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POLICY BRIEF

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THE CENTRE FOR RESEARCH ON FINANCIAL MARKETS AND POLICY®

Containing Non-Performing Loans During Periods of Macroeconomic Shocks in Kenya

Executive Summary

Credit risk concerns are not new to the Kenyan banking sector, although these concerns have heightened in the wake of the COVID-19 pandemic. Non-Performing loans (NPLs) have risen steadily over the last five years reflecting a combination of economic, regulatory and some bank-specific constraints. Literature has sufficient evidence of the inverse relationship between NPLs and banking sector stability, with a negative feedback loop to the economy. In fact, global evidence based on a study conducted by the IMF shows that in 80% of the financial and economic crises between 1980 and 2015, NPLs nearly doubled in most OECD countries. However, analysis on Kenyan data confirms a resilient banking sector, with a weak link between economic performance and NPLs in periods of severe disruptions. The sector is profitable, well capitalized and liquid, offering a buffer against shocks. Policy response tools have particularly focused on enhancing capital and banks adoption of proactive measures and remedial efforts, which have been effective in containing a rapid escalation of NPLs. As a result, it is estimated that in the event of a credit risk shock, the sector returns to a steady state with the shocks dissipating by half in about 2.4 years.

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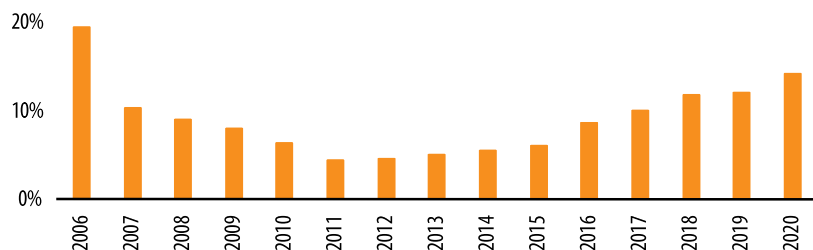
1. Context and Importance

High and rising non-perfoming loans (NPLs) have the potential to delay recovery from the pandemic by tying down resources that could otherwise fund the return of economic activities. Moreover, the potential threat of capital loss from increased loan loss provisions could reduce banks' incentive to lend to the private sector, worsening the already fragile credit posture of many developing markets such as Kenya's. Globally, evidence of second-round shocks associated with the pandemic on bank balance sheets is still limited but growing. Even so, there are considerable lags across most economies and marked variances in the magnitude of shocks and timing of the shock hits. On one hand, evidence of strains on European banks has been weak. In fact, European banks recorded lower NPLs in 2020, at the height of the crisis, made possible by previously instituted remedial strategies. Other commentators noted that while banks were 'catching Corona', the effect on banks' balance sheets had not become as evident given the easing of regulatory requirements on loan classification and provisioning. On the other hand, NPLs in emerging markets were expected to escalate, given the depths of COVID-19 shocks and the lower scale of policy intervention. Unlike in advanced economies, most emerging and developing markets lack the resources, the necessary depth and infrastructure to deal with a sharp deterioration in asset quality. At the same time, asset quality concerns could be more profound in Sub-Saharan Africa, where legacy structural challenges have kept NPL ratios in double digits, especially in commodity-dependent and politically fragile states.

Figure 1: Non-performing Loan (NPL) Ratio



In Kenya, evidence of the effects of the attendant shocks from the pandemic on bank balance sheets is still scanty, potentially due to the prospective lag in the transmission. Notably, this varies remarkably across sectors. However, like most balance sheets across the world, the unprecedented and decisive prudential, monetary and fiscal support that was deployed in the wake of the crisis could be masking the impulse on banks. This raises the policy question; how much capital should banks hold to mitigate credit risks and financial instability concerns in Kenya?

That said, the end of insolvency moratoria, employment protection schemes and the unparalleled central bank liquidity support across many developing markets could trigger a sizeable increase in NPLs. Moreover, in some economies, loans emerging from moratoria and other COVID-19 forbearance measures have so far

underperformed the overall loan book, and signs of weakening credit quality are apparent. Given the negative feedback to the economy, NPLs continue to command greater attention from banks, financial sector regulators, governments and investors, with a notable increase in NPL-driven stress tests. To ensure that banks remain well-cushioned against future shocks and minimize moral hazard risks, regulators have commenced reducing some of the COVID-19 macro-prudential response measures. Undoubtedly, these measures have to be designed in a manner that preserves incentives for lending while at the same time maintaining overall stability. A premature withdrawal of stimulus could worsen credit risk for banks with implications for lending and stability.

2. Methods and Findings

Using Kenya annual banking sector data from 2001 to 2020, we analyze how bank asset quality has responded to shocks from the economy and changes in institutional factors, in the short and long-term. From the study findings, we deduce policy inferences on the potential credit shock on banks' balance sheet, their duration and potential policy and remedial tools to mitigate an escalation in the levels of NPLs. We find that;

- Macroeconomic shocks, associated with a slowdown in GDP growth, would trigger an increase in NPLs though the relationship is not weak.
- NPLs affect the risk taking behavior of banks in the short run. The immediate impulse response by banks is to reduce NPLs after a spike in the previous quarter. However, as NPLs decline in the long run, banks scale up lending, increasing their credit risk exposure.
- An increase in lending in the short term will reduce the NPL ratio for banks. However, this could leave banks exposed to increased credit risks – high NPLs in the long-run.
- Credit risk rises with the growth in capital (moral hazard effect) in the short-run, but further capital build ups result in a decline in credit risk (regulatory effect) in the long-run. This points to the need to ascertain the optimal thresholds.
- Low cost-to-income ratio (CIR) could mean an under-provisioning for bad debt or less monitoring resources. Accordingly, NPLs could increase with low CIR in the short-run. However, in the long- run, improved efficiency ratio could confer effective loan-loss management and therefore lower NPLs.
- Increased money supply has a cooling effect on credit risk, which can be linked to an improved liquidity and business environment.
- A shock in any period is self-correcting at a rate of 24.96% per quarter, implying that it takes close to two and half years for the effect of a shock on bank balance sheets to be reduced by half.

3. Policy Recommendations

No doubt, the credit outlook has improved somewhat as economies re-emerge from lockdowns, owing to the ongoing vaccination campaigns against COVID-19. However, the road to recovery is likely to be slow and highly unpredictable given the uncertainty in the containment of the pandemic. Sustained mobility restrictions and prolonged pain for businesses could be a tipping point for banks given the potential increase in NPLs. To address the issue at hand, polcy makers may consider the following recommendations:

- The weak link between macroeconomic shocks and NPLs should provide some comfort in banks' self-regulation and effectiveness of remedial measures when it comes to containing asset quality deterioration concerns.
- Banks entered the crisis with stronger profitability, liquidity and capital buffers. The buffers should be sustained for future resilience.
- A significant buildup in capital continue to provide a cushion against growing NPLs over the long term, and shall inform the risk-taking behavior of banks.
- Improve macro-prudential regulations to ensure lingering risks from the economy do not crystalize into NPLs. This should support further progress in the adoption of IFRS 9 as well as other global best practices.
- NPLs in Kenya rise with an increase in capital until a certain threshold (moral hazard effect), after which more capital build-ups decrease NPLs (disciplinary or regulatory effect).
- The regulator could continuously monitor and forecast evolving credit risk scenarios; and perform regular stress test on the system to ensure proactive interventions for sustained stability.
- The duration taken for half of the shock to wear off is close to two and half years. This would require closer monitoring, regular reviews and collaborative efforts towards sustained NPL mitigation and resolution.
- Prudential interventions including moratoriums could slow down the increase in NPLs. However, the regulator could ensure that such measures do not aggravate moral hazards by dis-incentivizing borrowers to effectively service their loans.

Reference

Atiti F., Kimani S. and Agung R., 2022. *Macroeconomic Shocks and Credit Risk in the Kenyan Banking Sector, KBA Working Paper Series (WPS/04/2022)*

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