The Capping Interest Rates Debate: Market Failure or Necessary Intervention?

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The Presentation is in three broad areas:

• One, we are beyond debating and are now in the stock-taking stage.

• Two, before the interest rates capping, we were on the right path; it needed consolidation and fine-tuning and not legislative disruption.

• Three, structural and policy issues that influence interest rates need to be addressed since the short-cut of fixing the price will not work.
Key issues

1. Interest Rate capping:
   • The issue has moved beyond the debate state to collating and analysing evidence of the effect:

2. Banking Industry trends:
   • The banking industry has made tremendous strides over the past three decades under a dynamic regulatory regime underpinned by market-based pricing policy.

3. Banks and economy:
   • Role in Supporting Enterprise Development
   • Partnerships (both local and international) towards resource mobilisation and investments; financing under the public-private-partnerships

4. Cost of credit and Banking Amendment Act 2016
   • There is a delicate balance between addressing cost of credit and access to credit.
   • Interest rate is a price whose determination has both structural and policy dimensions; interest rates regulation does not address the policy and structural influences on cost of credit; such regulation potentially has adverse implications.
Beyond the Debate

• The law introducing caps on lending rates was signed in August 2016, and became effective in September 2016.
  • Expectations – households and business to flock to banks to access “cheap” credit;
  • Reality – the opposite of the expectations is what is prevailing: (a) tighter credit conditions so as to price risk within the caps (b) portfolio realignment away from risky segments (c) balance rationalisation – liabilities (deposits and lines of credit) are looked at more carefully so that they appropriately march the assets profile in the new dispensation.

• First round effects:
  • Capital markets have had an immediate hit – (a)listed banks account over 30% market capitalisation (b) Insurance companies and pension funds invested in bank stocks (c) foreign investors exiting the market has put the local currency under pressure with the attendant instability challenges.
  • Listed banks market capitalisation has come down by more than 25%; the overall market capitalisation has come down by nearly 20%
• First round effects:
  • Slowdown in credit to the private sector has been exacerbated - January 2016 (16.8% growth); August 2016 (5.4% growth); December 2016 (4.3% growth).
  • branch closure; staff reduction; relocating shared function for some international banks.
  • Reduced appetite for lines of credit towards supporting SMEs from international development financial institutions

• Spill-overs to the market:
  • Manufacturing sector (e.g. motor assembly) has been hit by low sales largely attributed to limited credit to households and small business to buy vehicles;
  • Construction sector has seen a slowdown – low credit for development; low housing demand on account of limited credit
  • Early evidence of crowding out of the private sector as banks prefer lending to government – quantity channel (less money to private sector) as opposed to the price channel (expensive money to private sector)
Beyond the Debate

• Increasingly, the effect is taking a two dimensional angle:
  • It will have a magnitude effect (it will hurt the businesses and households)
  • It will have a persistence effect (the effect will have long-lasting effects)

• The IMF, CBK, World Bank, et. al. have scaled down the economy’s medium term outlook.

• The economy could drift towards a vicious cycle

Sovereign challenges (debt, commitment to assure financial stability)
Banking Industry challenge
Growth challenges
Increasingly a competitive market structure than regional peer

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<thead>
<tr>
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<th>2001</th>
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<tbody>
<tr>
<td>Kenya</td>
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<td>Rwanda</td>
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<td>Tanzania</td>
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<tr>
<td>Uganda</td>
<td>0.39</td>
<td>0.36</td>
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</table>

Source: Sanya & Gaertner, IMF, 2012

Kenya’s Banking Sector is More Competitive than Other Countries

Source: The Role of Capital Requirements on Bank Competition and Stability: The Case of Kenyan Banking Industry by Ragnar Gudmundsson, Kethi Ngoka-Kisinguh & Maureen Teresa Odongo
Positive Strides (Pricing)

• The market competition dynamics have shaped the credit pricing trend.

• That trend has consistently been downwards, with upward spikes being associated with macroeconomic volatility and fiscal pressure; once market normalcy restored, the downward trend resumes.

• The interest rate spreads are now at single digit level.

Source: CBK
## Growing Deposit Accounts

Source: CBK 2015 Annual Report

<table>
<thead>
<tr>
<th>Year</th>
<th>No. of Deposit Account Holders (1)</th>
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<td>2012</td>
<td>15,861,417</td>
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<td>2013</td>
<td>21,880,556</td>
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<td>2014</td>
<td>28,438,292</td>
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<td>2015</td>
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</table>

More Kenyans are Saving than Ever Before
Network Expansion

Figure 3: Bank Branches

Source: CBK

Figure 4: No. of Agents

- Q1-13: 18,082
- Q2-13: 19,679
- Q3-13: 21,618
- Q4-13: 23,477
- Q1-14: 24,645
- Q2-14: 26,750
- Q3-14: 30,449
- Q4-14: 34,381
- Q1-15: 36,080
- Q2-15: 39,871
- Q3-15: 40,224
- Q1-16: 39,871
Financial inclusion trend

Source: FSD Kenya FinAccess Survey (Various Issues)
Growing SME Loans Portfolio

• The share of SME lending relative to total lending by commercial banks is higher in Kenya (23.4%) compared to other major markets in Sub Saharan Africa like Nigeria (5%) and South Africa (8%). According to a study quoted in the report, this ratio is at 17% in Rwanda and 14% in Tanzania placing Kenya as the leading country among the five countries referred to in the study.

• The preferred source of financing for a large number of SMEs is overdrafts despite the fact that banks have introduced several trade finance and asset finance products designed for the SME market.

1. The nexus between finance and economic performance is clear: finance supports growth.
   • Banks lend across all key sectors of the economy.
2. The resource mobilisation agenda is beyond the local economy:
   • Partnerships with international lenders – lines of credit to support enterprises.
   • Banks support the development of capitals markets (dominate market capitalisation of listed companies and are the leasing issuers of long term notes
3. Partnerships (both local and international) towards resource mobilisation and investments; financing under the public-private-partnerships

Source: KNBS Economic Survey
(i) Disclosure of information on loans where:
“A bank or financial institution shall, before granting a loan to a borrower, disclose all the charges and terms relating to the loan”.

(ii) Introduction of a capping on lending rates and determination on the minimum interest payable to depositors:
“The maximum interest rate chargeable for a credit facility in Kenya at no more than four percent, the base set and published by the Central Bank of Kenya; and “
“The minimum interest rate granted on a deposit held in interest earning [account] in Kenya to at least seventy percent, the base set and published by the Central Bank of Kenya”.

(iii) Sanctions
“Fine of KES 1 million for violation and/or one year jail term for the CEO of the financial institution
The Banking (Amendment) Act 2016

• Cost at the expense of access?

Assumption: caps are meant to protect customers by making loans more affordable, and increase access to finance.

  • Affordability and access are critical constraints; but they are not equally binding. Pursuit of affordability shouldn’t be at the expense of access.

• What if the cap is arbitrarily determined (as is the case in the proposed law)?

  (a) it could be too low to cover the financial entities’ costs of providing credit, in which case compliance will only mean that part of the costs will be passed on to the consumer in form of other fees and charges; otherwise the decision will be not to lend to a customer whose risk and costs surpass the cap.

  (b) if they are set too high, then there is a tendency of the rates to rise towards the cap, thus making the cost of credit high to the disadvantage of the customers (the assumed beneficiaries of the caps), banks, and the economy at large.
Possible Implications of the Interest Rate Capping

- Discourage innovations aimed at high risk/low scale credit segment;
- Banks will prefer to lend to Government than households and businesses;
- Lead to credit rationing and distortions to the detriment of SMEs, low income and first time borrowers;
- Discourage supply of funds to the financial system, thus encouraging informal mechanisms. This will negate that strides that the country has made in enhancing financial inclusion through formal systems;
- Banks will have an incentive to introduce additional fees or modify terms of the loans to increase the effective rates, thus negating the strides made in pricing transparency such as the APR mechanism;
- Lead to credit concentration amongst large borrowers, with the attendant risks of non-performing loans and possible systemic risks;
- Non-financial market players will see an incentive to increase sales through credit under more stringent terms to the detriment of customers;
- Lenders will have the incentive to provide credit in hard currency, with the attendant risk being foreign exchange risk. The remedy could be an equally undesirable foreign exchange control.
The Bill—Experiences of other jurisdictions

**Examples in Africa**

- **Mauritania**: Fixed margin above a benchmark. It is noteworthy that Mauritania has among the weakest financial sector generally and banking industry in particular to provide a good comparator economy.

- **Zambia**: Differentiated caps depending institution (bank, microfinance or non-bank financial institution); the caps have not necessarily served the intentions of access and affordability and therefore it cannot be show-cased as a model.

- **Ethiopia**: The National Bank of Ethiopia removed all interest rate ceilings in 1998; there is however a defactor ceiling for most micro-finance institutions have maintain low rates due to political reasons. The banking industry in Ethiopia is fairly closed and has a significant government participation, attributes that differentiates it from Kenya’s.

- **Egypt**: Civil and commercial credit are subject to a 7% ceiling while commercial banks determine interest rates for loans. Egypt has a strong banking industry that operates on market-based principles for the benefit of the economy.

**Example in Latin America**

- **Ecuador**: caps have led to illegal lending flourishing whose prevention has necessitated more supervision and control

- **Mexico and Chile**: record to lending to the poor and vulnerable has not been impressive, a factor largely attributable to attributed to the interest rate caps. These economies are still lagging behind many of the Latin American peers in the financial inclusion agenda.

- **Colombia and Brazil**: They are easing on the caps. They have been persuaded that the presence of interest rate caps is associated with less financial access.
So What Actually Happens When You Have Caps

• **Zambian Case:**
  • January 2013 Zambia had introduced caps on the effective maximum lending rates by commercial banks, microfinance service providers and other non-bank finance institutions.
  • The effects were seen in the near-collapse of the credit market – credit to households, SMEs; the local currency was hard hit as lenders gave hard-currency loans to non-tradable sectors (not earning foreign exchange).
  • Repealed in November 2015
  • The implication of removing the caps is that there is no limit as to the maximum rate of interest that financial institutions can provide.
So What Actually Happens When You Have Caps

• **Germany Case**
  • Largely self-regulation;
  • Credit law does not specify interest rate ceiling
  • Court defined ceiling of 2 x average rates;
  • Little variation in some years, maximum 2006 = 21.1%.
  • “Discomfort zone” rather than fixed point
  • Main requirement for transparency on charges
    • APR disclosure;
    • Compulsory charges included in APR
So What Actually Happens When You Have Caps

• Japan Case

• Dual regulatory regime until 2007:
  • banks and consumer finance houses treated differently;
  • bank regulatory regime (Interest Rate Restriction Law) had stepped maximum legal rates for different sizes of bank loan, from 15% for loans over Y1M to 20% for loans under Y100,000;
  • Maximum rate for non bank lenders progressively reduced from 109.5% in 1983, to 40%, 29.2% (with consumers’ voluntary agreement) up to December 2006.

• New legislation introduced phased tightening from December 2006 to 2009 to introduce one of tightest regulatory regimes:
  • Separate non-bank regime abolished
  • Rates reduced to 20% by 2009
  • Ceiling includes all ancillary charges
So What Actually Happens When You Have Caps

• **US Case**
  • Regulation of credit markets largely devolved to states;
  • Main exceptions are national banking and credit cards;
  • Most states regulate price of credit differently for different types of provider;
  • Small loans are the most common exception to the main interest rate control regime;
  • 6 states have deregulated completely and no longer have an interest rate cap;
  • In addition 31 states allow payday subject to a maximum charge per $100 lent over a 14-day period, one state has extended the minimum payday term to 31 days; the remaining 12 states do not allow payday lending.
  • The Military Lending Act (MLA) provide protections against predatory lending practices targeted at U.S. service members and their spouses and dependents.
    • Under the MLA, covered credit transactions are capped at a 36% Military APR (MAPR).
So What Actually Happens When You Have Caps

• **France Case**
  • Tightly specified ceiling set at 33% above average rate set quarterly by Banque de France;
  • Rates differ for 3 categories of loans;
    • Top rate peaked 27.09% in 1993:
  • All compulsory charges must be included in APR
  • Statutory formula for default charges, which may exceed legal maximum APR;
  • Comprehensive delinquency register (FICP) managed by Banque de France;
  • Creditors bear whole risk of lending to registered individuals and financial institutions required by law to register payment incidents
So What Actually Happens When You Have Caps

• UK Case
  • Light touch, market-based approach;
  • No interest ceiling (with single exception of not for profit lending);
  • Tightly specified requirements on contracts, presentation of price;
  • Requirement for clarity, transparency;
  • Requirement to lend responsibly;
  • Agreements subject to “unfair” credit test.
• Payday Loans have a cap on total costs:
  • a cap on the total cost of the loan of 100% of the loan amount;
  • Therefore if you borrow £100, the total amount you pay back including all interest, fees and other charges, and paying back the capital must not be more than £200.
Considered Views on Capping in Kenya

On one side of the debate:
• Parliament
• ICPAK

One side of the debate:
• The National Treasury and the Central Bank of Kenya – Explicitly voiced their opposition to the Bill before its enactment
• Other financial market placers – cognisant of market linkages – have voiced their concern (Nairobi Securities Exchange; Fund Managers).
• The affected business segments have started voicing their concern on the effect of the capping on their business – initially some in this segment were for the capping.
Considered Views on Capping in Kenya

• The IMF’s Conclusion of the First Review under the ‘Stand-By Arrangement and Standby Credit Facility’ - January 25, 2017:

“The macroeconomic outlook is overall positive, including robust growth and reduced external imbalances. However, interest rate controls are likely to reduce access to credit, weighing on growth. They also complicate monetary policy and adversely affect banking sector profitability, especially for small banks. Although the adverse effects of the controls are manageable in the near term, if maintained, they could potentially pose a risk to financial stability. Therefore, it is essential to remove these controls, while taking steps to prevent predatory lending and increase competition and transparency of the banking sector”. 
Key Observations

• Capping of interest rates does not ameliorate the true causes of market failure. The more effective ways of reducing interest rates on loans over the long run and of improving access to finance, include:
  • *Measures that enhance competition and product innovation;*
  • *Improving financial consumer protection frameworks,*
  • *Increasing financial literacy;*
  • *Promoting credit bureaus and putting in place measures to enhance credit information sharing;*
  • *Enforcing disclosure of interest rates;*
  • *Promoting microcredit products; and*
  • *Full implementation of all the structural and policy factors that influence the overall cost of credit as determined by the “Committee on Increasing Credit to the Private Sector).*
**Key Recommendations: Increasing Private Sector Credit**

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<th>Area</th>
<th>Initiative</th>
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| Interest Rates | • Require banks to use as a reference rate based on an average of Central Bank Rate (CBR) and a two-month moving average of the 91-day T-Bill rate (NT/CBK/KBA)  
  • Engage top retail banks to lower interest rates for signaling effect (NT/CBK)  
  • Promote the disclosure of APR by banks to enhance transparency in loan pricing (KBA) |
| Collateral | • Enact amended Companies Act and Insolvency law (NT/AG)  
  • Amend the Chattels Transfer Act and Hire Purchase Act to promote lending (NT/AG)  
  • Accelerate reforms in Lands and Companies Registries (AG/Lands)  
  • Establish the legal and regulatory framework to support the creation of an electronic movable assets register (NT/AG) |
| Information | • Implement revised Credit Reference regulations (CBK/KBA)  
  • Expand credit information sharing mechanism to include most of the credit providers including utilities, phone companies etc (NT/CBK/KBA) |
| Efficiency | • Implement NPS regulations to facilitate infrastructure sharing (NT/CBK/KBA)  
  • Expedite establishment of Alternative Dispute Resolution Mechanism (ADR) (NT/CBK/KBA) |
| Instruments | • Facilitate increased use of leasing and factoring (NT/CBK/KRA)  
  • Enhance efficiency of the Horizontal Repo Market (CBK/KBA) |
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<th>Area</th>
<th>Initiative</th>
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<tbody>
<tr>
<td>Institutions</td>
<td>• Establish the proposed Kenya Development Bank (NT)</td>
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<td></td>
<td>• Establish the proposed Biashara Kenya (NT)</td>
</tr>
<tr>
<td>Consumers</td>
<td>• Enact financial services consumer protection law (NT/CBK)</td>
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<td></td>
<td>• Develop consumer protection and financial education national strategy and framework (NT/CBK)</td>
</tr>
<tr>
<td>Competition</td>
<td>• Expedite the study into competition in the banking sector to be undertaken by the Competition Authority of Kenya (NT/CAK)</td>
</tr>
<tr>
<td>Alternative investment vehicles</td>
<td>• Fast-track implementation of Treasury Mobile Direct to offer retail/individuals alternative saving mechanisms besides saving through banks (Individuals to subscribe directly for government securities thus indirectly compel banks to offer competitive deposit rates) (NT/CBK)</td>
</tr>
<tr>
<td></td>
<td>• Fast track capital markets reforms to make capital markets a more efficient and attractive alternative source of long term funds (including demutualisation of the Nairobi Securities Exchange) (NT/CMA/NSE)</td>
</tr>
<tr>
<td>Regulation of Credit Market</td>
<td>• The increasing number and range of credit providers in Kenya creates the need for unified oversight on credit provision - to oversee credit arrangements (NT)</td>
</tr>
<tr>
<td>Opportunity Cost of Credit to Private Sector</td>
<td>• Ensure Government Borrowing does not crowd out private sector and adopt alternative sources such as the Euro Bond while improving Government cash management (NT)</td>
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</table>
• Capping interest rates does not address a market failure problem; it instead introduces one.

• The Kenyan experiment will play out like that of other economies that have tried this blunt tool and on the process hurt themselves.

• As a price, interest rate is an outcome of an interplay of many factors – some structural and others policy. If high interest rates are persistent, then the remedy lies in addressing the policy and structural problems.
Thank you.