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POLICY BRIEF

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Promoting Banking Sector Stability through Appropriate Fiscal and Interest Rate Policies

Executive Summary

Appropriate fiscal and interest rate policies has been emphasized both at the global and local levels through various intervention aimed at promoting banking sector stability. As regulators attempt to tackle the twin shocks of high inflationary pressures experienced in 2023 and unwinding COVID-19 pandemic measures amidst fiscal risks due to high sovereign debt levels in developing economies. Evidence shows monetary policy stance has implications on fiscal and banking sector stability whereby contractionary monetary policy raises fiscal and banking sector stability risks when public debt is elevated due to a tight sovereign-bank nexus. Additionally, increase in interest rate and credit risks lowers banking sector stability while bank capital accumulation strengthened banking sector stability. Interventions to promote banking sector stability should focus on implementing effective interest rates and fiscal policies, through encouraging banks maintaining appropriate sovereign-bank nexus.

Authored by: Camilla Talam[1] & Samuel Kiemo[2]

1. Context

Globally, the 2020-2023 steep interest rates hikes, and other tightening liquidity conditions occasioned by policy measures adopted to contain both the adverse effect of covid-19 pandemic and persistent high inflation led to elevated banking sector stability and fiscal risks in both developed and emerging economies. As of June 2022, thirty seven (37) developing economies globally had tightened their monetary policy rates to curb elevated and rising inflation, with 45.6 percent of global economies facing double digit inflation. Rapidly rising inflation was driven by several factors including geopolitical tensions, increasing energy and food prices, unfavorable weather shocks and persistent supply chain disruptions. Despite the supply-driven nature of inflation, the majority of economies, particularly in developing economies tightened policy rates to lower inflation. More importantly, these economies may have tightened to prevent interest rate differentials that would significantly affect their debt positions. Nonetheless, with revenue remaining the same, higher debt service is likely to raise fiscal deficits and lead to further accumulation of debt. As demand and economic growth is likely to be subdued, marginal changes such as volatile revenue or revenue shortfalls or changes in credit ratings may push developing countries with a high debt distress to debt default. Debt default will be due to further worsening debt sustainability as this constrains their ability to roll-over debt, reduces the demand for their debt in secondary markets and may have other macro-financial implications such as reinforcing sovereign bank nexus and hindering capital market development that affect domestic financial markets.

For Kenya, the banking sector stability may be strengthened with rise in interest rate through net gains from increased profitability from high lending rates amidst absorbing repricing loses from holding government securities. However, tighter monetary policy stance and increased appetite for domestic borrowing by the government increases banks vulnerability by incentivizing the banking sector to increase its holding of the government bonds. This vulnerability may increase the impact of interest rate risks should the government bond market be adversely impacted leading to significant losses from bond repricing for interest-sensitive assets or those marked to the market. On other hand, tighter monetary policy is expected to appreciate the domestic currency thus easing debt sustainability concerns. However interest rate differentials between developing country like Kenya and global markets coupled with higher risk premium due to weaker sovereign credit rating may offset the effect of the currency appreciation and leading to greater risks as interest rates increase domestically. Thus rising interest rates coupled by volatility in the exchange rate markets continue to shape banking sector risks through banking sector credit and bond repricing channels.

In Kenya, domestic interest rates also increased significantly. In three and a half years from 2020, short term interest rates domestically have increased by 200 basis points, while long term interest rates have increased by 150 basis points, compared with less than 100 basis points movements previously, indicating increased volatility in interest rates that is likely to increase banking sector stability concerns on interest rate risks in Kenya's banking sector (**Table 1**).

1. Rogers Ochenge is a Lecturer at the Department of Economic Theory of Kenyatta University and an adjunct lecturer at the Strathmore Institute of Mathematical Sciences. All correspondence to rochenge@yahoo.co.uk and rogers.ochenge@ku.ac.ke

Table 1: Trends in Kenya's Key Interest Rates (Annual Average Yields/Rates)

	Treasury Bills (%)			Treasury Bonds (%)				Others (%)	
Year	91-days	182-days	364-days	5-year	10-year	15-year	20-year	CBR*	LR**
2015	10.87	12.17	12.93	13.08	13.32	13.51	13.67	10.13	16.16
2016	8.63	10.91	11.69	13.66	14.08	14.25	14.32	10.67	16.57
2017	8.37	10.43	10.95	12.75	13.22	13.46	13.68	10.00	13.67
2018	7.77	9.54	10.45	12.02	12.71	12.92	13.08	9.33	13.06
2019	6.84	7.82	9.48	10.77	11.95	12.48	12.80	8.92	12.44
2020	6.85	7.50	8.55	10.90	11.99	12.59	13.02	7.23	12.00
2021	6.96	7.58	8.54	10.97	12.28	12.88	13.28	7.00	12.08
2022	8.21	9.01	9.89	12.54	13.37	13.75	13.91	7.63	12.34
2023*	10.09	10.46	10.93	13.68	14.24	14.24	14.26	9.42	13.01

Source: Central Bank of Kenya.

**Central Bank Rate; ** Bank Lending Rate, 2023 numbers were as at June 2023*

On the other hand, banks in Kenya remained resilient, characterized by adequate capital. Holding strong capital buffers with total Capital Adequacy ratio (CAR) remaining above minimum requirement of 14.5 percent. Bank liquidity conditions have also remained high (Table 2). However, bank resilience could be impaired by the evolving global and domestic developments that could impact banks' assets quality and in turn, capital erosion. The rising interest rates domestically and globally in view of monetary policy tightening, amidst limited fiscal scope poses banking sector stability to banks in two aspects.

Table 2: Banking Sector Financial Soundness Indicators for Kenya

Figures in Percent	2010	2008	2010	2012	2013	2014	2016	2017	2018	2019	2020	2021
CAR (Total Capital)	17	18	21	22	X	X	X	18	19	19	19	20
CAR (Tier 1)	16	16	19	19	19	16	16	16	17	17	17	17
Gross NPLs to Gross Loss	21	8	6	5	5	5	9	11	12	12	15	14
Return on Assets (ROA)	3	3	4	4	4	3	3	3	3	3	2	3
Return on Equity (ROE)	29	29	31	34	29	27	25	21	23	21	14	22
Liquidity Ratio	45	37	45	42	39	38	41	44	49	50	55	56
Private sector Growth	12	29	20	11	20	22	5	3	2	7	8	9
Credit to Government Growth	53	3	13	64	(21)	15	30	8	(2)	9.7	43	28
Total Bank Credit as a % to GDP	N/A	N/A	29	32	34	36	36	32	30	31	28	30

Source: Central Bank of Kenya.

2. Policy Problem

Against this backdrop, examining the role of interest rate risks in promoting banking sector stability amidst fiscal risks in Kenya is pivotal. Despite banks in Kenya remaining resilient, characterized by adequate capital, the resilience could be impaired by the evolving global and domestic developments that could impact banks' assets quality and in turn, capital erosion. The rising interest rates domestically and globally in view of monetary policy tightening, amidst limited fiscal scope poses banking sector stability to banks in two aspects. First is through tightening of lending standards as banks fully implement risks-based pricing leading to dampening credit growth and reduced profitability due to reduced earnings from credit advances. Secondly as interest rises, banks holding significant proportions of government bonds are likely to experience losses through bond repricing. This rises the policy question on the appropriate interest rate policy to adopt for promoting banking sector stability amidst heightened fiscal risks emanating from sovereign-bank nexus in Kenya

3. Methods and Results

Results of a study link monetary policy stance to fiscal and banking sector stability using annual bank-level data from 2001-2022 for 37 banks in Kenya, extracted from banks published reports. Bank Stability Index (BSI) that was constructed to examine the evolution banking sector stability conditions, revealed banking sector has remained resilient over the study periods, despite experiencing some episodes of financial instability. The study also found monetary policy stance has implications on fiscal and banking sector stability whereby contractionary monetary policy raises fiscal and banking sector stability risks when public debt is elevated due to a tight sovereign-bank nexus. Increases in interest rate and credit risks were found to lower banking sector stability while bank capital accumulation strengthened banking sector stability. A high sovereign-bank nexus increases banking sector stability through repricing risks reflected via interest rate and liquidity risks.

4. Policy Recommendations

To address the issue at hand policy makers may consider undertaking the following recommendations:

i. Adopting appropriate interest rate policy taking cognizance of its implication on fiscal and banking sector stability.

ii. Banks to adopt appropriate sovereign-bank nexus balancing profitability and possible reprising loses.

iii. Tracking of sovereign-bank nexus overtime to cover multiple business cycles to enhance understanding of sovereign-bank nexus dynamics towards coordinating monetary, fiscal and macroprudential policies.

5. References

Talam, C. & Kiemo, S (2023). Interest Rate Risk in Kenya: The Banking Sector Stability and Fiscal Risks Nexus. Kenya Bankers Association Working Paper series.

Kenya Bankers Association
13th Floor, International House, Mama Ngina Street
P.O. Box 73100– 00200 NAIROBI
Telephone: 254 20 2221704/2217757/2224014/5
Cell: 0733 812770/0711 562910
Fax: 254 20 2221792
Email: research@kba.co.ke
Website: www.kba.co.ke

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