CO-OPERATIVE BANK OF KENYA We are you

Conference Call transcript

28 September 2016

SUSTAINING GROWTH MOMENTUM IN A CHANGING OPERATING ENVIRONMENT

Operator
Good day ladies and gentlemen and welcome to the Co-operative Bank of Kenya investor conference call on sustaining growth momentum in a changing operating environment. All participants are currently in listen-only mode and there will be an opportunity for you to ask questions later during the conference. If you should need assistance during the call please signal an operator by pressing star and then zero. Please also note that this call is being recorded. I would now like to turn the conference over to Mr Patrick Nyaga. Please go ahead, sir.

Patrick Nyaga
Thank you. Good day ladies and gentlemen. Welcome to our conference call focusing on sustaining the growth momentum in a changing environment. With me on the call are the usual suspects, our Credit Managing Director, Mr Anthony Mburu. I guess you will be asking him a lot of questions about the credit. Then we have James Kaburu, our Head of Investor Relations and Strategy, and we have Anthony Muli, our Economist. So I'm going to take you through the presentation. I know we sent to you a document with about 30 or so slides, but because most of these are focussing on what we gave you in Q2 2016 I will probably be taking about maximum 15 minutes to give the highlights on some of the areas that we have not touched on. So I'm not going to spending a lot of time. I would rather spend a bit of time having questions from yourselves and us trying to provide some answers and some strategies on where we are heading in this environment.

I start with the macroeconomic environment. Nothing much has changed. Inflation about 6.2% and we note that even when the governor of central bank and the MPC were looking at the CBR they considered that the inflation is stable and that's the reason why they dropped it from 10.5% to 10%. So basically nothing much has changed on that front. I go through the next couple of slides, the overview of the Kenyan banking industry. Of course you know what has happened. The Bill is now law and we have to implement the Bill to the letter. In terms of where the bank is in terms of strategic plan we are doing our 2015 to 2019 five-year strategic plan. Of course with some of the things happening we might have to tweak it a bit, but everything is on course. We have listed a number of strategies that we are pushing there. And because I will talk about them in a bit more detail then I will not at the moment focus on that.

Again in a couple of slides from slide number seven to slide number 18 this is our transformation agenda. And I think we have shared with you on this before. but probably to note that looking back and reflecting on the changes we are currently experiencing this is one single strategy that the bank undertook two years ago which has really helped us. And it is going to continue assisting supporting us in driving our growth and profitability in this environment and into the future. And I will be talking a bit

more in detail about that. That takes us all the way to the transformation function on slide number 17 where we are emphasising that transformation is with us to stay. The function is actually fully embedded into the business today and we are seeing our transformation journey continuing. We need to continue innovating and we need to continue transforming.

A summary of the key gains that we have to date, this is basically what we went through with you, a profit before tax of Kshs 10.4 billion as at 30th June. Even though the changes came into effect this affected our business from about September we still had July and August where we continued earning at the same rate as the June 2016 profits. So I will move on and look at now the key part of the presentation which is really sustaining competitiveness in a changed operating environment and just doing a bit of background there.

We see the current government came into office on a manifesto that included lowering the cost of credit to the general public and various efforts have been done over the last four years, not yielding much fruit. Interest rate spread averaging 11.5% compared to some other countries in the jurisdictions of about 46%. In July 2016 CBK hosted talks with commercial banks and was trying to explore the mechanism for reducing the lending rates, especially after there was information the Bill is passing in parliament. But I think banks were not in a position to discuss and come to a conclusion that should have stopped the Bill from being enacted. And therefore on July 28th we saw the national assembly pass the bill. I think most of all, all of us, did not expect the president to sign it. However we did, and we can only work towards what we need to do going forward now that it was signed into law.

Some indicators on the Kenya financial state, and this is based on the financial access [?] survey of 2016. 17.4% of the population is excluded from access to financial services. 17.2% have access only to informal financial services. That includes unregulated moneylenders. Only 38.4% use bank services, and out of that 68.3% of these are in the capital city of Nairobi. Kenya has only 24,458 recorded mortgages while the economy has capacity to do 100,000 plus. Therefore that presents a lot of opportunity to us. The banking sector holds about 8.5 million loan accounts against 34.7 million deposit accounts. And we think there is an opportunity to grow lending there based on the fact that only probably from a percentage perspective 8.5 million loan accounts compared to 34.7 million deposit accounts there seems to be room to grow.

So how are we sustaining our competitiveness in a changing environment? I think we have sat as management and clearly identified volume business growth as one of the key strategies to drive within a margin. You can only replace your lost income through more volume. And also enhanced operational efficiency. We are noting that the journey we started two years ago, and that is the transformation journey, will definitely help us do this. And we will be looking at some of the strategies we are driving and how exactly they are going to be impacting positively on this. We have a 30 million member cooperative movement. We continue developing innovative products around that customer segment and going forward we are even looking to developing more.

What did we do immediately when we got the president signing the Bill? I think we provided market leadership by announcing that we will comply. And we used the famous book ‘Who Moved My Cheese’. Rather than lament about who has taken my cheese or who has moved our cheese we straight away

went ahead looking for new cheese. And therefore we did a team brief for the whole bank and we also went to the public to say that we are going to comply. And we have been receiving quite a few benefits around that in terms of increased loan applications. Some of our branches have seen a 100% growth in loan applications.

So in terms of volume sales we are going to be leveraging on our multi-sales and multi-functional areas and expansive branch network to gain a fair share of the new quality assets. And we are being ambitious to grow our market share in terms of volumes, while at the same time keeping the risk profile in check. So in the remainder of 2016 and into 2017 Co-op Bank is focussed on growing volumes and increasing loan book will partially compensate for the fall in the interest rate margin. The demand for credit which is now available at the lower price of 14%. And basically we just assumed for example that we are going to be increasing the loan book twofold. One, for existing customers they have now more capacity to borrow. Using the same repayments that they were using before they can grow their loan book. And also we are looking at new customers that have now come into the bracket of being able to borrow.

The Co-op Bank portfolio by market segment, I think our biggest segment right now is corporate, which was within those margins actually. Overall our lending rate average was about 16.2% so a drop initially to 14.5% was not going to be a very significant one. And now to 14%. In terms of prudent credit risk management it remains a great priority. And I think this is where we are saying the strategy to grow volume will be anchored into our MOU so we will continue doing our retail banking loans using the MOU. The micro and SME sector have now capacity to borrow more, and apparently we have funding in the pipeline that has now come to support the micro and SME lending. We have a consultancy we are working on with IFC for a number of months that will help us grow that book.

In our transformation we had the strategy of sales force effectiveness. And basically this is where we are trying to say can we grow sales volumes from our existing customers and also new customers. And this we have been working on very well. We have cemented all the products and identified the average product per customer, and now we are driving the growth in terms of products per customer.

Non-funded income streams are currently at 33% of our total revenue. We will have to continue focussing here. Some of the loans that we have given to our customers do attract some charges like the appraisal fee, like the commitment fee. Obviously we were giving concessions on those and some of those we will not be giving as high concessions as we have been giving. Therefore there is an opportunity to grow revenues there. We are going to continue focussing on our alternative channels. You remember earlier we started the branch transformation and channel migration where most of our customers have been moved into cheaper channels. And we will continue doing that strategy.

Trade finance products, our book is quite low. We have now beefed up the trade finance department and we expect to at least triple that book in the next year or so. So basically we are just continuing with what we started two years ago. And the other point there is cost optimisation and operational efficiency. A lot of mileage has been achieved there but there is still a lot of room for improvement where we continue focussing on some of the manual processes, internal processes or customer service

processes where we have identified and prioritised to automate most of them over a period of time. And we have a very big team that is working on that.

Our data analytics project. We have a project on master data management and trying to make sure that we optimise our data usage or value. So we have a lot of data with that. On this project we are trying to make sure that all this data is of value to us. I think initially we were only creating about 15% value out of our data. We want to improve that significantly to above 60% to 70%. We are focussing on distinctive customer experience. Now that pricing is uniform or homogenous across the various banks the way to go here is to continue improving the customer service to our customers. Prior to the Bill coming into force we had done a lot of branch transformation and we had covered about 145 branches. Some of the other things now we are doing is to identify high net worth customers and creating a service excellence for them through our branch network especially in major towns.

In terms of staff productivity we continue enhancing this. When we started the transformation project two years ago we had rid of 150 staff but progressively over the last two years we have seen about 600 reduction in our staff complement, and this is basically out of natural attrition without replacement. As we move customers into alternative channels we continued creating efficiencies. And this is going to continue in different pockets where we have not fully transformed.

So in terms of 2016 revised projections remember that the capping of the interest rate affected us from September so to speak, so we had eight months of the previous regime. Therefore looking at this year we are projecting a 19% growth by the end of 2016 compared to December 2015. And I think this projection is based on the current volume. If we continue growing the volumes the way we are seeing them in terms of loans we may end up being even better than that, but I think we want to be a bit conservative here and talk about 19% growth from the Kshs 15.4 billion PBT last year. Our assets are likely to grow by about 14%. Our deposits are likely to grow by 12%. Our loans and advances are likely to grow by 12.3%. And this is the projection for 2016.

In terms of 2017 we are looking at a much more conservative position because remember 2017 is an election year in Kenya. Historically when there is an election year loan growth for example always declines on average 4% to 5%. So we are a bit conservative there. But again looking at the efficiencies that we are talking about, looking at the volume growth in terms of our loans, we expect to at best to maintain the same profitability position from 2016 into 2017. In terms of cost to income ratio we are projecting anywhere between 49% and 50%. Our loans and advances we grew half year by 8%. We have seen quite a bit of volume even before the capping. So we are projecting that in 2017 we will grow that by 15%, deposits by 16%, total assets by 10%. NPL we are currently at about 4.2%. We want to be a bit conservative to say we will close the year at 4.5%. But 2017 we project 4.7% to 5% maximum NPL. In terms of return on assets we expect to close 2016 at 3.3%. 2017 maintaining the same profitability but slight growth in assets we may expect a small decline to about 3%. Return on equity we project to close 2016 at about 22.3% and for the full year 2017 about 20%.

So in a nutshell and maybe probably in conclusion we note that most of our loans were not very highly priced before the capping of the interest rate. I think we have talked about an average rate of 16.2%. With the capping to 14.5% initially and now 14% we probably are looking at an average of 13.5%, and

therefore not a very significant drop. Of importance to note is the fact that only 10% of our book was in micro credit and SME. And that is where the biggest impact is because most of those loans were at 2.5% or 2% per month, meaning that they were at 24% or 25% annually. So that is coming down to 14.5%. But the book was only 10% of our total portfolio. I think that is where we are. We are optimistic that between 2016 and 2017 the banking business will continue to grow now that customers can afford loans much more. I think that is what I have as a presentation. I think there will be a lot of questions and answers. I think we are better off dealing with that rather than me continuing to talk about some of the numbers. I am sure we can always give you answers to your questions. Thank you very much.

Operator
Thank you very much sir Ladies and gentlemen, at this time if you do wish to ask a question please press star and then one on your touchtone phone. If you decide to withdraw your question please press star and then two to remove yourself from the queue. Our first question is from Ola Ogunsanya of Renaissance Capital. Please go ahead.

Ola Ogunsanya
Good afternoon. Thank you for taking this call. My first question is just to clarify. Are you guiding for a decline in the loan book in 2017? And was it 4% to 5%? Also just clarify if loans have been repriced following the reduction in the central bank rate to 10%. And going forward how does that process work? Do you have to give customers the one month notice or is the repricing effective immediately? Also I understand that there was a meeting with the central bank governor sometime last week. If you could please give some clarity on what sort of discussions you are having with the governor. And finally on the non-interest revenue side of things you are guiding for a NIM compression of 2.2%. How much of this can be offset by non-interest revenue? Because when I compare non-interest revenue in Kenya to other countries like Nigeria it is still quite high. It contributes highly to operating income. So what is the risk that the regulators become a bit more stringent in terms of regulating fees? I understand it is highly regulated now, but what are the risks going forward? Thank you.

Patrick Nyaga
Thank you. We can take one more.

Operator
Thank you. The next question is from Godfrey Mwanza. Please go ahead.

Godfrey Mwanza
Hi. Thanks for the call. Could you just give me a sense on just how… you are saying you are going to compensate for lower margins with more volume? But how much appetite should you really have to take on credit risk when if you look at your one-year treasury bonds at 11.2% or the three-year treasury bond at 12.25% you are talking about only 175 basis points reward for taking credit risk per year. I'm not sure that's enough. That's the gross number. If you take a risk-adjusted number and subtract the 100 basis points for cost of risk it doesn't seem like you are being compensated too much for taking credit risk given how low interest rates have become. So I don't see why you should be so aggressive with your plans to increase credit growth. I don't know if you can comment on that.

Patrick Nyaga
Okay. One more question maybe.

Operator
Our next question is from Sharat Dua of Charlemagne Capital. Please go ahead.

Sharat Dua
Good afternoon. It is related to both of the previous questions unsurprisingly. First of all I just wanted to clarify. When we had the call at the half year results in August this Bill was being talked about obviously. And at that time, Patrick, you said if it was approved in its state that it was at that time it would hurt your NIM by about 400 basis points, which seemed sensible frankly. But you seem to be much less worried about it now. It certainly doesn't seem that you are talking about such an order of NIM compression. So if you could clarify that, and tie it in with a bit more detail really linked to the book. As the previous question asked, there are clearly several categories of loans which do not make sense now at 14% maximum interest rate where you were charging 18% or 22%. SMEs, micro, unsecured, credit cards, these sorts of things. So I would really like to understand why you would still be talking about significant loan growth. I know there is a market share opportunity but there has got to be a fear that this credit is not worth it at such a cap. Thank you.

Patrick Nyaga
Okay. Thank you very much. Maybe we can start with the questions from three different people. Let me just answer a few and then our Credit Director can answer the others. Maybe starting from behind, Sharat, you are clarifying we seem not to be very worried about the drop in terms of the interest rates being capped at 14.5% and now 14%. I think a more thorough analysis into our book shows that the book that we would be worried about in terms of drop in the interest rates is really SME and micro. As I said earlier that is only 10% of our book and therefore not a significant portion to really worry us, as opposed to an institutions that has 30% or 40% of their book being in SME and micro. That is probably why the worry is not really there given that that will not impact us much. Even if you maintain the current book as it is or you grow the book to make sure that you cover for the shortfall, the risk exposure will not be much. Anthony will be talking in much more detail about that.

In terms of NFI I think the first question was how much loan growth we would envisage to offset the shortfall. One, we are looking at offsetting the shortfall in two ways. One, grow the loan book. Maybe using a very simple example as I had said earlier, you have a customer whose repayment has been Kshs 300,000 every month and you have given that customer for example Kshs 20 million. What we are saying is the customer can continue paying Kshs 300,000 but you give him much more loan, maybe another Kshs 10 million. Their affordability is not affected because the customer was comfortable paying Kshs 300,000. You have added Kshs 10 million more. They still continue paying Kshs 300,000 but it creates more business opportunities with the additional loan that you are giving them. At the end of the day that customer will create more ability to actually come for more loans because now he can even pay more than Kshs 300,000 over time. So there is clearly an opportunity with the existing customers to grow loans to offset the shortfall.

However if you are to do that strictly and statistically, and assuming that we are only using interest income to offset the gap, then we would need to grow our loans by about Kshs 3.5 billion every month. And that will probably be about Kshs 45 billion in 2017 because we are not really worried about 2016. And that is achievable. We have done this before in the past. We are looking at the customers that are able to afford additional loans if that is possible. We also then have those new customers who are not in the bracket of affording loans, but because of the interest rates coming down… Of course we have to spend a bit of time with those ones because we have to do the risk profile first. But at the end of the day you will get a number of customers being able to come in.

The other element that we will be using to offset the shortfall is NFI. As I said earlier obviously we have approval from central bank – and they are very strict nowadays as you said – on all the charges that we levy to customers. So what we have been doing in the past is to do a lot of concessions to the customers. And even now we are going to continue doing it, but what we are doing now is there is room to increase NFI. For example if you are charging 3% for the appraisal fee, but you have been erasing that completely to zero for a customer, even if you put back 1% you will have increased your NFI. So that is another way of looking at it. The new loans that we are giving will attract additional NFI in terms of appraisal fee, commitment fee, even as we are increasing tariffs. So clearly we should be able to offset that gap, not necessarily in the next four months, but in 2017 within the whole 12 month period we should be able to do a bit of that. That is what we are hoping.

Now, the issue of if the government [unclear] at 12.2% and you are lending at 14% is the one point differential enough to take care of the risk. If you look at what is happening now a lot of banking institutions are actually going for the government securities. Like what happened last week, there was an oversubscription. So there is the expectation that government will be able to afford debt from the public at lower rates. And therefore it will still make sense to lend to customers at 14% because generally and depending on the period the government securities could be much lower. Currently the government treasury bills are at 7%. If we are paying customers 7% on the savings accounts then probably it is much better for a customer to go for the savings account rather than the government securities where they have to fill papers and stuff like that. So although that may not be very clear right now I think it will be clear as we go by. Let me let Anthony answer a few of the other questions.

Anthony Mburu

Thank you very much for the questions. They are very deep questions, a very clear understanding of the situation we are in. The issue of the loan growth I think Patrick has well covered. But just a bit of detail in terms of what we are anticipating or where we are seeing the opportunity. The risk is that the margins have reduced. And that margin shrinking, let me say first of all in terms of our breakeven point based on our risk pricing model for retail, corporate and cooperatives currently indicates that even if you look at our yields and returns from the previous period clearly there is margin that was on the table in terms of surplus above the breakeven. So we have got room even within that 14% to be able to risk price all the way from the credit card market to the more high-risk products. Obviously there is a low-cost corporate and cooperatives. So what we are looking at is some gradual shift in our mix.

Our mix is currently 29% corporate, 28% personal loans, and then the others as depicted in the June numbers. So the mix is going to shift slightly towards personal loans that are check-off away from the

walk-ins because of the risk profile. More around SMEs and less around the micro. And then more in terms of cooperatives and corporates, away from what we were doing on some of the other products. As you will probably see in our mix the e-credit loans and flexi-loans are higher risk and lower margin for now. We are now deemphasising, but they are not a big section of where our revenues come from. Therefore from a growth point of view or from an ability to manage them at the current risk price we will still be able to manage it on a portfolio basis. And then secondly these products also help with the issue of deposit gathering which is much needed. We need the funding and the ability to bring in the deposits. So you need these products and you need this range to be able to get in the deposits based on the ratios of deposits to loans, and be able to then fund the correct or the lower risk side of the book.

So we think that it is possible to lend at this new regime with a margin of roughly 7%. It is still possible to create a yield curve around the low, medium and high-risk customers. All the way from 14% down to a range of 3% or 4% should be sufficient to give us a risk curve. In terms of the volume to compensate for the risk appetite I think Patrick covered the issue of the returns versus the bonds. It is already happening in terms of that the yields on government paper are starting to come down. Therefore the opportunity cost of putting your money in government paper there will still be a benefit of putting it into loans.

The other thing maybe in addition to what Patrick said is the element of when you have a customer there is much more you can do with him than if you put your money in government paper. Yes, you may get the yield but you will not get those other revenues. The NFI that we need to build on, we need to start to build on it now. So the more customers we can get, the more we can get from transactional and other products, the better. Instead of being product-centric we are able to look at it from a customer-centricity and be able to see a 360 view of the client in terms of all the other products that they are able to get from us and get a yield out of that, not just looking at the loan yield.

Now, I think there was a question, are we anticipating a decline in loan growth in 2017. No, I think the projection is a 15% growth year on year in terms of 2016 to 2017. And I think Patrick has clearly articulated that. Where do we see the opportunities? We see the opportunities around retail mortgages. We see opportunities around capex for small business customers, SMEs. Maybe not the micro but definitely the SMEs. And we also see opportunities around manufacturing, especially around the area of import substitution. There have been tariff changes that help with local assembly and local manufacturing of some things that make it a bit more price competitive. So we see opportunity there. We also see opportunity, as we had mentioned at half year, around infrastructure. So we think that there are going to be opportunities out there for us to grow our loan book over and above the consumer section around personal loans. We have already seen quite an increase in demand just purely on the back of volume increase in number of applications and value of applications that we are seeing.

There was a question around the recent MPC, what was said. I think the drop from 10.5% to 10% was driven by private sector credit slowdown. Private sector credit last year by December 2015 was at 17% growth rate. This growth rate has dropped to almost 7% by July/August. So obviously there needed to be some impetus or at least a signalling of impetus on that side of things, while keeping some stability in terms of being able to watch out for things around inflation and things around the global picture so that we don't end up… because financial stability is now going to be critical.

Your comment around alignment of fiscal policy with monetary policy so that the whole issue of stability because now the CBR is obviously controlled by government or by central bank that is going to be very critical. Also the issue of forex reserves. I think there was a lot of confidence around the amount of forex reserves that are there, and the buffers that are available to central bank to stabilise currency. So there was a lot of optimism. And also looking at inflows through diaspora remittances or exports. So looking at those, stability on oil prices. So your comment around that, that gave the confidence that the move being taken to try and stimulate private sector credit will be the right move. So the anchoring of their decision to lower was well justified by the issues around private sector growth and the stability and other factors that central banking looks at, the monetary policy committee looks at.

On the NFI side on top of what Patrick has said in terms of room to increase there is also room to do more in terms of value-added services. I guess it is time for a little bit more innovation, less margin but a little bit more innovation around value-added services. Value-added services around collections, value-added services around payments, a lot more segmentation of our book so that we are able to look at some sectors from an advisory point of view and be able to build up fees from that. And so we believe that with that we should be able to compensate.

Now there was a question about NIMs, half year 4% NIM, now 2.2%. Obviously at that time we were doing worst case scenario and that is why we were using 4%. It wasn't very clear at that point in terms of exactly what that meant in terms of the book. We have now been able to do a thorough analysis. At the time we had made some assumptions that an increase in the expense, the interest expense, will affect all deposits. Today obviously we have been able as an industry to define was deposits this affects, and that has a different impact. On the credit side we have also been able to identify the loans that we are talking about that are affected by this. And as a result from the very dire situation we were looking at earlier on of NIMs dropping by 4% we are now looking at NIM drop of about 2.2% in terms of whatever.

But we will continue to look at those numbers and crunch those numbers and see where we stand. I think that covers it. Yes, I'm sure there are certain risk models that might lock out a certain customer base. But for us at the moment the customer base that would be affected by this is very small. We believe the vast majority of our customers, 90% of so of our market segment, will be able to be priced at these new prices and compensated by the opening up of new markets or new customer segments should be able to get us there.

Patrick Nyaga

I think the other question that has been asked that maybe has not been covered by Anthony was have we repriced the book. Yes, with the initial capping we changed our book to 14.5%. With the new CBR dropping from 10.5% to 10% the new book is being priced at 14%. But the existing book we have given a one-month notice. And this is basically to give precedence [?] that when the rates go the other route we then are also able to give 30 days' notice as required. So to answer your question, new loans are at 14%, deposits are at 7%. Old loans – we mean the ones that are at 14.5% – we have given a 30 days' notice to effect to 14% on 20th October.

Operator
Thank you very much sir. Ladies and gentlemen, again if you wish to ask a question please press star and then one. Our next question is from Ronak Gadhia of Exotix. Please go ahead.

Ronak Gadhia
Hi guys. Thanks for the presentation and the questions. Just a follow-on. You briefly mentioned this. On the deposit side can you quantify what the exact impact on your cost of deposits will be as a result of the new regulation? The second, it does seem like maybe going forward SME and micro loans at Co-op Bank and some of the other banks the focus will be reduced. What is your sense of how this will impact the overall credit flow to the economy, and how will that affect overall GDP growth? Those are the two questions.

Patrick Nyaga
Okay. Thank you Ronak. In terms of cost of deposits I think it is very clear that the law applies to interest-earning deposits. Now, from where we sit interest-earning deposits include savings accounts, fixed deposits and call deposits. If you look at our book as at 30th June this year we had about Kshs 7 billion in savings accounts. We had about Kshs 18 billion in call deposits. And we had Kshs 87 billion in fixed deposits. Now, about Kshs 165 billion out of the Kshs 260 billion that we've spotted was transaction accounts and current accounts. And those do not attract any interest because these are accounts that customers can walk in and out any time they want. So in terms of an impact savings accounts were probably earning the lowest, some of them probably zero, some others at 1% or 2% maximum. So Kshs 7 billion out of the book of Kshs 260 billion even if you moved that from 2% to 7% they impact is nothing much to worry about.

Now, fixed deposits are Kshs 87 billion. Okay, call deposits as well. Most of those call deposits were actually negotiated so most of them were at 5%, 6%, some of them even higher than 7%. So therefore at Kshs 18 billion the impact is very minimal. Fixed deposits if you remember late last year we had a big problem where fixed deposits were even going up to 18%, 20% or 21%. Now, what we have realised is that with the cap in loans then we have been able to reduce significantly the fixed deposit rate. So probably at the moment we are talking about 8.5% from a high of 12% or 14%. So again the impact on the fixed deposits is not major. So I think what worried us most was more the revenue side than the cost of deposit side.

Therefore it was not really difficult to move the various interest-earning accounts to 7% and the impact is quite minimal. Actually we are looking at a monthly impact of about Kshs 500 million we are only looking at about Kshs 80 million in terms of interest expense. The bigger problem is probably on the revenue side. So obviously going forward we are sitting around the table to continue with the discussion around how we continue attracting deposits that are not expensive. But clearly especially some of the banks that were taking interest earning deposits at 13% or 14% now they can't do that. Therefore for some of the big banks like us it has helped us reduce the cost of fixed deposits. Anthony will clarify more.

Ronak Gadhia
Why can't they get deposits at 13% or 14%? Oh, because of the cap on interest rates.

Patrick Nyaga
You can't take 13% and then lend it at 14%. So that pressure into the industry has come down a bit. Also looking at even the other investment alternatives which are probably mainly T-bills a lot of investors would probably go for T-bills, not bonds, because of the long-term nature of the bond. So I think those are some of the other benefits that are factoring into the market out of the interest rate cap.

Ronak Gadhia
Okay. Does that mean the business model of some of the smaller banks will be significantly disrupted and you might see some issues arising at those banks?

Patrick Nyaga
Well, I may not be very specific, not knowing what is happening to them, but clearly looking at a business model where a bank would take deposits at 13% or 14% and lend that deposit to SME and micro at 25% or 26% with a cap on interest rates at 14% then it means there are no opportunities to lend that money at 25%, so you can't take it at 13%. So I think there could be some serious discussions with some of those institutions and probably we could see one or two consolidations in the market to try and make this a bit more [unclear].

Anthony Mburu
I think the additional point there is anybody with a regional network is obviously going to benefit. Anybody without an agent network that was relying on wholesale money, there will be a bit of a change in the model. They may have to now reconsider their model in terms of the retail space. But as Patrick said what we are seeing overall is a benefit in terms of the business model that we are carrying at the moment. But as other things come into play, for example the issue of technology and other things that could come into play, we begin to look at what happens to the business model. But I think what Patrick was saying was there seems to be a benefit around fixed deposits. And I guess we are hoping that we will be able to get that benefit.

You asked a question around SME and micro, will the focus reduce, will this impact on GDP. I think just to be very clear, SME will still be profitable. By SME here I am talking about those who are borrowing for business purposes from a working capital or capex point of view from Kshs 2 million all the way to Kshs 150 million to Kshs 200 million. It maybe move a little bit. The average loan sizes may go up in order for economies of scale and other things to be seen. But I see an increase in terms of that space. It is not going to go away. On the micro side, those who borrow less than Kshs 2 million, six months to two years, again it depends on the model that one is running. There are different models. There is group lending. There is individual lending. What sectors are you looking at? Are you clustered in terms of your regional exposure?

Clearly outside of Nairobi there is a huge market still for SME lending and if you are able to cluster them around technology and around a more efficient model there is still an opportunity to lend into the micro space. So I think the impact that was desired that this is going to stimulate growth we foresee that people are going to go back to their projects, re-look at their capital costs and find that projects that had been looking unviable will begin to become more viable. So we are foreseeing an increase in

demand. We are already seeing quite a bit of that in the personal loans, consumer loans, people relooking at their ability to pay. We are seeing a bit of that on the business side. By business I mean SME. And we are also beginning to see a little bit of it on the micro. But it is early days. Where maybe because of the gestation period the upturn has not quite taken off on the corporate side, but we foresee it will also take off. They take a bit longer to make their decisions. But we foresee…

So the downside for credit is just more around the economic issues around what I may call the macroeconomic issues. Just a sense of do people trust that the stability issues will persist or continue to be there for long enough to allow for growth. As long as people are happy with the financial stability issue then I think the required growth in credit and the impact on GDP shall happen. The risk is around the element of keeping the fiscal policy and monetary policy going so that there is financial stability. If that happens then we foresee growth. I don't know. Our economist is here. I don't know whether he wants to add.

Anthony Muli
Ronak, what we are looking at is in the short term a slight reduction in access to credit by the SMEs. Remember that we now offer about 23.4% of our loans that is the full banking in the SME. In the short term that might go down a bit. But obviously out of innovations and new ways of measuring and mitigating the risk around there then that would normalise again in the medium term.

Ronak Gadhia
Okay. Thanks guys.

Operator
Thank you. Our next question is from James Starke of SBG Securities. Please go ahead.

James Starke
Good afternoon. Thank you for the call. Firstly on loan growth could you describe your loan disbursement tempo at the moment, perhaps either per week or per month as it is right now, and how that compares to what it was prior to the cap? And also what it was at this time last year in the same interval, whether weekly or monthly. And then of that growth you've mentioned you have seen a big upsurge in applications. How much of your current disbursement is advancing to clients who now have increased affordability as a result of rates coming down, and you are just financing them back up to what that affordably now allows them? And if you can on that point comment on what it now means for asset quality. Should rates then start moving up you have now financed this individual to their maximum, and if CBR started to move up it would conceivably have an impact on that particular client's debt service capacity. And what you see that doing for your asset quality metrics.

Then separately on loan yields if you could perhaps talk us through the average yield prior to the cap of each of the loan lending segments you have on slide 24 just to get a sense of which were the rich and which were the not so rich areas. And lastly on funding costs do you see the floor on deposits in any way applying to interbank lending irrespective of whether it is overnight or further out in term? And then also on term deposits do you see scope to manage costs down, or the floor implied by this legislation

becoming some sort of magnet for term deposits and eventually all term deposits in the market will be priced at 7%? Thank you.

Patrick Nyaga
Good afternoon James. You are asking a lot of details which I may not be able to provide right now, but let me just give a rough estimate. In terms of loan growth we used to process about 300 applications per day especially on the retail end, which is personal loans and SME and micro. Today we are now talking about… At the beginning when this regime first came in place and we said we were willing to proceed with it that moved up to 1,250 applications per day. It has now stabilised at about 1,000 applications per day. Mostly these are retail, and by retail I mean personal loans. 70% of them are refinancing, people who can now afford to pay slightly more, and 30% of these are new applications. 60% of those are qualifying, 40% are not. While we have not changed our risk model we have been running a relatively conservative risk model with pretty good buffer in terms of debt to income ratio and the various other parameters that we use.

What we have added or the only additional thing we have done to risk rating is to include credit scoring as an additional measure especially for the new customers. Obviously for the refinance we don't need to. We have our own credit scoring model. But for the new customers we have also added that to give us that additional benefit. So now how does that compare to six months ago? Clearly this is a much bigger volume of business than what we were doing before. Same time last year, a much bigger volume. From a mix point of view obviously that is where the demand is. Now, where do we see ourselves going? We are obviously from a marketing point of view or sales point of view focussing our attention more on the cooperatives because obviously they carry a lower risk. So we are looking out obviously for more of those deals. Even for SME the deals we are approving are more the bigger customers, the higher end. But we are still servicing our retail customers. We are still servicing our personal loans customers who carry the lowest risk based on check-off, based on employers, contracts and MOUs we have with those employers.

You ask a question about risk if the rates go up. If the rates go up, yes, we will carry a risk. If rates go up the payment ability may be constrained. But as I said we have always had a slightly more conservative debt income ratio analysis and that takes into consideration an uptick of up to maximum 4%. So if the CBR moves from 10% to about 14% or 15% we believe we should still be able to keep the same risk profile. If it moves above that then yes, the risk profile would be a challenge. Now, do we see them allowing that kind of an increase in price all of a sudden? I don't think so. If they begin to tick upwards I think they have already started to show by that reduction of 10.5% to 10% the sort of environment they want to live with. Those sudden movements of 200, 300 or 400 basis points we want to believe that they will stabilise. As I said at the last MPC the alignment between fiscal policy and monetary policy was emphasised.

Loan yields on page 24, let me start by talking about the average. The average across the board we were at 17% before the KBRR was reduced to 9.7%. We dropped to 16% or thereabout once the KBRR came down, 16.2% or thereabout. The range is we had corporate at about 12.5% to 13%. On the other hand we had the personal loans at about 14.5% or 15%. Then the outliers were the micro at 20% to 21%. But you can see it is hardly 2% of our book. And for the SME we were in the average of

17.5% or almost 18%, and that was about 8% of our book. So by and large that's why we are saying that overall the shrinkage we expect on yields on loans is about 2.04% and then on the deposit side another point something percent. So that is where the NIMs we are seeing reducing by 2.2%. So those are roughly the numbers. But we can work out some of them in more detail and James can get back to you on that.

You asked a question around the interbank and is it affected by this pricing regime. I believe the law was more around interest paid to deposit accounts in banks to customers as opposed to the interbank or the relationship between us and the other banks at central bank based on the interbank market. So we don't foresee it affecting the interbank market. But we are hoping that on average deposits will be pulled to that 7% range just out of the fact that the avenues for where to invest that money have been capped.

James Starke
Thank you. If we could just return to your affordability buffer, you say you factor in a 400 basis point headroom. Are you not leaving some affordability on the table here? Some other lender could finance your borrower for this difference which you are prudently leaving? But your borrower when rates do move is still as affected as if you had lent them the money. How do you manage that sort of dynamic?

Patrick Nyaga
I think that's a very good observation, James. I think my only comment is that transparency around the CRB in terms of debt profile of a customer, we do scrubs every month to review the profile of our customer in terms of their indebtedness out there in the market. That is one as a way of monitoring the portfolio. Two is that we are requiring from a conditions point of view a lot more in terms of the lower end customers that they must be banking with us. If it is a personal loan their salary account must be with us and the salary pay point must be here. If they are business customers we expect a much higher throughput and we monitor that through our systems in terms of what throughput they are taking through us in terms of account turnovers. So hopefully just based on the relationship side of things we should be able to manage and monitor where those risks begin to surface and take mitigating measures early enough.

But you are right. It is a risk that we leave there on the table. But we hope that it doesn't give too much leeway to the client to go and borrow elsewhere. This is more around the issue of working capital. That is where the risk is the biggest. When it comes to capital expenditure items through relationship management, through working closely with the customers we are able to evaluate needs and agree this is the need. And if somebody has got a change in plans we keep reasonably close to the customer. We are able to come back and say, okay, what are your changing needs? Rather than go to somebody else let's sit back and see based on the buffers that are on the table. But I agree with you. It is a risk. And as I've mentioned we have got the mitigants that we have in place from a monitoring point of view to manage the risk. But yes, at the end of the day there will be that factor of risk. Some of it is priced. Some of it is not priced. And where it is not priced we take on additional security.

James Starke

Thank you. If we could just return to the current situation and how many loan applications you are receiving and rejecting, when do you expect this to normalise? Obviously there is a time when this is going to be quite high intensity and then it will taper off. How far out do you think that is? And also if you could just clarify. You mentioned you were rejecting about 40% of your new applications. What were your rejection rates prior to where we find ourselves now?

Anthony Mburu

Previously we would go looking for customers as opposed to customers coming to us. Therefore with that targeted approach to acquisition of customers then clearly the rejection rates were much lower. But now because they are walking in through the door, they have to meet the criteria, the rejection rate has gone up to that 40%. We had a rejection rate of between 15% and 20%, but today the rejection rate has gone up to 40%. And we foresee especially on the business side that might go up slightly because the gestation period for business to come in and seek applications is slightly longer. Therefore we think this period of higher applications may persist for the next two or three months. It is anybody's guess as to how much longer this will last. We are still in early days. It has been a month and we have had that sort of upsurge. I thought by now it would have slowed down to be honest, but it doesn't seem to be slowing down. And I hope that at least in the next month or so it will normalise to a slightly better position. I see the same happening across some of our competitors. They have also had the same sort of increase in demand. Some have reacted by rejecting the demand but some have through their models been able to pick it up. So we are watching and seeing how the situation is. I really can't say how much longer it will last. But we think another month or so before it start to normalise or we begin to adjust our processes.

James Starke

Thank you. If I could just follow on then. Of these new borrowers what is their previous financial background in terms of where were they getting credit from before? I mean are they new to the banking system? Are they perhaps coming from micro credit providers? Where were they getting their finance before?

Anthony Mburu

Excellent question. We are still picking up data on this. Most of them are new in terms of new to borrowing. Somebody who probably didn't have a loan before. That is why the rejection rate is that high because when you then try to look at credit history you are having to use their savings numbers to evaluate. And the only thing you can do is reject some of them because of the credit history. But the vast majority of them are new borrowers. There is an element of some coming in from other banks and a little bit from micro finance, but very little from micro finance. The vast majority are people who were not borrowing before and are now having the opportunity to borrow. I do not have the numbers, so let me not try and give you numbers I don't have. These are just anecdotally. And then some from the other banks, very little from the micro finance.

James Starke

Thank you very much.

Operator

Thank you. Ladies and gentlemen, a final reminder if you wish to ask a question please press star and then one. Our next question is a follow-up from Godfrey Mwanza. Please go ahead.

Godfrey Mwanza
Hi. No, I'm fine thanks. Actually my question was asked and answered.

Operator
Thank you. We do have a follow-up question from James Starke. Please go ahead.

James Starke
Thank you. Given a few months ago we all would have thought an interest rate cap was unlikely, what are your thoughts on how likely a fee cap is?

Patrick Nyaga
Let me just answer that. Actually at the moment all fees are capped by the central bank. To some extent central bank has to approve any change on a tariff that you want to do in a bank or a tariff you want to introduce, even if you introduce a new product. So about two or three years ago this came into effect. Before we could just change our tariff the way we want. Now you have not that possibility. And in fact it is a very tough job to convince central bank to change any of your tariffs today. And if there is a change it only changed by the inflation rate which is about 6%. For example if you are charging a person tariffs for $200 the maximum if you are lucky enough to convince them to increase it then you can only increase it by 6%. I think already that side of things is controlled. As we were saying earlier we already have approval but we are not using the maximum approved tariff at the moment. So I'm not very sure whether there will be a cap on that. But maybe that is something that we need to... we can't be so sure.

Anthony Mburu
I think, James, just to add to what Patrick has said, one is there is already existing legislature around us requiring central bank approval for any tariff new or any changes. In one year you cannot increase your tariffs by more than 6%, by more than the rate of inflation. So we have already been in that regime. That is why you will find possibly tariffs have not changed significantly across the banking industry. Now, could they come back and do some further changes to that regime? Your guess is as good as mine. Let me say that where we are today, where we find ourselves today as a banking industry is because of not being homogenous and to some extent not being able to be united in some of the decisions it was very difficult for us to sit down all of us as bankers and offer an alternative.

We were given an opportunity to offer an alternative to this cap. But it was very difficult to come around the table and agree on what those alternatives would be. Because for the last 16 years we have had this battle of are they going to cap rates or not. And always the technical argument has prevailed. I guess there was always a feeling that it couldn't happen. But I believe today if something like this came up and we had an alternative way of dealing with it we are much clearer that we would need to be much more sober about our decision-making because I think if we had offered a more viable alternative to the cap it would have been listened to. So we kept on about making a down payment. But I guess nobody was willing to give up margins voluntarily.

James Starke
Thank you.

Operator
Thank you. Our next question is a follow-up from Ronak Gadhia. Please go ahead.

Ronak Gadhia
Sorry, just a small follow-up. It seems the strategy to replace the decline in margins is to grow volumes. So you are growing volumes and at the same time your ROE is coming off slightly based on the guidance you are giving. So how does that impact your dividend pay-out if at all?

Patrick Nyaga
Thank you, Ronak. Last year our dividend pay-out was about 37% because we paid 80 cents per share based on the profit before tax of Kshs 15.4 billion. Our projection this year is probably to retain the same level of dividend. And at higher PBT that would probably be about 31% dividend pay-out, which is much higher than the 25% that we used to pay previously. The reason we are doing this is even though we have projected a similar sort of performance in 2017 we may not be 100% sure. So we want to make sure that our capital ratios are strong enough into next year and therefore not increase our dividend pay-out this year. Next year once we are done with the elections and we end the year then into 2018 our projection are that business will start growing significantly and at that point in time we can increase our dividend pay-out.

Ronak Gadhia
Okay. Thank you.

Operator
Thank you. Ladies and gentlemen, a final reminder if you wish to ask a question please press star and then one now. We will pause a moment to see if we have any further questions. Sir, it would appear that we have no further questions. Do you have any closing comments?

Patrick Nyaga
Yes. Thank you very much all on behalf of my colleagues here and Cooperative Bank of Kenya. We are delighted that you listened to us and all the questions gave a bit of insight into what we are doing. In case you have any clarifications or comments you can always send an email to us. Thank you very much.

Operator
Thank you very much, sir. Ladies and gentlemen, that concludes the conference. Thank you for joining us and you may now disconnect your lines.

END OF TRANSCRIPT