Impact of interest rate caps

The parliamentary committee on Finance and National planning has recommended that interest rate cap be removed. This follows President Uhuru Kenyatta's decision to send the Finance Bill back to Parliament, asking MPs to repeal the rate cap.

Most of the impact of a removal of caps is likely to be felt next year. We expect the following

- **Economic activity to increase in 2020**

  In the interest rate cap environment, private sector credit growth has remained subdued as banks' risk appetite has reduced. A removal of the cap could lead to an increase in credit growth. Commercial banks are unlikely to raise rates to the pre-rate cap levels.

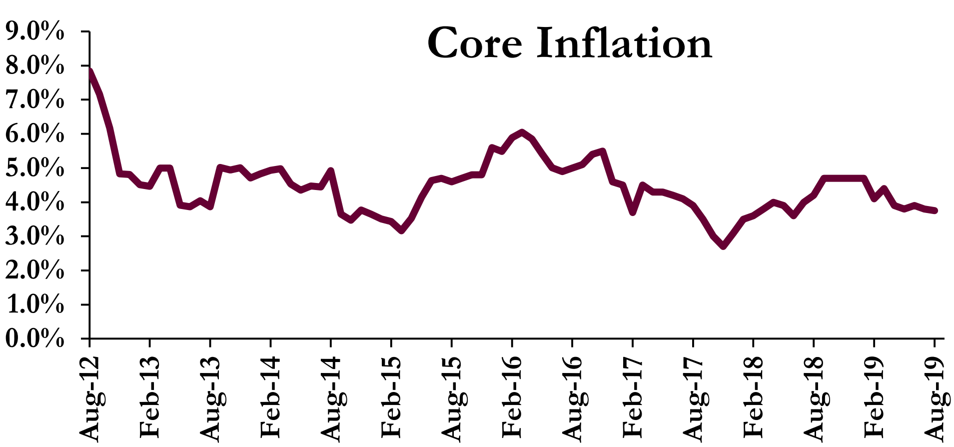
  The manufacturing sector is unlikely to record an immediate pick-up as the operating environment remains unfavourable (high power and logistic costs).

  The government's austerity measure are likely to dampen growth

- **Gradual pick-up in inflation**

  Demand pressures have remained muted as indicated by the low core inflation. As economic activity picks up, core inflation is expected to rise.

  Meanwhile, headline inflation is expected to remain below CBK's upper target on the back of subdued food and fuel prices.



Date: 30th October 2019

Sovereign Credit Rating (outlook):

Moody's: B2 (stable)
Fitch: B+ (stable)
S&P: B+ (stable)

Sep Inflation:
3.83%

91-Day T-Bill (28th Oct-19):
6.42%

182-Day T-Bill (28th Oct-19):
7.22%

364-Day T-Bill (28th Oct-19):
9.78%

Analyst

Sarah Wanga

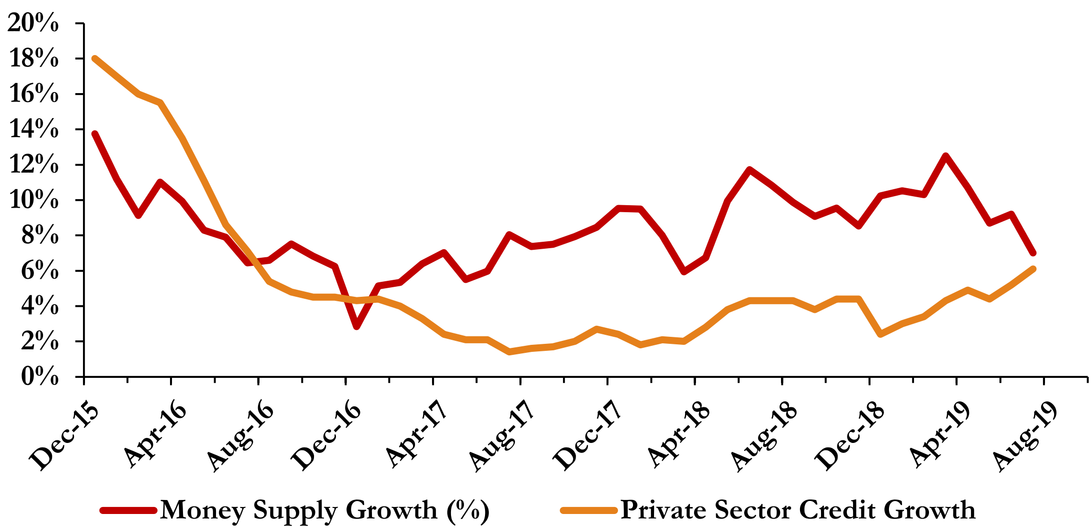
+254711047105

wangas@aibcapital.com

CERTIFICATIONS & REQUIRED DISCLOSURES BEGIN ON PAGE 5

- **MPC likely to cut the Central Bank Rate**

  The effectiveness of monetary policy has been reduced in the rate cap environment. Following the removal of caps, we expect CBK to reduce the CBR to spur growth on the back of low inflation and a stable currency.



- **The yield curve is expected to shift upwards**

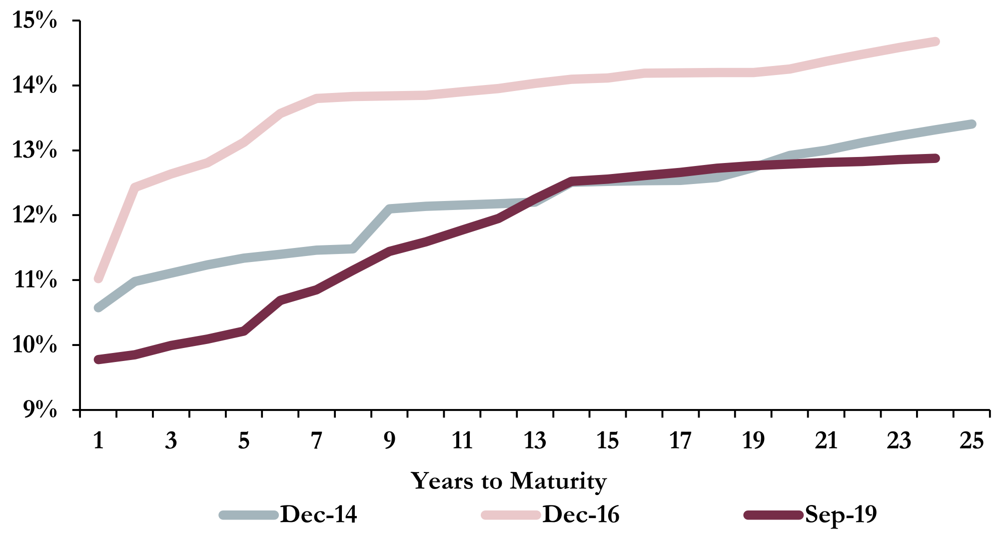
  CBK has been able to keep rates low because of the high demand for government paper. The bank has issued long papers (that are unattractive to most players) but has managed to mostly achieve its borrowing target.

  Removal of the caps will reduce demand for government paper. To meet its target borrowing we expect CBK to do the following:

  - **Issue short-term papers**: These are attractive to most market players and could help increase demand for government paper.

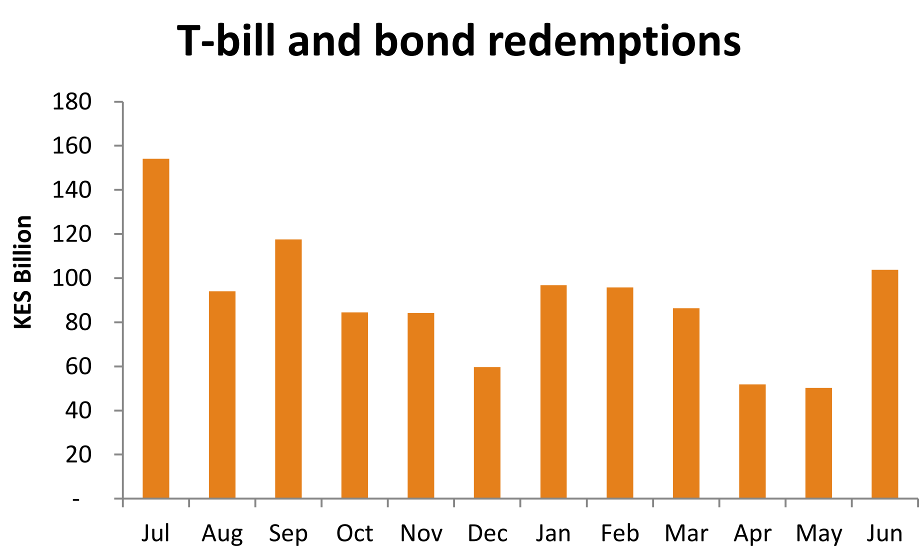
  - **Accept aggressive bids**: As demand for government paper gradually reduces, CBK may be forced to accept aggressive bids in order to achieve its domestic borrowing target

  The increase in rates is likely to be gradual and is likely to affect short-term yields.. We don't expect rates to rise to the 2015/16 levels (immediately before rate cap introduction) as the present macroeconomic conditions are different. Rates are more likely to increase to the 2014 levels.



Pressure on government borrowing is likely to come from:

- **High redemptions:** Previously, most T-bill and bond redemptions have been rolled over. However, this is unlikely to be the case as commercial banks will likely channel the maturing cash to the private sector. Thus we expect pressure on the government borrowing program as subscription rates reduce while less maturities are rolled over.



- **Government's appetite for debt**: According to the budget policy statement the government intends to increase its domestic borrowing target from KES 454 billion from the initial target of KES 397 billion. This could exert pressure on rates.

➢ **Equity Market: Banking stocks are expected to rally**

If interest rate caps are removed, we expect the following:

- Lending is likely to increase
- Profitability is expected to increase
- NPL ratios could increase as banks increase lending to risky borrowers
- Yield on loans to increase as the risk adjusted premium increases

We expect banking stocks to rally as their profitability prospects improve following the removal of rate caps.

Based on 1H19 numbers, we believe that Standard Chartered and Equity Bank are best placed to take advantage of the situation.

	Loan/Deposit Ratio	Liquidity Ratio
Equity Bank	67.57%	61.60%
Cooperative	79.65%	43.50%
DTB	70.63%	54.30%
Barclays	81.27%	38.70%
SCBK	52.54%	67.23%
NIC	77.39%	52.38%
Stanbic	74.41%	55%
KCB	86.67%	32.20%

CONTACTS:

Research Desk
Sarah Wanga
wangas@aibcapital.com
(+254) 711047105

Victor Koech
koechv@aibcapital.com
(+254) 711047133

Equities Dealing
Bernard Kung'u
kungub@aibcapital.com
(+254) 711047108

Benard Gichuru
gichurub@aibcapital.com
(+254) 711047111

Brian Tanui
tanuib@aibcapital.com
(+254) 711047124

Bond Dealing
Crispus Otieno
otienoc@aibcapital.com
(+254) 711047113

Titus Marenye
marenyet@aibcapital.com
(+254) 711047118

Disclaimer:

Though utmost care has been taken in the preparation of this report, we do not guarantee the accuracy or completeness of the information contained herein nor will AIB Capital Ltd be held liable for the information contained herein. The views expressed in this report are solely those of the Research Department and are subject to change without notice.

LXM USA LLP assumes responsibility for the research report's content in regards to Research distributed in the US. US recipients of this research who wish to effect transactions in any security covered by this report must do so with or through LXM USA LLP. Transactions in such securities by recipients of the report are to be effected only through LXM US

LLP in accordance with Rule 15a-6.1. The research analysts preparing the research report are resident outside the United States and are not associated persons of any US regulated broker-dealer and that therefore the analyst(s) is/are not subject to supervision by a US broker-dealer, and are not required to satisfy the regulatory licensing requirements of FINRA or required to otherwise comply with US rules or regulations regarding, among other things, communications with a subject company, public appearances and trading securities held by a research analyst account.