COVID-19: Why It Might Get Difficult to Access Bank Loans

By Irene Irungu

Small businesses account for the vast majority of employment and job growth in the Kenyan economy. But these firms have been disproportionately impacted by the COVID-19 pandemic and are now facing a credit crunch.

Local banks are seeing a growing percentage of loans fall into the "non-performing" category – meaning that borrowers have fallen behind or ceased making payments.

This is making it increasingly difficult for these lenders to issue new loans at a time when struggling businesses need all the help they can get.

According to the KNBS Economic Survey, the informal sector provided approximately 83% of total employment in the country and created 91% of the new jobs last year.

The Capital Markets Authority (CMA) estimates that 86% of the total demand for the Small and Medium Enterprises' (SMEs) funds is obtained from bank financing.

As such, most banks in Kenya have tailored loan products targeting these SMEs.

The demand highlighted above led to the launch of an unsecured loan, *Stawi,* by the Central Bank of

Kenya (CBK) in collaboration with five other banks, targeting SMEs. However COVID-19 pandemic has posed challenges to these efforts.

The measures put in place to contain the spread of the pandemic such as restricted movement and curfews have impaired the operations of SMEs. This has, in turn, negatively impacted revenue streams for many. This poses a challenge to banks who have heavily lent to these businesses. When the affected SMEs cannot repay their loans, it impacts the bank's loan portfolio whose quality is dictated by the creditworthiness of the borrowers.

This article focuses on examining the loan quality of local banks during this pandemic period by analyzing their non-performing loans. The loan portfolio quality is an extremely important component of a bank's profile because loans are considered an asset out of which a bank produces the bulk of its profits.

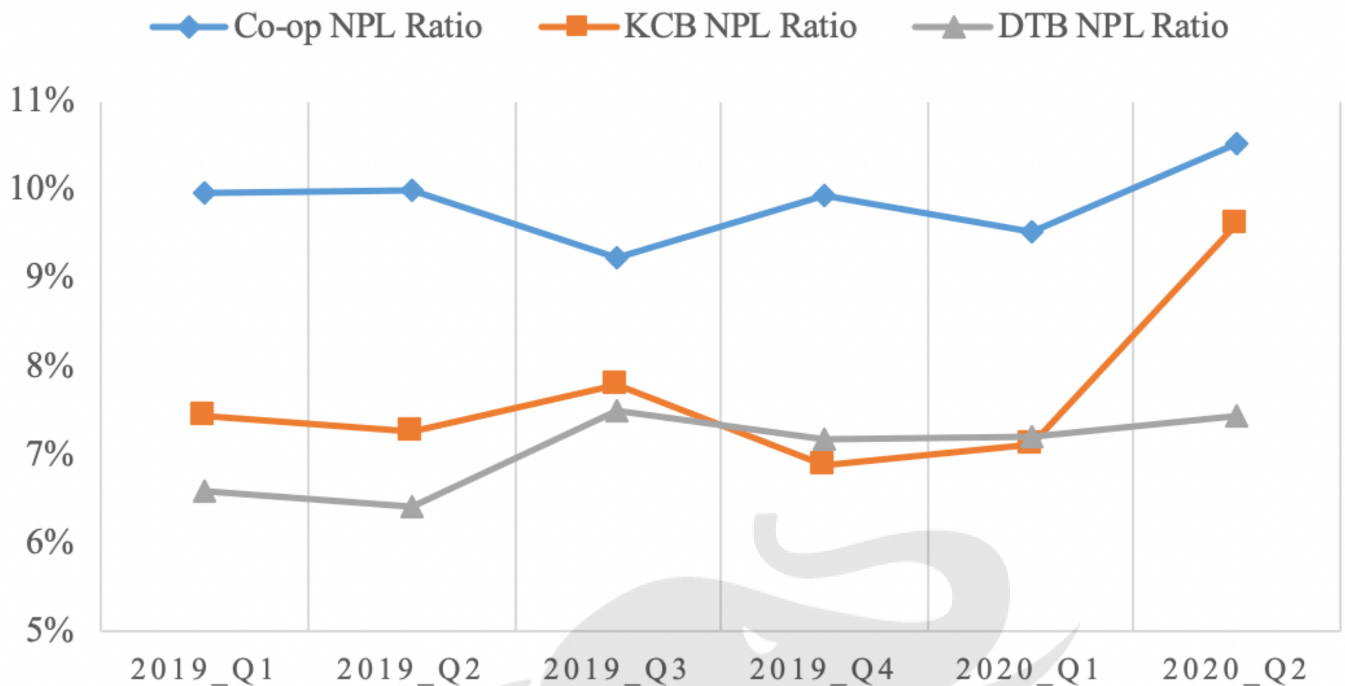
A bank that is able to maintain satisfactory quality will make sufficient profits to generate capital for expansion. However, not all of a bank's customers will pay back what they borrowed. Some will make repayments for a period of time and then default on the full payment of interest and principal. In a nutshell, Non-Performing Loans (NPL) represent loans in which the interest or principal is more than 90 days overdue.

We analyse the banks' loan portfolio quality between the first quarter of 2019 and the second quarter of 2020 for three publicly listed banks that are offering the *Stawi* loan product, namely: KCB, Co-operative Bank (Co-op) and Diamond Trust Bank (DTB).

Non-Performing Loans (NPL) Ratio

The loan portfolio quality of banks is measured by their NPL ratio -the amount of non-performing loans as a proportion of the total loans issued to customers; popularly known as the banks' loan book.

The ratio reveals the extent to which a bank has lent money to borrowers who are not paying it back.



Both KCB and Co-operative Bank experienced an increased NPL ratio between the first and second quarters of 2020. This indicates a deteriorating loan portfolio quality within the period that SMEs' revenue generation streams have been strained due to the measures put in place to contain the COVID 19 pandemic.

Indeed, KCB moved from an NPL ratio of 7 % to an NPL ratio of 10% during the pandemic; meaning they were losing 3 more shillings for every 100 shillings they issued as loans to defaulting borrowers.

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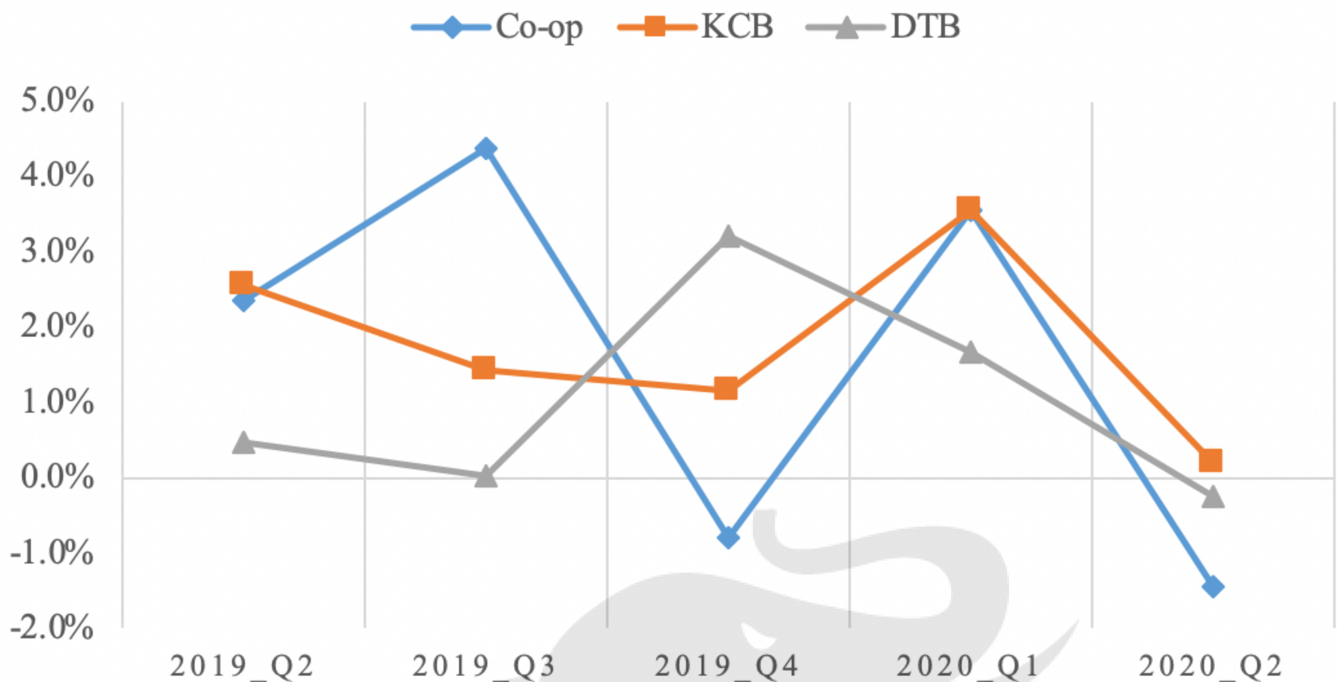

A look at the rate of growth of the loan portfolio in the chart above reveals that the three banks experienced a sharp dip in the amount in loans they advanced to their respective customers. This shows that banks shied away from issuing more loans to their customers within the period the pandemic peaked.

"Borrowers rushed to seek moratoriums on their loan repayment. For banks, this is a loss of interest income, while it's crucial so as to avoid these loans [from] falling into the NPL category which would reduce profits through provisions," CPA Alex Muikamba, a financial expert affirms.

Interest Income versus Non-Performing Loans

Since margins on bank loans are usually low, the complete loss of a single non-performing loan can wipe out the profits generated from dozens of performing loans. We now compare the interest income from the loans with the amount of Non-Performing loans.

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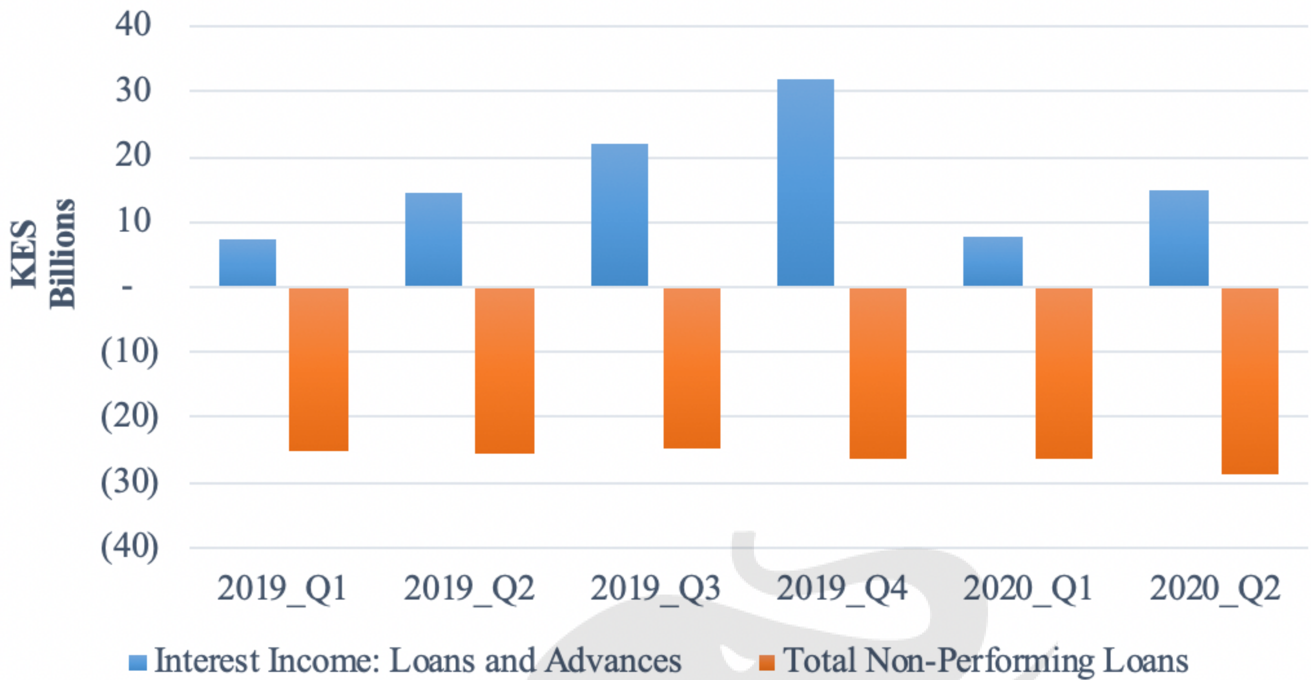
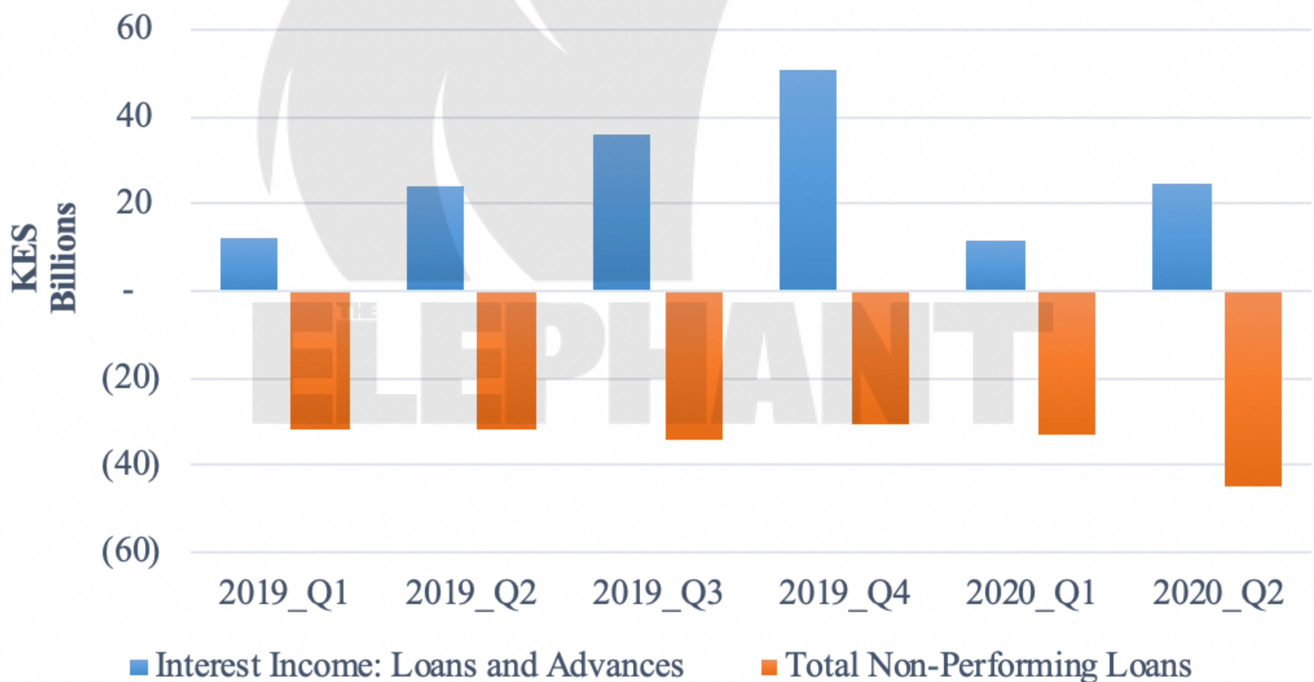
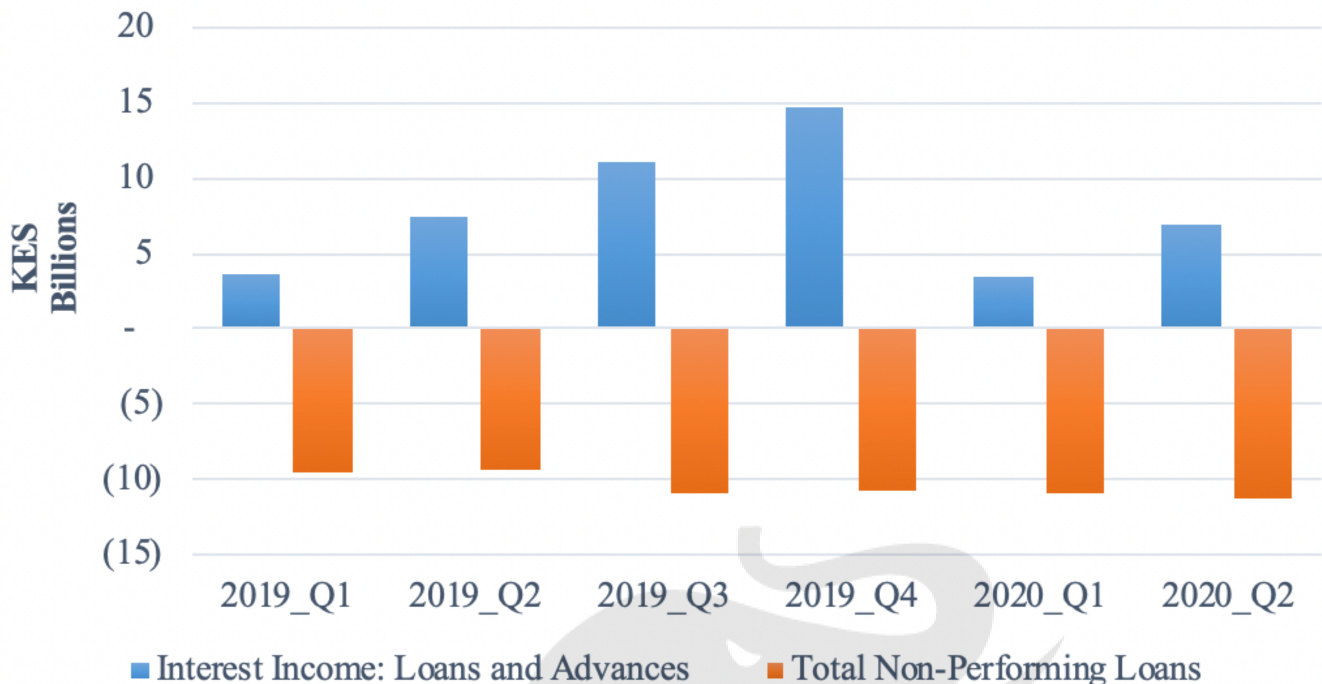

Co-op: Interest Income and NPL
KES Billions
40
30
20
10
-
(10)
(20)
(30)
(40)
2019_Q1
2019_Q2
2019_Q3
2019_Q4
2020_Q1
2020_Q2
Interest Income: Loans and Advances
Total Non-Performing Loans


KCB: Interest Income and NPL
KES Billions
60
40
20
-
(20)
(40)
(60)
2019_Q1
2019_Q2
2019_Q3
2019_Q4
2020_Q1
2020_Q2
Interest Income: Loans and Advances
Total Non-Performing Loans



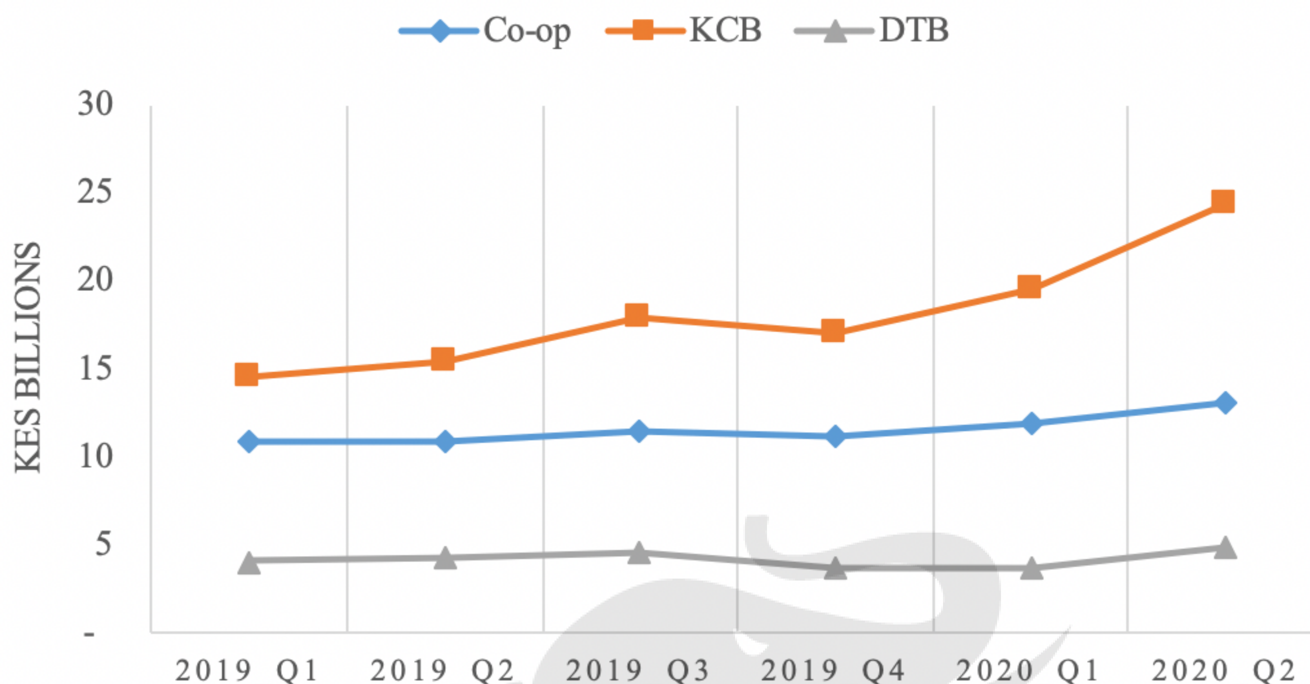
It is observed that the total non-performing loans exceeded the interest income from loans and advances in most quarters for the three banks.

When loans are classified as non-performing, banks are compelled to stop accruing interest on those assets. This implies that their net interest income will fall as their funding costs remain unchanged.

Loan-Loss Provisions

Banks usually set aside an allowance for uncollected loans from customers to cover for any losses that may be occasioned by the Non-Performing loans. This allowance is referred to as the loan-loss provisioning.

During the peak period of the pandemic in the second quarter of 2020, banks are seen to have increased their loan-loss provisioning in response to the declining loan portfolio so as to remedy the situation before it gets out of hand. The KCB increased their loan loss provisioning to a greater extent as compared to the other two banks that were analyzed. This is because of the higher increase in its non-performing loans as observed in the sharp rise of its NPL ratio.



These increased provisioning costs will be charged against operating income and will fall through to the bottom line, reducing net income attributable to shareholders.

As uncertainty surrounds the time it will take for the economy to recover from the effects of the pandemic, so is the recovery of affected SMEs borrowers.

What happens to the Non-Performing Loans though?

Muikamba suggests that to mitigate NPLs, banks will have to restructure the loans to make it easier for borrowers to repay by extending the loan terms and hence reducing the instalment.

In a circular on the measures to mitigate the adverse impact of COVID-19 on loans and advances, the CBK recommended loan restructuring where a bank may negotiate with the borrower to work out revised terms to enable the borrower to make payment under more relaxed terms. This relief, however, was granted only to those borrowers whose loans were performing as at 2nd March 2020. For borrowers who were already struggling to make their repayments, they would have to contend with foreclosure which involves the recovery of any collateral used to secure the loan.

For unsecured loans, banks would be obliged to write-off the loans by removing them from their balance sheet.

In the extreme event where write-offs exceed existing loan-loss reserves and available profits from other sources, shareholders' equity will have to be written down.

This would in turn affect capital levels which could necessitate new funding to ensure the banks meet the regulatory minimum capital requirements. The banks could also strengthen their capital levels by reducing loan growth so as to shrink its loan portfolio. In such a scenario, it would mean that you would have a difficult time accessing a bank loan.

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Additional contribution by Purity Mukami. This article was first published by Africa Uncensored's [Piga Firimbi].

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