Central Bank of Kenya

Credit Officer Survey

March 31, 2021

CENTRAL BANK OF KENYA COMMERCIAL BANKS' CREDIT OFFICER SURVEY FOR THE THE QUARTER ENDED MARCH 31, 2021

1.0 COMMERCIAL BANKS' CREDIT OFFICER SURVEY

1.1 BACKGROUND

Credit risk is the single largest factor affecting the soundness of financial institutions and the financial system as a whole. This is informed by lending being the principal business for banks. The ratio of gross loans to total assets decreased marginally from 55.34 percent in the quarter ended December 31, 2020 to 55.0 percent in the quarter ended March 31, 2021.

The Central Bank of Kenya (CBK) undertakes a quarterly Credit Officer Survey to identify the potential drivers of credit risk. The survey requires senior credit officers of banks to indicate their banks perception or actual position in the immediate past quarter and the subsequent quarter in terms of demand for credit, credit standards, interest rates, asset quality, credit recovery efforts, deployment of liquidity and impact of implementing new standards.

1.2 SURVEY METHODOLOGY

Senior Credit Officers[1] complete most of the survey and collate inputs from senior officers responsible for the other aspects. For the quarter ended March 31, 2021, 38 operating commercial banks and 1 mortgage finance company participated in the Commercial Banks Credit Officer Survey.

The survey sought to establish the lending behavior in the banking sector in respect to all the eleven economic sectors. Questions were posed on demand for credit, credit standards for approving loans, level of interest rates, non-performing loans, the effect of repeal of capping of interest rates[2] on lending to Small and Medium sized Enterprises (SMEs), credit recovery efforts, implementation of International Financial Reporting Standards (IFRS) 9 on Financial Instruments and implementation of IFRS 16 on Leases. The survey questions are generally phrased in terms of changes over the past three months or expected changes over the next three months.

The survey also included questions with regard to liquidity in the banks. The banks were required to state their appetite for deployment of liquidity towards extension of credit, interbank lending and other forms of investment.

Following the declaration by the World Health Organization of coronavirus (COVID-19) outbreak as a pandemic in March 2020, CBK through the credit officer survey assesses the impact of the pandemic on the banking sector.

The survey included questions relating to the adverse impact of the pandemic on the banks, measures taken by banks to curb the adverse impact of the pandemic and their experience in implementing the emergency measures introduced by CBK to mitigate the impact of the pandemic.

[1] *These are officers involved in most of the credit decisions hence are able to provide reasonably accurate and complete responses from their bank's perspective. They also collate input on non-credit aspects from their counterparts.*

[2] *The capping of interest rates law came into effect on September 14, 2016 and was repealed on November 7, 2019.*

1.3 KENYAN BANKING SECTOR PERFORMANCE

The Kenyan Banking Sector recorded growth in the quarter ended March 31, 2021, compared to the quarter ended December 31, 2020. Some of the sector's performance indicators are as follows: -

- The aggregate balance sheet increased by 2.0 percent to Ksh.5,528.44 billion in March 2021 from Ksh.5,420.08 billion in December 2020.

- Gross loans increased by 1.4 percent from Ksh.2,999.47 billion in December 2020 to Ksh.3,040.45 billion in March 2021. The growth in gross loans was mainly due to increased advances in the Financial Services, and Energy and Water sectors.

- Total deposits increased by 2.8 percent from Ksh.4,021.94 billion in December 2020 to Ksh.4,133.15 billion in March 2021.

- The asset quality, measured by gross non-performing loans to gross loans ratio deteriorated from 14.1 percent in December 2020 to 14.6 percent in March 2021. This was attributed to a slowdown in business activities as a result of adverse effects of COVID -19 pandemic.

- The total capital adequacy ratio marginally decreased from 19.2 percent in December 2020 to 18.9 percent in March 2021. This is as a result of a lower increase in total capital (1 percent) as compared to the increase in total risk weighted assets (2.7 percent). The capital adequacy ratio reported in the two periods were above the minimum statutory limit of 14.5 percent.

- Quarterly profit before tax increased by Ksh.22.3 billion from Ksh.23.6 billion in December 2020 to Ksh.45.9 billion in March 2021. This was as a result of a higher decrease in expenses (22.8 percent) as compared to decrease in income (4.6 percent). Return on Assets increased to 2.7 percent in March 2021 from 1.6 percent in December 2020.

- Return on Equity increased from 13.8 percent in December 2020 to 22.0 percent in March 2021. This is as a result of a higher increase in quarterly profits before tax (94.7 percent) than increase in total shareholders' funds (2.4 percent).

- During the quarter ended March 2021, liquidity in the banking sector increased from 54.6 percent in December 2020 to 56.3 percent in March 2021. This was well above the minimum statutory ratio of 20 percent.

1.4 SUMMARY OF CREDIT OFFICER SURVEY FINDINGS

- **Demand for credit:** In the first quarter of 2021, the perceived demand for credit remained unchanged in seven economic sectors, increased in three sectors and decreased in one sector. The main sectors with unchanged demand for credit are Mining and Quarrying, Agriculture, and Energy and Water.

- **Credit Standards[3]:** In the first quarter of 2021, credit standards remained unchanged in eight economic sectors and were tightened in two sectors namely Tourism and Real Estate sectors. 71 percent of the respondents indicated that credit standards for Personal and Household sector were either tightened or remained unchanged.

  Tightening of credit standards in the three sectors is attributed to the effects of COVID – 19 pandemic.

[3] *Credit standards are guidelines used by commercial banks in determining whether to extend a loan to an applicant.*

- **Repeal of interest rate capping law:** 82 percent of the respondents indicated that after the repeal of interest rate capping law, the demand for credit remained unchanged while 18 percent noted that demand for credit increased.

- **Lending to Small and Medium-sized Enterprises (SMEs):** In the quarter ended March 31, 2021, 76 percent of the respondents indicated that the repeal of interest rate capping law had no effect on their lending to SMEs. 24 percent of the respondents indicated that the repeal had increased their lending to SMEs since majority of the banks are on-boarding risk based pricing models which has increased financial institutions appetite to lend to SMEs.

- **Non-Performing Loans:** During the quarter under review, the respondents indicated that NPLs remained unchanged in six economic sectors and increased in five sectors. The sectors with increased NPLs were Personal and Household, Real Estate, Transport and Communication, Tourism, and Trade.

  The increase in NPLs was mainly due to a challenging business environment as a result of COVID-19 pandemic.

- **Expected Non-Performing Loans levels during the fourth quarter:** 53 percent of the respondents expect the level of NPLs to rise in the second quarter of 2021 as a result of the COVID-19 pandemic containment measures announced in March 2021. 32 percent of the respondents indicated that NPLs are likely to fall in the second quarter of 2021. This is attributed to enhanced recovery efforts being implemented by most banks. The respondents indicated that all the eleven economic sectors will be affected negatively by the pandemic.

- **Credit Recovery Efforts:** For the quarter ending June 30, 2021, banks expect to intensify their credit recovery efforts in all economic sectors. The intensified recovery efforts are aimed at improving the overall quality of the asset portfolio.

- **International Financial Reporting Standard (IFRS) 9 on Financial Instruments:** Implementation of IFRS 9 has had an adverse impact on commercial banks' capital adequacy due to increased provisioning. This led the commercial banks to explore injection of more capital.

- **International Financial Reporting Standard (IFRS) 16 on Leases:** Most banks indicated that implementation of IFRS 16 increased their risk weighted assets, which has in turn negatively affected their capital adequacy ratios.

- **Liquidity risk:** During the quarter ended March 31, 2020, liquidity in the banking sector increased from 54.6 percent in December 2020 to 56.3 percent in March 2021. The ratio remained above the minimum statutory ratio of 20 percent.

- Banks intend to deploy excess liquidity towards lending to the private sector, investing in Treasury Bills and Bonds, interbank lending, CBK liquidity management through repos and increased cash holdings.

2.0 SURVEY FINDINGS

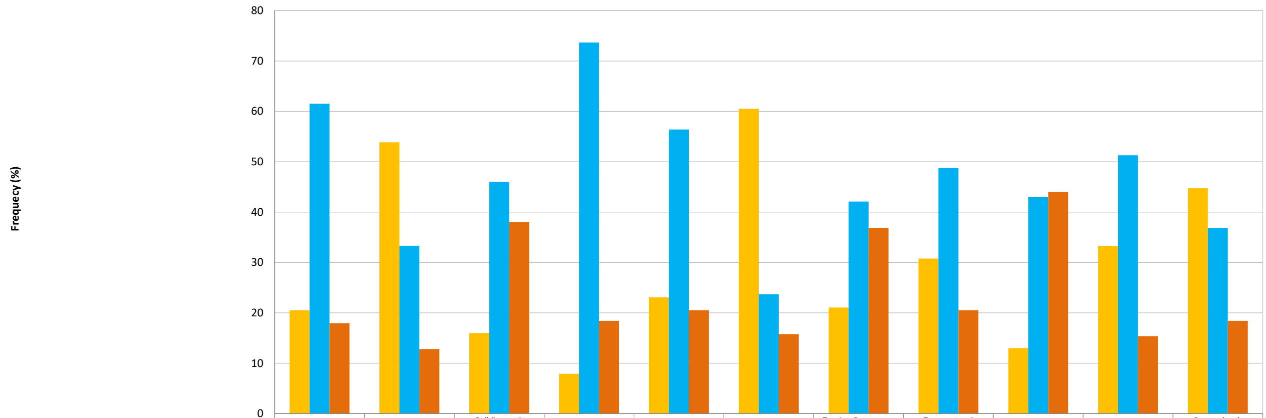
2.1 Demand for Credit

- In the first quarter of 2021, the perceived demand for credit remained unchanged in seven economic sectors. It increased in three sectors and decreased in one sector.
- The main sectors with unchanged demand for credit are Mining and Quarrying, Agriculture, and Energy and Water.
- Perceived demand for credit significantly decreased in the Real Estate sector due to subdued demand for housing units.
- Perceived demand for credit increased in Personal and Household, Trade and Manufacturing sectors.
- **Chart 1** and **Table 1** below present the trend in the perceived demand for credit in the last two quarters.

Table 1: Change in Demand for Credit

Percentage (%)	December 2020			March 2021		
	Increased	Remained Unchanged	Decreased	Increased	Remained Unchanged	Decreased
Agriculture	26	58	16	21	62	18
Manufacturing	41	41	18	54	33	13
Building and Construction	16	46	38	16	46	38
Mining and Quarrying	13	74	13	8	74	18
Energy and Water	26	62	13	23	56	21
Trade	56	28	15	61	24	16
Tourism, Restaurant and Hotels	26	45	29	21	42	37
Transport and Communication	28	59	13	31	49	21
Real Estate	13	43	44	13	43	44
Financial Services	32	61	8	33	51	15
Personal and Household	47	34	18	45	37	18

Chart 1: Demand for Credit



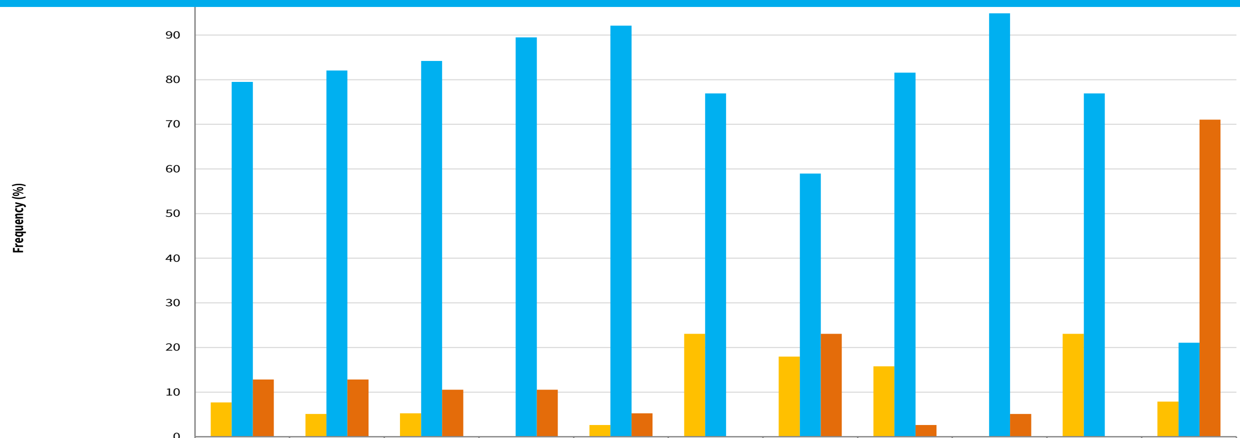
	Agriculture	Manufacturing	Building and Construction	Mining and Quarrying	Energy and Water	Trade	Tourism,Restaurant and Hotels	Transport and Communication	Real Estate	Financial Services	Personal and Household
Increased(%)	21	54	16	8	23	61	21	31	13	33	45
Remained Unchanged (%)	62	33	46	74	56	24	42	49	43	51	37
Decreased (%)	18	13	38	18	21	16	37	21	44	15	18

2.2 Factors Affecting Demand for Credit

- In the quarter ended March 31, 2021, ten of the eleven factors affecting demand for credit had no impact. The only factor that negatively impacted the demand for credit is COVID-19 pandemic as reported by 71 percent of therespondents reported. This is depicted in **Chart 2** and **Table 2**.

Debt securities, and loans from non-banks were cited as having had the least impact on the demand for credit during the quarter under review. These were reported by 95 percent, 92 percent, 89 percent and 84 percent of the respondents respectively.

Chart 2: Factors affecting Demand for Credit



	Internal Financing	Loans from other banks	Loans from non banks	Issusance of debt securities	Issuance of equity	Cost of borrowing	Available investment opportunities	Reduction of the Central Bank Rate (CBR)	Political Risk	Repeal of Interest Rate Capping	COVID – 19 pandemic
Increased (%)	8	5	5	0	3	23	18	16	0	23	8
Remained Unchanged (%)	79	82	84	89	92	77	59	82	95	77	21
Decreased (%)	13	13	11	11	5	0	23	3	5	0	71

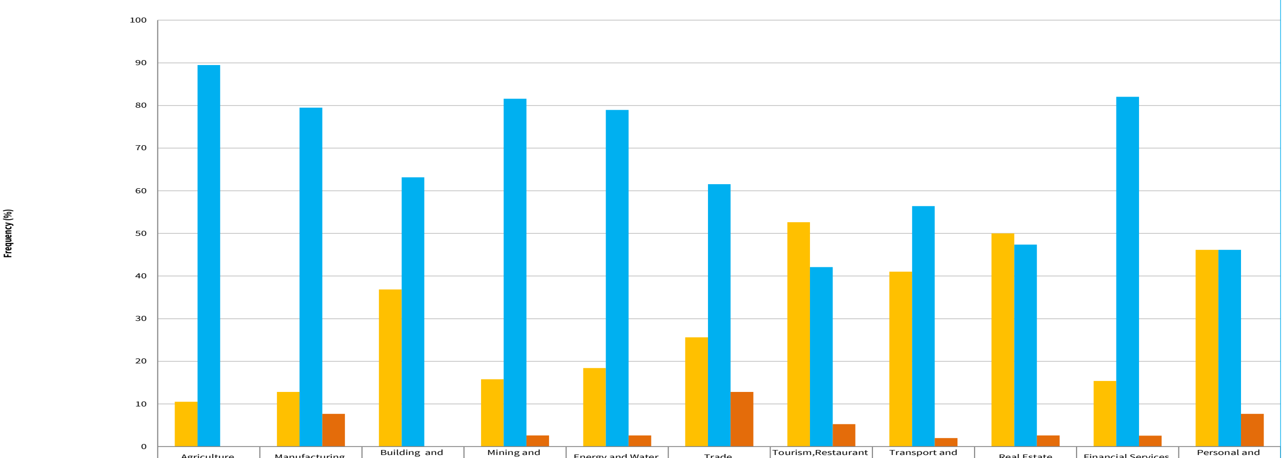
Table 2: Factors Affecting Demand for Credit

Percentage (%)	December 2020			March 2021		
	Increased	Remained Unchanged	Decreased	Increased	Remained Unchanged	Decreased
Internal Financing	11	79	11	8	79	13
Loans from other banks	5	77	18	5	82	13
Loans from non-banks	3	84	13	5	84	11
Issuance of debt securities	5	89	5	0	89	11
Issuance of equity	3	94	3	3	92	5
Cost of borrowing	18	77	5	23	77	0
Available investment opportunities	16	62	22	18	59	23
Reduction of the Central Bank Rate (CBR)	18	82	0	16	82	3
Political Risk	3	92	5	0	95	5
Repeal of Interest Rate Capping	23	77	0	23	77	0
COVID – 19 pandemic	28	18	54	8	21	71

2.3 Credit Standards

- In the first quarter of 2021, credit standards remained unchanged in eight economic sectors and were tightened in two sectors namely Tourism and Real Estate sectors.
- Personal and Household sector credit standards recorded an equal measure of being tightened and remaining unchanged.
- Tightening of credit standards in the two sectors is attributed to the effects of COVID – 19 pandemic.
- This is presented in **Chart 3** and **Table 3** below.

Chart 3: Credit Standards



	Agriculture	Manufacturing	Building and Construction	Mining and Quarrying	Energy and Water	Trade	Tourism,Restaurant and Hotels	Transport and Communication	Real Estate	Financial Services	Personal and Household
Tightened (%)	11	13	37	16	18	26	53	41	50	15	46
Remained Unchanged (%)	89	79	63	82	79	62	42	56	47	82	46
Eased (%)	0	8	0	3	3	13	5	2	3	3	8

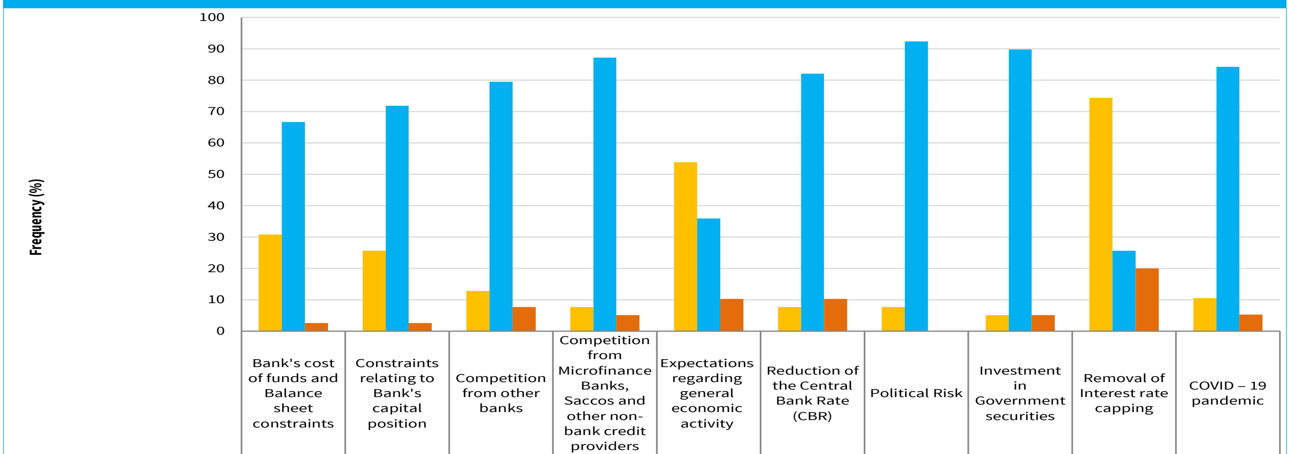
Table 3: Credit Standards for Loans to Various Economic Sectors

Percentage (%)	December 2020			March 2021		
	Tightened	Remained Unchanged	Eased	Tightened	Remained Unchanged	Eased
Agriculture	16	82	3	11	89	0
Manufacturing	18	72	10	13	79	8
Building and Construction	37	61	3	37	63	0
Mining and Quarrying	24	74	3	16	82	3
Energy and Water	21	74	5	18	79	3
Trade	28	59	13	26	62	13
Tourism, Restaurant and Hotels	58	39	3	53	42	5
Transport and Communication	51	46	2	41	56	2
Real Estate	55	39	5	50	47	3
Financial Services	18	74	8	15	82	3
Personal and Household	45	42	13	46	46	8

2.4 Factors Affecting Credit Standards

- In the quarter ended March 31, 2021, eight factors had little impact on credit standards whereas two factors had an impact.
- Competition from Saccos, Microfinance banks, other Credit Providers; political risk, investment in Government Securities, and reduction of CBR are the main factors that had no impact on credit standards. This was reported by 89 percent, 89 percent, and 89 percent respectively.
- Expectations regarding general economic activity and removal of interest rate capping led to tightening of credit standards.
- A comparison of the trend in the factors affecting the banks' credit standards are shown in **Chart 4** and **Table 4**.

Chart 4: Factors affecting Credit Standards



	Bank's cost of funds and Balance sheet constraints	Constraints relating to Bank's capital position	Competition from other banks	Competition from Microfinance Banks, Saccos and other non-bank credit providers	Expectations regarding general economic activity	Reduction of the Central Bank Rate (CBR)	Political Risk	Investment in Government securities	Removal of Interest rate capping	COVID – 19 pandemic
Tightened (%)	31	26	13	8	54	8	8	5	74	11
Remained unchanged (%)	67	72	79	87	36	82	92	90	26	84
Eased (%)	3	3	8	5	10	10	0	5	20	5

Table 4: Factors affecting credit standards

	December 2020			March 2021		
	Tightened	Remained Unchanged	Eased	Tightened	Remained Unchanged	Eased
Bank's cost of funds and Balance sheet constraints	34	66	0	31	67	3
Constraints relating to Bank's capital position	32	65	3	26	72	3
Competition from other banks	8	87	5	13	79	8
Competition from DTMs, Saccos, and other Credit Providers	5	89	5	8	87	5
Expectations regarding general economic activity	54	38	8	54	36	10
Reduction of the Central Bank Rate (CBR)	8	89	3	8	82	10
Political Risk	13	84	3	8	92	0
Investment in Government Securities	8	89	3	5	90	5
Removal of Interest rate capping	64	36	20	74	26	20
COVID –19 pandemic	18	74	8	11	84	5

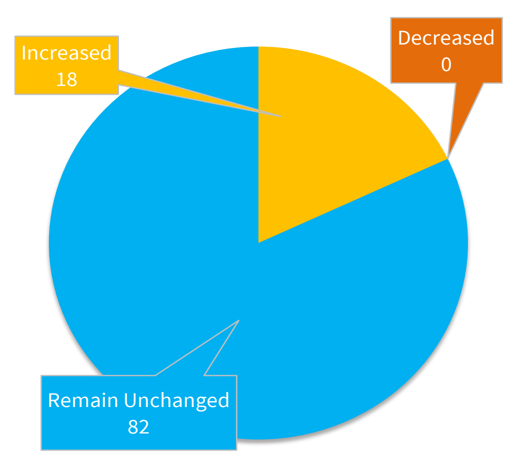
2.5. Repeal of Interest Rate Capping Law

- Following the repeal of capping of interest rates effective November 7, 2019, the Central Bank of Kenya has continued to assess its impact on demand for credit, lending to SMEs, actual credit granted, and Non Performing Loans (NPLs).

2.5.1 Effect of Repeal of Interest Rate Capping Law on Actual Credit Granted in the First Quarter of 2021

- 82 percent of the respondents indicated that after the repeal of interest rate capping law, the demand for credit remained unchanged while 18 percent noted that demand for credit increased.
- This is depicted in **Chart 5** below.

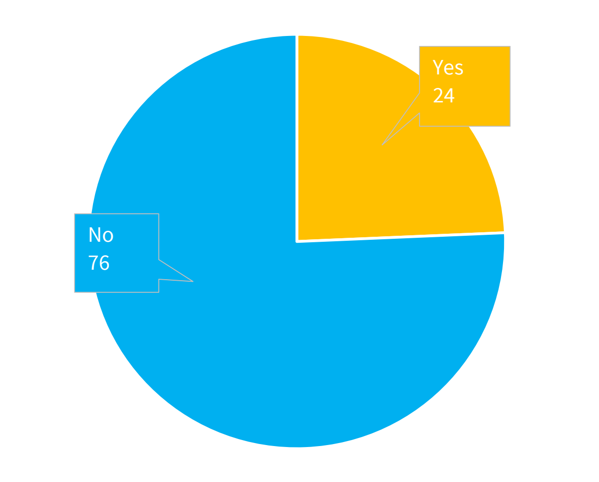
Chart 5: Repeal of Interest rate cap effect on actual credit granted in quarter one of 2021 (%)



2.5.2 Effect of repeal of Interest Rate Capping Law on Lending to SMEs in the First Quarter of 2021

- In the quarter ended March 31, 2021, 76 percent of the respondents indicated that the repeal of interest rate capping law had no effect on their lending to SMEs, while 24 percent indicated that the repeal had increased their lending to SMEs since majority of the banks are on-boarding risk based pricing models which has increased financial institutions appetite to lend to SMEs. This is indicated in **Chart 6**.

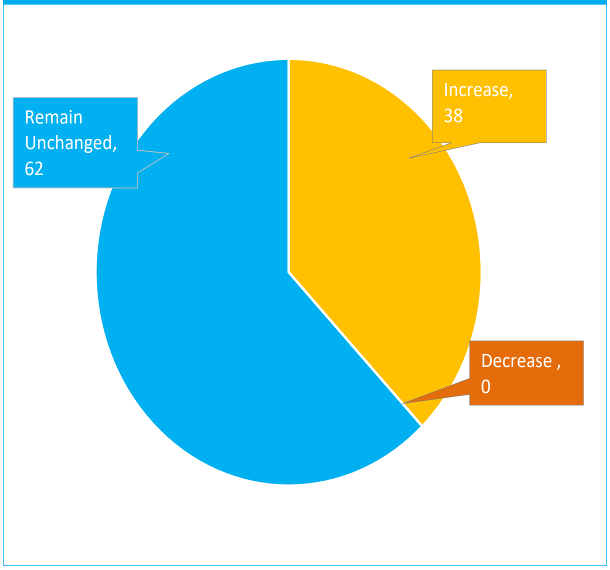
Chart 6: Effect of Repeal of Interest Rate Capping Law on lending to SMEs (%)



2.5.3 Effect of repeal of Interest Rate Cap Law on expected credit to be granted in the Next Quarter

- With regards to the expected credit to be granted in the second quarter of 2021, 62 percent of the respondents felt that the repeal of interest rate capping will have little or no impact on the expected credit granted.
- 38 percent of the respondents indicate that repeal of interest rate capping law would lead to an increase in demand for credit.
- The movement on demand for credit in the next quarter is shown in **Chart 7**.

Chart 7: Interest rate cap effect on expected credit to be granted in quarter 2 of 2021 (%)



2.5.4 Effect of repeal of Interest Rate Capping Law on the Level of NPLs in the First Quarter of 2021

- In the quarter ended March 31, 2021, 92 percent of the respondents indicated that the repeal of interest rate capping law had no effect on level of NPLs.
- 5 percent of the respondents indicated that asset quality improved whereas 3 percent indicated that it deteriorated. This is as indicated in **Chart 8** below.

Chart 8: Effect of repeal of interest rate capping on NPLs over the past quarter (%)

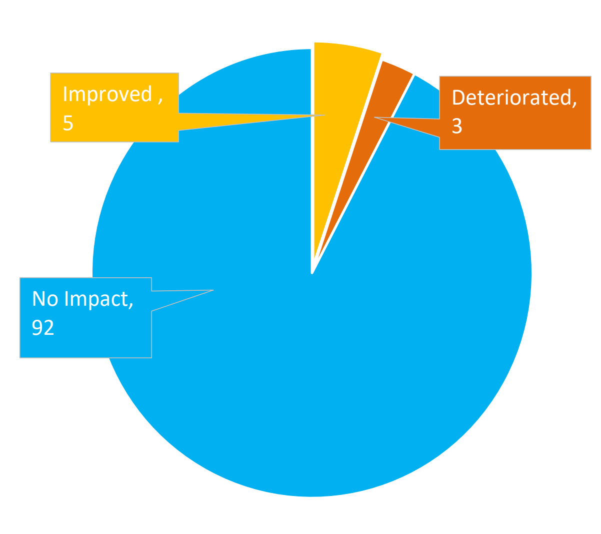
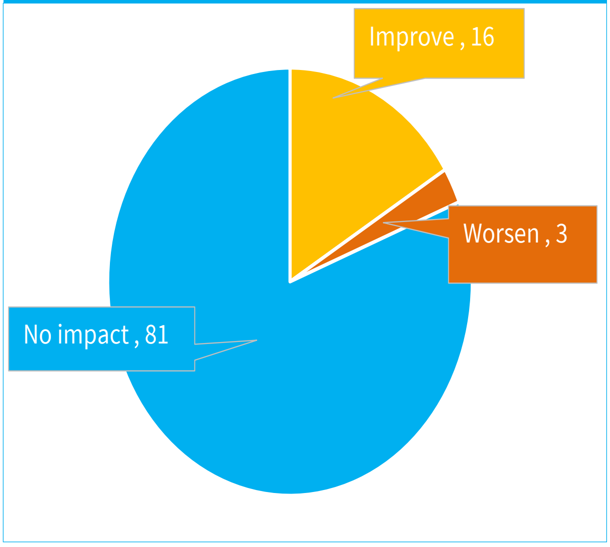


Chart 9: Interest rates cap effect on level of NPLs in the next quarter (%)



2.5.5 Effect of repeal of Interest Rate Capping Law on the Expected Level of NPLs in the Second Quarter of 2021

- 81 percent of the respondents anticipate that repeal of interest rate capping law will have no impact on the level of NPLs in the second quarter of 2021. This is because the pricing of loans has no impact on repayment ability.
- 16 percent of the respondents expect the repeal of law on capping of interest rates to have positive impact on NPLs whereas 3 percent of the respondents expect a negative impact. This trend is as indicated in **Chart 9 below**.

2.6 Non-Performing Loans (NPLs)

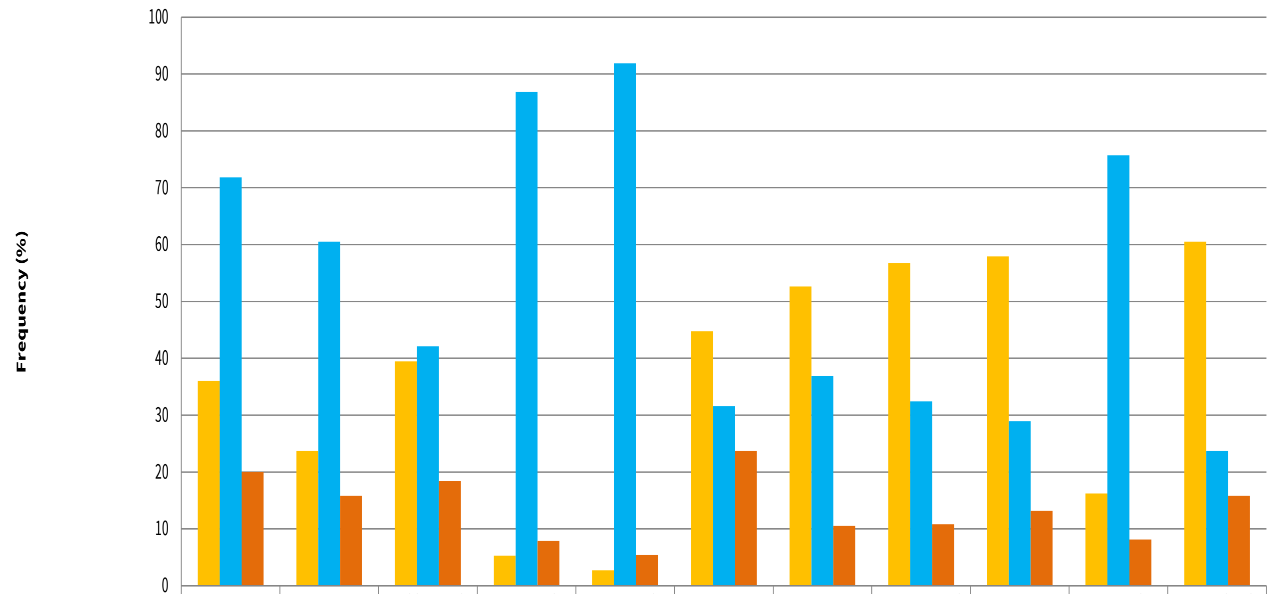
2.6.1 Non - Performing Loans during the quarter ended March 31, 2021

- During the quarter under review, the respondents indicated that the level of NPLs remained unchanged in six economic sectors and increased in five sectors.
- The sectors that recorded increased NPLs are Personal and Household, Real Estate, Transport and Communication, Tourism, and Trade.
- **Table 5** and **Chart 10** and depicts this.

Table 5: Non-Performing Loans Trend Per Economic Sector

Percentage (%)	December 2020			March 2021		
	Rose	Remained Unchanged	Fell	Rose	Remained Unchanged	Fell
Agriculture	36	66	20	36	72	20
Manufacturing	32	47	21	24	61	16
Building and Construction	41	38	22	39	42	18
Mining and Quarrying	3	84	13	5	87	8
Energy and Water	3	87	11	3	92	5
Trade	45	29	26	45	32	24
Tourism, Restaurant and Hotels	53	37	11	53	37	11
Transport and Communication	47	42	11	57	32	11
Real Estate	53	37	11	58	29	13
Financial Services	8	81	11	16	76	8
Personal and Household	55	32	13	61	24	16

Chart 10: Non-Performing Loans

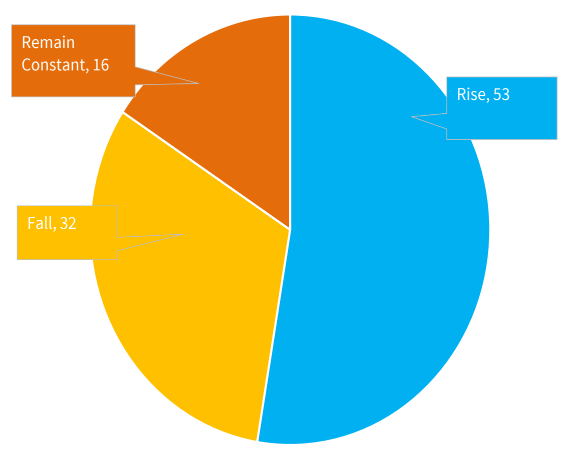


	Agriculture	Manufacturing	Building and Construction	Mining and Quarrying	Energy and Water	Trade	Tourism,Restaurant and Hotels	Transport and Communication	Real Estate	Financial Services	Personal and Household
Rose (%)	36	24	39	5	3	45	53	57	58	16	61
Remained unchanged (%)	72	61	42	87	92	32	37	32	29	76	24
Fell (%)	20	16	18	8	5	24	11	11	13	8	16

2.6.2 Expected Non-Performing Loans during the Second Quarter of 2021

- 32 percent of the respondents indicated that NPLs are likely to fall in the second quarter of 2021. This is attributed to enhanced recovery efforts being implemented by most banks.
- 53 percent of the respondents expect the level of NPLs to rise in the second quarter of 2021 as a result of the continued COVID-19 pandemic and the associated containment measures. The respondents indicated that all the eleven economic sectors will be affected negatively by the pandemic.
- 16 percent of respondents expect NPLs to remain constant. This is depicted in **Chart 11**.

Chart 11: Expected movements of NPLs in the next Quarter (%)



2.7 Credit Recovery Efforts in the Second Quarter of 2021

- For the quarter ending June 30, 2021, banks expect to intensify their credit recovery efforts in all economic sectors. The intensified recovery efforts are aimed at improving the overall quality of the asset portfolio.
- The main sectors that banks intend to intensify credit recovery efforts in order to enhance reduction of NPLs therefore improving the overall quality of their asset portfolio are: -

  i. Personal and Household (87 percent).
  ii. Transport and Communication (84 percent).
  iii. Trade (82 percent).
  iv. Building and Construction (82 percent).
  v. Real Estate (79 percent).

- The responses on the expected credit recovery efforts by the banks are depicted in **Chart 12** and **Table 6**.

Chart 12: Credit Recovery Efforts

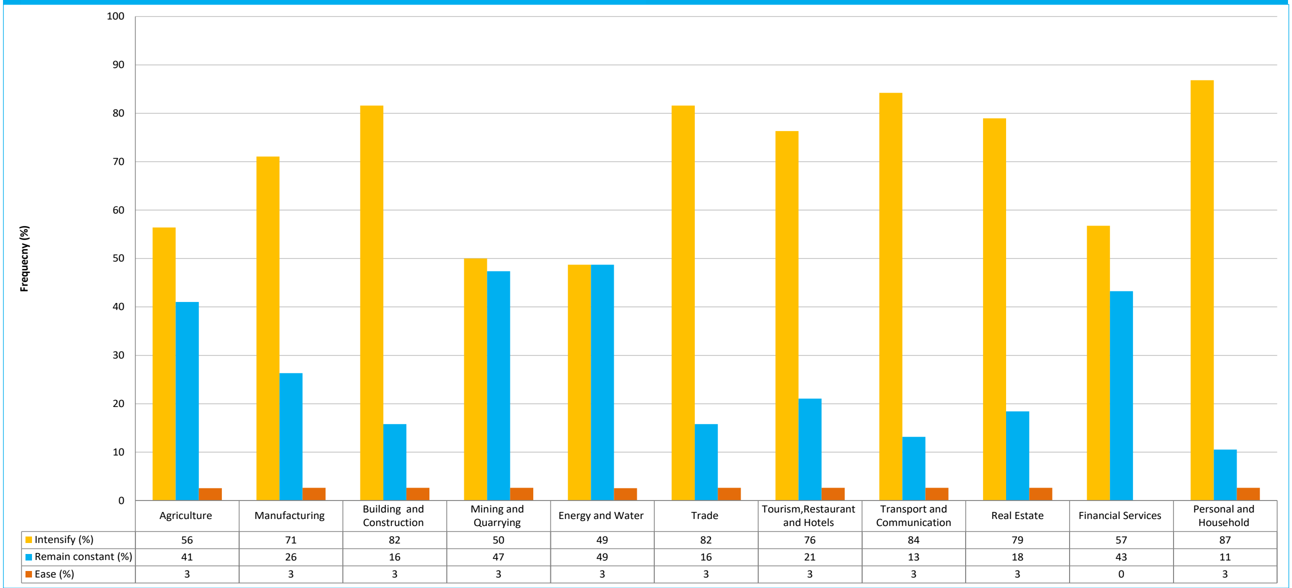


Table 6: Credit Recovery Efforts

	December 2020			March 2021		
	Intensified	Remained Unchanged	Eased	Intensified	Remained Unchanged	Eased
Agriculture	65	32	3	56	41	3
Manufacturing	79	18	3	71	26	3
Building and Construction	84	13	3	82	16	3
Mining and Quarrying	62	35	3	50	47	3
Energy and Water	59	38	3	49	49	3
Trade	89	8	3	82	16	3
Tourism, Restaurant and Hotels	79	18	3	76	21	3
Transport and Communication	84	13	3	84	13	3
Real Estate	84	13	3	79	18	3
Financial Services	61	39	0	57	43	0
Personal and Household	87	11	3	87	11	3

2.8 International Financial Reporting Standard (IFRS) 9 on Financial Instruments

- The International Financial Reporting Standard (IFRS) 9 on Financial Instruments became effective from January 1, 2018. This standard replaced International Accounting Standard (IAS) 39 on Financial Instruments (Recognition and Measurement).
- IFRS 9 introduced a new method of determining provisions for expected losses on loans extended by lending institutions.
- Institutions are required to recognize expected credit losses at all times and to update the amount of expected credit losses recognized at each reporting date to reflect changes in the credit risk of financial instruments.
- The Central Bank of Kenya assesses: -

i). The challenges the banks have experienced in the implementation of IFRS 9 and mitigation measures implemented.

ii). Whether the banks have made any changes in the assumptions used in IFRS 9.

iii). What the banks have done to ensure that the assumptions are more reliable.

2.8.1 Challenges experienced in the Implementation of IFRS 9 and Mitigation Measures

- Most banks have adopted a tight credit risk appraisal, ensuring that facilities are well secured and that alternative sources of repayment are available.
- In addition, banks have changed their lending policies to align them with IFRS 9. However, implementation of IFRS 9 has had some challenges. These include: -

i. Negative impact on capital adequacy due to increased provisioning.

ii. Estimation of future looking Macroeconomic overlays is especially challenging in a pandemic environment

iii. Incorporating reliable macro-economic factors in the model is challenging in an uncertain economy.

iv. Cost implication for the relevant technology, consultants and personnel training.

v. Incorporating an effective interest rate in the model is difficult as its cumbersome to implement without automation.

vi. Minimal growth in loan book due to rigorous risk profiling and credit appraisal standards leading to a negative impact on profitability.

vii. Lack of adequate historical data for assessment and re-modeling of the IFRS 9 assumptions and parameters including Probability of Default (PD) and Loss Given Default (LGD).

viii. Continuous improvement of the business model.

As a mitigation measure, banks have indicated that:

i. They have injected additional capital to accommodate the expected rise in credit losses.

ii. They have developed statistical models to facilitate predictions and retained outside consultants to assist in estimating and sense checking the models.

iii. Some banks have developed internal rating models to assess credit risks across all sectors including for SMEs. Banks have therefore introduced unsecured credit products for SMEs.

iv. Automation of the model to minimize errors and gaps in implementation.

v. Banks have engaged consultants to validate the assumptions to ensure that they are reliable.

vi. The focus of banks is now more on secured lending.

vii. Banks have revamped their credit recovery efforts.

2.8.2 Changes made by commercial banks on the assumptions used in IFRS 9

- The use of forward-looking information is a key component of the Expected Credit Loss (ECL) impairment approach. Commercial banks are now considering historic, current and forward-looking information (including macro-economic data).

  This aims at ensuring that credit losses are recognized at an early stage, rather than waiting for an incurred loss event to occur before credit losses are recognized.

- ECLs are measured in a way that is not just determined by evaluating a range of possible outcomes, adjusted for the time value of money, but also considering 'reasonable and supportable' information about past, present and future events and economic conditions.

- During the quarter under review, the survey revealed the following:-

i. Some of the respondents indicated that they have updated their assumptions to include the current macro-economic indicators.

ii. Banks are facing challenges in modeling data related to the global COVID-19 pandemic and its predicted impact on loan performance.

    Banks are still assessing the effects of COVID-19 to generate different assumptions that will need to be included in the models.

iii. Whereas IFRS 9 provides a 30 day back stop in roll over from stage 1 to stage 2, same banks have maintained a more conservative measure of 1 day past due as the change over from stage 1 to stage 2.

2.8.3 Actions by the commercial banks to ensure that the assumptions are reliable

- Some of the respondents have indicated that they are currently reviewing their assumptions on a quarterly basis to ensure that they are reliable. This aims at ensuring that losses in different sectors are reflected accurately in the model.
- Some banks have also indicated that their model parameters (probability of default and Loss Given Default) are updated twice yearly to ensure all parameters are up to date and relevant.
- Some banks have done data cleanup to ensure its integrity and automation of the model to minimize errors.
- Change assumptions on Probability of Default (PD) computation from portfolio based to sector based.

2.9 International Financial Reporting Standard (IFRS) 16 on Leases

- The International Financial Reporting Standard (IFRS) 16 on Leases became effective from January 1, 2019. This standard replaced International Accounting Standard (IAS) 17 on Leases.
- The main difference between IAS 17 and IFRS 16 is the treatment of operating leases by lessees. Under IAS 17, a lessee was not obligated to report assets and liabilities from operating leases on their balance sheet but instead report the leases as off balance sheet items. IFRS 16 changes this by requiring lessees to recognize operating leases right of use (ROU) assets and lease liabilities on the balance sheet.
- IFRS 16 aims to improve the quality of financial reporting for companies with material off balance sheet leases. However, financial institutions have been facing challenges with the implementation of IFRS 16.

- During the quarter ended March 31, 2021, 95 percent of the respondents had implemented and 92 percent of the respondents assessed the likely impact of IFRS 16 on their financial performance and position. These are depicted in **Chart 13** and **Chart 14** respectively.

Chart 13: Banks that have implemented IFRS 16 on Leases (%)

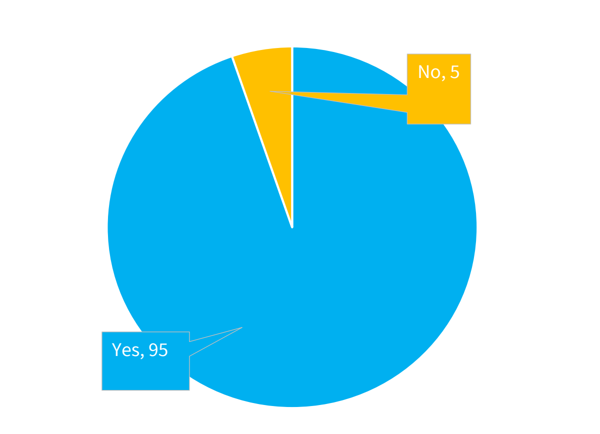
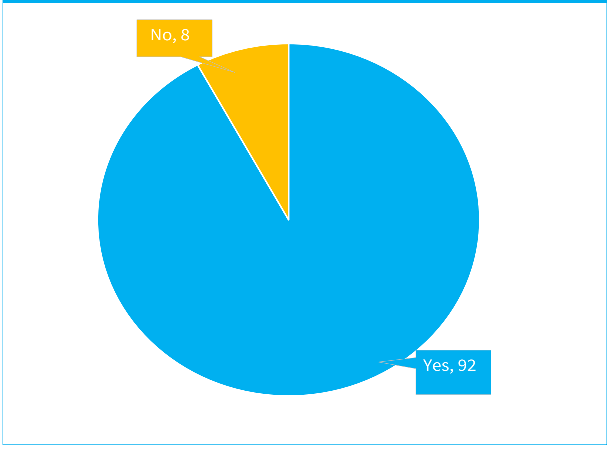


Chart 14: Banks that assessed the likely impact of IFRS 16 (%)



2.9.1 Impact of IFRS 16 on Banks' Financial performance and position

- Most banks indicated that implementation of IFRS 16 increased their risk weighted assets, which has in turn decreased their capital adequacy ratios. It also has a negative impact on the banks' retained earnings.
- This called for capital injection to strengthen the banks' capital adequacy.

2.9.2 Challenges experienced in the Implementation of IFRS 16

- Most banks indicated that the major challenge they face in implementation of IFRS 16 is cost of training their staff for compliance with the standard.
- As a mitigation measure, banks indicated that they are implementing the following: -
  - i) Updating and amortization of lease schedule especially when the bank enter into new leases.
  - ii) Determination of the Effective Interest Rates (EIR) especially due to the volatility in interest rate movements.
  - iii) Continuous review of leases for renegotiation and ensuring that the lease terms are reasonable.

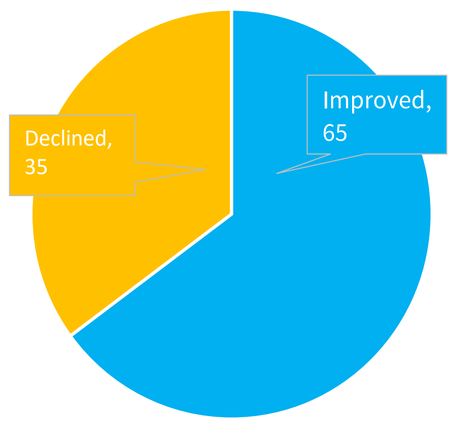
2.10 Liquidity Risk

- During the quarter ended March 31, 2021, liquidity in the banking sector increased from 54.6 percent in December 2020 to 56.3 percent in March 2021. The ratio remained above the minimum statutory ratio of 20 percent.
- Banks whose liquidity deteriorated in the last two quarters intend to solve this by: -
  - i). Mobilizing deposits from the general public.
  - ii). Enhanced loan collections and recoveries.
  - iii). Sourcing for strategic investment partners.

2.10.1 Commercial Banks' liquidity positions

- During the quarter ended March 2021, 65 percent of the respondents indicated that their liquidity position had improved as indicated in **Chart 15**.

Chart 15: Movement in liquidity risk (%)



- As indicated in **Chart 16**, with the improved liquidity, it is expected that in the second quarter of 2021, issuance of credit will increase as most banks intend to deploy the additional liquidity towards lending to the private sector (29 percent), investing in Treasury Bonds (25 percent), investing in Treasury Bills (20 percent), interbank lending (14 percent), CBK liquidity management through repos (7 percent), and increase their cash holding (4 percent).

2.10.2 Factors that led to improved liquidity over the first quarter of 2021

During the quarter ended March 31, 2021, liquidity improved mainly as a result of: -

i). Increased deposits (47 percent),
ii). Maturity of government securities (24 percent),
iii). Loan recovery (18 percent), and
iv). Capital injection (7 percent).

- The drivers of improved liquidity are indicated in **Chart 17** below.

Chart 16: Plans with improved liquidity (%)

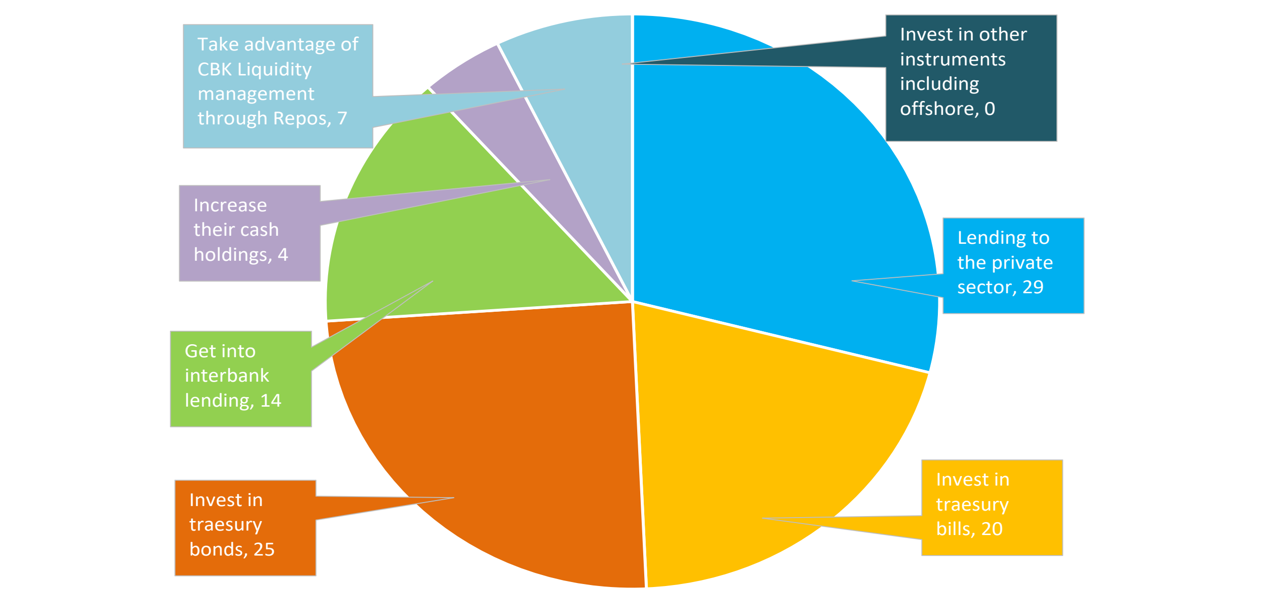
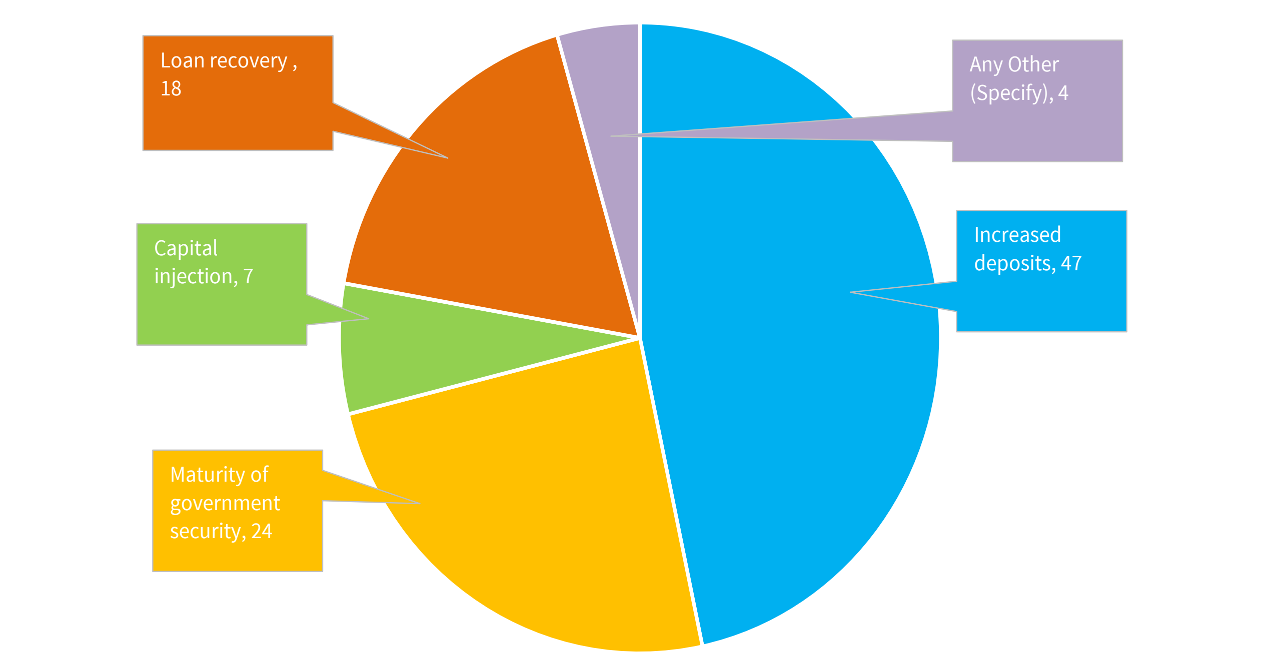


Chart 17: Reasons for improved liquidity (%)



2.10.3 Commercial Banks' interbank activities during the quarter

- During the quarter ended March 31, 2021, 54 percent of the respondents indicated that their interbank lending activities decreased. This is indicated in **Chart 18** below.
- 74 percent of the respondents indicated that their interbank borrowing decreased. This is indicated in **Chart 19** below.
- Interbank lending and borrowing have generally decreased due to tightening of credit standards by institutions.

Chart 18: Increase in interbank lending(%)

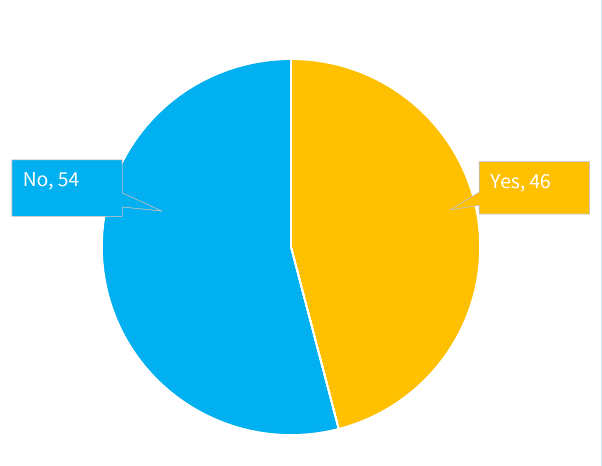
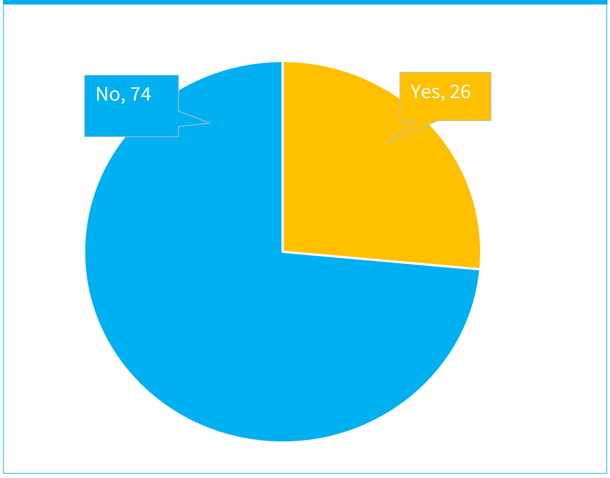


Chart 19: Increase in Interbank borrowing (%)



2.11 Impact of the Global Coronavirus Pandemic on the Banking Sector

The ongoing COVID-19 pandemic has devastated many countries, with significant human, economic and social costs. The global economic outlook has been highly uncertain, with unprecedented volatility in the financial markets.

The adverse effects of the pandemic on the Kenyan economy is already evident that the impact may be severe. In this regard, CBK through the credit survey assessed the impact of the pandemic on the banking sector.

The survey covered areas relating to:

i) Impact of the pandemic on the banks,
ii) Measures taken by banks to curb the potential impact of the pandemic; and
iii) Banks' experience in implementing the emergency measures introduced by CBK to mitigate the impact of the pandemic.

2.11.1 Impact of Coronavirus (COVID-19) pandemic on the banks

The commercial banks have indicated that the pandemic had an impact on their business. Some positive impacts include:

- Financial services classified as essential services.

- Increased use of digital platforms (Mobile and internet banking) and an opportunity for banks to revamp their delivery channels.

- Increased demand for lending to Fast Moving Consumer Goods (FMCG), health and technology companies.

Some of the adverse effects include:

- Reduction in earnings due to likelihood of additional provision and low loan revenue due to reduction in lending rates.
- Banks have had to absorb significant operational costs in extending forbearance credit support in terms of payments holidays and restructures for affected customers, this has led to deterioration of core capital position.
- Increased expenditure. Banks have been compelled to purchase Personal Protective Equipment (PPE) for staff as well as ensuring that their premises are well fumigated.
- Increased Non-Performing Loans, which may be attributed to slowdown in business, business closures and job losses.
- Decreased loans advanced to customers as banks become more cautious due to the high risk of credit default.

Some of the key risks increased by the pandemic include:

- **Credit risk**: Due to increased requests from clients to avail moratorium on their facilities, non-performing loans are likely to increase with uncertainty on when the economic and COVID-19 pandemic situation will improve.
- **Operational risk**: Need for enhanced business continuity plans given risk of COVID-19 infection of bank staff.
- **Cyber security risk**: Due to increased use of digital banking.

2.11.2 Measures taken by banks to curb the potential impact of coronavirus pandemic on its business

Commercial banks have put in place the following measures to curb the potential impact of the pandemic:-

- Banks have implemented their Business Continuity Plans (identification of critical processes critical staff and their back-ups).
- Granting client requests on loan moratoriums depending on sectors.
- Banks have put in place work rotation plans for all staff members and automated their processes to ensure social distancing.
- Banks have assessed the various industries and the expected impacts thereon and are reaching out to the affected customers to discuss restructures to manage the situation.
- Banks have tightened their credit standards on granting of new loans to enable the assessment of the impact of the pandemic in each industry.
- Banks are actively reaching out and working with customers to understand their constraints caused by the pandemic and offering a number of reliefs including restructuring of facilities and providing moratoriums on both interest and principal where necessary.
- Giving payment holidays to the customers who have been adversely affected by the pandemic. This will enable them stay afloat and eventually be able to recover and get back to businesses
- Supporting customers with working capital financing to cover the increase in working capital gap (due payments to suppliers and fixed costs) attributed to slowdown in sales revenue/no revenue.
- Continuous portfolio monitoring for early warning signs to ensure quality of the asset book.

2.11.3 Impact of implementing the emergency measures introduced by CBK to mitigate the impact of the Coronavirus Pandemic

The emergency measures issued by CBK along with their impact on the banking sector include: -

i. **Lowering the Central Bank Rate to 7 percent:** Whereas the intention was to encourage lending, due to disruption of the country's economy by the pandemic, there is reduced appetite for borrowing and lending.

ii. Majority of the banks indicated that **lowering the Cash Reserve ratio to 4.25 percent** availed more funds for onward lending to Micro, Small and Medium Enterprises MSME's. Further, the funds assisted in balancing the banks liquidity position now that most clients are asking for relief and moratorium

2.11.4 Suggested proposals to further mitigate the impact the Coronavirus Pandemic

- The respondents made proposals for CBK to consider to further mitigate the impact of COVID-19. In summary, the banks have noted that there is need for CBK in conjunction with the National Treasury to come up with other specific measures that particularly cushion institutions. This could be in form of :-
  i. Additional funding to be offered at concessionary rates to the commercial banks.
  ii. Credit Guarantee Schemes.

LIST OF RESPONDENTS

1. Absa Bank Kenya Plc.
2. Access Bank (Kenya) Plc.
3. African Banking Corporation Ltd.
4. Bank of Africa Kenya Ltd.
5. Bank of Baroda (K) Ltd.
6. Bank of India.
7. Citibank N.A Kenya.
8. Consolidated Bank of Kenya Ltd.
9. Co-operative Bank of Kenya Ltd.
10. Credit Bank Ltd.
11. Development Bank of Kenya Ltd.
12. Diamond Trust Bank (K) Ltd.
13. DIB Bank Kenya Ltd.
14. Ecobank Kenya Ltd.
15. Equity Bank Ltd.
16. Family Bank Ltd.
17. First Community Bank Ltd.
18. Guaranty Trust Bank (Kenya) Ltd.
19. Guardian Bank Ltd.
20. Gulf African Bank Ltd.
21. Habib Bank A.G Zurich.
22. HFC Ltd.
23. I & M Bank Ltd.
24. Kingdom Bank Ltd.
25. KCB Bank Kenya Ltd.
26. Mayfair Bank Ltd.
27. Middle East Bank (K) Ltd.
28. M Oriental Bank Ltd.
29. National Bank of Kenya Ltd.
30. NCBA Bank Kenya Plc.
31. Paramount Bank Ltd.
32. Prime Bank Ltd.
33. SBM Bank Kenya Ltd.
34. Sidian Bank Ltd.
35. Spire Bank Ltd.
36. Stanbic Bank Kenya Ltd.
37. Standard Chartered Bank (K) Ltd.
38. Victoria Commercial Bank Ltd.
39. UBA Kenya Bank Ltd.

Central Bank of Kenya

Haile Selassie Avenue P.O. Box 60000 - 00200 Nairobi |Tel: (+254) 20 - 286 0000 / 286 1000 / 286 3000

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