Central Bank of Kenya

JULY - SEPTEMBER 2017

CREDIT SURVEY

CENTRAL BANK OF KENYA (CBK) COMMERCIAL BANKS' CREDIT OFFICER SURVEY JULY - SEPTEMBER 2017

1.0 BACKGROUND

1.1 COMMERCIAL BANKS' CREDIT OFFICER SURVEY

Credit risk is the single largest factor affecting the soundness of financial institutions and the financial system as a whole. Lending is also the principal business for banks. The ratio of total loans to total assets for the quarter ended September 30, 2017 was 58.23 percent; a decline of 0.74 percentage points from 58.97 percent reported in the quarter ended June 2017.

The Central Bank of Kenya (CBK) undertakes a quarterly Credit Officer Survey to identify the potential drivers of credit risk. The Credit Officer 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 and credit recovery efforts.

1.2 SURVEY METHODOLOGY

Senior Credit Officers[1] responsible for credit in all operating commercial banks complete the Credit Survey questionnaire.

For the quarter ended September 2017, 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, standards for approving loans, interest rates, non-performing loans, the effect of capping of interest rates[2] and credit recovery efforts. The survey questions are generally phrased in terms of changes over the past three months or expected changes over the next three months.

[1]*These are officers involved in most of the credit decisions hence are able to provide reasonably accurate and complete responses from their banks perspective.*
[2]*The capping of interest rates came into effect on September 14, 2016.*

The credit officer survey for the quarter ended September 30, 2017, included questions on implementation of International Financial Reporting Standard (IFRS) 9 on Financial Instruments.

1.3 KENYAN BANKING SECTOR PERFORMANCE

The Kenyan Banking Sector recorded growth in the quarter ended September 30, 2017, compared to the quarter ended June 30, 2017. Some of the sector's performance indicators are as follows:-

- The aggregate balance sheet increased by 2.03 percent from KShs 3.95 trillion in June 2017 to KShs 4.03 trillion in September 2017. This is attributed to an increase in balances held at the Central Bank of Kenya from KShs 0.15 trillion in June 2017 to KShs 0.18 trillion in September 2017. Further, there was an increase in investment in Government securities from KShs 1.01 trillion in June 2017 to 1.03 trillion in September 2017.
- Gross loans increased slightly by 1.02 percent from KShs 2,366.13 billion in June 2017 to KShs 2,390.43 billion in September 2017. This increase in gross loans was mainly attributable to an increase in gross loans in the Trade, Energy and Water, Mining and Quarrying, Manufacturing, Agriculture, Building and Construction and Tourism sectors.
- Total deposits increased by 1.4 percent from KShs 2.86 trillion in June 2017 to KShs 2.90 trillion in September 2017. This was mainly due to increased foreign currency deposits made by Oil Supply Companies, Government Agencies and Telecommunication companies.
- The ratio of gross non-performing loans to gross loans increased from 9.91 percent in June 2017 to 10.44 percent in September 2017. This was attributed to a challenging business environment.
- The ratio of core capital to total risk-weighted assets decreased slightly from 16.8 percent in June 2017 to 16.2 percent as at September 2017. The total capital to total risk-weighted assets ratio also decreased from 19.6 percent in June 2017 to 18.8 percent in September 2017. The decreased capital ratios are attributed to a higher increase in risk-weighted assets compared to the increase in core capital and total capital.

- Core capital and total capital increased from KShs 526.41 billion and KShs 613.19 billion in June 2017 respectively to KShs 532.73 billion and KShs 615.98 billion in September 2017 respectively. The core and total capital adequacy ratios remained above the statutory minimum of 10.5 percent and 14.5 percent respectively.
- Return on Assets decreased to 2.6 percent in September 2017 from 2.8 percent in June 2017. This may be attributed to a slowdown in the economy, which had a negative impact on profitability. Profit in the quarter ended September 2017 decreased from KShs 13.84 billion in June 2017 to KShs 6.1 billion.
- Return on Equity decreased to 20.6 percent in September 2017 from 22.3 percent in June 2016. There was a considerable growth in the shareholders' funds as compared to the decline in profitability.
- The Average Liquidity Ratio increased to 45.6 percent in September 2017 from 44.7 percent in June 2017. Total liquid assets grew by 4.60 percent while total short-term liabilities grew by 2.79 percent.

1.4 SUMMARY OF FINDINGS

- **Demand for credit:** In the third quarter of 2017, the perceived demand for credit remained unchanged in nine sectors while it decreased in the Real Estate sector. Respondents attributed this trend to a challenging business environment.

- **Credit Standards[3]** remained unchanged in all the eleven economic sectors in the third quarter of 2017.

  However, in comparison to the Second quarter of 2017, additional number of respondents tightened their credit standards in the Building and Construction (17 percent), Transport and Communication (4 percent) and Tourism (4 percent) sectors respectively. This was attributted to a slowdown in economic activity and the uncertainties during the electioneering period.

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

- **Level of Interest Rates:** In the third quarter of 2017, 97 percent of the respondents indicated that their banks held their interest rates constant; whereas 3 percent of the respondents indicated that their banks decreased their interest rates. This trend on interest rates could be an indication that the commercial banks currently have their interest rates at or below the ceiling of 14 percent. The Banking (Amendment) Act 2016, limits interest rates chargeable on loans at not more than 4 percent above the prevailing Central Bank Rate (CBR).

- **Lending to Small and Medium-sized Enterprises (SMEs):** Majority of the commercial banks indicated that interest rate capping negatively affected their lending to SMEs. Respondents have indicated that interest rate capping has compelled banks to increase their risk mitigation measures. Tightening of credit standards has reduced credit facilities granted to SMEs.

- **Non-Performing Loans:** Generally, the commercial banks expect an increase in the levels of NPLs in the fourth quarter of 2017 with 59 percent of the respondents indicating so. This expected rise in NPLs is attributed to the slowdown in economic activity and the political uncertainty experienced in the country during the quarter.

- **Credit Recovery Efforts:** The banks expect to tighten their credit recovery efforts in nine of the eleven economic sectors. Banks intend to intensify credit recovery efforts in the following sectors:-

  i). **Tourism sector:** due to the seasonal fluctuations of cash flows mainly as a result of the political uncertainty in the country.
  ii). **Agriculture sector:** due to the persistent drought in the first half of the year, banks intend to intensify recovery efforts so as to collect amounts due during the rainy season.
  iii). **Building and Construction** sector to enhance collections from contractor payments by the Government of Kenya, in the fourth quarter of 2017.
  iv). The intensified recovery efforts in five sectors (Manufacturing, Trade, Transport, Personal/ Household, Real Estate, and Financial Services

sectors) aim at improving the overall quality of the asset portfolio. This is in line with the banks' expectations that loan defaults in these sectors will rise during fourth quarter of 2017 due to slowdown in economic activity.

- **International Financial Reporting Standards (IFRS) 9 on Financial Instruments:** Majority of the commercial banks had done an assessment of the impact of IFRS 9 on their performance. The respondents noted that IFRS 9 would result in probable change in business model, injection of additional capital to cater for the increased provisioning and a reduction in credit risk appetite.

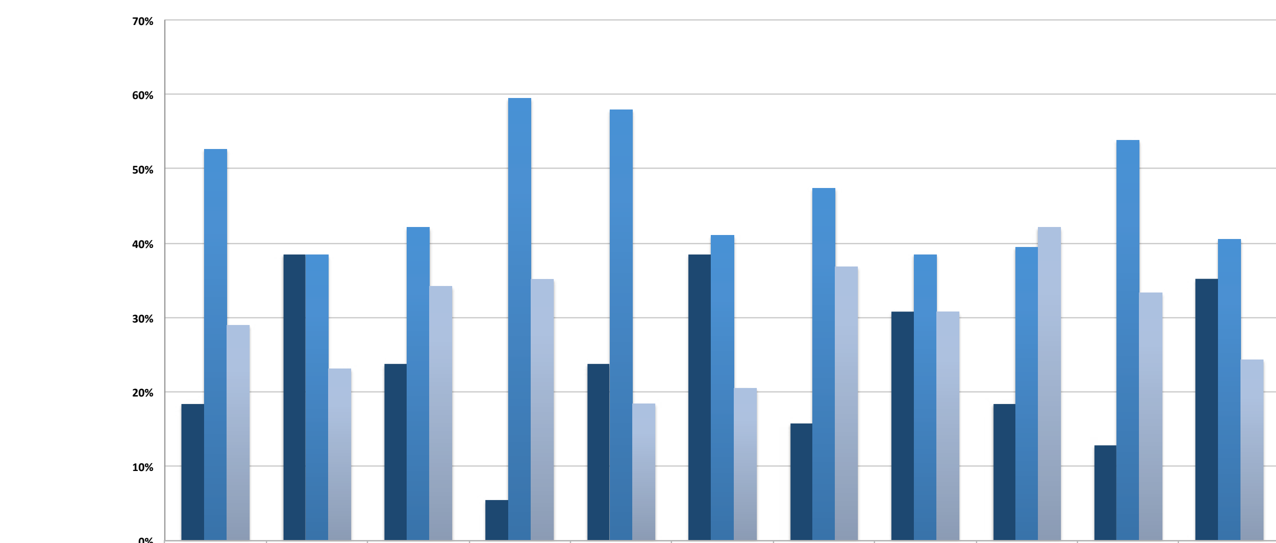
  The commercial banks that had not assessed the impact of IFRS 9 indicated that the assessment would be done by end of December 2017.

2.0 SURVEY FINDINGS

2.1 DEMAND FOR CREDIT

- In the third quarter of 2017, demand for credit remained unchanged in nine economic sectors. These are Mining and Quarrying, Energy and Water, Financial Services, Agriculture, Tourism, Building and Construction, Trade, Transport and Communication and Personal/Household sectors.
- The respondents indicated that none of the eleven sectors reported increased demand for credit.
- Demand for credit in the Real Estate sector decreased with 42 percent of the respondents indicating so. This may be attributed to a challenging business environment.
- The manufacturing sector had an equal number of respondents who felt that demand for credit increased and remained constant. This was represented by 38 percent of the respondents.
- This may be attributed to the political uncertainties experienced in the quarter as well as slowdown in business activity.

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%	38%	24%	5%	24%	38%	16%	31%	18%	13%	35%
Remained Unchanged	53%	38%	42%	59%	58%	41%	47%	38%	39%	54%	41%
Decreased	29%	23%	34%	35%	18%	21%	37%	31%	42%	33%	24%

Table 1: Change in Demand for Credit

	September 2017			June 2017		
	Increased	Remained Unchanged	Decreased	Increased	Remained Unchanged	Decreased
Agriculture	18%	53%	29%	15%	59%	26%
Manufacturing	38%	38%	23%	25%	55%	20%
Building and construction	24%	42%	34%	18%	46%	36%
Mining and Quarrying	5%	59%	35%	5%	74%	21%
Energy and water	24%	58%	18%	18%	64%	18%
Trade	38%	41%	21%	49%	38%	13%
Tourism, Restaurant and Hotels	16%	47%	37%	15%	64%	21%
Transport and Communication	31%	38%	31%	23%	60%	18%
Real Estate	18%	39%	42%	24%	42%	34%
Financial Services	13%	54%	33%	15%	64%	21%
Personal/Household	35%	41%	24%	44%	33%	23%

2.2 FACTORS AFFECTING DEMAND FOR CREDIT

- In the quarter ended September 2017, eight factors affecting demand for credit had no impact on demand for credit as indicated in **Chart 2.**
- However, 72 percent of the respondents indicated that demand for credit decreased attributing it to political risk.
- Issuance of debt securities, issuance of equity, internal financing, retention of CBR, loans from non-banks, loans from other banks and non-bank institutions, cost of borrowing and available investment opportunities were cited as having had the least impact on the demand for credit during the quarter under review. This was reported by 86 percent, 84 percent, 84 percent, 74 percent, 74 percent, 74 percent, 61 percent and 59 percent of the respondents respectively.
- However, political risk had the highest effect on decreasing demand for credit with 71 percent of the respondents indicating so.
- **Chart 2** and **Table 2** present the trend in the factors affecting demand for credit in the quarter under review.

Chart 2: Factors Affecting Demand for Credit

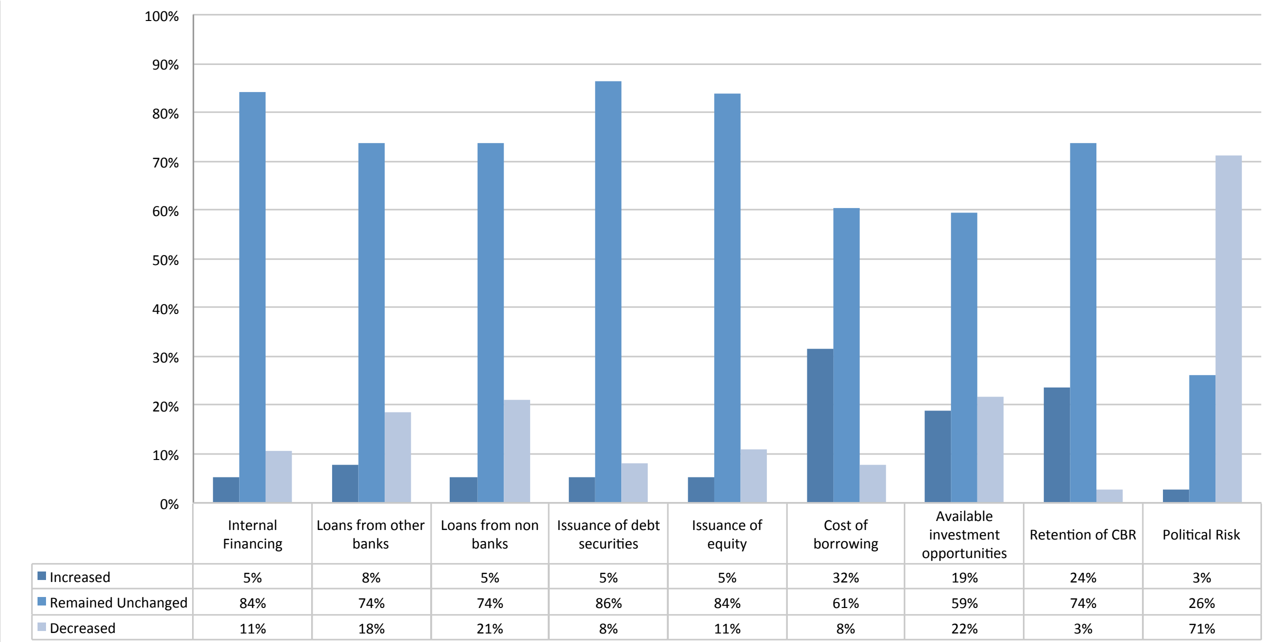


Table 2: Factors Affecting Demand for Credit

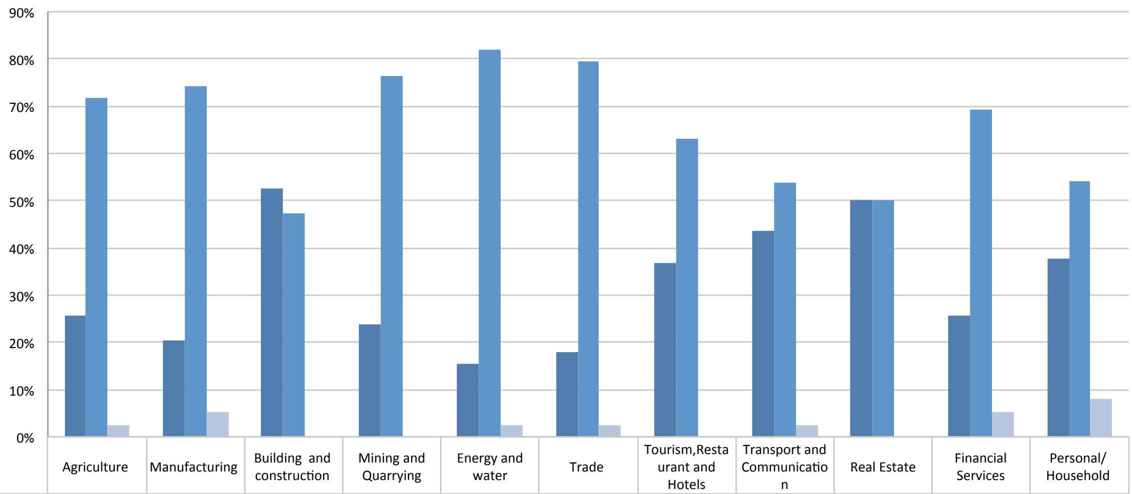
	September 2017			June 2017		
	Increased	Remained Unchanged	Decreased	Increased	Remained Unchanged	Decreased
Internal Financing	5%	84%	11%	8%	77%	15%
Loans from other banks	8%	74%	18%	10%	59%	31%
Loans from non-banks	5%	74%	21%	5%	73%	23%
Issuance of debt securities	5%	86%	8%	3%	89%	8%
Issuance of equity	5%	84%	11%	0%	89%	11%
Cost of borrowing	32%	61%	8%	39%	53%	8%
Available investment opportunities	19%	59%	22%	21%	64%	15%
Retention of CBR	24%	74%	3%	13%	74%	13%
Political Risk	3%	26%	71%	3%	29%	68%

2.3 Credit Standards

- Credit Standards in nine economic sectors remained unchanged in the third quarter of 2017.
- In comparison to the Second quarter of 2017, an additional number of respondents tightened their credit standards in eight economic sectors. These are Building and Construction, Real Estate, Financial Services, Transport and Communication, Tourism, Energy and Water, Personal/Household and Mining and Quarrying sectors. This was reported by additional 17 percent, 6 percent, 6 percent, 4 percent, 4 percent, 2 percent, 2 percent and 1 percent of the respondents respectively.

- Slowdown in economic activity and the uncertainties during the electioneering period were cited as the main driving factors for tightening of credit standards in the aforementioned sectors.
- Credit standards in the Real Estate sector had mixed reactions from the respondents with an equal number of respondents (50 percent) indicating that the standards both tightened and remained constant. This would be as a result of the political uncertainties in the country.
- These responses are presented in **Chart 3** and **Table 3.**

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/ Household
Increased	26%	21%	53%	24%	15%	18%	37%	44%	50%	26%	38%
Remained Unchanged	72%	74%	47%	76%	82%	79%	63%	54%	50%	69%	54%
Decreased	3%	5%	0%	0%	3%	3%	0%	3%	0%	5%	8%

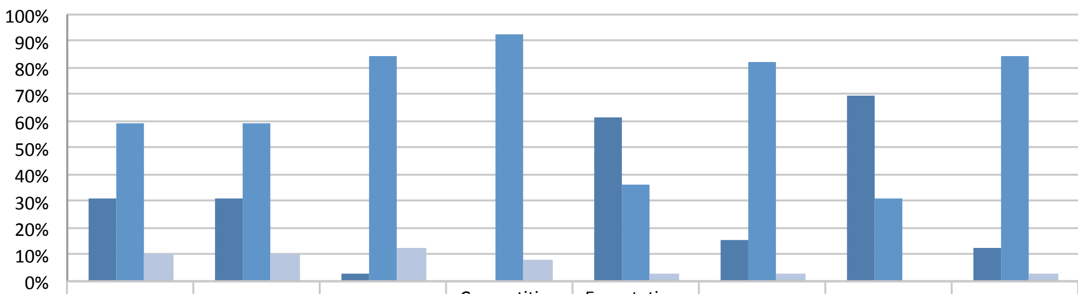
Table 3: Credit Standards for Loans to Various Economic Sectors

	September 2017			June 2017		
	Tightened	Remained Unchanged	Eased	Tightened	Remained Unchanged	Eased
Agriculture	26%	72%	3%	33%	63%	5%
Manufacturing	21%	74%	5%	23%	68%	10%
Building and construction	53%	47%	0%	36%	62%	3%
Mining and Quarrying	24%	76%	0%	23%	75%	3%
Energy and water	15%	82%	3%	13%	78%	10%
Trade	18%	79%	3%	23%	63%	15%
Tourism, Restaurant and Hotels	37%	63%	0%	33%	67%	0%
Transport and Communication	44%	54%	3%	40%	53%	8%
Real Estate	50%	50%	0%	44%	54%	3%
Financial Services	26%	69%	5%	20%	75%	5%
Personal/Household	38%	54%	8%	36%	44%	21%

2.4 Factors Affecting Credit Standards

- During the quarter ended September 2017, six factors (competition from DTMs, competition from other banks, investment in Government Securities, retention of CBR, constraints relating to banks' capital position and Banks' cost of funds) had little impact on credit standards.
- However, expections regarding the general economic activity and political risk due to the uncertainties during the electioneering period were cited as factors that led to tightening of credit standards with 69 percent and 62 percent of the resposondents respectively indicating so. A comparison of the trend in the factors affecting the banks' credit standards are shown in **Chart 4 and Table 4**.

Chart 4: Factors Affecting Credit Standards



	Bank's cost of funds & Balance sheet constraints	Constraints relating to Bank's capital position	Competition from other banks	Competition from DTMs, Saccos, & other Credit Providers	Expectations regarding general economic activity	Retention of CBR	Political Risk	Investment in Government Securities
Tightened	31%	31%	3%	0%	62%	15%	69%	13%
Remained unchanged	59%	59%	85%	92%	36%	82%	31%	85%
Eased	10%	10%	13%	8%	3%	3%	0%	3%

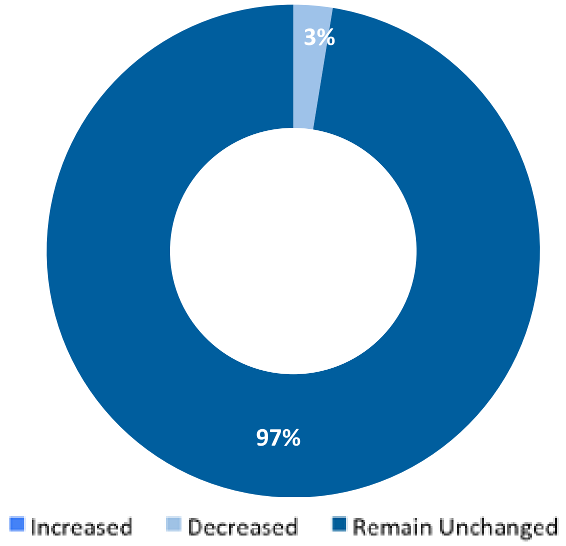
Table 4: Factors Affecting Credit Standards

	September 2017			June 2017		
	Tightened	Remained Unchanged	Eased	Tightened	Remained Unchanged	Eased
Bank's cost of funds & Balance sheet constraints	31%	59%	10%	35%	55%	10%
Constraints relating to Bank's capital position	31%	59%	10%	25%	63%	13%
Competition from other banks	3%	85%	13%	5%	88%	8%
Competition from DTMs, Saccos, and other Credit Providers	0%	92%	8%	5%	88%	8%
Expectations regarding general economic activity	62%	36%	3%	55%	38%	8%
Retention of Central Bank Rate (CBR)	15%	82%	3%	23%	78%	0%
Political Risk	69%	31%	0%	55%	40%	5%
Retention of KBRR	13%	85%	3%	13%	83%	5%

2.5 Interest Rate Movements

- The movement of interest rates in the quarter was mainly attributed to the capping of interest rates that came into effect in September 2016; as well as retention of the CBR rate at 10 percent.
- The interest rate movements in the quarter under review are depicted in **Chart 5** below.

Chart 5 : Interest Rate Movements



- 97 percent of the banks held their interest rates constant while 3 percent reduced their interest rates. This may be attributed to the retention of Central Bank Rate (CBR) at 10 percent and the fact that the Banking (Amendment) Act 2016, limits interest rates chargeable on loans at not more than 4 percent above the prevailing Central Bank Rate (CBR).

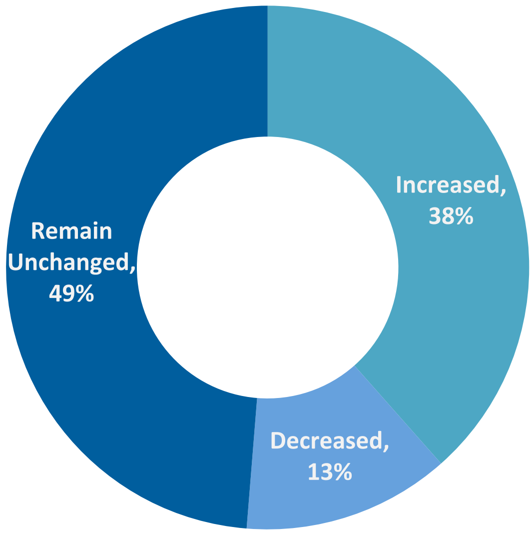
2.6 Capping of Interest Rates

- With the interest rate capping effective September 2016, the credit survey sought to find out the impact it had on demand for credit, lending to SMEs, actual credit granted over the quarter to September 30, 2017 and the expectations of changes over the next three months.
- The survey also sought to find out how NPLs in the fourth quarter of 2017 will be affected by the interest rate capping.

2.6.1 Effect of Interest Rate Capping on Demand for Credit

- 49 percent of the respondents indicated that the demand for credit remained unchanged while 13 percent noted that demand for credit decreased.
- Interest rate capping led to increased demand for credit as indicated by 38 percent of the respondents who attributed this to cheaper credit. This trend was the same as what was reported in quarter two of 2017 as depicted in **Chart 6.**

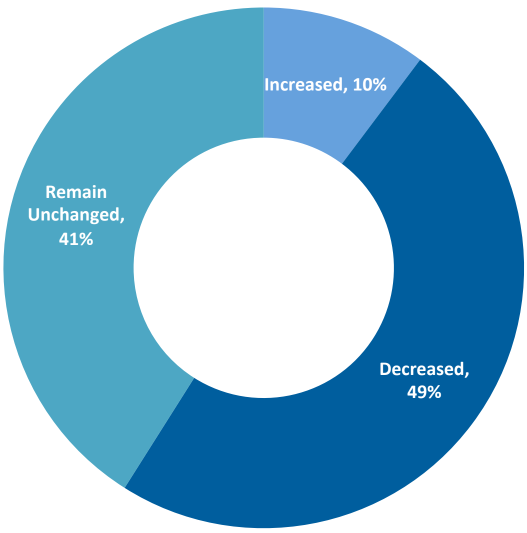
Chart 6 : Impact of Interest Rate Cap on Demand for Credit



2.6.2 Impact of Interest Rate Capping on Actual Credit Granted

- 49 percent were of the view that the actual credit granted decreased while 10 percent of the respondents indicated that the actual credit granted increased as depicted in **Chart 7.**
- 41 percent of the respondents indicated that interest rate capping had little effect on the actual credit granted.
- This depicts a situation of mixed reactions as the commercial banks take a wait-and-see approach on how the market will react to the capping of interest rates.

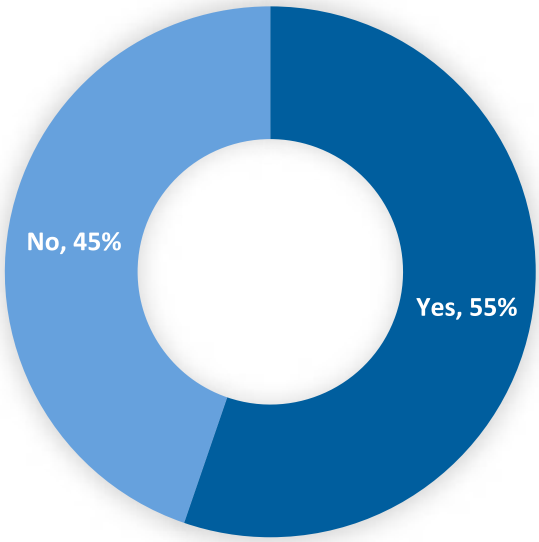
Chart 7 : Impact of Interest Rate Cap on Actual Credit Granted



2.6.3 Effect of Interest Rate Capping on Lending to SMEs in third Quarter of 2017

- 55 percent of the commercial banks indicated that interest rate capping negatively affected their lending to SMEs.
- This trend is a replica of that of the second quarter where 54 percent of the respondents felt that interest rate capping negatively affected their lending to SMEs.
- Interest rate capping has compelled banks to increase their risk mitigation measures. Tightening of credit standards has led to reduced credit facilities granted to SMEs. This is indicated in **Chart 8.**

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



2.6.4 Interest Rate Cap Effect on Demand for Credit in Fourth Quarter of 2017

- With regards to the expected demand for credit in the fourth quarter of 2017, most of the respondents anticipate that interest rate capping will have little impact on actual credit advanced as indicated by 72 percent of the respondents.
- However, 8 percent of the respondents felt that interest capping will lead to an increase in actual credit advanced.
- 20 percent of the respondents felt that the actual credit advanced will decrease attributing it to slowdown in economic activity as a result of political uncertainity in the country. Expected movement on demand for credit in the fourth quarter is shown in **Chart 9.**

Chart 9 : Impact of Interest Rate Cap on Expected Demand for Credit in Q4 2017

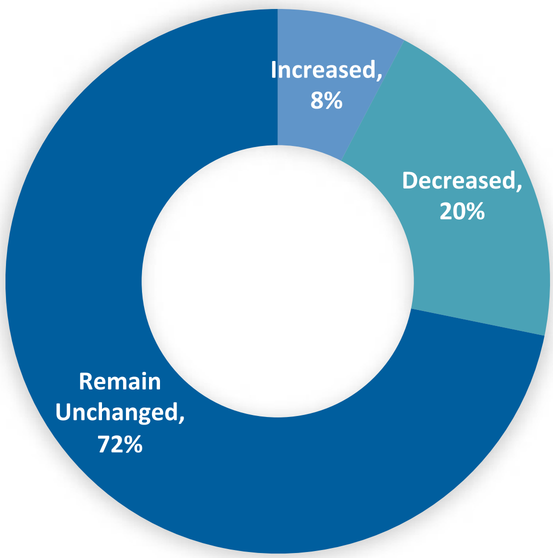
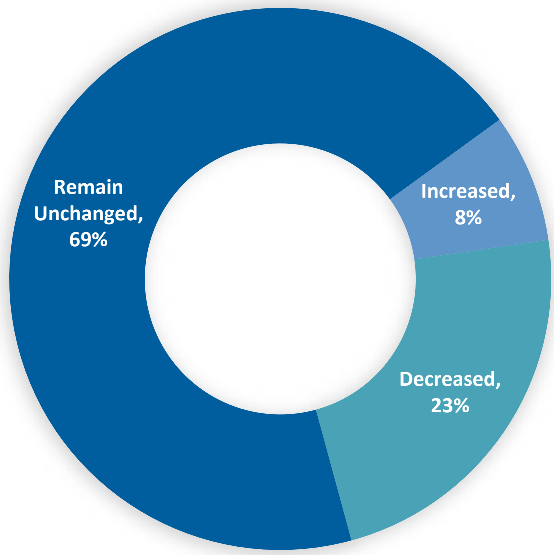


Chart 10 : Impact of Interest Rate Cap on Actual New Credit in Q4 2017



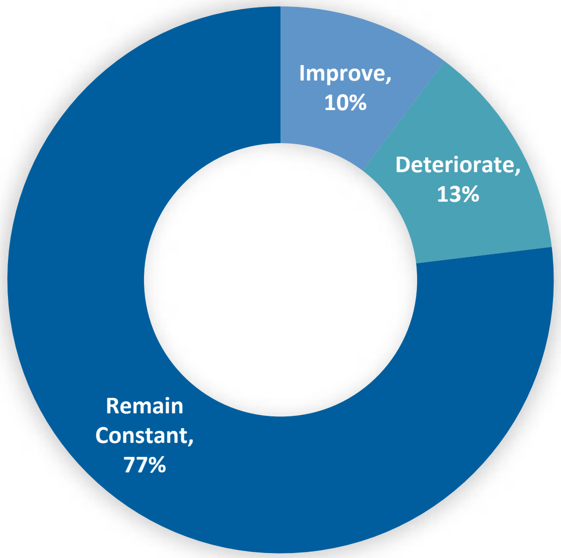
2.6.5 Effect of Interest Rate Capping on Actual New Credit over the next three months

- In the fourth quarter of 2017, most of the respondents anticipate that the interest rate capping will have little impact on actual credit advanced as indicated by 69 percent of the respondents. Respondents attributed this to the slowdown in economic activity and the current political uncertainty in the country.
- However, 8 percent of the respondents felt that interest rate capping would lead to an increase in new credit advanced while 23 percent felt that the new credit advanced would decrease as indicated in **Chart 10.**

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

- In the fourth quarter of 2017, 77 percent of the respondents are of the view that the NPLs would not change since the pricing of the loans has no impact on repayment ability. This is due to the fact that monthly installments are agreed upfront.
- 10 percent of the respondents expect the capping of interest rates to have a positive impact on NPLs. Respondents have attributed this to the current favorable interest rates, which led to cheaper credit.
- 13 percent of the respondents indicated that NPLs would deteriorate as indicated in **Chart 11.** This mixed reaction may be due to the wait and see approach on how the market will react once the political environment stabilizes.

Chart 11 : Effect of Interest Rate Capping on NPLs

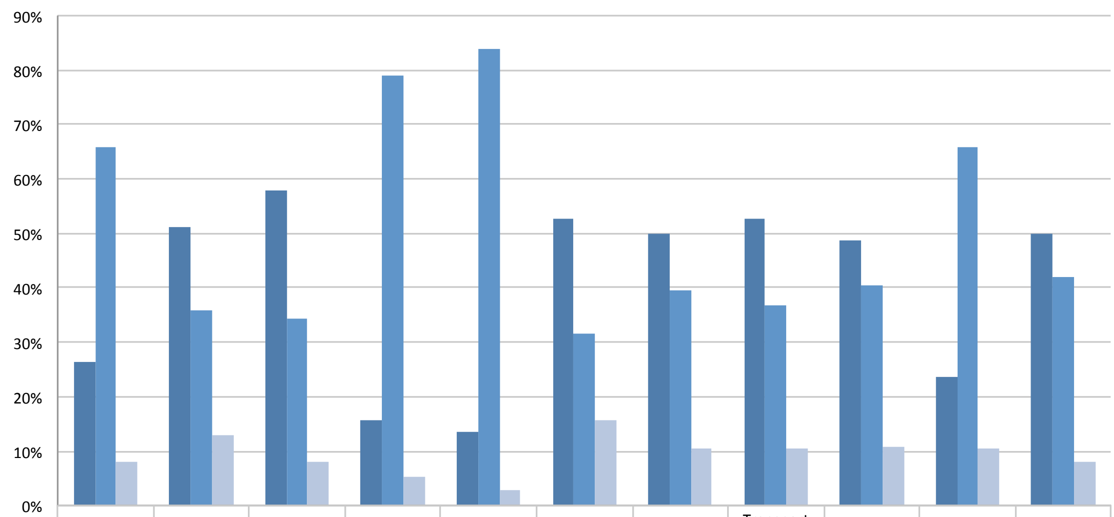


2.7 Non-Performing Loans (NPLs)

2.7.1 Non - Performing Loans during the quarter ended September 30, 2017

- During the quarter under review, the levels of NPLs remained constant in four economic sectors and increased in seven Economic sectors.
- NPLs in four sectors (Energy and Water, Mining and Quarrying, Financial Services and Agriculture sectors) remained constant.
- NPLs increased in the Building and Construction, Trade, Real Estate, Tourism, Transport and Communication, Manufacturing and Personal/ Household sectors. This was attributed to a challenging business environment coupled with political uncertainties. This is depicted in **Chart 12.**

Chart 12: 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/ Household
Rose	26%	51%	58%	16%	14%	53%	50%	53%	49%	24%	50%
Remained unchanged	66%	36%	34%	79%	84%	32%	39%	37%	41%	66%	42%
Fell	8%	13%	8%	5%	3%	16%	11%	11%	11%	11%	8%

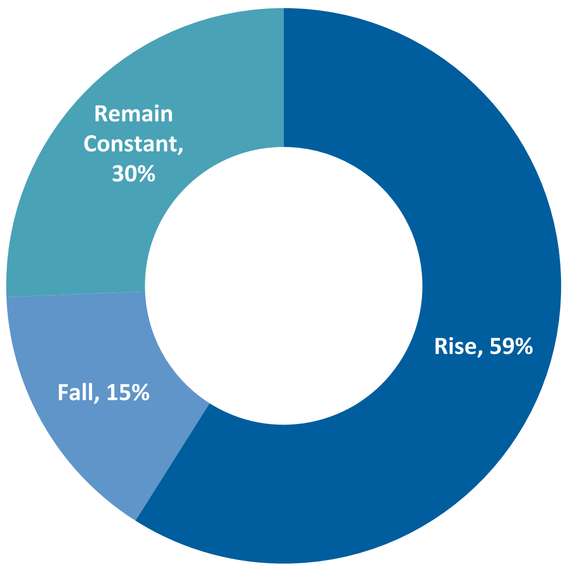
Table 5: Non Performing Loans Trend Per Economic Sector

	September 2017			June 2017		
	Rose	Remained Unchanged	Fell	Rose	Remained Unchanged	Fell
Agriculture	26%	66%	8%	29%	61%	11%
Manufacturing	51%	36%	13%	28%	51%	21%
Building and construction	58%	34%	8%	36%	44%	21%
Mining and Quarrying	16%	79%	5%	5%	84%	11%
Energy and water	14%	84%	3%	5%	84%	11%
Trade	53%	32%	16%	36%	36%	28%
Tourism, Restaurant and Hotels	50%	39%	11%	34%	39%	26%
Transport and Communication	53%	37%	11%	28%	49%	23%
Real Estate	49%	41%	11%	39%	42%	18%
Financial Services	24%	66%	11%	8%	74%	18%
Personal/Household	50%	42%	8%	31%	49%	21%

2.7.2 Expected Non Performing Loans Levels during the Next Quarter

- 59 percent of the respondents expect the level of NPLs to rise in the fourth quarter of 2017. This is because of the slowdown in economic activity and the political uncertainty being experienced in the country. This is depicted in **Chart 13.**

Chart 13 : Expected Movements of the NPLs



2.8 Credit Recovery Efforts in the Next Quarter

- For the quarter ending December 31, 2017, banks predict that credit recovery efforts will be intensified in nine 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. Banks intend to intensify credit recovery efforts in the following sectors:-

  i) Tourism sector: due to seasonal fluctuations of cash flows during peak and low seasons.

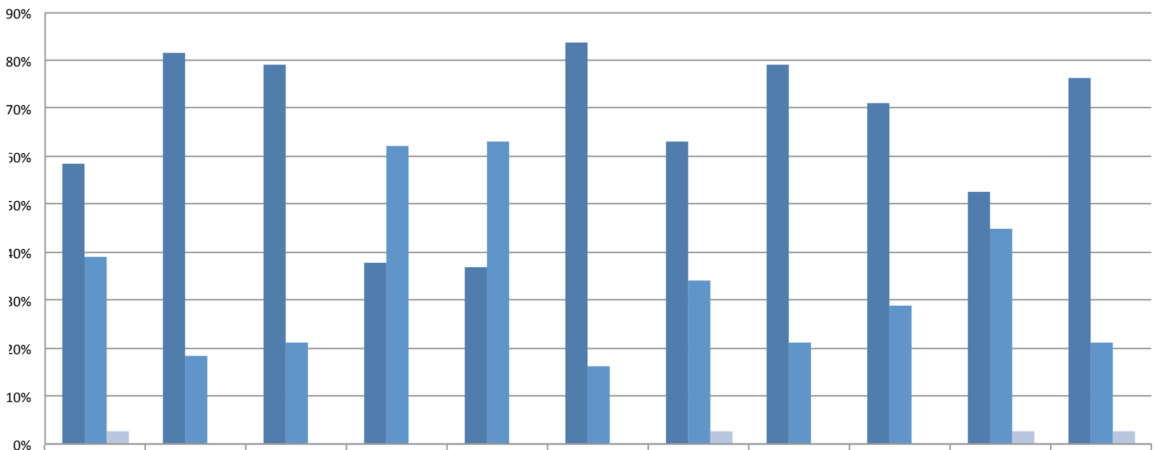
  ii) Agriculture sector: due to the low harvest and persistent drought, banks intend to intensify recovery efforts so as to collect amounts due during the rainy season.

  iii) Building and Construction sector to enhance collections from contractor payments by the Government of Kenya, in the fourth quarter of 2017.

  iv) The intensified recovery efforts in five sectors (Manufacturing, Trade, Transport, Personal/ Household, Real Estate, and Financial Services sectors) aim at improving the overall quality of the asset portfolio. This is in line with the banks expectations that loan defaults in these sectors will rise during the fourth quarter of 2017 due to slowdown in economic activity.

- The responses on the expected credit recovery efforts by the banks during the quarter ending December 31, 2017 are depicted in **Chart 14** and **Table 6.**

Chart 14: Credit Recovery Efforts



	Agriculture	Manufacturing	Building and construction	Mining and Quarrying	Energy and water	Trade	Tourism,restaurant and Hotels	Transport and Communication	Real Estate	Financial Services	Personal/ Household
Intensify	58%	82%	79%	38%	37%	84%	63%	79%	71%	53%	76%
Remain constant	39%	18%	21%	62%	63%	16%	34%	21%	29%	45%	21%
Ease	3%	0%	0%	0%	0%	0%	3%	0%	0%	3%	3%

Table 6: Credit Recovery Efforts

	September 2017			June 2017		
	Intensified	Remained Unchanged	Eased	Intensified	Remained Unchanged	Eased
Agriculture	58%	39%	3%	59%	41%	0%
Manufacturing	82%	18%	0%	74%	26%	0%
Building and construction	79%	21%	0%	74%	26%	0%
Mining and Quarrying	38%	62%	0%	39%	61%	0%
Energy and water	37%	63%	0%	44%	56%	0%
Trade	84%	16%	0%	74%	26%	0%
Tourism, Restaurant and Hotels	63%	34%	3%	72%	28%	0%
Transport & Communication	79%	21%	0%	76%	24%	0%
Real Estate	71%	29%	0%	74%	26%	0%
Financial Services	53%	45%	3%	46%	54%	0%
Personal/Household	76%	21%	3%	79%	21%	0%

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

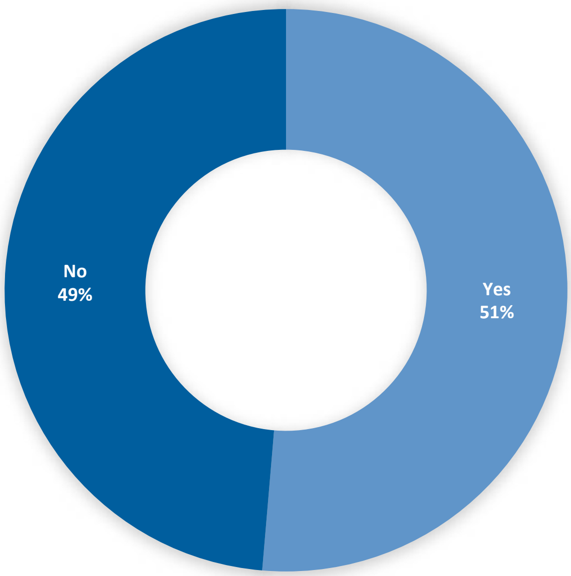
- In July 2014, the International Accounting Standards Board (IASB) issued the final International Financial Reporting Standard (IFRS) 9 on Financial Instruments Standard. This initiative resulted in the replacement of International Accounting Standard (IAS) 39, on Financial Instruments (Recognition and Measurement).
- The main objective of the new IFRS 9 is to provide users of financial statements with more useful information about an entity's expected credit losses on financial instruments.
- Institutions are required to recognize expected credit losses at all times and to update the amount of expected credit losses recognized at each reporting date to reflect changes in the credit risk of financial instruments.
- Given that the implementation of IFRS 9 is expected to come into effect beginning January 1, 2018, the Central Bank of Kenya sought to assess:-
  - i) The commercial banks' preparedness in the implementation of the IFRS 9; and
  - ii) the impact it would have on the commercial banks.
- Commercial banks are currently required to ensure sufficiency of capital to cover all potential risks on an ongoing basis. Commercial banks in Kenya are required to maintain a capital adequacy ratio of 14.5 percent, which includes a capital conservation buffer of 2.5 percent.

An analysis of the outcome of the assessment on IFRS 9 is detailed below.

2.9.1 Impact of IFRS 9 on commercial banks performance and position

- 51 percent of the respondents have assessed the likely impact of IFRS 9 on their financial position.
- 49 percent of the respondents on the other hand have not assessed the impact of IFRS 9 on their financial position. However, the respondents indicated that the assessment of the impact of IFRS 9 will be conducted by end of December 2017. This is depicted in **Chart 14.**

Chart 14 : Number of Banks that have assessed the likely impact of IFRS 9



2.9.2 Impact of IFRS 9 on Credit Risk

- Respondents indicated that the implementation of IFRS 9 will have a negative impact on the banks' profitability. Lending to unsecured facilities will be highly unlikely given that provisioning levels are expected to increase under IFRS 9. This will reduce the banks' credit risk appetite.
- Most of the respondents indicated that implementation of IFRS 9 will result in banks tightening their credit standards. They will be more inclined to secured lending as opposed to unsecured facilities.

2.9.3 Impact of IFRS 9 on Business Model

- Most of the respondents have indicated that implementation of IFRS 9 will result in banks reviewing their business models, strategic objectives and credit policies in order to realign with the IFRS 9 requirements. Further, banks intend to tighten their credit standards and as a result, banks will be skewed towards collateral based lending as opposed to unsecured lending.

2.9.4 Challenges envisaged in the Implementation of IFRS 9

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

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

As a mitigation measure, banks have indicated that they are currently exploring injection of additional capital, enhancing staff capacity through training as well as reviewing their policies and procedures. This is aimed at ensuring full compliance with IFRS 9.

LIST OF RESPONDENTS

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

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