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Special Report

Capping of Interest Rates in Kenya.
"What next for the banks?"

The year 2016 is clearly hardly done with its surprises (what with BREXIT) with the latest unexpected happening being the assenting of the Banking Amendment Act 2015 that seeks to cap interest rates in Kenya by President Uhuru Kenyatta . Read the full statement **here**

What exactly happened?

The National Assembly passed the Banking (Amendment) Bill 2015 on July 28th 2016 seeking to introduce a cap on interest rates that banks charge on loans and pay on deposits. According to the Bill,

> " A bank or a financial institution shall set-
> the maximum interest rate chargeable for a credit facility in Kenya at no more than four per cent, the base rate set and published by the Central Bank of Kenya; and
> the minimum interest rate granted on a deposit held in interest earning in Kenya to at least seventy per cent , the base rate set and published by the Central Bank of Kenya.

This is the third time that a similar attempt has been made, the first being in 2001 and the second in 2011, with both occasions of course not bearing any fruits. The issue of lower rates forms part of the manifesto of the governing Jubilee party. Noting that next year Kenya will be having its General Elections, we feel that the president's assent was more of a political move than anything else.

What next?

The Bill is expected to be published in the Gazette as an Act of Parliament within seven days after assent. The Act of Parliament comes into force on the fourteenth day after its publication in the Gazette unless the Act stipulates a different date on or time at which it will come into force. We expect a more clearer directive from the Cabinet Secretary Finance detailing the whole process and date of its coming into effect, as well as what happens to existing loans bearing in mind the existing contractual agreements.

	KCB Bank	Equity Bank	Co-op Bank	Barclays Bank*	Stanchart Bank	DTB Bank*
Yield on interest earning assets	13.0%	14.0%	14.0%	11.7%	11.2%	13.8%
Cost of funds	4.0%	2.7%	4.8%	3.1%	3.0%	6.0%
NIM	**9.0%**	**11.3%**	**9.2%**	**8.6%**	**8.2%**	**7.8%**
Non-interest to total income	**31.6%**	**33.8%**	**32.1%**	**32.2%**	**31.3%**	**20.5%**
Cost to income ratio	47.9%	49.6%	45.3%	51.9%	48.4%	41.7%
NPL ratio	9.1%	4.7%	4.6%	4.3%	13.3%	3.9%
ROaE	23.1%	27.0%	25.4%	21.3%	24.0%	21.1%
EPS	6.86	4.99	2.63	1.56	21.65	25.19
NAV	29.67	19.80	11.93	7.79	115.79	132.03
DPS	2.00	2.00	0.80	1.00	12.50	2.50
P/E	4.8	7.2	5.0	6.2	9.6	6.3
P/B	1.1	1.8	1.1	1.2	1.8	1.2
Price	32.75	36.00	13.25	9.70	207.00	159.00
YTD % return	**-21.9%**	**-4.8%**	**-23.0%**	**-22.4%**	**23.3%**	**-4.8%**

* Barclays Bank and DTB Bank stats are based on 1Q16 earnings

Source: ApexAfrica estimates

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What will be the implication of the new law to the banking sector?

On lending..

The whole idea of having floating rates is to allow banks to cushion themselves for taking on risk by charging premiums that are commensurate to the risk undertaken. While interest rates have been relatively higher than the SSA average, the countries within the East African region pretty much mirror each other with respect to the macroeconomic indicators, including interest rates. No doubt, the spreads have been undoubtedly relatively high as indicated by an average NIM of 7.4% for the entire sector in FY15, with the 6 Tier 1 banks recording a NIM of 9.2% and Equity Bank leading the pack with a 12.3% Net Interest Margin. However, a look at the portfolios handled by these banks would explain why Equity Bank spreads would be that high, given that 82% of its loans are lent to the high risk SME sector and 76% of deposits being current and savings accounts mostly from retail customers and SMEs which attract low rates.

Capping interest rates would result in the following:

- increased lending (volume over margin) causing a significant rise in NPLs and consequently increased provisions,
- increased investment in processing loans which would result in higher overheads and a longer duration for the whole loan processing cycle or
- lending only to customers with a good repayment potential.

All these three instances would result in margin erosion for the banks.

As such, the sensible thing to do would be to restrict lending to customers whose risk margin would be adequately covered by the rates stipulated by law, which currently would be 14.5%. That said, most of the mid to low tier banks are exposed to high risk customers, so what happens to them?

We therefore expect to see the following:

- Reduced lending as the banks reevaluate their strategies. We believe it will be a quiet period for banks at least for the next few months as they evaluate how best to tackle the new development. We therefore expect this to impact 2H16 performance.
- A consolidation of the banking sector may finally be happening as most of the smaller banks will not be able to survive given that their cost of funds is extremely high and capping lending rates would most probably render their operations loss making.

The question that begs though is what will happen to existing loans. Noting the contractual agreements in place, we think the new law would only affect new borrowings. We may then see banks trying to grow their portfolios by attracting new customers (the less risky ones) through offering to refinance their existing loans with other banks.

On deposits..

Banks with largely retail oriented deposits will get hit the hardest given that corporate accounts already earn high rates that are pegged on the T-bill.

Which bank will get affected the most?

Equity Bank:

As of 1H16, 42% of Equity Bank's deposits comprised of savings accounts, and 24% fixed deposits, implying that 66% of its deposits would automatically demand a minimum of 7.35% deposit rate compared to the average cost of fund of 2.7% reported in 1H16.

Co-op Bank:

With only 33.0% of its total deposits being current accounts, the bank may face significant cost increases once it is forced to reprice the 67% of the deposits which are interest earning. Co-op Bank management pointed out during the 1H16 investor briefing that should the bill be passed, its NIMs (currently at 9.2%) would decline by 40% further reiterating our concerns.

Which bank would least feel the impact?

- Banks that are more reliant on corporate/wholesale deposits including CFC Stanbic and Stanchart Bank
- Banks with a smaller portion of interest earning deposits such as KCB Bank and Barclays Bank
- Banks with a huge chunk of high net worth deposits and are already paying relatively high rates for those deposits. Case in point DTB Bank.

KCB Bank:

We note that as of 1H16, only 34% of KCB Bank's deposits were interest earning and out of this, 42% was from corporate accounts (meaning that they were already earning high rates). This is quite a small chunk compared to its peers but at the same time, we do not underestimate the impact that an upward revision of deposit rates would have on the bank's margins.

DTB Bank:

With a predominantly high SME and high net worth clientele, DTB's interest earning deposits account for 70% of total deposits. The bank's cost of funds at 6.0% is the highest in the Tier I space. This would imply that the bank is already compensating its depositors at rates that are higher than the average rates and implementation of the new law result in a much less impact on its cost base.

How does this affect the economy?

Government borrowing remains substantially high in Kenya further exacerbating the high interest rate problem. In an auction conducted recently for the 10 year bond, the government accepted 70% of the bids at an average rate of 15.267%. This implies how desperate the government is for financing. Would it then not be only sensible to conclude that banks will revert to lending to the government which is desperately in need of cash, and avoid the risky private sector as much as possible? According to 2015 stats, government domestic debt accelerated 156.5% y/y to KES 524.1B, accounting for 18.8% of total credit while private sector credit grew 18.0% to KES 2.2T to account for 79.6% of total credit.

Of course as banks divert most of their assets to government securities, the government will be spoilt for choice which may see rates decline like they did in the first half of the year. But since we know the government's appetite is huge, an uptick will be imminent.

The bulk of lending to the private sector in 2015 was to the wholesale and retail sector (13.5%), personal services (12.9%), manufacturing (10.4%) and real estate (10.1%). Reduced private sector credit will result in constrained economic growth which means that the country may not be able to achieve the 6.0% growth rate estimated for 2016.

How will listed banking stocks react upon market opening tomorrow?

We expect a slide in banking sector stocks once the market opens tomorrow owing to uncertainty over the impact that the new law will have on the performance of the different banks. This should however self correct in the medium term as banks reevaluate their strategies and communicate the same with investors.

We believe that banks with diversified income and exposure to regional markets will aggressively pursue growth in the two to enhance bottom line performance. Overall, while we think capping of interest rates may have a major impact in earnings growth in the near term, we remain bullish on the Tier I banks (KCB Bank, Co-op Bank, Equity Bank and DTB Bank) over the long term. We however advice investors to adopt a wait and see approach.

Appendix

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