Central Bank of Kenya

CREDIT SURVEY

DECEMBER 31, 2020

CENTRAL BANK OF KENYA COMMERCIAL BANKS' CREDIT OFFICER SURVEY FOR THE QUARTER ENDED DECEMBER 31, 2020

1.0 COMMERCIAL BANKS' CREDIT OFFICER SURVEY

1.1 BACKGROUND

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 decreased marginally from 55.90 percent in the quarter ended September 30, 2020 to 55.34 percent in the quarter ended December 31, 2020.

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, deployment of liquidity and impact of implementing new standards.

1.2 SURVEY METHODOLOGY

Senior Credit Officers[1] complete most of the survey and collate inputs from senior officers responsible for the other aspects. For the quarter ended December 31, 2020, 38 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, credit standards for approving loans, level of interest rates, non-performing loans, the effect of repeal of capping of interest rates[2] on lending to Small and Medium sized Enterprises (SMEs), credit recovery efforts, implementation of International Financial Reporting Standards (IFRS 9) on Financial Instruments and implementation of IFRS 16 on Leases. The survey questions are generally phrased in terms of changes over the past three months or expected changes over the next three months.

The survey also included questions with regard to liquidity in the banks. The banks were required to state their appetite for deployment of liquidity towards extension of credit, interbank lending and other forms of investment.

Following the declaration by the World Health Organization of coronavirus (COVID-19) outbreak as a pandemic in March 2020, CBK through the credit officer survey assessed the impact of the pandemic on the banking sector.

The survey included questions relating to impact of the pandemic on the banks, measures taken by banks to curb the potential impact of the pandemic and their experience in implementing the emergency measures introduced by CBK to mitigate the impact of the pandemic.

[1] *These are officers involved in most of the credit decisions hence are able to provide reasonably accurate and complete responses from their bank's perspective. They also collate input on non-credit aspects from their counterparts.*

[2] *The capping of interest rates law came into effect on September 14, 2016 and was repealed on November 7, 2019.*

1.3 KENYAN BANKING SECTOR PERFORMANCE

The Kenyan Banking Sector recorded growth in the quarter ended December 31, 2020, compared to the quarter ended September 30, 2020. Some of the sector's performance indicators are as follows: -

- The aggregate balance sheet increased by 2.93 percent to Ksh.5,420.08 billion in December 2020 from Ksh.5,265.99 billion in September 2020.

- Gross loans increased by 1.90 percent from Ksh.2,943.45 billion in September 2020 to Ksh.2,999.47 billion in December 2020. The growth in gross loans was mainly due to increased advances in the Personal and Household, Manufacturing, Energy and Water sectors.

- Total deposits increased by 3.01 percent from Ksh.3,904.41 billion in September 2020 to Ksh.4,021.94 billion in December 2020.

- The asset quality, measured by gross non-performing loans to gross loans ratio deteriorated from 13.64 percent in September 2020 to 14.14 percent in December 2020. This was attributed to a slowdown in business activities as a result of adverse effects of COVID -19 pandemic.

- The total capital adequacy ratio increased from 18.24 percent in September 2020 to 19.15 percent in December 2020. This is as a result of a higher increase in total capital (6.35 percent) as compared to the increase in total risk weighted assets (1.26 percent). The capital adequacy ratio reported in December 2020 was above the minimum statutory limits of 14.5 percent.

- Quarterly profit before tax decreased by Ksh.5.65 billion from Ksh.29.22 billion in September 2020 to Ksh.23.57 billion in December 2020. This was as a result of a higher increase in expenses (10.42 percent) as compared to increase in income (4.44 percent). Return on Assets decreased to 1.64 percent in December 2020 from 1.76 percent in September 2020.

- Return on Equity decreased from 15.07 percent in September 2020 to 13.82 percent in December 2020. This is as a result of the decrease in quarterly profits before tax (19.35 percent) whereas total shareholders' funds increased by 3.41 percent in December 2020.

- During the quarter ended December 2020, liquidity in the banking sector increased from 53.25 percent in September 2020 to 54.55 percent in December 2020. This was well above the minimum statutory ratio of 20 percent.

1.4 SUMMARY OF CREDIT OFFICER SURVEY FINDINGS

- **Demand for credit:** In the fourth quarter of 2020, the perceived demand for credit remained unchanged in seven economic sectors. It increased in two sectors and decreased in one sector. An equal number of respondents (41 percent) indicated that demand in manufacturing sector remained unchanged and increased.

- **Credit Standards[3]:** In the fourth quarter of 2020, credit standards remained unchanged in seven economic sectors and were tightened in four sectors namely Tourism, Real Estate, Transport and Communication, and Personal and Household sectors.

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

Tightening of credit standards in the four sectors is attributed to the effects of COVID – 19 pandemic namely business disruptions, low occupancy of housing and commercial units, and loss of employment.

- **Repeal of interest rate capping law:** 90 percent of the respondents indicated that after the repeal of interest rate capping law, the demand for credit remained unchanged, while 10 percent noted that the demand for credit increased.
- **Lending to Small and Medium-sized Enterprises (SMEs):** In the quarter ended December 2020, 58 percent of the respondents indicated that the repeal of interest caps had no effect on their lending to SMEs. 42 percent of the respondents indicated an increase in lending to SMEs since majority of the banks are on-boarding risk-based pricing models which has increased financial institutions appetite to lend to SMEs.
- **Non-Performing Loans:** During the quarter under review, the respondents indicated that the level of NPLs remained unchanged in five economic sectors and increased in six sectors. NPLs increased in Personal and Household, Tourism, Real Estate, Transport and Communication, Trade and Building and Construction.

  The increase in NPLs was mainly due to a challenging business environment as a result of COVID-19 pandemic.
- **Expected Non-Performing Loans levels during the fourth quarter:** 38 percent of the respondents indicated that NPLs are likely to fall in the first quarter of 2021 as a result of enhanced recovery efforts. 33 percent of the respondents indicated that NPLs are likely to increase in the first quarter of 2021.
- **Credit Recovery Efforts:** For the quarter ended March 31, 2021, banks expect to intensify their credit recovery efforts in all economic sectors. The intensified recovery efforts are aimed at improving the overall quality of the asset portfolio.
- **International Financial Reporting Standard (IFRS) 9 on Financial Instruments:** Implementation of IFRS 9 has had an adverse impact on commercial banks' capital adequacy due to increased provisioning. This led the commercial banks to explore injection of more capital.
- **International Financial Reporting Standard (IFRS) 16 on Leases:** Most banks indicated that implementation of IFRS 16 increased their risk weighted assets, which has in turn negatively affected their capital adequacy ratios.
- **Liquidity risk:** During the quarter ended December 2020, 74 percent of the respondents indicated that their liquidity position had improved. This is supported by the banking industry liquidity increase from 53.25 percent in September 2020 to 54.55 percent in December 2020.

  Banks intend to deploy excess liquidity towards lending to the private sector, investing in Treasury Bills and Bonds, interbank lending, CBK liquidity management through repos and increased cash holdings.

2.0 SURVEY FINDINGS

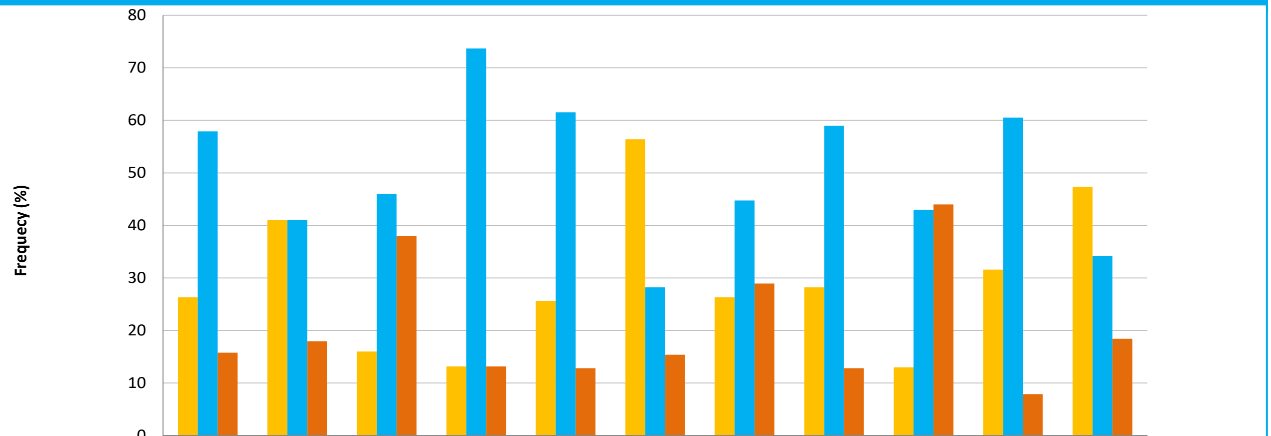
2.1 Demand for Credit

- In the fourth quarter of 2020, the perceived demand for credit remained unchanged in seven economic sectors. It increased in two sectors and decreased in one sector. An equal number of respondents (41 percent) indicated that demand in manufacturing sector remained unchanged and increased.
- The main sectors with unchanged demand for credit are Mining and Quarrying, Energy and Water, and Financial Services.
- Perceived demand for credit significantly decreased in the Real Estate sector due to subdued business activities.
- **Chart 1** and **Table 1** below present the trend in the perceived demand for credit in the last two quarters.

Table 1: Change in Demand for Credit

Percentage (%)	September 2020			December 2020		
	Increased	Remained Unchanged	Decreased	Increased	Remained Unchanged	Decreased
Agriculture	34	53	13	26	58	16
Manufacturing	32	47	21	41	41	18
Building and Construction	16	46	38	16	46	38
Mining and Quarrying	8	76	16	13	74	13
Energy and Water	24	63	13	26	62	13
Trade	44	36	21	56	28	15
Tourism, Restaurant and Hotels	16	42	42	26	45	29
Transport and Communication	21	55	24	28	59	13
Real Estate	13	43	44	13	43	44
Financial Services	23	69	8	32	61	8
Personal and Household	45	37	18	47	34	18

Chart 1: Demand for Credit

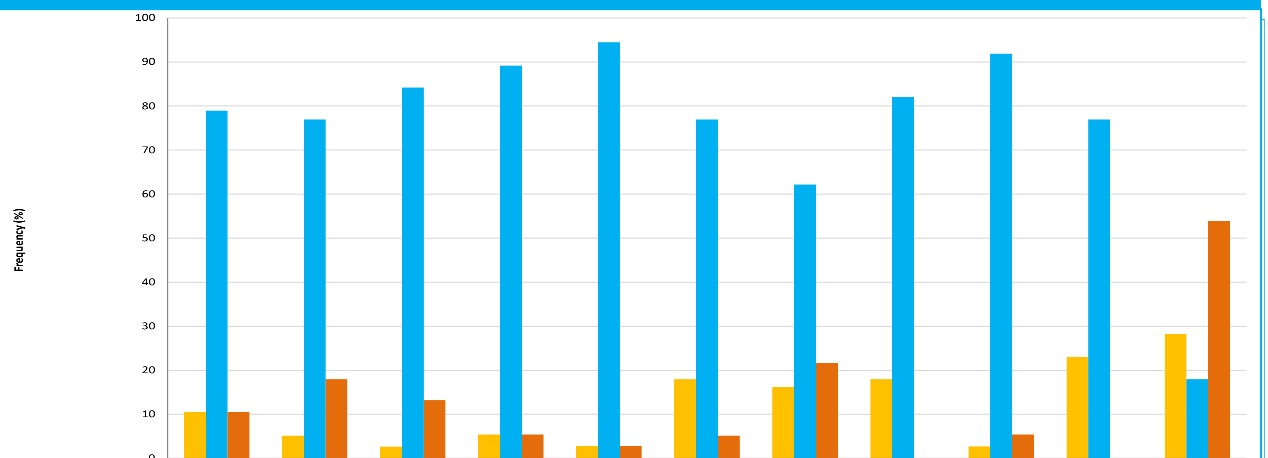


	Agriculture	Manufacturing	Building and Construction	Mining and Quarrying	Energy and Water	Trade	Tourism,Restaurant and Hotels	Transport and Communication	Real Estate	Financial Services	Personal and Household
Increased(%)	26	41	16	13	26	56	26	28	13	32	47
Remained Unchanged (%)	58	41	46	74	62	28	45	59	43	61	34
Decreased (%)	16	18	38	13	13	15	29	13	44	8	18

2.2 Factors Affecting Demand for Credit

- In the quarter ended December 31, 2020, ten out of the eleven factors affecting demand for credit had no impact. 54 percent of the respondents reported that the COVID-19 pandemic had negatively impacted the demand for credit. This is depicted in **Chart 2** and **Table 2**.
- Issuance of equity, political risk, issuance of debt securities, and loans from non-banks were cited as having had the least impact on the demand for credit during the quarter under review. These were reported by 94 percent, 92 percent, 89 percent and 84 percent of the respondents respectively.

Chart 2: Factors affecting Demand for Credit



	Internal Financing	Loans from other banks	Loans from non banks	Issusance of debt securities	Issuance of equity	Cost of borrowing	Available investment opportunities	Reduction of the Central Bank Rate (CBR)	Political Risk	Repeal of Interest Rate Capping	COVID – 19 pandemic
Increased (%)	11	5	3	5	3	18	16	18	3	23	28
Remained Unchanged (%)	79	77	84	89	94	77	62	82	92	77	18
Decreased (%)	11	18	13	5	3	5	22	0	5	0	54

Table 2: Factors Affecting Demand for Credit

Percentage (%)	September 2020			December 2020		
	Increased	Remained Unchanged	Decreased	Increased	Remained Unchanged	Decreased
Internal Financing	8	81	11	11	79	11
Loans from other banks	3	76	21	5	77	18
Loans from non-banks	5	71	24	3	84	13
Issuance of debt securities	3	89	8	5	89	5
Issuance of equity	3	89	8	3	94	3
Cost of borrowing	16	76	8	18	77	5
Available investment opportunities	14	65	22	16	62	22
Reduction of the Central Bank Rate (CBR)	19	81	0	18	82	0
Political Risk	11	83	6	3	92	5
Repeal of Interest Rate Capping	17	81	3	23	77	0
COVID – 19 pandemic	17	33	50	28	18	54

2.3 Credit Standards

- In the fourth quarter of 2020, credit standards remained unchanged in seven economic sectors and were tightened in four sectors namely Tourism, Real Estate, Transport and Communication, and Personal and Household sectors.
- Tightening of credit standards in the four sectors is attributed to the effects of COVID – 19 pandemic.
- This is presented in **Chart 3** and **Table 3** below.

Chart 3: Credit Standards

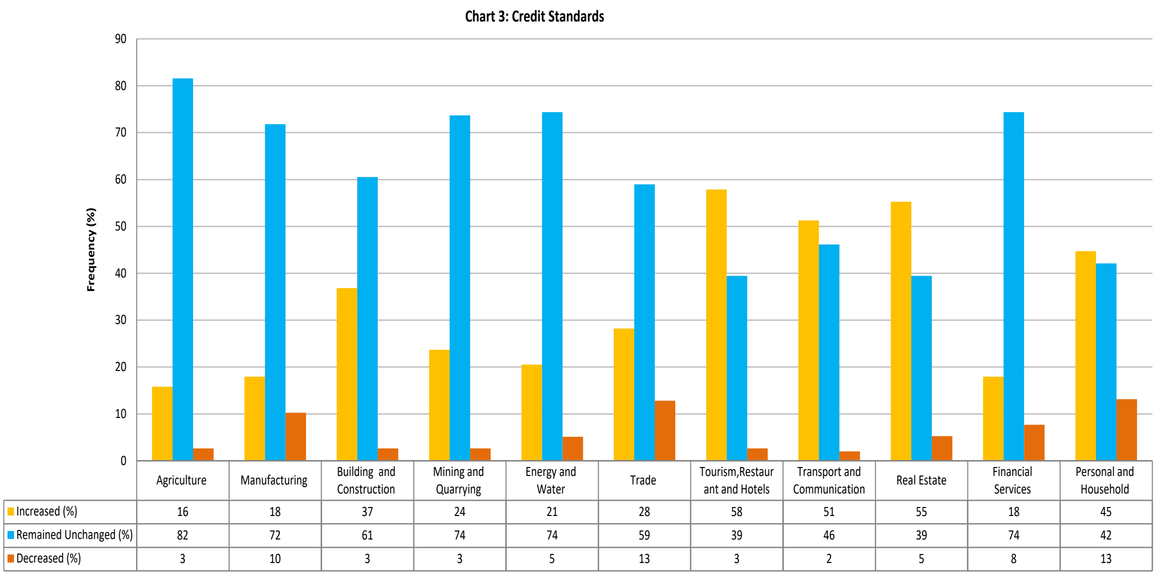


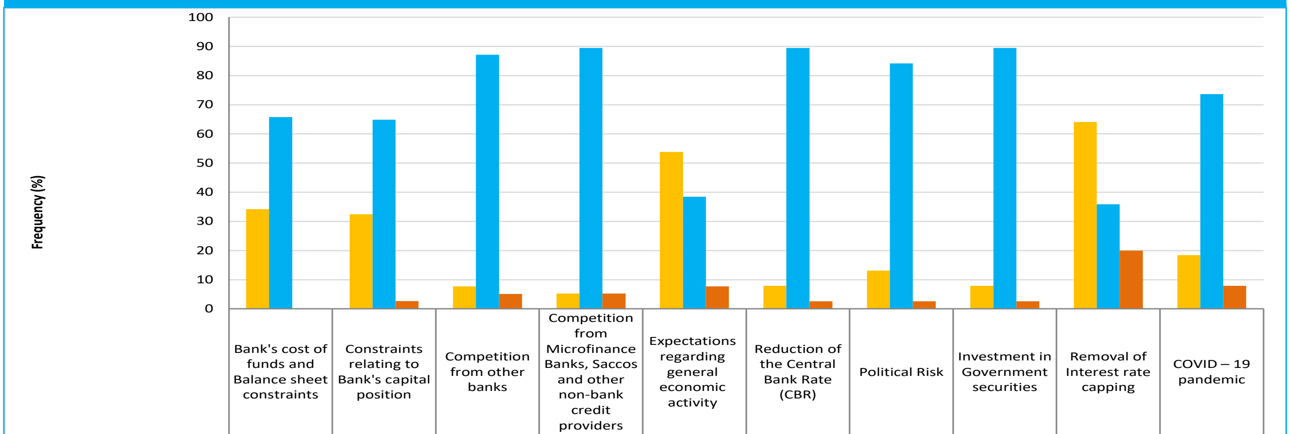
Table 3: Credit Standards for Loans to Various Economic Sectors

Percentage (%)	September 2020			December 2020		
	Tightened	Remained Unchanged	Eased	Tightened	Remained Unchanged	Eased
Agriculture	18	74	8	16	82	3
Manufacturing	21	62	18	18	72	10
Building and Construction	43	49	8	37	61	3
Mining and Quarrying	26	71	3	24	74	3
Energy and Water	21	71	8	21	74	5
Trade	26	56	18	28	59	13
Tourism, Restaurant and Hotels	55	37	8	58	39	3
Transport and Communication	51	46	2	51	46	2
Real Estate	58	32	11	55	39	5
Financial Services	23	72	5	18	74	8
Personal and Household	47	29	24	45	42	13

2.4 Factors Affecting Credit Standards

- In the quarter ended December 31, 2020, eight factors had little impact on credit standards whereas two factors had an impact.
- Competition from Saccos, Microfinance banks, other Credit Providers; political risk; investment in Government Securities and reduction of CBR are the main factors that had no impact on credit standards. All these were reported by 89 percent of the respondents.
- Expectations regarding general economic activity and removal of interest rate capping led to 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**.

Chart 4: Factors affecting Credit Standards



	Bank's cost of funds and Balance sheet constraints	Constraints relating to Bank's capital position	Competition from other banks	Competition from Microfinance Banks, Saccos and other non-bank credit providers	Expectations regarding general economic activity	Reduction of the Central Bank Rate (CBR)	Political Risk	Investment in Government securities	Removal of Interest rate capping	COVID – 19 pandemic
Tightened (%)	34	32	8	5	54	8	13	8	64	18
Remained unchanged (%)	66	65	87	89	38	89	84	89	36	74
Eased (%)	0	3	5	5	8	3	3	3	20	8

Table 4: Factors affecting credit standards

	September 2020			December 2020		
	Tightened	Remained Unchanged	Eased	Tightened	Remained Unchanged	Eased
Bank's cost of funds and Balance sheet constraints	29	66	5	34	66	0
Constraints relating to Bank's capital position	24	71	5	32	65	3
Competition from other banks	13	79	8	8	87	5
Competition from DTMs, Saccos, and other Credit Providers	5	92	3	5	89	5
Expectations regarding general economic activity	54	38	8	54	38	8
Reduction of the Central Bank Rate (CBR)	11	79	11	8	89	3
Political Risk	8	87	5	13	84	3
Investment in Government Securities	13	82	5	8	89	3
Removal of Interest rate capping	63	32	20	64	36	20
COVID –19 pandemic	19	73	8	18	74	8

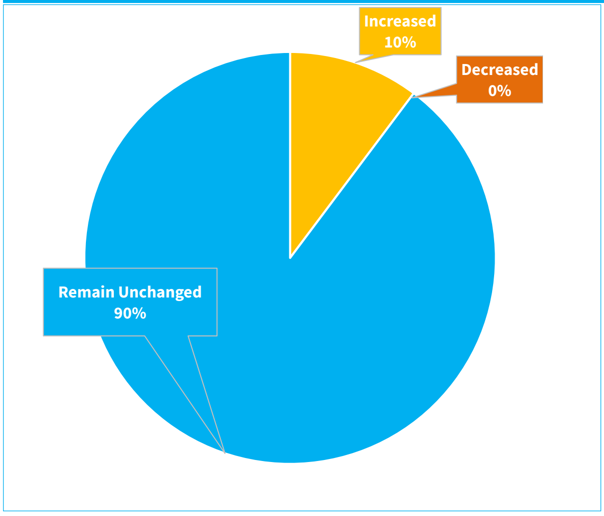
2.5 Repeal of Interest Rate Capping Law

- Following the repeal of capping of interest rates effective November 7, 2019, the Central Bank of Kenya has continued to assess its impact on demand for credit, lending to SMEs, actual credit granted, and Non Performing Loans (NPLs).

2.5.1 Effect of Repeal of Interest Rate Capping Law on Actual Credit Credit Granted in Fourth Quarter of 2020

- 90 percent of the respondents indicated that after the repeal of interest rate capping law, the demand for credit remained unchanged while 10 percent noted that demand for credit increased.
- This is depicted in **Chart 5** below.

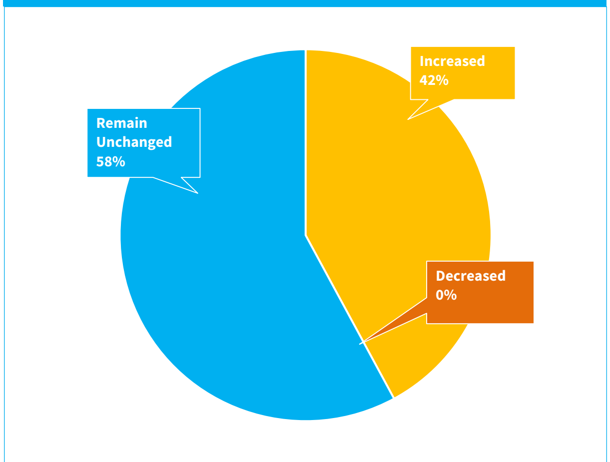
Chart 5: Repeal of Interest Rate Cap Effect on Actual Credit Granted during the Fourth quarter (%)



2.5.2 Effect of repeal of Interest Rate Capping Law on Lending to SMEs in fourth Quarter of 2020

- In the quarter ended December 2020, 58 percent of the respondents indicated that the repeal of interest rate capping law had no effect on their lending to SMEs, while 42 percent indicated that the repeal had increased their lending to SMEs since majority of the banks are on-boarding risk based pricing models which has increased financial institutions' appetite to lend to SMEs. This is indicated in **Chart 6**.

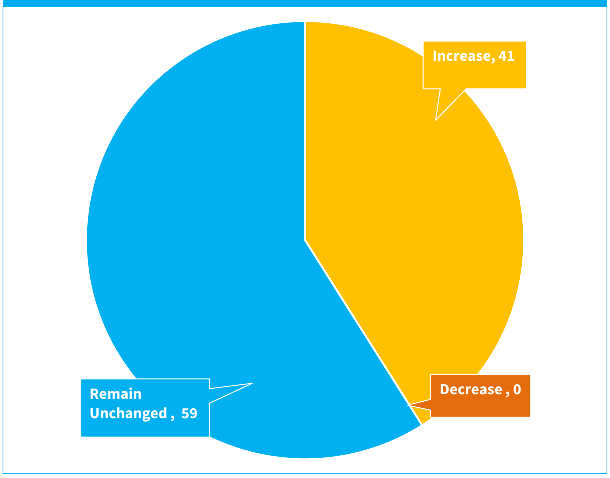
Chart 6: Effect of Repeal of Interest Rate Capping Law on lending to SMEs (%)



2.5.3 Effect of repeal of Interest Rate Cap Law on Expected credit to be granted in the next quarter

- With regards to the expected credit to be granted in the first quarter of 2021, 59 percent of the respondents felt that the repeal of interest capping had little or no impact.
- 41 percent of the respondents indicated that repeal of interest rate capping law would lead to an increase in demand for credit.
- The expected movement on demand for credit in the next quarter due to repeal of interest rate law, is shown in **Chart 7**.

Chart 7: Effect of Repeal of Interest Rate Capping Law on Expected Credit to be granted in the Next Quarter (%)



2.5.4 Effect of repeal of Interest Rate Capping Law on the Level of NPLs in the Fourth Quarter of 2020

- In the quarter ended December 31, 2020, 87 percent of the respondents indicated that the repeal of interest rate capping law had no effect on level of NPLs.
- 10 percent of the respondents indicated that asset quality improved whereas 3 percent indicated that it deteriorated. This is as indicated in **Chart 8** below.

Chart 8: Effect of repeal of interest rate capping on NPLs over the past quarter (%)

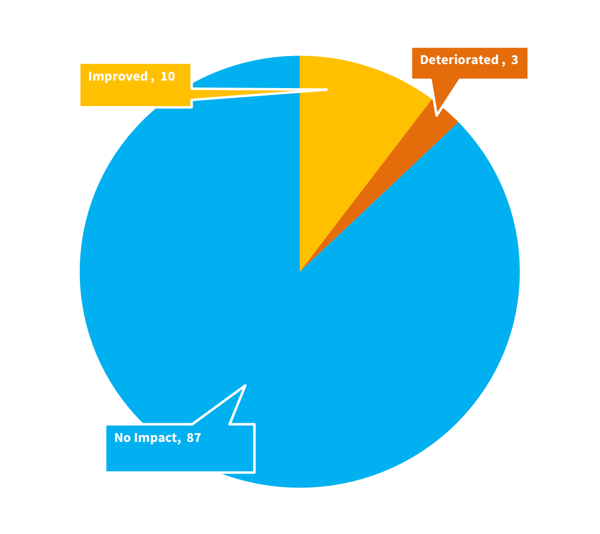
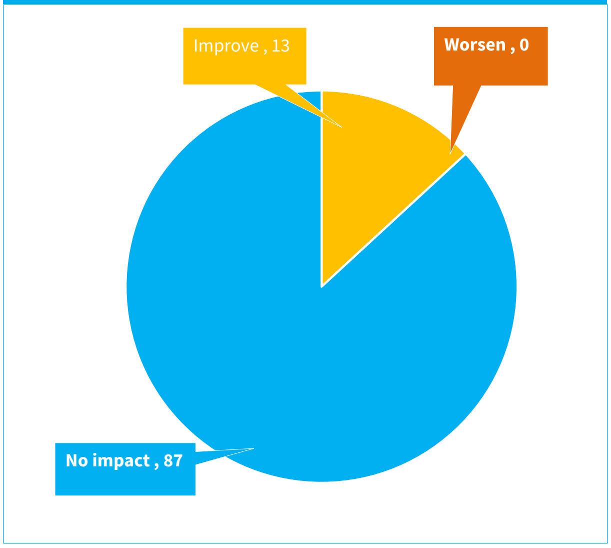


Chart 9: Interest rates cap effect on level of NPLs in the next quarter (%)



2.5.5 Effect of repeal of Interest Rate Capping Law on the Expected Level of NPLs in the First Quarter of 2021

- 87 percent of the respondents anticipate that repeal of interest rate capping law will have no impact on the level of NPLs in the first quarter of 2021. This is because the pricing of loans has no impact on repayment ability.
- 13 percent of the respondents expect the repeal of law on capping of interest rates to have positive impact on NPLs. This trend is as indicated in **Chart 9** below.

2.6 Non-Performing Loans (NPLs)

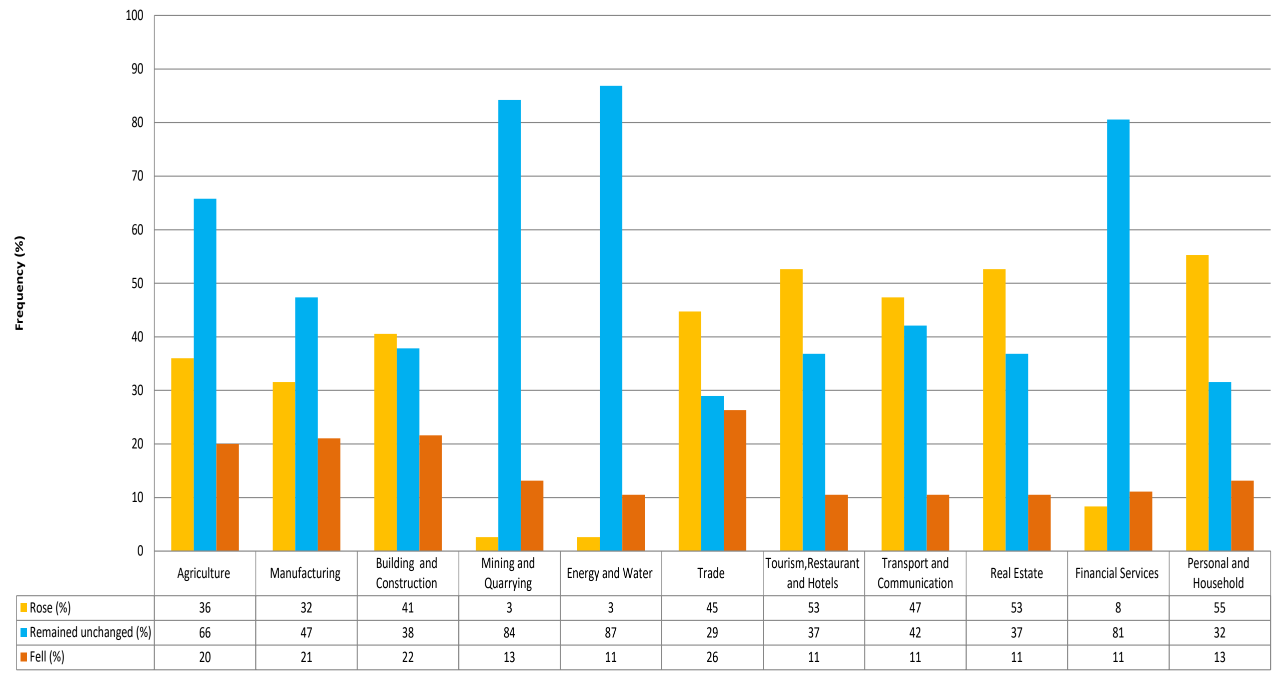
2.6.1 Non - Performing Loans during the quarter ended December 31, 2020

- During the quarter under review, the respondents indicated that the level of NPLs remained unchanged in five economic sectors and increased in six sectors namely Personal and Household, Tourism, Real Estate, Transport and Communication, Trade and Building and Construction.
- **Table 5** and **Chart 10** depicts this.

Table 5: Non-Performing Loans Trend Per Economic Sector

	September 2020			December 2020		
Percentage (%)	Rose	Remained Unchanged	Fell	Rose	Remained Unchanged	Fell
Agriculture	36	53	20	36	66	20
Manufacturing	26	53	21	32	47	21
Building and Construction	42	34	24	41	38	22
Mining and Quarrying	16	71	13	3	84	13
Energy and Water	8	76	16	3	87	11
Trade	45	29	26	45	29	26
Tourism, Restaurant and Hotels	58	26	16	53	37	11
Transport and Communication	55	29	16	47	42	11
Real Estate	58	24	18	53	37	11
Financial Services	21	63	16	8	81	11
Personal and Household	55	29	16	55	32	13

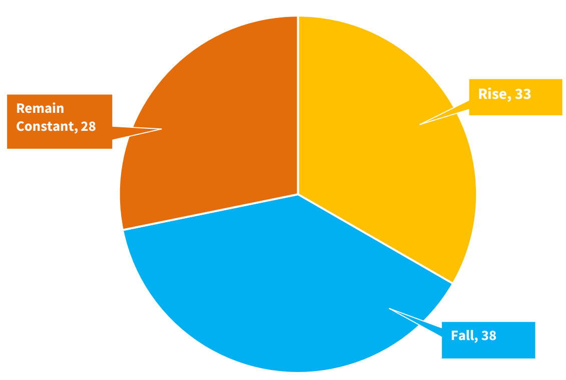
Chart 10: Non-Performing Loans



2.6.2 Expected Non-Performing Loans during the First Quarter of 2021

- 38 percent of the respondents indicated that NPLs are likely to fall in the first quarter of 2021. This is attributed to enhanced recovery efforts being implemented by most banks.
- 33 percent of the respondents expect the level of NPLs to rise in the first quarter of 2021 as a result of the global COVID-19 pandemic.
- 28 percent of respondents expect NPLs to remain constant. This is depicted in **Chart 11**

Chart 11: Expected Movements of NPLs in the First Quarter of 2021 (%)



2.7 Credit Recovery Efforts in the First Quarter of 2021

- For the quarter ending March 31, 2021, banks expect to intensify their credit recovery efforts in all economic sectors. The intensified recovery efforts are aimed at improving the overall quality of the asset portfolio.
- The main sectors that banks intend to intensify credit recovery efforts in order to enhance reduction of NPLs therefore improving the overall quality of their asset portfolio are: -

  i. Trade (89 percent),
  ii. Personal and Household (87 percent),
  iii. Real Estate (84 percent),
  iv. Transport and Communication (84 percent), and
  v. Building and Construction (84 percent).

- The responses on the expected credit recovery efforts by the banks are depicted in **Chart 12** and **Table 6.**

Chart 12: Credit Recovery Efforts

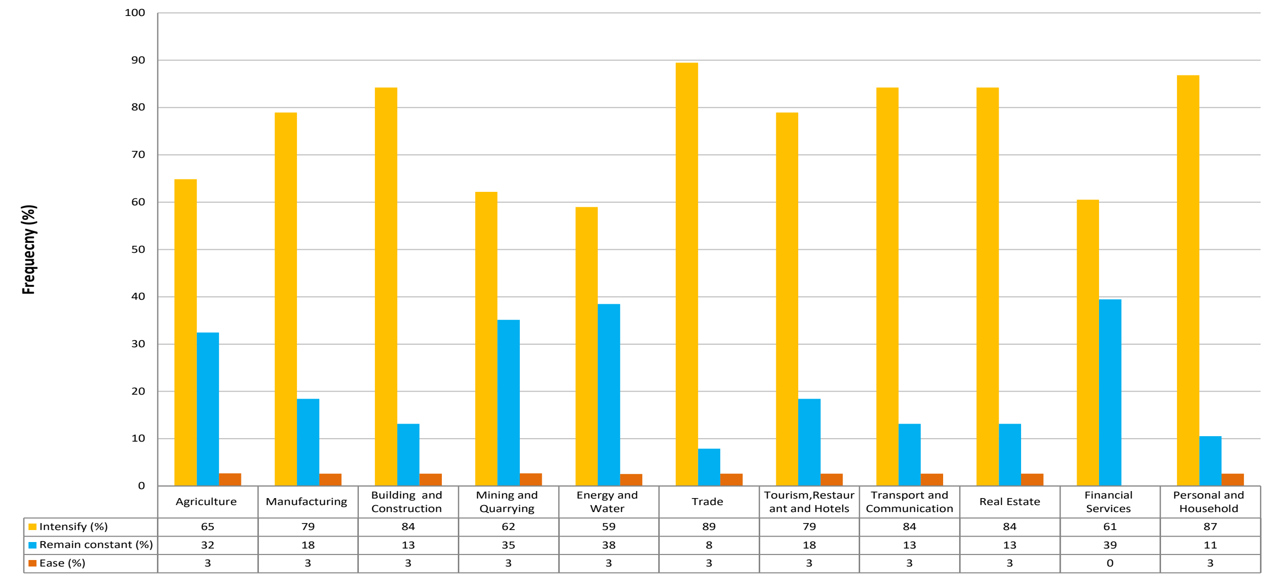


Table 6: Credit Recovery Efforts

	September 2020			December 2020		
	Intensified	**Remained Unchanged**	**Eased**	**Intensified**	**Remained Unchanged**	**Eased**
Agriculture	54	38	8	65	32	3
Manufacturing	66	29	5	79	18	3
Building and Construction	71	21	8	84	13	3
Mining and Quarrying	50	45	5	62	35	3
Energy and Water	46	46	8	59	38	3
Trade	76	18	5	89	8	3
Tourism, Restaurant and Hotels	71	24	5	79	18	3
Transport and Communication	82	13	5	84	13	3
Real Estate	79	13	8	84	13	3
Financial Services	62	36	3	61	39	0
Personal and Household	71	18	11	87	11	3

2.8 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).
- IFRS 9 introduced a new method of determining provisions for expected losses on loans extended by lending institutions.
- 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.
- The Central Bank of Kenya assesses: -

i). The challenges the banks have experienced in the implementation of IFRS 9 and mitigation measures implemented.

ii). Whether the banks have made any changes in the assumptions used in IFRS 9.

iii). What the banks have done to ensure that the assumptions are more reliable.

2.8.1 Challenges experienced in the Implementation of IFRS 9 and Mitigation Measures

- Most banks have adopted a tight credit risk appraisal, ensuring that facilities are well secured and that alternative sources of repayment are available.
- In addition, banks have changed their lending policies to align them with IFRS 9. However, implementation of IFRS 9 has had some challenges.

These include: -

i. Negative impact on capital adequacy due to increased provisioning.

ii. Challenges in getting reliable macro-economic indicators.

iii. Incorporating reliable macro-economic factors in the model is challenging in an uncertain economy.

iv. Cost implication for the relevant technology, consultants and personnel training.

v. Incorporating an effective interest rate in the model is difficult as its cumbersome to implement without automation.

vi. Minimal growth in loan book due to rigorous risk profiling and credit appraisal standards leading to a negative impact on profitability.

vii. Lack of adequate historical data for assessment and re- modeling of the IFRS 9 assumptions and parameters including probability of default (PD) and loss given default (LGD).

viii. Continuous improvement of the business model.

As a mitigation measure, banks have indicated that:

i. They have injected additional capital to accommodate the expected rise in credit losses.

ii. They are continuously improving their business models to incorporate forward-looking credit risk assessment models in compliance with IFRS 9 requirements.

iii. Some banks have developed internal rating models to assess credit risks across all sectors including for SMEs. Banks have therefore introduced unsecured credit products for SMEs.

iv. Automation of the model to minimize errors and gaps in implementation.

v. Banks have engaged consultants to validate the assumptions to ensure that they are reliable.

vi. The focus of banks is now more on secured lending.

vii. Banks have revamped their credit recovery efforts.

viii. Banks are enhancing staff capacity through training as well as reviewing their policies and procedures to ensure full compliance with IFRS 9.

ix. Close monitoring of changing trends in macroeconomic indicators that may affect customers' ability to repay including robust credit monitoring.

x. Banks focus on high yielding assets.

2.8.2 Changes made by commercial banks on the assumptions used in IFRS 9

- The use of forward-looking information is a key component of the Expected Credit Loss (ECL) impairment approach. Commercial banks are now required to consider historic, current and forward-looking information (including macro-economic data).

  This aims at ensuring that credit losses are recognized at an early stage, rather than waiting for an incurred loss event to have occurred before credit losses are recognized.

- ECLs are measured in a way that is not just determined by evaluating a range of possible outcomes, adjusted for the time value of money, but also taking into account 'reasonable and supportable' information about past, present and future events and economic conditions.

- During the quarter under review, the survey revealed the following:-

i. Some of the respondents indicated that they have updated their assumptions to include the current macro-economic indicators.

ii. Banks are facing challenges in modeling data related to the global COVID-19 pandemic and its predicted impact on loan performance.

   Banks are still assessing the effects of COVID-19 to generate different assumptions that will need to be included in the models.

iii. Some banks have conducted various stress tests to isolate industries that are most vulnerable and are being monitored in order to incorporate them into their various models, using the three scenarios (Baseline, Plausible and Worst case Scenario).

2.8.3 Actions by the commercial banks to ensure that the assumptions are reliable

- Some of the respondents have indicated that they are currently reviewing their assumptions on a quarterly basis to ensure that they are reliable. This aims at ensuring that losses in different sectors are reflected accurately in the model.
- Some banks have also indicated that their model parameters (probability of default and Loss Given Default) are updated twice yearly to ensure all parameters are up to date and relevant.
- Some banks have done data cleanup to ensure its integrity and automation of the model to minimize errors.
- Change assumptions on PD computation from portfolio based to sector based.

2.9 International Financial Reporting Standard (IFRS) 16 on Leases

- The International Financial Reporting Standard (IFRS) 16 on Leases became effective from January 1, 2019. This standard replaced International Accounting Standard (IAS) 17 on Leases.
- The main difference between IAS 17 and IFRS 16 is the treatment of operating leases by lessees. Under IAS 17, a lessee was not obligated to report assets and liabilities from operating leases on their balance sheet but instead report the leases as off balance sheet items. IFRS 16 changes this by requiring lessees to recognize operating leases right of use (ROU) assets and lease liabilities on the balance sheet.
- IFRS 16 aims to improve the quality of financial reporting for companies with material off balance sheet leases. However, financial institutions have been facing challenges with the implementation of IFRS 16.
- During the quarter ended December 31, 2020, 97 percent of the respondents had implemented and assessed the likely impact of IFRS 16 on their financial performance and position. These are depicted in **Chart 13** and **Chart 14** respectively.

Chart 13: Banks that have implemented IFRS 16 on Leases (%)

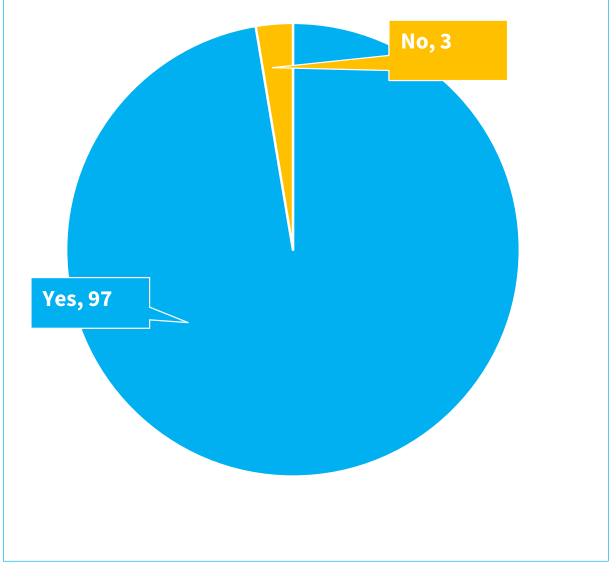
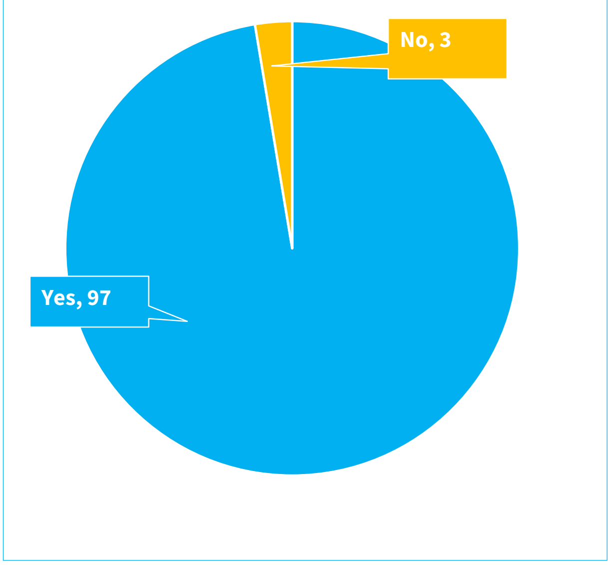


Chart 14: Banks that assessed the likely impact of IFRS 16 (%)



2.9.1 Impact of IFRS 16 on Banks' Financial performance and position

- Most banks indicated that implementation of IFRS 16 increased their risk weighted assets, which has in turn decreased their capital adequacy ratios.
- This called for capital injection to strengthen the banks' capital adequacy.

2.9.2 Challenges experienced in the Implementation of IFRS 16

- Most banks indicated that the major challenge they face in implementation of IFRS 16 is cost of training their staff for compliance with the standard.
- As a mitigation measure, banks have indicated that they are: -
  - i) training their staff on the job.
  - ii) changing their business models and risk management tools.
  - iii) Continuous review of leases for renegotiation and ensuring that the lease terms are reasonable.

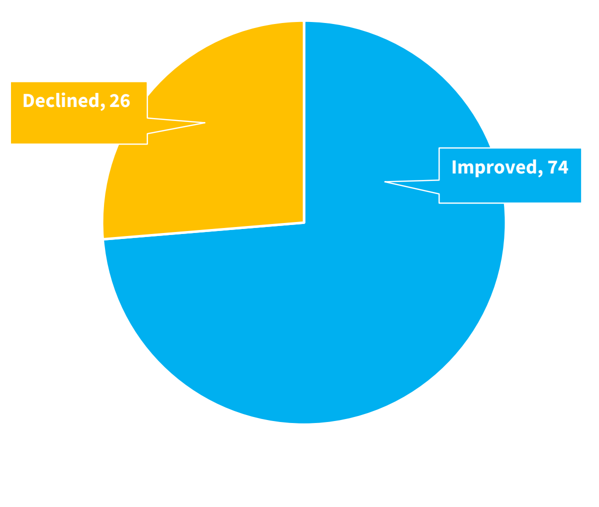
2.10 Liquidity Risk

- During the quarter ended December 31, 2020, liquidity in the banking sector increased from 53.25 percent in September 2020 to 54.55 percent in December 2020. The ratio remained above the minimum statutory ratio of 20 percent.
- Banks whose liquidity deteriorated in the last two quarters intend to solve this by: -
  - i). Mobilizing deposits from the general public.
  - ii). Enhanced loan collections and recoveries.
  - iii). Sourcing for strategic investment partners.

2.10.1 Commercial Banks' liquidity positions

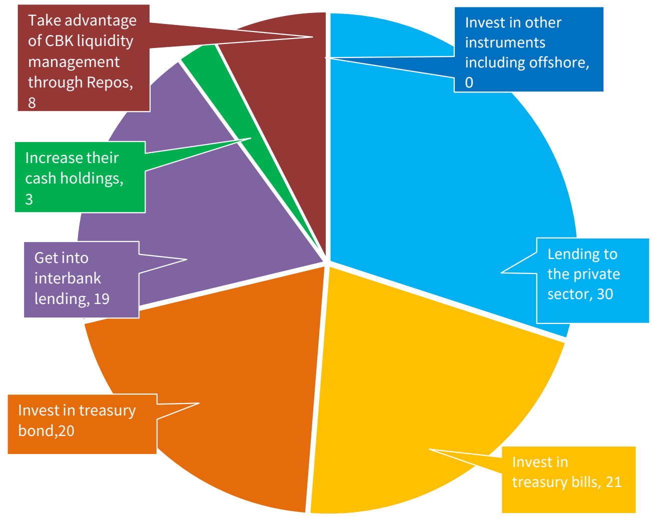
- During the quarter ended December 2020, 74 percent of the respondents indicated that their liquidity position had improved as indicated in **Chart 15**.

Chart 15: Movement in liquidity risk (%)



- As indicated in **Chart 16,** with the improved liquidity, it is expected that in the first quarter of 2021, issuance of credit will increase as most banks intend to deploy the additional liquidity towards lending to the private sector (30 percent), investing in Treasury Bills (21 percent), investing in Treasury Bonds (20 percent), interbank lending (19 percent), CBK liquidity management through repos (8 percent), and increase their cash holding (3 percent).

Chart 16: Plans with improved liquidity (%)



2.10.2 Factors that led to improved liquidity over the third quarter

During the quarter ended December 31, 2020, liquidity improved mainly as a result of: -

i). Increased deposits (46 percent),

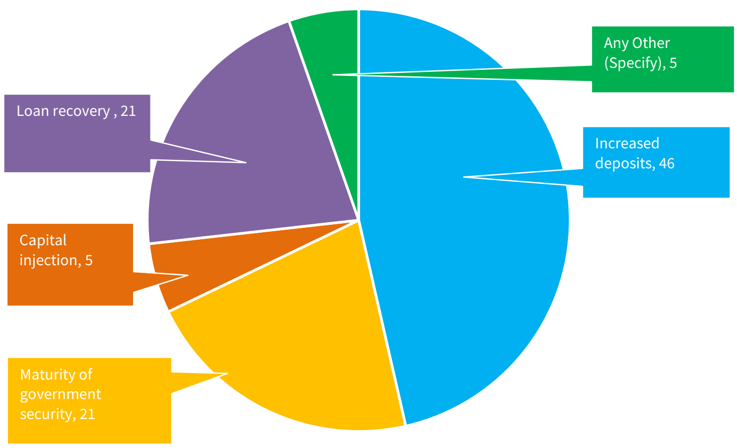
ii). Maturity of government securities (21 percent),

iii). Loan recovery (21 percent), and

iv). Capital injection (5 percent).

- The drivers of improved liquidity are indicated in **Chart 17** below.

Chart 17: Reasons for improved liquidity (%)



2.10.3 Commercial Banks' interbank activities during the quarter

- During the quarter ended December 31, 2020, 64 percent of the respondents indicated that their interbank lending activities increased. This is indicated in **Chart 18** below.
- 63 percent of the respondents indicated that their interbank borrowing decreased. This is indicated in **Chart 19** below.
- Interbank lending and borrowing has generally decreased due to tightening of credit standards by institutions.

Chart 18: Increase in interbank lending (%)

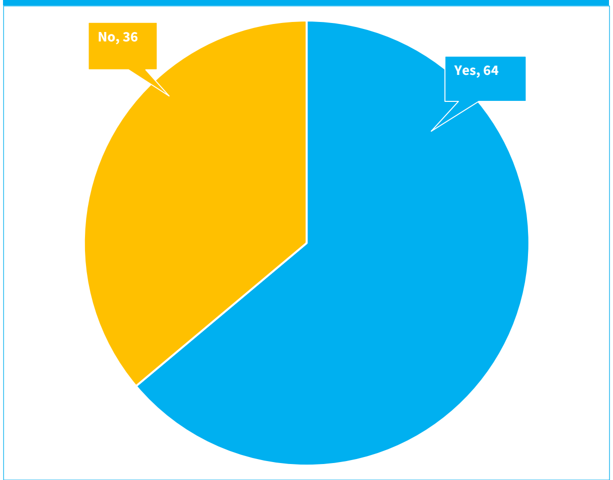
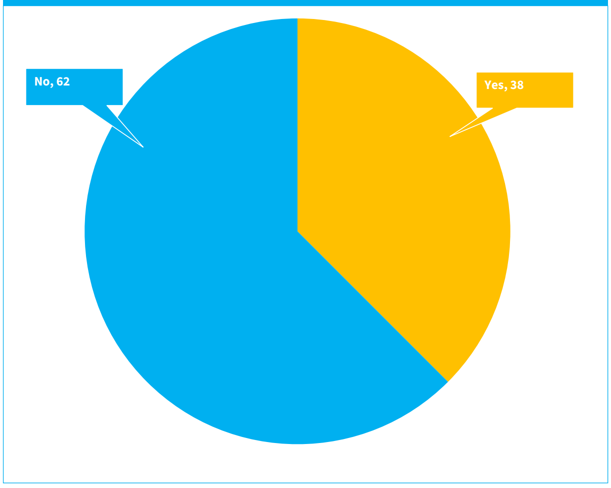


Chart 19: Increase in Interbank borrowing (%)



2.11 Impact of the Global Coronavirus Pandemic on the Banking Sector

The ongoing COVID-19 pandemic has devastated many countries, with significant human, economic and social costs. The global economic outlook has been highly uncertain, with unprecedented volatility in the financial markets.

While the extent of the adverse effects of the pandemic on the Kenyan economy is still evolving, it is already evident that the impact may be severe. In this regard, CBK through the credit survey assessed the impact of the pandemic on the banking sector. The survey covered areas relating to:-

i) Impact of the pandemic on the banks,
ii) Measures taken by banks to curb the potential impact of the pandemic; and
iii) Banks' experience in implementing the emergency measures introduced by CBK to mitigate the impact of the pandemic.

2.11.1 Impact of Coronavirus (COVID-19) pandemic on the banks

The commercial banks have indicated that the pandemic had an impact on their business. Some positive impacts include:

- Financial services classified as essential services.
- Increased use of digital platforms (Mobile and internet banking).
- Increased demand for lending to Fast Moving Consumer Goods (FMCG), health and technology companies.

Some of the adverse effects include:

- Decrease in profitability because of slowdown in business.
- Banks have had to absorb significant operational costs in extending forbearance credit support in terms of payments holidays and restructures for affected customers, this has led to deterioration of core capital position
- Increased expenditure. Banks have been compelled to purchase Personal Protective Equipment (PPE) for staff as well as ensuring that their premises are well fumigated.
- Increases in Non-Performing Loans which may be attributed to slowdown in business, business closures and job losses.
- Decreased loans advanced to customers as banks become more cautious due to the high risk of credit default.

Some of the key risks increased by the pandemic include:

- **Credit risk**: Reduced cash flows by some of the borrowing customers necessitating loan restructures, value chain disruptions in some sectors and some businesses have shut down their operations.
- **Operational risk**: Need for enhanced business continuity plans given risk of COVID-19 infection of bank staff.
- **Cyber security risk**: Due to increased use of digital banking.

2.11.2 Measures taken by banks to curb the potential impact of coronavirus pandemic on its business

The commercial banks have put in place the following measures to curb the potential impact of the pandemic:-

- Banks have implemented their Business Continuity Plans (identification of critical processes, critical staff and their back-ups).
- Sensitization and enhanced awareness of staff through regular e-mails and phone text messages.
- Banks have put in place work rotation plans for all staff members and automated their processes to ensure social distancing.
- Banks have assessed the various industries and the expected impacts thereon and are reaching out to the affected customers to discuss restructuring to manage the situation.
- Banks have tightened their credit standards on granting of new loans to enable the assessment of the impact of the pandemic in each industry.
- Banks are actively reaching out and working with customers to understand their constraints caused by the pandemic and offering a number of reliefs including restructuring of facilities and providing moratoriums on both interest and principal where necessary.
- Giving payment holidays to the customers who have been adversely affected by the pandemic. This will enable them stay afloat and eventually be able to recover and get back to businesses.
- Supporting customers with working capital financing to cover the increase in working capital gap (due payments to suppliers and

fixed costs) attributed to slowdown in sales revenue/no revenue.

- Continuous portfolio monitoring for early warning signs to ensure quality of the asset book.

2.11.3 Impact of implementing the emergency measures introduced by CBK to mitigate the impact of the Coronavirus Pandemic

The emergency measures issued by CBK along with their impact on the banking sector include: -

i. **Review and extension of personal loans for up to one year:** Banks have received and processed several requests from clients for restructuring of their loans and moratorium for payment of the principal amounts in order to reduce the level of non-performing loans.

ii. **Assessment and restructuring of loans to Medium sized enterprises and corporate borrowers :** Banks have indicated that:-

  - They expect a reduction in interest income as a result of restructurings.
  - They have received several restructuring requests. However, the biggest challenge is that customers are quoting CBK emergency measures as a blanket approval with the assumption that the grace period applies to all.
  - There is a challenge in getting rational projected financials for each business to determine the likely pandemic impact on each business.
  - Currently, the assessment is done on a case by case basis. Allowing moratorium on both principal and interest is mainly for customers severely affected by the pandemic.

iii. Banks are currently **meeting all loan extension and restructuring costs.** However, this will put a strain on the bank's operations hence necessitating measures to reduce/cut costs as much as possible for sustainability.

iv. **Lowering the Central Bank Rate to 7 percent:** Whereas the intention was to encourage lending, due to disruption of the country's economy by the pandemic, there is reduced appetite for borrowing and lending.

v. Majority of the banks indicated that **lowering the Cash Reserve ratio to 4.25 percent** availed more funds for onward lending to Micro, Small and Medium Enterprises (MSME's). Further, the funds assisted in balancing the banks liquidity position now that most clients are asking for relief and moratorium.

vi. **Extension of maximum tenor of repos to 91 days** will come in handy if the situation persists as banks will be able to accommodate customers for longer periods of moratorium.

2.11.4 Suggested proposals to further mitigate the impact of Corona Virus Pandemic

- The respondents made proposals for CBK to consider to further mitigate the impact of COVID-19. In summary, the banks have noted that there is need for CBK in conjunction with the National Treasury to come up with other specific measures that particularly cushion institutions.

- This could be in form of additional funding to be offered at concessionary rates to the commercial banks.

LIST OF RESPONDENTS

1. Absa Bank Kenya Plc
2. Access Bank (Kenya) Plc.
3. African Banking Corporation Ltd.
4. Bank of Africa Kenya Ltd.
5. Bank of Baroda (K) Ltd.
6. Bank of India.
7. Citibank N.A Kenya.
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. First Community Bank Ltd.
18. Guaranty Trust Bank (Kenya) Ltd.
19. Guardian Bank Ltd.
20. Gulf African Bank Ltd.
21. Habib Bank A.G Zurich.
22. HFC Ltd.
23. I & M Bank Ltd.
24. Kingdom Bank Ltd.
25. KCB Bank Kenya Ltd.
26. Middle East Bank (K) Ltd.
27. Mayfair CIB Bank Ltd.
28. M Oriental Bank Ltd.
29. National Bank of Kenya Ltd.
30. NCBA Bank Kenya Plc.
31. Paramount Bank Ltd.
32. Prime Bank Ltd.
33. Standard Chartered Bank (K) Ltd.
34. SBM Bank Kenya Ltd.
35. Spire Bank Ltd.
36. Sidian Bank Ltd.
37. Stanbic Bank Kenya Ltd.
38. Victoria Commercial Bank Ltd.
39. UBA Kenya Bank Ltd.

Central Bank of Kenya

Haile Selassie Avenue P.O. Box 60000 - 00200 Nairobi |Tel: (+254) 20 - 286 0000 / 286 1000 / 286 3000

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