Tracking the Impact of Interest Rates Capping: Lessons & Experiences

In 2016, the Kenyan Parliament passed a bill amending the Banking Act to introduce restrictions on bank interest rates for lending and deposits. This action was intended to regulate interest rate spreads and culminated into passing of the Banking (Amendment) Act, 2016 by parliament and ascent by the President, coming into effect on September 14, 2016. The amendment put (i) a cap on lending rates at 4.0 percent above the Central Bank Rate (CBR) and (ii) a floor on the deposit rates at 70 percent of the CBR (Central Bank of Kenya, 2018).

However, despite its noble intentions, capping interest rates has led to unintended consequences. Statistics and studies from various institutions including the Central Bank of Kenya show evidence of the negative effects of interest rate capping on the Kenyan financial sector as well as the entire economy.

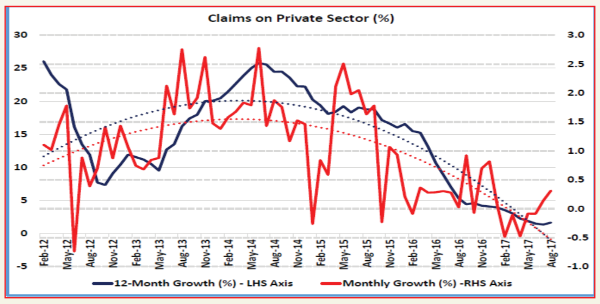
The study by the Central Bank of Kenya which was released in March 2018 uses bank level data covering the period before and after the capping of interest rates to investigate the impact of the amended law. Results from this study show that capping of interest rates has infringed on the independence of the central bank and complicated the conduct of monetary policy, producing perverse outcomes in which accommodative monetary policy stance has resulted in deceleration in growth of credit to the private sector.

There is evidence of reduced financial intermediation by commercial banks at the lower segments of the economy observed through a significant increase in the average loan size to larger enterprises, and declining small loans accounts (Central Bank of Kenya, 2018).

Capping interest rates has led to a shift to lending to government and large corporates away from Micro, Small and Medium Enterprises (MSMEs), meaning banks are cautious on the smaller ticket size borrowers perceived as riskier, yet restrictions brought about by the limitations of the law do not permit pricing for this risk.

Results from the study further show that, whereas demand for credit immediately increased following the capping of lending rates, credit to the private sector continued to decline. Furthermore, the study results show that while the structure of revenue of the banks started to shift away from interest income, some banks increased fees on loans in a bid to offset loss in interest income. Small banks have experienced significant decline in profitability, which may complicate their viability (Central Bank of Kenya, 2018).

Figure 1: Growth Trends of Private Sector Credit (%)



Source: Central Bank of Kenya

Another study conducted by the Kenya Bankers' Association shows similar results. According to this study, the capping of interest rates was followed by a slowdown of credit to the private sector. In addition, there is evidence of credit reallocation skewed against households and sectors such as trade which are largely made up of SMEs also perceived risky especially if they are unsecured credits. The study however, found no evidence of deposits responding to the incentives provided by the new law.

Other areas of impact the study uncovered include; adverse effects seen in the capital markets because investors were discouraged from supplying funds to the financial system due to limited/restricted return imposed on banks, as a result, the economy experienced capital flight following the passing of the law. This saw banks shares on the stock market dropped from over 30 percent to about 27 percent by 20thMarch 2017 with bank capitalization declining from KES 580 billion to KES 520 Billion. Subsequently, the value of the stock market (market capitalization) dropped from KES 2.1 Trillion to KES 1.8 Trillion over the same period.

This situation is not unique to Kenya. Capping interest rates has led to undesired consequences in other jurisdictions including advanced countries like France, Germany and the USA, as well as developing countries like El Salvador, Kyrgyz Republic and Zambia. The negative implications tend to worsen with time. Some of the reported negative effects include;

- The withdrawal of banks from the poor or specific segments of the society, such as the small borrowers due to higher loan management costs which was observed in countries like Bolivia, Columbia, the Dominican Republic, Ecuador, Haiti, Nicaragua, Peru, Poland and Zambia. In Ecuador, the caps led to illegal lending flourishing whose prevention necessitated more supervision and control. In Mexico and Chile, the record to lending to the poor and vulnerable was not impressive, a factor largely attributed to the interest rate caps.
- The increase in average loan size, pointing to lower access by small borrowers and larger loans to more established firms was observed in Bolivia, Ecuador, South Africa and Zambia.
- Reduced transparency evidenced by increase in the total cost of loans through additional fees and commissions was witnessed in Armenia, Nicaragua, South Africa, and Zambia
- Decreased diversity of products for low-income households was witnessed in France and Germany.
- In Italy there was evidence of reduced banking competition arising from the capping of interest rates.
- In both the United states and Japans capping interest rates was followed by an increase in illegal lending.

The Ugandan Situation

In Uganda, there has previously been debate as to whether capping of lending interest rates could work as a way of reducing the cost of credit in Uganda.

Uganda's historical economic experience and journey as well as and the experience of other countries should help inform this debate.

Having suffered economic mismanagement and financial repression for decades, Uganda undertook reforms with the aim of revamping the economy as well as improving efficiency in the allocation of resources.

Among the reforms, was the liberalization of the financial sector. The objectives of this direction, was to create a more efficient banking system, lower the cost of credit, increase the access of banking services by the general population, improve the mobilization of savings, improve prudential regulation and supervision and promote the diversification of financial markets.

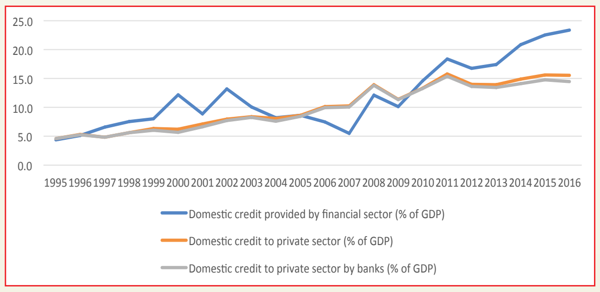
The above steps saw the determination of interest rates being market driven, reduction in direct credit to government, prudent regulation (legal and regulatory reforms), privatization of financial institutions, allowing for the free movement of capital between Uganda and the rest of the world, as well as foreign exchange rate liberalization.

Following the reforms, Uganda has registered some success in terms of domestic private sector credit growth and other indicators of financial sector improvement.

Domestic credit to the private sector as a percentage of GDP increased from about 4.6 percent in 1995 to about 15.6 per cent in 2016. The ratio of domestic credit to the private sector by banks to GDP also increased from 4.6 percent to 14.5 percent over the same period.

The reforms attracted a number of regional and global banks, while at the same time helped local banks to strengthen their capabilities, increase their branch networks as well as provide a wide range of products and services. The number of commercial banks increased from 12 in 1987 to 25 and in 2017 while the number of commercial bank branches increased from 84 to over 455 over the same period. Subsequently, the number of commercial bank branches per 100, 0000 adults increased from 1.1 in 2004 to about 2.8 in 2016 while depositors with commercial banks per 1,000 adults increased from 87.1 in 2004 to 253.1 in 2016.

Figure 2: Trends in Credit to the Private Sector (% of GDP)



Source: WDI, World Bank (2018)

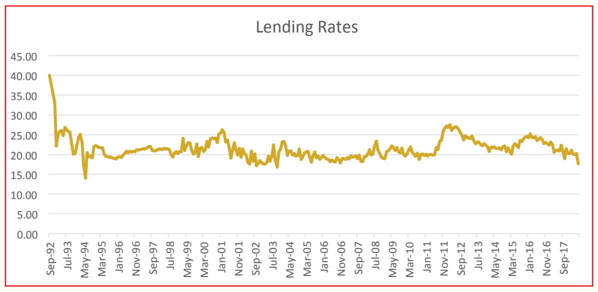
The reforms have also created a conducive environment that has promoted innovations and the development of new products. This has encouraged the development of new products and services, adoption of new and efficient models of business as well as encouraging the participation of new players including mobile network operators (MNOs) and fintechs. This has created competition as well as partnerships with traditional banks, leading to the overall improvement and efficiency of the industry.

Within a repressed financial system, such developments would have been hard to achieve. As a consequence of the outreach expansion, investment in technology to enhance efficiency, and taking advantage of the synergetic partnerships between banks and mobile network operators, the economy has made tremendous strides in financial inclusion. Statistics from FinScope Surveys show that, the proportion of adult Ugandans accessing and using financial services, in other words those that are financially included, increased from 57 percent in 2006 to 73 percent in 2018.

Legal and regulatory reforms in the financial sector have also contributed greatly to macroeconomic and financial sector stability. Following the enactment of the Bank of Uganda Act 1993 and other related legislations, Uganda's financial sector has experienced relative calm. The independence of the Central Bank has enabled it maintain financial stability as well as macroeconomic stability. Inflation has for the most part has been low and in single digits averaging about 7.9 percent since 2006. Indeed, in the last two years, inflation has been below the central bank's target of 5 percent, standing at an average of 4.5 percent. Macroeconomic stability has been key to driving the growth experienced in the financial sector which has translated growth in the economy at large.

However, despite the noted improvements, Uganda's banking industry still faces a number of challenges in its operations which continue to impact the pricing of credit. Although, the average commercial banks' lending interest rates have declined from 40 percent in September 1992 to 17.7 percent in May 2018, they are still high standing at an average of about 20 percent in the last ten years. The high lending interest rates have previously attracted debate from different spheres with calls for government to intervene by putting a ceiling as has been the case some countries. However, this debate focuses largely on the symptoms without interrogating the underlying causes of high interest rates.

This article thus attempts to throw more light on the on issues surrounding the interest rate debate.



Source: Bank of Uganda, 2018

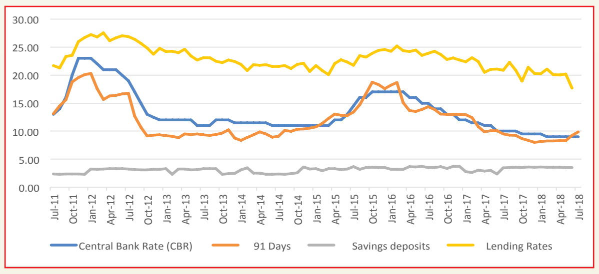
Factors that contribute to the determination of interest rates

Just like prices of other commodities or services, interest rate is the price at which money is lent out and is dependent on a number of factors that mirror the structure of the money and financial market in a particular geography. It is a proxy to the cost of doing business in an economy.

When setting the price of credit, banks consider a number of factors both internal (within the bank's control) and external (beyond the bank's control). These include the cost of funds, the lending risk, the level of savings, other bench mark rates such as the Treasury bill rates (TBR), the central bank rate (CBR), the macroeconomic indicators like inflation and exchange rates, the level of non-performing loans and the bank's administrative and operating costs.

Factors like CBR & TBR a are used as signals for the policy direction by the central bank Although it currently stands at 9 percent, since its introduce in July 2011, the CBR has averaged 13.4 percent. Movement in the CBR and Treasury Bill rates have been followed by a gradual reduction in commercial bank lending interest rates. Weighted average lending rates have declined from 24.3 percent in August 2016 to 17.7 percent in June 2018.

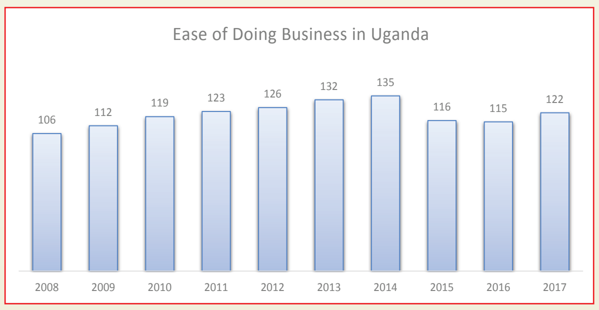
Figure 3: Trends of selected Interest Rates in Uganda



Source: Bank of Uganda, 2018

The overall cost of doing business directly impacts on the operating cost of banks. Uganda has a high cost of doing business largely due to infrastructure deficits in terms of roads, electricity and internet coverage, corruption etc. Uganda is ranked 122 by the World Bank's Ease of Doing Business survey. Many banks in Uganda have cost to income ratios of over 70 percent which is very high by industrial standards.

Banks incur both administrative and operating costs in form of maintaining banking infrastructure, payments of salaries and wages to its staff, taxes, license fees, rent for office space, the cost of funds in form of the interest the Bank pays for the deposits held, the costs relating to non-performing loans, and the liquidity premium costs which the Bank incurs to ensure funding is always available to its customers at any time and all these costs are factored into the setting of interest rates.



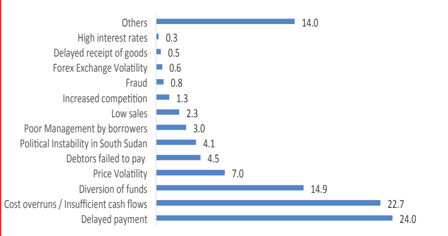
Source: WDI, World Bank, 2018

On top of the high operating costs, banks face very high lending risks due to the limited borrowing profile of customers with key challenges faced at the lending criteria yardstick of insufficient capacity to pay back as well as low level of willingness to pay.

A survey by Bank of Uganda shows that high interest rates are not the highest-ranking cause of loan defaults, instead delayed payments (24%), cost overruns (23%) and diversion of funds by borrowers (15%) constitute the top causes (62%).

Tracking the Impact of Interest Rates Capping: Lessons & Experiences

Figure 4: Causes of Loan Defaults in Uganda



Source: Bank of Uganda

Like any other developing country, Uganda faces budgetary constraints largely due to low levels of revenue mobilization (low tax to GDP ratio) and thus requires other sources of revenue to finance its expenditure.

One of the available sources is borrowing from the domestic financial system. This option however, has its shortcomings in that it leads to the crowding out of private sector credit. Numerous studies have documented this crowding out effect of government borrowing domestically especially in narrow financial markets like in Uganda. In addition to this, the country's risk rating from an investor perspective also has a bearing on cost of credit. Political uncertainties, riots, threats of instability, expenditure prioritization, policy inconsistencies etc. deter the flow of foreign direct investment in the financial sector as well as other sectors. This not only reduces the amount of funds available for lending (pushing up the interest rates) but also impacts on the movement of the exchange rate. Movements in exchange rate can affect the price level and overall cost of doing business by way of imported inflation. This is very true for a country that is a net importer and one whose cost of production depends heavily on imported petroleum products.

What can be done to lower lending rates

As has been the experience in several countries, capping interest rates is arguably not a viable solution to lowering the cost of credit. Capping of interest rates is a distortion of realities and tends to have more negative consequences mostly un-intended as noted earlier. A shift in policy could benefit a selected number of borrowers only especially the corporate sector and government in form of bonds and treasury bills. This actually undermines a key objective of a banking system which is intermediation through provision of credit to small & medium enterprises and households/personal borrowers who then collectively constitute the important value chain that drives an economy. Legislated interest rate regimes do not necessarily translate into lower cost of credit and in fact they discourage investment in the financial sector, which sector is the fuel of an economy.

However, high lending interest rates are not desirable either, thus a long-term solution to bring the cost of credit down remains a priority. There is a need for finding solutions to the underlying causes of high interest rates highlighted above. This requires concerted efforts from all stakeholders both within and outside the financial sector including government and the private sector.

Government

The government has a large role to play when it comes to lowering the cost credit in Uganda. Key issues that government can focus on include reducing the cost of doing business, reducing governments domestic borrowing and fast-tracking reforms in various related areas like land registry, facilitating courts of judicature with human & financial resources, providing enabling laws & frameworks for the growth of capital markets, maintaining investor confidence through political stability and consistency in fiscal policy frameworks among others.

Specific areas worth consideration include;

- Opportunity Cost Govt Domestic Borrowing Vs Credit to Private Sector: Ensure Government Borrowing does not crowd out private sector and adopt alternative sources while improving Government cash management.

  Better prioritization of Govt expenditure: Champion oversight fiscal discipline and more accountability, better governance and faster delivery of projects, Prioritize budget spending.

- Reducing the cost of doing business: the government should improve its efficiency with regards to delivery of infrastructure investment which have the potential of reducing on the costs of doing business and also result in multiplier effects that will help spur economic growth and financial inclusion.
- In addition, since one of the underlying causes of nonperforming loans is the non-settlement of Government arrears, government should commit to and implement a systematic & predictable approach to settling its debts to service providers promptly.
- Fast track capital markets reforms to make capital markets a more efficient and attractive alternative source of long term funds.
- Accelerate reforms in the Lands and Companies Registries; and establish the legal and regulatory frameworks to support the creation of an electronic assets register (Both movable & immovable) so as to facilitate collateral linkages to credit provision. There is good progress being made here and the legislature can help in expediting this process

Bank of Uganda and other regulators

Regulators could focus on the following among others,

- Reducing Credit Risk: this can be achieved by strengthening of the Credit Reference Bureau and information sharing mechanisms to include other service providers such as utility and phone companies.
- Incentivize financial institutions that promote product innovation;
- Champion financial literacy and financial consumer protection frameworks,
- Facilitate use of specific Products/Instruments e.g. leasing and factoring products; and enhance the efficiency of the horizontal Repo market.

To Banks & Financial Institutions

Banks and other financial sector players need to focus on innovation, reducing operating costs, promoting financial inclusion and literacy, embracing arbitration and reconciliation as faster dispute resolution mechanisms in loan recovery.

- Reducing Banks' operating costs: this can be done through banks undertaking collaboration projects that involve shared technology platforms to bring down the cost of service delivery while increasing outreach to customers that were previous excluded.
- Promoting financial inclusion and bring the informal economy into the financial system, through agent banking needs to be fast tracked. This will increase the customer base for banks, reduce unit costs and mobilize the much-needed deposits required for financial intermediation.
- Promoting microcredit products that seek to address the needs of the lower segments of the population

To borrowers & overall public

As earlier indicated, all players have a role to play.

- Reducing Non-Performing Loans: there is need for attitude change whereby Individuals, businesses and other corporate bodies who borrow funds from the commercial banks and other financial institutions to adhere to the culture of paying back their debts.
- Build good credit history. Pay back when you borrow, seek remedial measures from your financier when you anticipate or face stress, way before they are forced intervene on their own.
- Focus on cashflow: Cash is king! Always focus on where the cash will come from to drive business as well as repay the borrowing. Consideration of where your product or service will be marketed and demand sustained is therefore critical.
- Avoid diversion of funds under any/all circumstance without the knowledge/consent of your lender.
- Maintain records especially financial records.
- Loan finance need not necessarily be the first source of financing especially for start-ups considering that it has a price.

Musa Lwanga
Research Economist