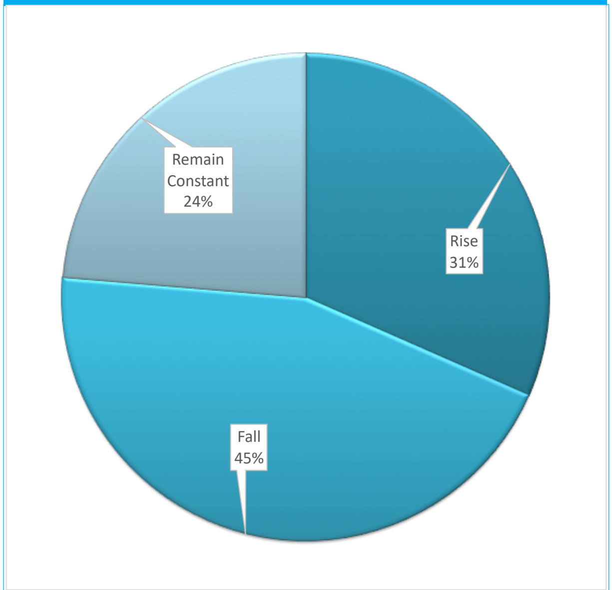
Table 5: Non Performing Loans Trend Per Economic Sector

	June 2018			September 2018		
	Rose	Remained Unchanged	Fell	Rose	Remained Unchanged	Fell
Agriculture	13%	74%	13%	5%	76%	19%
Manufacturing	13%	56%	31%	18%	58%	24%
Building and Construction	32%	45%	24%	35%	41%	24%
Mining and Quarrying	5%	84%	11%	6%	83%	11%
Energy and Water	5%	81%	14%	5%	81%	14%
Trade	26%	39%	34%	30%	41%	30%
Tourism, Restaurant and Hotels	11%	57%	32%	6%	67%	28%
Transport and Communication	26%	45%	29%	30%	51%	19%
Real Estate	34%	39%	26%	39%	42%	19%
Financial Services	5%	73%	22%	8%	69%	22%
Personal/Household	29%	47%	24%	35%	46%	19%

2.7.2 Expected Non Performing Loans Levels during the fourth quarter of 2018

- 45 percent of the respondents expect the level of NPLs to fall in the fourth quarter of 2018. This is attributed to enhanced recovery efforts being implemented by most banks. The banks' strategy is mainly focused on recovery of Non-Performing Loans. Almost an equal number of respondents expect NPLs to remain constant (24 percent) and to rise (31 percent). This is depicted in **Chart 13.**

Chart 13: Expected movements of NPLs



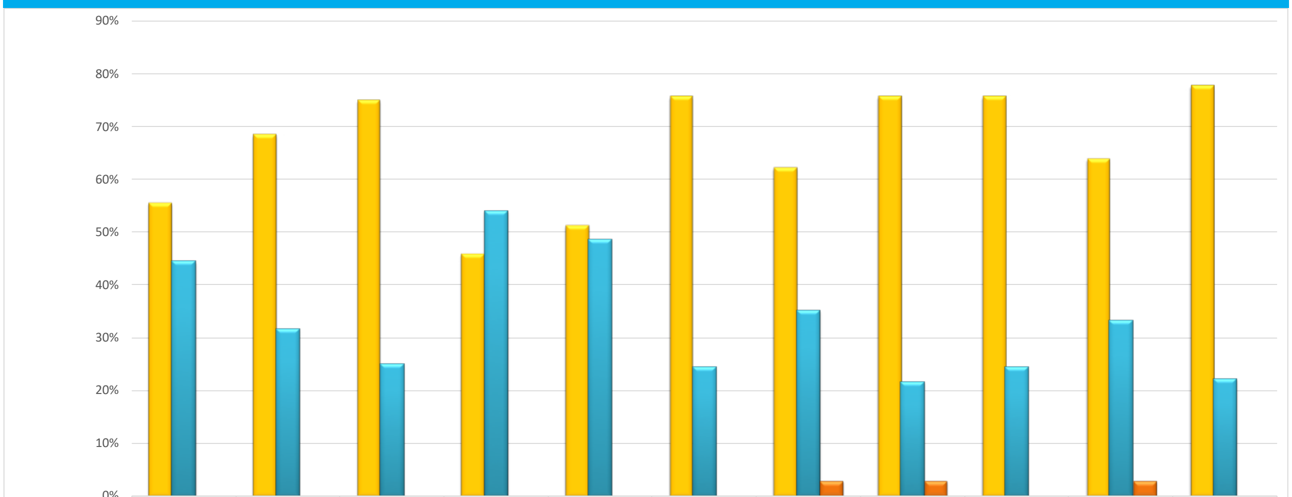
2.8 Credit Recovery Efforts in the third quarter of 2018

- For the quarter ended December 31, 2018, banks expect to intensify their credit recovery efforts in ten of the eleven economic sectors. The sector whose Credit recovery efforts is expected to remain unchanged is Mining and Quarrying sector.

- 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 fourth quarter of 2018.

- These 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	56%	68%	75%	46%	51%	76%	62%	76%	76%	64%	78%
Remain constant	44%	32%	25%	54%	49%	24%	35%	22%	24%	33%	22%
Ease	0%	0%	0%	0%	0%	0%	3%	3%	0%	3%	0%

Table 6: Credit Recovery Efforts

	June 2018			September 2018		
	Intensified	Remained Unchanged	Eased	Intensified	Remained Unchanged	Eased
Agriculture	59%	41%	0%	56%	44%	0%
Manufacturing	78%	22%	0%	68%	32%	0%
Building and Construction	87%	13%	0%	75%	25%	0%
Mining and Quarrying	49%	51%	0%	46%	54%	0%
Energy and Water	49%	51%	0%	51%	49%	0%
Trade	89%	11%	0%	76%	24%	0%
Tourism, Restaurant and Hotels	74%	24%	3%	62%	35%	3%
Transport & Communication	79%	18%	3%	76%	22%	3%
Real Estate	86%	14%	0%	76%	24%	0%
Financial Services	62%	32%	5%	64%	33%	3%
Personal/Household	82%	18%	0%	78%	22%	0%

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
  ii. The challenges they 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 and Model

- Most of banks are applying stringent criteria in underwriting credit and also seek good quality securities thus reducing the credit risk appetite. Further, banks have taken a deliberate focus towards credit recovery and continue to maintain a cautious lending strategy. There is also a high provisioning in the loan book and banks will have a reduced lending appetite.

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.

2.9.3 Challenges experienced in the Implementation of IFRS 9

The commercial banks have indicated that they experience challenges that may limit the implementation of IFRS 9. Some of the cited challenges include:

- Capital constraints due to increased provisioning.
- Review of policies that in essence will affect the business model.
- Inadequate technical skills and modeling capabilities.
- Cost implication for the relevant technology and personnel training.

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 Ltd.
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.

Haile Selassie Avenue P. O. Box 60000 - 00200 Nairobi
Tel: 20 - 2860000/2861000/ 2863000 Fax: 20 - 340192