KENYA BANKERS
ASSOCIATION

STATE OF THE BANKING INDUSTRY REPORT

June 2019

CENTRE FOR RESEARCH ON
FINANCIAL MARKETS AND POLICY®

STATE OF THE BANKING INDUSTRY REPORT

The Centre for Research on Financial Markets and Policy® was established by the Kenya Bankers Association in 2012 to offer an array of research, commentary, and dialogue regarding critical policy matters that impact on financial markets in Kenya. The Centre sponsors original research, provides thoughtful commentary, and hosts dialogues and conferences involving scholars and practitioners on key financial market issues. Through these activities, the Centre acts as a platform for intellectual engagement and dialogue between financial market experts, the banking sector and the policy makers in Kenya. It therefore contributes to an informed discussion that influences critical financial market debates and policies.

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ABOUT THIS REPORT

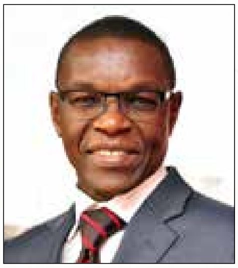
The State of the Banking Industry (SBI) Report is an annual publication of the *Kenya Bankers Association Centre for Research on Financial Markets and Policy*® aimed at contributing to the understanding of the Kenyan banking industry. The report is motivated by the fact that stakeholders seeking perspective on the Kenyan banking industry engage various sources including market analysts, banks, the Kenya Bankers Association (KBA) Secretariat, the Central Bank of Kenya (CBK) and other financial sector regulators. This breadth of views is underpinned by the respective institution's analytical work, making this report contributory to the diversity of analyses.

The Kenya Bankers Association Centre for Research on Financial Markets and Policy® has compiled a database of financials at bank level spanning over one and half decades. The database, together with other secondary data whose source is duly acknowledged, buttresses this report's analysis. The financials database, indicated as KBA data in the report, is based on published financial statements by banks up to December 31, 2018.

The report's analysis is undertaken at industry level as well as in the three tier clusters – Tier 1, Tier 2 and Tier 3 – based on the classification of the CBK's Bank Supervision Annual Report 2017. It also draws on the background work that is published under the *Kenya Bankers Association Working Paper Series* and other relevant published work as cited in the report and links provided as appropriate.

This issue of the SBI has benefited from discussions, comments and suggestions from banks, analysts and academic researchers. However, the analysis and inferences are entirely those of the report's authors and should not be attributed to those who commented on it, the KBA General Body, and Governing Council.

The Authors:



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FOREWORD

The Kenyan Banking Industry is on a strong footing. As the Kenya Bankers Association's inaugural State of the Banking (SBI) report shows, the banking industry is steadily picking momentum as it adjusts from the market shocks of 2015 – 2016 and the Banking Amendment Act 2016 that introduced interest rate caps.

It is evident that the banking industry is on a growth trajectory. The outstanding loans and advances are on an increasing path, although the pace has been tapering over the past three years. With the industry remaining well capitalised and liquidity being sufficient and increasingly well distributed, it is anticipated that the credit growth tapering is at an inflection point. The stretch of that point will be influenced by the extent to which the downside challenges to the industry's optimal operations are redressed.

Market distortions that have led to financial resource allocation shifting away from the core of the small and medium enterprises (SMEs), which are core to the economy's sustained growth, need to be tackled. As the SBI observes, banks are expected to continue deploying technology for efficiency and cost management as well as product design that utilises the analytical capability of data abundance.

The ensuring interventions will admittedly support the industry as it embraces the CBK's Banking Sector Charter that espouses transparency, customer centricity and encouraging credit allocation to the SMEs. As the Banking Sector Charter is being rolled out, the market will of necessity balance the considerations on asset quality improvement and growth, given the double-digit level of the Gross NPLs/Gross Loans ratio. This is especially so as the banking industry moves beyond the 2018 transitioning year to the IFRS 9 asset classification.

It is clear that investments in the form of financial resources, personnel and technology is expected to remain on the fore towards ensuring that banks remain compliant to regulations – covering issues ranging from capital, corporate governance, all disclosures, and Anti Money Laundering and Countering Terrorist Financing (AMLCFT). We see the inevitability of the banking industry embracing what would be considered as emerging global best practice in the post global financial crisis era. Increasingly, compliance assurance goes beyond what personnel can do to include algorithms that will be complementary – so-called Reg-Techs.

Market contestability will remain at the centre of the Kenyan banking industry. Picking from the developments of 2018, there will be a lot of attention paid on the link between market structure, credit allocation and overall economic performance, hinging on the aspect of market power as could be influenced by the relative size of market players. The SBI analysis has commenced on the analytical work to evaluate the extent to which organic growth, and mergers and acquisitions in the banking industry, will potentially shape market competition going forward.

Dr. Habil Olaka,
Chief Executive Officer

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ABBREVIATIONS

AMLCFT	Anti-Money Laundering and Countering Terrorist Financing
CBK	Central Bank of Kenya
CMA	Capital Markets Authority
GDP	Gross Domestic Product
IAS	International Accounting Standards
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
KBA	Kenya Bankers Association
KES	Kenyan Shillings
NPLs	Non-Performing Loans
NSE	Nairobi Securities Exchange
SBI	State of the Banking Industry
SMEs	Small and Medium Enterprises
TRWA	Total Risk Weighted Assets

EXECUTIVE SUMMARY

A comprehensive view of the performance of the Kenyan banking presents an accurate depiction of the interaction between the state of the economy, the broader macroeconomic policy environment and how it relates to market outcomes, and the regulatory developments that influence market stability. The completeness of the broader analytical approach goes beyond the narrow assessment of the financials of individual market players is an acknowledgement that financial performance is an output of the interplay between the various dynamic components of the economy.

KES2.3tr
Loans & advanced as at the end of 2018

52%
Loans advanced by the banking industry as a percentage of economy's real GDP

- The amount of outstanding loans and advances by the banking industry as at the end of 2018 was at KES 2.5 trillion, an equivalent of about 52 percent of the economy's real GDP. This points to how the banking industry is intricately intertwined with the broader economy to the extent of the influence of one over the other being bi-directional. The Kenyan banking industry has over the past one and half decades been characterised by steady growth, with outstanding credit increasing nearly ten-fold from KES 264 billion in 2003.
- The three years ending December 2018 have been characterised by adjustments that are likely to transition the industry to the next level. Asset growth has tapered as normalcy returns to a market starting from a period of volatility that was fortunately not systemic. The changes in the banking industry credit pricing regime with effect from September 2016 has seen a shift in assets away from segments considered riskier as banks seek to optimise on investments that balance returns and asset quality.

- How banks respond to both risks and returns balance depending on their respective liquidity positions, which in themselves are a function of the size of the bank and chosen market segment. The regulatory support has enabled efficient distribution of liquidity in the market, cognisant of the market segmentation that especially becomes apparent when there is market stress. As this report argues, the lower tier banks that often experience liquidity challenges

during the stress times have adopted a conservative stance of trading off profitability for liquidity. Market confidence in the lower tier banks is increasingly becoming evident as they have registered consistent growth in deposits as well as loans and advances. The lower rate of loans and advances growth compared to deposits has seen their relatively lower loan-to-deposit ratio, thus manifesting their conservative stance.

- The economic environment upon which banks are operating has been characterised by output growth often described as strong but whose underlying dynamics from a credit perspective portend a conundrum. Even then, the banking Industry's non-performing loans (NPLs) have been on the rise, their gross levels as a proportion of gross loans breaching the single digit level in two of the past three years. The NPL's build-up have shaped the performance of banks' credit in the sense that: (a) it influenced the banking industry's risk perception (b) it defied the growth threshold effect given its persistence even as the real GDP growth maintained a positive trajectory (c) it reflected weaknesses that characterise a '*creditless*' growth. There is, therefore, a clear demand-side angle to the tight private credit market.
- There is an obvious focus on the level of NPLs in the market. Whilst that level is not necessarily in its historical high levels, its persistence over the past five years is feeding into the banking industry's risk-taking behaviour. Even with the comfort of capital adequacy, the industry is putting efforts to enhance recovery. That is necessary but not sufficient unless there is a move towards prompt settlement of delayed payments by government and private sector, and sustainably mitigating the challenges to households and enterprise that have weaned their ability to meet obligations with lenders.
- The banking industry's financial performance therefore showcases a delicate balance between careful asset growth amidst returns-risks trade-offs and cost management and efficiency enhancement. The positive growth trajectory of the industry's overall returns is a pointer to the continued consolidation of market confidence following the shocks of 2015 – 2016. This has shaped investor expectations as would be gauged from the capital markets. The place of the banking industry in the broader capital markets and the NSE, in particular, is seen both from where the market sits in the broader economy and the structure of the market itself.
- The NSE is obviously highly concentrated and foreign dominated. Five institutions account for two-thirds of total market capitalisation, four of which are banks. With the weak correlation between the performance of the NSE and the broader economic performance it can be surmised that where the economy goes is not necessarily where the securities market goes, it is obvious that where the banking sentiments go is where the market goes. The positive sentiments arising from the banking industry market upturn over the past two years – constraints notwithstanding – have been a key driver of investor expectations.

Photo Credit/ Mkambe Tuva

Photo Credit/ Enos Teche

Chapter 1

INTRODUCTION

The state of the Kenyan banking industry is underpinned by the interplay between the state of the economy, the broader macroeconomic policy environment and how it relates to market outcomes, and the regulatory developments that influence market stability.

Any narrow assessment of the industry – often leaning solely on financial performance – is bedevilled by the limitation of the failure to recognise the linkages between the aforementioned three strands of performance influencers.

The Kenyan Bankers Association (KBA) *State of the Banking Industry (SBI)* report outlines the market development in 2018, grounding its analysis on the historical evolution of performance for a period of about one and half decades. Instructively, the past three years ending December 2018 have shaped the banking industry in at least three respects.

- First, the market has fully settled from the volatility of 2015 – 2016 arising from the collapse of three banks. The prevailing stability is, on the one hand, a vindication of the Central Bank of Kenya (CBK) supervisory framework that obviated the market challenges from becoming systematic.

With a substantial resolution of one of the banks under receivership during 2018 (CBK Communiqué, April 2018[1]) and the positive strides in the resolution of the other bank under receivership (CBK Communiqué, April 2018[2]) the market is on a path to full normalcy.

1 See https://www.centralbank.go.ke/uploads/press_releases/1206917992_Press%20Release%20-%20Chase%20Bank%20-%20April%2017%202018.pdf

2 See https://www.centralbank.go.ke/uploads/press_releases/1876260207_Press%20Release%20-%20Imperial%20Bank%20Limited%20-%20April%205%202019%20(004).pdf

On the other hand, the inherent structural characteristics of the *'small bank'- 'big bank'* dichotomy are such that in the event of a market shock, liquidity flow is disrupted as the inter-bank market almost ceases (Osoro and Muriithi, 2017[3]).

The CBK's lender-of-last resort window is available. However, the *Bagehot conditions* – the central bank disposition to (i) lend without limit (ii) to solvent but illiquid financial market player (iii) against good collateral (iv) at high rates – impose a tendency of the lower tier banks to confront a liquidity-profitability trade-off. As this report shows, this trade-off is at play and is of influence on the performance of banks across the various tiers.

- Second, the economic environment upon which banks are operating has been characterised by output growth often described as strong but whose underlying dynamics from a credit perspective portend a conundrum. There has been a tight private sector credit conditions, notwithstanding that the CBK's monetary policy stance which has been described as appropriately accommodative (IMF, 2018[4]). The CBK's Monetary Policy Committee (MPC) is justifiably cautious in arguing that instances of policy accommodation could lead to perverse outcomes as would be triggered by further tightening of banks credit to the private sector.

  The puzzle that confronts banks is how on the one hand the *'creditless'* growth – real economic output being on an upward trajectory but with negative real growth of bank credit to the private sector – will shape banks financial performance, and on the other hand how such performance will influence the economy's growth outlook.

  The delicate balancing act is needed to avoid moving the economy from *'creditless'* growth as for instance observed by World Bank (2019)[5] to a *'growthless'* credit recovery (Juselius and Dremann, 2014[6]). The fulcrum of these two extremes is the interaction between the banks' asset quality and economic performance, and how such interaction feeds into the lenders risk-taking attitudes.

3 Osoro, J. and Muriithi, D. (2017), "The Interbank Market in Kenya: An Event-Based Stress Analysis Based on Treasury Bill Market" European Scientific Journal Vol.13, No.16. 127 – 145.

4 IMF (2018) https://www.imf.org/en/Publications/CR/Issues/2018/10/23/Kenya-Staff-Report-for-the-2018-Article-IV-Consultation-and-Establishment-of-Performance-46301

5 World Bank (2019), Kenya Economic Update, Edition No. 19; April.

6 Juselius, M and Drehmann M. (2014), "Growthless Credit Boom and Creditless Recoveries", Bank for International Settlement (BIS), July. [https://www.bis.org/events/conf140909/juselius_drehmann_paper.pdf]

The Banking Industry's non-performing loans (NPLs) have been on the rise, especially over the past three years. Their gross levels as a proportion gross loans breached the single digit level in two of the three years, being 12.3 percent and 12.0 percent by the end of 2017 and 2018 respectively up from 9.4 as at the end of 2016.

This report's interpretation of the interplay between rising NPLs and the overall economic performance is guided by two strands of arguments. One argument is that increases in NPLs is to a large extent dependent on the phase of the cycle the economy is in. During an economic boom, lenders could ride on positive sentiments and take more risks.

Once the economic cycle turns, the lending standards are tightened, thus amplifying the impact of an economic downturn on credit volumes and quality (Rajan, 1994[7]; Ruckes, 2004[8]). Based on the foregoing, arguments around reverse causality in NPLs and economic growth abound.

The other argument is that an economy's real output weakness is often associated with an increase in NPLs as a ratio of gross loans (Espinoza and Prasad, 2010[9]). By this line of thought, a persistent rise in real output will lead to NPLs declining, with some asserting that there is a real GDP growth threshold that tips the direction of NPLs growth (Mohaddes, Raissi and Weber, 2017[10]) – in other words, any growth above the threshold has the effect of reversing NPLs growth trend and vice versa.

It is evident that the level of NPLs as at the end of 2018, and the trend over the past five years that can be characterised as a build-up, shaped the performance of the banks credit in the sense that: (i) it influenced the banking industry's risk perception (ii) it defied the growth threshold effect given its persistence even as the real GDP growth maintained a positive trajectory (iii) it reflected weaknesses that characterise a 'creditless' growth. This report, therefore, surmises that there is a clear demand side angle to the tight private credit market.

7 Rajan, R. (1994), "Why Bank Credit Policies Fluctuate: A Theory and Some Evidence", The Quarterly Journal of Economics, Vol 109, No. 2, 399 – 441.

8 Ruckes, M. (2004), "Bank Competition and Credit Standards", The Review of Financial Studies Vol. 17, No. 4. 1073 – 1102

9 Espinoza, R. and Prasad, A. (2010), "Non-Performing Loans in GCC Banking System and their Macroeconomic Effects" IMF Working Paper WP/10/224, October. (https://www.imf.org/external/pubs/ft/wp/2010/wp10224.pdf)

10 Mohaddes, K., Raissi, M. and Weber, A. (2017), "Can Italy Grow Out of Its NPL Overhang? A Panel Threshold Analysis", IMF Working Paper WP/17/66, March. (https://www.imf.org/en/Publications/WP/Issues/2017/03/24/Can-Italy-Grow-Out-of-Its-NPL-Overhang-A-Panel-Threshold-Analysis-44761)

- Third, the adjustment process that the banking industry has undergone over the period September 2016 to December 2018 when the Banking (Amendment) Act, 2016 that introduced caps on lending rates have seen the market: (i) gradually shift away from segments considered riskier (ii) seek to optimise on investments that balance returns and asset quality (iii) respond to both risks and returns balance depending on liquidity positions, which in themselves are a function of size of the bank and chosen market segment.

The alluded demand side angle to the tight private sector credit market is augmented by the supply side dimension. On the supply side, the observed portfolio shifting away from risky segments, and the risks-returns balance has influenced banks' increased investments in government securities. As this report shows, the financial performance of banks has therefore been influenced by the two forces of demand and supply of private sector credit.

As observed by the IMF (2018)[11], Kenya's fiscal deficit has remained high and public debt is increasing and, in the process, threatening medium-term growth. The Fund further argues that "headwinds from fiscal consolidation and weak credit growth will weigh on economic activity in the near term".

It is clear from the analytical work published by the *Kenya Bankers Association Centre for Research on Financial Markets and Policy®*, among others, that legislative distortions that lead to resources shifting from the private sector is growth constraining. A sustained increase in domestic public borrowing that crowds out the private sector is negatively related to the economy's gross fixed capital formation, and consequently hurts output growth (Lidiema, 2017[12]).

When the crowding out takes the form of some key economic sectors missing out on credit, it potentially has huge adverse implications for financial inclusion both in the short- and long-run (Ochenge and Tiriongo, 2018[13]). On a comparative basis, private sector credit is stimulative of economic growth than government borrowing from the banking sector (Chebet and Kiemo, 2017[14]).

The above background provides the setting upon which the state of the banking industry for 2018 is outlined. It provides the underpinning context for understanding the interaction between the market players, the regulatory requirements, customer and shareholder expectations, and how the interactions feed into banks' financial performance. In essence, financial performance by whichever measure is seen as consequential of the interactive process.

> "The adjustment process that the banking industry has undergone over the period September 2016 to December 2018 when the Banking (Amendment) Act, 2016 that introduced caps on lending rates have seen the market: gradually shift away from segments considered riskier"

12%
Non-performing loans as a percentage of Gross loans in 2018

11 IMF (2018) https://www.imf.org/en/Publications/CR/Issues/2018/10/23/Kenya-Staff-Report-for-the-2018-Article-IV-Consultation-and-Establishment-of-Performance-46301

12 Lidiema, C. (2017), "Effects of Government Borrowing on Private Investments in Kenya", KBA Centre for Research on Financial Markets and Policy® Working Paper Series No 22 (WPS/06/17), August. (https://www.kba.co.ke/downloads/Working%20Paper%2022.pdf)

13 Ochenge, R and Tiriongo, S. (2018), "Gaps from the Cap: Implications for Financial Inclusion in Kenya", KBA Centre for Research on Financial Markets and Policy® Working Paper Series No 23 (WPS/01/18), August. (https://www.kba.co.ke/downloads/Working%20Paper%2023.pdf)

14 Chebet, C. and Kiemo, S. (2017), "Price Channel versus Quantity Channel? The Relationship between Government Domestic Borrowing from Commercial Banks and Private Sector Credit in Kenya" KBA Centre for Research on Financial Markets and Policy® Working Paper Series No 19 (WPS/03/17), July. (https://www.kba.co.ke/downloads/WPS%2019.pdf)

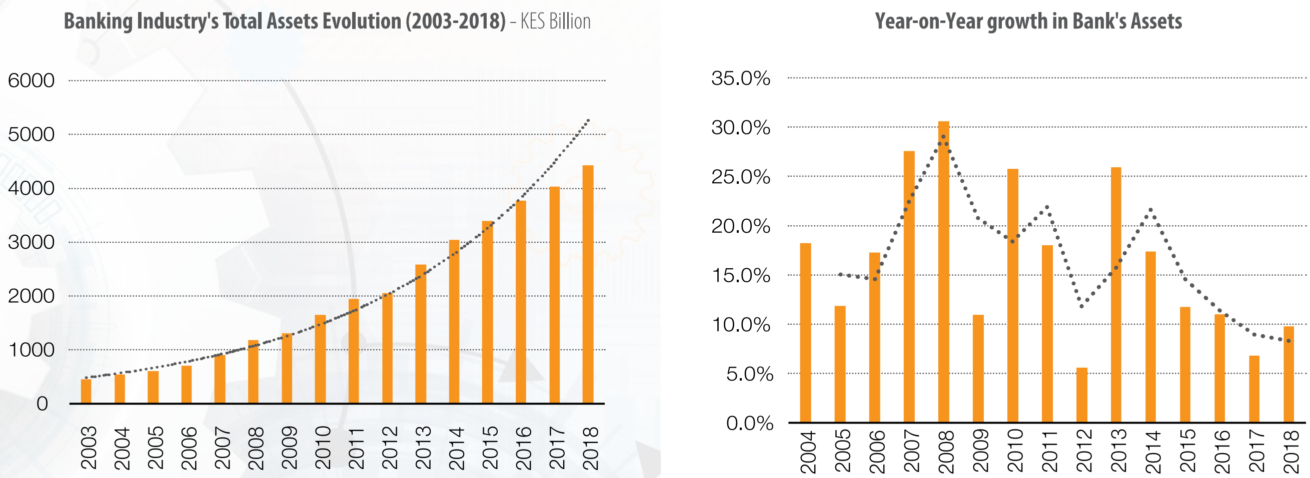
Chapter 2

INDUSTRY GROWTH – TAPERING BEFORE THE MOMENTUM PICK?

2.1 Total Assets

The banking industry's asset growth of 9.8 percent in 2018 is an improvement from the 6.8 percent growth in 2017. This growth is modest by historical standards, for double-digit asset growth was almost the norm in much of the decade preceding 2015 (**Figure 1**). The modest growth in asset position is on the back of increased investment in government securities driven by the perception of less risk in lending to the government especially in an environment where lending interest rates are arbitrarily capped.

Figure 1: Total Assets



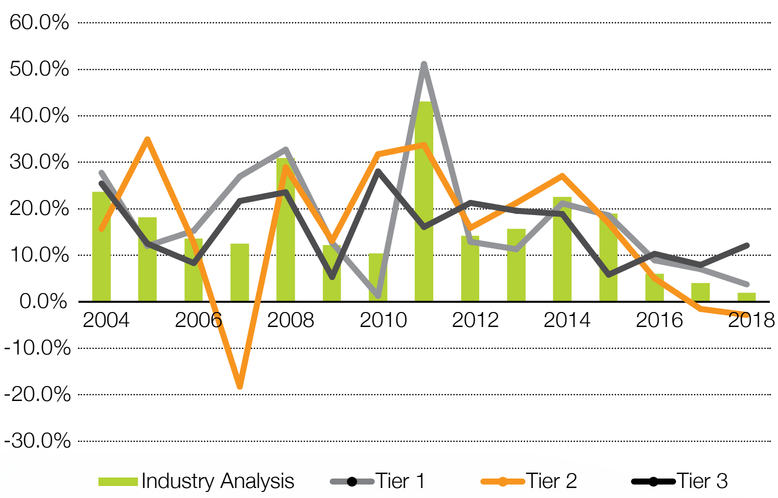
Source: KBA

It is therefore hardly surprising that the modest asset growth position, especially over the past two years, has been on the back of the drastic slowdown in the growth of banks' loan portfolio. In 2018, the loan book marginally grew by 1.90 percent compared to 4.03 percent growth registered in 2017. A closer examination of the loans and advances trend reveals interesting patterns amongst the various market tiers. While the overall market reflected a slowdown in the rate of growth of loans and advances, the trend was not homogeneous across the industry.

As **Figure 2** shows, the rate of growth of loans and advances amongst Tier 1 and Tier 3 banks over the past two years has been above the industry average. Over the same period, the rate of growth loans and advances for Tier 2 banks was on the negative territory, a culmination of a steady declining trend that commenced in 2014. The significance of Tier 2 banks to the overall industry performance is obvious in the sense that even with the other tiers showing positive growth rates – indeed Tier 3 banks registered a positive growth trend in the 2017-2018 period – the overall growth was on a sustained downward trend since 2015.

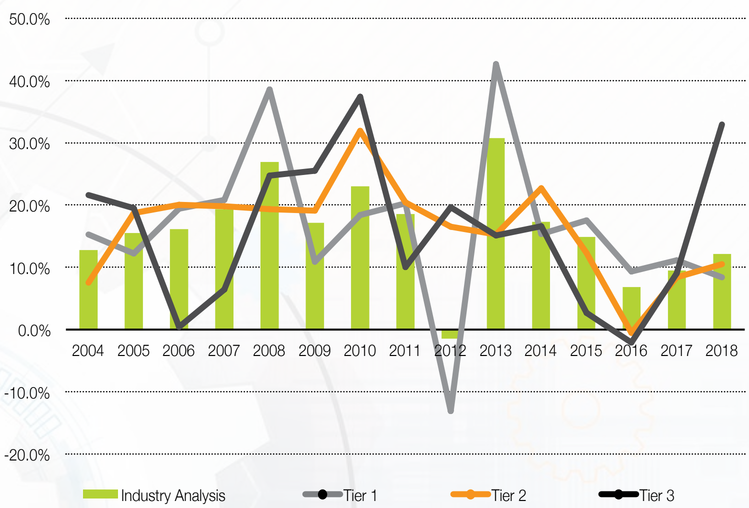
"It is therefore hardly surprising that the modest asset growth position, especially over the past two years, has been on the back of the drastic slowdown in the growth of banks' loan portfolio."

Figure 2: Growth in Loans and Advances



Source: KBA

Figure 3: Growth in Deposits



Source: KBA

2.2 Deposits

The past three years have seen the rate of growth of bank deposits sustain an upward trend, reversing the declining growth rate trend that commenced in 2013 (**Figure 3**). The picking of momentum in the growth in deposit – the main source of funding for banks – has been supported by the mobilization of deposits through agency banking and mobile banking platforms which have gained vast traction in the industry. In 2018, deposits grew by 10.7 percent compared to a 9.2 percent growth registered in 2017.

While the growth in deposits is trending towards the pre-2013 pick level, the most notable development is the rebound in deposits' growth in Tier 3 banks. Following the 2015 – 2016 market turbulence associated the failure of three banks, the liquid stress that manifested in the flight of deposits saw its rate of growth amongst Tier 3 banks shrink by 2.1 percent.

The share of Tier 3 banks to total deposits remain small and therefore not likely to substantially influence the overall deposits growth. Nonetheless, the fact that they registered a 33 percent deposits growth in 2018 compared to 9 percent in 2017 is a commentary that market confidence is continuously being entrenched in this market segment.

2.3 Loan to Deposit Ratio

The growth evolution of deposits on the one hand and loans and advances on the other culminates in the loan to deposit ratio that has been on the downward trend over the past three years (**Figure 4**). As the growth rate of deposits rose from 6 percent in 2016 to 11 percent in 2018, the loans rate of growth took the opposite trend – being 2 percent in 2018 compared to 6 percent and 4 percent in 2016 and 2017 respectively. Consequently, the loans to deposits ratio declined from 84 percent in 2016 to 74 percent in 2018.

The loan to deposit ratio – computed as total loans and advances divided by total deposits – conveys an important message on the state of market liquidity. For banks, liquidity is principally assured by the ability to convert assets to cash without having to accept large discounts in their value. Deposits are considered as a stable source of funding for banks such that a bank finding itself with low deposits will of necessity lean towards non-deposit funding whose availability and price are often more sensitive to changes in economic or financial conditions.

Figure 2 and **Figure 3** provide interesting insights on the recent trends in the loans and deposits amongst the various segments of the banking industry. Over the past three years, the rate of growth of deposits amongst Tier 3 banks has been steady and positive, being substantially higher than the other two tiers and indeed the industry average in 2018. Over the same time, the rate of growth of loans has been stable, albeit slightly above the other two tiers.

In effect, the loan to deposit ratio has been lower in the smaller banks compared to the bigger banks. This is not unique to Kenya. There are at least two reasons why large banks generally tend to have higher loan to deposit ratio than smaller banks.

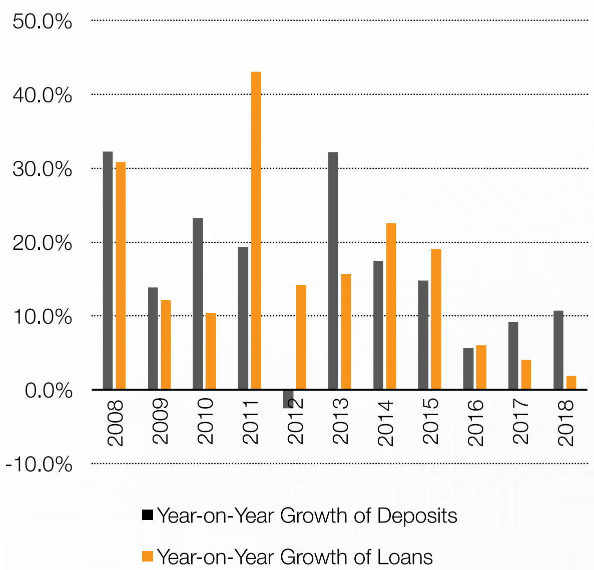
- One, there are advantage differentials between large banks and small banks when it comes to some types of loans. For example, large ticket loans that large banks typically make are not feasible for small banks due to the latter's caution when it comes to exposing a large share of their loan portfolio to a single large borrower[15].

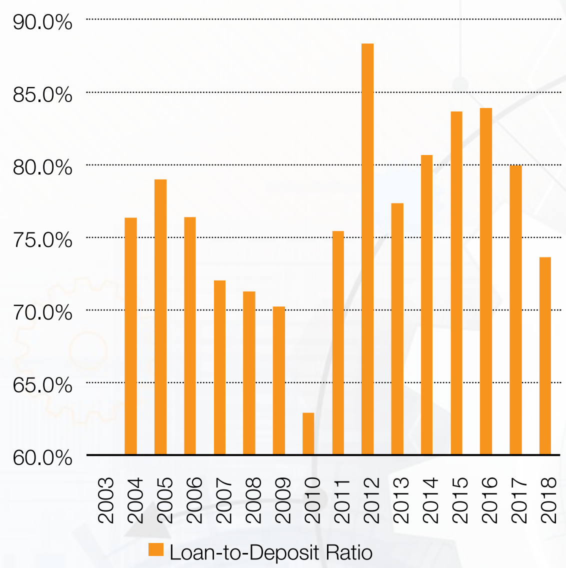
  Smaller banks are therefore inclined to making many small loans, each for no more than they respectively could readily absorb in the event of default. In the Kenyan case, even those small loans are sparingly being given under the capped interest rates regime that commenced in September 2016.

- Two, large banks have an additional non-deposit funding avenue such as specialised lines of credit and access to capital markets that – while in principle could be available to smaller banks – are not readily accessed by smaller bankers.

15 The CBK's Prudential Guidelines (January 2013) – see here [https://www.centralbank.go.ke/wp-content/uploads/2016/08/PRUDENTIAL-GUIDELINES.pdf] – and Risk Management Guidelines (January 2013) – see here [https://www.centralbank.go.ke/wp-content/uploads/2016/08/risk-management-guidelines-january-20131.pdf] – provide sufficient guidance on the loan ticket size vis-à-vis loan size.

Figure 4: Loan to deposit Ratio





Sources: KBA

All these are pointers to why, as alluded to in this report's introduction, smaller banks are increasingly trading profitability for liquidity, as would be confirmed by the loan to deposit ratio trends.

It is possible to have a loan to deposit threshold that works towards mitigating liquidity risks without necessarily being prescriptive of a possible equilibrium point. As **Figure 4** shows, the loan to deposit ratio for Kenyan banks over the past 15 years ending December 2018 has been in the 70 percent to 84 percent range except for two outliers in 2010 and 2012 when the ratios were 63 percent and 88 percent respectively.

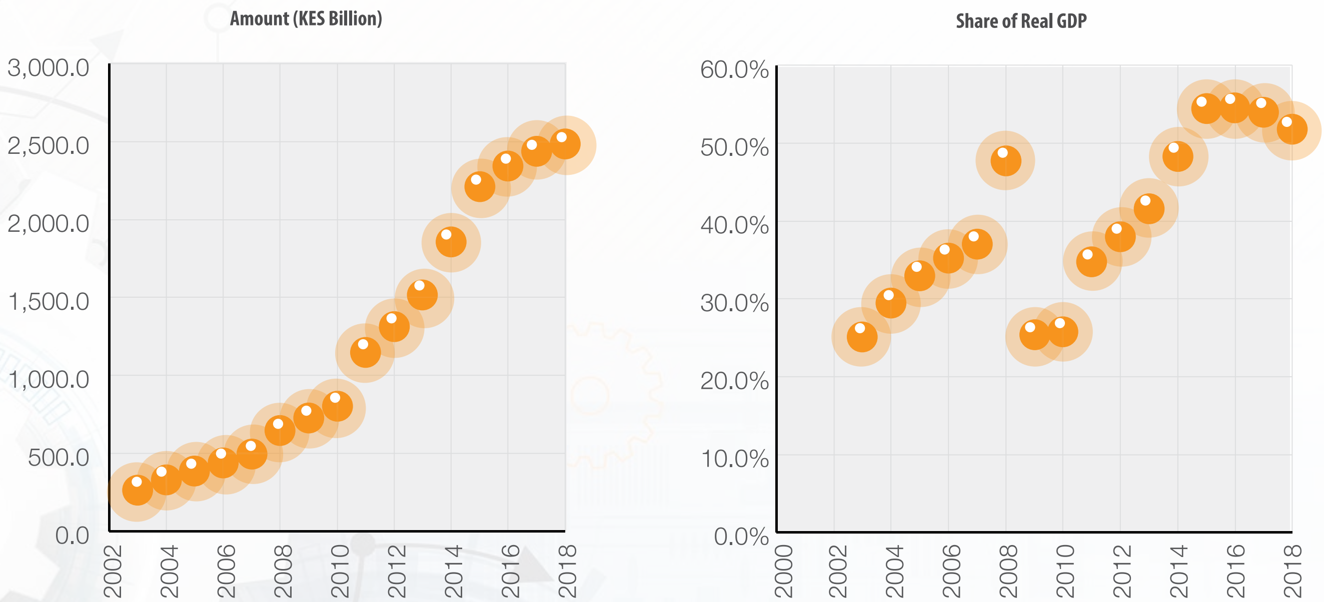
At a broader level, the policy discussion can be hinged upon how to mitigate liquidity risks in the entire systems in a manner that promotes an intermediation process that is linked to the economic/business cycles. That can be done through policy designs that incentivise banks to mobilise more deposits during an economic upturn and create loanable funds to support lending during an economic downturn, a dynamic process that requires sufficient time lags.

2.4 Observations

The extent to which the banking industry is embedded in the economy is evident from the amount of outstanding loans and advances (**Figure 5**). As at the end of 2018, the outstanding loans and advances by banks was about KES 2.5 trillion, equivalent to 52 percent of GDP. This is an increase from KES 265 billion and 25 percent respectively one and half decades. The growth in loans and advances, just like the banking industry's total assets, have maintained a positive growth trajectory, albeit with the rate of growth slowing over the past three years.

The evolution of the policy environment – especially the credit pricing regime that has over the past three years been controlled – and the private sector operating environment will shape the pace of growth in the industry in the near term. In particular, the transitioning of the non-financial private sector enterprises from the challenge of operating at surplus capacity – meaning that demand for credit is more for working capital – to demand for additional capacity will influence the pace of the banking industry's growth asset growth in the medium term.

Figure 5: Loans and Advances



Source: KBA

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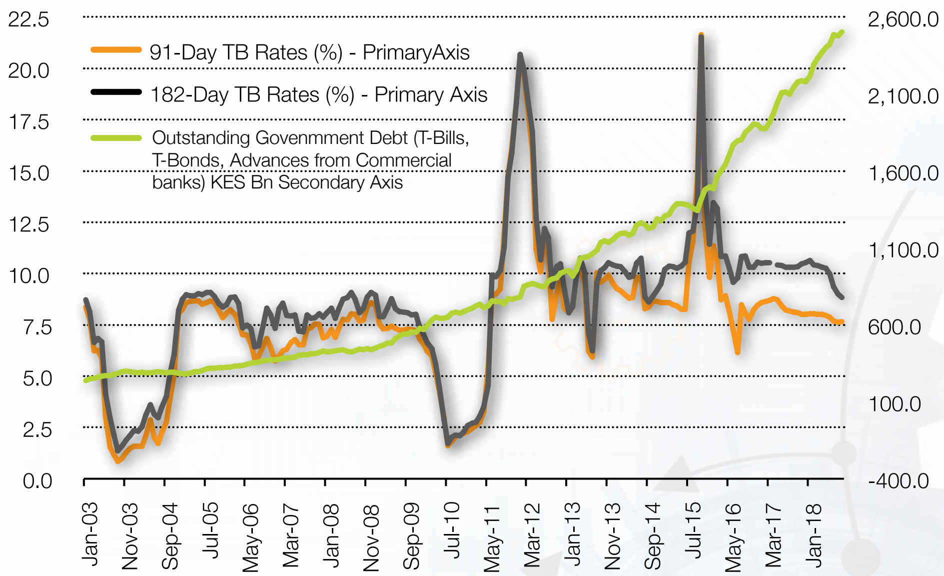
Furthermore, the growth in outstanding credit to the private sector going forward will be influenced by the trajectory of government securities in the domestic market, both from a quantity and price dimension. The market over the period 2003 – 2018 depicts two regimes. **Figure 6** shows that the period 2003 to 2011 was characterised by a gently rising amount of outstanding government securities on the back of stable rates – except instances of sharp declines that were not sustained. The subsequent period (2011 – 2018) has been characterised by a steady increase in the outstanding amounts and elevated rates –except instances of rates spikes that were also not sustained.

Figure 6: Government Securities (Outstanding Amount and Rates)



Source: CBK

Chapter 3

ASSET QUALITY – REASON TO WORRY?

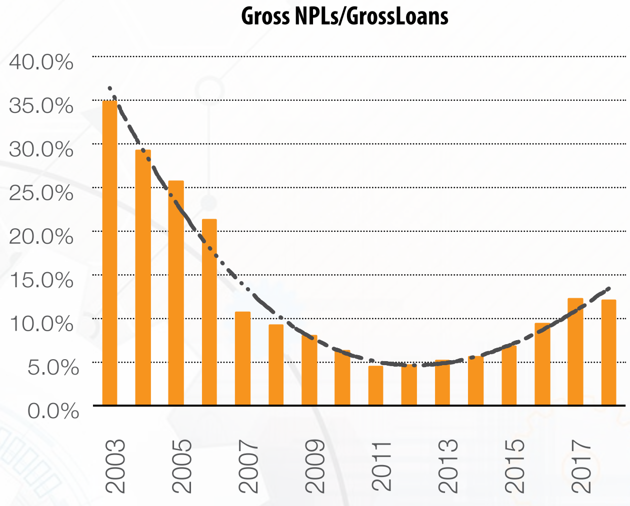
3.1 Non-Performing Loans

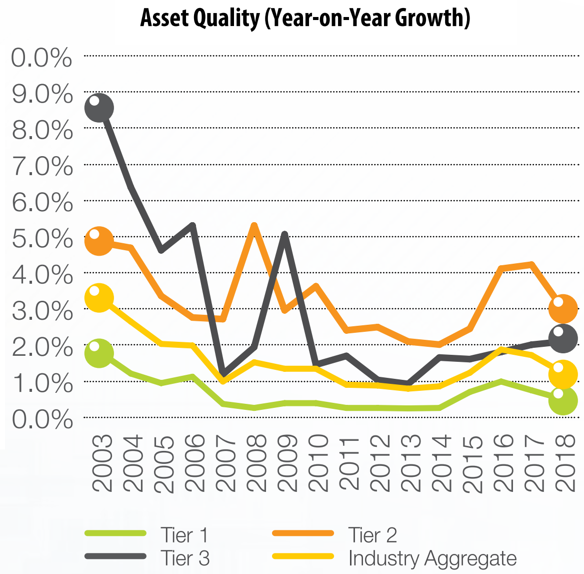
The build-up of NPLs over the five years ending 2018 has been noticeable for its persistent rise (Figure 7). It presents a shift from the preceding five years when the trend represented a significant quality improvement from as high as 35 percent of gross loans being classified as NPLs to the 4.4 percent to 8 percent range during the 2009 – 2013 period. Subsequently, the Gross NPLs/Gross Loans ratio has risen to about 12 percent as at the end of 2018.

As **Figure 7** shows, the rate of growth of Gross NPLs/Gross Loans ratio amongst Tier 1 banks has consistently remained below the industry average and within a narrow range 0.4 percent to 1.9 percent. Tier 2 banks continue to experience a consistently higher growth rate of the ratio over time. Tier 3 banks have had an erratic rate of Gross NPLs/Gross loans ratio growth for the period 2002 to 2010, with the rate consistently tracking the industry trend and below the Tier 2 banks' trend in the subsequent period.

It is clear that the pattern of NPLs' evolution is not uniform across the market. Over the past two years during which private sector credit growth has been muted, the industry's growth of the Gross NPLs / Gross Loans ratio declined from 1.7 percent to 1.2 percent. The declining trend was observed amongst Tier 1 and Tier 3 banks while Tier 2 Banks had the opposite trend.

Figure 7. Nonperforming Loans





Source: CBK; KBA

Overall, the denominator effect is at play over the past two years and the upward trend, even with the observed tapering, is as much about the challenges enterprises and households are facing in meeting their obligations with lenders as it is about the slow pace of credit growth.

On the balance though, a double-digit level of the Gross NPLs/Gross Loans ratio is an issue that needs redressing both from quality improving measures and asset growth standpoints.

Table 1: Capital Adequacy Ratios

	2014	2015	2016	2017	2018	Minimum Capital Adequacy Ratios
Core Capital/ TRWA	16%	16%	17%	16%	17%	10.5%
Total Capital/ TRWA	19%	19%	20%	19%	18%	14.5%
Core Capital/ Total Deposits	17%	17%	19%	18%	17%	8.0%

TRWA = Total Risk Weighted Assets

A historical perspective informs the view that the simultaneity of asset quality improvement and growth can gradually be realised. The period 2003 and 2009 that saw the Gross NPLs/Gross Loans ratio plummet from a high of nearly 35 percent was (as seen in **Figure 7** accompanied by a sustained growth in the banking industry assets. The 2010 – 2015 period was a good balance between risk-taking and sustenance of asset growth.

Furthermore, the circumstances that occasioned the high Gross NPLs/Gross Loans ratio in the high of 30s, largely governance in nature, have been redressed through a robust regulatory framework (for instance the earlier cited *Prudential Guidelines* and the *Risk Management Guidelines*, both of 2013). CBK (2003)[16] indicates that these high ratios were largely concentrated in a few banks, and particularly public sector banks and were historical in nature and arose due to weak credit risk management and external influence on the board and management of the institutions affected.

3.2 Capital Adequacy – Sufficient Cushioning?

The simultaneous redressing of asset quality and growth as noted above requires sufficient capital base. **Table 1** shows that the banking industry is sufficiently capitalised, with market players meeting the regulatory capital adequacy requirements and having enough cushioning that supports the overall market stability. In 2018, the core capital base on the industry grew by 5.3 percent, being a 5.3 percent, 9.3 percent and 1.9 percent in Tier 1, Tier 2 and Tier three banks respectively.

In 2018, the banking industry saw an 11.7% increase in loan-loss provisions. The rise the loan-loss provisions is on the back of the industry moving from IAS 39 standard of financial asset classification and transitioning to IFRS 9 with effect from January 1, 2018. The transition brings to the fore three aspects that have to be borne in mind going forward:

- One, banks will have to measure more of their assets at fair value, with changes in fair value recognized in profit and loss as they arise.
- Two, banks will have to make early recognition of impairment losses on receivables and loans; in essence they will have to will have to start providing for possible future credit losses in the first reporting period a loan goes on the books even when they are a high probability that the loans in question will be fully collectible.
- Three, there will be new significant disclosure requirements that could necessitate new systems and processes to collect the necessary data.

The banks, with the support the CBK, fully transitioned to the new standard during 2018. The incremental provisions arising from the full implementation of the IFRS 9 in 2018 are to be charged on the balance sheet in equal amounts over a five-year period. From 2019 henceforth, the full loss provisions will be charged as a cost on banks' comprehensive income.

3.3 Observations

There is an obvious focus on the level of NPLs in the market. Whilst that level is not necessarily in its historical high levels, its persistence over the past five years is feeding into the banking industry's risk-taking behaviour. Even with the comfort of capital adequacy, the industry is putting efforts to enhance recovery. That is necessary but not sufficient unless there is a move towards prompt settlement of delayed payments by government and private sector, and sustainably mitigating the challenges to households and enterprise that have weakened their ability to meet obligations with lenders.

16 CBK Bank Supervision Annual Report 2003. [https://www.centralbank.go.ke/images/docs/Bank%20Supervision%20Reports/Annual%20Reports/bsd2003.pdf]

Chapter 4

FINANCIAL PERFORMANCE – ALL ROSY?

4.1 Total Income

The banking industry's total income grew by 3.3 percent in 2018, a reversal of the previous year's 4.8 percent decline. While that is a positive development, the rate is well below the double-digit levels seen during the 2014 – 2016 period (Table 2). The increase in income during this period was largely attributed to an increase in interest in government securities by 15.68% with the biggest contribution in the increase being among Tier 1 banks. The reversal of the 2017 decline was noticeable amongst Tier 3 banks, whose rate of growth was well above the other two Tiers.

Table 2: Banking Industry's Total Income

	2014	2015	2016	2017	2018
Tier 1 Banks	13.80%	13.68%	14.11%	-0.66%	5.45%
Tier 2 Banks	17.64%	20.17%	11.84%	-11.02%	1.14%
Tier 3 Banks	16.04%	15.03%	4.91%	-9.90%	11.04%
Industry Aggregate	14.84%	15.42%	12.54%	-4.79%	3.30%

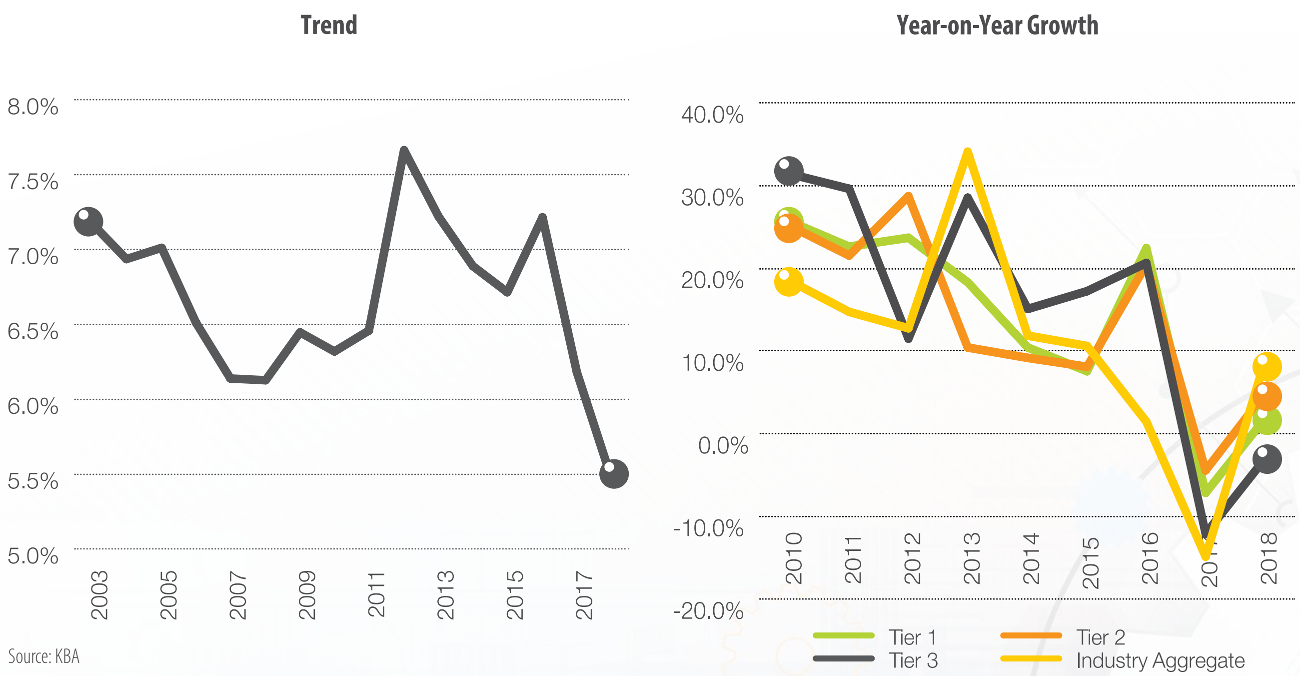
The state of the industry's total income was shaped by:

- One, the juggling of investments between loans and advances on the one hand and government securities on the other. As earlier observed in **Figure 2**, while the growth in the banking industry's loans and advances have since 2014 been on a declining trend, Tier 3 banks have seen that rate reverse and move in the positive direction since 2017. **Figure 3** shows a strong growth in deposits amongst Tier 3 bank over the period 2016 – 2018.

  The relatively higher rate of growth of total income amongst Tier 3 banks is linked to the deliberate focus of the banks in this category to convert the deposits to loans. The earlier observed low loan to deposit ratio in Tier 3 banks compared to the other two Tiers, while reflecting the liquidity management strategy in this category, has seen them lean towards credit as opposed to treasury investments.

Against this backdrop, the recovery of net interest income amongst Tier 3 banks in 2018 after a general declining trend since 2010 has been relatively stronger than that of banks in the other categories (**Figure 8**). Even as the net interest trend remains on a declining trend from a high of 7.7 percent in 2012 to 5.5 percent by the end of 2018, it is apparent that banks in the Tier 3 category are on a steady recovery path following the 2005 – 2016 market shocks whose effects were skewed towards them.

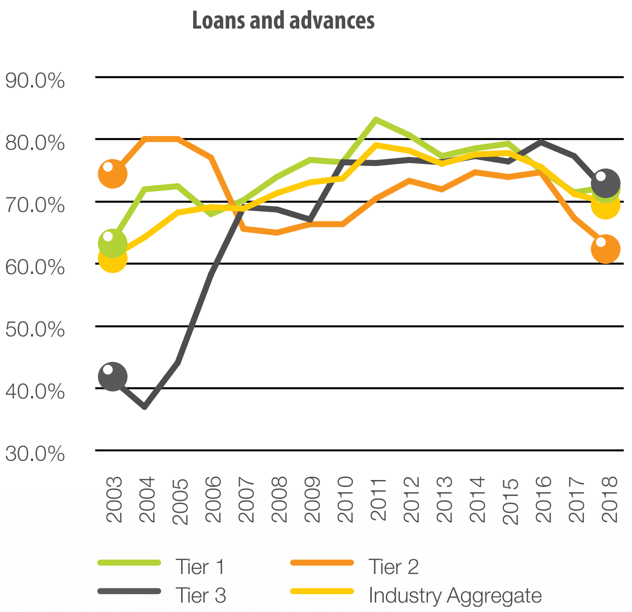
Figure 8: Net Interest Income – Trend and Year-on-Year Growth

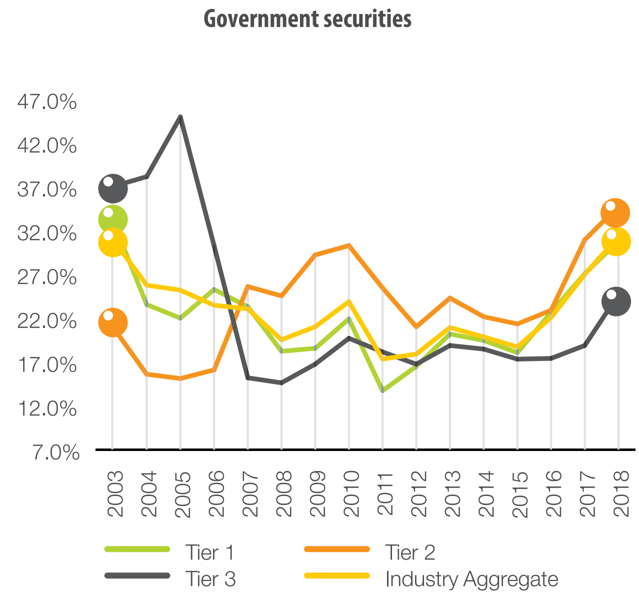


Source: KBA

While the share of banks' total income from interest on loans and advances remains the largest, its declining growth trend as observed has been compensated by earnings from investments in government securities (**Figure 9**). Consequently, crowding out of private sector credit is evident given that the middle to large size category of the market players that has the benefit of liquidity is relatively more active than the lower market sized players.

Figure 9. Share of Total Income



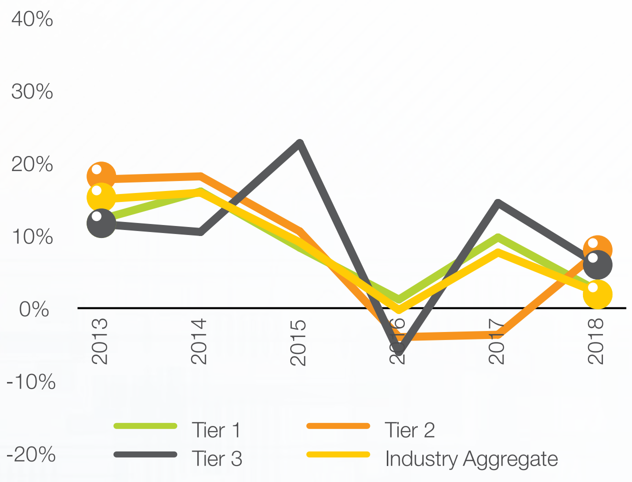


Source: KBA

- Two, fees and commissions – whose share of total income has always been substantially lower than both investment in securities and interest from loans and advances – has been on a general downward but erratic trajectory, growing by 2 percent in 2018 **(Figure 10)**. All in all, in 2018, the highest increase in fees and commissions' income was among Tier 2 banks having risen by 8 percent. Tier 3 banks saw the income from fees and commissions rise by 6 percent while Tier 1 banks recorded a 2 percent rise in fees and commissions income, similar to the industry's average.

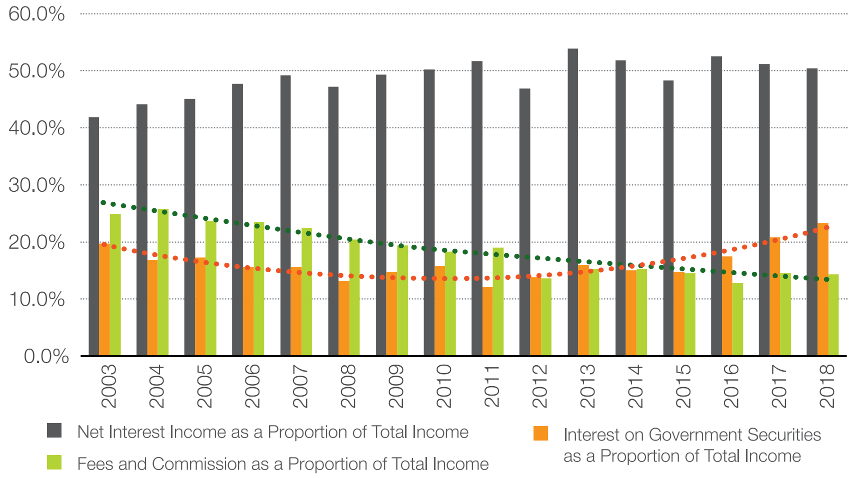
As **Figure 11** shows, interest income dominates the share of banks total income. The share of fees and commission has consistently been on a downward trajectory, declining from about 25 percent one and half decades ago to 14 percent by the end of 2018. Earnings from investments government in government securities whose share of total income had fallen from about 20 percent in 2003 to about 11 percent in 2011 have reversed the trend with such share rising to about 23 percent by the end of 2018.

Figure 10: Year-on-Year Growth in Income from Fees and Commissions



Source: KBA

Figure 11: Shares of Total Income

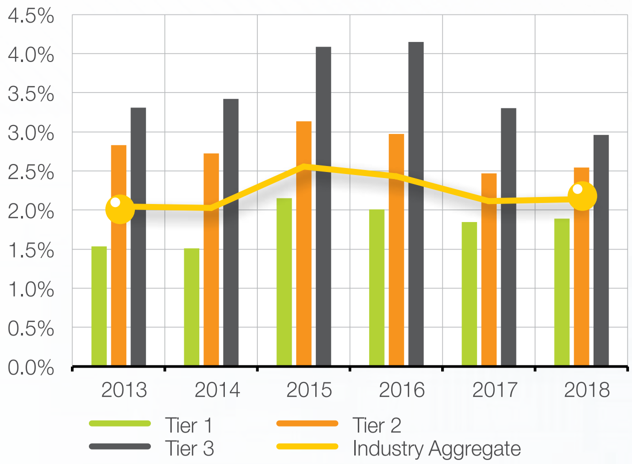


Source: KBA

4.2 Funding Costs

The average cost of funding has stabilised in the 2.0 percent – 2.6 percent range over the period 2013 to 2018 (**Figure 12**)**.** Despite the relative stability in the average cost of funding, it marked differences is evident across the different Tiers. The finding costs for Tier 1 banks have remained consistently below the industry average while those Tier 2 and Tier 3 have remained above the industry average.

Figure 12: The average cost of funds



Source: KBA

Tier 3 banks have the highest cost of funding. It is evident that economies of scale have played in favour of large banks when it comes to funding costs. The large banks have embraced the agency banking model to augment their wide branch network in mobilising deposits. This in addition to the earlier alluded non-deposit funding avenue in the form of specialised lines of credit and access to capital markets that are not readily accessed by smaller bankers.

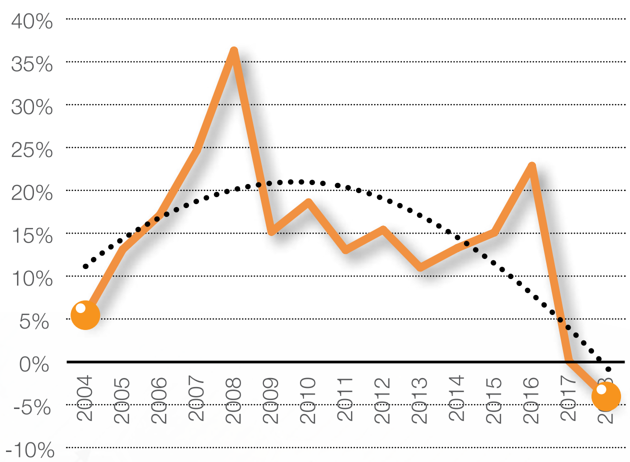
4.3 Operating Expenses

The banking industry has embraced technology with the need of enhancing its efficiency and complementing the conventional channels of product delivery. The year-on-year growth in total operating expenses that had hot a high of 36 percent in 2008, declined to the 11.0 percent to 22.0 percent range 2009 to 2016 (**Figure 13**). Subsequently, the operating expenses grew by a marginal 0.1 percent in 2017 and actually declined in 2018 by 4.0 percent. The trend in operating expenses reflects how the market is responding to the dynamic operating environment.

One such response is seen in the extent to which banks are embracing technology both as a tool for managing operating expenses as well as a reaction to non-conventional competition. Financial technology is increasingly changing the shape of banking industry in the sense that competition in the provision of financial services is well beyond the formal regulated institutions. While there are regulatory differentials, customer expectations are not asymmetrical.

Furthermore, financial technology presents opportunities as well as challenges to market players – especially banks. The interaction of these two segments – banks and financial technology players - is shaping the extent of market realignment and has both growth and operating costs management dimensions.

Figure 13: Operating Expenses



Source: KBA

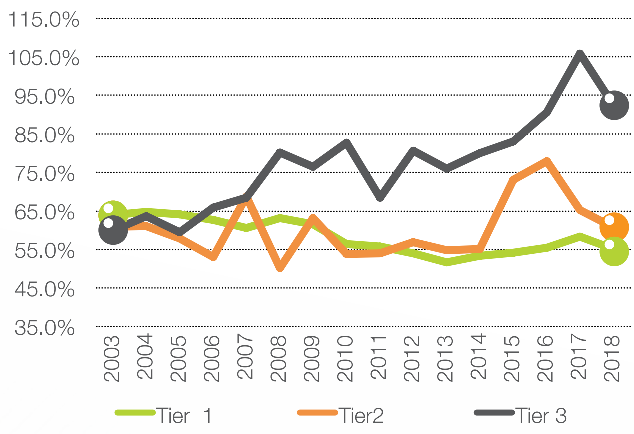
4.4 Cost-to-Income

The cost-to-income ratio improved in 2018 across all the bank Tiers, but still reflected the extent to which banks are not homogeneous (**Figure 14**). The ratio, which measures operating expense as a percentage of operating income, is a good proxy of efficiency and productivity for banks. Lower ratios generally indicate higher efficiency, but several factors can affect the ratio, including a bank's business model and size.

The generally declining cost-to-income ratio among Tier 1 banks is an indication of improving efficiency in this market cluster over time. While the improvement in the cost-to-income ratio that is seen across the board on 2018 compared to 2017 is partly linked to slowdown in the growth of total operating expenses (**Figure 13**) as well as recovery in year-on-year growth in interest income (**Figure 8**); the sustained decline in the rate of income growth from 2013 to 2017 saw the cost-to-income ratio in the Tier 3 category break from the other two categories.

The cost-to-income trend and divergences amongst various market clusters is not unique to Kenya. Like in other markets, its is a function of how banks manage their costs and how that relates to the extent to which they convert costs to a unit of income. In a broader sense, banks' funding modalities and of revenue diversification avenues have an implication on the cost-to-income ratio. A recent study (Roengpitya, Tarashev, Tsatsaronis and Alan Villegas, 2017[17]) indicates that the ratio is favourable to retail funded banks than wholesale funded banks.

Figure 14: Cost-to Income Ratio



Source: KBA

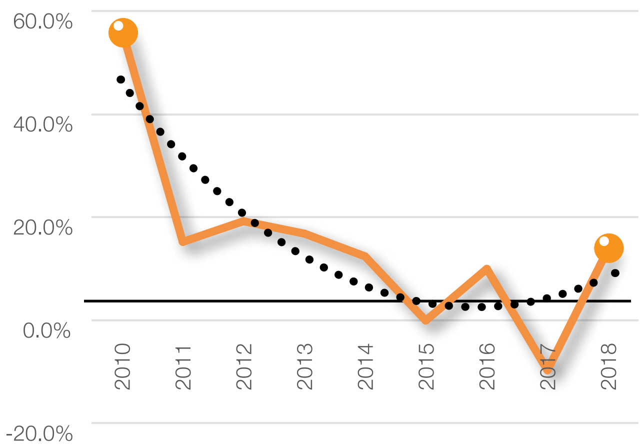
4.5 Profits, Returns on Capital and Return on Assets

The banking industry's profitability growth registered a recovery in 2018 following the gradual declining trend in the recent past years that culminated in a negative rate in 2017 (**Figure 15**). On the one part, the evolution of the industry's operating expenses (**Figure 13**) contributed to the recovery in profitability growth.

On the other part was the year on year growth in net interest income that reversed its declining growth trend (**Figure 8**). The return in assets as well as return on capital, registered a modest recovery in 2018 compared to 2017, albeit remaining lower that their peak levels in the past decade seen in the 2011-2012 period (**Figure 16**).

17 Roengpitya, R., Tarashev, N., Tsatsaronis, K. and Alan Villegas, (2017), "Bank business models: popularity and performance", BIS Working Papers No 682, December.[https://www.bis.org/publ/work682.pdf]

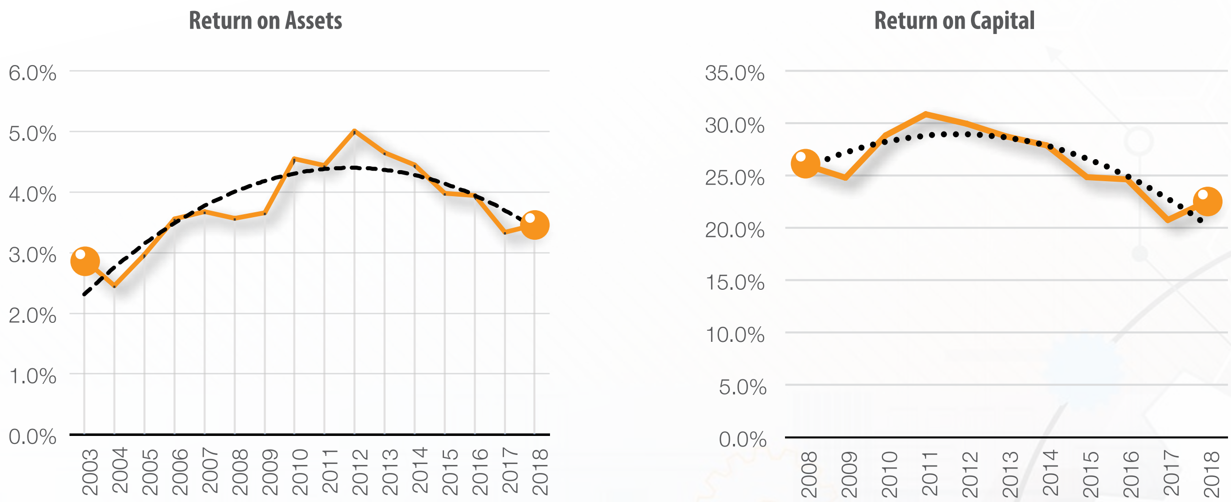
Figure 15: Growth in Profit Before Tax



Source: KBA

Photo Credit/ FT

Figure 16: Return on Assets and Capital



Source: KB

4.6 Observations

The banking industry's financial performance as outlined above has been a delicate balance between careful asset growth amidst returns-risks trade-offs given the controlled pricing regime, and cost management and efficiency enhancement. The positive growth trajectory of the industry's overall returns is a pointer to the continued consolidation of market confidence following the shocks of 2015 – 2016.

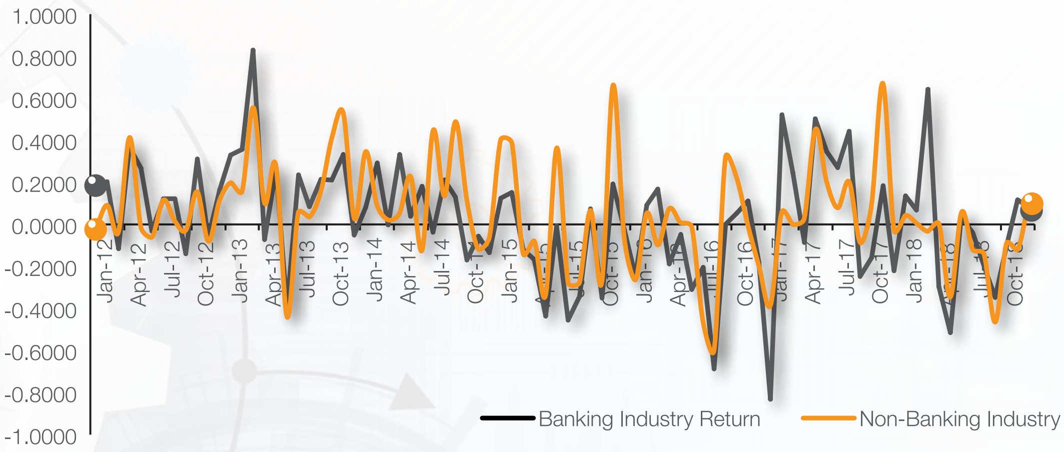
Chapter 5

INVESTORS' MARKET SIGNAL – THE MARKET GOES WHERE BANKS GO? OR VICE VERSA?

The banking industry continues to play a key role in promoting the development of the economy's capital markets. A construction of the banks' stock returns based on the unweighted average of the individual bank stock returns of all the banks listed on the Nairobi Securities Exchange (NSE) and the construction of nonbank stock return based on selected companies from the different segments of industries at the NSE demonstrates the extent of influence of the banking industry[18].

One of the characteristics of the NSE as would be inferred from the bank – nonbank stock returns is that asset returns tend to be extrapolative in the sense that returns on either side of the dichotomy are positively correlated with their respective past performance. Furthermore, bank and non-bank stock returns exhibit clear co-movement (**Figure 17**) with a clear pattern of higher returns of the bank stocks in 2018 compared to that of non-bank stocks.

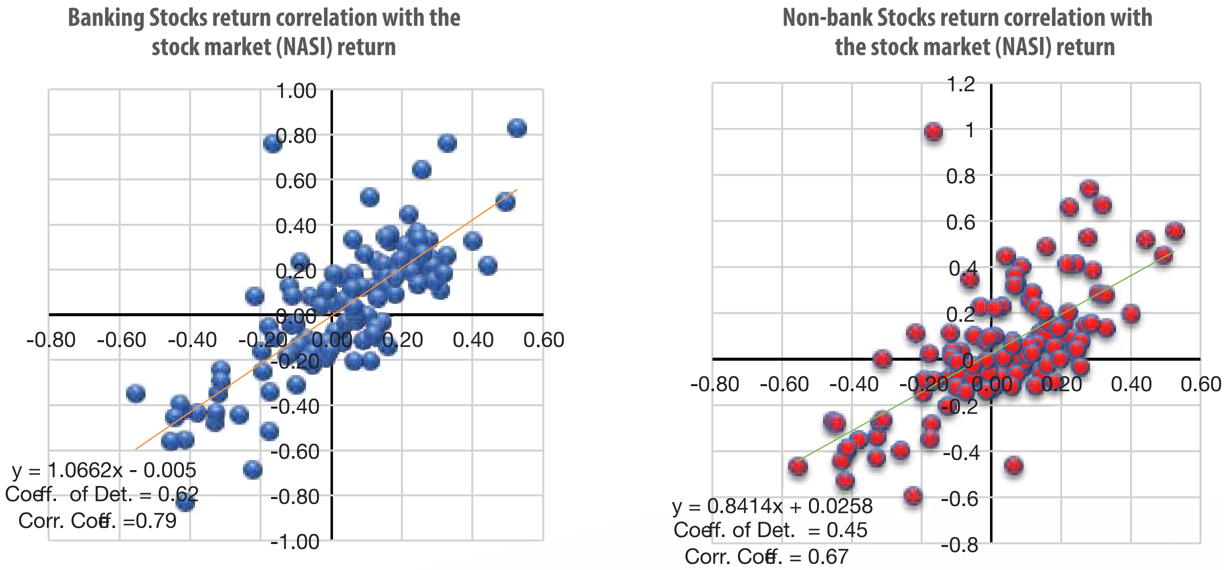
Figure 17: Bank-NonBank Stock Returns Evolution



Source: Based on data from African Markets Database data from June 2009 to December 2018

18 For the non-bank stocks, this analysis considers nine companies, one from each market segment - Stanlib Fahari-REIT, Kakuzi, Bamburi Cement, Britam, Car & General, Centum Investments, EABL, KPLC and Kenya Airways. The return of the non-bank stocks is computed as an unweighted average of the returns of the stocks of the nine companies.

Figure 18: Bank -Non-Bank Stocks Returns' Association with Overall Market Performance



Source: Based on data from African Markets Database data from June 2009 to December 2018

The co-evolution of bank – nonbank returns comports with the co-evolution seen in studies that analyse Kenya's financial system from a bank-based versus a market-based dichotomy (e.g. Osoro and Osano, 2014[19]). But the observed evolution is on the back of the observation that the correlation between bank stocks returns and the overall market performance is stronger than that between nonbank stocks returns and the overall market performance (**Figure 18**).

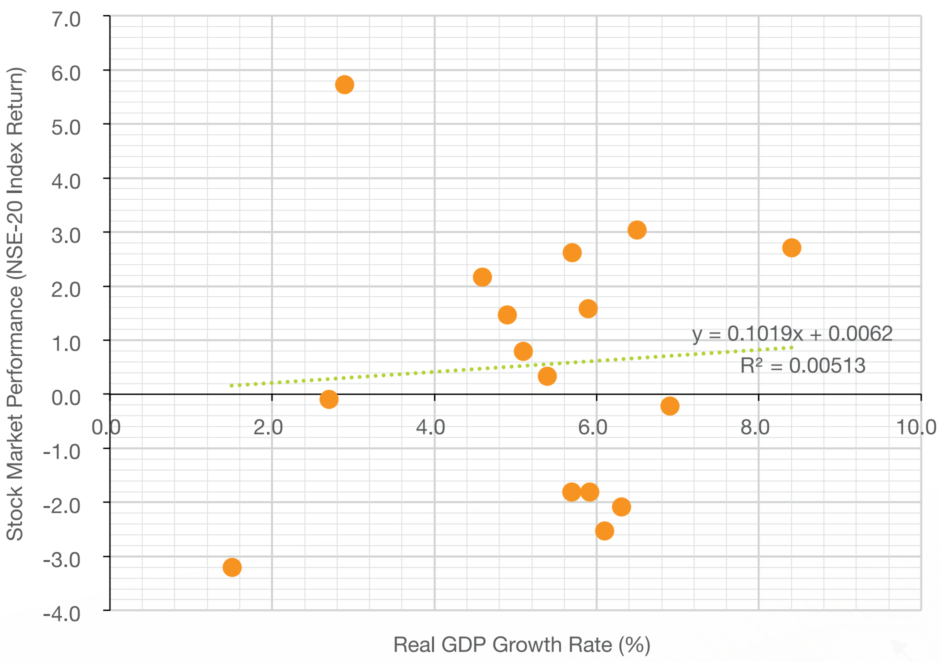
Noteworthy, the observations from **Figure 18** are purely a matter of relativity, for both segments have a strong link to overall performance**.** A closer look at the data (**Table 3**) puts a spotlight on the place of banks in the broader market context. One clear inference is that not only are banks closely associated with performance of the overall market, but they have strong association amongst themselves; this speaks to the linkages that exists within the banking system. The other inference is that listed agencies that that have strong business links to banks – for instance telecommunication companies that have partnerships with banks and investment companies that have bank stocks in their portfolio – show strong association with the overall market and with banks' stock returns.

19 Osoro J., and Osano E., (2014), "Bank-based Versus Market-based Financial System: Does Evidence Justify the Dichotomy in the context of Kenya?" KBA Centre for Research on Financial ***Markets*** and Policy® Working Paper Series No 10 (WPS/05/14), December. [https://www.kba.co.ke/downloads/Working%20Paper%20WPS-10-14.pdf]

Table 3: Stock Market Performance: Bank and Non-Bank Stock Returns Correlations

	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22
NASI (1)	1																					
Housing Finance (2)	0.44	1																				
Barclays (3)	0.57	0.38	1																			
Co-operative (4)	0.54	0.36	0.46	1																		
DTB (5)	0.48	0.26	0.29	0.43	1																	
Equity (6)	0.72	0.41	0.47	0.62	0.42	1																
I&M (7)	0.56	0.26	0.25	0.41	0.25	0.49	1															
KCB (8)	0.71	0.36	0.55	0.54	0.39	0.62	0.45	1														
NBK (9)	0.40	0.25	0.31	0.34	0.43	0.39	0.24	0.32	1													
NIC (10)	0.57	0.50	0.53	0.48	0.49	0.47	0.30	0.45	0.33	1												
Stanchart (11)	0.60	0.37	0.36	0.43	0.32	0.50	0.34	0.53	0.24	0.60	1											
Stanbic (12)	0.37	0.23	0.18	0.40	0.27	0.44	0.26	0.21	0.12	0.33	0.49	1										
Safaricom (13)	0.68	0.19	0.32	0.31	0.23	0.34	0.39	0.44	0.22	0.28	0.27	0.18	1									
Stanlib Fahari-REIT (14)	0.22	0.20	0.03	0.36	0.29	0.20	0.18	0.05	0.17	0.22	0.16	0.02	0.10	1								
Kakuzi (15)	0.23	0.05	0.20	0.23	0.21	0.16	0.09	0.15	0.20	0.17	0.11	0.02	0.14	0.59	1							
Bamburi Cement (16)	0.35	0.01	0.24	0.29	0.30	0.30	0.18	0.33	0.27	0.29	0.32	0.13	0.25	0.08	0.24	1						
Britam (17)	0.43	0.26	0.21	0.35	0.35	0.33	0.30	0.29	0.23	0.27	0.23	0.25	0.26	0.05	0.18	0.01	1					
Car & General (18)	0.05	0.13	0.19	0.19	0.23	0.16	0.15	0.08	0.32	0.21	-0.03	0.18	-0.05	0.06	0.12	0.05	0.10	1				
Centum Investments (19)	0.617	0.385	0.398	0.575	0.447	0.566	0.387	0.446	0.366	0.561	0.429	0.384	0.367	0.407	0.237	0.133	0.441	0.201	1			
EABL (20)	0.522	0.229	0.295	0.422	0.234	0.517	0.509	0.435	0.229	0.293	0.421	0.270	0.313	0.213	0.076	0.229	0.101	0.019	0.35	1		
KPLC (21)	0.441	0.175	0.368	0.381	0.400	0.384	0.300	0.312	0.327	0.416	0.206	0.242	0.273	0.041	0.162	0.281	0.244	0.225	0.40	0.26	1	
Kenya Airways (22)	0.257	0.083	0.125	0.203	0.130	0.176	0.157	0.177	0.110	0.143	0.015	0.001	0.178	-0.040	0.038	0.042	0.146	0.019	0.30	0.04	0.18	1

Figure 19: Correlation Between the Performance of the NSE and the Overall Economy



Source: KNBS and NSE Data

5.1 Observations

The place of the banking industry in the broader capital markets and the NSE in particular needs to be seen both from where the market sits in the broader economy and the structure of the market itself. In line with popular expectations, equity returns should have a positive association with real GDP growth. Such expectations are based on the argument that good economic fortunes point to optimism that reflects itself in stock prices. **Figure 19** shows that such association is weak, an observation confirmed by earlier studies[20].

Underlying the above observation is a market that is highly concentrated and foreign dominated. According to CMA (2019[21]), five listed entities account for nearly 68 percent of the total market capitalization during the first quarter of 2019; four of these entities are banks. Further, foreign investor participation for the period January - February 2019 averaged at 77 percent. Ultimately, whereas where the economy goes is not necessarily where the securities market goes, it is obvious that where the banking sentiments go is where the market goes. The positive sentiments arising from the banking industry market upturn over the past two years – constraints notwithstanding – have been a key driver of investor expectations.

20 *Ibid*

21 CMA (2019), "The Capital Markets Soundness Report Volume X", Quarter 1. [https://www.cma.or.ke/index.php?option=com_phocadownload&view=category&id=5&Itemid=261]

Chapter 6

OUTLOOK

- There has always been a bi-directional influence between the performance of the banking industry and the overall economy. That is why this report observes that state of banking in Kenya, like in other similar markets, is the confluence of interplay between the state of the economy, the broader macroeconomic policy environment and how it relates to market outcomes, and the regulatory developments as they relate to market stability.
- Through the indicated interaction, the banking industry has not only been resilient but is also anticipated to sustain the positive momentum it has build post the market shocks of 2015 – 2016. The pace of that momentum is likely to be influenced by extent to which the downside challenges to optimal operations by banks are redressed.
- Obvious among such challenges is the interest rates capping law that came into effect in September 2016 and whose negative ramifications have filtered through to the entire financial system and the economy. It's evident that the law has distorted incentive for lending to the private sector in the event of risks being above the capping level, hence implicitly leading to resource allocation shifting away from the core of the real economy.
- Government fiscal outturn under the medium-term expenditure framework and the objective of fiscal consolidation is likely to influence the extent of the shifting of resource allocation between the public sector and the private sector. That will have an influence on the structure and cost of funding in the market. It will also influence the extent to which the market will juggle the considerations on asset quality improvement – given the double-digit level of the Gross NPLs/Gross Loans ratio - and total asset growth. This happens on the back of the banking industry moving beyond the 2018, the year of transitioning to the IFRS 9 asset classification.
- Beyond the changes in asset classification that will have implications on the levels of loss provisions, banks are expected to continue deploying technology for efficiency and cost management as well as product design that utilises the analytical capability of data abundance. The ensuing interventions will support the industry as it embraces the CBK's Banking Charter that espouses transparency, customer centricity and encouraging credit allocation to small and medium enterprises.
- As that happens, investments in in terms of financial resources, personnel and technology is expected to remain on the fore towards ensuring that banks remain compliant to regulations – covering issues ranging from capital, corporate governance, all disclosures, and Anti-Money-Laundering and Countering Terrorist Financing (AMLCFT). In line with the emergent global practice post the global financial crisis, compliance will go beyond personnel to include algorithms that will be complementary – so-called RegTechs, meaning the utilisation of information technology to enhance regulatory processes.
- Finally, it is anticipated that a lot of attention will be paid on the link between market structure, credit allocation and overall economic performance, hinging on the aspect of market power as could be influenced by the relative size of market players. It will be interesting evaluate the extent to which organic growth, and mergers and acquisitions in the banking industry will potentially shape market competition.

The interplay between these aspects is potentially a forerunner to changes in market concentration and power. At the same time partnerships between banks and non-bank actors, notably financial technology firms and mobile network operators will likely continue to shape market power, competition and intermediation. *The Kenya Bankers Association Centre for Research on Financial Markets and Policy®* is undertaking analytical work in this area that will be unveiled in its 8th Annual Banking Research Conference in September 2019.

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