Capping interest rates: bad Economics or Necessary intervention?

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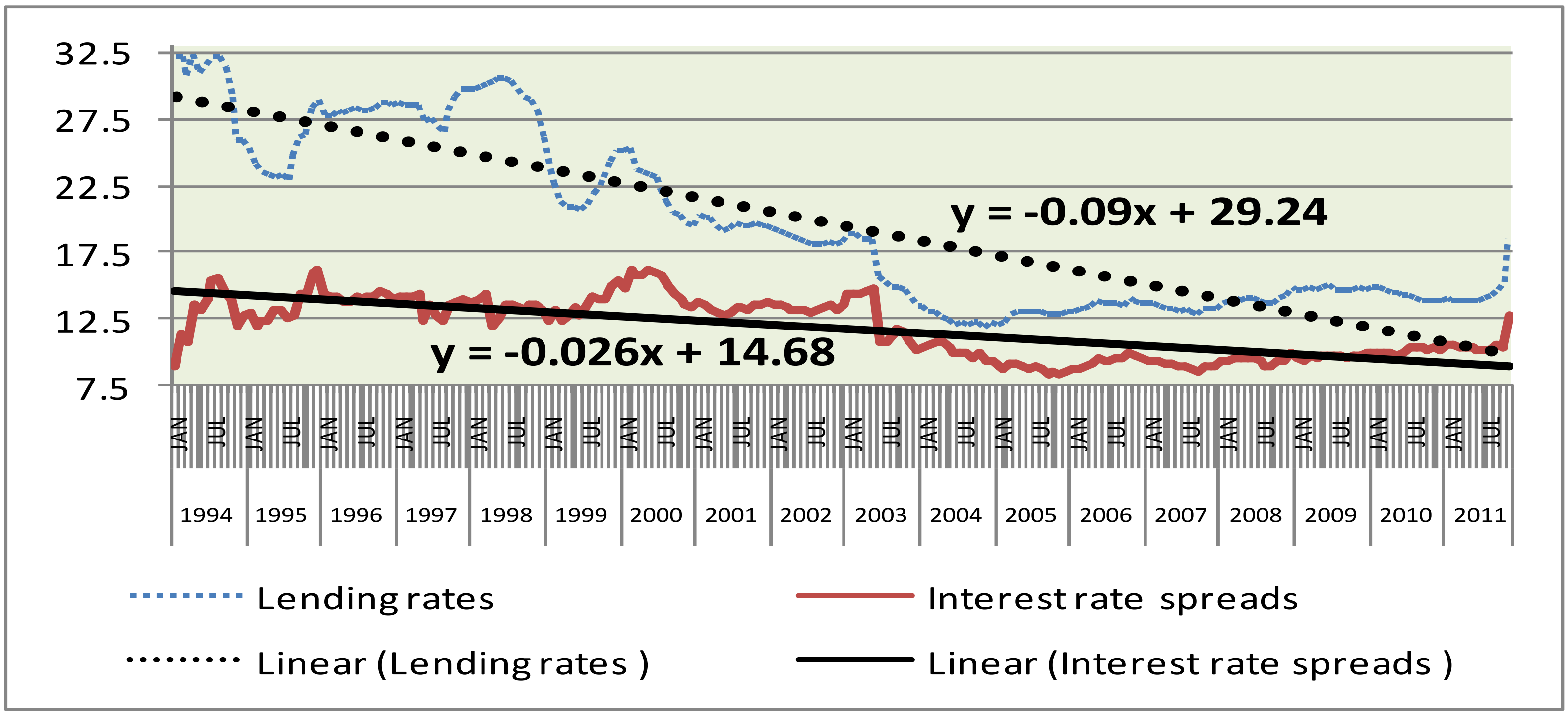
Banks recognize that there is a problem

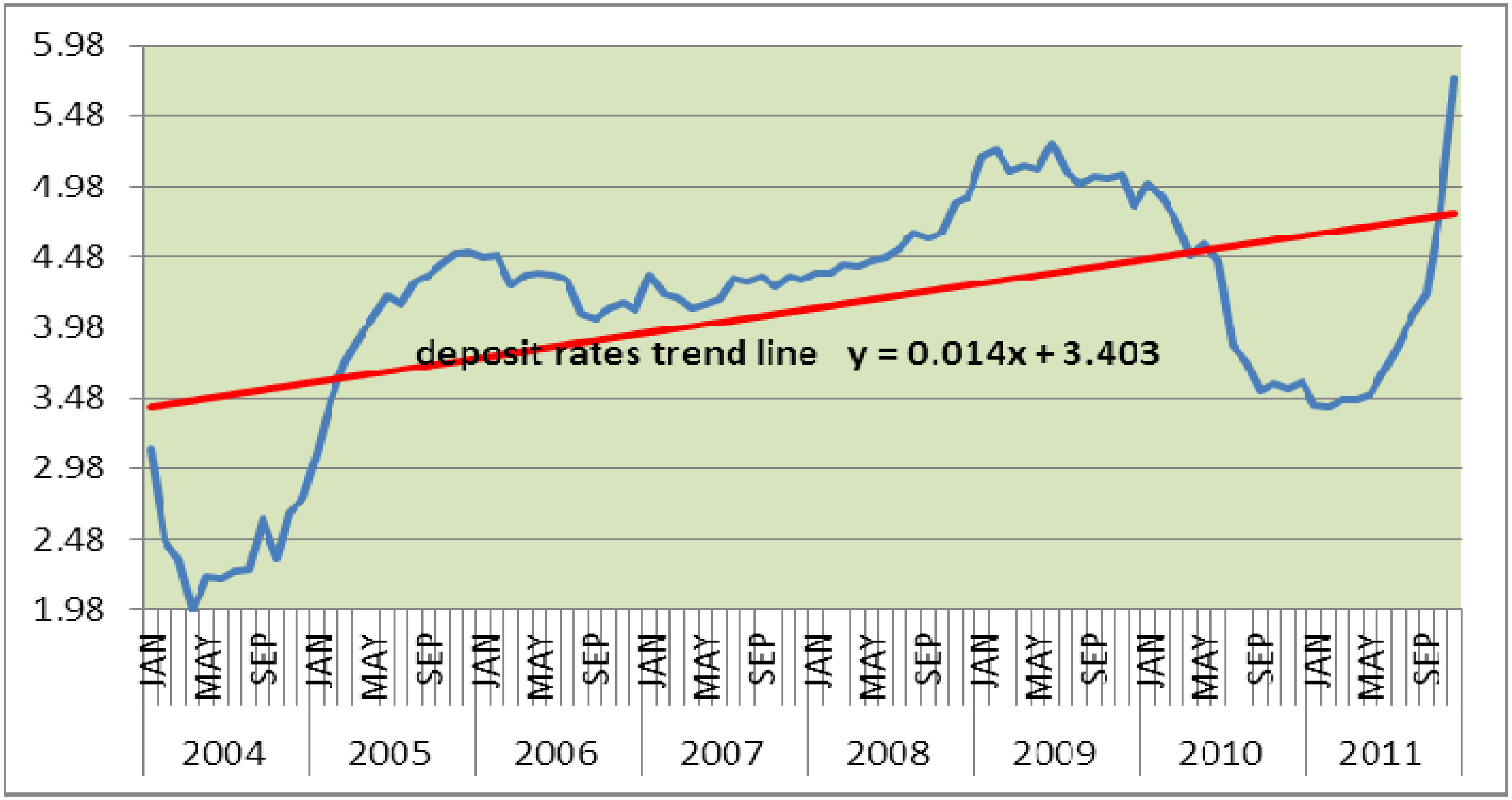
- Lending rates have been high but they have been going down gradually since 2003

- They came from a high of 32.18% in Jan 2004 to 13% in early 2011



Deposit rates have rising

- Deposit rates on the other hand have been going up over time



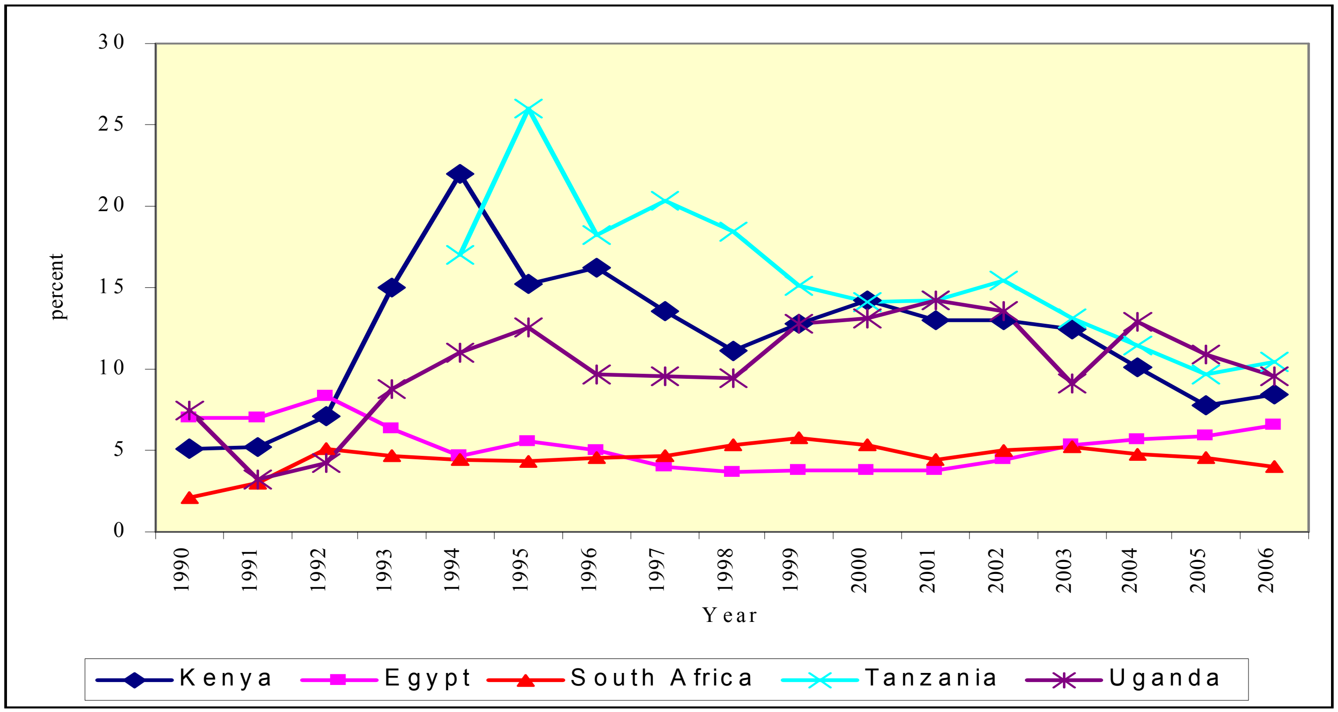
Spread has been declining

- As a result of the rising deposit rates and falling lending rates, interest spread has been declining over time

Regional comparisons of the spread

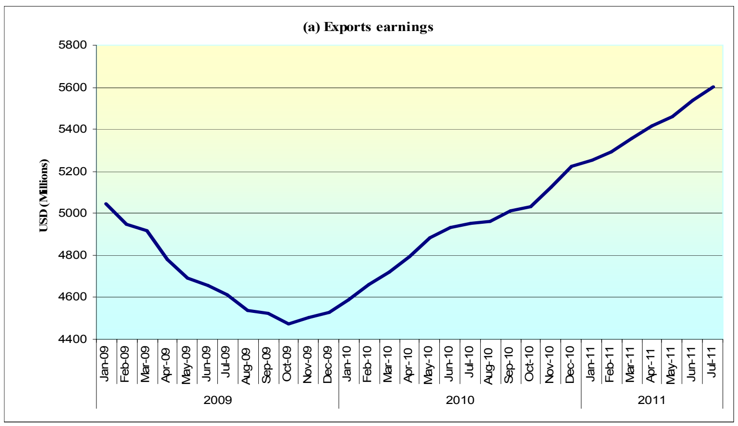
- The high interest rates are not just high in Kenya but is a regional problem

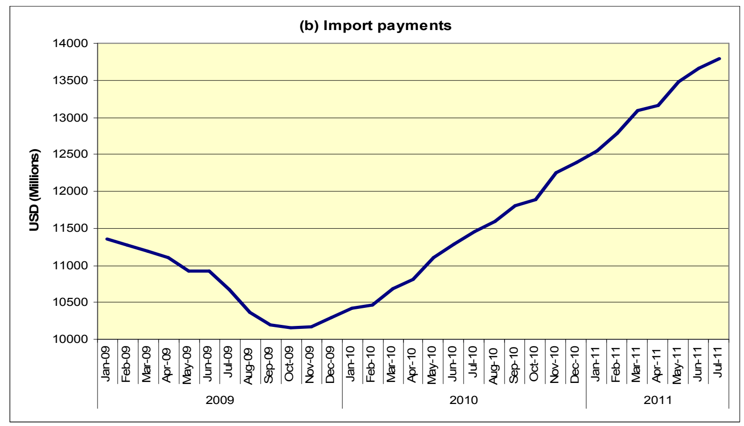
- Spreads are in fact lower in Kenya than Uganda and Tanzania

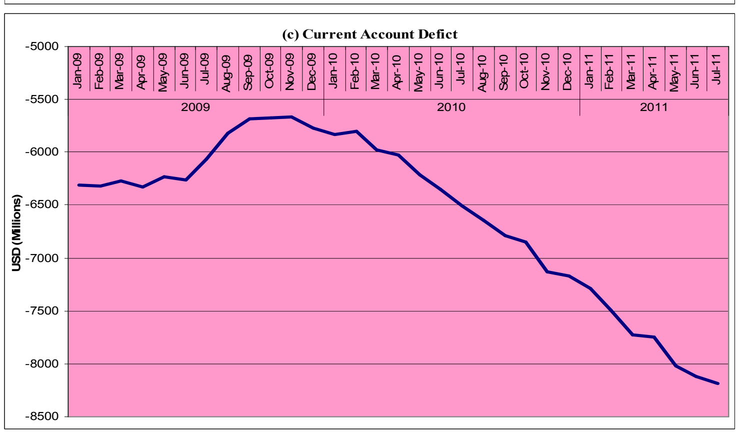


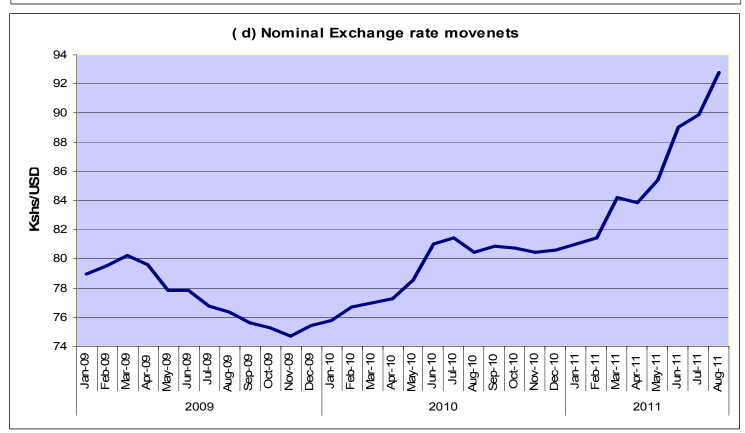
Causes of Recent Steep rise in Lending rates

1. Underlying Structural problems in the economy
   - Weak Current Account Position, led to high inflation and depreciation of the shilling forcing monetary policy tightening which led to increased lending rates



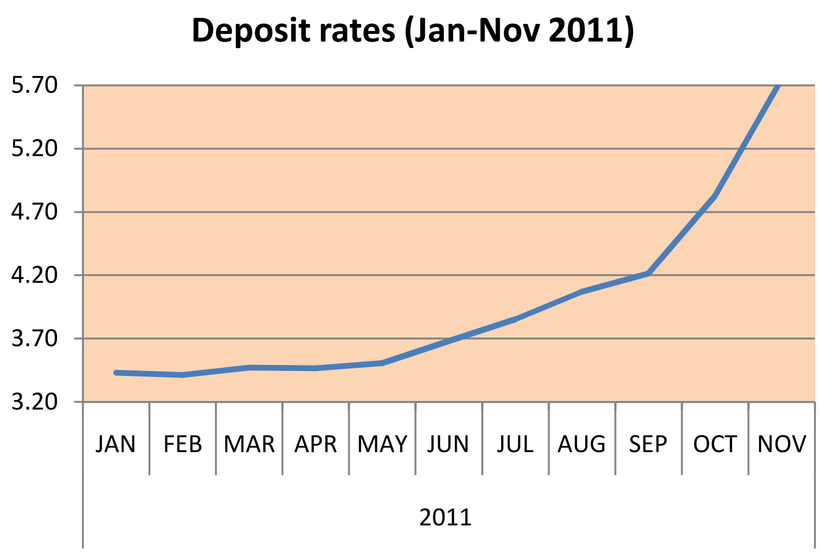


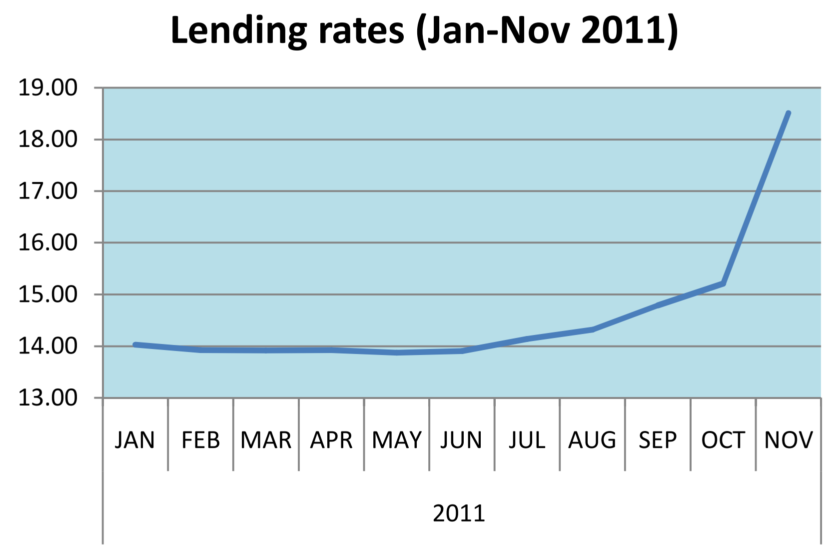




Causes of Recent Steep rise in Lending rates

- Lending rates increased as a result of the tightening
- Deposit rates also increased

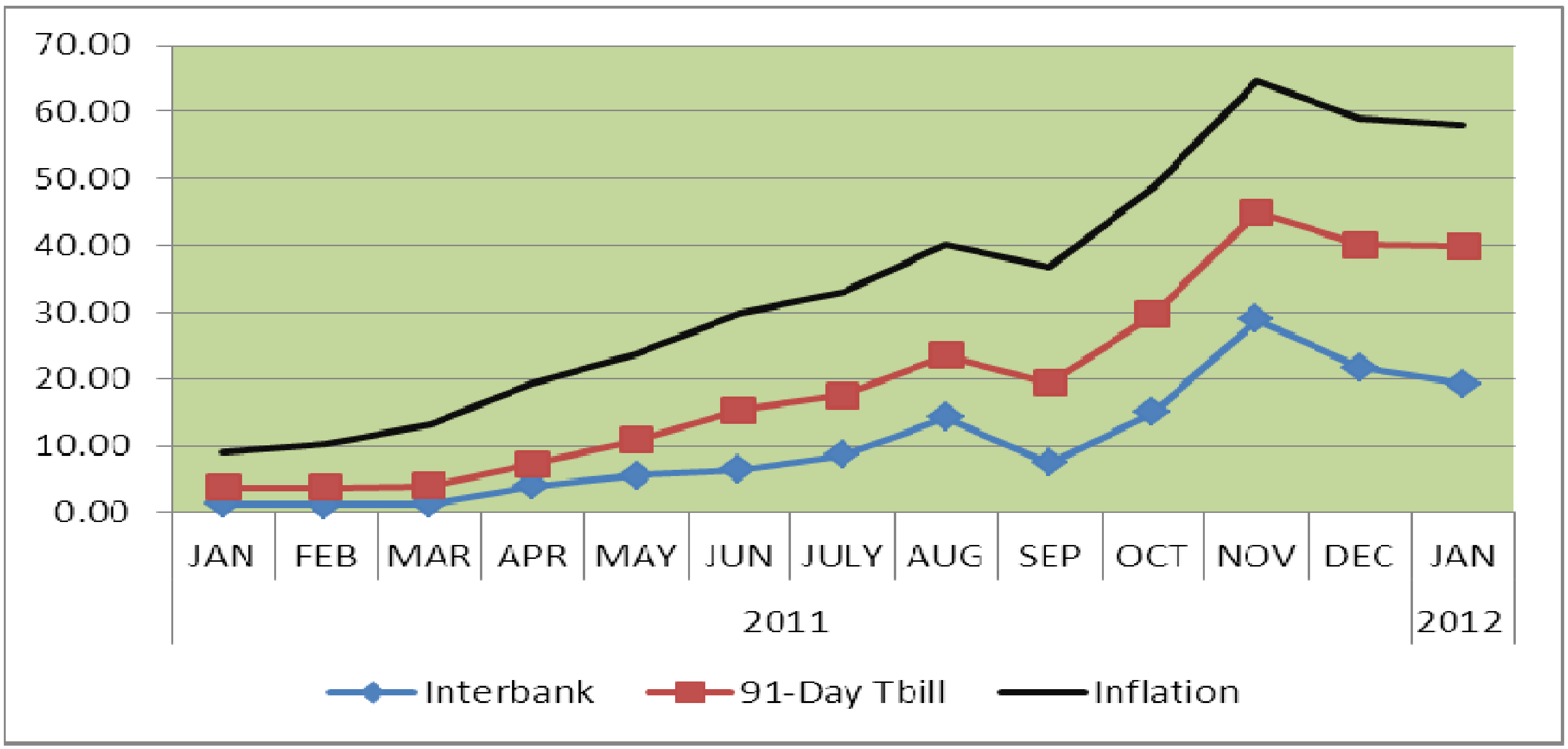




- This is the main source of the recent concerns on interest rates

But problem is temporary

- There are signs the problem is already easing with the falling inflation and a stronger shilling (Dec 2011 and Jan 2012)
  - Inflation has been declining since Dec 2011
  - Market rates have started to come down



Demystifying misperception on bank profits

- 3-year banks' return on assets (2008-2010) averaged 4.29%, compared to the return on assets of big listed companies of 19.37%

- Return on equity for the banks over the same period averaged 29.65%, while that of the big listed companies was at 30.86%.

- This shows that profitability of the banking industry is not above the market average

Demystifying misperception on bank profits

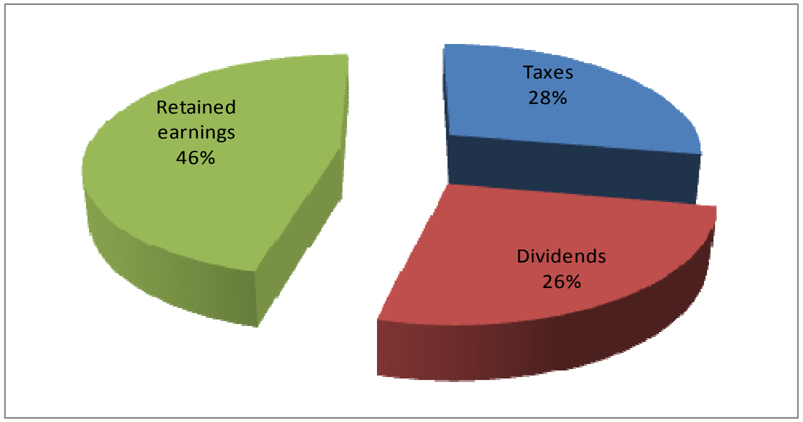
	Return on Assets				Return on Equity			
Large Listed Companies	2008	2009	2010	3-year Average	2008	2009	2010	3-year average
Safaricom	40.60%	27.30%	29.50%		46.80%	29.80%	33.40%	
Bamburi	17.30%	29.90%	22.70%		29.40%	45.80%	35.00%	
Breweries	52.20%	45.80%	47.00%		57.20%	51.30%	52.50%	
BAT	13.40%	15.30%	15.80%		51.10%	51.60%	46.00%	
Pan African	1.92%	1.39%	3.36%		9.87%	8.08%	19.60%	
Kenya RE	12.62%	9.75%	9.63%		21.25%	16.08%	15.70%	
British American	3.00%	3.47%	4.84%		6.00%	9.50%	12.00%	
Average	**20.15%**	**18.99%**	**18.98%**	**19.37%**	**31.66%**	**30.31%**	**30.60%**	**30.86%**
Banks								
Kenya Commercial Bank	3.00%	3.60%	5.20%		26.90%	28.70%	28.20%	
Barclays Bank	4.70%	4.70%	6.20%		39.20%	37.20%	34.30%	
Standard Bank	4.70%	5.40%	5.40%		41.30%	48.70%	37.90%	
Equity Bank	6.10%	5.70%	7.00%		24.20%	23.90%	32.90%	
Cfcstanbic	1.50%	1.40%	2.00%		18.40%	16.40%	21.00%	
Co-op Bank	3.70%	3.30%	3.60%		23.90%	23.10%	27.50%	
Average	**3.95%**	**4.02%**	**4.90%**	**4.29%**	**28.98%**	**29.67%**	**30.30%**	**29.65%**

Bank profit distribution

- Kenyan government receives 28% of bank profits as taxes

- 46% of profits are re-invested or used for business expansion like opening of new branches (retained earnings)

- Shareholders get only 26% of the profits in direct payments



Banks Care - What are they doing about high interest rates?

- Extended loan repayment periods by mutual agreement

- Maximum increase in loan repayment amount capped to 20% of current level of instalment

- Waiver of administrative charges on loans by mutual agreement

- Absorption of additional costs arising from changes in the macroeconomic environment

- Early repayment penalties have been waived

Outcomes of banking sector initiatives as at January 2011

- Loan repayment period extended on 440,380 loan accounts amounting to Kshs 99.8 billion

- Waiver of early repayment penalty on 1,210 loan accounts amounting to Kshs 237.9 million

- Capping maximum increase in repayment has been done on 9,655 cases amounting to Kshs 51.9 billion

- In addition, most banks did not change interest rates on existing loans when Central Bank of Kenya announced further tightening of its monetary stance when CBR rose to 18%

- 1,296 cases of loans totaling Kshs. 994.2 million did not attract interest under the in-duplum rule.

What does the initiatives by the banks show?

- That the banking industry is cognizant of the difficulties facing borrowers following increases in interest rates

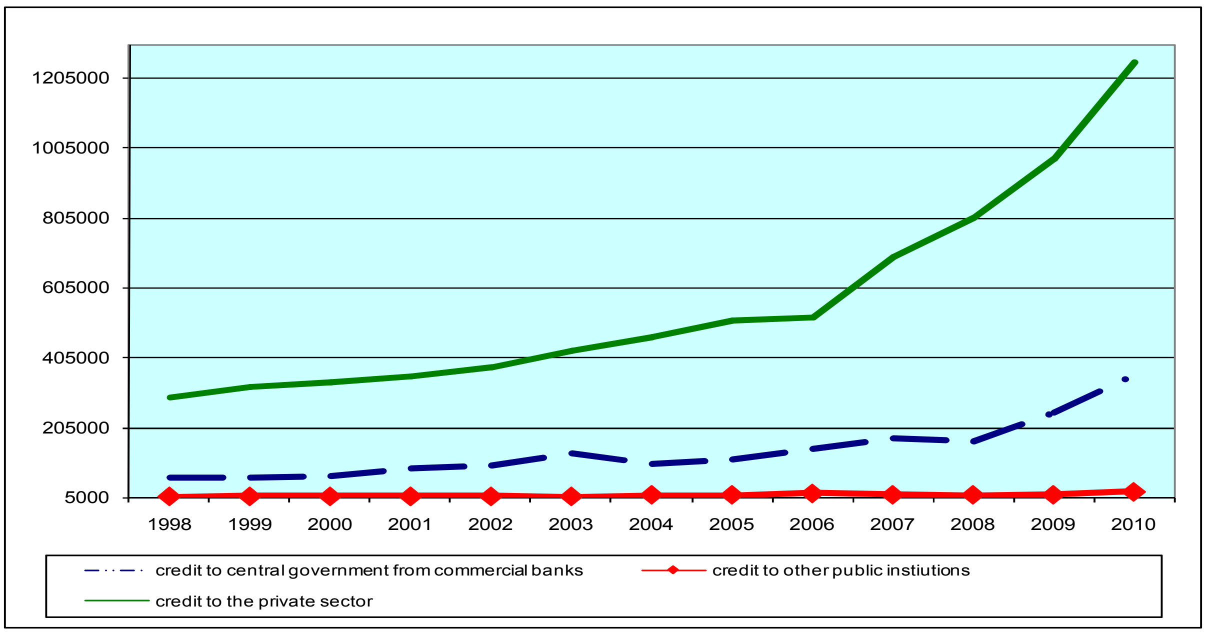
- Is already taking measures to mitigate the borrower’s burden
- The measures were the initiative of the KBA members and demonstrate a degree of self regulation in the face of challenges in the industry.

Success of the Banking industry during the period of no controls

Tremendous credit growth

- Contrary to the opinion that high interest rates have stifled credit growth, there has been an exponential growth in credit

Growth in credit

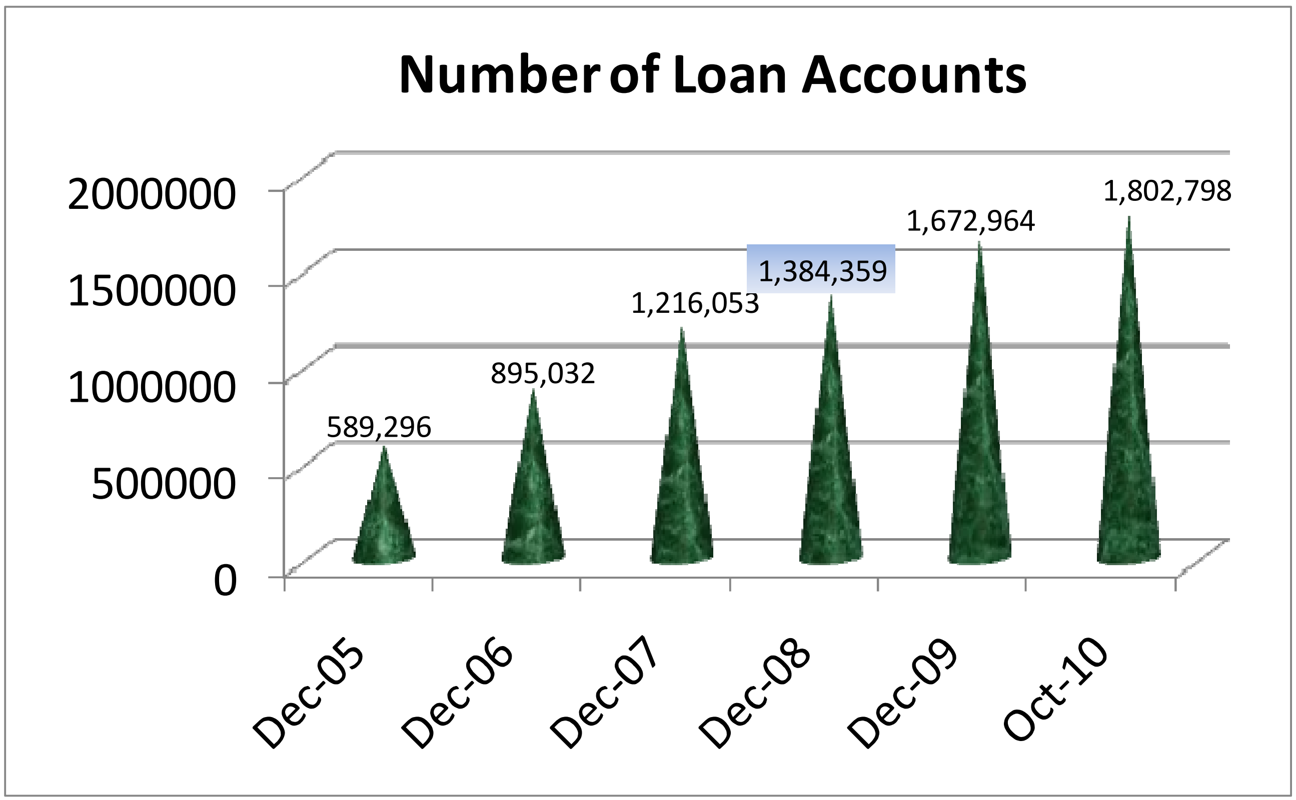


- Credit growth to the private sector has been phenomenal

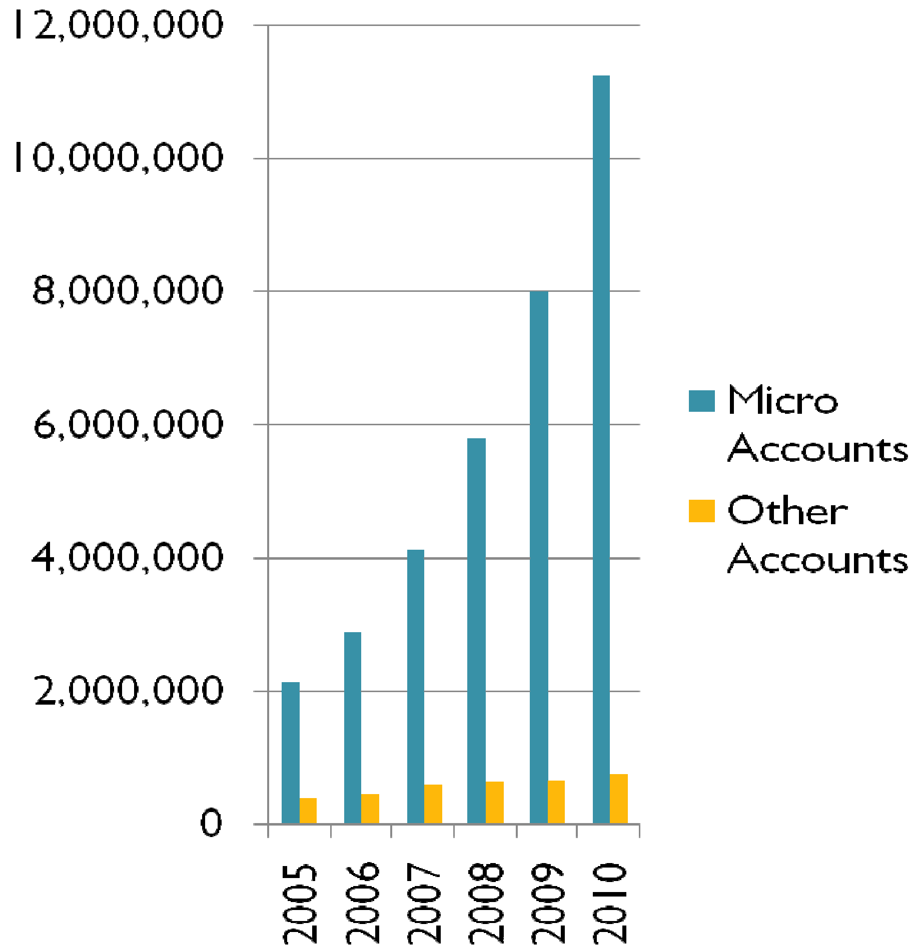
Loan accounts

- Number of loan accounts have increased by 207% from 589,296 in December 2005 to 1,802,798 in October 2010

- Some 13,803 are mortgage loans.

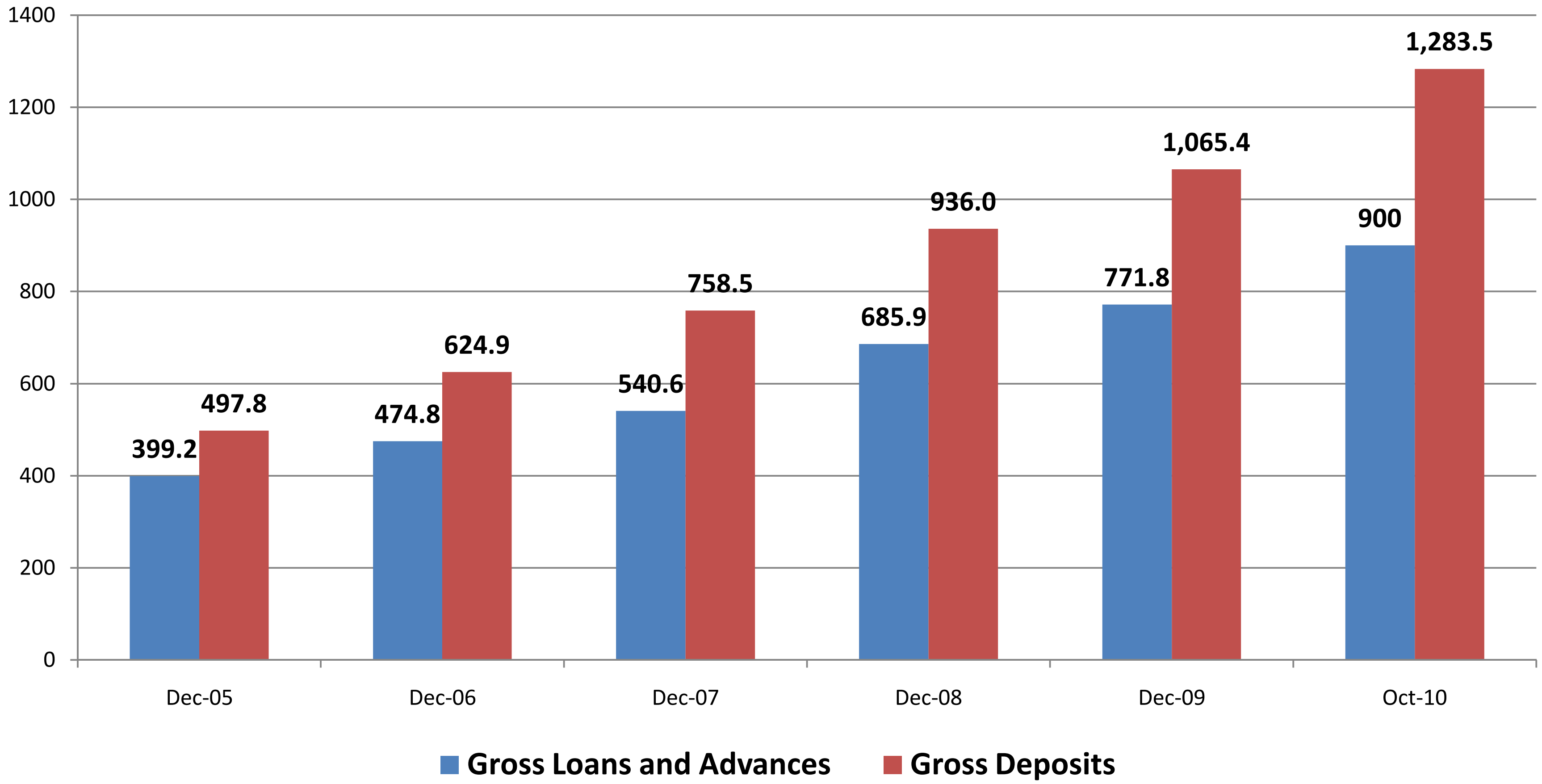


Deposit Accounts



- Number of deposit accounts has increased from 2.55m in 2005 to nearly 12 million at end of September 2010. The takeoff seems to start in 2007
- Number of micro accounts has increased by 425% from about 2.14 million accounts in 2005 to about 11.25 million accounts at end of September 2010. These are covered by the Deposit Protection Fund.
- Growth attributable to reduced costs of maintaining micro accounts and introduction of innovative instruments
- But also increased branch outlets that solve the physical distances
- Barriers of entry have been significantly reduced

Value of Deposits (Kshs. Bn)

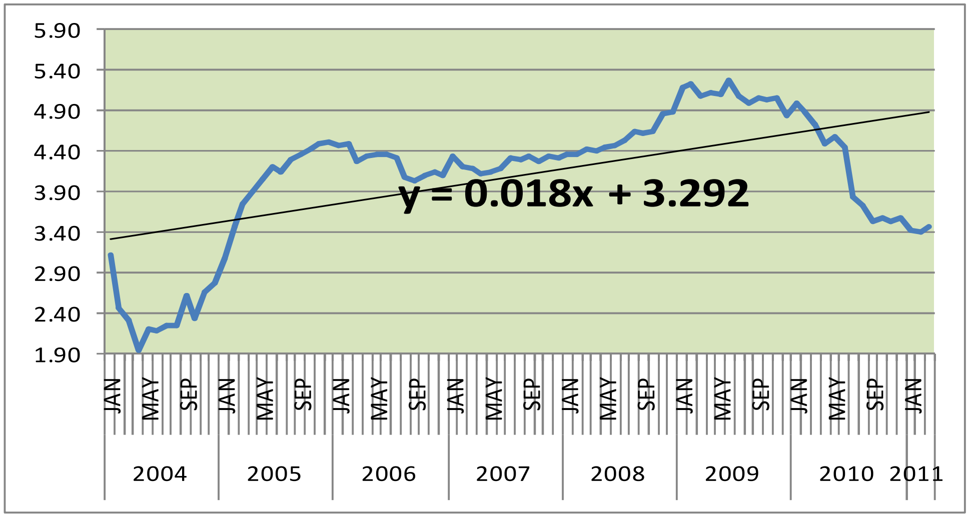


- But the loans and advances are 70% of total deposits

Deposit rates have been going up

- Due to several measures instituted in the sector (especially since 2004), deposit rates have in fact been gradually going up over time

Trends in deposit rates in Kenya (2004-2011)

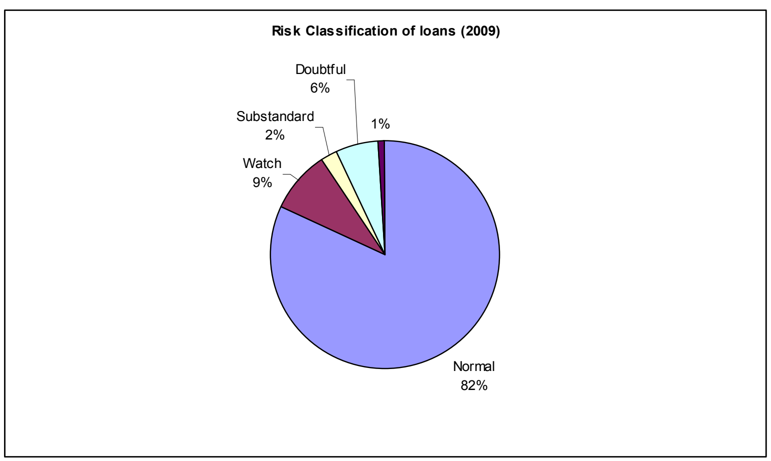


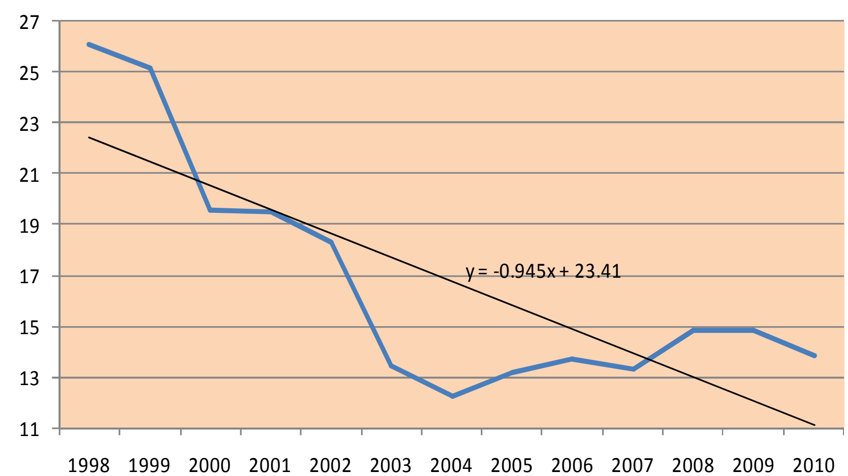
- The slight reduction since 2009 could be attributed to expansionary monetary policy actions which led to a reduction in interest rates

Asset Quality has significantly gone up leading to a reduction in lending rates

- Asset quality (AQ) is measured by the ratio of net non-performing loans to gross loans
- AQ has significantly improved from a high of 38.9% in 2001 to 6.1% in February 2011
- In fact, 82 percent of the loan portfolio of the banking sector are classified as normal in 2009
- This has made the lending rates to gradually go down as shown in the figure
- The lending rates are expected to reduce even further as monetary tightening eases

Risk Classification of loans (2009)

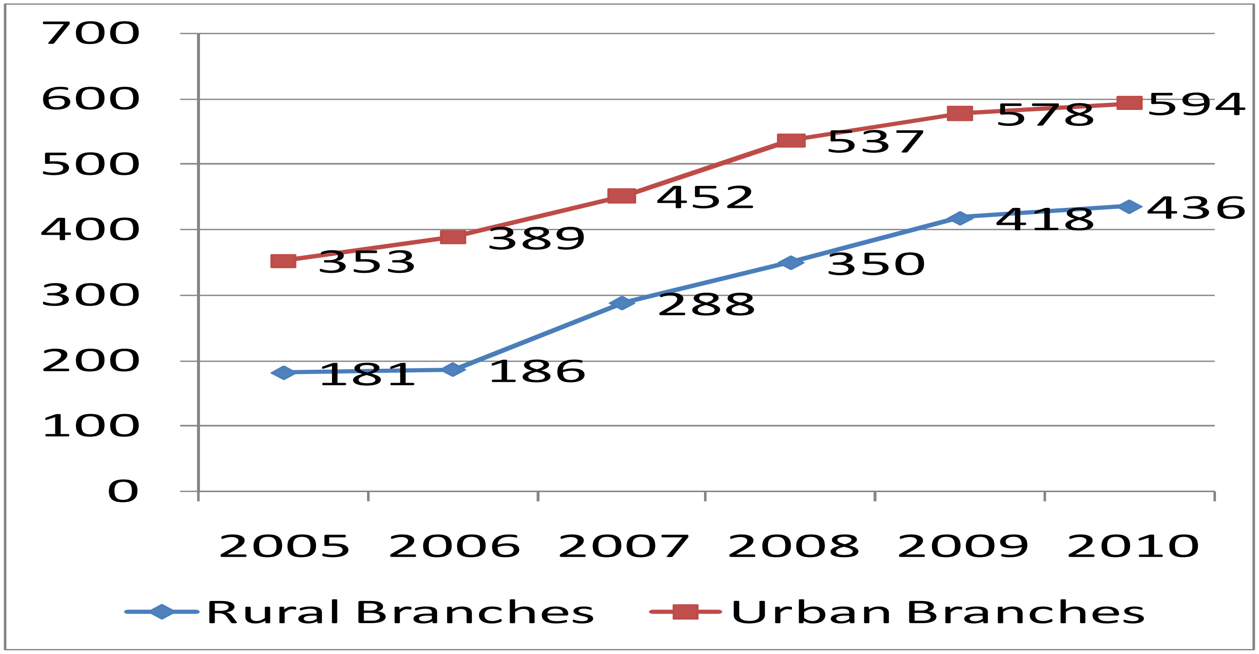




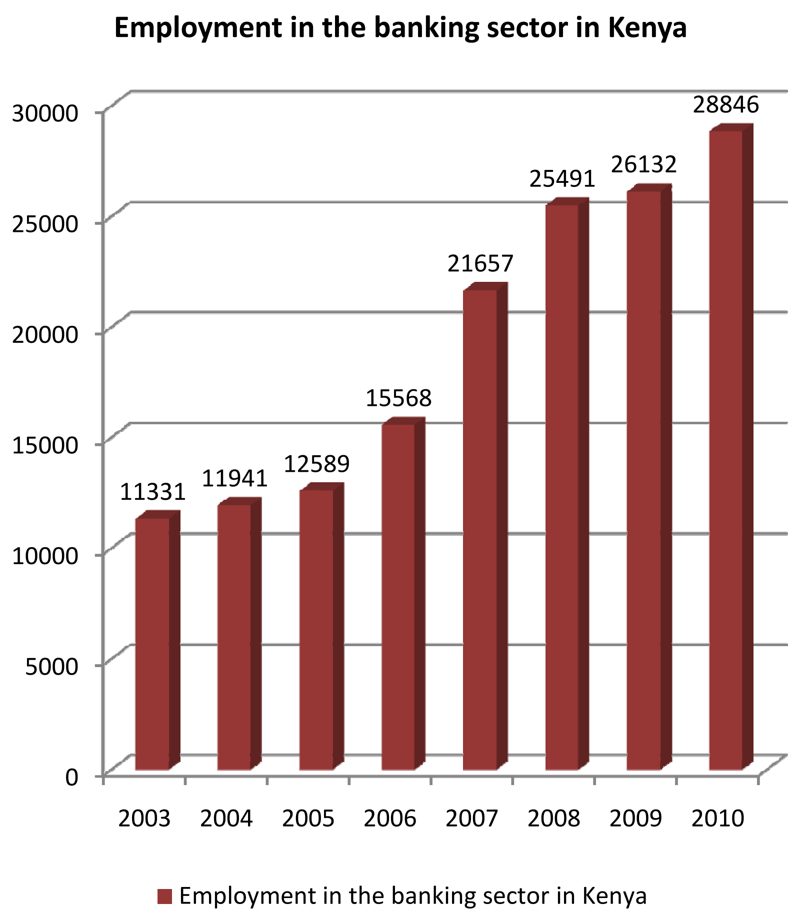
Source: CBK's Bank Supervision Annual Report (2009)

Increased financial access

- Exponential growth of bank branches from 534 end of 2005 to 1030 end of September 2010
- Number of rural branches has grown by 140% compared to 68% in urban areas
- Two National Deposit Taking Microfinance Institutions have opened 31 branches since 2009 (16 in rural areas)
- In total expanding financial services is evident



Employment creation



- Employment has increased by 154.5% between 2003 and 2010 from 11,331 in 2003 to 28,846 in 2010
- Controlling interest rates will mean retrenchment of staff leading to increased unemployment in the country especially youth unemployment
- Vision 2030's goal is to reduce youth unemployment from 75% to 35% by 2012
- This goal will not be achievable with controls in the employment creating sectors like the baking sector.

Experience of Other Countries with interest rate controls

- **India**
  - The Reserve Bank of India notes that the administered savings deposit rates have not moved in sync with the changing market conditions and therefore has generally been unfavorable to savers
  - Deregulation has also been found to limit product innovation in India as the banks do not have the incentive to innovate – this is one of the arguments for deregulation of the savings deposit rates in India

Experience of Other Countries with interest rate controls

- **Indonesia, Malaysia and the Philippines –**
  - had controls on interest rates at one time or the other
  - Most of these countries started to deregulate interest rate when they realized that the controls were not supporting overall development and growth policies
  - Controls led to negative real rates which led to a fall in financial savings.

Experience of Other Countries with interest rate controls

- Hong-Kong
  - Interest rates were controlled until July 2011
  - Were deregulated when it was realized that controls hampered the efficient transmission of monetary policy
  - Controls are therefore likely to effect monetary policy transmission into the economy

Is capping interest rates then a solution in Kenya ?

- Interest rates controls is not a solution
  - Controls will not reduce supply side inflation
  - Will not reduce government appetite for money in the domestic markets
  - Have never worked elsewhere
  - Cannot and should not be used to try to solve a temporary problem

Is capping interest rates then a solution in Kenya ?

- Will lead to possible retrenchment of staff to reduce costs – staff costs constituted 34% of operating expenses in 2010

- Will curtail banks’ capacity to lend by reducing deposit inflows and the amount of funds available for lending; as a result, borrowers would be driven to the costlier alternatives such as informal money lenders

- Banks will in addition not lend to high risk borrowers. Unsecured lending and lending to the micro sector will fall tremendously

- Will stifle banking sector growth since there will be no money for expansion while the formally unbanked still remain at about 70% of the population

Way forward

- Problem is structural and long term measures will require fixing structural problems
  - Measures to reduce current account deficit including import substitution policies and export promotion measures (improving competitiveness of country's exports)
  - Measures to deal with supply constraints that lead to inflation including acreage under irrigation etc

- Self Regulation - Coming up with mutually agreeable Regulations among the key players in the sector including the Central Bank, Treasury and Bankers

- Negotiations - Giving room to Client-Banks Negotiations on terms and conditions of rewarding deposits and credit advances
- Addressing Financial Education and Consumer protection Issues

Thank You