

The Impact of Capping Interest Rates on the Kenyan Economy

During the week, Members of Parliament passed a bill that sought to amend the Banking Act by placing restrictions on the rate which banks offer on loans and deposits. This amendment will put (i) a cap on lending rates at 4.0% above the Central Bank Rate (CBR) and (ii) a floor on the deposit rates at 70% of the CBR. This is not the first time such an Act has been proposed. In 2001, there was an attempt to amend the CBK Act and cap the lending rates at 4.0% above the 91-day T-bill and the deposit rates at 4.0% below the 91-day T-bill, bringing the spread to 8.0%. Also in 2013, the Kenya Parliamentary Budget office proposed the pegging of the deposit rates to the lending rates. In both of this attempts it the restrictions were not successful.

In any economy, banks act as an intermediary through which people deposit funds and get loans. So banks essentially make money from the difference between the rate which they pay depositors and the rate which they charge borrowers. These rates are determined by market forces, that is, demand and supply, but also several other factors come into play. Placing a cap on interest rates will have an effect on the industry's efficiency as it doesn't account for several factors that might affect the banks decision to opt for certain spreads. Furthermore, pegging it to the Central Bank Rate will depend largely on the transmission mechanism of monetary policy decision into the economy and the effectiveness of the Monetary Policy Committee in assessing the state of the economy. Though the monetary policy is gaining relevance, we are yet to see it a true pricing mechanisms for investors and banks.

For the past 20 yrs, Kenyan banks have been enjoying interest rate spreads of about 11.4% on average, way above the world average of 6.6%. The Central Bank Governor, Dr. Patrick Njoroge is on record acknowledging that this is too high but he does not advocate for an interest rate peg as it will bring about rigidity in the financial system and may introduce a lot of shadow banking and shylocks as people who can't access credit from the banks due to their low credit quality are priced out of the market.

Below is a table indicating the 5 main factors that influence spreads in the banking system. We analysed each with regard to the past experience and the current situation/outlook to make a case as to whether an interest rate cap is actually the best decision.

| Factors | Description | Past Situation | Current Situation/Outlook | Argument for/against interest rate cap |
|-------------------------|--|---|--|--|
| Market Structure | This is where macroeconomic environment affects the country's spreads through its impact on credit risk and in turn, the quality of loans | Generally, the Kenyan economy has been stable with a GDP growth of 5.0% on average. There have been one off shocks in interest rates and inflation but have not persisted for more than 1 quarter | Kenya's macroeconomic outlook remains strong and stable with a long term GDP prospect of 5.0% | Against |
| Credit Risk | This is where the risk of loss due to the inability or unwillingness of a counter-party to meet its contractual obligations prompts banks to price loans higher to cater for this risk | Banks were finding it hard to assess potential borrower's ability to service loans leading to high NPLs | Today banks have Credit Reference Bureaus where they can access information on borrowers' credit worth | Against |
| Regulation | This is where prudential guidelines and monetary policies affect bank's | The CBK introduced the Kenya Bank's Reference Rate in 2014 which was to be used as a tool to | The CBK plans to introduce an Annual Percentage Rate (APR) pricing model, to | For |

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|-------------------------------------|---|--|---|----------------|
| | pricing of loans and deposits | price loans. This proved to be ineffective as banks failed to disclose on how they arrive at the margin they add above the set rate | enable bank customers to compare the different bank loan rates on a common computational model. The APR mechanism would allow borrowers to compare bank loans on standardized parameters instead of focusing on interest rates alone | |
| Information Flow/Asymmetry | (a) From the bank's perspective, lack of information on borrowers' credit worth will prompt them to raise rates to cover for this risk (b) From the consumers' perspective, lack of information on competitors' rates will lead to banks taking advantage of this and offering higher rates | Banks and consumers lacked a platform where they can access credit worth and competitor information, respectively | Banks have the Credit Reference Bureaus where they can access customer credit history while consumers can get competitor information directly from the CBK | Against |
| Distribution of Market Power | In a market controlled by few banks, there tends to be low customer bargaining power in turn leading to higher spreads | We have 42 commercial banks, but the 6 largest banks control 52.4% of the entire industry. This leads to few banks controlling the market resulting to skewed liquidity and higher lending rates | We expect sector realignment where small banks will merge therefore being able to compete with their larger counterparts. However, the smaller banks may be acquired by the larger banks making them even stronger reducing consumer bargaining power | Neutral |

From the above table 3 out of the total 5 indicators indicate that an interest rate cap is not the best decision, however, there are 2 issues that need to be addressed. Distribution of market power is skewed towards 6 large banks, that has in the past rendered CBK's regulations ineffective. 6 banks control 52.4% of the entire industry of 42 banks. Clearly competition is among these 6 banks and they determine the direction of the industry. This can be witnessed in the interbank market where liquidity is skewed amongst large banks, who in turn shut down smaller banks in the interbank market making them resort to expensive funding leading to them offering higher lending rates to maintain a certain spread to remain profitable.

Placing caps can and have been used by other economies but not for the control of spreads but rather to control extreme lending and borrowing behaviour. In such economies the cap is usually way higher than the prevailing lending rates. In South Africa, the cap on loans is 2.2x the repo rate plus 20%. Currently the repo rate is 7.0% bringing the cap to 35.4%, way above the prevailing commercial prime lending rate of 10.5%.

We are of the view that capping interest rates might solve the high interest rate spreads in the banking sector but will lead to other challenges such as (i) locking out of SMEs and other "high risk" borrowers from accessing credit as banks will prefer to loan to the government (ii) straining small banks who effectively

have been shut out from the interbank market and now have to mobilise funds at rates higher than what they are getting now and can only lend out within the stipulated margins, (iii) it is based on an unreasonable premise that the highest extra risk premium in the Kenya market is 4%, (iv) may lead to banks colluding so as to push up the yields on the treasury instruments, and (iii) the emergence of shadow banking systems which may result into inefficiencies in terms of transmitting the effects of policy decision into the economy

It is due to all the above factors that we believe this amendment will do more harm to the economy than good.