Central Bank of Kenya

The Impact of Interest Rate Capping on the Kenyan Economy: Highlights

Draft for Comments

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BACKGROUND

1. **The amended law capping interest rates in Kenya {the Banking (Amendment) Act, 2016} came into force in on September 14, 2016 setting bounds on lending and deposit rates.** It sets the maximum lending rate at no more than four per cent above the Central Bank base rate; and the minimum interest rate granted on a deposit held in interest earning accounts with commercial banks to at least seventy per cent of the same rate. In line with the Central Bank of Kenya (CBK) Act (Section 36(4), the CBK set the Central Bank Rate (CBR) as the base rate.

2. **Despite the interest rate capping law, Kenya embraces a free market economy.** Following adverse impact of the various price controls implemented in the first twenty years after independence in 1963, the Government gradually shifted to a market economy in the early 1990s. The interest rate capping law, is therefore inconsistent with the spirit of a free market economy.

3. **The law was implemented following concerns raised by the public regarding the high cost of credit in Kenya.** Implementation of the law was expected to lower the cost of credit and increase access, however, emerging evidence point to adverse effects of the law on the Kenya economy.

4. **Interest rate capping undermines the independence of the Central Bank.** Article 231 of the Constitution stipulates that the Bank shall not be under the direction, or control of any person or authority in the exercise of its powers, or in the performance of its functions. The constitutional functions of CBK under Article 231 (3) is to formulate monetary policy, promote price stability, issue currency and perform other functions conferred upon it by an Act of Parliament.

I. EMERGING EVIDENCE OF IMPACT OF INTEREST RATE CAPPING IN KENYA

Emerging evidence point to adverse impact of the law on interest rate capping as follows:

A. Impact on intermediation and pace of Financial inclusion:

5. **Following interest rate capping a number of borrowers have been shunned by banks.** Since the commencement of the interest rate capping law in September 2016, the number of loan accounts has declined significantly between October 2016 and June 2017, thereby resulting in rising average loan size, by 36.7 percent over the period. The rising value of loan size vis-à-vis reduced number of loan accounts reflects lower access to small borrowers and larger loans to more established firms.

6. **Despite general growth in the average loan sizes, there are sectoral differences.** During October 2016 to June 2017, the change in the loan size vary by sector. The most rapid increase was witnessed in the tourism and hotels sector at 76.3 percent- partly attributed to the large number of SMEs in the sector, which may have been denied loans during this period. The personal household loans, on the other hand, reported declining average loan size during the period - personal household loans are payroll based and are less risk and have lower administrative costs, therefore banks may have encouraged higher uptake of loans in this category as part of their business re-engineering strategy.

7. **Investment in Government securities has increased since the inception of the law:** The share of

commercial banks holding of government securities has increase while the share of credit to the private sector has continued to declining.

8. **Banks have increased share of their income from fees and commissions since the inception of caps**. Following interest rate caps, the income of the commercial banks have shifted their revenue sources in favour of non-interest income. The share on non-interest income stood at 12.4 percent in September but it has increased gradually to 15.2 percent in June 2017. The shift to non-interest income is witnessed across all the categories of commercial banks.

B. Risks to financial stability

9. **Banking sector remains resilient despite interest rates caps.** Banks remain adequately capitalized with core and total capital to risk weighted assets averaging 15.8 percent and 18.4 percent above the regulatory requirements of 10.5 percent and 14.5 percent, respectively.

10. **Small banks have witnessed significant declines in capital following interest rates caps.** Although small banks are not systemic, their vulnerability to shocks given low capital base can trigger industry-wide fears. Tier III (small size) banks recorded the largest capital erosion after interest capping. This may be attributed to reduced earnings that impacted on capacity to build-up capital. Tier I banks (large size) have maintained high capital build-up levels. Tier II (medium size) banks appear to have been affected by instability in late 2015 and 'new normal' requirements.

11. **Profitability of the banking sector has declined since the inception of interest rate caps.** The return on equity (ROE) touched the lowest level of 19.8 percent in February 2017 with return on assets (ROA) reaching the lowest level of 2.3 percent in January 2017**.** Decline in earnings over time may pose risks to financial stability through increased balance sheet risks reduced capacity to build capital buffers to absorb shocks.

12. **The structure of deposits has shifted in favour of demand deposits which has implications on long term funding of assets.** There was a marked decline in time deposits (interest earning accounts) vis-à-vis demand deposits (non-interest earning accounts) which has consequences on loan maturity mismatch.

C. Impact on Monetary policy

13. **Interest rate caps has undermined the conduct of monetary policy.** Following the MPC meeting in January 2018, it was noted that there was scope for accommodative monetary, however, interest rate caps had created an environment of possible perverse outcomes, thus constraining the MPC from using the CBR to signal its policy stance. In addition, when the interest rate capping was implemented the CBR rate was at 10.5 percent. With the binding deposit and lending rates, the lending rate was capped at 14.5 percent while the rate of growth of credit to the private sector was at approx. 8 percent per annum. On September 20, 2016, the MPC held its meeting and noted that inflation was expected to decline but there were concerns regarding the slowdown in credit to the private sector. Consequently, the MPC decided to reduce the CBR by 50 basis points to 10.0 percent with the anticipation of reversing the declining trend. However, credit to the private sector continued to decline leading one to conclude that the monetary policy action produced perverse outcomes- accommodative monetary policy yielded unexpected decline in credit to the private sector.

14. **Going forward, under the interest rate capping regime, there is no guarantee the central bank will be able to achieve its intended objectives.** In the interest rate capping environment, use of CBR will result in perverse outcomes. During the phase of monetary policy loosening to stimulate credit expansion to support growth, the interest rate cap will also adjust downward. As a result, those individuals with credit risk above the capped rate will be shunned by banks thereby leading to contraction in growth of credit to the private sector. On the other hand, during the tightening phase of monetary policy, the banks will be able to have a relatively wider space to price risk and therefore increase credit to the private sector contrary to the intention of the monetary policy stance.

D. Impact on economic performance

15. **The impact of interest rate caps on the economy continue to be felt through the exclusion of the MSMEs.**

- According to the KNBS MSME 2016 Survey, MSMEs account for approximately 28.4 percent of GDP. Most of the MSMEs are concentrated in three main sectors- Wholesale and Retail (60 percent); Manufacturing (11.6 percent); and Accommodation and Food Services sector (9 percent). The rest of the sectors of the economy account for approximately 19.5 percent of MSMEs.
- However, banks have started to drift away from MSMEs loans: According to the Finaccess Survey, the share of MSME lending by commercial banks is high in Kenya, at 23.4 percent in 2015. However, a survey conducted by KBA in late 2016, shows that the average MSMEs loans has declined to 17 percent, with the small banks providing 39 percent of the lending to the MSMEs.
- **Withdrawal of credit to this segment has implications on economic growth prospects:** The real GDP growth in 2017, contributed by the MSMEs declined by 1.4 percent points. As a result, overall real GDP growth is expected to decline by 0.40 percentage points.

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