

INTEREST RATE CAPPING BY THE CENTRAL BANK OF KENYA ON LOANS UPTAKE

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ABSTRACT

The rate of interest charged on loans and advances which makes banks earn interest income and the rate of interest paid to depositors, which translates to the cost of funds both have a significant impact on the performance of any commercial bank. This study sought to determine the effects of Interest Rate Capping By The Central Bank Of Kenya On Loans Uptake. The capping law took effect on 14th September 2016 as a result of the numerous issues raised by the public with regard to the cost of credit. The law stipulates that the lowest rate banks can offer on deposits is 70% of the CBR and the lending rate at 4% above the CBR. This study had three specific objectives: To establish the effect of interest rate capping on credit uptake performance of commercial banks In Kenya; To identify the effect of interest rate capping on profitability of commercial banks in Kenya; To investigate the effect of interest rate capping on the portfolio of non-performing loans on commercial banks in Kenya. The descriptive research design was utilized in the study. The study targeted the 36 licensed commercial banks out of the 43 registered

ones, leaving out 6 commercial banks which are either acquired by other banks, under receivership or statutory management. Secondary data capturing the performance of the commercial banks over the period 2015-2017 was obtained from published financial statements, CBK publications and journals, World Bank Journals and relevant Government Ministries. The data obtained from the study environment was analyzed through descriptive statistics and inferential statistics by use of SPSS version 16. The findings of the study established that credit uptake increased following the introduction of the capping law. This was mainly due to issuance of loans to large borrowers. The profitability of the banks in the period under review increased. In addition, the non performing loans portfolio also increased. The study concluded that interest rate capping positively affects performance of commercial banks. The study recommends that the Central bank and the Government through the ministry of Finance should come up with policies that benefit banks, large and small borrowers.

Key Words: *interest rate capping, central bank of Kenya, loans uptake*

INTRODUCTION

Interest rate capping is a form of government control in the financial sector. Over the recent years, there has been a decline on the number of countries using this form of control mainly because most countries are aiming at having liberal financial policies. There are several reasons why governments may opt to use interest rate caps, most of which are political and economic. One of them could be to support an industry or sector where there is a market failure or in areas where a greater financial resource is needed. Market failures usually result from market information asymmetries, moral hazards, adverse selections or the inability of financial institutions to differentiate between high risk and low risk clients. Therefore according to Miller

(2013), interest rate caps are a useful tool to support a sector until it's able to sustain itself. Since the capping of interest rates has a tendency to distort the market and cause adverse biases, financial institutions tend to favor their lending to low risk clients which in turn leads to inefficiencies in the financial intermediation process.

According to Ramsey (2013), this discrimination leads to a situation where those in dire need of financial assistance being locked out of the available finances because they are considered high risk. Financial institutions can however still remain profitable in the midst of interest rate capping by the government by venturing into other sources of income such as non-funded income as well as cutting their costs. Restrictions brought by the capping of interest rates may lead into alternative lending by the financial sectors such as lending to the government and in extreme cases where the capping may become unprofitable, banks and microfinance institutions may withdraw from certain locales such as rural areas or from expensive market segments because they cannot cover their costs. This scenario in turn leads the low income, high risk borrowers to turn to shylocks and other unlicensed money lenders for funding and too often these loans come at a very high cost. According to evidence, interest rate caps on loans discourage microfinance non-governmental organizations (NGOs) and other sources of finance for the poor from converting into licensed financial institutions (Helms and Reille, 2004).

On 14th September 2016, the interest rate cap law came into effect, aiming at making credit affordable to the 'common man'. The law puts a ceiling on lending rate by banks and other financial institutions to at most 4% above the Central Bank of Kenya (CBK) base rate, known as the Central Bank Rate (CBR). This was because of high cost of borrowing which deterred access to credit by a large section of the population and persistently high interest rate spreads. In early 1990s, Kenya's financial sector was liberalized to allow market-driven interest rates. Financial sector liberalization should result in narrow interest rate spreads through competition. Despite this, interest rate spreads in Kenya were way above 10% even in the post-liberalization period.

The banking sector in Kenya is 'oligopolistic' in nature. With 42 licensed commercial banks, a significant share of the market is dominated by five (5) large banks. The few large banks are perceived to be stable and account for over 50% of the market share (deposits and loans). Therefore, they can attract large deposits at low deposit rates and many loan applications at higher rates, resulting in higher spreads. Such market 'inefficiencies' may warrant government intervention, which can be directly by being a player in the market or indirectly through legislation. This is meant to protect consumers in most cases and to ensure macroeconomic stability. Consequently, the government intervened to correct the inefficiencies in the financial sector by making into law, the Bill that caps interest rates.

RESEARCH PROBLEM

Interest rate capping is one of the oldest and mostly recurring government intervention methods in the financial market. Usury laws, which is currently replicated in interest rate control was in practice even in ancient Egyptian government. Aristotle, one of the early advocates of interest rate control argued that money was sterile and thus should not earn interest (Hester & Benjamin, 2016). Milton Friedman in his argument was against all form of control by government. He stated that any form of control would bring shortage and he gave an example of price fixing on tomatoes which he went ahead and concluded that such move would cause shortage. Government intervention on any form of control distorts market forces and the results are not very much predictable. The prevailing average interest rate in 2016 was 18.5% and the law set it at no more than 4% of the CBK rate. This meant that the capping slashed the interest rate by 4.5% a big hit on the banks revenue. The government intervenes in the market when it perceives that the interest rate being charged is excessive and may not foster its growth target. Interest rate capping is perceived as welfare enhancing in that individuals will get access to credit at lower and less burdensome rate and will be able to improve their lives cheaply (Hester & Benjamin, 2016). On the wake of high interest rate charged by commercial banks in Kenya, the legislature wanted to reign on the banks by limiting them on interest rate chargeable. The parliament successfully passed the bill and president assented on the bill to become law which came into force in September, 2016. The move was widely condemned by banks, the IMF and the Central Bank governor was against the law from the onset of it. He argued that, while it was very clear that the interest rate at the time were high, there were other tools available which could better cure the problem other than legislation which could bring other shocks to the economy. The legislators and the executive arm of the government were adamant that only legislation was going to instill discipline among the commercial banks by reducing the interest rate to socially acceptable level. The proponents of interest rate capping cited other countries Zambia, South Africa, North African countries and other bigger economies like Germany and USA who had some form of interest rate controls and were still doing well economically (Maimbo & Gallegos, 2014). The policy makers hoped that the reduction in interest rate would open up credit facilities to the poor and the other vulnerable groups by making it affordable. This would spur growth across the economy as the cost of capital would be lower and liquidity issues among companies would be reduced significantly. Consequently, indebtedness and the vicious circles of poverty among the households and companies were going to be reduced as funds could be cheaply accessed (Happy, Gerhard & William, 2002). The positive performance of businesses forecasted as a result of availability of affordable credit would bring more employment opportunities and hence better living standards. There are mixed results on effects of interest rate capping on availability of credit from researches already done. Bekaert, Harvey & Lundblad (2001) indicated that governments had been letting go interest rate capping to liberalize their financial policies so as to make financial markets more accessible and have positive growth, productivity and reduce poverty levels. This is to suggest that there were more benefits from opening up business control from the government intervention. According to Demitriades & Luintel (2001) interest rate caps

were successful in Republic of Korea between 1956 and 1994 and financial liberalization afterwards did not significantly increase the financial inclusion. Howard (2013), found that interest rate caps was a good policy for government where insufficient credit is being provided to a particular industry that is of strategic importance to the economy, but only as a short term measure. He went further to state that as far as the caps were high enough to ensure profitable banking industry, the interest rate control ensured fairness and protected consumers from usury. Galindo, Schiantarelli & Weiss (2007) advised that liberalizing the financial functioning of an economy like reduction of interest rate control improved efficiency in investment most of the times. Introduction of interest rate caps has also seen some banks exiting the 9 markets or rationing credit by extending such services to less risk borrowers. A study done by the World Bank in 2014 on effectiveness of interest rate caps returned negative results on its ability to ensure financial inclusivity and availability of credit save for some instances in the USA. In the wake of these conflicting findings on the relationship between interest rate caps and availability of credit, it is worth examining what the Kenyan economy has taught us so far. The study will return results on whether the government has achieved its objectives of ensuring availability of affordable credit in the economy. Having examined the experiences in other countries across the globe, a study of Kenyan scenario will corroborate or contradict findings of those other researches. This research paper will examine the interest rate capping by the central bank of Kenya on loans uptake of the banks listed on the Nairobi Securities Exchange.

OBJECTIVE OF THE STUDY

The overall objective of this study is to establish the effect of interest rate capping by the central bank of Kenya on loans uptake of the banks listed on the Nairobi Securities Exchange.

SPECIFIC OBJECTIVES

1. To establish the effect of Interest rates on loans uptake a case of banks listed on the Nairobi Securities Exchange.
2. To find out the effect of Level of Deposits on loans uptake of the banks listed on the Nairobi Securities Exchange.
3. To establish the overall effect of Inflation on loans uptake of the banks listed on the Nairobi Securities Exchange.
4. To find out if the Size of the Bank on loans uptake of the banks listed on the Nairobi Securities Exchange.

THEORETICAL REVIEW

Classical Theory of the Rate of Interest

This theory was initially advanced in the early 1930's by the economist Marshall and Fisher, and was later on propagated by others such as Pigou, Taussig and Knight. The rate of interest is regarded as the factor bringing about the willingness to save, as well as a demand for

investments into a state of equilibrium with each other. This therefore implies that when savings exceed investments, the interest rates will fall, and when the investments exceed the savings, interest rates go up. Gorder (2009) argued that the Increase in interest rates, which is the reward for savings, will drive savings up. Caplan (2000) pointed out that the equilibrium point of interest rates is established at that point at which the supply and demand for capital are equal. Keynes however offered criticism of this theory of interest rates. He pointed out that the assumption by Marshall and Fisher that the level of income was given was erroneous. According to Keynes, income is not a constant but a variable, and that equality between investments and the saving levels can be established by the changes in the levels of income, and not due to the variations of interest rates. Rochan and Vernengo (2001) argued that if the classical theory of interest rates holds true, banks that are highly liquid should offer credit at lower interest rates since savings exceed investments, and thus a need to attract customers, where else banks which have low liquidity should offer credit at higher interest rates since investments far outweigh savings, and the high interest rates would act in discouraging high borrowing, and all this would help in the mechanism of establishing an equilibrium position in the market or economy.

Loanable Funds Theory

This was a theory advanced by the Swedish economist Knut Wicksell that seeks to differ in part with the classical theory of interest rates and thus offered improvements on the classical theory of interest rates. This theory states that the relationship between quantities of loanable funds demanded and the interest rates is inverse in nature. The rate that brings about an equality between the supply as well as the demand of loanable funds can be defined as the equilibrium interest rate. This theory sought to improve the earlier classical theory of interest rates by arguing and recognizing how important hoarding as a factor affects interest rates. The theory also tried to link together investments, savings, and quantity of money and liquidity preference. The theory also took into consideration the role that bank credit will have as an important source of loanable funds. This theory sheds light and takes into account both aspects of the problem, be they monetary or non-monetary. Ngugi (2001) points out that interest rate is that price which brings about an equity in the supply as well as the demand of loanable funds, thus establishing an equilibrium point. There are three primary or key sources for the demand of loanable funds, i.e. the government, businessmen and consumers. Funds may also be demanded for purposes of hoarding, in both forms, liquid and cash. Savings help in the supply of loanable funds, as well as dis-hoarding and credit from the bank. If interest rates are high, there is a higher incentive to save and vice versa. This theory also applies as well to bank credit or money as more credit is issued at a higher than at a lower rate of interest. Saunders (2010) argued that the interest are determined similarly to how the economy determines the demand and the supply of goods and services. Accordingly, assuming all other factors are held constant, then as when supply of loanable funds goes up, interest rates will also go up. Saunders (2010) goes further to argue that as the interest rates fall, demand for loanable funds increases, and the demand going down as interest rates rise up. Olokoyo (2011) explains the attendant risks of commercial banks having to

set very high rates of interest in order to optimize their returns from lending. Commercial banks will induce the problem of adverse selection and moral hazards by setting high interest rates. The effects that this has is that banks attract borrowers who have very risky projects into their portfolio. Ngetich and Wanjau (2011) argue that interest rate control help to keep in check how much spread banks will enjoy, and this goes a long way in keeping a control on the moral hazards associated with nonperforming loans.

Efficient Markets Hypothesis

For many years, the Efficient Market Hypothesis (EMH), has been considered one of the most important and central propositions in finance. Markowitz introduced the theory in 1952, and subsequently Fama advanced it in the 1970's. According to this theory, financial markets efficiencies exists, and this enables all the stock prices to reflect all relevant information, thus rendering it nearly impossible for an investor to "beat the market". Information that is correct is of profound importance to investors in a market, and this information is of great importance to investors in forming expectations, as well as in making investment returns (Samuelson and Fama, 1965). According to Fama, there are three forms of market efficiency. First there is the Weak form of market efficiency whereby only historical information is the only information available in a market to the investors. Both public and private information may not be available in the market to the investors. Secondly, there is the Semi-strong form of market efficiency, whereby additionally to the historical information and data available to the weak form, there is also public information now available to the market. Finally, in the Strong form, we now have historical, public, as well as private information being available in the market. Thus in such a scenario, insider information is of no benefit, since the markets will reflect all the information relevant to a given security.

RESEARCH METHODOLOGY

This study adopted a descriptive research design. According to Mugenda and Mugenda (2003), descriptive research is a process of collecting data in order to test hypotheses or to answer questions concerning the current status of the subjects in the study. A descriptive study determines and reports the way things are. The choice of the descriptive study design is based on the fact that the research will be interested on the state of affairs already existing in the field and no variable was manipulated. This study therefore generalized the findings to a larger population.

RESEARCH RESULTS

Interest Rate Levels and Spread

Both interest rate and spread have significantly decreased after the cap. The interest rate for commercial banks loans and advances fell from 17.66% in August 2016 to an average of 13.7% between September 2016 and December 2017, which was 3.7% above the CBR of 10%. Further, with the CBR lowered to 9% in July 2018, the interest rate dropped slightly to an average of

12.8% in August 2018. The cap has resulted in lower interest rate spread from 11.2% in August 2016 to 4.9% in August 2018. This is evidenced in lower lending rates and increase in deposit rates from 6.4% in August 2016 to 7.9% in August 2018.

Non-performing Loans

The ratio of non-performing loans (NPLs) to gross loans has generally increased across all economic sectors. NPLs in the trade sector increased from 12.7% in the second quarter of 2016 to 20.9% in the second quarter of 2018, the largest among the economic sectors. Before being overtaken by the trade sector, building and construction generally had the largest share on NPLs from the first quarter of 2016 (17.2 %) to the first quarter of 2018 (20.6 %), which is attributed to delayed payments by both the private sector and government. NPLs have generally been on an upward trend in all the key economic sectors with a sharp rise witnessed in the first two quarters of 2018. The trend is mainly attributed to delayed loan repayments resulting from slowdown in business.

Profitability

Interest rate cap has resulted in a decline in commercial banks' profits. Many commercial banks recorded decreased profits resulting from reduced interest rate spreads. In 2017, the average pre-tax profit for commercial banks was Ksh 73.39 billion compared to Ksh 85.35 billion in 2016, a 14% drop. However, in 2018, profitability in the banking sector has improved owing to a decrease in general expenses. Pre-tax profits increased by 2.1% between the first and second quarter of 2018. Similarly, pre-tax profits increased by 3.2% from Ksh 36.5 billion in the fourth quarter of 2017 to Ksh 37.7 billion in the first quarter of 2018.

Interest vs. Non-interest Income

Non-interest income rose while interest income fell. To compensate for the decline in profits, commercial banks resorted to measures to increase their non-interest incomes. Consequently, they increased their commissions and fees, introduced new charges such as loan insurance on overdrafts and increased investments in government securities. For example, net fees and commission income increased by 35.8% in 2017 compared to 7% in 2016 for Equity Bank and 16.4% in 2017 compared to 10.3% in 2016 for KCB Bank. Net interest income for Equity Bank fell by 16.4% in 2017 compared to an increase of 23.3% in 2016 while for KCB Bank, it grew by only 2.9% in 2017 compared to 19.7% in 2016. Overall, non-interest income for commercial banks increased from 12.4% in September 2016 to 15.2% in June 2017, implying a shift to non-interest income. Further, the share of interest income in total operating income declined to 68.5% in December 2017 from 71.2% in December 2016 while non-interest income rose from 28.8% in December 2016 to 31.5% in December 2017.

Demand for Credit

Demand for credit shot up immediately after the cap before taking a downward trend in February 2017. The ratio of advances to deposit rose from 85.7% in September 2016 to an all-time high of 89% in January 2017 after which it took a downward trend and to 79% in June 2018 owing to tighter financial conditions.

Credit Growth and Structure in Key Sectors

Growth of commercial bank credit to various sectors improved in the first two quarters of 2018 compared to 2017. In the first quarter of 2018, building and construction, finance and insurance, households and business services sectors recorded positive demand for credit compared to the same period in 2017 which was negative. Agriculture, and mining and quarrying sectors recorded negative growth rates in demand for credit in the first quarter of 2018. However, this was an improvement compared to a similar period in 2017. In the second quarter of 2018, other than mining and quarrying that had a decline of 8.4%, all the remaining ten economic sectors had a growth in credit, better than the performance in the same period of 2017 and reflecting recovery in private sector credit. It is expected that interest rate cap will have little effect on demand for credit in the third quarter of 2018.

Trend in Private Sector Credit

Growth in private sector credit has declined since the law came into effect. However, the effects were more severe in 2017 than 2018. The annual growth of credit to the private sector between the year 2016 and 2017 reveals significant disparities. For example, growth in credit to the private sector in January 2016 was 17% compared to 4.4% in the year 2017; in July 2016, it was 6.4% compared to 1.4% in 2017. Small borrowers were the most affected due to increased risk mitigation measures which have led to tightening of credit standards by commercial banks. The financial sector is, however, revealing signs of recovery with growth in credit to private sector in 2018 showing greater improvements compared to 2017. Other than implementation of interest rate ceiling, the decline in private sector credit is also attributed to other factors, namely: liquidation of three commercial banks namely Chase Bank, Dubai Bank and Imperial Bank and prioritization of loan recovery by banks. Despite the cap, growth in total domestic credit in 2017 was higher than in 2016. Even with the decline in credit to the private sector, total domestic credit grew by 7.9% in 2017, 1.5% higher than in 2016. This is specifically attributed to a 12.1% growth in credit to the national government, implying that the growth in credit to national government was stronger than the decline in credit to the private sector. Further, the share of national government credit in total domestic credit grew from 20% in 2016 to 24% in 2017 while the share of private sector credit fell from 77% in 2016 to 73% in 2017.

Economic Growth

Overall economic performance in Kenya worsened in 2017, partly attributed to a fall in private sector credit. In countries with efficient banking sector, access to credit by the private sector is likely to promote economic growth as it results in stimulation of economic activities. Economic growth as measured by real GDP decreased from 5.8% in 2016 to 4.9% in 2017. This is linked partially to the effects of poor weather conditions, prolonged electioneering period and a decline in growth in credit to the private sector. Limited access to credit by the private sector is likely to reduce private sector investments, which can have adverse effects on growth.

In 2018, the economy has been on a positive trajectory and portraying signs of recovery. Quarterly GDP growth rates in 2018 are higher than those of 2017. For example, in the first two quarters of 2018, the economy grew by 5.7% and 6.3%, respectively, compared to 4.7% in similar quarters in 2017. Improved economic performance in 2018 can be partially attributed to increased uptake of bank credit by manufacturing, construction and service sectors.

CONCLUSION

The interest rate cap brought some negative effects on the general economy, with the effects more severe in 2017 than in 2018. However, some recovery has been witnessed in 2018 with increases in growth of credit to the private sector, and general economic growth. Market power in the banking sector is likely to influence interest rate spreads, with the few large banks likely to have the advantage. Nevertheless, the law has generally succeeded in bringing down interest rate spreads. The CBK needs to be granted exclusive powers to implement both the monetary policy rules in Kenya and come up with policies that ensure competitive and efficient banking industry.

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