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POLICY BRIEF

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THE CENTRE FOR RESEARCH ON FINANCIAL MARKETS AND POLICY®

Impact of COVID-19 Pandemic on Bank Lending – A Sectoral Analysis

Executive Summary

Understanding the role that shocks and uncertainty play on the banking sectors' willingness to extend credit to the private sector remains paramount for policy makers. From the study, the multifaceted impact of the COVID-19 pandemic on bank customers across various sectors increased scrutiny of the banking sector loan book and resulted in a disproportionate allocation and extension of credit. Moreover, policy interventions to contain the financial implications of the pandemic shock were considered distortionary blurring the 'true' state of the banking system. This challenged credit quality identification and raised implied credit risks. Understandably, this had micro and macro-economic consequences posing the risk of undermining the sustainability of Kenya's economic prowess. More positively, the banking sector remained resilient in light of healthy capital and liquidity buffers. The study however reveals that the regulator would need to strengthen supervisory monitoring and incentivize banks to provide targeted diagnostics based on asset quality reviews and forward-looking assessments on potential shocks and their impact on bank assets to sustain positive credit allocation to the private sector.

Authored by: Stephanie Kimani

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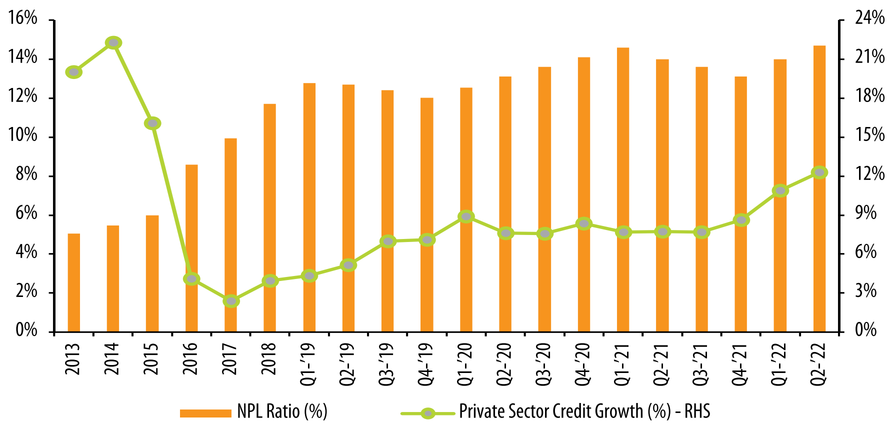
1. Context and Importance

Even as the global economy recovers from the COVID-19 pandemic, there remain challenges in the assessment of borrower credit quality in the banking sector. Concerns around poor credit risk management and credit quality identification, given some of the bold policy measures undertaken by authorities to support livelihoods, has raised implied credit risks.

Figure 1: Private sector credit and asset quality dynamics



Source: Central Bank of Kenya

One of the concerns was that some of the residual policy support measures masked true credit risk conditions. An immediate example in Kenya would be the suspension of the listing of loan defaulters on credit reference bureaus (CRBs) with a view of supporting borrowers amidst the COVID-19 induced economic shock. There is evidence of a subsequent bank risk aversion, as noted by a dip in private sector credit growth in Q2-2020. This fueled the need for prudence as banks maintained and/or adopted high quality lending practices as well as approaches to ensure that bank provisions remained adequate in light of projected credit losses. This included but was not limited to banks suspending unsecured lending, requiring higher value collaterals and higher lending rates for shorter maturities. Moreover, the multifaceted impact of the pandemic on bank customers across various sectors increased scrutiny of the banking sector loan book. Fundamental changes in the business environment have strengthened the need for a remediation of loan portfolios so as to remain financially viable. This undoubtedly had an impact on banks' risk appetite towards some segments resulting in a disproportionate allocation and extension of credit.

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It is therefore of interest for policymakers to understand how bank lending decisions are affected during times of uncertainty/shocks, such as that of the COVID-19 pandemic. This is understandably so given that the banking sector remains an important source of funding for many businesses, and one that is not easily substituted for funds obtained through other types of intermediaries or by debt directly placed in credit markets (Himmelberg and Morgan, 1995). This study provided novel evidence of changes in banks' lending decisions, as proxied by the supply of bank loans to the private sector, as they faced significant uncertainty during the pandemic. Specifically, the study used pandemic features to assess its causal impact on the supply of bank loans to the private sector across key sectors in Kenya.

2. Methods and findings

Using aggregate sector specific credit growth data between 2017 and 2020, the study established the impact of the COVID-19 pandemic on bank lending behavior. From the findings the study deduced the impact of the shock on bank lending behavior with special focus on the lasting impact of the shock on credit trends.

Several insightful findings are documented. First, the impact of the pandemic shock was moderated by various policy actions that helped avoid further damage to key sectors – helping maintain the flow of credit to the economy. Policies aimed at minimizing pandemic-induced economic damage by stimulating demand were not sufficient in countering supply shocks. In addition, there was a noted decline in credit allocation to sectors that benefited from fiscal stimulus measures after the end of the fiscal support. The pandemic had a larger effect on sectors highly exposed to mobility and social gathering restrictions such as transport, trade and restaurants. Moreover, there were varying durations and reactions to the pandemic shock on credit allocation. Across all sectors, there was evidence of a lagged response. Lockdowns, Work from Home (WFH) and Social distancing measures dented consumer demand significantly raising credit risks and conservative lending practices towards businesses in the services sectors. Finally, a reduction in spending of some activities had an indirect positive impact on disposable incomes for those (i) still employed and (ii) had stable incomes – resulting in a shift in consumption patterns that influenced the decline in credit to some segments (e.g., consumer durables).

3. Policy Inferences

These findings portend several implications for policy. The weak correlation between the COVID-19 pandemic shock and credit allocation across various sectors should provide the central bank some comfort in banks' self-regulation and effectiveness of remedial measures when it comes to containing asset quality concerns. Strong capital and liquidity buffers anchored the banking sectors resilience during the COVID-19 pandemic. This should provide policymakers adequate comfort in knowing that regulatory reforms such as raising bank capital buffer ratios should help ease credit risks and anchor credit extension activities to the private sector.

Moreover, there is need to improve macro-prudential regulations to ensure lingering risks following periods of shocks/uncertainty do not crystalize into NPLs. Therefore, there to continuously monitor and forecast evolving credit risk scenarios; and perform regular stress test on the system to ensure proactive interventions for sustained stability. Finally, prudential interventions including moratoriums could slow down the increase in NPLs. However, indirectly these interventions are distortionary, challenge credit quality identification and raise implied credit risks – which could undermine credit allocation.

4. References

The impact of the COVID-19 pandemic on bank lending – A sectoral analysis - Stephanie Kimani (2022).

Kenya Bankers Association
13th Floor, International House, Mama Ngina Street
P.O. Box 73100– 00200 NAIROBI
Telephone: 254 20 2221704/2217757/2224014/5
Cell: 0733 812770/0711 562910
Fax: 254 20 2221792
Email: research@kba.co.ke
Website: www.kba.co.ke

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