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POLICY BRIEF
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THE CENTRE FOR RESEARCH ON FINANCIAL MARKETS AND POLICY®

Focusing on Bank Internal Factors to Attain Risk-Based Credit Pricing in Kenya

Executive Summary

Concerns over the high cost of bank credit in Kenya, with the implication of constraining credit supply, has led to a policy shift in favour of risk-based credit pricing, where banks are expected to determine their lending rates on account of the perceived risk of the borrowers. Thus, if a borrower is considered risky, risk-based pricing will have the borrower paying more in the form of higher interest rate resulting in higher total amount paid for the borrowed money. Even so, the extent to which the banks internal factor could constrain the fruition of this pricing framework is more apparent from various banking sector indicators. As such, there is a need to understand the extent that the bank internal factors affect the lending rates, and consequently suggest policy options that would speak to the constraints arising thereof.

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The Centre for Research on Financial Markets and Policy®

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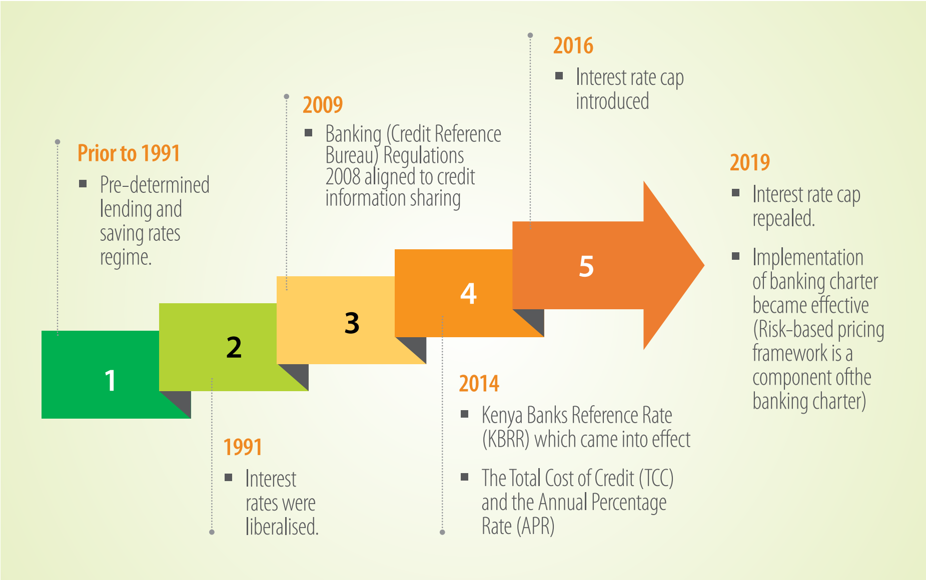
1. Context and Importance

Bank credit has remained a significant source of financing for all sectors in Kenyan economy. Even so, concerns over the high cost of credit, with the implication of constraining credit supply, has persisted over the years. Consequently, the government had been pursuing diverse policy options (See **Figure 1**) to address this problem. More recently, the policy directive has shifted to stimulating fair bank credit pricing through the adoption of risk-based pricing, where banks are expected to determine their lending rates based on the perceived risk of the borrowers. Accordingly, if a borrower is considered risky, risk-based pricing will have the borrower paying more in the form of a higher interest rate resulting in a higher total amount paid for the borrowed money.

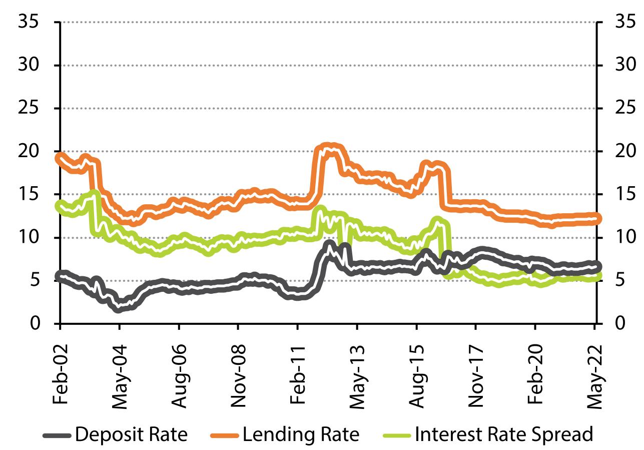
Figure 1: Government Initiatives to lower lending rates, Pre 1991 to 2022



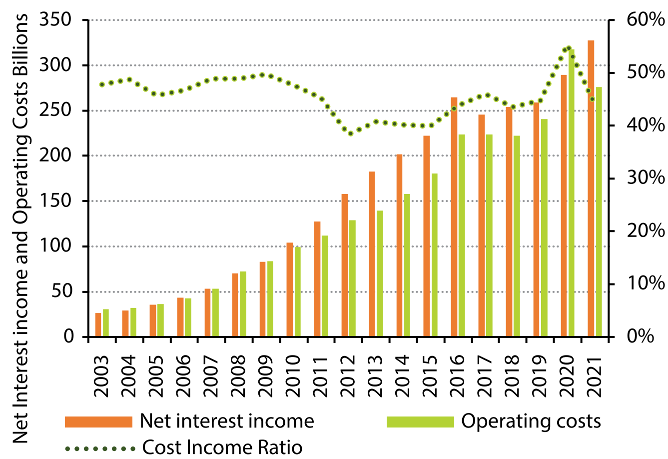
With no doubt, the risk-based pricing framework presents a number of merits to both the banks and the borrowers. However, trends in the banking sector indicators clearly puts to question the ability of the banking sector to smoothly transition into the risk-based credit pricing regime. First, as depicted by **Figure 2a**, the interest rate spread has continued to shrink over the years, and superficially, it would be construed that the banks operating efficiency has been improving substantially. However, this may not necessarily be the case since the impact of interest rate cap introduced in the later part of 2016 and the slow roll out of the risk-based pricing framework could be contributing to low lending rates, and consequently, declining interest rate spread. Reinforcing the concerns on the ambiguity of the level of the bank operating efficiency, the cost-income ratio, which is represented in **Figure 2b**, has remained relatively high, standing at slightly over 40 percent.

Figure 2: Recent trends in Kenyan credit market

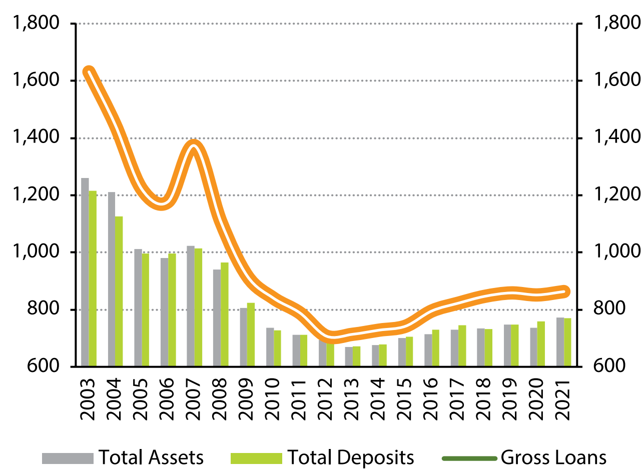
Interest rate spread, February 2002 – May 2022



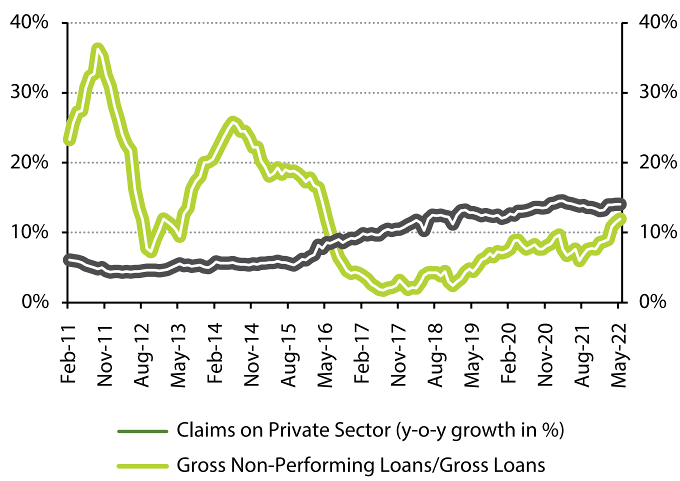
Cost Income Ratio, Operating costs and Net interest income, 2003 – 2021



Concentration of banking sector activities, 2003 – 2021



Credit growth and riskiness of banks' loan portfolio



Source: Central Bank of Kenya and Kenya Bankers Association database

Second, even though the risk-based pricing frameworks allows banks to raise their pricing based on the customer's risk profile, the low concentration in the industry's credit, assets and deposits (See **Figure 2c**)[1] points to a situation where it would be potentially difficult for the banks to raise their interest rates, even at times when the customer risk profile dictates so. Lastly, the credit risk, which is proxied by the gross non-performing loan/gross loans, has been on an upward trajectory (**Figure 2d**), and this points to the increasing risk in the banking sector. Furthermore, theoretically it has been shown that a rise in the riskiness of bank loan portfolio has the implication of raising the interest rates and thus discouraging borrowing.

Thus, with a view of the significant role of the banking sector in financing investments and businesses in the economy, these trends in the banking sector indicators reinforces the need to understand how bank internal factors affect bank credit pricing in Kenya, and consequently pursue policy options that would speak to the constraints arising thereof.

1. As at end 2021, the highest level of bank concentration in the banks' credit activity, as measured by Herfindahl-Hirschman Index (HHI) equaled 863.2, as the index equaled 773.4 for banks' assets and 769.7 for bank deposit activity. A measure below 1000 depicts a competitive market structure.

Table 1: Relationship between Bank Internal Factors and Credit Pricing

	Bank Internal factors	Bank Category			
		Industry	Bank tiers		
			Tier 1	Tier 2	Tier 3
1	Total bank assets	Negative	Positive	Positive	Negative
2	Credit risk	Positive	Negative	Negative	Positive
3	Bank deposits	Negative	Negative	Negative	Positive

***Positive** – *Increase in the bank internal factor will lead to an increase in credit prices, and vice versa.* ***Negative** – *Increase in the bank internal factor will lead to a decline in credit prices, and vice versa.*

2. Methods and results

Two step analysis was pursued using data from audited financial statements of Kenyan commercial banks over the period 2003 – 2021. A baseline analysis was undertaken at the industry level, and thereafter, an in-depth analysis was pursued on banks at tier level to disentangle banks' diverseness that could have been obscured at the industry level analysis.

The results reveal significant differences at industry level and across the banks tiers on the effect of banks internal factors on credit pricing (**Table 1**). At the industry level, it emerged that an increase in bank asset base would result in a reduction in the cost of bank credit. Likewise, the same is the case with an increase in bank deposits. In contrast, a rise in credit risk is potentially associated with an increase in cost of credit. The tier level analysis shows disparities across the bank tiers, suggesting the uniqueness of bank attributes across the tiers.

Among the tier 3 banks, an increase in a bank's asset base would likely to result in a reduction in the cost of bank credit, a scenario that is contrary to both tier 1 and tier 2 banks. Furthermore, while increases in credit risks are likely to tilt upwards the cost of credit among tier 3 banks, increases in bank deposits is expected to reduce the cost of credit among tier 1 and tier 2 banks, but increase among tier 3 banks.

3. Policy recommendations

Banks internal factors affects credit pricing by Kenya banks. Consequently, policy considerations to support banks optimize their internal factors remain instrumental to support the implementation of risk-based credit pricing framework in Kenya. Key among these policies is:

- Allow each bank to independently determine its lending rate but incentivize the banks to share the same with the borrowers. While the industry level analysis demonstrated that as bank size increases the lending rate is likely to decrease, possibly because of the economies of scale creeping in the banks' operations, the contrary results manifested among tier 2 banks. Thus, taking note of the difficulties of customizing regulations based on bank tiers, it is prudent to allow individual bank to take into account its peculiarity in pricing credit. Even so, banks have to be encouraged to share their pricing framework with their customers.
- Inspire greater public trust in the banking system to attract more deposit and reduce the cost of funds. The level and cost of deposit mobilization by banks have a direct impact on the resulting lending rate. Thus, the Kenya Deposit Insurance Corporation (KDIC) needs to enhance its programs to boost public confidence and trust in the banking system, so as to raise the level deposits.
- Pursue policies that will necessitate harmonization of borrowers credit score. The credit score remains a key component of credit pricing. However, depending on how the scoring is computed, a bank customer could potentially have different score. Hence, the need to pursue credit scoring harmonization, possibly by having a centralized database.

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