Kingdom Securities Limited

Interest Rate Caps

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Finance Bill 2019 - Interest Rate Cap Law – Repeal or Not to Repeal Section 33B: The president refused to assent in to law the Finance Bill 2019 which had been passed by the national assembly on the September 26th, 2019. The president requested the parliament to retract the Interest Rate Cap Law which was introduced in September 14th 2016 through section 33B of the Banking Act.

The president raised the following issues

i. Reduction of Credit to the Private Sector and especially MSMEs.
ii. Decline in economic growth
iii. Weakening in effectiveness of monetary policy
iv. Reduction of loans and advances
v. Mushrooming of shylocks and other unregulated lenders in the financial sector
vi. Effects in the banking sector:
    a. Withdrawal of lending to specific sectors
    b. Increase in average loan size- lower access to small borrowers and larger loans to more established firms
    c. Decrease in diversity on loan products

Our View: We reviewed the macroeconomic environment and banking sector pre and post capping and below is our take.

Reduction of Credit in the Financial Sector: With reference to credit growth, the view by the executive refers to the report on Interest Rate Capping on the Economy of Kenya (March 2018) report released by the CBK. The report noted a sluggish growth on private credit post-cap than pre-cap.

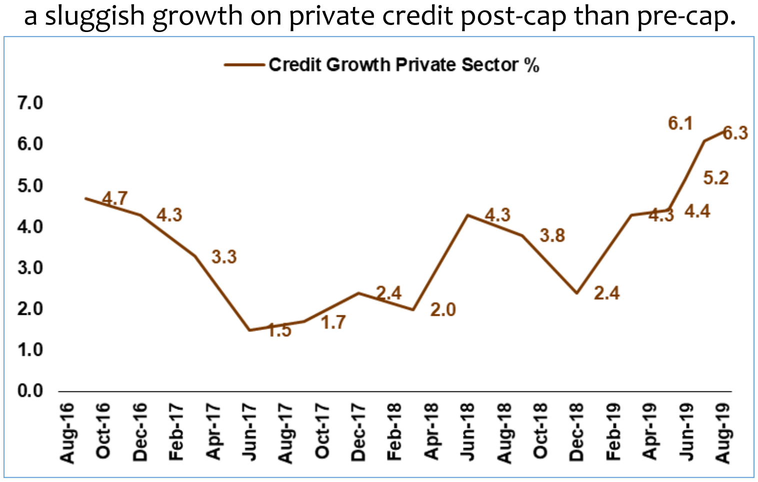

Figure 1: Private Credit Growth Source: CBK, KSL

With declining yield on government securities, banks have reversed this narration and reverted to their traditional business of lending.

Repealing of the caps will not accelerate credit growth faster than current rates as banks have already adjusted their balance sheet towards lending while focusing on quality lending rather than mass lending

Economic Growth: The economy has continued to grow on a 5 year average of 5.6% with the lowest growth of 4.9% witnessed in 2017 which was curtailed by the agriculture sector due to drought and repeat general election.

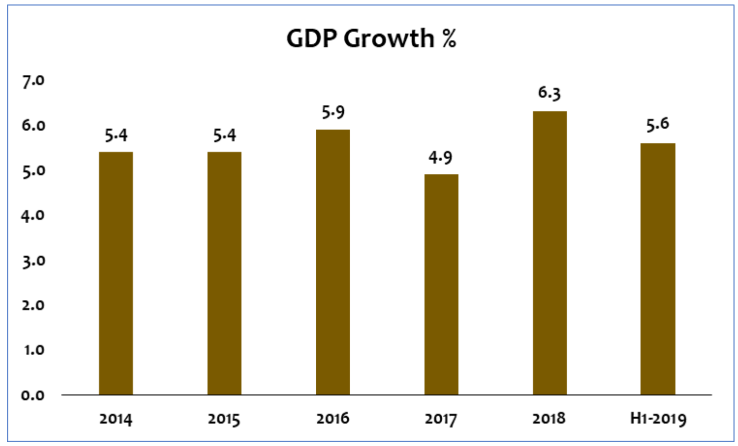

Figure 2: GDP Growth Rate Source: KNBS, KSL

With limited monetary policy space, it will be difficult for CBK to use monetary tools in managing economic health. Lifting of the cap will give CBK necessary room.

Growth in Loan Book: Review of the banking industry 2018 and h1-2019 has indicated an expanding loan book. The dip in 2017 was compensated by a rise in investment in government securities. We project the book to grow further in two digit space as share of holdings in government security by tier one banks was scaled down.

Re-categorization of loan has seen banks shift MSME lending into the digital lending space to cut the gap caused by interest rate capping creating efficiency while managing NPLs.

Investment Strategy: Introduction of caps saw financial institution shift holdings from risky assets in Private Lending to government papers aiding the government with cheap funds in the expense of the private sector.

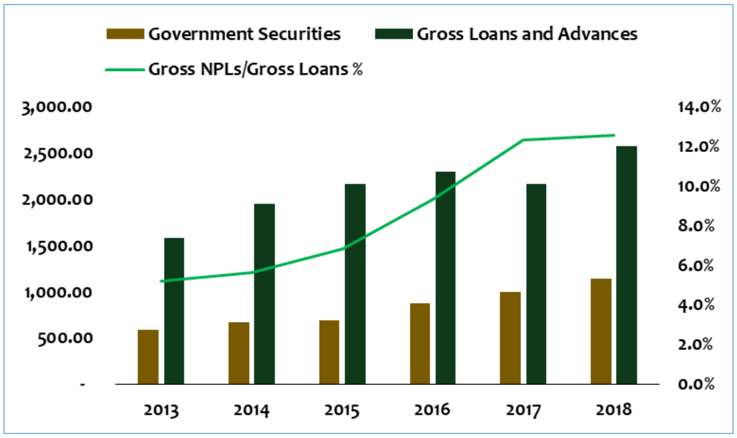

Figure 3: Banking Industry Investments Source: CBK, KSL

The government saw the liquidity environment as an opportunity and increased offer levels for weekly T-Bill Auction from KES 16Bn to KES 24Bn and T-Bonds offers from KES 20BN to KES 40Bn (KES 50Bn reopened bonds and KES 60Bn on IFB).

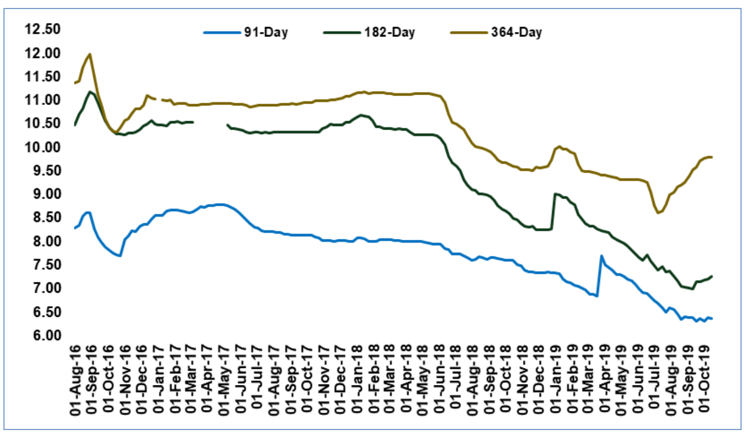

Figure 4: T-Bill Rates Source: NSE, KSL

Government dominance in the money market suppressed returns and forced a downward shift of the yield curve while liquidity levels benefited tier 3 banks through a low interbank.

The removal of the cap will see an upward shift on the yield curve as government is forced to offer a better return by competing with the private sector for available funds. This will lead to less appetite in domestic debt.

The upward shift in yield will affect Secondary Bonds Trading as investors will be holding expensive papers. Last two months, the market has been starved of bids but with a glut of offers as the investors' position for a repeal.

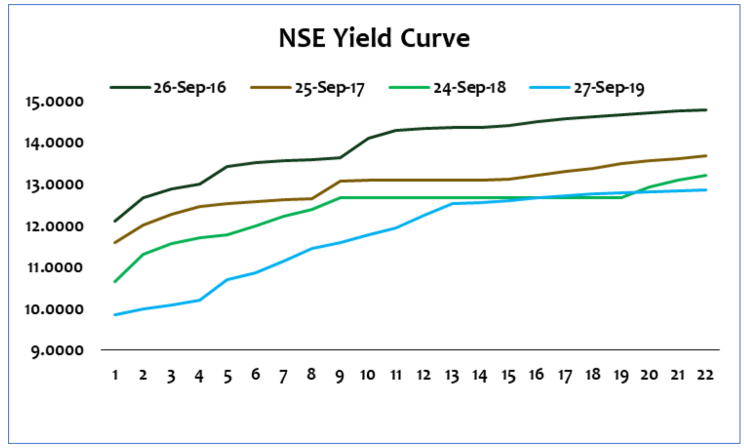

Figure 5: NSE Yield Curve Source: NSE, KSL

We has earlier advised our client to focus on the 364 day paper. With our view of rate cap, we review and switch to 91 day paper with the aim of benefiting on reinvestment returns.

More Political Will than Economic Factors: The repealing of the Interest Rate Capping Law has been introduced to parliament twice in the Finance Bill 2017 - 2017/2018 Budget and Finance Bill 2018 - 2018/2019 Budget. On the two occasions, the law was rejected by parliamentarians and the president assented the bills into law.

This is the first time the president has rejected to assent the bill returning in to parliament. The house will review the bill with the president's recommendation and may either;

i. Amend the bill by repealing Section 33B. or
ii. Pass the bill a second time without considering the presidents reservation. This will require a two third majority.

Our opinion is the options left leads to only one direction; repealing of the law. The MPs, for the third time, have resisted to repeal the law insisting the high interest rate will affect the common man. This will force them to pass the bill through parliament. The motion will struggle to garner the required two thirds majority to overturn the president's memorandum. The president is seen confident due to the handshake government where he and the opposition leader have recently managed to sway votes with ease.

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