

The Puzzle of Covid-19 on Bank's Loan Book in Kenya.

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INTRODUCTION

Emergency of COVID-19 has disrupted world economies and could be a serious challenge to retail banks and micro finance institutions. According to an article published on 27th February 2020 by Peter Lee, banks came into the coronavirus pandemic much stronger than they went into the global financial crisis but will the capital and liquidity buffers they have built be sufficient to see them through the most dramatic economic crash in history?

There has been a heated debate on whether banks should adopt blanket restructure approach or case by case approach. This paper focuses on giving insights of the two approaches.

Key words: **Incentives, Liquidity, Moratorium, Restructures.**

BLANKET RESTRUCTURES APPROACH.

Behavioral economists say that economic agents respond to incentives. Following Covid-19, the government through Central Bank of Kenya (CBK) and through presidential pronouncements has provided economic agents, in this case, debtors, with the following incentives to default:

Incentives:

1. They have been told they won't be listed with credit reference bureau (CRB).
2. They have been told banks will go slow on downgrade/classification on non performing facilities.
3. They have been told the banks can either extend period for 12 months or restructure (sic) at their (banks') costs.
4. They have been informed that Cash Reserve Ratio (CRR) is being lowered so that banks can have more cash (liquidity). For "lending" perhaps?
5. They have been told that base rate has been reduced (which means lower rates for their loans).

No doubt liquidity of the bank is important. But it's normally a short term objective. Profitability on the other hand is a long-term objective. Blanket moratorium or holiday will affect liquidity, yes. Some experts argue that this should not be used as the reason for not taking a blanket moratorium approach. Picture this. Banks wait for the customers to come forward one-by-one, they don't yet they are affected by Covid-19. They don't pay their loans. So banks also lose, first on liquidity that they worried about. Loans go into arrears and move to nonperforming loan (NPL), which means we take provisions and so we lose the second time- on profitability. So without a blanket approach, banks might be staring at losing both birds. They will lose on liquidity (that they are worried about now) and eventually on profitability (when loans end up in NPL).

Banks strategy at this time should move away from interest income and focus more on stability. Portfolio at Risk (PAR) /nonperforming loan (NPL) will drive these nuts, banks won't be stable. To take care of liquidity and such other concerns, banks can create a buffer fund/account from the expected liquidity following the easing of CRR. Banks can also focus now on

non-funded income. But does this approach consider balance sheet challenges while managing loan stress and customer sensitivity?

CASE BY CASE APPROACH

Case by case approach is the most conservative approach to take. For instance, recent guidance from the OCC on using capital and liquidity buffers to support lending has suggested that banks should stay above the minimum requirements but consider getting closer to the minimums. Each bank will need to determine its own appetite for risk but most will likely be very hesitant to go below a minimum unless there is a coordinated bank response to a severe need.

According to PWC paper on CoVid-19, Banks need to tailor their needs based on specific customer characteristics. Focus on addressing evolving needs as well as servicing and containment. For example, banks might want to identify customers who:

- a) are likely to face temporary financial strain and reaching out with customized solutions such as payment skips, interest deferrals, new credit lines, and fee waivers
- b) have special servicing needs (such as the elderly who are accustomed to branch banking) and developing solutions to continue serving them
- c) could be more financially hurt by this crisis and create thoughtful procedures to support containment plans
- d) where refinancing and expansion of the product set may be appropriate given the changing market conditions.

RECOMMENDATION

Banks should be cautious with the blanket restructures; it may be counter-productive to take an entirely case-by-case approach. I would propose the following:

1. Blanket restructures for customers in high impact industries. These customers do not have to approach the bank. Limit the type of restructure to a moratorium on principal for 3 months.
2. Simplified restructure for any customer from any industry who approaches the bank. Again, limit this to moratorium on principal for 3 months. Minimize the documentation required and have this processed.
3. Use a more detailed approach for customers who require longer moratoria, are not able to service even interest, or require other concessions such as loan consolidation or reduced pricing. These can go through a more rigorous process.

This will give banks an edge at demonstrating their ability to be customer centric. It will be a good opportunity for banks to collect data that can be used to determine the best way forward (blanket restructure for all vs for high impact industries).

REFERENCE

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