



CAPPING OF INTEREST RATES; WHICH WAY FORWARD? OCTOBER 2019

There is continued and raging debate on the impact of the interest rate cap on Kenya's economy. Recently, the discussion has centred on the contribution of this policy to the decline in private sector credit since its introduction in 2016 through amendment to the Banking Act. The Institute supported the interest cap law based on reasons that it protects consumers from high interest rates, increases access to finance and makes loans affordable for economic growth.

Recently, the President in his Memorandum to Parliament gave several reasons for declining to assent to the Finance Bill 2019. He cited unintended effects to the economy such as the reduction of credit to the private sector, decline in economic growth, slowdown of monetary policy transmission to inflation and growth thus weakening Central Bank's mandate, reduced loan advances by banks and which has led to mushrooming of shylocks and other unregulated lenders in the financial sector.

Whilst the interest cap has had its fair share in contributing to the stated problems, the truth is, there are other macroeconomic, social and political factors that have significantly affected the economy. There is a shortfall in revenue collection against increasing public expenditure needs. Kenya's budgetary needs have been increasing over the years partly due to high spending on infrastructural projects. This has necessitated borrowing from both external and domestic market as a way of bridging the financing deficit.

Statistics from the Central Bank of Kenya shows that domestic debt greatly contributes to the public debt in Kenya. Since 2015/2016 to 2018/19, domestic debt has risen tremendously; 1,397,125.72, 1,646,527.48, 1,945,253.27, 2,371,650.53 and 2,703,984.44 for 2015/16/17/18/19 respectively as by March 2019. The continued domestic borrowing concentrates resources to the public sector while leaving little for the private sector. This is normally referred to as the crowding out effect of private sector investment.

A comparative analysis of interests charged by other online lending platforms also demonstrates that banks equally charge high interest on loans they offer through online platforms. For instance, the monthly maximum interest rates charged by M-Shwari is 7.5%, KCB-Mpesa 6%, Barclays Timiza 6%, Branch 16% and Tala 15%. Removal of interest rate caps will further subject the customers to high cost of credit and collateral demands that might eventually undermine the intent of credit affordability and availability to the small-scale business enterprise owners

As Parliament considers the President's reservations, it would be important for it to ensure that the reasons that led to capping of interest rates are adequately addressed. Removing the rate ceiling without taking into consideration other measures to develop the credit market and protect consumers would mean that the problems of abuse and over-indebtedness remain.

A functioning credit market is an important lever of economic growth. As such, the credit markets should evolve and cope with the dynamics of the current operating environment. The Credit Reference Bureau (CRB) in Kenya should therefore strive to enhance the credibility and reliability of the credit score as a tool for enhancing access to credit, promoting competition, and improved market efficiency. As is currently, credit information shared by CRB is not fully utilized for risk-based pricing of loans because the lenders rely on a range of different metrics; with the credit score being considered to be only one of several metrics. The absence of complete positive information from non-bank credit providers undermines the validity of the score.

Because the riskiness of a loan depends on its size, and not just on the identity of the borrower, Banks should transparently segregate retail loans into their own versions of prime and subprime risk exposure, using third-party credit scores of potential borrowers to offer them different rates. In India for instance, banks have adopted an external benchmarking regime that utilizes three credit score slabs from the Credit Information Bureau (India) Ltd to price new loans. Customers with high credit score, defined in excess of 760 out of a maximum 900, pay 1% lower rate. Banks in Kenya should henceforth adopt a verifiable scoring model or embrace external credit score mechanisms, such as adopted in India to ensure there is complete transparency in their offerings.

As a mid-term measure, we propose a graduated interest rate cap that would allow a higher rate for high risk lending and a lower rate for lowly rated customer risk. Notwithstanding the change, the country needs to consider utilization of the Credit Reference Bureau rating as a tool for risk analysis and hence proper profiling of persons for credit. Parliament should henceforth put in place mechanisms to enhance loans price transparency, consumer literacy, improved consumer protection as well as instituting a system for availing of credit information to the public and potential borrowers.

This debate on interest rate cap is healthy for the economy. It calls for sobriety and a moderated approach for the benefit of all players including policy makers, banks, Micro, Small and Medium Enterprises (MSMEs) and the public for the benefit of the economy.

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