Central Bank of Kenya

JANUARY - MARCH 2020

CREDIT SURVEY

CENTRAL BANK OF KENYA COMMERCIAL BANKS' CREDIT OFFICER SURVEY JANUARY - MARCH 2020

1.0 COMMERCIAL BANKS' CREDIT OFFICER SURVEY

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 57.42 percent in the quarter ended December 31, 2019 to 56.94 percent in the quarter ended March 31, 2020.

The Central Bank of Kenya (CBK) undertakes a quarterly Credit Officer Survey to identify the potential drivers of credit risk. The survey was revised to include new aspects such as implementation of International Financial Reporting Standard (IFRS) 9 and 16, liquidity risk and emerging developments. 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 emerging developments on commercial banks' financial position and performance.

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 March 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 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 the coronavirus (COVID-19) outbreak as a pandemic, 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 banks 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 March 31, 2020, compared to the quarter ended December 31, 2019. Some of the sector's performance indicators are as follows: -

- The aggregate balance sheet increased by 3.49 percent from Ksh.4,832.35 billion in December 2019 to Ksh.5,001.16 billion in March 2020. The increase was attributed to increased investment in government securities and foreign currency loans during the period.
- Gross loans increased by 2.62 percent from Ksh.2,774.65 billion in December 2019 to Ksh.2,847.44 billion in March 2020. The growth in gross loans was mainly due to increased advances in the Manufacturing, Trade, Personal/ Household and Tourism, Restaurant and Hotels sectors.
- Total deposits increased by 3.8 percent from Ksh.3,554.42 billion in December 2019 to Ksh.3,688.08 billion in March 2020. There was an increase in both foreign and local currency deposits.
- The asset quality, measured by ratio of gross non-performing loans to gross loans deteriorated from 12.01 percent in December 2019 to 12.54 percent in March 2020. This was attributed to a slowdown in business activities.
- The total capital adequacy ratio decreased from 18.79 percent in December 2019 to 18.50 percent in March 2020. This is as a result of a higher increase in total risk weighted assets as compared to increase in total capital. The capital adequacy ratio reported in March 2020 was above the minimum statutory limits of 14.5 percent.
- Quarterly profit before tax increased by Ksh.3.73 billion to Ksh.38.34 billion in March 2020 from Ksh.34.61 billion in December 2019. Return on Assets decreased to 2.33 percent in March 2020 from 2.54 percent in December 2019. The total assets increased by 3.49 percent whereas quarterly profit before tax decreased by 60.53 percent during the quarter hence the decrease in Return on Assets.
- Return on Equity decreased to 20.38 percent in March 2020 from 21.23 percent in December 2019. This is as a result of a drop in quarterly profit before tax in March 2020.
- During the quarter ended March 2020, liquidity in the banking sector marginally increased from 49.7 percent in December 2019 to 51.45 percent. This was well above the minimum statutory ratio of 20 percent.

1.4 SUMMARY OF CREDIT OFFICER SURVEY FINDINGS

- **Demand for credit:** In the first quarter of 2020, the perceived demand for credit remained unchanged in nine economic sectors except Personal/household and Trade sectors whose demand for credit was perceived to have increased. The increased demand in the two sectors is attributed to increased demand for consumer goods and services.
- **Credit Standards[3]:** In the first quarter of 2020, credit standards remained unchanged in eight economic sectors and tightened in two sectors (Real Estate and Tourism, Restaurants and Hotels).

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

- The main sectors with unchanged credit standards are Energy and Water, Mining and Quarrying, Financial Services and Agriculture. Tightened credit standards in the Real Estate and Tourism, Restaurants and Hotels sectors was attributed to a slowdown in economic activity coupled by the effects of COVID – 19 pandemic.

- **Repeal of interest rate capping law:** CBK has continued to assess the impact of the repeal of interest rate capping law on demand for credit, lending to SMEs, and actual credit granted.

  80 percent of the respondents indicated that after the repeal of interest rate capping law, the demand for credit remained unchanged, 17 percent noted that demand for credit increased while 3 percent noted that demand for credit decreased.

- **Lending to Small and Medium-sized Enterprises (SMEs):** In the quarter ended March 2020, 68 percent of the respondents indicated that the repeal of interest rate capping law did not negatively affect their lending to SMEs.

- **Non-Performing Loans:** During the quarter under review, the respondents indicated that the levels of NPLs remained unchanged in four economic sectors and increased in seven sectors. The main sectors with increased NPLs include Tourism, Restaurant and Hotels, Transport and Communication, Trade, Real Estate, Personal/Household, Building and Construction and Manufacturing sectors.

  The increase in NPLs was mainly due to a challenging business environment.

- **Expected Non-Performing Loans levels during the second quarter:** 61 percent of the respondents indicated that NPLs are likely to increase in the second quarter of 2020 as a result of the global COVID-19 pandemic. The respondents indicated that all the eleven economic sectors will be affected negatively by the pandemic.

- **Credit Recovery Efforts:** For the quarter ended June 30, 2020, banks expect to intensify their credit recovery efforts in nine of the eleven 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 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 March 2020, liquidity of the banking industry remained fairly stable.

- **Banks** indicated that they intended to deploy excess liquidity towards credit, mostly by lending to the private sector, CBK liquidity management through repos and interbank lending. In addition, banks intend to utilize excess liquidity to invest in treasury bills and bonds.

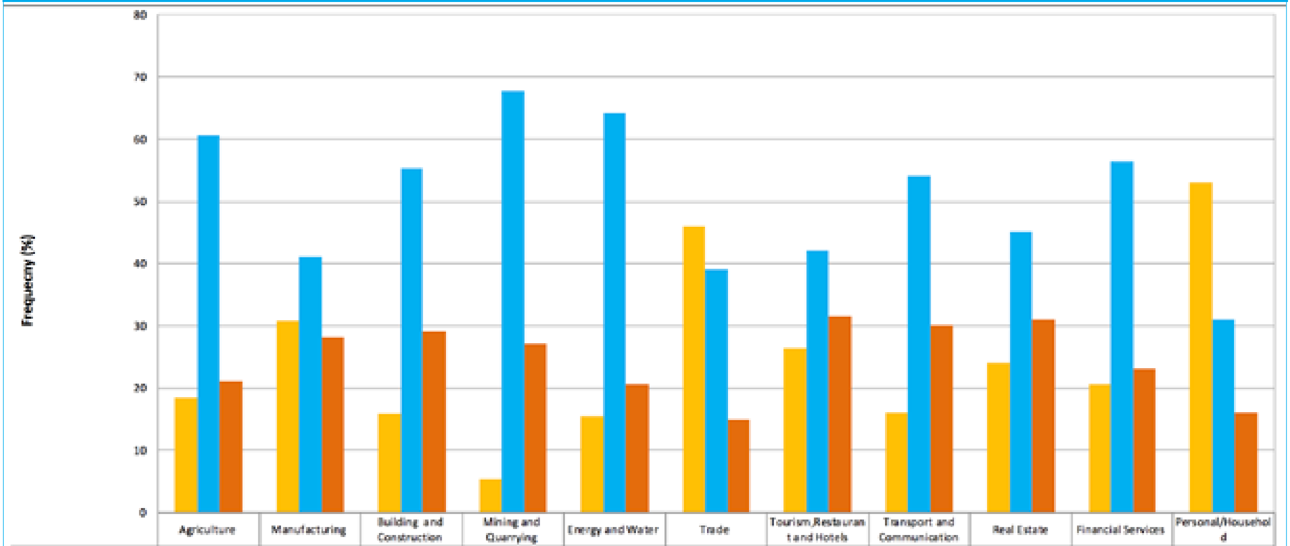
2.0 SURVEY FINDINGS

2.1 Demand for Credit

- In the first quarter of 2020, the perceived demand for credit remained unchanged in nine economic sectors and increased in two economic sectors.
- The main sectors with unchanged demand for credit are Mining and Quarrying, Energy and Water, Financial Services, Transport and Communication and Agricultural sectors.
- Perceived demand for credit on the other hand increased in the Personal/Household and Trade sectors. The increased demand in the two sectors is attributed to increased demand for consumer goods and services

Chart 1 and **Table 1** below present the trend in the demand for credit in the last two quarters.

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/Household
Increased(%)	18	31	16	5	15	46	26	16	24	21	53
Remained Unchanged (%)	61	41	55	68	64	39	42	54	45	56	31
Decreased (%)	21	28	29	27	21	15	32	30	31	23	16

Table 1: Change in Demand for Credit

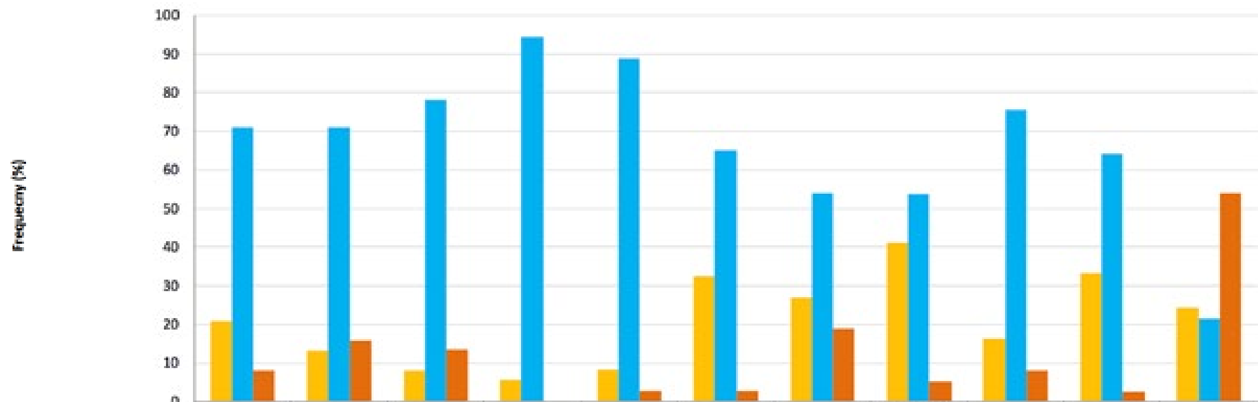
	December 2019			March 2020		
	Increased (%)	Remained Unchanged (%)	Decreased (%)	Increased (%)	Remained Unchanged (%)	Decreased (%)
Agriculture	29	53	18	18	61	21
Manufacturing	35	48	17	31	41	28
Building and Construction	27	47	26	16	55	29
Mining and Quarrying	7	79	14	5	68	27
Energy and Water	16	68	16	15	64	21
Trade	39	48	13	46	39	15
Tourism, Restaurant and Hotels	20	63	17	26	42	32
Transport and Communication	26	48	26	16	54	30
Real Estate	31	41	28	24	45	31
Financial Services	17	55	28	21	56	23
Personal/Household	43	40	17	53	31	16

Factors Affecting Demand for Credit

- In the quarter ended March 31, 2020, ten out of the eleven factors affecting demand for credit had no impact. However, 54 percent of the banks reported that the COVID-19 pandemic had a negative impact on the demand for credit. This is depicted in **Chart 2** and **Table 2.**

- Issuance of debt securities, issuance of equity, loans from non-banks and political risk were cited as having had the least impact on the demand for credit during the quarter under review. This was reported by 94 percent, 89 percent, 78 percent and 76 percent of the respondents respectively.

Chart 2: Factors affecting Demand for Credit



	Internal Financing	Loans from other banks	Loans from non banks	Issuance 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 (%)	21	13	8	6	8	32	27	41	16	33	24
Remained Unchanged (%)	71	71	78	94	89	65	54	54	76	64	22
Decreased (%)	8	16	14	0	3	3	19	5	8	3	54

Table 2: Factors Affecting Demand for Credit

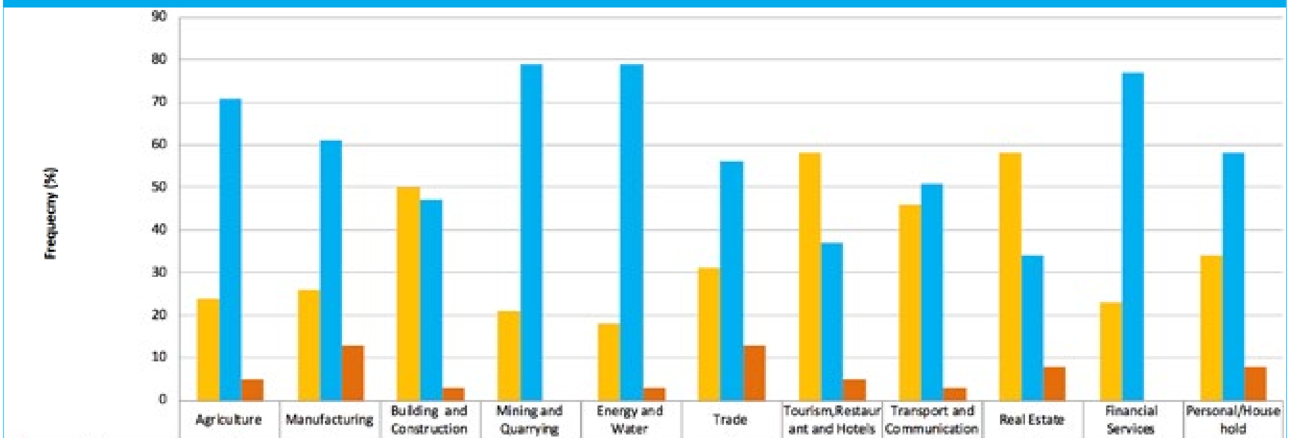
	December 2019			March 2020		
	Increased (%)	Remained Unchanged (%)	Decreased (%)	Increased (%)	Remained Unchanged (%)	Decreased (%)
Internal Financing	6	78	16	21	71	8
Loans from other banks	10	68	22	13	71	16
Loans from non-banks	4	73	23	8	78	14
Issuance of debt securities	4	83	13	6	94	0
Issuance of equity	4	86	10	8	89	3
Cost of borrowing	17	80	3	32	65	3
Available investment opportunities	29	55	16	27	54	19
Reduction of the Central Bank Rate (CBR)	13	81	6	41	54	5
Political Risk	13	83	4	16	76	8
Repeal of Interest Rate Capping	-	-	-	33	64	3
COVID – 19 pandemic	-	-	-	24	22	54

Credit Standards

- In the first quarter of 2020, credit standards remained unchanged in eight economic sectors and tightened in three sectors (Real Estate, Building and Construction and Tourism, Restaurants and Hotels). The main sectors with unchanged credit standards are Energy and Water, Mining and Quarrying, Financial services and Agriculture.
- Tightened credit standards in the Real Estate, Building and Construction and Tourism, Restaurants and Hotels sectors was attributed to a slowdown in economic activity coupled by the effects of the COVID–19 pandemic.

This is presented in **Chart 3** and **Table 3** below.

Chart 3: Credit Standards



	Agriculture	Manufacturing	Building and Construction	Mining and Quarrying	Energy and Water	Trade	Tourism,Restaurant and Hotels	Transport and Communication	Real Estate	Financial Services	Personal/House hold
Increased (%)	24	26	50	21	18	31	58	46	58	23	34
Remained Unchanged (%)	71	61	47	79	79	56	37	51	34	77	58
Decreased (%)	5	13	3	0	3	13	5	3	8	0	8

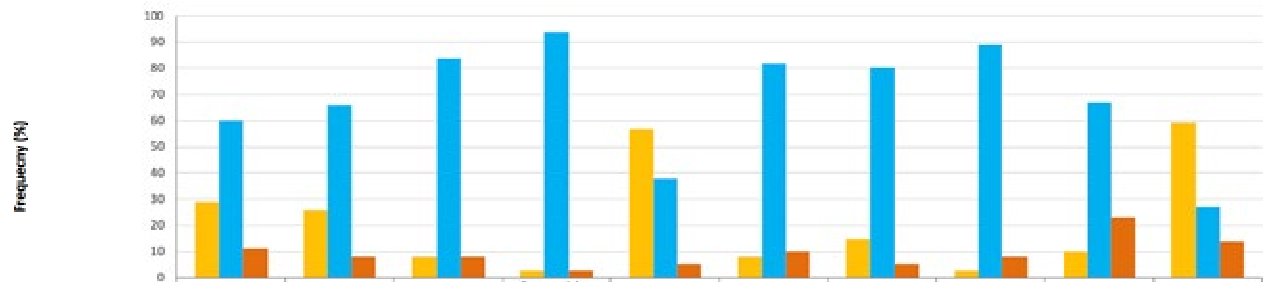
Table 3: Credit Standards for Loans to Various Economic Sectors

	December 2019			March 2020		
	Tightened (%)	Remained Unchanged (%)	Eased (%)	Tightened (%)	Remained Unchanged (%)	Eased (%)
Agriculture	4	90	6	24	71	5
Manufacturing	9	78	13	26	61	13
Building and Construction	39	58	3	50	47	3
Mining and Quarrying	7	90	3	21	79	0
Energy and Water	3	88	9	18	79	3
Trade	9	75	16	31	56	13
Tourism, Restaurant and Hotels	10	84	6	58	37	5
Transport and Communication	34	60	6	46	51	3
Real Estate	42	48	10	58	34	8
Financial Services	6	87	7	23	77	0
Personal/Household	19	58	23	34	58	8

2.4 Factors Affecting Credit Standards

- In the quarter ended March 31, 2020, eight factors had little impact on credit standards.
- Competition from Saccos, Microfinance banks, other Credit Providers; investment in Government Securities, competition from banks, reduction of CBR and political risk are the main factors that had no impact on credit standards. This was reported by 94 percent, 89 percent, 84 percent, 82 percent and 80 percent respectively.
- 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 (%)	29	26	8	3	57	8	15	3	10	59
Remained unchanged (%)	60	66	84	94	38	82	80	89	67	27
Eased (%)	11	8	8	3	5	10	5	8	23	14

Table 4: Factors affecting credit standards

	December 2019			March 2020		
	Tightened (%)	Remained Unchanged (%)	Eased (%)	Tightened (%)	Remained Unchanged (%)	Eased (%)
Bank's cost of funds and Balance sheet constraints	35	61	3	29	60	11
Constraints relating to Bank's capital position	26	68	6	26	66	8
Competition from other banks	9	84	6	8	84	8
Competition from DTMs, Saccos, and other Credit Providers	3	91	6	3	94	3
Expectations regarding general economic activity	25	66	9	57	38	5
Reduction of the Central Bank Rate (CBR)	6	91	3	8	82	10
Political Risk	13	77	10	15	80	5
Investment in Government Securities	9	88	3	3	89	8
Removal of Interest rate capping	-	-	-	10	67	23
COVID –19 pandemic	-	-	-	59	27	14

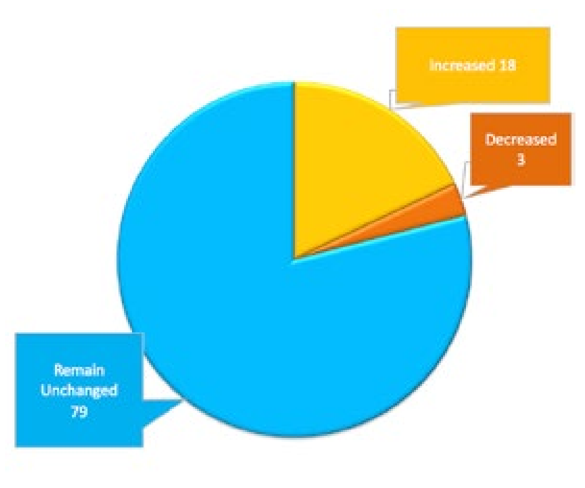
2.5 Repeal of Interest Rate Capping Law

- 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 First Quarter of 2020

- 79 percent of the respondents indicated that after repeal of interest rate capping law, the demand for credit remained unchanged while 18 percent noted that demand for credit increased.
- 3 percent of the respondents noted that demand for credit decreased after repeal. This is depicted in **Chart 5**.

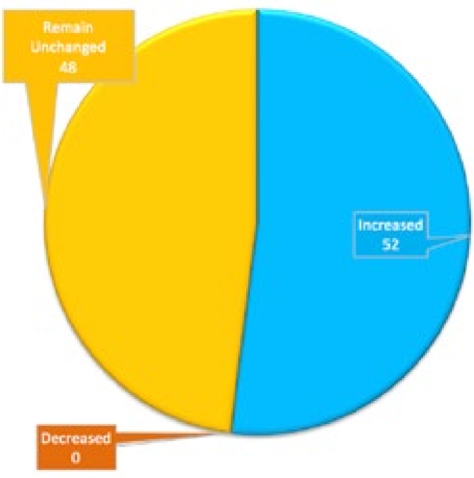
Chart 5: Effect of Repeal of Interest Rate Cap Law on Actual Credit granted over the past quarter (%)



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

- In the quarter ended March 31, 2020, the respondents indicated the repeal of interest rate capping law had a positive impact on their lending to SMEs. This was reported by 52 percent of the respondents who indicated that lending to SMEs increased. This is indicated in **Chart 6.**
- Following the repeal of interest rate capping law, majority of the banks are on-boarding risk based pricing models. This has increased financial institution's appetite to lend to SMEs.

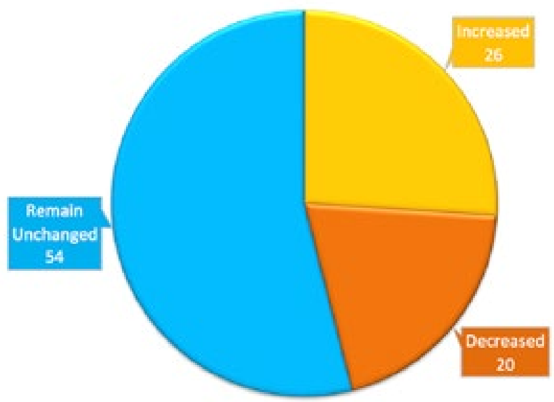
Chart 6: Effect of Repeal of Interest Rate Capping Law on lending to SMEs (%)



2.5.3 Effect of repeal of Interest Rate Cap Law on Demand for Credit in Second Quarter of 2020

- With regards to the expected demand for credit in the second quarter of 2020, 54 percent of the respondents felt that the repeal of interest capping will have little or no impact on the demand for credit.
- 26 percent of the respondents anticipate that repeal of interest rate capping law will lead to an increase in demand for credit while 20 pecrent felt that the demand for credit will decrease.
- The expected movement on demand for credit in the second quarter is shown in **Chart 7.**

Chart 7: Interest rate cap effect on actual new credit granted over the next three months (%)



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

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

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

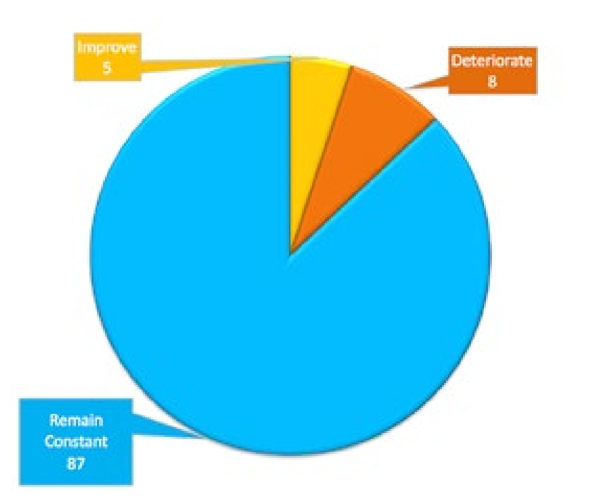
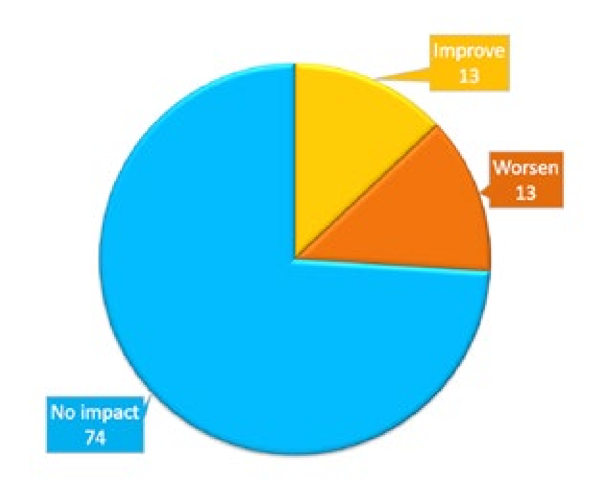


Chart 9: Interest rates cap effect on level of NPLs in the next quarter (%)



2.5.5 Effect of repeal of Interest Rate Capping Law on the Expected Level of NPLs in the Second Quarter of 2020

- 74 percent of the respondents anticipate that repeal of interest rate capping law would have no impact on the level of NPLs in the second quarter of 2020. This is because the pricing of loans has no impact on repayment ability.
- An equal number of respondents (13 percent) expect the repeal of law on capping of interest rates to have both a negative and positive impact on NPLs. This mixed reaction may be attributed to the uncertainties in slowdown in the economy due to the on-going global COVID-19 pandemic. This trend is as indicated in **Chart 9** below.

2.6 Non-Performing Loans (NPLs)

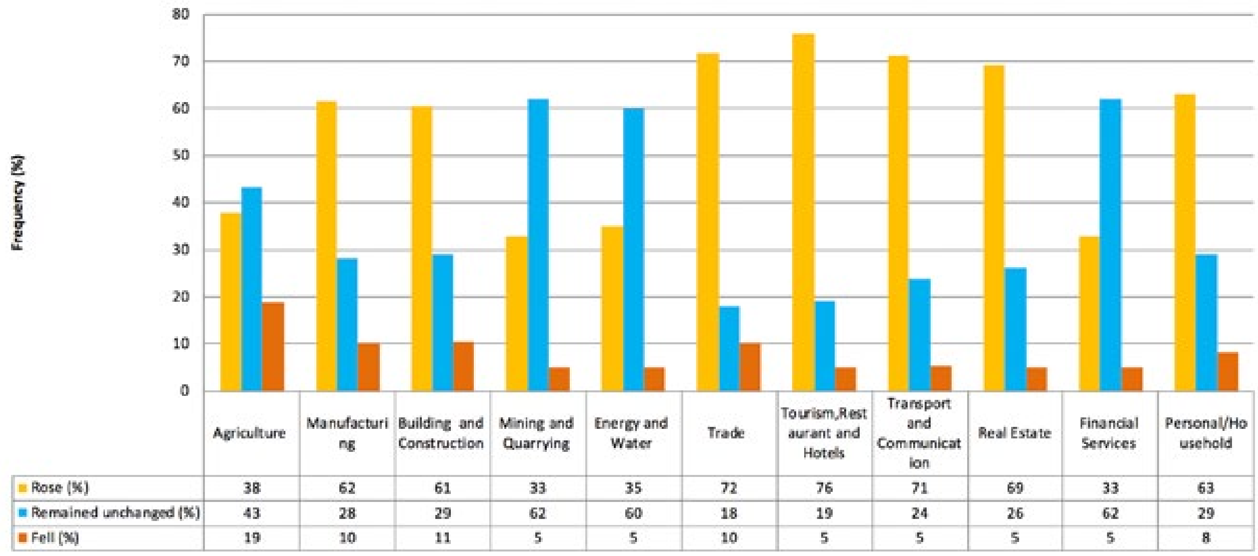
2.6.1 Non - Performing Loans during the quarter ended March 31, 2020

- In the quarter ending March 31, 2020, the respondents indicated that the level of NPLs increased in seven economic sectors and remained unchanged in four economic sectors (Financial Services, Mining and Quarrying, Energy and Water and Agriculture).
- NPLs increased in the Tourism, Restaurant and Hotels, Transport and Communication, Trade, Real Estate, Personal/Household, Building and Construction, and Manufacturing sectors. **Table 5** and **Chart 10** and depicts this.

Table 5: Non Performing Loans Trend Per Economic Sector

	December 2019			March 2019		
	Rose (%)	Remained Unchanged (%)	Fell (%)	Rose (%)	Remained Unchanged (%)	Fell (%)
Agriculture	6	67	27	38	43	19
Manufacturing	13	55	32	62	28	10
Building and Construction	16	45	39	60	29	11
Mining and Quarrying	0	76	24	33	62	5
Energy and Water	6	74	20	35	60	5
Trade	23	35	42	72	18	10
Tourism, Restaurant and Hotels	7	63	30	76	19	5
Transport and Communication	23	40	37	71	24	5
Real Estate	26	29	45	69	26	5
Financial Services	10	61	29	33	62	5
Personal/Household	19	39	42	63	29	8

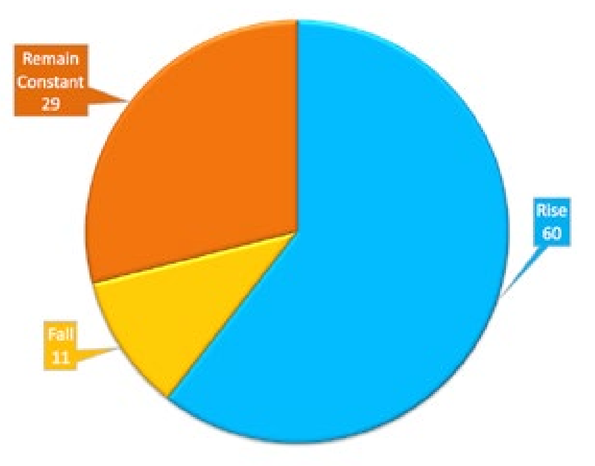
Chart 10: Non-Performing Loans



2.6.2 Expected Non-Performing Loans during the next Quarter

- 60 percent of the respondents expect the level of NPLs to rise in the second quarter of 2020. This is attributed to the challenging business environment as a result of the on-going global COVID-19 pandemic.
- 11 percent of the respondents expect the level of NPLs to fall in the second quarter of 2020. This is attributed to enhanced recovery efforts being implemented by most banks.
- 29 percent of respondents expect NPLs to remain constant. This is depicted in **Chart 11.**

Chart 11: Expected movements of NPLs in the next Quarter of 2020 (%)



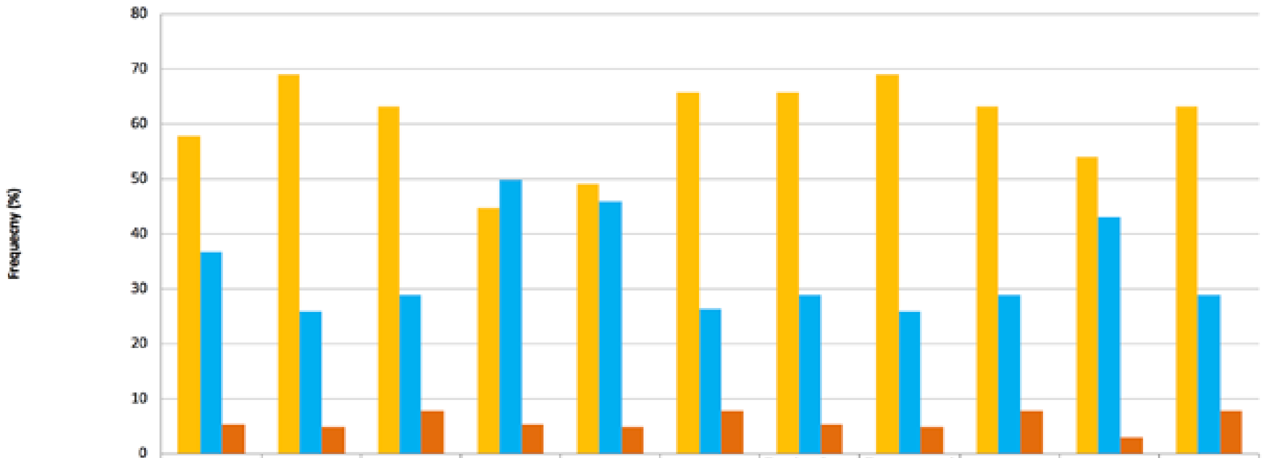
2.7 Credit Recovery Efforts in the Second Quarter of 2020

- For the quarter ended June 30, 2020, banks expect to intensify their credit recovery efforts in ten of the eleven economic 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 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) Manufacturing, and Transport and Communication (69 percent),
  ii) Tourism, Restaurant and Hotels; and Trade (66 percent)
  iii) Building and Construction, Real Estate and Personal/Household (63 percent),
  iv) Agriculture (58 percent),
  v) Financial Services (54 percent); and
  vi) Energy and Water (49 percent).

- Credit recovery efforts are expected to remain unchanged in the Mining and Quarrying since the level of bad debts in this sector is low. The responses on the expected credit recovery efforts by the banks are depicted in **Chart 12** and **Table 6.**

Chart 12: 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 (%)	58	69	63	45	49	66	66	69	63	54	63
Remain constant (%)	37	26	29	50	46	26	29	26	29	43	29
Ease (%)	5	5	8	5	5	8	5	5	8	3	8

Table 6: Credit Recovery Efforts

	December 2019			March 2020		
	Intensified (%)	Remained Unchanged (%)	Eased (%)	Intensified (%)	Remained Unchanged (%)	Eased (%)
Agriculture	62	38	0	58	37	5
Manufacturing	67	33	0	69	26	5
Building and Construction	77	23	0	63	29	8
Mining and Quarrying	45	55	0	45	50	5
Energy and Water	50	50	0	49	46	5
Trade	81	19	0	66	26	8
Tourism, Restaurant and Hotels	62	34	4	66	29	5
Transport and Communication	77	20	3	69	26	5
Real Estate	90	10	0	63	29	8
Financial Services	57	39	4	54	43	3
Personal/Household	77	23	0	63	29	8

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.
- Following implementation of IFRS 9 beginning January 1, 2018, the Central Bank of Kenya has continued to assess: -

  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 bank have done to ensure that the assumptions are more reliable.

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

- It is worth noting that 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) Commercial banks are also not able to predict which other macro-economic data are likely to affect the economy.
  iv) Cost implication for the relevant technology, consultants and personnel training.
  v) Negative impact on profitability.

- 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 the board including for SMEs. Banks have therefore introduced unsecured credit products for SMEs.
  iv) Banks have engaged consultants to validate the assumptions to ensure that they are reliable.
  v) The focus of banks is now more on secured lending.
  vi) Banks have revamped their credit recovery efforts.
  vii) Banks are enhancing staff capacity through training as well as reviewing their policies and procedures to ensure full compliance with IFRS 9.

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.

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

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

  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.

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.

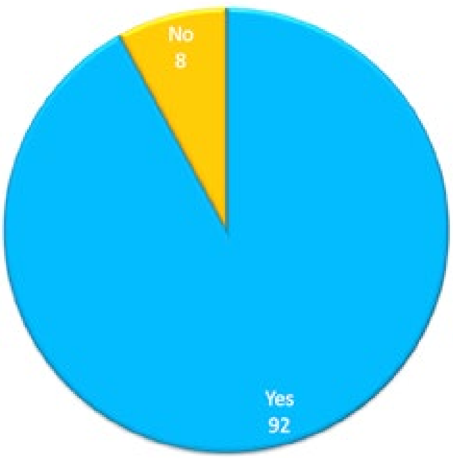
2.9 International Financial Reporting Standard (IFRS) 16 on Leases

- 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 March 31, 2020, 89 percent of the respondents had implemented IFRS 16 and 92 percent of the respondents had assessed the likely impact of IFRS 16 on their financial performance and position. This is depicted in **Chart 13** and **Chart 14** below.

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 would call 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, and
  ii) changing their business models and risk management tools.

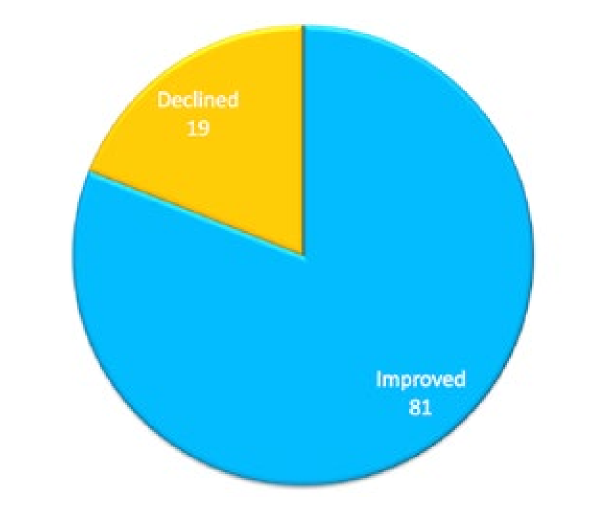
2.10 Liquidity Risk

- During the quarter ended March 31, 2020, liquidity in the banking sector increased from 49.74 percent in December 2019 to 51.45 percent in March 2020. This 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.

2.11 Commercial Banks' liquidity positions

- During the quarter ended March 2020, 81 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 next quarter, issuance of credit will increase as most banks intend to deploy the additional liquidity towards lending to the private sector (28 percent), investing in treasury bills and bonds (20 percent), CBK liquidity management through repos (17 percent) and interbank lending (12 percent).
- In the previous quarter, issuance of credit was expected to increase as most banks intended to deploy the additional liquidity towards lending to the private sector (35 percent), investment in treasury bonds (27 percent), interbank lending (16 percent) and CBK liquidity management through repos (14 percent).

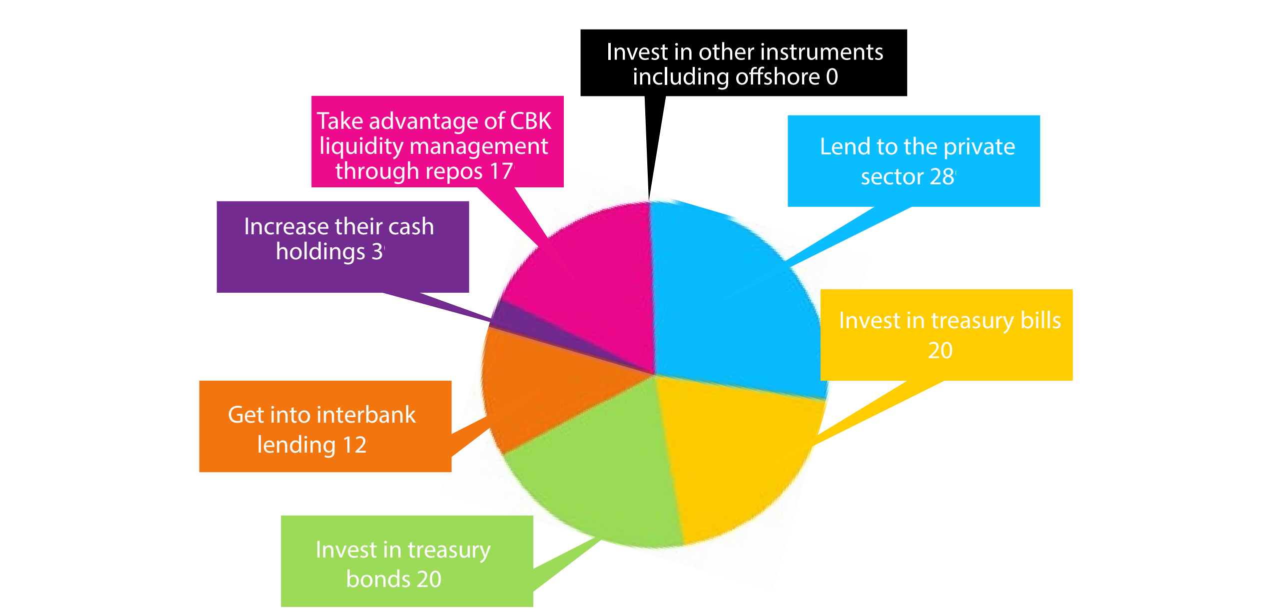
2.12 Factors that led to improved liquidity over the past quarter

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

  i) Increased deposits (54 percent),

  ii) Maturity of government securities

Chart 16: Plans with improved liquidity (%)

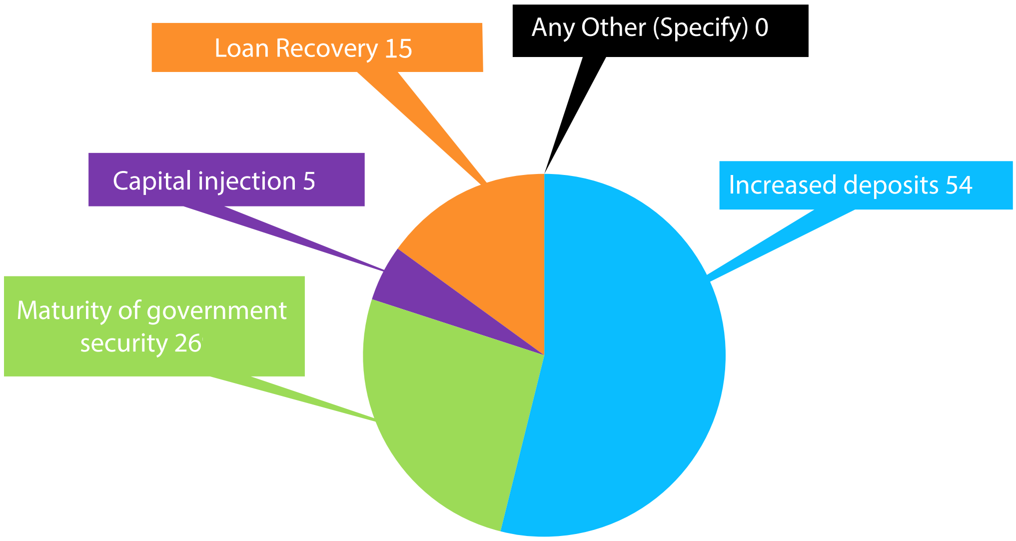


(26 percent), and

iii) Loan recovery (15 percent).

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

Chart 17: Reasons for improved liquidity (%)



2.13 Commercial Banks' interbank activities during the quarter

- During the quarter ended March 2020, 46 percent of the respondents indicated that their interbank lending activities increased. This is indicated in **Chart 18** below.
- 71 percent of the respondents indicated that their interbank borrowing decreased. This is indicated in **Chart 19** below.

Chart 18: Increase in interbank lending(%)

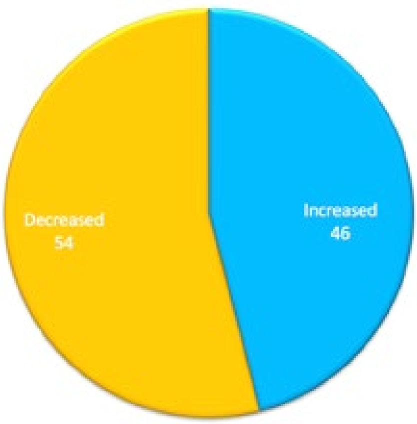
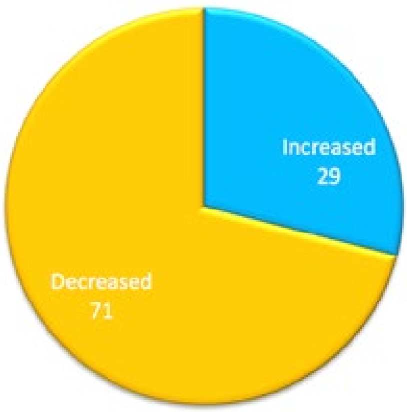


Chart 19: Increase in Interbank borrowing (%)



2.14 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) Adverse 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.
- A summary of the survey findings is set out here below.

2.14.1 Adverse impact of COVID-19 (Coronavirus) pandemic expected by the banks

The commercial banks have indicated that they expect the pandemic to have a negative impact on their business. Some of the adverse effects include: Decrease in profitability because of slowdown in business.

- 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.
- Decrease in loans advanced to customers as bank become more cautious due to the high risk of credit default.
- Expected deterioration of core capital position as the bank absorbs the impact of the waivers to the customers and further downgrade of non-performing loans.

2.14.2 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 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 restructures and moratoriums 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 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 their businesses.
- Supporting customers with working capital financing to cover the increase in working capital requirements (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

2.14.3 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.

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 the 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 principle 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. **Waiving of digital charges:** Banks have waived all charges for digital platforms balance enquiries and transfers between mobile money wallets and bank accounts. This has led to increased usage of mobile banking platforms.

v. **Lowering the Central Bank Rate to 7.25 percent:** This had no significant impact yet on the operations of most banks as at the end of March 2020. Whereas the intention was to encourage lending, due to disruption of the country's economy by the pandemic, there is less appetite for borrowing and lending.

vi. Majority of the banks indicated that **lowering the Cash Reserve ratio to 4.25 percent** has availed more funds to be used for onward lending to MSMEs. Further, the funds will also assist in balancing the banks liquidity position now that most clients are asking for relief and moratorium.

vii. **Flexibility on loan classification and provisioning for loans** that were performing as at March 2, 2020 but restructured due to the pandemic will improve the quality of the banks' loan books. It is expected that lower provisioning in the coming months will protect the bank against further losses and eroding of capital.

viii. **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.

2.14.4 Suggested proposals to further mitigate the impact the Coronavirus 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 the following:-
  i. Credit Guarantee Schemes[4];
  ii. Additional funding to be offered at concessionary rates to the commercial banks; and
  iii. Encourage use of discount window at minimal rate and without the stigma that is associated with use of discount window.

[4] *A credit guarantee scheme provides third-party credit risk mitigation to lenders through the absorption of a portion of the lender's losses on the loans made to SMEs in case of default, typically in return for a fee.*

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. Absa Bank Kenya Plc
6. Citibank N.A Kenya.
7. Consolidated Bank of Kenya Ltd.
8. Credit Bank Ltd.
9. Co-operative Bank of Kenya Ltd.
10. Development Bank of Kenya Ltd.
11. Diamond Trust Bank (K) Ltd.
12. DIB Bank Kenya Ltd.
13. Ecobank Kenya Ltd.
14. Equity Bank Ltd.
15. Family Bank Ltd.
16. First Community Bank Ltd.
17. Guaranty Trust Bank (Kenya) Ltd.
18. Guardian Bank Ltd.
19. Gulf African Bank Ltd.
20. Habib Bank A.G Zurich.
21. HFC Ltd.
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. M Oriental Bank Ltd.
28. National Bank of Kenya Ltd.
29. NCBA Bank Kenya Plc.
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.

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