Central Bank of Kenya

The Impact of Interest Rate Capping on the Kenyan Economy

Draft for Comments

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Abstract

The interest capping law became operational on September 14, 2016. It was implemented following concerns raised by the public regarding the high cost of credit in Kenya, which was viewed as a hindrance to credit access by a large segment of the population. Implementation of the law, was therefore, expected to lower the cost of credit and increase access to credit. The objective of this study is to investigate the impact of the interest rate capping law in Kenya. Although the period since the law became operational may not be sufficiently long for the full effects on the economy to manifest, we nonetheless investigate based on the emerging evidence, whether the intentions of the interest rate capping law have been achieved. To unravel the evidence, we first review the literature on the outcomes of interest rate controls. International experience shows that in most cases, caps have produced undesirable outcomes, such as reduced intermediation and transparency, reduced bank competition and increased risk to financial stability.

Using bank level data covering the period before and after the interest rate capping law, coupled with selected macroeconomic indicators, our analysis shows that interest rate caps have started to yield negative effects which include the following: First and foremost, the capping of interest rates has infringed on the independence of the central bank and complicated the conduct of monetary policy. It is found that under the interest rate capping environment, monetary policy produces perverse outcomes. Secondly, there is evidence of reduced financial intermediation by commercial banks, as exemplified by the significant increase in the average loan size arising from declining loans accounts, mainly driven by the large banks, thus shunning the smaller borrowers. Thirdly, banks have shifted lending to Government and the large corporates. Whereas demand for credit immediately increased following the capping of lending rates, credit to the private sector has continued to decline. Fourthly, while the structure of revenue of the banks has started to shift away from interest income, some banks have exploited the existing approval limits to increase fees on loans in a bid to offset loss in interest income. Fifth, although the banking sector remains resilient, small banks have experienced significant decline in profitability in recent months, which may complicate their viability. Sixth, rationing out Micro, Small and Medium Enterprises (MSMEs) from the credit market by the commercial banks is estimated to have lowered growth in 2017 by 0.4 percentage points. However on the other side, banks have started adjusting their business models towards enhancing efficiency. We note that these outcomes which have emerged in the last one year may present a partial picture, as a much clearer picture is envisaged to emerge in the medium to long term.

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A. Introduction

1. **Kenya embraces a free market economy despite the interest rate capping law.** Kenya's financial sector policy environment has evolved from a period of direct controls in the 1970s to full liberalization in the 1990s, thereby paving way for market-determined interest rates. The Government's commitment to a free market economy is enshrined in the ***Sessional paper No.1 of 1986 on Economic Management for Renewed Growth***. The sessional paper outlined the direction the country desired to follow in the wake of sub-optimal economic outcomes arising from various forms of controls that were in place at the time. These controls were introduced at independence in line with the Government policy agenda which embraced a mixed economy as outlined in the ***Sessional Paper No. 10 of 1965 on African Socialism and its application to planning in Kenya***.

2. **The amended law capping interest rates in Kenya came into force in September 2016, setting limits on lending and deposit rates.** In August 2016, the President of Kenya signed the Banking (Amendment) Bill 2015. The Banking (Amendment) Act, 2016 came into effect on September 14, 2016. It sets the maximum lending rate at no more than four per cent above the Central Bank base rate; and the minimum interest rate granted on a deposit held in interest earning account to at least seventy per cent of the same rate. For purposes of the amended Banking Act (Section 33B) and in line with the Central Bank of Kenya (CBK) Act (Section 36(4)), the CBK set the Central Bank Rate (CBR) as the base rate.

3. **However, interest rate capping law undermines the independence of the Central Bank and impacts on the conduct of monetary policy.** The independence of the Central Bank of Kenya as anchored in Article 231 of the Constitution stipulates that the Bank shall not be under the direction or control of any person or authority in the exercise of its powers or in the performance of its functions. In the execution of its core mandate of formulating and implementing monetary policy directed at achieving and maintaining stability in the general level of prices, the Central Bank uses the Central Bank Rate (CBR) to achieve monetary policy objectives. In addition, the interest rate capping regime has resulted in perverse monetary policy outcomes in which accommodative monetary policy stance has resulted in deceleration in growth of credit to the private sector.

4. **Evidence of the impact of interest rate capping have started to emerge.** Emerging evidence show that commercial banks have adjusted their business models resulting in declining financial intermediation, directed their lending in favour of large corporate borrowers and Government thereby shunning small and risky borrowers, and reduced transparency. Although the banking sector remains resilient the evidence point towards reduced competition and decline in profitability notably for Tier III banks. The impact on economic growth has also begun to show, though this may take longer time to fully materialize.

5. **The objective of this study is to assess the emerging impact of interest rate capping in Kenya.** The rest of the paper is organized as follows; Part 1.1 discusses historical developments on controls in Kenya; Part 1.2 discusses interest rates and cost of credit in Kenya while part 1.3 highlights interest rate capping and central bank independence. Part 2.0 provides an overview of evidence of impact on impact of interest rate controls; Part 3 outlines the expected outcome; Part 4 provides the empirical strategy while Part 5 discusses the evidence of impact of caps and Part 6 concludes.

Historical Developments on Controls in Kenya

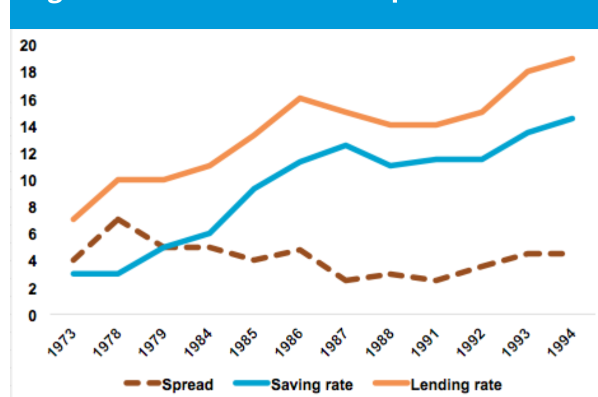
6. **Following independence in 1963, Kenya embraced policies which had a market orientation of mixed economy.** The publication of the ***Sessional Paper No. 10 of 1965 on African Socialism and its application to planning in Kenya***, outlined the government intention to implement policies to foster African socialism, growth and development. Among the raft of policies outlined in the Sessional Paper was the control of resources to ensure that property is used in the mutual interests of society and its members. At the time it was felt that in order to control effectively, sufficiently and not excessively many types and degrees of controls were required ranging from none, through influence, guidance and control of a few variables such as prices and quantities, to absolute control represented by state ownership and operations.

7. **The controls were exercised in virtually all sectors of the economy.** Price, wage, rent and output controls, import duties, income taxes and subsidies were used selectively and in combinations to direct the uses of private property, limit profits, and influence the distribution of gains. In this section we discuss selected controls which were implemented in the banking and the foreign exchange market with a view to helping us conceptualize what the consequences of the current interest rate capping will be in the medium to the long-term.

Controls in the Banking Sector

8. **Kenya's experience with interest rate caps dates back to post-independence period.** After attaining independence in 1963, the Government pursued a regime of interest rate capping and quantitative credit controls with the aim of encouraging investment and spurring economic growth and development. Interest rate controls entailed fixing minimum saving rates for all deposit taking institutions and maximum lending rates for all commercial banks, NBFIs and building societies. As a result the spread between the lending and savings rate were stable.

Figure 1: Interest rates and spreads



Source: CBK

9. **The government policy of maintaining low interest rates (financial repression) resulted in negative real interest, especially in periods affected by shocks.** Following the inflationary pressures associated with the economic shocks that hit the country in the early 1970s, interest rates on both deposits and loans were raised for the first time since independence in June 1963[1]. Nonetheless, the real interest rates remained negative until the mid-1980s. Low and largely negative real rate affected savings mobilization leading to low savings levels[2]. Control of deposit rates resulted in the suppression of mobilization of financial savings and amount of loanable funds. As a result, loans advanced

[1] 1974–1978 Development Plan.

[2] This is the central pillar of the so called Macknnon and Shaw Hypothesis on financial repression. Data on savings rate was obtained from Mwega, F.M, Ngola, S.M and Mwangi, N. (1990). Real Interest rates and Mobilization of Private Savings in Africa: A Case Study of Kenya. AERC Research Paper No. 2.

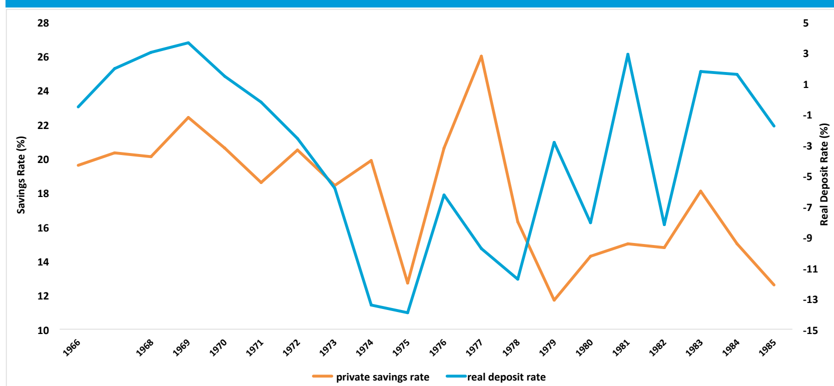
by banks were biased towards short term credit to parastatals and major firms. Moreover, the measures under the interest rate control policy regime were not sufficient to deal with or offset the adverse effects of external shocks.

10. **Controls in the banking sector resulted in growth of credit to the public sector.** The Government had firm control over the allocation of credit to various sectors. Sectors which were perceived to be important were allocated a larger share of credit. However, these sectors were not necessarily profitable to repay the loans.

- In the allocation of credit, the government took a substantial and rising share of loanable funds to finance the budget deficit and fund parastatals. The share of government net domestic credit rose from an average of 18 percent in 1970-74, to an average of approximately 45 percent in 1990-93.

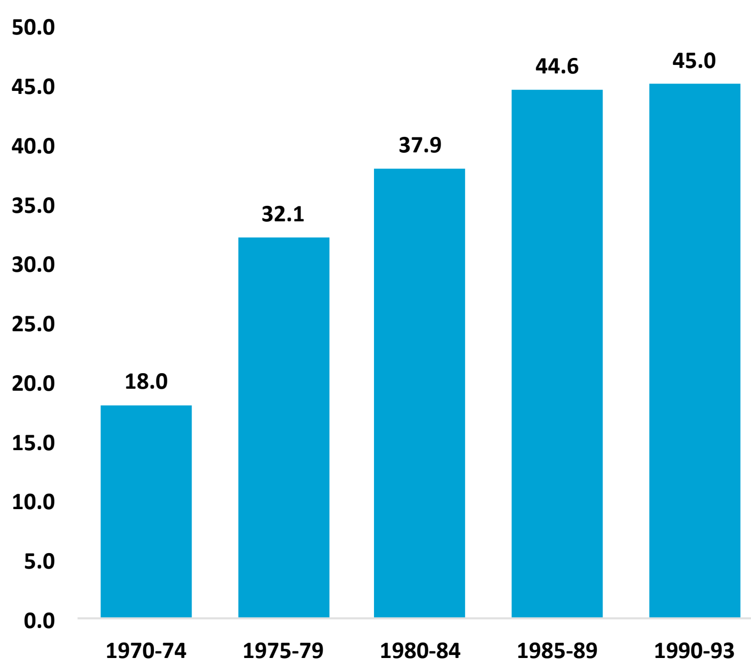
11. **Consequently, Bank failures were witnessed during this period largely on account of poor lending policies, undercapitalization and poor management**[3]**.** Following increased leading to government by the banks to finance the bloated public sector, including financing the loss making state corporations,

Figure 2: Savings and real deposit rates



Source: CBK

Figure 3: Share of credit of the banking sector to Government (%)



Source: CBK

[3] A list of the failed banks and reasons for failure is shown in Appendix II.

the banks started to experience challenges resulting in bank failures. The reasons advanced for the widespread bank failures include: non-performing loans; unsecured insider lending; mismanagement; ineffective Board; undercapitalization and poor lending policy.

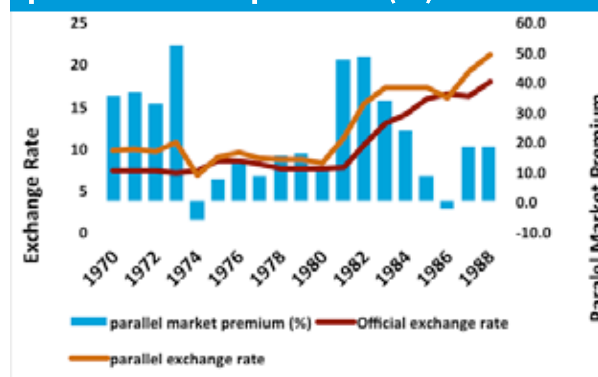
Controls in the Foreign Exchange Market

12. **The Exchange Control Act CAP 113 and its subsidiary legislation, rules and regulations anchored activity in the foreign exchange market.** The Act provided that all foreign exchange transactions (such as sale, purchase, borrowing or lending of foreign currency as well as maintenance of foreign balances, payment to non-residents, export of any financial instrument or bill of exchange and transfer of securities between non-residents and residents) were prohibited unless directly permitted by the Central Bank of Kenya or directly through the authorized dealers.

13. **Forex controls resulted in rationing of the foreign exchange.** The government resorted to rationing of foreign exchange with priority being given to importers of essential goods while tight restrictions were imposed on the non-essential imports. However, bureaucratic procedures made it difficult to access forex to import essential goods. On the other hand, a parallel/black market for foreign exchange emerged to address the growing foreign exchange needs for non-essential imports.

14. **The parallel market had a high forex premium[4].** The exchange rate in the parallel market fluctuated according to the forces of demand and supply for the US dollar and other desired currencies. For instance, during the international oil crisis in 1973, and prolonged drought in 1981-84, which resulted in increased cost of importation of fuel and food, the parallel market premium was above 40 percent of the official exchange rate. The parallel market exchange rate was considered as proxy for a floating exchange rate.

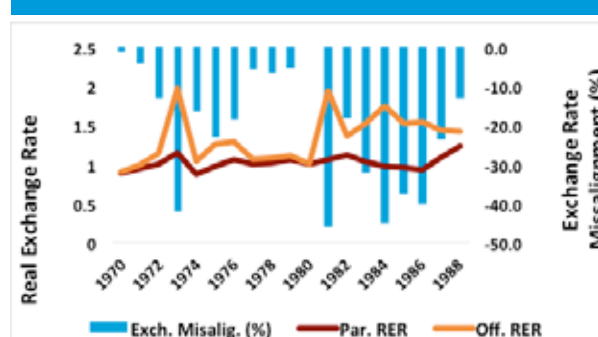
Figure 4: Exchange rate Ksh/US$ and parallel market premium (%)



Source: CBK

15. **The fixed official exchange rates against all the major currencies was not reflective of the true value of the Kenyan currency[5].** Following the high inflation in the country relative to the rest of the world during the mid-1970s and 1980s, the real exchange rate became overvalued. The magnitude of misalignment was moderate in the 1970s, averaging 13.6 percent, rising to approx. 28.6 percent in the 1980s.

Figure 5: RER and RER mislignment: 1970-88



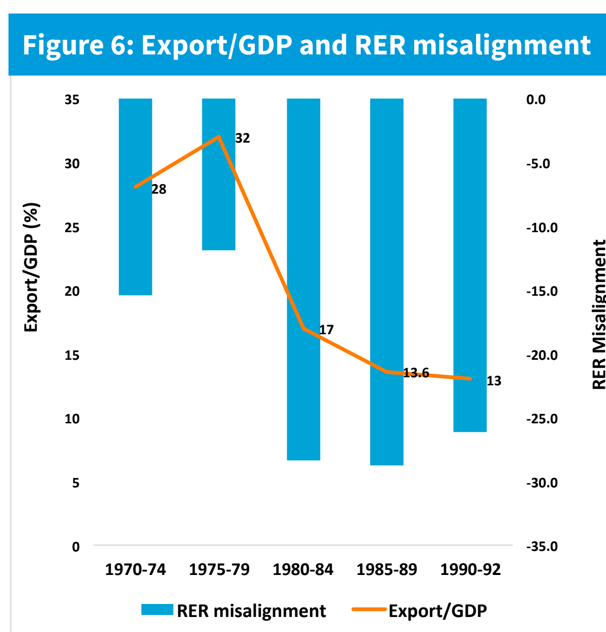
Source: CBK

[4]Data was obtained from a study by Kidane A. (1994). Indices of Effective Exchange Rates: A comparative study of Ethiopia, Kenya and the Sudan, AERC Research Paper No. 29.

[5]The misalignment is calculated as percent deviation of parallel real effective exchange rate from the official real effective exchange rate. Data extracted from Kidane A. (1994). Indices of Effective Exchange Rates: A comparative study of Ethiopia, Kenya and the Sudan, AERC Research Paper No. 29.

16. **Overvalued exchange rate impacted on exports competitiveness.** Following fixed exchange rate regime the overvalued exchange rate undermined exports performance. The exports to GDP ratio stood at approximately 28 percent in 1970-74, rising to approximately 32 percent in 1975-79. However, the various controls in the economy at the time, including overvalued real exchange rate, resulted in a decline in exports performance to 17 percent in 1980-84, and remained at almost the same level for the remainder of the 1980s to early 1990s.

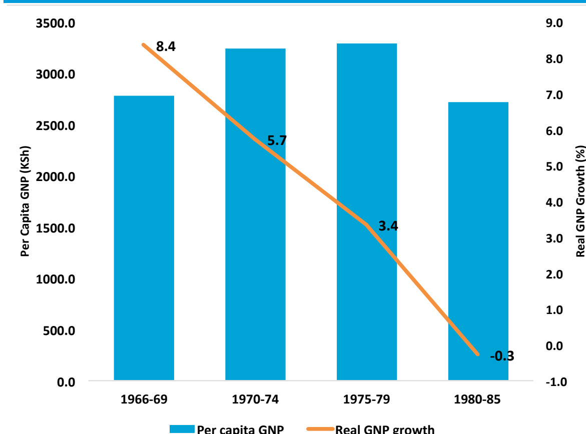
Figure 6: Export/GDP and RER misalignment



Source: CBK

17. **The many controls imposed on various sector resulted in significant contraction of the economy.** At the inception of the controls, the real GNP growth average 8.4 percent in 1966-69. Thereafter it declined to 5.7 percent in 1970-74. Despite the coffee boom of 1976-77, the average growth during 1975-79 declined to 3.4 percent. In 1980-84, the economy had contracted by 0.3 percent. During this time the per capita real GNP stagnated.

Figure 7: Per capita GNP (Ksh) and Real GNP growth (%)

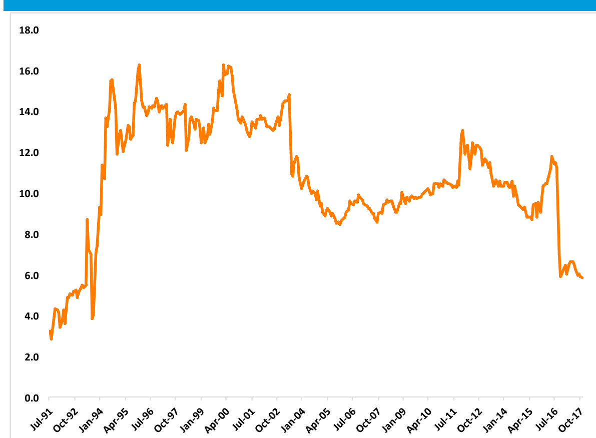


Source: CBK

Interest Rates and Cost of Credit in Kenya

18. **A market based interest rates determination was instituted in early 1990s following liberalization of the economy.** In 1990 banking institutions were allowed to reflect all lending related charges and fees on the cost of credit thereby resulting in higher effective rates on loans relative to the stipulated ceilings. Eventually, the interest rates were liberalized in July 1991. However, the interest rate spreads remained high.

Figure 8: Evolution of Interest Rate Spreads in Kenya



Source: CBK

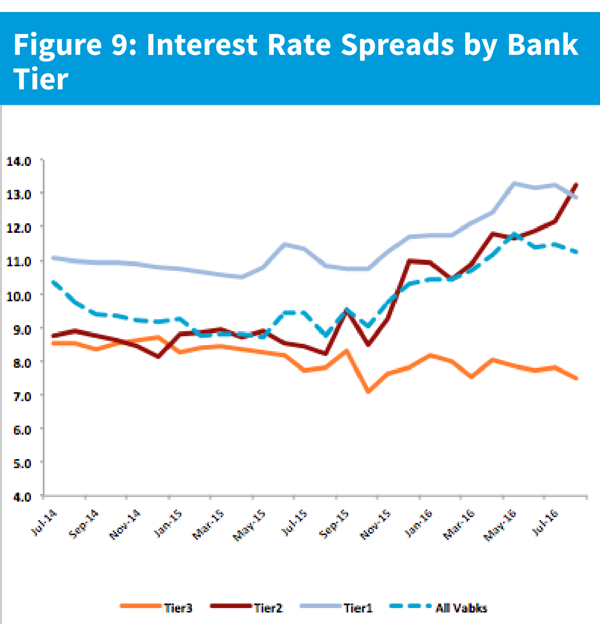
19. **High cost of credit triggered debate on interest rate capping.** Following concerns with the high cost of credit and interest rate spreads, the interest rate capping debate began in 2001, when a bill was introduced in Parliament proposing to peg commercial banks interest rates to the 91-day Treasury bill rate as CBK did not have a base rate at the time. The second attempt in 2013, called for rates to be capped consistent with the Central Bank Rate - both attempts failed largely on the strength of the arguments for free market interest rate structure. In addition, the banks were given a chance to self-regulate in terms of designing measures towards lower cost of credit.

20. **The Government initiated measures in a bid to lower the cost of credit and prevent capping of interest rates.** These initiatives include the following:

- The Credit Information Sharing. Credit Reference Bureaus (CRBs) were established to enhance credit information sharing mechanism and aid lenders in undertaking credit decisions based on credit history of borrowers.
- The Kenya Bankers Reference Rate (KBRR). The National Treasury constituted a Committee in January 2014 to explore ways of enhancing private sector credit and mortgage finance supply in Kenya. To enhance transparency in pricing of credit, the Committee recommended introduction of a transparent credit pricing framework known as the Kenya Banks' Reference Rate (KBRR). However, in practice, KBRR was less effective, owing to various challenges including the modalities of its computation and the limited flexibility of its review. Moreover, whereas the KBRR framework was duly implemented, it did not satisfactorily address the public concern regarding the high cost of credit.
- Establishment of currency centres to help lower transaction costs associated with transporting cash over long distances across the country.

21. **Despite numerous efforts by the Government, the Banking Sector continued to maintain high cost of credit with noticeable differences across bank tiers.** The interest rate spreads remained high, with variations across bank tiers and loan type. Whereas large banks (Tier 1) consistently maintained higher interest rate spreads, on average the small banks (Tiers 3) had the lowest and stable spreads, with medium-sized banks (Tier 2) falling in-between. In terms of borrowers, corporate clients enjoyed lower lending rates compared to personal and business categories, with the later attracting the highest rates. The variation in lending rates largely reflects variations in pricing of actual or perceived risks for different categories of borrowers, while variation across banks reflects the different funding constraints that characterize the bank tiers.

Figure 9: Interest Rate Spreads by Bank Tier



Source: CBK

22. **Compared to its peers, Kenya's banks maintained high interest rate spreads.** Calls for capping interest rates were mainly anchored on the high spreads between lending rates and deposit rates compared to other developing peer economies, and the resulting high profitability in the sector. Although Kenya's average interest rate spread that stood at 14.2 percent in 2000 had declined to 9.9 percent by 2014, it was still high compared to Kenya's comparators such as Mauritius, Namibia and South Africa which had much lower interest rate spreads.

Table 1: Interest Rate Spreads across Countries and Regions

	2000	2004	2008	2009	2011	2012	2013	2014	2015	2016
Angola	6.4	6.7	6.0	8.1	12.4	13.1	12.7	12.9	13.6	10.2
Botswana	6.1	5.9	7.9	6.3	5.9	7.4	7.1	6.5	5.4	5.2
Algeria	2.5	4.4	6.3	6.3	6.3	6.3	6.3	6.3	6.3	6.3
Egypt. Arab Rep.	3.8	5.7	5.7	5.5	4.3	4.4	4.6	4.8	4.7	5.7
Kenya	**14.2**	**10.1**	**9.5**	**9.7**	**10.8**	**12.0**	**10.8**	**9.9**	**9.2**	**9.5**
Mauritius	11.2	12.9	1.4	0.8	1.8	2.4	1.7	1.7	2.4	3.3
Namibia	7.9	5.0	5.4	4.9	4.4	4.4	4.3	4.5	4.6	4.2
Nigeria	9.6	5.5	3.5	5.1	10.3	8.4	8.8	7.2	7.7	9.4
South Africa	5.3	4.7	3.5	3.2	3.3	3.3	3.3	3.3	3.3	3.3
World	7.4	6.0	5.7	5.7	5.8	5.4	5.8	5.5	5.3	5.5
East Asia and Pacific	5.0	5.4	4.6	5.0	5.0	5.0	5.0	4.9	5.0	4.8
Sub-Saharan Africa	13.6	12.9	6.7	6.7	8.0	7.1	7.1	7.2	6.8	6.1

Source: World Bank

23. **As a result of high interest spreads Kenya's banking sector remained highly profitable compared to peers thus provoking debate on interest rate capping in the country.** The profitability ratios in the banking sector had remained high compared to other countries in the African region. For example in 2016, the return on assets (ROA) and return on equity (ROE) in Kenya stood at 3.1 percent and 24.5 percent, respectively – which is much higher compared to other countries in the region.

Table 2: Bank's Return on Assets and Return on Equity in Selected Countries					
YEAR	2012	2013	2014	2015	2016
Panel A: Return on Assets (ROA)					
Mauritius	1.4	1.3	1.4	1.2	1.4
Nigeria	2.4	2.3	2.5	2.5	1.3
South Africa	1.3	1.5	1.5	1.5	1.7
Malaysia	1.6	1.5	1.5	1.2	1.4
UK	0.2	0.2	0.3	0.3	0.3
Czech Republic	1.4	1.2	1.2	1.1	1.3
Australia	1.2	1.4	1.2	1.4	0.8
Singapore	1.4	1.2	1.1	1.2	1.1
Brazil	1.4	1.4	1.4	1.5	1.1
Kenya	4.6	3.6	3.4	3.1	3.1
Panel B: Return on Equity (ROE)					
Mauritius	18.1	15.3	15.2	12.1	13.6
Nigeria	18.9	18.9	21.2	19.7	10.3
South Africa	17.7	18.6	18.8	20.7	22.2
Malaysia	17.3	15.8	15.0	12.3	12.3
UK	3.2	3.8	5.6	4.4	3.8
Czech Republic	20.4	16.2	16.5	14.2	16.6
Australia	23.0	27.0	23.0	23.8	22.0
Singapore	16.4	15.3	13.2	13.6	11.3
Brazil	13.1	13.1	13.2	15.4	11.3
Kenya	29.8	28.9	26.6	25.2	24.5
Source: IMF FSIs data					

24. **The debate about the high cost of credit culminated into the Banking (Amendment) Act 2016, aimed at lowering the cost of credit.** The Central Bank has continued to implement the new law. However, concerns were raised regarding the negative consequences of the amended law. The impact of this law may be witnessed in the short term, and the medium- and long term.

Interest Rate Capping and Central Bank Independence

25. **Interest Rate Capping undermines the independence of the Central Bank which is entrenched in the Constitution of Kenya.** Article 231 of the Constitution establishes the Central Bank of Kenya and stipulates that the Bank shall not be under the direction or control of any person or authority in the exercise of its powers or in the performance of its functions. The constitutional function of CBK under Article 231 (3) is to formulate monetary policy, promote price stability, issue currency and perform other functions conferred upon it by an Act of Parliament.

26. **Under the Central Bank of Kenya Act, the principal object of the Central Bank is to formulate and implement monetary policy directed to achieving and maintaining stability in the general level of prices.** The CBR is one of the tools that the CBK uses to signal the direction of monetary policy with the aim of curbing inflation or achieving other Central Bank objectives. There is therefore a risk that if the CBR is directly linked to the borrowing rates for banks, this will inevitably influence decisions made by the Monetary Policy Committee in its deliberations around the CBR. Linking

the CBR to the borrowing rates for banks and directing the CBK to publish a "base rate" in this regard, impairs decision making and usurps the Bank's autonomy in the delivery of its constitutional mandate of formulating and implementing monetary policy.

27. **While the intention of enacting the Banking (Amendment) Act, 2016 may be noble, it contains several ambiguities, vague and imprecise provisions which have been challenged in court.** The ambiguity and equivocal nature of the Amendment Act lends it to various contradictory interpretations thus depriving consumers of their constitutional right to have the information necessary for them to gain the full benefit of the new law.

B. Overview of Available Evidence on Impact of Interest Rate Controls

Evidence on interest rate caps - International experience

28. **Globally, capping of interest rates has been declining over time[6].** Several countries have adopted some form of interest rate capping, including some advanced economies such as France, Germany and the USA. Nonetheless, caps on interest rates has declined over the years with more countries adopting liberal financial policies. However, the financial crisis of 2008 re-opened the debate on interest rate controls as a tool for consumer protection—El Salvador (2012), Kyrgyz Republic (2013) and Zambia (2013) introduced fresh interest caps after the financial crisis.

[6] The World Bank Working paper of 2014 by Maimbo and Gallegos (2014) on interest rate caps is one of the most widely cited papers as it provides a comprehensive review and general global landscape on interest rate caps. Overall, 76 countries around the world impose some form of interest rate caps on loans, most of which are in Sub Saharan Africa (SSA), and in Latin America and the Caribbean (LAC)

29. **Arguments for use of interest rate ceilings are varied.** These include use of caps to support a specific industry or sector, protect consumers from usury and exploitation, protect borrowers from predatory lending and excessive interest rates, form of subsidy to specific groups, decrease the risk-taking behavior of credit providers, among others.

30. **International experience shows that interest rate caps generally have negative effects which tend to worsen with time.** Countries with interest rate capping law have reported the following effects:

- **A withdrawal of banks from the poor or specific segments of the society,** such as the small borrowers due to higher loan management costs - evident in WEAMU countries, Bolivia, Columbia, the Dominican Republic, Ecuador, Haiti, Nicaragua, Peru, Poland and Zambia
- **An increase in average loan size,** pointing to lower access by small borrowers and larger loans to more established firms - evident in Bolivia, Ecuador, South Africa and Zambia.
- **Reduced transparency -** an increase in the total cost of loans through additional fees and commissions - witnessed in Armenia, Nicaragua. South Africa, and Zambia
- **Decreased diversity of products** for low-income households- witnessed in France and Germany
- **Reduced banking competition –** witnessed in Italy.
- **An increase in illegal lending –** evident in Japan and the United States.

Preliminary evidence on impact of interest rate caps- Surveys on Kenya

31. **The results of the surveys are sketchy since they have been conducted using limited samples and hence should be treated cautiously.** The results of the following surveys are summarized below: Kenya Private Sector Alliance (KEPSA) survey, the CBK Credit Officer surveys and surveys by the Monetary Policy Committee (MPC) Secretariat. The last two are in-house surveys conducted on a regular basis by Bank Supervision Department and the MPC Secretariat, respectively. Credit Officer Surveys are based on banks' expectations.

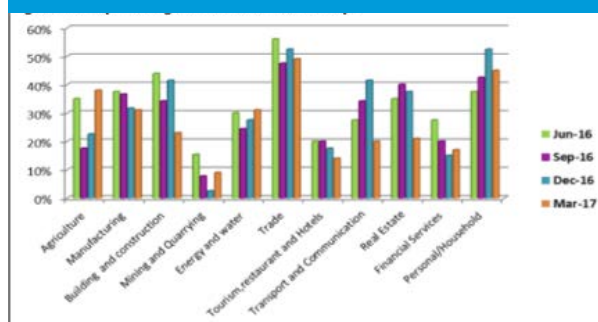
32. **Kenya Private Sector Alliance Survey revealed the following:**

- Respondents from the banking industry (83 percent) reported reduced lending since the capping of interest rates. However, some respondents from tier 1 reported an increase in lending, while others in tier 2 and 3 reported that they were not affected by the law.
- The Survey report attributed the recent slowdown in private sector credit growth to the capping of interest rates and increased investment by banks in government securities. No evidence was provided in the report of crowding out of lending to the private sector by government borrowing.
- Non-bank respondents who had accessed loans from banks after introduction of capping of interest rates reported that the law had a favorable effect on their businesses due to lower interest rates.
- The Survey showed that most of the respondents from the banking sector (78 percent) would like the capping of interest rates to be stopped, as they support more liberal and market driven policies. Reasons provided by banks are reduced lending to SMEs due to higher risk rating, focus by lenders on collateralized lending thereby locking out SMEs and individual borrowers, and that the cost of finance remained the same with a reduced repayment duration.
- However, the Survey showed that most of the non-bank respondents (73 percent) would like the capping of interest rates to continue due to affordable cost of finance, lower cost of loan repayments which encourage SMEs borrowing, banks had failed to exercise self-regulation and make loans affordable, and that capping of rates would inspire innovation and competition in the banking sector.
- The Survey report concluded that the introduction of interest rate capping had not necessarily translated to easy access to credit by borrowers since some of the borrowers deemed to be risky had been locked out.
- The Report provided several recommendations to make credit affordable and accessible in the long term. First, continuous engagement between the banking sector, non-bank businesses, and the CBK was necessary to explore additional measures to promote competition and innovation in the banking sector. Second, increased transparency and reduction in loan processing fees and charges by banks could help reduce the cost of borrowing. Lastly, government incentives such as rebates and guarantees for SME lending may be necessary to promote credit growth to the sector.

33. **CBK Credit Officer Surveys revealed the following:**

- The Credit Officer Survey is conducted quarterly by the Central Bank of Kenya to establish lending behaviour across sectors and potential drivers of credit risk in the banking sector. 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 and credit recovery efforts.
- **Banks have tightened credit standards for loan approvals:** The third quarter of 2016 saw the most severe tightening of credit standards, with 7 out of the 11 sectors being affected; namely Energy, Trade, Transport, Personal/ Household, Manufacturing, Financial Services and Agriculture. The tightening was mainly attributed to implementation of interest rate capping. In addition, banks also cited the reduction of the CBR[7], cost of funds and balance sheet constraints as additional factors that fuelled increased tightening of credit standards. In the fourth quarter of 2016 and the first quarter of 2017, credit standards were tightened in the Personal/Household, Real Estate, and Building and Construction economic sectors. This was mainly attributed to increased political risk due to the general elections, expectations regarding pace of general economic activity, and delayed government payments which increased the risk of default. Banks' lower capital position also contributed to the tighter standards.
- **Banks reported increased demand for credit in some sectors though the actual credit granted was expected to fall:** Sectors that generally recorded increased demand for credit following the capping of the lending rates in September 2016 were Trade, Personal/Households, Transport and Communication, Building and Construction, Energy and Water and Real Estate. However, a notable decline in demand for credit in the first quarter of 2017 was reported across sectors in line with the tightening of credit standards, though this was mainly attributed to the political risk in the run up to general elections—40 percent of banks expected a decline in credit demand. Overall the actual credit granted was generally expected to fall.

Figure 10: Key Findings of Credit Officer Surveys



Source: CBK

34. **MPC Surveys revealed the following:**

- The September 2016 Survey showed that banks expected credit supply to decline in the remainder of 2016 due to the capping of interest rates. Banks indicated that they had slowed down lending to assess the possible impact of the law and its implementation, in addition to reviewing of credit profiles, leading to realignment of their way of doing business in the wake of lower margins. The

[7] The MPC lowered CBR by 50 basis points from 10.5 to 10 percent in September 2017 to anchor inflation expectations.

law had left little room for factoring risk premium, and had therefore reduced their appetite for risk.

- The November 2016 Survey showed that commercial banks expected credit growth to decline due to uncertainties following capping of interest rates, including dealing with pressure to differentiate between low/ medium risk customers from high risk customers; need for reforms to manage existing portfolios and focus on cleaning their balance sheet, which would require banks to change their business models.
- The January 2017 Survey showed that private sector credit growth was expected to remain low due to lower risk appetite by banks, tighter credit processing after capping interest rates, and expected lower business investments by the private sector in an election year. As a result of interest rate capping, banks are:
  – Experiencing increased cost of funding and compressed net interest income, driving the need for diversification to other affordable sources of income
  – Focusing more on non-funded income and optimizing on financial technology to reduce costs
  – Focusing mostly on secured lending and
  – Selectively lending to sectors perceived as low risk

C. Expected Outcomes

35. **The amendment of the Banking Act was mainly motivated by the understanding that capping of interest rates would lower the cost of borrowing and increase access to bank credit by the populace.** This is in support of the notion by Stiglitz (1994) who argues in favor of certain forms of financial repression, indicating that repression can have several positive effects such as: improving the average quality of the pool of loan applicants by lowering interest rates; increasing firm equity by lowering the price of capital; and accelerating the rate of growth if credit is targeted towards profitable sectors such as exporters or sectors with high technological spillovers.

36. **However, based on international experience and local reviews preceding the amendment of the law, the interest rate caps are expected to result in the following:**

- **Increased demand for loans:** Following reduction in interest rates, demand for bank loans is expected to increase. This is mainly the case for those segments of the population which could not afford the high rates of interest prior to interest rate capping law, as well as top up by existing loanees. Loan applications by the small borrowers was thus expected to increase.
- **Reduced access to financial services:** Interest rate capping results in banks changing their lending behavior, viewing loans to small borrowers such as SMEs and individuals riskier and expensive to manage. Thus, they tend to offer less credit to these borrowers, preferring lending to government and large private borrowers.
- **Reduced transparency:** Interest rate caps, by restricting the ability of banks to make interest income, encourage banks to introduce or increase non-interest charges, such as fees, to compensate for lost income. As a result, it becomes difficult for customers to internalize the total cost of borrowing and also to make informed decisions on borrowing.

- **Elevated risks to financial stability:** the interest rate capping law is expected to impact the viability of the small banks compared to medium and large size banks. This may undermine the overall financial sector stability.
- **Reduced competition in the banking industry:** Following interest rate capping banks are expected to re-engineer their business models thus creating non-competitive tendencies in the industry- as a result there will be a tendency of concentration of business in a few banks. In addition, there will be a tendency for small banks to merge to survive resulting in furthering non-competitive practices.
- **Shifting to expensive loans:** The riskier borrowers rationed out resort to borrowing from alternative sources not regulated by the caps, which charge much higher rates.
- **Impairment of monetary policy transmission:** the Central Bank is charged with the mandate of conducting monetary policy aimed at ensuring price stability. To achieve this objective the CBK uses a number of tools, including the CBR. In the interest rate capping environment, use of CBR will result in perverse outcomes. During the phase of monetary policy loosening to stimulate credit expansion to support growth, the interest rate cap will also adjust downward. As a result, those individuals with credit risk above the capped rate will be shunned by banks thereby leading to contraction in growth of credit to the private sector.
- **Impact on economic growth:** interest rate capping law is expected to impact access to credit by the SMEs. Considering that SMEs account for a large share of enterprises, rationing out the SMEs by the banks will adversely impact their contribution to GDP and also compromise the overall real GDP growth prospects.

D. Empirical Strategy

37. The study uses data available at the CBK including (i) Bank level data- to assess the behavior of commercial banks and banking sector outcomes and (ii) real GDP and credit to private sector- to assess the impact on economic growth. It employs in-depth exploratory analysis while drawing from experiences of other countries and available studies on interest rate capping.

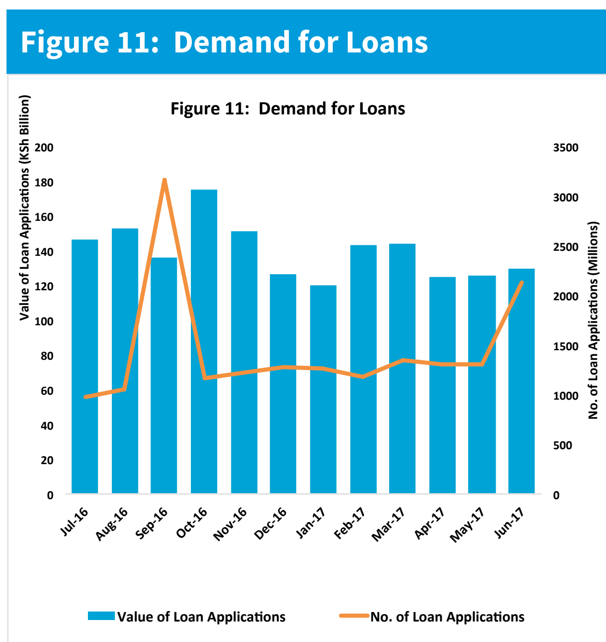
E. The Evidence

38. **In this section we present the emerging evidence on the impact of interest rate capping law under the following broad areas:** demand for credit, financial intermediation, and transparency by commercial banks, and migration to expensive loans, financial stability; impact on monetary policy transmission and; impact on economic growth.

Impact on demand for credit

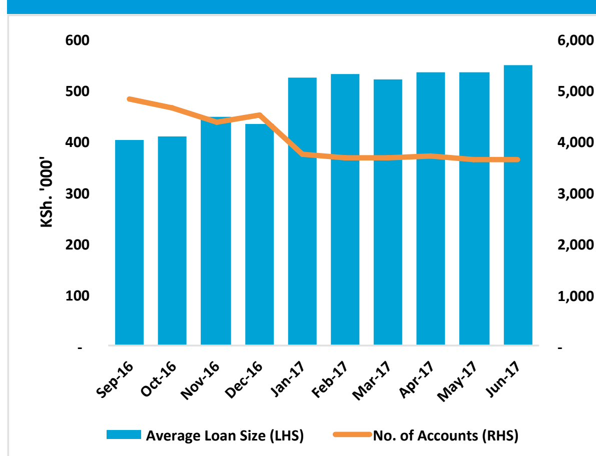
39. **Following the interest rate capping law the demand for loans witnessed temporary increase.** The reduction of interest rate to 14 percent following interest rate capping, resulted in increased demand number of loan applications. In the first three months of interest rate capping the number of loan applications increased by 20 percent. However, between December 2016 and April 2017, the growth of loan applications decelerated to 2.3 percent. The growth in loan applications was expected following reduction in interest rates from the market levels to the capped level- thus those potential borrowers who could not have thought of seeking loans because of high interest rates opted to apply.

Figure 11: Demand for Loans



Source: CBK

Figure 12: Evolution of No. of Loan Accounts & Average Loan Size



Source: CBK

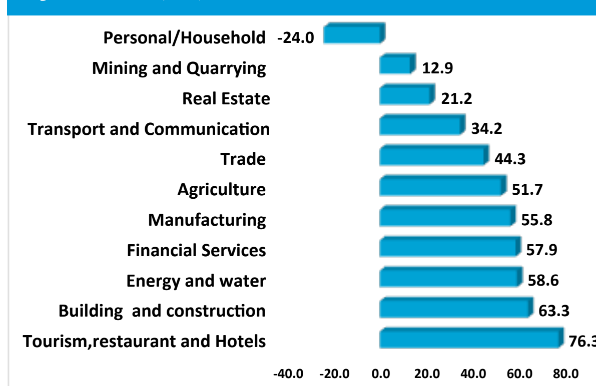
Impact on financial intermediation

i. Impact on lending to the private sector

40. **Following interest rate capping a number of borrowers have been shunned by banks.** Since the commencement of the interest rate capping law in September 2016, the number of loan accounts has continued to decline resulting in rising average loan size. The average loan size has increased by 36.7 percent between October 2016 and June 2017. The rising value of loan size vis-à-vis reduced number of loan accounts reflects lower access to small borrowers and larger loans to more established firms after the imposition of the caps. This evidence is consistent with the experiences of Ecuador, Bolivia, South Africa and Zambia, following implementation of interest rate capping in those countries.

41. **Despite general growth in the average loan sizes, there are sectoral differences.** During October 2016 to June 2017, the overall loan size grew by 36.7 percent, however, this growth vary by sector. The most rapid increase was witnessed in the tourism and hotels sector which recorded a growth of 76.3 percent- the rapid increase in loan size in this sector is consistent with the large number of SMEs in the sector, which may have been denied loans during this period. The personal household loans, on the other hand, reported declining average loan size during the period since they are payroll based and are less risk and have lower administrative costs.

Figure 13: Growth of average loan size by sector (%): October 2016- June 2017



Source: CBK

42. **The growth of average loan size vary by bank tier.** While the average overall loan size grew by 36.4 percent between September 2016 and June 2017, there are wide variations across bank categories. The large banks were the main drivers with a growth of 42.4 percent followed by small banks at 21.3 percent over the same period. The medium bank's average loan size grew by 2.0 percent. The rapid increase in average loan size by the large banks reflects the reluctance of large banks to lend to sections of the population which are perceived to be riskier.

Table 3: Average Loan Size by Bank Tier

	Sep-16	Dec-16	Jan-17	Feb-17	Mar-17	Apr-17	May-17	Jun-17
Large peer group	278	299	368	375	376	376	382	396
Medium peer group	1,731	1,796	1,685	1,690	1,730	1,769	1,708	1,765
Small peer group	1,665	1,738	2,025	2,099	1,735	2,078	2,058	2,020
All Banks	**402**	**433**	**522**	**530**	**519**	**534**	**535**	**548**

Source: CBK

43. **The large banks have hastened the reduced intermediation process.** The number of loan accounts has declined by 26.1 percent between October 2016 and June 2017, but there are noticeable differences across bank categories. While the loan accounts in the large banks has declined by 27.7 percent and that of medium banks by 11.1 percent, the small banks sustained a modest growth of 4.9 percent. Apparently, the large banks are leading in supporting the rationing out of small borrowers. Similar evidence was reported in WAEMU countries, Columbia, Poland, Dominican Republic, Ecuador, Haiti, Nicaragua, Peru and Zambia.

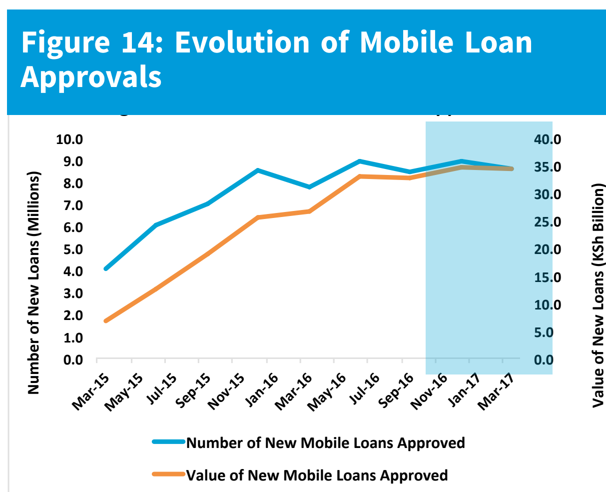
Table 4: Monthly Changes in Number of Loan Accounts by Bank Tier

	Oct-16	Nov-16	Dec-16	Jan-17	Feb-17	Mar-17	Apr-17	May-17	Jun-17	Cumulative Oct-2016 to June-2017
Tier 1	-3.3	-7.4	4.2	-18.4	-2.0	0.2	0.2	-1.5	0.1	-27.8
Tier 2	-6.6	7.7	-1.3	-4.2	-1.4	0.0	-1.3	-1.0	-3.0	-11.1
Tier 3	1.4	-0.4	-4.9	11.5	-3.8	-12.2	11.2	1.1	1.0	4.9
All Banks	**-3.4**	**-6.3**	**3.6**	**-16.8**	**-2.0**	**-0.1**	**0.4**	**-1.4**	**-0.1**	**-26.1**

Source: CBK

44. **Uptake of mobile loans has continued to increase.** The number and value of mobile loan approvals have been rising from 4 million in March 2015 to about 9 million in June 2016. Thereafter, the number of approvals remained almost constant with only a temporary dip in September 2016. The value of loan approvals also assumed the same trend, rising from Ksh 7 billion in March 2015 to between Ksh 33 billion and Ksh 34 billion from June 2016 to March 2017. The of number mobile loans approved dropped temporarily in September 2016 following the implementation of the interest capping law, because some banks temporarily suspended mobile loans at that period following the uncertainty as to whether the law applied to mobile loans.

Figure 14: Evolution of Mobile Loan Approvals



Source: CBK

ii. Impact on lending to government by banks

45. **Investment in Government securities has increased:** since the inception of the interest capping law, the commercial banks, as part of re-engineered investment strategy, have enhanced lending to the government. The share of commercial banks in government securities has continued to increase. In December 2015, the share of banks holding of government securities stood at 45.1 percent, at the inception of the interest rate capping law the share increased to 50.5 percent.

Table 5: Composition of Government Domestic Debt by Holder

	Mar-16	Jun-16	Sep-16	Dec-16	Jan-17	Feb-17	Mar-17	Apr-17	May-17	Jun-17
Banks	55.7	56.3	55.0	52.5	51.6	51.0	54.1	55.1	56.2	56.2
Insurance Companies	8.2	7.5	7.4	7.3	7.5	7.5	7.1	7.0	6.9	6.6
Parastatals	4.7	4.7	5.5	5.6	5.7	5.8	6.5	6.5	6.6	6.4
Pension Funds	25.5	25.9	26.6	28.0	28.6	29.0	28.2	27.5	27.9	28.1
Other investors	5.9	5.7	5.6	6.5	6.7	6.7	4.0	3.9	2.4	2.7
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Source: CBK

46. **Most banks reported increased deposits which were channeled to government securities market instead of enhancing lending to the private sector.** In 2016/17 there is evidence of up to 18 banks transferring funds from private sector credit to Government Securities especially in 2016/2017. This partly highlights a change in investment strategy by banks following the enactment of interest rate capping law. The Credit Officers' survey of June 2017 also confirms this development.

Table 6: Changes in investments in government securities by banks

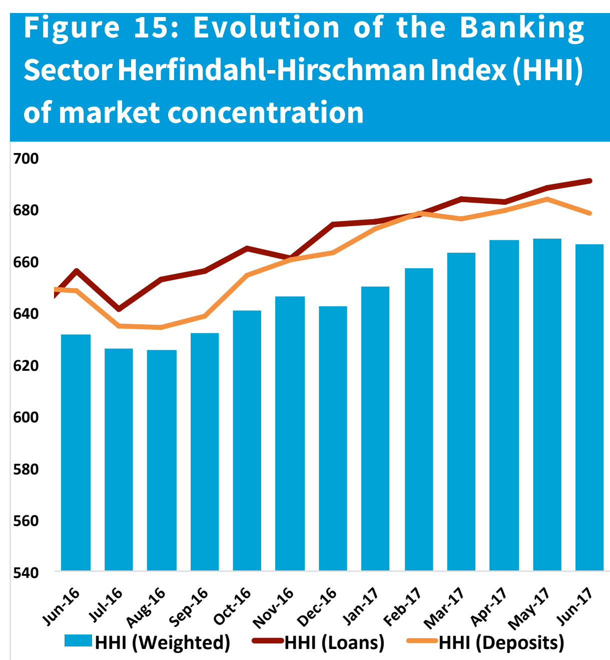
	FY 2014/15		FY 2015/16		FY 2016/17	
	Increasing	Decreasing	Increasing	Decreasing	Increasing	Decreasing
Panel A: Deposits						
Tier 1	6	1	7	0	7	0
Tier 2	13	0	6	7	7	6
Tier 3	17	4	5	16	12	9
All Banks	36	5	18	23	26	15
Panel B: Credit to the Private Sector						
Tier 1	6	1	6	1	6	1
Tier 2	12	1	12	1	6	7
Tier 3	17	4	17	4	11	10
All Banks	35	6	35	6	23	18
Panel C: Investments in Government Securities						
Tier 1			5	2	7	1
Tier 2			8	5	10	3
Tier 3			7	14	9	12
All Banks			20	21	26	16

Source: CBK

Impact on competition in the banking industry

47. **The banking sector remains competitive despite interest rate capping:** The level of competition[8] of the banking sector measures: share of deposits and loans, and the weighted market share, show that the banking sector still remains largely competitive, though the indicators suggest a mild decline in competition in the post-cap period. In the first half of 2016, the market concentration indicators were declining- implying increased competition in the industry. However, since the last quarter of 2016, these indicators started rising, marginally though- implying mild evidence of reduced completion in the industry. This may be on account of the reaction of banks to re-engineer their business models and also loss of deposits by small banks which impacted their capacity to lend thus driving potential borrowers to larger banks.

Figure 15: Evolution of the Banking Sector Herfindahl-Hirschman Index (HHI) of market concentration



Source: CBK

[8] The Herfindahl-Hirschman Index (HHI) of market concentration ranges between 0-10,000. A value of less than 1250 indicates a competitive market.

Impact on Transparency in the Banking Industry

48. **Following the interest rate capping law, some banks have exploited existing approval limits to increase non-interest charges on loans.** Capping the interest rates has resulted in banks exploiting the space in the approved limits to shore up their incomes. We analyzed Offer Letters issued by a Tier 1 bank and established that this particular bank had introduced additional requirements in late 2016. Notably, the appraisal fees for SME loans was increased to 3 percent of the value of loan from 2.5 percent before the interest rate caps while loan insurance was introduced. The most drastic measures were witnessed in the mortgage loan facilities where appraisal fees was increased from 1 percent on loan value for first time borrowers and 0.5 percent for repeat borrowers to a standard fees of 2.5 percent. In addition, a call deposit was introduced.

Table 7: Snapshot of Terms and Conditions Before and After Caps (A case of Tier 1 Bank)

		Before Interest Rate Caps	After Interest Rate Caps
Retail loan facilities	SME loans	2.5% appraisal fee	3% appraisal fee
	overdrafts	No loan insurance	Credit Life Assurance Policy(CLAP) introduced
	Local Purchase Order		
	Asset Based Financing(ABF)	1% for all non-school borrowers	2.5% for purchase of new vehicles
		0.5% for first time school borrowers	3% for purchase of used vehicles
		0% for repeat school borrowers	2.5% for all school borrowers
	High net worth customer facilities	Discounts on loan pricing	No discounts, all loans priced at CBR+4%
	Facilities secured by Customer's own funds Fixed Deposit Receipts (FDR)	No appraisal fee	0.5% appraisal fee introduced
Mortgage loan facilities	Appraisal fees	1% for new borrowers	2.5% for all borrowers
		0.5% for any repeat borrowers	
	Call deposits	No call deposits	Introduced for all facilities except for mortgage scheme facilities
	Stage inspection fees for construction facilities	Not charged	Introduced

Source: CBK

49. **As a result, the banks have enhanced the share of their income from fees and commissions in recent months.** Following interest rate caps, the income of the commercial banks have shifted their revenue sources in favour of non-interest income. The share on non-interest income stood at 12.4 percent in September but it has increased gradually to 15.2 percent in June 2017. The shift to non-interest income is witnessed across all the categories of commercial banks.

- The large banks, which had a stable share of fees and commissions in December 2015- September 2016, witnessed gradual increase to stand at 17.6 percent in June 2017.
- The medium sized banks recorded a share of 10.7 percent in June 2017 from 8.6 percent in September 2016.
- Among the small banks, the share of fees and commissions increased from 8.0 percent in September 2016 to 11.1 percent in June 2017.

Table 8: Evolution of Structure of Banking Sector Income by Tier

	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17
Panel A:All Banks									
Interest on Loans	60.6	63.4	62.5	62.1	61.1	61.2	55.7	56.0	54.8
Securities Income	16.1	13.9	15.0	17.9	19.0	18.4	21.7	20.9	21.7
Fees and Commisions	13.9	14.5	13.1	12.5	12.6	12.4	14.5	15.5	15.2
Other Income	9.3	8.1	9.5	7.4	7.3	8.0	8.0	7.9	8.3
Panel B: Tier 1									
Interest on Loans	60.1	61.9	62.2	60.9	59.3	59.9	54	54.5	52.7
Securities Income	15.3	12.7	13.7	16.7	18.5	16.9	21.1	19.6	21.8
Fees and Commisions	17.1	18.7	15.6	15.1	15.6	15.4	17.4	18.3	17.6
Other Income	7.5	6.7	8.5	7.3	6.7	7.9	7.6	7.7	7.9
Panel C: Tier 2									
Interest on Loans	60.5	64.5	61.0	62.7	62.8	61.5	57.9	57.1	53.5
Securities Income	16.8	15.2	16.9	20.3	20.4	20.9	24.1	24.3	24.8
Fees and Commisions	9.8	9.5	9.7	8.9	7.7	8.6	10.0	10.3	10.7
Other Income	12.9	10.8	12.4	8.0	9.1	9.0	8.0	8.4	11.0
Panel D: Tier 3									
Interest on Loans	64.8	68.9	70.4	69.0	68.6	69.4	61.0	64.2	64.1
Securities Income	19.1	17.0	16.4	17.5	18.1	18.7	18.0	18.2	17.9
Fees and Commisions	10.1	8.2	7.6	7.3	8.0	8.0	9.4	10.1	11.1
Other Income	9.1	5.9	5.6	6.3	5.3	3.9	11.6	7.6	6.8

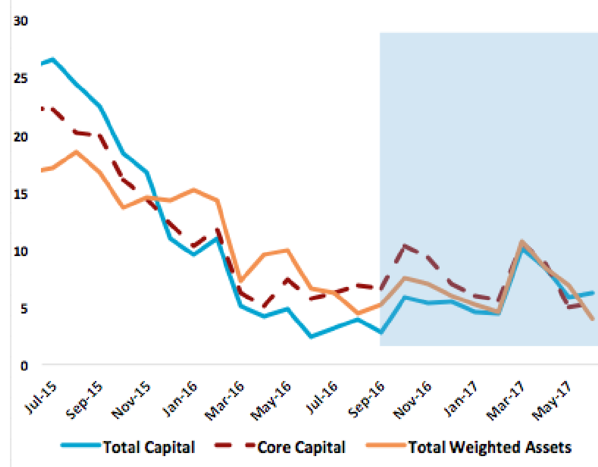
Source: CBK

Risks to Financial Stability

i. Impact on capital of banks

50. **Banking sector remains resilient despite interest rates caps.** Banks remain adequately capitalized with core and total capital to risk weighted assets averaging 15.8 percent and 18.4 percent above the regulatory requirements of 10.5 percent and 14.5 percent, respectively. However, capital had declined since August 2015 signaling either efficiency or overall erosion. The industry, however, remains stable in the post – interest rates caps period.

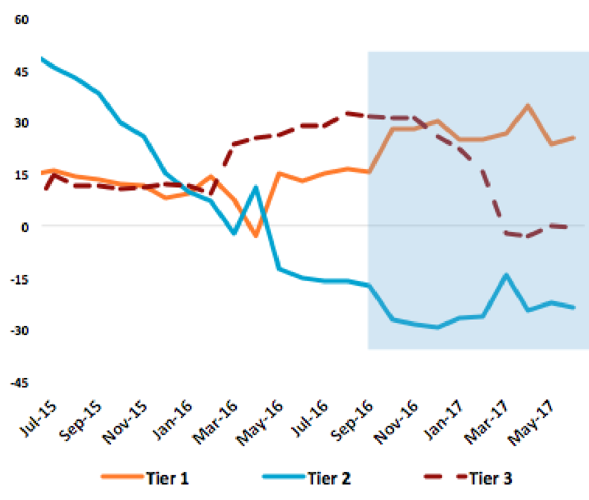
Figure 16: Growth of Capital of the Banking Sector



Source: CBK

51. **Small banks have witnessed significant declines in capital following interest rates caps.** Although small banks are not systemic, their vulnerability to shocks given low capital base can trigger industry-wide fears. Tier III (small size) banks recorded the largest capital erosion after interest capping. This may be attributed to reduced earnings that impacted on capacity to build-up capital. Tier I banks (large size) have maintained high capital build-up levels. Tier II (medium size) banks appear to have been affected by instability in late 2015 and 'new normal' requirements.

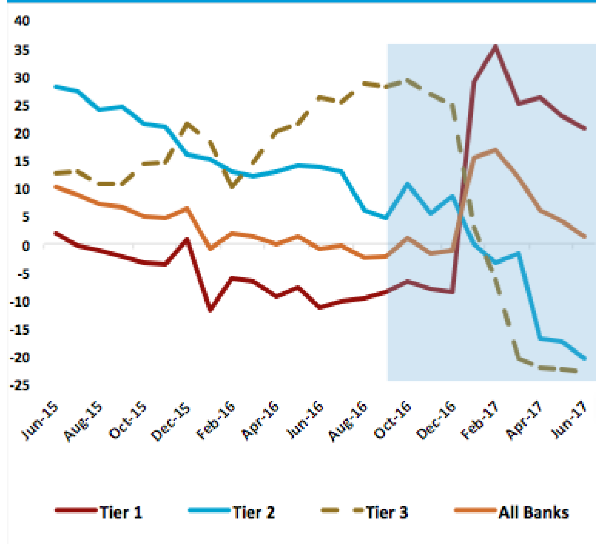
Figure 17: Evolution of Total Banking Sector Capital by Tier (%)



Source: CBK

52. **Small and medium size banks significantly scaled down accumulation of reserves.** Small and medium size banks depleted their reserves or did not have enough profits to shore up their capital base after the caps were introduced.

Figure 18: Evolution of Annual Growth Rates in Reserves Build-up by Tier



Source: CBK

ii. Impact on Profitability

53. **Deterioration in profitability of small banks accelerated in the post-caps period.** Tier III banks were the most affected in terms of profit before tax and the decline in profits seem to accelerate every quarter. This erodes the banks' ability to build capital buffers through retained earnings, hence vulnerable to shocks. Tier II banks have been on recovery path in post-caps period, perhaps due to the ongoing bank mergers and acquisitions.

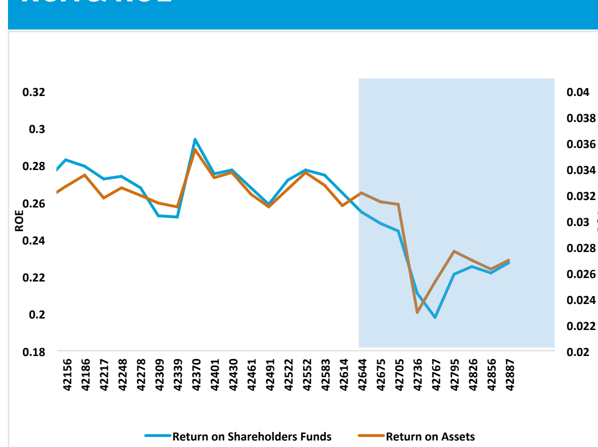
Table 9: Industry earnings measured by profits before tax									
	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17
Tier 1	-0.1	1.7	-0.2	21.5	33.7	37.9	32.2	-10.0	-11.6
Tier 2	26.2	23.3	9.9	-32.1	-48	-45.4	-43.7	-4.6	0.3
Tier 3	2.0	10.2	-8.4	-14.8	-4.9	-10.8	-23.7	-54.0	-74.4
All Banks	**8.3**	**9.3**	**2.9**	**2.9**	**2.1**	**4.6**	**2.7**	**-10.7**	**-11.7**

Source: CBK

54. **ROE and ROA of the banking sector have continued to decline since late 2016.** The return on equity (ROE) touched the lowest level of 19.8 percent in February 2017 with return on assets (ROA) reaching the lowest level of 2.3 percent in January 2017. Decline in earnings over time may pose risks to financial stability through increased balance sheet risks. Also reduces buildup of capital buffers to absorb any shocks. Profitability was the most affected by this interest rates capping law, although the decline started earlier in 2016.

55. **The profitability of the small banks has deteriorated in recent months.** Tier III banks recorded the lowest ROA and ROE, highlighting the challenges they faced in remaining profitable amid interest rates caps. This explains their high depletion of reserves and capital adequacy ratios. Persistent decline in profitability poses risks to financial stability in the event of large size shocks given the thin buffers.

Table 19: Evolution of Banking Sector ROA & ROE



Source: CBK

Table 10: Earnings by Bank Tiers									
	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17
Panel A: Return on Assets									
Tier 1	4.0	3.9	3.7	4.5	4.6	4.4	3.9	3.7	3.3
Tier 2	2.7	2.8	2.7	2.0	1.6	1.6	2.1	1.7	2.0
Tier 3	1.6	1.5	1.4	1.6	1.5	1.3	1.0	0.8	0.4
All Banks	**3.3**	**3.3**	**3.1**	**3.4**	**3.2**	**3.1**	**3.1**	**2.8**	**2.7**
Panel B: Return on Equity									
Tier 1	32.7	31.3	28.9	36.2	36.8	35.5	30.4	28.1	27.2
Tier 2	25.7	25.5	23.4	17.8	15.8	16.1	17.8	15.6	19.1
Tier 3	13.4	12.7	10.4	11.1	9.5	8.3	6.1	5.1	2.4
All Banks	**28.3**	**27.4**	**25.2**	**27.7**	**27.2**	**26.5**	**24.5**	**22.1**	**22.8**

Source: CBK

iii. Impact on liquidity of banks

56. **Overall, the banking industry has remained liquid.** The industry liquidity ratio averaged above 35 percent against a prudential minimum requirement of 20 percent throughout the period of this assessment, implying minimal liquidity risks even after interest rates caps. This high liquidity may be explained by increased holding of government securities by 40 banks, which rose by 40.4 percent between June 2015 and June 2017. The increase however decelerated in the year to June 2017 at 17.2 percent compared to 19.6 percent in the year to June 2016. Government securities are not only safe assets for banks, but they are also considered as liquid instruments in the computation of the liquidity ratio. Therefore banks can easily access additional liquidity in the event of potential risks using these securities as collateral if un-encumbered, unlike other assets.

Table 11: Banking Sector Liquidity Ratios

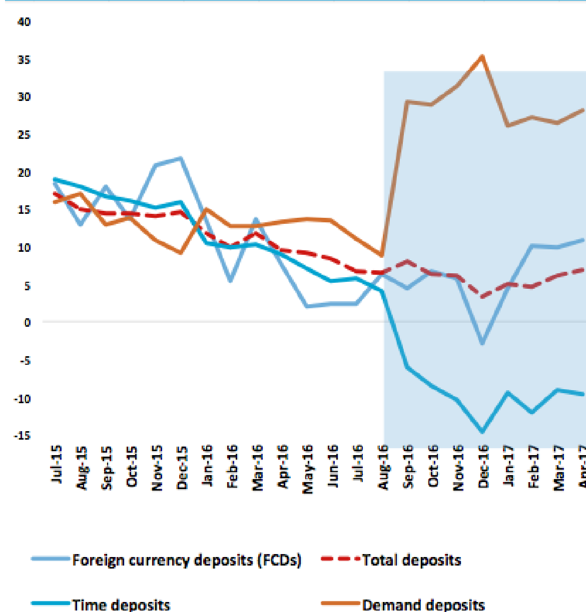
	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17
Tier 1	37.6	35.7	38.9	38.1	40.9	41.3	41.9	43.8	47.9
Tier 2	39.9	39.3	38.0	45.4	41.1	43.7	38.3	40.5	45.3
Tier 3	39.5	38.1	33.5	36.3	33.3	36.4	35.5	35.4	37.6
All Banks	**38.7**	**37.4**	**38.1**	**40.3**	**40.4**	**41.7**	**40.4**	**42.2**	**46.3**

Source: CBK

iv. Impact on Deposits Mobilization by Banks

57. **The structure of deposits has shifted in favour of demand deposits as a result of interests capping law which has implications on long term funding of assets.** There was a marked decline in time deposits (interest earning accounts) vis-à-vis an increase in demand deposits (non-interest earning accounts). In addition, the foreign exchange denominated deposits, which were on the decline in the period before the interest rate caps, started to increase. The shift in deposits in favour of demand deposits followed immediately after the interest rate capping law was implemented.

Figure 20: Evolution of Bank Deposits by Type



Source: CBK

58. **The declining deposits was more pronounced amongst Tier II and Tier III banks.** While only 5 banks recorded declines in deposits in the FY 2014/2016, a total of 23 Tier II and Tier III banks lost deposits in FY 2015/2016, with a further 15 banks still losing deposits in FY 2016/2017. In terms of banks deposit base, while the deposits increased by Ksh 433 billion or 20.2 percent in 2014/15, they increased by only Ksh 198 billion or 7.68 percent in 2015/16 and the growth in deposits declined to merely 7.4 percent in 2016/2017. As already indicated Tier II and Tier II banks were the worst affected by the decline in deposits especially in 2015/2016.

Table 12: Evolution of Bank Deposits

Ksh. & Percentage Changes	FY 2014/2015		FY 2015/2016		FY 2016/2017	
	Ksh. Billion	Percent	Ksh. Billion	Percent	Ksh. Billion	Percent
Tier 1	229.8	19.8	213.6	15.4	177.3	11.1
Tier 2	176.2	22.6	9.0	0.9	38.3	4.0
Tier 3	27.4	12.8	-24.1	-10.0	-9.7	-4.5
All Banks	**433.4**	**20.2**	**198.5**	**7.7**	**206.0**	**7.4**
No. of Banks	Increasing	Decreasing	Increasing	Decreasing	Increasing	Decreasing
Tier 1	6	1	7	0	7	0
Tier 2	13	0	6	7	7	6
Tier 3	17	5	5	16	12	9
All Banks	**36**	**6**	**18**	**23**	**26**	**15**

Source: CBK

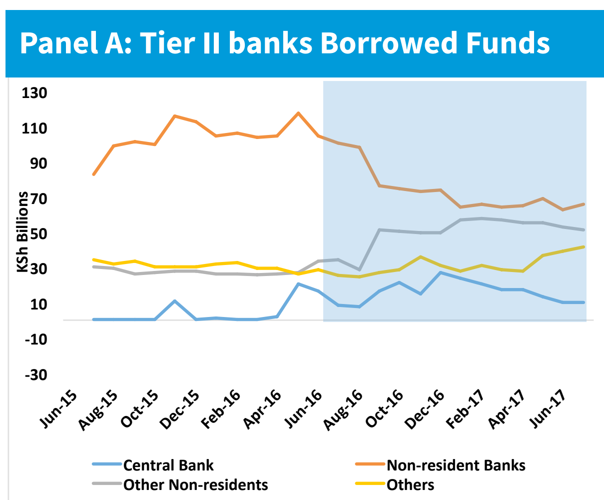
59. **There was recovery in total deposits in the first half of 2017.** However, this was not accompanied by commensurate impact on private sector credit (PSC), partly because a large proportion of total deposits is demand deposits, usually considered unstable to support effective lending. Banks increased the share of demand deposits to total deposits from an average of 46.4 percent over the period September 2015 to July 2016 compared to an average of 53.7 percent over the period August 2016 to June 2017. This limits the banks' ability to expand lending, hence slowdown in credit to the private sector in the period under review.

v. Impact on Funding Structure of Banks

60. **Interest rate capping has altered the funding structure of small and medium banks.** While Tier II banks sourced their funding from non-resident banks prior to caps, they have switched to other non-residents in post-caps period Tier III banks also experienced significant decline in funding from 'Others' in post-caps period.

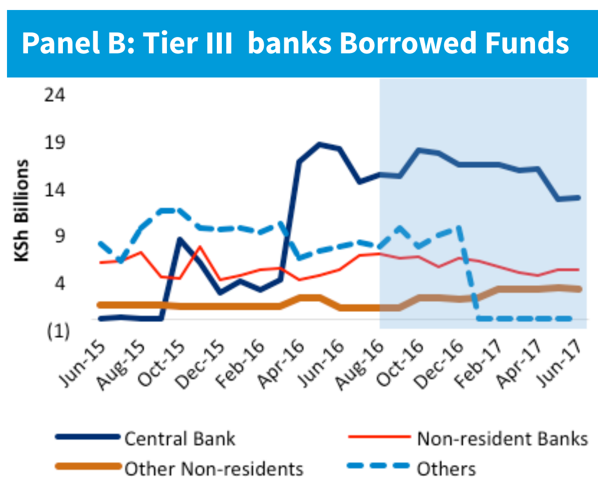
Figure 21: Commercial Banks Funding Outside Deposits

Panel A: Tier II banks Borrowed Funds



Source: CBK

Panel B: Tier III banks Borrowed Funds



Source: CBK

vi. Impact on Credit Risk

61. **Credit risks have become more elevated in post-caps period especially for medium banks.** The banking industry continues to face credit risks. The ratio of net NPLs to total capital among Tier II banks worsened to 69 percent in June 2017 compared to 19 percent in June 2016.

Table 13: Banking Sector Net NPLs/Total Capital

	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17
Tier 1	10.63	10.66	10.66	13.09	13.76	18.59	13.12	13.58	13.0
Tier 2	10.03	9.81	13.96	27.89	18.96	65.75	65.74	68.07	69.06
Tier 3	16.42	10.58	15.01	13.89	10.54	33.19	12.07	13.79	14.16
All Banks	**10.82**	**10.3**	**12.34**	**18.19**	**25.91**	**35.7**	**27.33**	**28.03**	**26.77**

Source: CBK

62. **The asset quality of banks deteriorated in post caps period largely attributed to tier banks.** The ratio of gross NPLs to gross loan increased from 10 percent in June 2016 to 23 percent in June 2017 signaling deteriorating asset quality for Tier II banks. Similar trend has been observed for Tier III banks and the overall industry.

Table 14: Banking Sector Gross NPLs/Gross Loans

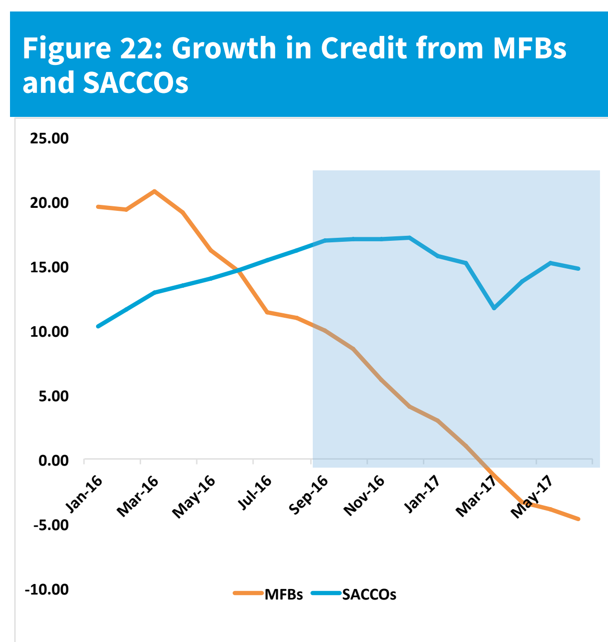
	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17
Tier 1	4.9	4.8	5.1	6.1	6.5	6.4	6.6	7.3	7.0
Tier 2	5.2	4.9	6	11	9.8	18.6	22.7	19.8	23.1
Tier 3	12.8	11.1	12.2	12.1	11.8	14.9	12.7	15.1	15.6
All Banks	**5.7**	**5.4**	**6.1**	**8.3**	**10.6**	**11.4**	**11.8**	**12.3**	**12.3**

Source: CBK

Migration to Alternative Borrowing Avenues

63. **Evidence of migration of borrowers to expensive sources of financing is weak.** The interest rate capping is expected to constrain access to credit by riskier borrowers who will eventually migrate to expensive sources of financing. While we do not have evidence about the upsurge in the number of predatory lenders, we argue that those borrowers who are rationed out by the commercial banks will seek loans from those institutions which are not subject to interest capping law - Micro financial institutions, SACCOS and non-regulated lenders. We, however, note that the growth in loans by MFBs declined significantly since late 2016 while that of SACCOs has declined marginally. This suggests that customers being rationed out by the commercial banks are not being accommodated by the institutions.

Figure 22: Growth in Credit from MFBs and SACCOs



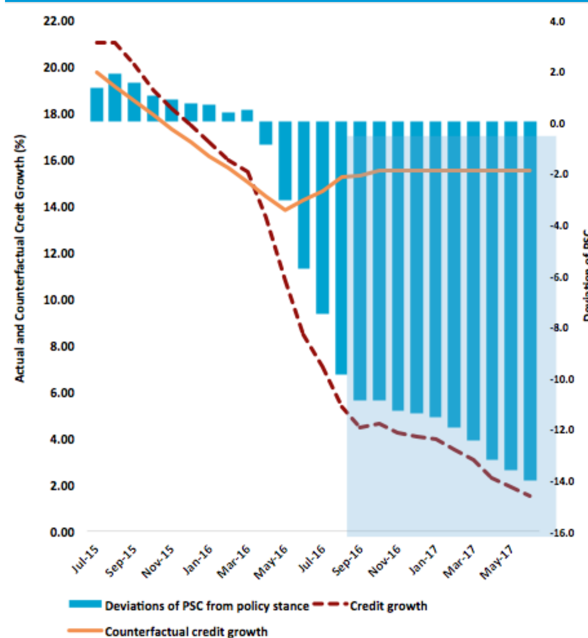
Source: CBK

Impact on the Conduct of Monetary Policy

64. **Available evidence suggests that under a normal environment monetary policy is effective.** A change in the central bank rate will affect other rates and consequently impact on the growth of credit to the private sector. Analysis based on data for the period up to September 2016, show the following;

- A 1 percentage change in CBR results in a 0.4 percentage change in credit to the private sector in the opposite direction. Therefore, following the monetary policy stance which was implemented up to mid-last year, the credit to private sector was expected to decline at a slow pace than witnessed during the period.

Figure 23: Evolution of credit to private sector



Source: CBK

65. **The interest rate caps has delivered perverse outcomes of monetary policy.** When the interest rate capping was implemented the CBR rate was at 10.5 percent. With the binding deposit and lending rates, the lending rate was capped at 14.5 percent while the rate of growth of credit to the private sector was at approx. 8 percent per annum. On September 20, 2016, the MPC, in its regular meetings, noted that inflation was expected to decline but had concerns with the slowdown in credit to the private sector. Consequently, it decided to reduce the CBR by 50 basis points to 10.0 percent with the anticipation of reversing the declining trend. However, credit to the private sector continued to decline leading one to conclude that the monetary policy action produced counterintuitive results… a loosening on monetary policy yielding unexpected decline in credit to the private sector.

66. **Going forward, under the interest rate capping regime, there is no guarantee the central bank will be able to achieve its intended objectives.** The Central Bank is charged with the mandate of conducting monetary policy aimed at ensuring price stability. To achieve this objective the CBK uses a number of tools, including the CBR. In the interest rate capping environment, use of CBR will result in perverse outcomes. During the phase of monetary policy loosening to stimulate credit expansion to support growth, the interest rate cap will also adjust downward. As a result, those individuals with credit risk above the capped rate will be shunned by banks thereby leading to contraction in growth of credit to the private sector. On the other hand, during the tightening phase of monetary policy, the banks will be able to have a relatively wider space to price risk and therefore increase credit to the private sector contrary to the intention of the monetary policy stance.

Impact on Economic Performance

67. **Interest rate capping law has further decelerated credit to the private sector thus impacting economic growth prospects:** Our analysis shows that different sectors of the economy respond at different speeds and magnitudes to changes in credit: some respond with a lag of 1 quarter while others respond with a lag of up to 4 quarters. In addition, the magnitude of response varies with the sector. Analysis show that a 10 percent change in sectoral credit results in between 0.11 – 0.17 percent changes in sectoral growth in the respective sectors. In view of these findings:

- The real GDP growth in 2016 contracted by 0.22 percentage points on account of the slowdown in credit to the economy.
- In 2017, from a baseline projection for real GDP growth of 5.7 percent, the slowdown in credit to the private sector could contract output by about 0.4 percentage points.
- The analysis is, however, preliminary given that one year may too short for full impact on economic growth performance to fully materialize.

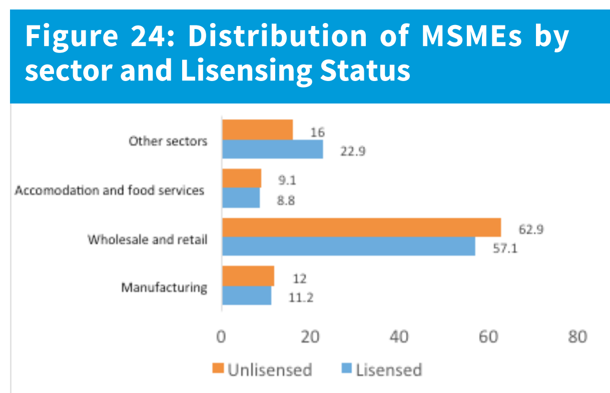
Table 15: Responses of Sectoral GDP to Sectoral Credit

Sector	Lags (Number of Periods it takes for the Impact to materialize - in Quarters)	Elasticity
Agriculture	2	0.017
Construction	4	0.015
Finance and Insurance	1	0.016
Manufacturing	1	0.014
Mining and Quarrying	5	0.011
Real Estate	2	0.015
Other	2	0.015

Source: CBK

68. **The MSMEs make a significant contribution to the economy but they are concentrated in the services sector.** According to the KNBS MSME 2016 Survey, MSMEs account for approximately 28.4 percent of GDP- most of the SMEs are registered and captured in the national accounts. Most of the MSMEs are concentrated in three main sectors- Wholesale and Retail (60 percent); Manufacturing (11.6 percent); and Accommodation and Food Services sector (9 percent). The rest of the sectors of the economy account for approximately 19.5 percent of MSMEs.

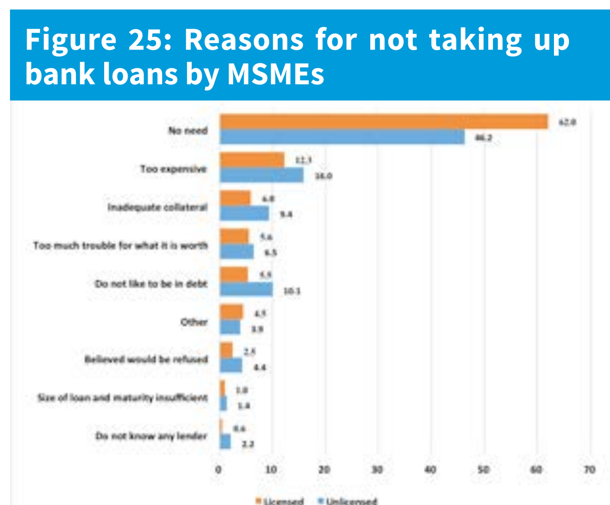
Figure 24: Distribution of MSMEs by sector and Lisensing Status



Source: KNBS

69. **The MSMEs have low uptake of bank loans:** The MSMEs Survey of 2016, shows that more than half of the MSMEs do not seek bank loans. The majority rely on family/own funds for working capital.

Figure 25: Reasons for not taking up bank loans by MSMEs



Source: KNBS

70. **Commercial banks have continued to drift away from MSMEs loans:** The small and medium entreprises have borne the greatest impact of the interest rate capping law. According to the Finaccess Survey, the share of MSME lending by commercial banks was high in Kenya, at 23.4 percent in 2015 compared to other countries. However, a survey conducted by KBA in late 2016, shows that the average MSMEs loans has declined to 17 percent, with the small banks providing 39 percent of the lending to the MSMEs.

Table 16: Share of SME Loans in Total Loans by Tier

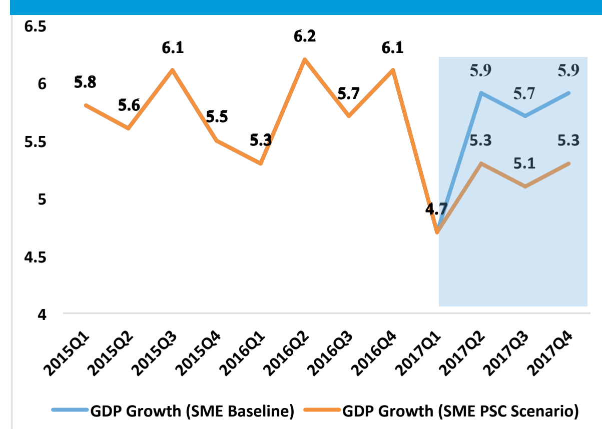
	Share of SME Loans to Total Loans	Average Interest Rate
Tier 1	11	19
Tier 2	21	17
Tier 3	39	17
Average*	**17**	**18**

* Weighted by market share of each bank

Source: KBA

71. **Withdrawal of credit to this segment has implications on economic growth prospects:** The real GDP growth in 2017, contributed by the MSMEs will decline by 1.42 percent points. As a result, overall real GDP growth is expected to decline by 0.40 percentage points.

Figure 26: Impact of rationing out MSMEs on Growth



Source:CBK

F. Conclusion

72. The objective of this study is to investigate the impact of the interest rate capping on the Kenya economy. The law capping interest rates became operational on September 14, 2016. It was implemented following concerns raised by the public regarding the high cost of credit in Kenya which may have impacted on access to loans by a large segment of the population. Implementation of the law, therefore, was expected to lower the cost of credit and increase access to credit. The law has been in operation for a year, although this is not sufficiently long for the full effects on the economy to manifest, nonetheless we investigate whether the intentions of the interest rate capping law have been achieved.

73. To unravel the evidence, we first review literature on from around the world on the outcomes of the interest rate controls. we note that in most cases caps have produced undesirable outcomes such as reduced intermediation with banks becoming less transparent, reduced banking competition and increased risk to financial stability. In addition, impact on the conduct of monetary policy and growth have been witnessed.

74. In this study we use bank level data covering a period before and after the interest rate capping period, obtained from the Central Bank of Kenya. In addition we use selected macroeconomic variables obtained from the Kenya national Bureau of Statistics. Based on the analysis we find that interest rate caps have started to yield negative effects on the Kenyan economy as follows:

- The interest rate caps infringes on the independence of the central bank and complicates the conduct of monetary policy. It is found that under the interest rate capping environment, monetary policy produces perverse outcomes.
- Reduced intermediation by commercial banks - there has been significant increase in average loan sizes arising from declining loans accounts, mainly driven by the large banks, thus shunning the smaller borrowers.
- The banks have shifted lending to Government and the large corporates.
- Whereas demand for credit increased following the capping of lending rates, credit to the private sector has continued to decline.
- The structure of revenue of the banks has started to shift away from interest income. In addition, some banks have exploited the existing approval limits to increase fees on loans in a bid to offset loss in interest income.
- The banking sector remains resilient. However, small banks have experienced significant decline in profitability in recent months, which may complicate their viability.
- Exclusion of MSMEs by the commercial banks will lower growth by 0.4 basis points in 2017 mainly on account of the reduced access to credit by the MSMEs.

75. We note that these effects have emerged in the last one year, however, they may become magnified in the medium to long term as was the case during the post-independence period.

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FAILED BANKS AND NON- BANK FINANCIAL INSTITUTIONS IN KENYA			
	NAME OF INSTITUTION	DATE CLOSED/RESTRUCTURED	REASONS FOR FAILURE
	Rural Urban Credit &Finance Ltd		Non- performing loans
1	Official Receivership	Dec-84	Insider loans(Unsecured)
	Continental Bank of Kenya Ltd		Non- performing loans
2	Official Receivership	Aug-86	Insider loans(Unsecured)
	Continental credit & Finance Ltd		Non- performing loans
3	Official Receivership	Aug-86	Insider loans(Unsecured)
	Capital Finance Ltd		Mismanagement
4	Under Consolidated Bank	Jan-87	
	Business Finance Co.Ltd		Ineffective Board
5	Under Consolidated Bank	Dec-89	Non- performing loans
	Estate Finance Co of (K) Ltd		Insider dealings(unsecured)
6	Under Consolidated Bank	Dec-89	Non- performing loans
	Home savings and motgage Co. Ltd		Non- performing loans
7	Under Consolidated Bank	Dec-89	Ineffective Board
	Nation Wide Finance Co. Ltd		Insider loans(Unsecured)
8	Under Consolidated Bank	Dec-89	Non- performing loans
	Union Bank of Kenya Ltd		Mismanagement
9	Under Consolidated Bank	Dec-89	Poor credit facilities
	Jimba Credit Corp Ltd		Asset/ Liabilities mismatch
10	Under Consolidated Bank	Dec-89	Credit concentration
	Kenya Savings &Mortgage Ltd		Asset/ Liabilities mismatch
11	Under Consolidated Bank	Dec-89	Non- performing loans
	Nairobi Finance Corp Ltd		Non- performing loans
12	Liquidation by DPF	Apr-93	Under capitalisation
	International Finance Co.Ltd		Insider loans(Unsecured)
13	Liquidation by DPF	Apr-93	Mismanagement
	Exchange Bank Ltd		Violation of Banking Act
14	Voluntary Liquidation	Apr-93	Licence revoked
	Post Bank Credit Ltd		Malpractice in Clearing House
15	Liquidation by DPF	May-93	Credit Concentration
	Inter Africa Credit Finance Ltd		Insider loans(Unsecured)
16	Liquidation by DPF	Jun-93	Non- performing loans
	Central Finance (K) Ltd		Under capitalisation
17	Liquidation by DPF	Aug-93	Non- performing loans
	Middle Africa Finance Corp Ltd		Non- performing loans
18	Liquidation by DPF	Aug-93	Under capitalisation
	Trade Bank Ltd		Malpracrices in Forex
19	Liquidation by DPF	Aug-93	Non- performing loans
	Trade Finance Co. Ltd		Non- performing loans
20	Liquidation by DPF	Aug-93	Mismanagement
	Diners Finance Ltd		Under capitalisation
21	Liquidation by DPF	Aug-93	Domino effects/Trade bank
	Allied Credit Ltd		Under capitalisation
22	Liquidation by DPF	Aug-93	Insider loans(Unsecured)
	United Trustee Finance Lltd		Insider loans(Unsecured)
23	Liquidation by DPF	Aug-93	Under capitalisation
	Pan-Africa Credit & Finance Ltd		Violation of Banking Act
24	Liquidation by DPF	Oct-93	Licence revoked
	Pan-Africa Bank Ltd		Violation of Banking Act
25	Liquidation by DPF	Oct-93	Licence revoked
	United Bank Ltd		Successfully restructured.
26	Restructured:Now Chase Bank	Aug-94	
	Thabiti Finance Co. Ltd		Under capitalisation
27	Liquidation by DPF	Dec-94	Insider loans(Unsecured)
	Meridien Biao (K) Ltd		Forex exposure
28	Liquidation by DPF	Apr-96	Malpracticse by directors
	Kenya Finance Bank Ltd		Non- performing loans
29	Liquidation by DPF	Jul-96	Mismanagement
	Heritage Bank Ltd		Non- performing loans
30	Liquidation by DPF	Sep-96	Malpracticse by directors
	Ari Banking Corp Ltd		Non- performing loans
31	Liquidation by DPF	Dec-97	Mismanagement
	Reliance Bank Ltd		Run on deposits
32	Liquidation by DPF	Sep-98	Cheque kiting
	Bullion Bank Ltd		Run on cert. of deposits
33	Re-opened on 20.1.2000	Sep-98	Non- performing loans
	Trust Bank Ltd		Run on deposits
34	Re-opened on 9.8.1999	Sep-98	Mismanagement
	Prudential Bank Ltd		Non- performing loans
35	Liquidation by DPF	Nov-98	Mismanagement
	City Finance Bank Ltd		Run on deposits
36	Re-opened on 17.4.2000	Nov-98	Mismanagement
	Fortune Finace Ltd		Run on deposits
37	Liquidation by DPF	Sep-99	Mismanagement

Appendix I: List of Failed Banks: 1984-1999

Appendix II: Financial sector reforms from late 1980s through the 1990s

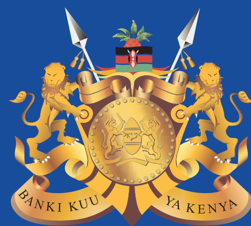
Period	Policy Action
1989	
Jun	FSAP credit approved
Jul	FSAP credit effective and indirect monetary policy measures initiated
Nov	Legislation providing for establishment of Capital Market Authority passed by Parliament
	Minimum saving deposit rate payable by banks and NBFIs raised by 0.5% and maximum lending rate for loans and advances not exceeding three years raised to 15.5%
The Banking Act (1968) was also revised, strengthening the activities of the Central Bank	
1990	
Jan	Capital Market Authority established
Mar	Rate on one-year treasury bond increased by 0.5% to enhance attractiveness
Apr	Minimum saving deposit rate increased by 1% together with maximum lending rate for loans with maturities up to 3 years.
	Treasury bill rate increased by 1%
	Requirement removed that ceilings on loan interest rate include all lending related charges and fees, permitting institutions to set their lending rates to reflect current market conditions
Nov	Treasury bill rate fully liberalized
1991	
June	Consolidated Bank of Kenya Act effected, providing for the transfer of assets and liabilities of banks and NBFIs with solvency problems to Consolidated Bank of Kenya
Jul	Interest rate fully liberalized
Oct	Convertible foreign exchange bearer certificate (Forexcs) introduced, marking the first step to liberalization of the foreign exchange market
Nov	Exchange control account partially relaxed by withdrawing the clause covering declaration of foreign currency held by incoming travelers
1992	
Jan	Minimum capital/assets ratio raised from 5.5% to 7.5% and prudential guidelines prepared to encourage self- regulation; including code of conduct of directors, chief executive and other employees, duties and responsibilities of directors, chief executives and management, appointment duties and responsibilities of external auditors and provision of bad and doubtful advances and loans
Mar	Ksh500 million in treasury bills acquired by CBK to replenish its stock of trading Portfolio
Apr	Secondary market for Forexcs's established
May	Marginal cost raised by 1% for additional increments of Ksh50 million in advances and rediscount of treasury bills and other government securities to ensure that commercial banks with overdrafts with central bank exceeding Ksh 50 million are appropriately sanctioned
Aug	Retention scheme introduced allowing 100% retention of foreign exchange earnings from non-traditional exports

Period	Policy Action
Oct	Commercial banks allowed to borrow foreign exchange currency to finance tea and coffee purchases in auctions
	Banks allowed to send dollar accounts for coffee and tea buyers and sellers
	New penalties announced for commercial banks failing to observe the mandatory cash and liquidity ratios
Nov	Retention scheme extended to cover traditional exports of goods at 50%
1993	
Feb	Retention scheme extended to service sector at 50%
	Foreign exchange allocation by central bank abolished
Mar	Foreign exchange certificate made redeemable at market exchange rate
	Devaluation of 25% of official shilling exchange rate
	Retention account suspended
Apr	Margin on central bank advances and discounts to banks increased
	Cash ratio increased from 6% to 8%
	Devaluation by 33% of official shilling exchange rate
May	Maturity life for securities to be eligible for rediscounting reduced to 45 days or less
	New penalty for banks failing to observe the mandatory cash ratio announced
	Re-introduction of retention scheme – 50% of all foreign exchange
	Further liberalization of foreign exchange system allowing commercial banks to effect foreign payments for their private clients without referring to the Central Bank of Kenya
	Import licensing system abolished short-list of prohibited and restricted imports
	Revolution of restriction on importation of assembled commercial vehicles
	Maximum import tariff reduced from 60% to 50% and tariff rate bands from 9 to 7
Jun	Introduction of one-way foreign exchange auction system
	Cash ratio raised from 8% to 10%
Aug	Paper eligible for rediscounting restricted by lowering maturities a) Treasury bill (half way). b) Treasury bonds (45 days or less).
	Securities accepted as eligible as collateral for overnight loans
	A two tier foreign auction system introduced
	Nairobi clearing house new arrangements effected to eliminate automatic provision of central bank credit to banks
	Registration of foreign exchange certificate holders with banks in order to buy them back at negotiated or market price
Sep	Registration of foreign exchange certificate by banks with Central Bank
Oct	Shilling exchange rate allowed to float freely
	Cash ratio raised from 10% to 12% with balance above the minimum requirement to earn interest at 35% per annum

Period	Policy Action
Nov	Central bank started daily foreign exchange transactions with commercial banks
	Commercial banks allowed to continue purchasing foreign exchange for oil and petroleum products from the market and central bank.
	Central bank continued entering into forward contracts for purchase of oil and related products out at market rates
	Credit guidelines abolished
	Cash ratio raised from 12% to 14% with excess balances paid 35% interest per Annum
	Restriction removed on remittance of profits, dividends and expatriate earnings
Residents allowed to borrow abroad up to US$1 million During the year central bank operated with a tight monetary policy with high money supply. Treasury bill diversified to accommodate investors' diverse liquidity preference. The 30-, 60- and 180-day bills were introduced adding to the 90-day bill that existed in the market.	
1994	
Feb	Cash ratio increased from 14% to 16% with interest paid on bank balances with bank in excess of 10% reduced from 25% to 20%
	Foreign exchange retention raised to 100%
	Residents allowed to open foreign currency accounts with banks in Kenya
	Restriction on local borrowing by foreign controlled companies removed
	Foreigners allowed to pay hotel bills and air tickets in either foreign or Kenya currency
Mar	Liquidity ratio for commercial banks and non-bank financial institutions to be maintained at 5 and 10 percentage points, respectively, above the current commercial bank cash ratio requirement
	Cash ratio raised from 16% to 20% and interest payment on commercial bank deposits at the bank withdrawn
Apr	Open market operations sale of Treasury bills to be at least 0.5 percent below the weekly average tender rate
	Commercial banks to borrow from the bank for a maximum of 4 consecutive days and no more than 10 days in any one month
Jun	Kenya accepted obligations of Articles of Agreement of the International Monetary Fund
	Foreign currency account holders encouraged to retain some of their funds overseas under the care of commercial banks
	Commercial banks required to back the funds retained overseas 100% by foreign assets
	Restated determination of the exchange rate by market force
	Cash ratio lowered 20% - 18%
Dec	Announced requirement for NBFIs to open account with central bank for purposes of maintaining cash ratio
1995	
Jan	Authorization and licensing of foreign exchange bureaus announced
	Foreign investors allowed to participate in stock exchange market under guided policy on ownership
	Reaffirmation that the regulatory body of the stock exchange would be Capital Market Authority
Mar	Commercial banks to observe foreign exchange exposure limit of 20% of the paid up capital plus unimpaired reserves
Apr	Newly converted NBFIs to observe half the mandatory 18% of the cash ratio

Period	Policy Action
Jun	A bill minimum 5 days introduced. Firms listed by NSE allowed to issue commercial paper and treasury bill of 5 days maturity
Jul	Balance of the newly converted banks to be 0.135 of the institutions' total deposits from 31.5.95.
	NBFIs subjected to the mandatory cash ratio requirement; requirement initially set at 1.8% of eligible deposits and raised progressively to 18% by December 1995
	Tightened conditions for overnight loans and rediscounting at central bank by commercial bank
	Treasury bills held at 50% of life to maturity for overnight loans or 75% for rediscount were eligible. Also bills to have two clear working days to maturity. Banks' lending in the inter-bank market not allowed to borrow over-night from central bank
	Commercial banks to submit weekly foreign currency exposure return every. Monday; off balance sheet items excluded from computation of foreign currency the stability of the financial system
	Investment compensation fund established to protect investors against losses arising from equity trading
	Foreign capital regulations revised to enable foreigners to own up to 40% of local company listed in NSE and equity participation by a single investor increased from 2.5% to 5.0%
	Liquidity ratio fixed at 25% for both banks and NBFIs and 20% for mortgages finance companies
Aug	Minimum investment in treasury bills under OMO lowered to Ksh 100,000 form 1000,000
	Procedure for renewal of licenses by banks and NBFIs modified 1st year licenses of branches to be computed and charged on a pro-rated basis; thereafter full licenses fees to be paid for the head office and all branches simultaneously
Sep	Commercial banks allowed to exclude deposits of financial institutions from cash ratio
	Commercial banks to submit monthly breakdown of government and parastatal deposits in addition to monthly statistic returns
Oct	Central bank launches a redesigned treasury bill that conforms to the magnetic ink character recognition (MICR) cheque clearing system. The new instrument serves as a bill and a cheque
	Banking Act Amended (27th October)
Dec	Central bank starts paying 5% interest on all cash balances held by commercial banks and NBFIs at Central Bank to facilitate a reduction in banking lending rates
	NBFIs required to invest in treasury bills a minimum of 50% of their liquid asset Withdrawn
	Repeal of Exchange Control Act
	Cash ratio raised to 18%
1996	
Jan	Central bank display OMO rates on the Reuter screen, to encourage independent decision on quotation for purchase of the treasury bills
May	Measures taken to improve effectiveness of secondary trading in financial instrument
	Treasury bills for 30, 90, and 180 days replaced by 28, 91 and 182 days; while 60 and 270 days were discontinued
	Cash ratio requirement relaxed to allow fluctuations up to minimum 15% but an average 18% for 14 days
	5% interest that commercial banks received on the cash balances with the central bank discontinued
The minimum paid up capital was raised during the year.	

Source: CBK & KIPPRA



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