CENTRAL BANK OF KENYA

CREDIT OFFICER SURVEY

APRIL-JUNE 2016

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1.0 FOREWORD

1.1 CREDIT OFFICER SURVEY

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 June 2016 was 61.16%; a slight decrease of 0.42% from 61.58% reported in March 2016. In order to identify the potential drivers of credit risk, the Central Bank of Kenya has been carrying out a quarterly Credit Officer Survey from 2012.

1.2 SURVEY METHODOLOGY

The credit officer survey for the quarter ended 30th June 2016 included five questions that focused on:-

- Demand for credit.
- Credit standards.
- Interest rates.
- Non-Performing loans.
- Credit recovery efforts.

The survey, conducted in July 2016, targeted senior credit officers of all 40 operational commercial banks and 1 mortgage finance company. Charterhouse Bank Ltd and Imperial Bank Ltd were excluded from the survey.

For the quarter ended 30th June 2016, CBK received Credit Officer Survey responses from all the 40 operational banks and 1 mortgage finance company. The list of the respondents is attached to this report as **Annex I**.

1.3 KEY FINDINGS

The key findings from the survey are detailed below:

1.3.1 Demand for credit

The perceived demand for credit remained unchanged in eight out of eleven economic sectors in Q2 of 2016. However, the actual demand for credit for Q2 of 2016 indicated that Financial Services sector recorded the highest increase in demand for credit with an increase of Kshs 34.2 billion or 42.7% attributed to increased lending by banks to Microfinance banks and SACCO's to fund their activities within the quarter.

1.3.2 Credit Standards

Credit standards largely remained unchanged in nine out of eleven economic sectors in Q2 of 2016. Credit standards were mostly tightened in Building & Construction and Real Estate economic sectors. Banks are safeguarding their loan portfolio arising from the emerging risk of default owing to the decreased uptake of residential and commercial units.

1.3.3 Interest Rates

In the Q2 of 2016, 68% of the banks held their interest rates constant, 27% decreased their interest rates while 5% increased their interest rates. The respondents that increased their interest rates attributed it to general deterioration of credit risk profile of customers which is in line with the increased non performing loans. The respondents that have reduced their interest rates attribute this to reduction of Central Bank Rate and decline in the interest rates of government securities hence banks attracting cheaper deposits from customers.

1.3.4 Non-Performing Loans (NPLs)

As compared to Q2 of 2016, the credit officers predict dropping of NPLs in ten out of eleven economic sectors in Q3 of 2016. The drop in NPLs is in line with the optimistic opinion[1] expressed by the private sector of increased growth in 2016 supported by macroeconomic stability, infrastructure investment, strong agriculture performance, and tourism recovery.

1.3.5 Credit Recovery Efforts

In Q3 of 2016, banks forecast an increase in credit recovery efforts in nine out of the eleven sectors. In Q3 of 2016, the highest increase in credit recovery efforts will be in Personal/Household, Trade, Transport and Communication and Building & Construction sectors. To support the envisaged increased credit recovery efforts, the banks intend to allocate more resources to monitoring and recovery of loans as well as use of external parties in the recovery process.

1.4 KENYAN BANKING SECTOR PERFORMANCE

The Kenyan Banking Sector recorded growth in the quarter ended 30th June 2016, compared to the quarter ended 31st March 2016. Some of the sector's performance indicators are as follows:

- The aggregate balance sheet increased by 2.80% from Kshs 3.57 trillion in March 2016 to Kshs 3.67 trillion in June 2016.
- Gross loans increased by 1.80% from Kshs 2.22 trillion in March 2016 to Kshs 2.27 trillion in June 2016.
- The ratio of gross non-performing loans to gross loans increased from 7.7% in March 2016 to 8.4% in June 2016. The increase in gross non-performing loans was mainly attributable to borrowers' cash flow constraints due to low business activity and recent retrenchment of staff some of whom had taken up loans with banks.
- Banking sector deposits increased by 2.6% from Kshs 2.56 trillion in March 2016 to Kshs 2.62 trillion in June 2016. The growth in deposit base was supported by branch expansion, use of technological innovations for deposit mobilization and the agency banking model.
- The ratio of core capital to total risk-weighted assets increased from 16.0% as at March 2016 to 16.3% as at June 2016. The total capital to total risk weighted assets increased marginally from 18.8% in

[1] MPC Market Perception Survey conducted in July 2016

March 2016 to 18.9% in June 2016. The capital adequacy ratios remained above the statutory minimum of 10.5% and 14.5% respectively.

- Cumulative unaudited pre-tax profits for the quarter ended 30th June 2016 stood at Kshs 42.8 billion compared to Kshs 38.4 billion for 31st March 2016, an increase of 11.7%. The growth in profits were mainly attributable to increased investment in government securities by commercial banks and increased lending rates from an average of 17.8% in Q1 of 2016 to an average of 18.1% in Q2 of 2016 respectively.

CENTRAL BANK OF KENYA
AUGUST 2016

2.0 SURVEY FINDINGS

2.1 Demand for Credit

2.1.1 Observations

- Eight out of eleven economic sectors recorded unchanged demand for credit in Q2 of 2016. The economic sectors were led by Mining and Quarrying (64%), Tourism, Restaurant and Hotels (55%), Energy and Water (50%), Agriculture (48%) and Financial Services (48%).
- The perceived demand for credit increased in three economic sectors namely Building & Construction, Trade and Personal/Household in Q2 of 2016. Although actual demand for credit increased in all the three aforementioned sectors, Financial Services sector recorded the highest increase in demand for credit with an increase of Kshs 34.2 billion or 42.7% attributed to increased lending by banks to Microfinance banks and SACCO's to fund their activities within the quarter.

Chart 1 and **Table 1** below present the trend in the demand for credit in the quarter ended June 2016 as compared to March 2016.

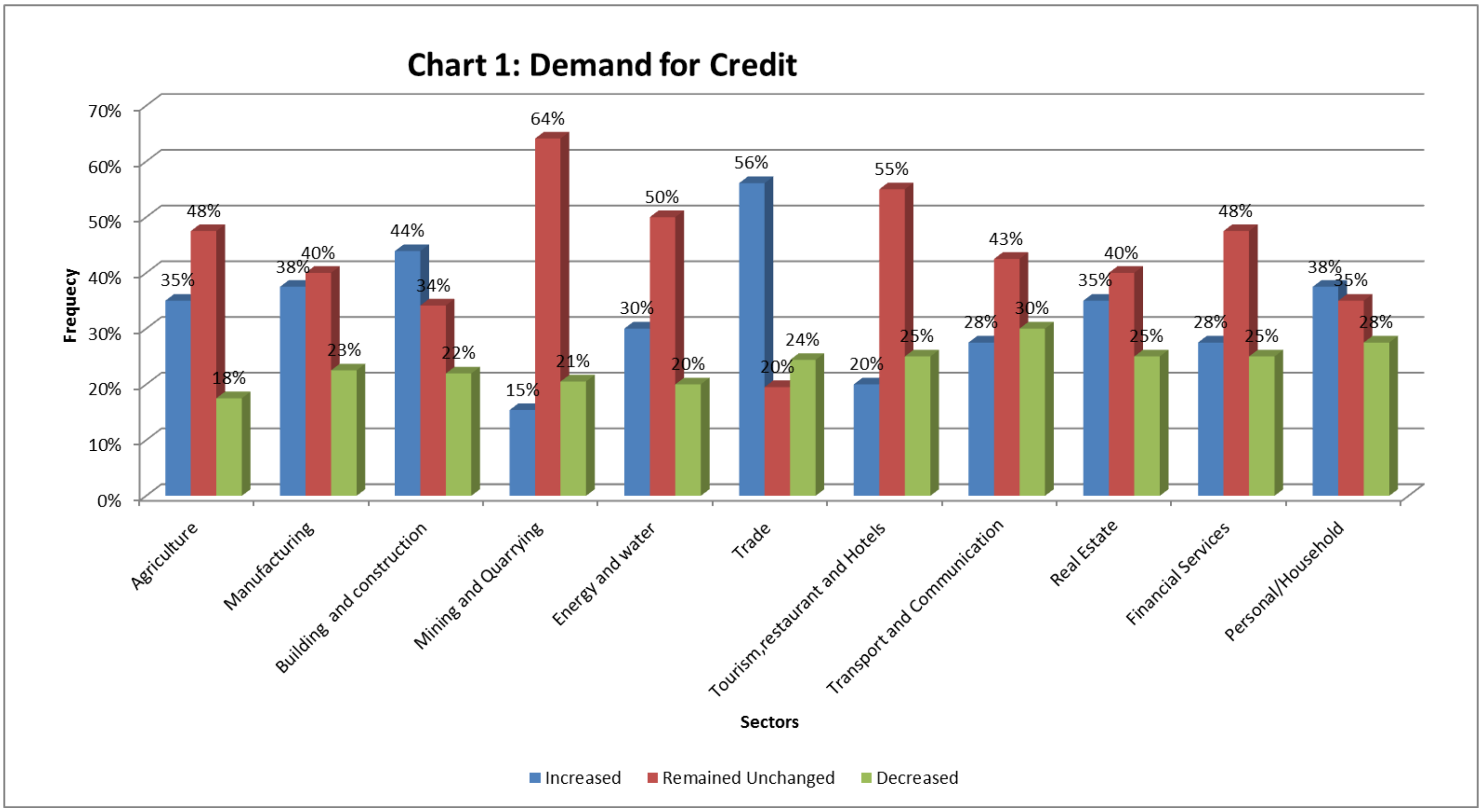


Table 1: Change in Demand for Credit

	June 2016			March 2016		
	Increased	**Remained Unchanged**	**Decreased**	**Increased**	**Remained Unchanged**	**Decreased**
Agriculture	35%	48%	18%	31%	62%	8%
Manufacturing	38%	40%	23%	41%	41%	17%
Building & Construction	44%	34%	22%	51%	27%	22%
Mining and Quarrying	15%	64%	21%	15%	64%	21%
Energy and Water	30%	50%	20%	29%	63%	7%
Trade	56%	20%	24%	63%	24%	12%
Tourism, Restaurant and Hotels	20%	55%	25%	30%	48%	23%
Transport and Communication	28%	43%	30%	39%	49%	12%
Real Estate	35%	40%	25%	45%	30%	25%
Financial Services	28%	48%	25%	31%	54%	15%
Personal/Household	38%	35%	28%	58%	28%	15%

2.2 Factors affecting demand for credit

2.2.1 Observations

- In Q2 of 2016, factors affecting demand for credit generally remained unchanged for all the eleven economic sectors.
- As compared to Q1 of 2016, reduction of CBR was cited in Q2 of 2016 as the factor that positively increased the demand for credit. In a forward looking way, it is envisaged that the effect of reduction of Central Bank Rate from 11.5 % to 10.5% effective 23rd May 2016 will be felt in Q3 of 2016. The envisaged reduction of the lending rates will subsequently result in increased appetite for credit from the customers.
- Other factors that affected demand for credit include political risk, issuance of debt securities and cost of borrowing factors. Some investors are adopting conservative strategies as the country approaches election year.

  Comparison between Q2 and Q1 of 2016 shows that, in Q2 of 2016, 44% of the respondents reported decrease in the demand for credit due to the cost of borrowing as compared to 73% respondents in Q1 of 2016. This is in line with the reduced weighted deposit rate from 7.2% in Q1 of 2016 to 6.4% in Q2 of 2016. As the cost of funding/deposits comes down the impact of cost of borrowing decreases.

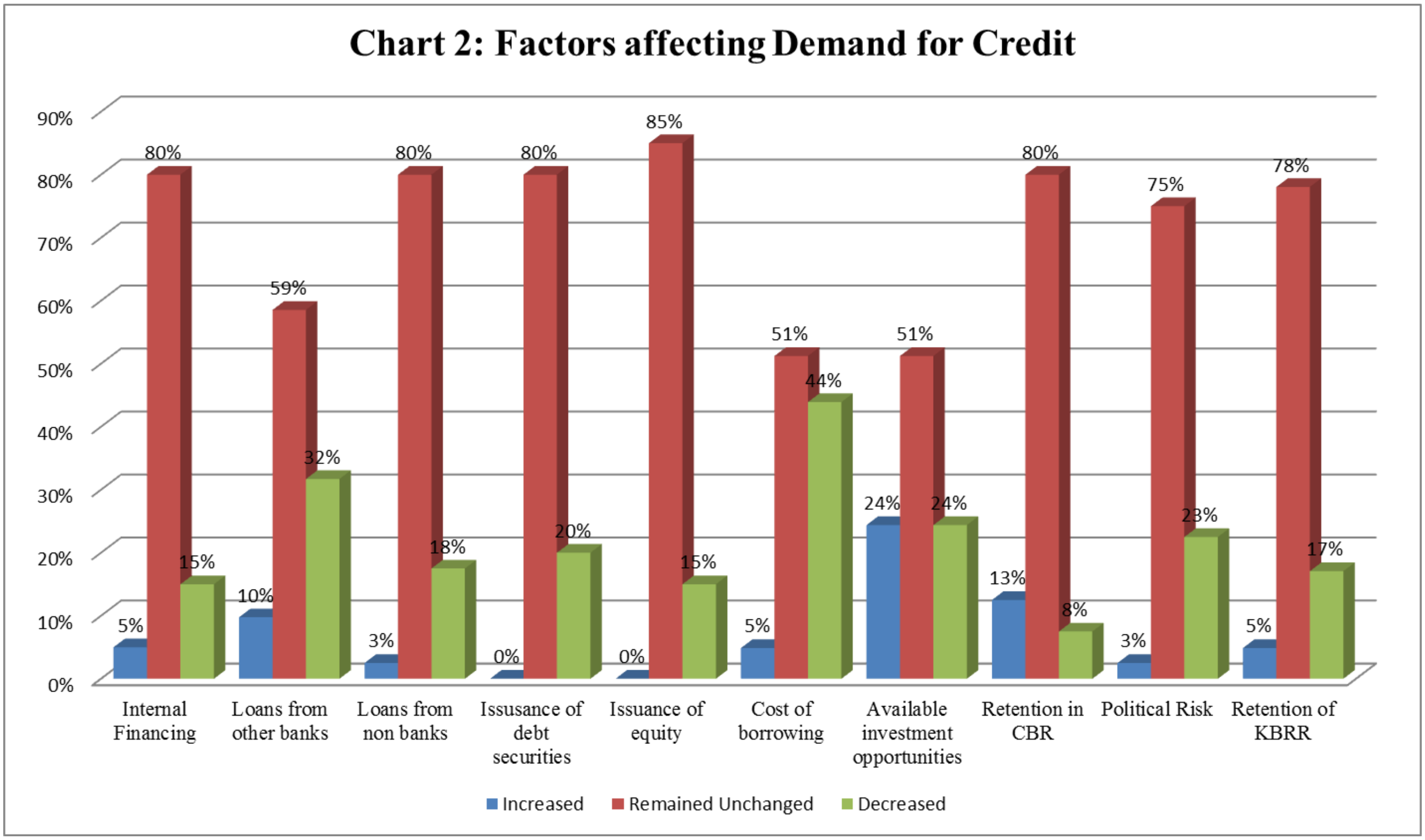


Table 2: Factors affecting Demand for credit

	June 2016			March 2016		
	Increased	**Remained Unchanged**	**Decreased**	**Increased**	**Remained Unchanged**	**Decreased**
Internal Financing	5%	80%	15%	5%	83%	13%
Loans from other banks	10%	59%	32%	10%	63%	27%
Loans from non-banks	3%	80%	18%	5%	78%	18%
Issuance of debt securities	0%	80%	20%	0%	90%	10%
Issuance of equity	0%	85%	15%	0%	90%	10%
Cost of borrowing	5%	51%	44%	12%	15%	73%
Available investment opportunities	24%	51%	24%	29%	56%	15%
Reduction in CBR	13%	80%	8%	3%	53%	45%
Political Risk	3%	75%	23%	5%	83%	12%
Retention of KBRR	5%	78%	17%	7%	41%	51%

2.3 Credit Standards

2.3.1 Observations

- Nine out of eleven economic sectors recorded unchanged credit standards in Q2 of 2016. The economic sectors were Agriculture (65%), Manufacturing (73%), Mining and Quarrying (73%), Energy and Water (83%), Trade (61 %), Tourism, Restaurant and Hotels (58%), Transport and Communication (56 %), Financial Services (73%) and Personal/Household (55%).

- Credit standards in Q2 of 2016 were tightened in all the eleven economic sectors as compared to Q1 of 2016. Credit standards were mostly tightened in Building & Construction and Real Estate economic sectors. Banks are safeguarding their loan portfolio arising from the emerging risk of default owing to the low uptake of residential and commercial units.

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

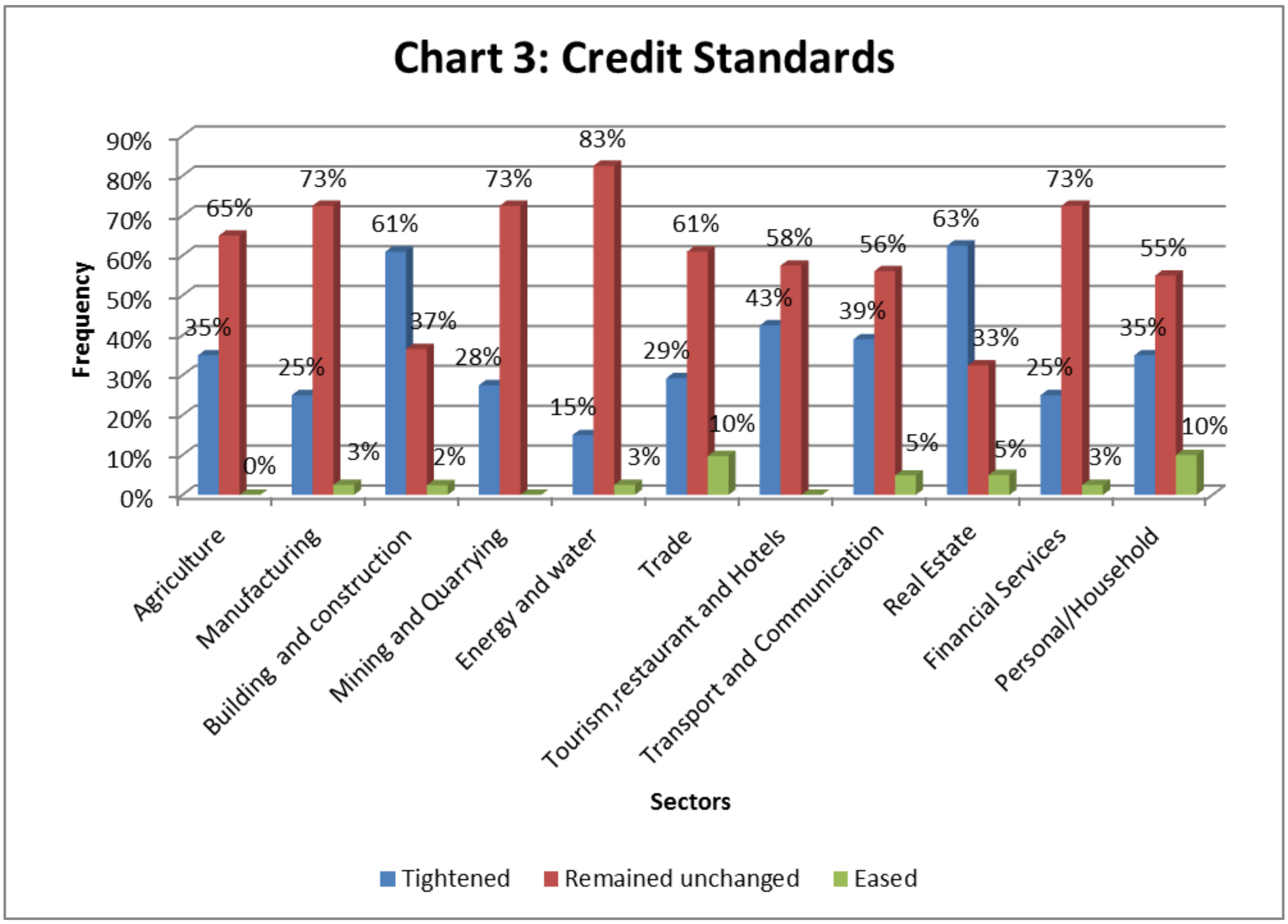


Table 3: Credit Standards for Loans to Various Economic Sectors

	June 2016			March 2016		
	Tightened	Remained Unchanged	Eased	Tightened	Remained Unchanged	Eased
Agriculture	35%	65%	0%	20%	75%	5%
Manufacturing	25%	73%	3%	15%	80%	5%
Building & Construction	61%	37%	2%	46%	54%	0%
Mining and Quarrying	28%	73%	0%	8%	93%	0%
Energy and Water	15%	83%	3%	10%	90%	0%
Trade	29%	61%	10%	20%	66%	15%
Tourism, Restaurant and Hotels	43%	58%	0%	35%	65%	0%
Transport and Communication	39%	56%	5%	27%	66%	7%
Real Estate	63%	33%	5%	43%	53%	5%
Financial Services	25%	73%	3%	5%	88%	8%
Personal/Household	35%	55%	10%	25%	60%	15%

2.4 Factors affecting credit standards

2.4.1 Observations

- In Q1 of 2016, all the factors that influence changes on credit standards had little impact.
- When compared to Q1 of 2016, more banks cited expectations regarding general economic activity (44%), Political Risk (29%) and Constraints relating to Bank's capital position (38%), as factors that contributed to their tightening of credit standards.

In regards to general economic activity, low business activities has resulted to increased NPLs prompting tightenening of credit standards by lenders.

Political risk has also been heightened due to among other factors the uncertainity surrounding the disbandment of Independent Electoral and Boundaries Commission in the quarter.

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

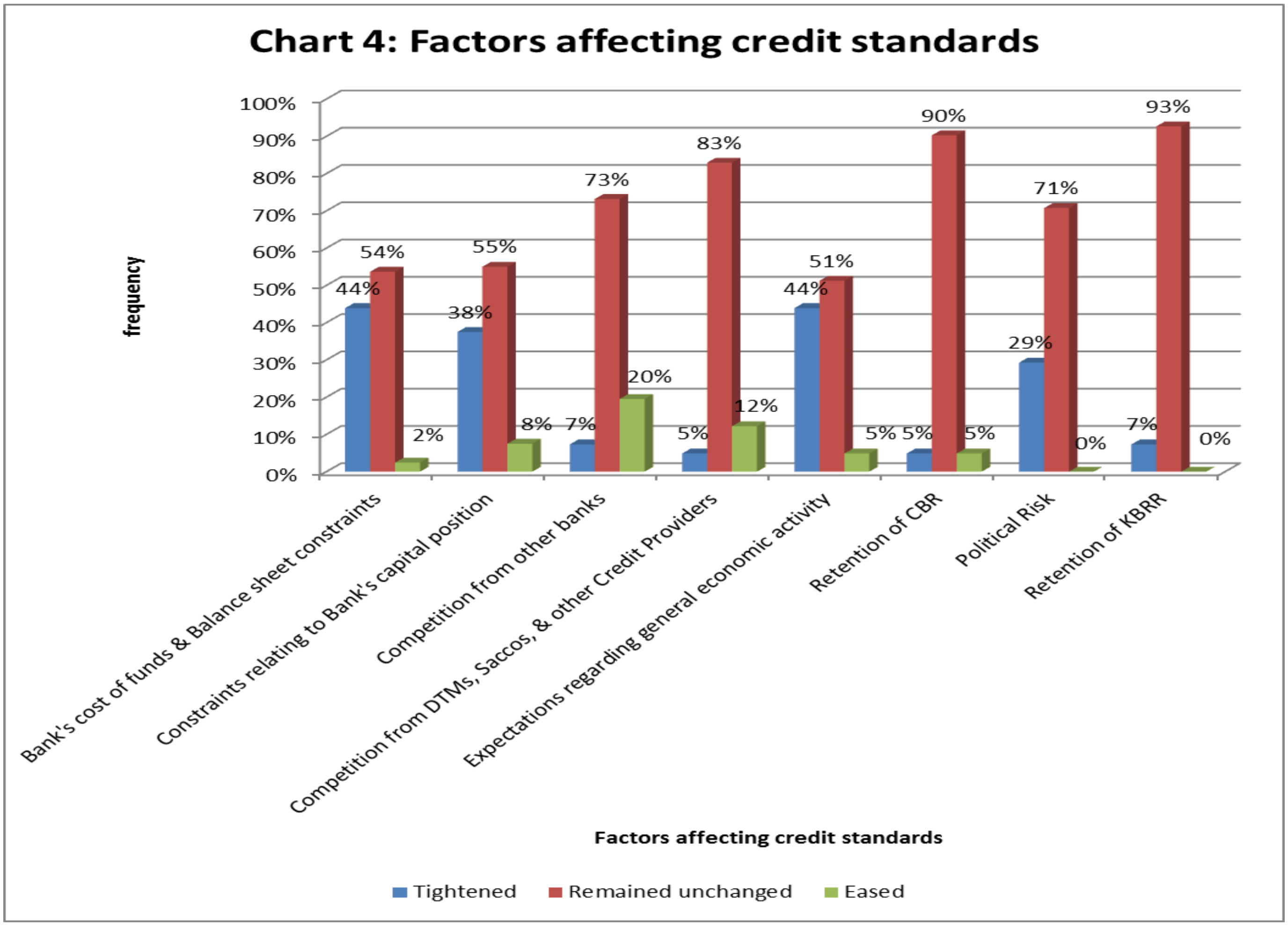


Table 4: Impact of factors affecting credit standards

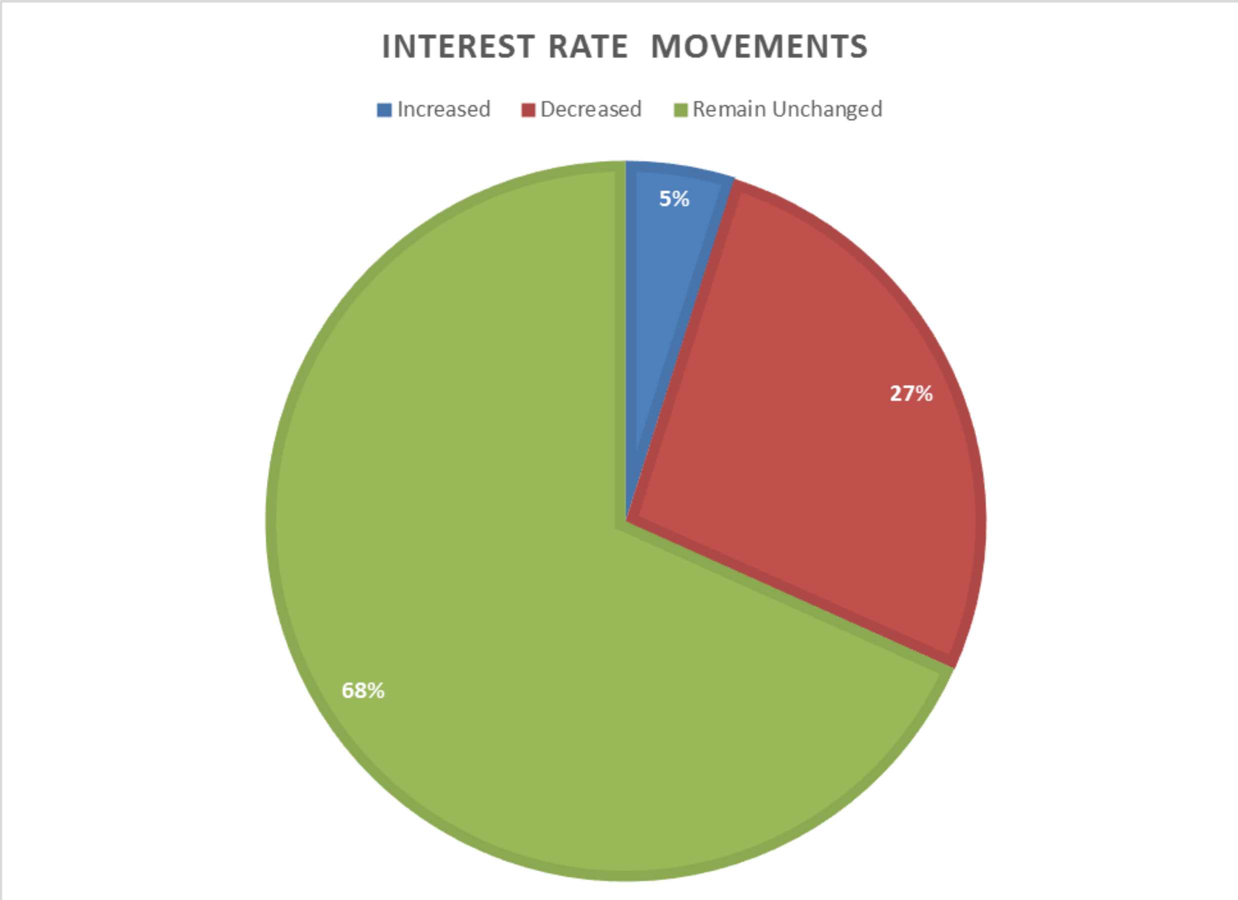
	June 2016			March 2016		
	Tightened	**Remained Unchanged**	**Eased**	**Tightened**	**Remained Unchanged**	**Eased**
Bank's cost of funds & Balance sheet constraints	44%	54%	2%	63%	38%	0%
Constraints relating to Bank's capital position	38%	55%	8%	23%	69%	8%
Competition from other banks	7%	73%	20%	7%	68%	24%
Competition from DTMs, Saccos, & other Credit Providers	5%	83%	12%	5%	88%	8%
Expectations regarding general economic activity	44%	51%	5%	27%	59%	15%
Reduction of Central Bank Rate (CBR)	5%	90%	5%	27%	66%	7%
Political Risk	29%	71%	0%	10%	83%	7%
Retention of KBRR	7%	93%	0%	24%	66%	10%

2.5 Interest rates

- In the Q2 of 2016, 68% of the banks held their interest rates constant, 27% of the banks reduced their interest rates while 5% increased their interest rates.
- The respondents that increased their interest rates indicated that in general terms the credit risk of most customers had deteriorated; customers risk profile is one of the parameters used to come up with a customer’s interest rate.
- Respondents who maintained their interest rates constant during the period under review attributed it to CBK’s retention of the KBRR, stable exchange rates and stable cost of funding.
- The respondents that reduced their interest rates attributed this to reduction of Central Bank Rate and decline in the interest rates of government securities hence banks attracted cheaper deposits from customers.

Responses on the movement of interest rates in Q2 of 2016 is depicted in **Chart 5** below.

Chart 5: Interest Rate Movements



3.6 Non-Performing Loans (NPLs)

3.6.1 Observations

- In the March 2016, Credit Survey, the respondents forecasted NPLs to generally remain unchanged in Q2 of 2016. However, actual NPLs in Q2 of 2016 indicate that NPLs increased in all the eleven economic sectors. The increase in NPLs was generally informed by:
  - Challenges in the business environment;
  - Political unrest in South Sudan has had a negative impact on Kenyan businesses with operations in South Sudan such as airlines, commercial banks traders and manufacturing companies; and
  - Real Estate sector has been affected by the slow uptake of residential units with high end property market experiencing declining sales and reducing margins.

- As compared to Q2 of 2016, the credit officers of commercial banks foresee a drop of NPLs in ten out of eleven economic sectors in Q3 of 2016 as depicted in Chart 5 below. The drop of NPLs is in line with the optimistic opinion expressed by private sector of increased economic growth in 2016 supported by macroeconomic stability, infrastructure investment, strong agriculture performance, and tourism recovery.

- Prediction of decreased NPLs in Q3 of 2016 in:
    - Trade and Transport and Communication sectors is due to proactive rigorous credit underwriting standards adopted by banks, close monitoring of early warning signs of non-performing loans and enhanced debt collection techniques. Further, performance in transport and communication sector has improved with the increase of foreign arrivals in Kenya. The increase in arrivals is attributable to measures instituted to boost tourist including; the charter incentive programme, hosting of global conferences, downgrading of travel advisories, visa waiver among others.
    - Real Estate as well as Building and Construction sectors could be attributed to measures provided for in the 2016/17 Budget Statement aimed at facilitating ease of realization of collateral through legal proceedings. Also measures such as setting up of an electronic collateral registry and the ongoing digitisation of land registries will ease the process of collateral creation, perfection and realization.

Chart 5 and **Table 5** below indicate respondents' expectations on NPL trend in Q2 of 2016.

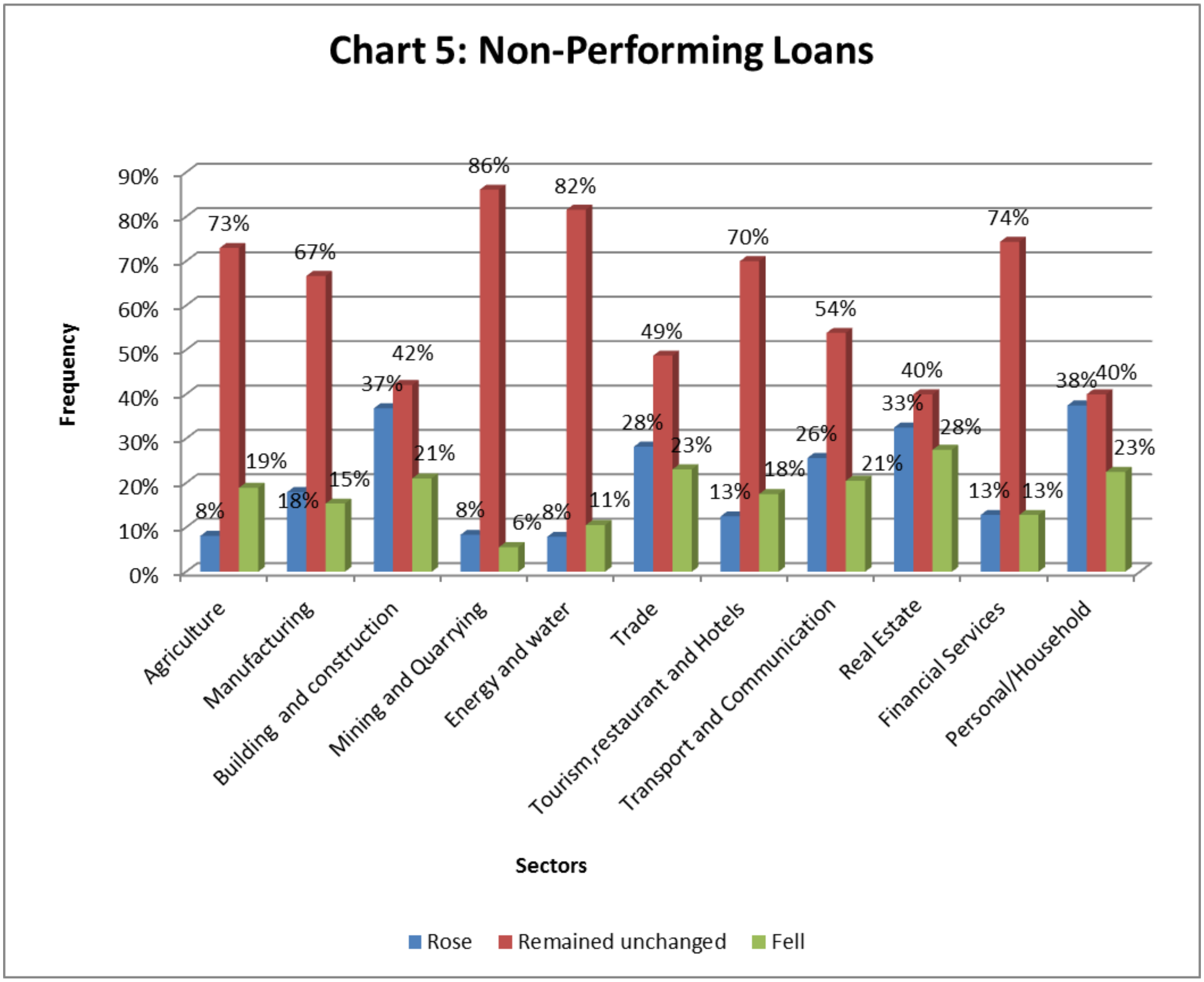
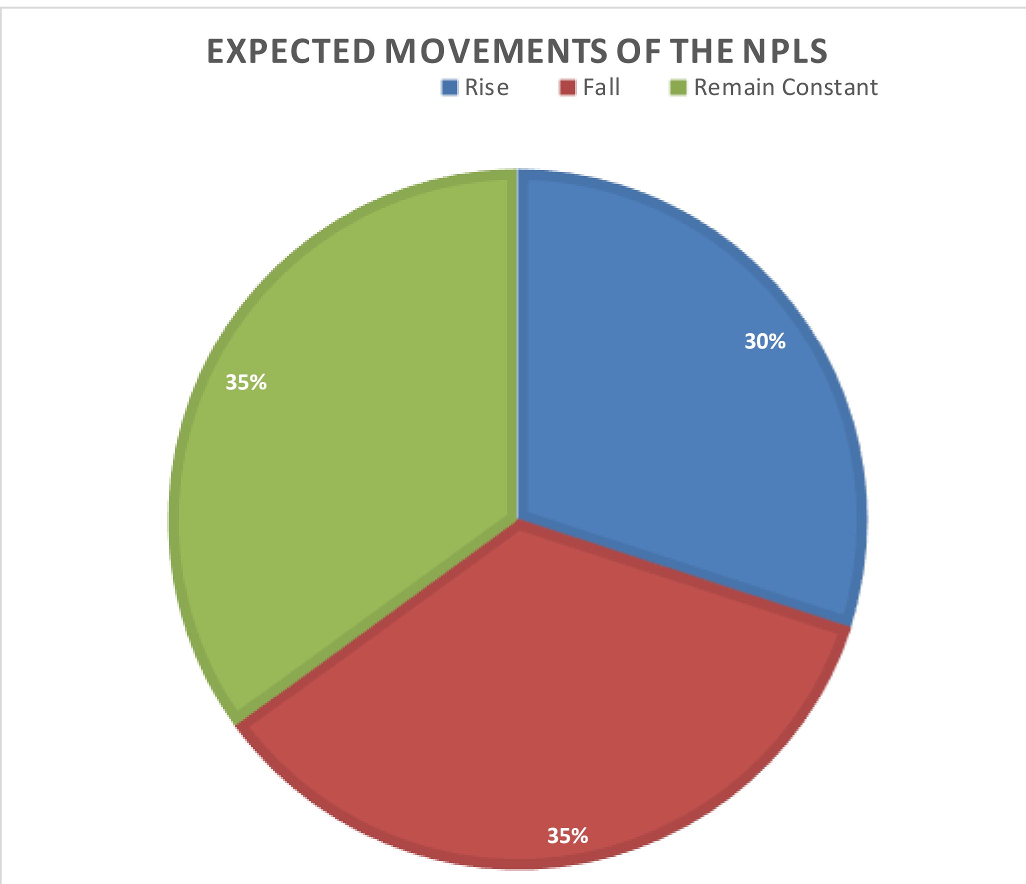


Table 5: Non Performing Loans Expectation Trend Per Economic Sector

	March 2016			March 2016		
	Rose	**Remained Unchanged**	**Fell**	**Rose**	**Remained Unchanged**	**Fell**
Agriculture	8%	73%	19%	21%	61%	18%
Manufacturing	18%	67%	15%	33%	58%	10%
Building & construction	37%	42%	21%	46%	38%	15%
Mining and Quarrying	8%	86%	6%	8%	87%	5%
Energy and water	8%	82%	11%	15%	77%	8%
Trade	28%	49%	23%	43%	38%	20%
Tourism, Restaurant & Hotels	13%	70%	18%	28%	67%	5%
Transport & Communication	26%	54%	21%	37%	53%	11%
Real Estate	33%	40%	28%	43%	48%	10%
Financial Services	13%	74%	13%	11%	74%	16%
Personal/Household	38%	40%	23%	63%	28%	10%

Chart 6: Expected Movements of the NPLs Across All the Economic Sectors



2.6 Credit Recovery Efforts

2.6.1 Observations

- In Q3 of 2016, banks forecast an increase in credit recovery efforts 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 in the:

- o Personal/Household sector is in line with the banks expectations that loan defaults on consumer loans will rise due to low business activity and retrenchment of staff some of whom have bank loans.
- o Transport and Communication aims at tapping into the positive returns in Transport and Communication sectors arising from increased arrivals to Kenya for either conference or tourism.
- o Building and Construction sector is a proactive strategy to ensure collection from contractors who received payments from National and County Governments in the quarter.

The responses on the expected credit recovery efforts by the banks during the quarter ending 30th June 2016 are depicted in **Chart 6** and **Table 6** below.

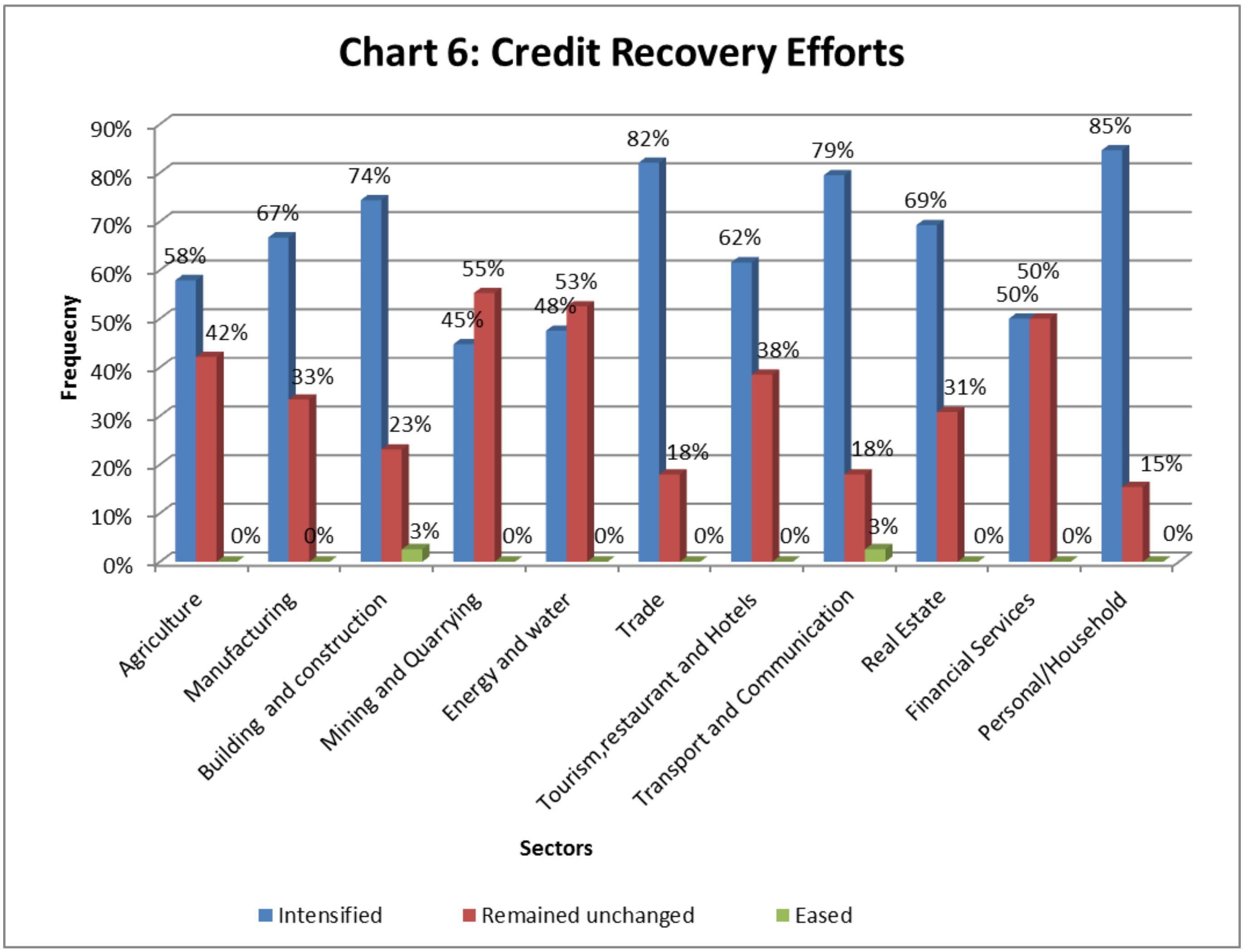


Table 6: Credit Recovery Efforts

	June 2016			March 2016		
	Intensified	**Remained Unchanged**	**Eased**	**Intensified**	**Remained Unchanged**	**Eased**
Agriculture	58%	42%	0%	44%	56%	0%
Manufacturing	67%	33%	0%	54%	46%	0%
Building & construction	74%	23%	3%	80%	20%	0%
Mining and Quarrying	45%	55%	0%	28%	72%	0%
Energy and water	48%	53%	0%	31%	69%	0%
Trade	82%	18%	0%	75%	25%	0%
Tourism, Restaurant & Hotels	62%	38%	0%	58%	43%	0%
Transport & Communication	79%	18%	3%	65%	35%	0%
Real Estate	69%	31%	0%	68%	33%	0%
Financial Services	50%	50%	0%	38%	59%	3%
Personal/Household	85%	15%	0%	80%	20%	0%

Annex I (List of Respondents)

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