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THE CENTRE FOR RESEARCH ON FINANCIAL MARKETS AND POLICY®

Promoting Financial Stability through Appropriate Bank Capital Measures

Executive Summary

Bank capital strength has been emphasized both at the global and local levels through various regulatory standards. As a result, bank regulators have been enhancing regulatory capital ratios over time. However, as capital increases, lending also increases resulting in elevated credit risk, and ultimately financial stability concerns. Evidence indicates strong regulatory capital don't appear to directly address rising financial stability concerns. Interventions to strengthen the link between bank capital and financial stability could focus on encouraging banks to hold optimal capital buffers commensurate with their risks, implementing risk-based dynamic capital policies and supporting market driven consolidation to strengthen financial stability.

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1. Context and Importance

The onset of the COVID-19 pandemic led to an extensive discussion on whether banks have adequate capital to withstand financial shocks emanating from the pandemic. Lessons from the 2008-2009 global financial crisis show that banks need adequate capital to strengthen their ability to cope with losses and reduce syestemic risk. Adequate bank capital would strengthen the resilience of the entire financial system.

Therefore, an important question arises on how much capital banks need to hold. The amount of capital needed by banks varies from country to country, due to different risks facing different banking sectors. For Kenya, bank capital and liquidity ratios have consistently remained above the minimum prudential requirement, indicating banking sector stability and resilience. Nonetheless, capitalization levels have been declining reflecting a capital draw down on banks in the last two years. Additionally, declining bank profitability over the past six years since 2015 raises concerns on the ability of banks to accumulate capital buffers quickly in response to a shock such as the COVID-19 shock. In terms of financial stability risks, the banking sector particularly over the past five years experienced elevated credit risks evidenced by rising ratio of gross non-performing loans (NPLs) to gross loans (**Table 1**).

Table 1: Kenya Banking Sector Financial Soundness Indicators

Figures in percentage	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Total Capital to Total Risk - Weighted Assets	20.8	19.4	21.9	23.2	19.2	18.8	18.7	18.5	18.7	18.8	19.2
Core Capital to Total Risk - Weighted Assets	18.7	17.3	18.9	19.4	15.9	15.7	16.3	16.0	17.2	16.8	16.7
Profit Before Tax (Annual Growth Rate)	48.5	23.7	27.2	13.1	14.4	(17.3)	40.3	(18.30)	16.4	8.7	(28.8)
Gross Loans (Annual Growth Rate)	19.9	30.2	10.4	15.6	25.3	21.5	(1.5)	3.8	7.1	9.0	7.0
Gross NPLs (Annual Growth Rate)	(5.6)	(8.3)	5.3	31.3	30.0	20.3	57.4	24.5	30.0	7.7	16.8
Return on Assets (ROA)	3.7	3.3	3.8	3.6	3.4	2.9	3.1	2.7	2.7	2.5	1.6
Return on Equity (ROE)	30.7	32.2	34.2	28.9	26.5	23.8	24.8	20.8	22.5	21.2	13.8
Liquidity Ratio	44.5	37.0	41.9	38.6	37.7	38.1	41.4	43.7	48.6	49.7	54.6
Non Performing Loans (NPL) Ratio	6.2	4.4	4.5	5.0	5.4	6.4	9.1	10.6	12.0	12.0	14.1

Kenyan banks have an extensive regional footprint in the East Africa region, a positive factor indicating the strength and importance of Kenyan banks in the region. The implication is that, with larger size comes greater risks that may become more difficult to manage if a bank becomes distressed due to differing legal framework and diverse regulatory authorities. Within the EAC, Kenya has the highest ratio of non-performing loans that reflects an elevated credit risk **(Table 2).**

Table 2: Banking Sector Financial Soundness Indicators from Selected African Countries

Figures in Percent (Year 2020)	Rwanda	Tanzania	Uganda	Angola	South Africa	Nigeria	Kenya
Total Capital to Risk-Weighted Assets	21.5	17.9	22.2	25.7	16.6	15.1	19.2
Core Capital to Total Risk-Weighted Assets	20.3	17.1	20.6	26.9	15.7	12.8	16.7
Non-performing Loans to Gross Loans Ratio	4.4	8.7	5.2	23.2	25.6	6	14.1
Return on Assets	2.8	2.1	3.2	4.3	0.6	2.2	1.6
Return on Equity	16.8	13.6	18.9	34.2	7.7	24.8	13.8

Source: Global Financial Development Database

> **Banks with strong financial positions prior to a shock have emerged resilient during periods of shock and financial stress.**

Against this backdrop, examining the role of banks capital in mitigating credit risks and promoting stability in the Kenya financial system is pivotal. Banks with strong financial positions prior to a shock have emerged resilient during periods of shock and financial stress. For example, large tier group banks experienced the highest growth in NPLs during the pandemic, but were resilient as they had higher profitability levels and higher capital levels relative to other tiers.

On this basis, increasing capital ratios to encourage banks to hold more capital to strengthen their financial positions emerges as a key guiding principle. Despite banks increasing their capital ratios in response to regulatory minima, vulnerabilities such as elevated credit risk persist raising financial stability concerns. However, holding higher levels of capital buffers may lead to lower lending. Taking cognizance that banks need to hold adequate capital buffers to absorb losses and continue to promote strong credit growth some policy blind spots still exist, especially on adequate bank capitalisation required for effective balancing of both lending and stability objectives. Particularly, focus should be on the optimal level of bank capital to absorb shocks and support credit growth, and whether capital buffers should be increased uniformly across time rather than during periods of stress as required. This brings us back to the policy question; how much capital should banks hold to mitigate credit risks and financial instability concerns and promote strong credit growth in Kenya?

2. Methods and Findings

Results of a study on the link between bank capital, credit risk and financial stability using annual bank-level data from 2001-2020 for 37 banks in Kenya form the evidence that informs the recommendations in this brief. A Financial Soundness Index (FSI) that was constructed to examine the evolution of financial stability conditions, revealed that banks in Kenya remain stable and resilient, though the stability and resilience have been on a declining trend since 2015. Additionally, higher bank capital ratios were found to lower credit risk and indirectly strengthen financial stability.

3. Policy Recommendations

On the basis of the above findings, policymakers may consider the following recommendations:

- Encourage banks to hold and continue to accumulate adequate capital buffers commensurate with the banks' risk portfolio.
- Implement risk-based dynamic capital policies that address key risks to banks, while supporting supply of credit for economic growth.
- Explore opportunities that support market driven consolidations to strengthen bank capitalization and complement policies aimed at increasing capitalization.

Reference

Kiemo S., Talam C., Rugiri I.W, 2022. *Bank Capital, Credit Risk and Financial Stability in Kenya. KBA Working Paper Series* (WPS/03/2022)

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