The POINT

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Moderating the Interest Rates Spread

The real interest rate spread in Kenya is among the highest in the world. This state of affairs is more worrisome because the banking industry has undergone substantial liberalisation. In September this year, Hon. Joe Donde forwarded a bill seeking to control interest rates thereby reversing aspects of the liberalisation. Following the publication of the bill, the Institute of Economic Affairs held a forum inviting Hon. J. Donde ***(M. P. Gem constituency)***, Mr. Isaac Awuondo ***(Chairman, Kenya Banker's Association)*** and Dr. Njuguna Ndung'u ***(Principal Analyst, Kenya Institute of Public Policy Research and Analysis)*** to brainstorm on the subject. The Point presents the issues discussed.

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Despite the liberalization of the financial sector Kenya has consistently maintained a high interest spread. More specifically, the interest rate applicable to the Treasury Bill, which is the government's risk free security has been unacceptably high and this has the primary effect of diverting the financial institutions such as banks into the heavy purchase of Treasury Bills.

While the government has consistently been issuing Treasury Bills, it has at the same time been expanding the public debt. Due to the extensive lending to the government, banking institutions have been lending to the private sector quite sparingly in the ostensible preference for safer investments.

As a result of the above scenario, it appears to many in Kenya that banking institutions are making substantial profits and exacerbating the public debt while denying loans to the public. This matter has been considered by various people but was accorded prominence when the Attorney General published a bill in the Kenya Gazette dated the 8th September 2000.

This bill, which was drafted by Hon. Joe Donde, is the Central Bank of Kenya (Amendment) Bill 2000. The stated objects of the bill are to harmonise the cost of lending and borrowing in the banking sector in order to ensure that the rates reflect the market conditions.

The intention is to make the Treasury Bill, as a risk-free security, the benchmark for the interest rates in the financial industry. The imposition of this requirement means that the spread on the interest rates may not exceed 6% and that the Central Bank of Kenya is to ensure that banking and financial institutions adhere to this provision. As a result, the interest

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rates on loans will be pegged to the 91-day Treasury Bill rates.

In reality, Kenyans have often lamented that the interest rates are unjustifiably high but there have been no concrete attempts to effect monetary responses to control the rates. At the same time, despite the fact that 36% of the loans issued by the banking institutions are non-performing, the common perception is that the real and expected effects of the liberalization regime seem to have been reaped only by banking institutions in the form of high profits.

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Figures show that the differential in the interest rates on deposits and Treasury Bills has grown higher than it was in the pre-liberalization era. It is due to the fact that this differential has been sustained and that has been the cause for public concern. The status quo remains that while Treasury Bill rates are high, the interest on deposits are not proportionate.

Causes of High Interest Spread in Kenya

E Public Debt

The most obvious cause of the high interest rates in Kenya is the huge public debt that the government carries. As an illustration of the size of this debt, in the financial year 2000/2001, out of a total proposed expenditure of Kshs. 266.2 billion, up to Kshs. 109.9 billion will be directed towards debt servicing.

Most of this debt has been accumulated from issuance of Treasury Bills and the cycle is repeated when the excess liquidity has to be mopped out by issuing Treasury Bills at higher rates. In the process, the government has become trapped in debt to the extent that it must issue more bills to honour its obligations on the maturing bills.

Due to this cycle, the government has had to offer progressively high interest rates on the Treasury Bills to attract bids. This state of affairs means that the size of the debt cannot be reduced because of the need to borrow to pay the maturing bills. It is an unenviable state of affairs that 41.2% of the total government expenditure is directed towards the redemption of debt.

E Deficits

At the time of the budget in June 2000, the domestic debt stood at Kshs. 182 billion and with the continued issuance of Treasury Bills, the government remains perpetually indebted. At the same time, due to the budget deficits that it faces, the government has had no option but to resort to borrowing to finance the expenditure. This has characterised the government as a perennial borrower. The borrowing of money is not necessarily the problem but the reason for concern is that the government goes into debt merely to pay earlier debt. In metaphorical terms, this behaviour is equivalent to digging even deeper holes in order to fill up the last one.

E Cash Ratios

Banking regulations require commercial banks to maintain a cash ratio of up to 10% of their total deposits with the Central Bank of Kenya. This cash ratio requirement means that while the banks must pay the interest on the deposits, they only keep 90% of the deposits for their operations because the Central Bank does not pay any interest on the 10% deposited with it. This requires the banking institutions to make up for the interest that they have to pay to depositors. This high cash ratio requirement adds to the cost of operations for bankers if they must pay interest to all depositors and reduces the revenue earning assets available to banking institutions.

E Litigation Costs

On the average, a civil case in Kenya takes no less than three years to complete. This means that even where the loan payments have been defaulted on, it usually takes a lot of time before the banking institution is able to sell the security to realise its payment. This long litigation process not only increases costs in terms of the legal fees, but also aggravates the interest problem. As compared to the defaulter, the lending banks are at a considerable disadvantage when there are non-performing loans. This inability to promptly recover loans affects the liquidity of banks and raises the cost that applies to loans.

E High Wage Bills

The financial institutions in Kenya have been the most active participants in the purchasing of Treasury Bills and by virtue of taking on a virtually risk free investment as the Treasury Bill, have been recording admirable profit levels. This has led to the demands by bank workers for higher wages that have raised considerably the operating costs of commercial banks. The wage demands have been costs that are passed on to the consumers of banking services. As a result, banking institutions bear heavy costs out of their success.

E Poor Lending

Because the government still owns or has interest in some banks in Kenya, its influence in the industry is considerable. Some of these banks have been lending funds to individuals and corporations without taking adequate security for the loans. When the loans are defaulted on, the banks often have no recourse but to let the funds pass as bad debt.

This practise of poor lending precipitated by government-owned banks often occasions the public great losses in assets and funds because the practise has often involved bank executives. Often bank executives lack the independence to reject politically influential people who apply for loans from government owned banking institutions. When these people default on their loans, the bank finds itself unable to recover the money owed to it because the loan was unsecured.

Effects of High Interest Rates

@ Inflation

Where the lending rates are high and borrowers have no options for raising capital, the goods and services produced from the money borrowed have to factor in the high cost of the capital. This means that since the borrowers have to service the loans and retain a mark up, the goods and services sold are more expensive because the entire cost of the loans are passed on to consumers.

As a consequence of this rise in the prices of goods and services, the level of inflation rises correspondingly. This phenomenon of rising prices and inflationary effect is called the price effect. This places the Central Bank in a dilemma because in raising short-term public debt, the trade off is made in the upward adjustment on inflation.

The problem is compounded where the Central Bank has to issue some more Treasury Bills to control the inflation that rises from the high interest rates.

@ Higher taxes

All Treasury Bills issued by the government have to be redeemed at some time in the future. Government payments to the holders of Treasury Bills are essentially derived from taxes. Meaning that any considerable rise in the interest rates payable on Treasury Bills must be accompanied by a rise in the taxes paid by Kenyans. In this direct sense therefore, the high interest rates paid on Treasury Bills translate into higher taxes for everyone while the high returns accrue to fewer people.

An indication of this rise in taxes is apparent in the fact that government revenue as a percentage of the Gross Domestic Product is fairly high as it stands at a figure above 15%. This is a figure that closely matches the revenue to GDP ratio of the Asian Tiger economies. Despite this impressive level of revenue collection, government borrowing has been increasing and this suggests that the government cannot meet all its obligations from the revenue that it collects. This leads to a situation where taxation is high without commensurate government services.

@ Increased Defaults

Considering that the matter of interest rates is a price for capital, where bank-lending rates are very high as to be usurious, prudent investors avoid applying for loans from banks altogether. The reason behind this is that in an environment of rising and arbitrarily set interest rates, prudent people who typically prefer low risk investments will not procure loans. Since the more prudent potential borrowers have opted out of the loans market, the higher risk borrowers are most likely to remain in the pool of borrowers.

By implication therefore, the pool of borrowers will consist of a higher proportion of probable defaulters. If banks continue to lend at high risk to this pool of higher risk borrowers, they will invariably face more defaults on loans as is presently the case in Kenya. To some extent therefore, by keeping the interest rates high, banks ensure that there is a rise in defaulters leading to the increase in the proportion of non-performing loans. Taking forward this argument, banking institutions must take partial responsibility for the fact that 36% of all the loans are non-performing.

@ Exchange Rate Effect

High interest rates on a virtually risk free instrument such as the Treasury Bill is attractive to speculators. Because some of the speculators are foreigners, the infusion of capital into the Treasury Bills market causes an artificial appreciation in the value of the Kenya shilling vis-à-vis other currencies.

This appreciation is sustained as long as the Treasury Bill rates remain attractive to the speculators. However, as soon as the Government's debt situation becomes serious, speculators all pull out to secure their profits with the consequence of a depreciated shilling and a banking industry crisis.

@ Cyclical Recession

While the sudden withdrawal of money by speculators occurs on one side, the remaining businesses experience difficult times as well. This is because the economy is generally maintained in recession because no new investment can be seriously undertaken. Added to the fact that banking institutions are unable to extend loans, the businesses that critically need credit to survive are starved of funds and face bankruptcies. So, the economic environment is faced with the unavailability of credit, a depressed domestic currency and increased bankruptcies.

For the businesses that keep going, the expansion is difficult due to the general reduction in both turnover and profitability. Domestic business expansion is difficult because while external finance is clearly unavailable, the low profitability from reduced economic activity largely rules out the possibility of self financing.

At the same time, the net worth of businesses is reduced because of the low profitability. The convergence of the factors such as decreased value of businesses, lowered profitability and the relative unavailability of credit sustains the recession in a vicious cycle.

Implications of the Bill

The Central Bank of Kenya (Amendment) Bill 2000, proposed the insertion of a new section with two clauses into the operational Central Bank of Kenya Act (Cap 491). Under clause 2 of the bill, it was proposed that a section 39(1) be inserted to require the Central Bank to ensure that the maximum interest rates charged for loans by the banking institutions was no more than 3% above the 91-day Treasury Bill rate.

> "Taking forward this argument, banking institutions must take partial responsibility for the fact that 36% of all the loans are non-performing"

In operation, this particular clause would require all the designated banking institutions to align the interest rates on loans to the Treasury Bill rate plus a further 3%. As a result, the Treasury Bill would be the benchmark for the determination of the interest charged on loan advances. The lending rate would at the most be only 3-percentage points above the 91-day Treasury Bill rate issued by the government. The direct implication then is that the banking institutions lose the discretion to set the interest rates in accordance with their assessment of the market and the individual loans policy.

Under the proposed section 39(2), the Bill required the Central Bank to ensure that the money held in deposit accounts receive interest at the rate of no less than 70 % of the interest paid on the 91-day Treasury Bills. Here too, the Bill sought to use a non-market mechanism to determine the interest paid by banking institutions to the deposits taken in.

The requirement that banking institutions do pay a predetermined minimum in interest on deposits coupled with the control of the maximum levels of interest on loans implies that the interest income for banks would be reduced substantially. Where the interest income constitutes the greater part of the individual bank's overall profits, such drastic reduction in the profitability levels could cause the smaller institutions to succumb and collapse altogether.

Another effect of the legislation is that it would deprive banks of the discretion to distinguish the risk profiles of the individual borrowers and attach the interest rates appropriate for the risk profiles of the borrowers. Because the interest on the loans cannot be legally varied beyond the legal guidelines, it is possible that banking institutions will for a while opt to advance loans to the borrowers with the lowest risk. This category of borrowers will include corporations with substantial assets hence few individuals will qualify for any loans.

If banking institutions resort to this form of discrimination, then the non-corporate borrowers will gradually be crowded out of the loans market. To the extent that the Bill is intended to make it easier for the non-corporate and individual borrowers to procure loans, it may not register a huge success in the immediate term.

Policy Choices

Because the high interest rates spread is fundamentally caused by the huge government debt, the principal imperative is for the government to reduce the issuance of Treasury Bills. This will enable it to consider a more far-sighted approach to the debt without resorting to the cycle of issuing new Treasury Bills to pay up maturing debt.

In short, the cycle of debt must be brought to an end. This will obviously mean that the government must balance its budget by spending cautiously while trying to raise more revenue. The prospects for the raising of revenue at this time are not possible without an unwise increase in taxation.

@ Secondary Market

Not only is the government at a disadvantage of having to borrow heavily but it also opts for the mechanism of fast maturing debt that stresses the economic environment further. Without doubt, the biggest problem in the manner in which the government of Kenya gets into debt is because of the over-reliance on the short-term instrument of the Treasury Bill to raise money.

The 91-day Treasury Bill is absolutely inappropriate as an instrument of raising debt because of the short period of maturity. The Central Bank of Kenya must now advise the government to use medium and longer-term instruments such as bonds for raising money.

As for the debt that the government has already assumed, the government should consider the development of a secondary market for such debt. Such a market could provide a reprieve for the government by allowing for a third party to assume the debt and pay the government's creditors while the government sorts itself out. After an agreed period, the government will then pay back the third party that assumed the debt.

The use of a longer-term instrument has the obvious advantage of allowing the borrower sufficient time to raise the money when the period expires and the creditor calls for it. In opting for this form of debt, the government would have to be committed to long-term and stable macro-economic policy to ensure that the repayment is made.

To further make the instruments more attractive, the instruments may be indexed to the rate of inflation to ease fears of such investments over long periods.

@ Policy Scrutiny

In the decisions concerning assumption of debt, the Central Bank merely acts as the government's agent and not necessarily as the official advisor on monetary policy. Inferentially therefore, the government is under no obligation to take cues from the Central Bank. It is imperative therefore that the Central Bank and officials at Treasury who take decisions that impact upon the economy should be made to defend their policy choices.

This will have the effect of making the public and researchers to assess the general understanding of the public officials regarding real effects of the policy choices that are recommended to the government. In due course it will become apparent to the government that the Treasury Bill is more useful as a tool of monetary policy and whose use could therefore be extended beyond the restricted use of merely raising short-term capital.

Figure 1: Interest Rates Trends June 1993 - September 2000

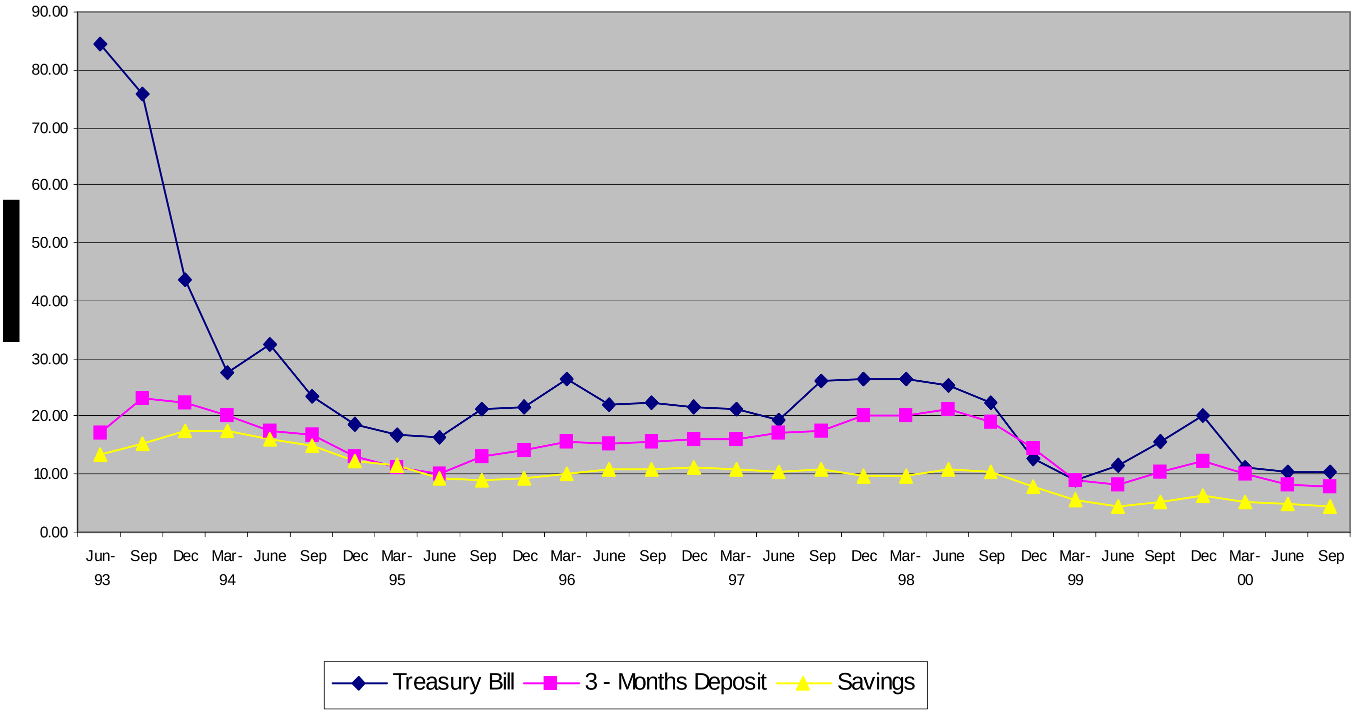

Table 1:
Government Domestic Debt

	Jun-98		Jun-99	
	shs bn	%	shs bn	%
Overdraft / Advances	12.2	8.4	9.0	6.0
Treasury Bills	121.0	83.2	101.7	67.7
Treasury Bonds	34.7	23.9	28.2	18.8
Government Stocks	3.7	2.5	3.4	2.3
Non-interest bearing debt	–	–	31.9	21.2
Less:				
Deposits	20.5	14.1	18.3	12.2
Advances to Parastatals	5.7	3.9	5.7	3.8
NET DOMESTIC DEBT	**145.5**	**100**	**150.3**	**100**

SOURCE: CBK ANNUAL REPORT 1999

Table 1 above shows the comparative figures in respect of the domestic debt as it stood in the months of June 1998 and June 1999. For the financial year 1998-1999, the Treasury Bills component of the domestic debt reduced in both absolute and percentage terms. Treasury Bonds, which are a longer term instrument, represent only 18.8% of the total domestic debt. The Treasury Bills component of the government domestic debt could be prudently cured by reducing debt generally and resorting to Treasury bonds to raising money. While the 12 month period represented in the table shows a debt reduction of 15.95%, in many ways, macro-economic prudence makes it imperative to progressively begin the shift towards longer term and manageable debt.

@ Intensifying Competition

Despite the fact that there are almost sixty institutions within the banking industry in Kenya, closer scrutiny reveals a highly concentrated industry. Naturally therefore the competitive strength of these institutions are not the same. In a situation where the largest 5 banks out of 60 institutions bear almost 60% of the total industry deposits, the competitive structure of that market is necessarily compromised. These larger institutions barely feel the competitive effect of the smaller institutions due to this market concentration.

In the premises, it is upon the Central Bank of Kenya to act in its regulatory capacity to encourage the intensification of competition in the banking industry. High spreads do also suggest that the specific banking industry is not sufficiently competitive.

Quite apart from the other benefits of competition the interest rates may be reduced if the industry's competitiveness were enhanced. Banking institutions would be compelled to improve their rates of interests on deposits while attempting to offer loans at rates that are really competitive.

To this end, the Central Bank must ensure a less concentrated market structure by moderating the adverse effects that the practises of the dominant institutions may impose on the smaller ones. Over time, the banking sector may become more competitive with the interest rate spread determined largely by Central Bank variables. In this manner, the regulatory authority will through it's prudence and vigilance commence the movement towards normalising the market structure.

Conclusion

The controversy raised by the Central Bank of Kenya (Amendment) Bill 2000 in turn raises fundamental questions about the competitive structure and stability of the financial industry in addition to the obvious implications on the economy as a whole. Policy makers, researchers and other Kenyans would wish to see a more active regulator in the Central Bank working objectively for the good of the banking institutions and their depositors.

The present crisis is an enduring indictment upon the Central Bank that must be considered thoroughly prior to any other efforts towards the liberalization of the financial industry. It is evident that the liberalization of the banking industry preceded the appropriate infrastructure for the competent regulation of the institutions. This state of affairs should worry the industry players, the government and the regulator as any further delays in this matter could precipitate a devastating banking crisis.

Postscript

The Central Bank of Kenya (Amendment) Bill 2000 was passed in parliament on the 29th November 2000. However, a compromise was reached which adjusted the permissible interest rates to be charged by banking institutions to 4%, thereby allowing for a maximum spread of 8%. At the same time, the banking institutions undertook to henceforth apply the ***"In Du Plum"*** principle in respect of loan advances. This principle means that the banking institutions will cease to levy further interest on any loans borrowed from them should the outstanding interest match the principal sum lent out. By this gesture, the interest payable on any loan may not exceed the principal sum lent out.

Included in the passed Bill was the requirement for the formation of a Monetary Policy Committee (MPC) to oversee the interest rate regime among other monetary policy questions. If a competent and autonomous MPC were put in place, it could easily become an important guardian of economic stability.

Pending Presidential assent, the subject bill is expected to pass into law within the first quarter of 2001. It is hoped that the lessons that a highly concentrated and poorly regulated industry risks a reversion to government legislation have been well and truly learned.

"Banking Sector Interest Rate Spread in Kenya"-
by Njuguna S. Ndungu and Rose W. Ngugi

Kenya Institute of Public Policy Research and Analysis (KIPPRA)
Discussion Paper No. 5/ 2000.
Reviewed by Duncan Oketch

The Banking sector interest rate spread is among the most controversial post liberalisation macroeconomic phenomena in Kenya. The authors begin by highlighting five determinants of interest rate spread. Chief among these is the market structure of the banking sector in respect of the internal organisation, management, regulatory framework and their contributions in terms of creating an incentive for resource mobilization by rewarding investors and encouraging competition for deposits.

It is observed that the regulations by the Central Bank should aim at achieving financial stability since instability results in high real loan rates and a widening spread. Hence the legal framework incorporates the adequacy of commercial law and the overall efficiency of the judiciary in enforcing legal decisions.

Implicit taxes like reserve and liquidity requirements having no interest payment tend to have high opportunity cost hence drain the reserves available for banks to advance credit thus reducing the scope of banks' income earning assets. Mandatory investments also limit banks efforts to capture high yielding investment by compelling them to inefficient allocation of funds into prioritised sectors despite non-optimal returns. Explicit taxes on the other hand, reduce the flexibility of the system by significantly reducing the funds available for discriminatory lending. The presence of taxes is argued to be responsible for discouraging the development of an alternative bank market and creating heavy reliance on the Central Bank's discount facilities that provide inexpensive and unlimited loans to banks.

The macroeconomic environment is identified as both a cause and consequence, thus being a self-feeding determinant. The chain reaction triggered off by macroeconomic instability increases uncertainty hence impacting adversely on borrower's credit worthiness thus increasing the risk premium charged by banks.

The risk factor in terms of interest risk, credit risk, foreign exchange risk and legal risk constitute the fifth determinant. Credit risk faces banks since they don't have prior knowledge of what proportion of the loans will perform. They are forced to charge premiums whose magnitude depends on credit policy, interest on alternative assets, amounts borrowed and types of client. This raises the effective rate to borrowers thus lowering credit demand. Instability and skyrocketing interest raise the level of non-performing loans for banks thus widening the spread. Foreign exchange risks arise when the banks borrow abroad and legal risk is faced when the legal framework for collateral and bankruptcy is unclear.

Based on the above findings, Ndungu and Ngugi attempt the derivation of an optimal spread in a Kenya-specific setting. This technical arithmetic derivation is based on the assumption of market power in the loans and deposits market, a one period analysis and expected profit maximisation by banks.

The authors also observe that loan market performance reflects a macroeconomic environment in which stability reduces risk premiums, ensuring positive returns and reducing credit risks. High implicit taxes increase the spread through the lending rate as the banks strive to maintain their profit margins. Its also pointed out that an attractive Treasury Bill rate in a non-competitive market compels banks to reallocate their assets portfolio and interest in risk free assets weakening the mediation process.

The publication concludes with four important recommendations. First, it recommends that the strengthening of the institutional framework including the review of the regulatory and legal framework to enhance confidence among depositors and investors and thereby strengthen enforceability of loan contracts. Second, macroeconomic stability is an absolutely necessary condition for the success of financial liberalisation processes. Third, it is suggested that the Central Bank keeps the implicit taxes at minimal levels to ensure that lending rates are kept down as banks endeavour to maintain their profit margins. Finally, the conduct of monetary policy should be in line with the goals of the financial sector to support its growth.

The lessons of this book clearly show that the wide interest rate spread in Kenya is not entirely attributable to banker’s avarice but that the situation as it manifests itself shows greater failure by regulatory authorities in particular.

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