Hezron O Nyangito: Impact of the global financial crisis on the Kenyan banking system

Keynote address by Dr Hezron O Nyangito, CBS, Deputy Governor of the Central Bank of Kenya, at the Kenya Institute of Bankers, Eldoret, 16 January 2009.

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Mr Stephen Anjichi, Executive Director, Kenya Institute of Bankers;
Mr Ben Kamau, Honorary Chairman, Kenya Institute of Bankers, Eldoret Chapter;
Committee Members of the KIB Eldoret Chapter present;
Distinguished Guests;
Ladies and Gentlemen:

I am honoured to be here this evening to join you on the occasion of the Kenya Institute of Bankers (KIB) Eldoret Chapter Annual Dinner. I take this early opportunity to sincerely thank the Chairman and Committee of the Chapter for the invitation. At the Central Bank we welcome opportunities such as this one that enable us to exchange views on topical issues with industry practioners. Given also that the year is still young, it is appropriate for me to wish you all a fruitful and prosperous 2009.

Mr. Chairman:

The topic that I was requested to speak on, "*The impact of The Global Financial Crisis on the Kenyan Banking System"* is indeed topical and has engaged policymakers across the world since 2007. I will therefore first explore the genesis of the global financial crisis, then review its potential impact on Kenya from a macro perspective and conclude by analysing its impact on the Kenyan banking system.

Ladies and Gentlemen:

2008 was indeed a historic year. Aside from the domestic/political problems experienced during the first quarter of the year, the financial disruptions triggered by the US subprime mortgage market precipitated a global financial crisis, which has simultaneously affected all the major world economies including the United States of America, the European Union, Japan and China. By end of 2008 all these economies were in a recession.

As you are already aware, the current financial crisis can be traced to a decade of low interest rates in the United States of America during the 1990s, which in turn spurred liberal lending practices by commercial banks to clients that had no ability to repay loans (the so called *sub-prime* clients), thereby compromising the quality of loans held by financial institutions. The widespread nature of lending to the sub-prime market, in turn, promoted a boom in the property market.

However, as the US experienced an economic slowdown and rising interest rates during the past two years, sub-prime mortgage defaults began soaring, and the securities built around these debts, including property prices began loosing value with contagion effect. The resultant strain from the financial crisis has had two critical consequences internationally: a Credit Crunch in the USA, and in countries that were exposed to the high risk mortgage-backed securities in Europe and Asia, and a liquidity crisis arising from the uncertainty over which institutions held problem debt and its actual value, so that banks have been prompted to restrict lending to one another, creating a major liquidity crisis in the global financial market.

The combination of a deteriorating credit market and liquidity strains precipitated the current financial crisis, and the collapse of America's largest mortgage institutions (Fannie Mae and Freddie Mac), and globally important investment banks such as Bear Stearns, Lehman

Brothers and Merrill Lynch. The resultant crisis has also led to panic selling in financial markets and a remarkable response by central banks.

Ladies and Gentlemen:

The current concern for most Kenyans and investors is the extent to which the contagion of this global crisis will affect the domestic economy. Among the questions being asked are: how will the domestic economy be affected? Through what channels will the global crisis permeate the domestic economy? What is the Central Bank or the larger Government of Kenya doing to mitigate any of these effects? What policy actions is the Central Bank and the Government supposed to undertake when such crisis occur? How does the global financial crisis affect economic outlook domestically?

First, I would like to underline that African markets have so far been remarkably resilient to the current Global Financial Crisis, primarily due to the fact that our financial systems do not hold any of the "toxic" securities and debts that have precipitated and spread the crisis in the international financial system. The exception is Nigeria, whose financial markets are currently experiencing enormous strains due to both global and local market liquidity issues and high dependence on oil.

However, it is expected Kenya's exposure to the crisis will be driven by the following key factors:

- Demand for Kenyan exports may decline. The recession in North America and Europe triggered by the credit crunch may reduce demand for Kenyan exports goods.
- Kenyan banks have deposits and placements in foreign institutions. Kenyan institutions also do have credit lines with foreign banking institutions. Collapse of any of these institutions or a credit crunch could hurt the economy. However, so far these effects have not been witnessed.
- Kenyans living abroad remit money home to support consumption, and for investment purposes. Early indications show that Remittances may decline as disposable incomes decline in the countries experiencing the global recession.
- Tourism could be affected as tourists postpone or cancel visits abroad on account of difficult economic conditions and uncertain duration of the economic recession. However, recent data indicates that tourism has fully recovered in Nairobi but Mombasa and the lodges are still lagging.
- Kenyan exporters and importers use letters of credit issued by financial institutions abroad to facilitate trade between Kenya and the rest of the world. Since confidence is returning and global interbank lending has now resumed, this effect may be very minimal.
- The shilling depreciated to the US dollar between September 1 and November 30, 2008 following pressure from the global financial crisis as foreign investors "fled to safety" while consolidating their finances to meet their obligations abroad.
- The stock markets, and respective investors, recorded a sharp fall in the value of their investments and general financial net worth following the current global financial meltdown. Stock markets fell by 21 percent in Uganda, 24 percent in the South Africa and 27 percent in Kenya between September 1 and November 30.
- Kenya receives foreign assistance from overseas for official use to finance development projects (e.g. roads, energy etc), and through NGOs to finance poverty reduction activities. This assistance could decline due to the crisis.

Mr. Chairman:

Let me now turn to the heart of my address this evening on the impact of the financial crisis on the Kenyan banking system. Overall, I am pleased to note that the outlook for Kenya's financial sector remains stable in view of the prevailing levels of capitalization, sound risk management systems, strong asset quality and profitability that the banking sector is currently enjoying. Specifically, the banking sector has enjoyed relatively strong performance during the last five years, supported by improved macroeconomic stability and legislative reforms which resulted in the implementation of revised prudential guidelines and risk management frameworks. These reforms have enabled the Central Bank to identify, monitor and control risks in a timely manner, while also strengthening corporate governance in banking institutions. The key highlights of the banking sector by end of November 2008 are:

- Deposits increased by 25% from Shs. 730 billion at November 2007 to Shs. 911bn in 2008 as the sector continues to expand its outreach and aggressively market for new deposits. The asset base of the sector also increased by 33% to stand at Kshs. 1.2 trillion. The asset growth was largely fuelled by an increase in loans and advances.
- The total capital to total risk weighted assets ratio of the sector increased from 16.7% in November 2007 to 18.1% in November 2008. This ratio is an indicator of the capital adequacy of the sector. The minimum statutory ratio is 12% and at slightly over 18%, the sector has some cushioning to absorb losses.
- The average liquidity of the sector which is the ratio of liquid assets to deposits and other short term liabilities stood at 37.3%. This was above the statutory minimum of 20%.
- The stock of non performing loans to gross loans decreased from 11.4% as at the end of November 2007 to 8.4% at the end of November 2008. The reduction is largely attributable to enhanced risk management practices by banks and NPL recoveries.
- The sectors profit before tax stood at Kshs. 40.2 billion for the eleven months ending November 2008. This is a 21% increase from the Kshs. 33.2 bn registered over a similar period in 2007. The enhanced profitability was driven by interest income on loans and advances and foreign exchange dealing income.

Ladies and Gentlemen:

This performance notwithstanding, it is important to observe that the financial sector could be vulnerable to effects of the global financial crisis and economic recession, as individuals and firms are likely to struggle to repay debts, thereby resulting in a deterioration of the quality of loan portfolio, and profitability in the financial system. In particular, the Central Bank is cognisant that there may be a lag and perhaps second round effects of the crisis on the Kenyan economy. We are therefore actively engaging banks to ensure that they have adequate capital buffers to withstand the current turbulences. We are also focusing on liquidity management strategies by banks to ensure that they can meet their obligations as and when they fall due.

Broadly speaking, there are three main areas of focus for Kenyan monetary authorities to respond in dealing with the current global financial crisis, notably: (a) the need to continuously strengthen the regulation of the financial sector; (b) a reappraisal of the role and activities in the capital markets and (c) the importance of strengthening coordination of regulatory authorities in Kenya. In this regard, the following policy measures and actions are recommended to safeguard the confidence of credit markets and stability of the financial system in Kenya.

In the Kenyan context, a highly enhanced regulatory and supervisory oversight of the banking system remains the key plank to addressing the on-going and unfolding global financial crisis.

This entails:

First, enhanced capital requirements for banks, thereby reducing their vulnerability to sudden asset-price movements and ensure they have the resources to support any off-balance sheet exposures. We have also enhanced and are constantly monitoring commercial banks' liquidity positions, thereby reducing the chances of institutions being threatened by a reduction in financial market liquidity. This is made possible through improving the bank's risk management capabilities, through better stress-testing of their market positions against possible adverse price movements. Also to review the role of credit-rating agencies in the financial system.

It is therefore gratifying to note in this regard that the recent passage of the Finance Act, 2008 has increased the minimum core capital for banks to Kshs. one billion by the end of 2012. This measure we believe will strengthen the banking sector further and enable it withstand periodic local and global turbulences. We are currently engaging banks whose core capital is currently below Kshs. 1 billion on their capital build up plans.

Secondly there is need to undertake reforms in the Capital Markets to restore investor trust and confidence. The reforms should also cover a reappraisal of the role and activities of investment banks which remain the weakest link in the financial sector and their regulatory structure in order to stem any downside risk to the banking system. The reforms will entail:

- Developing a comprehensive and enforceable regulatory framework and streamline the corporate governance in line with the international best practices and a thorough fit and proper vetting of directors and owners of these institutions.
- Re-assessing the use of the word "bank" by investment banks in Kenya – there is potential to confuse the public with traditional banking.
- Increase capitalization requirements – capital adequacy, and Institute risk management practices as well as improve disclosure requirements so financial market participants have better information.

Thirdly, the Kenyan financial sector is regulated by various institutions, namely, the Central Bank of Kenya, the Capital Markets Authority, the Insurance Regulatory Authority, and the Retirement Benefits Authority. Given the inter-dependence of financial markets, and contagion effects of risks emanating from any sector, there is need to begin thinking towards a Financial Services Authority (FSA), which will coordinate financial sector-wide stability surveillance at the technical level. In addition, regional cooperation is critical in addressing financial risks arising from events outside our borders, and within the Eastern Africa region.

Mr. Chairman:

I would like to conclude by underlining the role of professionals in managing global financial crisis. Professionals including bankers are on the spot like never before. There is of course considerable debate on the capacity of bankers, analysts, fund managers, credit rating agencies, regulators and accountants in the crisis.

Professionals have a sacrosanct responsibility to provide advice and guidance in their areas of speciality. Institutions such as KIB therefore play a key role in building the capacity of bankers to respond to emerging issues. The global financial system is evolving rapidly and professionals have to "up their game" if their institutions are to survive in these turbulent times. Bodies such as KIB must therefore provide relevant and appropriate capacity building programmes for their members. I must therefore commend the KIB Eldoret Chapter for organising today's forum that will enable your members to gather insights on topical issues. KIB indeed provides a useful knowledge base on the banking sector. I would therefore challenge you to add your voice in times such as this by providing advice as to how Kenya can continue on a growth trajectory, the global financial crisis not withstanding. At the Central Bank, we are open to knowledge sharing and welcome ideas from organizations such as KIB. I therefore urge you to continue addressing topical issues and share your recommendations with policymakers.

I do not wish to extend my remarks much further as I am acutely aware that social “ice breaking” and renewal of existing acquaintances is a critical component of gatherings such as this. I therefore wish the KIB Eldoret Chapter well in all its endeavours. Let me close my remarks by wishing you all a very pleasant and memorable evening.

Thank you.