CENTRAL BANK OF KENYA

CONSULTATIVE PAPER ON REVIEW OF THE RISK-BASED CREDIT PRICING MODEL

APRIL 2025

THE CENTRAL BANK OF KENYA

REVIEW OF THE RISK-BASED CREDIT PRICING MODEL

1.0 BACKGROUND

Kenya's interest rate policy regime has evolved through various phases. These include the interest rate liberalization in 1991, and the introduction of the Kenya Bankers Reference Rate (KBRR) in 2014, and interest rate capping from 2016 to 2019.

The Risk-Based Credit Pricing Model (RBCPM), introduced in 2019, was a collaborative strategic initiative by the Central Bank of Kenya (CBK) and the banking sector. The initiative was within the broader reform agenda to address persistent challenges in the credit market, including high lending rates and opaque pricing mechanisms, by creating a market-driven framework for pricing credit risk. Five years into its implementation, a review of the model is necessary.

The RBCPM was established at a time when CBK was undertaking critical reforms. This was a period considered as a transitional phase to a forward-looking monetary policy framework. RBCPM therefore preceded the rollout of: -

- a modern Central Securities Depository (DhowCSD).
- adjustments in the monetary policy communication strategy.
- a shift to an inflation targeting regime.
- the concurrent reforms in the interbank market aimed at ensuring alignment of short-term rates with monetary policy adjustments to achieve effective transmission of monetary policy.

With the lapse of five years since 2019, when the RBCPM was introduced, a reassessment of RBCPM was deemed necessary to determine if it still effectively complements the ongoing reforms in the banking sector.

There are lingering concerns regarding the availability, quality, and fairness of the credit scoring data underpinning the model, as well as consistency of RBCPM application across commercial banks. These issues have significant implications for maintaining the integrity of the model and ensuring that it aligns with global best practices as envisioned during its establishment.

Therefore, review of RBCPM within the evolving landscape of monetary policy is critical to ensure that credit pricing remains robust, adaptive, and in line with both domestic monetary policy reform objectives and international best practices. A careful examination of the model will help assess its efficacy and identify necessary adjustments that reinforce transparency, promote fairness, and enhance the overall efficiency of credit pricing.

2.0 MAIN DRIVERS LEADING TO THE INTRODUCTION OF THE RBCPM

The introduction of the RBCPM can be traced to two major developments in Kenya's banking sector.

a) Introduction of Kenya Bankers Reference Rate (KBRR)

- Lack of transparency and effective disclosure by banks was identified as a key factor contributing to high lending interest rates in Kenya. This was primarily due to limited information on credit products, which prevented the public from comparing and seeking more affordable credit options.

- KBRR was introduced in July 2014, as a common lending interest base rate for all commercial banks and microfinance banks in Kenya. The aim was to enhance transparency and disclosure in the pricing of credit as well as improve the transmission of monetary policy signals.
- KBRR acted as a uniform base rate for setting lending rates across all banks, and microfinance banks, for flexible interest rate loans.
- KBRR was computed as an average of the Central Bank Rate (CBR) and the two-month weighted moving average of the 91-day Treasury Bill rate.
- **The overall Lending Rate** for flexible rate bank loans was computed as **KBRR + 'K'**, where "K" was the premium levied by banks above KBRR and should cover the ***identified loan-associated risks and costs of providing the loan***.
- KBRR was reviewed and announced by the CBK, through the Monetary Policy Committee (MPC) Press Release, every six months.
- Banks were required to disclose to their customers and CBK the composition of "K".
- In January 2017, the Monetary Policy Committee (MPC) decided to suspend the KBRR framework, following the introduction of the interest rate capping law.
- Some of the challenges faced by the KBRR framework include: -

  ✓ Delayed transmission of changes in the components of KBRR, since it was reviewed after every six months.
  ✓ Resistance to change – The banks were suspicious of the KBRR framework due to lack of understanding of the objectives of the framework and thus they did not embrace it fully.
  ✓ Misconception that KBRR framework was a price control tool contrary to the objective of enhancing transparency and disclosure in pricing credit facilities.
  ✓ Limited scope – KBRR only covered flexible interest rate loans leaving out fixed interest rate loans and foreign currency loans.
  ✓ Lack of defined components of "K", which resulted in wide-varied levels of "K" among the banks.

b) Introduction of Interest Rate Capping

In August 2016, Parliament amended the Banking Act by introducing a cap on lending rates at not more than 4 percent above the Central Bank Rate (CBR) and a floor on the deposit rates at 70 percent of the CBR. The amendment was in response to concerns raised by the public regarding the high cost of credit in the country, which was perceived to have locked out a large segment of the population from the credit market. Interest rate capping raised concerns on the impact of the caps on the economy, financial inclusion and socio-economic concerns.

The interest rate caps led to a slowdown in monetary policy transmission and reduced lending activity of smaller banks, which were heavily affected by interest rate caps. Further, interest rate caps enabled shylocks and other unregulated lenders to flourish. These unregulated lenders offered credit at exorbitant rates in a predatory manner taking advantage of desperate citizens. These challenges ultimately led to the repeal of the interest rate cap in November 2019.

3.0 ROLLOUT OF THE RISK-BASED CREDIT PRICING MODEL

CBK implemented the RBCPM in 2019 following rollout of the Kenya Banking Sector Charter (KBSC) to enhance transparency and customer-centric practices in loan pricing. KBSC represents a commitment by banks to entrench a responsible and disciplined banking sector cognizant of, and responsive to, the unique socio-economic realities of the Kenyan populace. The Charter is premised on four central pillars: *adoption of customer centric business models, risk-based credit pricing, enhanced transparency* and *information disclosure, and entrenching an ethical culture*.

The RBCPM sought to allow banks to price loans according to the perceived risk of individual borrowers, rather than using a one-size-fits-all approach. It effectively combined the base rate as a reference rate with a set of risk-adjusted factors, such as a borrower's creditworthiness, collateral, and overall financial behaviour.

The total cost of credit *(Lending Rate)* in RBCPM is expressed as *Base Rate + Credit Risk Premium + Other Charges.* The elements of RBCPM components are as described below.

- **Base Rate** is the minimum interest rate at which banks can lend to its customers at breakeven point. The elements taken into consideration in the calculation of base rate include cost of deposits, administrative costs, operational costs and target return on shareholders' funds from lending amongst others.
- **Credit risk premium** is the compensation the banks expect from their borrowers depending on their risk profiles. CBK expects a detailed credit-scoring model that covers both qualitative and quantitative aspects of a borrower, when determining customers' credit worthiness.
- **Other charges** include all other charges related to lending, such as appraisal fees, processing fees, negotiation fees and commissions, be embedded in the model to arrive at the total cost of credit. Third party charges related to lending such as valuation fees, insurance costs and auctioneers' fees are excluded from the model and are directly borne by borrowers.

4.0 REVIEW OF THE RISK-BASED CREDIT PRICING MODEL

CBK's expectation of the RBCPM was to promote responsible lending practices by aligning credit pricing with borrowers' risk profiles while ensuring transparency and fairness. While the model has largely achieved its objectives in embedding these principles in credit pricing, it is now crucial to assess its effectiveness comprehensively and identify opportunities for enhancement. The review is aimed at ensuring that the model remains responsive to evolving risk profiles, market dynamics, and regulatory expectations while continuing to promote fairness, transparency, and economic stability.

5.0 REVIEW OF RBCPM

The review process included: -

- Generation of Terms of Reference for the review.
- Assessment of implementation of RBCPM by banks based on returns to CBK and inspection findings.
- Assessment of credit pricing models in selected jurisdictions.
- Consideration of proposal by the banking industry.

A brief on each of these activities are as outlined below.

a) Terms of Reference of the Review of the RBCPM

The Terms of Reference that guided the review of RBCPM is as outlined below.

- **Assess the model's efficacy**: A comprehensive evaluation of the RBCPM's impact on credit pricing, access to credit and challenges faced in implementing the model.
- **Propose adjustments or replacement:** Based on the findings of the survey, propose incremental improvements to RBCPM or recommend a complete overhaul.
- **Benchmark with comparator Jurisdictions**: Review practices in comparable jurisdictions to align the framework with international best practices while tailoring it to Kenya's unique context.
- Identify ways in which the Central Bank Rate can be anchored into risk-based credit pricing model for effective monetary policy transmission.

- Recommend a monitoring and evaluation framework for the recommended risk-based credit pricing model.

b) Assessment of Implementation of the RBCPMs by the banks

During the review process, findings of regular and target onsite inspections of various commercial banks to evaluate their compliance with the Kenyan Banking Sector Charter, specifically regarding the implementation of the RBCPM were considered. CBK noted that some banks have not implemented their RBCPM in pricing of customers credit as envisioned. The following are the key observations from the onsite target inspections: -

- The models' outputs were very high with unrealistic lending prices forcing banks to discount their interest rates. This indicates that most of the models, in their current design, are not suitable for effectively pricing loans.
- Some banks did not apply RBCP model pricing to some credit facilities such as mobile loans, cash backed facilities, facilities under funded schemes and facilities under the Government-to-Government arrangements.
- Some banks did not regularly update the variables used to determine the various components of their RBCP models.
- Some banks were imposing additional charges outside the RBCP model. The key charges imposed are late penalty interest rates, commitment fees, negotiating fees and processing fees.
- Banks apply lending rate differentiation based on customer segments rather than customizing credit pricing according to the risk profile of individual clients, as envisioned by the RBCP model.
- There is lack of adequate board oversight of RBCP model as most banks have not documented the model governance and review process in their credit policies. The policies should at minimum have provided the methodology of credit pricing, frequency of review of the credit pricing components, frequency of review of the customer's interest rate based on changes in the model output and threshold for review of customers interest rates.
- Banks with a high concentration on term deposits have a high cost of funds, leading to increased base lending rate.
- Most of the banks use 6 to 12 months average cost of deposits in computation of the cost of funds. This approach factors in historical deposits from periods of higher deposit costs. As a result, despite a decline in the Central Bank Rate (CBR), credit prices remained high due to the high cost of funds, as banks determine credit pricing based on the actual cost of deposits.

c) **Assessment of Credit Pricing Models in Selected Jurisdictions**

The credit pricing models for selected countries to establish any common trends and lessons learned that can feed into CBK's review of the RBCPM. Among the jurisdictions whose credit pricing models were reviewed included the United States, United Kingdom, Czech Republic, Mauritius, South Africa, India, Australia, Brazil, Singapore, Botswana, China, New Zealand, and Uganda.

Most of the selected jurisdictions have a common lending base rate, which in most cases is tied to the policy rate. Variations exist across the jurisdictions on the premium added to the base rate to arrive at the overall lending rate.

d) **Proposal by banking industry through the Kenya Bankers Association**

The Kenya Bankers Association (KBA) forwarded to CBK on April 10, 2025, the banking industry proposal for a unified base rate – the Kenya Base Rate (KBR). KBR is anchored on the interbank rate. KBA has proposed that banks will determine their lending rates by adding a premium ("K") to the unified KBR[1].

KBA proposed that the premium ("K") above KBR should be competitively determined by the banks based on their products and clients to reflect the principles of market-driven interest rates and risk pricing. This means that the banks will not apply to CBK for any approval or noting of their premium ("K").

This proposal of the premium ("K") being determined solely by the banks without any reference to CBK is a replica of how the premium ("K") was determined during the Kenya Bankers Reference Rate (KBRR) regime. It resulted in a myriad of premia ("K") across the banks and was one of the key challenges that led to the suspension of KBRR.

6.0 CBK PROPOSED COMMON REFERENCE RATE

The two commonly used rates in arriving at common reference rates for determining lending rates are policy rate and interbank rate. CBK has analysed the pros and cons of the two commonly used rates in determining the appropriate common reference rate.

6.1 Use of Policy Rate (The Central Bank Rate)

Pros

- Currently, CBR forms the base for pricing all Open Market Operations as well as the interbank rate.
- The formulation and determination of the CBR involves a wide range of variables. It reflects the monetary policy stance, following consideration of gaps of inflation from target and output from potential as well as developments in the global and domestic economy. These variables are observable on regular basis and embody the entire economy.
- There is an increasing understanding of the role of CBR by banks as well as expectations with respect to increases and decreases in the policy rate.
- The formulation of the CBR is shared with all banks and the public during the regular forums between the CBK, the banks and media.
- CBR facilitates the transmission mechanism of monetary policy to the real sector through adjustments in bank interest rates.
- CBR reflects risk-free or near risk free cost of funding to the banks.
- CBR is announced, in most cases every two-months, which gives banks sufficient time to effectively effect changes in their lending rates.
- CBR is forward looking.

Cons

- Not well understood by some market segments. But various initiatives by the CBK to enhance understanding and the role of the CBR as the base for all monetary policy operations will address this challenge.
- There have been instances of asymmetric response by some banks to changes in the policy rate. This challenge can be addressed through measures to enhance the transmission mechanism.
- CBR does not account for operating costs, necessitating the inclusion of an operating cost factor alongside the risk premium margin.

6.2 Use of Interbank Rate

[1] *KBR, the unified base rate will be equal to 2-month average of the overnight Interbank Rate.*

Pros

- Currently, interbank rate has been linked to the CBR through the interest rate corridor.
- It is a good reflection of the level of short-term liquidity in the market.

Cons

- Prone to volatility during periods of tight liquidity in the market. These swings are still reflected with a lag even with a moving average on the interbank rate.
- Not all banks participate in interbank lending but only those in need of short-term liquidity.
- The interbank rates do not necessarily reflect cost of funding since it is a reflection of the level of short-term liquidity in the market.
- Most banks that engage in interbank transactions primarily use the funds for liquidity management rather than for lending purposes.
- Interbank rate is backward looking.

6.3 CBK's Proposal

Based on the above analysis, CBK recommends: -

i. The use of the **policy rate (Central Bank Rate)** as the common reference rate for determining lending rates in the Kenyan banking sector. CBR, as the common reference rate, reflects the cost of funding to the banks. The common reference rate will change every two-months when the Monetary Policy Committee makes any change pronouncement on the CBR.

ii. The lending rates will be determined by adding a premium ("K") to the CBR. The premium ("K") will comprise:-

   a) The banks operating costs related to lending[2],
   b) Return to shareholders[3], and
   c) The borrowers risk premium[4].

iii. That where a banks' cost of funding is more or less than the common reference rate (CBR), the bank will factor in the extra/lower amount in the premium ("K") for review and noting by CBK.

iv. The banks to submit their proposed premium ("K") to CBK for review and noting prior to rolling out.

v. That the new model will apply to all loans[5] as defined under clause 1.4.3 of the CBK Prudential Guideline Risk Classification of Assets, Provisioning and Limitation on Interest Recoverable on Non-Performing Loans (CBK/PG/04):-

   a) For new loans, it will apply immediately from the effective date.
   b) For existing loans, banks will transition them to the new model within 3 months from the effective date.

---

[2] *Operating costs related to lending comprise salaries and allowances, director's remuneration and other expenses, repairs and maintenance, depreciation, occupancy and rental expenses, contract services and other operating expenses.*

[3] *Return to shareholders is the expected shareholders return from lending business.*

[4] *The borrowers risk premium is the compensation the banks expect from their borrowers depending on their risk profiles. CBK expects a detailed credit-scoring model that covers both qualitative and quantitative aspects of a borrower, when determining customers' credit worthiness and that the rate should be customer specific.*

[5] *"……. Loans comprise business and personal lending, overdrafts, credit card lending, Hire purchases, Residential and Commercial Mortgage, Project Finance, finance lease and other financing arrangement that are in substance loans."*

vi. CBK will publish the components of each bank's lending rate premium ("K") on its website, the Total Cost of Credit[6] (TCC) website, and in two newspapers of nationwide circulation.

7.0 NEXT STEPS

CBK seeks comments from the commercial banks and the public on the proposed common reference rate and computation of banks' lending rates by Friday, May 2, 2025. The comments can be shared through email: fin@centralbank.go.ke, or delivered in hard copy addressed to:-

The Director
Bank Supervision
Central Bank of Kenya
P.O. Box 60000-00200, City Square
NAIROBI.

CENTRAL BANK OF KENYA
APRIL 2025

[6] *Total Cost of Credit (TCC) website, developed by CBK and KBA, provides information on fees and charges relating to loan products offered by commercial banks and microfinance banks.*